

**"THE LEGAL AND REGULATORY FRAMEWORK
GOVERNING STOCKBROKERS AND INVESTMENT BANKS
IN KENYA"**

BY

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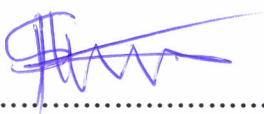
TABLE OF CONTENTS

DECLARATION	4
ACKNOWLEDGMENTS	5
DEDICATION	6
LIST OF ABBREVIATIONS	7
TABLE OF STATUTES	8
SUBSIDIARY LEGISLATION	9
LIST OF CASES	10
DEFINITION OF KEY TERMINOLOGIES	11
CHAPTER ONE	13
AN INTRODUCTION TO THE STUDY	13
1.1 Background and statement of the problem.....	13
1.2 Research Objectives.....	17
1.3 Research questions.....	18
1.4 Hypotheses	19
1.5 Scope and limits of the study.....	19
1.6 Theoretical framework	20
1.8 Literature Review.....	21
1.9 Significance of the study	25
1.10 Chapter Breakdown.....	26
CHAPTER TWO	28
APPROACHES TO REGULATION OF SECURITIES MARKET	28
2.1 Introduction	28
2.2 Understanding securities regulation and capital market.....	28
2.3 Regulatory approaches to securities market	30
2.4 Collapsed stockbrokers firms in Kenya.....	34
2.4.1 Shah Munge and Partners Stockbrokerage	34
2.4.2 Francis Thuo and Partners	35
2.4.3 Nyaga Stockbrockers.....	36
2.4.4 Discount Securities Limited.....	36

2.5	Conclusion.....	38
CHAPTER THREE		39
LEGAL AND REGULATORY FRAMEWORK FOR STOCKBROKERS AND INVESTMENT BANKS IN KENYA.....		39
3.1	Introduction	39
3.2	State regulation of securities markets in Kenya.....	40
3.2.1	Licensing and Registration	41
3.2.2	Market surveillance	43
3.2.3	Inspections	44
3.2.4	Investigations	45
3.2.5	Intervention measures.....	47
3.2.6	Criminal sanctions and financial penalties	48
3.4	Self-regulation of the capital markets	49
3.5	Conclusion.....	52
CHAPTER FOUR.....		54
CONCLUSION AND RECOMMENDATIONS		54
4.1	Introduction	54
4.2	Concluding observations	54
4.3	Recommendations.....	56
BIBLIOGRAPHY		58
BOOKS.....		58
JOURNAL ARTICLES		59
INTERNET ARTICLES.....		62
DISCUSSION PAPERS		64
NEWSPAPER ARTICLES.....		65
OTHER SOURCES.....		66

DECLARATION

I, **WEKESA SETH MUCHUMA**, do hereby declare that this is my original work and has not been submitted and is not currently being submitted for a degree in any other University.

 4/11/2011

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DEDICATION

This project is dedicated to my beloved parents, Caleb Musee and Mary Musee. Thank you Dad and Mum for your endless and unfailing support throughout the years. God bless you.

LIST OF ABBREVIATIONS.

CBK	Central Bank of Kenya
CMA	Capital Market Authority
ICF	Investor Compensation Fund
IFC	International Finance Corporation
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offer
KASIB	Kenya Association of Stockbrokers and Investment Banks
NSE	Nairobi Stock Exchange.
SITI	Securities Industry Training Institute
SRO	Self-Regulatory Organization

TABLE OF STATUTES

The Capital Markets Act, Cap 485A, Laws of Kenya.

The Companies Act, Cap 486, Laws of Kenya.

The Finance Act NO. 2 of 2009

SUBSIDIARY LEGISLATION

The Capital Markets (Licensing Requirements) (General) Regulations, 2002

LIST OF CASES

CMA v Shah, Munge & Partners Ltd civil appeals No. 913 & 930 of 2003

DEFINITION OF KEY TERMINOLOGIES

Stockbrokers - These are markets professionals who buy and sell securities as an agent for investors at a stock exchange in return for a brokerage commission.

Investment Banks - These are non-deposit taking institutions that advise on offers of securities to the public or a section of the public, corporate financial restructuring, takeovers, mergers, privatization of companies and underwriting of securities. In addition, investment banks also engage in the business of stockbroker, dealer, and fund manager of collective investment schemes and providers of contractual portfolio management services.

Demutualization - This refers to changes in the ownership structure of stock exchanges whereby exchanges organized as not-for-profit entities owned by members convert to publicly-owned organizations, usually for profit corporations

Investment Advisers or Fund Managers - These are market professionals who promulgate analysis and research on market securities, and advise investors on such securities at a commission. They also manage portfolios of securities on behalf of clients pursuant to a contract. Authorized securities dealers are banks licensed under the Banking Act or a financial institution approved by the Capital Markets Authority (CMA) to deal in fixed- income securities listed on the fixed income securities market segment at a stock exchange.

Collective Investment Scheme - These are specialized market players licensed to mobilize savings in financial assets and to enhance access to capital markets by small investors. They include mutual funds, unit trust, investment trusts and other forms of specialized collective schemes. Collective investment scheme offers a unique opportunity to investors in terms of professional management, economies and diversification portfolio and risk.

CHAPTER ONE

AN INTRODUCTION TO THE STUDY

1.1 Background and statement of the problem

Securities markets play a crucial role in economic growth and financial stability.¹ The main purpose of securities market is to serve as a mechanism for the transformation of savings into financing the real sector thus providing an alternative to bank financing.² Securities market also provides a platform where risks are transferred and their exposure diversified.³ This in turn enables players to unlock capital for new investments. Stability of securities markets depends largely on investors' confidence.⁴ It is therefore critical for a clear regulatory framework to be in place with an aim of controlling the activities being undertaken by the industry players in securities market.⁵ According to International Organization on Security Commission (IOSCO), there are three purposes of regulating securities in any capital market in the world.⁶ Securities regulation is important in protecting investors.⁷ Second, it is vital to regulate securities market to reduce systemic risk.⁸ Third, securities markets are regulated to promote fair, efficient and transparent capital markets.⁹

¹ B Black, "The Legal and Institutional Preconditions for Strong Securities Markets," *UCLA Law Review*, 2001 vol. 48, (Los Angeles, California: University of California at Los Angeles), pp. 781–855.

² *Ibid*

³ *Ibid*

⁴ Z Goshen & G Parchomovsy 'The essential role of securities regulation' (2006) vol 55 p. 714; Stavros Gadinis & Howell E. Jackson, *Markets as Regulators: A Survey*, 80 S. CAL. L. REV. 1239, 1242 (2007).

⁵ *Ibid*

⁶ International Organization for Security Commission (IOSCO) Objectives and Principles of Securities Regulations (Feb 2008) pp 5 at www.iosco.org. (accessed on 23rd April 2010)

⁷ *Ibid*

⁸ *Ibid*

⁹ *Ibid*

Most securities markets have a hybrid regulatory framework comprising of both state regulation and self-regulatory mechanisms.¹⁰ State regulation entails government set up laws, regulations and institutions to regulate and control the activities of the all players in the capital markets sector.¹¹ Self-regulation involves members of the sector coming together and prescribing a particular code to be observed and adhered to by all members. Ideally, there should not be government interference in self-regulatory framework.¹²

Stockbrokers, investment banks and other intermediary agencies play a critical role in securities markets. Stockbrokerage firms provide a link between investors and capital markets.¹³ The investor may not know the working of the stock market and thus the stock broking agencies have to take the responsibility of buying and selling securities on their behalf.¹⁴ The agencies inform investors about their various products and services so that they can invest in alternatives that are more profitable.¹⁵ Investment banks on the other hand, play an important role as intermediary between corporations and investors through initial public offering (IPOs).¹⁶ They provide underwriting services for new stock issues when a company decides to go public and seek equity funding.¹⁷ Underwriting means the investment bank purchasing an agreed number of shares of the new stock and resells

¹⁰ James J. Fishman, *Enforcement of Securities laws Violations in the United Kingdom*, 9 INT'L TAX & BUS LAW 131 (1991).

¹¹ Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541, 2553 (2006); Douglas C. Michael, *Federal Agency use of Audited Self-regulation as a Regulatory Technique*, 47 ADMIN.L. REV. 171 (1995).

¹² Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-regulation during the First Seventy years of the Securities and Exchange Commission*, 59 BUS LAW 1347 (2004); Marianne K. Smythe, *Government Supervised Self-regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 N.C.L.REV.475

¹³ Ibid

¹⁴ Ibid

¹⁵ Ibid

¹⁶ Ibid

¹⁷ Ibid

through a stock exchange. They also evaluate the company and determine a reasonable price at which to offer stock shares.¹⁸ In addition, invest banks offer financial advisory services to investors in all aspects of financing.¹⁹ This makes it necessary for the operations of stockbrokers and investment banks to be regulated.

Securities market in Kenya is governed by the Capital Markets Act which provides statutory provisions aimed at regulating capital markets in the country.²⁰ The Act sets out the requirements that all licensees, who include market intermediaries such as stock broking agencies and investment banks, are to fulfill before being granted a licence to operate as such.²¹ The Act is supplemented by the Capital Markets (Licensing Requirements) (General) Regulations, 2002. These regulations provide more detail on the minimum capital requirements as well as the accounting and reporting obligations for stockbrokers and investment banks.²² The regulations also provide prudential control mechanisms that these intermediaries are to follow in the conduct of their operations.

In terms of institutional framework, the Act establishes the Capital Market Authority (CMA) as a government regulator mandated with licensing and regulating the securities market in Kenya.²³ CMA also approves public offers and listing of securities traded at the Nairobi Stock Exchange.²⁴ It regulates the sector by developing regulations and providing

¹⁸ Ibid

¹⁹ Ibid

²⁰ Capital Markets Act Cap 485 laws of Kenya

²¹ Capital Markets Act, sections 23 and 24

²² Part II and III of the Regulations

²³ Capital Markets Act, section 5.

²⁴ Capital Markets Act, section 11

guidelines for the assets allocation in the capital market sector.²⁵ It was established in 1990. In addition, the Nairobi Stock Exchange was established as a self-regulatory institution whose role was to set standards to be observed by its members in order to protect and maintain the confidence of investors and integrity of the market.²⁶

As discussed earlier, most investors in the stock exchange use stockbroking agencies to trade in the market. They also rely on investment banks for financial advice.²⁷ The year 2007 saw Francis Thuo and Partners Limited collapse.²⁸ In 2008 Nyaga Stockbrokers also collapsed.²⁹ Discount Securities Limited collapsed in 2009. These stockbrokerage firms collapsed because of their inability to meet financial obligations owing to their clients.³⁰ In all the three cases, investors had raised complaints that the stockbrokers were trading in clients' shares without their consent.³¹ Before the three collapsed, in 2004, the stockbroking firm of Shah Munge and Partners had its licence suspended for mishandling clients' funds, by depositing them in their office accounts rather than the clients account. This went against the Capital Markets (Licensing Requirements) (General) Regulations,

²⁵ Ibid

²⁶ <https://www.nse.co.ke/nse/history-of-nse.html> (accessed 30 October 2010)

²⁷ Mbui Wagacha "Mobilizing Domestic Resources in Kenya: A survey of Shareholders strategy in the Capital Markets," discussion paper no. 22 (Nairobi: institute of policy analysis and research, IPAR, 2001)

²⁸ <https://allafrica.com/stories/200710090123.html> (accessed on 12 September 2010)

²⁹ <https://www.standardmedia.co.ke/business/article/114400> (accessed on 12 September 2010)

³⁰ The stockbroker has a fiduciary duty towards his client which is based on trust and confidence and as an agent of the client; he should not let his personal interests conflict with duty to his client, the principal. The collapse of discount securities limited faced corporate governance problems causing NSSF and other investors incur financial losses.

³¹ This practice is normally referred to as short selling. Short selling is the selling of stock or security that is not owned by the seller but that is promised to be delivered. Short selling is illegal in Kenya but is permitted in some jurisdiction such as the United States. Stockbrokers mainly engage in short selling so as to benefit from an overpriced stock or market.

2002³² which clearly stipulate that clients' funds are to be deposited in the clients account.³³

It is from the above situation that this study seeks to examine the effectiveness and adequacy of the existing regulatory tools available to CMA for regulating the affairs of stockbrokers and investment banks in securities market to avoid financial losses experienced by investors in the recent past when the three stock broking agencies collapsed. The tools should assist CMA in enforcing the provisions of the Act and its Regulations. The study focuses on the following six regulatory tools: licensing and registration; market surveillance; market intervention; investigations; inspections; and imposition of criminal sanctions and financial penalties. These regulatory tools are provided in legal and regulatory framework governing the operations of securities market in Kenya. It also looks at the challenges faced by NSE as a self-regulatory body in the securities market in Kenya.

1.2 Research Objectives

The general objective of the study is to critically analyze the adequacy and effectiveness of the existing regulatory tools available to CMA for regulating the business of stockbrokers and investment banks in securities market in Kenya

³² These are regulations that prescribe the manner in which securities market intermediaries should deal with the money of their investors.

³³ Regulation 20 of Capital Markets (Licensing Requirements) (General) Regulations, 2002.

The specific research objectives of the study are:

- I. To examine the various regulatory approaches available in regulating securities market in Kenya
- II. To examine the legal and institutional framework governing the affairs of stock brokers and investment banks in Kenya
- III. To assess adequacy and effectiveness of the regulatory tools available to CMA for regulating the operations of stockbrokers and investment banks in Kenya
- IV. To look at the challenges faced by NSE as a self-regulatory body of stockbrokers and investment banks in Kenya
- V. To make proposals on how to improve the regulation of stockbrokers and investment banks to protect investors and enhance market efficiency and integrity.

1.3 Research questions

The research questions of the study are:

- I. What regulatory approaches have been adopted in regulating securities market in Kenya?
- II. What is the legal and institutional framework governing the affairs of stock brokers and investment banks in Kenya?
- III. What is the adequacy and effectiveness of the regulatory tools available to CMA for regulating the operations of stockbrokers and investment banks in Kenya?
- IV. What challenges are faced by NSE as a self-regulatory body of stockbrokers and investment banks in Kenya?

- V. What proposals could be made in improving the regulation of stockbroker's and investment banks to protect investors and enhance market efficiency and integrity?

1.4 Hypotheses

The study is premised on the following three hypotheses:

- I. The current Kenyan legal and regulatory framework regulating stockbrokers and investment banks in Kenya does not adequately regulate their activities.
- II. The existing regulatory tools available to CMA for regulating the affairs of stockbrokers and investment banks are inadequate and ineffective
- III. The legal and institutional framework that govern stockbrokers and investment banks in Kenya need to be reformed.

1.5 Scope and limits of the study

The study will focus on the regulatory tools available to CMA for regulating the activities of stockbrokers and investment banks in Kenya. It will assess their effectiveness and adequacy of these tools to continue controlling the operations of stockbrokers and investment banks in securities market in Kenya. The study focuses on the following six regulatory tools: licensing and registration; market surveillance, market intervention, investigations, inspections and imposition of criminal sanctions and financial penalties. The study will also look at the challenges faced by NSE as a self-regulatory organization in the securities market. However, the study will not examine the impacts of the proposed amendments to the Act and its Regulations because it falls outside the scope of this study.

1.6 Theoretical framework

This study relies on the public interest theory of regulation.³⁴ The public interest theory of regulation is based on two assumptions. First, it assumes that markets often fail because of the problems of monopoly or externalities.³⁵ Second, it assumes that governments are capable of correcting these market failures through regulation. According to this theory, government regulates securities market to protect investors.³⁶

This theory has been criticized in three different ways. First, it has been argued that markets and private sectors are able to deal with market failures without any government intervention at all, let alone regulation.³⁷ Second, it is criticized by the argument that in the few cases where markets might not work perfectly, private litigation can address whatever conflicts industry players might have.³⁸ Third, in cases where markets and courts cannot solve the problems perfectly, government regulators are incompetent, corrupt and capture. Thus regulation will make things worse.³⁹ These three criticisms advocate for deregulation of markets.

This study is premised on this theory because regulation of securities market is aimed at ensuring an orderly, fair transparent and efficient market. Further, regulation of securities market protects investors who have put their savings into the market as well as protecting

³⁴ A Shleifer 'Understanding Regulation' *European Financial Management* (2005) vol 11 pp. 439 - 451; Steve P. Croley ;Theories of Regulation: Incorporating *Columbia Law Review* vol 98 No. 1 (Columbia Law Review Association Inc. 1998) pp 1 - 168 the Administrative Process' Richard A Posner 'Theories of Economic Regulation *The Bell Journal of Economics and Management Science* vol 2 no. 5 (The Rand Corporation Autumn 1974) pp 335.

³⁵ *Ibid.*

³⁶ *Ibid*

³⁷ *Ibid*

³⁸ *Ibid*

³⁹ *Ibid.*

the interests of the general public. However, the study argues that although government regulation should exist in securities market, there is need for government regulator to leave some room for a self-regulatory regime. Self-regulation enables the industry players to share their competences and experiences with the market with an aim of improving the efficiency in the activities of the market players as well as develop the market. It is however vital for the government to set some standards to guide the self-regulatory regime so that it can check on the self-interested action of the self-regulatory organization.

1.7 Research methodology

The method of inquiry that this study employed was the use of secondary data from relevant works that have been published on the subject, including books, journal articles and local newspapers and magazines. The study will also look at relevant statutory provisions including the Capital Markets Act and Finance Act, relevant judicial decisions and the relevant subsidiary legislation. The research, therefore, will involve an analysis of the various academic and non-academic documents on regulation of securities market in Kenya. Internet searches will also be used to utilize online materials.

1.8 Literature Review

There exists little literature locally on regulation of securities market in Kenya generally. However, there has been no available literature examining the adequacy and effectiveness of the existing regulatory tools available to CMA for regulating the operations of stockbrokers and investment banks in Kenya.

Stock Exchange.⁴⁶ There is however, no discussion of the regulatory tools available to the regulator when dealing with operations of stockbrokers and investment banks in the Kenyan securities market..

Rose Ngugi in her paper focuses on the historical development of the stock exchange market in Kenya.⁴⁷ She examines the various institutional and policy changes that have taken place in the NSE since its inception.⁴⁸ There is minimal discussion on the legal and regulatory framework relating to activities of stockbrokers and investment banks in Kenya. There is no discussion on the existing regulatory tools available to CMA for regulating the operations of stockbrokers and investment banks in the securities markets in Kenya. In addition, a number of legal and policy reforms have taken place from the time she published her work.

Grace Wambui Kibuthu in her masters thesis titled 'capital markets in emerging economies: a case study of the Nairobi Stock Exchange focuses on capital markets development in Africa using the Nairobi Stock Exchange as a case study.⁴⁹ She explores the historical development with a focus on its structure and organization, rules, regulations and practice, trend in market performance, recent developments and

⁴⁶ Ibid

⁴⁷ "Development of Nairobi Stock Exchange: A Historical Perspective" KIPPRA Discussion paper No. 27 (Kenya Institute for Public Policy and Research, KIPPRA, Nairobi, March 2003) https://books.google.co.ke/books/about/Development_of_the_Nairobi_Stock_Exchange.html?id=yv2xAAAAlAAJ&redir_esc=y (accessed on 19th October 2010)

⁴⁸ Ibid

⁴⁹ Grace Wambui Kibuthu 'capital markets in emerging economies: a case study of the Nairobi Stock Exchange' masters thesis submitted at the Fletcher School, Tufts University (Unpublished thesis April 2005) <https://www.proshareng.com/admin/upload/reports/> (accessed on 20th October 2010)

challenges and the way forward in the new millennium.⁵⁰ Although her thesis provide useful insights for this study, she did not focus on the regulatory tools in place to be utilized by CMA for regulating activities of stockbrokers and investment banks in securities market in Kenya. Further, her thesis does not take a legal perspective in analyzing the question of NSE and its opportunities and challenges. However, this study examines the effectiveness of the existing regulatory tools as enforcement mechanisms adopted by CMA to ensure stockbrokers and investment banks comply with the provisions of the Act and its regulations. It also takes a legal angle in looking at the challenges faced by NSE as a self-regulatory organization in securities market in Kenya.

Celia Taylor in her article 'capital market development in the emerging markets: Time to teach an old dog some new tricks' starts by looking at the various mechanisms of regulation.⁵¹ This is followed by looking at the effectiveness of the regulation in achieving the goals of protecting investors, ensuring an efficient allocation of capital and stimulating the demand for shares thus helping to contribute to the creation of dynamic markets.⁵² Her arguments are useful to this study. However, her article looks at regulation in the American jurisdiction. This is a market that is well established with an effective regulatory framework. On the other hand, this study focuses on the regulatory tools and mechanisms in the Kenyan securities market and how effective they are in controlling activities of stockbrokers and investment banks.

⁵⁰ Ibid.

⁵¹ Celia Taylor 'capital market development in the emerging markets: Time to teach an old dog some new tricks' American Journal of Comparative Law Vol 45 No. 1 (Winter 1997) pp 71-107 https://www.jstor.org/stable/840960?seq=1#metadata_inf (accessed 20th October 2010)

⁵² Ibid

A review of literature on the adequacy and effectiveness of the regulatory tools available in controlling the operations of stockbrokers and investment banks in securities market in Kenya reveals some gaps. There is very little literature on the securities regulation in Kenya let alone regulatory tools. The lack of a focused study on the regulatory tools and their effectiveness shows a glaring gap considering the losses suffered by investors after the collapse of the four stockbrokerage firms in the recent past.

This study therefore attempts to fill the gap by focusing on the adequacy and effectiveness of the existing regulatory tools available to the regulator for regulating the activities of stockbrokers and investment banks. The study focuses on six regulatory tools: licensing and registration; market surveillance, market intervention, investigations, inspections and imposition of criminal sanctions and financial penalties. It also examines the challenges faced by NSE as a self-regulatory organization in regulating the affairs of stockbrokers and investment banks. It makes proposals on how CMA could utilize the existing tools as well as developing new approaches and strategies to enhance market integrity and protect investors in securities market in Kenya

1.9 Significance of the study

Apart from the significant contribution of literature that already exists on the same subject, this study addresses a matter that is fundamental to the financial services regulation in Kenya. The study hopes to contribute better to the understanding of the regulatory framework of securities market in Kenya including a discussion on the effective utilization of the existing regulatory tools available to CMA for regulating securities market in Kenya. The outcomes of the study will be useful to policymakers in

addressing the problems associated with inadequate and ineffective regulation of stockbrokerage firms and investment banks to avoid further collapse of more stockbrokerage firms in the country.

1.10 Chapter Breakdown

The study has four chapters.

Chapter one provides an introduction to the research topic, statement of the research problem, theoretical framework within which the research will be carried out, the significance of the study, research objectives, research questions and hypothesis, research methodology to be used, literature review and chapter breakdown.

Chapter two provides the various approaches to regulation of securities market. It provides reasons why it is important for government to regulate capital market sector. It also examines the various self-regulatory mechanisms in the sector. Further it provides examples of failed and collapsed stockbrokerage firms thus setting the basis for the role and the need for adequate and effective regulatory tools to be utilized by CMA for regulating the affairs of stockbrokers and investment banks with an aim of protecting investors and maintaining market efficiency and integrity.

Chapter three provides a discussion on the relevant laws and regulations relating to the operations of stockbrokers and investment banks in Kenya. It critically examines and analyzes the existing legal and regulatory framework governing the operations of stockbrokers and investment banks. It also critically examines the adequacy and

effectiveness of the regulatory tools available to CMA for regulating the activities of stockbrokers and investment banks in Kenya. The chapter focuses on six regulatory tools: licensing and registration; market surveillance, market intervention, investigations, inspections and imposition of criminal sanctions and financial penalties. Finally, it provides the historical development of NSE and the challenges faced by NSE as a self-regulatory body in securities market in Kenya.

Chapter four provides a conclusion and specific recommendations of the study. The chapter provides the conclusions arrived at and specific recommendations for reforms. The recommendations should be considered by legislators and policy makers in the legislative amendments and policy reforms respectively.

CHAPTER TWO

APPROACHES TO REGULATION OF SECURITIES MARKET

2.1 Introduction

This chapter provides the various approaches to regulation of securities market. It provides reasons why it is important for government to regulate capital market sector. It also examines the various self-regulatory mechanisms in the sector. Further it provides examples of failed and collapsed stockbrokerage firms thus setting the basis for the role and the need for adequate and effective regulatory tools to be utilized by CMA for regulating the affairs of stockbrokers and investment banks with an aim of protecting investors and maintaining market efficiency and integrity.

This chapter starts by providing an understanding of capital markets and securities regulation. It is followed by discussion on justifications of regulating securities. Then it examines the various regulatory approaches to securities market globally and their application in Kenya. Finally it provides three examples of failed and collapsed stockbrokers in recent times in Kenya.

The next section provides a clear understanding of securities regulation and capital markets. It also gives justifications for regulating securities market.

2.2 Understanding securities regulation and capital market

Securities regulation is the field of law that regulates transactions and other dealings with securities. Regulation is designed to address asymmetries of information between issuers and investors, clients and market intermediaries and ensure smooth running of trading,

clearing and settlement mechanisms that will prevent market disruption and foster investor confidence.⁵³ In most cases the term securities regulation is understood to mean government regulation of capital market using state agency established by law to regulate the sector.⁵⁴ The development of a regulatory framework and supervision of regulated players is typically assigned to a public agency. However, sometimes, self-regulatory bodies such as stock exchanges take part in regulatory role.⁵⁵ In that case, the regulatory framework should ensure proper oversight of the self-regulatory body by the government regulator⁵⁶

Regulation of market intermediaries such as stockbrokers and investment banks ensure they enter and exit the market without disruption, conducts their business with clients with due care and trade fairly in the markets. The main regulatory tools for regulation of stockbrokers and investment banks are licensing requirements and market conduct obligations.

Capital market is a market where buyers and sellers engage in trade of financial securities like bond, stocks among others.⁵⁷ Capital market plays a significant role in the national economy. A developed, dynamic and vibrant capital market can contribute significantly

⁵³ Bernard Black, "The Legal and Institutional Preconditions for Strong Securities Markets," *UCLA Law Review*, 2011 vol. 48, (Los Angeles, California: University of California at Los Angeles), pp. 781–855. <https://www.slideshare.net/huongntt16/the-legal-and-institutional-preconditions-for-strong-securities-market> (accessed on 12th October 2010)

⁵⁴ *Ibid.*

⁵⁵ *Ibid.*

⁵⁶ Cally Jordan & Pamela Hughes, *Which way for Market Institutions: The Fundamental Question of Self-regulation*, 4 *BERKELEY BUS L.J.* 205, 207 (2007).

⁵⁷ *Ibid.*

in the speedy economic growth and development.⁵⁸ It mobilizes funds from individuals and institutions for further investments in the productive channels of an economy, activating idle monetary resources and puts them in proper investments. It also helps in capital formulation. Through mobilization of ideal resources it generates savings.

International organization for securities commissions provides three goals of securities regulation. These are: protecting investors, reducing systemic risk and ensuring that the market. It is important for securities regulation to protect investors from misleading information and fraudulent practices such as insider trading and front running from the players in the market. This will in turn boost confidence in the market.

The next section examines the various regulatory approaches adopted in regulating securities market globally and their application in the Kenyan capital market sector.

2.3 Regulatory approaches to securities market

As discussed above, it is critical to regulate securities to ensure the market is fair, efficient and transparent as well as protects investors. A sound regulatory framework plays a critical role in the development of securities markets. An effective regulatory framework is the basis for investors' confidence in the market which in turn attracts investors. This means that regulatory powers should be allocated to regulators properly for an efficient capital market.

⁵⁸ Ibid.

Regulatory approaches to securities markets comprise of state and self-regulatory frameworks.⁵⁹ The state regulatory system involves the central government being responsible for all aspects of securities markets. The government powers over capital markets are exercised by either a government ministry or an administrative body established and mandated to regulate securities markets or both.⁶⁰ The government controls the day to day activities of the market.⁶¹ This approach is common in the recently established capital markets where the entire market infrastructure including securities exchange was established by government. Although this approach has been justified on the basis of market failure, it has been criticized for being paternalistic in its approach.

Self-regulatory system entails a regulatory framework where industry players have established rules and regulations to govern itself.⁶² It is a system of self or private governance in the capital market sector.⁶³ It is mostly carried out by the securities exchange which prescribes rules that govern activities of the members and provides mechanisms for admission of new members.⁶⁴ It also monitors and investigates compliance and discipline members for fail to comply with prescribed rules.⁶⁵ A pure self-regulatory system is characterized by no direct government interference.⁶⁶ This approach

⁵⁹ See Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 *FORDHAM L. REV.* 2541, 2553 (2006); Douglas C. Michael, *Federal Agency use of Audited Self-regulation as a Regulatory Technique*, 47 *ADMIN.L. REV.* 171 (1995).

⁶⁰ *Ibid.*

⁶¹ *Ibid.*

⁶² See Ernest E. Badway & Jonathan M. Busch, *Ending Securities Industry Self-regulation as we know it*, 57 *RUTGERS L. REV.* 1351, 1372, (2005).

⁶³ *Ibid.*

⁶⁴ *Ibid.*

⁶⁵ *Ibid.*

⁶⁶ *Ibid.*

is based on the argument that individuals and institutions strive to uphold positive practices and standards set by the industry itself. This helps the players to benefit from the competence, skill and expertise of the industry.⁶⁷ It is however argued that this approach might slow down the development of capital markets.⁶⁸ This is because of its inability to respond to market dynamics and demands from investors.

Self-regulation is cost effective because it promotes an efficient rule which imposes a lower regulatory burden on the market players.⁶⁹ Further, the cost of regulation is determined by the industry players themselves. It also promotes the interests of market intermediaries to ensure that the markets are fair and transparent in order to attract and maintain investors.⁷⁰ Self-regulatory regime is more flexible and hence suitable in dealing with market dynamics. It can easily be applied cross-border because it is defined by a contract as opposed to jurisdictional limits set by a statute establishing a state regulatory agency.⁷¹

The weaknesses of a self-regulatory system can be summarized as follows:

The natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a façade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interest through the imposition of poorly anti-competitive restraints as opposed to those justified

⁶⁷ William L. Cary, *Self-Regulation in the Securities Industry*, 49 A. B. A. J. 244, 244 (1963).

⁶⁸ Ibid

⁶⁹ See Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 BROOK J. CORP FIN. & COM. L. 317 (2007). (On the strengths and weaknesses of self-regulation).

⁷⁰ Ibid

⁷¹ Ibid

by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation.⁷²

IOSCO has argued that an effective self-regulation must be defined within the context of government oversight.⁷³ State and self-regulation should not be viewed as alternatives but complimentary. This is because there are certain aspects of the market that can be effectively handled by a government agency while others are competently handled by a self-regulatory regime. A hybrid regulatory framework would be the best. Self-regulation with an oversight from government ensures that the market benefits from its accumulated wisdom and knowledge. This is the argument of this study.

In Kenyan context, the capital Market Act establishes CMA as the government agency mandated to regulate the securities sector in the country. The Act also recognizes the securities exchange and expressly provides for the promotion of self-regulation. However, NSE operates under oversight of the CMA. That makes the role of self-regulation in Kenya insignificant and ineffective.

This next section provides some examples of failed and collapsed stockbrokerage firms in the last five years and the reasons for the collapse.

⁷² See Report of Special Study of Securities Markets and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt.4 at 722 in Taylor, *Supra* note 14 at 74. But see Pritchard A.C., *Markets as Monitors: A Proposal to replace class Actions with Exchange as Securities and Fraud Enforcers*, 84 VA. L. REV.925; Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775 (2006); Lori Richards, *Self-Regulation in the New Era*, available at <http://www.sec.gov/news/speech/spch398.htm> (accessed on 20th November 2010).

⁷³ IOSCO, *Objectives and Principles of Securities Regulation*, available at www.iosco.org/librarypubdocs/pdf/IOSCOD323.pdf. (accessed on 20th November 2010).

2.4 Collapsed stockbrokers firms in Kenya

The last five years has seen four brokerage houses involved in malpractices that involved the misappropriation and mishandling of the clients funds by the owners, director and employees of these firms.⁷⁴ These includes: Shah Munge and Partners Stockbrokerage, Francis Thuo and Partners, Nyaga Brokers and Discount Securities.

2.4.1 Shah Munge and Partners Stockbrokerage

Stockbrokerage firm of Shah Munge and Partners was investigated by the Capital Market Authority and was found to have mishandled clients funds by depositing in its office accounts rather than a client account contrary to regulation 20 of the Capital Market (Licensing requirement) (General) Regulation. Upon investigation by CMA, the firm was found guilty of professional misconduct in misappropriating its clients' funds and suspended from Nairobi Stock Exchange (NSE).⁷⁵ The stock brokerage firm had transferred Kenya shillings Two fifty nine million (Kshs. 259,000,000) belonging to National Social Security Fund (NSSF) and deposited it into the office account rather than the clients account as required by law.⁷⁶

Shah Munge and Partners was suspended from transacting as stock brokers or dealing with any securities for a period of 30 days from 18th October, 2002 and financial penalty of Kshs. 1,500,000 imposed on the firm which was to be paid into the investor

⁷⁴ Capital Markets Authority Annual report 2009 <file:///C:/Users/TCA/Downloads/Annual2009.pdf> (accessed on 20th November 2010)

⁷⁵ See Nation Reporter, "*Shah Munge Lock-out Legal, says Regulator*," The Daily Nation March 7, 2007; Capital Markets Authority Annual report 2008 <file:///C:/Users/TCA/Downloads/Annual2008.pdf> (accessed on 20th November 2010)

⁷⁶ Ibid

compensation fund.⁷⁷ The directors of the firm were found to be severally liable for professional misconduct and were declared ineligible from taking directorships from any other brokerage firm listed in NSE for a period of one year.⁷⁸ The firm had to appoint new directors before re-admission to NSE could be granted.

Shah Munge and Partners appealed to the Capital Market Tribunal which enhanced the sanctions imposed by the Capital Market Authority.⁷⁹ The Tribunal held that the stock brokerage license be suspended for 3 years from 18th October 2002, the brokerage firm be suspended from dealing in securities and trading in NSE, the director be barred from taking directorship or any other managerial position of any other licensed stockbroker for a period of 5 years, re-admission to NSE and issuance of a license to the firm would be subject to compliance with licensing, approval and other requirements in the Act and Regulations.⁸⁰ The tribunal however set aside the authority's decision on the financial penalties and reduced the fine to the statutory limit of Kshs. 600,000.⁸¹

2.4.2 Francis Thuo and Partners

On the 5th March 2007 CMA announced one of the oldest stock brokerage firm in Kenya Francis Thuo and Partners Limited was indebted in the amounts of KShs. 125,000,000.

⁷⁷ Ibid

⁷⁸ Ibid.

⁷⁹ See Business Daily 'High Court confirms Shah Munge Suspension' Tuesday 19 May 2009 <https://www.businessdailyafrica.com/markets/539552-599906-unly5j/index.html> (accessed on 21st October 2010); Capital Markets Authority Annual report 2009 <file:///C:/Users/TCA/Downloads/Annual2009.pdf> (accessed on 20th November 2010)

⁸⁰ Ibid.

⁸¹ Ibid.

⁸²Preliminary investigations showed that there were fraudulent dealings by its directors and staff, weak capital position and the sale or illegal trading in their clients' funds.⁸³ On February 2007 Francis Thuo was closed by CMA and the amounts it owed investors stood at Kshs. 200,000,000.⁸⁴

2.4.3 Nyaga Stockbrockers

In March 2008 the firm of Nyaga stockbrockers was placed under statutory management by the Capital Market Authority.⁸⁵ Many investors who used the firm's services as an intermediary had lodged complaints with the regulatory authority regarding the status of their amounts.⁸⁶ As in the case with Francis Thuo stock Brokers discussed above the firm was trading in the clients shares without their consent. The firm is still under statutory management at the moment.⁸⁷

2.4.4 Discount Securities Limited

In the exercise of its mandate under the Capital Market Act and in a move to protect the interest of the customers of Discount Securities Limited, the Capital Market Authority (CMA) placed the stockbrokerage firm under statutory management on the 16th March

⁸² See Reuters 'Kenya regulator takes control of errant brokerage' 5th February 2010 <https://www.reuters.com/article/ozabs-kenya-stockbroker-idAFJ0E61409Q20100205> (accessed on 10th November 2010); Capital Markets Authority Annual report 2009 <file:///C:/Users/TCA/Downloads/Annual2009.pdf> (accessed on 20th November 2010)

⁸³ Ibid.

⁸⁴ Ibid.

⁸⁵ See 'The Standard 'Nyaga investors to take home Kshs. 50,000' 23rd May 2009' <https://www.standardmedia.co.ke/article/1144014896/nyaga-investors-to-take-home-sh50-000> (Accessed on 11th November 2010); Capital Markets Authority Annual report 2009 <file:///C:/Users/TCA/Downloads/Annual2009.pdf> (accessed on 20th November 2010)

⁸⁶ Ibid

⁸⁷ Ibid.

2009.⁸⁸ Zahir Sheikh and Peter Kahi were appointed the joint statutory managers of Discount Securities Limited. They were to serve for a period of six months. Besides, CMA suspended the firm from carrying out any transactions on the NSE for a period of ten days.⁸⁹ CMA assured the public that the action was taken in good faith to protect the interest of the investors.

CMA appointed KPMG as an independent director of Discount Securities Limited in October 2008 after it became apparent the stockbroker was facing serious corporate governance and liquidity problems.⁹⁰ The mandate of KPMG was to determine the viability of the company and provide appropriate recommendations for CMA's consideration. The CMA move was aimed at allowing the directors and management of Discount Securities Limited to restructure the operations of the company through rationalization of the expenses, review their branch network and dispose unutilized assets and investments.⁹¹

The statutory managers were to communicate to customers and creditors of Discount Securities Limited on the procedures for making claims in addition to mechanisms to facilitate transfer of CDS accounts for investors who desire to effect transfers to other market intermediaries. Affected customers were requested to give the statutory manager

⁸⁸ See Capital Business 'CMA takes over Discount Securities' 13th October 2008' <https://www.capitalfm.co.ke/business/2008/10/cma-takes-over-discount-securities/> (accessed on 23rd October 2010); Capital Markets Authority Annual report 2009 <file:///C:/Users/TCA/Downloads/Annual2009.pdf> (accessed on 20th November 2010)

⁸⁹ Ibid.

⁹⁰ Ibid

⁹¹ Ibid.

at least 14 days before forwarding their claims of lodging any requests for transfers of CDS Accounts.⁹²

2.5 Conclusion

This chapter has looked at the reasons why it is important to regulate securities market. It has discussed the various regulatory approaches available in regulating capital markets globally. It has examined the advantages and disadvantages of both self-regulation and state regulation. The same has been contextualized in Kenya. Kenya has adopted a hybrid regulatory framework which entails CMA as the government regulator having a heavy oversight over NSE, the self-regulatory body.

The chapter has also highlighted four cases of failed and collapsed stockbrokerage firms in Kenya in the last five years and reasons why they collapsed and action taken by CMA. These collapses points to some gaps in the current regulatory system, weak internal controls of the securities market intermediaries, stock brokers in particular, failure of the Nairobi Stock Exchange as the self-regulatory organization concerned to adequately regulate its members, inadequate capital adequacy requirements and lack of proper oversight by CMA, the regulatory authority over the activities of stockbrokers.

⁹² Daily Nation dated 16th March 2009

CHAPTER THREE

LEGAL AND REGULATORY FRAMEWORK FOR STOCKBROKERS AND INVESTMENT BANKS IN KENYA.

3.1 Introduction

This chapter provides a discussion on the relevant laws and regulations relating to the operations of stockbrokers and investment banks in Kenya. It critically examines and analyzes the existing legal and regulatory framework governing the operations of stockbrokers and investment banks. It also critically examines the adequacy and effectiveness of the regulatory tools available to CMA for regulating the activities of stockbrokers and investment banks in Kenya. The chapter focuses on six regulatory tools: licensing and registration; market surveillance, market intervention, investigations, inspections and imposition of criminal sanctions and financial penalties. Finally, it provides the historical development of NSE and the challenges faced by NSE as a self-regulatory body in securities market in Kenya.

It starts with an examination of the relevant laws and regulations which governs the operations of stockbrokers and investment banks. This is followed by an analysis of the adequacy and effectiveness of the various regulatory tools available to CMA for regulating the business of stockbrokers and investment banks. It then looks at the historical development of NSE before discussing challenges faced by NSE as a self-regulatory body in securities market.

3.2 State regulation of securities markets in Kenya

The Capital Market Act contains provisions that regulate the securities market in Kenya. The Act establishes CMA and gives it the primary responsibility of enforcing the provisions of the Act. It also gives CMA the powers to develop and implement rules and regulations to govern securities market in the country. In 2002 CMA developed and issued Capital Markets (Licensing Requirements) (General) Regulations, 2002 which set out the requirements for licensing, approval and financial requirements for securities market intermediaries.

CMA has been given enforcement powers by the Act. An enforcement regime is a critical aspect of any legal and regulatory framework. This is because it determines the effectiveness and efficiency of any regulatory regime. The enforcement regime in the securities market in Kenya comprises of a number of enforcement devices. The objective of these enforcement devices provided in the Act is to enhance confidence in the regulatory regime and protect investors.

There are six enforcement tools that CMA utilizes in regulating capital markets in Kenya. CMA enforces the provisions of the Act and its regulations through supervision which includes licensing or authorization, inspection, market surveillance, market intervention, investigation and sanctioning. While some of these regulatory tools are preventive in nature, others are curative in nature. Preventive measures include licensing and registration of stockbrokers and investment banks as well as market surveillance. Curative measures include inspection, market intervention, investigations and imposition of criminal sanctions and financial penalties.

The next section examines the effectiveness of each of the regulatory tools in enforcing the provisions of the Act and its regulations with an aim of promoting market efficiency and integrity and protecting investors.

3.2.1 Licensing and Registration

CMA draws its preventive approaches from its statutory powers which allow the regulator to undertake some activities aimed at stopping stockbrokers and investment banks which do not meet certain qualifications from joining the securities market. This is done through registration, authorization, approval and licensing of stockbrokers and investment banks. This approach helps the regulator to keep off stockbrokers and investment banks that have questionable financial, business and professional integrity from the market thus protecting investors.

CMA uses licensing as regulatory tool to assess the risks certain players could pose to the market. It has the responsibility of licensing stockbrokers and investment banks. This tool enables CMA to assess and evaluate the performance of licensed stockbrokers and investment banks. CMA has set the criteria to be met by stockbrokers and investment banks interested in securities market. The Act provides for the licensing requirements. Section 23 of the Act outlaws stockbrokers and investment banks from trading in securities without a valid license issued by CMA.⁹³ This license is granted upon meeting certain requirements set out in the regulations. The Act places an obligation on CMA to provide an opportunity to a stockbroker or investments bank which has applied for the

⁹³ Section 23 of the Act

licence before refusing to grant it a license.⁹⁴ Section 25 of the Act allows CMA to suspend or impose restrictions on the licence granted to stockbrokers and investment banks. Section 26 gives CMA powers to revoke a license if it is satisfied that the licenced entity has failed to comply with the provisions of the Act, its regulations and conditions stated in the license. The stockbrokers and investment banks are licenced on annual basis and CMA has the discretion to decline the renewal of the license if certain standards and compliance requirement are not met.⁹⁵ The Act has an obligation to publish in the Kenya gazette all the licenced stockbrokers and investment banks for that year.⁹⁶ The Act also requires CMA to publish the names and addresses of the stockbrokerage firm and investment bank whose license has been revoked within thirty days.⁹⁷ Section 28 of the Act provides requirements to be met before a license is granted.⁹⁸

Licensing and registration as a regulatory tool is not effective in detecting sophisticated fraudsters in the market. This can be seen from the four failed stockbrokerage firms. They were all licensed and registered to operate in the securities market.

⁹⁴ Section 24(6) of the Act

⁹⁵ Section 25(1) of the Act

⁹⁶ Section 27 (1) of the Act

⁹⁷ Section 27 (1) of the Act

⁹⁸ The Act provides that the applicant should be a company incorporated under the Companies Act. It also provides the minimum share capital in its regulations. The directors of the stockbrokerage firm and investment bank should not have been declared bankrupt. The CEO of the company must meet certain prescribed qualifications and the company should show the regulator that they have administrative capacity to carry out the business for which the license is required.

Regulation 15 of the CMA licensing Regulations provides more details on the specific requirement for a license is granted. It requires an applicant to prepare a business plan showing a share capital of Kshs. 5,000,000. The Regulations also contain requirements in relation to keeping books of accounts. For instance regulation 20 states how clients funds should be handled by stockbrokers and should be deposited in a separate bank accounts from the office accounts.

3.2.2 Market surveillance

The purpose of market surveillance is to protect the integrity of securities market through monitoring and ensuring that the electronic trading is fair, orderly, transparent, accurate and that sufficient information is released to the investing public in a uniform and timely manner⁹⁹. CMA has adopted a monitoring process of the players in the industry to ensure compliance with legal and regulatory requirements.¹⁰⁰ This regulatory approach plays three roles in securities market. First, it helps CMA to identify a problem and collect incriminating information from some stockbrokers and investment banks. Second, it enables CMA to gather information that could be utilized as evidence when making certain decisions regarding industry players. Third, it helps the regulator to remain updated on the happenings in the market and follow the changes taking place in the market.

CMA has various ways of utilizing this regulatory approach. It demands and analyses information and data from stockbrokers and investment banks relating to underlying trends in supply and demands an on traded process in order to detect any potential irregularity an anomalies in the market with an aim of detecting unfair or abnormal security dealings such as market manipulation, insider trading and market rumors that

⁹⁹ Capital market authority annual report 2008 pp.11

¹⁰⁰ Regulation 12 of the Licensing Regulations for instance, require the stock exchange to make daily reports to CMA on the securities transacted, price movements on each security, including the high, low and average price and the volume of transactions in respect of each security. Additionally, within 30 days after the end of each quarter, the stock exchange must furnish the Authority with a report of all securities transactions for each day inclusive of private transactions, names of the parties to each transaction and the holders of notifiable interest notified to the exchange in accordance with the Regulations on disclosure. The Trading Rules require the stock exchange to notify the Authority any extra ordinary occurrences on the exchange.

may cause price distortions hence compromising market integrity and investor confidence.¹⁰¹

CMA has adopted a proactive approach through the use of online and offline surveillance processes. Online surveillance involves real time monitoring of the trading activities as they happen to detect any market manipulations. Offline surveillance entails examining post trade transactions to determine if they are any artificial influence on the process of securities. This has been made possible by the availability of information obtained from Central Depository System (CDS) registry through CDS surveillance system and NSE's automated trading system surveillance window.¹⁰²

CMA has also collaborated with NSE's surveillance team to monitor trading activities consistently through electronic surveillance system facilitating sharing of information in detecting market abuses and taking appropriate and timely action.¹⁰³

3.2.3 Inspections

CMA conducts periodic onsite and offsite inspections. Sections 12(2) and 56 of the Central Depositories Act gives CMA power to full and free access to premises of licensed

¹⁰¹ Capital market authority annual report 2008 pp.12.

¹⁰² For instance, under section 13(1) of the Capital Markets Act, the Authority or its agent may by written notice require any person to furnish the Authority or agent within a specified duration returns or information as the notice may specify. Under section 9(4) of the Central Depositories Act, Central Depository Agents are required to furnish the CMA with such information or documents as it may require relating to a securities account. Other disclosure requirement on the Central Depository and Central Depository Agents in relation to the acquisition or disposal of book-entry securities are imposed by section 58(1).

¹⁰³ Capital market authority annual report 2009 pp.12.

stockbrokers and investment banks.¹⁰⁴ The purpose of on-site inspections is to check the level of compliance with legal and regulatory requirements. An inspection also helps the regulator to determine the financial stability and operational viability of stockbrokers and investment banks. CMA carries out inspections to examine the following: compliance with capital adequacy requirements, continuous reporting obligations, internal controls and record keeping requirements.¹⁰⁵ The Act allows CMA officers to conduct inspection into the affairs of stockbrokers and investment banks and collect relevant information for the purpose of decision making. In 2008 CMA conducted 149 inspections involving investment banks and 10 involving stockbrokers and one stockbrokerage firm was placed under statutory management.¹⁰⁶

Off-site inspections are conducted when CMA reviews interim and annual reports submitted by stockbrokers and investment banks. The Act and Regulations place an obligation on investment banks and stockbrokers to submit interim and annual reports to the regulator within prescribed timelines. The objective of the financial reports review is to examine compliance with eligibility and licensing requirements, enhance the quality of financial reporting and dissemination of information to investors.

3.2.4 Investigations

CMA has used investigation as a regulatory tool. The aim of its investigation is to help the regulator establish whether a suspected violation took place and the institution or

¹⁰⁴ Sections 12(2) and 56 of the Central Depositories Act 2000

¹⁰⁵ Capital market authority annual report 2008 pp.12.

¹⁰⁶ Ibid.

individual responsible for that particular violation.¹⁰⁷ CMA may initiate investigations upon determining possible breach of regulations by licensees or reported malpractice among stockbrokers and investment banks. Investigations entail identification of persons involved in the wrongdoing through collection of elaborate information regarding: primary issues, transactions in secondary markets and trading details and verification and analysis of the same. The Act and its Regulations prescribe various administrative actions to be undertaken to wrongdoers. These actions include financial penalties, warning, suspension and prohibition of dealing in securities among others. For instance in 2008, CMA investigated circumstances leading to the collapse of licensed stockbrokers that were subsequently placed under statutory management.

The Section 13A of the Act gives the CEO powers to conduct investigations into an alleged violation by stockbrokers or investment banks.¹⁰⁸ The Finance Act 2008 allows the regulator to apply for a warrant from a Magistrate Court to enable him conduct a search at the premises.¹⁰⁹ In 2009 CMA set up a Fraud Investigation Unit with a responsibility to investigate alleged violations of the law including fraud and collect evidence for purposes of prosecution.¹¹⁰ The main goal to be achieved by the Unit was to help CMA manage the risk of fraud through prevention, detection and deterrence. There

¹⁰⁷ Capital market authority annual report 2008 pp.12.

¹⁰⁸ Section 13 of the Act.

¹⁰⁹ The Magistrate has jurisdiction to issue a warrant authorizing the officer to (1) enter any premises to search for money, documents or assets and seize the same (2) direct the person in possession of the assets to act in accordance with the directions of CMA with a view to preserving the assets or (3) make copies of documents or extracts held by a bank.

¹¹⁰ This unit comprises of police officers from criminal investigation department with experience in investigating fraud, cyber and other white collar crimes. See Benson Kathuri, *The task ahead for market fraud unit*, THE STANDARD, May 13, 2009 at 18.

have been no prosecutions undertaken by CMA so far. The Act allows CMA to share critical information with other regulatory agencies in the country.

Apart from the fraud investigation Unit, CMA has contracted audit firms to investigate certain alleged violations of the law particularly among stockbrokerage firms. For instance in 2009 CMA contracted Price Waterhouse Coopers (PWC) to conduct a forensic audit on Francis Thuo and Partners and Nyaga Stock Brokers.¹¹¹ In addition to the forensic audit conducted by PWC, CMA fraud investigation Unit investigated the circumstances that lead to collapse of the stockbrokerage firms. It made recommendations for prosecutions of their directors.¹¹²

3.2.5 Intervention measures

The Act allows CMA to intervene in the affairs of stockbrokers and investment banks in certain situations with an aim of protecting investors and the integrity of the securities market to attract investments.¹¹³ Section 33A provides the manner in which CMA could exercise the powers to intervene.¹¹⁴ First, CMA has powers to remove officers or employees of stockbrokerage firm and investment bank who could be responsible for the breach of the provisions of the Act and its regulations or engaging in activities that

¹¹¹ James Anyanzwa, *CMA to Investigate troubled Broker*, THE STANDARD, June 2, 2009, at 26; See Standard Team, *Report reveals depth of lot at Stock Market*, THE STANDARD, Feb 10, 2009 at 17; Wahome Thuku *State to Prosecute former Brokerage firm manager*, THE STANDARD, Apr. 1, 2010 at 19.

¹¹² See Washington Gikunju, *Police turn the heat on Stock mart fraudsters*, BUSINESS DAILY, Oct. 26, 2010 at 31; Washington Gikunju, *Crackdown on Fraudsters*, BUSINESS DAILY, Oct. 27, 2010 at 19.

¹¹³ These situations include: if a person's license or approval is suspended under the provisions of section 25, a winding up petition is filed, a resolution to wind up licensed person has been proposed, a receiver or receiver manager has been appointed in respect of a licensed person or in respect of all or any of its assets.

¹¹⁴ Section 33A of the Act.

affects interests of investors negatively. However, CMA has not exercised this power since it was empowered.

Second, CMA has powers to revoke or cancel any existing power of attorney or appointment in favour of any other person. There is no evidence of CMA invoking this particular power. Third, CMA has been empowered to appoint a competent person who it considers to be familiar with the business on the board of directors of stockbrokerage firms and investment banks. CMA's appointee can only be removed from that position with approval of CMA or an order from the High Court. CMA has not exercised this power.

Lastly, CMA has powers to appoint a competent person as a statutory manager to be responsible for the management, control and conduct of the affairs of stockbrokerage firm and investment bank. CMA's appointee is allowed to exercise powers to the exclusion of the board of directors. This appointment should last for a period of less than six months. However it could be extended by an order of the High Court. CMA has invoked these powers in Francis Thuo & Partners when it appointed NSE as the statutory manager.¹¹⁵

3.2.6 Criminal sanctions and financial penalties

Before the amendments to the Finance Act 2008, CMA had no powers to impose sanctions and financial penalties because the Act did not contain provisions which

¹¹⁵ See Benson Wambugu, *High Court extends Brokers' Statutory Managers term*, BUSINESS DAILY, May 14, 2010 at 18.

empower CMA to impose criminal sanctions and penalties to stockbrokers and investment banks. However CMA licensing regulations gave powers to the regulator to impose sanctions and penalties to the stockbrokers and investment banks, their directors and employees. But with the collapse of Francis Thuo & Partners Ltd, the Finance Act was amended to give CMA powers to impose sanctions and financial penalties to stockbrokers and investment banks, their directors and employees.

Some of the sanctions include disqualification from employment or appointment as directors. This is aimed at preventing unqualified, unsuitable and incompetent individuals from managing stockbrokers and investment banks trading in the securities market. CMA exercised this power in the case of *CMA v Shah, Munge & Partners Ltd* where the court nullified the decision of the Tribunal.¹¹⁶ Further, CMA has been empowered to recover amounts equal to double the benefit accruing to the person from the breach. This power assumes that CMA has the capacity and technical know-how to assess the benefits accruing to a person from a breach.

3.4 Self-regulation of the capital markets

NSE is the self-regulatory body of securities markets in Kenya. The stock exchange has been in operation since 1954, as a voluntary association of stockbrokers registered under the Societies Act. At that time only Europeans were allowed to trade securities at the NSE. Africans and Asians were only permitted after Kenya got independence in 1963.¹¹⁷ At the time of attaining independence the stock market slowed down because investors

¹¹⁶ *CMA v Shah, Munge & Partners Ltd* civil appeals No. 913 & 930 of 2003

¹¹⁷ Nairobi Stock Exchange, Handbook: An Authoritative 5-year Performance Results of Listed Companies, 2002 Ed. (Nairobi, 2002), 164

were uncertain about the future economy of the country.¹¹⁸ Three years later, subscription of public issues went up after the country experienced a steady economic growth thus restoring public confidence in NSE.¹¹⁹ By 1966 17 companies were listed on the stock exchange and by 1970, NSE had 20 companies listed on the stock exchange. A few listed companies joined the stock exchange.¹²⁰

In 1984, the government of Kenya through Central Bank of Kenya (CBK) together with International Finance Corporation (IFC) conducted a survey titled 'development of money and capital markets in Kenya.'¹²¹ This study informed structural and institutional reforms in the financial sector.¹²² It led to the establishment of the Capital Markets Authority in 1989 as a state agency tasked to regulate the securities market in the country. It was given the responsibility of ensuring the development of capital markets and creating a conducive environment for economic growth.¹²³ 1988 saw the government carry out its privatization through NSE when it sold 20% of its ownership in Kenya Commercial Bank (KCB)¹²⁴

¹¹⁸ Ibid

¹¹⁹ Ibid

¹²⁰ Joseph H. Kimura and Yobesh Amoro, "Impediments to the Growth of the Nairobi Stock Exchange". IPAR Discussion Paper Series. 6.

¹²¹ Grace Wambui Kibuthu 'capital markets in emerging economies: a case study of the Nairobi Stock Exchange' masters thesis submitted at the Fletcher School, Tufts University (Unpublished thesis April 2005) <https://www.proshareng.com/admin/upload/reports/> (accessed on 20th October 2010)

¹²¹ Ibid.

¹²² Ibid

¹²³ Chapter 486, Laws of Kenya.

¹²⁴ NSE handbook

Ten more companies were listed on the stock exchange in 1990s. In 1991 NSE was incorporated as a limited liability company registered under the Companies Act.¹²⁵ The main function of NSE is to create and enforce rules relating to securities market. It sets eligibility criteria for admission of members to the stock exchange. In 1994, the NSE saw the number of licensed stockbrokers increase from six to fourteen. In 1995 seven more stockbrokers were licensed to trade at NSE.

In 1998 the government introduced some incentives to encourage foreign investment in the securities market. For instance the government introduced tax free venture capital funds at the same time scrapped capital gains tax on investment by insurance firms. It also allowed foreigners to have a stake in stockbrokerage and fund managers firms. 2000 saw some companies such as East African Breweries Ltd and Kenya Airways get listed in three stock exchanges across east African countries. In 2002 Central Depository and Settlement Corporation (CDSC) was established as a legal entity to run the automated, clearing, settlement, depository and registry system in the country.

The Act does not contain a provision that gives any power to NSE.¹²⁶ However, the CMA Regulations, Membership and Trading Rules and Listing Manual grant NSE some

¹²⁵ Cap 484, Laws of Kenya.

¹²⁶ The objects clause of the memorandum of association of the NSE empower it to: To formulate rules for the conditions under which the listing of a particular security may be effected, for the conditions under which applications for delisting may be made, for the carrying out of the business of the stock exchange with due regard to the interests of the investing public, suspension of trading of any given security, segregation of members and clients funds, ensuring fair representation of members in the elections of its board of directors, for the proper keeping of securities in its custody and for the responsibility of stock brokers and dealers for the actions of their employees or representatives in their dealings with the public. It is empowered to carry on the business as advisers on the administration and organization of industry and business and the training and utilization of personnel for industry to acquire, build maintain alter and enlarge buildings factories offices roads, railways etc. It is also empowered to take or otherwise acquire and

powers. These powers should be exercised subject to the provisions of the Act and its Regulations. This hinders the exercise of its powers. For example, NSE is only empowered to admit all stockbrokers and investment banks licensed by CMA.¹²⁷ Further, the rules developed by NSE cannot be amended or varied without prior approval of CMA. CMA is empowered to review any disciplinary action on its own volition taken by NSE against a stockbroker or investment bank. NSE cannot expel a stockbroker or investment bank unless its license has been revoked by CMA. NSE's budget is subject to CMA's approval. NSE can only suspend or delist securities with sanction of the CMA.¹²⁸ NSE lacks powers to investigate alleged violations by stockbrokers and investment banks, their directors and employees.

This overarching oversight function of CMA over NSE has affected the effectiveness of the self-regulatory framework. NSE has struggled in enforcing its membership and continuing disclosure obligations. Further, NSE role is affected by lack of separation between ownership and management. This amounts to a conflict of interests in its operations. The separation of management from its owners will boost corporate governance practices thus enhancing accountability and transparent in its activities.

3.5 Conclusion

This chapter has examined both state and self-regulatory mechanisms as provided in the Act and applicable regulations. It has analyzed the adequacy and effectiveness of the

hold shares in any other company having objects altogether or in part similar to those of the exchange. Can lend, borrow or raise or secure the payment of money and can invest its money in any manner Finally, it is empowered to do all such other things as may be conducive or incidental to the attainment of the other object.

¹²⁷ Regulation 13(2)

¹²⁸ Regulation 22

CMA regulatory tools as enforcement mechanisms in regulating operations of stockbrokers and investment banks. Some of the powers given to CMA to enforce a breach of the law have not been invoked by the regulator. It has provided a historical development of NSE as a self-regulatory organization. It has also examined the challenges faced by NSE in regulating securities market in Kenya. These challenges are occasioned by the overarching oversight role of CMA over NSE powers and role in the capital market sector as well as lack of separation between ownership and management of NSE.

CHAPTER FOUR

CONCLUSION AND RECOMMENDATIONS

4.1 Introduction

This concluding chapter has two objectives. First, it restates the major findings of this study. Second, it provides specific recommendations aimed at enhancing regulatory regimes of the securities market in Kenya.

4.2 Concluding observations

This study examined the adequacy and effectiveness of the legal and regulatory framework that governs the operations of stockbrokers and investment banks in Kenya. Stockbrokers and investment banks are among licensed market intermediaries in the securities market. It focused on the adequacy and effectiveness of the regulatory tools available to the CMA, state agency mandated to regulate the activities of the securities market. It also examined the challenges facing NSE as the self-regulatory body in the securities market in Kenya.

In order to achieve the research objectives, study addressed the first research question on what regulatory approaches have been adopted in regulating securities market in Kenya. After examining the various regulatory approaches, it went on to provide examples of the failed and collapsed stockbrokerage firms and how CMA addressed the situation. This was followed by a discussion aimed at addressing the second research question on the adequacy and effectiveness of the existing regulatory tools available to CMA for regulating securities market in Kenya. This was followed by looking at the challenges faced by NSE in controlling trading in the securities market. Lastly, the study made

specific recommendations in enhancing investors' protection and promoting integrity of securities market in Kenya.

Securities market in Kenya has adopted a hybrid regulatory framework. As discussed in chapter two of this study, stockbrokers and investment banks are regulated by state regulatory mechanism as well as a self-regulatory framework. The government established CMA as a public body with a responsibility of regulating securities market in the country. In addition, there is NSE in place as a self-regulatory body given powers to regulate trading in the securities market.

The Act and its regulations have given CMA a number of regulatory tools and powers to enforce the provisions of the Act and Regulations in relation to operations of stockbrokers and investment banks. Some of these tools include licensing, registration, authorization, approvals, inspection, intervention, market surveillance and imposition of criminal sanctions and financial penalties. As discussed in chapter three, CMA has been able to utilise some of the regulatory tools with an aim of protecting investors enhancing market integrity. It has utilised market surveillance, inspection and financial penalties. However, there are some powers that have not yet been invoked by the regulator since inception. This has caused some market failure that has made investors to lose some of their savings to fraudster stockbrokerage firms.

As argued in chapter three, NSE has its power and activities subjected to approval of CMA. This has hampered its effectiveness in regulating trading activities in the securities market.

4.3 Recommendations

The study makes the following six recommendations:

First, CMA should work closely with stockbrokers and investment banks to develop the culture of compliance. This could be achieved through training and proper communication between CMA and market intermediaries. They should be trained on the proper business practices and standards as well as the value of compliance. Regulation by itself cannot stop investment banks and stockbrokerage firms from collapsing.

Second, CMA should deploy wider selection of regulatory tools to enforce compliance with the provisions of the Act and its Regulations. The focus has been on imposition of some tools such as financial penalties while disregarding other tools such as taking necessary intervention measures to stop stockbrokers and investment banks from engaging in certain activities that hinder the development of an orderly, fair and efficient securities market.

Third, the proposed amendments to the Act and its Regulations should be passed to strengthen the laws regulating securities market in Kenya. It will improve the activities of stockbrokers and investment banks thus serve to protect investors from malpractices and ensure fraudsters are kept off before investors' loss their savings and suffer unnecessary losses.

Fourth, the Act should be amended to recognise NSE as a self-regulatory body with clear and significant powers and roles which are not subjected to an overarching oversight of CMA which hinders their effectiveness. This is vital considering the impeding

demutualization of the NSE which will entail a clear separation of the business from the regulatory role of NSE.

Fifth, CMA should consider establishing partnerships and collaborations with NSE and Kenya Association of Stockbrokers and Investment Banks (KASIB) in creating investor awareness. This will be useful tool in educating investors on their rights and interests in securities market. It will also allow employees of the three organisations to share their skills and experiences with investors.

Lastly, CMA should operationalize the Investors Compensation Fund established in section 18 of the Act. The board should be constituted to help in the operationalization of the Fund. The Fund will help in compensating investors who have lost their savings from the failure of stockbrokerage firms.

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