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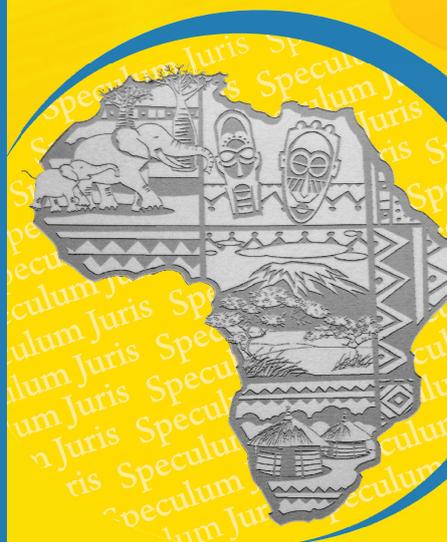
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Deconstructing the Legal Framework Governing Derivatives Markets in Zimbabwe

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Abstract

Derivatives are one of the measures that can be implemented to manage and control risks associated with financial instabilities. Derivatives mitigate and scale down the effects of certain financial risks by unbundling and transferring these risks between various parties. However, the adoption and use of derivatives has been limited, especially in developing countries. One main reason is the lack of a clear legal framework that regulates and governs how stakeholders should trade in derivatives. In Zimbabwe, there is a slow uptake of implementing derivatives. This is attributed to a lack of understanding of the nature of this complex financial instrument, since there is no clear legal framework that regulates and governs derivatives. Derivatives are being traded through Financial Securities Exchange (Private) Limited (FINSEC), which has issued guidelines that can be difficult to enforce in the event of disputes between parties. Although derivatives are complex

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financial instruments, stakeholders need to understand them. Regulation of derivatives, therefore, ensures that they are well understood, which ultimately inculcates confidence in stakeholders. A well-regulated derivatives market can protect stakeholders like investors who are invariably hesitant to engage in activities that they do not understand. Adopting a comparative analysis with Kenya, which promulgated the Capital Markets Act and its regulations, which govern and regulate the implementation of derivatives, this article seeks to discuss the importance of having a clear legal framework that regulates and governs the trading of derivatives.

Keywords: derivatives; financial instability; financial instrument; implementation; legal framework; market risks; regulation.

1 INTRODUCTION

The global reappearance of financial crises and their negative spill-over effects have brought to the fore the importance of financial sector reliability as a precondition for sustained economic growth.¹ What cannot be denied is that liquid markets can lead to more investments and improve the allocation of capital, thereby increasing prospects for long-term economic growth. Zimbabwe's financial sector has been affected by persistent illiquidity, capital erosion and associated financial sector risks, limited lender of last resort function, and deterioration in asset quality.² Since financial institutions are exposed to numerous risks, the need to manage or control these risks becomes inexorable. Various measures can be implemented to manage the risk associated with financial institutions and enhance their performance to render the economy more efficient, stable, and robust.³ One such measure is the implementation of derivative instruments,⁴ which play an important role in financial risk management, ultimately contributing to the economic growth of many countries, as accepted by Bish and Chikoko.⁵

However, for derivatives to manage and mitigate market risks properly, they must be regulated by a comprehensive legal framework. The need to have a comprehensive legal framework that regulates derivatives cannot be overemphasised, since derivatives can have a negative effect

- 1 Bonga, Chikeya and Sithole "The Need for Financial Stability in Zimbabwe: Use of Derivatives Securities" 2015 *Journal of Economics and Finance* 7
- 2 Bonga, Chikeya and Sithole 2015 *Journal of Economics and Finance* 7; see also Njanike "Derivative Market: An Integral Part of the Zimbabwe Stock Exchange" 2010 *Annals of the University of Petroşani, Economics* 218 who weighed in and stated that, "financial organizations are being exposed to high portfolio management risks which are inhibiting growth and sophistication."
- 3 This is particularly so if regard is made to the fact that risk management of a firm impacts its financial performance, see Anyango *The Effect of Financial Derivatives on the Financial Performance of Commercial Banks in Kenya* (LLM Thesis, University of Nairobi, 2022) 1; see also Njanike 2010 *Annals of the University of Petroşani, Economics* 218 who argued that, "Fund management firms and banks need to engage in more aggressive active dynamic portfolio management strategies so as to limit the level of risk they are being exposed to, thus the advent of derivatives and other innovative products in capital markets will bring about stable and sound operating environment which will play an integral role in portfolio growth and economic development."
- 4 Bish "A Guide to Narrow the Derivatives' Understanding Gap and Reduce Losses: How to Increase Knowledge, Controls and Reporting" 1997 *Ohio State Law Journal* 541 defines derivatives as "financial contracts whose value are derived from an underlying asset, rate or index"; see also Chagwiza "Liquidity derivatives as solution to Zimbabwean economic liquidity problems" 2013 *Global Advanced Research Journal of Economics, Accounting and Finance* 68 where he said that "derivatives are a requirement to strengthen the financial market."
- 5 See for example Bish 1997 *Ohio State Law Journal* 545; Lynch "Derivatives: A Twenty-First Century Understanding" 2011 *Loyola University Chicago Law Journal* 14; Fender "Corporate hedging: The impact of financial derivatives on the broad credit channel of monetary policy" *BIS Working Papers* 1; see also Chikoko "Are Derivatives Better Dead or Alive in Zimbabwe?" 2008 *The Dyke* 53 who noted that "the rewards of derivatives are not merely restricted to end-users but encompass the wider economy. By facilitating a more efficient distribution of risks, derivatives render the economy more efficient, stable and robust."

on the financial sector if not properly managed.⁶ While the use of derivatives have grown in both underdeveloped and developing markets, it cannot be denied that the development of derivatives in local or developing markets is limited. One of the factors that limit derivative development include a comprehensive legal and market infrastructure and restrictions on the use of derivatives by local and foreign entities.⁷ This confirms the view expressed by Mugambi,⁸ who postulates that “in any institution, a regulatory, prudential and legal framework is vital and needs to be put up in a bid to provide for careful supervision and governance of the market.”⁹

It therefore goes without saying that where the legal and regulatory framework is uncertain, stakeholders will be hesitant to employ the system. It is accepted that Zimbabwe has a derivatives market that is in its infancy.¹⁰ The problem, however, is that stakeholders in Zimbabwe are hesitant to implement the derivatives market, and one of the contributing reasons is the lack of a comprehensive legal framework and guidelines on how these instruments should be implemented to be an effective vehicle for improving the financial sector. The Financial Securities Exchange (Private) Limited (FINSEC), the market exchange currently trading in derivatives in Zimbabwe, confirmed that there is a slow uptake of derivative instruments in Zimbabwe, which is caused by the nature of these instruments as they are more complex than stocks or bonds.¹¹ Although FINSEC developed the Operational Guidelines for the Derivatives Market on the Financial Securities Exchange (Private) Limited, 2021 to govern the use of derivatives in Zimbabwe, these Guidelines are usually difficult to enforce in law, unlike the Act and its Regulations, hence the need for statutes such as the Securities and Exchange Act and the Reserve Bank of Zimbabwe Regulations that provide for the regulations of derivatives. The FINSEC Guidelines only fill a regulatory vacuum, but they cannot substitute for a comprehensive statutory regime.

Before the promulgation of the Capital Markets Act¹² and the Capital Markets (Derivatives Markets) Regulations, 2015, Kenya encountered the problems that Zimbabwe is facing in the implementation of derivatives. Before the enactment of these legal frameworks, Kenya faced a challenge in the implementation of derivatives by commercial banks, and one of the reasons was recognised as weak trading rules and the non-existence of a central counterparty.¹³ What this entails is that the lack of a legal framework governing the implementation of derivatives affects the usage of this important measure to manage risks associated with the financial sector. Thus, one can note that the stringent regulation of a derivatives market is a cornerstone for the success

6 According to Bish 1997 *Ohio State Law Journal* 539, “derivatives have played a role in the collapse of England’s most venerable bank, the bankruptcy of the richest county in California”; see also Chikoko 2008 *The Dyke* 52 who gave the example of the 1994 Mexican peso crisis to show how derivatives can accelerate and deepen financial crisis.

7 Ilyina *International Monetary Fund* 69.

8 Mugambi *Adoption of Equity Derivatives in Kenya* (MBA Thesis, Chandaria School of Business 2014) 22; Oldani “The Risk of OTC Derivatives: Canadian Lessons for Europe and the G20” 2015 *Centre for International Governance Innovation Papers* 7 who argued that “Regulation and enforcement are as important as information disclosure.”

9 See also Chikoko 2008 *The Dyke* 48 who argued that, “absence of a legal and regulatory framework for derivatives is a major snag since an economy must have a legal and regulatory framework conducive building liquidity in both primary and secondary derivatives markets.”

10 Chidaushe and Njaya “The Empirical Evaluation of the Association between Derivatives Markets and Market Factors in Zimbabwe and Botswana” 2023 *Research Journal of Finance and Accounting* 70. This confirms the views of Bonga *et al* 2015 *Journal of Economics and Finance* 6, that in 2015 Zimbabwean financial sector was not trading in derivatives.

11 Tome “FINSEC pushes for increased participation in derivatives market” *The Herald*, 3 March 2023.

12 Chapter 485A.

13 Eganza *Factors That Inhibit the Development of Financial Derivatives in the Kenyan Financial Sector* (MBA dissertation, Chandaria School of Business, 2016) 3; for some of the challenges see Muchiri *Challenges of Implementation of Derivatives Related Strategy Concept at the Nairobi Securities Exchange in Kenya* (MBA, University of Nairobi, 2015) 30–31.

and stability of the market.¹⁴ This article, therefore, seeks to analyse the existing Zimbabwean legal framework governing derivatives, identify gaps and propose legislative measures based on the Kenyan model.

By recommending the promulgation of a comprehensive framework that regulates and governs the trading of derivatives, this article seeks to contribute to both legal development and economic growth of the financial sector in Zimbabwe since the research will articulate the reasons why regulations of derivatives are essential in Zimbabwe. The article will interrogate the historical development of derivatives, wherein the types of derivative markets will be discussed. The article will also deal with the traditional and the modern developments in derivative market regulations. The importance of derivatives will also be discussed to highlight why it is important to have a legal framework that governs derivative markets. Having discussed the importance of derivatives, the article will then discuss the legal framework regulating derivatives both in Zimbabwe and Kenya. In these discussions, the shortcomings of the legal framework will be highlighted.

2 HISTORICAL DEVELOPMENT OF DERIVATIVES

Though it is not clear when derivatives were first used, it has been argued that derivatives contracts were developed as soon as humans started to make credible promises.¹⁵ According to Weber, the first derivatives contracts were written in cuneiform script on clay tablets, which, luckily for financial historians, were extremely durable.¹⁶ It is noteworthy that during the early years of the development of derivatives, derivatives instruments were mostly used by farmers to trade in their agricultural products. Pauletto noted that during the early years of the development of derivatives, trade in derivatives instruments took place at the gates of the cities, at the quaysides in port cities and in the city centres, where the trade was regulated by the government.¹⁷ The fact that early derivatives activities, though primitive, were regulated by the government shows that the regulation of derivatives has a long history, which can be gleaned from some of the developments that took place during different periods. This resonates well with the views expressed by Stout that laws regulating derivatives trading date back well before the modern era, just as derivative contracts.¹⁸

In many countries that were trading in derivatives, the regulation of these instruments became an important aspect due to the growth of derivatives. For example, derivatives contracts became legally enforceable in France in 1885.¹⁹ Although Germany tried to pass the regulatory framework that restricted the use of derivatives, it was argued that by the end of the nineteenth century, German financial markets had reached a size where it was no longer possible to avoid

14 See Njanike 2010 *Annals of the University of Petroşani, Economics* 227; see also Oldani *Centre for International Governance Innovation Papers* 7, who argued that “Regulation and enforcement are as important as information disclosure.”

15 Weber “A Short History of Derivative Security Market” 2008 *Working Paper* 5; Riederová and Růžičková “Historical development of derivatives’ underlying assets” 2011 *Universitatis Agriculturae Et Silviculturae Mendelianae Brunensis*, 522 used an example of Jacob’s marriage to Rachel as an example of a derivative contract in that by accepting to work for seven years to marry her, Jacob bought an option for those years of his labour as a guarantee of getting married to Rachel.

16 Weber *Working Paper* 5; see also Algieri “A Journey Through the History of Commodity Derivatives’ Markets and the Political Economy of (De) Regulation” (2018) *ZEF-Discussion Papers on Development Policy* 10, who argued that “the origins can be traced back to the early commerce in Mesopotamia in the 2000s B.C., then first contracts for future delivery of goods were written in cuneiform script on clay tablets.”

17 Pauletto “The History of Derivatives: A Few Milestones” *EFTA Seminar on Regulation of Derivatives Markets* 3.

18 Stout “Derivatives and the Legal Origin of the 2008 Credit Crisis” 2011 *Harvard Business Law Review* 11.

19 Weber *Working Paper* 37.

regulations by moving into 38 coffee houses and allies.²⁰ This explains that the most important aspect that forced the regulation of derivatives in the early years was the rapid growth of these instruments, and in some cases, the dangers that are associated with financial instruments.²¹ These factors still affect the regulation of derivatives in many countries in a modern legal framework.

Of interest to note about the development of derivatives markets is that the development shows that derivatives have been the preserve of the elite, sophisticated, advanced economies, whereby only developed countries use them, but due to increased financial crisis, both developed and developing markets have found the need to implement derivatives. This means that advanced economies have a greater percentage of the use of derivatives. This is supported by scholars like Koskei, who argued that Europe holds a large proportion in the use of derivatives,²² and further by Eganza, who also noted that,

in terms of the usage of financial derivatives by comparison, advanced economies account for almost two thirds of derivatives traded on exchanges and 38% of these are over the counter. Conversely, derivatives are not well understood or exchange-traded anywhere in Africa.²³

2 1 Types of Derivatives

There are various types of derivatives. However, the most recognised types of derivatives are forward contracts, futures contracts, swaps contracts, and options contracts.²⁴ These can be explained further as follows.

2 1 1 Forward Contracts

Forward contracts are contracts between two parties to sell or buy an asset in the future at an agreed time and a set price. This type of derivative is recognised for having the following features, *viz*, it is an agreement between the two counterparties which specifies a quantity and type of asset to be sold or purchased, the future date at which the delivery and payment are to be made and the price at which the payment is to be made.²⁵ It further obligates the seller to deliver the asset, and also the buyer to buy the asset, with no monetary exchange until the delivery date is reached, except for a small service fee, if applicable.²⁶ The type of derivative shows that it has an enforceability legal character in that the other party can enforce the contract in the event of non-performance.

2 1 2 Futures Contracts

Future contracts can be described as standardised contracts between two parties to buy or sell an asset at an agreed future date at a given price. The futures market solves some of the shortcomings of the forward market. Futures contracts are one of the most common derivatives used to hedge risk. A futures contract is an arrangement between two parties to buy or sell an

20 Weber *Working Paper* 37–38.

21 See Lynch 2011 *Loyola University Chicago Law Journal* 9, who stated that “as a result of their growth and apparent dangers, American and foreign government officials have recently turned their attention to better regulating derivatives.”

22 Koskei “An Analysis of the Derivatives Market Performance in Kenya: A Case of Nairobi Securities Exchange Derivatives Market” 2024 *Journal of Economics, Finance and Management Studies* 1338.

23 Eganza *Factors That Inhibit the Development of Financial Derivatives* 3–4.

24 Chidaushe 2018 *Journal of Business and Financial Affairs* 1; see also Njanike 2010 *Annals of the University of Petroşani, Economics* 219; Eganza *Factors That Inhibit the Development of Financial Derivatives* 9.

25 Islam and Chakraborti “Futures and Forward Contract as a Route of Hedging the Risk” 2015 *Risk Governance and Control: Financial Markets and Institution* 71.

26 *Ibid.*

asset at a particular time in the future for a particular price.

2 1 3 Swap Contracts

A swap is a financial contract to exchange a set of payments one party owns for a set of payments owned by another party. For Haugh, there are several types of swap derivative contracts and the most common of which are interest rate swaps and currency swaps. Other types of swaps include equity and commodity swaps.²⁷ This type of derivative has a counter-party risk legal character.

2 1 4 Options

An option is a contract that grants owners the right but not the obligation to purchase or sell a financial instrument for a specific price within a defined period. This means that there are two types of these options contracts: a call option, which gives the holder the right to buy the underlying asset by a certain date and for a certain price; and the put option, which gives the holder the right to sell the underlying asset by a certain date for a certain price. It is important to note that these options contracts are traded on an organised exchange.²⁸

The ISDA Master Agreement, which was published by the International Swaps and Derivatives Association (ISDA) to govern derivatives transactions, provides a framework for managing legal and credit risks and can be considered as an important legal instrument that governs the options contract.

2 2 Importance of Derivative Markets

Because financial markets face various risks which include systematic risk, like interest rate and exchange risk, and unsystematic risk like credit, financial, management, and liquidity risks,²⁹ derivative markets became important since they can be implemented to manage these risks. This means that the most common use of derivatives is to manage and reduce risks. According to Huang and Yao, “the good use of derivatives is beneficial for companies to achieve more effective risk control, reducing the risk of enterprises at the same time.”³⁰ This shows that one of the major uses of derivative markets is to manage the risks that are associated with financial markets.

Under risk management, derivatives are used to hedge against risks, which means an attempt to avoid the risk of loss by matching a given risk exposure with a counterbalancing risk, as in hedging a bet.³¹ Apart from being used to hedge against the risks, derivatives can be used by speculators to make profits by anticipating the general movements of prices in the market³² and can also be used by arbitrageurs to make riskless profit by exploiting price differentials in the markets through the use of derivatives.³³ For Njanike, there are four uses of derivatives, which are hedging, speculation, arbitrage and leverage.³⁴ As noted above, during the early years of

27 Haugh “Forwards, Swaps, Futures and Options” 2016 *Foundations of Financial Engineering* 4.

28 Hall *Options, Futures and Other Derivative Securities* (1992) 5.

29 Huang and Yao, “Financial Derivatives and Their Application in Enterprises Advances in Economics” 2021 *Business and Management Research* 3278.

30 *Ibid* 3279.

31 Sihvonen, *The Impact of Increasing Regulation on the Derivatives Market* (University of Applied Science 2014) 15 noted that “the reduction is achieved by entering in to derivatives contracts that enable the hedger to know the exact price of an asset in a set time in the future.”

32 According to Sihvonen “Regulation on Derivatives Market” 2014 15, the speculators either bet that the price of an asset goes up or they bet that it goes down.

33 Chidaushe 2018 *Journal of Business and Financial Affairs* 3.

34 Njanike 2010 *Annals of the University of Petroşani, Economics* 220.

derivative formation, speculators were denied the right to enforce their contract in the public courts hence they solved the problem of enforcement by moving their trading onto private venues that enforced their betting contracts for them, even as public courts refused to shoulder that burden.³⁵

Considering the uses of derivatives, it cannot be denied that derivative instruments are important in any financial sector, since they can be used to develop cash and capital markets, used for price discovery and to transfer risk. Chikwira thus summed the use of derivatives in the following words that, “derivatives markets have been reviewed and proved that they had beneficial contributions as risk-sharing mechanisms, providing firms with tools to hedge against eventualities and healthier information on financial markets.”³⁶ This resonates well with the views expressed by Njanike that “derivatives exchange can improve the allocation of resources, maintain efficient pricing and information flows, and act as a conduit for the transfer of risk within a country and even across countries, which means that derivatives encourage greater international investment.”³⁷ Njanike further explained the importance of derivatives markets, they provide a new avenue of risk management through the effective use of hedging, arbitrage, speculation and leverage techniques, thus enabling tactical investment decision-making.³⁸

From the foregoing, it is clear that derivatives are important not only to the end-users but to the entire economy. Chikoko explained the importance of derivatives for the wider economy when he argued that “the rewards of derivatives are not merely restricted to end-users but encompass the wider economy. By facilitating a more efficient distribution of risks, derivatives render the economy more efficient, stable and robust.”³⁹ The uses of derivatives show the importance of derivatives, and this article supports the argument that derivatives are vital in the financial sector, hence they need to be managed and regulated well to achieve their intended objectives.

2.3 Traditional Approach to Derivative Markets

The management of derivatives markets is one area that has generated interest in many jurisdictions. History shows that the regulation of two derivatives markets (exchange markets and Over the Counter [OTC]) has been subjected to various developments. Traditionally, the market for OTC derivatives had minimal regulations. Also, some aspects of derivatives were not regulated and therefore not enforceable by the public courts, and these include speculative derivatives.⁴⁰ Despite all the positives associated with derivatives in the early years, several high-profile incidents raised concerns among some regulators and others. Several firms with deep financial experience in the USA and UK have been reported to have suffered large losses in derivatives trading. For example, Orange County, Calif, which was considered one of the wealthiest counties in the United States, was declared bankrupt in 1994, allegedly due to derivatives trading involving leveraged repurchase agreements. The following year, the United Kingdom’s Barings Bank was also declared bankrupt because of speculation on futures by a

35 Stout 2011 *Harvard Business Law Review* 14.

36 Chikwira *Economic Role of Derivatives on Bank Lending, Firm Value and Economic Growth: Evidence of South Africa* (PhD Thesis, Durban University of Technology 2020) 26.

37 Njanike 2010 *Annals of the University of Petroșani, Economics* 226.

38 *Ibid* 224.

39 Chikoko 2008 *The Dyke* 53.

40 See Stout 2011 *Havard Business Law Review* 14.

rogue trader in its Singapore office.⁴¹

The above incidents, and some others, lead to minor changes in the way derivatives were sold, but for the most part, firms were responsible for tightening controls internally.⁴² How derivatives were managed, and the resultant effect of large losses on derivative trading, influenced the need for a proper regulatory regime to manage the risks. The traditional rationale for regulating financial markets, therefore, stems from concerns that events in these markets can have a significant impact on the economy. As already noted, derivatives need proper management and effective regulation to yield positive results. When managed improperly, they can pose a danger to the economy. Without a comprehensive legal framework, it is difficult to govern how stakeholders should trade derivatives and how they should enforce their rights in the event of breach by either party. This is the same challenge that Zimbabwe is still experiencing, since there is no legal framework that governs how derivatives are traded and how disputes should be resolved. Although firms can regulate how they trade on derivatives, such self-regulations pose challenges, especially in the enforcement of breaches. Therefore, there is a need for a state regulatory framework that can be enforced through the courts.

2.4 Modern Developments in Derivative Market Regulations

Literature shows that derivatives markets have become increasingly important in finance over the past few decades.⁴³ The derivatives markets were small until the 1970s, and since then, their growth has been driven by both demand and supply factors.⁴⁴ As a result of their growth and apparent dangers, in particular the financial calamity of 2007, which nearly brought the financial system to a shutdown, most jurisdictions, including American and foreign government officials, have recently turned their attention to better regulating derivatives.⁴⁵ The first modern group that contributed much to the regulation of derivatives is the Group of Twenty (G20) Finance Ministers and Central Banker Governors, who, in response to the 2007 financial crisis, agreed to reform the OTC derivatives market in 2009 with the key objectives of reducing systemic risk, improving transparency, supporting financial stability, and combating market abuse.⁴⁶ This G20 agreement became the yardstick for derivatives regulation among member states. Because of the G20 agreement, it has been argued that many countries now have legislative and regulatory frameworks that govern derivative markets.⁴⁷

In the United States of America, the Wall Street Reform and Consumer Protection Act of 2010, commonly known as the Dodd-Frank Act and in Europe, the Regulation No 648/2012 of the European Parliament and the Council on OTC derivatives, central counterparties, and trade repositories, changed the characteristics of OTC markets.⁴⁸ It has been noted that the Dodd-Frank Act aimed to increase transparency and accountability in the derivatives market as the

41 Prabha, Savard and Wickramarachi “Deriving the Economic Impact of Derivatives: Growth through Risk Management” 2014 *Milken Institute* 15.

42 *Ibid.*

43 Lynch 2011 *Loyola University Chicago Law Journal* 5 who argued that “the presence of derivatives in the global financial industry has grown enormously in the last two decades.” See also Mano *The impact of the Derivatives’ use, as a Hedging Instrument in the European Banking Sector* (LLM Thesis, Tilbury University 2013) 1 noted that “the derivative market has experienced a tremendous growth worldwide, the last decade, as it was giving the investors the possibility to invest in segments of the markets that were not attainable before.”

44 Prabha *et al.* 2014 *Milken Institute* 22.

45 Lynch 2011 *Loyola University Chicago Law Journal* 9.

46 Laurens “Regulation of Financial Derivatives Markets: A Review of the Link between Regulation and Market Liquidity” 2013 *SSRN Electronic Journal* 4.

47 *Ibid.*

48 Chikwira *Economic Role of Derivatives on Bank Lending, Firm Value and Economic Growth: Evidence of South Africa* (PhD Thesis, Durban University of Technology 2020) 24.

legislature was tasked with protecting United States of America taxpayers against the need for future bailouts and buffering the financial system from unbearable risk-taking.⁴⁹ This highlights the importance of regulating derivatives, to ensure transparency and accountability in the trading of derivatives.

What is noteworthy since the 2007 financial crisis is that many countries have embarked on promulgating laws that seek to manage derivative implementations, having been guided by the G20 agreement. These regulatory regimes have several goals, with the most important being to maintain smoothly functioning financial markets. Further, the regulation of derivative markets is a measure to protect investors and encourage them to participate in the trading of derivatives. Another important point to note is that regulation can seek to encourage institutions to manage risks prudently, but it cannot eliminate the risks inherent in financial intermediation. Regulators seek to reduce the risks taken on by the firms they regulate. Further, regulation of financial markets protects the public interest by protecting investors and guarding against systemic risk. Thus, since Zimbabwe is also affected by these market risks, there is need for a comprehensive legal framework governing derivatives trading.

3 REGULATION OF DERIVATIVES IN ZIMBABWE

This part of the article discusses the current position regarding the regulation of derivatives markets in Zimbabwe to highlight the weaknesses and/or shortcomings in the regulation of derivatives markets in Zimbabwe. Furthermore, key institutional bodies that are involved in the regulation of derivatives and those that could have been involved in the regulation of derivatives markets in Zimbabwe are also discussed to consider their roles in the implementation of derivatives markets.

3 1 Legal Framework Governing Securities

Various statutory provisions regulate the dealings of securities in Zimbabwe. These statutes govern how financial institutions and other stakeholders should trade and register various securities listed in the statutes. The securities that are traded in Zimbabwe include shares, bonds, and derivatives instruments. The following are statutes that deal with the trading of securities in Zimbabwe.

3 1 1 Securities and Exchange Act

The Securities and Exchange Act⁵⁰ is key legislation that governs securities in Zimbabwe. The long title of the Securities and Exchange Act identifies the following as some of the objectives of the Act:

to establish a Securities Commission and to provide for its objectives, functions and powers; to control and regulate the marketing of securities and investment in securities; to regulate and register securities exchanges; to regulate and license persons who trade or deal in or manage securities; to provide for the establishment and functions of central securities depositories to facilitate the marketing and transfer of securities.

From the objectives of the Securities and Exchange Act, it is clear that the regulations and control of securities exchanges are among the main objectives of the Act. The Securities and

49 Sihvonen *The Impact of Increasing Regulation on the Derivatives Market* (University of Applied Science 2014) 44.

50 [Chapter 24:25].

Exchange Act then defines a securities exchange to mean:

a person or entity that constitutes, maintains or provides a market place or facility, including an electronic trading system, at which or by means of buyers and sellers of securities can be brought together and offers to buy, sell or exchange securities can be regularly made and additionally, or alternatively, accepted.⁵¹

The Securities Exchange Act deals with securities which are also broadly defined under section 2 of the Act and encompass some types of derivatives instruments. The definition of securities means that the types of derivatives, such as futures contracts, are part of the securities that are allowed to be traded in Zimbabwe. Although the Securities and Exchange Act does not explicitly show that it regulates the trading of derivatives, the inclusion of the types of derivatives in the definitions of securities that are traded in Zimbabwe and the definition of exchange securities can be interpreted to mean that the Act regulates the trading of derivatives in Zimbabwe. This is further supported by the fact that the Securities and Exchange Act also establishes the Securities and Exchange Commission of Zimbabwe (SECZIM), which is mandated to, among other things, regulate trading and dealing in securities⁵² and to register, supervise, and regulate securities exchanges.⁵³ Of interest is that the SECZIM has already exercised its powers in terms of the Securities and Exchange Act and licensed FINSEC to trade in derivatives markets. The role of the SECZIM will be discussed further below.

Of importance to note is that in dealing with the issues of registration of securities exchanges, the Securities and Exchange Act does provide guidelines on how these securities exchanges are registered, and it is an offence that attracts an imprisonment term for one to operate a security exchange without registering with the SECZIM.⁵⁴ This means that the Act requires one to register as a securities exchange before trading in derivatives. This could mean that the Act regulates the trading of derivatives.

It is, however, important to note that despite being one of the major legal frameworks that control and regulate market securities, the Securities and Exchange Act does not explicitly govern or regulate trading in derivatives in Zimbabwe. The interpretation that can be given to the definition of securities means that derivatives fit within that definition, though the major concern that can arise with the Act is that it fails to provide for the regulation and control of some derivatives in details as with the Capital Markets Act of Kenya. Derivatives are one form of securities; as such, it is generally expected that these instruments are governed by the Securities and Exchange Act. The problem or weakness of the Securities and Exchange Act is that it does not provide a detailed guideline to how derivatives should be traded and regulated, unlike other securities such as bonds. The Act leaves the regulation of derivatives to any exchange market that would have registered with the Commission in terms of section 30 of the Securities and Exchange Act. It follows that the Act simply implies the inclusion of derivatives as securities without explicitly regulating how the securities must be traded, which ultimately creates legal uncertainty detrimental to market confidence.

3 1 2 Zimbabwe Stock Exchange Act

Another statutory enactment that deals with securities in Zimbabwe is the Zimbabwe Stock Exchange Act (hereinafter “the ZSE Act”).⁵⁵ The ZSE Act seeks, among other things, to provide

51 Section 2 of the Securities Exchange Act.

52 Section 4 (2)(a) of the Securities and Exchange Act.

53 Section 4 (2)(b) of the Securities and Exchange Act.

54 Section 29 of the Securities and Exchange Act.

55 [Chapter 24:18].

for the establishment and regulation of the Zimbabwe Stock Exchange and the Committee,⁵⁶ which is mandated to regulate the transaction of business on the Exchange.⁵⁷ The preamble to the Act, and the functions of the Committee of the Zimbabwe Stock Exchange, show that this Act deals with the issue of regulations of stocks, and the Act provides for who must trade in stocks. However, concerning derivatives instruments, the Act does not provide for its regulation. Unlike the Securities and Exchange Act, which broadly defines securities, the ZSE Act narrowly defines securities and limits the definition to:

fully paid-up share, stock, debenture, debenture stock, loan stock, unit in a unit portfolio or other security, other than a bearer security or proprietary right; including any right of option to acquire a security whether fully paid up or not.⁵⁸

If one applies the literal interpretation of the meaning of securities as defined above, one would argue that the ZSE Act excludes the trading in derivatives instruments. This leaves a lot to be desired, considering that the Zimbabwe Stock Exchange is the institution that is charged with the regulation of market exchange. If one compares this with other countries, for example South Africa and Kenya, which have a substantially developed and grounded derivatives market where the Johannesburg Stock Exchange and Nairobi Securities Exchange are licensed exchanges that trade in derivatives.⁵⁹ The above highlights that the ZSE Act is one of the statutes that deal with securities in Zimbabwe, it excludes the regulations of the derivatives, which is one of its major weaknesses. This has the implications of preventing exchange-traded derivatives, limiting investors' participation, as well as contracting financial-sector modernisation.

3 1 3 Reserve Bank of Zimbabwe Act and its Regulations

The Reserve Bank of Zimbabwe Act⁶⁰ is another statute that governs the operations of all banks in Zimbabwe. Banks are part of financial institutions that are prone to market risks. Banks typically act as important financial intermediaries in emerging and developing markets. As such, they support economic growth and development via lending to corporations, managing customer deposits, investing in sovereign debt, and facilitating the financing of foreign trade. However, these activities potentially expose banks to a range of systematic risks, including credit risk from lending, interest rate risk on both sides of the balance sheet, foreign exchange risk from trade receivables and financing, and liquidity risk from maturity mismatches between assets and liabilities.⁶¹ To manage these risks, banks need to implement derivative markets as a risk management tool.

By using derivatives, the bank could manage the floating-rate risk on the liability side and separately manage the fixed-rate risk on the asset side. It could structure both its assets and liabilities in ways that more appropriately reflect the needs of its customers and the broader economy.⁶² Despite the importance of derivatives in the management of derivatives, the Reserve Bank of Zimbabwe Act does not provide for the regulation of derivative instruments; its concern

56 Preamble to the ZSE Act.

57 Section 15(1)(b) of the ZSE Act.

58 Section 2 of the ZSE Act.

59 This is contrary to other jurisdictions, as explained by Kithinji "The Case for a Derivatives Market in Kenya" 2016 *Working Paper* 5, who argued that South Africa has a substantially developed and grounded derivatives market, where the Johannesburg Stock Exchange is a licensed exchange trading in derivatives; see also the case of Kenya, where the Capital Markets Authority approved the Nairobi Securities Exchange's application for operation of a derivatives market, see Kithinji 2016 *Working Paper* 7.

60 [Chapter 22:15].

61 Policy Framework for Safe and Efficient Derivatives Activity in Emerging and Developing Markets (2022) 4.

62 Policy Framework for Safe and Efficient Derivatives Activity in Emerging and Developing Markets (2022) 5.

is to:

regulate the issue of banknotes and coins, to provide for matters connected with banking, currencies, monetary policy and coinage and to provide for the supervision of banking institutions.⁶³

This shows that the Reserve Bank of Zimbabwe does not assist in the regulation of derivative markets. The Reserve Bank of Zimbabwe Act should provide for the regulation of derivatives particularly providing the powers of the RBZ on the trading of derivatives in Zimbabwe by stakeholders as a measure to reduce the systemic risk that is associated with derivatives trading.

3 1 4 Operational Guidelines for the Derivatives Markets

Besides the above-discussed statutory enactments that deal with securities, the other legal framework that is useful in the implementation of derivatives markets in Zimbabwe is the Operational Guidelines for the Derivatives Market on the Financial Securities Exchange (Private) Limited, 2021. These guidelines were issued by FINSEC exercising the powers conferred by section 85 of the Securities Exchange (Financial Securities Exchange) Rules, 2021. The importance of the guidelines cannot be denied as they confirm the minimum operational standards and requirements for participants and investors, and they are binding.⁶⁴ These are the only rules and guidelines that directly and explicitly regulate the trading of derivatives in Zimbabwe. As already discussed in this article, for derivative instruments to be accepted and to inculcate confidence in stakeholders, there must be a legal framework that provides for their operational standards. This view is supported by Chikoko, who argued that “derivatives users and traders should establish a guiding set of principles to provide a framework for effectively managing and controlling financial derivatives activities.”⁶⁵

Thus, the inclusion of procedures and principles that govern the trading of derivatives under the Operational Guidelines is an important step in the regulation and implementation of derivatives in Zimbabwe since it will ensure that stakeholders will feel protected and that they will be treated fairly hence they will be confident to trade in derivatives.

Another important aspect of the Guidelines is that they established a centralised marketplace. In terms of section 4(1) the Exchange establishes the Derivatives Board where market participants and investors alike can trade standardised futures and options contracts; a contract to buy or sell specific quantities of a commodity or other underlying assets at a specified price with delivery set at a specified time in the future. This shows one of the benefits of a regulated derivatives market which is creating financial safety and integrity. As confirmed by the Emerging Markets Committee of the International Organization of Securities Commissions,

one of the distinctive features of a centralized derivatives exchange is that the exchange (or the exchange’s clearinghouse) acts as a counterparty to every trade. Thus, those who use the exchange do not have to worry about the creditworthiness of the counterparties to their trades.⁶⁶

The Guidelines further provide for parties who are eligible to participate in derivatives markets and these include banks, custodians, securities dealers, investors, option contract writers and clearing house(s).⁶⁷ What can be noted from the Guidelines is that they are attempting to inculcate confidence in the stakeholders to implement and trade in derivatives since they both

63 Preamble of the Reserve Bank of Zimbabwe Act.

64 Section 2 of the Guidelines.

65 Chikoko 2008 *The Dyke* 54.

66 Emerging Markets Committee of the International Organization of Securities Commissions (2012) 3.

67 Section 7(1) of the Guidelines.

provide the power to monitor compliance with regulations and the power to enforce regulations. This shows that the Guidelines have incorporated the three main aims of regulating derivatives markets which are to ensure financial safety including the integrity of clearing houses and market participants, to ensure fairness, including fiduciary and related customer (investor) protection concerns and to ensure market efficiency and integrity.⁶⁸ FINSEC, in this regard, acts as a governmental agency with the power to regulate market risks through derivatives. The need for a governmental agency with the authority to regulate derivatives exchanges is almost universally accepted, and all countries with derivatives exchanges have such agencies.⁶⁹

Considering the foregoing, it is undoubtedly clear that although various statutory enactments that regulate and control securities do not provide for the regulation of derivatives markets in Zimbabwe, the Operational Guidelines are relevant in the implementation of derivatives in Zimbabwe. The only challenge with the Guidelines is their legal status. They are merely guidelines, are neither legislation nor delegated or subordinate legislation, but only designed to influence people's behaviour. This shows that the Guidelines do not provide adequate protection to investors unlike a binding legal framework such as the Capital Markets Act of Kenya.

3 2 Institutional Framework or Bodies Dealing with Derivatives Markets

Besides the legal framework discussed above, there are certain institutions that play a critical role in the implementation and regulation of securities in Zimbabwe. This part will discuss these institutional bodies that deal with securities in Zimbabwe with the aim of assessing whether they assist in the implementation of derivatives instruments in Zimbabwe.

3 2 1 The Zimbabwe Stock Exchange

The Zimbabwe Stock Exchange (ZSE) is the principal stock exchange of Zimbabwe. The ZSE is regulated by the Securities and Exchange Commission of Zimbabwe (SECZ),⁷⁰ which is established by the Securities Exchange Act. Dating back to 1894,⁷¹ the ZSE has evolved to be one of the advanced and diversified securities exchanges in Sub-Saharan Africa and it has been considered as one of the oldest stock exchanges in Africa.⁷² The ZSE currently provides a listing and trading platform for equity, debt, depository receipts, unit trusts, exchange-traded funds, and real estate investment trusts.⁷³

Although the ZSE was said to have traded in derivatives before 2004, the current position seems to suggest that the ZSE does not trade in derivatives. The governing legal framework only limited the securities that the ZSE can trade to fully paid-up shares, stock, debenture, debenture stock, loan stock, units in a unit portfolio, or other securities.⁷⁴ The governing Act (ZSE Act) does not recognise derivatives as part of the securities that the ZSE can trade. This means that currently, the ZSE does not assist in the implementation of derivatives markets. This highlights the weaknesses of the legal and institutional frameworks in Zimbabwe concerning the regulation of derivatives. This is particularly true considering that most countries that trade

68 For a discussion of the purpose of regulating derivative markets see Schwarcz "Regulating Derivatives: A Fundamental Rethinking" 2020 *Duke Law Journal* 578.

69 Emerging Markets Committee of the International Organization of Securities Commissions (2012) 5.

70 Bonga "Stock Market Volatility Analysis using GARCH Family Models: Evidence from Zimbabwe Stock Exchange" 2019 *MPRA Paper No. 94201*, 3.

71 This is considered the first stock market in Zimbabwe, and it is argued that it was established in June 1894 and was referred to as the Rhodesia Stock Exchange.

72 Mpofu "Does the Zimbabwe Stock Exchange (ZSE) have potential to support economic growth during the multicurrency system?" 2011 *ZEPARU Working Paper Series* 45.

73 Zimbabwe Stock Exchange, 2021 Annual Report.

74 Section 2 of the Zimbabwe Stock Exchange Act.

in derivatives use their stock exchange bodies to trade derivatives, like the Johannesburg Stock Exchange of South Africa, and the Nairobi Stock Exchange of Kenya.

3 2 2 Securities and Exchange Commission of Zimbabwe

The Securities and Exchange Commission of Zimbabwe (SECZIM) is the regulator of capital markets and is established by the Securities and Exchange Act. The SECZIM is an independent regulatory body that is responsible for overseeing and regulating the securities market in Zimbabwe. In terms of section 4 of the Securities and Exchange Act, the SECZIM is mandated among other things to provide high levels of investor protection and reduce systemic risk. This systemic risk includes a failure on the part of one or more registered securities exchanges or licensed persons to meet their obligations, which may result in other registered securities exchanges or licensed persons being unable to meet their respective obligations, and to promote market integrity and investor confidence.⁷⁵

Considering the functions of the SECZIM, it has been noted that the primary goal of the SECZIM is to promote transparency and fairness in the securities market, protect investors, and ensure that the market operates stably and efficiently.⁷⁶ To achieve these goals, the SECZIM licenses and registers market participants, regulates public offers and listings, oversees the conduct of market participants, and enforces compliance with securities laws and regulations. SECZIM has been working to improve the regulatory framework for the capital markets and to enhance investor protection. These powers and acts that the SECZIM can exercise as provided for under the Securities and Exchange Act cannot be changed or reserved without reasonable grounds.⁷⁷

As highlighted above, the Securities and Exchange Act broadly defines the securities that are regulated and the powers of the SECZIM. It is argued that the SECZIM has an important role to play in the implementation of derivatives in Zimbabwe. The only challenge that the SECZIM currently has is the lack of a stand-alone legal framework that regulates the implementation and usage of derivatives. As the regulatory body of securities, which includes derivatives as defined in terms of section 2 of the Securities and Exchange Act, the SECZIM should have a statutory instrument that outlines the rules and operations guidelines for the trading of derivatives. However, the role of the SECZIM in the implementation has been felt since it has already licensed FINSEC to trade in derivatives. Furthermore, SECZIM collaborates with FINSEC in guiding and raising awareness among stakeholders about the importance of using derivatives by holding webinars or seminars.

3 2 3 Financial Securities Exchange (Private) Limited (FINSEC)

One of the institutional bodies in Zimbabwe that deals with the trading of derivatives is the Financial Securities Exchange (Private) Limited (FINSEC), which is licensed by the Securities and Exchange Commission of Zimbabwe as a Securities Exchange (Alternative Trading Platform). FINSEC was established in 2016 with the vision of creating an inclusive and efficient capital market that can support the development of the Zimbabwean economy. It is in this regard that FINSEC has developed a derivative market to support the development of Zimbabwe's economy. The FINSEC derivatives market is an innovation within its financial landscape, currently offering alternative assets like futures and options on stocks and indices. These financial instruments derive their value from underlying assets or indices, empowering investors with unique strategies for risk management, diversification, and hedging.⁷⁸ FINSEC's

⁷⁵ See also the case of *Securities Exchange Commission of Zimbabwe v Gwatidzo N.O & Ors* SC 26-17, 5-6.

⁷⁶ Securities and Exchange Commission of Zimbabwe: Annual Report 2022, 4.

⁷⁷ See the case *Chengetedzai Depository Company Limited v Securities and Exchange Commission of Zimbabwe & Ors* HH 161-23.

⁷⁸ FINSEC's Journey towards Inclusive Capital Markets through Alternatives.

platform allows investors to trade these diverse derivatives, capitalising on price differentials and asset fluctuations. By offering this range of instruments, FINSEC enhances portfolio resilience and unlocks sophisticated investment strategies, granting investors access to alternative asset classes for greater financial flexibility and risk control.

As an integral part of FINSEC's ecosystem, this market empowers investors to explore and engage with alternative assets, reinforcing their financial strategies. The Operational Guidelines for the Derivatives Market, which lays down the operation's minimum standards, supports FINSEC's trading of derivatives. This shows that any party that wishes to trade in derivatives should be registered with FINSEC and start to trade in derivatives. However, the challenge with the powers of FINSEC is linked to the non-binding nature of the Guidelines. Further, the Guidelines do not provide how disputes should be reported or resolved. It therefore makes the role of FINSEC more difficult in enforcing compliance with the Guidelines. As already noted, the trading of derivatives is still in its infancy, hence the success of FINSEC in providing public oversight is difficult to measure. This also reduces market confidence and investors' protection since there is no clear dispute resolution mechanism within the Guidelines.

4 COMPARATIVE ANALYSIS WITH KENYA

4 1 Legal Framework on Derivatives Markets in Kenya

The derivatives market in Kenya falls under the scope of the securities and capital markets legal regime. This means that the legal framework that governs securities and capital markets is the same legal instrument that governs derivatives. Although several statutory enactments deal with securities and capital markets in Kenya, there are key statutory frameworks that govern the implementation or use of derivatives, and one of these instruments is the Capital Markets Act. The following part of the article will therefore discuss the key legal frameworks that regulate the use and/or implementation of derivatives.

4 1 1 Capital Markets Act

The principal Act that regulates securities and capital markets, and in particular the derivatives market in Kenya, is the Capital Markets Act. The preamble of the Act clearly shows that the objective of the Act is to "regulate and facilitate the development of an orderly, fair and efficient capital market in Kenya." This Act has key provisions that deal with capital markets generally, and these provisions also apply to derivatives markets. The Capital Markets Act defines key terms which relate to derivatives, and this makes its provisions relevant to any transactions in

derivatives within the capital markets.⁷⁹

Furthermore, the Capital Markets Act also defines derivatives exchange,⁸⁰ derivatives market,⁸¹ exchange-traded derivatives contracts,⁸² futures contracts,⁸³ among other key terms in derivative trading. Another key term defined by the Capital Markets Act is securities exchange. The definition of securities exchanges is all-encompassing in that a place where securities are traded is also included and further, it includes an organisation that deals with derivatives and has been approved by the Capital Markets Authority (hereafter “the CMA”) which is the primary regulatory body in Kenya’s security and capital markets. Providing these definitions is meant to ensure that those who are involved in the trading of derivatives are clear as to the nature of the transaction and the people who are dealing with it.

Apart from defining the key terms, the Capital Markets Act also establishes the CMA to regulate, promote, and facilitate the development of orderly, fair, and efficient capital markets including derivatives.⁸⁴ In the exercise of its mandate, the CMA is empowered to license institutions that can trade in securities and derivatives. The CMA is therefore responsible for licensing and regulating the Nairobi Securities Exchange (the NSE) which is the foremost institution that provides a trading platform for listed equity and debt securities in Kenya.⁸⁵

The mandates of the CMA show the importance of this body in the regulation of securities and in particular derivatives markets. Another provision of the Capital Markets Act worth noting in the regulations of the derivatives market, is Part III which lays down the provisions governing the establishment and operations of securities exchange, commodities exchange and derivatives exchange. It is under this part that the NSE was established. Further, section 19 of the Capital Markets Act prohibits any person from carrying out the business of any of these exchanges without the approval of the CMA.

Since the Capital Markets Act deals with various issues regarding the regulation of the exchanges, Part IV of the Capital Markets Act makes specific provisions with respect to the requirements and procedure for the granting of licenses to trade in these instruments. This means that in terms of the Capital Markets Act, people who seek to carry out business as derivatives dealers, for example, are required to hold a valid license which must be issued in terms of the requirements

79 The definitions are provided in s 2 of the Capital Markets Act.

80 This is defined as “a securities exchange which has been granted a license to list exchange traded derivative contracts by the Authority under the Act or approved for such purposes and in accordance with the regulations issued thereunder.”

81 Derivatives market is defined as “a place at which, or a facility, whether electronic or otherwise, by means of which offers or invitations to sell, purchase or exchange exchange-traded derivative contracts are regularly made on a centralised basis, being offers or invitations that are intended or may reasonably be expected to result, directly or indirectly, in the acceptance or making, respectively, of offers to sell, purchase or exchange exchange-traded derivative contracts, whether through that place, facility or otherwise, but does not include the office or facilities of a derivatives broker; or the facilities of a clearinghouse.”

82 This is defined to mean “standardized type of securities or financial instruments which derive their value from the value of underlying assets, indices, or interest rates that are transacted on a licensed derivatives exchange.”

83 Futures contract are defined to means “an agreement to buy or sell a particular security or other financial instrument or commodity for delivery or settlement in the future, at a price that is agreed upon when the contract is made, which obligates each party to the contract to fulfil the contract at the specified price and that may be settled by delivery, cash or offset at a derivatives exchange duly licensed by the Authority.”

84 Section 11(1) of the Capital Markets Act.

85 Ndirangu “The Regulatory Framework of the Derivatives Market in Kenya: An Outline” 2018 *Research Gate* 1.

set out under the Act.⁸⁶

Apart from setting the requirements and procedure for granting the license, the Capital Markets Act also sets out the circumstances and procedures under which the licenses issued may be revoked.⁸⁷ All these provisions of the Capital Markets Act are intended to ensure the efficient and effective trading of derivatives. Thus, it can be argued that by enacting the Capital Markets Act which provides for the regulations of exchanges, the Kenyan government inculcates confidence and encourages the use and implementation of derivatives.

Further, the Capital Markets Act provides for penalties for breach of the Act and other dispute resolution mechanisms. These provisions are important in issues such as derivatives trading where two or more parties are involved in a transaction. Thus, by providing for the dispute resolution mechanism, the Capital Markets Act intends to assist all parties involved in derivatives trading to a fair and equitable means of dealing with their disputes. This means that in terms of the Act, a party who is aggrieved by the decision of the Authority is allowed to appeal to the Capital Markets Tribunal which is established in terms of section 35A of the Capital Market Act.

It is therefore clear that the Capital Markets Act has the effect of instilling confidence to stakeholders who want to trade in derivatives because it extensively provides for the regulation and management of derivative trading in Kenya. The provisions of the Act are informative as to the nature of derivatives and how they should be traded.

4 1 2 Capital Markets (Derivatives Markets) Regulations, 2015

The Capital Markets Act allows the Minister (now the Cabinet Secretary for the National Treasury) to make regulations to give effect to the provisions of the Act. In exercising its powers in terms of section 12 of the Capital Markets Act,⁸⁸ the Cabinet Secretary for the National Treasury enacted the Capital Markets (Derivatives Markets) Regulations, 2015 (the Regulations) which is a subsidiary regulation of the Capital Markets Act. The Regulations are intended to give effect to the provisions of the Capital Markets Act and as such they comprehensively set out regulations for the derivatives markets by making provisions on issues such as licensing requirements and duties of derivatives exchange,⁸⁹ governance of a derivatives exchange,⁹⁰ requirements of clearing houses,⁹¹ transactions that may be conducted on a derivatives exchange, approval of derivatives contracts,⁹² licensing of derivatives brokers,⁹³ conduct of derivatives business⁹⁴ among other issues. This confirms the sentiments expressed by Kithinji who argued that,

the secondary legislation has principles relating to various aspects of a derivatives market, including but not limited to, licensing requirements and duties of a derivatives exchange and a clearing house, licensing of derivatives brokers, inspection powers of the authority and market offenses.⁹⁵

Thus, any person who wishes to apply for a license to act as an exchange must apply to the CMA in terms of the Capital Markets Act as read together with the Regulations. These regulations

86 Section 23(1) of the Capital Markets Act.

87 See s 26(1) of the Capital Markets Act.

88 Section 12 provides for the power of the Cabinet Secretary to issue rules and regulations.

89 This is provided under Part II as read together with s 34 of the Regulations.

90 Section 21 of the Regulations.

91 See Part III of the Regulations.

92 Sections 49 and 50 of the Regulations.

93 Part V of the Regulations.

94 Part VI of the Regulations.

95 Kithinji *The Case for a Derivatives Market in Kenya* 5.

provide for what constitutes market offences⁹⁶ and the penalty that can be imposed on anyone who is found guilty of these offences.⁹⁷ The importance of providing what constitutes market offences and the penalty for those who are guilty of these offences cannot be denied. This ensures that stakeholders are well aware of what they must do when trading in derivatives, and this instils confidence in participants to use these instruments. Thus, these regulations were promulgated to deal with the challenges that prevailed before 2015, as discussed above.

4 1 3 Nairobi Securities Exchange Derivative Rules (Derivatives Rules)

Since section 21 of the Capital Markets Act empowers an approved securities exchange to make rules to facilitate the effective conduct of its functions and for the regulation of its activities, products, systems, and fees, the Nairobi Securities Exchange (NSE) which is one of the approved securities exchanges in Kenya, has formulated its own set of rules regulating the derivatives exchange — the Nairobi Securities Exchange Derivatives Rules (NSE Derivatives Rules). Rule 1 of the NSE Derivatives Rules describes the purpose of the Derivatives Rules and directives as,

the achievement of the NSE objects by providing the procedures necessary to establish and regulate a fair and efficient derivatives market and to ensure that the business of the NSE is carried out in an orderly manner with due regard to the objects of the Capital Markets Act.

This demonstrates that the rules are designed to ensure that the NSE carries out its business in a systematic manner that encourages the participation of various parties in the implementation of the derivatives market.

The Derivatives Rules cover a broad range of subjects within the derivatives market. Unlike the Capital Markets Act and the Derivatives Markets Regulations which are generically designed for any entrant or participant at any level of the markets, the Derivatives Rules are refined with a more focused intention to cover the derivatives exchange and market platform established and operated by the NSE.⁹⁸ Moving through this specialised and practical approach, the Derivatives Rules regulate various key issues within the derivatives markets, which include, among others, the issue of derivatives membership and disciplinary procedures,⁹⁹ trading,¹⁰⁰ management of members' and clients' funds,¹⁰¹ derivatives securities,¹⁰² default and penalties,¹⁰³ ethics and conduct¹⁰⁴ and dispute resolution.¹⁰⁵

From the above, it is noted that Derivatives Regulations cover important issues that are essential to foster a conducive environment that encourages stakeholders to trade in derivatives. One of these provisions deals with dispute resolution. The Derivatives Rules define what constitutes client complaints, including failure to comply with client instructions or any agreement or mandate entered into with the client; contravention of the rules and directives; acting dishonestly, negligently, or recklessly and treating the client unreasonably or unfairly.¹⁰⁶ The Derivatives Rules stipulate that every member must establish and maintain appropriate procedures for the

96 Markets offences are provided for in ss 72–76 of the Regulations.

97 Section 78 of the Regulations.

98 Ndirangu 2018 *Research Gate*7.

99 Rule 3 of the Derivatives Rules.

100 Rule 5 of the Derivatives Rules.

101 Rule 8 of the Derivatives Rules.

102 Rule 12 of the Derivatives Rules.

103 Rule 10 of the Derivatives Rules.

104 Rule 16 of the Derivatives Rules.

105 Rule 17 of the Derivatives Rules.

106 Rule 17.1.1 of the Derivatives Rules.

handling of client complaints.¹⁰⁷ Rule 17.2 sets out the members' internal complaints handling procedures.

A complainant may lodge an unresolved complaint, in writing, with the NSE Director: Regulatory Affairs.¹⁰⁸ If the complaint remains unresolved, the Derivatives Rules prescribe the mode of dispute resolution to be through arbitration.¹⁰⁹ These provisions are important in that they provide for effective regulatory and oversight mechanisms, which are vital in the financial derivatives markets in Kenya to mitigate risks and ensure stability. As already highlighted above, through enhanced oversight, regulatory bodies can foster trust in the derivatives market, attract more investors, and ultimately contribute to the overall growth and development of the financial sector in Kenya.

It is important to note that the Derivatives Rules can be contrasted with the Capital Markets Act and its Regulations mainly because the Derivative Rules are designed on a more practical perception seeking not only to regulate the market as the legislative instruments do, but also to offer guidelines for the effective performance of the derivatives market.¹¹⁰ As argued by some scholars, a well-established financial derivatives market in Kenya can contribute to the overall stability and growth of the country's financial sector, providing opportunities for investors and facilitating economic development. This is what the Derivatives Rules of the NSE seek to achieve.

4 2 Institutional Framework Dealing with Derivatives

4 2 1 The Capital Markets Authority

One of the important institutional bodies in the regulation of the derivatives market in Kenya is the Capital Markets Authority (CMA). The role of the Capital Markets Authority, which has been discussed above which includes regulating, promoting and facilitating the development of orderly, fair, and efficient capital markets, including derivatives,¹¹¹ shows that one cannot discuss the regulation of derivatives markets in Kenya without mentioning this body corporate. One of the key duties of the CMA, which is critical in the regulation of the derivatives market, is the duty to register and license institutions that can trade in securities and derivatives. This role means that it is the CMA that determines who should be licensed to trade in derivatives and has the power to suspend or revoke licenses issued to the exchanges. It is therefore clear from the foregoing that the CMA is an important institutional framework in the regulation of derivatives in Kenya.

4 2 2 Nairobi Securities Exchange (NSE) Derivatives Market (NEXT)

As highlighted above, one of the approved and licensed derivatives exchanges in Kenya is the Nairobi Securities Exchange. The NSE is expected to fulfil the requirements under the Capital Markets Act and the Capital Markets (Derivatives Markets) Regulations, 2015 in regulating the derivatives market. In order to achieve that, the NSE has established the NSE Derivatives Market (NEXT). The role played by NEXT since it was established has been considered enormous. According to Koskei,

¹⁰⁷ Rule 17.1.2 of the Derivatives Rules.

¹⁰⁸ Rule 17.6.2 of the Derivatives Rules.

¹⁰⁹ This is covered under Rule 17.7 to 17.11 of the Derivatives Rules.

¹¹⁰ Ndirangu 2018 *Research Gate* 13.

¹¹¹ Section 11(1) of the Capital Markets Act.

the market performance of the NEXT has been growing gradually since its inception in July 2019. The number of deals in the derivatives market increased from 298 in 2019 to 703 in 2020; the number of contracts exchanged increased from 572 in 2019 to 1341 in 2020; and the turnover increased from 20,734,794 million in 2019 to 44,760,015 million in 2020.¹¹²

It is important to note that NEXT is a subsidiary of the Nairobi Securities Exchange Limited, and as such, it is governed by the NSE Derivatives Rules, the Capital Markets Act and the Capital Markets (Derivatives Market) Regulations. The NEXT falls under the supervision of the Capital Markets Authority. The NEXT market acts as the specialised market where derivatives are traded with standardised specifications as defined by the NSE. In terms of the types of derivatives that are offered by NEXT, it has been argued that NEXT facilitates the trading of two future contracts, *viz* the equity index futures and single stock futures. NEXT, therefore, plays an important role in the trading of derivatives in Kenya. Of importance to note is the fact that the NSE uses some of the banks to act as clearing houses. According to Chidaushe, in January 2016, the NSE signed six banks comprising Barclays Bank of Kenya, Cooperative Bank of Kenya, CFC Stanbic Bank, NIC Bank, Chase Bank, and CBA Bank to act as clearing members of the derivatives exchange.¹¹³

5 RECOMMENDATIONS AND CONCLUSION

Several issues regarding derivatives have been discussed in this article, and these include the use of derivatives, the development of derivatives markets, and the regulations of derivatives markets. It was highlighted that many countries have been exposed to high portfolio management risks, which are obstructing growth and sophistication requiring rigorous measures that can reduce and manage these risks. Derivatives have thus been considered as one of the measures that, if implemented well, will assist in managing market risks. It was therefore highlighted that derivative markets play a vital role in the management of market risks as they are used to mitigate or scale down the effect of risks through unbundling and transferring of risk between various parties.¹¹⁴ This shows that derivatives have been considered as important instruments in any financial institution, hence the need to find a way to enhance their implementation in Zimbabwe's financial market.

In the discussion on the development of derivatives, it was highlighted that derivatives have a long history. The article highlighted those various developments took place during different periods that shaped the regulations of derivatives markets. One of the key developments in the regulation of derivatives as highlighted in this article is the agreement reached after the 2007 financial calamity by the Group of Twenty Finance Ministers and Central Banker Governors (G20) wherein the parties agreed to reform the OTC derivatives market in 2009 with the key objectives of reducing systemic risk, improving transparency, supporting financial stability, and combating market abuse.¹¹⁵ It was therefore highlighted that the G20 agreement became the yardstick for derivatives regulation among member states, thus various countries now have legislative and regulatory frameworks which govern derivatives markets.¹¹⁶

It was further highlighted that most jurisdictions have noted the importance of regulating derivatives markets, which include that well-regulated derivatives markets act as a measure to protect stakeholders like investors who are hesitant to engage in activities they do not understand. Regulation of derivatives markets, as highlighted in this article, encourages institutions to

112 Koskei 2024 *Journal of Economics, Finance and Management Studies* 1340.

113 Chidaushe 2018 *Journal of Business and Financial Affairs* 83.

114 Mulei *Derivatives and Economic Growth in South Africa: Lessons for Kenya* (LLM Thesis, University of Cape Town 2019) 4.

115 Laurens 2013 *SSRN Electronic Journal* 4.

116 *Ibid.*

manage risks prudently, thus it protects public interest by protecting investors and guarding against systemic risk.

5 1 Recommendations

Considering the developments that took place in Kenya after the promulgation of the Capital Markets Act, the following recommendations were considered ideal for Zimbabwe to enhance the implementation of its derivatives market.

5 1 1 Promulgation of an Act and Regulations that Governs and Regulates Derivatives

The article highlighted that there is a slow uptake of derivatives instruments in Zimbabwe which is attributed to a lack of clear legal instruments that govern the usage of derivatives instruments unlike stocks and bonds that are clearly regulated. In this regard, it is recommended that Zimbabwe should promulgate a stand-alone Act and its regulations which governs and regulates the trading of derivatives markets like the Kenyan Capital Markets Act. A clear and stand-alone Act that governs and regulates derivatives markets builds confidence in stakeholders as they will understand the nature of the transaction they will be trading. As evidenced by the Kenyan position where the Capital Markets Act and its regulations provide for vital issues in the regulation and implementation of derivatives markets like derivatives membership, disciplinary procedures and disputes resolutions, a clear legal framework that provides for these issues in Zimbabwe will add transparency and consistency in the implementation of derivatives by stakeholders. This ultimately will invite investors and other stakeholders to trade in derivatives.

Although there are Operational Guidelines which were issued by FINSEC, these guidelines need to be backed by a statutory enactment, like the position in Kenya, where the Derivative Regulations issued by the NSE are supported by the Capital Markets Act and its Regulations. The importance of having the Act and the regulations that govern and regulate derivatives markets apart from the Guidelines issued by FINSEC cannot be gainsaid. Guidelines are usually difficult to enforce in law, unlike the Act and its regulations. Thus, the Guidelines issued by FINSEC ought to be backed by a clear Act and regulations on the regulation of derivatives.

5 1 2 Holding Seminars to Educate Stakeholders on Derivatives

Since derivatives are complex and difficult to understand, which prevents stakeholders from implementing them, the article also recommends the SECZIM as the regulatory body of securities to do regular webinars and seminars to educate stakeholders on the importance of derivatives and how they should be traded. Once stakeholders are aware of and understand the nature of derivatives, there will be great uptake in the implementation of these instruments since stakeholders will have confidence in using derivatives. The purpose of having these webinars and seminars is to educate stakeholders on the derivatives so that they will not be hesitant to use and implement derivatives.

5 2 Conclusion

The article discussed the regulation of derivatives markets in Zimbabwe, and it was highlighted that the absence of a legal and regulatory framework for derivatives is a major hurdle in the implementation of this useful instrument in the management of market risk. More so, the article adopted a comparative analysis with Kenya, which has promulgated the Capital Markets Act and its regulations that govern and regulate the implementation of derivatives. It was made clear by having done this comparative analysis that to fully implement derivative instruments, there is a need for a regulatory framework that governs the trading of derivatives. Enacting an Act that governs and regulates derivatives in Zimbabwe will ensure that stakeholders' concerns

and lack of understanding of the instrument will be addressed. Once there is a clear Act that is enforceable by law, stakeholders like investors will have confidence in using and implementing derivatives.