

**THE SUITABILITY OF KENYA'S CRIMINAL LAW ON THE DERIVATIVES
MARKET**

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**Submitted in partial fulfilment of the requirements for the award of the degree of Master
of Laws Degree (LL.M) of the University of Nairobi**

AUGUST, 2018

DECLARATION

I declare that this study is my own work and all my sources of information have been indicated and acknowledged by means of complete references. The study has not been presented to any examination body.

.....

Date.....

Signed

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This research project has been submitted with my approval as the supervisor.

.....

Date.....

Signed

Benjamin Munywoki Musau

DEDICATION

Dedicated to:

Those who abhor crime and work tirelessly to keep it at bay. May the Almighty reward your efforts.

The gallant sons and daughters of Kenya who strive to make it a better place for future generations. Your handwork is not in vain.

My motherland Kenya. Your opportunities and challenges continue to mould me.

Those who keep the straight and narrow path. This is the road to eternal life.

Bernard Kibet Sang, who nudged me to pursue a Master of Laws degree, May you positively impact many more.

ACKNOWLEDGEMENT

While my name solely appears on the cover of this study, I am by no means the sole contributor to this work. This study is a cumulative effort on more than one individual who in one way or another contributed to its success.

Gratitude to the Almighty God. In the words of Jeremiah 10: 16, “*There is none like you, o Lord: you are great, and great is your name in might*”.

The input of my supervisor, Mr B. M. Musau, was very instrumental. He made me understand and appreciate the rigours of intellectual thought through his constructive academic criticism. His constant exclamation “George.....You must have a grasp of what you are doing!” kept me intellectually alert through each sentence in this study. Thank you.

The staff at the Capital Markets Authority resource centre and the library at Hamilton Harrison & Mathews Advocates were very instrumental in my quest to get information on derivatives. The resources that I accessed at these institutions were instrumental to this study.

To everyone who inspired me through this journey. Thank you.

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- ii. Dodd-Frank Wall Street Reform and the Consumer Protection Act (2010)

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- iv. CMA, Guidelines on the Prevention of Money Laundering and Financing in the Capital Markets (2015) and CMA, Code of Corporate Governance Practices for Issuers of securities to the Public (2016).

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- iv. *Republic v Capital Markets Authority ex-parte James Murigu and Bath Rugalo* (2018) Nairobi High Court Miscellaneous Application 607 of 2016.
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- vii. *Alnashir Popat v Capital Markets Authority* (2016) eKLR.
- viii. *Simeon Muvengei v Republic* (2013) eKLR.

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- i. *Donoghue v Stevenson* [1932] UKHL 100.
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- vii. *Williams v Bailey* (1866) LR 1 HL 200.

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- i. *United States v Coscia* (2016) 177 F.Supp.3d 1087.
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Hong Kong

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ABBREVIATIONS AND ACRONYMS

ADB	African Development Bank
ADBI	Asian Development Bank Institute.
ARA	Asset Recovery Agency.
CBOT	Chicago Board of Trade.
CMA	Capital Markets Authority.
CME	Chicago Mercantile Exchange.
CMFIU	Capital Markets Fraud Investigation Unit.
CDS	Credit Default Swaps
Ch	Chancery Division.
CID	Criminal Investigations Directorate.
CMFA	Commodity Future Modernization Act
DPP	Director of Public Prosecutions.
EAC	East African Community.
EASRA	East African Securities Regulatory Authority.
EMIR	European Market Infrastructure Regulations.
F.Supp	Federal Supplement.
eKlr	Electronic Kenya Law Reports.
EACC	Ethics and Anti-Corruption Commission
EWCA	England and Wales Court of Appeal

FATF	Financial Action Task Force.
FMC	Futures Market Committee.
FEP	Futures Exchange Project.
FSD	Financial Sector Deepening Africa.
KYC	Know-Your-Customer.
IOSCO	International Organisation of Securities Commissions.
NSE	Nairobi Securities Exchange.
NEXT	Nairobi Securities Exchange Derivatives Exchange.
NYCE	New York Cotton Exchange.
OTC	Over-the-Counter.
SEC	Securities Exchange Commission.
USA	United States of America.
UKHL	United Kingdom House of Lords.
UK	United Kingdom.
WLR	Weekly Law Report.

ABSTRACT

The expansion and development of Kenya's financial markets have led to the diversification of services and products in the capital markets. These measures aimed at expanding and developing the financial markets are in tandem with the Kenyan government's aspirations to catalyze Kenya into a middle-income country by the year 2030. These development aspirations are embodied under the Vision 2030 development blueprint. The development of the financial markets in Kenya has, in the last one decade, seen the development of a legal and institutional framework on a derivatives exchange to complement the existing over-the-counter (OTC) derivatives market.

Derivatives are unique financial securities as their trading is subject to their underlying assets as compared to debt and equity securities, such as bonds and shares respectively, whose trading depends on the reputation or standing of the issuer. Investors use derivatives as instruments for hedging risks, arbitrage or speculation.

With the derivatives exchange in Kenya still at its nascent stages, there is the need to evaluate and analyse the supporting legal framework to include *inter alia*, the impact of the legal regime on combating financial crimes on the overall derivatives market. Kenya has put in place an elaborate legal and institutional framework to combat crimes at all levels of the economy, including in the derivatives market. However, in some instances, the law, enforcement and compensation frameworks on combating financial crimes are not in tandem with the developmental objectives of the derivatives market in Kenya. This study evaluates the existence of laws aimed at preventing crimes in the derivatives markets and appraises their suitability in the development of the derivatives market in Kenya.

CHAPTER ONE

INTRODUCTION

1.0 Introduction

Kenya's quest to expand its financial markets in the last two decades has led to the introduction of diverse products, including derivatives,¹ aimed at widening the financial markets.² A derivative is a financial instrument, contractual in nature, which derives its value from an underlying asset.³ The underlying asset can either be currency, equity, bond, interest rate, commodity or a combination of these assets.⁴ There are mainly four types of derivative instruments: futures, swaps, forwards, and options.⁵ Derivatives instruments offer investors platforms for the management of financial risks as they allow investors to offset risks to third parties, while at the same time making financial returns.⁶

The derivatives market is mainly divided into two: the Over-the-Counter (OTC) market and the derivative exchange. An OTC market is a decentralised market, without necessarily having a physical location, where market participants (sellers, buyers and brokers) trade with one another without the trading been disclosed to others and with no or minimal regulatory oversight.⁷ On the other hand, a derivatives exchange is a central location where derivatives are traded on and their trading is subject to regulatory oversight.⁸

¹ The Capital Markets (Futures Exchanges) (Licensing Requirements) Regulations (2013) (Repealed) and the Capital Markets (Derivatives Markets) Regulations (2015).

² Financial widening' is the increase in the number of financial services available to the public. It envisages the diversification of financial products.

³ Sanjeev Gupta, *Financial Derivatives Theory, Concepts and Problems* (India: Prentice Hall, 2015).

⁴ Timothy Lynch, 'Derivatives: A Twenty-First Century Understanding' (2011) 43 (2) *Loyola University Chicago Law Journal*, 3-50.

⁵ Futures are contracts for assets bought at an agreed price but delivered and paid for later and are mainly traded in the derivatives exchange.

Forwards are contracts between two or more parties to buy or sell assets on a specified price on a future date and are mainly traded in the OTC markets.

Swaps are contracts that involve the exchange of financial instruments between the parties with each party hoping to benefit more from the financial asset obtained than the one exchanged.

Options are contracts that allow a person to buy an asset at a specified price in the future.

These instruments are discussed in detail in Chapter Two.

⁶ *ibid.*

⁷ George Tsetsekos and Panos Varangis, 'Lessons in Structuring Derivatives Exchange' (February 2000) 15(1) *The World Bank Research Observer*, 85-98.

⁸ *ibid.*

Developments aimed at expanding the capital markets often call for a focus on the supporting legal framework to ensure that the objectives such expansion are supported under the law. One of the key supporting areas of law, which forms the crux of this study, is criminal law. The overall focus of this study is to appraise the suitability of the legal framework on combating financial crimes on the development of the derivatives market in Kenya.

This chapter delves into the study's background with an emphasis on the statement of the problem, the hypotheses, research methodology, research questions, sources of information; justifications and objectives, the theoretical framework and the overall arrangement of the chapters.

1.1 Background of the Study

Globally, financial systems have been (and are) targets of acts or omissions aimed at depriving investors and other stakeholders of their investments, money or gains: these unlawful acts or omissions are aptly referred to as 'financial crimes'.⁹ There is no specific definition of the term "financial crime" as the acts and omissions that constitute such crimes are too broad and wide and thus the definition may be said to be subjective.¹⁰ Primarily, the use of the term 'financial crime' is in reference to any non-violent crime which leads to financial loss. Financial crimes will range from embezzlement of financial resources; bribery and kickbacks; financial fraud and financially based cyber-crimes; terrorism financing and money laundering; to specific capital market offences like market manipulation, market abuse, insider trading and false trading.¹¹

As East Africa's financial hub, Kenya is vulnerable to financial crimes due to the continued development and attractiveness of its financial markets.¹² Kenya's financial markets are relatively more developed as compared to the other East African countries.¹³ The Kenyan financial markets are mainly characterised by the ever-expanding financial institutions and

⁹ Gerald Cliff and Christian Desilets, 'White Collar Crime: What It Is and Where It's Going' (2014) 28(2) Notre Dame Journal of Law, Ethics & Public Policy, 482.
><http://scholarship.law.nd.edu/cgi/viewcontent.cgi?article=1733&context=ndjlepp>< accessed 15th November 2016.

¹⁰ *Ibid.*

¹¹ Spencer Pickett, and Jennifer Pickett, *Financial Crime Investigation and Control* (Wiley, 2002).

¹² *ibid.*

¹³ Francis Mwea, 'Financial regulation in Kenya: Balancing Inclusive Growth with Financial Stability' (Overseas Development Institute Working Paper 2014), 2-5. <<http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/9279.pdf>> accessed 20th November 2016.

intermediaries like banks, microfinance institutions, savings and credit cooperatives, insurers, foreign exchange bureaus and a robust capital markets.¹⁴

Kenya's financial markets have undergone significant positive developments over the last three or so decades.¹⁵ These developments have been done with an aim of widening and deepening the financial services sector in tandem with Kenya's Vision 2030.¹⁶ These developments have resulted in the diversification of financial products, amongst them, the development of derivatives contracts trading in the OTC and exchange markets and the entry of additional financial market intermediaries and participants.¹⁷

It is against this backdrop of tremendous growth in Kenya's financial sector that saw Kenya's legislature and the Capital Markets Authority (CMA) put in place a legal and institutional framework on trading of derivatives in an exchange set up.¹⁸ This is in addition to the current OTC derivatives market where the derivatives are traded bilaterally between counterparties.¹⁹

Just like Kenya, policymakers and governments in Africa have continued to underscore the importance of developing their securities markets through product diversification and creation of an efficient regulatory regime as important aspects of catalysing economic growth and development through the money markets.²⁰ The establishment of a well-structured derivatives markets is not only critical in ensuring transparency in the money markets but is instrumental in stabilising the prices of commodities like grains; providing financial resources to investors and providing market participants and investors with opportunities to hedge and manage

¹⁴ FSD Kenya, *Financial access in Kenya. Results of the 2007 National Survey* (Nairobi, 2007)

¹⁵ Francis Mwea (n 13), 15-18.

¹⁶ <http://www.vision2030.go.ke/pillars/>> accessed 20th November 2016.

Vision 2030 is aimed at transforming Kenya into a "newly industrializing, middle-income country providing a high-quality life to its citizens by the year 2030" and is centred on the economic, social and political pillars. The development of financial is one of the drivers of the economic pillar. The development of the financial sector envisages the deepening and widening of the capital markets.

¹⁷ *ibid*, 13.

¹⁸ Ken Kahugu, 'A highlight of the Kenyan Budget-2010/2011' The Daily Nation Newspaper (Nairobi Kenya 10th June 2010)

¹⁹ Cedric Achille, Lamon Rutten et al, *Guidebook on African Commodities and Derivatives Markets* (African Development Bank, 2013), 69 and 77.

²⁰ Nancy Laibuni, Githinji Njenga, et al, 'Is There Need for an East African Commodity Exchange?' Kenya Institute of Policy Research and Analysis working paper 4/2013.

risks.²¹ Additionally, derivatives trading results in additional job opportunities as well as enhanced economic cooperation between people from different countries with cross-border based derivatives trading providing avenues for foreign investment.²²

In Kenya, the state has an obligation under Article 40 of the Constitution of Kenya to ensure that legally acquire property shall not be arbitrarily deprived off.²³ The state thus has a duty to provide a legal framework to prohibit and criminalise the arbitrary deprivation of lawful property.²⁴ This imposes a duty on the state to prevent financial crimes; the unlawful conversion of property.²⁵ Jennifer and Spencer Pickett in their book on financial crimes control encapsulate ‘financial crime’ as “the use of deception for illegal gain, normally involving a breach of trust, and some concealment of the true nature of the activities”.²⁶

Just like any other securities market, the prevention of financial crimes, as an aspect of ensuring market integrity, is critical for the efficient and proper functioning of a derivatives market.²⁷ Derivatives markets are prone to financial crimes: in particular, derivatives markets are prone to economic crimes that affect the general economy like corruption, theft, fraud and money laundering, and to market-specific offences, *inter alia*, market manipulation, false trading, and insider trading.²⁸

Sound anti-financial crimes legal framework not only ensures market integrity but ensures that criminals do not benefit from their crimes and also protects the derivatives market from manipulation and abuse.²⁹ With the derivatives exchange still in its nascent stages, Kenya has put in place a legal and institutional framework on combating financial crimes both at the general economy and the derivatives market levels.³⁰ The legal framework establishes a hybrid

²¹Anthony Saunders and Millon Cornett, *Financial Institutions Management: A Risk Management Approach* (6th ed, Mc-Graw Hill Irwin, 2008), 691-768, 769-789.

²² *ibid.*,

²³ Constitution of Kenya, Art 40 (2).

²⁴ *ibid.*

²⁵ Pickett (n 11).

²⁶ *ibid.*

²⁷ *ibid.*

²⁸ Discussed in chapter 3.

²⁹ *ibid.*

³⁰ The law on financial crimes grounded on laws and institutions relating to anti-corruption, the police service, public prosecutions, and prevention money laundering and the use of proceeds of crime. Discussed in more detail in chapter three of this study.

regulatory structure that revolves around state organs, financial markets regulators and market players in the prevention and combating of financial crimes that (may) arise in the derivatives market.³¹

The study will focus on appraising the suitability and adequacy of this legal regime on combating financial crimes in promoting the development of derivatives trading in Kenya. The derivatives market, which is part of the financial markets in Kenya, will always play a vital role in the overall development of Kenya as the capital markets are critical in mobilising capital in the economy.³²

1.2 Statement of the Problem

The regulatory regime on the prevention of crimes focuses on the prevention of crimes in both the general and specific sectors of the economy. Criminal activities occur across all spectres of the society and may affect the operations of specific sectors of the economy. In the financial securities market, criminal behaviour may result in the pecuniary loss by investors and loss of market integrity and confidence. With a relatively well-established OTC derivatives market and the development of the derivatives exchange still at its nascent stages in Kenya, there is the need to evaluate and analyse the impact of the criminal law regime on the overall derivatives market.

The current Kenyan legal framework on combating financial crimes is inadequate in ensuring the development of the derivatives market. The rigidity of the criminal law regime will curtail the development of some products into the derivatives exchange because the trading of such products will be against the criminal law regime. For example, the emergence of derivatives like credit default swaps (CDS) globally, which rely on insider information in their trading, call for a rethink on the absolute criminalisation of insider trading in Kenya, especially where such products may eventually trade in exchanges.

Further, whereas the OTC derivatives market is relatively developed than the derivatives exchange, it is less regulated in relation to the regulatory framework against specific market

³¹*ibid.*

³² Marylyse Linda, 'Effect of Financial Deepening on Financial Growth in Kenya' 4(7) (2015) International Journal of Business and Commerce, 1-50.

offences, unlike the exchange market. This may erode the integrity and confidence of the overall derivatives market in Kenya.

The implementation and compensation regime under the criminal law regime is structured to offer inadequate compensation and continues to rely on a disjointed enforcement mechanism with enforcement institutions performing overlapping and conflicting roles. This ultimately results in a legal framework that is inadequate in protecting the derivatives markets from the negative impacts of financial crimes.

1.3 Justification of the Study

There are inadequate information and literature on the link between criminal law and the capital markets. Given also the limited research on the legal regime on derivatives trading in Kenya, this study is important in bridging this knowledge gap. This is especially in the synthesis of the impact of the current legal framework on financial crimes on the derivatives market in Kenya, which is still a developing market.

The study will be instrumental in setting the ground for a review and critical appraisal, by policymakers and market regulators, on the need to provide a legal framework that balances the objectives of criminal law and the developmental objectives of the financial and capital markets in Kenya.

1.4 Theoretical Framework

1.4.1 Modernisation Theory of Development

The modernisation theory of development is used to explain the process of development that countries go through.³³ At the heart of the theory is the gradual transition of states from traditional to modern societies.³⁴ The theory maintains that traditional or pre-modern societies will develop into modern societies as they adopt more modern practices.³⁵ With different views

³³ Primrose Mawire, 'The Missing Link: Implications of Modernisation Theory and the Dependency Theory in Africa's Quest for Development', (July-August, 2013) 33(5) IOSR Journal of Humanities and Social Sciences, 41.

³⁴ *ibid.*

³⁵ Wil Hout, 'Classical Approaches to Development: Modernisation and Dependency' "in Jin Grudel and Daniel Hammeds (eds), *the Palgrave Handbook of International Development* (Macmillan 2016), 21-39.

on modernisation theory, the focus will be on Walt Rostow's theoretical postulations of development.³⁶

Walt Rostow conceptualises a country's development through five main stages.³⁷ The first stage is the traditional society.³⁸ The traditional economy has an unlimited production function with a surplus of resources.³⁹ There is no application of modern technology in a traditional economy.⁴⁰ The traditional society is viewed as agricultural or agrarian-based. The second stage, pre-conditions for take-off is characterised by the building of conditions for growth.⁴¹ It involves a shift from agrarian-based economies to the gradual introduction of industries. There is a gradual increase in international trade and there is an increase in technology application. The third stage, known as take-off, is a period of increased economic growth.⁴² The economy starts been driven by technological advancements, industries and the service industry and the aspects of the traditional economy start to fade away.⁴³ The fourth stage, the drive to maturity, is a prolonged phase towards sustainable economic growth.⁴⁴ The fifth stage is the mass consumption stage. This stage is characterised by an increase in the real income.⁴⁵

The development of Kenya's capital market is to be juxtaposed with the modernisation theory of development. Prior to the colonisation of Kenya at the start of the twentieth century, Kenya was an agrarian based economy.⁴⁶ The economy of the inhabitants was based on crop growing, hunting, and gathering.⁴⁷ The capital market was unheard of and there was no stock exchange. With the coming of the Europeans, Kenya was ushered into the second stage of growth: pre-conditions of growth. This involved the introduction of basic industries to the already existing agricultural economy.⁴⁸ This stage ushered in the Kenyan capital markets.⁴⁹ The 1920s ushered

³⁶ *ibid.*

³⁷ Walt Rostow, 'The Stages of Economic Growth' (1959) 12(1) *The Economic History Review*, 1-16.<
http://www.ufjf.br/oliveira_junior/files/2009/06/rostow.pdf> accessed 20th November 2016.

³⁸ *ibid.*, 4.

³⁹ *ibid.*

⁴⁰ *ibid.*

⁴¹ *ibid.*

⁴² *ibid.*, 7.

⁴³ *ibid.*

⁴⁴ *ibid.*, 8.

⁴⁵ *ibid.*, 11-13.

⁴⁶ Charles Hornsby, *Kenya. A History Since Independence* (I.B Tauris London 2012), 26-27.

⁴⁷ *Ibid.*

⁴⁸ *ibid.*, 27-35.

in share trading and the introduction of the Nairobi Stock Exchange at an informal level as an association of white stockbrokers.⁵⁰ The period after 1954 marked the formalisation of share trading.⁵¹

With Kenya becoming independent in 1964, the country gradually entered into a period of take-off.⁵² As the country trudged into the twenty-first century, with technological advancements and the growth of industries, aspects of the traditional economy started to fade away.⁵³ The capital markets began to be formally structured and the Kenyan securities exchange began dominating the East African region.⁵⁴ Many reforms introduced in the financial sub-sectors of banking, capital markets, pensions, and insurance led to increased financial innovation, and the proliferation of financial products.⁵⁵ These reforms, actualised through the improvement of the legal, regulatory and the institutional framework have over the years led to Kenya's achievement of wider developmental goals, including infrastructural development.⁵⁶

It is against this backdrop of the tremendous growth of Kenya's financial sector, particularly in the capital markets that have seen Kenya put in place a legal and institutional framework on Derivatives.⁵⁷ This is in tandem with the 2014-2023 Capital Markets Authority Master plan aimed at 'widening and deepening' of the securities markets.⁵⁸

As Kenya transitions to the fourth stage-the drive to maturity and the fifth stage-mass consumption, financial development will play a critical role in ensuring increased economic development.⁵⁹ As encapsulated by Ronald McKinnon on the role of the money and capital

⁴⁹ Rose Ngugi, 'Development of the Nairobi Stock Exchange: A Historical Perspective' (KIPPRA Discussion Paper No.27, 2003), 4-5.

⁵⁰ *ibid.*, 4.

⁵¹ *ibid.*, 5-12.

⁵² Hornsby (n 46), 420-421, 431-435, 469-473.

⁵³ *ibid.*

⁵⁴ Ngugi (n 49), 18-40.

⁵⁵ The Capital Markets Authority, 'Policy Framework and International Best Practices for a Futures Derivatives Market' (2014) <http://www.cma.or.ke/index.php?view=download&alias=225-policy-framework-and-international-best-practices-for-a-futures-derivatives-market&category_slug=researchpapers&option=com_docman&Itemid=587> accessed 10th November 2016.

⁵⁶ *ibid.*

⁵⁷ *ibid.*

⁵⁸ The Capital Markets Authority, 'Capital Markets Master Plan -2014-2023'(2nd ed, 2016). This is a 10-year master plan to provide strategic direction for the Authority. One of the key objectives of this master plan is to broaden the products and services of the capital markets.

⁵⁹ *ibid.*

markets development in an economy, there is a very strong link between the development of the financial sector and economic growth and development.⁶⁰ Accordingly, economic development creates demand for financial services and the financial markets respond automatically to these demands.⁶¹

Kenya's Vision 2030 underpins the need for increased economic development to enable the country meet the needs of its people.⁶² The development of financial markets is critical to the economic development of Kenya.⁶³ The need to develop Kenya's financial market is the foundation of financial innovation: this has led Kenya to develop a derivatives market to catalyse economic growth.⁶⁴ This approach of linking financial markets to development, calls for a re-evaluation or re-structuring of the financial markets regulatory regime with an aim of encouraging more development in the financial sector and at the same time ensuring investor protection.⁶⁵ In particular, one of the objectives of this study was to highlight the legal and institutional structure of the derivatives market in Kenya as key to economic development and how the anti-financial crimes regime fits into the development objective of the derivatives market.

1.4.2 Market Integrity Theory

Pioneered by Bryan Fodor, the Market Integrity Theory underpins the importance of integrity in financial markets, including in the derivatives trading markets.⁶⁶ Market integrity is primarily grounded on such measures such as low crime levels, the efficiency of law enforcement, market fairness and equal access to information by investors, prevention of financial crimes, adequate compensation mechanisms and utilisation of measures to boost market confidence.⁶⁷

Instructively, this theory postulates that the integrity of the financial market is measured by analysing the levels of misconduct and dishonesty in the market vis-a-vis the efforts that have

⁶⁰ Ronald McKinnon, *Money and Capital in Economic Development* (Washington, 1973).

⁶¹ *ibid.*

⁶² The Government of Kenya, *Kenya Vision 2030: A Globally Competitive and Prosperous Kenya* (2007), 87-92.

⁶³ *ibid.*

⁶⁴ The Capital Markets Authority (n 65), 29, 42 and 103.

⁶⁵ Edward Shaw, *Financial Deepening in Economic Development* (New York 1973).

⁶⁶ Bryan Fodor, 'Measuring Market Integrity: A Proposed Canadian Approach' (2008) 3 (15) *Journal of Financial Crime*, 261-268.

⁶⁷ *ibid.*

been undertaken to detect, prevent and educate market participants on such dishonesty and misconduct and promote efficiency and fairness.⁶⁸

Bryan Fodor encapsulates that there is a delicate interplay between law enforcement and the extent of misconduct and dishonesty in the market. The legal and institutional regimes influence the integrity of markets by encouraging or preventing misconduct and government (in)action in relation to regulating the market.⁶⁹

In order to ensure the development of the derivatives market and safeguard the integrity of the securities market, the law must be used as a tool of control and regulation.⁷⁰ The law serves various functions in any society, *inter alia*: as a tool for establishing acceptable standards; maintaining harmony and order; dispute resolution and protecting rights and freedoms.⁷¹

The role of the law in financial market development can be juxtaposed with the law matters thesis. In their groundbreaking research on investor protection under the law matters thesis, Rafael La Porta, Florencio Lopez *et al* revealed that the law is critical in shaping economic development and growth.⁷² The Law matters thesis perspective was first published in the 1998 paper ‘Law and Finance’ by Rafael La Porta, Florencio Lopez *et al*.⁷³ They established that the efficacy and success of a financial system mainly depend on the level of investor protection.⁷⁴ The aim of the law should be to protect investors from expropriation of their investments by the state.⁷⁵ Though the studies of Rafael La Porta, Florencio Lopez *et al* were broad-based as they also analysed economic and political systems in the areas of banking, labour markets, and corporate ownership, it is their research on investor protection that formed the crux of this study.

⁶⁸ *ibid.*

⁶⁹ *ibid.*

⁷⁰ Linus McManam, ‘Social Engineering: The Legal Philosophy of Roscoe Pound’ 33(1) (1958) St. John’s Law Review, 45-47.

⁷¹ David Funk, ‘Major Functions of the Law in a Modern Society Featured’ 23(2) (1972) Cape Western Reserve Law Review, 257-306

> <https://scholarlycommons.law.case.edu/cgi/viewcontent.cgi?article=2885&context=caselrev> accessed 19th November 2016.

⁷² Rafael La Porta, Florencio Lopez *et al*, ‘Law and Finance’ Journal of Political Economy 106 (1998), 1113-1155.

⁷³ *ibid.*

⁷⁴ *ibid.*

⁷⁵ *ibid.*

In buttressing what they termed as the law matters thesis, Rafael La Porta, Florencio Lopez *et al* in an earlier paper on the factors that affect the size of capital markets, postulated that countries with a higher number of initial public offers and listings exhibited better legal structures and enforcement.⁷⁶

Although the politics and finance theory rejects the importance of legal structures in financial development due to the enormous changes in the finance realm over the last decades without any significant changes in the law,⁷⁷ the existence of a legal regime that protects property rights in securities such as derivatives is critical for market development. Without such a legal system, there would be a lot of uncertainty and room for financial crimes. In this study, the Market Integrity theory offers the theoretical basis for protecting Kenya's derivatives market from financial crimes. The presence and prevalence of criminal activities in a derivatives market will erode the integrity and confidence in the market. The study builds on this market integrity theory to justify the existence of a regulatory regime aimed at preventing crimes in the derivatives market.

1.5 Literature Review

This section analyses the key secondary literature that the author relied upon. More instructively, this section focuses on the two key thematic areas that underpin this study: the place of the law in ensuring the growth and development of the derivatives market in Kenya and the role of the law in preventing financial crimes in order to safeguard the integrity and confidence of the derivatives market.

1.5.1 Derivatives and the Law on Derivatives

With the study's focus on the impact of the anti-financial crimes legal framework on the development of derivatives trading and not derivatives trading in Kenya, there is the need to have a general understanding on the legal structure of derivatives, their trading and legal basis in Kenya.

⁷⁶ Rafael La Porta, Florencio Lopez *et al*, 'Legal Determinants of External Finance' 52(3) (1998) *Journal of Finance*, 1131-1150.

⁷⁷ Ross Levine, *Legal Theories of Financial Development* (University of Minnesota, 2001), 5 > http://siteresources.worldbank.org/DEC/Resources/Legal_Theories_of_Financial_Development.pdf< accessed 20th November 2016.

Francis Mwege in arguing the case for financial innovation and development in Kenya draws from Kenya's Vision 2030 blueprint (the "Vision").⁷⁸ The structural framework on Kenya's Vision 2030 is on three main "pillars": the economic, political and social pillars.⁷⁹ Under the economic pillar, the Vision places focus on the development of the financial services sector as key to economic development and growth.⁸⁰ The development of the financial sector as envisaged under the Vision includes, *inter alia*: deepening of the capital markets and legal reforms aimed at bolstering capital markets transparency, integrity, and adequate enforcement mechanisms.⁸¹

Although the Vision is silent on the development of the derivatives markets, it is critical in linking financial markets development, the formulation of an anti-financial crimes structure and economic growth. In relation to financial markets development, the Vision places attention to the connection between the development of financial markets and economic development which forms the basis for the development of the derivatives market as part of 'deepening and widening' the capital markets as envisioned by Edward Shaw, in his 1973 book, '*Financial Deepening in Economic Development*'.⁸² This basis is critical in interrogating the foundational structure of the derivatives markets in Kenya which forms a critical objective of this study.

Gupta Sanjeev, in his book on financial derivatives, offers an instrumental understanding of derivatives instruments.⁸³ Gupta underscores the importance of derivatives instruments as they offer effective price signals of their underlying assets.⁸⁴ Similarly, the understanding on derivatives in other jurisdictions, like the United States of America, which may have informed the structure of Kenya's market, was also informed by journal articles by Abanomey and Mathur,⁸⁵ and George Tsetsekos.⁸⁶

⁷⁸ Mwege (n 13), 2.

⁷⁹ Kenya Vision 2030 is the country's development blueprint launched in 2008. It aims to transform Kenya into a "newly industrializing, middle-income country providing a high-quality life to its citizens by the year 2030". See Vision 2030 blueprint available at <http://www.nesc.go.ke> accessed 20th November 2016.

⁸⁰ *ibid.*

⁸¹ *ibid.*

⁸² Shaw (n 65).

⁸³ Sanjeev Gupta, *Financial Derivatives Theory, Concepts and Problems* (India: Prentice Hall, 2015).

⁸⁴ *ibid.*

⁸⁵ Abanomey and Mathur, 'International Portfolios with Commodity Futures and Currency Forward Contracts' (2001) 10 (3) *The Journal of Investing*, 61-68.

Although this material is written from a non-Kenyan market perspective, they offer critical insights about derivatives, the different types of derivatives, their importance and trading which is critical in understanding the various types of derivatives in Kenya. This is in line with one of the study's key objectives; to highlight the structure of the derivatives market in Kenya

Similarly, Timothy Lynch, in his journal article aptly titled "*Derivatives: A Twenty-First Century Understanding*" succinctly discusses modern-day derivatives trading.⁸⁷ The article gives insights on exchange-traded and cleared derivatives vis-à-vis OTC trade derivatives, and the trading of derivatives.⁸⁸ Although Timothy Lynch's article uses a technical financial language which is not the focus of this study, it provides an understanding of derivatives and their trading.⁸⁹

In tracing the relationship between the law and derivatives, Henry Bakken encapsulates that "since time immemorial, the great nemesis of those engaged in trading in futures [a type of a derivatives instrument] was the law".⁹⁰ The author traces this inadequacy of the law in recognising derivatives, in what he terms as "a long struggle spanning nearly 300 years", from 1610's Holland's prevention of short selling⁹¹ to the 1905 USA case of *Board of Trade v Christie Grain and Stock Company*,⁹² in which the Supreme Court held that mere substitution in the performance of a contract constituted delivery. The judges, despite their skill set, found it exceedingly difficult to understand a short sale.⁹³

In analysing the legal framework on derivatives, Alastair Hudson in his book, '*The Law on Financial Derivatives*' explores the nature and documentation of the derivatives contract.⁹⁴ The author ties the substantive English legal position on derivatives from the common law of

⁸⁶ George Tsetsekos and PanosVarangis, 'Lessons in Structuring Derivatives Exchange' (February 2000) 15(1) The World Bank Research Observer, 85-98.

⁸⁷ Timothy Lynch, 'Derivatives: A Twenty-First Century Understanding' (2011) 43 (2) Loyola University Chicago Law Journal, 3-50.

⁸⁸ *ibid.*

⁸⁹ *ibid.*

⁹⁰ Henry Bakken, *Futures Trading - Origin, Development and Present Economic Status* (Mimir Publishers Inc 1966), 6.

⁹¹ Selling of a security not owned by the seller.

⁹² (1905) 198 U.S., 236.

⁹³ Bakken (n 90), 6.

⁹⁴ Alastair Hudson, *The Law on Financial Derivatives* (Sweet and Maxwell, 1996)

contract to the enactment of a *sui generis* legal regime on derivatives trading in the United Kingdom.⁹⁵

Alastair Hudson's book and Henry Bakken's article are critical in providing case laws and English pre-legislative policy analysis on derivatives.⁹⁶ The authors go further and analyse issues touching on fraud and bribery in the derivatives market in more detail.⁹⁷ Although their focuses on non-Kenyan law, they provide key discussion points that were necessary to this study, key amongst them: the history of derivative instruments and the structure and nature of derivative instruments.⁹⁸

A derivative is a financial instrument, contractual in nature, which derives its value from an underlying asset.⁹⁹ Hugh Beale, in his edited book on contract law, notes that the law of contracts is concerned with the enforcement of agreements between parties.¹⁰⁰ Not all agreements are enforceable. The courts will look at the presence of certain key elements in all agreements before a court can enforce a contract. These elements include offer and acceptance, consideration, capacity, intention to create legal relations and form. In the absence of these elements, the agreement is invalid.¹⁰¹ Additionally, at the heart of English common law on contracts is the concept of 'consensus ad idem' (meeting of the minds) as critical to any valid contract.¹⁰² Without necessarily discussing derivative contracts, Hugh Beale offers the English common law position on contracts, which law continues to guide the formation of contracts, including derivative contracts in Kenya.¹⁰³

Although much of the literature on derivatives and the legal regime on derivatives is mainly non-African and non-Kenyan based, they are instrumental in understanding two key areas of focus of the study; First, the institutional structure of the derivatives market and secondly, the

⁹⁵*ibid.*

⁹⁶*ibid.*

⁹⁷*ibid.*

Additionally, the author analyses the use of derivatives as security and gives a synopsis of the taxation regime for derivatives.

⁹⁸*ibid.*

⁹⁹ Gupta (n 83).

¹⁰⁰ Hugh Beale (ed), *Chitty on Contract*, (38th ed, Vol 1, Sweet and Maxwell, 1999) 1-001-1-011, 1-7.

¹⁰¹*ibid.*

¹⁰² Beale (n 100), 1-011.

¹⁰³ Nancy Laibuni, Githinji Njenga, *et al*, 'Is There Need for an East African Commodity Exchange?' Kenya Institute of Policy Research and Analysis working paper 4/2013.

legal structure of derivatives. These two inform one of the study's key objectives of highlighting the legal and institutional structure of the derivatives market in Kenya.

It is worth noting that over the last two decades, the African Development Bank (ADB), the Capital Markets Authority (CMA) and the Kenya Institute of Public Policy Research and Analysis (KIPPRA) have been on the forefront in spearheading research on derivatives in Kenya and Africa in general. In particular, KIPPRA, through a 2013 study conducted by Nancy Laibuni, Moses Njenga, *et al*, underscored the need for formalised and institutionalised commodities derivatives market.¹⁰⁴ Their study was similar to ADB's sanctioned 'Guidebook on African Commodity and Derivatives Exchanges'.¹⁰⁵

1.5.2 Safeguarding against Financial Crimes: Regulation and Market Integrity

The legal conceptualisation of crimes in Kenya is instrumental in understanding financial crimes that are likely to occur in the derivatives market. In providing the nature of crimes under Kenya's criminal law regime, William Musyoka, in his book on criminal law, notes that crimes are conceptualised as public wrongs, either through an act or omission which is prohibited under the law.¹⁰⁶ The decision to criminalise an act or omission is done by an authorised sovereign body.¹⁰⁷ A crime has three main characteristics: one, it must be a harm emanating from human conduct, which the law seeks to prevent; two, the crime attracts a sanction to the offender.¹⁰⁸ Importantly, even though William Musyoka does not delve into the realm of financial crimes, the book offers the key legal elements of crimes and analyses the statutory principles, structure, and framework of criminal law in Kenya.

In analyzing the meaning and scope of the term 'financial crime', Spencer and Jennifer Pickett in their book titled '*financial crime, investigation and control*' conceptualise it as "the use of deception for illegal gain, normally involving the breach of trust, and some concealment of the true nature of the activities".¹⁰⁹ This position is also led credence by Gerald Desilet's journal

¹⁰⁴ *ibid.*

¹⁰⁵ African Development Bank (ADB), *Guidebook on African Derivatives Exchanges* (Abidjan, 2013).

¹⁰⁶ William Musyoka, *Criminal Law* (Law Africa, 2013), 1-20.

¹⁰⁷ *ibid.*

¹⁰⁸ This can be through non-custodial or a custodial punishment; and three, a formal legal process outlined under statute determines whether an accused or suspect is guilty or innocent.

¹⁰⁹ Spencer Pickett, and Jennifer Pickett, *Financial Crime Investigation and Control* (Wiley, 2002).

article on white-collar crime that puts financial crimes as part of white-collar crimes and is instrumental in providing the basis on which the law views such crimes.¹¹⁰

For purposes of ensuring proper draftsmanship in categorising financial crimes, Peter Gottschalk in his article aptly titled ‘Categories of Financial Crime’ classifies financial crimes into four broad categories: corruption, fraud, theft, and manipulation.¹¹¹ Written from a global perspective, this categorisation forms the basis for understanding the nature of financial crimes. More importantly, Peter Gottschalk discusses the specific crimes that constitute the set of crimes identified as ‘financial crimes’. Based on this categorisation espoused by Peter Gottschalk, this study evaluates the suitability of the Kenyan legal framework on the development of the derivatives market (more particular discussed in chapter 3).

In analysing the critical role of the law in regulation, Rafael La Porta, Florencio Lopez *et al* postulate that the law is critical in shaping economic development and growth.¹¹² They established that the efficacy and success of a financial system mainly depend on investor protection.¹¹³ The law serves various functions in any society: the law is a tool for establishing acceptable standards; maintaining harmony and order; dispute resolution and protecting rights and freedoms.¹¹⁴ The work of Rafael La Porta, Florencio Lopez *et al* is critical in this study as it provides the justification for evaluating the role of the law against crime on the development of the derivatives market in Kenya.

In protecting the financial markets from financial crimes, Masahiro Kawai and Eswar Prasad,¹¹⁵ observe that globally, in relation to other economic sectors, a more robust and elaborate regulatory structure has been established in the financial services sector.¹¹⁶ Due to the fiduciary nature of most financial products and services, the consumer of such services must be protected

¹¹⁰ Gerald Cliff and Christian Desilets, ‘White-Collar crime: What it is and Where is it Going?’ (2014) 18(2) Notre Dame Journal of Law, Ethics and Public Policy, 482-87.

¹¹¹ Peter Gottschalk, ‘Categories of Financial Crime’ 17 (4) Journal of Finance and Crime, 441-45.

¹¹² Rafael La Porta, Florencio Lopez *et al*, ‘Law and Finance’ (1998)106 Journal of Political Economy, 1113-1155.

¹¹³ *ibid.*

¹¹⁴ David Funk, ‘Major Functions of the Law in a Modern Society Featured’ (1972) 23(2) Cape Western Reserve Law Review, 257-306

<<https://scholarlycommons.law.case.edu/cgi/viewcontent.cgi?article=2885&context=caselrev>>accessed 19th November 2016.

¹¹⁵ Masahiro Kawai and Eswar Prasad, *Financial Markets Regulation and Reforms in Emerging Economies* (ADB, 2011), 3-21.

¹¹⁶ *ibid.*

from the consequences of a breach of the fiduciary relationship should it occur¹¹⁷ Thus, traders and market participants must protect consumers of financial services from financial crimes and opportunistic behaviour.¹¹⁸ With this book providing an important basis on the need for financial regulation, it provides little information on the institutional approach of such regulation.

Andreas Grünbichler and Patrick Darlap¹¹⁹ encapsulate that financial markets regulation is structured and designed to ensure financial stability and investor protection, especially to protect small and less informed investors and to prevent the dangers of monopolistic behaviour.¹²⁰ Countries should ensure that financial market supervision is well structured under the law and such supervisory role given to a properly functioning market regulator.¹²¹

Importantly, Andreas Grünbichler and Patrick Darlap provide a critical appraisal of the regulatory structure and the role of parliament in enacting the laws on regulation and the enforcement by a market regulator like CMA. However, they place little regard to the appropriate legal tools of market regulation.¹²² These tools include the use of contract laws, criminal laws, accounting policies and disclosure laws to ensure and facilitate efficiency in the market.

In outlining the approaches to regulatory structures in the securities markets, Jacob Gakeri provides that the regulatory approach is mainly either ‘government or government-led’ and/or ‘self-regulation’.¹²³ He breaks down self-regulation to “full intra-industry self-regulation” and “self-regulation with oversight”, “cooperative regulation” or “government-supervised self-regulation” which is a model that combines the attributes of government regulation and self-

¹¹⁷*ibid.*

¹¹⁸*ibid.*

¹¹⁹ Andreas Grünbichler and Patrick Darlap, *Regulation and Supervision of Financial Markets and Institutions A European Perspective* (Vienna 2003), 2-9.

¹²⁰*ibid.*

¹²¹*ibid.*

¹²² Stephen Crockett, ‘Central Banking, Financial Stability and Basel II’ (Speech at the 38th South Eastern Asia Central Banks Initiative Governors Conference held on 13th February 2003 in Manila, Phillipines).

¹²³ Jacob Gakeri, ‘Regulating Kenya’s Securities Markets: An Assessment of the Capital Markets Authority’s Enforcement Jurisprudence’ (2012) 2 (20) *International Journal of Humanities and Social Science*, 266-270.

regulation.¹²⁴ Importantly, although Jacob Gakeri does not focus on the regulatory regime that is specific to the derivatives market, he clearly points out the role of the Capital Markets Authority as the government-led regulatory regime vis-a-vis the role of the exchange and market intermediaries in self-regulation, which part of the study's focus on the derivatives exchange as a self-regulating organisation.

The above literature on combating financial crime and regulation of derivative markets, which cuts across various jurisdictions, is instrumental in providing the framework and principles that guide legal efforts aimed at combating financial crimes in the derivatives market as embodied under Kenyan law and in principles issued by the International Organisation of Securities and Capital Market Organisations (IOSCO) aimed at ensuring market integrity.¹²⁵ This is critical in appraising the current anti-financial crimes laws and their enforcement in the development and growth of the derivatives market in Kenya, which are the critical objectives of this study.

Ultimately, this study aims to evaluate the impact of the anti-financial crimes legal framework on the overall development of the derivatives market in Kenya in light of the fact that the OTC derivatives markets are still under-regulated. Levon Garlsan, in his journal article on getting a model universal regulatory framework for the OTC derivatives market, draws from lessons from USA and EU. Kenya can learn from the experiences of USA in re-thinking the regulatory approach for the OTC derivatives market.¹²⁶

Levon Garlsan postulates that prior to the financial crisis in 2008, USA's OTC derivatives markets were under-regulated. In a situation almost similar to the losses suffered by Kenya Airways in 2014-15 period due to the use of futures to hedge fuel, companies in the USA suffered huge losses due to investments in OTC traded derivatives.¹²⁷ For example, organisations such as Proctor & Gamble, Orange County Fund, and Mettalgeseellschaft AG

¹²⁴ *ibid*, 266.

¹²⁵ Bryan Fodor, 'Measuring Market Integrity: A Proposed Canadian Approach' (2008) 3 (15) *Journal of Financial Crime*, 261-268.

¹²⁶ Levon Garlsan, 'Towards a Universal Model Regulatory Framework for Derivatives: Post-Crisis Conclusions from the United States and the European Union' (2016) 37(3) *University of Pennsylvania Journal of Internal Law*, 966-969.

¹²⁷ *ibid*, 970-977.

made huge losses dealing in OTC derivatives.¹²⁸ Based on lessons from the USA, Kenya can take legal steps to subject the OTC derivatives market on the same anti-criminal laws as the derivatives exchange.¹²⁹

1.6 Research Objectives

1.6.1 General Objective

Appraise the suitability of the current legal framework on combating financial crimes on the development and growth of Kenya's derivatives market.

1.6.2 Specific Objectives

The specific objectives of the study are to:

- (i) succinctly outline and highlight the legal and institutional structure of the derivatives market in Kenya;
- (ii) appraise the impact of the current anti-financial crimes laws on the development and growth of the derivatives market in Kenya; and
- (iii) evaluate the impact of the criminal law enforcement and compensation mechanism on the growth and development of the derivatives market in Kenya.

1.7 Broad Argument Layout

Kenya has put in place an elaborate legal and institutional framework to combat crimes at all levels. The regulatory regime on prevention of crimes which is centred on legislation and institutions not only targets the entire economy but in some instances, it is sector specific. In the financial securities market, criminal behaviour is likely to result in the pecuniary loss by the investors and loss of market integrity and confidence.

The expansion and development of Kenya's financial markets have led to the diversification of products traded in the capital markets. This in line with the deliberate measures aimed at expanding the financial markets in line with Kenya's long-term economic blueprint, Vision

¹²⁸ Antanoli Kuprianov, 'Derivatives Debacles: Case Studies of Large Losses in the Derivatives Markets' (1995) 81(4) *Federal Bank of Richmond Economic Quarterly*, 1-7.

¹²⁹ Sahib Kholsa, 'Commodity Futures Trading in Kenya-Are We Ready for the Future?' (Master of Science in Actuarial Management, City University London, 2013), 12

2030. The introduction of a formalised derivatives markets legal regime in the second decade of the twenty-first century is in line with the expansion and development aspirations of the capital markets. Derivatives are unique financial securities, unlike other equity and debt securities like shares and bonds respectively, as their trading is subject to an underlying security, unlike shares and bonds which depend on the reputation or standing of the issuer. Derivatives can be used as for hedging risks, arbitrage and/or speculation.

The current Kenyan legal framework on combating financial crimes is inadequate in promoting the growth of the derivatives market in Kenya and ensuring sufficient protection to investors. Derivative contracts, due to their unique nature as securities backed by underlying assets, are prone to two levels of crimes, crimes directed at the security and those directed on the underlying assets. Even with the presence of suitable laws, the law has fallen short of ensuring that it is suited to prevent financial crimes. The rigidity of the law also curtails the development of more products in the derivatives market because the trading of such products will be against the criminal law regime. The global rise in derivative products like credit default swaps (CDS), which rely on access to non-public information of the sellers, calls for a rethink on the prohibition against insider trading, which prohibition exists under Kenyan laws.

Additionally, the financial crimes prevention regime in the derivatives market does not adequately cover the entire 'breadth and width' of the Kenyan derivatives market. The legal regime on the prevention and combating of market offences is targeted at criminal activities that are likely to happen or happen in the derivatives exchange. This effectively locks out the OTC derivatives market from the regime aimed at preventing market offences in derivatives trading.

The enforcement and compensation mechanism created under the law to combat financial crimes is inadequate. The regulatory regime offers inadequate compensation and establishes disjointed institutions that perform overlapping and conflicting roles. This ultimately results in a legal framework that is inadequate in protecting the derivatives markets from the negative impacts of financial crimes.

1.8 Research Hypotheses

Three hypotheses informed this study:

H.1 The legal and institutional structure of Kenya's Derivatives trading is still underdeveloped. The Derivatives Exchange is at its nascent stages, offering a limited number of tradable derivatives.

H.2 The current Kenyan legal framework on combating financial crimes is inadequate in the development of the derivatives market in Kenya and ensuring sufficient protection to investors as the derivatives market continues to develop. The rigidity of the law curtails the development of more products in the derivatives market because the trading of such products will be against the criminal law regime.

The financial crimes prevention regime does not adequately cover the entire breadth and width of the Kenyan derivatives market. The legal regime combating of market offences targets criminal activities that are likely to happen or happen in the derivatives exchange and ignores the OTC derivative markets.

H.3 The enforcement and compensation mechanism created under the law to combat financial crimes, though well-established in its structure, is inadequate. The regulatory regime offers inadequate compensation to the victims of financial crimes and establishes disjointed institutions that perform overlapping and conflicting roles. This ultimately results in a legal framework that is inadequate in protecting the derivatives markets from the negative impacts of financial crimes.

1.9 Research Questions

The following research questions underpinned this study:

- (i) How is the Kenyan derivatives market structured legally and institutionally?
- (ii) What is the impact of the legal regime on combating financial crimes in the growth and development of the Kenyan derivatives market? And
- (iii) What is the impact of the enforcement and compensation mechanism for financial crimes in the growth and development of the Kenyan derivatives market?

1.10 Research Methodology

This study is a qualitative type of research. By appraising the suitability of the legal regime on combating financial crimes in the development of the derivatives market in Kenya, the outcome was to determine the (in) appropriateness of the legal regime. The study achieved this through the analysis of the current laws on combating financial crime. The researcher did not collect numerical data in relation to financial crimes in the derivatives markets, as there were no recorded crimes in the derivatives market in Kenya at the time of finalising this study. This could be attributable to the fact that the exchange is still at its very nascent stages and the OTC market is not covered by the specific market criminal laws. The emphasis of the study was on the suitability of the legal regime of the legal regime on combating financial crimes in relation to the development of derivatives trading in Kenya. That is, whether the legal regime meets the objectives of the requirements of investor protection and development of the derivatives markets.

The study, which is legal and non-experimental in nature,¹³⁰ adopted the doctrinal legal research model. Doctrinal legal research involves the analysis of legislative and statutory provisions. The analysis aims at establishing the appropriate legal principles and ordering them in a logical manner.¹³¹ This informed the prevailing state of the legal regime in combating financial crimes in the derivatives market.

The researcher drew inferences from other jurisdictions with derivatives market in order to understand the appropriate regulatory model. These jurisdictions include the United Kingdom, the European Union, South Africa and the United States of America. It is worth noting, that although some of these jurisdictions are not common law jurisdictions like Kenya, they offer tremendous legal insights as they have well developed derivative markets compared to Kenya's.

¹³⁰ Wendy Olsen, *Data Collection* (London Sage, 2012), Ch 6.

A researcher will conduct a non-experimental research where he or she cannot manipulate the independent variable, in this case, financial crimes. The study is descriptive in nature and was concerned with obtaining information on the status and suitability of the legal framework aimed at combating financial crimes in the derivatives market in Kenya.

¹³¹ Paul Chynoweth, 'Legal Research in the Built Environments: A Methodological Approach (2014) 3 Salford Law Journal, 671.

The researcher used library and internet sources to collect and gather data and information. The primary sources of information included statutes and regulations. The secondary sources of information include books, case laws and judicial opinions, journals and legal periodicals. The resources at the Capital Markets Authority of Kenya resource centre, located in their offices on the second floor of Embankment Plaza in Nairobi's Upperhill area, were very instrumental in this study. The resource centre provided a wide array of literature on derivatives and regulation of security markets in Kenya and globally. The material used also by the CMA staff, ranged from books, journals, legislation and policies and internet-based information.

1.11 Chapter Breakdown

This study is broken down into five chapters:

Chapter One provides the introductory part of the study. As the introductory chapter, it delves into the study's background with an emphasis on the statement of the problem and the hypotheses, research methodology and research questions, sources of information; study's justifications and objectives; theoretical underpinnings of the study, and the overall arrangement of the chapters.

Chapter Two focuses on the legal and institutional structure of the derivatives market in Kenya. It outlines the legislative and policy framework on the derivatives market and its institutionalisation in Kenya.

Chapter Three appraises financial crimes as conceptualised under various laws and Regulations and Treaties applicable in Kenya. It lays focus on the elements, concepts of and aims of financial criminal law. More instructively, it appraises the law on money laundering, theft, fraud and market-specific offences. This chapter is specific to the financial crimes relevant to the derivatives market.

Chapter Four focuses on the enforcement and compensation regime of criminal law in Kenya. It appraises the suitability of this framework in the derivatives market.

Chapter Five summarises and concludes the study. Additionally the chapter provides recommendations and sums up this study.

CHAPTER TWO

THE LAW ON FINANCIAL DERIVATIVES: THE LEGAL AND INSTITUTIONAL STRUCTURE IN KENYA

2.0 Introduction

“...if we don’t speed up innovation and manage to launch more financing and investment vehicles, it will not only leave us shorthanded in meeting the increasingly diversified need of financial services from the real economy...”

Yang Kaisheng¹³²

Driven by the wisdom behind Yang Kaisheng’s quote above, Kenya’s financial sector has undergone tremendous changes in the last two decades.¹³³ Many reforms introduced in the financial sub-sectors of banking, capital markets, pensions and insurance have led to increased financial innovation and the proliferation of financial products and services that have improved and increased the efficiency of the financial system.¹³⁴ These reforms, actualised through the improvement of the legal, regulatory and the institutional framework have over the years led to the achievement of wider economic developmental goals like infrastructural development and enhanced access to financial services.¹³⁵

It is against this backdrop of tremendous growth in Kenya’s financial sector, particularly in the capital market, that saw Kenya put in place a legal and institutional framework on exchange-traded derivatives to complement the already existing OTC market¹³⁶ This is in line with the Capital Markets Authority Master plan that calls for the ‘widening and deepening’ of the capital markets.¹³⁷

¹³² Yang Kaisheng is a former president of the Industrial and Commercial Bank of China from 2005 to 2013.

¹³³ Francis Mwea (n 13), 2-5.

¹³⁴ The Capital Markets Authority, ‘Policy Framework and International Best Practices for a Futures Derivatives Market’ (2014), 3-24.<http://www.cma.or.ke/index.php?view=download&alias=225-policy-framework-and-international-best-practices-for-a-futures-derivatives-market&category_slug=researchpapers&option=com_docman&Itemid=587> accessed 10th November 2016.

¹³⁵ *ibid.*

¹³⁶ *ibid.*, 3.

¹³⁷ The Capital Markets Authority, ‘Capital Markets Master Plan -2014-2023’ (2nd ed, 2016).

The legal regime on derivatives is not an independent or standalone limb of the law.¹³⁸ It is within the ‘law of finance’.¹³⁹ With contemporary economic becoming complex and overlapping with the traditional concept of law, there has emerged a distinct legal field which combines contemporary financial regulation with traditional legal field inter alia: company law, criminal law, contract law and sale of goods to form a distinct field referred to as the ‘law of finance’.¹⁴⁰

It is against this backdrop that this chapter focuses on the regulatory and institutional structure of the derivatives market in Kenya. This chapter provided information and seeks to build knowledge on derivatives before delving into the next chapter on financial crimes as within the law of finance vis-à-vis the derivatives market.

2.1 History of Financial Derivatives

The use of derivative dates back to the middle ages. In thirteenth-and fourteenth-century Europe, buyers entered in wool purchase arrangements and agreements with Cistercian monasteries to be performed one to several years forward.¹⁴¹ The earliest recorded derivative type trading in Africa was in Alexandria, Egypt in the 1860’s with one of the first recorded transactions involving cotton trade in 1865. Thereafter, in 1899, the Alexandria Cotton Exchange, a more elaborate derivatives market was established.

The modern-day conceptualisation of exchange-traded derivatives is associated with the establishment of the Chicago Board of Trade (CBOT) in 1848 in the USA.¹⁴² CBOT provided a centralised location to negotiate formal derivative contracts by establishing rules and standards for the underlying grain commodities. The existence of formal derivative contracts, which in 1874 were only limited to forward contracts, enabled the grain traders to hedge against risks such as market fluctuations.¹⁴³ Thereafter, various other derivatives exchanges were established in the USA including the New York Cotton Exchange (NYCE) in 1874 and the Chicago

¹³⁸ Hudson (n 94)

¹³⁹ *ibid.*

The law of finance refers to the body of laws and regulations which impact on the finance industry. It is also referred to as financial services law.

¹⁴⁰ *ibid.*

¹⁴¹ *ibid.*

¹⁴² Lynch (n 87), 3-50.

¹⁴³ *ibid.*

Mercantile Exchange (CME), in 1919, which later emerged as one of the largest and well-established bourses for derivative trading.¹⁴⁴

In the 1970's, with the conceptualisation of the finance theory and increased research on derivatives,¹⁴⁵ derivatives instruments gained more recognition and use.¹⁴⁶ This resulted in the increased use of derivatives in a wide range of underlying assets; from the trading of options based on sugar prices and futures on gold in the 1980s to the trading of options, futures, swaps based on on share indexes, currencies, bonds, futures and interests from the 1990s to date.¹⁴⁷

Prior to CMA's efforts to establish a derivatives exchange in 2013, various private and government-backed stakeholders had already established an OTC market where derivatives would trade between the parties.¹⁴⁸ One of these well-known OTC markets was the establishment of the privately run Kenya Agricultural Commodity Exchange (KACE) as a commodities exchange in 1997 to provide a platform to trade in spot and forward contracts for a range of agricultural commodities.¹⁴⁹

In 2010, the Government of Kenya, in its annual financial budget read by the then Deputy Prime Minister and Minister of Finance,¹⁵⁰ announced that steps would be made towards developing an institutional and legal framework on a commodities and futures exchange in Kenya.¹⁵¹ Subsequently, the Minister of Finance initiated the Futures Exchange Project (FEP) that resulted in the establishment of the Futures Market Committee (FMC) on September 2010.¹⁵²

As part of its mandate of providing a roadmap for the establishment of commodity futures market in Kenya, the FMC undertook benchmark studies mainly in two jurisdictions, Mauritius

¹⁴⁴ *ibid.*

¹⁴⁵ In particular, the 1973 paper by Fischer Black and Myron Scholes titled as 'The Pricing of Options and Corporate Liabilities' gave a more elaborate view on derivatives.

¹⁴⁶ Timothy Lynch (n 97), 15.

¹⁴⁷ *ibid.*

¹⁴⁸ The Capital Markets Authority (n 137), 3-5.

¹⁴⁹ Winfred Karugu, 'Kenya Agricultural Commodities Exchange: Linking Small farmers to National and Regional Markets' (United Nations Development Programme, 2011).

¹⁵⁰ Hon. Uhuru Kenyatta

¹⁵¹ Ken Kahugu, 'A highlight of the Kenyan Budget-2010/2011' The Daily Nation Newspaper (Nairobi Kenya 10th June 2010)

¹⁵² The Capital Markets Authority (n 137), 3-5.

and India, with the key objective been to examine their legal frameworks with a view to informing on the appropriate legal framework for Kenya's derivatives market.¹⁵³

In May 2011, the Kenyan Government made policy recommendations which proposed the setting up of a regulated commodities futures exchange under the provisions of the Capital Markets Act.¹⁵⁴ The commodities exchange would, in the short term, trade in futures contracts with the underlying assets been internationally traded commodities such as currencies, minerals, energy and carbon credits.¹⁵⁵

Thereafter, in 2013, the Capital Markets (Futures Exchanges) (Licensing Requirements) Regulations¹⁵⁶ were enacted to guide the licensing of Futures' exchanges in Kenya.¹⁵⁷ These regulations were later replaced by the Capital Markets (Derivatives Markets) Regulations in 2015.¹⁵⁸ With a licensing framework in place, CMA licensed the Nairobi Securities Exchange's subsidiary, the Nairobi Securities Exchange Derivatives Exchange (NEXT), as the inaugural derivatives exchange in Kenya.¹⁵⁹

2.2 Financial Derivatives

A derivative instrument is a financial instrument, contractual in nature, which derives its value from an underlying asset.¹⁶⁰ The underlying asset can either be currency, equity, bond, interest rate, commodity or a combination of these assets.¹⁶¹ There are mainly four types of derivative instruments: futures, swaps, forwards, and options.¹⁶²

¹⁵³ CMA (n 137), 3.

The choice of the jurisdictions by CMA was based mainly on the similarities of the economies of Mauritius and India to that of Kenya as developing countries. In addition, other various unique characteristics included policy framework, product structure; regulatory model; type of market intermediaries; trading, clearing and settlement systems; monitoring and surveillance systems; price dissemination systems, as well as capacity building and sensitization for players in the commodity futures markets.

¹⁵⁴ *ibid.*

¹⁵⁵ *Ibid.*, 4.

¹⁵⁶ Legal Notice No. 108 of 2013.

¹⁵⁷ The National Treasury's Cabinet Secretary made the Regulations under section 12 (1) of the Capital Markets Act.

¹⁵⁸ Legal Notice No. 37 of 2015.

¹⁵⁹ Geoffrey Odundo, 'Making sense of derivatives: How NSE will handle new segment' (The Standard Newspaper, 2nd December 2015)

¹⁶⁰ Sanjeev Gupta, *Financial Derivatives Theory, Concepts and Problems* (India: Prentice Hall, 2015)

¹⁶¹ Lynch (n 97).

¹⁶² *ibid.*

Derivatives offer investors platforms for the management of financial risks as they allow investors to offset risks to third parties, while at the same time making financial returns.¹⁶³ Additionally, trading in derivative instruments contributes to the overall development of a country's financial sector by providing linkages between investors and the money markets.¹⁶⁴

2.2.1 The Derivative as a Contract

A derivative instrument is a financial instrument, contractual in nature, which derives its value from an underlying asset.¹⁶⁵ As a legally enforceable agreement, a derivatives instrument must meet all the legal elements of a contract under Kenyan law,¹⁶⁶ which applies the Substance of Common Law, the Doctrines of Equity and several Acts of the United Kingdom¹⁶⁷ that apply to contracts.¹⁶⁸

Under English Common Law, elements such as offer, acceptance, capacity, intention to create legal relations, formality (if any) and consideration must exist in an agreement for it to be valid as a contract.¹⁶⁹ The acceptance of the offer by the recipient of the offer must be an unequivocal or an unqualified expression of assent to the offer.¹⁷⁰ A binding agreement has to have consideration: that is, the price of the contract.¹⁷¹ Additionally, there must be the intention to create legally binding relations between the parties to a contract.¹⁷² In exchange-traded derivatives contracts, the exchange provides the format of the documentation used by the parties exchange and thus oral derivatives contract may not be binding.¹⁷³ In the OTC derivatives market, the format of the agreement is as agreed between the parties. The nature of the documentation is discussed below (in 2.2.2).¹⁷⁴

¹⁶³ *ibid.*

¹⁶⁴ *ibid.*

¹⁶⁵ Sanjeev Gupta, *Financial Derivatives Theory, Concepts and Problems* (India: Prentice Hall, 2015)

¹⁶⁶ The Law of Contracts Act (Cap 23 Laws of Kenya), s 2

¹⁶⁷ The Law Reform (Frustrated Contracts) Act (1943) and the Law Reform (Married Women and Tortfeasors) Act (1935).

¹⁶⁸ To the extent and subject to modifications in the said Schedule.

¹⁶⁹ *ibid.*

¹⁷⁰ *Henthorn v Fraser* [1892] 2 Ch 27.

¹⁷¹ *Hugh Beale* (n 102) 261-263.

¹⁷² *Kleinwort Benson v Malaysia Mining Corporation* (1989) 1 WLR 379.

¹⁷³ *Hugh Beale* (n 100) 4-001-4-004, 261-263.

¹⁷⁴ Documentation and Nature of Derivative Contracts.

2.2.2 Documentation and Nature of Derivative Contracts

The derivatives instrument may have as many as four main sub-sets of agreements or documents, structured into one single agreement.¹⁷⁵ The four sub-sets of documentation are composed of a master agreement, which is a standard form that outlines the general rules of the underlying asset; a confirmation or acceptance that the investor is willing to be bound by the terms of the derivative; a schedule outlining the rules of exchange or trading and where applicable, the appropriate credit support documentation. The totality of these four documents is the derivative instrument.¹⁷⁶ It is contractual in nature.¹⁷⁷

In *BNP Paribas v Wockhardt EU Operations (Swiss) AG*,¹⁷⁸ the court held that the derivatives contract is the amalgamation of all the sub-agreements discussed above. It correctly held, *inter alia*, that, “... all transactions are entered into in reliance on the fact that the master agreement and all confirmations form a single agreement between the parties (collectively referred to as ‘this Agreement’), and the parties would not otherwise enter in to the transaction...”¹⁷⁹

2.2.3 Types of Derivative Contracts

Contemporary derivative contracts or instruments are categorised into futures, forwards, options and swaps. Depending on the type of the derivative instrument, they trade in either an exchange or on the OTC market.¹⁸⁰ Derivative contracts such as swaps, forward and options are mainly traded in the OTC markets while futures are traded in centralised securities exchanges.¹⁸¹

Futures and Forwards are strikingly similar. They both allow investors to buy or sell an asset at a given price at a given date in the future.¹⁸² However, it is in their contractual structure that their difference lies. Futures are exchange-traded in a public exchange while forwards are traded privately between the parties.¹⁸³ Due to this, futures are standardised contracts approved by a market regulator while the terms and conditions of forward contracts are determined through the

¹⁷⁵ Alastair Hudson (n 94).

¹⁷⁶ *ibid.*

¹⁷⁷ *ibid.*

¹⁷⁸ [2009] EWHC 3116 (Comm).

¹⁷⁹ *ibid.*

¹⁸⁰ Gupta (n 165).

¹⁸¹ *ibid.*

¹⁸² *ibid.*

¹⁸³ *ibid.*

parties' negotiations.¹⁸⁴ Since futures are traded on an exchange, they have clearinghouses that guarantee transactions.¹⁸⁵ In relation to settlement and delivery, settlement and delivery in forward contracts take place at the end of the contract whereas futures are marked-to-market daily that is, daily changes in prices as and when they occur until the end of the contract.¹⁸⁶

Options, another type of derivative instruments, are contracts that allow the counterparty the right to exercise the benefits under the option instrument at a designated time.¹⁸⁷ The counterparty with the right to exercise the right is referred to as the 'buyer' and the other counterparty is the 'writer'.¹⁸⁸ A swap, on the other hand, is a contract through which parties exchange financial instruments based on a notional principal amount.¹⁸⁹ The underlying assets in swaps include, *inter alia*; interest rates, indices, forex rates and commodities prices.¹⁹⁰

2.3 Regulatory and Institutional Structure of the Derivatives Market in Kenya

Since the inception of share trading in Kenya in the 1950s, Kenya's regulatory framework on the securities markets has evolved from self-regulation, then to the government-led regulation to the current model of self-regulation with or without oversight.¹⁹¹ Self-regulation with oversight, also referred to as government-supervised self-regulation, blends government regulation and

¹⁸⁴ *ibid.*

¹⁸⁵ *ibid.*

¹⁸⁶ *ibid.*

¹⁸⁷ Abanomey and I Mathur, 'International Portfolios with Commodity Futures and Currency Forward Contracts' (2001) 10 (3) the Journal of Investing, 61-68.

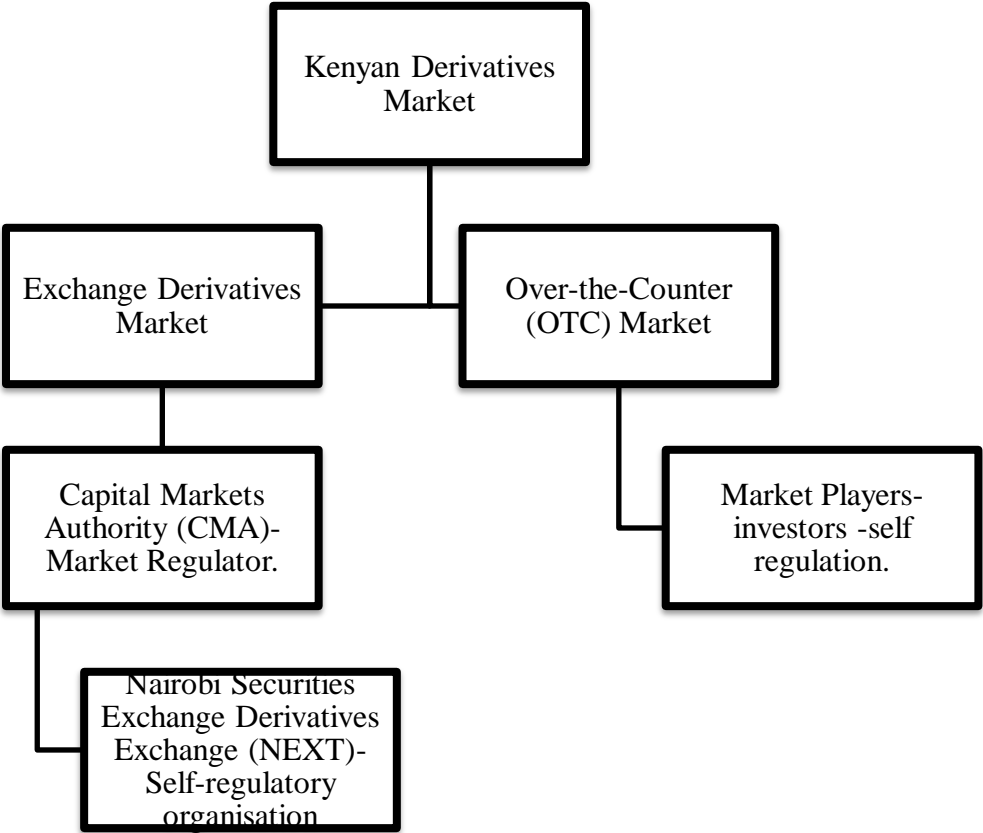
¹⁸⁸ For example, if Investor A enters into an option contract to buy \$100,000 in three months' time, at Kshs 90 per dollar, this is known as a call option and the opposite, where one enters into an option contract to sell the \$ 100,000 in three months' time, at Kshs 90 per dollar, is the put option. The Kshs 90 is the strike price also known as the contract price.¹⁸⁸ If at the end of three months the prevailing exchange rate in the market is Sh100 to the dollar, there is a potential gain of Kshs 1, 000, 000 before other costs are considered. The speculator buys \$100,000 at a unit price of Kshs 90. The sum used is Kshs 9, 000,000. The speculator then turns to the open market and sells the \$100,000 at the prevailing market price of Kshs 100. The sum received will be Sh10, 000, 000 hence a gross profit of Kshs, 1,000,000. However, if he sells at Kshs 85 per dollar, there is a potential loss of Kshs 500, 000; the speculator will let the option expire without exercising.

¹⁸⁹ For example, if K Ltd has issued Kshs.1, 000,000 in five-year bonds valued at an interest rate of 5% above the Central Bank of Kenya bank rate estimated to not to go above 10% over the next 5 years. Due to a need to tame inflation, the Central Bank of Kenya has been increasing its rate and it has grossed above the 10% and K Ltd is anxious about the increasing interest rates. K Ltd finds another company, A Ltd that is willing to pay K Ltd an annual rate of the current Central Bank rate plus 5% on the notional principal amount of Ksh. 1,000,000. In short, A Ltd will fund K Ltd's interest payment in the bond issue. In exchange, K Ltd will pay A Ltd a fixed annual rate of 6% on the notional principal of Ksh. 1, 000, 000 for 5 years. K Ltd benefits from the swaps if interest rates rise significantly while A Ltd will benefit when the interest rates fall.

¹⁹⁰ *ibid.*

¹⁹¹ Rose Ngugi, 'Development of the Nairobi Stock Exchange: A Historical Perspective' (KIPPRA Discussion Paper No.27, 2003), 4-19.

market self-regulation.¹⁹² On the other hand, under the self-regulation without oversight model, the market players are left to regulate themselves with no or minimal government intervention. Under these two regulatory models, the derivatives market is structured as:



Source: Author

In the exchange market, CMA, as the primary government-led regulator, has the responsibility of supervising the derivatives exchange including providing oversight and licensure to the market intermediaries.¹⁹³ Its mandate includes the monitoring of activities of the derivatives exchange and intermediaries, including prescribing transactions conducted on the derivatives exchange.¹⁹⁴

¹⁹² Jacob Gakeri, ‘Regulating Kenya’s Securities Markets: An Assessment of the Capital Markets Authority’s Enforcement Jurisprudence’ (2012) 2 (20) International Journal of Humanities and Social Science, 266-271.

¹⁹³ The Capital Markets (Derivatives Markets) Regulations 2015, Regulation 4.

¹⁹⁴ *ibid*, Regulation 49.

The Nairobi Securities Exchange (NSE) Derivatives Market acronymed as ‘NEXT’ is the only licensed derivatives exchange in Kenya. It was licensed by CMA, under the Capital Markets (Derivatives Markets) Regulations 2015, to trade in derivative instruments after having met all the requisite legal requirements touching on its net worth,¹⁹⁵ ownership and shareholding¹⁹⁶ and governance.¹⁹⁷ NEXT has the responsibility of ensuring that there is established a fair and transparent mechanism for derivatives trading market within an efficient market.¹⁹⁸ NEXT is a self-regulatory Organisation under Regulation 37 Capital Markets (Derivatives Markets) Regulations, 2015 which requires the derivatives exchange to have,

“(a) a procedure and appropriate system of exercising self-regulation over its derivatives members; (b) a code of conduct for its derivatives members; (c) adequate trading surveillance and compliance capacity; and (d) a procedure for dispute resolution”. This is in addition to Regulation 34(4), which provides that, “a derivatives exchange shall regulate the operations, standards of practice and business conduct of derivatives brokers who are its members and representatives or other employees of those derivatives brokers in accordance with the rules, policies, procedures and practices of the derivatives exchange”.

NSE Clear Ltd is the institution that novates or guarantees the settlement of trades on NEXT.¹⁹⁹ It acts as the buyer for every seller and the seller for every buyer.²⁰⁰ NSE Clear delivers the asset to the long (Buyer) and pays the proceeds to the short (Seller).²⁰¹ As a subsidiary of the

¹⁹⁵ Regulation 15 of the Capital Markets (Derivatives Markets) Regulations provides that:

- (1) *A derivatives exchange shall maintain, at all times, liquid net worth amounts of a type acceptable to the Authority, which shall be adequate in relation to the nature, size and complexity of the business of that derivatives exchange to ensure that there is no significant risk that liabilities may not be met as they fall due.*
- (2) *The minimum liquid net worth capital requirement for a derivatives exchange shall be —*
 - (a) *an amount equal to one half of the estimated gross operating costs of the derivatives exchange for the next twelve-month period; or*
 - (b) *such other liquid net worth amount as may be prescribed by the Authority.*

¹⁹⁶ NEXT is a wholly owned subsidiary of the NSE.

¹⁹⁷ Capital Markets (Derivatives Markets) Regulations 2015, Reg 21.

¹⁹⁸ *ibid*, Reg 34.

¹⁹⁹ In line with Part III of the Capital Markets (Derivatives Markets) Regulations.

²⁰⁰ *ibid*.

²⁰¹ *ibid*.

NSE, NSE Clear has its own capital and governance structure that is independent of that of the NSE.²⁰²

The derivatives clearing system is done through clearing banks which are commercial banks²⁰³ designated by the derivatives exchange to provide banking and related services to the derivatives exchange, the clearinghouse and the derivative brokers.²⁰⁴ Currently, three banks, Co-operative, Stanbic and Barclays Banks have been approved to provide financial settlement services for transactions between different clients and the brokers²⁰⁵ at the derivatives exchange.²⁰⁶

NEXT has also established a Settlement Guarantee Fund (SGF) as a condition for licensure.²⁰⁷ The Settlement Guarantee Fund aims at strengthening the financial integrity of settlement by the exchange.²⁰⁸ The fund must be a minimum of one hundred million Kenya shillings.²⁰⁹ At its commencement, NEXT deposited twenty billion shillings with NSE Clear to provide for the settlement of futures.²¹⁰

Unlike the elaborate regulatory and institutional structures in the derivatives exchange that are provided under the law, the regulation and set up of the OTC derivatives market is left to market participants.²¹¹ There is no focused government regulatory approach and the OTC derivatives market is only subject to the conduct of, and any regulations developed by, the participants.²¹²

The distinction in regulatory models between the exchange and OTC market is critical in the application of the laws on combating financial crimes in the derivatives market. Whereas the

²⁰² Godfrey Odundo (n 160).

²⁰³ As defined under section 2 of the Banking Act (Cap 488):-Means a company which carries on, or proposes to carry on, banking business in Kenya but does not include the Central Bank

²⁰⁴ Capital Markets (Derivatives Markets) Regulations 2015, Regulation 6.

²⁰⁵ The Capital Markets (Derivatives Markets) Regulations 2015, Regulation 2 defines a “derivatives broker” as “a body corporate admitted to the membership of a derivatives exchange and by the Authority to engage in the business of trading in derivatives contracts as an agent for investors in return for a commission and on its own account”.

²⁰⁶ Joshua Masinde, ‘Kenya to launch derivatives market’ Daily Nation Newspaper (Nairobi, 21st December 2014).

²⁰⁷ *The Capital Markets (Derivatives Markets) Regulations 2015*, Reg 44 (3).

²⁰⁸ *ibid*, Reg 4 (g).

²⁰⁹ *ibid*, Reg 5.

²¹⁰ Joshua Masinde (n 206).

²¹¹ Nancy Laibuni, Githinji Njenga, et al, ‘Is There Need for an East African Commodity Exchange?’ Kenya Institute of Policy Research and Analysis working paper 4/2013.

²¹² Cedric Achille, Lamon Rutten et al, *Guidebook of African Commodity and Derivatives Exchange* (African Development Bank, 2013), 38.

derivatives exchange has different levels of control to prevent or minimise crimes, the OTC derivatives market is largely left to the regulation of market participants.²¹³ This been the case, the formal derivatives markets remain largely undeveloped as the OTC derivatives market continues to flourish.²¹⁴ Institutionalised OTC derivative markets such as the Kenya Agricultural Commodities Exchange (KACE), the Nairobi Coffee Exchange among others continue to offer investors platforms to trade in derivatives contracts whereas six years after the establishment of a formal regulatory framework on the derivatives exchange, there has been very little investor activity in this market segment.²¹⁵ This calls for a rethink in the regulatory model to rope in all the segments of the derivatives market in order to ensure investor protection. The inconsistency and inadequacy in the application of the criminal law framework on the derivatives market-based on the OTC derivatives market and the derivatives exchange forms the basis of the next chapter.

²¹³ Edward Bowen, Makena Kaburu et al, 'Factors Influencing the Growth of Derivatives in Kenya: A Case Study of the Nairobi Securities Exchange' (2017) 4(3) The Strategic Journal of Business & Change Management, 710.

²¹⁴ *ibid*, 711.

²¹⁵ *ibid*.

CHAPTER THREE

‘TAMING THE THIEF IN A SUIT’: COMBATING FINANCIAL CRIMES IN THE DERIVATIVES MARKET

3.0 Introduction

The focus of this chapter is to evaluate the laws aimed at combating financial crimes, their applicability and suitability to the growth and development of the Kenyan Derivatives Market. Traditionally characterized as crimes committed by people clad in suits and white collared shirts in the course of their profession, financial crimes, and most of the economic crimes, embody the use of specialised knowledge and financial skill on the part of the perpetrators.²¹⁶ In a broad sense, financial crimes, conceived as the unlawful conversion of property, are crimes against property.²¹⁷ Jennifer and Spencer Pickett define ‘financial crime’ as “the use of deception for illegal gain, normally involving a breach of trust, and some concealment of the true nature of the activities”.²¹⁸

Alluding to ‘the thief in a suit’ in chapter is symbolic of the nature of the criminals expected in the derivatives market. These are criminals who are educated, skilled, and respectable in their professions and commit financial crimes using their skill and education à la Mary Asamani’s poem aptly titled “Thieves in Suits”:

“Thieves in suits,
Well-cut suits and clear-cut theft,
Diplomatic suits but in their pockets lie our sweats,
Yet, the suits shield them,
It elevates them from mere thieves to diplomatic thieves,
Ones whose families will you find trace not on the land,
Those that enjoy our sweats in the lands that lie afar,
Lands that were borne after their,

²¹⁶ Edwin Sutherland, a sociologist, introduced the use of the term ‘white-collar crime’ into criminology in the late 1930s by referring to ‘white-collar crime’ as “a crime committed by a person of respectability and high social status in the course of his occupation”.

²¹⁷ Pickett Spencer, and Jennifer Pickett, *Financial Crime Investigation and Control* (Wiley, 2002), Ch 1.

²¹⁸ *ibid.*

But prospers above thee”²¹⁹

Thus, due to the complexity of derivatives trading, the individual who is likely to engage in any criminal activities in the derivatives market will be suave, smart and knowledgeable, akin to the individual in the ‘suit and white-collared shirt’.²²⁰ However, a wide range of individuals can commit financial crimes, from organised criminals, business people, and employees to the criminal on the streets.²²¹

At the core of financial crime is fraud.²²² For a financial crime to exist, four elements must present: first, intention to commit the crime; secondly, a breach of trust; third, deceit and finally, legal injury must result.²²³ Additionally, financial crime may involve the use of violence and concealment of the property.²²⁴

The adverse effects of financial crimes to the economy and investors cannot be underestimated.²²⁵ According to the IMF, financial crimes have devastating economic, political and social consequences.²²⁶ Economically, these crimes negatively impact the development of the capital and financial markets and channel money away from the tax regime.²²⁷ Politically, financial crimes have the impact of lowering the reputation of countries and proceeds from crime may be used to fan opposition and rebellion. On the social front, increased financial crimes lead to increased social expenditure²²⁸ on efforts to combat such crimes.²²⁹

In underpinning the negative effects of financial crimes, the International Organization of Securities and Capital Market Organisations (IOSCO), with an aim of achieving its three key

²¹⁹ Adopted and modified from the poem ‘Thieves In Suits’ by <http://highonpoems.com/32982/english-poems/prose-poem/thieves-in-suits> accessed 15th November 2016. The poem is a symbolic description of a criminal who engages in economic and financial crimes. Such criminals are well dressed and have polished mannerisms and skill sets.

²²⁰ *ibid.*

²²¹ *ibid.*

²²² Fraud is conceived as the wrongful or criminal deception intended to result in financial or personal gain.

²²³ *ibid.*

²²⁴ *ibid.*

²²⁵ International Monetary Fund, ‘Financial System Abuse, Financial Crime and Money Laundering— Background Paper’ (2001) <<https://www.imf.org/external/np/ml/2001/eng/021201.pdf>> accessed 15th June 2017.

²²⁶ *ibid.*

²²⁷ *ibid.*

²²⁸ These are costs associated with combating crimes i.e. recruitment of more police officers, the building of prisons *et al.*

²²⁹ IMF (n 225).

objectives,²³⁰ continues to issue guidelines and standards to capital market regulators to enhance their capacity in detecting and combating financial crimes.²³¹

3.1 Ensuring Securities Markets Integrity: Protecting the Derivatives Market

The integrity of Kenya's derivatives market is very important in the economic development of Kenya.²³² Market integrity entails transparency, fairness and inclusivity.²³³ As part of the broader financial market in Kenya, the derivatives market must function with integrity to ensure economic development.²³⁴ This is in line with the Market Integrity Theory which postulates that integrity is the foundation of effective and efficient financial markets.²³⁵

Market integrity relies on such measures such as low crime levels, the efficiency of the enforcement of the law, market fairness, and equal access to information by investors, prevention of financial crimes, an adequate compensation mechanism and the utilization of measures to boost market confidence.²³⁶ Instructively, under the Market Integrity Theory, the integrity of the market is measured by analysing the levels of misconduct and dishonesty in the market vis-a-vis the efforts undertaken to detect, prevent and educate market participants on such dishonesty and misconduct and promote efficiency and fairness.²³⁷ This theory is led credence by IOSCO in its emphasis that market integrity should be at the core of capital markets development.²³⁸ In particular capital markets regulators are mandated to ensure that capital

²³⁰ Under the International Organization of Securities Commissions (IOSCO), Objectives and Principles of Securities Regulation (June 2010), the three key objectives of IOSCO are to ensure: investor protection; market fairness, efficiency and transparency and the reduction of systemic risk.

²³¹ International Organization of Securities Commissions (IOSCO), Objectives and Principles of Securities Regulation (June 2010).

²³² The World Bank, 'Financial Market Integrity'

<http://www.worldbank.org/en/topic/financialmarketintegrity/overview#1>. accessed 15th June 2017.

²³³ *ibid.*

²³⁴ *ibid.*

²³⁵ Bryan Fodor, 'Measuring market integrity: a proposed Canadian approach', (2008) 3(15) Journal of Financial Crime, 261-268.

²³⁶ *ibid.*

²³⁷ *ibid.*

²³⁸ International Organization of Securities Commissions (IOSCO), 'Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency' Consultation Report (2011), 9-19.

markets operate in a manner that ensures fairness and transparency;²³⁹ have in place suitable and effective trading control mechanisms;²⁴⁰ and monitor market abuse.²⁴¹

IOSCO has issued various guidelines with a view to ensuring securities markets globally are efficient and effective.²⁴² IOSCO mandates the various regulators to ensure that the implementation of these principles in the capital markets.²⁴³ Principally, there are three key objectives on the need for protecting securities markets: protecting investors, reduction of systematic risk, and ensuring market fairness and transparency.²⁴⁴

Investor protection entails the protection of investors from manipulative or fraudulent practices and misleading information: investors should all be on an equal footing.²⁴⁵ They should have access to the same quality and quantity of information to be able to evaluate their risks and advantages of investing.²⁴⁶ The law should protect investors from any harm that may result from unscrupulous criminals' with intent on eroding their investments.²⁴⁷

Closely linked to investor protection are the principles of market fairness, transparency and accountability. The law should aim at ensuring that all investors access to market information and facilities. The law should provide a mechanism to detect and penalise market manipulation and other market offences.²⁴⁸ Derivatives market regulation must promote practices aimed at ensuring fair treatment of all contracts and reliable price formulation.²⁴⁹

Importantly, derivatives markets should ensure minimised risk exposure to investors and where necessary, mitigate market failure,²⁵⁰ and regulations put in place to measure internal and

²³⁹ *ibid*, Recommendation 1,

²⁴⁰ *ibid*.

²⁴¹ *ibid*, Recommendation 5.

²⁴² International Organization of Securities Commissions (IOSCO), 'Objectives and Principles of Securities Regulation' (June 2010).

²⁴³ *ibid*.

²⁴⁴ *ibid*.

²⁴⁵ *ibid*, Principle 4, 'Objectives of Securities Regulation'.

²⁴⁶ *ibid*.

²⁴⁷ *ibid*

²⁴⁸ *ibid*.

²⁴⁹ *ibid*.

²⁵⁰ IOSCO Public Document No. 80, Causes, Effects and Regulatory Implications Of Financial and Economic Turbulence in Emerging Markets - Interim Report, IOSCO Emerging Markets Committee, September 1998, and IOSCO Public Document No. 99, Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets, IOSCO Emerging Markets Committee, November 1999

external market risk.²⁵¹ Proper structures should provide a mechanism for minimising investors' loss, should the market collapse or fail.²⁵²

It is integral to combat financial crimes in order to enhance and facilitate market fairness and investor protection with a view to ensuring investor confidence in the Kenyan derivatives market.²⁵³ Crimes related to fraud and market manipulation destabilise markets, create market disadvantages and generate illicit inflows that not only undermine governance but also hurt the wider economy and thus negatively affecting of the stability of the financial sector.²⁵⁴

3.2 Elements of Financial Crimes

Crimes are conceptualised as public wrongs either through an act or omission which is prohibited under the law.²⁵⁵ The decision to criminalise an act or omission is the preserve of an authorised sovereign body.²⁵⁶ A crime has two main characteristics: one, it is a harm emanating from human conduct, which the law seeks to prevent; and two, crime attracts a sanction to the offender.²⁵⁷

Under the doctrine of legality, the act or omission constituting the crime must be set out in law. In *Karanja and Others v Republic*,²⁵⁸ the court reiterated that the law must expressly prohibit a criminal act or omission.²⁵⁹ This is in line with the trite principle of law, *nullum crimen sine lege, nulla poena sine lege* ('no conduct shall be held criminal unless it is prohibited under the law').²⁶⁰

²⁵¹ *ibid.*

²⁵² *ibid.*

²⁵³ IOSCO (n 242).

²⁵⁴ World Bank (n 232).

²⁵⁵ William Musyoka, *Criminal Law* (Law Africa, 2013), 1-20.

²⁵⁶ *ibid.*

²⁵⁷ This can be through non-custodial or a custodial punishment; and three, a formal legal process outlined under statute determines whether an accused or suspect is guilty or innocent.

²⁵⁸ (2011) 2 EA 164

²⁵⁹ *ibid.*

²⁶⁰ This is reiterated under Article 50 (2) (n) of the Constitution of Kenya which provides:

*“Every accused person has the right to a fair trial, which includes the right
(n) not to be convicted for an act or omission that at the time it was committed or omitted was not
(i) an offence in Kenya; or
(ii) a crime under international law”*

The legal elements that are required for a conviction of a crime, including financial crimes are mainly two: the *actus reus* (prohibited conduct) and the *mens rea* (mental state).²⁶¹ In a criminal case, the prosecution has the burden to prove the existence of these two elements.²⁶² To ensure a conviction, the prosecution's standard of proof must be beyond reasonable doubt.²⁶³

The *actus reus* must be a prohibited conduct or omission²⁶⁴ under the law. In financial crimes, the prohibited conduct will be an act or omission aimed at deriving the investor from his/her investment or gains.²⁶⁵ The prohibited conduct will range from conversion of property, illegal gain from the property, a breach of trust to the concealment of property.

The *mens rea* is the mental state evidencing criminal intent. *Mens rea* is the willful intention to participate in the prohibited conduct or the knowledge of the prohibited conduct.²⁶⁶ The law should expressly provide for the *mens rea* of each crime unless the law provides that it is a strict liability crime.

3.2.1 Criminal Liability of Incorporated Entities and their Directors or Officers

The concept of corporate criminal liability is an ever expanding concept in legal systems worldwide with the recognition that just like natural persons, corporate entities can also commit crimes.²⁶⁷ However, it is also been recognised that corporate entities, like companies are artificial persons and as such cannot have intent to commit a criminal act without the involvement of natural persons.²⁶⁸ An incorporated entity can only act through its officers, employees or agents. In tort, courts have held incorporated entities as vicariously responsible

²⁶¹ Musyoka (n 255).

²⁶² *ibid.*

²⁶³ *ibid.*

²⁶⁴ For an omission to amount to be a criminal offence, there must be a legal duty or obligation placed on someone or an institution. Failure to discharge the obligation will thus amount to a criminal offence.

²⁶⁵ In some financial crimes, no act or omission may be required. The law may require the existence of some events or state of affairs as the *actus reus*. Such events or state of affairs include being in possession of something or be in control or custody of something i.e. been in control of proceeds of crime.

²⁶⁶ Depending on the nature of the financial crime and the provisions of the law, *mens rea* is the intention, state of mind aimed at achieving a certain purpose; foresight, the ability or position to know that act or omission has consequences; recklessness. It also includes the engagement of an activity whose consequences are known but are ignored; negligence, the breach of a duty no care owed to another; and knowledge that an act or omission is wrong or illegal.

²⁶⁷ George Otieno, *The Company as a Criminal: Comparative Examination of Some Trends and Challenges Relating to Criminal Liability of Corporate Persons* (2008) < <http://kenyalaw.org/kl/index.php?id=1919> > accessed 6th August, 2018.

²⁶⁸ *ibid.*

for the actions or omissions of their agent done within their scope of authority and when performing their employment obligations.²⁶⁹

Although Kenyan law does not provide clear provisions on corporate criminality, various statutes impose criminal sanctions not only on the company but also on its directors or agents. Primarily, under the Companies Act, company directors can be held personally liable for breach of their duties as directors or fail to comply with certain statutory obligations.²⁷⁰ Many of these offences constitute crimes of omission.²⁷¹ In these cases, the omission itself is the *actus reus*.²⁷²

Kenyan courts have recognised that companies can be held liable for criminal acts.²⁷³ Where a company commits an offence, it should be charged alongside its directors or those in charge of the management of the company. This can be discerned from the decisions in *Republic v Rootes (Kenya) Limited & B S Dobbs*,²⁷⁴ where the accused were charged with the offence of obtaining money by false pretence under section 308 of the Penal Code; and in *Republic v East African Oil Refineries Limited*,²⁷⁵ where the company was convicted for causing the death of one of its employees.

3.3 Classification of Financial Crimes

Financial crimes fall under different categorisations.²⁷⁶ Based on the financial sector the financial crimes occur, they can range from insurance crimes, banking crimes to capital markets crimes.²⁷⁷ Based on the similarities in various crimes, Peter Gottschalk in his article aptly titled “Categories of Financial Crime” classifies financial crimes into four broad categories: corruption, fraud, theft and manipulation. Each categorisation has sub-categories that fall under

²⁶⁹ Bernard v Sully (1931) 47 TLK 557.

²⁷⁰ The Companies Act, sections 98, 232, 252, 286, 335, 366, 382, 473, 549, 598, 629, 631, 664, 680, 681, 759, 818, 819, 826, 872 and 1002.

²⁷¹ *ibid.*

²⁷² *ibid.*

²⁷³ Otieno (n 267).

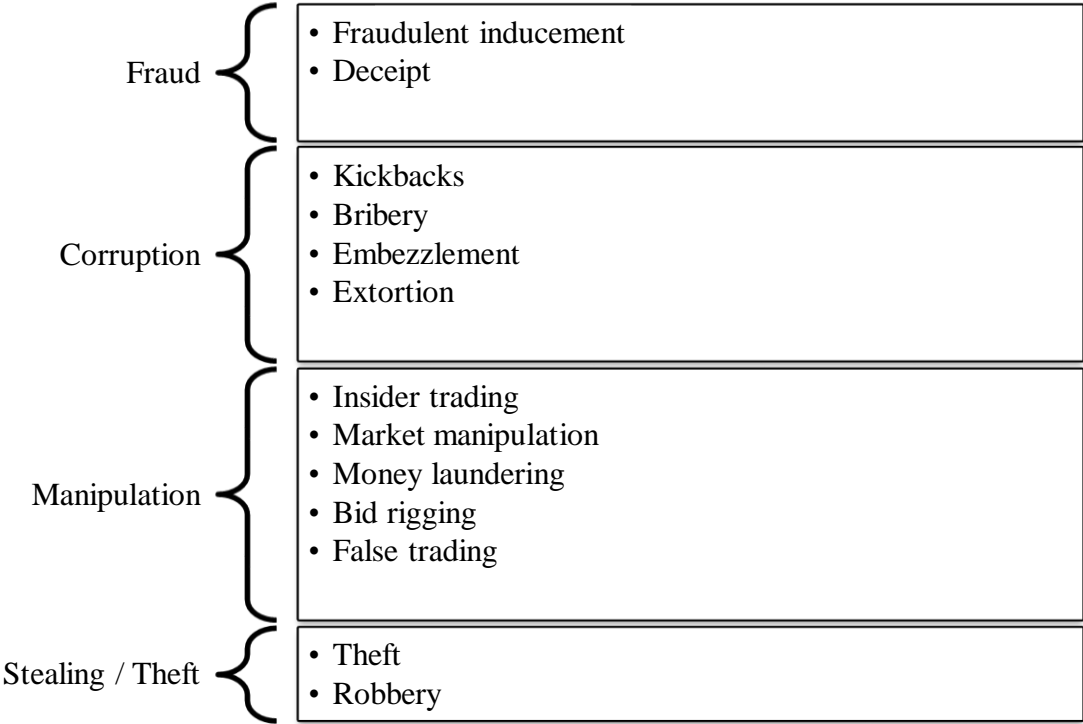
²⁷⁴ (1958) EA 13.

²⁷⁵ (1981) KLR 109.

²⁷⁶ They can be classified either by the sectors in which the crimes occur; the distinct characterizes of the crimes or by the nature of violence that result when the crimes occur. Financial crime also cuts across the commercial and public sectors of the economy.

²⁷⁷ Financial sector crimes target financial sector institutions like banks, capital markets and related institutions. Non-financial sector financial crimes target individuals and institutions outside the financial sector like retailers, education institutions, entertainments firms and professionals.

the prohibited conduct. Based on this classification, Peter Gottschalk diagrammatically captures financial crimes as:²⁷⁸



3.4 Protecting NEXT and Market Participants from Financial Crimes

The legal regime on protecting NEXT from financial crimes is mainly based on Kenyan law. ²⁷⁹ Additionally, the anti-financial crimes regime draws from international laws forming part of Kenyan Law and IOSCO Guidelines to market regulators.²⁸⁰ The Minister of Finance has also enacted Regulations aimed at safeguarding the derivatives exchange from various financial

²⁷⁸ Peter Gottschalk, ‘Categories of Financial Crime’ (2010) 17 (4) Journal of Finance and Crime, 441-45.
²⁷⁹ The relevant municipal law has two main categories: Those that are derivative market-specific and those that affect the economy in general.
²⁸⁰ Since its inception, the International Organization of Securities and Capital Market Organisations (IOSCO) has continuously provided guidance on the protection of security markets and products at all levels to ensure market integrity and the smooth running of capital markets. More importantly, IOSCO provides guidance to market regulators on the dos and don’ts.

crimes.²⁸¹ This is in addition to other existing legislative enactments and judicial pronouncements on combating financial crimes in the economy.

In the categorisation of financial crimes discussed above, the derivatives market is more prone to the manipulation and fraud categories. This is not to say that other categories do not and will not affect the derivatives market. The categories of corruption and theft cut across the broad specter of society. The specific financial crimes touching on the derivatives market are:

3.4.1 Corruption and the Derivatives Market

Corruption embodies a broad spectrum of actions and omissions that are understood to constitute conduct that is dishonest and fraudulent.²⁸² It also embodies dishonest and unethical behaviour by those entrusted with authority and is symptomatic of bad governance.²⁸³ Specific crimes under the broad classification of corruption include kickbacks, bribery, market manipulation, embezzlement and extortion.²⁸⁴

Kenya has in place laws on combating corruption. The legal regime on combating corruption in Kenya cuts across various policy and legislative enactments encapsulated under the Anti-Corruption and Economic Crimes Act²⁸⁵ and the Bribery Act.²⁸⁶ Although the duty to fight corruption lies with individuals, the law establishes the Ethics and Anti-Corruption Commission (EACC) to spearhead efforts against corruption.²⁸⁷

Although corruption is a malady that affects the society in general, across all corners of the society, in the derivatives market, the specific market offences that touch on fraud and market

²⁸¹ The Capital Markets (Derivatives Markets) Regulations (2015); Capital Markets (Conduct of Business) (Market Intermediaries) Regulations (2011); and the Capital Markets (Corporate Governance) (Market Intermediaries) Regulations (2011).

²⁸² Section 2 of the Anti-Corruption and Economic Crimes Act conceptualises ‘corruption’ as bribery, fraud, embezzlement, misappropriation of funds, abuse of office, the breach of trust or any other offence involving dishonesty in relation to the election to public office or in connection to a tax or levy imposed by the law.

²⁸³ *ibid.*

²⁸⁴ Pickett (n 217)

²⁸⁵ No 3 of 2003, Laws of Kenya.

²⁸⁶ No 46 of 2016.

²⁸⁷ Established under Section 3 (1) of the Ethics and Anti-Corruption Commission (EACC) Act, 2011. It is mandated to combat and prevent corruption and economic crime in Kenya through law enforcement, preventive measures, public education and promotion of standards and practices of integrity, ethics and anti-corruption.

manipulation have the aim of combating corruption.²⁸⁸ Additionally, in order to attract investors, one of the key pre-requisites for the development and growth of the derivatives includes, among others, good governance and the prioritisation of efforts aimed at combating corruption.²⁸⁹

3.4.2 Theft and the Derivatives Market

Kenyan has a legal regime on combating theft. Defined as the taking of another's property without their permission, this is criminalised under the Penal Code.²⁹⁰ The Penal Code creates several offences relating to the taking of another's property. These include the offences of theft,²⁹¹ robbery and extortion,²⁹² and burglary.²⁹³ In relation to derivatives, stealing is either of the underlying instrument or the identity of the proprietors of the asset or investor. The legal regime imposes criminal sanctions of fines and imprisonment for those found guilty of offences relating to stealing.²⁹⁴

There is an inadequate prohibition of identity theft, the acquisition of another's private identifying information for private gain, under the criminal law regime in Kenya, especially in this digital era.²⁹⁵ The use of a person's identity to offer derivative securities or as proprietors of the underlying assets for fraudulent purposes is possible.²⁹⁶ CMA as the sole approver of derivatives contracts requires the derivative exchange to put in place measures aimed at adequately identifying investors and proprietorship of the underlying assets.²⁹⁷ This regime of identification is popularly known as 'Know-Your-Customer'.²⁹⁸

²⁸⁸ Discussed below.

²⁸⁹ Michael Rundu, 'Factors That Inhibit the Development of Financial Derivatives in the Kenyan Financial Sector' (Masters of Business Administration Thesis, United States International university-Africa, 2016)

²⁹⁰ Cap 63, Laws of Kenya.

²⁹¹ *ibid*, Chapter XXV1.

²⁹² *ibid*, Chapter XXVIII.

²⁹³ *ibid*, Chapter XXVIX.

²⁹⁴ *ibid*.

²⁹⁵ The Penal Code is silent on the crime of identity theft.

²⁹⁶ See, Ken Kinyanjui, 'Fraudsters Cause Stir in Historic Credit Card Theft' Business Daily Newspaper (Nairobi, 19th August, 2009) where Identity theft was perpetrated in the banking industry where fraudsters hacked into the e-banking systems of bank customers and stole money.

²⁹⁷ The Capital Markets Authority (Derivatives Markets) Regulations (2015), Regulation 49

²⁹⁸ It mandated market intermediaries to ask for the provision of original and copies of identifying documents and other information, to adequately identify background information.

3.4.3 Market Manipulation

The term ‘market manipulation’ refers to practices aimed at forcing the market to behave in a certain manner.²⁹⁹ This may include the use of misleading information, deceit or misrepresentation, money laundering, false trading, market rigging and bucketing.³⁰⁰ In preventing market manipulation, market regulators will primarily use the law coupled with other market-based tools.³⁰¹

3.4.3.1 Misrepresentation and Deceit

Misrepresentation and deceit are forms of market manipulation embodied under the offence of manipulation of prices and cornering.³⁰² Cornering is encapsulated as the obtaining of enough stock in the market to influence its market price.³⁰³ Additionally, misrepresentation can also be viewed from the common law perspective of giving a false account in order to induce one to enter into a contract.³⁰⁴

²⁹⁹ IOSCO, Investigating and Prosecuting Market Manipulation (May 2000)

><https://www.iosco.org/library/pubdocs/pdf/IOSCOPD103.pdf>< accessed 15th June 2017.

³⁰⁰ *ibid.*

³⁰¹ In addition to the use of the law in preventing market manipulation, various other tools are used, *inter alia*:

- a. Proper derivatives contracts design. Where the terms of the derivative contracts reflect the market of the underlying asset, and then market manipulation practices are minimized. Knowledge of the cash market of the underlying asset is important in assessing the possibility of manipulation;
- b. Restriction on the position limits. Position limits should be designed to ensure that market participants do not attempt to manipulate the prices by demanding delivery of the underlying assets that exceed their economic availability and thus creating more demand than supply; and
- c. Market surveillance. The aim of market surveillance is to spot any adverse situations and scenarios in the market. Essentially the regulator must have access to market information on a real-time basis. Achieved by the exchange and intermediaries filing frequent reports with the regulator and the implementation of a surveillance system by the regulator.

³⁰² Regulation 74 (1) of the Capital Markets (Derivatives Markets) Regulations (2015) provides that,

“A person who directly or indirectly

(a) manipulates or attempts to manipulate the price of

(i) a derivatives contract that may be traded on a derivatives market;

ii) any commodity which is the underlying of a derivatives contract; or

(c) corners, or attempts to corner, any commodity which is the underlying of a derivatives contract, commits an offence.”

³⁰³ *ibid.*

³⁰⁴ Hugh Beale (ed), *Chitty on Contract* (38th ed, Vol 1, Sweet and Maxwell, 1999) 6-001-6-135, 386-402.

In *Parabola Investments Ltd v Browallia Cal Ltd*,³⁰⁵ the U.K Court of Appeal upheld the holding of the trial court that an employee who worked for the applicant had intentionally and deliberately fraudulently misrepresented investors to invest in derivatives through concealment of trade losses.³⁰⁶

Similarly, in *United States v. Coscia*,³⁰⁷ Michael Coscia, then a manager of a firm dealing with derivatives developed and used an algorithm to manipulate the prices and information of futures contracts.³⁰⁸ This was in an effort to confuse the market participants and induce them to react to deceptive information so that he would gain a profit from trading.³⁰⁹

The legal position on misrepresentation under contract law is set out under the Substance of Common Law and Doctrines of Equity as at 1859.³¹⁰ Unfortunately, Kenya does not have any statutory provisions on misrepresentation. Given the current developments in the economic and political structures in Kenya and globalisation, common law may not be up to date. Common law, as at the reception date, did not contemplate the complexities of modern financial systems and the concept of misrepresentation may not be watertight to ensure that it does not happen.³¹¹ England, where Kenya derives the principle of misrepresentation under its common law, has enacted the Misrepresentation Act 1967 to strengthen the common law foundation.³¹²

Additionally, the current legal structure does not cater for misrepresentation that emanates from other jurisdictions.³¹³ With the current framework allowing for international derivatives, the territoriality of the law does no safeguard investors from misrepresentation arising from external

³⁰⁵ [2010] EWCA Civ 486.

³⁰⁶ *ibid.*

³⁰⁷ (2016) 177 F.Supp.3d 1087.

³⁰⁸ *ibid.*

³⁰⁹ *ibid.*

³¹⁰ Law of Contract Act (Cap 23, Laws of Kenya).

³¹¹ *ibid.*

³¹² The Misrepresentation Act-U.K (1967).

³¹³ The Preamble of the Capital Markets Act provides that it is “*An Act of Parliament to establish a Capital Markets Authority for the purpose of promoting, regulating and facilitating the development of orderly, fair and efficient capital market in Kenya*” (emphasis mine)

jurisdictions.³¹⁴ Their only recourse would lie with the CMA liaising with the other jurisdiction's regulator and depending on their law; such misrepresentation may not be a crime.³¹⁵

The legal regime on misrepresentation in the derivatives market should be able to clearly spell out the misrepresentation threshold and tests to evaluate market misrepresentation and without been too specific and leaving room for an expansion, outline the types of misrepresentation in the derivatives market, *inter alia*: tape painting,³¹⁶ and pumping and dumping.³¹⁷

3.4.3.2 Money Laundering and the Derivatives Market

Kenya has enacted laws to prevent money laundering and the use of criminal proceeds in the economy. Described as the concealment of illegally obtained money,³¹⁸ money laundering in derivatives markets can take place in any or all the three stages of money laundering: placement,³¹⁹ layering³²⁰ and integration.³²¹ The derivative market offers a vast array of opportunities for transforming money into a diverse range of assets.³²²

³¹⁴ *ibid.*

³¹⁵ It is worth noting that there is no collaborative framework between CMA and other regulators in other jurisdictions and as such, in case of the need to collaborate, it will be done on a need by need basis.

³¹⁶ Tape painting is the one of the most common forms of market misrepresentation in the derivatives market. This is the reporting of fictitious transactions or fictitious advancing of bids to give an impression of price movements in the derivatives market as it gives an impression that there is intense demand for the derivatives.

³¹⁷ Scheme(s) aimed at boosting the price of a security through recommendations and/or opinions based on false, misleading and/or exaggerated statements.

³¹⁸ Article 6 of the United Nations Convention against Transnational Organized Crime (the "Palermo Convention") defines money laundering as comprising of three criminal elements:

"The conversion or transfer of property, knowing it is derived from a criminal offense, for the purpose of concealing or disguising its illicit origin or of assisting any person who is involved in the commission of the crime to evade the legal consequences of his actions.

The concealment or disguising of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property knowing that it is derived from a criminal offense

The acquisition, possession or use of property, knowing at the time of its receipt that it was derived from a criminal offense or from participation in a crime".

³¹⁹ 'Placement' is the introduction of the illegal proceeds into the financial system.

³²⁰ 'Layering' involves converting the proceeds of crime into another form and creating complex layers of financial transactions to disguise the audit trail, source and ownership of funds.

³²¹ 'Integration' involves supplying apparent legitimacy to illicit wealth through the re-entry of the funds into the economy in what appears to be normal business or personal transactions

³²² CMA, Guidelines on the Prevention of Money Laundering and Terrorism Financing in the Capital Markets (2015).

The legal framework on Anti-Money Laundering and Terrorism Financing cuts across the international and municipal level.³²³ Due to the cross-boundary nature of money laundering, regional and international bodies have been formed to combat with it.³²⁴ At the international level, The Financial Action Task Force (FATF) is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing.³²⁵ The Palermo Convention calls for all states to implement a regulatory and supervisory regime, which minimizes the possibility of money laundering through customer identification, the reporting of suspicious transactions and record keeping.³²⁶

In Kenya, the primary legislation on money laundering is the Proceeds of Crime and Anti-Money Laundering Act.³²⁷ The Act outlines the specific offences related to money laundering and their punishment and sets up an institutional structure on combating money laundering.³²⁸

In line with the Act, CMA, as the regulator and NEXE, as the derivatives exchange, through their structures are mandated to monitor all transactions and report suspicious transactions in the derivatives market to prevent money laundering. CMA has issued guidelines on anti-money laundering to provide guidance to market intermediaries on anti-money laundering.³²⁹ These Guidelines are elaborate in defining money laundering, the process of money laundering and methods used and outlining the obligations of market intermediaries in the prevention money laundering and more importantly, give specificity to provisions in the Proceeds of Crime and Anti-Money Laundering Act.³³⁰

³²³ The Palermo Convention (n 328).

³²⁴ *ibid.*

³²⁵ <http://www.fatf-gafi.org/> accessed 20th June 2017.

Countries, like Kenya, which are not members of FATF may be members of a FATF-style regional body. Kenya is a member of the Eastern and South African Anti Money Laundering Group (ESAAMLG).

³²⁶ The Palermo Convention, Article 6(1).

³²⁷ No. 9 of 2009, Laws of Kenya

³²⁸ The institutional set-up of countering money laundering is a four-tier structure. At the top is the Asset Recovery Agency and the Financial Reporting Center, with the mandate of recovering money and assets obtained from money laundering, and monitoring money laundering respectively; at the center are the sector-specific regulators charged with the mandate of overseeing their specific sectors and at the bottom are the key sector players where money laundering is likely to occur

³²⁹ CMA (n 322).

³³⁰ *ibid.*

3.4.3.3 False Trading in the Derivatives Market

In the derivatives market, false trading is an offence. This is the false or misleading appearance of trading where a person purports to execute a sale or purchase order without having effected a *bona fide* purchase or sale in reality.³³¹

In Hong Kong, the court in *HKSAR v Fu Kor Kuen*,³³² found the defendants guilty of false trading for trading in derivatives issued by the same issuer on the stock exchange amongst themselves with an aim of profiting from a rebate scheme. The defendants achieved this by placing orders to and sell against each other at the same time and price in order to generate a substantial trading volume.³³³ This was because under the rebate scheme, so long as each of the defendant's trade volume reached a certain prescribed level, they would each receive a rebate that would eventually offset their transaction costs and ultimately results in an almost risk-free profit.³³⁴ The offence of "false or misleading appearance" aims at ensuring that the derivatives market reflects "the forces of genuine supply and demand".³³⁵

Additionally, the offence of false trading appears to cover 'spoofing'. Spoofing is the placing and quick cancellation of an order that the trader never intended to be executed.³³⁶ Such behaviour can cause movement of prices in the derivatives market as it alters the perception of the traders.³³⁷ Although the law is clear on *actus rea* of spoofing, the law is vague on the *mens rea* requirements for spoofing.³³⁸ It is not clear whether one innocent act of placing and cancelling an order that ultimately results in change in prices of the underlying assets is tantamount to false trading or whether a spoofing pattern is required to prove the offence of false trading.³³⁹

³³¹ The Capital Markets Act, Section 32 G and the Capital Markets (Derivatives Markets) Regulations (2015), Regulation 72.

³³² (2010) CACC 179 of 2010.

³³³ *ibid.*

³³⁴ *ibid.*

³³⁵ *ibid.*

³³⁶ Gardner, Black's Law Dictionary (8th edn, 2008)

³³⁷ *ibid.*

³³⁸ The Capital Markets Act, Section 32 G and the Capital Markets (Derivatives Markets) Regulations 2015, Regulation 72.

³³⁹ *ibid.*

Similarly, in criminalising false trading, the law criminalises a situation where a sale or purchase does not result in a change of ownership especially where an investor wants to restructure his ownership to incorporate beneficial ownership of the derivatives. Due to the uncertainty on what a *bona fide* sale or purchase is, the law may leave participants who engage in wash trading,³⁴⁰ especially where the transaction does not create market risk, and/or matching orders³⁴¹ for legitimate commercial reasons, not aimed at manipulating the market, open to prosecution for false trading. This thus calls for the establishment of an economic test to guide investors on what constitutes false trading and the threshold for criminality.

3.4.3.4 Insider Trading in the Derivatives Market

Insider trading is conceptualised as the practice of trading on the securities exchange, to one's own advantage, based on having access to non-public information; the prevention of insider trading is integral to the integrity of the market.³⁴² The prohibition of insider trading is important in preventing informational asymmetry in the securities markets which undermine investor confidence and erodes market integrity.³⁴³ At the heart of the prohibition against insider trading is the principle of disclosure, that all material information must be accessed by the market participants. Article 35 of the Constitution of the constitution underpins the right to access information.³⁴⁴

The Capital Markets Act provides the legal framework against insider trading.³⁴⁵ The criminalization of insider trading is an absolute prohibition.³⁴⁶ However, the emergence of credit default swaps (CDS) has called for a rethink on the prohibition against insider trading.³⁴⁷

³⁴⁰ 'Wash trading' is the sale or purchase of securities that does not involve a change in the beneficial ownership.

³⁴¹ Matching orders refer to the purchase of derivatives at a price that is substantially the same as the price at which the investor knows that an associate has made an offer to sell the same or substantially the same number of them and vice-versa

³⁴² Capital Market Act, s 32B.

³⁴³ International Organization of Securities Commissions (IOSCO), Objectives and Principles of Securities Regulation (June 2010), 5, 18 and 43.

³⁴⁴ Right to access information.

³⁴⁵ The Capital markets Act, Section 32B.

³⁴⁶ Through amendments to the Capital Markets Act over the years, there has been reinforcement to legal framework against insider trading. Driven by the legal lacuna, particularly highlighted in Republic V Terry Davidson, (2010) Nairobi Chief Magistrate's Court Criminal Case No. 1338 of 2008, where the accused, a former chief executive of Kenya Commercial Bank (KCB) was cleared of insider trading as at that time the charge was not clearly spelt out in law.

³⁴⁷ Yesha Yadav, 'Insider Trading in Derivatives Markets', (2015) 103 Georgetown Law Journal, p. 381.

Conceived in the early 1990s,³⁴⁸ CDS is an arrangement or agreement where the seller of the CDS instrument compensates the buyer, usually the lender of the underlying loan facility, in the event of default by the borrower.³⁴⁹ The seller insures the lender against loan defaulting with the lender by making a series of payments known as the CDS fee or spread to the seller, and in exchange, receives money if the loan defaults.³⁵⁰ With the need to manage risks, lenders will mainly use CDS to trade off or minimize the risk of the loans they issue.³⁵¹

Thus, for the lenders to engage in trading of CDS, by their very nature of their business, they will be privy to borrower's confidential information.³⁵² From the current context of insider trading, the trading of CDS appears to subvert the law on insider trading by their very design and structure, insofar as lenders rely on insider information to transfer their loan risks.³⁵³ Although derivatives like CDS are not currently trading on derivatives exchanges, their continued emergence and popularity call for the rethinking of the conventional legal regime underpinning the prohibition of insider trading especially where they will start trading in exchanges.³⁵⁴ There is the need to qualify the criminalization of insider dealing. The legal regime should define transactions or securities that are subject (or not subject) to the prohibition of insider trading.

Kenya can benchmark with the United Kingdom in relation to the criminalisation of insider dealings. Part V of the U.K Criminal Justice Act³⁵⁵ provides the specific securities to which the offence of insider dealings applies: this is provided in the second schedule to the Act and is subject to any conditions made by Her Majesty's Treasury.³⁵⁶ The securities that are subject to

³⁴⁸ Smithson Charles and Mengle David, 'The Promise of Credit Derivatives in Non-financial Corporations (and Why It's Failed to Materialize)' (2016) 18 (4) Journal of Applied Corporate Finance, 54–60.

CDS have been in existence from the early 90s, with early trades been done in 1991 by Bankers Trust and J.P. Morgan & Co. from 1994. For example, in 1994, J.P. Morgan extended a \$4.8 billion credit facility to Exxon. Thereafter, with Exxon facing a threat of \$5 billion as punitive damages for the 1989 Exxon Valdez oil spill, J.P. Morgan sold the credit risk from the credit line to the European Bank of Reconstruction and Development in order to cut the statutory reserves that J.P. Morgan was required to hold against Exxon's default and thus improving its own balance sheet.

³⁴⁹ *ibid.*

³⁵⁰ *ibid.*

³⁵¹ *ibid.*

³⁵² *ibid.*

³⁵³ *ibid.*

³⁵⁴ *ibid.*

³⁵⁵ 1993.

³⁵⁶ Criminal Justice Act –U.K (1993), Sections 53 and 54.

the offence of insider dealing in the U.K are shares, debt securities, warrants, depository notes, options, futures and contracts for differences as securities.³⁵⁷ By having such a specified list under the law, the blanket prohibition on insider trading under Kenyan law can be removed and allow for the introduction of derivative securities whose basis is insider dealings.

3.4.4 Price Manipulation in the Derivatives Market

Regulation 74 of the Derivative Regulations criminalizes the indirect or direct manipulation of derivative prices.³⁵⁸ ‘Price manipulation’ is the deliberate attempt to interfere with the free and fair operation of the market and create artificial or misleading prices.³⁵⁹ The prohibition against price manipulation in the derivatives market extends to the manipulation of the price of the underlying asset or commodity.³⁶⁰ The prohibition against price manipulation protects investors from losses and promotes market confidence.³⁶¹

The blanket nature of this prohibition will derail the development of the derivatives market in Kenya, as it will limit the introduction of derivative products. There is the need to amend and qualify this prohibition to extend only to commodities or assets that are not subject to legally sanctioned price manipulation. This prohibition will prevent the introduction of derivatives whose underlying assets are oil or energy or other commodities subject to price stabilization.³⁶² Under the Energy Act in Kenya, the price of refined oil like petroleum and electricity is subject to the price setting mechanism of the Energy Regulatory Commission and not to market forces.³⁶³ Similarly, the government through market interventions such as subsidies and under the Price Control (Essential Goods) Act³⁶⁴ is able to manipulate commodity prices outside of the market forces.³⁶⁵

³⁵⁷ *ibid.*

³⁵⁸ Capital Markets (Derivatives Markets) Regulations (2015).

³⁵⁹ Robert Mudida, *Modern Economics* (Focus, 2003), 10.

³⁶⁰ Capital Markets (Derivatives Markets) Regulations (2015), Reg 74.

³⁶¹ IOSCO (n 323).

³⁶² Price Control (Essential Goods) Act (No 12 of 2006, Laws of Kenya).

³⁶³ No 12 of 2006, Laws of Kenya.

³⁶⁴ *ibid.*

³⁶⁵ *ibid.*

3.4.5 Fraud in the Derivatives Market

Fraud is the criminal deception that results in the financial or loss of property.³⁶⁶ The law also envisages the employment and/or use of fraudulent or deceptive devices and artifices, and the fraudulent inducement of trading in derivatives as offences.³⁶⁷ It is unclear on what the law terms as ‘devices, scheme or artifices’ as methods through which fraud can be perpetuated in the derivatives market.³⁶⁸

Additionally, the law recognizes the omission of material information resulting in financial loss as fraud.³⁶⁹ In relation to companies, sections 818 and 819 of the Companies Act prohibit the dissemination of false or misleading information by companies. The criminalisation of false or misleading information includes dissemination of such information in a reckless manner without authenticating it.³⁷⁰

The law prohibits fraudulent inducement of trading. Regulation 76 of the Derivatives Regulations prohibits the concealment of material information or the use of misleading or deceptive information aimed at inducing another to trade in derivatives. Similarly, section 16 of

³⁶⁶ Bryan Gardner, *Black's Law Dictionary* (8th ed, 2008)

³⁶⁷ Capital Markets (Derivatives Markets) Regulations (2015), Regulations 75 and 76 provides:

75. (1) A person who, directly or indirectly, in connection with any transaction with any other person involving trading in a derivatives contract —
(a) employs any device, scheme or artifice to defraud that person;
(b) engages in any act, practice or course of business which operates as a fraud or deception, or is likely to operate as a fraud or deception, of that person; or
(c) makes any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, misleading, commits an offence.

76. (1) A person who directly or indirectly, induces or attempts to induce another person to trade in a derivatives contract by —
(a) making or publishing any statement, promise or forecast that is false, misleading or deceptive;
(b) concealing material facts; or
(c) recording or storing in, or by means of, any mechanical, electronic or other device, information that is false or misleading in a material fact particularly to induce or attempt to induce that person to trade in a derivatives contract, commits an offence.

³⁶⁸ *ibid.*

³⁶⁹ *ibid.* Reg 75(1) (c).

³⁷⁰ Companies Act, s 819(b).

the Prevention of Fraud (Investments) Act criminalises the fraudulent inducement of any person to invest in any security.³⁷¹

The criminalisation of fraudulent trading is further buttressed by Section 1002 of the Companies Act which prohibits a company from carrying out any fraudulent business or with an aim of defrauding.³⁷² The legal framework is however unclear on fraud manifested where a derivatives contract is created and sold by individuals with the intention of causing financial loss to the investors or the buyers without the expectation that the investors will earn a profit or earn from the derivatives.³⁷³

3.5 Prohibition of Trading Derivatives outside the Derivatives Exchange

The law prohibits derivative brokers from dealing with derivatives traded outside the derivatives exchange.³⁷⁴ This effectively locks out licensed derivatives brokers from OTC derivatives markets.³⁷⁵ This ensures that OTC derivatives markets do not benefit from the expertise of licensed derivative brokers.³⁷⁶ With no regulatory regime to cover OTC derivative markets and prevent financial crimes, such markets may be deemed to be unattractive. This regime is oblivious of the fact that derivative instruments like forwards are traded in OTC markets and may not achieve the ultimate aim of expanding the derivatives market in Kenya.³⁷⁷

3.6 Is the Legal framework on Combating Financial Crimes in the Derivatives Market in Kenya Adequate?

The legal regime on combating financial crimes may be termed as comprehensive in terms of the scope and number of laws.³⁷⁸ It is broad to cover all the spheres of the economy.³⁷⁹ As outlined above, the possible financial crimes that are likely to threaten the derivatives market are covered under the law. Kenya has put in place laws to prevent theft, market manipulation,

³⁷¹ No 1 of 1977, Laws of Kenya.

³⁷² Companies Act, s 1002.

³⁷³ *ibid.*

³⁷⁴ Capital Markets (Derivatives Markets) Regulations (2015), Reg 77.

³⁷⁵ *ibid.*

³⁷⁶ *ibid.*

³⁷⁷ Capital Markets Authority, 'Capital Markets Master Plan -2014-2023' (2nd ed, 2016).

³⁷⁸ William Musyoka (n 255).

³⁷⁹ *ibid.*

corruption and fraud.³⁸⁰ The presence of this regime is very critical in the development and growth of the derivatives market. It boosts market integrity which in turn result in continued growth due to investor confidence.³⁸¹ The integrity of the will depend on the crime levels and enforcement efficiency.³⁸² The increased investor confidence may ultimately lead to increased foreign investment resulting in increased economic growth and development.³⁸³

Despite the comprehensive nature, in scope and number of the legislation, the law still falls short of providing a conducive framework for the growth and development of the derivatives market. There is need for sector guidelines to provide specific guidance of the criminal law regime, which is very broad-based and covers the entire breadth of the economy. Guidelines are instrumental in providing direction on the regulator’s viewpoint in discharging its regulatory role in combating financial crimes. Guidelines are instrumental in providing detailed information on how a regulator will enforce the law and regulations and how it will apply the provisions of the law relating to financial crimes.³⁸⁴

CMA has only issued guidelines relating to combating money laundering and terrorism financing in the securities markets and on corporate governance.³⁸⁵ CMA’s counterpart regulator in the anti-competition realm, the Competition Authority of Kenya has been on the forefront in the publication of guidelines on how to deal with statutorily created offences relating to anti-competitive behaviour like restrictive trade practices, abuse of dominance and

³⁸⁰ The criminal law regime like the Penal Code (Cap 63), the Economic Crimes and Anti-Corruption Act (No 3 of 2003), the Proceeds of Crime and Anti-Money Laundering Act (No 9 of 2009) and the market sector laws like the Capital Markets Act (Cap 485A) and regulations made under it.

³⁸¹ Bryan Fodor, ‘Measuring market integrity: a proposed Canadian approach’, (2008) 3(15) Journal of Financial Crime, 261-268.

³⁸² *ibid.*

³⁸³ *ibid.*

³⁸⁴ IOSCO, “Principles for the Regulation and Supervision of Commodity Derivatives Markets” (2011), 48 provides that, “Market Authorities should make clear to market participants what constitutes manipulative, abusive conduct or other prohibited conduct.....Because of this need to exercise subjective judgment, and in order to permit flexibility in preventing novel approaches to market abuses, some Market Authorities might specify those activities which may impair fair and orderly markets; including examples of such activities, or their effects, which they consider relevant to assess manipulative or abusive conduct and to have in place specific rules which prohibit such actions”

³⁸⁵ CMA, Guidelines on the Prevention of Money Laundering and Financing in the Capital Markets (2015) and CMA, Code of Corporate Governance Practices for Issuers of securities to the Public (2016).

buyer power and illegal mergers and acquisitions.³⁸⁶ CMA may issue similar guidelines to link financial crimes and the capital markets.

One of the aims of the law is to create a conducive environment for the development.³⁸⁷ The law against insider trading negates the role of the law as a developmental tool.³⁸⁸ The emergence and continued popularity of credit default swaps (CDS) trading globally call for a rethink on the prohibition against insider trading.³⁸⁹ With Kenya's derivative market been geared towards product diversification, the current regime on insider trading will stifle the introduction of CDS in the market especially where these derivatives may precipitate exchange-based trading.³⁹⁰

Globally, undue influence and pressure, that is not based on fraud, been exerted on investors and buyers have been on the rise, especially where the sellers or brokers have an existing financial relationship with the buyers i.e. financial advisors or a financial institution.³⁹¹ Kenya's legal framework appears to be inadequate in protecting investors from undue influence from brokers and financial advisors in the derivatives market.³⁹² This is because under the doctrine of privity of contracts,³⁹³ for undue influence to vitiate a contract it has to be exerted by a party to the contract and not from a third party.³⁹⁴ There is a high possibility that derivative brokers and other market intermediaries may exert undue influence and pressure on unsuspecting investors in order to earn commissions because derivative transactions are complex to the average investor and the intermediary has greater knowledge than the buyer does.

A model legal regime on the legal prohibition of undue influence is the United Kingdom's law prohibiting undue pressure selling. The Prevention of Fraud (Investments) Act prohibits high-

³⁸⁶ <https://www.cak.go.ke> <accessed 8th January 2018.

³⁸⁷ Kevin Davis and Michael Trebiclock, 'The Relationship Between Law and Development: Optimists versus Skeptics' 56(4) American Journal of Comparative Law (2008), 8-14

> https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1124045 < accessed 8th January 2018.

³⁸⁸ *ibid.*

³⁸⁹ Yadav (n 347).

³⁹⁰ *ibid.*

³⁹¹ Edward Bursk, 'Low Pressure Selling' (July-August 2006) Harvard Law Review

³⁹² Under section 3 of the Judicature Act (Cap 8): the substance of the common law applied by the Courts of England as at 12th August, 1897 is the applicable common law in Kenya. This thus means that even with the concept of undue influence evolving over the years, the applicable law is not in tandem with modern realities.

³⁹³ Under the common law doctrine of privity of contract only parties to the agreement can sue to enforce their rights under the agreement. A contract cannot confer rights or impose an obligation to a person who is not a party to the contract.

³⁹⁴ *Williams v Bailey* (1866) LR 1 HL 200.

pressure selling.³⁹⁵ This is the unethical and unsophisticated selling of securities to unsophisticated investors by using inducements and psychological pressure.³⁹⁶ In the UK, concerns about the use of aggressive selling techniques also led to the enactment of the Timeshare Act³⁹⁷ and the Door Step Regulations.³⁹⁸ The two laws allow for a fourteen days and seven days and fourteen days respectively through which a purchaser can cancel the contract and get back the money.³⁹⁹

Additionally, the focus of the criminal regime is more on the exchange and not on the OTC derivatives markets.⁴⁰⁰ Whereas the criminal regime on theft, corruption and money laundering cuts across the exchange and OTC derivatives markets, the market-specific offences of market manipulation, insider trading and market fraud apply to the exchange market only.⁴⁰¹ This is because the legal regime on market-specific offence is centred on the Capital Markets Act and its regulations which only focus on the exchange-based capital markets in Kenya.⁴⁰² The import of the law is that when market manipulation practices such as artificial pricing occur in the OTC segment, investors will not have recourse under the market-specific criminal law regime and can only find relief under their contracts.⁴⁰³ The end result is a scenario where one segment of the market is more 'protected' under the criminal law regime.

This uneven legal regime can be best illustrated by Kenya Airways' significant financial losses, in the financial years 2014-2016,⁴⁰⁴ partly attributed to fuel hedging by using derivatives under the OTC market set up.⁴⁰⁵ Kenya Airways had hedged its fuel costs in advance and levels that ultimately led to the airline paying more fuel than the then market prices.⁴⁰⁶ Although their

³⁹⁵ 1958.

³⁹⁶ *ibid.*

³⁹⁷ 1992- The Act applies to contracts over property ownership based on time.

³⁹⁸ 1987- They Regulations apply to contracts of goods or services worth more than 35 pounds.

³⁹⁹ *ibid.*

⁴⁰⁰ Capital Markets Act, s 11, Part III and Part IV.

⁴⁰¹ *ibid.*

⁴⁰² The Preamble of the Capital Markets Act provides that it is "An Act of Parliament....regulating the development of an orderly, fair and efficient capital markets in Kenya.

⁴⁰³ Capital Markets Act, s 11, Part III and Part IV.

⁴⁰⁴ Kenya Airways had pre-tax losses of Kshs. 25. 7 billion in 2014/15 and 26.2 Billion in 2015/16.

For more information on the financial results of Kenya Airways refer to it annual results available at <https://www.kenya-airways.com/about-us/investor-information/annual-reports/en/>> accessed 19th December 2017.

⁴⁰⁵ Rawlings Otini, 'KQ goes slow on fuel hedging after steps that did not pay off' The Business Daily Newspaper (Nairobi, 16th August 2016).

⁴⁰⁶ *ibid.*

might not have been any criminal activity as a result of the fuel derivatives, the fact that there was no criminal law intervention either to investigate market manipulation through misrepresentation points to the fact that the OTC market is not subject to the legal regime against market offences in the OTC market.⁴⁰⁷

The irony of this legal protection regime is that the market which is ‘more protected’ has remained largely undeveloped due to lack of investments.⁴⁰⁸ Since its establishment in around the year 2015, there have been single derivative traded through NEXT.⁴⁰⁹ Although a number of other factors, such as institutional capacity and regulatory bottlenecks, can be attributed to this lackluster performance of the derivatives exchange, it is without a doubt that the inconsistency in the application of the regulatory framework between the exchange and the OTC may be attributed to the exchange’s poor performance.⁴¹⁰

⁴⁰⁷ Capital Markets Act, s 11, Part III and Part IV.

⁴⁰⁸ Duncan Miriri, ‘Kenya’s bourse Scales back its derivatives ambitions’ (Reuters, 30th June 2016)<<https://www.reuters.com/article/us-kenya-nse/kenyas-bourse-scales-back-its-derivatives-ambitions-idUSKCN0ZF18S>> accessed 20th December 2018.

⁴⁰⁹ *ibid.*

⁴¹⁰ *ibid.*

CHAPTER FOUR

‘RUNNING AFTER THE VILLAIN’: THE ENFORCEMENT AND COMPENSATION FRAMEWORK FOR FINANCIAL CRIMES

4.0 Introduction

“Regulatory enforcement in the financial services sector has assumed increasing importance over recent years, particularly following a number of high profile cases...” Andrew Haynes.⁴¹¹

This chapter evaluates the enforcement and compensation mechanisms that would be set in motion when financial crimes occur in the Kenyan derivatives market. The continued development and sophistication of the capital markets in the last two decades has led to legal reforms aimed at preventing and combating financial crimes.⁴¹² The rise in and potential of increasing financial crimes and the need to protect the securities markets from such crimes has seen the establishment of an enforcement and compensation mechanism that cuts across all the different facets of the securities market. As part of the securities market, the derivatives market is subject to this framework.⁴¹³

A framework that is able to provide adequate regulation is not sufficient if there exists no, or there exists a weak, enforcement and compensation mechanism.⁴¹⁴ IOSCO principles on regulation provide that a market regulator’s enforcement responsibility must be clearly and objectively provided for under the law to ensure a strong enforcement regime.⁴¹⁵ Additionally the powers of the regulator should be adequately backed by appropriate resources to fulfill its mandate.⁴¹⁶

⁴¹¹ Andrew Haynes, *Financial Services Law Guide* (2nd Ed, Tottel, 2002), 359.

⁴¹² This has been marked by the enactment of, *inter alia*: the Proceeds of Crime and Anti-Money Laundering Act (No 9 of 2009) to provide the legal framework on combating money laundering; the Capital Markets Amendment Act (2013) which provided for the offence of insider trading; The Anti-Corruption and Economic Crimes Act to provide the legal framework on corruption and related economic crimes and the Capital Markets (Derivatives Markets) Regulations (2015) to provide the framework on market offences.

⁴¹³ *ibid.*

⁴¹⁴ International Organization of Securities Commissions (IOSCO), Objectives and Principles of Securities Regulation (June 2010), Part A, “Principles Relating to the Regulator”.

⁴¹⁵ *ibid.*

⁴¹⁶ *ibid.*

Although the enforcement mechanism in the Kenyan capital markets is a multi-agency approach,⁴¹⁷ the enforcement framework in the derivatives market is primarily institutionalised around the functions and roles of CMA.⁴¹⁸ CMA has the mandate to conduct market surveillance, monitor, investigate and take appropriate actions with a view to safeguarding the derivatives exchange market from financial crimes.⁴¹⁹ Through the Capital Markets Fraud Investigation Unit and other CMA organs, CMA is mandated to ensure that market integrity is upheld in the derivatives exchange.⁴²⁰ In fulfilling its enforcement mandate, CMA works together with other state and non-state actors.⁴²¹

Despite efforts to curb financial crimes, these crimes still happen and are likely to happen and result in monetary loss and legal injury.⁴²² Where the pecuniary loss has resulted from a financial crime attributable to a licensed market intermediary, the Investor Protection Fund provides compensation.⁴²³ The Investor Protection Fund is a specialized independent compensation fund.⁴²⁴ The law envisages that the fund has the ability to provide reasonable, if not full compensation, for any loss suffered because of a financial crime that directly or indirectly result in financial loss.⁴²⁵

4.1 Enforcing Good Market Practices: The Critical Role of CMA

IOSCO in its principles on securities markets provides that each member state will ensure that the derivatives market regulator has adequate and sufficient powers, resources and capacity to perform its roles.⁴²⁶ Additionally, these principles provide that each member state must ensure

⁴¹⁷ In addition to the role played by CMA, the enforcement framework encompasses the roles played by NEXT, as a self-regulating organisation, the police, the Financial Reporting Centre, the Director of Public Prosecutions, and the Ethics and Anti-Corruption Commission.

⁴¹⁸ The Capital Markets Act (Cap 485A). This is in line with IOSCO's, "Principles for the Regulation and Supervision of Commodity Derivatives Markets" (2011) at Page 50, which recommends that, "*Market Authorities should have adequate powers and capacity to investigate and prosecute actual or suspected market abuse, including attempted manipulation*".

⁴¹⁹ *ibid.*

⁴²⁰ *ibid.*

⁴²¹ *ibid.*

⁴²² IOSCO, "Principles for the Regulation and Supervision of Commodity Derivatives Markets" (2011).

⁴²³, Capital Markets Act (Cap 485 A), s 18.

⁴²⁴ *ibid.*

⁴²⁵ *ibid.*

⁴²⁶IOSCO (n 423).

that the derivatives markets regulator has adequate and comprehensive surveillance, inspection and investigation, and enforcement powers.⁴²⁷

As the regulator, the law places the duty of enforcement of the laws on combating financial crimes in the derivatives exchange market on CMA.⁴²⁸ The mandate to ensure market integrity and promoting investor confidence lies with CMA.⁴²⁹ CMA has put in place administrative divisions to ensure and monitor compliance and enforcement and has issued guidelines dealing with corporate governance and money laundering, aimed at bolstering its enforcement mandate.⁴³⁰ This is in line with the IOSCO principles on securities markets.⁴³¹

4.1.1 Reporting Financial Crimes: Strengthening Whistleblowing and Witness Protection

Although the derivatives exchange market in Kenya is in its nascent stages, it may end up to be a complex market just like other more established markets in South Africa, the USA and Seychelles.⁴³² The need for market surveillance will increase by the day as the likelihood of financial crimes increase with financial deepening.⁴³³ The ability of CMA to keep track of market developments will depend on its monitoring and surveillance capacity and its ability to collect information on the ongoings of the market.⁴³⁴ Such information collection may stem from the statutory information reporting obligations imposed on the market participants or may come from anonymous sources that may at times, depending on the nature of information or

⁴²⁷ *ibid.*

⁴²⁸ The Capital Markets Act (Cap 485A).

⁴²⁹ *ibid.*

⁴³⁰ CMA has the following departments: Investor Protection, Investor Education, Licensing and Approvals, and Research and Policy. See <https://www.cma.or.ke/index.php/about-us/vision-and-mission> accessed on 24th July, 2017 for a more detailed exposition on the roles of each department.

⁴³¹ That the market regulator has adequate and sufficient powers, resources and capacity to perform in its roles. Part A, “Principles Relating to the Regulator” in International Organization of Securities Commissions (IOSCO), Objectives and Principles of Securities Regulation (June 2010).

⁴³² Alastair Hudson, *Law on Financial Derivatives* (2nd edn, Sweet and Maxwell, 2012) alludes to the complex nature through which derivatives market are structured.

CMA, Policy Framework and ‘International Best Practices’ for Establishment and Operations of a Futures/Derivatives Market (2013) captures the complexity of the derivatives market.

⁴³³ *ibid.*

⁴³⁴ IOSCO, “Principles for the Regulation and Supervision of Commodity Derivatives Markets” (2011), Principle on ‘Information Sharing’ calls on “*Market regulators... to have arrangements that allow them to share information on large exposures in linked markets and on supplies relative to these markets*”.

disclosure, need protection.⁴³⁵ In cognisance of this, CMA has proposed to set up an information repository under the Financial Sectors Support Project of the World Bank to assist in information gathering.⁴³⁶ The purpose of the repository is to ensure timely access to information about the securities market.

Whistleblowing is also gaining root as a method of information sharing and reporting malpractices.⁴³⁷ The use of whistleblowing is becoming a very popular of reporting malpractices to regulators. Various Kenyan regulators and oversight authorities including the Capital Markets Authority, the Ethics and Anti-Corruption Commission and the Competition Authority of Kenya, have adopted whistleblowing.⁴³⁸

With CMA having provided an online platform⁴³⁹ for whistleblowing, the legal framework on whistleblowing continues to be inadequate⁴⁴⁰ and in some cases antagonistic to encouraging a culture of whistleblowing.⁴⁴¹ The current legal regime is silent on the legal conundrum that would result in instances where whistleblowing would result in a breach of trust and betrayal by the whistleblower.⁴⁴² In fact, where there exists a fiduciary duty coupled with a duty of confidentiality, the whistleblower can be held liable for the breach of these duties.⁴⁴³

The advent of a whistleblowers portal by CMA in 2015 has not increased the use of whistleblowing as a tool to stop financial crimes in the securities market in Kenya as its uptake

⁴³⁵ *ibid.*

⁴³⁶ CMA, 'Annual Report and Financial Statements (2016), 34 and 41.

⁴³⁷ Whistleblowing involves the reporting and disclosure of information on the committing of a crimes or a malpractice to the relevant authority by an employee or a person with internal information of an organisation. The whistleblower can be disclosed or remain anonymous.

⁴³⁸ Transparency International (Kenya), 'Comprehensive legislation on whistleblower protection in Kenya' (Policy brief July 2011).

⁴³⁹ The CMA whistleblower portal can be accessed through <https://www.cma.or.ke/index.php/whistleblower-portal> <accessed 24th July 2017.

⁴⁴⁰ *ibid*

⁴⁴¹ Section 41 of the Public Officers Ethics Act (No 4 of 2003) prohibits whistleblowing by public officers by providing that:

"A person who, without lawful excuse, divulges information acquired in the course of acting under this Act is guilty of an offence and is liable, on conviction, to a fine not exceeding five million shillings or to imprisonment for a term not exceeding five years or to both".

⁴⁴² *ibid.*

⁴⁴³ This is more applicable to those who by their nature are bound to keep confidential information like advocates, directors and bankers.

has been minimal.⁴⁴⁴ With no report or information been processed through the whistle blowers portal, CMA has proposed to give monetary rewards to whistleblowers in view to the low uptake of whistleblowing.⁴⁴⁵ Whereas the idea of monetary reward is a plausible move, it does not address the shortcomings of whistleblowing where there may exist a conflict with other fiduciary duties.

It is indeed imperative that the person who makes a genuine complaint be protected from those whom the complaint is against.⁴⁴⁶ It is against these that the issue of witness protection arises.⁴⁴⁷ The complainant, either known or unknown, must be given protection from any harm that is likely to occur.⁴⁴⁸ Generally, the investigator must protect all complainants.⁴⁴⁹ However, the development of the Kenyan legal regime on witness protection has led to the evolution of a false notion that witness protection is only for certified witnesses receive.⁴⁵⁰ Based on this misconceived notion, the Witness Protection Act provides that witness protection covers those approved for protection by a government authority.⁴⁵¹ This, in the long run, creates a slow bureaucratic system of sharing critical information on any financial crime and hinders the deterrence of these crimes.

4.1.2 Policing Financial Crimes: Need for Building CMA's Policing Capacity

Securities markets in many developing countries are dominated by various interest groups that aim to stall regulatory controls and reforms with an aim of circumventing regulation.⁴⁵² These interest groups promote market abuse to the disadvantage of other market players.⁴⁵³ The establishment of a proper regulatory capacity will thus safeguard against market abuse and

⁴⁴⁴George Ngigi, 'CMA moves to improve whistleblower protection' Business Daily Newspaper (Nairobi, 8th July 2016).

⁴⁴⁵*ibid.*

⁴⁴⁶Wilson Kiprono, Kibet Ngetich and Wokabi Mwangi, "Challenges Facing Criminal Justice System in Relation to Witness Protection in Kenya" (2015) 20 (10) IOSR Journal Of Humanities And Social Science (IOSR-JHSS), 93.

⁴⁴⁷*ibid.*

⁴⁴⁸*ibid.*

⁴⁴⁹*ibid.*

⁴⁵⁰ The Witness Protection Act (No 16 of 2006) at Section 5(1) provides that "*the decision to admit into or exclude any person from the programme, shall be the responsibility of the Director [of the Witness Protection Agency]*".

⁴⁵¹*ibid.*

⁴⁵² Ali Ibrahim, 'Developing Governance and Regulations for Emerging Capital and Securities Markets' (2007) 39 Rutgers Law Journal, 15-16.

⁴⁵³ *ibid*, 16.

prevent destabilisation caused by such market abuses.⁴⁵⁴ With this in mind, CMA is tasked with the dual mandate of developing and providing oversight to the securities market.⁴⁵⁵ In *BOC Gasses v Capital Markets Authority*,⁴⁵⁶ the Capital Markets Tribunal was categorical that “...with respect to the matter before us, we find that the respondent [CMA] has the dual statutory mandate of promoting the development of the Capital market as well as regulating. In our view, the respondent should continually strive to achieve both mandates...”⁴⁵⁷

However, the overall responsibility of investigating and combating criminal activities in Kenya lies with the National Police Service.⁴⁵⁸ Organized under the overall leadership of the Inspector General of Police, the National Police Service has the Kenya Police Service and the Administrative Police Service units.⁴⁵⁹ From a legal and albeit practical point of view, it is the Kenya Police that is tasked with combating financial crimes, even in the derivatives market.⁴⁶⁰ The combating of such financial crimes by the Kenya Police is, or should be, done through its various departments/ divisions tasked with investigations, combating internet and cyber-crimes and fraud prevention among other duties.⁴⁶¹ These investigative functions are mainly done through the Directorate of Criminal Investigations, popularly known as CID.⁴⁶²

With the mandate of ensuring market integrity and promoting investor confidence lying with CMA coupled with its lack of policing functions, CMA has collaborated with the Kenya Police’s Directorate of Criminal Investigations and established the Capital Markets Fraud Investigation unit (CMFIU).⁴⁶³ This collaboration consolidates investigations of securities

⁴⁵⁴ *ibid.*

⁴⁵⁵ Capital Markets Act, section 11.

⁴⁵⁶ (2006) (Nairobi Appeal No. 20 of 2006).

⁴⁵⁷ *ibid.*

⁴⁵⁸ The National Police Service Act (No.11A of 2011).

⁴⁵⁹ *ibid.* The Kenya Police’s mandate is to safeguard the security of the citizenry by providing adequate security protection, investigating crimes and providing other related support services in line with these roles. On the other hand, the Administration Police main responsibility is the provision of security support to government administrative organs.

⁴⁶⁰ *ibid.*

⁴⁶¹ *ibid.*

⁴⁶² The Directorate of Criminal Investigations has specialized units mandated to deal with cybercrimes, fraud, economic crimes, serious crimes, tax crimes, narcotics and drugs trading and banking fraud and terrorism. See <http://www.cid.go.ke/><accessed 24th July 2017 for more on the investigative units of the Department.

⁴⁶³ CMA outlines the functions of The Capital Markets Fraud Investigation Unit as, *inter alia*: (see <https://www.cma.or.ke/index.php/investor-protection/capital-markets-fraud-investigations>>accessed 24th July 2017):

1. Detection, prevention and apprehension of offenders perpetrating fraud within the Securities market.

related financial crimes under ‘one roof’.⁴⁶⁴ The Capital Markets Fraud Investigation unit is mandated to investigate all capital markets related offences, apprehend the offenders and act as the focal point for the dissemination of criminal intelligence information on the securities markets.⁴⁶⁵

The fact that CMA, with the legal mandate to investigate and undertake enforcement actions relating to financial crimes in the derivatives market relies on the Kenya Police may point to inadequate institutional capacity.⁴⁶⁶ The aspect of collaboration, though not a sign of CMA’s weakness points to lack of proper institutionalisation of its role.⁴⁶⁷ The challenge of such a collaborative framework lies in the administrative functioning of the Kenya Police. Due to the geographical and security-based deployments needs of the police officers, it means that CMFIU is an ‘amorphous’ unit; a unit without human resources stability with police officers working under it reporting to two different centers of control: the Capital Markets Authority and the Kenya Police.⁴⁶⁸ Additionally, due to the nature of the training of the Kenya Police, the skill set of police officers is not adequate to understand the complexities of the derivatives market.⁴⁶⁹

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2. Collection, analysis and dissemination of relevant criminal intelligence, within the market.
 3. Investigation and prosecution of detected / reported cases relating to the Securities market.
 4. Act as liaison unit between the Authority and other investigative agencies.
 5. Co-ordinates with the Authority’s Investigation and Enforcement Department whereby it takes up matters which have a criminal aspect for investigation and prosecution whilst the Authority’s Investigation & Enforcement Department pursues compliance with the Capital Markets Regulatory framework.
 6. Assist members of the public in the spirit of “Utumishi kwa wote” on relevant capital market issues.

⁴⁶⁴ *ibid.*

⁴⁶⁵ *ibid.*

⁴⁶⁶ The Capital Markets Act (Cap 485A) at section 13B provides that the Authority may investigate:

(1) Where the Authority has reasonable cause to believe, either on its own motion or as a result of a complaint received from any person, that—

- a) an offence has been committed under this Act; or*
- b) a licensed or approved person may have engaged in embezzlement, fraud, misfeasance or other misconduct in connection with its regulated activity; or*
- c) the manner in which a licensed or approved perm has engaged or is engaging in the regulated activity is not in the interest of the person’s clients or in the public interest,*
the Authority may in writing depute a suitably qualified person to conduct investigations into the matter on behalf of the Authority.

⁴⁶⁷ *ibid.*

⁴⁶⁸ *ibid.*

⁴⁶⁹ Steve Mbogo, “Institute proposes special police unit to monitor crimes” Business Daily Newspaper (Nairobi, 4th October 2011).

4.2 Enforcement Actions by CMA

As the principal regulator of the derivatives market, CMA in its mandate of ensuring market integrity and boosting investor confidence has an array of enforcement actions to deter financial crimes. These actions include market intervention; imposing sanctions and penalties and instituting judicial proceeding.

4.2.1 Enforcement through Market Intervention

CMA may interfere with the management and operations of a licensed market participant if it is of the opinion that the operations of the licensee are in breach of the regulatory regime. This is in order to ensure adherence to the law, corporate governance and safeguard investor interests.⁴⁷⁰CMA may opt to appoint an external party as the statutory manager or from amongst the employees of the licensee with the mandate of managing the operations of the licensee until such a time that CMA is of the opinion that the licensee is compliant.⁴⁷¹ Over the last decade, CMA has placed two stockbrokers under statutory management.⁴⁷² There have been no market interventions in the licensed entities in the derivatives market.⁴⁷³

4.2.2 Enforcement through the Imposition of Sanctions and Penalties

CMA, as the market regulator imposes sanctions and appropriate penalties to market intermediaries, market participants and their staff for breaches of the law or conditions.⁴⁷⁴ The objective of these sanctions and penalties is to deter, prevent or warn the concerned parties.⁴⁷⁵ They mainly act as deterrents from continued breach and in some instances; provide a mechanism for remedying the breach.⁴⁷⁶

⁴⁷⁰The Capital Markets Act (Cap 485) at section 33 provides that CMA can only intervene in the management of a licensee where the licensee is been wound up or an insolvency practitioner has been appointed or where CMA, in its own opinion, discovers that there is need to interfere with the management of the licensee in order to safeguard the market, investors and prevent or stop any illegality.

⁴⁷¹*ibid.* The statutory manager's tenure is for a renewable gazetted period of six months

⁴⁷²The affected entities were Discount Securities Limited (DSL), Nyaga Stockbrokers Limited, Francis Thuo and Partners limited.

⁴⁷³ This can be attributed to the fact the derivatives exchange In Kenya is very nascent.

⁴⁷⁴The Capital Markets Act (Cap 485), section 11(3),

⁴⁷⁵Spencer Pickett and Jennifer Pickett, *Financial Crime Investigation and Control* (Wiley, 2002).

⁴⁷⁶*ibid.*

The sanctions imposed on market intermediaries include whole or partial suspension of their licenses and the imposition of conditions.⁴⁷⁷ On individuals, especially those related to market intermediaries, CMA might restrict their employability or directorships in other listed companies.⁴⁷⁸

In *Capital Markets Authority v Jeremiah Gitau Kiereini*,⁴⁷⁹ CMA had barred Jeremiah Gitau Kiereini from directorships in other listed companies and imposed a financial penalty due to alleged engagement in poor corporate governance practices, fraud and conflict of interest during his stint as a director and chairperson of the board of directors of CMC Holdings Limited Kenya.⁴⁸⁰

Upon the constitution of a committee to investigate the allegations, CMA found him culpable for the breach of his fiduciary duties as a director and pronounced itself that Jeremiah Kiereini should not hold any other directorships in listed companies and was to compensate CMC holding two times the amount deemed to have been lost.⁴⁸¹ Although on Appeal, the court declared the decision by CMA as illegal, as CMA had not followed the right procedure in making the decision, this decision however reflects CMA's legal mandate in relation to imposing sanctions on individuals.⁴⁸²

Similarly, in *Peter Muthoka v Capital Markets Authority*,⁴⁸³ in relation to Peter Muthoka's stint at board of directors of CMC Holdings,⁴⁸⁴ the extent of CMA's role in imposing sanctions came into play. CMA had barred Peter Muthoka, just like the Kiereini's case (above), from sitting in boards of listed companies due to the breach in his fiduciary duties as a director and the breach of corporate governance practices and principles.⁴⁸⁵

⁴⁷⁷The Capital Markets Act (Cap 485), s 11(3).

⁴⁷⁸ *ibid.*

⁴⁷⁹ (2014) Civil Appeal 9 of 2014, [2014] eKLR

⁴⁸⁰ *ibid.*

⁴⁸¹ *ibid.*

⁴⁸² *ibid.*

⁴⁸³ Judicial Review 355 & 356 of 2012 [2012] eKLR

⁴⁸⁴ The facts before the court were similar to those discussed in *Capital Markets Authority v Jeremiah Gitau Kiereini* (2014) Nairobi Civil Appeal 9 of 2014 above.

⁴⁸⁵ *ibid.*

The broad powers of CMA may lead to a conclusion of regulatory bias. On one hand, CMA is involved in the license and approval the market intermediaries and their activities and on the other hand, it has the power to investigate and impose sanctions. This is akin the being the judge, jury and executioner. In *Broseau v Alta Securities Commission*,⁴⁸⁶ the court held to the effect that

*“...Securities Commissions, by their nature, undertake several different functions. The Commissions’ empowering legislation clearly indicates that the Commission was not meant to act like a court in conducting internal review and certain activities which might otherwise be considered “biased”, form an integral part of its operations....A security commission’s role, which gives it a special character, its structures and responsibilities must be considered in assessing allegations of bias...”*⁴⁸⁷

In almost all cases involving the imposition of sanctions by CMA that have ended up in the courts, CMA has been accused of having breached the principles of natural justice: in particular, the right to fair administrative action and fair hearing.⁴⁸⁸ In all these cases, the courts have found CMA to have breached the rights to fair administrative action and fair hearing. This is exhibited in the cases of *Peter Muthoka v Capital Markets Authority*,⁴⁸⁹ *Capital Markets Authority v Jeremiah Gitau Kiereini*,⁴⁹⁰ *Alnashir Popat v Capital Markets Authority*,⁴⁹¹ and *Republic v Capital Markets Authority ex-parte James Murigu and Bath Rugalo*.⁴⁹²

It is worth noting that the sanctions imposed by CMA are non-criminal in nature.⁴⁹³ They are mainly administrative sanctions. Criminal sanctions can only be placed after a judicial process.⁴⁹⁴ This can only be done after CMA has forwarded the matter to the DPP as it does not have prosecutorial jurisdiction.⁴⁹⁵ The challenge of this approach is that in most cases, the CMA

⁴⁸⁶ (1989) 1 Supreme Court Reports, 301.

⁴⁸⁷ *ibid.*

⁴⁸⁸ Constitution of Kenya (2010), Article 47 and Fair Administrative Actions Act (No 4 of 2012), Section 12

⁴⁸⁹ Judicial Review 355 & 356 of 2012 [2012] eKLR.

⁴⁹⁰(2014) Nairobi Civil Appeal 9 of 2014.

⁴⁹¹ (2016) eKLR.

⁴⁹² (2018) (High Court of Kenya at Nairobi, Miscellaneous Application 607 of 2016).

⁴⁹³ The Capital Markets Act (Cap 485), section 11(3).

⁴⁹⁴ *ibid*, these sanctions include suspension and cancellation of licenses.

⁴⁹⁵ Constitution of Kenya, Article 157.

will only pursue the most egregious crimes or large scale cases as CMA has other competing priorities such as the development of the capital markets.⁴⁹⁶ With the burden of criminal law being beyond reasonable doubt, which is significantly higher than the burden in administrative matters, CMA may opt to aggressively pursue administrative sanctions as opposed to criminal actions which will lead to very few criminal matters.⁴⁹⁷ Further, a majority of criminal prosecutors lack the specialized skills to successfully prosecute financial crimes.⁴⁹⁸ Based on these shortcomings, it is considered best practice to have securities markets regulators to have direct prosecutorial powers.⁴⁹⁹

4.2.3 Enforcement through Civil Judicial Proceedings

Although the enforcement mechanism against financial crimes is primarily under criminal law, such crimes will also embody other civil wrongs. CMA or the victims of the financial crimes can pursue civil remedies in the courts. CMA as evidenced in *Capital Markets Authority v Jeremiah Gitau Kiereini*⁵⁰⁰ and *Peter Muthoka v Capital Markets Authority*,⁵⁰¹ (discussed in 4.2.2) may be party to civil proceedings.

In most cases touching on financial crimes in the securities market, negligence will be the underlying cause of the crime. As a common law tort, negligence is the breach of duty of care that result in legal injury. The constitutive ingredients of negligence were well elucidated in the case of *Donoghue v Stevenson*,⁵⁰² as: first, the existence of a duty of care to a third party, in what is called as the “neighbour principle”; secondly, the breach of that duty of care; and thirdly, the resultant legal injury to the third part.⁵⁰³

Where there is an underlying aspect of negligence is caused by the market intermediary, the victims may institute a civil action against the perpetrators in addition to any criminal activity.

⁴⁹⁶ Ana Carvajal and Jennifer Elliot, ‘The Challenges of Enforcement in Securities Markets. Mission Impossible?’ (International Monetary Fund Working Paper, August 2009), 12-22.

⁴⁹⁷ *ibid*, 20.

⁴⁹⁸ *ibid*.

⁴⁹⁹ *ibid*.

⁵⁰⁰ (2014) Civil Appeal 9 of 2014.[2014] eKLR

⁵⁰¹ Judicial Review 355 & 356 of 2012 [2012] eKLR

⁵⁰² [1932] UKHL 100. A case involving a beer manufacturer’s failure to ensure the meeting of quality standards in the production of beer resulting in the presence of a decomposing snail inside the bottle of beer

⁵⁰³ *ibid*.

Under the criminal limb of the suit, the remedies granted will mainly be imprisonments and fines, while under the civil limb of the suit, the victims will be pushing for the common law remedy of damages and/or equitable remedies of injunction, specific performance or restitution.

4.3 Enforcement through NEXT as a Self-Regulatory Organisation

Self-regulation encompasses the intra-industry regulation with market participant establishing their own rules and regulations to guide them without external influence or regulation.⁵⁰⁴ The aspect of self-regulation within the securities markets is important in complementing and enhancing government based regulation centralised around CMA.⁵⁰⁵ In order to create a balance between state-based regulation, and for self-regulation to be effective, the law ensures the safeguarding of self-regulation through oversight from government or the principal regulator.⁵⁰⁶ Additionally, the self-regulating organs must ensure adherence to the law and the highest standards of professionalism.⁵⁰⁷

The fact that CMA may not be in a position to monitor all aspects of the derivatives market effectively, necessitates the need to rope in NEXT to complement CMA's role,⁵⁰⁸ where the derivatives exchange is able to also supervise, monitor and/or provide enforcement actions in the derivatives market under the authority and approval of the regulator.⁵⁰⁹

As a self-regulatory organization, NEXT has set up the derivatives oversight committee, product advisory committee and the risk management committee to provide oversight.⁵¹⁰ To this end, NEXT should put in place a code of conduct, an effective market surveillance system and an elaborate system of dispute resolution.⁵¹¹ The law also mandates NEXT to put in place rules,

⁵⁰⁴ Jacob Gakeri, 'Regulating Kenya's Securities Markets: An Assessment of the Capital Markets Authority's Enforcement Jurisprudence' (2012) 2 (20) International Journal of Humanities and Social Science, 266.

⁵⁰⁵ *ibid.* The author (Jacob Gakeri) opines that the regulatory approaches to securities markets are Government or Government-led and Self-regulation. However, a third categorization, which is a configuration of the two variously, described as "Self-regulation with Oversight" or "Cooperative regulation" or "Government-Supervised Self-regulation" has developed.

⁵⁰⁶ Self-regulation in the securities markets characterized with oversight from the government or the CMA is "Self-regulation with Oversight". See J Gakeri (n 505).

⁵⁰⁷ International Organization of Securities Commissions (IOSCO), Objectives and Principles of Securities Regulation (June 2010).

⁵⁰⁸ The need to have the market regulate itself also creates market confidence and relieves off the burden of regulation from the authorities.

⁵⁰⁹ The Capital Markets (Derivatives Markets) Regulations (2015), Regulation 37.

⁵¹⁰ CMA, 'Annual and Financial Report' (2016), 42.

⁵¹¹ *ibid.*

regulations and appropriate systems of regulating derivative brokers, who are members of the exchange.⁵¹² As a condition for licensure by CMA, NEXT is mandated to ensure the implementation of all the rules, regulations and systems of self-regulation that have been approved by CMA.⁵¹³

Despite the law creating a NEXT as a self-regulatory regime, this regime is not able to exercise independent oversight as CMA exercises an overarching mandate over the regulatory functioning of the self-regulatory organization.⁵¹⁴ CMA must approve the rules and regulations of the self-regulatory regime before their implementation thus making the self-regulatory regime subject to external forces, the CMA.⁵¹⁵ Similarly, it is not clear on the level of enforcement action and imposition of penalties that can be taken by the self-regulatory regime as it is subject to CMAs approval and thus may be subjective from one exchange to another, especially where there will exist more than one licensed derivatives exchange.⁵¹⁶ By law, CMA is the primary organ to monitor, survey and imposes penalties in the derivatives market and thus any other institutional framework to achieve CMA's role under its directions is dependent on it.⁵¹⁷

4.4 Enforcement through Criminal Proceedings: Prosecuting Financial Crimes

As discussed above, administrative redress is not the only way financial crimes are dealt with in the derivatives market. Criminal proceedings are very critical in effective enforcement.⁵¹⁸ Criminal sanctions act as deterrents: these include jail, fines and extradition.

The Directorate of Public Prosecutions (DPP) conducts all criminal prosecutions in Kenya.⁵¹⁹ The DPP is obliged to take up all criminal matters as the prosecutor of the state.⁵²⁰ The DPP

⁵¹² *ibid.*

⁵¹³ The Capital Markets (Derivatives Markets) Regulations (2015), Regulation 38.

⁵¹⁴ *ibid.*

⁵¹⁵ *ibid.*

⁵¹⁶ *ibid.*

⁵¹⁷ *ibid.*

⁵¹⁸ William Musyoka (n 255).

⁵¹⁹ Constitution of Kenya, Article 157.

⁵²⁰ *ibid.*

prosecutes in the name of the ‘Republic’.⁵²¹ Thus, even for financial crimes in the derivatives market, the onus of prosecuting them is with the office of the DPP.⁵²²

Despite the derivatives market being at its nascent stages, the state has prosecuted several securities market-based offences, key amongst them, the offence of insider trading.⁵²³ There has been no reported prosecution of any financial crime in the securities market in Kenya. The lack of criminal convictions leading to imprisonment or fines may create the perception that the criminal enforcement framework is weak, in spite of the administrative sanctions imposed by the CMA and the self-regulatory organisations.

In the current circumstances where CMA lacks prosecutorial powers, good coordination between CMA and the DPP is critical in order for the criminal system to function effectively and optimally.⁵²⁴ This coordination will ensure that information between CMA and the DPP is passed effectively and fast and ensure that resources are shared when necessary.⁵²⁵ The criteria for passing of matters to the DPP should be developed and be set out in law in order to ensure that objectively, the serious and damaging financial crimes cases are prosecuted.⁵²⁶

4.5 Recovery of Derivatives Contracts and Underlying Assets Purchased through Proceeds of Corruption, Crimes and Money Laundering

Under the Proceeds of Crime and Anti-Money Laundering Act⁵²⁷ and the Anti-Corruption and Economic Crimes Act,⁵²⁸ the state, through the Asset Recovery Agency (ARA) and the Ethics and Anti-Corruption Commission (EACC) respectively is mandated to recover any asset purchased or obtained from money obtained from corruption, money laundering and any criminal activity. Through a legal process that commences with investigations by the police and

⁵²¹ William Musyoka (n 255).

⁵²² *ibid.*

⁵²³ In *Republic v Terrence Davidson*, (2010) Nairobi Chief Magistrate’s Court Criminal Case No. 1338 of 2008, the state charged the accused, a former chief executive of Kenya Commercial Bank (KCB) with insider trading. The court acquitted him of the offence of insider trading as at that time the charge was non-existent in law.

⁵²⁴ Carvajal and Elliot (n 497), 21.

⁵²⁵ *ibid.*, 22.

⁵²⁶ *ibid.*, 22.

⁵²⁷ No. 9 of 2009, Laws of Kenya

⁵²⁸ No 3 of 2003, Laws of Kenya.

ends with the decision by a court of competent jurisdiction, ARA and EACC confiscate such property for the benefit of the state.⁵²⁹

In relation to derivatives, the holders of the derivatives contract or its underlying asset(s) forfeit them to the state.⁵³⁰ Where investors are using illegal money to invest in derivative contracts, the investors will forfeit the contracts and the benefits to the state.⁵³¹ It becomes problematic for underlying asset obtained using proceeds of crime and unsuspecting investors have invested in derivative contracts riding on such an asset. The forfeiture and confiscation of such an asset will result in the derivatives contract been void due to the contract's illegality.⁵³² With the recognition of international derivatives, the use of assets in other jurisdictions to underlie derivative contracts in Kenya may make it hard for investors to conduct due diligence and obtain information on the proprietary history of the assets and the owners and their source of financing to acquire such assets.

4.6 The Securities Markets Enforcement Jurisprudence

The enforcement jurisprudence of Kenya's securities market has been characterised as "heavy-handed and fault finding type" a 'la Joseph Kimura and Yobesh Amolo.⁵³³ This conclusion was based on the actions of CMA in the first five years of its establishment. Between the years of 1995 to 2001, CMA had delisted ten companies, suspended five companies, two companies were denied the authority to list and two stockbrokers were suspended.⁵³⁴ This was one of the most active periods of the enforcement regime.⁵³⁵

However, despite all the enforcement actions taken by the CMA during this period, there were no convictions for financial crimes in court: the enforcement actions were more administrative. The 2001 case of *Republic v Terrence Davidson and Bernard Kaburu*⁵³⁶ was one of the first

⁵²⁹ The Proceeds of Crime and Anti-Money Laundering Act (No. 9 of 2009, Laws of Kenya) and the Anti-Corruption and Economic Crimes Act (No 3 of 2003, Laws of Kenya).

⁵³⁰ The Proceeds of Crime and Anti-Money Laundering Act (No. 9 of 2009, Laws of Kenya), Part VII.

⁵³¹ *ibid.*

⁵³² Hugh Beale (ed), *Chitty on Contract*, (38th ed, Vol 1, Sweet and Maxwell, 1999), 386-402. Under English Common law, any contract based on an illegality is invalid.

⁵³³ Joseph Kimura and Yobesh Amolo, 'Impediments to the Growth of the Nairobi Stock Exchange'

⁵³⁴ Rita Rotich, *Determinants of the Decision by Companies to List at the Nairobi Securities Exchange* (Master of Business Administration Thesis, University of Nairobi, 2011), 10-12.

⁵³⁵ *ibid.*

⁵³⁶ 2008 (Nairobi CMCC No. 1338 of 2008).

cases touching on financial crimes in Kenya. This case, touching on insider trading resulted to an acquittal of the accused due to the lack of clear prohibition of insider trading under the law.⁵³⁷ No significant progress has been made to prosecute and convict people of financial crimes in the securities markets in Kenya. However, there are a number of ongoing cases touching on financial crimes in companies listed in the securities exchange: this range from the prosecution of directors of collapsed financial and retail institutions.⁵³⁸

The structure of CMA may ultimately lead to the conclusion that it is heavy handed and fault finding. It is structured in a way that it plays the role of investigator, prosecutor and hangman and operates with a view to finding fault on those it investigates.⁵³⁹ In *Alnashir Popat v Capital Markets Authority*,⁵⁴⁰ CMA's manner of conducting investigations was put in the spotlight.⁵⁴¹ The matter related to intended inquisitorial hearings to a bond issue by Imperial Bank Limited. The contention was that the inquisitorial nature was aimed at finding fault on the directors of the bank in issuing the bond and yet CMA had approved the bond issue.⁵⁴² This violated the right to equal protection under the law and fair administrative action due to the CMA's conflict of interest.⁵⁴³ The court held that it would be wrong for CMA to seek to investigate the circumstances that led to the bond approval without acknowledging the role its officers played in the approval of the bond.⁵⁴⁴

Similarly, in *Republic v Capital Markets Authority ex-parte James Murigu and Bath Rugalo*,⁵⁴⁵ CMA was faulted for its efforts to punish individuals who did not fall under its regulatory ambit.⁵⁴⁶ This was in relation to CMA's overzealous pursuit of the directors of Uchumi Supermarkets Limited for the breach of their fiduciary duties that led to the near collapse of the

⁵³⁷ *ibid.*

⁵³⁸ These include the ongoing cases of *Republic v Naem Ahmed Shah* and others in relation to fraud in the collapsed Imperial Bank of Kenya; *Republic v Makarios Agumbi, and Others* in relation to conspiracy to defraud Chase Bank Kenya Limited; and in the decided case of *Republic v Chris Kirubi* and others over an irregular sale of a store belonging to Uchumi Supermarket Limited Kenya.

⁵³⁹ Capital Markets Act, s 11.

⁵⁴⁰ (2016) Nairobi High Court Petition No. 245 of 2016.

⁵⁴¹ *ibid*, para 4-7.

⁵⁴² *Ibid.*

⁵⁴³ *Ibid.*

⁵⁴⁴ *ibid*, Para 137.

⁵⁴⁵ (2018) (High Court of Kenya at Nairobi, Miscellaneous Application 607 of 2016).

⁵⁴⁶ *ibid*, para 5.

supermarkets chain.⁵⁴⁷ In issuing the orders of certiorari and prohibition, the court agreed with the applicants that CMA actions aimed at punishing individuals who were beyond its regulatory ambit for the only reason that they once sat as directors of a troubled company without establishing fault.⁵⁴⁸

However, as Jacob Gakeri postulates in his journal article on the evaluating the jurisprudence of the Kenyan capital markets, it is impossible to characterise CMA's enforcement jurisprudence because of the lack of a similar jurisdiction for a comparative study.⁵⁴⁹ This is because the enforcement jurisprudence of a country is dependent on many variables like funding, staffing levels, role of the securities market, regulatory preference and private enforcement: all which are country specific.

4.7 Enforcement Capacity and the Need for Greater Cooperation Amongst Foreign Regulators

Even with the enactment of enabling legislation on combating financial crimes, CMA and other institutions capacity to effectively enforce the law is what counts.⁵⁵⁰ Numerous factors will always have an impact on the enforcement of anti-financial crimes laws. These include the level of institutional funding, political will, regulatory willingness and attitudes to enforce the laws, institutional capacity and effective court system.⁵⁵¹ With the right mix of these factors the derivatives market will be said to be well protected from financial crimes.⁵⁵² This will be indicated by the derivatives market been characterised as fair, liquid and stable by the market players and risk analysts once it is fully operational.⁵⁵³

Financial crimes are transboundary in nature and may take international dimensions. This rings true to the securities markets.⁵⁵⁴ In the derivatives markets, the underlying assets, the investors and the exchange may be in different jurisdictions.⁵⁵⁵ This creates a ripe environment for the

⁵⁴⁷ *ibid*, para 57.

⁵⁴⁸ *ibid*, paras 5, 129 and 130.

⁵⁴⁹ Gakeri (505), 285.

⁵⁵⁰ Carvajal and Elliot (n 497), 12-22.

⁵⁵¹ *ibid*, 23-28.

⁵⁵² *ibid*, 29-32.

⁵⁵³ *ibid*, 29.

⁵⁵⁴ *ibid*, 22.

⁵⁵⁵ *ibid*.

commission of financial crimes in one jurisdiction which may not be addressed by the legal regime of one country and thus enabling criminals to quickly move across borders and execute transaction in more than one country.⁵⁵⁶ As a result, the ability to share information amongst the different regulators has become integral to successful combating of financial crimes. Ultimately, CMA must ensure it enters into as many cooperative frameworks with other regulators to provide a collaborative effort on combating financial crimes.⁵⁵⁷ With this, CMA should maximize on IOSCO's draft Multilateral Memorandum for Information Sharing (MMOU) which sets best practice and standards on information sharing.⁵⁵⁸

4.8 The Compensation Framework

4.8.1 The Investor Compensation Fund

In addition to any other remedies available under the law, section 18 of the Capital Markets Act establishes the investor compensation fund as an independent fund for purposes of compensating investors who suffer pecuniary harm from the failure of any licensed market intermediaries.⁵⁵⁹ The Investor Compensation Fund ensures payment to an affected investor or individual who suffers any pecuniary loss from the activities and operations of a licensed market intermediary.⁵⁶⁰ Under Regulation 70 of the Capital Markets (Licensing Requirements) (General) Regulations, compensation is limited to fifty thousand Kenya shillings (Kshs. 50,000).⁵⁶¹

The statutory compensation limit of fifty thousand Kenya shillings is inadequate currently where the investment in the securities exchange by individual persons and entities are in the millions, if not billions. Additionally, with the market and the legal regime recognizing the central role of institutional investors and sophisticated investors as key players in the securities

⁵⁵⁶ *ibid.*

⁵⁵⁷ *ibid.*

⁵⁵⁸ Kenya signed the MMOU in February 2009.

⁵⁵⁹ Capital Markets Act, Part IV-CMA licenses market intermediaries.

⁵⁶⁰ The Investor Compensation Fund draws its money from mandatory contributions by market intermediaries, financial penalties' imposed by the CMA on market intermediaries, proceeds from ill-gotten wealth and interest accrued from its money. Additionally, where the fund makes payment to any individual or entity, the market intermediary that was liable for the pecuniary loss suffered is obligated to refund the amount paid out by the fund and where such a market intermediary is been liquidated, such amount will be refunded by the liquidator.

⁵⁶¹ Legal Notice No. 152 of 2002.

markets, a compensation regime that caps the maximum payable amount at fifty thousand shillings offers inadequate protection and acts as a disincentive to investments.⁵⁶²

4.8.2 Entrenching an Elaborate Criminal Compensation Regime in Kenya

Restitution is one of the main objectives of criminal law. Section 2 of the Victims Protection Act,⁵⁶³ envisages restitution as restoring the victim to the status prior to the offence resulting in the legal injury or loss.⁵⁶⁴ Restitution envisages compensation of the victims after the assessment by the court. Section 175(2) of the Criminal Procedure Code also allows courts to make order of compensation in criminal trials.⁵⁶⁵

Despite the law, Kenyan courts hardly make restitution orders after convictions in criminal trials. In signifying the court's reluctance in ordering for compensation, Mutuku J in *Simeon Muvengei v Republic*⁵⁶⁶ stated that, "While under section 175(2) of the Criminal Procedure Code, a court can order compensation in a criminal case, care must be taken to avoid situations where an accused could be prejudiced. It is my view that ordering compensation ...to the complainant in circumstances where the court did not carefully examine the circumstances leading to the civil liability is prejudicial..."

The established norm is that compensation is the preserve of civil trials after culpability has been established by the criminal trials. Civil litigation is by its nature expensive, time-consuming and subject to procedural intricacies. This thus makes court based efforts for compensation of financial crimes a difficult route for victims.

Compensation schemes to provide redress for victims of crimes exist in several legal systems. In 1995, the United Kingdom enacted the Criminal Injuries Compensation Act⁵⁶⁷ to establish a statutory framework on compensation after decades of operating a non-statutory compensation scheme. Canada, the USA, Australia and New Zealand have well organised and established systems of criminal compensation.

⁵⁶² The Capital Markets (Licensing Requirements) (General Regulations) 2002, Part III-VI.

⁵⁶³ No 17 of 2014.

⁵⁶⁴ *ibid.*

⁵⁶⁵ Cap 75, Laws of Kenya.

⁵⁶⁶ (2013) eKLR.

⁵⁶⁷ 1995

Under various African customs, there are elaborate compensation formulas and schemes for victims: this is known as the ‘blood money’ concept.⁵⁶⁸In *Republic v Mohamed Abdow*,⁵⁶⁹ the court accepted the use of camel, goats and other traditional ornaments to the aggrieved family as settlement for the murder under Islamic and customary law.

To better align the criminal compensation framework, Kenya can enact regulations on restitution in financial crimes injuries to complement the compensation provided under the Investor Compensation Fund. This is in line with Article 50 (g) of the Constitution which mandates parliament to enact legislation for the protection and welfare of victims of crimes. The legal framework can ensure that funds for compensation of victims are set off from the perpetrators property, income and prison earnings. The gravity and extent of the financial crime should inform the court on the amount of compensation to be granted to the victims.

4.9 A Fragmented Enforcement Framework: The Need for an Integrated Enforcement Framework in the Capital Markets: Is there need for a Financial Sector Ombudsman?

The Kenyan enforcement structure on combating financial crimes has been a fragmented process with different responsibilities and powers been vested in different institutions.⁵⁷⁰ Even with CMA’s overarching mandate, no single institution has the power or ability to take an overall responsibility over combating financial crimes.⁵⁷¹ A fragmented structure is expected to do better in enforcing laws as it ensures a focused regulator for only a small market segment especially where there are multiple regulators responsible for different sectors of the economy.⁵⁷² The overlapping nature of Kenya’s securities markets enforcement framework is best encapsulated in the decision by Mativo J in *Ernst and Young v Capital Markets Authority*:⁵⁷³

“...I also find that the first respondent [CMA] functions were authorized by the relevant statute and that the structure authorizes overlapping functions.

⁵⁶⁸ Pravin Bowry, ‘Compensation for Victims of Crimes Necessary’ The Standard Newspaper (Nairobi, 13th June 2012).

⁵⁶⁹ (2013) eKLR

⁵⁷⁰ These institutions include the Police, CMA, EACC and ARA.

⁵⁷¹ *ibid.*

⁵⁷² IOSCO, Transparency and Market Fragmented (Report from the Technical Committee of IOSCO, November 2001), 8-9.

⁵⁷³ (2017) Nairobi Petition Number 385 of 2016, 20.

*Administrative bodies are created for a variety of reasons and to respond to a variety of needs. In some cases, the legislature may decide that in order to achieve the ends of the statute, it is necessary to allow and overlap in functions....*⁵⁷⁴

A fragmented enforcement framework is prone to the challenge of duplication of laws and directives where two or more sets of regulations or directives touch on the same matter.⁵⁷⁵ The possibility of conflicts between institutions in the performance of the same roles is real.⁵⁷⁶

An integrated enforcement system would eliminate the overlapping of roles.⁵⁷⁷ This would create a system that is non-duplicative in nature.⁵⁷⁸ The likelihood of disputes in the performance of roles would be minimised.⁵⁷⁹ This would be critical in monitoring risks across the economy as the approach to such monitoring is controlled from one point and is not antagonistic.⁵⁸⁰ An integrated regime would enable smoother and a more frequent flow of information. This would minimise the challenges of information bureaucracy associated with a fragmented system.⁵⁸¹

An integrated framework would mean the creation of a single framework in the derivatives and securities markets as the focal point for combating financial crimes under the proposed Financial Services Authority of Kenya.⁵⁸² This may not necessarily lead to the disbandment or undermining of the roles of the Capital Markets Authority, National Police Service, Director of Public Prosecutions or the other agencies involved in enforcement.⁵⁸³ It may involve the strengthening of the Capital Markets Fraud Investigation Unit to a unit that is semi-independent with a workforce that works free from the interference of the National Police Service and CMA. As a semi-autonomous unit, the CMFIU will be the focal point on all enforcement actions in combating financial crimes in the derivatives market and all other agencies will take directions from it.

⁵⁷⁴ *ibid.*

⁵⁷⁵ Paul Richards, 'International Capital Market Fragmentation' (2007) 45 International Capital Markets Association Quarterly Assessment, 7-9.

⁵⁷⁶ *ibid.*

⁵⁷⁷ Andreas Grünbichler and Patrick Darlap, *Regulation and Supervision of Financial Markets and Institutions A European Perspective* (Vienna 2003), 6.

⁵⁷⁸ Retirements Benefits Authority, 'Case for Consolidated Financial Sector Regulation in Kenya' (2008), 5.

⁵⁷⁹ *ibid.*

⁵⁸⁰ *ibid.*

⁵⁸¹ *ibid.*

⁵⁸² Financial Services Authority Bill (2017).

⁵⁸³ *ibid.*, Part XVI.

This integration in the enforcement and compensation framework can also be achieved through the establishment of the office of the financial ombudsman.⁵⁸⁴ This can be a stand-alone semi-autonomous office or structured within the existing Commission on Administrative Justice (the Ombudsman)⁵⁸⁵ or within the proposed Financial Services Authority.⁵⁸⁶ The financial ombudsman should have the specific mandate of investigating and settling disputes arising in the financial sector, including in the derivatives market. The office should have prosecutorial powers to prosecute crimes financial crimes.⁵⁸⁷ This way, the role played by CMA, police, ARA, EACC and the DPP in relation to the securities markets will be fused into one independent office with the requisite technical capacity.

⁵⁸⁴ *ibid*, Part XI.

⁵⁸⁵ Constitution of Kenya, Art 59 (4) and the Commission on Administrative Justice Act (No.23 of 2011).

⁵⁸⁶ Financial Services Authority Bill (2017), Part XI.

⁵⁸⁷ Jacob Gakeri (n 534), 283.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.0 Introduction

This chapter summarises the research and marks the conclusion of this study. It also informs recommendations on any legal reforms and future studies on the suitability of the legal framework on combating financial crimes on the development of the derivatives market in Kenya. Importantly this chapter evaluates whether the study met its objectives and whether the research questions were adequately answered and the hypotheses (dis)proved.

5.1 Summary

The general objective of this study was to appraise the efficacy of the current legal framework on combating financial crimes on the development of the Kenyan Derivatives market. More particularly, the study was to succinctly outline and highlight the legal and institutional structure of the derivatives market in Kenya; appraise the legal framework on financial crimes in relation to the development of the derivatives market in Kenya; and evaluate the enforcement mechanisms of financial crimes in the derivatives market in Kenya.

First, in evaluating the legal and institutional structure of the derivatives market in Kenya, the study notes that the development of the derivative exchange in Kenya in the period after 2013 ushers in a new dawn in financial innovation and deepening of the financial markets.⁵⁸⁸ In order to broaden the financial services sector and in fulfillment of Kenya's Vision 2030, the Kenyan financial markets have undergone significant positive developments over the last two or so decades.⁵⁸⁹ Due to the reforms and restructuring of the securities market, new financial products have been introduced, amongst them, exchange-traded derivatives.⁵⁹⁰

It is against this backdrop of tremendous growth in Kenya's financial sector that has seen Kenya put in place a legal and institutional framework on trading of derivative instruments in a

⁵⁸⁸ CMA, 'Policy Framework and International Best Practices for a Futures Derivatives Market' (2014).

⁵⁸⁹ Francis Mweya, 'Financial regulation in Kenya: Balancing Inclusive Growth with Financial Stability' (Overseas Development Institute Working Paper 2014).

⁵⁹⁰ *ibid.*

securities exchange.⁵⁹¹ Just like Kenya, policymakers and governments in Africa have continued to underscore the importance of developing their capital markets, through product diversification and creation of an efficient regulatory regime, as important aspects of catalyzing economic growth and development through the money markets.⁵⁹²

Kenya has an elaborate legal framework on the exchange-traded derivatives encapsulated under the Capital Markets Act and the Capital Markets (Derivatives Markets) Regulations, 2015. The Nairobi Securities Exchange (NSE) Derivatives Market (NEXT) is the licensed derivatives exchange in Kenya, licensed by CMA. However, unlike the elaborate legal framework for exchange-traded derivatives, OTC derivatives remain largely unregulated by the security market regulators and their regulation is mainly left to OTC market participants.⁵⁹³ There is no focused government regulatory approach in the OTC derivatives market and they are only subject to the overall legal regime that guides conduct and any regulations developed between the participants.⁵⁹⁴

The distinction in the regulatory models between the exchange and OTC derivatives market is critical in the application of the laws on combating financial crimes in the derivatives market. Whereas the formal derivatives market has different levels of control to prevent or minimise crimes, the informal derivatives market is largely left to the regulation of market participants.⁵⁹⁵ The irony of this regulatory approach is that the exchange derivatives markets remain largely undeveloped as the OTC derivatives market continues to flourish.⁵⁹⁶

The establishment of well-structured derivatives markets is not only critical in ensuring transparency in the money markets but is instrumental in stabilizing the prices of commodities like grains; providing financial resources to investors and providing market participants and

⁵⁹¹ Ken Kahugu, 'A Highlight of the Kenyan Budget-2010/2011' The Daily Nation Newspaper (Nairobi Kenya 10th June 2010)

⁵⁹² Nancy Laibuni, Githinji Njenga, et al, 'Is There Need for an East African Commodity Exchange?' Kenya Institute of Policy Research and Analysis working paper 4/2013.

⁵⁹³ Cedric Achille, Lamon Rutten et al, *Guidebook of African Commodity and Derivatives Exchange* (African Development Bank, 2013), 38.

⁵⁹⁴ *ibid.*

⁵⁹⁵ Edward Bowen, Makena Kaburu et al, 'Factors Influencing the Growth of Derivatives in Kenya: A Case Study of the Nairobi Securities Exchange' (2017) 4(3) The Strategic Journal of Business & Change Management, 710.

⁵⁹⁶ *ibid.*, 711.

investors with opportunities to hedge and manage risks.⁵⁹⁷ Additionally, increased trading in derivatives trading will result in enhanced economic cooperation between people from different countries as international or cross-border based derivatives trading provides avenues for foreign investment.⁵⁹⁸

Secondly, as regards the second objective of appraising the legal framework on financial crimes in relation to the development of the derivatives market in Kenya, the prevention of financial crimes, as an aspect of ensuring market integrity, is critical for the efficient and proper functioning of the derivatives market.⁵⁹⁹ Derivatives markets are also prone to financial crimes.⁶⁰⁰ Although the definition of the term 'financial crime' is too broad and wide, the term is mainly used to explain any non-violent crime that leads to financial loss. In particular, derivatives markets are prone to financial crimes that affect the general economy like corruption, theft, fraud and money laundering, and are also prone to market-specific offences, *inter alia*, market manipulation, false trading, bucketing and insider trading.

The legal regime on protecting the derivatives markets from financial crimes has its basis on Kenyan domestic laws, international laws forming part of Kenyan Law and IOSCO Guidelines to market regulators.⁶⁰¹ The study appraised the suitability of the Kenyan legal regime based on the model of classification of financial crimes based on Peter Gottschalk categorization in his journal article aptly titled 'Categories of Financial Crime'.⁶⁰² Peter Gottschalk classifies financial crimes into four broad categories: corruption, fraud, theft and manipulation.⁶⁰³

Kenya has elaborate laws on combating corruption. The legal regime on anti-corruption in Kenya cuts across various policy and legislative enactments but is primarily encapsulated in the Anti-Corruption and Economic Crimes Act⁶⁰⁴ and the Bribery Act.⁶⁰⁵ Although the duty to fight

⁵⁹⁷ *ibid.*

⁵⁹⁸ Anthony Saunders and Millon Cornett, *Financial Institutions Management: A Risk Management Approach* (6th ed, Mc-Graw Hill Irwin, 2008), 691-768.

⁵⁹⁹ *ibid.*

⁶⁰⁰ Gerald Cliff and Christian Desilets, 'White Collar Crime: What It Is and Where It's Going' 28(2) *Notre Dame Journal of Law, Ethics & Public Policy* (2014), 482-487.

⁶⁰¹ The legal regime entails two main categories: Those that are derivative market-specific and those that affect the economy in general.

⁶⁰² Peter Gottschalk, 'Categories of Financial Crime' 17 (4) *Journal of Finance and Crime*, 441-45.

⁶⁰³ *ibid.*

⁶⁰⁴ No 3 of 2003, Laws of Kenya.

corruption lies with individuals, the law establishes the Ethics and Anti-Corruption Commission (EACC) to spearhead efforts against corruption.⁶⁰⁶

Kenya has laws on combating theft. Defined as the taking of another's property without their permission, theft is a criminal offence under the Penal Code.⁶⁰⁷ The Penal Code creates several offences relating to the taking of another's property. These include the offences of theft,⁶⁰⁸ robbery and extortion,⁶⁰⁹ and burglary.⁶¹⁰ Stealing, in relation to derivatives, is directed at either at the underlying instrument or at the identity of the proprietors of the asset or investor. The legal regime imposes criminal sanctions of fines and imprisonment for those found guilty of the offences relating to stealing.⁶¹¹

Kenya in place a regime to prevent money laundering and terrorism financing, the primary legislation on money laundering is the Proceeds of Crime and Anti-Money Laundering Act.⁶¹² The Act outlines the specific offences related to money laundering and their punishment and sets up an institutional structure on combating money laundering.⁶¹³ In line with the Act, CMA, as the regulator and NEXT, as the derivatives exchange, through their structures are mandated to monitor all transactions and report suspicious transactions in the derivatives market to prevent money laundering. CMA has issued guidelines on anti-money laundering to provide guidance to market intermediaries on anti-money laundering.⁶¹⁴ These Guidelines are elaborate in defining money laundering, the process of money laundering and methods used and outlining the obligations of market intermediaries in the prevention money laundering and more

⁶⁰⁵ No 46 of 2016.

⁶⁰⁶ Established under Section 3 (1) of the Ethics and Anti-Corruption Commission (EACC) Act, 2011, EACC's mandate is to combat and prevent corruption and economic crime in Kenya through law enforcement, preventive measures, public education and promotion of standards and practices of integrity, ethics and anti-corruption.

⁶⁰⁷ Cap 63, Laws of Kenya.

⁶⁰⁸ *ibid*, Chapter XXV1.

⁶⁰⁹ *ibid*, Chapter XXVIII.

⁶¹⁰ *ibid*, Chapter XXVIX.

⁶¹¹ *ibid*.

⁶¹² No. 9 of 2009, Laws of Kenya

⁶¹³ The institutional set-up of countering money laundering is a four-tier structure. At the top is the Asset Recovery Agency and the Financial Reporting Center, with the mandate of recovering money and assets obtained from money laundering, and monitoring money laundering respectively; at the center are the sector-specific regulators charged with the mandate of overseeing their specific sectors and at the bottom are the key sector players where money laundering is likely to occur

⁶¹⁴ CMA, Guidelines on the Prevention of Money Laundering and Terrorism Financing in the Capital Markets (2015).

importantly, give specificity to provisions in the Proceeds of Crime and Anti-Money Laundering Act.⁶¹⁵

There is a criminal law framework prohibiting misrepresentation in the derivatives market. Misrepresentation and deceit are forms of market manipulation embodied under the offence of manipulation of prices and cornering.⁶¹⁶ Additionally, misrepresentation, from the common law perspective, is the giving a false account in order to induce one to enter into a contract.⁶¹⁷ The legal position on misrepresentation under contract law is set out under the substance of common law and doctrines of equity as at 1859.⁶¹⁸

However, the current legal structure does not cater for misrepresentation that emanates from other jurisdictions.⁶¹⁹ With the current framework allowing for international derivatives, the territoriality of the law does no safeguard investors from misrepresentation arising from external jurisdiction.⁶²⁰ Their only recourse would lie with the CMA liaising with the other jurisdiction's regulator and depending on their law; such misrepresentation may not be a crime.⁶²¹

Kenya has put in place laws aimed at curbing market-specific offences in the derivatives market. The law also envisages the criminalisation of the employment and/or use of fraudulent or deceptive devices and artifices, and the fraudulent inducement of trading in derivatives as offences.⁶²² In the derivatives exchange, false trading is an offence. This is the false and/or misleading appearance of trading where a person purports to execute a sale or purchase order without having effected a *bona fide* purchase or sale in reality.⁶²³ The false trading offence is the false and/or misleading appearance of trading or with respect to a derivatives contract.⁶²⁴ Regulation 74 of the Derivative Regulations 2015 criminalizes the indirect or direct

⁶¹⁵ *ibid.*

⁶¹⁶ *ibid.*, Regulation 74 (1).

⁶¹⁷ Hugh Beale (ed), *Chitty on Contract*, (38th ed, Vol 1, Sweet and Maxwell, 1999) 6-001-6-135, 386-402.

⁶¹⁸ Law of Contract Act (Cap 23, Law of Kenya).

⁶¹⁹ The Capital Markets Act, Preamble.

⁶²⁰ *ibid.*

⁶²¹ It is worth noting that there is no collaborative framework between CMA and other regulators in other jurisdictions and as such, in case of the need to collaborate, it will be done on a need by need basis.

⁶²² The Capital Markets (Derivatives Markets) Regulations (2015), Regulations 75 and 76

⁶²³ The Capital Markets Act at Section 32 G of and Regulation 72 of the Capital Markets (Derivatives Markets) Regulations (2015)

⁶²⁴ *ibid.*

manipulation of derivative prices.⁶²⁵ The law also prohibits derivative brokers from dealing with off-exchange derivatives.⁶²⁶ This effectively locks out licensed brokers from the over the counter markets.⁶²⁷ This ensures that over the counter derivatives markets do not benefit from the expertise of licensed derivative brokers.⁶²⁸

The Capital Markets Act also prohibits insider trading.⁶²⁹ The prohibition of insider trading is important in preventing informational asymmetry in the securities markets as it undermines investor confidence and erodes market integrity.⁶³⁰ At the heart of the prohibition against insider trading is the principle of disclosure, that all material information must be accessed by the market participants. Article 35 of the Constitution guarantees the right to access information.⁶³¹

However, the emergence of credit default swaps (CDS) trading globally has called for a rethink on the prohibition against insider trading.⁶³² ACDS is an arrangement or agreement where the seller of the CDS instrument compensates the buyer, usually the lender of the underlying loan facility, in the event of default by the borrower.⁶³³ Thus, for the lenders to engage in trading of CDS, by their very nature of their business, they will be privy to borrower's confidential information.⁶³⁴

Thirdly, the study aimed at evaluating the enforcement and compensation framework for financial crimes on the development of the derivatives market. A framework that is able to provide adequate regulation is not adequate if there exists no or there exists a weak enforcement and compensation mechanism.⁶³⁵ The market regulator's enforcement responsibility must be

⁶²⁵ Capital Markets (Derivatives Markets) Regulations (2015).

⁶²⁶ *ibid.* Reg 77.

⁶²⁷ *ibid.*

⁶²⁸ *ibid.*

⁶²⁹ The Capital markets Act, s 32B.

⁶³⁰ International Organization of Securities Commissions (IOSCO), Objectives and Principles of Securities Regulation (June 2010).

⁶³¹ Right to Access Information.

⁶³² Yesha Yadav, 'Insider Trading in Derivatives Markets', (2015) 103 Georgetown Law Journal, p. 381.

⁶³³ *ibid.*

⁶³⁴ *ibid.*

⁶³⁵ Part A, "Principles Relating to the Regulator" in International Organization of Securities Commissions (IOSCO), Objectives and Principles of Securities Regulation (June 2010).

clearly and objectively provided for under the law.⁶³⁶ Additionally, the powers of the regulator should be adequately backed by appropriate resources to fulfil its mandate.⁶³⁷

With enforcement mechanism in Kenya tailored around several agencies,⁶³⁸ the enforcement framework in the derivatives market is primarily institutionalised around the CMA.⁶³⁹ CMA has the mandate to conduct market surveillance, monitor, investigate and take appropriate action with a view to safeguarding the derivatives market from financial crimes.⁶⁴⁰ CMA, through the Capital Markets Fraud Investigation Unit (CMFIU) and other departments, has the mandate to uphold market integrity and safeguard investors in the derivatives market.⁶⁴¹ In fulfilling its enforcement mandate, CMA is obligated under the law to collaborate and work other state and non-state organs.⁶⁴²

As the principal regulator of the derivatives market, CMA, in its mandate of ensuring market integrity and boosting investor confidence, has an array of enforcement actions to deter financial crimes. These actions include market intervention, imposing sanctions and penalties and instituting judicial proceeding. Although the enforcement mechanism against financial crimes is primarily under criminal law, such crimes will also embody other civil wrongs through which result in actions for civil remedies.

The Directorate of Public Prosecutions (DPP) conducts all criminal prosecutions in Kenya.⁶⁴³ The DPP is obliged to take up all criminal matters as the prosecutor of the state.⁶⁴⁴ The DPP prosecutes in the name of the 'Republic'.⁶⁴⁵ Thus, even for financial crimes in the derivatives market, the onus of prosecuting them is with the office of the DPP.⁶⁴⁶

⁶³⁶ *ibid.*

⁶³⁷ *ibid.*

⁶³⁸ In addition to the role played by CMA, the enforcement framework encompasses the roles played by NEXT, as a self-regulating organisation, the police, the Financial Reporting Centre, the Director of Public Prosecutions, and the Ethics and Anti-Corruption Commission.

⁶³⁹ The Capital Markets Act (Cap 485A).

⁶⁴⁰ *ibid.*

⁶⁴¹ *ibid.*

⁶⁴² *ibid.*

⁶⁴³ Constitution of Kenya, Article 157.

⁶⁴⁴ *ibid.*

⁶⁴⁵ William Musyoka, *Criminal Law* (Law Africa, 2013).

⁶⁴⁶ *ibid.*

Under the Proceeds of Crime and Anti-Money Laundering Act⁶⁴⁷ and the Anti-Corruption and Economic Crimes Act,⁶⁴⁸ the state, through the Asset Recovery Agency (ARA) and the Ethics and Anti-Corruption Commission (EACC) respectively have the mandate to recover any asset purchased or obtained from money obtained from corruption, money laundering and any criminal activity. Through a legal process that commences with investigations by the police and ends with the decision by a court of competent jurisdiction, ARA and EACC confiscate such property for the benefit of the state.⁶⁴⁹

In relation to compensation for financial crimes, the remedy of restitution is one of the main objectives of criminal law. Section 2 of the Victims Protection Act,⁶⁵⁰ envisages restitution as restoring the victim to the status prior to the offence resulting in the legal injury or loss.⁶⁵¹ Restitution envisages compensation of the victims after the assessment by the court. Section 175(2) of the Criminal Procedure Code also allows courts to make an order of compensation in criminal trials.⁶⁵² Despite the law, Kenyan courts hardly make restitution orders after convictions in criminal trials.⁶⁵³

In addition to any other remedies available under the law, section 18 of the Capital Markets Act establishes the investor compensation fund as an independent fund for purposes of compensating investors who suffer a pecuniary harm from the activities of any licensed market intermediaries.⁶⁵⁴ The Investor Compensation Fund ensures that payment to an affected investor or individual who suffers any pecuniary loss from the activities and operations of a licensed market intermediary.⁶⁵⁵ Under Regulation 70 of the Capital Markets (Licensing Requirements)

⁶⁴⁷ No. 9 of 2009, Laws of Kenya.

⁶⁴⁸ No 3 of 2003, Laws of Kenya.

⁶⁴⁹ The Proceeds of Crime and Anti-Money Laundering Act (No. 9 of 2009, Laws of Kenya) and the Anti-Corruption and Economic Crimes Act (No 3 of 2003, Laws of Kenya).

⁶⁵⁰ No 17 of 2014.

⁶⁵¹ *ibid.*

⁶⁵² Cap 75, Laws of Kenya.

⁶⁵³ Simeon Muvengei v Republic (2013) eKLR

⁶⁵⁴ The CMA does licensure of Market Intermediaries.

⁶⁵⁵ The Investor Compensation Fund draws its money from mandatory contributions by market intermediaries, financial penalties' imposed by the CMA on market intermediaries, proceeds from ill-gotten wealth and interest accrued from its money. Additionally, where the fund makes payment to any individual or entity, the market intermediary that was liable for the pecuniary loss suffered is obligated to refund the amount paid out by the fund and where such a market intermediary is been liquidated, such amount will be refunded by the liquidator.

(General) Regulations, compensation is limited to fifty thousand Kenya shillings (Kshs. 50,000).⁶⁵⁶

5.2 Conclusion

The study reiterated the truism that informed the problem of the study, that the current Kenyan legal framework on combating financial crimes is inadequate in ensuring the overall development of the derivatives market in Kenya and ensuring sufficient protection to investors. Whereas the over the counter market is more prominent and developed than the exchange market, it less regulated in relation to the regulatory framework against of criminal behavior, unlike the exchange market. The criminal law regime does not adequately cover the entire breadth and width of the Kenyan derivatives market. The legal regime on the prevention and combating of specific market offences targets criminal activities that are likely to happen or happen in the derivatives exchange. This effectively locks out the over the counter derivative market from the regime aimed at preventing market offences in derivatives trading. This may erode the integrity and confidence of the overall derivatives market in Kenya.

The study thus makes the following specific conclusions:

5.2.1 Suitable Laws Aimed at Combating Financial Crimes in the Derivatives Market

Kenya has put in place laws aimed at combating financial crimes in the general economy, which also touch on the derivatives market. The aim of these laws is to preventing theft, corruption, money laundering, and fraud. There are laws on combating corruption in Kenya.⁶⁵⁷ Kenyan has elaborate laws on combating theft. The Penal Code⁶⁵⁸ creates several offences relating to the taking of another's property. These include the offences of theft,⁶⁵⁹ robbery and extortion,⁶⁶⁰ and burglary.⁶⁶¹ The offence of stealing, in relation to derivatives, targets the underlying instrument or the identity of the proprietors of the asset or investor. There are also laws to prevent money laundering and the use of criminal proceeds in the economy. Money laundering

⁶⁵⁶Legal Notice No. 152 of 2002.

⁶⁵⁷ Anti-Corruption and Economic Crimes Act (No 3 of 2003, Laws of Kenya) and the Bribery Act (No 46 of 2016).

⁶⁵⁸ Cap 63, Laws of Kenya.

⁶⁵⁹*ibid*, Chapter XXVI.

⁶⁶⁰*ibid*, Chapter XXVIII.

⁶⁶¹*ibid*, Chapter XXVIX.

in derivatives markets can take place in any or all the three stages of money laundering: placement,⁶⁶² layering⁶⁶³ and integration.⁶⁶⁴ The derivative market offers a vast array of opportunities for transforming money into a diverse range of assets.⁶⁶⁵ The primary legislation on money laundering is the Proceeds of Crime and Anti-Money Laundering Act.⁶⁶⁶

In preventing market-specific financial crimes aimed at manipulating the derivatives market, the Capital Markets Act and the Capital Markets (Derivatives Markets) Regulations criminalise the offences of false trading, bucketing, insider trading, manipulation of derivative prices and the trading of derivatives outside the exchange by licensed derivative brokers.

In preventing fraud, Kenya has elaborate provisions in the Penal Code aimed at preventing forgery. Similarly, Capital Markets (Derivatives Markets) Regulations criminalizes the employment and/or use of fraudulent or deceptive devices and artifices, and the fraudulent inducement of trading in derivatives as offences.⁶⁶⁷

5.2.2 Legal Lacunas in the Legal Regime on Combating Financial Crimes in the Kenyan Derivatives market

The existence of elaborate laws on combating financial crimes does not rule out the availability of unsuitable legal provisions to the derivatives market. These provisions are encapsulated hereunder.

The criminalisation of false trading under the Capital Markets Authority (Derivatives Market) Regulations is inadequate. In the derivatives market, false trading is the offence of false and/or misleading appearance of trading where a person purports to execute a sale or purchase order without having effected a *bona fide* purchase or sale in reality.⁶⁶⁸ The law does not define what

⁶⁶² 'Placement' is the introduction of the illegal proceeds into the financial system.

⁶⁶³ 'Layering' involves converting the proceeds of crime into another form and creating complex layers of financial transactions to disguise the audit trail, source and ownership of funds.

⁶⁶⁴ 'Integration' involves supplying apparent legitimacy to illicit wealth through the re-entry of the funds into the economy in what appears to be normal business or personal transactions

⁶⁶⁵ CMA, Guidelines on the Prevention of Money Laundering and Terrorism Financing in the Capital Markets (2015).

⁶⁶⁶ No. 9 of 2009, Laws of Kenya

⁶⁶⁷ The Capital Markets (Derivatives Markets) Regulations (2015), Regulations 75 and 76.

⁶⁶⁸ Section 32 G of the Capital Markets Act and Regulation 72 of the Capital Markets (Derivatives Markets) Regulations (2015)

is a bona fide purchase or sale of derivative as it out rightly criminalises a situation where a sale or purchase does not result in a change of ownership. Due to this uncertainty on what bona fide sale or purchase is, the law may leave participants who engage in wash trading,⁶⁶⁹ especially where the transaction does not create market risk, and/or matching orders⁶⁷⁰ for legitimate commercial reasons, not aimed at manipulating the market, open to prosecution for false trading. This thus calls for the establishment of an economic test to guide investors on what constitutes false trading and the threshold for criminality.

The criminalisation of insider trading is rigid and may prohibit the development of the certain derivatives market in Kenya. The prevention of insider trading is integral to the integrity of the market as it prevents informational asymmetry in the securities markets which undermine investor confidence and erodes market integrity.⁶⁷¹ However, the emergence of credit default swaps (CDS) has called for a rethink on the prohibition against insider trading.⁶⁷² CDS involve an arrangement where the seller of the CDS compensates the buyer, usually the lender of the underlying loan facility, in the event of default by the borrower.⁶⁷³ Thus, for the lenders to engage in trading of CDS, by their very nature of the business, they will be privy to borrower's confidential information.⁶⁷⁴

Kenya can benchmark from the legal regime on insider dealings in the United Kingdom. Part V of the U.K Criminal Justice Act ⁶⁷⁵ provides that the offence of insider dealings applies to certain specific securities that are listed in the second schedule to the Act and satisfies any conditions applying to it under an order made by the UK Treasury.⁶⁷⁶ The second schedule lists shares, debt securities, warrants, depository notes, options, futures and contracts for differences as securities subject to the offence of insider dealing in the U.K.⁶⁷⁷ By having such a specified

⁶⁶⁹ Wash trading is the of sale or purchase of securities that does not involve a change in the beneficial ownership of them makes an offer

⁶⁷⁰ Matching orders refer to the purchase of derivatives at a price that is substantially the same as the price at which the investor knows that an associate has made an offer to sell the same or substantially the same number of them and vice-versa

⁶⁷¹ International Organization of Securities Commissions (IOSCO), Objectives and Principles of Securities Regulation (June 2010).

⁶⁷² Yesha Yadav, 'Insider Trading in Derivatives Markets', (2015) 103 Georgetown Law Journal, p. 381.

⁶⁷³ *ibid.*

⁶⁷⁴ *ibid.*

⁶⁷⁵ 1993.

⁶⁷⁶ Criminal Justice Act –U.K (1993) s 53 and 54

⁶⁷⁷ *ibid.*

list under the law, the blanket prohibition on insider trading can be removed and allow for the introduction of derivative securities in the exchange whose basis is insider dealings.

The criminalization of the employment and/or use of fraudulent or deceptive devices and artifices, and the fraudulent inducement of trading in derivatives is unclear.⁶⁷⁸ The law does not provide a criterion for identifying these fraudulent devices. The regime is also silent on criminalizing the sale of derivatives with the intention of causing financial loss to the investors with or without the expectation that the investors will earn a profit or earn from the derivatives.⁶⁷⁹

The prohibition of price manipulation of derivative contracts and underlying assets is not suitable for the development of the market. Regulation 74 of the Derivative Regulations criminalizes the indirect or direct manipulation of derivative prices.⁶⁸⁰ The blanket nature of this prohibition will derail the development of the derivatives market in Kenya, as it will limit the introduction of derivative products. There is the need to amend and qualify this prohibition to extend only to commodities or assets that are not subject to legally sanctioned price manipulation. This prohibition will prevent the introduction of derivatives whose underlying assets are oil or energy or other commodities which are subject to price stabilization.⁶⁸¹ Under the Kenyan Energy Act, the price of refined oil products and electricity is subject to the price setting mechanism of the Energy Regulatory Commission and not to market forces.⁶⁸² Similarly, the government through market interventions such as subsidies and under the Price Control (Essential Goods) Act⁶⁸³ is able to manipulate commodity prices outside of market forces.⁶⁸⁴

The law prohibits derivative brokers to ensure that they only deal with derivatives traded in the derivatives market.⁶⁸⁵ This effectively locks out licensed brokers from the over the counter markets.⁶⁸⁶ This ensures that OTC derivatives markets do not benefit from the expertise of

⁶⁷⁸ The Capital Markets (Derivatives Markets) Regulations (2015), Reg 75 and 76.

⁶⁷⁹ *ibid.*

⁶⁸⁰ Capital Markets (Derivatives Markets) Regulations (2015).

⁶⁸¹ Price Control (Essential Goods) Act (No 12 of 2006, Laws of Kenya)

⁶⁸² No 12 of 2006, Laws of Kenya.

⁶⁸³ *ibid.*

⁶⁸⁴ *ibid.*

⁶⁸⁵ *ibid.* Reg 77.

⁶⁸⁶ *ibid.*

licensed derivative brokers.⁶⁸⁷ With no regulatory oversight to cover OTC derivative markets and prevent financial crimes, such markets may be deemed to be investor unfriendly. This regime is oblivious of the fact that derivative instruments like forwards are traded in OTC markets and may not trade in the exchange derivatives market in Kenya as they are unstandardised contracts.⁶⁸⁸

There is the need to criminalize and/or prohibit high-pressure selling under Kenyan law. High-pressure selling is the unethical and unsophisticated selling of securities to unsophisticated investors by using inducements and psychological pressure. With the issue of undue influence and pressure been exerted over investors and buyers is on the rise globally, especially where the sellers or brokers have an existing financial relationship with the buyers i.e. financial advisors or a financial institution, Kenya's legal framework appears to be inadequate in protecting investors from undue influence in the derivatives market.⁶⁸⁹ Undue influence and pressure, in most cases in the derivatives market, is because derivative transactions are complex to the average investors and the seller has greater knowledge than the buyer does. Kenya's legal regime on undue influence, founded on common law, may require a review to put it into par with modern trends.

On the enforcement side, the fact that CMA in investigating and undertaking enforcement action relating to breaches in the derivatives market and has to rely on the Kenya Police to enforce this mandate points to inadequate regulatory capacity.⁶⁹⁰ The aspect of collaboration, though not a sign of weakness points to lack of proper institutionalisation of its role.⁶⁹¹ The challenge of such a collaborative framework lies in the administrative functioning of the Kenya Police. The police are subject to regular deployments that deprive CMA a stable human resource enforcement pool and they may also be subject to two different centres of control: CMA and the Kenya Police.⁶⁹² Such control may at times conflict and deny CMA the investigative and enforcement capacity as the officers attend to other duties. Additionally, due

⁶⁸⁷ *ibid.*

⁶⁸⁸ Timothy Lynch, 'Derivatives: A Twenty-First Century Understanding' (2011) 43 (2) Loyola University Chicago Law Journal, 3-50.

⁶⁸⁹ The Judicature Act (Cap 8), s 3.

⁶⁹⁰ The Capital Markets Act, s 13B.

⁶⁹¹ *ibid.*

⁶⁹² *ibid.*

to the nature of the training of the Kenya Police, there is an inadequate skill set in combating crimes in the securities markets.⁶⁹³

Ultimately, even with CMA's overarching enforcement mandate, no single institution has the power or ability to take an overall responsibility for combating financial crimes in the derivatives market.⁶⁹⁴ An integrated enforcement system would eliminate the overlapping of roles.⁶⁹⁵ This would mean the creation of a single framework in the derivatives and securities markets to be the focal point in combating financial crimes under the proposed Financial Services Authority and can be achieved through the establishment of the office of the financial ombudsman.⁶⁹⁶ This can be a stand-alone semi-autonomous office or within the existing Commission on Administrative Justice (the Ombudsman)⁶⁹⁷ or within the proposed Financial Services Authority.⁶⁹⁸ The financial ombudsman should have the specific mandate of investigating and settling disputes arising in the financial sector, including the derivatives market. The office should have prosecutorial powers to prosecute crimes financial crimes.⁶⁹⁹ This way the role played by CMA, police, ARA, EACC and the DPP in relation to the securities markets will be synergised into one independent office with the requisite technical capacity.

On the compensation mechanism, the investor compensation limit of fifty thousand Kenya shillings provided under the law is inadequate in an era where investments in the securities markets are in the millions, if not billions.⁷⁰⁰ In addition to the investor compensation fund, restitution is one of the main objectives of criminal law. This is the compensation of the victims after the assessment by the court where guilt has been established.⁷⁰¹ Section 175(2) of the Criminal Procedure Code allows courts to make compensation orders in criminal trials.⁷⁰² However, Kenyan courts hardly award criminal compensation. To better align the criminal

⁶⁹³ Steve Mbogo, 'Institute Proposes Special Police Unit to Monitor Crimes'the Business Daily Newspaper (Nairobi,4th October 2011).

⁶⁹⁴ *ibid.*

⁶⁹⁵ Andreas Grünbichler and Patrick Darlap, *Regulation and Supervision of Financial Markets and Institutions A European Perspective* (Vienna 2003), 6.

⁶⁹⁶ Financial Services Authority Bill (2017), Part XI.

⁶⁹⁷ Constitution of Kenya, Art 59 (4) and the Commission on Administrative Justice Act (No.23 of 2011).

⁶⁹⁸ Financial Services Authority Bill (2017), Part XI.

⁶⁹⁹ Jacob Gakeri (n 505), 283.

⁷⁰⁰ The Capital Markets (Licensing Requirements) (General) Regulations 2002, Regulation 70

⁷⁰¹ Victims Protection Act (No 17 of 2014), s 2.

⁷⁰² Cap 75, Laws of Kenya.

compensation framework, Kenya can enact the Financial Crimes Injuries Restitution Regulations to supplement the compensation provisions in and the Investor Compensation Fund

5.2.3 One Derivatives Market-Two Legal Regimes: Towards a Uniform Regulatory Framework for the Derivatives Market

There is the need for regulatory oversight of the OTC derivatives market as the current Kenyan regime does not focus on market offences that occur in the OTC derivatives market.⁷⁰³ Whereas the criminal law that covers the general areas of criminal law like theft, corruption and money laundering apply to the OTC derivatives market, the specific derivatives market offences such as bucketing, price manipulation and false trading do not apply to this market segment.⁷⁰⁴ It is also ironic that the law makes it an offence for derivatives brokers to deal with OTC derivatives.⁷⁰⁵ The end result of this uneven regulatory regime is that the OTC derivatives market continues to attract more investors than the exchange derivatives market.⁷⁰⁶ This is a more reason for regulators to get worried and find a regulatory model that will protect investors in the OTC derivatives market from financial crimes.

Kenya can learn from the experiences of the USA in re-thinking the regulatory approach for the OTC derivatives market.⁷⁰⁷ Prior to the financial crisis in 2008, the OTC derivatives market in the USA was under-regulated. In a situation similar to the losses suffered by Kenya Airways in 2014-15 due to use of futures to hedge fuel, companies in the USA suffered huge losses due to investments in OTC traded derivatives.⁷⁰⁸ For example, organisations such as Proctor & Gamble, Orange County Fund and Mettalgeseellschaft AG have made huge losses dealing in OTC derivatives.⁷⁰⁹

⁷⁰³ The Capital Markets (Derivatives Markets) Regulations (2015).

⁷⁰⁴ Capital Markets Act, (Cap 485A) s 32B-32J.

⁷⁰⁵ The Capital Markets (Derivatives Markets) Regulations, Regulation 77.

⁷⁰⁶ Sahib Kholsa, 'Commodity Futures Trading in Kenya-Are We Ready for the Future?' (Master of Science in Actuarial Management, City University London, 2013), 12.

⁷⁰⁷ Levon Garlsan, 'Towards a Universal Model Regulatory Framework for Derivatives: Post-Crisis Conclusions from the United States and the European Union' 37(3) (2016) University of Pennsylvania Journal of Internal Law, 966-969.

⁷⁰⁸ *ibid*, 970-977.

⁷⁰⁹ Antanoli Kuprianov, 'Derivatives Debacles: Case Studies of Large Losses in the Derivatives Markets' 81(4) (1995) *Federal Bank of Richmond Economic Quarterly*, 1-7.

Driven by the risks posed by the OTC markets, USA began the reform process in the year 2000 with the enactment of the Commodity Future Modernization Act (CMFA) which targeted swaps.⁷¹⁰ Although the CMFA prohibited the Securities Exchange Commission (SEC), the regulator, from regulating OTC swaps, it was given the authority to regulate security-based swaps like credit default swaps.⁷¹¹ Further, in 2010, the Dodd-Frank Wall Street Reform and the Consumer Protection Act were enacted to strengthen regulatory control of the OTC swap markets.⁷¹² The Commodities Futures Trading Commission and the SEC continue to work hand in hand to provide regulatory oversight.⁷¹³

On the other hand, in Europe, the European Market Infrastructure Regulations (EMIR) lay down a comprehensive regime for the regulation of OTC derivatives markets in the region.⁷¹⁴ EMIR introduced reporting requirements for derivatives markets through trade repositories aimed at introducing transparency; and rules for mitigating counterparty risks through the clearing of derivatives in a centralised manner.⁷¹⁵

Similarly, in South Africa, the enactment of the Financial Markets Act⁷¹⁶ in 2012 roped in the OTC derivatives market in the regulatory regime. This was in accordance to the European Market Infrastructure Regulations which were adopted by the G20 league of countries for which South Africa is a member. In 2014, regulations were enacted to guide OTC markets on the categorisation of OTC derivatives for purposes of listing; and assets and resources required for trade repositories and clearing houses and central counterparties.

With the above three regulatory case studies in mind, Kenya may opt to regulate the OTC derivatives markets through the reforms to the Capital Markets Act or have a stand-alone legal regime. This way, the derivatives market will be under regulatory control and one market will not be prone to more risks of financial crimes.

⁷¹⁰ Levon Garlsan (n 719), 967.

⁷¹¹ *ibid*, 970-977.

⁷¹² *ibid*.

⁷¹³ *ibid*.

⁷¹⁴ *ibid*, 969.

⁷¹⁵ *ibid*, 985, 989, 1002-1005.

⁷¹⁶ No. 19 of 2012.

5.3 Limitations of the Study

The objective of this study was to appraise the suitability of the legal regime in combating financial crimes in the development of the derivatives market in Kenya. To this extent, two critical issues limited the study.

First, the derivatives exchange was still at its nascent stages at the time of the study. Purposely, the study was for informative reasons and to provide a reform agenda before derivatives trading in the exchange is fully operational. Over time, when the derivatives market is well operational, there is need to conduct an empirical analysis of the trends and levels of financial crimes in the market and enforcement measures undertaken.

Secondly, the study appraised the suitability of the Kenyan legal regime based on the model of classification of financial crimes based on Peter Gottschalk categorization in his article titled 'Categories of Financial Crime'.⁷¹⁷ Peter Gottschalk classifies financial crimes into four broad categories: corruption, fraud, theft and manipulation.⁷¹⁸ Due to the lack of a clear-cut legal definition of financial crimes, categorizations of such crimes will always differ. In this study, the use of the term 'financial crime' is in reference to any non-violent crime, which leads to financial loss to investors and/or loss of confidence and integrity in the derivatives market.

5.4 Recommendations

With the inadequacy of the legal framework discussed above, the following recommendations are critical:

The criminalisation of false trading under Section 32 G of the Capital Markets Act and Regulation 72 of the Capital Markets (Derivatives Markets) Regulations (2015) Regulations should be qualified to allow for investors to structure their legal and beneficial ownership of derivatives.

The absolute criminalisation of insider trading under Section 32B of the Capital Market Act should also be qualified to only certain securities. Kenya can benchmark from the legal regime

⁷¹⁷ Peter Gottschalk, 'Categories of Financial Crime' 17 (4) *Journal of Finance and Crime*, 441-45.

⁷¹⁸ *ibid.*

on insider dealings in the United Kingdom. Part V of the U.K Criminal Justice Act ⁷¹⁹ provides that the offence of insider dealings applies to certain specific securities that are listed in the second schedule to the Act and includes shares, debt securities, warrants, depository notes, options, futures and contracts for differences as securities.⁷²⁰

The absolute criminalisation price manipulation in the derivatives market under Regulation 74 of the Capital Markets (Derivatives Markets) Regulations should be qualified to allow for trading of assets that are subject to statute or legal based price manipulation. The criminalisation of price manipulation will prevent the introduction of derivatives whose underlying assets are oil or energy, electricity or other commodities subject to the price setting mechanism of the Energy Regulatory Commission under the Energy Act ⁷²¹ and the Price Control (Essential Goods) Act⁷²² respectively.

There is the need to criminalize and/or prohibit high-pressure selling under Kenyan law. High-pressure selling is the unethical and unsophisticated selling of securities to unsophisticated investors by using inducements and psychological pressure.

There is need to regulate the OTC derivatives markets through the reforms to the Capital Markets Act or through a stand-alone legal regime. With no regulatory oversight to cover OTC derivative markets and prevent financial crimes, such markets may be deemed to be investor unfriendly.

There is also need to create an integrated criminal enforcement system would eliminate the overlapping of roles of the CMA, police, EACC, ARA and other criminal enforcement organs.⁷²³ This would mean the creation of a single framework in the derivatives and securities markets to be the focal point in combating financial crimes under the proposed Financial Services Authority⁷²⁴

⁷¹⁹ 1993.

⁷²⁰ *ibid.*

⁷²¹ No 12 of 2006, Laws of Kenya.

⁷²² *ibid.*

⁷²³ Andreas Grünbichler and Patrick Darlap, *Regulation and Supervision of Financial Markets and Institutions A European Perspective* (Vienna 2003), 6.

⁷²⁴ Financial Services Authority Bill (2017), Part XI.

On the compensation front, regulations to operationalise a criminal compensation scheme to should be enacted the Victims Protection Act to complement the Investor Compensation fund. Such a compensation regime will also be in alignment with Article 50 (g) of the Constitution which mandates parliament to enact legislation for the protection and welfare of victims of crimes.

There is need for sector guidelines to provide specific guidance on the CMA's viewpoint of the criminal law regime, which is very broad-based and covers the entire breadth of the economy. Although Guidelines do not have the force of law, they are instrumental in providing the regulator's viewpoint in discharging its regulatory role in combating financial crimes. Guidelines are instrumental in providing detailed information on how a regulator will enforce the law and regulations and how it will apply the provisions of the law relating to financial crimes.⁷²⁵

CMA has only issued guidelines relating to combating money laundering and terrorism financing in the securities markets and on corporate governance.⁷²⁶ CMA's counterpart regulator in the anti-competition realm, the Competition Authority of Kenya has been on the forefront in the publication of guidelines on how to deal with statutorily created offences relating to anti-competitive behaviour like restrictive trade practices, abuse of dominance and buyer power and illegal mergers and acquisitions.⁷²⁷ CMA may issue similar guidelines to link financial crimes and the capital markets.

In conclusion, with the derivatives exchange in Kenya still at its nascent stages further empirical study on the effects of the criminal regime on its development needs to be undertaken once the market grows and there is active trading. Over time, when the derivatives market is operational,

⁷²⁵ IOSCO, "Principles for the Regulation and Supervision of Commodity Derivatives Markets" (2011), 48 provides that, "*Market Authorities should make clear to market participants what constitutes manipulative, abusive conduct or other prohibited conduct.....Because of this need to exercise subjective judgment, and in order to permit flexibility in preventing novel approaches to market abuses, some Market Authorities might specify those activities which may impair fair and orderly markets; including examples of such activities, or their effects, which they consider relevant to assess manipulative or abusive conduct and to have in place specific rules which prohibit such actions*"

⁷²⁶ CMA, Guidelines on the Prevention of Money Laundering and Financing in the Capital Markets (2015) and CMA, Code of Corporate Governance Practices for Issuers of securities to the Public (2016).

⁷²⁷ <https://www.cak.go.ke> <accessed 8th January 2018.

there is need to conduct an empirical analysis of the trends and levels of financial crimes in the market and enforcement measures undertaken and their impact on the derivatives market.

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