EXCLUSION IN THE KENYAN CAPITAL MARKETS: A CRITICAL ANALYSIS OF THE EFFECT OF REGULATION ON FINANCIAL DEEPENING

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DECLARATION

This thesis is my original work and has not been presented in any other university.

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This Thesis has been submitted with my approval as a university supervisor.

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DEDICATION

This work is dedicated to the nuclear family I am about to start. May the endurance and dedication that has manifested in writing this thesis manifest manifold as a virtue in our family.

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LIST OF ABBREVIATIONS AND ACRONYMS

BCSC	British Columbia Securities Commission
CBK	Central Bank of Kenya
CDA	Central Depositories Agents
CMA	Capital Markets Authority
FSA	Financial Services Authority
GDP	Gross Domestic Product
ICESCR	International Covenant on Economic Social and Cultural Rights
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offer
NSE	Nairobi Securities Exchange
RTD	Right to Development
SACCO	Savings Credit Co-operatives
SEBI	Securities and Exchange Board of India
SEC	Securities Exchange Commission
SRO	Self-Regulatory Organization
USA	United States of America

TABLE OF STATUTES

1. Banking Act Cap 488.
2. Capital Markets (Licensing Requirements) (General) Regulations, 2002
3. Capital Markets Act, Cap 485A
4. Capital Markets(Securities)(Public Offers Listings and Disclosures) Regulations 2002 Amended 2016.
5. Companies Act No 17 of 2015.
6. Constitution of Kenya 2010
7. National Payment Systems Act of 2011
8. The Central Depositories Act
9. The Co-operatives Act
10. The SACCO Societies Act
11. The National Social Security Fund

ABSTRACT

This thesis analyses the role that the law plays in the exclusion that persists in the capital markets. It shows that the capital markets laws have provisions that act as barriers to entry thus stifling competition and innovation in the capital markets. This leads to the markets remaining shallow and excluding a large part of the population.

The research argues that there are changes in the law that could be made to allow for more inclusion in the capital markets. It thus sought to identify the changes that should be made in the law to enhance inclusion.

Through doctrinal research methodology, the research reviewed the legal framework critically to see the extent to which it contributes to the established causes of exclusion in capital markets. The research also adopted a comparative approach in identifying global trends towards regulation. It reviewed the approach used by the province of British Columbia, the United Kingdom and by the International Accounting Standards Board.

The research found that the law is at the heart of the causes of exclusion in the Kenyan capital markets. That through an amendment to the law, the impediments to inclusion would be addressed and corrected. It further shows that there is a global shift from rule-based regulation towards a principle-based regulation in capital markets regulations and regulation generally.

The research concluded that Kenya should adopt a principles-based regulatory approach. It further proposes several amendments to the capital markets and related regulations that should be amended towards this direction.

CHAPTER ONE

INTRODUCTION

1.0 Background

Kenya has about 4% of its adult population that participates in the capital markets.[1] This is against a backdrop of 75% financial inclusion levels in the country.[2] Countries that have deep and wide capital markets have high levels of participation by the population in the capital markets. The United States probably has the highest levels of participation second only to China[3]. Around 85 per cent of the population in the US participates in the capital markets through trading in stocks[4]. A survey conducted by the Federal Reserve in 2013 revealed that 48.8 per cent of US households where holders of publicly listed equities[5].

Having more citizens participating in the capital markets has been hailed as the bedrock of enhancing capital markets liquidity and stabilizing markets amidst the uncertainty of foreign-owned institutional investors[6]. Markets with a low percentage of the population participating in the capital markets, especially as retail investors, will have liquidity challenges as most liquidity

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[1]"Kenya's Capital Markets set for Reforms"(The Oxford Group, Kenya Report 2016) https://www.oxfordbusinessgroup.com/overview/market-movers-sector-set-further-reforms-future-looks-bright accessed 11 March 2018.

[2] Michael King, "The Kenyan Financial Transformation" (2000-2015) World Bank, http://blogs.worldbank.org/allaboutfinance/kenyan-financial-transformation-2000-2015, last accessed 11/11/2016.

[3]Samuel Shen and Brenda Goh "China stock market freezing up as sell-off gathers pace" *Reuters* (2015) http://www.reuters.com/article/2015/07/09/us-china-stocksidUSKCN0PI04Q20150709#sTs26smqWIb1pfWc.97, accessed 28 February 2016.

[4]Shilpa Puri "Investors in Equity Markets-Markets in Motion" (2010) 1 No 2, Financial Technologies Knowledge Management Company Ltd.

[5] Jesse Bricker, Lisa Dettling, Alice Henriques, Joanne Hsu, et al "Changes in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finances"(2014) Vol 100 No 4 Federal Reserve Bulletin http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf, accessed 02 January 2017.

[6] Bassey Udo, "Nigeria"s SEC wants more retail investors in capital market" *Premium Times* (Lagos,6 March 2016) <http://www.premiumtimesng.com/business/business-news/199655-nigerias-sec-wants-retail-investors-capital-market.html > accessed 1 January 2018.

are provided by retail investors as opposed to institutional investors who have long investment horizons on financial instruments that they purchase[7].

Owing to the low participation by citizens in the capital markets, African markets are still considered as frontier markets that are marked with low liquidity, few listings and high risks[8]. The leading powers in the capital markets space in Africa are arguably Nigeria and South Africa[9]. Despite their dominance, they are still grappling with the need to enhance inclusion of retail local investors in their markets to provide the much-needed liquidity and stability[10].

Retail investors bring about stability in the markets since they are not as volatile as the foreign institutional investors who flee markets and enter markets in large droves based on global economics patterns[11]. Investments and divestitures by the huge foreign investors often cause price and general market instability[12]. Increased local participation will bring about more liquidity in the markets and ultimately increase the efficiency of the markets[13]. With efficient markets, we will have predictable returns which will deepen the capital markets.

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[7] ibid

[8] "Africa's stock exchanges meet but size holds them back, Too few listings, too little liquidity: Africa's stock markets struggle" *The Economist* (Kigali, 16 December 2016) < http://www.economist.com/news/finance-and-economics/21711084-too-few-listings-too-little-liquidity-africas-stockmarkets-struggle-africas-stock > Last Accessed 10 July 2018.

[9] "About Johannesburg Stock Exchange" *African Markets* (Johannesburg 11 September 2018) < https://www.african-markets.com/en/stock-markets/jse/about> Last accessed 26 September 2018.

[10] Ryk-van Niekerk, "JSE wants more retail investors" *Money Web* (Johannesburg 31 May 2016) https://www.moneyweb.co.za/investing/jses-working-exchanges-across-africa-cross-listings-etfs/ last accessed 2/26/2017.

[11] Huzaifa Husain, "Retail Investors: Unsung Heroes of the Indian Capital Market, *Live Mint* (21 October 2015) < http://www.livemint.com/Money/9z76YT1kd4zTIfghQGQSiI/Retail-investors-unsung-heroes-of-the-Indian-capital-market.html> last accessed 2/26/2017.

[12] ibid.

[13] Malkiel Burton, "The Efficient Market Hypothesis and Its Critics" (2003) The Journal of Economic Perspectives, Volume 17, Number 1, 59-82(24).

The study is premised on the fact that capital markets are a major part of the capital raising forum in an economy together with the banking sector.[14] Kenya recognizes the role of capital markets in fundraising for the needs of the economy as espoused under Vision 2030 which states one of its hallmarks to be the deepening of the capital markets.[15]

The Kenyan Government recognizes the need to increase participation of its citizens in the capital and money markets as seen in the introduction of M-Akiba bonds.[16] The Capital Markets Authority (CMA) holds an annual capital markets open day to educate citizens on opportunities available in the capital markets[17].

Furthermore, the Constitution of Kenya 2010, outlines the national values and principles to include equity, inclusiveness, protection of the minority among others[18]. The financial services in Kenya should adhere to these national principles and values. The capital markets ought to be inclusive with the participation of more members of the republic.

A strong and deep capital market would provide an alternative source of funding for capital requirements of both the government and private entities. A weak capital market allows the banking sector to become a monopoly in the in the provision of capital for both government and the private sector. This denies the population choice with regards to capital raising. A choice is the ability to determine one over the other and it preserves the dignity of a people.

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[14] Jonathan Dodoo, Money and Capital Markets, http://aiu.edu/publications/student/english/Money%20and%20Capital%20mkt.html last accessed 20 November 2016.
[15] Kamau Thugge, Njuguna Ndungu and Owino Otieno, "Unlocking the Future Potential for Kenya-Vision 2030" [2010] Oxford University Press, 39-45.
[16] Otiato Guggulu, "M-Akiba bond set to trade next month" *e Daily Nation*, (Nairobi 8 September 2011).
[17] < https://www.cma.or.ke/index.php/investor-education/circulars-2 > last accessed 3/8/2018.
[18] Constitution of Kenya 2010, Article 10.

1.1. Statement of the Problem

State regulation of capital markets in Kenya started in 1989 with the establishment of the Capital Markets Authority (CMA)[19]. Prior to this, the market was self-regulated and indeed some aspects were unregulated. The onset of regulation slowed down growth of the capital markets as measured against the listing patterns at the Nairobi Securities Exchange [20]. The Nairobi Securities exchange has experienced dismal growth in terms of listings after state regulation than it did during the era of self-regulation.

Whilst there has been enacted myriad legislation[21] that have focused on enhancing the integrity of the markets, the markets have responded to these legislations by shrinking to consolidate their ground rather than venture out.

While acknowledging the role of regulation in the protection of consumers, the law should not act as an impediment to growth and innovation. Provisions of the Capital Markets Act and regulations thereunder, the Companies Act, the Central Depositories Act and other laws that affect capital markets should enable the growth, dynamism and innovation-leading growth- of the capital markets. However, the impact of these laws on capital markets deepening has been negative at least when measured against the listings at the Nairobi Securities Exchange, the number of securities exchanges, the percentage of the population that participates in capital markets and the diversity of products on offer in the Kenyan capital markets.

[19] Capital Markets Authority Act 1989, S. 2.
[20] Njaramba Gichuki, "The Paradox in the Implementation Matrix in Capital Markets Reforms in Kenya (A Paper presented at the Emerging Trends in Commercial & Financial Law Workshop, June 9–10, 2011, KCB Leadership Centre, Karen, Nairobi" [2011] Academia 11 < https://uonbi.academia.edu/NjarambaGichuki >.
[21] Under powers granted under section 12 (1) of the Capital Markets Act.

When the capital markets remain shallow due to slow growth, the lesser the number of people who shall be reached and served, which leads to more exclusions from the markets.

1.2. Objectives of the Study

The main objective of this study is to propose legal reforms towards increasing participation in Kenya's capital markets. This objective is broken down into the following specific objectives:

1. To identify how regulation contributes towards exclusion in the Kenyan capital market.
2. To evaluate the suitable form of regulation that would enhance inclusion.
3. To recommend reforms to the capital markets legal framework to enhance inclusion.

1.3. The Research Questions

The researcher sought to answer several questions in meeting the research objectives. The questions informed the literature that the researcher reviewed when conducting this research project.

1. In what ways does the current capital markets legal framework enhance exclusion in the Kenyan capital markets?
2. What nature of regulation would enhance the growth of the Kenyan capital markets?
3. Which reforms can be made in the Kenyan capital markets legal framework to enhance inclusion in the capital markets?

1.4. Statement of the Hypothesis

This study is hinged upon the hypothesis that the regulatory framework is a key determinant of the levels of inclusion in the capital markets. It hypothesizes that there are amendments that can be made and should be made to the regulatory framework to enhance inclusion in the Kenyan capital markets. It further makes a preliminary prediction that the current regulatory framework has stifled

inclusion in the Kenyan capital markets and that it requires, if not a comprehensive replacement, to be abolished.

1.5. Theoretical Framework

1.5.1. Economic Analysis of Law

Sociological jurisprudential theories like the economic analysis of law as expounded by Richard Posner[22] are hinged upon the understanding that the function of the law is to ensure the greatest economic fulfilment of the people. The economic analysis of law is built upon Bentham's Utilitarianism[23] but focuses on economic benefit as the ultimate purpose of the law. According to the economic analysis of law theorists, the ultimate goal of the law is to achieve a state where no one feels worse off from the allocation of resources within the economy, while at least some person feels better off from the allocation in what is described as *Pareto superior efficiency* principle[24].

Posner argues that it may be hard to achieve this Pareto superior ethos in practical aspects of everyday living[25]. He proposes, instead, the use of the *Kaldor-Hicks* efficiency principle which states that although the allocation of resources may create winners and losers, the losers should be compensated by the winners[26].

This research is anchored on the persuasion that the legal framework should promote efficiency - both *Pareto Superior efficiency* and *Kaldo-Hicks efficiency*- by ensuring that the manner in which the capital markets operate promotes equitable societies.

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[22] MDA. Freeman, *Introduction to Jurisprudence* (8th ed, Sweet and Maxwell, 2008) 707.
[23] ibid.
[24] ibid.
[25] ibid.

[26] *Freeman* (n 28) 704.

Inclusion in the capital markets would help more people access financial instruments for purposes of investment thereby ensuring that more people benefit from the available investment opportunities in the capital markets. In this way, the P*areto* efficiency will be achieved as a greater number will benefit from the economic opportunities provided by capital markets. The ideal position under this theory is that capital markets in their operations should leave more people economically better off.

1.5.2. Theories of Economic Regulation

The theories of economic regulation are important in the financial inclusion discourse. The two theories of economic regulation are the public interest theory and the capture theory[27]. The former justifies regulation by government to protect the vulnerable participants in the market. The latter refers to the need to regulate the conflicting interests of the various interest groups in the industry. Regulation theories justify government interference through regulation as being essential in correcting information asymmetries between the regulator and the market, protect the customers from exploitation, market operators from rival operators and from excessive interference by the executive[28].

This study avers that the government has a role to play in ensuring that the capital markets are accessible to the citizens of the country. The regulations should eliminate the information asymmetries, protect customers from exploitation thereby enhancing inclusion of more people in the capital markets. The government has a greater role to play through policy formulation, regulation, supervision and creating access to the capital markets. The low participation in the capital markets reflects a need for more governmental regulation or deregulation especially on the

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[27] Njaramba Gichuki, "Access to Financial Services: A Human Rights Perspective" [2015] East Africa Law Journal, 175-195.

[28]< http://regulationbodyofknowledge.org/general-concepts/theories-of-regulation/ >last accessed 01 October 2017.

grounds of public interest. Such efforts must be made by the government to bolster inclusion of retail investors in the Kenyan capital markets.

1.5.3. Marxism

Marxism argues that a state is a tool of the bourgeoisie for the oppression of the proletariat[29]. The economic system is supported by the state to perpetuate the oppression of the lower class. The efforts of individual participants in the system lead to self-destruction as each seeks for self-aggrandizement[30]. And as Paul Friere[31] argues, the solution need not come from government intervention as the theory of regulation proposes. This is so because, as Paul Freire argues, the oppressor, cannot be expected to bring change to the status quo. He is not able to bring real change to help uplift the oppressed. He thrives in the oppression. However, if the oppressed disengage from the oppression, which they hate, they can actively fight against it not with the purpose of replacing the oppressor, but out of a genuine need to change the oppression narrative. Change can only come when the people realize that they are oppressed and develop a pedagogy of the oppressed that will liberate them from the systemic shackles of the bourgeoisie[32].

This research argues that the market players also have a role to play in enhancing inclusion in the capital markets. They should be the ones to come up with products that enhance inclusion especially by adopting information technology and present these for regulation by the government.

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[29] Karl Marx and Friedrich Engels, "The Manifesto of the Communists" [1886] International Publishing Co.< http://www.bl.uk/learning/histcitizen/21cc/utopia/methods1/bourgeoisie1/bourgeoisie.html > last accessed 03 February 2018.

[30] ibid.

[31] Paul Freire, "Pedagogy of the Oppressed" < https://selforganizedseminar.files.wordpress.com/2011/08/freire_pedagogy_oppresed1.pdf > last accessed 03 February 2018.

[32] ibid.

The government as Marxism would argue, being an establishment of the bourgeoisie, may not be incentivized to help more people access the benefits in the capital markets.

1.5.4. Efficient Market Hypothesis Theory

The study is also informed by the Efficient Market Hypothesis (EMH) theory of economics whose proponents argue that where there are multiple buyers and sellers, markets are efficient and the share price reflects the true worth of the share[33]. In encouraging people to purchase stocks, the EMH theory advises that the market always tends towards efficiency and therefore there is an almost guaranteed way of making money from the stock exchange. Efficient markets reward all participants since they get their money's worth in purchasing any unit in the stock exchange.

However, for the EMH theory to stand, there must be enough liquidity in the market. Liquidity helps in the pricing of securities in the markets towards the equilibrium price which is the intrinsic value of the securities. Without proper liquidity, there will be mispricing of securities and this would create economic inefficiencies. It is these inefficiencies that financial analysts exploit to make supernormal returns as other people who are not aware of the mispricing (especially retail investors) lose out. One way of enhancing liquidity is through an increase in the number of participants[34].

There is, therefore, need to encourage more participants in the capital markets to fulfil the principles of the EMH theory. The EMH theory assumes a market free of securities mispricing, where investors cannot be exploited. More people should, therefore, be encouraged to join the

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[33] Eugene Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work" (1970) 25 No 2 The Journal of Finance, 383-417.

[34] "Africa"s stock exchanges meet but size holds them back, Too few listings, too little liquidity: Africa"s stockmarkets struggle"< http://www.economist.com/news/finance-and-economics/21711084-too-few-listings-too-little-liquidity-africas-stockmarkets-struggle-africas-stock > last accessed 5 May 2018.

capital markets as a way of enhancing distribution of resources hence achieving the efficient market hypothesis.

1.6. Literature Review

The researcher has reviewed the works of six scholars speaking to the subject of capital markets regulation, financial deepening in the capital markets and financial inclusion.

Dr Gakeri, in his article, *Regulating Kenya's Securities Markets: An Assessment of the Capital Markets Authority's Enforcement Jurisprudence*[35], argues that Kenya has adopted a government-led approach towards regulating capital markets. He opines that despite one of the key mandates of the Capital Markets Authority being to encourage self-regulation, the overarching powers of the executive have made regulation predominantly government led. He notes the tension between the quest to self-regulate vis-a-vis government regulation. Adherents of self-regulation argue in its favour since it allows regulation to benefit from the superior market knowledge that participants have compared to the limited knowledge of the executive[36]. The pro-government regulation scholars posit that to self-regulate would be tantamount to self-preservation[37].

Dr Gakeri submits that although self-regulation has had a long-standing status in financial services regulation, there has been a move towards government-led regulation on the premise of public interest and investor protection[38]. Indeed, the International Organization of Securities Commissions (IOSCO) acknowledges that self-regulation must be within the confines of

[35] Jacob Gakeri, "Regulating Kenya's Securities Markets: An Assessment of the Capital Markets Authority's Enforcement Jurisprudence, (2012) 2 No 20 International Journal of Humanities and Social Science,265-291.
[36] Jonathan Macey & Hideki Kanda, "The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges" (1990)75 Cornell Law Rev, 1007.
[37] Kenneth Durr & Robert Colby, "The Institution of Experience: Self-Regulation Organizations in the Securities Industry 17892-2010" < www.sechistorical.org > Accessed on 21 January 2017.
[38] Gakeri (n 41), 270.

government oversight[39]. That the two systems should augment each rather than have exclusive systems of either.

He concludes that in Kenya, self-regulation has taken a backseat in securities regulation in favour of a government-led regulatory framework. He critics the lack of proper oversight over CMA and the interference by the government in operation of the Authority that makes it a puppet of the presidency. Quoting the transparency international report of 2009, Gakeri argues that this interference renders the Authority ineffective in dispatching its regulatory mandates.

The article by Dr Gakeri does not show the results of the government led regulation approach on the capital markets laws enacted and how the laws hinder the development of the capital markets. While he notes that the government led regulatory framework may not be appropriate for the capital markets, his research does not point out the particular laws that result from this approach that impede the growth of the capital markets.

This research seeks to analyse the laws and regulations enacted by CMA and show how they impeded the growth of the capital markets. It also seeks to illustrate how the current model of regulation impedes growth.

Dr Njaramba has argued[40] that financial inclusion is not recognized as a legal right either in international legal instruments or in the local legal regime. It may appear therefore that financial inclusion is a commercial issue to be left to the factors of demand and supply. Although financial inclusion is not a legal right, laws play a vital role in financial services by not only providing for

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[39] Roberta Karmel, "Should Securities Industry Self-Regulatory Organizations be Considered Government Agencies?" (2008)14 STAN. J. L. BUS. & FIN, 151.
[40] Njaramba Gichuki, "Access to Financial Services: A Human Rights Perspective" [2015] East Africa Law Journal, 175-195.

a framework through which the financial markets are organized but also establishing the regulatory bodies that ensure compliance and growth of the markets[41].

The question of inclusion in the capital markets space has thus been debated from a business point of view since it is not per se a legal right[42]. The situation of the Kenyan Capital Markets, as Njaramba[43] notes are that the markets are very thin with only very few participants. The products are also few and the listed companies are not increasing at a fast rate[44]. He wonders why there is still one securities exchange in the country over a three decades and notes that the markets are not growing as fast despite the many efforts made on the regulatory front.

The bond markets have also faced similar lethargy with very few people participating. This hinders liquidity- a key factor for development of the debt securities markets[45]. As a result, Kenyan markets have remained both illiquid and thin[46]. The number of bonds being listed is few and the government has not been issuing treasury bills that are long-term choosing to concentrate on short-term bills[47]. Retail investors, who entail majority of Kenyan households, would be more attracted to long-term government bonds that do not require active management of their bond portfolios[48].

In the two articles, Dr Njaramba looks at financial regulation and how it contributes to the growth of the capital markets in Kenya. He contends that despite a matrix of laws the markets have not deepened. He does not, however, analyze the provisions of the laws that could in themselves be an

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[41] ibid.
[42] ibid.
[43] Njaramba Gichuki, "The Paradox in the Implementation Matrix in Capital Markets Reforms in Kenya (A Paper presented at the Emerging Trends in Commercial & Financial Law Workshop, June 9–10, 2011, KCB Leadership Centre, Karen, Nairobi" [2011] Academia 11 < https://uonbi.academia.edu/NjarambaGichuki >.
[44] ibid.
[45] Aduda J, Chogii J & Murayi M, "The Effect of Capital Market Deepening on Economic Growth in Kenya" < http://erepository.uonbi.ac.ke/handle/11295/61133 > last accessed 28/02/2017.
[46] ibid.
[47] Angela Kithinji, Martin Mbewa & Rose Ngugi, "Development of Bonds Market: Kenya's Experience" (2007) KIPPRA Working Paper No. 15.
[48] ibid.

inhibitor to the growth of the markets. This research seeks to advance the discourse by Dr Njamaba by analyzing the capital markets laws, regulations, guidelines and practice codes to identify provisions that inhibit growth.

Dr Njaramba looks at financial inclusion from a human rights perspective and posits that financial inclusion has been left as a business rather than legal endeavour since it is not a right fitting in the Hohfield definition of rights. This research looks at financial inclusion as a constitutional concept in arguing that the capital markets legal system must enhance inclusion otherwise they could be challenged as being unconstitutional. The research makes a case for the adoption of inclusion as a legal norm that should be reflected in the regulatory approach of the capital markets and in the regulations enacted to regulate capital markets. It is important to reduce the inclusion discourse into a legal norm rather than a commercial concept left to the forces of demand and supply. Commercial interests may not have included as a heartbeat of their operations. At best business interests focus would be on how much money could be made from inclusion rather than seeking to come up with products that address the needs of the people.[49]

Mwega [50] has researched on financial inclusion in the financial markets with a bias to the banking sector. He notes that inclusion has been attained through financial innovations like Mpesa, mobile banking, internet banking. He notes that the innovation in the banking sector has been successful without compromising on financial stability[51]. He looks at regulation as vital in the ensuring financial inclusion through use of innovation. For this reason, the National Payment System Act

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[49] John Kay, "Other People's Money: Making Finance Serve the Needs of the Economy" the 3rd Financial Sector Deepening Annual Lecture on Financial Inclusion at the National Museum Auditorium on 3rd February 2017. <http://fsdkenya.org/annual-lecture/ > accessed 4 March 2017.

[50] Francis Mwega, "Financial regulation in Kenya: Balancing inclusive growth with financial stability" https://www.odi.org/publications/8977-financial-regulation-kenyabalancing-inclusive-growth-financial-stability accessed 11/24/2016.

[51] ibid.

of 2011 was enacted to deal with concerns of security, money laundering and inadequate regulation.

The friendly regulatory platform has allowed for innovation in products like Mpesa and mobile banking innovations that have generally brought about inclusion in the financial service sector. In fact, data from the last Global index survey shows that over seventy-five per cent of Kenyan adults have a formal account. This places Kenya ahead of the financial inclusion levels globally and ahead of other more developed countries like Chile, Brazil, India, Mexico and Russia[52]. Most of this is attributed to the growth of Mpesa and mobile money services that link members owning bank accounts to their mobile phones.

Mwega[53] argues that the Kenyan banking sector has outperformed other African countries by being a leader in SME lending, an area not well captured in other large African economies competing with Kenya. The availability of cash for the SMEs which constitute 90%[54] of all the enterprises in the country is an essential step towards inclusion and enables most businesses to access the much-needed capital.

Indeed, from Mwega's discourse, it is apparent that much growth can result from inclusion through a friendly regulatory framework. Mwega focused on the impact of regulation on the growth of the banking sector in Kenya. The banking sector in Kenya is well developed compared to the thin capital markets. This research analyzes the relationship between the regulatory framework and the growth of the capital markets in Kenya.

[52] Michael King, “The Kenyan Financial Transformation” (2000-2015) World Bank, http://blogs.worldbank.org/allaboutfinance/kenyan-financial-transformation-2000-2015, last accessed 11/11/2016.
[53] Francis Mwega, “Financial regulation in Kenya: Balancing inclusive growth with financial stability” https://www.odi.org/publications/8977-financial-regulation-kenyabalancing-inclusive-growth-financial-stability accessed 11/24/2016.
[54] ibid.

Dr Okioga [55]in "*The Capital Market Authority Effectiveness in the Regulation of Financial Markets perspectives from the financial sector actors"* looks at the effectiveness of CMA in regulating financial markets in Kenya. He notes the many corporate governance issues that bedevil financial markets and is quick, like Dr Gakeri to point fingers at an overbearing executive which through corrupt motives seeks to control the regulators.

He looks at regulation as a response to market malpractices. He highlights general malpractices that have bedevilled the Kenyan economy in the last three decades ranging from the closing of several banks which sank with depositor's money. He highlights Euro Bank, where NSSF money invested by Shah Munge and Partners Stock Brokers, was lost upon the collapse of the bank. Mr Munge was a director of Euro Bank and a partner in the stockbroker. He notes instances of corruption in NSSF where the highest bidder was paid, Kes. 11 Billion to construct houses in Embakasi, Nairobi with an additional Kes. 2 billion being paid to the already inflated bid amount.

Okiaga points out the collapse of Discount Securities Ltd and Nyaga Stock Brokers as some of the market intermediaries that have suffered due to poor corporate governance and corruption. He opines that these are some of the reasons why regulation is important in financial markets. His only rider is that the regulator must be truly independent and objective to perform their obligations.

Dr Okiaga, concludes from his research that there is a positive correlation between financial services regulation and capital markets performance and development. He notes that proper regulation would have a positive contribution to the capital markets development. He, however, does not review the laws to establish if they amount to effective regulation practice. His research

[55] Charles Okioga, "The Capital Market Authority Effectiveness in the Regulation of Financial Markets perspectives from the financial sector actors" (2013) 2 No 11 Australian Journal of Business and Management Research, 15-24.

further does not show whether the regulation has a bearing on financial inclusion. He proposes further research on whether the process of regulating the markets is inclusive.

This research answers the question of the process of regulating capital markets and whether it is inclusive through a review of best practices in regulating capital markets vis a vis the Kenyan approach. It also goes granular in analyzing whether we have effective laws that enhance inclusion.

Rose Ngugi, Daniel Amanja and Isaya Maana[56], in *Capital Market, Financial Deepening and Economic Growth in Kenya*, noted that the capital markets-through bonds and stocks- contributes 1% of the total finance raising revenues in the market. They note that this is dismal since the attainment of Kenya's Vision 2030 would require 30% of required resources to be harnessed locally. They note that capital markets development is important in enhancing financial deepening. They highlight the advantages that accrue from capital markets such as price discovery, liquidity provision, reduction of transaction cost and transfer risk. These make it easy to do business which has a ripple effect on economic development.

Rose et al state that there is a significant relationship between financial market deepening and economic development. they identify the legal and policy framework as a key factor affecting financial deepening. Further, they point towards domestic financial sector liberalization as a precursor to deepening of the markets.

Finally, Rose et al discuss the concept of financial access and its relation to capital markets development. They point out a positive correlation between the two. They opine that access is also related to capital markets sophistication. The authors do not, however, look at the impact of

[56] Rose Ngugi, Daniel Amanja and Isaya Maana, "Capital Market, Financial Deepening and Economic Growth in Kenya, < https://www.researchgate.net/publication/265445432_Capital_Market_Financial_Deepening_And_Economic_Growth_In_Kenya > accessed 4 July 2017.

regulation on financial deepening. Their research focuses on the relationship between the growth of the economy and the depth of the financial sector. This research addresses the questions of the relationship between the depth of financial markets and capital markets regulation.

Agnes Munene, in her PhD Thesis, titled *Financial Deepening and Capital Market Development in Kenya*[57] notes that several efforts have been undertaken towards financial deepening by the Kenyan government. She argues that this stems from the realization that capital markets are a critical part of mobilizing investment funds to be channelled and utilized to attain Kenya's vision 2030.

She defines financial deepening as expanding the size of the financial organization and enabling entry of the informal market into the formal economic system to improve market efficiency and intermediation[58]. She avers that financial markets are deep if they are diverse in the products they offer investors[59].

She analyses the relationship between financial deepening and capital markets development noting that the two are positively correlated. Financial deepening according to Agnes would be enhanced if CMA would increase access and trading in the market by increasing the platforms for trading and settlement. She further notes the needs to provide incentives for listings and capital raising as well as promote investor education and public awareness of products available.

She notes that the emerging markets seem to stagnate or collapse despite government intervention aimed at financial deepening. Her research does not look at the effectiveness of the measures taken

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[57] Agnes Wanja, "Financial Deepening and Capital Market Development in Kenya" (DPhil thesis, Kenyatta University 2017).
[58] Margaret Nnenna, "Evaluating the nexus between financial deepening and stock Market in Nigeria" (2012)8 European Scientific Journal, 18-29.
[59] Paul Popiel, "Developing Financial Markets International Finance Corporation" (1990) World Bank Working Papers, Washington DC.

with an aim of critiquing them. This is partly what this research does. She notes that the efforts at financial deepening appear not to be bearing fruit in emerging markets. In the instance of Kenya, the financial deepening program was established to develop financial markets. Yet the capital markets have had a slow growth in listed entities and other financial products that could be offered.

It is her contention that CMA should deepen the markets by introducing new products to allow investors to diversify their risks through various investment opportunities. It is not clear how CMA would do that other than availing a legal framework for market intermediaries to launch these products. She further recommends that CMA should license more trading and settlement platforms to spur the growth of the capital markets.

In her conclusion, Agnes suggests that financial deepening should be approached by both CBK and CMA jointly rather than in isolation. She argues that the synergies would lead to a higher effect on financial deepening.

Agnes focuses on the impact of financial deepening in the capital markets. She analyses several aspects of financial deepening like depth, liquidity and access. She does not address regulation which is a factor affecting deepening. She proposes further research be conducted on the impact of other aspects of financial deepening would have on market development. this research is a quest in that direction. It shows the nexus between regulation and financial deepening and the impact on this has on financial inclusion in the capital markets.

1.7. Justification of the Study

From the review of the above literature, there are aspects of the Kenyan economy- like the banking sector that has achieved great levels of financial inclusion. Researchers have set out to define financial deepening and its impact on the economy and capital markets development. The scholars

have not addressed themselves to dissecting the legal framework to identify aspects that could be making it ineffective in enhancing deepening and inclusion in the capital markets. The discussion on whether financial inclusion is a legal issue seeing as it does not qualify as a human right has not been settled.

This research is important for the regulator and policymakers in that it provides a legal basis for advancing financial inclusion discourse. It advises them on changes to the law that may be enacted that would make the financial markets deeper.

1.8. Research Methodology

The researcher adopts a doctrinal research methodology approach in answering the research questions. In so doing the researcher reviewed the legal framework relating to capital markets to test whether it has any co-relation with the established causes of exclusion in the capital markets. This also entailed a review of the literature by scholars on the topic of inclusion and financial deepening in capital markets.

The researcher then took a comparative approach in the search for best practices in regulation of capital markets. Through a review of literature on the regulatory approach used in British Columbia, the UK and by the International Accounting Standards Board, the researcher made propositions as to the best practices in regulation.

1.9. Limitations

This research is limited in scope as it analyzes inclusion in the capital markets exclusively. Due to interoperability of the market, factors in other sectors could be affecting inclusion in capital markets. However, the research did not put such factors to consideration. It would be desirable for this research to be conducted on the entire financial markets rather than focusing only on capital

markets. Such an in-depth research would not be possible since this research is time-based and with limited resources.

1.10. Chapter Breakdown

Chapter 1. Introduction

A summary of the research proposal forms the introductory chapter of this thesis. It provides a glimpse of how the research was conducted, the literature that was reviewed, the assumption and limitation faced and the data collection techniques. Chapter one offers a good background to the study by identifying the problem of inclusion in Kenyan capital markets. It introduces the concept of exclusion as a product of an inappropriate legal framework.

Chapter 2. Financial Deepening and Financial Inclusion: The legal basis

Chapter two explores the legal basis of the concepts of financial inclusion and financial deepening. In so doing, it makes a case for the centrality of social economic rights while advocating for active pursuit of financial inclusion as a legal norm. It argues that economic rights are a bedrock to the enjoyment of other legal rights and freedoms.

This chapter also gives the constitutional and human rights basis for championing financial inclusion. It, in so doing, frames financial inclusion as a legal norm and not a just an economic concept.

Chapter 3. Exclusion in the Kenyan Capital Markets: Evidence from the Regulatory Framework

This chapter analyses relevant provisions of the Companies Act, Capital Markets Act, Central Depositories Settlement Corporation Act and the regulations and guidelines thereunder. The

review is structured around how these laws interact with five factors that influence capital markets deepening in Kenya.

Chapter 4. Emerging Best Practice in Capital Markets Regulation

The chapter starts with a fundamental discussion on the regulatory approach that would enhance capital markets development. It shows the regulatory approaches used by developed markets to enhance the growth of their markets and entrench inclusion. The chapter concludes by proposing the regulatory philosophy that should be adopted in Kenya to enhance capital markets deepening.

Chapter 5. Conclusions and Recommendations

This chapter summarizes the changes that should be made to the Kenyan regulatory and policy framework based on findings from the analysis of the regulatory framework and lessons from other developed markets.

CHAPTER 2

FINANCIAL INCLUSION AND FINANCIAL DEEPENING: THE LEGAL BASIS

2.0. Introduction

a. Financial Inclusion

There is yet to be global unanimity as to the definition of financial inclusion.[60] Widely, it refers to the extent which firms and households can access or use formal financial services[61]. The nature of formal financial services will differ from one jurisdiction to another. Under-developed markets will have formal financial services as opening a bank account or a mobile money account. However, there are other formal financial services that can be offered in the market such as insurance, pension, investments schemes, trading of securities and credit services.

b. Financial Exclusion

The lack of access to formal financial services would constitute financial exclusion. Access may be geographical in nature where providers do not have branches that can serve far-flung areas of the market. It could also be a factor of regulation where parts of the population are unable to meet the regulatory requirements. The use of terminology that the market is unfamiliar with also contributes in making markets inaccessible to the un-understanding population[62].

Products that do not fit the market or that are not affordable are other causes of financial exclusion[63]. Products could be unfit for the market because they have not been tailored to cure a

[60] Alper Aras, "Financial Regulatory Issues for Financial Inclusion"[2017] United Nations Economic and Social Commission for Asia and Pacific, 5. < https://www.unescap.org/sites/default/files/S6_Regulatory-Issues-for-FI.pdf> accessed 1 July 2018.
[61] Thorsten Beck and Asli Demirgu, "Access to Finance: The Unfinished Agenda" (2008) 22 No. 3 The World Bank Economic Review, 383–396.
[62] Anju Patwardhan, Ken Singleton and Kai Svhmitz, "Financial Inclusion in the Digital Age" [2018], 11. <https://www.ifc.org/wps/wcm/connect/f5784538-6812-4e06-b4db-699e86a0b2f2/Financial+Inclusion+in+the+Digital+Age.pdf?MOD=AJPERES > Accessed 10 August 2018.
[63] ibid.

market need or are priced in an inflexible manner. The affordability aspect of products is made worse by the fact that offering financial services to small businesses and low-income earners have a high cost and lower margins for the offeror of the products. This increases exclusion within the financial services sector.

c. Financial Deepening

Financial deepening refers to the enlarged delivery of financial facilities by financial institutions to all people in society[64]. Perhaps a more descriptive description would be Ndebbio's who refers to financial deepening as the expansion of provision of financial assets for economic growth by raising domestic savings and deepening the size of monetary systems[65]. Deepening allows placement of more savings through the creation of innovative products and avenues of saving and investing money[66].

The concepts of financial deepening and financial inclusion are related to the extent that they both seek to provide access to finance to a larger population through activities like product innovation, legislative changes and systems changes. These two concepts are used by fiscal policymakers in accessing economic wellbeing of countries. As discussed in chapter one, they have not been discussed from a legal perspective since they are not considered as legal norms but rather commercial issues.

d. Financial Exclusion in Capital Markets

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[64] Margaret Nnenna, "Evaluating the nexus between financial deepening and stock Market in Nigeria" (2012)8 European Scientific Journal, 18-29.

[65] John Ndebbio, "Financial Deepening, Economic Growth and Development: Evidence from Selected sub- Saharan African Countries" [2004] African Economic Research Consortium (AERC) Research Paper 142, 9.

[66] Ibid.

Lack of knowledge or financial illiteracy has been identified as one of the main inhibitors towards financial development[67]. However, it is not the only cause of exclusion in the growth of capital markets. Creation of capital markets that serve the poor and the excluded would entail legal reforms, the creation of institutions, educating consumers and offering support to existing institutions[68].

Just like exclusion in other financial services sectors, capital markets exclusion is evidenced by large populations being unable to access the products offered by the capital markets. Mostly the excluded are the poor in society who are involved in the production of raw material at the base of the production pyramid[69]. A sad circus is created in that lack of access to financial services exacerbates poverty[70] and poverty makes financial services inaccessible.

2.1. A legal basis for Financial Inclusion

Whilst contending with the fact that financial inclusion is not a legal right in the HohFeld's approach to rights, we in the next pages demonstrate that financial inclusion is a legal norm. We discuss this from a social economic rights perspective, right to development and from a constitutional point of view.

2.1.1. Social Economic Rights

Social economic rights are provided for under the International Covenant on Economic, Social and Cultural Rights (ICESCR). There is no optional protocol to the covenant that creates a mechanism

[67] Shawn Cole, Thomas Sampson and Bilal Zia, "Prices or Knowledge? What Drives Demand for Financial Services in Emerging Markets?" (2009) Harvard Business School Working Paper 09-117 pg. 2.
[68] Kate Lauer and Mayada El-Zoghbi, "Funding 2.0: Building Inclusive Financial Markets" [2013] < http://www.cgap.org/blog/funding-20-building-inclusive-financial-markets > accessed 9 July 2018.
[69]Trilochan Sastry, "Financial Inclusion in Capital Markets: Challenges and Opportunities for Producer Companies" Working Paper No: 555. < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3024522 > accessed 9 July 2018.
[70] Njuguna Ndungu , "Balancing Financial Inclusion and Stability" [2012] < http://www.cgap.org/blog/balancing-financial-inclusion-and-stability > accessed 9/July/2018.

by which individuals and groups complaints against states can be adjudicated. Nations are yet to agree on how social economic rights should be enforced in the world of nations owing to the unique nature of these rights[71].

Some scholars have made the argument that there is a need to treat these rights as universal, inter-related, ubiquitous and on the same wavelength as other civil-political rights that have gained universal acceptance as justiciable and mandatory[72].

On the other side of the paradigm are those that consider these rights as “soft law”, utopian ideals, aspirational objectives that are to be achieved progressively into the future[73]. This school of thought sees these rights as not being justiciable as are civil and political rights. They advance a thinking that there would be challenges that would result from creating obligations for states to implement them. There is also a challenge of clarifying concepts found in the treaty such as “standard of living”, “progressive realization”, “maximum use of available resources” which casts doubts as to whether these rights can be fully realized or become justiciable at some point[74]. Kenya has adopted the latter approach.

ICESCR is part of Kenyan law since the Kenyan Constitution recognizes international law, properly domesticated, and the general principles of international law as part of the Kenyan law[75].

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[71] “Open-Ended Working Group to Consider Options Regarding the Elaboration of an Optional Protocol to the International Covenant on Economic, Social and Cultural Rights, UN Doc. E/CN.4/2004/44” <https://www.ohchr.org/en/issues/escr/oewg/pages/openendedwgindex.aspx >accessed 9 July 2018.

[72] Michael Dennis and David Stewart, “Justiciability of Economic, Social, And Cultural Rights: Should There be an International Complaints Mechanism To Adjudicate The Rights To Food, Water, Housing, And Health?”(2004)98 No 3 The American Journal of International Law, 464.

[73] Advisory Opinions Application 2 Of 2012, EKLR, Par. 69. Where similar thoughts were expressed by the Supreme Court of Kenya’s interpretation of Article 27 of the Constitution of Kenya 2010 on the one-third minimum representation of either gender in elected positions.

[74] Michael Dennis and David Stewart, “Justiciability of Economic, Social, And Cultural Rights: Should There be an International Complaints Mechanism To Adjudicate The Rights To Food, Water, Housing, And Health?”(2004)98 No 3 The American Journal of International Law, 462-515.

[75] Constitution of Kenya 2010 Article 2(5) and (6).

ICESCR was domesticated on 1 May 1972 with a reservation that the prevailing circumstances in Kenya would not allow conversion of principles therein into mandatory requirements under Kenyan law for the state to comply with[76].

This treaty thus remains as soft law, only indicating the commitment by the government to achieve the ethos espoused therein. The general language of the treaty is as such. It leaves the state with the option of tailor-making its own means of achieving the principles within the treaty.

For instance, article 2(1) of the ICESCR provides that:

> "Each State Party to the present Covenant undertakes *to take steps,* individually and through international assistance and co-operation, especially economic and technical, to the maximum of its available resources, with *a view to achieving progressively the full realization of the rights recognized in the present Covenant by all appropriate means*, including particularly the adoption of legislative measure"

Article 11 of ICESCR identifies one of the rights that states signatories to the treaty should ensure their citizens enjoy. It requires that a member state should ensure its citizens *have an adequate standard of living where living conditions are continuously improved through provision of food, clothing and housing amenities*.

As stated in the foregoing, the "how" is left for the member states to configure. This research proposes that financial inclusion is one of the many "*hows*" that should be used to achieve this right.

[76] https://treaties.un.org/pages/ViewDetails.aspx?src=IND&mtdsg_no=IV-3&chapter=4&clang=_en last accessed 10 September 2018.

At the heart of the treaty is the alleviation of poverty. Which at a bare minimum is the availability of food, shelter and clothing for the population. Financial inclusion is a tool for poverty alienation[77]. Access to financial products offers solutions for alleviating poverty. In so doing, the rights under the treaty are achieved.

Access to financial services is such basic a need since it is a precursor to the enjoyment of the other civil and political rights. Only when the economic burden is lifted, will the people easily attain or agitate for granting of the other rights. Sadly, despite being so basic a right, it is not justiciable[78]. There is no international tribunal so formed where an individual can plead a case against a state for not providing water, food, proper housing or healthcare. Rather, these rights are noted as aspirational goals to be achieved progressively since they would require substantial time and resources to achieve[79].

It is on the premise of the role that financial inclusion would play in a helping Kenya attain its obligations under ICESCR, and the fact that it is basic for the attainment of other fundamental human rights, that makes it of central legal concern.

2.1.2. Right to Development

We have argued that financial inclusion is an important step towards the attainment of social economic and cultural rights. We have however noted that these rights are merely aspirational and not justiciable as such. The right to development is a higher form of social economic and cultural

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[77] See generally conclusions by Ogunsakin Sanya and Fawehinmi Olumide, "Financial Inclusion as an Effective Policy Tool of Poverty Alleviation: A Case of Ekiti State" (2017)8 Issue 4 IOSR Journal of Economics and Finance, 01-10.

[78] Michael Dennis and David Stewart, "Justiciability of Economic, Social, And Cultural Rights: Should There be an International Complaints Mechanism To Adjudicate The Rights To Food, Water, Housing, And Health?"(2004)98 No 3 The American Journal of International Law, 462-515.

[79] Ibid.

rights. The right to development is an inalienable human right that safeguards the entitlement for individuals to participate in, contribute to and enjoy economic development[80].

It was codified as a right in the 1980s and has been hailed as pivotal in the quest for self-determination[81]. It is a compatriot of the right to equality and democracy in international human rights discourse[82]. The adoption of the Right to Development (RTD) through a UN General Assembly resolution in 1986[83] make compliance with it among state nations a fait accompli.

RTD upgrades economic rights to the level of civil and political rights in international human rights discourse. Looking at economic rights from an RTD perspective, economic rights come out as cardinal international human rights norm that does not play second fiddle to other rights[84]. RTD ensures that social economic rights are not incompatible or antithetical as when juxtaposed against the civil and political rights[85].

The right to development is an inalienable human right that safeguards inter alia, the entitlement for individuals to participate in, contribute to and enjoy economic development[86]. Access to finance would without a doubt provide an opportunity for the citizens to participate and enjoy economic development while the converse would limit participation and enjoyment.

[80] Declaration on the Right to Development, Art 1.
[81] Amede Obiora, "Beyond the Rhetoric of a Right to Development" (1996) 18 No 3&4 Law &Policy.
[82] ibid, 357.
[83] Resolution passed on 4 December 1986 through a roll-call and affirmed as a right in the 1993 World Conference on Human Rights. < http://www.un.org/esa/documents/ecosoc/docs/1999/e1999-23.pdf > accessed 7 September 2018.
[84] Amede Obiora, "Beyond the Rhetoric of a Right to Development" (1996) 18 No 3&4 Law &Policy, 377.
[85] Santos Boaventura De Sousa, "*Toward a new Common sense: Law Science and Politics in the Paradigmatic Transition"* (1995) New York, Routledge. Santos argues that historical capitalism should be brought to trial for violation of human rights in underscoring the interdependence between social economic rights and civil-political rights.
[86] Declaration on the Right to Development, Art 1.1.

The state is required to create favourable conditions that will ensure all citizens enjoy the right to development[87]. To do this, article 2 of the declaration on the right to development requires the state to create policies and programs affecting persons within their jurisdiction that would enable them to enjoy the RTD.

It is our contention that among the policies that would have a great impact on the ability of citizens to enjoy the RTD is financial inclusion. The more inclusion there is, in increasingly more financial services, the more people will be able to attain economic development.

Just as states put in place measures to show compliance with fundamental human rights, the state should through legislative and other measures ensure enforcement of RTDs in their jurisdictions. This is notwithstanding the ICESCR treaty in which states have limited their compliance exposure by regarding the rights therein as soft law.

As per article 2(6) of the Kenyan Constitution, the RTD is hard law that should be enforced within the country. It behoves the government to put in place measures towards this end. Financial inclusion is one of the policies and legislative measures that should be taken into consideration to ensure compliance with the declaration on the Right to Development.

2.2.Financial Inclusion and the Constitution of Kenya 2010

Hans Kelsen describes the law as composing of norms that derive from focusing on what ought to be rather than what is[88]. What "ought to be" itself derives from another normative premise. The

[87] Declaration on the Right to Development, Art 3.
[88] Brian Bix, "Hart, Kelsen and Legal Normativity" 2018,< https://journals.openedition.org/revus/3984 > last accessed 10 September 2018.

hierarchy of norms continues until we get to the foundational norm upon where all the other legal norms are based. The foundational norm is the "g*rundnorm*"[89].

In a constitutional democracy, the grundnorm is the constitution[90]. It is the norm from which other norms gain legitimacy. As discussed in the foregoing paragraphs, financial inclusion would lead to the attainment of economic and social rights. These rights are articulated under article 43 of the Constitution of Kenya 2010. The right to access formal financial services is not covered as part of the social economic rights in the constitution. It, however, is fundamental in helping to attain the rights enshrined in the constitution. Indeed, without it, the constitutional rights may just be a mirage owing to the economic aspect that underpins virtually all rights and freedoms.

2.2.1. Constitutional Principles

Article 11 of the Kenyan constitution outlines the national values and principles which, standing alone, are not justiciable[91]. Like the preamble, they show the spirit of the law that should guide interpretation of the constitution. The spirit should be reflected in the development of national policies[92]. It should also influence the enactment, implementation and interpretation of all laws[93].

The constitutional values and principles are patriotism, national unity, sharing and devolution of power, the rule of law, democracy and participation of the people; human dignity, equity, social justice, **inclusiveness, equality**, human rights, non-discrimination and protection of the

[89] ibid
[90] Hopton T.C, "Grundnorm and Constitution: The Legitimacy of Politics" (1978) 71, < http://lawjournal.mcgill.ca/userfiles/other/6042331-hopton.pdf > accessed 12 September 2018.
[91] Benard Eboso, "Judicialization of Politics Under the Constitution of Kenya 2010" (LLM thesis University of Nairobi, Kenya 2014).
[92] Constitution of Kenya 2010, Art 10(1)c.
[93] Constitution of Kenya 2010, Art 10(1)d.

marginalized; good governance, integrity, transparency, accountability and sustainable development.

Inclusiveness is noted as one of the national principles. Its application cuts across the whole society and all government relationships with the subjects. It is a national value and selective application is unthinkable. To ensure access to financial services is to entrenching inclusiveness in the financial sector.

Therefore, inclusion in the financial sector as a legal norm finds its constitutional vindication under the national values and principles. It accordingly ranks high in the order of legal norms as it becomes recognized a *grund norm* in the Keynesian manner of thinking. Inclusion becomes a legal norm because it is in the constitution and the constitution is the *Grund Norm*. The constitution itself becomes the *grund norm* because it gains legitimacy from the sovereignty of the people-whence the sovereignty vest.[94]

This being the case, it behoves the relevant players and in particular those who shape policy and regulatory framework of the financial markets to enhance financial inclusion. It is a societal value, not just a judicial value that must be inculcated by all bodies interfacing with the citizens. In particular, for purposes of the current study, the need for financial inclusion in the capital markets is a fait accompli for the regulators of capital markets.

2.2.2. Financial Inclusion in the Equality Discourse

Equality inherently alludes to a discourse on rights[95]. This is so because equality finds origin in human rights declarations such as the American Declaration of Independence of 1776 that all men

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[94] Njoya & 6 others -Vs- Attorney General and 3 Others (no.2) (2004) KLR 261.Dictum by Ringera J (as he then was)
[95] Peter Western, "The Empty Idea of Equality," (1982) 95 No 3 Havard Law Review, 542.

are created equal[96]. The Universal Declaration of Human Rights at article 1 reiterates the centrality of the belief that all humans are born equal in dignity and rights.

If then all people are equal for all intents and purposes, it follows that all the rights of people including their civil, political, social and economic rights should be equal. Where inequality of rights thrives, then discord is bound to arise from the oppressed in an act of revolution which will undermine economic development and derail achievement of even a broader scheme of rights. This has been witnessed over history and led to the revolt against apartheid and feudalism systems that thrived on the premise of inequality of rights[97].

The Kenyan constitution under article 27 upholds this tenet stating that every person is equal before the law and has the right to equal protection and equal benefit of the law. Further, it expounds that equality pervades even to the full and equal enjoyment of all the rights and fundamental freedoms.

Furthermore, economic rights are part of the cohort of rights under the constitution of Kenya 2010. The attainment of equality under the sphere of economic rights in the context of unequal economic power among citizens is not easy to achieve. One way would be to take from the "haves" and give to the "have nots'. This methodology would, however, result in an inequality in the sense that the "haves' would be treated in an adverse manner. Hence the warning by Kameri[98] that in enhancing equality one faces the risk of creating another inequality.

[96] Thomas Jefferson, "American Declaration of Independence of 1776".< https://www.archives.gov/founding-docs/declaration-transcript > accessed 30 August 2018.
[97]Nazir Carrim, "Human Rights under Apartheid" (2007) <http://wiredspace.wits.ac.za/bitstream/handle/10539/2032/CarrimN_Chapter%204.pdf?sequence=10&isAllowed=y > accessed 30 August 2018.
[98] Patricia Mbote, "Fallacies of Equality and Inequality, Multiple Exclusions in Law and Legal Discourses"(2013) Inaugural Lecture, University of Nairobi.

A better approach to enhancing economic equality that does not include taking from one party in favour of another -for no justifiable reason- would be through decentralization of the means towards economic empowerment. For instance, removing barriers to entry into financial markets would be one way of entrenching equality. Law plays an important role in entrenching and justifying inequalities[99].

One way of ensuring economic equality is thus through financial inclusion. Financial inclusion enables persons to access credit from financial institutions to enable them to meet their economic needs. It creates a flow of cash to more people in the economy increasing the earnings of the more people in the population. Inclusion in capital markets provides businesses with alternative forms of raising capital for their businesses and the general population with an alternative avenue for personal savings and investment.

Since the government cannot provide resources for all people to enjoy economic rights, to ensure equality, it has the responsibility to create an avenue where all citizens can engage in commercial activities towards attaining their economic needs. Space so created should enhance equality by removing requirements that hinder sections of the society from being part of the system.

Most people are excluded from financial markets, because they lack financial literacy, and/or are poor. Sadly, because they are excluded, they become poorer. And the poorer one gets the more difficult it becomes to access finance.

Financial inclusion as a panacea for inequality of economic rights amongst subjects of the law is utmost importance. It is important even though it is not an economic right *per se.* Its centrality derives from the fact that it is the most equitable way of entrenching economic equality. Financial

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[99] Ibid.

inclusion is so closely related to the attainment of equality of economic rights that it must be elevated as a legal norm inequality discourses.

2.3. Conclusion

Financial inclusion draws from the constitutional values of inclusiveness and equality. It thus gains legitimacy as a constitutional principle that should be cascaded downwards through public policies and institutions. It enhances the economic equality of people in the belief that all people should enjoy equal rights.

Furthermore, inclusion in the financial sector is central to the attainment of social economic rights and the right to development. Although it is not listed as part of the global social economic rights, we have argued that it underpins and facilitates the achievement of social economic rights and the right to development.

Since it falls within the calibre of social economic rights and right to development, financial inclusion should be implemented progressively. In the words of Lady justice Mumbi[100], this means there must be active steps being taken either through legal reform or institutional restructuring to achieve this constitutionally national value and a fundamental enabler of social economic rights and the right to development.

The following chapter enumerates the challenges that the Kenyan legal framework manifests in ensuring there is increased access to financial services offered in the capital markets.

[100] Mitubell Welfare Society vs. The Attorney General & 2 Others Petition No. 164 of 2011 eKLR.

CHAPTER 3

EXCLUSION IN THE KENYAN CAPITAL MARKETS: EVIDENCE FROM THE REGULATORY FRAMEWORK

3.0. Introduction

This chapter entails a critical review of the legal framework governing capital markets to identify ways in which it contributes to exclusion in capital markets. This in no way suggests that the legal framework is the only cause for exclusion. A report by CMA on the reasons for slow uptake of products in Kenya, reveals other factors affecting deepening of the Kenyan markets other than regulation[101].

Chepkoiwo[102] in analyzing the challenges facing the development of the capital market identifies a raft of other factors that affect inclusion in capital markets. His empirical analysis of data for the period between 2005 and 2010 reveals that capital market development is influenced by liquidity in the capital markets, quality of institutions, average individual earnings, level of savings and bank development[103].

The regulatory framework is at the heart of these inhibitors of inclusion to a larger extent. It may also hinder capital markets deepening by creating regulatory obstacles[104]. This chapter shows how

[101] "Study on The Low Uptake of Capital Markets Products in Kenya Research Paper, Capital Markets Authority, June 2018" (2018) Capital Markets Authority of Kenya, 3 <file:///C:/Users/s.munene.CENTUM/Centum%20Investment%20Company%20Limited/OneDrive%20-%20Centum%20Investment%20Company%20Limited/Downloads/CMA%20Study%20on%20Low%20Uptake%20of%20Capital%20Markets%20Products%20Final%202%20(1).pdf > accessed 02 September 2018.

[102] Nicholas Chepkoiwo, "Factors Affecting the Development of Emerging Capital Markets. The Case of Nairobi Stock Exchange" (MBA thesis University of Nairobi 2011) > http://erepository.uonbi.ac.ke/bitstream/handle/11295/13115/Chepkoiwo_Factors%20Affecting%20The%20Development%20Of%20Emerging%20Capital%20Markets.%20The%20Case%20Of%20Nairobi%20Stock%20Exchange.pdf?sequence=3&isAllowed=y < accessed 1 September 2018.

[103] Ibid P. 44.

[104] "Study on The Low Uptake of Capital Markets Products in Kenya Research Paper, Capital Markets Authority, June 2018" (2018) Capital Markets Authority of Kenya, 62 <file:///C:/Users/s.munene.CENTUM/Centum%20Investment%20Company%20Limited/OneDrive%20-

the current regulatory framework inhibits inclusion in the capital markets space directly or indirectly. Directly through provisions that discourage participation in the capital markets or indirectly through promoting practices that entrench inclusion.

As described in chapter one, capital markets deepening, or development is directly related to inclusion in the capital markets. Now that the intersectionality of development of capital markets and inclusion in capital markets is settled[105], we use these terms interchangeably in describing the effect legislation has on inclusion in the capital markets.

3.1.Central Depositories Act

This Act of parliament[106], provides the framework for the operationalization of central depositories. The central depositories established must be licensed by CMA[107]. The Central Depositories Act (CD Act) and the rules thereunder, provide for rules that are applied in the settlement of securities and establishment of depositories.

This act affects the deepening of capital markets in three ways. First in the requirements for licensing of who can become a central depository agent. Secondly, the rules of operating a central depository should enable internet trading and therefore instant settlement of trades. This would increase the accessibility of the markets by wider groups of broader geographical locations. Thirdly, the rules on dematerialization of shares should be automated to allow for a quicker process.

%20Centum%20Investment%20Company%20Limited/Downloads/CMA%20Study%20on%20Low%20Uptake%20of%20Capital%20Markets%20Products%20Final%202%20(1).pdf > accessed 02 September 2018.

[105] Ryk-van Niekerk, "JSE wants more retail investors" *Money Web* (Johannesburg 31 May 2016) https://www.moneyweb.co.za/investing/jses-working-exchanges-across-africa-cross-listings-etfs/ last accessed 2/26/2017.

[106] The Central Depositories Act, No. 4 of 2000.

[107] The Central Depositories Act, S 5.

There is need to liberalize this aspect of the capital markets through regulatory reforms including possibility of deregulation now that government-led efforts show no clear efforts towards self-regulation[108].

3.1.1. Who can become a Central Depository Agent?

The CD Act outlines the requirements of who qualifies to be licensed as a central depository[109]. A company established under the Companies Act, that meets the governance and minimum capital requirements set under the act, may apply for an approval to act as a licensed central depository.

However, the depository so licensed should appoint agents referred to as Central Depositories Agents (CDAs). The act states that only specific persons would qualify to be appointed as CDAs these groups are licensed trading participants, subsidiaries of banks or financial institutions, institutional investors or a corporate prescribed by the authority[110].

In limiting the nature of parties that can act as agents of central depositories, the law hinders the ability to reach more people onto the capital markets. The CDAs interface with the public directly they facilitate opening of securities account with the central depositories. In limiting who can become a CDA, the ability to reach a wider number of people is limited.

Broadening the number of people who can act as CDAs would lead to the inclusion of technology-based companies into this space with the potential of growth in the internet trading space. Increase in competition would also open the markets to the more people.

3.1.2. Rules on Internet Trading

[108] Jacob Gakeri, "Regulating Kenya's Securities Markets: An Assessment of the Capital Markets Authority's Enforcement Jurisprudence, (2012) 2 No 20 International Journal of Humanities and Social Science,265-291.
[109]Central Depositories Act, 2000, S 5.
[110] ibid, S 9.

Use if internet trading has the possibility of enhancing inclusion in the capital markets. It helps to tap into most young people who have access and are prone to using the internet. It also enables real-time settlement of trades and movement of cash.

The experience in Korea, US and China have seen a tremendous increase in the number of retail traders participating in the capital markets[111]. The cost of trading has gone low in these markets and the traditional brokers/intermediaries have faced immense competition from online traders[112]. The duration for settlement has reduced to almost instantaneous settlements.

In Kenya, the mobile phone penetration rate is high with up to 80 % of Kenyans having access to the internet. The use of mobile money is also ubiquitous. The use of online trading in securities would thus increase the number of market participants enhancing liquidity and inclusion.

In May 2017, amendments to the Central Depository Operational Procedures allowed the use of mobile phones by natural persons to open CDS accounts[113]. The innovation can help many to access the markets owing to the ubiquitous access to mobile phones in Kenya[114]. The reach of smartphones among the adult population in Kenya in 2018 was at 90% making Kenya the global leader of internet traffic coming from mobile phones[115]. These rules provide for ways of delivering orders to CDAs using the mobile phone device and for checking one's balances and summary of trades via an online platform.

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[111] "Factors Influencing Liquidity in Emerging Markets Report of the IOSCO Emerging Markets Committee" (2007) IOSCO, 17. < https://www.iosco.org/library/pubdocs/pdf/IOSCOPD258.pdf > accessed 10 September 2018.
[112] ibid.
[113] Central Depository Operational Procedures, 2012 (Revised 2018) Rule 3.2.
[114] "Kenya's mobile penetration hits 88% to 38 Million users" *Kenyan Wall Street* 8 Jan 2016. < https://kenyanwallstreet.com/kenyas-mobile-penetration-hits-88-to-38-million-users/ > last accessed 10 September 2018.
[115] James Ngunjiri, "Kenya Tops in Phone Internet Traffic Global" *eBusiness Daily* (Nairobi, 20 March 2018) <https://www.businessdailyafrica.com/corporate/tech/Kenya-tops-in-phone-internet-traffic-/4258474-4349966-3m4lrez/index.html > accessed 12 August 2018.

However, the rules do not provide for the real-time digital transfer of shares. Such rules would guide the CDAs on how to facilitate internet trading to ensure real-time settlement of sales. It would not be possible to set up and operate an internet trading platform for stocks in Kenya using these rules or the legal framework generally.

3.1.3. Dematerialization of Shares

Rules 5.2, 5.3 and 5.5 [116] outline the processes to be followed in dematerialization of shares. The investor must fill a CDS 2 form attaching relevant certificates to deliver them to a CDA. The documents are transferred to the issuer upon making necessary verifications transfers the documents to the CDSC[117]. The CDSC transfers the documents to the Issuer and if there are any rejected documents, the same is forwarded to the CDA.

The above process is manual and tedious. Often documents get lost in the process. The process is also expensive for shareholders who must travel to surrender their documents to CDAs. Where certificates are lost or torn, shareholders must swear affidavits and pay replacement fees[118]. These manual processes make the capital markets inaccessible and costly. The manual process becomes more difficult where the dematerialization is happening together with a transmission.

The Central Depository Operational Procedures, 2012 (Revised 2018) should be amended to provide for electronic processes of ensuring speedy and less bureaucratic processes.

[116] Central Depository Operational Procedures, 2012 (Revised 2018).
[117] Ibid, Rule 5.3.9.
[118] See procedure on < http://nsekenya.co.ke/shares-transfer/. > accessed 1 September 2018.

3.2. Companies Act 2015

While the Central Depositories Act addresses the liquidity aspects of enhancing growth in the capital markets, the quality of institutions present in the republic affects listing on securities exchanges.[119] If there were good companies to invest in, we may have more people participate in capital markets. This would, in turn, deepen the markets. The Safaricom IPO is a case in point. The initial public offering (IPO) was oversubscribed by 532%[120]. This shows that if there were many other companies like Safaricom being offered for listing, the markets would deepen.

The Companies Act[121] is the central legislation in determining the quality of companies that exist in Kenya. This translates to the quality of companies that will seek to list. But even more interesting, it will influence their decisions to list.

3.2.1. Reporting Standards

The Companies Act influences listings by requiring less of public companies in terms of reporting as opposed to the standard required for listed companies. This makes companies shy away from listing due to the public scrutiny that would come with listing[122].

If the requirements for listing are not too far apart from those of operating an unlisted company, the arbitrage for not listing is abolished. In so doing we would have more listings.

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[119] Nicholas Chepkoiwo, "Factors Affecting the Development of Emerging Capital Markets. The Case of Nairobi Stock Exchange" (MBA thesis University of Nairobi 2011) > http://erepository.uonbi.ac.ke/bitstream/handle/11295/13115/Chepkoiwo_Factors%20Affecting%20The%20Development%20Of%20Emerging%20Capital%20Markets.%20The%20Case%20Of%20Nairobi%20Stock%20Exchange.pdf?sequence=3&isAllowed=y < accessed 1 September 2018.

[120] Duncan Miriri, "Kenya's Safaricom IPO Oversubscribed By 532 Pct" *Reuters*(Nairobi, 30 May 2008) <https://www.reuters.com/article/kenya-safaricom-idUSL3007123920080530 > accessed 20 September 2018.

[121] No. 17 of 2015, Laws of Kenya.

[122] Joseph Kimura and Jobesh Amoro, "Impediments to the growth of the Nairobi Stock Exchange" (1999) IPR Discussion paper No. 018/99.

Disclosing affairs to the public is one of the things that sets listed companies apart. Section 662 and 683 of the Companies Act makes it a requirement that financial statements of all companies incorporated in Kenya to be lodged with the registrar of companies. Section 670 further requires that listed companies publish their accounts on their websites for public scrutiny.

When the Companies registry finally puts in place this functionality, the next question in mind is whether this information should be available to the public. If it were to be the case it would be a good move to ensure the high quality of local companies- the fundamental unit of corporate organization in Kenya.

A look at the government portal on e-citizen where company record ought to be filed, there is no portal for uploading financial statements as required by law while there is a portal to upload annual returns and other corporate documents.

There are three competing issues in this regard;

First is the commercial benefit that such a move would have on the financial markets. The elimination of the disclosure arbitrage between listed companies and private companies would be eliminated. Therefore, more companies would seek to put in place better reporting mechanisms that would improve the quality of private institutions and embolden them to move into the quoted companies' space. Potential Private Equity buyers would also have a large pool of companies to choose from as they generate their deals. The ripple effect would be increased activity in corporate commercial activities.

The second and third view is constitutional. First, the private companies may argue that their constitutional right to privacy should not be infringed by allowing for such a disclosure[123]. The counter to this would be that it is not among the rights that cannot be limited due to the public interest under article 25 of the Constitution. They can, therefore, be limited for public good such as one expressed in the preceding paragraph.

The third constitutional issue is in article 35 of the constitution which proves that

> "Every citizen has the right of access to information held by the State"

This behoves an interpretation that information held by the registrar of companies, an agent of the state, should be available to Kenyans unless there is a compelling public interest to the contrary.

The Companies Act should, therefore, require more of companies especially public companies to encourage listing. In Indonesia, all public companies are required to list in the mandatory listing requirements for public companies[124].

3.2.2. Governance Requirements

[123] Constitution of Kenya 2010, Art 31, provides for protection of people's privacy- a generous interpretation may bring such company information under this protection.

[124] "Study on The Low Uptake of Capital Markets Products in Kenya Research Paper, Capital Markets Authority, June 2018" (2018) Capital Markets Authority of Kenya, 3 <file:///C:/Users/s.munene.CENTUM/Centum%20Investment%20Company%20Limited/OneDrive%20-%20Centum%20Investment%20Company%20Limited/Downloads/CMA%20Study%20on%20Low%20Uptake%20of%20Capital%20Markets%20Products%20Final%202%20(1).pdf > accessed 02 September 2018.

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The Companies Act no 17 of 2015 outlines the various factors that would lead to disqualification of a director from office[125]. It extends the obligations of directors by codifying the common law duties of a director[126]. Heavy fines are imposed for flaunting of the requirements by directors[127].

The Companies Act prescribes that a private company should have at least one director[128] while a public company should have at least two directors. It states that at least one director for both companies must be a natural person[129]. It does not require that there must be independent directors in these companies. The governance standards required for a listed company as discussed in the succeeding paragraphs are far removed from the requirements of this act. In the governance aspect, the Companies Act discourages listing by creating a governance arbitrage for non-listing.

The Listing regulations[130] on the other hand require under GEMS, for a minimum of five directors with independent directors being at least a third of the total number of directors so appointed[131]. The regulation further requires that directors should demonstrate expertise in governance and management of the business. Further, a third of directors must have completed a Directors Induction Program (DIP)[132].

The listing regulations provide for sound governance for listed entities. If these were transferred to other public companies and public interest companies[133] the quality of institutions in Kenya

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[125] Companies Act, s 215 to 232 conditions listed are being an undischarged bankrupt, criminal offences and failure to comply with the law as some of the grounds for disqualification of directors.
[126] Companies Act, s 142 to 147.
[127] Companies Act, s 148, 223, 228 and 232.
[128] Companies Act, s 128.
[129] Companies Act, s. 129.
[130] Capital Markets (Securities) (Public Offers Listing and Disclosures) Regulations 2002 Amended 2016.
[131] Ibid first schedule Part C.
[132] Program offered by the Institute of Directors (Kenya).
[133] The term "public interest companies" is used loosely to refer to companies that though not public, affect a substantial part of the economy or population.

would improve. Stringent corporate governance requirements would this cease being a hindrance to listing by local companies.

3.3. Capital Markets (Securities) (Public Offers Listing and Disclosures) Regulations 2002 Amended 2016

The reality of a nation with an income per capita that is 9% of the global average[134] should be reflected in the legislation instruments regarding minimum investment amounts stipulated in the law. This would reduce the exclusion of the majority of the low-income earners from the markets.

Expanding the private offers requirements rules would be one of the innovations required to enable the raising of money from larger pools of people without having to be regulated.

The Capital Markets (Securities) (Public Offers Listing and Disclosures) Regulations 2002 Amended 2016 define a private offer as among other things an offer made to not more than one hundred people with a minimum ticket size of one hundred thousand Kenyan shillings (Kes. 100,000)[135]. The offerees must be people able to assess the risks associated with the offer. The securities so offered should also not be freely transferable. Such offers are not regulated by the Authority[136].

This rule is aimed at ensuring that the masses are protected from unscrupulous business people. This is done by ensuring only people able to assess the risk involved participate in unlisted offers. The innuendo herein seems to be that only those who have more money (a minimum of Kes. 100,

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[134] "Kenyan Per Capita" *Trading Economics* < https://tradingeconomics.com/kenya/gdp-per-capita > accessed 2 August 18.
[135] Capital Markets (Securities) (Public Offers Listing and Disclosures) Regulations 2002 Amended 2016, Regulation 21
[136] Ibid, Regulation 20.

000) can assess the risk involved in an investment. This is an explicit exclusion of the low-income earners from arranging themselves as the wealthy would fund their business and enterprises.

A survey conducted in 2015 showed that only 2.8% of formal earners earn one hundred thousand a month. This adds up to about sixty-eight thousand Kenyans. The minimum ticket size imposed by the authority for private offers is restrictive and creates a community of privileged few who can access the capital markets without regulation while the rest must undergo the rigours of regulation. This exclusion breeds inequality and is offensive to the constitutional spirit as espoused in the national values and principles.

Further, the requirement that securities traded under a private offer should not be freely transferable is a hindrance to the growth of a business. This effectively prevents public companies from allowing their shares to trade without the approval of the capital markets authority. The public offers regulations in effect lock out public companies from using their shares to raise funds without getting approval from the authority.

The restriction of transferability of shares is a relic of ancient English legislation, the Bubble Act of 1720. The essence of restricting free transferability of shares is to lock companies from the capital markets[137]. This is mainly because free transferability makes equity more liquid thereby increasing its value[138]. It thus does not seem logical that the regulations should insist that if shares are freely transferable they should not be issued to the public without approval of the authority. Considering the vastness of the republic and the millions of people to require the approval of an Authority situate in the capital city is an inhibition to accessing capital markets.

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[137] Margaret Patterson and David Reiffen, "The Effect of the Bubble Act on the Market for Joint Stock Shares" (1990) 50 No 1 The Journal of Economic History, Cambridge University Press, 163-171.
[138] Ibid.

Furthermore, the restriction of transferability of shares under the Companies Act is a requirement of private companies[139]. The regulations dictate that only private companies can issue their shares as private offers. Private companies have a maximum of 50 shareholders[140] limiting their ability to raise fund from the public through issuance of shares. By requiring public companies' shares not to be freely transferable when making a private offer, the regulations not only contradict the spirit of the Companies act but also exacerbate the exclusion from capital markets.

Apart from the requirements for making private offers, the first schedule of the listing regulations[141]outlines the extensive requirement for public listing of shares. A brief critique of these requirements follows:

3.3.1. Share Capital Requirement

In requiring that an Issuer of securities to the public must have a minimum share capital of twenty million shillings for listing in the alternative investment segment or fifty million in the main investment segment, small companies that are not keen to list are locked out of issuing shares to the public. This is in line with regulation 8 of the listing regulations[142] that states that one cannot issue shares to the public without listing them unless they meet the requirements under these two segments.

If small companies seek to list, they may list under the Growth Enterprise Market Segment (GEMS). But to list under GEMS, one must have fully paid share capital of ten million.

[139] Companies Act No 17 of 2015, s 9(a)1.
[140] ibid, s 9(a) ii
[141] The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002
[142] ibid.

These requirements dictate the nature of markets that can exist in Kenya. They envision a market of big players where small companies are expected to borrow from banks or elsewhere since they cannot access the market unless they have a minimum of ten million shillings in share capital. Smaller companies are due to this technicality excluded from the markets.

Issuers of debt securities in the market are faced with similar setbacks. The second schedule of the listing requirements[143] requires an issuer of debt securities to the market to have a minimum paid up share capital of fifty million shillings. The locking out of small firms from raising capital from the capital markets is a systemic exclusion will hinder growth of the markets.

In creating such requirements, the regulations on listing dictate the nature of markets that can exist. For an entrepreneur wishing to create a debt market for small-scale firms in Kenya that have lower than fifty million in issued capital, their hands are tied by this requirement.

The minimum listing share capital requirements thus inhibit innovation by creating a straight-jacket for capital markets.

3.3.2. Track record, profitability and future prospects

Issuers under the main market segment are required to show evidence of profitability and track record of up to five years[144]. In the alternative section, the track record should be two years with evidence of profitability[145]. Businesses that are not profitable yet are limited in their ability to access financing from the capital markets. The GEMS section does not require profitability. But the GEMS will only apply to those companies interested in listing. If a company merely wants to

[143] ibid, 40.
[144] ibid, 36.
[145] ibid.

make a public issue of shares without listing immediately, then they are locked out of the markets unless they show profitability.

Such companies can only resort to making private offers despite the limitations noted above. Technology companies like Amazon[146], Tesla[147] that made issues to the public and later listed in the New York stock exchange even before attaining profitability would be locked out if they had attempted to do so in Kenya.

3.3.3. Size of an Issue

The requirement for issuance of fixed income securities[148] require that minimum size of a debt issue in the market should be fifty million. The minimum ticket size is placed at one hundred thousand for a corporate bond. These requirements show a market that is focused on serving big corporates and not interested in meeting the needs of the small and medium enterprises who would require to raise a debt of less than fifty million shillings from the markets.

Furthermore, the minimum ticket size of one hundred thousand excludes a huge part of the population from participating in the debt markets under the capital markets.

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

Market intermediaries in Kenyan capital markets are licensed by the CMA. The Capital Markets (Licensing Requirements) (General) Regulations, 2002, hereinafter the "Licensing Regulations"

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[146] Jon Markman, "The Amazon Era: No Profits, No Problem" *Forbes* (May 23, 2017) <https://www.forbes.com/sites/jonmarkman/2017/05/23/the-amazon-era-no-profits-no-problem/#50385954437a > accessed 10 September 2018.

[147] Jordan Golson, "Tesla is the most valuable US carmaker because of hope, not results" *The Verge* (10 April 2017) < https://www.theverge.com/2017/4/4/15180402/tesla-most-valuable-carmaker-market-capitalization-ford-gm > last accessed 26/9/2018.

[148] The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002 Part A, schedule 2.

outline the conditions required for licensing and continued licensing of the market intermediaries.

The Licensing Regulations stipulate the minimum requirements that market intermediaries should meet for them to operate in the Kenyan markets. We analyze some of the requirements that create barriers to entry in this field thereby creating exclusion.

3.4.1. Membership

Regulation 5[149] envisions a securities exchange that is held by trading participants. The trading participants are licensees of CMA[150]. Limiting shareholding of securities exchanges to persons having trading rights on the exchange excluded other parties that would be willing to set up securities exchanges and are not licensees of CMA.

The CMA had to provide for rules on demutualization of the Nairobi Securities Exchange (NSE)[151] for the general population to subscribe for shares in the NSE. The requirement on membership of securities exchange is a barrier to entry into the market created by the legal framework. The securities exchange is the heartbeat of capital markets. It is indeed the marketplace. By locking it out to the general population locks out the potential for innovative exchanges being set up especially on the internet.

3.4.2. Minimum Share Capital

The Licensing Regulations require that stole-brokers and dealers should have a minimum paid up share capital of fifty million shillings and twenty million shillings respectively[152]. Investment

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[149] The Capital Markets (Licensing Requirements) (General) Regulations, 2002
[150] ibid regulation 5(2).
[151] The Capital Markets (Demutualization of The Nairobi Securities Exchange Limited) Regulations, 2012
[152] The Capital Markets (Licensing Requirements) (General) Regulations, 2002, Regulation 15 (1).

advisers and fund managers should have a minimum paid-up capital of two million five hundred shillings for an adviser and ten million for a fund manager[153]. CMA has indicated the possibility of reviewing the cost of participating in the capital markets to be globally competitive[154]. The minimum capital requirements for market intermediaries envisions participants in a big market. If one wanted to start a securities exchange to serve a specific region, say growers of coffee in Muranga, and get stoke brokers and fund managers on board, the capital requirements placed in law would make such a venture uneconomical.

These capital requirements thus act as an inhibition to deepening of capital markets and accordingly to the inclusion of other more people into the capital markets space.

3.4.3. General Requirements for Licensing

The second schedule of the Licensing Regulations provides for the fees payable by licensees of the capital markets. The minimum annual fee payable by licensees is one hundred thousand shillings up to two hundred and fifty thousand shillings. These are not exorbitant fees for participants in a vibrant and big market. However, for a small market, fashioned to cater to specific groups of people, the figures are prohibitive.

Just like the minimum capital requirements, the approval and renewal fees make it impossible to tailor create a small securities exchange that can meet the needs of the people in specific target regions. Such small markets would scale to become giant markets over time. In so doing, the markets will become broader and deeper limiting exclusion in the capital markets.

[153] ibid, Regulation 29(1)d(iv).
[154] James Anyanzwa, "Stockbrokers, investment advisers seek to exit NSE citing low returns" *East African Standard* (Nairobi, Tuesday, July 24, 2018)< http://www.theeastafrican.co.ke/business/Stockbrokers-investment-advisers-seek-to-exit-NSE/2560-4678338-lyd1l7/index.html > accessed 29 August 2018.

3.5.National Social Security Fund Act

Kenya's vision 2030 is to have the domestic private savings equivalenting 25% of the GDP by 2030[155]. Domestic savings are essential to promote development and access to capital markets. Without the availability of savings there will be no investments to be made and the capital markets cannot develop where there is no demand for investment capital[156].

Increase in domestic savings affects inclusion in capital markets in two ways. First, more people have money that can be deployed for investment purposes in the capital markets. Secondly, increased savings leads to capital availability for capital-intensive projects that have appetite for growth capital through rights issues and similar products which deepen the markets even further.

The country may increase savings that would lead to deeper capital markets through enhanced National Social Security Fund (NSSF) savings by changing the regulatory framework governing social security fund.

The Kenyan social security framework has a combined individual contribution of Kes. 400 shillings. This amounts to about 0.5% of the average salary in Kenya. The contribution is low compared to that of Uganda and Tanzania despite Kenya having a more developed pension sector than the two[157]. Savings of Kes. 400 monthly results to negligible amounts of savings at the point of retirement by contributors[158].

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[155] "Kenya Vision 2030, A Globally Competitive and Prosperous Kenya" (2007),9. < https://www.researchictafrica.net/countries/kenya/Kenya_Vision_2030_-_2007.pdf > accessed 10 September 2018.

[156] Vassilis Kostoglou and Nagi Bairamli, "The Role of Savings in the Economic Development of the Republic of Azerbaijan" unpublished. < https://www.it.teithe.gr/~vkostogl/files/Publications/dimosieuseis_e33.doc > accessed on 2 August 2018.

[157] Justus Ondari, "Kenya's ticking pension time bomb" *E-daily Nation* (Nairobi, May 17 2010).

[158] At best assuming 35 years of contribution, total contributions per individual in the entire working life amounts to Kes. 168,000.

The revised NSSF Act of 2013 proposed to increase the contribution to twelve per centum of the employees' pensionable salary[159]. The implementation of this requirement has been contested in court since the commencement of the Act in January 2018. At the point of writing this thesis, the matter is still being contested in court[160].

Successful mandatory savings by the population has been credited for growth of Singapore[161]. In Singapore, mandatory savings ranged from 50% to 25% of all income with the employer mapping up the same contribution[162]. The savings made under the plan with interest were guaranteed to go to the contributor at retirement. This encouraged proper governance of the funds as well as providing adequate capital for public sector development[163].

The low savings made under the mandatory social security fund limits the disposable income that retirees can use to make investments into the capital markets. But even more importantly, the low savings limit the ability of the NSSF to make investments through venture capital and private equity that would boost the growth of the capital markets.

3.6.The Banking Act

The Kenyan Banking Act[164] was enacted to consolidate laws regulating the business of banking in Kenya. One of the ways that the banking act influences the capital markets in on the interest rates. This is so in two ways. Firstly, access to credit -that may be deployed into capital markets directly

[159] The National Social Security Fund Act, 2013, s 20.
[160] Victor Juma, "Industrial Court stops higher NSSF pension contributions" *business daily* (Nairobi, 25 June 2014) < https://www.businessdailyafrica.com/news/Industrial-Court-stops-higher-NSSF-pension-contributions-/539546-2361846-10tia7rz/index.html> accessed 11 August 2018.
[161] Benedict Koh, Olivia Mitchell, Toto Tanuwidjaja "Developments in Mandatory Defined Contribution Plans: Investment Patterns in Singapore"s CPF System", (2006) Pension Research Council Working Paper Pension Research Council The Wharton School, University of Pennsylvania, 2. < http://countrystudies.us/singapore/32.htm > Accessed 10 August 2018.
[162] ibid
[163] ibid.
[164] Chapter 488 Laws of Kenya.

or towards growth of businesses that list on the securities exchange -is dependent on the interest rates charged. High rates would scare away borrowers[165]. If credit is not accessible, the growth in leveraged investments is affected.

Secondly, high-interest rates on borrowings mean that investors will be better off giving their money to the banks for onward lending at a higher rate than they would get in investing the money in the capital markets. The general impact of these two responses is slow growth in the economy [166].

There is empirical evidence in studies done in Indonesia that interest rate increase has a corresponding decrease in market liquidity which in turn causes underdevelopment of the markets[167]. Higher interest rate exposes investors to a higher cost of capital. The punitive cost of capital locks out those who would only depend upon credit to invest in the capital markets[168].

In Kenya, the law on interest capping was introduced through an amendment to the Banking Act[169]. The motivation was to ensure affordable access to capital by the citizenry for investment and other purposes[170].

The Central bank of Kenya has maintained that the law has had a negative impact on the economy by locking out risky small and medium enterprises from accessing loans from banks.[171] Attempts

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[165] Simon Adede, "Lending Interest Rate and Economic Growth in Kenya" (MBA thesis, University of Nairobi 2015),42.
[166] Ibid.
[167] Ihda Muktiyanto, "Determinant Factors of Market Liquidity in the Indonesian Equity Market" (DPhil thesis, University Melbourne, Australia 2015)98.
[168] Ibid.
[169] Banking (Amendment) Act, 2016, s 33B.
[170] Kenyan lawmakers say interest rate cap laws to stay, *Reuters* (Nairobi, 13 April 2018) < https://af.reuters.com/article/kenyaNews/idAFL8N1RQ1GW?feedType=RSS&feedName=kenyaNews accessed 10 September 2018.
[171] The Impact of Interest rate Capping on the Kenyan economy: Highlights, March 2018. < https://www.centralbank.go.ke/wp-content/uploads/2018/03/Summary-of-the-study-on-Interest-rate-Caps_February-2018.pdf > accessed 10 August 2018.

to reverse the capping of interest rate through the Finance Bill 2018, was not successful with parliament insisting on the law[172].

The herculean task remains in being able to manage interest rates so that the cost of capital is not too high and to create a leeway for banks to avail capital to all customers while being able to price the risk aspect. The balance is important since both extremes lead to exclusions from the financial sector which is normally closely interlinked.

Section 33B of the Banking Act limits the banks from being able to price and issue risky loans due to the cap. In so doing, the risky small businesses are unable to access finance for growth thereby excluding them from accessing financial services. The act should create interventions that would ensure the banking sector does not charge unreasonable rates to the market thus increasing the cost of capital, whilst ensuring that the banks have leeway to price for loans given to clients with high risks.

3.7.The Savings Credit Co-operatives (SACCOs) Act and the Co-operatives Act

Another way of enhancing capital markets would be to look inwards at what is working locally and fashion our capital markets around it. The Savings Credit Co-operatives (SACCOs) are ubiquitous and quite successful in Kenya[173]. Instead of focusing on bolstering the idea of companies and how they work in Kenya, the capital markets should be arranged to allow the free exchange of shares owned by members of co-operatives. By creating a stock exchange for co-

[172] Cynthia Ilako, “MPs retain rate cap in proposed law changes” Aug. 25, 2018,< https://www.the-star.co.ke/news/2018/08/25/mps-retain-rate-cap-in-proposed-law-changes_c1808042 > accessed 9 September 2018.
[173] Agatha Wamaitha, “More Kenyans join SACCOs as social needs pile pressure” *The Star*, (Nairobi 10 August 2018). Government statistics showed that a third of Kenyans were members of cooperatives.

operatives, a third of Kenyan population[174] as opposed to the dismal 4% [175]would be thrust into the capital markets space.

Of most importance is the liquidity that would result from such a listing. The liquidity would appeal to an even larger number of participants and in effect deepen the SACCO industry**.** The SACCO Societies are established under the wider Co-operative Societies Act[176]. The rights of transferring shares held in a SACCO are thus described under section 20 of the Co-operative Societies Act. The act provides that sale must be to another member or the SACCO and the shares must have been held for a period of one year.

Section 20 makes shares in a SACCO illiquid. Illiquidity is one of the causes of exclusion in the capital markets[177]. An amendment to section 20 to allow for wider options of disposing of SACCO shares and removal of the one-year lock-in period would increase the liquidity of these shares.

But even if this was so the SACCO shares would not trade under the trading systems licensed by CMA. Because of the definition of securities under the Capital Markets Act[178] does not include shares of co-operatives as securities[179]. The definition of a security under the Capital Markets Act should be expanded to included shares issued by co-operatives and other self-help groups. The

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[174] Ibid.

[175] Currently, only 4 % of the adult population participates in the capital markets. See Kenya's Capital Markets set for Reforms"(The Oxford Group, Kenya Report 2016) https://www.oxfordbusinessgroup.com/overview/market-movers-sector-set-further-reforms-future-looks-bright accessed 11 March 2018.

[176] No. 12 of 1997.

[177] Nicholas Chepkoiwo, "Factors Affecting the Development of Emerging Capital Markets. The Case of Nairobi Stock Exchange" (MBA thesis University of Nairobi 2011) > http://erepository.uonbi.ac.ke/bitstream/handle/11295/13115/Chepkoiwo_Factors%20Affecting%20The%20Development%20Of%20Emerging%20Capital%20Markets.%20The%20Case%20Of%20Nairobi%20Stock%20Exchange.pdf?sequence=3&isAllowed=y < accessed 1 September 2018.

[178] Cap 485A Laws of Kenya.

[179] ibid s 2.

idea is to liberalize the markets to allow for the trading of all manner of products that the markets come up with according to the existing business dynamics.

If SACCO shares would be allowed to trade under the Kenyan legal framework, it could increase activity in the capital markets by creating liquidity to holders of shares. A larger number of people would be able to trade and join various societies. This would be made possible with deletion of the requirement that one cannot be a member of more than one co-operative society[180]. Persons dwelling in regions away from where the co-operative operates should be able to join them and this would enhance access to savings and investment opportunities to a larger population[181].

Finally, the SACCO Act at section 38 limits the investments that a SACCO can make with funds received. These are in government securities, bank deposits and shares of other co-operatives or SACCO societies. The three categories established should be increased at a minimum to map those given to pension funds[182]. This would increase the impact the SACCOs have on other aspects of capital markets such as private equity and venture capital that would increase activity in the capital markets.

3.8.Conclusion

The practice in Kenya has been that companies do not use the capital markets unless they are seeking large amounts of money. In any other event, they prefer getting financing from the banks that are cheaper as they do not have floatation costs[183].

[180] Co-operatives Act s 18.
[181] ibid, 18 (ii), Currently does not allow co-operatives to have members outside their locale of operation.
[182] Retirement Benefits Authority Investment Guidelines. > http://www.rba.go.ke/index.php/en/news-items/93-rba-s-investment-guidelines < last accessed 9/20/2018.
[183] Joseph Kimura and Jobesh Amoro, "Impediments to the growth of the Nairobi Stock Exchange" (1999) IPR Discussion paper No. 018/99, 3.

The impact of this is that small-scale businesses do not consider capital markets as an avenue to raise funds. This is left for bigger companies with profitability track record[184]. But why should the small-scale fundraising be restricted to the banks? The street answer is that it would be too expensive to raise small amounts of money from the capital markets.

But raising capital is only expensive because of the way that capital markets are structured to operate. The legal framework should be flexible to allow the setting up of securities exchanges that can be cheaper and thus useful in helping small-scale traders raise money from the capital markets.

At a bare minimum, the law should liberalize the monopoly enjoyed by banks in the capital markets space. Although banks in Kenya play a central role in capital markets acting as Custodians, Brokers, Investment Banks, and CDAs, bank development should not be a hindrance to capital markets growth. Due to the role that banks play in capital markets, they may act as a hindrance to growth of the capital markets to consolidate their banking activity rather than facilitating businesses to seek funds from the public [185].

The growth of the capital markets is as shown above curtailed by an inflexible legal framework that creates barriers to entry into the markets or requirements that stifle the growth of participants. The legal framework seeks to create markets that favour big ticket activities in the capital markets. It requires players to have large capital and limits the nature of persons that can participate in the

[184] The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002, Regulation 8 requires that an issuer of shares that are not being listed fulfil the requirement under the Alternative Investment Market Segment or Fixed Income Securities Market Segment. One of the requirements under these categories is a track record of profitability.

[185] Joseph Kimura and Jobesh Amoro, "Impediments to the growth of the Nairobi Stock Exchange" (1999) IPR Discussion paper No. 018/99.

capital markets. In so doing, small-scale businesses and entrepreneurs are locked out of the capital markets.

Furthermore, the legal framework does not reflect the local realities but is keener at creating a market that meets the standards of other developed markets[186] rather than seeking to see how the local realities can be used to create a dynamic capital market that serves the general population.

Now that we have established that the legal framework creates exclusion, we in the next chapter show the model of regulation that should be used so that the legal framework is not a hindrance to markets deepening and inclusion.

[186] As evidenced by the availability of regulations for Venture Capital Companies, Asset-Backed Securities, Derivatives, Exchange Trades Funds, REITs etc, with dismal or no creation of the products by the market. This shows a regulator who is steering the markets towards a certain direction rather than addressing the needs of the market.

CHAPTER 4:

EMERGING BEST PRACTICE IN CAPITAL MARKETS REGULATION

4.0.Introduction

The legal and broader institutional environment influence the growth of the financial markets. Regulations that protect creditors and minority investors, for instance, are associated deeper markets that are vibrant, have ownership that is spread out, higher dividends payout and better valuations of the companies operating in that space[187].

Beck[188], in analyzing the factors that are impediments to the development and efficiency of financial intermediation in Brazil notes that reforms in the regulatory framework would be the back-borne towards success in financial sector development. It is probably because of the centrality of the financial sector to the economy that makes the regulation an important aspect of this sector.

The situation is the same in Kenya where the capital markets are regulated by the Capital Markets Authority, The Retirement Benefits Authority, The Central Bank of Kenya, The Registrar of Companies and the Insurance Regulatory Authority.

Proponents of regulation justify it on the premise that retail investors have an uneven relationship with financial professionals offering the product to the market[189]. They acknowledge that

[187] Nicholas Chepkoiwo, “Factors Affecting the Development of Emerging Capital Markets. The Case of Nairobi Stock Exchange” (MBA thesis University of Nairobi 2011), 19 > http://erepository.uonbi.ac.ke/bitstream/handle/11295/13115/Chepkoiwo_Factors%20Affecting%20The%20Development%20Of%20Emerging%20Capital%20Markets.%20The%20Case%20Of%20Nairobi%20Stock%20Exchange.pdf?sequence=3&isAllowed=y < accessed 1 September 2018.

[188] Thorsten “Impediments to the Development and Efficiency of Financial intermediation in Brazil” (2000) World Bank Working Paper, Washington DC, 5.

[189] Harald Benink and David Llewellyn, “Systemic Stability and Competitive Neutrality Issues in the International Regulation of Banking and Securities” (1995) Journal of Financial Services Research, 9(3/4), 393-407.

wholesalers in the capital markets need not be regulated as much as retail investors. As such, wholesale investors should be subject to a different regulatory regime from retail investors. There would be a risk of over-regulation if wholesalers were subjected to similar regulatory requirements as retailers[190].

4.1.The Regulation Fallacy

State regulation is construed by the customers as a sign of approval given by the regulator on products and market intermediaries. They thus use it as an excuse not to exercise due diligence on the products and/or intermediaries since they have been approved by the regulator[191].

The market intermediaries on the other hand look at state regulation as prescribing "the what to do" and rarely go over and above prescribed requirements[192]. They further ride on the comfort given by the seal of approval by the regulator in presenting their products or themselves to the market.

The reality is that regulation is not an alternative to prudence on the part of financial market customers and the market intermediaries. The fallacy of state regulation is that it is not construed for what it really is by players in financial markets.

4.2.Why then State Regulation?

Given the fallacy of public regulation, it may be prudent to gravitate toward self-regulation. The principles of contract law backed by efficient judicial enforcement should provide enough deterrent for people keen to take advantage of consumers in the market. Resort to public regulation

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[190] Charles Goodhart, Philipp Hartmann, David Llewellyn, Liliana Rojas-Suarez, Steven Weisbrod, "*Financial regulation, Why, how and where now*?" (1998) Routledge, London and Newyork.
[191] ibid 3.
[192] ibid.

is justified in instances where there is a need to protect consumers from exploitation by monopolies, protect less informed investors and ensure systemic stability[193].

In regulating, the regulator should be aware of the poison in the chalice. While public regulation would be important for the aforementioned reasons, it may create pitfalls that would slow down market development as discussed in chapter three above.

4.3.The over-regulation debate

In the United States of America (USA), the Sarbanes Oxley Act enacted in 2002 is considered as a harbinger of over-regulation against a backdrop of a global shift towards deregulation. A report from a commission set up to investigate the shift by investors from the New-York Securities exchange to the London Securities Exchange pointed out the superiority of the legislative approach adopted by London[194]. The adoption of a principles-based regulatory regime in London has been credited for the success in usurping the place of New York [195].

One of the main reasons why the USA took this unconventional move was due to several Enron-like scandals between 2000 and 2002 that questioned the suitability of the legislative framework in curbing market impropriety[196].

Other than the Sarbanes Oxley Act, the Enron scandal also stimulated soul-searching around the role and nature of regulation. The reflection brought to the fore the debate on "rule-based" vis a

[193] ibid, 4.

[194] Jenny Anderson, "U.S. Financial Sector Is Losing Its Edge Report Says" *N.Y. Times*, (Newyork,22 January 2007), 3.- The Mckinsey report showed that London had increased its share of global stock-offering volume from 33% to 63% between 2001 and 2007. In the same period, New York"s share decreased from 57% to 16%.

[195] Clara Furse, " Sox is Not to Blame London is Just Better as a Market" *Financial Times* (London, 18 September 2006),19.

[196] Rosemary Peavler, "The Enron Scandal That Prompted the Sarbanes-Oxley Act" < https://www.thebalancesmb.com/sarbanes-oxley-act-and-the-enron-scandal-393497 > accessed 1 September 2018.

vis "principle-based" regulation[197]. The debate on the differences between rule-based and principle-based regulation is still open[198]. However, on a broad scale, rule-based regulation is prescriptive while principle-based regulation is instructive.

Rules prescribe what should be done and assume a one fit all approach which creates the impression of over-regulation for products that may not fit that straight jacket so created. Principles give guidelines that are not binding and encourage the regulated entities to come up with their own ways of complying with the principles. The regulator prescribes the principles and leaves implementation to the market players to innovate ways to comply. The principle-based regulation also encourages self-regulation among players with the regulator focusing on systemic risks rather than on prudential obligations.

Since there is no limit to the nature of innovation that markets will create, a rule-based approach will always be a constraint to the market players who will be prevented from creating products by the legislative bottle-neck. Such entrepreneurs will feel over-regulated by the market. Their growth will be stifled, and they would avoid such a market if they have a choice[199]. Similarly, big players would be constrained unnecessarily if they were required to follow a similar standard of regulation as retail traders. They would fee over-regulated not because the legislation is legion, but rather because they are not suitable for their circumstances. This is the challenge that comes with rules that seek to have the one-fits-all approach. The panacea is in using principles rather than rules.

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[197] Cristie Ford, "New Governance, Compliance, and Principles-Based Securities Regulation" (2008) 45 issue 1 American Business Law Journal, 5.

[198] ibid, 7-10

[199], Jenny Anderson, "U.S. Financial Sector Is Losing Its Edge Report Says" *N.Y. Times*, (Newyork,22 January 2007), 3.- The Mckinsey report showed that London had increased its share of global stock-offering volume from 33% to 63% between 2001 and 2007. In the same period, New York"s share decreased from 57% to 16%.

[199] Clara Furse, " Sox is Not to Blame London is Just Better as a Market" *Financial Times* (London, 18 September 2006),19.

4.4.Practical Application of Principle-Based Regulation

Use of principle-based regulation has been successful in the United Kingdom- as applied by the Financial Services Authority (FSA)-, in British Columbia province of Canada securities regulator and in the European countries' Generally Acceptable Accounting Principles (GAAP) in accounting regulation.

We analyze the use of principle-based regulation under these three examples to pick regulatory lessons that may be adopted in Kenya.

4.4.1. The case of the UK FSA

Shortly upon its promulgation in 2001, the Financial Services Authority FSA set out to adopt a principle based regulatory framework for the UK market. It tore down the detailed rules that were established to govern the capital markets and replaced them with short high-level requirements accompanied by guidelines[200].

The FSA further reduced the listing regulations by up to 40% to simplify the legal framework and migrate from prescriptive rule-based to principle-based[201]. FSA has taken other bold moves like allowing the market to formulate the guidance notes for implementing the regulatory principles[202]. In an active attempt to shift regulation from itself to the market players, the FSA continues to ask the market to provide solutions for emerging issues in the market. Its role shifts to risk management in the system.

[200] ibid, 14
[201] "FSA, Better Regulation Action Plan: What We Have Done and What We Are Doing" (2005), http://www.fsa.gov.uk/pubs/other/better_regulation.pdf, at 7.
[202] ibid, 8.

The approach by FSA is in line with the three goals of legislation [203] -systemic risk management, retail investors protection and monopolistic control. The approach by FSA is to adopt principle-based regulation from the approval stage to internal processes. The goal for FSA in adopting principle-based regulation is to secure a better regulatory framework. Some of the benefits include lower costs, increased competition and innovation and results focused regulations[204].

The FSA model has been a success because it is results-oriented[205]. It rides on the understanding that the market is best placed to come up with processes that will result in desired legislative outcomes[206]. The authority merely sets out the desired regulatory objective and the players are free to innovate various ways in which they will achieve the objective without having to all follow a predetermined path.

Some of the advantages attributed to principle-based approaches by FSA are the use of senior managers to implement legislation and not the regulator, create flexibility for new business that fostering innovation and enhancing substantive compliance by firms as opposed to merely ticking a compliance box as is the case where rules are prescribed[207].

Finally, the principle-based approach is seen as creating equality in the markets as each market intermediary is judged based on the merits of their circumstances and not against peers or fixed rules. It thus is a fairer approach towards regulation. It encourages technological innovation to

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[203] Charles Goodhart, Philipp Hartmann, David Llewellyn, Liliana Rojas-Suarez, Steven Weisbrod, "*Financial regulation, Why, how and where now*?" (1998) Routledge, London and Newyork, 4.
[204] ibid.
[205] Julia Black, Martyn Hopper and Christa Band, " Making a success of Principles-based regulation" (2007) Law and Financial Markets Review, 192.
[206] ibid.
[207] ibid, 195.

meet market demands and creative ways of meeting regulatory objectives within the confines of the market intermediary's strengths[208].

The UK FSA has operationalized its result-based approach and has been attracting more capital due to perceived conducive regulatory environment[209]. Although there lacks unanimity of thought as to the effect of principle-based regulation since the rules-based approach also has its merit[210], the market perception is largely in favour of principles-based regulation.

4.4.2. The British Columbia Model

Securities regulation in Canada is arranged around provinces despite there being an overall national regulatory body. The province of British Columbia has led the pack on principle-based regulation. The British Columbia Securities Commission (BCSC) has argued that having complex rules do not help investors understand the markets better nor stop fraudulent actors. It, therefore, turns its focus towards creating broad standards to replace rules and regulations. It allows the subjects of regulations to use their experience in the industry to develop strategies that will enable them to comply with regulations. This enables actors to fashion compliance in a manner that best suits their business. The regulator focusses then on reviewing compliance with the broad principles without requiring a one size fits all kind of regulation[211].

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[208] Christopher Decker, " Goals- Based and Rules-based approaches to regulation" (2018) BEIS Research Paper Number 8,29.
[209] Clara Furse, " Sox is Not to Blame London is Just Better as a Market" *Financial Times* (London, 18 September 2006),19.
[210] Julia Black, "The Rise, Fall and fate of Principles Based Regulation" (2010) LSE Law, Society and Economy Working Paper 17
[211] Cristie Ford, "New Governance, Compliance, and Principles-Based Securities Regulation" (2008) 45 issue 1 American Business Law Journal, 5, 18.

With the regulator taking a back seat, the frontline is taken by market actors through self-regulatory industry organizations like investment and fund dealers associations. The impact is increased innovation and flexibility of the capital markets in creating varied products for the markets[212].

It is the contention of BCSC that prescriptive requirements encourage firms to focus on detailed compliance rather than tap into their own innovative minds to think of ways of getting the best for the market and their clients while complying with the law[213].

The fabric of the British Columbia model of securities regulation is based on an understanding that compliance that brings an equivalent level of growth and deepening of the capital markets should have fewer rules that are communicated effectively and that are easy to comprehend by all actors.

Finally, the British Columbia model is anchored on the need to have results-oriented regulation. The results-oriented regulation model is in line with changes in governance that insists that governments should be more accountable and have systems that serve the people[214]. In a similar manner, regulation's effectiveness and appropriateness should be measured against how effectively it solves the problems that face the market[215].

The results-oriented approach towards regulation has three main aspects[216]. First, the clear measurable results that are expected by the legislation. Second, have a problem-solving approach and finally creating partnerships with market players to the greatest extent possible to shift regulation from the regulator to the market.

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[212] ibid.
[213] BCSC, New Proposals for Securities Regulation: A New Way To Regulate (2002), < http://www.bcsc.bc.ca/uploadedFiles/2002_New_Proposals.pdf > accessed 10 September 2018.
[214] Peter Aucoin, "The New Public Management: Canada In Comparative Perspective" (1995) Montreal Institute for Research and Policy, 277.
[215] Malcolm Sparrow, "*The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance*" (2000) Brookings Institute Press, 3-10.
[216] ibid.

The approach has made Vancouver, in British Columbia, to have the most offices by publicly traded companies in Canada[217]. It has been hailed as the backbone of the Canadian economies having the largest capital raises by foreign and local companies[218]. British Columbia is the only province in Canada get an "A" grade for regulatory reform that impacts the lives and business endeavours through innovative ideas in the capital markets[219].

4.4.3. Principle-Based Regulation in Accounting Standards

Following the Enron scandal, there was the increased clamour for adoption a principle-based approach to accounting regulation by the U.S accounting standard board who were accused of being too focused on rules[220]. This led to increased activity towards creating principles to govern accounting standards[221]. Although there is no unanimity of thought that US standards of accounting are rule-based and not principle-based, United Kingdom and Canada have a more principle-based regulatory framework for accounting standards[222]. It is also evident that the US is making efforts towards adopting more principle-based framework[223].

One of the main reasons for the principles-based approach is the harmonization of accounting standards in the world[224]. It is thus possible to have diversity and flexibility within a system that harmonizes a regulatory framework. This illustrates the possibility of using principles to reduce

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[217] Brenda Leong, “BC”s Capital Markets: A Major Engine to the Economy” (2011) < https://www.bcsc.bc.ca/About_Us/Speeches/BC%E2%80%99s_Capital_Markets__A_Major_Engine_of_Growth_for_Canada%E2%80%99s_Economy/ > last accessed 01 October 2018.
[218] ibid.
[219] British Columbia Regulatory Reforms, “Achieving a modern Regulatory Environment” (2015)Fourth Annual Report < https://www2.gov.bc.ca/assets/gov/government/about-the-bc-government/regulatory-reform/pdfs/regulatory_reform_annual_report_201415_for_web.pdf > last accessed 01 October 2018.
[220] Frederick Gill, “Principles-Based Accounting Standards” (2003) 28 No 4, N.C. J. INT”L L. & COM.REG, 967.
[221] FASB, Proposal: Principles-Based Approach to U.S. Standard Setting (2002) Financial Accounting Standards Board, <http://www.fasb.org/proposals/principles-based_approach.pdf. >accessed 20 August 2018.
[222] Cristie Ford, “New Governance, Compliance, and Principles-Based Securities Regulation” (2008) 45 issue 1 American Business Law Journal, 5, 12.
[223] ibid.
[224] Frederick Gill, “Principles-Based Accounting Standards” (2003) 28 No 4, N.C. J. INT”L L. & COM.REG,969.

rules without the risk of creating disparate or unequal situations but rather creating a system that works harmoniously across diverse groups.

Although it may be difficult to have a pure form of rule-based or principle-based regulation in accounting regulation, the global inclination is towards principle-based regulation rather than rule-based. This is despite an acknowledgement by some commentators that in accounting, there can never exist a pure form of principle-based regulation with the goal being in striking a balance[225].

International Accounting Standards (IAS) are stated to be 'principles-based' instead of 'rules-based'[226]. Power is on the chief finance officers of organizations to interpret and present their financial statements based on their understanding of the principles stated[227]. For instance, IAS 16 on property, plant and equipment allows for different choices to be made by the reporting firms as to the method of reporting the value of tangible assets in the balance sheet. They may be accrued at cost or on a revaluation model that factors in deprecation[228]. For the option taken by the reporting firm, there ought to be an explanation justifying the approach.

If the accounting standards were rules-based, they would detail examples and illustrations for treatment of various accounting items. While this may bring about some level of clarity, the accountant's work would be dull, only looking to justify his accounting choices based on the list provided to him[229]. The current framework needs the accountant to apply himself to a deeper

[225] "Principles-Based Accounting Standards" (2008) <
http://pwc.blogs.com/corporatereporting/files/principlesbased_accounting_standards.pdf >
[226] Salvador Carmona "On the global acceptance of IAS/IFRS accounting standards: The Logic and implications of the principles-based system" (2008), ELSEVIER,456.
[227] ibid.
[228] International Accounting Standards, IAS 16- Property Plant and Equipment.
[229] Salvador Carmona "On the global acceptance of IAS/IFRS accounting standards: The Logic and implications of the principles-based system" (2008),ELSEVIER,456.

understanding of the accounting work. It imposes a fiduciary obligation on the accountant to make choices that can be defended. This shifts the regulatory burden from the regulator.

The accounting standards approach could be borrowed by other financial markets regulator keen on creating robust markets that have the players themselves in charge of compliance rather than merely ticking some boxes.

4.5.Principle-Based Regulation in Kenya?

The capital markets Authority (CMA) posits that it adopts a principle-based approach in approving products based on section 12A of the Capital Markets Act[230]. Section 12A gives the authority the power to issue guidelines and notices on any matter relevant to the capital markets in Kenya and the players. The issuance of guidelines forms part of a principle-based regulation to the extent that the guidelines are not obligatory on the market participants.

The regulatory framework in Kenya is heavy. Apart from the two main acts; Capital Markets Act and the CDSC act, there are 17 regulations and 5 guidelines[231]. All these policy documents lack coherent principles/standards that they seek to achieve. They are prescriptive rules for actors and relating to various products that may be issued by the market.

The regulatory objective of CMA is stated as;

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[230] CMA Kenya Website: <https://www.cma.or.ke/index.php?option=com_content&view=article&id=277&Itemid=646 >last accessed 8 September 2018.

[231] ibid,< https://www.cma.or.ke/index.php?option=com_phocadownload&view=category&id=37&Itemid=197# > last accessed 8 September 2018.

"the creation, maintenance and regulation, of a market in which securities can be issued and traded in an orderly, fair, and efficient manner, through the implementation of a system in which the market participants are self-regulatory to the maximum practicable extent[232]"

The Authority has attained the first part of this objective- the creation and maintenance of regulation. However, it is yet to adopt a system that encourages self-regulation. The system that currently exists appears to be one of over-regulation rather than self-regulation. The regulation of Venture Capital Companies, Asset-Backed Securities, Derivatives, Exchange Trades Funds, REITs- products that the market has dismal or no appetite for shows the proclivity of the Authority towards creating regulations.

This overzealous approach makes the authority appear to be leading the market against the norm where legislation trails the market. A reversal of this norm may limit innovation as the market is only allowed to grow within regulator ambits. An adoption of a principles-based regulatory framework would be a good way to avoid this poison in the legislative chalice.

Part IIA of the Capital Markets recognizes the role of self-regulatory organizations (SROs). They make application to the authority to be recognized as such upon fulfilling the minimum requirements provided for by the Act. The SROs can only perform responsibilities delegated expressly by CMA[233]. The attempt at adopting a principle-based regulation by the CMA is feeble. The framework's DNA is prescriptive in nature. It seeks to regulate self-regulated bodies as it would other intermediaries. SROs are considered as subject to regulation in the same breath as other intermediaries[234].

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[232] Capital Markets Act, s 11(c).
[233] Capital Markets Act, s18 B(c).
[234] ibid, s 12.

The Capital Markets Authority thus still holds dear the regulatory powers that it seeks to devolve to SROs. It insists on frontline regulation. It further seeks to be prescriptive even as to the way SROs can be formed and regulation. Self-regulation without the written consent of CMA is a criminal offence[235].

4.6.Conclusion

This chapter has shown that the world is moving away from a rule-based regulatory framework in favour of a principle-based regulatory framework. The rules that were pointed as inhibitors to inclusion under chapter 3 would not be present if truly our regulatory framework was principle-based rather than rule-based.

[235] Ibid, 18B(4).

CHAPTER 5:

CONCLUSIONS AND RECOMMENDATIONS

5.0.Conclusions

This study set out to show how legislative reforms can be and should be put in place to enhance capital markets deepening in Kenya. In deepening the markets, more people would be included in the capital markets space. Chapter one shows the extent of exclusion in the capital markets which is not in tandem with the great levels of financial inclusion locally. It reviewed the literature on exclusion in Kenya noting the forms of exclusions in Kenya. This set a basis for investigating whether the legal framework can be used to increase levels of inclusion in the capital markets-which was the main objective of this study.

Under chapter two, the study set the ground for the rest of the research by showing that inclusion is a legal issue and should not just be considered as purely a commercial and economic issue. It tied exclusion to constitutional and international human rights and made a case for its recognition as such in legal and economic discourse.

Chapter three discussed the various pieces of legislation that inhibit inclusion and showed ways in which they inhibit inclusion. The chapter summarized that the current legal framework inhibits financial deepening and causes exclusion in the capital markets.

Finally, chapter four sought to identify the global trend towards capital markets regulation. The chapter made a case for adoption of a principles-based model of regulation as opposed to a rule-based method of regulation. It showed the benefits that accrue to a principle-based method of regulation towards financial markets deepening and inclusion. It identified that Kenya capital markets are heavily a rule based on their regulatory approach. There have been feeble attempts at

moving the Kenyan framework towards a principle-based regime, but this remains work in progress.

5.1.Recommendations

The research makes policy and regulatory recommendations from the above research:

5.1.1. Policy Recommendations

The capital markets should adopt a principle-based model of regulation. This should reflect in the legislative framework put in place. The framework should move from rules and regulations to general principles and non-obligatory practice guidelines. The market players would then be allowed to craft themselves and their products within the general principles. This would allow innovation in the market leading to deepening and inclusion in the capital markets.

The Capital Markets Authority should devolve its regulatory powers to self-regulatory organizations as required under section 18 (b) of the Capital Markets Act.

5.1.2. Amendments of the Legal Framework

a. The Capital Markets Act

The self-regulatory organizations in the capital markets should be taken as partners in regulating the industry and should not be regulated in the same manner as other market intermediaries. The Capital Markets Act should be amended at section 12 to free the organizations from being subject to regulation in a similar fashion as other market intermediaries and grant them broad powers to ensure compliance with regulatory principles set for the industry.

Section 2 of the Capital Markets Act should be amended to include shares of a co-operative society as securities for purposes of the Capital Markets Act.

b. The Capital Markets Regulations

i. Capital Markets (Securities) (Public Offers Listing and Disclosures) Regulations 2002 Amended 2016

The limits on what private offers under regulation 21 of the Capital Markets (Securities) (Public Offers Listing and Disclosures) Regulations 2002 Amended 2016 should be expanded to bring more issuance of securities to the public outside the ambit of regulation. The minimum ticket size should be reduced and the number of participants in a private offer expanded.

Furthermore, the listing requirements on issuers of securities to the market under the first schedule with regards to minimum capital requirements, profitability track record and minimum size of a firm that can raise debt from the capital markets should be abolished and left for determination by respective securities exchanges where such companies seek to list. This will allow creating of exchanges for small companies and those for large companies.

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

The requirement that only trading participants can form a securities exchange under regulation 5 should be abolished to liberalize the market and allow the creation of more securities exchanges.

The minimum capital requirements under regulation 15 and 29 for market intermediaries and annual fees under the second schedule only relevant for players in a big market. These should be abolished and left for determination by the securities exchanges where they would seek to serve.

c. The Central Depositories Act

Section 5 of this Act should be amended to liberalize requirements on who should become a central depositories agent away from licensed trading participants, subsidiaries of banks or financial institutions, institutional investors or a corporate prescribed by the authority.

Secondly, the Central Depository Operational Procedures, 2012 (Revised 2018) rules of operating a central depository should enable internet trading and therefore instant settlement of trades. This would increase the accessibility of the markets by wider groups of broader geographical locations.

The rules should also be amended to provide for an automated internet-based process of dematerialization of shares to allow for swifter processes.

d. The NSSF Act

The NSSF Act of 2013 should be enforced as relates to contributions to increase the amount of money available for investment in the capital markets through private equity initiatives which would lead deepening of markets.

e. The Companies Act

The Companies Act companies under section 662 and 683 should be amended to require publication of financial reports of all companies outside the "small companies" regime in a manner accessible to all citizens as is required for listed companies.

Section 142 to 147 should be expanded to add more requirements on who can become a director of a public company akin to those required under first schedule part C of the Capital Markets (Securities) (Public Offers Listing and Disclosures) Regulations 2002 Amended 2016 for listed companies. The governance requirements for companies outside the "small companies" regime should be scaled upwards to improve the quality of our institutions.

f. The SACCO Societies Act and Cooperatives Act

Section 20 of the Co-operative Societies Act should be amended to allow for the free transfer of shares held in co-operatives and remove the one-year lock-in period for holding shares in a co-operative society. This would make the shares more liquid.

Section 38 of the SACCO Societies Act should be amended to expand the scope of investments that can be made by SACCOs from government securities, bank deposits and shares of other co-operatives or SACCO societies. This would increase the impact the SACCOs have on other aspects of capital markets such as private equity and venture capital that would increase activity in the capital markets.

g. The Banking Act

In line with a principle-based regulatory framework, section 33A that caps interest rates should be repealed in its entirety. However, to cushion Kenyans from exploitation, the lending business should be liberalized and brought under the same regulator to be guided by the same principles. The "shylocks" should be recognized under the law and given protections given to banks in enforcing and charging property.

A liberal market with many players would tilt the market towards a competitive market reducing consumer exploitation.

5.2. Recommendation for Further Research

This research was focused on the effect of legal framework towards financial inclusion in the capital markets. It has sought to espouse a regulatory philosophy that should be adopted when regulating capital markets.

A broader research analyzing the impact of the regulatory framework towards financial inclusion in all financial services thereby proposing a regulatory philosophy(ies) for regulating financial services in Kenya would be desirable. This would culminate to the creation of a Financial Services Access bill to provide for reforms in the financial services sector to enhance inclusion.

A further study may be conducted to investigate the multiple exclusions that may exist in the capital markets especially with regards to special interest groups and women. More research could also be conducted to check for compliance of the capital markets legal framework with the Constitution of Kenya 2010.

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