

**COMBATING INSIDER TRADING IN KENYA'S CAPITAL MARKETS:  
CHALLENGES AND OPPORTUNITIES FOR REFORM**

A Paper submitted in partial fulfilment of the requirements of the Master of Laws

(Public Finance and Financial Services Law) degree

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## **DECLARATION**

I hereby certify that this is my original work done in partial fulfilment of the requirements of the Master of Laws degree in Public Finance and Financial Services Law and it has not been submitted to any other institution for any other qualification.

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## **DEDICATION**

To my Parents

## **ABSTRACT**

The capital markets are expected to play a pivotal role in the attainment of Kenya's development blueprint 'vision 2030.' It is, therefore, essential that obstacles to the attainment of a fair and efficient market are examined and rooted out. This study investigates the limitations of the Capital Markets Act in combating insider trading. It also examines whether reforms would promote a fair and efficient capital market.

The study makes use of existing literature as well as decided cases to investigate the inadequacies in the formulation of and provisions for inside information, material price-sensitive information, publication of information, possession of information and disclosure of information in the Capital Markets Act. This literature draws out key learnings from other jurisdictions and analyses how legislation in developed economies treats challenges to the enforcement of insider trading laws. The doctrinal analysis is triangulated with results of a survey of practical experiences of legal practitioners in applying the Capital Markets Act.

The findings affirm the existence of conceptual difficulties in determining the elements of the crime of insider trading. As a consequence, it is concluded that the present formulation of insider trading law is inadequate. The study, therefore, makes suggestions for reforms to the provisions on insider trading in the Capital Markets Act.

## **ABBREVIATIONS**

**CMA:** Capital Markets Authority.

**FSB:** Financial Services Board.

**NSE:** Nairobi Securities Exchange.



### **LIST OF STATUTES:**

1. Capital Markets Authority Act, Chapter 485A, Laws of Kenya.
2. Companies Act, Chapter 486, Laws of Kenya.

### **LIST OF CASES:**

1. *Republic v Bernard Mwangi Kibaru*, Nairobi CMCC 1337 of 2008.
2. *Republic v Terrence Davidson*, Nairobi CMCC 1338 of 2008.

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## **DEFINITION OF TERMS:**

A **capital market** is a financial market in which financial assets with a maturity term of more than one year are traded. It consists of both the primary market where newly issued securities are distributed among investors, and the secondary markets where already existent securities are traded.<sup>1</sup> While a bond market handles the buying and selling of debt securities, a stock market typically handles the buying and selling of company stocks and other securities. Companies, financial institutions or governments issue bonds as a means of borrowing long-term funds. They are normally issued for a fixed number of periods and are repayable on maturity.

An **efficient market** is one in which prices fully reflect all available information on a stock market, and all market participants are privy to the information; therefore no investor has an advantage in predicting the return on stock.<sup>2</sup>

**Information asymmetry** refers to the information imbalance between financial service providers and the investors they deal with. An example is corporate officers, company directors and persons in similar positions who generally have access to information that may not be available to all investors. Those persons with easy and or prior access to this

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<sup>1</sup> Capital Markets Authority website.

<[http://www.cma.or.ke/index.php?option=com\\_docman&task=cat\\_view&gid=22&itemid=30](http://www.cma.or.ke/index.php?option=com_docman&task=cat_view&gid=22&itemid=30)> Accessed 30 June 2010.

<sup>2</sup> S. M. Bainbridge, 'An Overview of Insider Trading Law and Policy: An Introduction to the Insider Trading Research Handbook' [2012] *No. 12-15 UCLA School of Law, Law-EconResearch Paper Series* 1-37, 26. <SSRN: <http://ssrn.com/abstract=2141457>> Accessed on 30 October 2012.

information may profit from it before public release.<sup>3</sup> Public policy-making bodies have attempted to alleviate this phenomenon by prohibiting such trading activities of insiders.

The term **insider** is generally used to describe people who by virtue of their relationship with the company have privileged access to information about the company and its affairs that are not generally known to the public or securities market.<sup>4</sup> This information may be used by a person either to buy securities at their current price before the information becomes public and causes prices to rise, or to sell securities at their current price before the price falls when that information becomes public.

**Insider trading** refers to buying, selling and dealing in shares and securities of a listed company by insiders such as directors, officers of management team, employees of the company or any other connected persons such as auditors, consultants, lawyers, analysts who possess material inside information which is not available to the investing public.<sup>5</sup>

**Investor protection** refers to the protection accorded to shareholders and creditors by the legal system. Investors obtain certain rights or powers when they finance firms, for instance the right to receive certain corporate information. All non-controlling investors need their interests and rights protected if they are to reap the justified benefits of their investment. Outside investors face the risk that returns on their investments will never materialize. This is

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<sup>3</sup> George .E. O, Akingunola R.O, and Oseni J.E, 'The Influence of Information Asymmetry on Initial Public Offers in the Nigerian Stock Market' [2012] (92) *International Research Journal of Finance and Economics* 32-42, 34. < <http://www.internationalresearchjournaloffinanceandconomics.com>> Accessed 12 October 2012.

<sup>4</sup> N. Walter, 'Prioritizing Enforcement in Insider Trading', (2012) (30) 2 *Yale Law and Policy Review*, 521-530, 522. < SSRN: <http://ssrn.com/abstract=2140867>> Accessed on 30 October 2012.

<sup>5</sup> V. Sharma, 'Prohibition on Insider Trading: A Toothless Law?'(Law School Research Paper No. 996, University of London-Centre for Commercial Law Studies 2009) 5. < SSRN: <http://ssrn.com/abstract=1400824>> Accessed 19 January 2010.

because of the possibility of expropriation by the managing and controlling shareholders, often referred to as the “insiders.”<sup>6</sup>

**Participants** in the capital markets include investors: both individual and corporate, issuers, stockbrokers and investment banks and the market regulator. An issuer is a publicly traded company, one that raises money by issuing its own stock. Stockbrokers are intermediary institutions that assist investors to trade shares at the stock exchange, while investment banks are also investment intermediaries, but with a wider mandate that includes authority to buy shares in their own name.

**Securities regulation** as used in this paper refers to the creation by government, state authorities and self-regulatory organizations of rules, standards and controls that aim to shape or prohibit certain behaviour, decision-making and transactions in financial markets and institutions.

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<sup>6</sup> N. Walter, ‘Prioritizing Enforcement in Insider Trading’, (2012) (30) 2 *Yale Law and Policy Review*, 521-530, 521, 522. < SSRN: <http://ssrn.com/abstract=2140867>> Accessed on 30 October 2012.

## 1. CHAPTER ONE: A BROAD OVERVIEW AND LAYOUT OF RESEARCH

“I realise the important role of the capital markets in accelerating the raising of capital to finance investment in key areas such as infrastructure to help propel Kenya to middle income status by year 2030.”<sup>7</sup> Mr. Kungu Gatabaki, newly appointed chairman of the Capital Markets Authority.

Kenya’s new long term development blue-print ‘Kenya vision 2030’ aims to create a globally competitive and prosperous country with a high quality of life by the year 2030. A key sector under this development blueprint is the creation of a vibrant financial sector which is to be achieved through the deepening of financial markets by raising institutional capital and tapping international sources of capital.<sup>8</sup> This deepening of financial markets has generally been found to promote economic development and it is also the case that well-functioning capital markets are known to increase economic efficiency, investment and growth.<sup>9</sup>

Indeed, the importance of capital markets to an economy should not be underestimated since capital markets provide a mechanism by which businesses obtain equity capital and long term loans from the public. These markets ensure an efficient transfer of monetary resources from those who save money towards those who need capital. Also, from the investors’ perspective, joint stock companies facilitate fast, safe and simple way of transfer of property through the sale and purchase of shares in the stock market. Thus, the stock market facilitates investment in financial assets. In addition, it provides a gateway into

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<sup>7</sup> Nation Reporter, ‘Vision 2030 to Guide New CMA Chair’ *Business News, Daily Nation* (Nairobi 16 June 2011), 33.

<sup>8</sup> Government of Kenya, *Kenya Vision 2030* (Ministry of Planning and National Development, Nairobi 2007) 76.

<sup>9</sup> R. Ngugi et al, ‘Capital Market, Financial Deepening and Economic Growth in Kenya’ (Conference Paper) 1. < Stable URL: <http://www.csae.ox.ac.uk/conferences/2009-EDiA/papers/513-Isaya.pdf>> Accessed 12 February 2010.

Kenya for global and foreign portfolio investors, which is critical in supplementing the low domestic saving ratio.<sup>10</sup>

It is noteworthy that our development blueprint recognises that a strong regulatory framework promotes public investor confidence, enhances market integrity and is conducive for companies and financial markets to become internationally competitive.<sup>11</sup>

This is in keeping with the public interest theory of regulation which states that regulatory frameworks ensure market abuse such as insider trading does not thrive.<sup>12</sup> Insider trading, which is the focus of this study, is generally prohibited because it favours few insiders with advantageous information while denying the same to the public.

The public interest theory of regulation referred to above also posits that legal reform is deemed necessary where such abuses are not contained. This is because they would otherwise undermine public investor confidence, market integrity and global competitiveness. It is in consonance with this view that many countries that have adopted insider trading legislation, including Kenya, continue to reform these legislation.

In the case of Kenya, the Capital Markets Act expressly prohibits insider trading and establishes this practice as a criminal offence. Despite this prohibition, there have been very few prosecutions and none of these have been successful partly due to challenges faced in the prosecution process. It is within this context that this study investigates the

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<sup>10</sup> Ibid.

<sup>11</sup> Government of Kenya, *Kenya Vision 2030* (Ministry of Planning and National Development, Nairobi 2007) 76.

<sup>12</sup> R. A. Posner, 'Theories of Economic Regulation' [1974] 5(2) *The Bell Journal of Economics and Management Science* 335-358, 335. < Stable URL: <http://www.jstor.org/stable/3003113>> Accessed 3 January 2011.

challenges in the prosecution of the offence of insider trading and examines whether reforms would as a result promote a fair and efficient capital market.

Due to resource constraints, the focus of this study is narrowed to challenges arising out of the legal provisions on insider trading. It is, however, acknowledged that although the legal framework is of immense importance, the development of a vibrant capital market requires a lot more than an adequate legal framework.<sup>13</sup>

### **1.1. Background to the Study**

Dealing in shares and stocks in Kenya started in the 1920's as a sideline business conducted by accountants, auctioneers, estate agents and lawyers.<sup>14</sup> The Nairobi Stock Exchange, the country's only securities exchange, was established in 1954 through registration as a voluntary association of stockbrokers under the Societies Act and was subsequently incorporated as a company limited by guarantee.<sup>15</sup> As is the case with a number of other securities exchanges around the world, the Nairobi Stock Exchange was a mutual exchange owned by its members who acquired such membership by owning seats on the exchange. At the dawn of independence, activity in the exchange slumped due to the uncertainty of trading conditions in a newly independent Kenya. After independence, however, Kenya achieved sustained economic growth and there were a number of highly oversubscribed public issues of shares. Share prices fell with the inflation resulting from the oil crisis in 1972.

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<sup>13</sup> J. Gakeri, 'Enhancing Securities Markets in Sub-Saharan Africa: An Overview of the Legal and Institutional Arrangements in Kenya' [2011] 9 (1) *International Journal of Humanities and Social Sciences* 134-169, 136< [http://www.ijhssnet.com/journals/vol\\_1\\_9\\_Special\\_Issue\\_July2011/18.p.d.f](http://www.ijhssnet.com/journals/vol_1_9_Special_Issue_July2011/18.p.d.f)> Accessed 12 July 2012.

<sup>14</sup> Nairobi Securities Exchange Website< [www.nse.co.ke](http://www.nse.co.ke)> Accessed 20 November 2012.

<sup>15</sup> J. McFie, '*High Quality Financial Reporting: The Case of the Nairobi Stock Exchange*' (Lambert Academic Publishing, Germany 2010) 90.



Over the years, concerns have raised about inadequate corporate governance standards and poor performance as an exchange and more specifically regarding the ownership and directorship structure where a significant number of the directors of the Nairobi Stock Exchange are stock brokers and ownership was pegged to trading privileges.<sup>16</sup> This pointed to inherent conflict of interest between the owners, the members and the management.

As is the trend in exchanges worldwide, it was proposed that demutualization would restructure the governance at the Nairobi Stock Exchange.<sup>17</sup> By separating ownership rights from trading rights, board appointments would be by the shareholders of the exchange rather than by appointment on the basis of membership to the exchange. It was, therefore, hoped that that the resultant board would be a representative board comprised of individuals who have the knowledge, capacity, skill, experience and expertise to take decisions that are in the best interest of the stock exchange, relevant stakeholders and the market as a whole and not merely for the benefit of the individual interests groups and member companies which the directors might feel they have the obligation to represent.

The demutualization process commenced in 2005 and in July 2011, the Nairobi Stock Exchange Limited changed its name to the Nairobi Securities Exchange Limited thereby reflecting the evolution into a full service securities exchange.<sup>18</sup> In September 2011 the Nairobi Securities Exchange, as part of the demutualization efforts, converted from a

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<sup>16</sup> VIPsight Archives Africa – Kenya  
<[http://vipsight.eu/index.php?option=com\\_content&view=article&id=22&Itemid=68&lang=en](http://vipsight.eu/index.php?option=com_content&view=article&id=22&Itemid=68&lang=en)> Accessed on 20 November 2012.

<sup>17</sup> The Finance Act 2010 which came into force on January 1, 2011 contained amendments to the Capital Markets Act and in particular, Section 20 of the Capital Markets Act (Cap. 485A) was amended to provided that a securities exchange licensed under the Act should be incorporated as a company limited by shares.

<sup>18</sup> This supports trading, clearing and settlement of equities, debt, derivatives and other associated instruments.

company limited by guarantee to a company limited by shares and adopted a new Memorandum and Articles of Association reflecting the change.<sup>19</sup> The impact of these efforts remains to be realized.

With regard to its regulatory framework, the Rules and Regulations of the Nairobi Stock Exchange were published in 1954, reprinted with amendments in 1981 and subsequently revised. The Exchange published its listing manual in 2002. The 'Continuing Listing Obligations applicable to all Market Segments' reproduces the Fifth Schedule of The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations 2002, drawn up by the Capital Markets Authority, and is stated as such.<sup>20</sup>

The Nairobi Securities Exchange (NSE) is a self-regulatory organization and is the secondary market and the sole licensed trading exchange in the country. It is supervised by the Capital Markets Authority (CMA). All applications for listing at the stock exchange must be approved by the CMA, and are subject to NSE Rules and Regulations.

Meanwhile, the Capital Markets Act and subsidiary legislation governing takeovers and mergers, collective investment schemes, foreign investors, and guidelines on corporate governance makes up the core regulatory framework for capital markets and securities in Kenya. The Capital Markets Authority Act was promulgated in 1989.<sup>21</sup> It established a capital markets and securities regulatory body, the Capital Markets Authority (CMA), which was set up in the same year. Subsequently in July 2000, the Capital Markets

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<sup>19</sup> Nairobi Securities Exchange Website <<http://www.nse.co.ke/media-center/press-release.html?start=120>> Accessed 20 November 2012.

<sup>20</sup> Ibid.

<sup>21</sup> J. McFie, *'High Quality Financial Reporting: The Case of the Nairobi Stock Exchange'* (Lambert Academic Publishing, Germany 2010) 91.

Authority Act was amended to include new provisions expanding the powers of the authority.<sup>22</sup> It was renamed the Capital Markets Act.

The systematic development of Kenya's capital markets and securities can be traced back to a government decision in 1980 to cut back on the operations of the public enterprise sector in order to broaden the base of ownership and enhance capital market development. In 1984, the International Finance Corporation and the Central Bank of Kenya conducted a study on the "Development of Money and Capital Markets in Kenya." This study became a blueprint for structural reforms in the financial markets. It recommended the need to develop capital markets in order to facilitate long term capital.<sup>23</sup> Further, the government indicated its commitment in facilitating growth of the capital market reform in late 1980s, which saw the introduction of institutional and policy reforms.<sup>24</sup>

The Capital Markets Act establishes the Capital Markets Authority as the statutory regulator, with the objective of promoting, regulating and facilitating the development of an orderly, fair and efficient market in Kenya.<sup>25</sup> Another objective of the Capital Markets Authority is the protection of investor interests, for instance through the prohibition and criminalisation of insider trading.<sup>26</sup> This is because investors need protection given that they are often faced with the possibility of investing their money in entities which expose

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<sup>22</sup> J. Gakeri, 'Enhancing Securities Markets in Sub-Saharan Africa: An Overview of the Legal and Institutional Arrangements in Kenya' [2011] 9 (1) *International Journal of Humanities and Social Sciences* 134-169, 142< [http://www.ijhssnet.com/journals/vol\\_1\\_9\\_Special\\_Issue\\_July2011/18.p.d.f](http://www.ijhssnet.com/journals/vol_1_9_Special_Issue_July2011/18.p.d.f)> Accessed 12 July 2012

<sup>23</sup> R. Ngugi et al, 'Capital Market, Financial Deepening and Economic Growth in Kenya' (Conference Paper) 3. < Stable URL: <http://www.csae.ox.ac.uk/conferences/2009-EDiA/papers/513-Isaya.pdf>> Accessed 12 February 2010.

<sup>24</sup> See Government of Kenya, *Sessional Paper No1 of 1986 on Economic Management for Renewed Growth* (Ministry of Planning and National Development, Nairobi 1986).

<sup>25</sup> Capital Markets Act preamble.

<sup>26</sup> Capital Markets Act s 11(d).

their investment to unnecessary risks, mismanagement or lack of accountability thereby imposing agency costs on them.<sup>27</sup>

The Capital Markets Act is the law governing insider trading in Kenya. This Act prohibits insider trading, stipulates the statutory defences and sets out the sanctions for insider trading. It makes the CMA responsible for the licensing, regulation and supervision of all capital markets participants.<sup>28</sup> The Act also disseminates rules and regulations and is empowered to carry out enforcement and sanctions.

In the enforcement of existing laws, the courts in Kenya have recognised that the rationale behind the prohibition of insider trading is the promotion of market integrity by enhancing an orderly and fair operation of the market.<sup>29</sup> This was highlighted during the country's first trials for insider trading in which Bernard Mwangi Kibaru and Terrence Davidson were unsuccessfully prosecuted. These formed the basis of concern over the adequacy of existing insider trading legislation in Kenya.<sup>30</sup>

This study will make use of the challenges in the prosecution of the two cases to investigate the limitations of the Capital Markets Act in combating insider trading in Kenya with a view to charting a path for reform.

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<sup>27</sup> K. Mwaura, 'The Failure of Corporate Governance in State Owned Enterprises and the Need for Restructured Governance in Fully and Partially Privatized Enterprises: The Case of Kenya.' [2007] 31 (14) *Fordham International Law Journal*-34-75, 40.  
<<http://ir.lawnet.fordham.edu/ilj>> Accessed 5 January 2010.

<sup>28</sup> The Capital Markets Authority also supervises the Nairobi Securities Exchange (NSE).

<sup>29</sup> *Republic versus Bernard Mwangi Kibaru*, Nairobi CMCC 1337 of 2008, 8.

<sup>30</sup> P. Wanyama, 'Kenya: Why Law on Insider Trading Needs Urgent Overhaul,' *Business Daily (Nairobi)* (Nairobi 29 November 2010). < <http://www.propertykenya.com/news/1391618-cobrand!-> > accessed 11 June 2010.

## **1.2. Research Problem**

Kenya aspires to create a vibrant and globally competitive financial sector by deepening its financial markets. The achievement of this goal is, however, threatened by the existence of market abuses such as insider trading, which are known to render capital markets unattractive to potential investors and which may lead to the loss of existing investors.

Although the Capital Markets Act prohibits an insider from trading while in possession of information which is non-public and price-sensitive, this prohibition is plagued by several challenges. These arise due to ambiguity in the formulation of the set of facts that must be proven beyond reasonable doubt in order to convict a defendant for the crime of insider trading. These facts are that the defendant was an insider; that the defendant transacted while in possession of inside information and that the information in question was price-sensitive and had not been disclosed to the public.

Currently, the existence of this set of facts is very difficult to prove mainly due to the conceptual cloudiness with which the offence of insider trading is formulated. The concept of price-sensitive information is plagued with vagueness and ambiguity and there are no objective criteria for determining whether a corporate entity can be said to be in possession of information, as well as for determining whether or not this information is public. These conceptual obscurities raise evidentiary difficulties for the prosecution and enable accused persons to easily raise doubts as to the existence of any element of the crime in order to obtain an acquittal.

A likely consequence of this situation is the prevalence of insider trading and consequently a lowered investor confidence in our capital markets hence operating as a drawback to the achievement of the aspirations set out in the national development blueprint.

In a nutshell, this study examines the extent to which weaknesses in the provisions relating to insider trading in the Capital Markets Act hinder the prosecution of this offence.

### **1.3. Literature Review**

The literature review commences with the discussion on why insider trading is viewed as a problem in this paper. It then examines literature on enforcement of insider trading law and notes the paucity of relevant literature on the financial market in Kenya. It thus moves on to learnings from other jurisdictions and analyses how literature on insider trading in other developed markets treats challenges to the enforcement of insider trading laws. Finally, it narrows down on the knowledge gap which is the focus of the paper.

To begin with, a considerable amount of seminal works have been published around the academic debate on insider trading. Several arguments are presented against insider trading; the most common of which is that insider trading is ‘unfair.’ This is because insiders obtain access to and are able to obtain profit from information to which other market participants lack access.<sup>31</sup> Secondly, insider trading hampers the company’s potential to attract more investors because the public may begin to perceive the financial markets as scams.<sup>32</sup> They then lose faith in the stock market and decide to put their savings elsewhere, making firms unable to raise capital through stock issues. Thirdly, insider trading damages investor confidence in the integrity of the financial markets where a fiduciary duty or other relationship of trust exists because this trust is breached when an

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<sup>31</sup> See for example E.M.Cinar ‘The Issue of Insider Trading in Law and Economics: Lessons for Emerging Markets in the World’ [1999] 19 (4) *Journal of Business Ethics* 345-353, 346. <<http://www.jstor.org/stable/25074103>> Accessed on 31 July 2009; J. Hartmann, ‘Insider Trading: An Economic and Legal Problem.’ <<http://www.gonzagajil.org/pdf/volume1/Hartmann/Hartmann.pdf>> Accessed 5 August 2010; H. McVea, ‘What’s wrong with insider dealing?’ [1995] 15(3) *Legal Studies* 390-414. <<http://onlinelibrary.wiley.com/doi/10.1111/j.1748-121X.1995.tb00527.x>> Accessed 1 August 2010.

<sup>32</sup> See D.W. Carlton. and D.R. Fischel, “The Regulation of Insider Trading”, (May 1983) 35 (5) *Stanford Law Review* 857-895. <Stable URL: <http://www.jstor.org/stable/1228706>> Accessed 29 July 2009.

insider trades in the securities of the company based on corporate confidential information for personal gain.<sup>33</sup> Fourthly, it is argued that insider trading delays the flow of information since a manager who wants to profit from information must withhold it from colleagues until after his stock transactions.<sup>34</sup> Such delay of transmission of information within the firm potentially hampers decision-making and the taking of corporate action in the firm thereby causing injury to the firm. This may further injure the firm's reputation when it becomes widely known as an 'insider's firm'. Fifthly, insider trading is likely to lead to a conflict of interests between a firm and its managers, as insider managers tend to work for their own interests and not that of the firm or shareholders.

On the other hand, there are economists and legal scholars who contend that laws making insider trading illegal should be revoked.<sup>35</sup> These include Henry Manne, Milton Friedman, Thomas Sowell, Daniel Fischel and Frank H. Easterbrook. They hold the view that insider trading based on information which is material and non-public benefits investors in general by more quickly introducing new information into the market. Other arguments are that insider trading is the most appropriate form of compensation package in terms of financial benefits arising from trade in securities, thereby providing incentives for managers. This policy debate is rehashed by later authors.<sup>36</sup>

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<sup>33</sup> See E.M.Cinar 'The Issue of Insider Trading in Law and Economics: Lessons for Emerging Markets in the World' [1999] 19 (4) *Journal of Business Ethics* 345-353, 347.  
<<http://www.jstor.org/stable/25074103>> Accessed on 31 July 2009.

<sup>34</sup> See H. McVea, 'What's Wrong with Insider Dealing?' [1995] 15(3) *Legal Studies* 390-414,405.  
<<http://onlinelibrary.wiley.com/doi/10.1111/j.1748-121X.1995.tb00527.x>> Accessed 1 August 2010.

<sup>35</sup> See for example H. G. Manne, 'The Case for Insider Trading,' (March 2003) *The Wall Street Journal Online* 1-3.<<http://people.wku.edu/indudeep.chhachhi/519files/519hout/Instr0303.pdf>> Accessed 1 August 2010; D.W. Carlton. and D.R. Fischel, 'The Regulation of Insider Trading' (May 1983) 35 (5) *Stanford Law Review* 857-895, 857. <Stable URL: <http://www.jstor.org/stable/1228706>> Accessed 29 July 2009.

<sup>36</sup> S. M. Bainbridge, 'An Overview of Insider Trading Law and Policy: An Introduction to the Insider Trading Research Handbook' [2012] *No. 12-15 UCLA School of Law, Law-EconResearch Paper Series* 1-37, 24-34. < SSRN: <http://ssrn.com/abstract=2141457>> Accessed on 30 October 2012.

It is noteworthy that there is practically no empirical evidence indicating that insider trading is the most efficient and accurate form of compensation.<sup>37</sup> Indeed, despite the foregoing academic debate, all major economies have legislation prohibiting insider trading and these are supported by varying policy backgrounds. For example, insider trading has been criminalised in the United Kingdom in part so that there is no inequality of bargaining power between one party who has inside information which the other party could not have, and also so as to preserve a perception of market integrity among investors.<sup>38</sup>

Thus, this widespread legislation is in keeping with the general view that allowing insiders to trade at the expense of uninformed outsiders diminishes investor confidence and hurts the integrity of the capital markets. It is for these reasons that this paper takes the position that insider trading should indeed be prohibited.

In the local context, literature on various aspects of capital markets in Kenya includes research on the role of the legal and institutional framework in securities markets governance and investor protection, the need for high quality disclosure and the adequacy of regulation of capital market intermediaries.<sup>39</sup>

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<sup>37</sup> See Professor Bainbridge in *Diamond v. Oreamuno*, 248 N.E. 2<sup>nd</sup> 910, 912 (N.Y.C.A) [1969].

<sup>38</sup> A. Hudson, 'Criminal Offences in the Law of Finance' in *The Law of Finance* (Sweet and Maxwell, London 2009) 301.

<sup>39</sup> See for example J. Gakeri, 'Enhancing Securities Markets in Sub-Saharan Africa: An Overview of the Legal and Institutional Arrangements in Kenya' [2011] 1(9) *International Journal of Humanities and Social Sciences* 134-169 < [http://www.ijhssnet.com/journals/vol\\_1\\_9\\_Special\\_Issue\\_July2011/18.p.d.f](http://www.ijhssnet.com/journals/vol_1_9_Special_Issue_July2011/18.p.d.f) > Accessed 12 July 2012. J.B. McFie, 'High Quality Financial Reporting: The Case of the Nairobi Stock Exchange' (Lambert Academic Publishing, Germany 2010); L.W. Mathu, 'The Investor and Capital Market Intermediaries: Is the Investor Adequately Protected?' (LLM Thesis, University of Nairobi School of Law 2008).



Among these studies is Jacob Gakeri's exploration of the role of legal norms in the enhancement of securities markets in Kenya.<sup>40</sup> He postulates that appropriate legal and institutional frameworks are necessary for securities markets to thrive and deepen. He highlights that the legal framework must facilitate the proper functioning of the securities markets by ensuring that relevant disclosure requirements are complied with.

Gakeri further argues that whereas developing jurisdictions can learn from legal regimes of jurisdictions with deep and vibrant securities markets, such laws should not be replicated without testing their appropriateness. He asserts that rules and institutions that function well in one country may not be appropriate in another because of the absence of supportive norms and corresponding institutions. This factor is recognised in this paper while gathering strengths of insider trading legislation in various jurisdictions for their comparative value. These strengths provide a point of reference for proposing improvements to Kenya's law only where weaknesses or gaps have been identified. In this way, Kenya's legal framework is brought in line with developments globally.

One of the weaknesses an emerging economy is likely to experience lies in the quality of information and its disclosure.<sup>41</sup> In relation to this, James Mc Fie investigates the meaning of high quality financial reporting and examines disclosure in annual reports of forty seven companies listed on the Nairobi Stock Exchange to see if it can be described as "high

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<sup>40</sup> J. Gakeri, 'Enhancing Securities Markets in Sub-Saharan Africa: An Overview of the Legal and Institutional Arrangements in Kenya' [2011] 1(9) *International Journal of Humanities and Social Sciences* 134-169, 136 < [http://www.ijhssnet.com/journals/vol\\_1\\_9\\_Special\\_Issue\\_July2011/18.p.d.f](http://www.ijhssnet.com/journals/vol_1_9_Special_Issue_July2011/18.p.d.f) > Accessed 12 July 2012.

<sup>41</sup> E.O. George, R.O Akingunola and J.E Oseni, 'The Influence of Information Asymmetry on Initial Public Offers in the Nigerian Stock Market' [2012] (92) *International Research Journal of Finance and Economics* 32-42, 33. < <http://www.internationalresearchjournaloffinanceandconomics.com> > Accessed 12 October 2012.

quality.”<sup>42</sup> He finds that the use of International Financial Reporting Standards is a vital factor in assisting companies move towards high quality disclosure. His book is relevant because he provides unique insight into the Capital Markets Authority regulations and Nairobi Securities Exchange requirements on disclosure and assesses them in light of international standards. The present study will analyse Kenya’s formulation of the legal provisions on insider trading and in that process assess the adequacy of existing disclosure requirements to Kenya’s markets.

Whereas literature on Kenya’s capital markets is silent on enforcement of the law, countries with developed markets appear to have more studies and publications on the enforcement of existing insider trading laws explaining challenges they have faced with regard to the elements of the offence of insider trading and how these were overcome. These works also point to varying approaches in the application and enforcement of the law on insider trading from which Kenya can draw, taking into account the underlying variations and differences.

How does literature on insider trading in developed economies treat challenges to the enforcement of insider trading laws? Howard Chitimira critically assesses the South African Securities Services Act. This Act came into effect in February 2005 and consolidated the law relating to the regulation and control of exchanges and securities trading such as the Stock Exchanges Control Act, the Financial Services Board Act, the Financial Markets Control Act and the Custody and Administration of Securities Act.<sup>43</sup>

He notes that the new Act was aimed at introducing adequate and more effective

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<sup>42</sup> J. McFie, *‘High Quality Financial Reporting: The Case of the Nairobi Stock Exchange’* (Lambert Academic Publishing, Germany 2010).

<sup>43</sup> H. Chitimira, ‘The Regulation of Insider Trading in South Africa: A Roadmap for Effective, Competitive and Adequate Regulatory Statutory Framework’ (LLM Thesis, School of Law at University of Fort Hare 2008) 73. <<http://hdl.handle.net/10353/230>> Accessed 21 October 2011.

legislation to free the South African financial markets and companies from illicit practices such as insider trading. Although some amendments and new offences for market abuse practices were introduced by the Securities Services Act, Chitimira observes that many deficiencies in the Insider Trading Act of 1998 Act were simply carried over into the New Act. He therefore seeks to investigate and expose these deficiencies for purposes of recommending practical measures that may be taken to resolve the insider trading problem in South Africa. While Chitimira highlights the strengths and weaknesses of the new Act, he explains that the new Act retains many weaknesses of the previous Act with little or no changes to them.

With regard to insider information, Chitimira notes that the South African Act presents knowledge on the part on the insider that he has inside information as a prerequisite for liability without requiring that the defendant be shown to have deliberately exploited the inside information in concluding the illicit transaction.<sup>44</sup> Although the regulators would have to prove that the defendant was aware that his information was inside information, he observes that this removes the overwhelming evidentiary difficulties which would otherwise be placed on regulators to prove that the defendant had deliberately exploited the inside information.<sup>45</sup>

Further, the Securities Act retains the criteria to be used in determining what information qualifies as ‘inside information’.<sup>46</sup> The first criterion is that the information ought to be specific or precise. Therefore, market transactions based on vague or general information,

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<sup>44</sup> South African Securities Services Act s 73 and 77.

<sup>45</sup> H. Chitimira, ‘The Regulation of Insider Trading in South Africa: A Roadmap for Effective, Competitive and Adequate Regulatory Statutory Framework’ (LLM Thesis, School of Law at University of Fort Hare 2008) 78. <<http://hdl.handle.net/10353/230>> Accessed 1 October 2011.

<sup>46</sup> South African Securities Services Act s 74. See repealed Insider Trading Act s 3.

rumours, suspicion, conjecture, speculation or combination thereof do not fall within the purview of the Act.

The second criterion is that information must be of a non-public nature in order to ground liability; the Act provides ample guidance to assist in making the determination that information has been stripped of its non-public character. Any information is regarded as having been made public when it is published in accordance with the rules of the relevant regulated market to inform investors and their advisors; when contained in public records maintained by the relevant statutory regulator; when it can be readily acquired by those likely to deal in securities; or is derived from information which has been made public. Information may be regarded as having been made public even if it can only be acquired by persons exercising diligence, or expertise or by observation; it is communicated to a section of the public and not to the public at large; it is communicated only on payment of a fee or it is only published outside the republic. Thus, prompt disclosures of new developments by insiders may significantly reduce their exposure to liability for the use of such information in their market transactions. The third criterion is that the information must have been obtained by a person while occupying the status of insider. The fourth criterion is that the information ought to be material; information that is likely to have a material effect on the price or value of any securities or financial instrument.

Amongst the flaws Chitimira identifies, and that is relevant to this study, is the absence of mandatory disclosure requirements for the reporting of transactions consummated by insiders. He also notes that the Securities Services Act does not establish an affirmative duty of disclosure for companies or institutions that come into possession of material

price-sensitive information.<sup>47</sup> Such requirements make trading by the insiders a matter of public record thereby deterring insiders from dealing in non-public material information. Such reporting is likely to enhance market efficiency because it enlarges the pool of information from which market analysts can draw in performing their tasks. He notes that a mandatory duty on insiders would ensure that non-public price-sensitive inside information is disclosed in such a way that all stakeholders are given equal access to relevant information and at the same time to minimize the possibility of any unfair advantage to a few selected persons.

Chitimira's assessment of the South African legal and institutional framework in light of international developments is a source of useful benchmarks for studying Kenyan legislation especially on inside information, and non-public information. The applicability of these benchmarks to Kenya's situation will be examined in this work. This study will also assess the extent and adequacy of existing mandatory disclosure requirements in Kenya.

Another author, Vaibav Sharma, studies the Indian securities market and considers why there is a poor enforcement rate there despite the existence of regulation prohibiting insider trading.<sup>48</sup> He opines that India needs to bring its securities market to the level of the security markets of United States (U.S) and the United Kingdom (U.K). These being the two largest financial markets of the world, they can act as a guide to the emerging market of India. Although he examines insider trading from the time of first regulation against it

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<sup>47</sup> H. Chitimira, 'The Regulation of Insider Trading in South Africa: A Roadmap for Effective, Competitive and Adequate Regulatory Statutory Framework' (LLM Thesis, School of Law at University of Fort Hare 2008) 79, 102. <<http://hdl.handle.net/10353/230>.> Accessed 21 October 2011.

<sup>48</sup> V. Sharma, 'Prohibition on Insider Trading: A Toothless Law?' (Law School Research Paper No. 996, University of London-Centre for Commercial Law Studies 2009) 8. <[SSRN:http://ssrn.com/abstract=1400824](http://ssrn.com/abstract=1400824)> Accessed 19 January 2010.

in the United States, United Kingdom and India up until the present time, he fails to show how the drafting of the Indian Law has contributed to poor enforcement. He is likewise not very specific on why the provisions in the old UK law make it difficult to secure convictions.

Among Sharma's proposals for improving India's enforcement regime is the reduction of disclosure time to one day and that disclosure should be made to both the exchange as well as the regulator as opposed to the exchange only. He also suggests the increase in criminal penalties to make them more punitive and deterrent as well as the introduction of civil penalties based on the profits made or loss avoided, as is done in the United States. While he studies the gap between the enactment and enforcement of insider trading law in the Indian context, this paper studies it in the Kenyan context. The present study will also investigate the relevance and applicability of his proposals to the Kenyan context.

Sharma explains enforcement gaps by the legislative history of countries; that for the United States, the main idea behind the laws was to provide a deterrent effect in society and so it was thus expected that no more than a few insider traders would be caught. For the United Kingdom, enforcement was quite low until recent years because insiders were treated as criminals, giving the prosecution a heavy burden of proof which was difficult to discharge. This rendered enforcement costly. He states other factors contributing to the low enforcement as legislation which was drafted in such a way as to make enforcement well-nigh impossible with the burden of proof being inappropriately placed and the standard of proof being too high; agencies charged with administering the law also lacked the desire, enthusiasm, resources or expertise to enforce the law.

Edward Swan and John Virgo in their more recent work, observe that the failure of a number of high profile criminal trials exposed weaknesses in the UK insider trading laws

arising from reliance on criminal penalties which were difficult to prove.<sup>49</sup> The difficulties in proof arose from the use of concepts that were difficult to define such as “price-affected securities”. Indeed the entire criminal prosecution process is considered cumbersome, time consuming, and obtaining a conviction requires the proof of the *mens rea* constituting the offence beyond reasonable doubt. The authors note that this gap in protection was filled by the introduction of express market abuse prohibitions, commonly referred to as ‘the civil offence of market abuse’ as well as UK’s implementation of the European Union Market Abuse and Insider Trading Directive which required adoption of common regulatory provisions by all European Union (EU) member States and cooperation between those states to prevent market abuse from being initiated in one state and impacting on others. These included steps to make markets more transparent, such as requiring the reporting of suspicious transactions, disclosing inside information and disclosing insider trades in an issuers’ financial instruments among other requirements.

Swan and Virgo observe that under UK’s Financial Services and Markets Act (FSMA), information is considered precise if it is specific enough to enable a conclusion to be drawn as to the possible effect of circumstances that exist or may reasonably be expected to come to existence.<sup>50</sup> With regard to publicity, information is said to be generally available when it has been disclosed in accordance with the rules of the prescribed market; is contained in records open to public inspection or can be accessed publicly via the internet or can be obtained by research or analysis.<sup>51</sup>

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<sup>49</sup> E. Swan and J. Virgo, *Market Abuse Regulation* (Oxford University Press, London 2010) 6.

<sup>50</sup> Financial Services and Markets Act s 118 c (5).

<sup>51</sup> Financial Services and Markets Act s 118c (8) and (9).

It is admitted that financial crimes are generally difficult to prove.<sup>52</sup> The recognition of these practical problems has sometimes resulted in judicial leniency enabling the prosecution to secure convictions without meeting its burden of proof on all necessary elements of the case.<sup>53</sup> As part of the lessons drawn from other jurisdictions, this paper will examine the response of the courts to these challenges in Kenya.

From the foregoing, this paper identifies a knowledge gap in the paucity of academic work on the challenges faced in the prosecution of the offence of insider trading in the Kenyan context. In order to complement existing literature and analysis of the legal framework on insider trading in Kenya, primary data will be sourced through questionnaires and follow-up interviews with key informants at the Capital Markets Authority and legal practitioners.

#### **1.4. Theoretical Framework**

Within the ordinary business context, taking advantage of the less informed position of other parties is common and in the absence of misrepresentation or fraud is rarely prohibited. This is especially where such information is acquired through diligence and zeal.

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<sup>52</sup> See generally N. Dorn, 'The Metamorphosis of Insider Trading in the Face of Regulatory Enforcement' [2011], 19 (1) *Journal of Financial Regulation and Compliance* 75 – 84, 76, 81. <<http://dx.doi.org/10.1108/13581981111106185>> Accessed on 23 October 2012; Carvajal Ana and Elliott Jennifer, 'The Challenge of Enforcement in Securities Markets: Mission Impossible?' [2009] WP/09/168 *IMF Working Paper*, 1-37. < SSRN: <http://ssrn.com/abstract=1457591>> 21 November 2012; K. Langenbucher, 'The 'Use or Possession' Debate Revisited—Spector Photo Group and Insider Trading in Europe' [2010] 5 (16) *Capital Markets Law Journal* 452-470, 457. < <http://cmlj.oxfordjournals.org/>> Accessed 20 November 2012.

<sup>53</sup> See generally K. Langenbucher, 'The 'Use or Possession' Debate Revisited—Spector Photo Group and Insider Trading in Europe' [2010] 5 (16) *Capital Markets Law Journal* 452-470. < <http://cmlj.oxfordjournals.org/>> Accessed 20 November 2012.



However, it is a principle of common law that if a director or other officer of a company makes use of confidential information acquired as a consequence of his office for his own personal gain, he thereby breaches his fiduciary duty to the company and is liable to account to the company for any profit made.<sup>54</sup> This obligation not to profit from a position of trust is a manifestation of the obligation to avoid a conflict arising between duty and one's personal interest. A difficulty arises in applying such conflict of duty and interests to insider trading especially in cases where the insider is buying shares from outsiders to whom he owes no fiduciary duty.

The rationale for the criminalisation of insider trading is centred on the debate between the two broad schools of thought on insider trading. On the one hand, that insider trading enhances market efficiency and on the other hand that it is a demonstration of a lack of market integrity. The main reason for criminalisation is to deter insiders from obtaining an unfair advantage of inside information and earning profits from the lack of knowledge of the outsiders.<sup>55</sup> This problem is created when there is asymmetric information, that is, managers and other insiders know more about the current condition and future prospects and problems of the firm than outside investors. The insiders can exploit this information at the expense of investors.<sup>56</sup> The concern is with such information being acquired by virtue of the insider's position with the company and where such information is

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<sup>54</sup> See *Green and Clara Pty Ltd v Bestobell Industries Pty Ltd* (1982) 1 ACLC 1.

<sup>55</sup> See A. Hudson, 'Criminal Offences in the Law of Finance' in *The Law of Finance* (Sweet and Maxwell, London 2009) 326.

<sup>56</sup> E.O George, R.O Akingunola, and J.E Oseni, 'The Influence of Information Asymmetry on Initial Public Offers in the Nigerian Stock Market' [2012] (92) *International Research Journal of Finance and Economics* 32-42, 34. < <http://www.internationalresearchjournaloffinanceandconomics.com>> Accessed 12 October 2012.

unavailable to an outsider no matter what degree of diligence or zeal the outsider possesses.

Thus, parties are held responsible for insider trading because of acquiring information in a fiduciary capacity, knowing it was intended for a company, purpose and not for trading for personal gain. In addition, they may be held responsible because of misappropriating information belonging to the issuing company, whether or not that individual is a corporate insider.<sup>57</sup>

Market regulation could be approached from different perspectives. This is in light of the theories that have been advanced to explain government regulation of the economy. The two main theories of market regulation are the 'public interest' theory and the 'economic theory.' Richard Posner, a proponent of the public interest theory, holds the view that regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market practices.<sup>58</sup> This theory encompasses the idea that people need protection from business abuses and market failures. The regulatory body is, therefore, considered to represent the interest of the general society in which it operates rather than the private interests of the regulators.

On the other hand, according to George Stigler's economic theory, the original purposes of a regulatory program are thwarted through the efforts of the interest group because regulatory agencies over time come to be dominated by the industries they regulate. Thus, the regulator fails to act in the interest of the general society and focuses only on the

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<sup>57</sup> N. Walter, 'Prioritizing Enforcement in Insider Trading', (2012) (30) 2 *Yale Law and Policy Review*, 521-530, 522. < SSRN: <http://ssrn.com/abstract=2140867>> Accessed on 30 October 2012.

<sup>58</sup> R. A. Posner, 'Theories of Economic Regulation' [1974] 5(2) *The Bell Journal of Economics and Management Science* 335-358, 335. < Stable URL: <http://www.jstor.org/stable/3003113>> Accessed 3 January 2011.

interest group that has captured it. Such interest groups include insiders such as market professionals and corporate managers at the expense of shareholders and the public generally. This theory insists with the political scientists that economic regulation serves the private interests of politically effective groups. Considering that insiders form the minority group and cannot be said to have captured the regulatory process with regard to insider trading, Stigler's theory is not considered applicable in this study.

The theoretical framework within which the problem under study is explored is the public interest theory of regulation. Under this theory, laws are promulgated to serve the interests of the general public, and where such interests are not served, the laws ought to be reformed.

The public interest theory assumes that markets are extremely fragile and likely to operate very inequitably if left alone, resulting in market failures. Thus the occurrence of a market failure justifies governmental intervention by way of regulation because of the grave consequences such failure is likely to have on an economy. Examples of market failures include risks posed by information asymmetry, systemic instability, market manipulation and misconduct as well as anticompetitive behaviour such as abuse of monopolies.<sup>59</sup> Whereas competition is healthy and highly encouraged because of its positive effects on product quality and price, regulatory intervention is deemed opportune where competition is suppressed through creation of cartels, restriction of entry or exit into the market among others. As such, this regulation ameliorates market failures for the benefit of broader civil society and is necessary only to the extent to which it corrects the targeted market failure.

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<sup>59</sup> E.O George, R.O Akingunola and J.E Oseni, 'The Influence of Information Asymmetry on Initial Public Offers in the Nigerian Stock Market' [2012] (92) *International Research Journal of Finance and Economics* 32-42, 33, 34. < <http://www.internationalresearchjournaloffinanceandconomics.com>> Accessed 12 October 2012.

The public interest theory embraces the correction of market failures as the main criterion against which regulatory outcomes are to be assessed. In light of this, theorists call for regulatory reform rather than deregulation thereby revealing their basic commitment to the position that regulatory failures are not inevitable.<sup>60</sup>

Whereas it is argued that the theory suffers from a lack of supporting empirical evidence as well as from significant conceptual vagueness, it enjoys some modest support from the fact that regulators sometimes act to further general interests; a phenomenon which might not be completely explained by competitor theories.<sup>61</sup>

The public interest theory is adopted in this work because securities regulation is viewed as having been put in place as a response to market failures, more specifically, market abuses stemming from information asymmetry. As already stated, this asymmetry arises when insiders obtain and make use of information to which general investors do not have access. The public interest view holds that governments regulate securities to facilitate the efficient functioning of security markets by ameliorating market failures, for the benefit of broader civil society. In securities, the public interest would be served if the market system allocated information in a socially efficient manner.

In the case of Kenya, the Capital Markets Act creates offences which are part of the way in which the capital market is regulated. These offences form part of criminal law and so the enforcement process entails criminal proceedings.<sup>62</sup> As is the requirement with criminal offences, a formal prosecution is commenced. The defendant must then be proved to have

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<sup>60</sup> S. P. Croley, 'Theories of Regulation: Incorporating the Administrative Process' [1998] 98(1) *Columbia Law Review* 1-168, 70. < Stable URL: <http://www.jstor.org/stable/1123396>> Accessed 7 January 2011.

<sup>61</sup> See for example George Stigler's economic theory.

<sup>62</sup> A. Hudson, 'Criminal Offences in the Law of Finance' in *The Law of Finance*. (Sweet and Mawell, London 2009) 293.

committed the offence with a 'criminal intent.' Further, the offence must be proved by evidence which establishes the defendant's guilt beyond reasonable doubt. This high standard must be met if a criminal offence is to be proved.

The application of the public interest theory of regulation in this work also takes into account that the legal system in Kenya is based on the English common law system. The reason for this is historical, that Kenya was previously a colony of Great Britain. As such, principles of English law and English legal concepts are generally applicable under the Kenyan legal system.<sup>63</sup> In addition, many of the statutes have been drafted based on existing English statutes. Thus, although market failure justifies regulatory intervention under the public interest theory of economic regulation, Kenya's law is likely to have been drafted based on market failure experience in the United Kingdom and elsewhere.<sup>64</sup> Indeed it is observed that regulatory modernization in Sub-Saharan Africa has historically not been a reaction to crises but is typically a by product of piecemeal reform and replication of developments in other jurisdictions.<sup>65</sup>

Thus, the effectiveness of regulatory intervention, though difficult to measure, is gauged in this paper by the experience of other jurisdictions in applying similar provisions, the extent to which the elements of the crime of insider trading can be proved in order to sustain a conviction, as well as the experiences of legal practitioners.

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<sup>63</sup> This fact is evidenced by the Judicature Act (Chapter 8, Laws of Kenya), which sets out the sources of law applicable in Kenya and requires the Kenyan courts to exercise their jurisdiction in conformity with the substance of common law, doctrines of equity and statutes of general application in force in England in 1897. The application of the substance of English common law and doctrines of equity is subject to any Kenyan statutes that override the common law or equitable doctrines, and is applicable only so far as the circumstances in Kenya permit.

<sup>64</sup> J. Gakeri, 'Financial Services Regulatory Modernization in East Africa: The Search for a New Paradigm for Kenya' [2011] 1 (16) *International Journal of Humanities and Social Sciences* 161-172, 161 <[http://www.ijhssnet.com/journals/vol\\_1\\_9\\_Special\\_Issue\\_July2011/18.p.d.f](http://www.ijhssnet.com/journals/vol_1_9_Special_Issue_July2011/18.p.d.f)> Accessed 12 July 2012.

<sup>65</sup> Ibid.

The general approach in this study is that the challenges experienced in the prosecution of the offence of insider trading have the effect of promoting information asymmetry; the mitigation of these challenges through effective prohibition of insider trading will as a consequence ensure the flow of information to the general public. Thus, the purpose of securities regulation as viewed from the lens of the public interest theory will have been achieved.

### **1.5. Objectives**

The objectives of this research are as follows:

1. To assess whether the legal provisions relating to ‘inside information’ and ‘material price sensitive information’ impede upon the prosecution of the offence of insider trading.
2. To assess whether the legal provisions relating to ‘public information’ and ‘possession of information’ impede upon the prosecution of the offence of insider trading.
3. To assess the adequacy of the legal provisions on disclosure of information in curbing the offence of insider trading.

### **1.6. Research Justification**

Given the pivotal role that the capital markets are expected to play in the attainment of Kenya’s development blueprint ‘vision 2030,’ it is imperative that obstacles to the attainment of a fair and efficient market are examined and rooted out through legal reform. In view of this, the concerns that there have been no convictions based on the existing law on insider trading ostensibly due to challenges in the application of the legal provisions in the insider trading law ought to be studied and the relevant law subjected to reform. It is

therefore hoped that this study will add to the body of knowledge that will inform the reforms in the existing securities legislation.

### **1.7. Hypothesis**

The provisions in the Capital Markets Act relating to inside information, material price-sensitive information, publication of information, possession of information and disclosure of information are vaguely formulated and are therefore difficult to prove, thus hindering the effective prosecution of the offence of insider trading.

### **1.8. Research Questions**

1. To what extent do the legal provisions on ‘inside information’ and ‘material price sensitive information’ impede upon the prosecution of the offence of insider trading?
2. To what extent do the legal provisions on ‘public information’ and ‘possession of information’ impede upon the prosecution of the offence of insider trading?
3. To what extent are the legal provisions on disclosure of information adequate in curbing the offence of insider trading?

### **1.9. Methodology**

This research is doctrinal and empirical in nature. Whilst the doctrinal approach helps in the analysis of legislative provisions, case law and legal principles, the empirical approach assists in the collection of data. This is conducted through questionnaires that are administered to key informants at the Capital Markets Authority and legal practitioners because of their experience in application and enforcement of the Capital Markets Act. Data sought from the informants includes their experience with and perceptions about challenges in the prosecution of the offence of insider trading; more specifically the

provisions relating to the meaning of inside information, price-sensitive information, material information, publication of information, possession of information by a body corporate and disclosure of information. This is then triangulated with the analysis. The empirical approach provides a useful complement to the doctrinal approach and sheds light on perceptions held by legal practitioners with regard to the legal provisions under study.

### **1.10. Chapter Breakdown**

Chapter one provides a broad overview, literature review, theoretical framework, layout and methodology of the research.

Chapter two analyses the legal provisions on insider trading in the Capital Markets Act and makes use of case law to illustrate existing challenges to their enforcement.

Chapter three presents a survey of the shortcomings of existing legislation as experienced by legal practitioners in Kenya as well as their views on the proposals for reform. It then discusses the findings and draws conclusions.

Chapter four addresses the challenges posed by inadequacies in the legal provisions identified in the previous chapters. While drawing lessons from other jurisdictions, it examines the extent to which proposed bills and regulations address these challenges.

Chapter five concludes and makes suggestions for reform in light of the study's findings. It, thereafter, sums up the study.



## **2. CHAPTER TWO: INADEQUACIES IN THE LEGAL PROVISIONS**

This chapter examines the formulation of the core elements of the offence of insider trading and makes use of Kenyan cases to analyse how these inadequacies present a challenge to the prosecution of this offence. It is an investigation of the inadequacies in the legal provisions on insider trading. Thus, the research in this section contributes to the overall study by examining whether the text of the law on insider trading in Kenya creates an environment in which the ideal of market efficiency can be experienced through the effective prohibition of insider trading.

As discussed previously, the Capital Markets Act prohibits an insider from trading while in possession of information which is non-public and price-sensitive.<sup>66</sup> On this basis, the elements of the insider trading offense can be summarised as the dealing in securities by a person who is an insider; who possesses certain information; the information is non-public; and the information is also price-sensitive. Considering that insider trading is a criminal offence under the Act, the prosecution is expected to prove these elements beyond reasonable doubt in order to secure a conviction for the offence.

As stated in the previous chapter, this study will give emphasis to the application of the provisions of the Capital Markets Act in the country's first trials for insider trading, since these cases demonstrate weaknesses in the application of existing law. The trials involving Mr. Bernard Kibaru and Terence Davidson arose from alleged insider trading involving the shares of a retail supermarket chain, Uchumi Limited, which is a public limited company

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<sup>66</sup> Capital Markets Act s 32 A and 33.

incorporated in 1975 under the Companies Act.<sup>67</sup> The cases evolved from similar set of facts and could actually be considered as one.

In brief, the facts are that Mr. Terrence Davidson who was the Chief Executive Officer of Kenya Commercial Bank, Uchumi's bankers, was accused of being privy to information on the financial status of the company when he instructed his stockbroker to sell Uchumi Limited shares just a few days before the retail supermarket chain collapsed.<sup>68</sup>

A similar allegation was made against Mr. Bernard Kibaru, who at the time was a senior executive at Uchumi and who disposed of his shares in the company just a few days before it collapsed.<sup>69</sup> In its judgement, the court found for the defendants, highlighting that the company's information memorandum clearly showed that the company was making losses and was technically insolvent and the losses were a fact known to the public. The alleged information-processing channel in the Uchumi cases is illustrated overleaf.

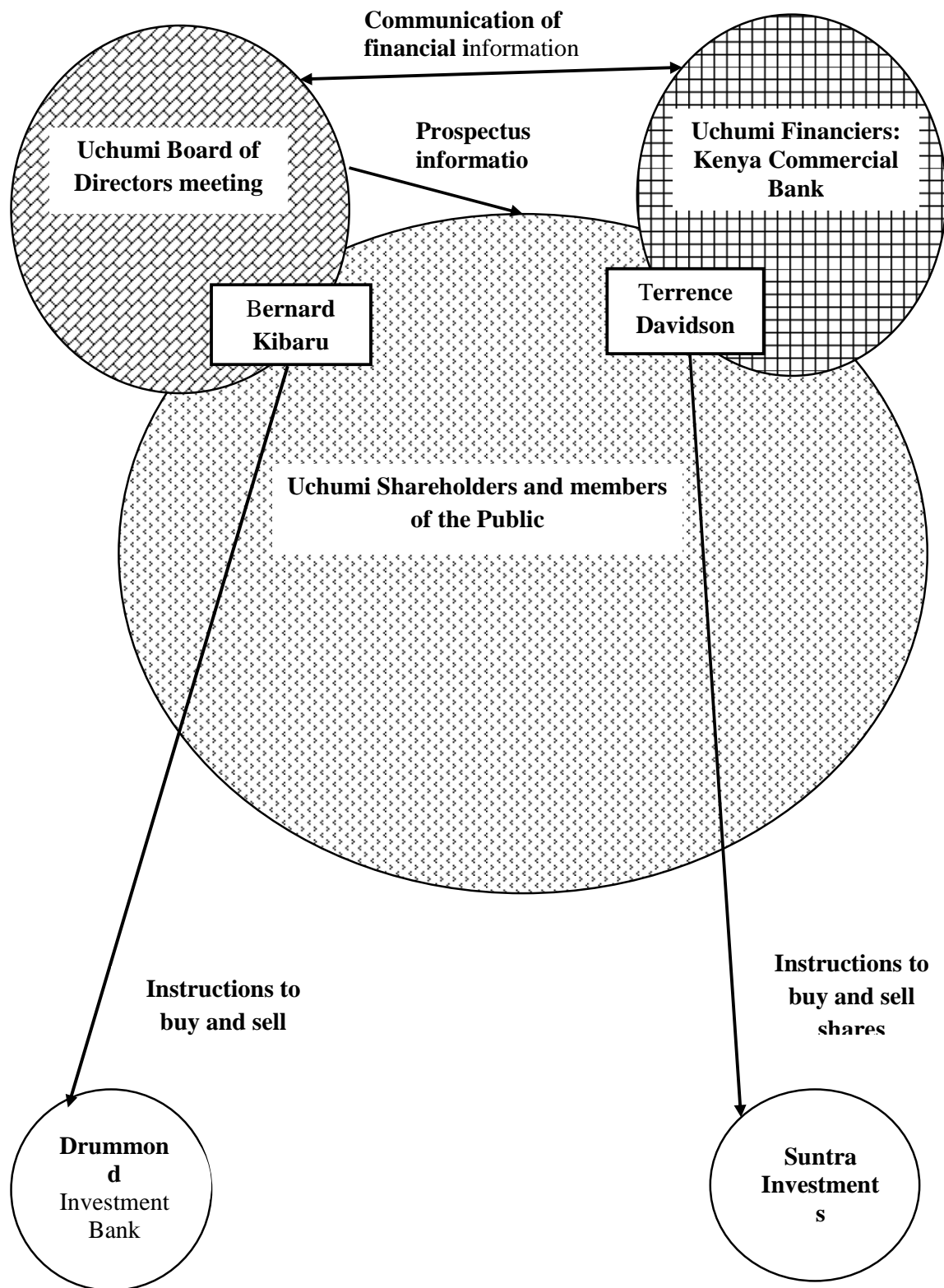
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<sup>67</sup> Chapter 486 of the Laws of Kenya. See <[www.uchumi.com](http://www.uchumi.com)>: In early 2000s Uchumi started to experience financial and operational difficulties occasioned by a sub-optimal expansion strategy coupled with weak internal control systems. This resulted in a marked dwindling of the Company's resources which culminated in its inability to meet its obligations on an ongoing basis. Initial restructuring of Uchumi did not forestall the deteriorating performance of the Company. Eventually, in May 2006, the Board of Directors resolved that the Company ceases operations and in June 2006, the Company was placed under receivership. Simultaneously, the Capital Markets Authority (CMA) suspended the Company's listing on the Nairobi Securities Exchange (NSE). The company's receivership was however lifted in 2010 after an upward turn of affairs and the company was successfully re-listed in the Nairobi Securities Exchange in May 2011.

<sup>68</sup> *Republic versus Terrence Davidson*, Nairobi CMCC 1338 of 2008.

<sup>69</sup> *Republic versus Bernard Mwangi Kibaru*, Nairobi CMCC 1337 of 2008.

*Figure 1: Alleged information processing channel in the Uchumi cases*



While making reference to these cases, it will be demonstrated that the concept of inside information is plagued with vagueness and ambiguity and that conceptual difficulties arise in determining what information is non-public and price-sensitive. It will also be established that there are no objective criteria which determine publication of information as well as how information can be possessed by a corporate entity. Cumulatively, these factors raise evidentiary difficulties for the prosecution of the offense and enable accused persons to utilise the existing loopholes to obtain acquittals.

### **2.1. Ambiguity in the Meaning of Inside Information**

The Capital Markets Act prohibits insider trading in Kenya.<sup>70</sup> The Act further prohibits the use of unpublished price-sensitive information and proscribes the dealing in securities by insiders on the basis of unpublished price-sensitive information.<sup>71</sup> Moreover, an insider is prohibited from communicating such information or counselling or procuring others to deal in securities on the basis of this information.<sup>72</sup> As a consequence, the Act discourages conduct that may facilitate the practice of insider trading and any activities related to it.

The definition of an insider is provided in the Capital Markets Act as follows:

*“Any person who is or was connected with a company, or is deemed to have been connected with a company and who is reasonably expected to have access, by virtue of such connection, to unpublished information which, if made generally available, would be likely to materially affect the price or value of the securities of*

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<sup>70</sup> Section 33 of the Act is the operative provision in so far as prohibition of insider trading is concerned. This section embodies the general rule, defences and prescribes harsh criminal sanctions for offenders. It identifies the persons who must not deal in securities by virtue of their connection with a body corporate in the preceding six months.

<sup>71</sup> The Capital Markets Act in section 32A prohibits the use of unpublished price-sensitive information.

<sup>72</sup> Capital Markets Act s 33 (4).

*the company, or who has received or has had access to such unpublished information.”*<sup>73</sup>

From this definition, it is observable that the concept of information is central to the prohibition of insider trading. An offence will only be committed when a person has inside information which is used to deal in securities. It is, therefore, surprising that the Act does not give guidance with regard to the meaning of ‘information’. The term is susceptible to a number of interpretations. It is a term that is used in a vacuous and broad manner, thereby begging the question, what exactly is meant by the term ‘information’ under the Capital Markets Act?

The literal interpretation of this term information would be open to include material that could vary from the contents of a prospectus all the way through to rumours and even speculations. This possibility for open interpretation would easily accord a defence to insider traders if they were to claim that they transacted their trade based on insider information which was already available in the market in the form of speculation.

The evidence of this ambiguity is demonstrated by the case of *The Republic versus Bernard Mwangi Kibaru* in which the accused was charged with the offence of insider trading.<sup>74</sup> The prosecution alleged that the accused was prompted to sell shares on the basis of information he had obtained by virtue of his position in Uchumi Supermarkets. This information, that the company was performing poorly and that it continued to make losses, was allegedly not generally available to the public. In order to prove its case, the prosecution called six witnesses. They testified that before the accused sold his shares, he was the head of the buying and merchandising department and had been attending the

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<sup>73</sup> Capital Markets Act s 2. See also s 32A and s 33.

<sup>74</sup> *Republic versus Bernard Mwangi Kibaru*, Nairobi CMCC 1337 of 2008.

Uchumi board of directors meeting where the poor performance of the company was discussed. The accused was subsequently put on his defence and the defence demonstrated that Uchumi's poor performance and the pulling out of its major shareholders was a matter that had been publicized in the newspapers.

The court outlined the issue for determination as whether or not the accused by virtue of his position as an employee of Uchumi Supermarkets had obtained, in the course of his employment, information which was generally unavailable to the public and which information he exploited in selling his shares in the company. Eventually, the accused was acquitted on the ground that he had based the sale of his shares on information that had been publicized in the newspapers.

The significance of this case is that for purposes of determining whether information is in the public domain, a newspaper report is deemed acceptable as information. A fundamental objection to this view is that a newspaper report could range from an official corporate advertisement, to a criticism by a competing corporate entity, to a tabloid article replete with the latest gossip or even to a well-researched article from a credible source. Whereas all these are probable contents of newspaper articles, they are not of equal reliability and credibility.

The problems of proof arising from the broad and vacuous meaning of the term information are exacerbated by the need to establish this information as the basis for the prohibited transaction. This requirement is reflected in section 32A of the Act which makes reference to insider trading as trading on the 'basis' of unpublished insider information. It is arguable that the basis of an individual's decision is a mental element, which can only be known to the transacting party. As such, an external party may never really be in a position to determine such a basis unless it is expressed orally or in writing

by the decision-maker. Indeed, the mere existence of information in the public domain does not necessarily mean that trade was conducted on the basis of this public information. Thus, unless there is a confession, it would appear that the prosecution may find it impossible to secure a conviction under section 32A of the Act.

From the foregoing, it should be sufficient for the prosecution to demonstrate the mere possession or knowledge of non-public information by an insider at the time of the offending transaction in order to ground liability. In order to secure convictions, there would be need for an amendment of section 32A, to replace dealing in securities 'on the basis of ' with 'while in the possession of' or 'knowledge of ' of non-public information. This is instead of the existing requirement that the prosecution must establish the basis of the insider's decision to trade; which, as seen above, is virtually impossible. Such an amendment would also motivate the prompt disclosure of material information by insiders and corporations.<sup>75</sup>

A final point in relation to insider information is that the definition of an insider in section 33 implies a person-connection; meaning that what makes a person an insider is not their connection to information but their connection to the company. It creates a causal link between employment in a body corporate and acquisition of information.<sup>76</sup> Under this approach, the prosecution would need to prove that the accused had been an insider, and further, that information obtained in their condition as insider was the basis of the transaction in question. This creates an even more onerous burden the prosecution to discharge.

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<sup>75</sup> South African Securities Services Act in sections 73 and 77 merely requires knowledge as a prerequisite for liability. It does not require that the defendant be shown to have deliberately exploited the inside information.

<sup>76</sup> Capital Markets Act s 33(11).

Illustrative of this is the case of *The Republic versus Bernard Mwangi Kibaru* where the prosecution had to prove the ‘person-connection’ and did this by demonstrating that before Kibaru sold his shares, he was the head of the buying and merchandising department and had been attending the Uchumi board of directors meeting where the poor performance of the company had been discussed.

It is noticeable that this link between employment in a body corporate and acquisition of information bears the underlying assumption that price-sensitive information is acquired only in the course of employment. Thus, the consideration that information was obtained when “it was not in the ordinary course of business” could avail an acceptable defence under the Capital Markets Act. Again, such an approach begs several unanswered questions: What is the ordinary course of business? Is this limited to the ordinary hours of work? Is this limited to communication between persons who have dealings resulting from work-related relationships? Are there situations which could be considered borderline, for instance information exchanged over a social evening drink by colleagues? The uncertainty created by these questions that are not dealt with in the law could be used by the defence to show that information was not obtained in the ordinary course of business and as such provide a loophole to escape liability.

## **2.2. Lack of Clarity in the Determination of Material Price-Sensitive Information**

Price-sensitive information generally means any information that relates directly or indirectly to a listed company and which if published, is likely to materially affect the price of securities of such company.

This information that is unknown to the public may be used by a person who wants to buy securities at their current price before the information becomes public and causes prices to



rise. For example, an insider with information about a potential merger by can gain advantage by buying shares in the company before the news of the merger becomes public, which would ordinarily result in the share price of the company increasing. A person who has the information and wants to sell securities at their current price before the information becomes public and causes prices to fall could likewise use such information. An example is a director selling shares in his company before negative news about the company reaches the public domain, after which the price of such shares usually declines.

Although insiders are still free to participate in the financial markets, the transactions they engage in are limited to those for which the information has no price implications or for which the information is public since a total ban on trading by insiders would constitute an unjustifiable limitation to their freedom of economic activity. This is also the case in developed markets where insider trading prohibitions have undergone careful definition and judicial interpretation.<sup>77</sup> It is noteworthy that the Capital Markets (Securities) (Public Offers, listing and Disclosure) Regulations 2002 defines material information as ‘any information that may affect the price of an issuer’s securities or influence investment decisions. The regulations thereafter provide a list of such information.’<sup>78</sup> This definition and list is replicated in the Nairobi Securities Exchange Management and Membership rules.<sup>79</sup>

It is therefore a matter of significance that whereas the Capital Markets Act in section 32A makes reference to ‘unpublished price sensitive information’ and prohibits the use of

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<sup>77</sup> S.M. Bainbridge ‘An Overview of Insider Trading Law and Policy: An Introduction to the Insider Trading Research Handbook’ [2012] *No. 12-15 UCLA School of Law, Law-Econ Research Paper Series* 1-37, 3. < SSRN: <http://ssrn.com/abstract=2141457>> Accessed on 30 October 2012.

<sup>78</sup> See Regulation 2.

<sup>79</sup> Nairobi Securities Exchange Website <<http://www.nse.co.ke/regulatory-framework/category/42-nairobi-securities-exchange-nse.html>> Accessed 21 October 2011.

unpublished insider information, arguments have been raised about vagueness in the use of either term. The Act makes use of the terms ‘unpublished price sensitive information’, and unpublished insider information interchangeably and again in section 33 expressly prohibits the use of price-sensitive information by persons connected to a body corporate.

A brief review of the case of *The Republic versus Terrence Davidson Alias Terry Davidson* will help explain the challenges in prosecuting the offence of insider trading resulting from such ambiguity in the application of the terms publication and materiality of information.<sup>80</sup> The accused in this case was charged with two counts and four alternative charges of insider trading.<sup>81</sup> The prosecution’s position was that the accused was the Chief Executive Officer and the Managing Director of Kenya Commercial Bank (KCB). KCB were the bankers of Uchumi Supermarkets Ltd and the main Uchumi transaction account was held at KCB where all sale proceeds were banked. The charges against the accused were premised on the contention that, as the Chief Executive Officer of KCB, he was in a position to get price-sensitive information on Uchumi that was not generally available. It was alleged that this information was the basis upon which the accused sold his shares.

The defence demonstrated that Uchumi’s poor performance and the pulling out of its major shareholders was a matter that had been publicized in the newspapers. In addition, the defence was of the view, and the court concurred, that financial information was not

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<sup>80</sup> Considering that Kenya relies on judicial precedent and these are decisions of the magistrates’ court, these judgments are not binding on other courts but are of persuasive value. A judgment by the High Court or Court of Appeal would have been preferable as it would set a precedent on insider trading case in Kenya. The judgments are however useful for this study as they provide a practical indication of how existing insider trading provisions of law have generally been understood, interpreted and applied.

<sup>81</sup> *Republic versus Terrence Davidson*, Nairobi CMCC 1338 of 2008.

material information as it was not included in the list provided in the Capital Markets (Securities) (Public Offers, Listing and Disclosure) Regulations 2002.

In delivering its judgment, the court found that the information availed to KCB regarding Uchumi was financial in nature and that the financial improvement experienced by Uchumi immediately after the rights issue was what was anticipated in the information memorandum of the rights issue that had been supplied to the public. Further, Uchumi's poor performance and the pulling out of its major shareholders was a matter that had been publicized in the newspapers and was, therefore, not unavailable to others. The accused was, therefore, acquitted on all charges. As a result of the ambiguous definition of material price-sensitive information, the issue in this case became one of interpretation; whether or not financial information is material or price-sensitive.

Admittedly, it is important to have a clear definition or criteria to determine 'publication' and 'material information' in order to impose certain restrictions against the use of such privileged or insider information for personal benefit before such information becomes available to the public market. Given that the standard of proof in insider trading prosecutions is beyond reasonable doubt, like in all criminal matters, the absence of a clear definition or criteria creates a loophole through which insider traders can escape liability. This applies especially when they begin to challenge the nature of the information involved and cast doubts as to its publication or materiality.

This paper takes the approach that the decision of the court in *The Republic versus Terrence Davidson*, in finding that financial information is not material information, flies in the face of the rules of statutory interpretation. Indeed, according to the literal rule of interpretation, the words of a statute must be interpreted according to their ordinary, literal and grammatical sense as found in the dictionary. Notably, the Capital Markets

(Securities) (Public Offers, listing and Disclosure) Regulations 2002 defines material information as ‘any information that may affect the price of an issuer’s securities or influence investment decisions. The regulations thereafter provide a list of such information.’<sup>82</sup> Using the literal rule of interpretation, the list provided in the regulations could not be deemed to be exhaustive especially because the provision states that such material information “includes” the provided information.<sup>83</sup> The mere fact that the financial information was not listed does not mean, as the court in its wisdom would like us to believe, that financial information is not material information. The final item on the list which reads “or any other peculiar circumstances that may prevail with respect to the issuer or the relevant industry” is further indicative of the non-exhaustive nature of the list provided.

Indeed, the *ejusdem generis* rule which applies to resolve the problem of giving meaning to groups of words where one of the words is ambiguous or inherently unclear is applicable here as well. On the whole, the rule states that where "general words follow enumerations of particular classes or persons or things, the general words shall be construed as applicable only to persons or things of the same general nature or kind as those enumerated." <sup>84</sup>

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<sup>82</sup> See Regulation 2.

<sup>83</sup> In the case of *Fisher versus Bell* [1961] 1 QB 394, the defendant, a shopkeeper, was prosecuted for displaying an illegal flick-knife for sale. Because it is an offense to offer such an item for sale under the Restriction of Offensive Weapons Act (1951) he was convicted. On appeal, however, it was held that *offer for sale* has a technical meaning in law, and a shop window display is an Invitation to treat, not an offer in contractual terms. The conviction was therefore quashed. In 1961 a further Act was passed making it an offense to 'expose for the purpose of sale' an offensive weapon.

<sup>84</sup> In the case of *Powell versus Kempton Park Race Course* [1899], A.C 143, it was an offence to use a “house, office, room or other place for betting” and the defendant was operating from a place outdoors. The court held that “other place” had to refer to other indoor places because the words in the list were indoor places and so he was not guilty.

Applying the *ejusdem generis* rule, the final item on the list which reads “or any other peculiar circumstances that may prevail with respect to the issuer or the relevant industry” in the Capital Markets (Securities) (Public Offers, listing and Disclosure) Regulations 2002 ought, therefore, to be understood in a particular context. It ought to be understood in the context of any information that may affect the price of an issuer’s securities or influence investment decisions. The foregoing arguments strongly support the position that financial information definitely falls within this wider bracket.

### **2.3. Lack of Criteria to Define Publication of Information**

As alluded to in the foregoing discussion, publication is a critical factor in determining whether or not a transaction is prohibited. The reason behind this is that, unpublished insider information may be utilised by a person who wants to buy securities at their current price before the information becomes public and causes prices to rise. On the other hand, the information could be used by a person who wants to sell securities at their current price before the information becomes public and causes prices to fall could likewise use it.

It is therefore important to note that the Capital Markets Act is silent on when information can properly be said to have been published. To a great extent, this is an omission whose consequences to the prosecution process should not be underestimated.

The impact of uncertainty in the meaning of public information is illustrated in the case of *The Republic versus Terrence Davidson* whose facts have been described above.<sup>85</sup> As discussed, the defence in that case ably demonstrated that Uchumi’s poor performance was a matter that had been publicised in the newspapers. It is noteworthy that the decision by KCB to stop financing Uchumi was not public, and was known to Davidson on account of

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<sup>85</sup> *Republic versus Terrence Davidson*, Nairobi CMCC 1338 of 2008.

his position at the Bank. However, Davidson's trading despite his precise knowledge about Uchumi's true financial situation was not sufficient to sustain a conviction just because it was shown that there was public knowledge about Uchumi's general poor financial position.

Thus, whereas it was publicised in the newspapers that Uchumi was generally performing poorly, the decision by KCB to stop financing Uchumi was not known to the public. The ruling in this case seems to suggest that the position in Kenya with respect to publication of information is that information that is partially non-public is still considered public information. It matters not that only some and not all information is not in the public domain; and so long as only some of the information is in the public domain then the information is concluded to be in the public domain and any trade conducted on the basis of such information will not qualify as insider trading.

This case further provokes pertinent questions as follows: Is mere publication in newspapers sufficient publication? Should this publication take a specific form?

As was noted in the case of *The Republic versus Bernard Mwangi Kibaru*, the accused was acquitted on the ground that he had based the sale of his shares on information that had been publicized in the newspapers. This ruling seems to suggest that for purposes of determining whether information is in the public domain, a newspaper article suffices as publication of information.

It is noteworthy that objections could be raised to this view because newspapers vary in terms of content, reliability, credibility among other differences. In addition, the information could be published by the issuing company or even speculators in which case

reliability would vary depending on the source of the article. It may, therefore, not be entirely sufficient to term all newspaper articles as publication.

From the foregoing discussion, it is clear that there are no objective criteria with which to determine when information can be said to have been published. As demonstrated above, this becomes a problem of proof for the prosecution and a loophole that can be explored by accused persons to obtain acquittals.

#### **2.4. Difficulties in Assessing Possession of Information by Corporate Bodies**

An examination of the Capital Markets Act indicates that Section 33 is the operative provision in so far as prohibition of insider trading is concerned. It identifies the persons who must not deal in securities by virtue of their connection with a body corporate in the preceding six months. These include an officer of that body corporate or of a related body corporate, a director, secretary, executive officer, or employee, receiver, receiver manager, official manager or his deputy, or a trustee of the body corporate.<sup>86</sup> The person could also be a substantial shareholder in that body corporate or in a related body corporate; or occupies a position that may reasonably be expected to give him access to information.

The definition of an insider in the Act envisages a natural person as well as a juristic person in the form of a corporate entity.<sup>87</sup> This is evidenced by the existence in the Capital Markets Act of penalties for insider trading for natural persons as well as for companies. Again, sanctions for contravening the Act include fines for corporate bodies and a fine and/or imprisonment for natural persons.<sup>88</sup> In addition, the Act makes reference to

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<sup>86</sup> Capital Markets Act s 33 (9).

<sup>87</sup> Capital Markets Act s 33.

<sup>88</sup> Capital Markets Act s 33 (12).

defences that corporate entities may rely on. These defences are set out in section 33(5b), section 33(7) and section 33(8) of the Capital Markets Act and are listed below.

The first provision is section 33(5)(b) which precludes a bearer of insider information from communicating that information if he knows or has reason to believe that the other person will make use of the information to deal in or procure another person to deal in those securities. This avails a defence where the insider can demonstrate that they did not know or have reason to believe the other person will make use of the information to deal in the securities. The second provision is section 33(7), which enables a body corporate to enter into transactions at any time even if one of its officers is in possession of insider information so long as the decision to transact was entered by another person other than the officer; there were arrangements to ensure that insider advise or information was not communicated and that indeed the insider advise or information was not communicated. The third provision is section 33(8) which allows bodies corporate to trade in securities of other bodies corporate based on insider information. This is in instances where the information is obtained in the course of duty at their own body corporate relating to proposed dealing by their body corporate in the securities of the other body corporate.

The Capital Markets Act defines an insider as follows:

*“Any person who is or was connected with a company, or is deemed to have been connected with a company and who is reasonably expected to have access, by virtue of such connection, to unpublished information which, if made generally available, would be likely to materially affect the price or value of the securities of the company, or who has received or has had access to such unpublished information.”*<sup>89</sup>

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<sup>89</sup> Capital Markets Act s 2. See also section 32A and 33.



This definition could be applied to investment banks as well as their employees, underwriters, financial analysts, lawyers as well as persons who come across insider information in a casual or fortuitous manner from persons connected to companies.

The foregoing discussion and definition raises a number of salient questions that are not covered by the Act. When then, does a corporate body become an insider trader? How does a corporate possess information? How does the requirement for knowledge in section 33(5) (b) apply to corporate bodies?

A corporate body can become an insider because it is possible for bodies corporate to trade in securities of other bodies corporate. This becomes insider trading when the transaction is based on insider information. In instances where the information has been obtained in the course of duty at their own body corporate relating to proposed dealing by their body corporate in the securities of the other body corporate, the Act provides a defence to the offence of insider trading.<sup>90</sup>

With regard to possession of information, a primary and superficial approach would be the physical possession of information in the form of physical files, computers, and flash disks etcetera by a corporate body.

Information may also be possessed in a non-tangible sense by individuals within the body corporate because they know or are aware of the information. Because the Act does not state how a body corporate possesses information, inferences would have to be drawn from the law of agency and the Companies Act.<sup>91</sup>

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<sup>90</sup> Capital Markets Act s 33(8).

<sup>91</sup> The Companies Act, Chapter 486 of the Laws of Kenya.

Corporate entities are run by natural persons, usually those who make up the board of directors. Since the board is responsible for the day-to-day management of a company, it would, therefore, have to be inferred that where information is possessed by a majority of the board or in the alternative by the directing mind and will of the corporate, then that corporate is deemed to possess the information. Under the law of agency too, a company can be said to possess information where the information is in the possession of the company's agents who have authority to receive information on the company's behalf. Several inferences that have to be drawn above may well be an indicator that the insider trading law with regard to corporate entities is not sufficiently laid down in the Act and may become evidentiary hurdles during prosecution.

To sum up, whereas the Act foresees insiders as natural persons as well juristic persons, its focus lies more on natural persons. Thus, it fails to provide for juristic persons, such as corporate entities, and how they can be considered as insiders.

## **2.5. Gaps in Information Disclosure Requirements**

The Capital Markets Act obliges all companies that offer securities for sale to the public to publish an information memorandum in compliance with requirements prescribed by the authority.<sup>92</sup> These disclosure requirements are to be fulfilled before an issuer is permitted to distribute its securities through the stock exchange. A further requirement is the continual disclosure of developments which may lead to substantial movement in the price of its securities.<sup>93</sup> This is because with the passage of time from the initial prospectus distribution, the disclosure contained in the prospectus becomes of decreasing

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<sup>92</sup> See also, Capital Market Listing and Disclosure Regulations 2002.

<sup>93</sup> The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002, Fifth Schedule.

informational value to the investor. The issuer will need to provide more relevant and current information as long as securities continue to be available for sale in the public market. These initial and continual disclosure requirements are binding to the issuing companies and not to insiders generally or to directors specifically.

Mandatory disclosure requirement for insiders are a regulatory feature which ensure that transactions by insiders are a matter of public record. These have the effect of deterring insiders from dealing in non-public material information. Of equal importance is the affirmative duty of disclosure for companies or institutions that come into possession of material, price-sensitive information. Such a duty of mandatory reporting and timely disclosure would eliminate the very existence of material non-public information. It would also enhance market efficiency as it would enlarge the pool of information from which market analysts can draw in the performance of their tasks resulting in accurate pricing of investment instruments. Such disclosure is relied upon heavily by regulators in most developed markets.<sup>94</sup> This is because it ensures that market participants have equal access to information which will affect market price.

As indicated in the literature review, the present study seeks to analyse Kenya's formulation of the legal provisions on insider trading and in that process assess the relevance and applicability of mandatory disclosure to Kenya's markets. It was also stated that this study will assess the adequacy of provisions on disclosure in Kenya. In light of this, an examination of the Capital Markets Act reveals that the duty to disclose is limited

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<sup>94</sup> K. Langenbucher, 'The 'Use or Possession' Debate Revisited—Spector Photo Group and Insider Trading in Europe' [2010] 5 (16) *Capital Markets Law Journal* 452-470, 463. < <http://cmlj.oxfordjournals.org/> > Accessed 20 November 2012.

to the company directors and the issuing company or institution. It fails to extend to insiders generally.

Admittedly, this is a significant gap since the extension of such provisions to insiders generally would have the effect of deterring insiders from exploiting material non-public information in their possession or even requiring insiders with information to abstain from trading. It would ensure that trade by insiders is placed on the public record and would therefore promote market efficiency by ensuring that prices reflect non-public information as well.

Further, there is no denying that the prosecution would have a lighter and less complicated task in proving the breach of disclosure requirements as compared to proving the breach of the existing insider trading rules. All things considered then, these benefits would be lost on our market if our legislation were to remain as it is.

## **2.6. Conclusion**

This chapter has demonstrated that inadequacies in the provisions of existing law and its enforcement can be identified from the application of the law and existing literature to the two insider trading cases that have been prosecuted in Kenya. These include lack of clarity in the meaning and application of core elements of the crime of insider trading such as insider information, publication of information and material information in the Act. It has also been shown that the absence of mandatory disclosure requirements for insiders places the duty of curbing insider trading solely on the market regulator. Effectively, the problem in the Kenyan context appears to be inadequacies in the drafting of the statute coupled with narrow interpretation of existing laws; these render it well-nigh impossible to prove the crime of insider trading beyond reasonable doubt and enables insider traders escape the

law by casting doubts in the prosecution case. It is, therefore, evident that the prohibition of insider trading as presently formulated is inadequate and almost impossible to prosecute effectively.

### **3. CHAPTER THREE: DATA COLLECTION AND ANALYSIS**

This chapter presents the research and analysis of shortcomings of the Capital Markets Act as experienced by legal practitioners in Kenya as well as their views on the proposals for reform. It begins with a discussion of the methodology adopted in carrying out the study. This includes the research design, target population of the study, sample and sampling techniques, description of data collection and analysis tools. It then discusses the findings and draws conclusions.

The research under this chapter contributes to the overall study by providing a mirror against which actual practices can be reflected to test the hypothesis that the provisions in the Capital Markets Act relating to insider trading are vaguely formulated and are therefore difficult to prove, thus hindering the effective prosecution of the offence of insider trading.

#### **3.1. Research Design: Population of the Study and Sampling Procedure**

The research design was an exploratory survey which was adopted in order to reach an in-depth understanding of the experiences of legal practitioners. This involved gathering data that would provide a description of views and experiences of persons who apply the Capital Markets Act and more specifically, those provisions that deal with insider trading. The survey questionnaire was uploaded on cyberspace and the link distributed to key informants in order to obtain primary data on the application and enforcement of existing legal provisions on insider trading.<sup>95</sup>

The study population constituted legal practitioners in law firms in Nairobi, those in the Capital Markets Authority, the Nairobi Securities Exchange, in-house counsel and

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<sup>95</sup> < <http://law-research.org> > as at May 2012.

academia. The study population was limited to Nairobi firms mainly because practise in this area is concentrated in the capital.

The sample was purposive, with informants being purposively selected from the Capital Markets Authority, the Nairobi Securities Exchange and legal practitioners in specific law firms in Nairobi that are known to engage in capital markets practice.

The rationale for this purposive sampling was developed when the research instrument was pre-tested on a variety of legal practitioners attending the Law Society of Kenya Annual General Meeting. A majority of the lawyers were of the view that the Capital Markets Act and the law on insider trading is specialised area of law.<sup>96</sup> They suggested that the questionnaire should be administered only to specific lawyers and firms that dealt with capital markets, since this is not a generalised area of legal practice.

The lawyers making up the research population were, therefore, identified through the law firms listed as practising in the Capital Markets field in commonly used independent sites that have international ranking system for law firms. The main one used in this study was the IFLR 1000 web listings for sourcing legal counsel. These were supplemented with the listing of lawyers in the Capital Markets field in HG.org Legal Directories as well as Chambers Global, an international legal research company.

### **The Survey Instrument**

The survey instrument used was a semi-structured questionnaire comprising nine (9) questions. The questions were designed to elicit data in accordance with the research question.<sup>97</sup> The possible survey responses were presented in a likert chart, a psychometric

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<sup>96</sup> The Law Society of Kenya Annual General Meeting was held on 26<sup>th</sup> March 2011 at the Intercontinental Hotel.

<sup>97</sup> See Appendix 3: Survey Questionnaire.

scale commonly involved in research that employs questionnaires. It is the most widely used approach to scaling responses in survey research.<sup>98</sup>

The questionnaire was uploaded on cyberspace and administered by the researcher via email and the possibility was opened up for follow-up interviews with key informants at the Capital Markets Authority and legal practitioners in law firms in order to obtain primary data on the application and enforcement of existing legal provisions on insider trading.

### **Validity and Reliability**

The reliability of a research instrument concerns the extent to which the instrument yields the same results on repeated trial, while validity determines whether the research truly measures that which it was intended to measure or how truthful the results are.

The researcher tried as much as possible to maximise the reliability and validity of data she collected by ensuring data collection techniques yielded relevant and correct information. The techniques to ensure this included triangulation and pre-test/pilot study. The researcher applied the triangulation method by combining the doctrinal approach as well as making use of questionnaires to complement the doctrinal approach.

For reliability, the researcher carried out a pilot study where she pre-tested the instrument before using it. This was in order to check for vocabulary, language level and how well the questions were understood. The researcher also refrained from asking leading questions. The information obtained from pre-testing of the instrument was used to revise the questionnaire and gauge whether questions met the objectives of the study.

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<sup>98</sup> Research Methods Knowledge Base Website < <http://www.socialresearchmethods.net/kb/scallik.php> > Accessed 20 November 2010.



### **Ethical Considerations**

An application for research permit was made at the National Council for Science and Technology and the permit obtained.<sup>99</sup> The permit was obtained during the preparation of the doctrinal section of the paper and it expired before data collection stage. It was renewed upon expiry.<sup>100</sup> An assurance was given to the subjects that any data or information collected would be treated in the strictest confidence, and would not be directly referenced in oral or written reports. Privacy was assured by the use of emails directed specifically at the subjects. There were no meetings, observers or listeners.

### **Challenges Encountered In the Survey**

Due to an apparent lack of time there was a noticeable disinclination on the part of respondents towards survey questionnaires. The researcher had to send reminders by email and phone call before the survey questionnaires were duly completed. Some respondents promised to revert but failed to do so even after being reminded. Thus the data collection was conducted over a three month period, and even then, not all the identified subjects responded to the survey. Some of the respondents experienced internet down-time and were only able to complete the questionnaire after several attempts.

### **3.2. Results of the Survey**

The questionnaires were completed online and the data stored in the database. After collection, the data was reviewed for inconsistencies. It was then organised and analysed. The survey questionnaire themes were divided and analysed in relation to the main research themes as follows:

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<sup>99</sup> See Appendix 1.

<sup>100</sup> See Appendix 2.

### **Introduction: Personal Information and Approach to Insider Trading Legislation**

The introductory section of the study sought to establish the respondent's occupation and the years of experience they had in engaging with capital markets law. It also sought to find out the respondent's views on prohibition of insider trading and whether they thought this prohibition would enhance investor confidence in Kenya's Capital Markets. The purpose of these questions was to gauge the respondent's level of experience as well as their approach in applying the Capital Markets Act.

*Table 1: Distribution of respondents by occupation*

<b>Occupation</b>	<b>Number of Respondents</b>	<b>Percentage</b>
Law Firm	10	66.6%
Securities Exchange	1	6.6%
Capital Markets Authority	1	6.6%
Academic	1	6.6%
In-House Lawyer	2	13.3%

In terms of occupational distribution, majority (66.6%) of the respondents were based in law firms and 13.3% were in-house counsel. The remainder were from the Securities Exchange, the Capital Markets Authority and academia. Thus, data was obtained from a variety of respondents, all engaging with the Capital Markets Act in varying capacities.

*Table 2: Distribution of respondents by years of experience*

<b>Years of experience</b>	<b>Number of Respondents</b>	<b>Percentage</b>
Below 2 years	2	13.3%
Between 2-9years	10	66.6%
10 years and above	3	20%

Regarding experience, the overwhelming majority of respondents had considerable experience in capital markets law. Those with experience ranging from two to nine years comprised 66.6% of the sample. The respondents with over ten years of experience accounted for 20% of the sample. Those under 2 years of experience comprised only 13% of the sample.

*Table 3: Distribution of respondents by their approach to prohibition*

<b>Approach</b>	<b>Number of Respondents</b>	<b>Percentage</b>
Insider Trading should be prohibited	15	100%
Insider Trading should NOT be prohibited	0	0%

The question on whether insider trading should or should not be prohibited sought to test the acceptability of Prof Henry Manne's argument defending insider trading. The argument is that insider trading enhances market efficiency by ensuring speedy availability of information into the market.

All the respondents had a common approach to the prohibition of insider trading. There was resounding agreement that insider trading should be prohibited. This approach was consistent with that of several works referred to in the literature review as well as the approach taken by legislative trends worldwide.

*Table 4: Distribution of respondents by opinion on investor confidence*

<b>Opinion on investor confidence</b>	<b>Respondents</b>	<b>Percentage</b>
Effective prohibition of insider trading will promote investor confidence.	14	93%
Effective prohibition of insider trading will NOT promote investor confidence.	1	7%

According to data elicited in this survey, the overwhelming majority of respondents were of the view that effective prohibition of insider trading would indeed promote confidence of investors in Kenya's capital markets. There was the odd 7% that did not agree with this opinion.

#### **Inside Information: The Term 'Information' Under The Act**

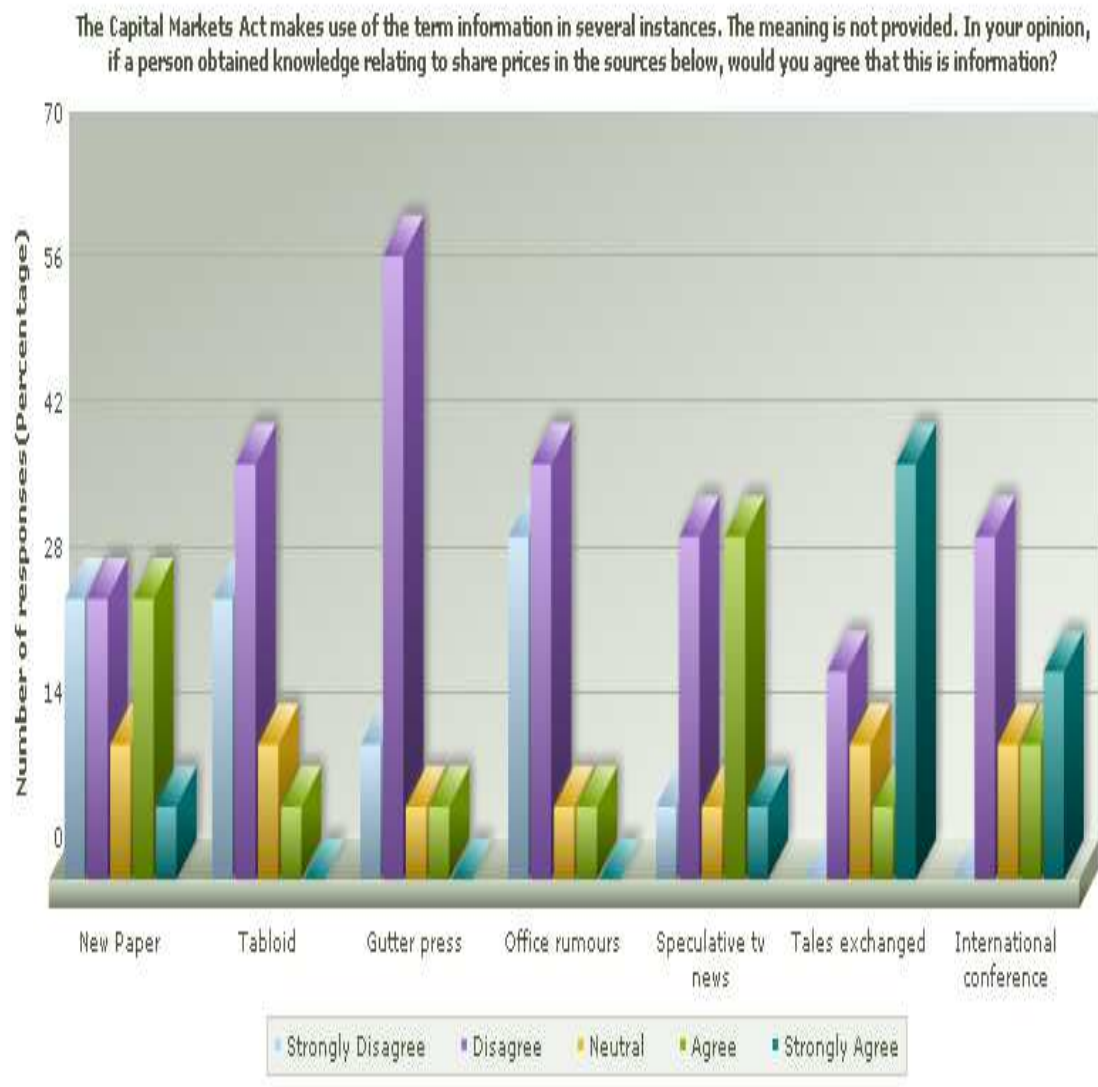
The study sought to find out the subject's interpretation and understanding of the term information as used in the Act. The purpose of this question was to demonstrate the variety of ways in which the term information can generally be understood. The responses are represented in the graph overleaf.

Majority of the respondents were in agreement that gutter-press, office rumours and tabloids could not be properly described as information. There was uncertainty about

whether corporate advertisements in newspapers and speculative television news reports could be considered as information.

There was a notable strong agreement that both tales exchanged over an evening drink or a game of golf as well as news gathered from another company during an international conference was indeed information.

*Figure 2: The Term 'Information' under the Act*



The respondent's views are an indicator the general perception of information varies and if they were placed on a continuum, corporate advertisements in newspapers would lie on the weaker end of the continuum while news gathered in an international conference would lie on the strongest end. The other accepted perceptions of information would then fall at various positions within the continuum.

### **Materiality of Information**

Further, the study then sought to establish whether the subjects' understanding of the material information corresponds to the definition provided in the Capital Markets regulations. The Capital Markets (Securities) (Public Offers, listing and Disclosure) Regulations 2002 defines material information as 'any information that may affect the price of an issuer's securities or influence investment decisions' and provides a list of such information.<sup>101</sup> This list, however, does not include financial information.

The purpose of this question was therefore to gauge whether respondents viewed financial information as material. For the avoidance of doubt, financial information was unpackaged to read 'information on assets and liabilities.'

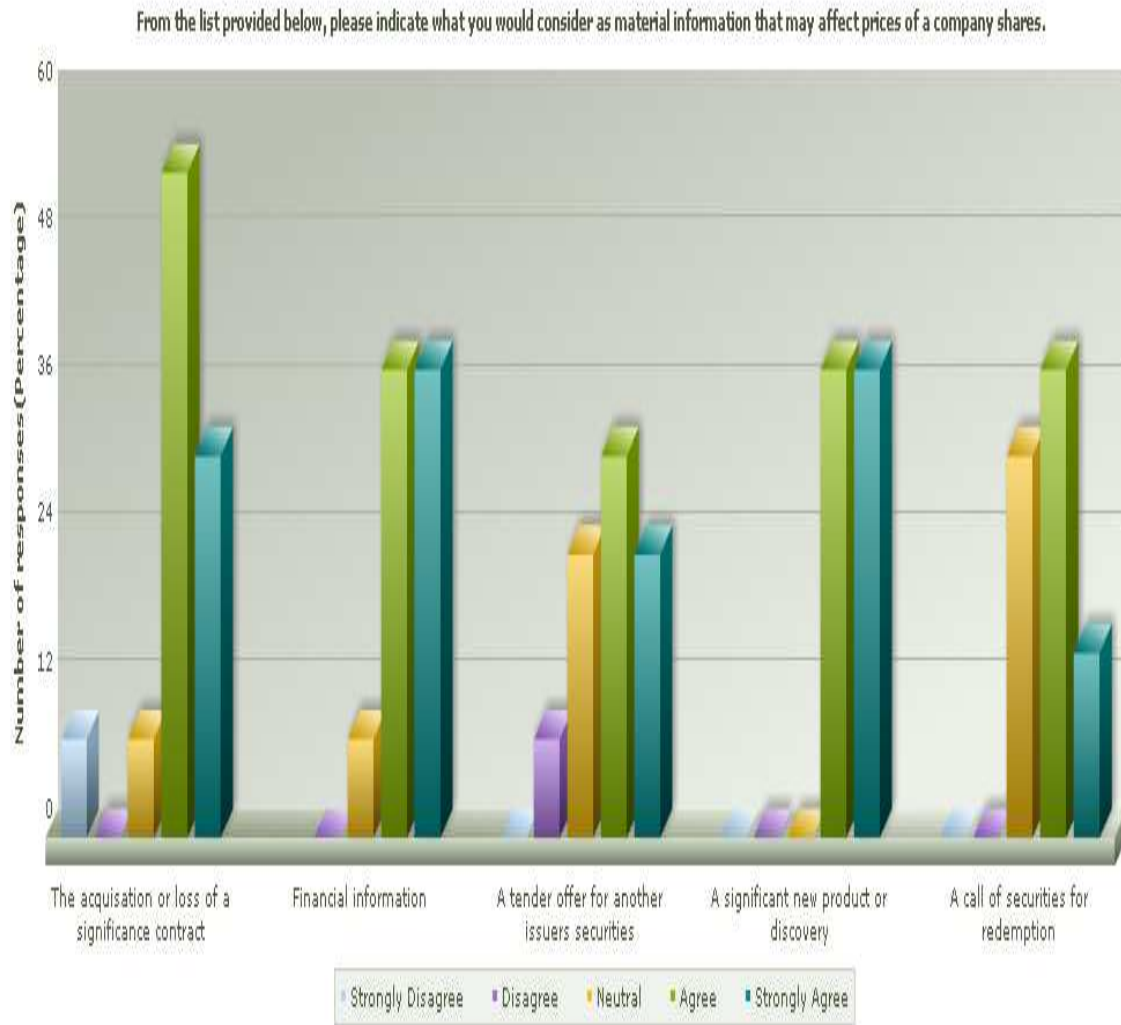
All the respondents were of the view that the various categories of information were indeed material. These were the acquisition or loss of a significant contract, information on assets and liabilities, a tender offer for another issuer's securities, a significant new product or discovery and a call of securities for redemption. Only 8% thought the tender offer and loss of significant contract were material.

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<sup>101</sup> See Regulation 2.

The responses are represented in the graph below:

*Figure 3: Materiality of Information*



There was consensus that information on assets and liabilities was material information. It seems clear from this evidence that financial information is generally understood to be material information. As anticipated, this position contrasts with the view of the court in *Republic versus Terrence Davidson*.<sup>102</sup>

<sup>102</sup> See Nairobi CMCC 1338 of 2008.

### **The Understanding of Prompt Disclosure**

With regard to publication of information, the study sought to find out what the subjects considered as prompt disclosure. The purpose of this question was to find out how much the subjects appreciated the need for disclosure of information.

The overwhelming majority (54%) recommended disclosure of price-sensitive information within 24 hours. Those who recommended disclosure as soon as the information was received accounted for 38% of the respondents. Only 8% proposed disclosure of information within 48 hours. These responses confirm that the requirement of prompt disclosure of information is generally considered an important aspect of securities law.

### **General Assessment of Enforcement of the Act**

Under the theme enforcement, the study sought to find out the subjects' view or experience on the factors that cause low enforcement of legal provisions. It also required them to rate the performance of the Capital Markets Authority in enforcing the law. The purpose of this question was to demonstrate public perceptions regarding levels of enforcement of the Capital Markets Act by the regulatory body.

According to the data elicited in the survey, 85% of the respondents consider the capital markets legislation as having been drafted in a way that makes enforcement impossible. Those who regarded the standard of proof as being too high comprised 15% of the respondents. Majority of (46%) the respondents indicate a 'low' rate when it comes to the Capital Market Authority's desire and enthusiasm to enforce the law. They also received a low rating for expertise to enforce the law.

The vast majority of respondents showed little confidence in the adequacy of insider trading law. Almost half faulted the regulator's desire, enthusiasm and expertise in



enforcing the law. The criticism accorded to the law was however, greater than that apportioned to the market regulator.

### **3.3. Discussion**

This discussion is centred on the main issues arising in the research paper. These are the problem of ambiguity of the term information; the meaning of materiality of information; the meaning of publication of information; difficulties arising out of the possession of information by corporate bodies and the disclosure of information. They are discussed in light of the two objectives of this research which were to examine the inadequacies of the Capital Markets Act in addressing the elements of the offence of insider trading and to determine whether legal reforms are needed in order to curb insider trading and to promote a fair and efficient capital market.

The study commenced with a review of literature which presented a debate on whether or not insider trading should be prohibited.<sup>103</sup> Guided by the reality that all major economies have legislations prohibiting insider trading, this paper consistently took the position that insider trading ought to be prohibited. Further support for the prohibition of insider trading is now provided by overwhelming evidence from respondents. The prohibition is supported because respondents consider that it would promote confidence of investors in the capital markets. This response suggests that debates and academic theories should be tested in light of realities in the capital market.

The first issue under discussion is the problem of ambiguity of the term information. According to the respondents, corporate advertisements in the newspapers, speculative

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<sup>103</sup> S. M. Bainbridge, 'An Overview of Insider Trading Law and Policy: An Introduction to the Insider Trading Research Handbook' [2012] *No. 12-15 UCLA School of Law, Law-EconResearch Paper Series* 1-37, 24-34. < SSRN: <http://ssrn.com/abstract=2141457>> Accessed on 30 October 2012.

news reports, tales exchanged over an evening drink or game of golf as well as news gathered in an international conference are all considered information. However, gutter press, office rumours and tabloids should not be termed as information. This position qualifies previous arguments in this study, which placed all these in one bundle as information. The finding, however, corroborates the argument that the term information is not specific and can be understood in many different ways. As previously noted, ‘information’ is a term that is used in a vacuous and broad manner in the Capital Markets Act. It is therefore suggested that information should be statutorily defined for the avoidance of doubt.

The problems of proof arising from this broad usage of the term information are exacerbated by the Act’s requirement to establish this information as the basis for the prohibited transaction.<sup>104</sup> Further, the causal link established between employment in a body corporate and acquisition of information presents the assumption that price-sensitive information is acquired only in the course of employment.<sup>105</sup> This avails the defence that information was obtained when “it was not in the ordinary course of business” and the debate about what the ordinary course of business means. It is proposed that the mere possession of inside information during the conduct of transactions should suffice to ground liability, as opposed to the requirement to establish the information as the basis of the trade. Further, the consideration that information is inside information when it was ‘obtained in the ordinary course of business’ should also be eliminated.

The definition of insider trading in the proposed legislation, presents a shift from a person-connection, to an information-connection which automatically reduces the market

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<sup>104</sup> Capital Markets Act s 32 A.

<sup>105</sup> Capital Markets Act s 33(11).

regulator's burden from proving both that a person is an insider and that the person dealt with prohibited information to proving only that a person dealt with prohibited information.

In addition, three criteria which information must meet in order to qualify as inside information is proposed. First, it must relate to particular securities or a particular issuer of securities as opposed to securities generally or issuers of securities generally. Second, the information has not been made public and third, if it were made public, it would have a material effect on the price of any securities. Thus, the problem of vagueness would be eradicated in this manner.

There is a need to eliminate reference to trading on the 'basis' of unpublished insider information, in order to relieve the market regulator of the burden of proving this mental element. There is further need to disregard the assumption that price-sensitive information is only acquired in the course of employment and thereby remove the defence currently available under the Capital Markets Act that information was obtained when "it was not in the ordinary course of business."

The second issue under discussion is with regard to materiality of information. This paper took the approach that the decision of the court in *The Republic versus Terrence Davidson*, in finding that financial information is not material information was erroneous. This position is supported by the literal rule of interpretation which stipulates that the words of a statute must be interpreted according to their ordinary, literal and grammatical sense. It was also stated earlier in this work that applying the literal rule of interpretation, the list provided in the regulations could not be deemed to be exhaustive especially because the

provision states that such material information “includes” the provided information.<sup>106</sup> Consequently, the fact that the financial information was not on the list ought not to have been interpreted as excluding financial information from the scope of material information. It now seems clear from the evidence, from the survey on materiality of information, that market practitioners consider financial information as material. An implication of this is the acknowledgment that there are indeed problems of interpretation of the existing law. Judicial interpretation has read the word material information so narrowly as to exclude financial information therefore providing a means of escaping liability and is contrary to the spirit of the legislation. A broader interpretation is therefore proposed.

The third issue was on publication of information. In this regard it was indicated in the previous chapters that the Capital Markets Act does not provide objective criteria with which to determine when information can be said to have been published. This becomes a problem of proof for the prosecution and a loophole that can be explored by accused persons to obtain acquittals. It was noted that the proposed law provides an insight into the meaning of information being ‘made public’.<sup>107</sup> It is proposed that guidelines be established to assist the industry in dealing with the problem of determining when information can properly be said to have been published.

The fourth issue under discussion is on the possession of information by corporate bodies. Whereas the Act foresees insiders as natural persons as well as juristic persons, its focus lies on natural persons. It therefore fails to provide for legal persons such as corporate

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<sup>106</sup> In the case of *Fisher versus Bell* [1961] 1 QB 394, the defendant, a shopkeeper, was prosecuted for displaying an illegal flick-knife for sale. Because it is an offense to offer such an item for sale under the Restriction of Offensive Weapons Act (1951) he was convicted. On appeal, however, it was held that **offer for sale** has a technical meaning in law, and a shop window display is an Invitation to treat, not an offer in contractual terms. The conviction was therefore quashed. In 1961 a further Act was passed making it an offense to 'expose for the purpose of sale' an offensive weapon.

<sup>107</sup> Securities Industry Bill 2011 s 86.

entities and how they can be considered as insiders. As such, the existing law on corporations as insider traders remains largely untested and neither do the proposed laws tackle this aspect of insider trading. It is suggested that the gap in determining how corporations can be considered insiders and how they can be considered to have knowledge or possession of information still needs to be bridged.

The fifth and final issue is on disclosure of information. The importance of disclosure as a foundation for promoting investor confidence in the capital markets is underscored by the results of the survey as well as literature and arguments raised in the study. This reverses the onus of proof so that the accused would be required to prove his compliance with the disclosure requirements. It has been observed that the Capital Markets Act lacks mandatory disclosure requirements for the reporting of transactions by insiders. It likewise fails to create an affirmative duty of disclosure for companies or institutions that come into possession of material price-sensitive information.

The obligation to disclose material changes or new developments which are not in the public knowledge and which are necessary for the financial appraisal of the issuer should be strengthened. The regulations should also impose a duty on insiders to promptly disclose their interests in securities of an issuer. In the revision of the legal provisions, it is proposed that the affirmative duty of prompt disclosure for companies and the reporting of transactions by insiders should be stated in clear and unambiguous terms.

From the foregoing, it can be surmised that there is overwhelming evidence that the provisions on insider trading in the capital markets legislation are weak and this contributes to poor enforcement of the law. The enforcement process should be improved through adequately resourcing and staffing the market regulator to conduct prosecutions. Further, the proscribing of a variety of activities which serve to facilitate the practice of

insider trading is likely to make the combat of insider trading more effective.<sup>108</sup> Such activities include market manipulation; false trading and market rigging transactions; fraudulently inducing trading in securities; use of manipulative or deceptive devices; and false or misleading statements inducing securities transactions. An overhaul of the enforcement effort in relation to insider trading is therefore proposed. If insider trading is to be curbed, it is necessary that the regulator is enthused and equipped to do so. There is also a need to widen the scope of prohibited conduct in order to incorporate market manipulation, use of manipulative devices, issuing of false statements and related activities that threaten integrity of the capital market.

The Capital Markets Act has a criminal focus, which as discussed in this study, is difficult to traverse. These challenges in criminal prosecution of financial offences make a compelling case for an increased application of existing civil and administrative avenues, whose requirement of proof is on a balance of probabilities and therefore lower than criminal prosecution.

The results of the study thus support the argument that the law as drafted is weak. Further, it is admitted that there are enforcement problems resulting from this weakness and these are complemented by an apparent poor desire and lack of enthusiasm by the market regulator to enforce the law.

### **3.4. Conclusion**

This study has examined the elements of the offence of insider trading in the Capital Markets Act. The results of the survey indicate that there is great support for the prohibition of insider trading and that there are indeed inadequacies in the provisions on

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<sup>108</sup> E.Swan and J.Virgo, *Market Abuse Regulation* (Oxford University Press, London 2010) 6.

insider trading as presented in the Capital Markets Act. The current survey finds that the term information is perceived in different ways by practitioners and that financial information is indeed considered inside information. It also finds that there is need to impose a time-frame within which price-sensitive information should be made public. These results are consistent with the analysis of case law and comparative literature conducted in the previous chapters in which the elements of the offence of insider trading in the Capital Markets Act were analysed in light of existing case law to illustrate challenges to their enforcement. The study therefore concludes that the prohibition of insider trading as presently formulated is inadequate and almost impossible to prosecute effectively. This presents a compelling case for reform to ensure legal provisions that make up the elements of insider trading are clarified.

#### **4. CHAPTER FOUR: ADDRESSING INADEQUACIES IN THE LAW**

While drawing on lessons from other jurisdictions, this chapter examines proposed Bills and Regulations in the capital markets and securities' sector and discusses them with respect to their sufficiency in mitigating the inadequacies in existing law.<sup>109</sup> The research in this section contributes to the overall study by examining the suitability of proposed legislation in resolving the challenges in prosecuting insider trading and as a consequence in promoting a fair and efficient capital market required for Kenya's economic development.

Three Bills are identified among several proposed laws due to their connection with insider trading and are examined with regard to their provisions relating to inside information, material information, publication of information, possession of information by corporate bodies and information disclosure requirements.

The three are the Capital Markets Authority Bill 2011, which makes provision for the establishment of the Capital Markets Authority as the regulator of the securities industry;<sup>110</sup> the Securities Industry Bill 2011, which is drafted with the stated purpose of regulating the securities industry and providing investors with protection from business abuses and market failures by proscribing insider trading; and the Securities Industry (Continuing Disclosure Obligations of Issuers) Regulations 2011, which proposes to govern disclosure obligations of issuers.

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<sup>109</sup> Other proposed legislations are Capital Markets Authority (Advertising) Regulations 2011; Securities Industry (Asset Backed Securities) Regulations 2011; Securities Industry (Collective Investment Schemes) Regulations 2011; Securities Industry (Internet Trading) Regulations 2011; Securities Industry (Takeovers) Regulations 2011; Securities Industry (Offers of Securities) Regulations 2011; Securities Industry (Licensing of Regulated Persons).

<sup>110</sup> Capital Markets Authority Bill 2011 s 4.



#### **4.1. Inside Information**

In the previous chapters, it was observed that the term information is core to the prohibition of insider trading yet the Capital Markets Act does not give guidance with regard to its meaning. Indeed the perception of market practitioners with regard to information incorporates a wide range of concepts.<sup>111</sup> Further, the evidentiary burden on the regulator is increased by the requirement to establish this information as the basis for the prohibited transaction. The third weakness that was noted in relation to inside information is that the definition of an insider in the Act creates a causal link between employment in a body corporate and acquisition of information hence, the prosecution would need to prove both that the accused had been an insider and that information obtained in their condition as insider was the basis of the transaction in question.<sup>112</sup> The dearth of a set of criteria to qualify information as ‘inside information’ was also alluded to as a shortcoming of existing law on insider trading. Cumulatively, these weaknesses create an onerous burden for the prosecution to discharge.

As discussed in the literature review, these difficulties are not new and have also been experienced and mitigated in other jurisdictions. For instance, South Africa’s law sheds light on the meaning of inside information because it lays down criteria that ought to be met in order for information to qualify as ‘inside information’.<sup>113</sup> First, the information ought to be specific or precise. Thus, market transactions based on vague or general information, rumours, suspicion, conjecture, speculation or combination thereof do not fall within the purview of the Act. Second, information must be of a non-public nature in order

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<sup>111</sup> See Chapter 3.2 Inside Information: The term ‘Information’ Under the Act.

<sup>112</sup> Capital Markets Act s 33(11).

<sup>113</sup> South African Securities Services Act s 74.

to ground liability. The South African Securities Services Act provides ample guidance to assist in making the determination that information has been stripped of its non-public character. Any piece of data loses its ‘inside information’ status upon its being made public. Thus prompt disclosures of new developments by insiders may significantly reduce their exposure to liability for the use of such information in their market transactions. Thirdly, the information must have been obtained by a person while occupying the status of insider. Fourthly, the information ought to be material; information that is likely to have a material effect on the price or value of any securities or financial instrument.

The UK’s Financial Services and Market’s Act provides an expanded definition of inside information in relation to three different categories of securities. In summary the information is inside if it is not generally available, it relates directly or indirectly to the security in question and would, if available, have a significant effect on price. The Act then goes ahead and defines the meaning of precise information as information which indicates circumstances that exist or may reasonably be expected to come into existence or is specific enough to enable a conclusion to be drawn.<sup>114</sup>

With regard to the person-connection approach, it is observable that the position in the United Kingdom does not require someone to be an ‘insider’ but only requires that someone behaves inappropriately with regard to relevant information not generally available.<sup>115</sup> Thus, the prosecution does not shoulder the additional burden of demonstrating that a person was an insider at the time of the relevant transaction.

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<sup>114</sup> Financial Services and Markets Act (2000) s 118(C).

<sup>115</sup> Financial Services and Markets Act (2000) (Market Abuse) Regulations 2008, SI 2008/1439 s 118(4) and 118(8).

These practices from other jurisdictions are to some extent reflected in the Securities Industry Bill 2011 which legislates on insider trading in sections 83 to 87. The Bill defines an insider, the offence of insider trading, inside information and offers criteria for what is to be considered as information that has been “made public.” Under these provisions, the definition of an insider is simply given as ‘a person in possession of inside information.’<sup>116</sup> The offence of insider trading is committed if a person deals in listed securities or their derivatives that are price-affected in relation to the information in his possession.<sup>117</sup> An insider commits the offence of insider trading either by disclosing insider information to another person outside the performance of employment functions or by encouraging another to deal in insider information knowing or having reason to believe that the trading will take place.<sup>118</sup>

With this new definition, there is a definite shift from a person-connection, to an information-connection. Such a shift automatically reduces the market regulator’s burden from proving both that a person is an insider and that the person dealt with prohibited information to proving only that a person dealt with prohibited information.

The Securities Industry Bill lays down three criteria which information must meet in order to qualify as inside information. First, it must relate to particular securities or a particular issuer of securities as opposed to securities generally or issuers of securities generally. Second, the information has not been made public and third, if it were made public, it would have a material effect on the price of any securities. The implication of this provision is that inside information is no longer an amorphous concept, but can be

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<sup>116</sup> Securities Industry Bill 2011 s 83 (b).

<sup>117</sup> Securities Industry Bill 2011 s 84 (1).

<sup>118</sup> Securities Industry Bill 2011 s 84 (1) (a) and (b).

identified using the criteria provided. The development of criteria to determine inside information is comparable to other jurisdictions, such as South Africa, where the problem of vagueness has been eradicated in this manner. That notwithstanding, the proposed laws provide criteria for ‘inside information,’ but fail to tackle the meaning of ‘information’ in general. As such, the term information could still be used in reference to unspecific or imprecise collection of data, vague or general information, rumours, and suspicion, conjecture, speculation or combination thereof thereby providing possibilities for casting doubts on the prosecution case.

It is noteworthy, as an improvement of the provisions in the Act, that the Bill makes no reference to insider trading as trading on the ‘basis’ of unpublished insider information. The market regulator is thereby relieved of the overwhelming evidentiary burden of proving this mental element. For instance, had the proposed legislation been applied in the context of the Kibaru and Davidson cases, the prosecution would not have been had pressed to establish the basis of the sale of shares. It would have sufficed to demonstrate that the accused was in possession of inside information and that their trade in shares was conducted while in possession of that information. It would have been unnecessary to attempt the insurmountable task of proving that the trade was motivated by the inside information.

This position was taken into account by European regulators in the judgment of the European Court of Justice in the *Spector* case.<sup>119</sup> At the heart of this Belgian case was the question of whether one who trades while in possession of inside information is an ‘insider trader’ or only those who trade with the intention of exploiting their information

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<sup>119</sup> See European Court of Justice (ECJ) Case C-45/08 *Spector Photo Group NV, Chris van Raemdonck v Commissie voor het Bank-, Financie-en Assurantiewezen* (CBFA) [2010] OJ 2010, C 51, 6-7.

advantage. The court reasoned that an act of trading while being in possession of inside information strongly suggests that the information is being relied upon to some extent. Thus regulators are entitled to prosecute whenever persons trade while in possession of inside information without a need to prove that the decision to trade was wholly or partially based on inside information.<sup>120</sup>

In addition, the Bill eliminates the need for a link between employment in a body corporate and acquisition of information, which link bears the underlying assumption that price-sensitive information is acquired only in the course of employment. The Bill therefore removes the possible defence that information was obtained when “it was not in the ordinary course of business,” which is available under the Capital Markets Act. It eradicates debate around the unanswered questions relating to borderline cases of what the ordinary course of business is and what it is not.

#### **4.2. Material Price-Sensitive Information**

It was observed that the Capital Markets Act lacks definitional precision in relation to the term ‘material price sensitive information’ such that ambiguities and doubts can always be raised in favour of the accused.<sup>121</sup> A problem of narrow interpretation of existing laws was

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<sup>120</sup> ‘Spector Photo Group’ is a listed company under Belgian Law. In order to implement a stock option scheme, which Spector operated for its employees, the company bought shares by way of a series of open market transactions. A total of 27,773 shares were purchased in five tranches. The last installment was bought on 13 August 2003 at an average share price of E9.97. Shortly afterwards, on 21 August 2003, the company announced a possible takeover as well as first half-year results for that financial year, both of which were perceived as positive news by the market. The price per share subsequently rose to E12.50. Later that year the Belgian financial services authority held that the company and its director had violated the Belgian insider trading rule. The authority pointed to the fact that the last order was not only changed as far as price limits and the number of shares were concerned, but also made especially urgent, probably, so the argument ran, in order to avoid the acquisition of the last installment of shares falling in the period of time when the (anticipated) price increase following the announcement of a takeover was being expected to occur by the company’s executives. Spector challenged the decision, arguing that the financial services authority had failed to prove a causal link between the knowledge of the imminent positive news (soon to be disclosed to the public) and the transaction. Pursuant to Article 234 of the EU-Treaty (now Article 267) the Belgian Court referred this, among other 1 questions to the European Court of Justice (ECJ).

<sup>121</sup> *Republic versus Terrence Davidson*, Nairobi CMCC 1338 of 2008.

also noted. There was consensus among market participants in the survey that financial information is material information.<sup>122</sup> More specifically, it was argued in the previous chapter that contrary to the ruling in *The Republic versus Terrence Davidson*, financial information is indeed material information especially where it has an effect on the price of an issuer's securities or has an influence on investment decisions.

These difficulties in proof arising from the use of concepts that were difficult to define such as 'price-affected securities' were also noted by authors Swan and Virgo when they observed that a number of high profile criminal trials exposed weaknesses in the United Kingdom's insider trading laws arising from reliance on criminal penalties which were difficult to prove.<sup>123</sup>

Drawing primarily from practices in other jurisdictions, one possibility of curing the ambiguity in the meaning of material information is to develop regulation that qualifies the definition of material information through supplying a list of such price sensitive information.<sup>124</sup> India has developed such a list and this list includes information relating to periodical financial results of the company; intended declaration of dividend; issue of any class of securities; any major expansion plans or execution of new projects; amalgamation, mergers or takeovers; disposal of whole or substantial part of undertaking; any significant change in policies or company operations.

In the context of Kenya, a 'Listing Manual' was published by the Exchange in 2002. The 'Continuing Listing Obligations applicable to all Market Segments' is a reproduction of the Fifth Schedule of The Capital Markets (Securities)(Public Offers, Listing and

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<sup>122</sup> See Chapter 3.2 Materiality of Information.

<sup>123</sup> E. Swan and J. Virgo, *Market Abuse Regulation* (Oxford University Press, London 2010) 6.

<sup>124</sup> Securities Exchange Board of India (Prohibition of Insider Trading) Regulations 1992.

Disclosures) Regulations 2002, drawn up by the Capital Markets Authority, and is stated as such. Although such a list exists, the court in *Republic versus Terrence Davidson* read financial information to mean information that was not material.<sup>125</sup>

It is argued that contrary to the ruling in the case *Republic versus Terrence Davidson*, financial information is indeed material information especially where it has an effect on the price of an issuer's securities or has an influence on investment decisions.<sup>126</sup> This is because the list is not exhaustive and having regard to the *ejusdem generis* rule, the list ought not to be interpreted in a restrictive and closed manner. Indeed there was consensus in the survey that financial information was material information. It seems clear from this evidence that financial information is generally understood to be material information.

While the Capital Markets Act makes use of the terms 'unpublished price sensitive information', and 'unpublished insider information' interchangeably without providing a definition of either, the Securities Industry Bill avoids the use of both terms. Invariably, the need for definitions is thereby eradicated. The Bill however provides as the third criteria which information must meet in order to qualify as inside information; that if it were made public, it would have 'a material effect' on the price of any securities.

From the foregoing, this paper takes the position that the definition of material information in the Capital Markets (Securities) (Public Offers, Listing and Disclosure) Regulations 2002 as any information that may affect the price of an issuer's securities or influence investment decisions as well as the list provided is sufficient.

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<sup>125</sup> Nairobi CMCC 1338 of 2008.

<sup>126</sup> Securities Exchange Board of India (Prohibition of Insider Trading) Regulations 1992.

### 4.3. Publication of Information

The analysis of the case of *The Republic versus Terrence Davidson* in the previous chapter provoked the question as to the meaning of publication of information. It was noted that this was a gap in the Capital Markets Act since it is silent on when information can properly be said to have been published. This raised complexities about whether it matters if some and not all information is not in public domain and whether this publication must take a specific form.

This challenge of ambiguity in the meaning of public information has also been experienced and solved in other jurisdictions, such as South Africa and United Kingdom. As discussed in chapter one, public information has been clarified in other jurisdictions by the drafting of a guiding list of situations when information could properly be said to have been publicized.<sup>127</sup> Such lists provide guidance in the determination of whether or not information has been stripped of its non-public character. Examples of guiding situations include when such information is published in accordance with the rules of the relevant regulated market to inform investors and their advisors; when it is contained in public records maintained by the relevant statutory regulator; when it can be readily acquired by those likely to deal in securities or is derived from information which has been made public. Information may be regarded as having been made public even if it can only be acquired by persons exercising diligence, or expertise or by observation; it is communicated to a section of the public and not to the public at large; it is communicated only on payment of a fee or it is only published outside the republic.

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<sup>127</sup> South African Insider Trading Act, s 3.



Similarly, the UK's Financial Services Authority has published the Code of Market Conduct (COMC) which identifies a number of factors which the authority will take into account in deciding whether information is generally available. These include whether the information has been disclosed to a prescribed market through a Regulatory Information Service; whether the information has been disclosed in accordance with the rules of the prescribed market; whether the information is contained in records open to public inspection; and whether information can be accessed publicly using expertise and resources available at cost.<sup>128</sup>

These solutions could provide benchmarks and serve as best practices that may be adopted in Kenya where it is found appropriate. It is considered that the development of similar guidance could strengthen Kenya's law and make it more enforceable because this would route out this definitional gap identified in the legislation.

A response to the gap identified in the existing Act with regard to public information is underscored in the Securities Industry Bill because it gives insight into the meaning of information being 'made public'.<sup>129</sup> Under the Bill, public information includes information acquired by the exercise of diligence or expertise, information communicated to a section of the public, information acquired only by observation, information communicated only on payment of a fee or published only outside Kenya. Information is public if it is derived from public information, if it can be readily acquired by those likely to deal in any securities, if it is contained in records that are open to the public or if it is published in accordance with the rules of a securities exchange. These criteria cure the loophole identified in the previous chapter in which a conviction could not be sustained

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<sup>128</sup> UK Financial Services Authority Code of Market Conduct MAR 1.2.12  
<<http://fsahandbook.info/FSA/html/handbook/MAR/1/2>> Accessed 20 October 2012

<sup>129</sup> Securities Industry Bill 2011 s 86.

because part of the information was in public domain. Under the Bill, information is either public or non-public, thereby leaving no room for grey areas.

#### **4.4. Possession and Knowledge of Information by a Body Corporate**

Although the law anticipates the prosecution of corporations for insider trading, Kenya has not had any prosecutions involving corporations. The Act foresees insiders as human persons as well as corporate entities, but focuses on natural persons. As noted in the previous chapter, it inadequately provides for juristic persons, such as corporate entities, regarding how they can be considered as insiders. The proposed laws, likewise, lack provisions governing the possession of insider information by a company and therefore also fall short in this regard.

That notwithstanding, an attempt to deal with corporate liability is noticeable in the Securities Industry Bill because it holds directors liable where offences by companies are a result of the consent, connivance or neglect of the directors.<sup>130</sup> It goes further than the Capital Markets Act in so far as directors are made more accountable for offences committed by their companies thus demanding a greater sense of responsibility and accountability from them.

By and large, the existing law on corporations as insider traders remains largely untested and neither do the proposed laws tackle this aspect of insider trading.

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<sup>130</sup> Capital Markets Authority Bill 2011 s 52.

#### **4.5. Mandatory Disclosure Requirements: Prompt Disclosure and Reporting of Trade**

It was pointed out in the previous chapters that the Capital Markets Act lacks mandatory disclosure requirements for the reporting of transactions conducted by insiders as well as for the prompt disclosure of insider information. It has also been shown that the duty to disclose has been limited specifically to issuing companies and directors yet the definition of insiders includes wider group of persons.

Studies indicate that substantive law on disclosure as well as the prohibition of all forms of market abuse, among other factors, form the foundation of strong securities law.<sup>131</sup> In the literature review, Sharma's proposals for improving India's enforcement regime include the reduction of disclosure time to one day and that disclosure should be made to both the exchange as well as the regulator as opposed to the exchange only.<sup>132</sup>

Edward Swan and John Virgo likewise note that this gap in protection in the UK insider trading laws was filled by steps to make markets more transparent; such steps included requiring the reporting of suspicious transactions, disclosing inside information and disclosing insider trades in an issuing company's financial instruments among other requirements.

In considering the deterrence of insider trading through full disclosure it is also appropriate to take into account the experience in the United States. Section 16(a) of the Securities Exchange Act 1934 requires that "every person who is directly or indirectly the beneficial

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<sup>131</sup> E.Swan and J.Virgo, *Market Abuse Regulation* (Oxford University Press, London 2010) 6.

<sup>132</sup> V. Sharma, 'Prohibition on Insider Trading: A Toothless Law?' (Law School Research Paper No. 996, University of London-Centre for Commercial Law Studies 2009) 45.  
< SSRN: <http://ssrn.com/abstract=1400824>> Accessed 19 January 2010.

owner of more than 10% of any class of any equity security . . . or who is a director or an officer of the issuer of such security shall file . . . within 10 days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month."

Thus, not only is the insider obliged to file a statement with the Securities Exchange Commission indicating changes to his ownership within any given month, the Government Printing Office also publishes monthly reports detailing such changes in insider holdings and "an active financial press follows and publishes extracts from the statements filed". In this manner details of insider trading are given a wide circulation.

This study considers these proposals both relevant and applicable to the Kenyan context because they would make the market more transparent thereby reducing the likelihood of the occurrence of insider trading.

The Securities Industry (Continuing Disclosure Obligations of Issuers) Regulations 2011 attempts to fill the identified gap by establishing a general obligation to disclose. The obligation is to disclose material changes or new developments which are not in the public knowledge and which are necessary for the financial appraisal of the issuer; that would

affect the value or market price of securities or which is necessary to avoid the establishment of a false market in securities.<sup>133</sup>

In addition, the regulations impose a duty on directors and substantial shareholders to disclose their interests in securities of an issuer. This interest is kept by the issuer in a register, which is open to inspection by the public free of charge.<sup>134</sup> Further, by creating an affirmative duty of disclosure for companies or institutions that come into possession of material price-sensitive information, the Bill attempts to eliminate the very existence of material non-public information. This should thereby enhance market efficiency through accurate pricing of investment instruments.

The requirement for directors and substantial shareholders to disclose their interests is suitable for Kenya because they ensure that the insider's trades become a matter of public record. In this way, directors are deterred from dealing in non-public material information. This reporting is likely to enhance market efficiency as it reduces information asymmetry and widens the pool of information available to investors.

However, as noted earlier, the duty to disclose is still confined to directors. It does not encompass insiders entirely. In the decided cases for instance, Kibaru was found to be an insider without having been a director.<sup>135</sup> Davidson was likewise an insider without having been a director of the issuer company.<sup>136</sup>

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<sup>133</sup> The Securities Industry (Continuing Disclosure Obligations of Issuers) Regulations 2011 r 4.

<sup>134</sup> The Securities Industry (Continuing Disclosure Obligations of Issuers) Regulations 2011 r 10 to r 16.

<sup>135</sup> *Republic versus Bernard Mwangi Kibaru*, Nairobi CMCC 1337 of 2008.

<sup>136</sup> *Republic versus Terrence Davidson*, Nairobi CMCC 1338 of 2008.

Further the bills provide for a disclosure time limit of five days.<sup>137</sup> This is too long compared to the twenty four hour period proposed in the survey by market participants.<sup>138</sup>

#### **4.6. Traversing the Rigorous Standards of Criminal Liability**

On the whole, there is an evident difficulty in the reliance on criminal prosecution to curb insider trading. This is exemplified by the challenges experienced in Kenya as illustrated in chapter two. As demonstrated in the literature review, other jurisdictions share in this experience and consider the entire criminal prosecution cumbersome and time consuming partly because obtaining a conviction requires the proof of the *mens rea* constituting the offence beyond reasonable doubt. For this reason, they have sought various solutions to the problem. An example is United Kingdom's Financial Services Authority which has a policy of pursuing criminal proceedings only when there is enough evidence to provide a realistic prospect of convicting the defendant and where a criminal prosecution is in the public interest, considering the seriousness of the offence and the circumstances surrounding it.<sup>139</sup> Such a policy is an admission of the inherent difficulties in criminal prosecution of insider trading.

The discussion in this chapter shows that the proposed legislations to some extent mitigate the challenges identified in the Capital Markets Act. They, however, also present new requirements of proof that the prosecution must fulfil. Further, the Capital Markets Authority Bill 2011 attempts to improve the enforcement process through empowering the Authority to conduct its own prosecutions for offences under legislations administered by

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<sup>137</sup> The Securities Industry (Continuing Disclosure Obligations of Issuers) Regulations 2011 r 10(3).

<sup>138</sup> See Chapter 3.2 The Understanding of Prompt Disclosure.

<sup>139</sup> E. Swan and J. Virgo, *Market Abuse Regulation* (Oxford University Press, London 2010) 206.

the Authority.<sup>140</sup> This is in contrast to the current position where prosecutions are channelled to the office of the Attorney General, a system which may result in prosecutions being conducted by persons who many not have the market regulator's expertise to do so.

Given that enforcement is a problem in financial crimes generally, criminal offences compete for scarce police resources with other seemingly more serious crimes.<sup>141</sup> As such, breaches of securities laws are unlikely to be seen as priority and it is worth considering whether the market regulator is better placed to conduct these prosecutions. Whether or not they have the capacity is a point of contention, considering that the prosecution in the Davidson and Kibaru cases were conducted by a special prosecutor appointed by the CMA from private practice. Indeed, the survey on market practitioners indicated low public perceptions regarding levels of and capacity for enforcement of the Capital Markets Act by the regulatory body.

Further, the draft reforms now acknowledge that the proscribing of a variety of activities that serve to facilitate the practice of insider trading make the combat of insider trading more effective.<sup>142</sup> The Securities Industry Bill 2011 does this by expanding the scope of investor protection by also proscribing other market abuses that are not provided for in the existing Act.<sup>143</sup> These include market manipulation; false trading and market rigging

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<sup>140</sup> Capital Markets Authority Bill 2011 s 50.

<sup>141</sup> N. Dorn, 'The Metamorphosis of Insider Trading in the Face of Regulatory Enforcement' [2011], 19 (1) *Journal of Financial Regulation and Compliance* 75 – 84, 76.  
<<http://dx.doi.org/10.1108/13581981111106185>> Accessed on 23 October 2012.

<sup>142</sup> Penalty for the offence of insider trading includes both fine and imprisonment. However, the Bill goes beyond the Act and also takes into account the gain made or loss avoided and ensures that the fine imposed is higher than or equal to the gain made or loss avoided.

<sup>143</sup> Securities Industry Bill 2011 s 88 to s 94.

transactions; fraudulently inducing trading in securities; use of manipulative or deceptive devices; and false or misleading statements inducing securities transactions. This enhances the integrity of the capital market.<sup>144</sup> It has also been noted that where the regulatory framework effectively controls market abuses such as insider dealing and unauthorised disclosures, prospects for building investor and consumer confidence are high, since investors tend to target markets that protect them against risks.<sup>145</sup>

Despite the foregoing, it would appear important to consider other available avenues of enhancing information asymmetry as provided in the Act. This may suggest the selective use of criminal prosecution, especially because of its deterrent effect. It also makes a compelling case for an increased application of existing civil and administrative avenues, whose requirement of proof is on a balance of probabilities and therefore lower than criminal prosecution.

The foregoing discussion shows that the legal arrangements suggested in the proposed legislation have been implemented in other jurisdictions. They appear practical within Kenya's existing institutional arrangements and do not require the establishment of new structures. It is, therefore, suggested that the proposals in the Bill would assist the market regulator, to a certain extent, in lowering evidentiary difficulties occasioned by challenges that currently exist in determining what information is inside information. In addition,

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<sup>144</sup> A. Hudson, 'Criminal Offences in the Law of Finance' in *The Law of Finance* (Sweet and Maxwell, London 2009) 294.

<sup>145</sup> J. Gakeri, 'Enhancing Securities Markets in Sub-Saharan Africa: An Overview of the Legal and Institutional Arrangements in Kenya' [2011] 91(9) *International Journal of Humanities and Social Sciences* 134-169, 136 < [http://www.ijhssnet.com/journals/vol\\_1\\_9\\_Special\\_Issue\\_July2011/18.p.d.f](http://www.ijhssnet.com/journals/vol_1_9_Special_Issue_July2011/18.p.d.f)> Accessed 12 July 2012.



there is a need to address the other unresolved flaws in order to render the prosecution of insider trading a less arduous task.

#### **4.7. Isolating the Flaws**

The regulatory goal of the Securities Bill is stated as the protection of investors and connected purposes.<sup>146</sup> On the other hand, the Capital Markets Act has its goal as the development of a fair and efficient capital market in Kenya.<sup>147</sup> This variation implies a transfer of focus from market efficiency to investor protection.

Although these regulatory goals are different, they are very connected and in some instances overlap.<sup>148</sup> The renewed focus on investors is perceptible in the provisions of the Bill. Illustrative of this is the spirited deterrence of market abuse and malpractices;<sup>149</sup> the up scaling of fines payable as sanctions and the channelling of all fines towards an investor protection fund;<sup>150</sup> the introduction of an explicit right of action for damages<sup>151</sup> etc.

Market efficiency, on the other hand, prioritises information disclosure and elimination of information asymmetry. In an efficient market, prices fully reflect all available information on the stock market and key information is almost freely available to all participants. It is arguable that these measures eventually contribute towards the protection of investors.

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<sup>146</sup> Securities Industry Bill 2011 Preamble.

<sup>147</sup> Capital Markets Act Preamble.

<sup>148</sup> *Financial Assessment, A Handbook* (The World Bank and the International Monetary Fund 2005) 141.

<sup>149</sup> Securities Industry Bill 2011 s 88 to s 94.

<sup>150</sup> Securities Industry Bill 2011 s 123 (i).

<sup>151</sup> Securities Industry Bill 2011 s 93.

Nevertheless, shortcomings attributable to a focus on the investor and not issuers are noticeable in the proposed legislation. These include an absence of a corporate right of recovery from insiders who make use of issuer information. The provisions on prompt and mandatory disclosure of information are also inadequate. A further shortcoming, albeit unrelated, is the existence of gaps in regulatory enforcement measures arising from an under-resourced regulatory body.

- **Legislative gaps in the provision on information in general**

As discussed previously, the proposed laws provide more expansive criteria for the meaning of ‘inside information’.<sup>152</sup> However, there is no criterion applicable to the meaning of the term ‘information’ in general. This is because the term information could be understood in a variety of ways as demonstrated by the respondents in the survey. It could be taken to mean unspecific or imprecise collection of data, vague or general information, rumours, and suspicion, conjecture, speculation or combination thereof. Thus, the concern about providing possibilities for casting doubts on the prosecution case still holds true.

- **Inadequacies in the provisions on corporations as insiders and as issuers**

With regard to corporations as insiders, it was noted that the existing law on corporations as insider traders remains largely untested. The proposed laws also fail to address how the various provisions on insider trading can be applied to corporations. Related to this, is the absence of a corporate right of action for issuers.

A consequence of the emphasis on the protection of investors in the proposed laws is that attention has been concentrated on the negative impact of insider trading on buyers and

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<sup>152</sup> Securities Industry Bill 2011 s 83 and 84.

sellers of stock while ignoring the corporations and the shareholders who own them. As such, issuer companies appear to have been left with no explicit right of action.<sup>153</sup> Usually, information belongs to the company that issues the securities. This information could range from marketing plans to trade secrets and patents. While investors seek the most profitable investments for their funds, companies use information to increase the value of their shares enabling them to acquire capital more easily.

It is arguable that the public interest would be served by giving all investors a fair chance in the acquisition of publicly traded shares. An element of unfairness arises when employees and company insiders obtain benefits that are not available to the company's shareholders as this beats the purpose of their purchase of the shares. This also perpetrates the image of the issuer as an 'insider's company.'

As a consequence, it is imperative that a statutory corporate right of recovery for issuers whose information has been illegally used and abused in concluding transactions be introduced.

- **Prompt and Mandatory disclosure by insiders**

Although the duty to disclose is provided for in the proposed legislation, it is confined to directors and does not encompass insiders entirely. The scope of duty to disclose is considered narrow and inadequate taking into account the fact that insiders can include managers, employees of a company and even providers of services such as lawyers, bankers and printing companies.

Further, the bills provide for a disclosure time limit of five days.<sup>154</sup> It is posited that this period is too long compared to the twenty four hour period proposed by market

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<sup>153</sup> Securities Industry Bill 2011 s 119.

<sup>154</sup> The Securities Industry (Continuing Disclosure Obligations of Issuers) Regulations 2011 r 10(3).

participants in the survey. This proposal is consistent with proposals in other jurisdictions to have disclosure periods reduced to just one day.<sup>155</sup>

- **Enforcement**

The effectiveness and dynamism of the market regulator in enforcement of existing regulation was questioned in the previous discussion considering that the prosecution in the Davidson and Kibaru cases were conducted by a special prosecutor appointed by from private practice. Market participants in the survey also doubted the regulator's capacity and expertise to enforce the provisions of the Act unscrupulously.<sup>156</sup> Apart from showing little confidence in the adequacy of insider trading law, the vast majority of respondents faulted the regulator's desire, enthusiasm and expertise in enforcing the law.

Enforcement capacity is even more crucial now that the draft reforms acknowledge that the proscribing of a variety of activities that serve to facilitate the practice of insider trading make the combat of insider trading more effective.<sup>157</sup> This has been done by including other market abuses that are not provided for in the existing Act.<sup>158</sup> These and other new provisions widen the mandate of the enforcement body and create a greater need for vigilance and surveillance. They thereby provide a challenge to which the market regulator is called to rise.

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<sup>155</sup> V. Sharma, 'Prohibition on Insider Trading: A Toothless Law?' (Law School Research Paper No. 996, University of London-Centre for Commercial Law Studies 2009) 45.  
< SSRN: <http://ssrn.com/abstract=1400824>> Accessed 19 January 2010.

<sup>156</sup> J. Gakeri, 'Enhancing Securities Markets in Sub-Saharan Africa: An Overview of the Legal and Institutional Arrangements in Kenya' [2011] 91(9) *International Journal of Humanities and Social Sciences* 134-169, 143< [http://www.ijhssnet.com/journals/vol\\_1\\_9\\_Special\\_Issue\\_July2011/18.p.d.f](http://www.ijhssnet.com/journals/vol_1_9_Special_Issue_July2011/18.p.d.f)> Accessed 12 July 2012.

<sup>157</sup> Penalty for the offence of insider trading includes both fine and imprisonment. However, the Bill goes beyond the Act and also takes into account the gain made or loss avoided and ensures that the fine imposed is higher than or equal to the gain made or loss avoided.

<sup>158</sup> Securities Industry Bill 2011 s 88 to s 94.

#### **4.8. Conclusion**

Proposed legislation drafted by the Capital Markets Authority make a laudable attempt in mitigating inadequacies in existing law. They enhance clarity in the meaning of core elements of the crime of insider trading such as insider information and publication of information. They also establish mandatory disclosure requirements. In several ways therefore, the proposed laws better empower the market regulator to ameliorate insider trading, market abuses and failures in the Capital Markets in Kenya. However, some shortcomings such as the ambiguity in the term information and the legislative gaps in the possession of insider information by juristic persons still remain unaddressed.

## **5. CHAPTER FIVE: CONCLUSION AND SUGGESTIONS FOR REFORM**

This chapter seeks to summarise the study by highlighting the objectives and findings of the study and to make suggestions for reform based on the findings of the research. It is hoped that the findings and the suggestions will add to the body of knowledge that will inform the reforms in the existing securities legislation. This should in turn enable the capital markets accelerate the raising of capital to finance investment in key areas such as infrastructure and help propel Kenya to middle income status by year 2030.

### **5.1. Summary of Findings and Conclusion**

The objectives of this research were to examine the extent to which various provisions of the Capital Markets Act impede the prosecution of the offence of insider trading. The findings would determine whether legal reforms are needed in order to curb insider trading and to promote a fair and efficient capital market.

The literature, statute and case law having been triangulated with the results of the survey bring out a holistic view of the legal provisions on insider trading in the Capital Markets Act. Thus, the study's main findings are that the provisions of the Capital Markets Act relating to insider trading are weak and therefore difficult to enforce. Currently there are conceptual difficulties in determining the elements of the crime of insider trading thus enabling accused persons to utilise the existing loopholes to obtain acquittals. That notwithstanding, Kenya's capital market has the potential of being more vibrant and more globally competitive. This potential is evidenced by the possibility of reforming existing legislation governing the capital markets to effectively combat insider trading.

The hypothesis of this study was that the provisions in the Capital Markets Act relating to inside information, material price-sensitive information, publication of information,

possession of information and disclosure of information are vaguely formulated and are therefore difficult to prove, thus hindering the effective prosecution of the offence of insider trading. In light of the findings, it is considered that the hypothesis has been proved.

## **5.2. Suggestions for Reform**

Relying on the previous discussion of literature, case analysis and comments from the market, there seems to be a compelling case for reform of legislation on insider trading. To a certain extent, the Bills and proposed Regulations drafted by the Capital Markets Authority make a laudable attempt in mitigating some of the inadequacies in existing law.

On the question of information, the first proposal is that information should be statutorily defined for the avoidance of doubt. The second one is that the mere possession of inside information during the conduct of transactions should suffice to ground liability, as opposed to the requirement to establish the information as the basis of the trade. The third proposal is that the consideration that information is inside information when it was ‘obtained in the ordinary course of business’ should be eliminated.

With regard to publication of information, it is suggested that guidelines be established in order to assist the industry in dealing with the problem of determining when information can properly be said to have been published. Considering that the proscribing of a variety of activities that serve to facilitate the practice of insider trading make the combat of insider trading more effective, it is also suggested that the scope of prohibited conduct be widened in order to incorporate conduct such as market manipulation, use of manipulative devices, issuing of false statements and related activities that threaten integrity of the capital market.

Since the law does not currently provide for prompt and mandatory disclosure requirements for insiders, it is proposed that the affirmative duty of prompt disclosure and the reporting of transactions be provided and extended to insiders generally.

Other suggestions that are not addressed in proposed legislation are as follows:

Judicial interpretation has read the word material information so narrowly as to exclude financial information. Such an interpretation provides a means of escaping liability and is contrary to the spirit of the legislation. A broader interpretation is therefore proposed.

While the law clearly states that insider trading can be undertaken by a corporation, it is wanting when it comes to determining how corporations can be considered insiders and how they can be considered to have knowledge or possession of information and how they can exercise a corporate right of action for damages. Thus, the law appears to focus on natural persons, and to this extent it is contrary to the spirit of the legislation. It should be read, understood and interpreted with corporate bodies in mind.

There is a need to overhaul the enforcement effort in relation to insider trading. If insider trading is to be curbed, it is necessary that the regulator is robust, enthused and equipped to do so. Problems of proof present considerable obstacles and so long as this situation prevails, alternative enforcement measures such as civil and administrative enforcement measures need to be taken more seriously. The challenges entailed in the criminal prosecution of offences in the financial services realm as outlined above also make a compelling case for an increased application of existing civil and administrative avenues, whose requirement of proof is on a balance of probabilities and therefore lower than criminal prosecution.



It is also recommended that further research be conducted into related areas such as the adequacy of existing penalties and the effectiveness of civil remedies in order to enhance the overall effectiveness of insider trading legislation.

### **5.3. Summing up**

This study has examined the provisions of the Capital Markets Act on insider trading in light of key learnings from other jurisdictions and Kenyan cases. It identified limitations in the Capital Markets Act which operate as a drawback to the efficient and fair operation of the market. If not addressed, these problems threaten to prevent the Act from achieving its purpose of ensuring a fair and efficient market. These limitations are in the formulation of the elements that make up the crime of insider trading which create loopholes that make the prosecution and combating of insider trading difficult. The study has also examined the suitability of proposed legislation and made the case for reform having obtained experiences of legal practitioners through a survey. These proposals for reform, discussed above, can to an extent effectively deal with the limitations identified in the law. It is hoped that the reforms will play a role in raising investor confidence in Kenya's capital markets and attract many investors. This will enable the capital markets contribute in a major way to Kenya's Economic development and to the achievement of the blueprint vision 2030.

## APPENDIX 1: RESEARCH AUTHORIZATION

REPUBLIC OF KENYA



### NATIONAL COUNCIL FOR SCIENCE AND TECHNOLOGY

Telegrams: "SCIENCETECH", Nairobi  
Telephone: 254-020-241349, 2213102  
254-020-310571, 2213123  
Fax: 254-020-2213215, 318245, 318249  
When replying, please quote

NCST/RR/12/1/SS-011/359/5

P.O. Box 30623-00100  
NAIROBI-KENYA  
Website: [www.ncst.go.ke](http://www.ncst.go.ke)  
5<sup>th</sup> April, 2011  
Date:

Our Ref:

Anne Emily Kotonya  
Strathmore University  
P. O. Box 59857 00200  
NAIROBI

#### RE: RESEARCH AUTHORIZATION

Following your application for authority to carry out research on **"Assessing the effectiveness of Law in mitigating insider trading in Kenya's Capital Markets"** I am pleased to inform you that you have been authorized to undertake research in **Nairobi District** for a period ending **31<sup>st</sup> December, 2011**.

You are advised to report to the **Chief Executive Officer, Capital Markets Authority, the selected Judges/Magistrate(s), the Registrar of the selected Courts in Nairobi District, the Private Prosecutor and the selected Lawyers, the Chief Executive Officer, Nairobi Stock Exchange** before embarking on the research project.

On completion of the research, you are expected to submit **one hard copy and one soft copy** of the research report/thesis to our office.

**P. N. NYAKUNDI**  
**FOR: SECRETARY/CEO**

Copy to:

The Chief Executive Officer  
Capital Market Authority  
NAIROBI

## APPENDIX 2: RESEARCH AUTHORIZATION-RENEWAL

REPUBLIC OF KENYA



### NATIONAL COUNCIL FOR SCIENCE AND TECHNOLOGY

Telephone: 254-020-2213471, 2241349  
254-020-310571, 2213123, 2219420  
Fax: 254-020-318245, 318249  
When replying please quote  
secretary@ncst.go.ke

P.O. Box 30623-00100  
NAIROBI-KENYA  
Website: www.ncst.go.ke

Our Ref: NCST/RRI/12/1/SS011/359

Date: 4<sup>th</sup> June 2012

Anne Emily Kotonya  
Strathmore University  
P.O.Box 59857-00200  
Nairobi.

#### RE: RESEARCH AUTHORIZATION

Following your application for authority to carry out research on "*Assessing the effectiveness of law in mitigating insider trading in Kenya's Capital Markets*," I am pleased to inform you that you have been authorized to undertake research in **Nairobi Province** for a period ending **31<sup>st</sup> December, 2012**.

You are advised to report to the **Chief Executive Officer, Capital Markets Authority, the Chief Justice and the Permanent Secretaries of selected Ministries** before embarking on the research project.

On completion of the research, you are expected to submit **two hard copies and one soft copy in pdf** of the research report/thesis to our office.

**DR. M. K. RUGUTT, PhD HSC.**  
**DEPUTY COUNCIL SECRETARY**

Copy to:

The Chief Executive Officer  
Capital Markets Authority  
The Chief Justice  
The Permanent Secretaries  
Selected Ministries.

*"The National Council for Science and Technology is Committed to the Promotion of Science and Technology for National Development."*

## **APPENDIX 3: SURVEY QUESTIONNAIRE**

### **CAPITAL MARKETS: A SURVEY OF INSIDER TRADING LAW AND ITS ENFORCEMENT IN KENYA**

I invite you to participate in a survey of capital markets sector.

The intent of this survey is to provide insight into the legislation on insider trading and its enforcement in Kenya. The results of this survey will inform reform proposals to deepen the capital market and as a consequence, contribute to the creation of a vibrant globally competitive financial sector. I guarantee that any data collected will be treated in strict confidence and will not be directly referenced in an oral or a written report.

#### **General Information**

1. What is your occupation?

- ☐ I work in a Law Firm
- ☐ I work at the Nairobi Stock exchange
- ☐ I work at the Capital Market Authority
- ☐ I am an Academic
- ☐ I am an In-House Lawyer

2. Years of experience in Capital Markets Law / Regulation

- ☐ Below 2 Years
- ☐ Between 2 - 9 Years
- ☐ 10 years and above

#### **Introduction**

3. There is a debate among legal and economic scholars as to whether or not there should be laws prohibiting insider trading.

Which is your approach? Should insider trading be prohibited in Kenya?

☒ Yes

☐ No

4. Do you think investors will be more confident in Kenya's Capital Market if the prohibition of insider trading in Kenya is effected?

☒ Yes

☐ No

### **THEME 1: THE CAPITAL MARKETS ACT, Chapter 485A of the Laws of Kenya**

6. The Capital Markets Act makes use of the term 'information' in several instances. The meaning is not provided. In your opinion, if a person obtained knowledge relating to share prices in the sources below, would you agree that this is information?

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
1. A corporate advertisement in a news paper	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. An article in a tabloid	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Gutter press	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Office rumours	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. A speculative television news report	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Tales exchanged over an evening drink or a game of golf	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. News gathered from another company during an international conference	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>

## THEME 2: INSIDER TRADING

6. Insider trading can only take place when information is not publicized. Do you agree with the following recommendations below with regard to disclosure of information?

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Prompt disclosure of price-sensitive information by insiders should be mandatory	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Transactions by insiders involving securities instruments by their companies should be made a matter of public record	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

7. What would you regard as prompt disclosure of information by insiders?

- ☒ As soon as the information is received
- ☐ Within 24Hrs
- ☐ Within 48Hrs
- ☐ Other

8. From the list provided below, please indicate what you would consider as material information that may affect prices of a company's shares.

		Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
1.	The acquisition or loss of a significant contract.	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>
2.	Information on assets, liabilities and cash flows.	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>
3.	A significant new product or discovery	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>
4.	A call of securities for redemption	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>
5.	A tender offer for another issuer's securities	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>

### THEME 3: ENFORCEMENT

9. The capital Market Authority is empowering to carry out investigation, enforcement and sanctions under the Capital Markets Act. In your view/experience which factor causes low enforcement of legal provisions?

- ☒ The legislation is drafted in such a way as to make enforcement well-nigh impossible
- ☐ The burden of proof is inappropriately placed
- ☐ The standard of proof is too high

10. How would you rate Capital Markets Authority in terms of the following;

	Very High	High	Medium	Low	Very Low
Desire to enforce the law	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>
Enthusiasm to enforce the law	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>
Recourse to enforce the law	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>
Expertise to enforce the law	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>

11. Any other comments/explanations



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