

UNIVERSITY OF NAIROBI

SCHOOL OF LAW

THE INVESTOR AND CAPITAL MARKET INTERMEDIARIES: IS THE  
INVESTOR ADEQUATELY PROTECTED?

BY

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G62/70950/2007

A Thesis submitted in Partial Fulfillment of the Requirements for the Degree of  
*Master of Laws*

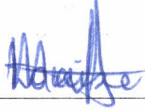
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**DECLARATION**

**I, LOUISE WANGUI MATHU**, do hereby declare that this is my original work, and has not been submitted for the award of a degree in any other University

Signed:



Dated:

28th November 2008

This thesis has been submitted for examination with my approval as University Supervisor

**DR. WINNIE KAMAU**

Signed:



Dated:

28/11/2008

## **Dedication**

For my mother, Naomi Muringa Mathu, thank you for your unfailing support throughout  
the years

And

Isaac Mwangi, for your patience, friendship and encouragement.

## **Acknowledgments**

Firstly, I thank God for his grace and strength towards the completion of this project. I am truly nothing without Him.

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For the support and encouragement of my friends and all classmates in International Trade and Investments Law and Public Finance, LL.M 5<sup>th</sup> Intake - thank you all.

To all my friends, too many to name, who prayed for me and offered words of encouragement, I am grateful.

## **Table of Abbreviations**

ATS	Automated Trading System
CBK	Central Bank of Kenya
CMA	Capital Markets Authority
ICF	Investor Compensation Fund
IFC	International Finance Corporation
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
NSE	Nairobi Stock Exchange
SITI	Securities Industry Training Institute
SRO	Self Regulatory Organisation

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

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## CHAPTER 1

### INTRODUCTION

#### 1.1. Background

The core objectives of securities regulation are the protection of investors; ensuring fair, efficient and transparent and the reduction of systemic risk.<sup>1</sup> Of these three objectives, investor protection must be at the core of capital markets regulation which is particularly important for small investors<sup>2</sup> (as opposed to institutional investors). The stability of capital markets hinges largely on investor confidence. If events occur that shake the confidence of the investor community, money moves out of the market and share prices drop, triggering even more sales. This condition is referred to as systemic risk and refers to the possibility that even minor shocks in the system may be magnified into a system wide calamity.<sup>3</sup>

The regulatory structure for capital markets normally provides a choice between statutory regulation and self-regulation. The former is characterised by the government using the full power of the law and the latter by the industry policing its own activities on the basis of agreed standards on a collective basis.<sup>4</sup> Statutory regulation has a considerable benefit in that it is capable of being applied to all participants including the investors. However, it is far less flexible and responsive to changing market conditions and market evolution. Self-regulation is far more flexible but usually only applies to the members of the particular organisation concerned, in this case, the stock exchange. A balance between the two is usually the best

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<sup>1</sup> IOSCO-International Organisation for Securities Commissions. *IOSCO Objectives and Principles of Securities Regulation* (Feb 2008) pp 5 at [www.iosco.org](http://www.iosco.org) (last accessed on September 22, 2008)

<sup>2</sup> Augustin Fosu, Mwangi Kimenyi and Njuguna Ndung'u. "Economic Reforms and Restructuring in Sub-Saharan Africa: The Financial Sector and Regulation/Deregulation of Infrastructure." *Journal of African Economics*, Vol 12, Supplement 2 (Oxford University Press: October 2003) pp 143

<sup>3</sup> The World Bank. *Securities Market Development: A Guide for Policy Makers* (New York: Economic Development Institute of the World Bank, Regulatory Reform and Enterprise Division, May 1996) pp 3-1

<sup>4</sup> *Ibid* at pp 3-8

result and the particular mix adopted depends largely on the needs of the particular jurisdiction.

Capital market intermediaries play the very important role of providing the linkage between investors and capital markets, with each providing different services to investors. The main capital market intermediaries operating in Kenya's capital markets are stockbrokers, investment banks, investment fund managers, investment advisers, authorised securities dealers and collective investment schemes. Stockbrokers are market professionals who buy and sell securities as an agent for investors at a stock exchange in return for a brokerage commission. Investment banks 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 a stockbroker, a dealer, and fund manager of collective investment schemes and provider of contractual portfolio management services. Investment advisers or fund managers are market professionals who promulgate analysis and research on capital markets securities, and advise investors on such securities at a commission. They also manage portfolios of securities on behalf of clients pursuant to a contract. Authorised 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 schemes are specialised market players licensed to mobilize savings in financial assets and to enhance access to capital markets by small investors. They include mutual funds, unit trusts, investment trusts and other forms of specialised collective investment schemes. Collective investment schemes offer a unique opportunity to investors in terms of

professional management, economies of scale and diversification of portfolio and risk.<sup>5</sup>

Regulation of the various types of capital market intermediaries should address entry criteria, capital and prudential requirements, ongoing supervision and discipline of entrants, and the consequences of default and financial failure. The oversight of market intermediaries should primarily be directed to the areas where their capital, client money and public confidence may most be put at risk.<sup>6</sup> High standards of prudential and business conduct by market intermediaries are of vital importance because investors are more willing to invest if they are assured that their orders are carried out fairly and efficiently, and that their interests are safeguarded.

The Capital Markets Authority (CMA) was inaugurated in March 1990 following the Kenyan government's recognition of the need to enhance capital market development in the country. The formation of the CMA was the culmination of efforts starting from as far back as the 1980s, when the Government of Kenya realised the need to design and implement policy reforms to foster sustainable economic development with an efficient and state financial system. In particular, it set out to enhance the role of the private sector of the economy, reduce the demands of public enterprises on the exchequer, rationalise the operations of the public enterprise sector to broaden the base of ownership and enhance capital market development. In 1984, a study on the Development of Money and Capital Markets in Kenya was jointly undertaken by the Central Bank of Kenya (CBK) and the International Finance Corporation (IFC) with the objectives of making recommendations on measures that would ensure active development and strengthening of the financial sector. This became a blueprint

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<sup>5</sup> See Capital Markets Act, Cap 485A, Laws of Kenya, Section 2 and Capital Markets Authority Handbook, *Capital Market Authority (Nairobi:2006)* pp 35-40

<sup>6</sup> *Supra* note 1 at pp 33

for structural reforms in the financial markets. In November 1988, the Government set up the Capital Markets Development Advisory Council and charged it with the role of working out the necessary modalities including the drafting of a bill to establish the CMA. The following year in November 1989, the bill was passed in parliament and subsequently received Presidential assent leading to the enactment of the Capital Markets Authority Act and the establishment of the CMA.<sup>7</sup>

The years following establishment of the CMA saw the Government's divestiture to the public of its shares in a number of companies such as Kenya Airways, Mumias Sugar Company and Kenya Commercial Bank (KCB). With rapid advances in technology, there was need to automate the stock exchange in keeping with global trends. In order to deepen and strengthen the capital markets, the CMA embarked on reforming the regulatory framework which culminated in the repeal of the Capital Markets Authority Act and in its place, was enacted the Capital Markets Act, Cap 485A in 2001.

Following the Government's divestiture in the Kenya Electricity Generating Company (KenGen) in 2006 which released 659 million shares to the public, Scangroup's initial public offering (IPO) of 69 million shares and the listing by introduction of Equity Bank shares<sup>8</sup>; and the recent IPO by Safaricom Limited in 2008, the number of investors in the stock market has grown by leaps and bounds. In the year 2007 alone, the number of Central Depository System (CDS) Accounts increased by 120 percent to 1.8 million.<sup>9</sup> As an inevitable consequence of this increase, the number of complaints on the part of the investors

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<sup>7</sup> Capital Markets Authority Handbook. Capital Market Authority (Nairobi:2006) pp 4

<sup>8</sup> Annual Report of the Capital Markets Authority (Nairobi: Capital Markets Authority, 2006)

<sup>9</sup> Francis Ochieng and Samuel Njoroge. "CMA seeks to create more awareness through the Investment Banking and Insurance Expo." [www.cma.co.ke](http://www.cma.co.ke) (last accessed on September 22, 2008)

on a wide range of issues has been on the rise.<sup>10</sup> These complaints range from those occasioned by inefficient market players when overwhelmed by this increased activity to those relating to the dealing with client accounts by unscrupulous market players without the authorisation of clients.<sup>11</sup>

Research shows that the most commonly used method of share acquisition in Kenya is through stockbrokers as capital market intermediaries<sup>12</sup>. In 2007 and 2008, two major stockbrokerage houses, Francis Thuo and Partners Limited and Nyaga Stockbrokers respectively collapsed following their inability to meet financial obligations owing to their clients.<sup>13</sup> In both cases, investors had raised complaints that the stockbrokers were trading in client's shares without their consent.<sup>14</sup> Prior to this, in 2002, the stockbroking firm of Shah Munge and Partners had its licence suspended for mishandling a client's funds, by depositing them in its "office account" rather than the "client account". This was a clear violation of the Capital Markets (Licensing Requirements) (General) Regulations which clearly stipulate that client's funds are to be deposited in the "clients account".<sup>15</sup>

The most basic issue for emerging capital markets like Kenya, and indeed for all markets, is to ensure the primacy of investors in the market. The bedrock of any market is market integrity and investor confidence. Investors have an implicit faith in their brokers and

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<sup>10</sup> It is instructive to note that investor complaints received by the Capital Markets Authority in the 2006/2007 financial year rose to 199 up from 57 in the 2005/2006 financial year.

<sup>11</sup> Capital Markets Authority, "Investor Complaints in the Stock Market" at [www.cma.co.ke](http://www.cma.co.ke) (last accessed on September 22, 2008)

<sup>12</sup> See Mbui Wagacha, "Mobilising Domestic Resources in Kenya: A Survey of Shareholders Strategy in the Capital Market," Discussion Paper No. 022, (Nairobi: Institute of Policy Analysis and Research, IPAR, 2001)

<sup>13</sup> 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 his duty to his client, the principal.

<sup>14</sup> This practice is normally referred to as short selling. Short selling is the selling of a 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 jurisdictions such as the United States. Stockbrokers mainly engage in short selling so as to benefit from an overpriced stock or market.

<sup>15</sup> Regulation 20



advisers which is based upon the appearance of good faith and objectivity. Strong licensing standards and swift, effective disciplinary sanctions for errant parties in instances of malpractices are very important. Investors will always be reluctant to invest in markets which are not trustworthy. No market can succeed without public confidence and this is therefore the reason why investor-centric policies are of such vital importance. It is however important to note that regulation should seek to strike a balance between catering for the protection of investors and at the same time provide the market with freedom to innovate and develop.

The Kenyan legal framework regulating the activities and operation of capital market intermediaries comprises the Capital Markets Act (Cap 485A, Laws of Kenya) as the main statute and the Capital Markets (Licensing Requirements) (General) Regulations, 2002 as subsidiary legislation. The Act sets out the requirements that all licensees, who include capital market intermediaries, are to fulfil before being granted a license to operate as such. The regulations supplement the Act and detail the minimum capital requirements as well as the accounting and reporting obligations for capital market intermediaries. Additionally, prudential control mechanisms that these intermediaries are to follow in the conduct of their operations are also stipulated.

The institutional structures comprise the Capital Markets Authority (CMA) as the state regulator, and the Nairobi Stock Exchange (NSE) as a self regulatory organisation (SRO). At present the regulatory role of the CMA is largely duplicated by the NSE in regulating the members of the exchange.

An examination of the structures and the stated relevant securities laws will be carried out in this research paper to ascertain their adequacy of the legal framework and institutional

structures regulating the activities of capital market intermediaries, identify any existing weaknesses or gaps and thus establish a case for policy reform.

## 1.2 Statement of the Research Problem

The years 2007 and 2008 have seen the collapse of two major stockbroking firms in Kenya, Francis Thuo and Partners and Nyaga Stockbrokers respectively. These events have seen many Kenyan investors lose their hard earned savings that had been invested through these stockbrokers.<sup>16</sup> The role of the CMA as the state regulator is to oversee the activities of stockbrokerage houses and ensure that they act in accordance with the laid down law. In addition, the CMA is required to take action where necessary to protect the interests of investors. The NSE as the self regulatory organisation is also expected to properly regulate its members' activities.

With the growth and developments witnessed in Kenya's capital markets in recent years, such as a large increase in the number of investors, the current legal framework has evidently not kept up to speed. This is with particular reference to entry criteria, capital adequacy requirements, prudential control, management and ownership structures relating to capital market intermediaries. The mutual status of the NSE, that is, the lack of separation in its ownership and management, indicates that the NSE in its present form is not an efficient self regulatory organisation. The weaknesses, gaps in legislation as well as weaknesses in the institutional structures have contributed greatly to the problems that Kenya's stockbrokerage

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<sup>16</sup> Indications as at the writing of this paper are that another stockbrokerage house, Discount Securities Limited is facing what the CMA refers to as corporate governance problems. This may have resulted in the National Social Security Fund (NSSF) and other investors incurring financial losses.

industry in particular has experienced in the recent past and the subsequent financial losses suffered by investors.

### 1.3 Theoretical Framework

Several theories have been advanced to explain the observed pattern of government regulation in an economy. These include the *public interest theory* and several versions, proposed by either political scientists or economists, of the *interest group* or *capture theory*.<sup>17</sup>

Posner classifies both of these theories, *public interest theory* and the *interest group theory* as theories of economic regulation and states that properly defined, “economic regulation” refers to taxes and subsidies of all sorts as well as to explicit and legislative administrative controls over rates, entry and other facets of economic activity. Professor Croley<sup>18</sup> has also expounded on the *public interest* and *capture theories* as *theories of regulation* and not strictly as *theories of economic regulation* as Posner has done.

The *capture theory* takes the view that the regulatory framework is the result of a “market for regulation”. This theory indicates that it is difficult, in many cases, to pinpoint a public interest that can be protected by the regulatory framework. It draws attention to the fact that the state is apparently also quite capable of failure. Capture theory imputes a direct interest on the part of particularly affected market players for regulation that is to their advantage. The real architects of regulatory structures are therefore identified as being individual players,

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<sup>17</sup> 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 at [www.jstor.org](http://www.jstor.org) (last accessed on September 29, 2008)

<sup>18</sup> See Steven P. Croley, “Theories of Regulation: Incorporating the Administrative Process,” *Columbia Law Review*, Vol. 98, No. 1 (Columbia Law Review Association, Inc: Jan 1998), pp. 1-168 at [www.jstor.org](http://www.jstor.org) (last accessed on September 29, 2008)

especially financial market players, who call for regulatory intervention, often as a means of preventing entry into the market by new players and additional competition.<sup>19</sup>

The *public interest theory* at the basic level states that the regulatory world is populated by three types of actors - the regulator, the citizenry at large, and special interest groups. Special interest groups are described as organised subsets of the citizenry who are especially sensitive to particular regulatory policies and who thus have especially strong preferences about what constitutes desirable regulatory outcomes in particular areas. Examples of special interest groups would be manufacturers, lawyers or stockbrokers who would all have a special interest in the regulatory policies regarding their particular area of specialisation.<sup>20</sup>

The goals of the citizenry and of special interest groups are straightforward. Members of the citizenry want, first, regulatory outcomes that satisfy their preferences, and, second, the opportunity to pursue all of their other goals. In other words, members of the citizenry seek what they consider to be desirable regulatory policies, but their pursuit of desirable regulatory policies competes with their pursuit of other goals, such as employment and other aspects of daily existence. Their stake in regulatory policy making is thus limited. Special interest groups' stakes in regulatory policy are also limited, but less so. In fact, what distinguishes a special interest group from the rest of the citizenry is exactly its heightened stake in regulatory outcomes. Special interest groups, like the citizenry at large, seek what they consider to be desirable regulatory policies in whatever regulatory areas that affect them particularly. Relative to the citizenry at large, though, they do so more actively.<sup>21</sup>

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<sup>19</sup> Deutsche Bundesbank Monthly Report. "Securities Market Regulation: International Approaches." (Deutsche Bundesbank: January 2006) pp 41. at [www.bundesbank.de](http://www.bundesbank.de) (last accessed on September 29, 2008)

<sup>20</sup> *Supra* note 18 at pp 34

<sup>21</sup> *Ibid* at pp 66

The regulator's goals as explained under this theory are more complex. First, regulators have one important, self-regarding goal, the prolonged enjoyment of holding their positions. Regulators seek to preserve their positions both for the current personal benefits associated with those positions, and for the expected personal benefits they will receive upon leaving those positions as a consequence of having held them. For instance, private employers will pay more for former holders of public office. In this mode, regulators pursue special interest regulatory outcomes when doing so furthers their self-preservation, and they pursue more general interests, that is, policies enjoying broad public support, when doing that furthers their political self-preservation.<sup>22</sup>

Contemporary public interest theorists argue that regulatory outcomes ameliorate market failures and vindicate the citizenry's interests not routinely, but sometimes, and much more commonly than other scholars of regulation acknowledge. The originators of the contemporary public interest theory, Michael Levine and Jennifer Forrence state:

“[W]e can see regulation as the necessary exercise of collective power through government in order to cure "market failures," to protect the public from such evils as monopoly behaviour, "destructive" competition, the abuse of private economic power, or the effects of externalities. Something like this account, explicitly or implicitly, underpins virtually all public-interest accounts of regulation.”<sup>23</sup>

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<sup>22</sup> Ibid at pp 66, 67

<sup>23</sup> Michael E. Levine & Jennifer L. Forrence. Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis. 6J.L. Econ. & Org. 167, 185 (special issue 1990) as quoted in Steven P. Croley. "Theories of Regulation: Incorporating the Administrative Process." *Columbia Law Review*, Vol. 98, No. 1 (Columbia Law Review Association, Inc: Jan 1998), pp. 69 at [www.jstor.org](http://www.jstor.org) (last accessed on September 29, 2008)

The advantages and disadvantages of self-regulation are context-specific, depending on the institutional, economic and social framework within which the particular example of self-regulation exists. Self-regulation requires a check on self-interested action by the self-regulating industry. Government does not necessarily have to provide this check. However, a comprehensive analysis of the other potential constraints on industry action, and in particular by the public, is required to assess the likely success or failure of the self-regulatory regime. Increasing accountability by self-regulating industries to the public and government in the setting and enforcing of public goals raises administrative costs (potentially above the costs of direct government regulation). It can also reduce the “efficiency” and effectiveness of regulatory instruments. However, without these accountability mechanisms in some form, self-regulation is an invitation to self interested rule making by the “regulated” parties. The answer to the question on whether the public interest can be effectively protected by private sector actors, without accountability mechanisms that negate any real benefit from such regimes, is heavily dependant on the particular regulatory context.<sup>26</sup>

The public interest theory is the guiding theory of this research paper, the justification being that because activities in capital markets have effects on participants such as investors and the general public at large, there is a public interest in regulating market participants who also include market intermediaries. In light of this, the regulation of capital markets is important firstly for investor protection, secondly, for the safeguarding and maintenance of a functioning competitive framework and lastly, for the prevention of potential systemic risks.

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<sup>26</sup> Ibid

## 1.4 Objectives

The general objective of this research is to look at and carry out an analysis of the existing regulatory framework in relation to capital market intermediaries and the implications on investor protection. The specific objectives are:

- (a) To examine the role of the Capital Markets Authority (CMA) as the state regulator and analyse how effectively it performs this role;
- (b) To assess whether the current regulatory framework effectively protects investors against malpractices that may be committed by capital market intermediaries;
- (c) To assess the effectiveness of the Nairobi Stock Exchange (NSE) as a self-regulatory organisation.

## 1.5 Research Questions

1. Is the present legal framework regulating the activities of capital market intermediaries adequate?
2. Does the Capital Markets Authority effectively perform its role of regulating capital market intermediaries and in particular stockbrokers?
3. Does the current regulatory framework effectively protect investors against breaches of duty and malpractices by capital market intermediaries?

4. Is the Nairobi Stock Exchange an effective Self Regulatory Organisation (SRO)?

## 1.6 Hypotheses

1. The current Kenyan legal framework regulating capital market intermediaries does not adequately regulate the activities of capital market intermediaries.
2. The Capital Markets Authority appears overwhelmed by its regulatory role at present and does not adequately regulate market intermediaries and in particular stockbrokers.
3. The provisions of the current regulatory framework do make provision for the protection of investors but is not wholly adequate.
4. The Nairobi Stock Exchange is not an effective Self Regulatory Organisation (SRO).

## 1.7 Literature Review

The literature by Kenyan authors in relation to the capital markets appears to have been spurred following the major amendments made to the then Capital Markets Authority Act<sup>27</sup> and subsequent renaming of this statute to the Capital Markets Act<sup>28</sup> which took place in 2001. A 2001 study, *Mobilising Domestic Resources in Kenya: A Survey of Shareholders Strategy in the Capital Market*<sup>29</sup> is a study that examines the factors that determine shareholder strategies in Kenya's capital markets. It comprises a compilation of shareholders'

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<sup>27</sup> Cap 485

<sup>28</sup> Capp 485A

<sup>29</sup> Mbui Wagacha, Discussion Paper No. 022, (Institute of Policy Analysis and Research, IPAR: Nairobi, 2001)



attitudes collected through a survey and analyses the demographic profiles of investors in the Nairobi Stock Exchange (NSE), their investment strategies, their assessment of the managers of enterprises whose shares they hold, and of regulators who regulate them, the structure of asset portfolios, their information sources on portfolio performance as well as their opinions on the various aspects of the capital markets. This paper does not provide much information by way of the regulatory framework governing the capital markets in Kenya, but it is however useful in providing data regarding the interaction between investors and stockbrokers as market intermediaries which is fundamental to my research paper.

*Development of Nairobi Stock Exchange: A Historical Perspective*<sup>30</sup> published two years later in 2003 explores the evolutionary process of the stock market in Kenya and identifies the institutional and policy changes that have shaped the development pattern of the Nairobi Stock Exchange (NSE). The article contains a substantial discussion of the trading system, membership of the NSE, new listings and taxation policy and the regulatory framework. Discussion of the regulatory framework is minimal and limited, only examining the existing legal framework governing securities in Kenya until the year 1998. There have notably been many changes to securities legislation from that time to date.

*Capital Market Policies in Kenya: Historical Trends and Challenges*<sup>31</sup> is a paper that reviews the policy environment in Kenya and assessing whether it has positively impacted on the development of Kenya's stock market. This paper continues the trend of examining the changes and trends in government policies in relation to the development of Kenya's capital markets. Specifically, the paper reviews stock market policies since independence, evaluates

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<sup>30</sup> Rose Nguni. KIPPRA Discussion Paper No.27 (Kenya Institute for Public Policy and Research, KIPPRA: Nairobi, March 2003)

<sup>31</sup> Munyundo M. Masinde and Thomas N. Kibua. Discussion Paper No. 048 (Institute for Public Policy Analysis and Research, IPAR: Nairobi, June 2004)

the performance of the Nairobi Stock Exchange over time, gives a critique of past stock market policies and identifies areas for further analysis. The paper looks at the macroeconomic policies, financial sector policies, regulatory policies and regional integration policies put forward by the government since the inception of the Nairobi Stock Exchange. There is however no in-depth discussion of the regulatory framework as such as the article focuses on the larger macroeconomic issues that impact on the stock market.

The thesis, *Capital Markets in Emerging Economies: A Case Study of the Nairobi Stock Exchange*<sup>32</sup> in keeping with the early trend of Kenyan literature on securities regulation, takes a historical perspective not unlike that taken in Rose Ngugi's paper.<sup>33</sup> The author traces the path of development of the Nairobi Stock Exchange (NSE) but with an emphasis on its structure and organisation, rules and practice. Discussion of the regulatory framework is only limited to a few of the changes made to the Capital Markets Authority Act<sup>34</sup> (now embodied in the Capital Markets Act<sup>35</sup>). There is additionally some substantial discussion on Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya, guidelines introduced in 2002 by the Capital Markets Authority (CMA). This thesis goes a step further than the previous literature mentioned, in attempting to give an overview of the legal framework that governs the operations of the capital markets in Kenya

There are number of articles and texts by international writers which provide different perspectives on capital markets regulation in general. *Securities Market Development: A*

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<sup>32</sup> Grace Wambui Kibuthu, Thesis submitted at the Fletcher School, Tufts University. (Unpublished thesis: April 2005) [www.fletcher.tufts.edu/research/2005/Kibuthu](http://www.fletcher.tufts.edu/research/2005/Kibuthu) (last accessed on May 8, 2008)

<sup>33</sup> Supra note 30

<sup>34</sup> Cap 485, now repealed

<sup>35</sup> Cap 485 A

*Guide for Policy Makers*.<sup>36</sup> Is a text that was published by the World Bank's Economic Development Institute to provide useful information regarding the development of capital markets with a particular focus on developing countries. It sets out the factors that a state should consider before setting up capital markets and the requisite regulatory framework that is necessary for the running of capital markets. The text does take cognisance of the fact that approaches will differ from jurisdiction to jurisdiction and only seeks to provide a framework or general guideline of the essentials. Much attention is given to the issue of regulation and enforcement, which are not only pertinent to the setting up of new capital markets but also to already existing and growing capital markets. Emphasis is made on the importance of securities regulation for the protection of investors, which is vital if public confidence is to be maintained in capital markets. Various country studies of capital markets in emerging economies such as Ghana, Zimbabwe and Kenya are provided which will provide useful information for this project paper.

*Economic Reforms and Restructuring in Sub-Saharan Africa: The Financial Sector and Regulation/Deregulation of Infrastructure*<sup>37</sup> is an article that looks reforms that are needed in the financial services sector as a whole in Sub-Saharan Africa. The capital markets are examined as a part of the financial services sector with emphasis being placed on the need for investor protection. Investor protection of small investors in particular (that is as opposed to institutional investors) is highlighted. Small investors need to be properly protected through strict enforcement of securities law and regulation. The Article further suggests that government regulation of securities markets should be more of an oversight function over self-regulatory agencies such as the stock exchanges and brokerage industry. The approach of

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<sup>36</sup> Published by the Economic Development Institute of the World Bank, Regulatory Reform and Enterprise Division: New York, May 1996

<sup>37</sup> Augustin Fosu, Mwangi Kimenyi and Njuguna Ndung'u. *Journal of African Economics*, Vol 12, Supplement 2, (Oxford University Press: October 2003)

this article is very broad, in that it looks at the Sub-Saharan region as a whole and not individual countries such as Kenya, for instance.

*Capital Market Development in the Emerging Markets: Time to Teach an Old Dog Some New Tricks*<sup>38</sup> is a study that examines how the economies of former communist eastern European states have set up developed their capital markets since the fall of communism. Case studies of the Russian and Polish models are provided. This study is in keeping with the trend in literature that focuses on the need for development of capital markets in emerging economies through proper structures and regulatory requirements. The author of this article states that she does not seek to answer all the relevant questions relating to a regulatory structure but focuses on the need for issuer disclosure in capital markets and the regulatory framework required to facilitate this. There is some discussion on the place of self regulatory organisations in the capital markets and the views of proponents and detractors of SROs which will be of relevance to my research paper.

*Capital Markets Regulation in Nigeria and the UK: The Role of the Courts*<sup>39</sup>. This article provides a comparative analysis of the regulatory frameworks touching on securities regulation and judicial approaches as applied in both countries. The significance of this article is that both countries had overhauled their securities regulation regimes (Nigeria in 1999 and the UK in 2000) and the author compares the changes that the new regulatory frameworks have brought about in both countries. The article is of particular relevance because Kenya had also overhauled its then Capital Markets Authority Act in 2001 so as to keep pace with the changes in the securities market as a result of technological advancements

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<sup>38</sup> Celia R. Taylor. *The American Journal of Comparative Law*, Vol. 45, No. 1, (Winter, 1997), pp. 71-107 Published by: American Society of Comparative Law at [www.jstor.org](http://www.jstor.org) (last accessed on July 31, 2008)

<sup>39</sup> Eva Lomnicka. *Journal of African Law*, Vol. 46, No. 2, (2002), pp. 155-166 Published by: Cambridge University Press on behalf of the School of Oriental and African Studies (last accessed on July 31, 2008)

and growth of capital markets both nationally and internationally. The findings of this article provide useful insights that could be adapted to the Kenyan context for more efficient capital markets.

*The Essential Role of Securities Regulation*<sup>40</sup> is an article that takes a different perspective from the mentioned texts and articles on the rationale for securities regulation. The Article posits that the essential role of securities regulations is to create a competitive market for sophisticated professional investors and analysts who the authors refer to as "information traders". The authors of the article refutes the conventional wisdom that securities regulation protects the common investor stating that, properly understood, securities regulation is not a consumer protection law. In advancing this view, the article states that securities regulation may be divided into three broad categories: (i) disclosure duties; (ii) restrictions on fraud and manipulation; and (iii) restrictions on insider trading. While this article provides a different point of view from that which I intend to present on investor protection as one of the rationales for securities regulation, it provides insights from a different perspective that are quite useful for academic thought and discourse.

The above review of the literature indicates that the literature available in the area of securities regulation generally is considerable. Various perspectives have been taken with a focus on investor protection. Disclosure by listed companies is regarded as one of the most important, if not *the most* important, aspect of investor protection. However, there is a notable paucity of literature by non-Kenyan authors regarding investor protection in relation to capital market intermediaries, particularly stockbrokers. Literature by Kenyan authors has

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<sup>40</sup> Zohar Goshen and Gideon Parchomovsky. American Law and Economics Association Annual Meetings. Paper 9. 2005 at [www.law.bepress.com/alea/15th/art9](http://www.law.bepress.com/alea/15th/art9) (last accessed on July 31, 2008)

tended to focus on the capital markets and the NSE from a historical and developmental perspective and there is not much by way of an analysis of the regulatory framework in place for the protection of investors vis-à-vis capital market intermediaries.

## **1.8 Research Justification**

With the increase in investor participation in Kenya's capital markets, a close examination and analysis of the regulatory framework in relation to capital market intermediaries is of importance. I intend to identify existing gaps and weaknesses in existing legislation as well as institutional structures and recommend reforms that are necessary to ensure that investor confidence in the capital markets is not eroded. This research will not only be of academic value but is also intended to act as a useful as a tool for policy reform in the regulation of capital market intermediaries.

## **1.9 Scope and Limits of the Study**

There is a paucity of literature and research work on the regulation of capital market intermediaries. As such, there has been reliance on a few sources of literature for purposes of referencing. However, I have supplemented these sources with field work in the form of interviews with officials of the CMA and NSE.

## **1.10 Research Methodology**

The research primarily relied on library research comprising primary materials such as Acts of Parliament and subsidiary legislation. Secondary materials relied on were text books,

articles and internet sources. Due to paucity of literature in this area, I also conducted face to face interviews with officials of the NSE and CMA which through the use of questionnaires (see Appendices I and II).

## **1.11 Chapter Overview**

Chapter One is an introduction of the research topic, statement of the research problem, theoretical framework within which the research was carried out, the research justification, objective of the research, research questions and hypotheses, methodology applied, literature review and a chapter summary.

Chapter Two looks at important aspects of regulation of capital market intermediaries from a conceptual perspective. This chapter also provides illustrative examples of failed Kenyan stockbrokerage houses thus setting the basis or showing the need for adequate regulation of capital market intermediaries to ensure investors are adequately protected.

Chapter Three examines and critically analyses the existing legal framework regulating capital market intermediaries in Kenya while identifying existing gaps and weaknesses. The role of the CMA in this regard, as state regulator and the NSE as a self regulatory organisation (SRO), are also included in this discussion.

Chapter Four of examines the proposed amendments to the Capital Markets Act and the Capital Markets (Licensing Requirements) (General) Amendment Regulations 2002.

Chapter Five contains conclusions and recommendations for reform.

## CHAPTER 2

### AN OVERVIEW OF SECURITIES REGULATION

#### **Introduction**

The objectives of this chapter will be to point out the rationales for securities regulation and give an overview of the necessary components for adequate regulation of capital market intermediaries. The chapter will conclude by providing a view of the Kenyan perspective on practical incidences of malpractices by capital market intermediaries, focusing on stockbrokers in particular.

#### **2.1 Capital Markets and Securities Regulation**

Capital markets refer to the aspect of financial markets which provides long term capital for investments. Capital markets foster the mobilisation of investor savings into productive investments by providing an outlet for accumulated capital (savings) and allocating the capital to investments that bring the greatest value to the economy.<sup>41</sup> Capital markets are also a mechanism through which risk is transferred and risk exposure diversified thus allowing firms to unlock capital for new investments. Risk transfer and pricing mechanisms in the market allow financial institutions, such as banks and insurance companies, to manage risk more efficiently; and markets may therefore work as a buffer for disruption of banking

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<sup>41</sup> Capital Markets Authority Handbook. (CMA. Nairobi. 2006) pp 31



system and therefore contribute to financial stability. The more efficient markets are, the better these outcomes are achieved and the greater the contribution to an economy.<sup>42</sup>

Securities regulation refers to the regulation of public issuers of securities, secondary markets, asset management products, and market intermediaries such as stock brokers, investment banks, dealers and advisors. Regulation is intended to address asymmetries of information between issuers and investors, clients and market intermediaries and between counterparties to transactions. It is also meant to ensure the smooth functioning of trading as well as clearing and settlement mechanisms to prevent market disruption and foster investor confidence.<sup>43</sup> This chapter will focus on the regulation of market intermediaries with a particular focus on stockbrokers and the implications for investors.

## 2.2 Objectives of Securities Regulation

As mentioned, there main objectives of securities regulation, investor protection, ensuring that markets are fair, efficient and transparent and reducing systemic risk. The three objectives are closely related and do overlap in some respects, for instance, many of the requirements that help to ensure fair, efficient and transparent markets also provide investor protection and also help to reduce systemic risk. A brief discussion on each of these objectives will shed more light on their importance in contributing to the stability and proper functioning of capital markets.

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<sup>42</sup> See Ana Carvajal and Jennifer Elliott. 'Strengths and Weaknesses in Securities Market Regulation: A Global Analysis'. IMF Working Paper, WP/07/259. International Monetary Fund (November 2007) pp 4 [www.imf.org](http://www.imf.org) (last accessed September 22, 2008)

<sup>43</sup> Ana Carvajal and Jennifer Elliott. 'IMF Study Points to Gaps in Securities Market Regulation.' IMF Monetary and Capital Markets Department (February, 2008) at [www.imf.org](http://www.imf.org) (last accessed September 22, 2008)

### 2.2.1 Investor Protection

Investor protection must be at the core of securities regulation because it is critically important for fostering confidence in capital markets, more so in nascent and emerging capital markets. Investors should be protected from misleading, manipulative or fraudulent practices, including insider trading, front running or trading ahead of customers and the misuse of client assets. Full disclosure of information material to investors' decisions is the most important means for ensuring investor protection. Investors are, thereby, better able to assess the potential risks and rewards of their investments and, thus, to protect their own interests.<sup>44</sup>

As regards market intermediaries, only duly licensed or authorised persons should be permitted to hold themselves out to the public as such. Supervision of market intermediaries should achieve investor protection by setting minimum standards for market participants.

Initial and ongoing capital requirements imposed upon those license holders and authorised persons should be designed to achieve an environment in which market intermediaries can meet the current demands of its counter parties and, if necessary, wind down its business without loss to its clients. Investors in capital markets are particularly vulnerable to misconduct by intermediaries but the capacity of individual investors, particularly the small investors, to take action, may be limited. Transactions in securities can be rather complex in character for the ordinary citizen and thus the possibility of fraudulent schemes requires strong enforcement of securities laws which should include a comprehensive system of inspection, surveillance and compliance.<sup>45</sup>

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<sup>44</sup> Supra note 1 at pp 5

<sup>45</sup> Ibid at pp 5,6

### **2.2.2 Ensuring Fair, Efficient and Transparent Capital Markets**

The fairness of the markets is closely linked to investor protection and, in particular, to the prevention of improper trading practices. Market structures should not unduly favour some market users over others and regulation should be used to detect, deter and penalize market manipulation and other unfair trading practices. Efficient capital markets require that relevant information disseminated in a timely manner and this should be reflected in the price formation process. Transparency may be defined as the degree to which information about trading (both for pre-trade and post-trade information) is made publicly available on a real-time basis. Pre-trade information concerns the posting of firm bids and offers as a means to enable investors to know, with some degree of certainty, whether and at what prices they can deal. Post-trade information is related to the prices and the volume of all individual transactions actually concluded.<sup>46</sup>

### **2.2.3 Reduction of Systemic Risk**

For capital markets to operate effectively, investor confidence is vital. If events occur that shake the confidence of the investor community such as the collapse of a capital market intermediary, money moves out of the market and share prices drop triggering even more sales by panicked investors. Systemic risk refers to the possibility that even minor shocks or disturbances in the system may be magnified into a system wide calamity an occurrence that can also be referred to as contagion.

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<sup>46</sup> Ibid at pp 6

Although regulators cannot be expected to prevent the financial failure of market intermediaries, regulation should aim to reduce the risk of failure. This can be done through the use of capital and internal control requirements for market intermediaries. Regulators should promote and allow for the effective management of risk and ensure that capital and other prudential requirements are sufficient to address appropriate risk taking, allow the absorption of some losses and check excessive risk taking. Where financial failure does occur, regulation should seek to reduce the impact of that failure, and, in particular, attempt to isolate the risk to the failing institution.<sup>47</sup>

### **2.3 Forms of Regulation**

The choice of a regulatory structure can usually be made between two options. The first broad choice is between functional regulation and institutional regulation. Functional regulation involves having a separate regulator for each key activity for instance, stock broking and fund management. This can lead to multiple regulations for firms or groups engaging in a variety of activities. Institutional regulation implies the ability of a single regulator to cover any activity undertaken by an institution which it supervises, which can lead to allegation of a lack of expertise in complex product fields.<sup>48</sup>

The second broad choice is between statutory and self regulation. Under statutory regulation, the state directly influences the market by prescribing rules for the market to follow and by conferring upon a supervisor, that is, a government authority or agency, the powers necessary to monitor and enforce compliance with these rules. In contrast, self-regulation is

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<sup>47</sup> Supra note 1 at pp 33

<sup>48</sup> Supra note 3 at pp 3-8

characterised by an industry policing its own activities on the basis of agreed standards on a collective basis.<sup>49</sup>

## 2.4 Principles of Regulation

It is important that whatever form of regulation is applied, it should not become an end in itself. Regulation should be effective which means that it should be operationally efficient or that it should fulfil the desired functions. The best reflection of the quality of effective securities regulation is the extent to which it ensures a functioning market mechanism.<sup>50</sup>

The benefits of regulation have to be compared with the costs, that is, the cost efficiency of the regulation should be assessed. The importance of this is that regulation ties up resources on the part of both the industry and supervisors. It generates costs which are ultimately passed on to the market players. In addition, opportunity costs are created if market players' preferences are met either only partially or not at all, or if innovation is hampered. This is a danger that generally exists in an over - regulated environment. Although, in practice, it is difficult to carry out a cost-benefit analysis, it is an indispensable element of a sound regulatory framework.<sup>51</sup>

A third principle is that regulation should, as a general rule, be competitively neutral. It should create equal competitive conditions for all market players without giving preferential

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<sup>49</sup> Ibid

<sup>50</sup> Deutsche Bundesbank Monthly Report. "Securities Market Regulation: International Approaches." (Deutsche Bundesbank: January 2006) pp 38, 39 at [www.bundesbank.de](http://www.bundesbank.de) (last accessed on September 29, 2008)

<sup>51</sup> Ibid at pp 39

treatment to or discriminating against any given player. Regulators should also avoid rules that set up barriers to entry or other competitive hurdles which hamper innovation or permit entrenched monopolistic revenue.<sup>52</sup>

Finally, regulators have to carefully assess the implications of securities market regulation, starting with national markets but also looking at cross-border activities. In a world of internationally integrated markets, these two dimensions are inseparably linked.<sup>53</sup>

## 2.5 Capital Market Intermediaries

Capital market intermediaries is a term that refers to stockbrokers, investment banks, investment fund managers and agents who perform the diverse functions of managing, individual portfolios, executing orders, dealing in or distributing securities and providing information relevant to the trading of securities. The oversight of capital market intermediaries should primarily be directed to the areas where their capital, client money and public confidence may most be put at risk. The possible areas or instances where investors face risks in this regard include, incompetence or poor risk management which may lead to a failure of due execution, a failure to obtain due settlement or a failure to provide adequate advice; breach of duty which may lead to misappropriation of client funds or property, the misuse of client instructions for the intermediary's own trading purposes,<sup>54</sup> manipulation and other trading irregularities, or fraud on the part of the intermediary or its employees; the insolvency of an intermediary which may result in the loss of client money, securities or

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<sup>52</sup> Supra note 50 at pp 39

<sup>53</sup> Ibid

<sup>54</sup> Also referred to as "front running" or trading ahead of customers

trading opportunities, and may reduce confidence in the market in which the intermediary participates.<sup>55</sup>

Taking into account the possible risks discussed above, regulation of capital market intermediaries can be said to have three main objectives, to protect client assets from insolvency of the firm or appropriation of the firm or its employees; to guard against defaults and sudden disruption to the market, either through sudden insolvency or settlement failure; and, to ensure that intermediaries are fair and diligent in dealing with their clients.

The International Organisation for Securities Commissions (IOSCO)<sup>56</sup> provides principles that are to guide countries in effectively regulating capital market intermediaries.<sup>57</sup>

Regulation should provide for minimum entry standards for market intermediaries;<sup>58</sup> there should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake;<sup>59</sup> capital market intermediaries should be required to comply with standards for internal organisation and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters;<sup>60</sup> there should be a procedure for dealing with the failure of a market intermediary in order to minimise damage and loss to investors and to contain systemic risk.<sup>61</sup>

Following is a discussion of the essential elements of each of these principles.

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<sup>55</sup> Supra note 1 at pp 33, 34

<sup>56</sup> IOSCO is the leading international grouping of securities market regulators. Its current membership comprises regulatory bodies from over 100 countries which have day-to-day responsibility for securities regulation and the administration of securities laws.

<sup>57</sup> IOSCO provides 30 principles which are not only limited to the regulation of capital market intermediaries but to all aspects of regulation relating to capital market operations generally. IOSCO recommends the practical implementation of the principles under the relevant legal framework in the jurisdictions of its member countries in order to achieve the overall objectives of securities regulation. Refer Supra note 1.

<sup>58</sup> Principle 21

<sup>59</sup> Principle 22

<sup>60</sup> Principle 23

<sup>61</sup> Principle 24

### 2.5.1 Licensing and Supervision

The licensing and supervision of market intermediaries should set minimum standards for market participants and provide consistency of treatment for all similarly situated intermediaries. It should also reduce the risk to investors of loss caused by negligent or illegal behaviour or inadequate capital. The licensing process should require a comprehensive assessment of the applicant and all those who are in a position to control or materially influence the applicant. When considering licensing regulations, there should be set conditions of entry which make clear the basis of participation for market intermediaries.

Regulation should determine whether participation in the market by an intermediary should be based upon a demonstration of appropriate knowledge, resources, skills and ethical attitude. There should also be a consideration of past conduct. In a number of jurisdictions, regulations set out detailed criteria relating to education, training, experience that applicants should meet before being licensed, with a view to protecting the investor.<sup>62</sup>

### 2.5.2 Capital Adequacy

The capital structures of market intermediaries are of importance to regulatory authorities, who are concerned about systemic risk and the negative externalities that can arise from defaults. National regulatory authorities throughout the world have therefore for many years imposed minimum capital requirements for market intermediaries.<sup>63</sup> There should be an

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<sup>62</sup> Supra note 1 at pp 34

<sup>63</sup> Elroy Dimson and Paul Marsh, "Capital Requirements for Securities Firms," *The Journal of Finance*, Vol. 50, No. 3, Papers and Proceedings Fifty-Fifth Annual Meeting, American Finance Association, Washington, D.C., January 6-8, 1995 (Blackwell Publishing for the American Finance Association Jul., 1995), pp. 821 at [www.jstor.org](http://www.jstor.org) (last accessed on September 29, 2008)



initial capital requirement for intermediaries as a condition of entry into the market which ensures that the owners of the business have a direct financial stake in the business.

The protection of investors and stability of financial systems are increased by an adequate supervision of ongoing capital standards. Capital adequacy standards set by regulators should be designed to allow a firm to absorb some losses, particularly in the event of large adverse market moves. These standards should also seek to achieve an environment in which a market intermediary could wind down its business over a relatively short period without loss to its customers or the customers of other firms and without disrupting the orderly functioning of the financial markets. A firm should ensure that it maintains adequate financial resources to meet its business commitments and to withstand the risks to which its business is subject.<sup>64</sup> The amount of capital needed by a market intermediary to ensure an acceptably small probability of failure depends on the risk of the portfolio of security positions it holds or the nature and amount of business it operates. The regulations need to be designed so that, even if investors use the services of a securities firm for instance, with substantial risk exposure, the firm's capital will be sufficient to cover the chance of loss with an acceptably high degree of probability.<sup>65</sup>

### **2.5.3 The Conduct of Business Rules and Other Prudential Requirements**

Investors are more willing to invest in capital markets if they are assured that their orders are carried out fairly, efficiently and that market intermediaries can be relied on to safeguard their interests. Market intermediaries should therefore conduct themselves in a way that protects the interests of their clients and helps to preserve the integrity of the market. The

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<sup>64</sup> Supra note 1 at pp 36

<sup>65</sup> Supra note 63 at pp 822

management of a market intermediary should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the whole firm.

Instances of operational breach can occur despite the existence of internal procedures designed to prevent the relevant misconduct or negligence. It is not practical for a regulator to oversee adherence to those internal procedures on a day to day basis and this responsibility falls upon the senior management of the intermediary. Senior management must ensure that they are able to discharge that responsibility which requires that they understand the nature of the firm's business, its internal control procedures and its policies on the assumption of risk.<sup>66</sup>

The specific details regarding the internal organisation of a firm will vary depending on the size of the firm, the nature of its business and the risks it undertakes. Generally, however, the regulation of market intermediaries should adhere to standards as recommended by the International Organisation of Securities Organisations (IOSCO).<sup>67</sup>

- (i) Integrity and diligence - A firm should observe high standards of integrity and fair dealing and should act with due care and diligence in the best interests of its customers and the integrity of the market.
- (ii) Terms of engagement - A written contract of engagement with a customer will generally be necessary and appropriate. A firm should similarly be ready to

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<sup>66</sup> Supra note 64

<sup>67</sup> The standards are selectively reproduced from IOSCO Objectives and Principles of Securities Regulation, February, 2008 edition. Refer Supra note 1

provide a customer with a full and fair account of the fulfilment of its responsibilities to the customer.

- (iii) Information about customers - A firm should seek from its customers any information about their circumstances and investment objectives relevant to the services to be provided. Where the activities of an intermediary extend to the giving of specific advice, it is of particular importance that the advice be given upon a proper understanding of the needs and circumstances of the customer: a matter generally encompassed in the rule of conduct that the intermediary must “know your client.”
- (iv) Information for customers - A firm should make adequate disclosure to its customers, in a comprehensible and timely way, of information needed to make a balanced and informed investment decision.
- (v) Market practice - A firm should observe high standards of market conduct and comply with any relevant law, code or standard as it applies to the firm. This includes complying with all applicable legal and regulatory requirements as well as with the firm’s own internal policies and procedures.
- (vi) Operational controls - Effective policies and operational procedures and controls in relation to the firm’s day-to-day business operations should be established.

- (vii) Conflicts of interests - A firm should try to avoid any conflict of interest arising but, where the potential for conflicts arise, should ensure fair treatment of all its customers by proper disclosure, internal rules of confidentiality or declining to act where conflict cannot be avoided. A firm should not place its interests above those of its customers.
  
- (viii) Proprietary trading - There should be clear policies within the firm covering the circumstances in which proprietary trading is permitted. The regulator should obtain information about a regulated firm's own proprietary trading and determine that the firm's net capital is adequate in relation to the risk associated with its proprietary trading. The information provided should be sufficient to allow for an understanding of the overall business and risk profile of a firm and its affiliates. It should also allow for the regulation of margin trading and the detection of conflicts of interest or manipulative practices.

#### **2.5.4 Action in the Event of Financial Failure of an Intermediary**

The failure of an intermediary can have far reaching consequences as it lead to a loss of confidence in the market system leading to systemic problems. A market regulator should have a clear plan for dealing with the eventuality of failure by market intermediaries. Given that the circumstances of financial failure are unpredictable any plan that put in placed needs to be flexible.<sup>68</sup>

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<sup>68</sup> Supra note 1 at pp 38.39

## 2.6 Self Regulatory Organisations (SROs)

A discussion of the SROs is vital in a discussion regarding capital market intermediaries given the complementary role that they play to the state's regulation of capital markets either directly or through a quasi-governmental body. A Self Regulatory Organisation is defined as an association of industry members who agree as a condition to membership in the organisation, to submit voluntarily to common rules and requirements. The rationale for self regulation is that it makes use of market players' expertise on market issues and is also able to react more flexibly and quickly to market developments. By making those regulated actual participants in the regulatory process, they become more aware of the goals of regulation and their own stake in it. For market intermediaries who have a vested interest in functioning markets and protecting its reputation, this is particularly relevant. Self-regulation has additional advantages; in some instances self-regulatory bodies can promote adherence to ethical standards beyond those which could be established as a matter of law; self-regulation is also arguably cost effective because it fosters efficient rules and does not require expensive oversight by government bureaucracies.<sup>69</sup>

Self-regulation also has its drawbacks as it can create conflicts of interest and the members of the self regulatory organisation may be tempted to use a facade of industry regulation as a shield to ward off more meaningful regulation. Additionally, established market operators can seal off their markets, thereby setting up barriers to new entrants at the customers' expense. SROs have played a key role in the regulation of capital markets. They can set rules that include regulation of market transactions, regulation of market participants, resolution of disputes and enforcement of actions. They should develop qualification standards for market

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<sup>69</sup> Supra note 39 at pp 73

intermediaries, rules for these firms to participate in the market, rules for dealings with customers and clients, and ensure that members fully comply with these rules and with securities laws and regulations. Self regulation can effectively combine monitoring by private entities with oversight by government regulatory agencies with the role of self-regulation varying from country to country.<sup>70</sup> In some countries only one SRO operates but in others more than one SRO may exist.<sup>71</sup>

Regardless of the extent to which self-regulation is used, the government regulator should retain the authority to inquire into matters affecting investors or the market. Where the powers of an SRO are inadequate for inquiring into or addressing particular misconduct or where a conflict of interest necessitates it, the regulator should take over the responsibility for an inquiry from an SRO. It is important, therefore, to ensure that the information provided by the SRO to the regulator allows these matters to be identified at an early stage. SRO's should follow similar professional standards of behaviour on matters such as confidentiality and procedural fairness as would be expected of the regulator.<sup>72</sup>

## **2.7 The Kenyan Perspective**

Capital markets thrive on users' confidence and trust. The growth of Kenya's capital markets therefore hinges critically on the ability of investors to trust the market, facilitative and predictive policy and legal and regulatory framework, and active private sector characterized

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<sup>70</sup> Recna Aggarwal. "Globalization, Technology, and Regulation in Capital Markets Strategies for Latin America and the Caribbean." (Paper prepared for Inter-American Development Bank's Conference on "A New Focus for Capital Market Development in Latin America and the Caribbean) February 5-6, 2001. Washington D.C.

<sup>71</sup> The United States for instance has more than one securities exchange and therefore a number of SROs as well.

<sup>72</sup> Supra note 1 at pp 13

by quality issuers.<sup>73</sup> Investors place their trust on market intermediaries and it is the duty of the intermediaries to ensure that they do not betray that trust.

As at 23<sup>rd</sup> April 2008, the Capital Markets Authority (CMA) had renewed the licenses of 17 investment banks, 8 stockbrokers, 16 fund managers, 19 investment advisers 11 authorised depositories.<sup>74</sup> Research has shown that the most commonly used method of share acquisition in Kenya is through stockbrokers as capital market intermediaries. Following the Government's divestiture in the Kenya Electricity Generating Company (KenGen) in 2006 which released 659 million shares to the public; Scangroup's initial public offering (IPO) of 69 million shares and the listing by introduction of Equity Bank shares; and the Safaricom IPO by Safaricom limited, the number of investors in the stock market has grown in large numbers. Stockbrokers have therefore had to handle a large number of investor's accounts which has unfortunately also resulted in a rise in the number of complaints by investors regarding malpractices by stockbrokers. Complaints regarding trading in clients' shares by stockbrokers without authorisation from their clients have been on the increase. This practice is normally referred to as short selling which is the selling of a stock 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 form in some jurisdictions such as in the United States. Stockbrokers mainly engage in short selling so as to benefit from an overpriced stock or market.<sup>75</sup> Other complaints by investors related to the delay in receipt of refunds following initial public offerings. (IPOs)

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<sup>73</sup> Capital Markets Authority Annual Report, 2007, pp 10

<sup>74</sup> Kenya Gazette Notice No. XXXX of 2008

<sup>75</sup> 'Short selling' at [www.investopedia.com](http://www.investopedia.com)

The CMA the government body allocated the responsibility of overseeing the operations and activities of Kenya's capital markets. This involves carrying out the functions of licensing, market surveillance and conducting investigations with a view to examining alleged or suspected violations of the capital market regulations.<sup>76</sup> In the last 5 years, three stockbrokerage houses have been involved in malpractices that involved the misappropriation and mishandling of client's funds by the owners, directors and or/employees of these firms.

### **2.7.1 Shah Munge & Partners**

The stockbrokerage firm of Shah Munge and Partners was investigated by the Capital Markets Authority in 2002 and was found to have mishandled clients' funds by depositing them in its office account rather than a client account, contrary to Regulation 20 of the Capital Markets (Licensing Requirements) (General) Regulations. Upon investigation by the Capital Markets Authority (CMA), the firm was found guilty of professional misconduct in misappropriating its client's funds and suspended the firm from the Nairobi Stock Exchange (NSE). The stockbrokerage firm had transferred Kenya shillings 259 million belonging to the National Social Security Fund (NSSF) and deposited it into the "office account" instead of the "clients' account as is required by law."<sup>77</sup>

Shah Munge & Partners was suspended from transacting as a stockbrokers or dealing in any securities for a period of thirty (30) days from 18<sup>th</sup> October 2002 and a financial penalty of Kshs. 1.5 Million imposed on the firm which was to be paid into the Investor Compensation Fund. The directors of the firm were found to be severally liable for professional misconduct

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<sup>76</sup> Functions of the CMA are discussed more fully in Chapter 3

<sup>77</sup> See Article by the Nation Reporter. "Shah Munge Lock-out Legal, says Regulator." The Daily Nation, March 7, 2007



and were declared ineligible from taking directorships of any other stockbrokerage firm listed on the NSE for a period of one year. The firm would also have to appoint new directors before re-admission to the NSE could be granted. Shah Munge & Partners appealed to the Capital Markets Tribunal which enhanced the sanctions imposed by the Capital Markets Authority. The tribunal held that, the stockbrokerage licence be suspended for three (3) years from 18<sup>th</sup> October 2002; the stockbrokerage firm be suspended from dealing in securities and trading in the NSE; the Directors be barred from taking up directorships or any other managerial position of any other licensed stockbroker for a period of five (5) years; readmission to the NSE and issuance of a licence to the firm would be subject to compliance with licensing, approval and other requirements in the Act and attendant regulations. The Tribunal however set aside the Authority's decision on financial penalty and reduced the fine to the statutory limit of Kenya shillings 600,000.<sup>78</sup>

### **2.7.2 Francis Thuo & Partners**

On 5th March 2007, the Capital Markets Authority (CMA) announced that one of the oldest stockbrokerage firms in Kenya, Francis Thuo & Partners Limited, was indebted in the amount of Ksh125 million. Preliminary indications showed that there were fraudulent dealings by its directors and staff, weak capital position and the sale and/or illegal trading in their clients' funds.<sup>79</sup> On February 2007, Francis Thuo was closed by the CMA and the amount it owed investors stood at Ksh200 million.<sup>80</sup> Investigations into the firm are still ongoing and a final report yet to be released in the public domain.

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<sup>78</sup> See Article by the Nation Reporter, "Shah Munge Lock-out Legal. says Regulator," The Daily Nation, March 7, 2007

<sup>79</sup> *NSE lends Sh100m to troubled Nyaga Stockbrokers Ltd*, Erik Ombok. [www.capitalfm.co.ke/news/Business](http://www.capitalfm.co.ke/news/Business)

<sup>80</sup> An approximate figure

### 2.7.3 Nyaga Stockbrokers

On 6<sup>th</sup> March 2008, the firm of Nyaga Stockbrokers was placed under statutory management by the Capital Markets Authority (CMA). Many investors who used the firm's services as an intermediary had lodged complaints with the regulatory authority regarding the status of their accounts. As is the case with Francis Thuo Stockbrokers discussed previously, the firm was trading in clients' shares without their consent.<sup>81</sup>

### Conclusion

The cases discussed above point to some weaknesses in the regulatory system that is currently in place; weak internal controls of market intermediaries, stockbrokers in particular; failure of the Nairobi Stock Exchange (NSE) as the self-regulatory organisation concerned to adequately regulate its members; inadequate capital adequacy requirements and lack of proper oversight by the regulatory authority - the CMA, over the activities of capital market intermediaries. In order to properly ascertain where the problems lie, a close and critical examination of securities laws regulating capital market intermediaries and of necessity, the institutional structures currently in place, will be carried out in the next chapter.

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<sup>81</sup> Geoffrey Irungu, "Nairobi Bourse set to Pay Francis Thuo Investors." Business Daily Newspaper, 22 August 2007

## CHAPTER 3

### THE KENYAN REGULATORY FRAMEWORK

#### Introduction

The Kenyan regulatory framework that deals with capital market intermediaries comprises the Capital Markets Act<sup>82</sup> and subsidiary legislation in the form of the Capital Markets (Licensing Requirements) (General) Regulations, 2002 as the applicable law. The chapter commences with an overview of the law as it is, followed by a critique of the both the Act and the regulations pointing to any existing gaps and weaknesses. In addition to the laws are the institutional structures, the Capital Markets Authority (CMA) as the state regulator and the Nairobi Stock Exchange (NSE) as the self-regulatory organisation (SRO), which complements the role of the CMA. An examination of the regulatory institutions will assess whether these institutions perform their respective roles of regulating capital market intermediaries effectively and highlight any weaknesses in their operations and structures.

#### 3.1 Regulation of Kenya's Capital Markets

The regulation of capital markets in Kenya is primarily governed by the Capital Markets Act. Under this Act of Parliament is established the Capital Markets Authority (CMA)<sup>83</sup> for the purpose of facilitating the development of orderly, fair and efficient capital markets in Kenya through effective regulation that encourages innovation and safeguards market integrity.<sup>84</sup> The CMA is empowered to make and issue regulations to regulate market intermediaries such

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<sup>82</sup> Cap 485A. Laws of Kenya

<sup>83</sup> See Section 5(1). Capital Markets Act. Cap 485A

<sup>84</sup> Mission statement of the CMA. See Capital Markets Authority. Annual Report. 2007 (CMA. Nairobi: 2007) pp 2

as investment banks, stockbrokers and authorised securities dealers.<sup>85</sup> In accordance with this power, in 2002, the CMA issued the Capital Markets (Licensing) (General) Regulations, 2002 which set out the requirements for licensing, approval and financial requirements for capital market intermediaries.

The Nairobi Stock Exchange (NSE), Kenya's only stock exchange to date, is a self regulatory organisation (SRO) that seeks to complement the role of the CMA in ensuring that the capital markets operate efficiently. In this regard, the NSE has its own rules regarding management and membership of the Exchange.<sup>86</sup> The regulatory approach applied in Kenya is therefore one that seeks to strike a balance between state regulation through the CMA and self-regulation by the NSE.

### **3.2 The Capital Markets Act**

Part IV of the Capital Markets Act sets out the requirements that prospective capital market intermediaries are to fulfil before being granted a licence to operate. Section 23(1) prohibits the carrying on of any business by any person as a stockbroker, dealer, investment adviser, fund manager, investment bank, authorised securities dealer, authorised depository unless they hold a valid licence issued by the CMA. In the case of the renewal of a licence, the application is to be made within three months, but not later than one month prior to the expiry of the licence.<sup>87</sup> A licence is only to be granted if the applicant meets and continues to meet such minimum financial and other requirements as the CMA may be prescribe.<sup>88</sup> The substantive requirements regarding the licensing requirements are to be found in the Capital

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<sup>85</sup> Under Section 12 (1) of the Capital Markets Act

<sup>86</sup> Management & Membership Rules of Nairobi Stock Exchange Limited (NSE, Nairobi)

<sup>87</sup> Section 24 (1)

<sup>88</sup> Section 24 (3)

Markets (Licensing Requirements) (General) Regulations. The CMA is empowered to grant a licence upon such conditions or restrictions as it thinks fit and has the authority to vary any condition or restriction or impose further conditions or restrictions.<sup>89</sup> Section 24 (5) requires the CMA to give an applicant the opportunity to be heard before grant of a licence is refused or before refusal of renewal of a licence. Licences granted expire on the thirty-first day of December in each year.<sup>90</sup>

In the case of a renewal of a licence, the CMA must satisfy itself that the licensed person is in compliance with the provisions of the Capital Markets Act the Capital Markets (Licensing) (General) Regulations.<sup>91</sup> Where an applicant seeking renewal of a licence has not complied with all the requirements of the law, the CMA may extend an existing licence for a period of three months in order to permit an applicant to take such action as the CMA deems necessary for the applicant to come into compliance with the Capital Markets Act and the licensing regulations.<sup>92</sup> On 26<sup>th</sup> February 2008, the CMA extended the licenses of six stockbrokers and two investment advisers for a period of three months.<sup>93</sup> At the time the CMA announced the extension of these licenses, it also indicated that the circumstances leading to the extension of the licenses for these firms did not pose serious risk to investors or clients of these firms and the capital markets industry in general.<sup>94</sup> In the granting of such an extension to any person the CMA may impose such conditions or restrictions as it deems appropriate on the activities

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<sup>89</sup> Section 24 (4)

<sup>90</sup> Section 24 (6)

<sup>91</sup> Section 25 (1)

<sup>92</sup> Section 25 (2)

<sup>93</sup> The stockbrokerage houses that had their licenses extended were Crossfield Securities Limited, Discount Securities Limited, Ngenye Kariuki and Company Limited, Solid Investment Securities Limited, Reliable Securities Limited and Bob Mathews Stockbrokers Limited, which are stock brokers. The investment advisers also affected by this decision were Franklin Management Consultants Limited and WSD Capital Kenya Limited.

<sup>94</sup> 'CMA Renews Licenses'. Press release from the CMA at [www.cma.or.ke](http://www.cma.or.ke) (last accessed on September 30, 2008)

of such a licensee.<sup>95</sup> At the expiry of the three months period on 26<sup>th</sup> May 2008, the licenses of all the six stockbrokers granted the extension were renewed and one of the investment banks also had its license renewed.<sup>96</sup> The CMA is not obliged to disclose what requirements a licensee has failed to fulfil therefore requiring an extension of its license, as opposed to an outright renewal. However, given the recent experience of the collapse of two large brokerage houses in 2007 and 2008, it may be advisable for the CMA to consider making this information known to the public. Such disclosure to the public would serve to prevent speculation that may arise among the investors that such extensions could be an indication that a stockbroker is facing financial troubles and may be about to collapse.

Where a licensed person acts in contravention of the provisions of the Act or regulations made by the CMA<sup>97</sup> or has since the grant of a licence ceased to qualify for such a licence<sup>98</sup> or is guilty of malpractice or irregularity in the management of his affairs, the CMA may direct the person to take whatever action the CMA deems necessary to correct the conditions resulting from any contravention of any provisions of the Capital Markets Act or other rules and regulations and to come into compliance with the provisions of this Act or any rules or regulations made thereunder. The CMA can also suspend or impose restrictions or limitations on the licence granted to the person.<sup>99</sup> As is the case with extension of licenses, the CMA is also not obligated to disclose to the public why a licensee has its license suspended. For transparency to be created in the eyes of the investing public, the CMA should also consider disclosing this information.

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<sup>95</sup> Section 25 (3)

<sup>96</sup> Franklin Management Consultants Limited had their license suspended for failing to comply with the laid down requirements.

<sup>97</sup> Section 25 (4) (a)

<sup>98</sup> Section 25 (4) (b)

<sup>99</sup> Section 25 (4) (c)

The CMA may revoke a licence or approval it has granted if it is satisfied that the licensed or approved person has contravened or failed to comply with any provisions of this Act or any rules or regulations made there under; or has ceased to be in good financial standing; or has since the grant of the licence, ceased to qualify for such a licence; or is guilty of malpractice or irregularity in the management of his business; or is adjudged bankrupt. Before such a licence is revoked however, the CMA is to appoint a statutory manager and the person affected by such revocation will be allowed an opportunity to be heard.<sup>100</sup> A prospective stockbroker or dealer who has a licence revoked or renewal of a licence refused also ceases to be a member of the stock exchange.<sup>101</sup>

Section 27 (1) of the Act requires the CMA to publish in the Kenya Gazette before the thirtieth day of April each year, the names and addresses of all persons licensed or approved in a particular year. The names of persons whose licences have been revoked are also to be published in the Kenya Gazette within thirty days of such revocation.<sup>102</sup> Where a licensee ceases to carry on the business for which a licence has been granted or there is a change in their business particulars such as a change in business name they are required to inform the CMA within fourteen days.<sup>103</sup>

In order for a licence to be granted, an applicant must fulfil a number of requirements. Firstly, the applicant must be incorporated as a company under the Companies Act, with such minimum share capital as is prescribed by the CMA.<sup>104</sup> The directors of such a company must not have been declared bankrupt; denied any licence or approval under the Act or equivalent legislation in any other jurisdiction or if he/she has been a director of a company providing

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<sup>100</sup> Section 26

<sup>101</sup> Section 29 (3)

<sup>102</sup> Section 27 (1) (b)

<sup>103</sup> Section 28

<sup>104</sup> Section 29 (1) (a)

banking, insurance, financial or investment advisory service, had his/her licence revoked by the appropriate authority.<sup>105</sup> Thirdly, at least one director and one employee who is the chief executive of the applicant company, must have satisfied the prescribed minimum qualifications;<sup>106</sup> In the case of a stockbroker, dealer or other person prescribed by the CMA the applicant company must have lodged security in such sum as may be determined by the CMA or an equivalent bank guarantee or bond with the securities exchange of which it is a member or with the CMA or other person approved by the CMA.<sup>107</sup> The applicant should have the necessary administrative capacity to carry on business for which the licence is required.<sup>108</sup> An applicant for a stockbroker's licence is only permitted to carry on business solely on behalf of clients<sup>109</sup> and an applicant for a dealer's licence is to carry on business solely on the applicant's own behalf<sup>110</sup>.

None of the persons engaged or to be engaged in the position of executive director or other senior capacity of an applicant should have previously been involved in the management or administration of an institution offering financial services whose licence has been revoked owing to any failure on the part of the management; or taken part in or been associated with any such business practices as would, or have, cast doubt on his/her competence or soundness of judgment.<sup>111</sup> Upon fulfilling the requirements set out and paying the requisite admission fee, the licensee may be admitted as a member of a securities exchange.<sup>112</sup>

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<sup>105</sup> Section 29 (1) (b)

<sup>106</sup> Section 29 (1) (c)

<sup>107</sup> Section 29 (1) (d)

<sup>108</sup> Section 29 (1) (e)

<sup>109</sup> Section 29 (1) (f)

<sup>110</sup> Section 29 (1) (g)

<sup>111</sup> Section 29 (1) (h)

<sup>112</sup> Section 29 (2)



### **3.3 The Capital Markets (Licensing Requirements) (General) Regulations, 2002**

The Capital Markets (Licensing Requirements) (General) Regulations, 2002 are a set of comprehensive regulations that prescribe requirements for licensing and approval of capital markets institutions including securities exchanges, stockbrokers, dealers, investment advisers, fund managers, investment banks, authorised securities dealers, authorised depositories, credit rating agencies and registered venture capital funds. These regulations prescribe detailed financial requirements for these institutions, functions, code of conduct and reporting obligations of capital market institutions.<sup>113</sup> I will focus on Parts III and V of the regulations which set out the licensing requirements for stock brokers and investment banks respectively. I have chosen to focus on the licensing requirements of these two kinds of capital market intermediaries because it is mainly through them that the Kenyan investing public acquires securities in the Kenyan stock market.<sup>114</sup> The regulations relating to stockbrokers do in a number of instances also apply to dealers. This research will however not focus on dealers as there are none that are currently licensed to operate as such in Kenya's capital markets.

#### **3.3.1 Stockbrokers**

##### **3.3.1.1. Licensing Requirements**

Under Regulation 15 of the Licensing Regulations, an applicant seeking a licence as a stockbroker is required to present, a certificate of incorporation, memorandum and articles of

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<sup>113</sup> Capital Markets Authority Annual Report. 2001. CMA

<sup>114</sup> Research shows that the most commonly used method of share acquisition in Kenya is through stockbrokers as capital market intermediaries. See Mbuyi Wagacha, "Mobilising Domestic Resources in Kenya: A Survey of Shareholders Strategy in the Capital Market," Discussion Paper No. 022. (Nairobi: Institute of Policy Analysis and Research, IPAR, 2001) It is also notable that there may also be a trend of stockbrokerage firms transforming into investment banks. Ashbhu Securities Ltd, formerly a stockbrokerage firm transformed itself into an investment bank. *Afrika Investment Bank in 2008.*

association, a statement of the unaudited accounts for the period of the accounting year ending not earlier than six months prior to the date of application and audited accounts for the preceding two years (where applicable).<sup>115</sup> In addition, the applicant is required to present a business plan containing; the particulars of the management structure; the directors, including one or more executive directors; their qualifications; addresses and details of other directorships; the shareholding structure which shall disclose whether any of the shareholders will have an executive role to oversee the day to day operations of the business.<sup>116</sup>

Other requirements of the business plan are: evidence of a share capital of Kshs 5,000,000 in the case of a stockbroker; qualifications, experience and expertise of the chief executive of the applicant which must be shown to be relevant to effectively manage or operate the business of a stockbroker or dealer; the proposed management qualifications of key personnel; the financial projections for three years; the proposed information technology and access to the trading network in compliance with the trading, clearing, delivery and settlement requirements of the securities exchange to which the applicant intends to be admitted as a member; one bank reference; two business references; the proposed premises suitably located and equipped to provide satisfactory service to clients in the field of activity to which the licence relates or evidence acceptable to the CMA that such premises will be available; the staff capable of providing professional services to clients in the field of activity to which the licence relates or evidence acceptable to the CMA that such staff will be available; the proposed independent auditor; and a declaration that no person is a director or holds beneficial interest either directly or indirectly in more than one member of a securities exchange.<sup>117</sup>

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<sup>115</sup> Regulation 15 (1) (a) to (c)

<sup>116</sup> Regulation 15 (1) (d) (i) to (iv)

<sup>117</sup> Regulation 15 (1) (v) to (xv)

Regulation 15 (2) requires that every person who is, or is to be, a director, chief executive, manager or floor dealer of a stockbroker or dealer shall be fit and proper to hold the particular position that he/she holds or is to hold. An applicant for a dealer's or stockbrokers licence is also required to lodge a security of Kshs 1,500,000 or such higher amount with a securities exchange or provide a guarantee in a form acceptable to the CMA from a bank to the securities exchange or the central depository.<sup>118</sup> In order for an applicant who has been granted a licence to receive admission to a securities exchange, they are also required to present a letter of compliance with the licensing requirements from the CMA.<sup>119</sup>

### **3.3.1.2 Financial Requirements for Stockbrokers**

Under Regulation 16 (1), the level of shareholders funds or paid up share capital and financial reserves for stockbrokers shall not be below Kshs 5,000,000 or such higher amount as may be determined by the CMA at any time during the licence period.<sup>120</sup> The minimum paid up share capital is to always be unimpaired and is not to be advanced to the directors or associates of the stockbroker.<sup>121</sup> The working capital shall not be below twenty percent of the prescribed minimum shareholders funds or three times the average monthly operating costs whichever is higher.<sup>122</sup> Any unsecured advances, loans and other amounts to directors or associates shall in aggregate not exceed ten percent of the prescribed minimum shareholders funds at any time provided that such loans are with respect to any amount in excess of the

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<sup>118</sup> Regulation 39 (2) (a) and (c)

<sup>119</sup> Regulation 15 (10) Regulations 15 (4) to (9) relate to stockbrokers being granted authorisation to deal through subsidiaries and the manner in which their operations in this relationship are to be carried out are set out thereunder. A discussion on these has not been included as they do not form part of the main focus of this paper.

<sup>120</sup> The CMA proposed amendments to this Regulation in 2007 to increase the minimum paid up share capital to Kshs 50,000, 000. Details of the proposed amendments are discussed in detail in Chapter 4

<sup>121</sup> Regulation 16 (2)

<sup>122</sup> Regulation 16 (3)

minimum paid up capital.<sup>123</sup> As regards the ratio of the stockbroker's bank overdraft, the ratio to the paid-up capital is not to exceed twenty percent at any time.<sup>124</sup>

The figure of Kshs 5,000,000 as the minimum share capital for stockbrokers does not presently reflect the growth that the capital markets have experienced in the last few years. This growth has translated into stockbrokers dealing in significant amounts of money on behalf of their clients, amounts which are far higher than the stipulated minimum capitalisation requirement of Kshs 5,000,000. The minimum share capital amount for stockbrokers should therefore be revised upwards to guarantee financial strength of these market intermediaries.

### **3.3.1.3 Accounting Records and Reporting Requirements**

Stockbrokers are required to maintain accounting documents for a minimum period of seven years. Such documents include journals or other records of original entry containing an itemised daily record of all purchases and sales of securities, all receipts and deliveries of securities; ledgers reflecting all assets and liabilities, income, expense and capital accounts; all cheque books, bank statements, cancelled cheques and bank reconciliation accounts; clients' accounts itemising separately each account of a client, all purchases, sales, receipts and deliveries of securities.<sup>125</sup>

Regulation 20 spells out clearly how clients' funds are to be handled by stockbrokers. Clients' funds are to be deposited in one or more bank account(s), which account(s) are to

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<sup>123</sup> Regulation 16 (4)

<sup>124</sup> Regulation 16 (5)

<sup>125</sup> Detailed list of all required accounting documents are listed under Regulation 19

contain only clients' funds and be clearly marked "clients' accounts". Such client accounts are not to be overdrawn for any reason. Separate records are to be kept for each account showing the name and address of the bank where the account is maintained, the dates, amounts of deposits and withdrawals and also the exact amount of each client's beneficial interest in the account. Clients' accounts are to be reconciled on a regular basis to ensure the amount indicated corresponds with the balances in the client account at any given time. Stockbrokers are to ensure that clients' orders for payments made in advance are executed according to clients' instructions and in any event not later than one month from the date of receipt of the clients' funds. Orders not executed within one month for whatever reason are to be renewed by fresh instructions from the client.

The CMA Regulations stipulate that stockbrokers are to submit to the CMA and the securities exchange of which they are members, quarterly reports and accounts within fifteen days of the end of each calendar quarter; half yearly reports and accounts within thirty days of the end of each half year; audited annual accounts within three months following the end of the stockbroker and dealer's financial year; a financial statement complying with the disclosures on income, expenditure and a balance sheet.<sup>126</sup>

Due to the position of trust that stockbrokers as capital market intermediaries hold in relation to their clients, the accounts of stockbrokers should not only be submitted to the CMA as regulator, but should also be made public. This would ensure that the investing public is aware of the financial position of capital market intermediaries which would enable them make an informed choice on which intermediary they would like to deal with. In addition, situations such as those witnessed with the closure of stockbrokerage houses due to their

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<sup>126</sup> Regulation 21

inability to meet their financial obligations may be avoided due to the close scrutiny to which their accounts would be subjected in the public domain.

#### **3.3.1.4 Conduct of Stockbrokers**

Stockbrokers are required to conduct their business efficiently, honestly, and fairly, with the integrity and professional skills appropriate to the nature and scale of activities.<sup>127</sup> In assessing whether these intermediaries are carrying out their business fairly and honestly, regard is to be made to management and organisational structure, reporting principles and procedures, internal audit procedures, procedures for compliance with the securities laws and risk management policies which the stockbroker or dealer has adopted or proposes to adopt for its business.<sup>128</sup>

Stockbrokers in particular are in a position of trust in relation to their clients who expect them to execute their orders as requested. The Licensing Regulations require stockbrokers to execute orders only where the client has made sufficient arrangements for funds or securities with the stockbroker. Orders are to constitute written instructions by a client to a stockbroker as to the security name, quantity, price or price limits and duration or validity of instructions.<sup>129</sup> Only written orders are to be accepted and the stockbroker is to ensure that the client is not only capable of honouring the order before acting on the order, but has also made arrangements with the stockbroker for fulfilment of its obligations arising from such order.<sup>130</sup> Clients' written orders are to be executed in the chronological sequence in which they are

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<sup>127</sup> See Regulation 22 (b)

<sup>128</sup> Regulation 22 (d)

<sup>129</sup> Regulation 23 (a)

<sup>130</sup> Regulation 23 (b)

received and they are to be given priority over orders of any shareholder or employee of the stockbroker or related dealer subsidiary, whether directly or indirectly.<sup>131</sup>

Stockbrokers are to maintain a daily record of orders received from clients showing the name of each client, the specific order and time the order was given.<sup>132</sup> Due diligence and care is to be exercised at all times so as not to misinform or misdirect clients and factual, accurate information should be provided to clients' through newsletters and advertisements.<sup>133</sup> Stockbrokers are to act in the best interests of the client and are to make recommendations on purchase, sale or exchange in line with the client's investment objectives, financial situation.<sup>134</sup>

The Licensing Regulations specify the particular circumstances in which stockbrokers are to sell securities. A stockbroker is only to sell securities when the stockbroker or its client has; or the stockbroker believes on reasonable grounds that its client has an existing exercisable and unconditional right to vest the securities in a purchaser of the securities.<sup>135</sup> Regulation 25 (4) states that a person is deemed to sell securities where he/she; purports to sell securities, offers to sell securities, holds himself out as entitled to sell securities or instructs a stockbroker to sell securities. Contrary to this regulation, following the closure of Francis Thuo and Partners and Nyaga Stockbrokers indications were that these stockbrokers were trading in clients' shares without the clients' authorisation.

The Licensing Regulations recognise the role of self-regulation and stipulate that any code of conduct or agreements to self regulate the operations of stockbrokers and dealers are to be

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<sup>131</sup> Regulation 23 (c)  
<sup>132</sup> Regulation 23 (d)  
<sup>133</sup> Regulation 23 (g)  
<sup>134</sup> See Regulation 23 (h)  
<sup>135</sup> Regulation 25 (1)

submitted to the CMA for prior approval and must be consistent with Security Regulations.<sup>136</sup> At present however, the Nairobi Stock Exchange (NSE) does not have a code of conduct for its members and only has Membership and Management rules governing its affairs. The Management Rules are not comprehensive enough to act as a code of conduct to regulate its members and this gap that may have contributed to the failure of the NSE to rein in errant stockbrokers.

### **3.3.2 Investment Banks**

#### **3.3.2.1 Licensing Requirements**

Some of the basic requirements for the grant of a licence to an applicant seeking licensing as an investment bank are the same as those for dealers or brokers as set out above. An application for licensing as an investment bank is to be submitted with a certificate of incorporation, memorandum and articles of association, a statement of the unaudited accounts for the period of the accounting year ending not earlier than six months prior to the date of application and audited accounts for the preceding two years (where applicable).<sup>137</sup> In addition, the applicant is required to present a business plan containing; the particulars on the management and shareholding structure of the investment bank; the directors; their qualifications; addresses and details of other directorships; evidence of financial capability or investment capability or investment capital of an amount of thirty million shillings in cash or portfolio of securities comprising fixed income securities and listed shares.<sup>138</sup>

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<sup>136</sup> Regulation 26 (1)

<sup>137</sup> Regulation 15 (1) (a) to (c)

<sup>138</sup> Regulation 39 (2) (d) (i) to (iv)



The qualifications, experience and expertise of the chief executive of the applicant and the dealers are also to be included in the business plan and must be relevant to effectively manage or operate the business of an investment bank; the proposed operating systems including dealing infrastructure suitably located and equipped to provide satisfactory service to clients and staff capable of providing services to clients.<sup>139</sup> A person licensed by the CMA as an investment bank shall be admitted and registered with the securities exchange as a full member of the securities exchange on payment of an admission fee.<sup>140</sup>

Investment banks unlike commercial banks are not deposit taking institutions. They are authorised to carry out a number of functions; offering advisory services on public offering of securities, corporate financial restructuring, takeover, mergers, acquisitions and privatisation, corporate financing, options including issuance of equity or debt securities or loan syndication; engaging in the business of a dealer; promoting or arranging underwriting or issuance of securities; promoting and acting as a fund manager of collective investment schemes ; providing investment advisory services and contractual portfolio management.<sup>141</sup>

Investment banks are also authorised to engage in the business of a stockbroker on condition that the investment bank acquires a controlling interest in a stockbroker that is a member of the securities exchange.<sup>142</sup> A controlling interest in this case is designated as fifty one percent or more of the share capital of a stockbroker.<sup>143</sup> Upon such acquisition of a stockbroker by an investment bank the securities exchange membership rights of the stockbroker vest in the investment bank.<sup>144</sup>

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<sup>139</sup> Regulation 39 (v) and (vi)

<sup>140</sup> Regulation 41

<sup>141</sup> Regulation 40 (a) to (f)

<sup>142</sup> Regulation 42 (1)

<sup>143</sup> Regulation 42 (3)

<sup>144</sup> Regulation 42 (2)

In terms of the conduct of investment banks, they are required to comply with the provisions on client accounts, maintaining of records, reporting obligations, conduct, prohibited dealings and associations, investment requirements and appointment of custodian, relating to stockbrokers and dealers.<sup>145</sup>

### **3.3.2.2. Financial Requirements**

The financial requirements relating to investment banks stipulate that the level of shareholders funds or paid up share capital reserves shall not fall below Kshs 30,000,000 at any time during the licence period.<sup>146</sup> The minimum paid up share capital is to always be unimpaired and shall not be advanced to the directors or associates of the investment bank<sup>147</sup> and the net working capital shall be three times the monthly operating expenses or twenty percent of the share capital, whichever is higher.<sup>148</sup> Regulation 44 (4) prohibits investment banks from borrowing at any one time in excess of forty percent of its shareholders funds including any overdraft facilities and such borrowings shall be for investment in securities. Any unsecured advances or loans to directors or associates shall be made out of shareholders funds which are in excess of the prescribed minimum shareholders funds provided that such loans shall not exceed ten percent of the shareholders funds at any time.<sup>149</sup>

The CMA has proposed amendments that would see the minimum share capital of investment banks raised to a minimum of Kshs 250,000,000.<sup>150</sup> This is in keeping with the significant

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<sup>145</sup> Regulation 43

<sup>146</sup> Regulation 44 (1)

<sup>147</sup> Regulation 44 (2)

<sup>148</sup> Regulation 44 (3)

<sup>149</sup> Regulation 44 (4)

<sup>150</sup> Discussed in Chapter 4

growth that has been witnessed in the capital markets, and has seen investment banks dealing in increasingly large amounts of money, far above their capitalisation levels.

### 3.4 A Critique

#### 3.4.1. Licensing

In theory, regulation through licensing is viewed as a stricter means of ensuring minimum requirements are fulfilled before a person can be granted authorisation to provide a service, as opposed to other means of regulation such as certification. Licensing requires that minimum requirements be met failing which a licence is not granted - an “all or nothing” approach. Certification on the other hand implies that some prescribed level of competence has been attained and is usually based on a system of gradation with differing minimum requirements at the different levels. In practice however, the quality level actually achieved by a licence may be lower than expected in principle particularly as concerns the ‘borderline’ cases; borderline cases referring to applicants who would have met a substantial number of requirements but not all the requirements.<sup>151</sup>

With regard to the licensing of market intermediaries under the Capital Markets Act, provision is made for the extension of licenses where an applicant seeking renewal has not complied with the stipulated requirements; what can be termed “borderline” cases.<sup>152</sup> Extension can be positive as it allows the licensees some more time to comply with the requirements laid down by the regulator as occurred when the licenses of 8 licensees were extended in early 2008.<sup>153</sup> However, instances where an applicant requires such extension for

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<sup>151</sup> See C.A.E. Goodhart, *Financial Regulation*, . Second Edition, pp 210, 211

<sup>152</sup> Section 25 (2)

<sup>153</sup> Supra note 156

a number of times is required may indicate some failure, either financial or relating to corporate governance issues on the part of the intermediary, which could have negative implications for investors acting through these intermediaries.

### **3.4.2. Capital Adequacy**

“Capital adequacy”<sup>154</sup> can be described as the minimum capital that market intermediaries are required to maintain at all times. Principle 22 of the IOSCO Objectives and Principles of Securities Regulations states that: “There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.” This regulatory principle accurately identifies the purpose of capital adequacy, that as a general guideline, capital must be sufficient to protect a financial organisation’s customers and counterparties from various risks, such as market risk, settlement/counterparty risk, credit risk and operational risk. Additionally, an efficient capital adequacy structure can also send timely warning signals to intermediaries to re-focus on their risk management, as a decline in the capital base can expose the intermediary to significantly higher levels of risks.<sup>155</sup>

In order to ensure efficient functioning of stock markets it is imperative for all participants to have confidence in each other’s stability and the ability to effectively manage risk. The inability of any one intermediary to honour his commitment may call into question the financial solvency of other market intermediaries, leading to serious market disruption and decline in investor confidence. Therefore, there is a dire need to establish adequate capital

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<sup>154</sup> In some jurisdictions, capital adequacy is also referred to as “regulatory capital”.

<sup>155</sup> Ibid IOSCO, ‘Guidance to Emerging Market Regulators Regarding Capital Adequacy Requirements for Financial Intermediaries.’ Report of the Emerging Markets Committee of the International Organization of Securities Commissions (IOSCO: December 2006) pp 4

adequacy standards, safeguards and procedures to ensure an intermediary's financial resources are sufficient to withstand the risk to which its business is subject and reduce potential hazards.

Different jurisdictions have different ways of arriving at the minimum capital requirements for capital market intermediaries. In the United States and Canada for instance, the approach used is applying a capital adequacy regime which is based on the liquidity or net capital requirement. This is an approach which requires that securities firms maintain minimum levels of highly liquid assets to adequately satisfy all their obligations and provide a cushion against potential losses arising from general risks. In the Philippines a risk based capital adequacy approach is used. This means that the minimum level of capital that has to be maintained by firms which are licensed, or securing a broker dealer license, take into consideration the firm size, complexity and business risk. Such risks that are considered in determining the capital requirement include among others, operational, position, counterparty and underwriting risks.<sup>156</sup>

In Kenya, the Capital Markets Authority (CMA) as the regulator has no specific criteria for determining the minimum capital requirements for licensees.<sup>157</sup> The capital requirements are, however, based on the analysis of similar emerging markets and their licensees. The minimum capital requirements for capital markets intermediaries in Kenyan law regarding minimum share capital requirements and working capital requirements for stockbrokers and investment banks are far below what is adequate. Due to a significant amount of growth that has been experienced in the capital markets, stockbrokers and investment banks currently deal in significant amounts of money and the current capitalisation levels do adequately

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<sup>156</sup> Ibid at pp 5

<sup>157</sup> Information obtained from interview with CMA officer

reflect this growth. The investor would be better protected if these institutions were better capitalised which would serve to guarantee their financial strength.

### **3.4.3 The Role of the Capital Markets Authority (CMA)**

The Capital Markets Authority (CMA) as regulator of Kenya's capital markets is responsible for developing and sustaining a fair, efficient and orderly market with systemic stability and integrity. In performing its oversight function, the CMA has put in place a regulatory and oversight structure that includes, regular surveillance of trading in securities in the market and their settlement; periodic reviews of all licensed persons in order to ensure they continue to comply with the oversight regulations; periodic reviews of all listed companies to ensure that they meet listing and disclosure requirements; follow-up on the implementation of good corporate governance practices by both licensed persons and listed companies.<sup>158</sup>

Supervision of market intermediaries' conduct through inspection and surveillance helps to ensure the maintenance of high standards and the protection of investors. These preventative programs are a necessary complement to investigation and enforcement programs.<sup>159</sup>

Market surveillance of licensees as carried out by the CMA involves planning, monitoring and conducting operations aimed at detecting unfair or irregular security dealings that may compromise market integrity and investor confidence. The introduction of the Automated Trading System (ATS) in September 2006 has allowed the CMA to implement an electronic surveillance of the ATS so to carry out reviews of securities transactions with regards to

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<sup>158</sup> Capital Markets Authority Annual Report, 2007, pp 11

<sup>159</sup> IOSCO. *IOSCO Objectives and Principles of Securities Regulation*. (IOSCO-International Organisation for Securities Commissions: Feb 2008) pp 14 at [www.iosco.org](http://www.iosco.org)

securities trends, authenticity of price movements and trade volumes and track any suspect trades.<sup>160</sup> The CMA is in the process of upgrading its current surveillance system over the ATS with a more powerful one that will enhance the surveillance of the securities trading platform.<sup>161</sup>

The CMA also conducts investigations with a view to examining alleged or suspected violations of the capital market regulations. These investigations involve the identification of persons/entities behind capital markets irregularities and violations, gathering data regarding primary issues, transactions in the secondary markets, trading details and subsequent analysis of the data. Upon the completion of the investigation and where it is determined that a capital markets regulation has been violated, appropriate enforcement measures are instituted as provided for in the Capital Markets Act and other securities regulations.

To confirm the level of compliance with the requirements of the laid down securities regulations, the CMA carries out on-site inspections of market intermediaries. In the financial year ended June 30, 2007, the regulator carried out 122 on-site inspections involving 10 investment banks, 11 stockbrokers, 14 fund managers, 21 investment advisers and 6 authorised depositories. The areas focused on included, compliance with capital adequacy requirements, adherence to continuous reporting obligations with emphasis on submission of quarterly reports, compliance with record keeping requirements and confirmation as to whether stock-broking companies' front-office operations were conducted in accordance with relevant securities laws, rules and regulations.<sup>162</sup> The regulator also carries out off-site

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<sup>160</sup> Supra note 158 at pp 12

<sup>161</sup> Information obtained from interview with CMA officer

<sup>162</sup> Supra note 160 at pp 13

inspections which involve reviewing financial reports to determine continuous compliance by both licensees and listed companies.

Following the placing under statutory management of the two collapsed stockbrokerage houses, Nyaga Stockbrokers and Francis Thuo and Partners, it became clear that these firms were not able to meet their financial obligations to their clients. It is likely that this financial situation would have been reflected in their books of accounts. If this was not reflected, this may be indicative of a failure on the part of the auditors to present the true financial position of the firms.<sup>163</sup> The failure of these two stockbroking firms may also be indicative of some weaknesses in the surveillance of capital market intermediaries by the CMA. Given that these firms had been facing liquidity problems prior to their collapse, the CMA should have captured this through their on-site and off-site inspections. Another possible scenario is that the CMA may have been aware of the financial troubles facing these firms and failed to take necessary actions to protect investors.

#### **3.4.4. The Nairobi Stock Exchange (NSE)**

The Nairobi Stock Exchange is Kenya's only stock exchange to date and has been in operation since 1954, initially, as a voluntary association of stockbrokers and from 1991 as a limited liability company registered under the Companies' Act.<sup>164</sup> As the market operator, a core function of an exchange, is to create and enforce the rules governing the stock market. The scope of exchange rule-making and enforcement activity varies considerably from jurisdiction to jurisdiction, but most exchanges are rule-setters at least in respect of the

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<sup>163</sup> Investigations into these two firms are still ongoing and the CMA has not released the results into the public domain.

<sup>164</sup> Cap 484. Laws of Kenya



admission of members, the admission of products to trading and the trading process itself.<sup>165</sup>

As a self-regulatory organisation (SRO), the NSE performs a number of functions as discussed below.

#### **3.4.4.1. Member Regulation**

The first main element of the member regulation function, and one which is common to all exchanges, is the setting of the eligibility rules for the admission of members/participants. The Nairobi Stock Exchange (NSE) in fulfilling this function has Management and Membership Rules which stipulate the requirements for membership to the exchange.<sup>166</sup> In accordance with the Capital Markets Act and its regulations, the membership rules as set out do not conflict with the Capital Markets Act and other regulations.

A second element of member regulation, which exchanges in some countries still perform, is the comprehensive regulation of member firms. This generally covers the regulation of sales practices and prudential requirements, but may also include setting qualification standards for industry professionals. In countries where this comprehensive regulation of investment firms is undertaken by other regulatory bodies, exchanges normally rely on that regulation and focus their own member regulation on areas relating specifically to the behaviours and systems capabilities needed to participate in the exchange's trading processes.<sup>167</sup>

The NSE as a self regulatory body does regulate the activities of its members through the carrying out of on-site and off-site inspections of its members in much the same manner as

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<sup>165</sup> IOSCO. 'Regulatory Issues Arising from Exchange Evolution,' Consultation Report. Technical Committee of the International Organization of Securities Commissions.(IOSCO: March 2006) pp 6.7

<sup>166</sup> Part II of the Nairobi Stock Exchange Management and Membership Rules.

<sup>167</sup> Supra note 165 at pp 8

the CMA. However, the role of the NSE of overseeing the activities of its members is hampered by the fact that there is a lack of separation in its ownership and management which has the effect of creating a conflict of interest. Separation of ownership and management would serve to ensure corporate governance, thereby ensuring transparency and accountability in the dealings of the exchange.

A conflict of interest also arises from the fact that the members of the NSE act as both the principals and agents to their clients. A stockbroker or investment bank may in certain instances advise a client to buy or sell particular shares which it may not be in their best interests to do. The capital market intermediary may misadvise a client so as to gain through charging of brokerage fees.

Self regulation by the NSE of capital market intermediaries cannot be adequate as long as the NSE remains a mutual institution. Demutualisation is the term that denotes the change in the legal status of a stock exchange from a mutual association with one vote per member to a company limited by shares with one vote per share with majority decision making. It involves the separation of trading rights and ownership. Demutualisation signifies that an exchange has become a profit making firm in a competitive capital markets environment.<sup>168</sup> While in most emerging market jurisdictions, the decision to demutualise is largely made by policy-makers, it is based on a process that is achieved through a consultative and consensus-seeking process, reflecting the value placed on social cohesiveness in these societies. This process recognises that various commercial stakeholders have substantial lobbying powers and that without sufficient “buy-in” from the significantly varied interests and convergence of

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<sup>168</sup> Sam Mensah, “Demutualising African Stock Exchanges: Challenges and Opportunities” (Paper presented at the 9<sup>th</sup> Annual Conference of the African Stock Exchanges Association, Cairo, Egypt, 10-12 September 2005)

expectations, the lack of support from a broad stakeholder base could pose a major hurdle in the process of demutualisation.<sup>169</sup>

Both the CMA and the NSE have commissioned separate studies on how the NSE should be demutualised with differing results on how this process can be successfully carried out. Broad consultations with all relevant stakeholders are indeed important but it remains clear that demutualisation is a necessity if the NSE is to adequately perform its role as a self-regulatory organisation.

Another shortcoming of the current Kenyan self-regulatory framework is that there are no minimum qualifications standards for industry professionals. This means that at present, almost anyone could become a stockbroker without there being any mechanism to ensure that they have the proper skills and training. There has recently been an attempt made to remedy this situation. In mid-2008, a regional training institute for capital market participants, the Securities Industry Training Institute (SITI) was launched. This institute is an initiative of the Nairobi, Dar-es-Salaam, Uganda and Rwanda Securities Exchanges, supported by the International Finance Corporation (IFC). It is expected to develop into a regional capacity building centre, with branches in all member countries and headquarter offices in Kampala, Uganda. The institute will initially offer courses such as market fundamentals, portfolio management, the market participants' course, and corporate governance. Pilot training programmes have already been held in Kampala and Nairobi, but the institute is expected to

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<sup>169</sup> IOSCO. 'Exchange Demutualisation in Emerging Markets,' Emerging Markets Committee of the International Organisation of Securities Commissions (IOSCO: April 2005) pp 11 from [www.iosco.org](http://www.iosco.org)

become fully operational by December 2008.<sup>170</sup> It remains to be seen whether these programmes will be seriously implemented in Kenya.

#### **3.4.4.2. Trading regulation**

The regulation of trading, with a view to ensuring fair, orderly and efficient trading, is normally the core responsibility of all exchanges. The trading (or “market”) regulation function generally includes; setting trading rules; conducting trading surveillance to ensure orderly markets and detect potential market abuse; enforcing trading rules and taking disciplinary action against participants in breach of the rules; and informing the securities regulatory authority of infractions, where appropriate.<sup>171</sup>

There are a number of major challenges attendant to the implementation of self-regulation. Self-regulation assumes that the industry has the capability to police itself. It also assumes that the industry has the incentive to operate fair and efficient markets. If self-regulation is to be effective, it also requires competition among market participants so that they will monitor each other. If conflicts of interest undermine the role of self-regulation then the benefits of controlling the activities of members and enhancing investor confidence may not be valued highly.<sup>172</sup>

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<sup>170</sup> Press Communique, 11<sup>th</sup> Meeting of the East African Securities Exchanges Association (EASA) held on 12<sup>th</sup> September 2008, at Serena Hotel

<sup>171</sup> Reena Aggarwal, “Globalisation, Technology and Regulation in Capital Markets. Strategies for Latin America and the Caribbean.” (Paper prepared for Inter-American Development Bank’s Conference on “A New Focus for Capital Market Development in Latin America and the Caribbean.” Washington, D.C. February 5-6, 2001)

<sup>172</sup> Ibid

In an emerging capital market such as Kenya's capital markets, there is usually the concern that if there are only a handful of capital market intermediaries who are members of the self regulatory organisation or have too much influence, it would not be good for the capital markets. The governance structure of the SRO plays a major role in determining the effectiveness of the SRO's oversight activities. Kenya currently has one stock exchange, the NSE, with some of its owners also being owners or directors of the capital market intermediaries which are members. This arrangement has hampered the proper functioning of the NSE as an effective SRO because of the conflict of interest that arises from its mutual status.

### **3.5. The Investor Compensation Fund**

Section 18 of the Capital Markets Act establishes the Investor Compensation Fund (ICF) for the purposes of granting compensation to investors who suffer pecuniary loss from the failure of a licensed stockbroker to meet his financial obligations. The fund is yet to be operationalised as there is currently no Board in place to administer it. As a result of this investors who suffered loss from the failure of the stock broking firms of Nyaga Stockbrokers and Francis Thuo and Partners to meet their financial obligations have not been compensated. It is not clear if and when they will receive compensation as investigations are still ongoing.

The maximum amount of compensation an investor can receive from the ICF is Kshs 50,000. Compensation can only be paid out in relation to a stockbroker that has been placed under statutory management and the funds from the stockbroker are not adequate to pay the investor. The figure of Kshs 50,000 is far below the sums that many individual investors invest in the stock market through capital market intermediaries and should be revised

upwards to boost investor confidence. On the other hand however, the question of moral hazard arises where stockbrokers may take greater risks in the expectation that should something go wrong, investors can be compensated from the ICF. It is important therefore that inasmuch as compensation should be carried out, there should also be measures to ensure that compensation is provided under strict conditions to prevent misuse of the ICFs funds.

## **Conclusion**

From the foregoing, it is clear that the regulatory framework, both in the law and the regulatory institutions themselves have a number of inadequacies. In terms of the law, the minimum capital requirements for stockbrokers and investment banks are too low and should be revised upwards. The financial reports of capital market intermediaries are not disclosed to the public which is an element of transparency that is lacking and does not do well to foster investor confidence. Both the Capital Markets Act and the Licensing Regulations do not provide for the regulation of the many stock broking agents who are currently in operation. Qualifications for industry professionals are clearly lacking which puts investors at risk as they may not receive adequate advice from capital market intermediaries before investing in the stock market due to lack of proper training. The role of auditors who prepare the accounting and auditing reports of capital market intermediaries is also one of great importance. There is need to ensure that the auditors present reports that reflect the true financial position of capital market intermediaries to ensure that the investing public is able to make an informed choice on which capital market intermediary to use based on correct information.

With regard to the institutional structures, despite the CMA carrying out surveillance over the activities of capital market intermediaries, there remains a gap because the CMA thus far appears to have failed in good time the financial troubles that were facing the stock broking firms of Francis Thuo and Partners and Nyaga Stockbrokers. The effect of this is that many investors lost their hard earned savings and are to date yet to receive compensation.

The NSE being a mutual organisation at present, that is, there being no separation between its ownership and management cannot be an effective self regulatory organisation.

The inadequacies mentioned above indicate that investors are not adequately protected when dealing with capital market intermediaries. The CMA has proposed a number of amendments to the Capital Markets Act and the Licensing Regulations to deal with some of these inadequacies. These amendments are discussed in the following chapter.

## CHAPTER FOUR

### PROPOSED AMENDMENTS TO THE LAW IN RELATION TO CAPITAL MARKET INTERMEDIARIES

#### Introduction

In May 2008, the Capital Markets Authority (CMA) announced that it had finalised amendments to the Capital Markets Act and regulations. Further, pursuant to Section 12(2)(b) of the Capital Markets Act, the CMA publicly exposed the proposed amendments for the stipulated period of thirty days, inviting comment by stakeholders and the public at large. The CMA received comments, in particular from the Nairobi Stock Exchange (NSE). This chapter will examine the proposed amendments to the Capital Markets Act and the Capital Markets (Licensing Requirements) (General) (Amendment) Regulations as they relate to capital market intermediaries and their implications if they become law.

#### 4.1 Proposed Amendments to the Capital Markets Act

##### 4.1.1. Propriety of Persons Owning and Controlling Licensed Persons

In order to ensure better controls and oversight of the fitness and propriety of persons that own and control licensed persons, who include stockbrokers, dealers and investment banks, the Capital Markets Authority (CMA) has proposed a number of amendments to the Capital Markets Act. Under the proposed amendment to section 29 (1) (b) of the Act, before the CMA can grant a license, it would be required to satisfy itself that none of the directors of an applicant have been declared bankrupt; or has been a director of a licensee that has been



denied a license in Kenya or in another jurisdiction, or has been a director of a company providing banking, insurance, financial or investment advisory services whose licence has been revoked by an appropriate authority. The proposed amendment intends to extend these requirements to the shareholders of applicants as well. Additionally, neither the directors nor shareholders of an applicant should have been convicted of an economic crime by a court of law of competent jurisdiction. This proposed amendment seeks to ensure the propriety of owners and managers of licensees to ensure that they are individuals who can have the trust of the investors.

#### **4.1.2. Ownership and Management of Capital Market Intermediaries**

It is the case with the majority of stockbrokerage houses in Kenya at present that the shareholders or owners of these companies are often also involved in their management. This has the effect of creating a conflict of interest. In order to cure this problem, the amendments propose that none of the persons engaged or to be engaged in the position of executive director or other senior capacity in the case of a stockbroker, investment bank or fund manager, controls or is beneficially entitled directly or indirectly to more than twenty five percent of the issued share capital of the licensed person.<sup>173</sup> Further, the amendments propose to limit the substantial ownership by a single person of licensees that handle clients' funds to a maximum of twenty five per cent of the issued share capital of the licensed person.<sup>174</sup> These two amendments would serve well in dealing with the conflict of interest that often arises in ownership and management of funds that belong to the investing public and are entrusted to capital market intermediaries.

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<sup>173</sup> Proposed new Section 29 (1) (h)

<sup>174</sup> Proposed new Section 29 (1) (A)

In proposing the amendment on separation of ownership and management, the aim of the CMA is to ensure proper corporate governance standards in these institutions are maintained. This separation would aim to make these institutions more professional in their operations while at the same time ensuring transparency and accountability in their dealings for the benefit of investors.

#### **4.1.3. Record Keeping**

The substantive provisions in relation to record keeping are currently found in the Capital Markets (Licensing Requirements) (General) (Amendment) Regulations. The CMA has proposed the inclusion of an entire section on record keeping in the Capital Markets Act to ensure that adequate and complete records are being maintained by all licensed persons.<sup>175</sup> If approved, all licensed persons will be required to keep, in Kenya, adequate and orderly records which will include records of their business affairs, financial position, internal organisation, compliance with statutory and regulatory requirements, risk management systems and records relating to business transactions undertaken for customers. In order to allow for the tracing of all aspects of securities transactions, licensed persons will be required to keep records from the initial order to the final settlement of the deal. All records are to be kept for a period of seven years and in the case of records relating to a customer, for a period of seven years from the time the account with the customer is closed. The alteration or modification with the intent of giving a false impression of the subject matter of the record is proscribed. Failure to comply with the record keeping requirements as set out would amount to an offence.

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<sup>175</sup> *Proposed new Section 30B*

Record keeping is an important aspect of investor protection, particularly more so in instances where there are malpractices by capital market intermediaries. Properly kept records would be very beneficial in enabling the regulatory authority to trace trading activities carried out by capital intermediaries and establish any illegal activities may have taken place and bring the culpable party or parties to book.

#### **4.1.4. Tracing and Blocking Assets**

The CMA has also proposed amendments to the Act that would see its powers to trace and block assets strengthened.<sup>176</sup> In instances where the CMA has reasonable grounds for suspecting that assets are directly or indirectly connected to insider dealing or market manipulation, whether in Kenya or elsewhere, or to a person who is suspected of engaging in insider dealing or market manipulation, or to an associate of such a persons, the CMA would have the authority to direct any person who has control over such assets to take any action with respect to such assets as the CMA may direct. This would be done with a view of protecting the assets until the court determines the appropriate course of action to be taken. In a situation where a person appeals to the Capital Markets Tribunal against the CMA's directive to block assets, the person would be required to comply with the CMA's directive until the appeal is heard and determined. The rationale behind this would be to ensure that the assets are not tampered with in the interim period during which an appeal is being heard.

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<sup>176</sup> Proposed new Section 13A

#### **4.1.5. Supervision of entities whose licenses have been revoked**

The CMA seeks to continue supervising the functions of entities that may have had their licenses revoked. Such supervision is to be carried out in the public interest to ensure that such entities do not undertake any activities that they are not licensed to undertake and thus mislead the investing public.<sup>177</sup>

### **4.2. Proposed Amendments to the Capital Markets (Licensing Requirements) (General) Regulations**

#### **4.2.1 Increased Minimum Share Capital**

A significant number of amendments are proposed to the Capital Markets (Licensing Requirements) (General) (Amendment) Regulations. The first of these would see the minimum paid-up share capital of stockbrokers raised from Kshs 5,000,000 to Kshs 50,000,000.<sup>178</sup> Stockbrokers with share capital below this newly prescribed minimum are to be given six months within which they are to comply with this new regulation counting from the date of its commencement.<sup>179</sup>

It is also proposed that the minimum paid-up share capital of investment banks be raised to Kshs 250,000,000 from the current minimum of Kshs 30,000,000. When seeking a license an applicant would also be required to present evidence of the paid up share capital of a minimum amount of two hundred and fifty million shillings. The current regulation in

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<sup>177</sup> Proposed new subsection 3 to Regulation 26

<sup>178</sup> Amendment of Regulation 15 (1) (d) (v)

<sup>179</sup> To amend Regulation 16 (1)

relation to minimum paid up share capital of investment banks only requires an applicant to show evidence of financial capability or in the alternative investment capital of a minimum amount of thirty million shillings in cash or portfolio of securities comprising fixed income securities or listed shares.<sup>180</sup> Investment banks would also be given six months within which to comply with this regulation counting from the date of its commencement.

Licensees would be required to notify the CMA of changes to their capital structure within five working days from the date of the change.<sup>181</sup>

The proposed increase in the amount of minimum share capital requirements for stockbrokers and investment banks were informed by the fact that the capital markets had grown significantly. This growth has translated to capital market intermediaries, notably, stockbrokers and investment banks dealing in significant amounts of money. The CMA's assessment of this situation was that the capitalisation levels were not adequate enough with regards to the turnover of these institutions. In addition, the CMA's assessment was that investors would be better protected if these institutions were better capitalised thus guaranteeing their financial strength.

#### **4.2.2. Increased Oversight over Changes in Key Personnel and Shareholders**

It is proposed that licensees, which includes stockbrokers and investment banks, are not to make changes in their shareholders, directors, chief executive or key personnel before receiving approval of the proposed change in writing from the CMA.<sup>182</sup> Where any person in

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<sup>180</sup> Regulation 39 (d) (iii)

<sup>181</sup> Proposed new Regulation 54A

<sup>182</sup> Proposed new regulation 53 (B) (1)

the category mentioned was formerly employed by or otherwise connected with another licensee of the CMA, the CMA would require details regarding their departure to be forwarded in support of any request for approval.<sup>183</sup> To further keep track of the key personnel of licensees, licensees will be required to lodge annually with the CMA, a list of key personnel working with the licensee and any change is to be communicated to the CMA within five days.<sup>184</sup>

The rationale for this amendment is to ensure that the management of capital market intermediaries is in the hands of individuals who can be entrusted to fulfill the fiduciary duty they owe to the investors.

#### **4.2.3. Branches/Places of Business**

A new regulation 53C (1) is proposed to require that licensed persons are not to open any branch or place of business or change the location of a branch or existing place of business without the approval of the authority. The closure by a licensee of any of its places of business in Kenya must be preceded by giving three months' written notice to the CMA of its intention to do so. This requirement would enable the regulatory authority to keep track of capital market intermediaries and their activities.

#### **4.2.4. Separation of Ownership and Management**

In keeping with the proposed amendment to the Capital Markets Act requiring separation in the ownership and management of capital market intermediaries, namely stockbrokers,

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<sup>183</sup> Proposed new regulation 53 (B) (2)

<sup>184</sup> Proposed new regulation 53 (B) (3)

investment banks or fund managers,<sup>185</sup> amendment to the Licensing Regulations is also proposed to reflect the same. Any person who controls or is beneficially entitled directly or indirectly to more than twenty five percent of the issued share capital of a licensee is not to be appointed to a senior position such as that of executive director.<sup>186</sup> Control or shareholding of a licensee, whether directly or indirectly, would also to be limited to a maximum of twenty five percent for any one person. Licensees would be given a period of two years within which to comply with these requirements.<sup>187</sup>

#### **4.2.5. Professional Indemnity**

Given the position of trust that capital market intermediaries have in relation to the investor, stockbrokers and investment banks would be required to obtain professional indemnity insurance to secure an amount which should not be less than five times their daily average turnover.<sup>188</sup> The daily average turnover is to be calculated based on the firm's turnover for the previous year or other amount that the CMA may determine.<sup>189</sup> Professional indemnity is an important aspect of investor protection because it would ensure that capital market intermediaries are held more accountable for their actions. Capital market intermediaries owe their clients a fiduciary duty and the markets and the investors should not be exposed to the losses arising from the breach of these fiduciary duties through negligence, omissions,

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<sup>185</sup> Proposed new Section 29(1)(h)(iii)

<sup>186</sup> Proposed new regulation 53D (1)

<sup>187</sup> Proposed new regulation 53B (2)

<sup>188</sup> Proposed new regulation 51B. The requirement for professional indemnity is a measure similar to that required of Advocates in practice who and medical practitioners who are also required to take out professional indemnity.

<sup>189</sup> Supra note 187

misrepresentations or malpractices.<sup>190</sup> Professional indemnity would serve to have intermediaries take cover for the failure of their employees.

#### **4.2.6. “Know your Customer” Obligations**

In order to prevent money laundering and other illicit activities, the CMA proposes to strengthen the already existing obligations of licensees to “know their customers”. In order to do this, the licensees would be required to maintain adequate records on beneficial ownerships with customers so as to assist in investigations as and when required. Licensees would be required to maintain information on their clients’ such as in the case of a natural person, any person on whose behalf they are acting and whether acting as nominee, trustee or any other capacity. In the case of limited partnerships, the name of the general partner and in an unlimited partnership, the names of other partners. Where the client is a trust, the names of the settlers, trustees, protectors and principals named beneficiaries on whose behalf the trust is being operated. However, where the customer is a financial institution such as a bank, insurance company or collective investment fund and is conducting business collectively on behalf of a large number of underlying customers and where the financial institution is subject to rules or regulations that require the financial institutions to conduct customer due diligence, the license would be permitted to rely on the financial institution to hold beneficial ownership information and need not hold that information himself.<sup>191</sup>

#### **4.2.7. Publishing of Financial Statements**

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<sup>190</sup> Budget Speech for the Fiscal Year 2008/2009 delivered in Parliament by the then Minister for Finance, Hon Amos Kimunya on 12<sup>th</sup> June 2008

<sup>191</sup> Proposed new regulation subsections 1(e) and (f) of Regulation 80



In order to increase the transparency in the market and give investors the opportunity to make a decision as to which capital market intermediaries to deal with, all intermediaries dealing directly with public funds would be required to publish their audited financial statements in the press for scrutiny. Such accounts would constitute an audited balance sheet and profit and loss statements for the financial year which are to be published within three months of the end of each financial year. In addition to publication in the press, licensed capital market intermediaries would also be required to exhibit throughout the year in a conspicuous position in every office and branch in Kenya, a copy of these audited accounts. The names of the licensees' directors are also to be published.<sup>192</sup>

#### **4.2.8. Auditors of Capital Market Intermediaries**

The CMA in seeking to look further into the auditing of capital market intermediaries seeks power to raise queries with the auditor of a licensee and the licensee in relation to supervisory issues. The proposed new regulation would give the CMA power to arrange trilateral meetings with a licensed person and its auditor from time to time with regard to the licensed person's business, its accounting and control system and its annual accounts.<sup>193</sup>

The CMA also proposes amendments that would require the auditor of a licensed person to be approved by the CMA. A licensee would be required to seek written approval from the CMA for the appointment of an auditor at least one month prior to such an appointment.<sup>194</sup>

The auditor of an intermediary would be required to report, serious breach or non-compliance with the provisions of the Capital Markets Act or other regulations of the CMA; a criminal

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<sup>192</sup> Proposed new regulation 51C

<sup>193</sup> Proposed new regulation 51(5)

<sup>194</sup> Proposed new regulation 53A(1)

offence involving fraud or other dishonesty committed by the licensed person or any of its officers or employees; serious irregularities that may jeopardise the security of investors or creditors. Where the auditor is unable to confirm that the claims of investors and creditors of the licensed person are capable of being met out of the assets of the licensed person, he would be required to report the matter immediately to the CMA.<sup>195</sup>

The proposed amendments would give the CMA significant powers in relation to auditors of licensees. If an auditor of a licensed person failed to comply with the stipulated requirements, the CMA would have power to remove him from office and appoint another person in his place.<sup>196</sup> Auditors would be required to serve for a maximum of four (4) consecutive years. Change of the auditor of licensed person would have to be approved and the CMA would have to be given one month's written notice of such change.<sup>197</sup>

The role of auditors in relation to capital market intermediaries is of great importance. It is only with accurately and correctly prepared financial statements that investors can have proper information based on which to choose a capital market intermediary of their choice. Additionally, properly prepared financial statements would ensure that intermediaries who are not in a position to meet their financial obligations to their clients can be identified at an early stage and necessary action taken. This would go a long way to preventing situations such as have been witnessed with the collapse of Nyaga Stock brokers and Francis Thuo and Partners.

#### **4.2.9. Compliance and Reporting Requirements**

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<sup>195</sup> Proposed new regulation 53A(2)

<sup>196</sup> Proposed new regulation 53(5)

<sup>197</sup> Proposed new regulation 55B

To ensure that licensees comply with the regulatory requirements, every licensee would be required to designate a compliance officer whose responsibility will be to liaise with the CMA on all compliance matters.<sup>198</sup> The CMA proposes stricter requirements on reporting by licensees such as in cases where a stockbroker and an investment bank has overdrawn a clients' account, the licensee would be required to report such an overdraw to the CMA within twenty-four hours.<sup>199</sup> At present stockbrokers are required to submit to the CMA quarterly, half-yearly and annual reports.<sup>200</sup> The proposed amendment to regulation if passed would see stockbrokers being required to prepare monthly reports and accounts which would be made available to the CMA on request.<sup>201</sup> The same requirement would also extend to investment banks which would be required to prepare monthly reports of their financial performance.<sup>202</sup>

In keeping with IOSCO's principles on accounting and auditing standards, which recommend comprehensive and well-defined accounting principles that are of a high and internationally acceptable quality, the proposed amendments would also see all licensees being required to prepare all financial statements in accordance with International Financial Reporting Standards.<sup>203</sup>

Whereas the current licensing regulations only require that licensees submit to the CMA their management accounts at the end of each year before their licenses can be renewed, the proposed amendments if passed would see stockbrokers, dealers, investment banks and fund

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<sup>198</sup> Proposed new regulation 53A

<sup>199</sup> Proposed amendment to Regulation 20(a)

<sup>200</sup> Regulation 21

<sup>201</sup> Proposed proviso to Regulation 21(1)

<sup>202</sup> Proposed amendment of Regulation 32(1)(b)

<sup>203</sup> Proposed new Regulation 51A (1)

managers being required to publish their half-year unaudited financial statements and full-year audited financial statements in at least two daily newspapers of national circulation.<sup>204</sup>

The requirement for more frequent preparation of financial reports would serve to ensure the CMA as the capital markets regulator is able to adequately track the financial status of capital market intermediaries. Any intervention that may be necessary to protect the interests of investors can be taken in adequate time to prevent investors incurring avoidable losses.

#### **4.2.10. Stockbroking Agents**

The current licensing regulations have not adequately dealt with the issue of stockbroking agents, despite the large number of dealers that are located throughout the country who provide stockbroking services on behalf of registered stockbrokers. The new regulations seek to bring stockbroking agents properly within the ambit of securities laws and regulate their activities for the benefit of investors.

A new regulation would see stockbroking agents being required to be duly contracted by a stockbroker in writing in order to render services.<sup>205</sup> The CMA would require that such standard form agency agreements and any subsequent amendments made to them be submitted to the CMA for approval.<sup>206</sup> Stockbrokers would be required to forward to the authority on an annual basis, a register of agents that they have contracted. Any change in agents would be required to be communicated to the CMA within 5 working days.<sup>207</sup>

Regulations would be required to conduct all necessary due diligence to establish the

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<sup>204</sup> Proposed new Regulation 51A(2)

<sup>205</sup> Proposed new Regulation 22A (1)

<sup>206</sup> Proposed new Regulation 22A (3)

<sup>207</sup> Supra note 205

competence, fitness and propriety of any person who is to be appointed as an agent. Stockbrokers would be required to have specific regard to the past experiences and conduct of any such person in establishing their capacity to facilitate the purchase and sale of securities as an agent of the stockbroker in the best interests of investors.<sup>208</sup>

At present stockbroking agents act for a number of stockbrokers at the same time. It is proposed to restrict stockbroking agents to act as agents for only one stockbroker at a time. The onus of ensuring that an agent is not acting for another stockbroker would be placed on the stockbrokers themselves. In instances where a stockbroking agent is acting for more than one stockbroker at the time when this sub-regulation comes into force, the sub-regulation provides a period of six months within which such a stockbroking agent is to come into compliance with this requirement.<sup>209</sup>

In order to protect investors, it is proposed that agents are not to handle or deal with clients' funds.<sup>210</sup> As the principal in the stockbroker-stockbroking agent relationship, the responsibility of ensuring that the stockbroking agent conducts its business efficiently, honestly and fairly with the integrity and professional skills appropriate to the nature and scale of activities and in accordance with the requirements of the Capital Markets Act and issued regulations will lie with the stockbroker.<sup>211</sup> In the event of any misfeasance by the stockbroking agent, the stockbroker who appointed the stockbroking agent would bear the responsibility of reporting such misfeasance to the CMA within 48 hours of the event.<sup>212</sup> The

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<sup>208</sup> Proposed new Regulation 22A (2)

<sup>209</sup> Proposed new Regulation 22A (4)

<sup>210</sup> Proposed new Regulation 22A (5)

<sup>211</sup> Proposed new Regulation 22A (6)

<sup>212</sup> Proposed new Regulation 22A (7)

same requirements in relation to stockbroking agents would apply to investment banks which may use stockbroking agents.<sup>213</sup>

## **Conclusion**

The finance bill for the fiscal year 2008/2009 incorporated some of the amendments proposed by the CMA with a view to ensuring the public interest is safeguarded. The amendments pointed out in the bill in particular, related to strengthening corporate governance of capital market intermediaries; strengthening the powers of the CMA to trace and freeze assets upon reasonable suspicion of a person's involvement in fraudulent activities; increasing minimum capital requirements for stockbrokers and investment banks and a requirement for professional indemnity for capital market intermediaries.

The proposed amendments to the Capital Markets Act discussed in this chapter are yet to be approved and passed by parliament in the case of amendments to receive approval by the minister. If they become law, they would go a long way to contributing towards investor protection in Kenya's capital markets. However, the proposed amendments have not addressed certain important aspects such as the demutualisation of the NSE and mandatory qualification requirements for capital market professionals. The amendments should also require the CMA to disclose the reasons for extension as well as suspension of capital market intermediaries for the purpose of transparency towards investors. It is not clear why some of the amendments are in the Licensing Regulations which are subsidiary legislation instead of in the Capital Markets Act. Important provisions such as those relating to publication of

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<sup>213</sup> Proposed amendment to Regulation 43

financial statements of capital market intermediaries in the press and mandatory professional indemnity should be in the Act which has greater force.

Much still remains to be done notwithstanding the proposed amendments which are a positive step in the right direction. The following final chapter of this paper will comprise the conclusion and recommendations based on findings of the research.

## CHAPTER 5

### CONCLUSION AND RECOMMENDATIONS

#### 5.1. Conclusions

The findings from previous chapters indicate that the current Kenyan regulatory framework relating to regulation of capital market intermediaries, both in terms of the law and the regulatory institutions themselves, have a number of inadequacies. In terms of the law, the minimum capital requirements for stockbrokers and investment banks are too low and should be revised upwards. The financial reports of capital market intermediaries are not disclosed to the public which is an element of transparency that is lacking and does not do well to foster investor confidence. Both the Capital Markets Act and the Licensing Regulations do not provide for the regulation of the many stock broking agents which is a glaring gap in the law.

Qualifications for industry professionals are clearly lacking which puts investors at risk as they may not receive adequate advice from capital market intermediaries before investing in the stock market due to lack of proper training. The role of auditors who prepare the accounting and auditing reports of capital market intermediaries is also one of great importance. There is need to ensure that the auditors present reports that reflect the true financial position of capital market intermediaries to ensure that the investing public is able to make an informed choice on which capital market intermediary to use based on correct information.

With regard to the institutional structures, despite the CMA carrying out surveillance over the activities of capital market intermediaries, there remains a gap because the CMA thus far



appears to have failed to capture in good time the financial troubles that were facing the stock broking firms of Francis Thuo and Partners and Nyaga Stockbrokers. The effect of this is that many investors lost their hard earned savings and are to date yet to receive compensation.

The mutual status of the NSE hinders it from being an effective SRO and there is need to correct this situation to ensure that investors are adequately protected.

The proposed amendments to the Capital Markets Act and the Licensing Regulations are commendable but these have not gone far enough in addressing certain issues such as demutualisation of the NSE.

## **5.2. Recommendations**

1. The immediate passing into law of the proposed amendments to the Capital Markets Act and approval by the minister of the amendments to the Capital Markets (Licensing Requirements) (General) Regulations.<sup>214</sup> Strengthened securities laws regulating the activities of capital market intermediaries will serve to protect investors from malpractices and ensure that errant intermediaries are stopped before investors suffer unnecessary losses.
2. Strengthening of the legal requirements contained in the Licensing Regulations by placing them in the Capital Markets to give them greater force of law. This is with particular reference to professional indemnity for stock brokers and investment banks and publication of financial statements by capital market intermediaries to the public.

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<sup>214</sup> As discussed in Chapter Four of this paper

3. Demutualisation of the NSE from its current mutual status. It is clear that self regulation by the Nairobi Stock Exchange (NSE) of capital market intermediaries cannot be adequate as long as the NSE remains a mutual institution. Demutualisation is the term that denotes the change in the legal status of a stock exchange from a mutual association involving the separation of trading rights and ownership.<sup>215</sup> Both the CMA and NSE have commissioned separate studies on the approach to be taken in demutualisation. Stakeholders should come up with a consensus on a suitable way in which to demutualise the NSE and have the same put into law.
4. The introduction of minimum qualification standards for employees of capital market intermediaries is a major gap that should be addressed. As mentioned earlier in this paper a Securities Industry Training Institute (SITI) based in Uganda was launched in mid-2008.<sup>216</sup> The initial basic courses offered by SITI on market fundamentals, portfolio management, the market participants' course, and corporate governance should be made compulsory for all who are interested in working in Kenya's capital markets and be a pre-requisite to licensing by the CMA.
5. The Investor Compensation Fund (ICF) though provided for in law has to date not been fully operationalised. No Board has been appointed to administer the fund and no investors have received compensation for pecuniary losses incurred from the failure of licensed stockbrokers. The CMA should take urgent steps to see that the ICF comes into operation to ensure that investors who suffer loss are compensated in a timely manner.

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<sup>215</sup> Sam Mensah. 'Demutualising African Stock Exchanges: Challenges and Opportunities' Paper presented at the 9<sup>th</sup> Annual Conference of the African Stock Exchanges Association. Cairo, Egypt. 10-12 September 2005

<sup>216</sup> Washington Gikunju. 'Capital Markets Training Institute Launched' Business Daily Newspaper, 15 September 2008

6. Greater transparency by the CMA of its decision making process with regard to the licensing of capital market intermediaries. In particular, the reasons for the extension of licenses as opposed to their outright renewal should be made known to the public. Failure to disclose the reasons for these decisions leads to much speculation among investors and results in a loss of confidence in the capital markets.

It is clear from the foregoing that the task of adequately regulating capital market intermediaries is not an easy one. Its importance cannot be gainsaid as it is vital to ensuring protection of investors and in turn the maintenance of confidence in the capital markets which is key to its survival.

## APPENDIX I

### **Questionnaire Directed to the Capital Markets Authority (CMA)**

#### **Aim of the Survey**

This questionnaire is directed to the Capital Markets Authority and is part of the research project on '*The Investor and Capital Market Intermediaries: Is the Investor Adequately Protected?*' The project aims to understand the role of the capital market intermediaries in Kenya's capital markets and assess the adequacy of the law and institutions regulating their activities.

#### **Confidentiality**

The researcher carrying out this project guarantees complete confidentiality in the use of the data collected in this survey.

**Please enclose any published or official material that you feel would be relevant to understanding the role of the Capital Markets Authority (CMA) in regulating capital market intermediaries.**

1. What led to the drafting of the proposed amendments to the Capital Markets Act and the Capital Markets (Licensing Requirements) (General) Regulations, 2002? In particular amendments relating to;
  - (a) Minimum share capital requirements of stockbrokers and investment banks
  - (b) Separation of ownership and management

2. How does the CMA determine the minimum share capital requirements for capital market intermediaries, stockbrokers and investment banks in particular?
3. Have the proposed amendments to the Act and the Licensing Regulations been passed into law
4. How far has the CMA progressed in investigating the collapse of stockbrokerage houses Nyaga Stockbrokers and Francis Thuo and Partners?
5. Was the CMA aware of the financial troubles that Nyaga Stockbrokers and Francis Thuo and Partners were facing prior to their collapse?
6. How effective is the CMA in the supervision of capital market intermediaries?
7. How effective is the surveillance of the Automated Trading System (ATS) by the CMA in preventing irregular dealings in securities?
8. The 2007 CMA annual report indicates that the number of investor complaints the CMA received for the year ended June 30<sup>th</sup> 2007 was 1999, an increase of over 100% from the figure of 57 complaints received the previous year.
  - (a) What may have caused this rise in the number of complaints?
  - (b) What were the majority of complaints about?
9. What is the situation or progress at present with regard to demutualisation of the Nairobi Stock Exchange (NSE)?

10. The 2007 CMA Annual Report states that a study on 'The Adequacy and Institutional Arrangements of Capital Market Service Providers' was carried out by the CMA. Could the researcher be able to peruse the results/findings of the study for purposes of this research?
11. As regards prudential requirements for capital market professionals, what steps has the CMA taken to introduce minimum licensing qualifications as a mandatory requirement?

## APPENDIX II

### **Questionnaire Directed to the Nairobi Stock Exchange (NSE)**

#### **Aim of the Survey**

This questionnaire is directed to the Nairobi Stock Exchange and is part of the research project on ‘The Investor and Capital Market Intermediaries: Is the Investor Adequately Protected?’ The project aims to understand the role of the capital market intermediaries in Kenya’s capital markets and assess the adequacy of the law and institutions regulating their activities.

#### **Confidentiality**

The researcher carrying out this project guarantees complete confidentiality in the use of the data collected in this survey.

**Please enclose any published or official material that you feel would be relevant to understanding the role of the Nairobi Stock Exchange (NSE) as a self regulatory organisation?**

1. What is the role of the NSE as a self-regulatory organisation (SRO)?
2. Does the NSE have a code of conduct governing the conduct of its members?
3. Does the NSE regulate the activities of investment banks?
4. Does the NSE look into the prudential requirements of member firms, for instance, in relation to the qualifications of the individuals managing stockbrokerage firms and investment banks?

5. Does the NSE effectively regulate the activities of its members?
6. What, if any, is the role of the NSE in the investigations relating to the collapsed firms of Nyaga Stockbrokers and Francis Thuo and Partners?



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