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THE REGULATION OF STOCKBROKERS IN KENYA'S CAPITAL MARKETS

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DECLARATION

I, **ONDIEKI EDNA MORAA**, do hereby declare that this thesis is my original work submitted in partial fulfillment of the Masters of Laws (LL. M) at the University of Nairobi, School of Law and has not been submitted or is not pending submission for a diploma, degree or PhD in any other university. Furthermore, all references made to texts, articles, papers and journals, and other pertinent materials, have been fully acknowledged.

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This thesis has been submitted for examination with my knowledge and approval as the University of Nairobi (School of Law) supervisor.

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DR. JACKSON BETT

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DEDICATION

I would like to dedicate this work to my family for their love and support. Thank you and May God bless you always.

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LIST OF ABBREVIATIONS

AGM	Annual General Meeting
CAP	Chapter
CDA	Central Depository Agent
CMA	Capital Markets Authority
IAS	International Accounting Standards
IFC	International Finance Corporation
IFRSs	International Financial Reporting Standards
IOSCO	International Organization of Securities Commission
IPOs	Initial Public Offer
NSE	Nairobi Securities Exchange
NASD	National Association of Securities Dealers
NYSE	New York Stock Exchange
SEC	Securities and Exchange Commission (US)
UFAA	Unclaimed Financial Assets Authority
US	United States of America

TABLE OF STATUTES, REGULATIONS AND GUIDELINES

Banking Act Cap 488 of the Laws of Kenya

Central Depositories Act No. 4 of 2000, Revised Edition 2013 [2012].

Constitution of Kenya, 2010

Capital Markets Act Cap. 485A of the Laws of Kenya

Capital Markets (Conduct of Business) Market Intermediaries Regulations (2011)

Capital Markets (Corporate Governance) (Market Intermediaries) Regulations (2011)

Capital Markets (Licensing Requirements) General Regulations 2002

Capital Markets Guidelines on Financial Resource Requirements for Market Intermediaries

Capital Markets Foreign Investors Regulations, 2002

Code of Corporate Governance Practices for Issuers of Securities to the Public, 2015

Objectives and Principles of Securities Regulation, International Organization of Securities Commission, 2017

Unclaimed Financial Assets Act No 40 of 2011

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CHAPTER ONE: INTRODUCTION

1.0 Introduction

It is a fundamental truism that the existence of a robust, efficient and arguably lively capital market must of necessity be preceded by an established legal regime that not only provides for the establishment of a proper regulatory framework but also contains a set of rules and/or principles of law from where the rights of the various players can be easily ascertained without unnecessary litigation. On the contrary, poor legal regimes will more likely than not dampen the growth of the capital markets or at least ensure its collapse, a result that any investor would not want to hear of.

The capital markets can be defined as a platform for long-term investments such as shares and government bonds among others.[1] The capital markets legal and regulatory framework governs entities that seek to issue securities[2] to the public in order to obtain funds for investment purposes. These entities include listed companies and corporate bond issuers. Companies seek to offer securities as a form of equity for the funds that they receive from investors in order to repay back the money after the lapse of the set bond period. In the case of public listed companies, the investor has the right to sell his or her shares at a time of their choosing and thus obtain the funds that had been invested in a listed company's shares.[3]

Companies seek additional funds through the capital markets for purposes of expanding their businesses by assessing more capital inflows for long term and capital-intensive

[1] Chisholm AM, *An Introduction to International Capital Markets: Products, Strategies, Participants,* Second edition, (West Sussex: John Wiley & Sons Ltd, 2009) at 1.
[2] Section 2 of the Capital Markets Act defines securities as a tradable financial instrument that represents either a stake in the ownership of a public listed company or a representation of a credit-debt relationship between an individual and a corporate entity or a government entity.
[3]Ibid.

developments.[4] Additionally, the listing of companies on any securities exchange is not only to enhance transparency in the operations of the entity but also to adhere to the dictates of good corporate governance practices.[5]

Trading of securities in the capital markets is facilitated by stockbrokers who interact with investors as market intermediaries or licensed persons in the purchase of securities. Stockbrokers also act as transaction advisors to companies interested in listing their securities at the securities exchange. For an entity to be licensed as a stockbroker, the entity must be a duly registered corporate entity as provided for by the Companies Act, 2015.[6] The entity must also meet the licensing requirements issued by the Capital Markets Authority (the Authority) and any other requirements as the Authority may prescribe in accordance with Part IV of the Capital Markets Act. Once the Authority is satisfied with the credentials of an entity and it meets all the requirements for licensing, it issues a license for such entity and the body corporate is referred to as a licensed person.[7]

Currently, pursuant to the Capital Markets Authority's 2017-2018 Annual Reports, there are nine (9) stockbrokers licensed by the Authority. A stock broker is a person who carries on the business of buying or selling of securities as an agent for investors in return for a commission.[8] There are various laws and regulations applicable to stockbrokers that are geared towards managing business risks and promoting investor protection. However, there are challenges in adherence to the laws and regulations by the stockbrokers.

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[4] Alvin Ang and others, 'Internal Capital Markets in Family Business Groups During the Global Financial Crisis' (Social Science Research Network 2018) SSRN Scholarly Paper ID 2517810 <https://papers.ssrn.com/abstract=2517810> accessed 12 December 2018.
[5] Gardiner Means, *The Modern Corporation and Private Property* (Routledge 2017) <https://www.taylorfrancis.com/books/9781351479356> accessed 19 December 2018.
[6] Act No. 47 of 2015.
[7] Section 2 of the Capital Markets Act.
[8] ibid.

Some of the applicable laws and regulations are: -

a) The Capital Markets Act[9]

b) The Central Depositories Act[10]

c) Capital Markets (Conduct of Business) Market Intermediaries Regulations[11]

d) Capital Markets (Corporate Governance) (Market Intermediaries) Regulations[12]

e) Capital Markets (Licensing Requirements) (General) (Amendment) Regulations[13]

f) Capital Markets Guidelines on Financial Resource Requirements for Capital Market Intermediaries[14]

g) Central Depositories Operational Rules[15] and Procedures.[16]

1.1 Background

The securities markets and the general trading in securities has proven to be a key investment vehicle that has sustained several economies around the world through the generation of wealth.[17] This is because the securities markets have proven time and again to be an efficient mechanism through which countries can not only accumulate capital but can also direct the capital towards different sectors of the economy.[18] This wealth has to be directed to the different sectors of the economy through an efficient mechanism that responsibly allocates the financial resources at the disposal of participants in the securities markets.[19] In order to achieve

[9]Cap 485A of the Laws of Kenya.
[10] No. 4 of 2011.
[11] Capital Markets (Conduct of Business) Market Intermediaries Regulations 2011.
[12]Capital Markets (Corporate Governance) (Market Intermediaries) Regulations 2011.
[13]Capital Markets (Licensing Requirements) (General)(Amendment) Regulations 2017.
[14] Financial Resource Requirements for Capital Markets Intermediaries.
[15]The Central Depository Rules, 2004.
[16]The Central Depository Operational Procedures, 2012.
[17]Jonathan Macey and David Swensen, 'Recovering the Promise of the Orderly and Fair Stock Exchange' (2016) 42 Journal of Corporation Law 777.
[18]ibid.
[19]ibid.

this, the dealings in securities in the markets must constantly and consistently be facilitated by an efficient pricing mechanism that ensures that they maintain their marketability.[20] Additionally, the environment around securities markets must be that which is clothed with complete transparency and accountability from the players. To put it simply, the requirement of utmost disclosure remains a fundamental tenet of the efficient operation of the financial markets.[21]

Key in the securities markets are the financial intermediaries who provide a wide range of services to the investors.[22] Some of these services include the facilitation of the exchange of securities, undertaking to manage the investment portfolios, and most importantly, the provision of information to investors either as advisors to the investors or as a discharge of their fiduciary duties with respect to the investment portfolios put in their trust and care by investors.[23] In the securities markets, that are constantly changing and increasing in complexity, investors have religiously relied on the services such as the provision of information by stockbrokers to reap the maximum profits from the markets.[24] Therefore, stockbrokers have facilitated the continued participation of the public in the securities markets.[25] The value of this information definitely lies in its ability to shed light on the fundamentals of the available opportunities in the markets and their suitability to the investors' tastes and preferences in so far as dealings in the securities markets are concerned.

The provision of this crucial information to investors ultimately underscores the relative importance of stockbrokers to investors and their continued necessity in the securities

[20]Alessio M Pacces, 'Financial Intermediation in the Securities Markets Law and Economics of Conduct of Business Regulation' (2000) 20 International Review of Law and Economics 479.
[21]Stephen J Choi, 'A Framework for the Regulation of Securities Market Intermediaries' (2004) 1 Berkeley Business Law Journal 45.
[22]Robert A Prentice, 'Moral Equilibrium: Stockbrokers and the Limits of Disclosure' (2011) 2011 Wisconsin Law Review 1059.
[23]ibid.
[24]ibid.
[25]Michael J Aitken and others, 'How Brokers Facilitate Trade for Long-Term Clients in Competitive Securities Markets' (1995) 68 The Journal of Business 1.

markets.[26] Therefore, the provision of information by stockbrokers to investors, directly or indirectly in the securities markets remain a crucial and absolutely necessary service in the exchange of securities.[27] Theoretically, in order to help investors make the most optimal and rational decisions with regards to the risks and returns from investing in securities, investors require an optimal amount of information.[28] Additionally, an optimal amount of knowledge and information about securities in the hands of investors may aid in the pricing of securities and the efficient allocation of resources.[29] However, the information provided by stockbrokers as such must be synthesized to a level that makes it easier for an investor to understand and use for their benefit.[30] However, the reality is rather different. The level of information asymmetry between professionals in the securities markets and the individual investors is rather high.[31] In fact, it has been stated that individual investors are neither in a position to efficiently analyze and utilize the information given to them nor are they capable of effectively evaluating the quality and value of the information in the absence of stockbrokers.[32]

It, therefore, becomes imperative that investors carefully select a stockbroker who is experienced enough to correctly break down the information and help them make the most out of the information.[33] This serves to further underscore the relative importance of stockbrokers and other financial intermediaries such as investment advisors given that even the most sophisticated investor may at one point in time require the services of these intermediaries in

[26]ibid.
[27]Emad Abdel Rahim Dahiyat, 'The Legal Recognition of Online Brokerage in UAE: Is a Conceptual Rethink Imperative?' (2016) 25 Information & Communications Technology Law 173.
[28]ibid.
[29]ibid.
[30]Christian Leuz and Peter Wysocki, 'The Economics of Disclosure and Financial Reporting Regulation: Evidence and Suggestions for Future Research' (2016) 54 Journal of Accounting Research 525.
[31]Brad Barber and Terrance Odean, 'The Courage of Misguided Convictions: The Trading Behavior of Individual Investors' (Social Science Research Network 2000) SSRN Scholarly Paper ID 219175 <https://papers.ssrn.com/abstract=219175> accessed 23 December 2018.
[32]Pacces (n 20).
[33]Barber and Odean (n 31).

the sophisticated securities markets.[34] It is for this reason that the Capital Markets Act[35]was enacted providing for the Capital Markets Authority which is mandated to protect the interests of the investors by being the regulatory body of all the intermediaries in the securities markets.[36] The Capital Markets Authority as such is supposed to ensure that at all times, intermediaries such as stock brokerage firms conduct their business in an orderly, fair and efficient manner to all the parties involved.[37] The Capital Markets Authority is also mandated to develop rules and regulations to regulate the operations of the securities markets.[38] To solve the problem of information asymmetry, the Capital Markets Authority seeks to see to it that information about the investment segments are disseminated as far and wide as possible so that individual investors are able to make sound investment choices.[39]

In developing the rules and regulations, the Capital Markets Authority, intends to see to it that any conflict of interest between investors and intermediaries is avoided and that the protection of the investors' interests remain supreme.[40] It also hopes to see to it that investors are protected and that they remain confident in the integrity of the services of intermediaries and of the securities markets.[41] Without a proper legal and institutional framework, it becomes almost impossible to guarantee that intermediaries will adequately advance the interests of the investors especially now that the Authority seeks to see to it that the securities markets are as inclusive as possible.[42] It is important to note that virtually almost all aspects of the financial markets are plagued with the problem of information asymmetry especially the quality and

[34]Donald C Langevoort, 'Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation' (2002) 97 Northwestern University Law Review 135.
[35]Capital Markets Act (n 9).
[36] ibid, Section 11.
[37]ibid.
[38]ibid.
[39]ibid, Section 11(2).
[40]ibid, Section 11(1)(d).
[41]ibid, Section 11(1)(c).
[42]ibid, Section 11(1)(b).

value of that information to investors.[43] However, when it comes to securities markets, more often than not, investors lack any or have limited knowledge on the machinations of the securities markets or even the skills required as opposed to intermediaries whose businesses are founded on their knowledge and expertise.[44]

Therefore, the relationship between the individual investors and the intermediaries in capital markets are built on trust which basically implies the stockbroker working in the best interest of the investors.[45] The stockbroker cannot allow an investor to harbour any doubts about the ability of the firm to deliver best results and as such the stock brokerage business is one that is founded on having a good reputation in the industry.[46] However, the employees of a stock brokerage firm may at times concern themselves less with the reputation of the firm and pay attention to pursuing their own interests and not that of the clients.[47] There is also the possibility that an entire stock brokerage firm may deem it fit to advance their own interests against those of the clients by choosing to exploit the clients in the short run rather than by building a noteworthy reputation.[48] In some cases, due to the competitive nature of stock brokerage firms, some firms are tempted to feed clients misleading information in order to grow their client base since most clients are normally just shopping for high-quality services.[49] The existence of information asymmetry in the securities markets and the inability of a few brokerage firms to strictly adhere to the principles of utmost disclosure does not only portend negative on individual investors but also pollutes the securities markets.[50]

[43]Renhui Fu and others, 'Financial Reporting Frequency, Information Asymmetry, and the Cost of Equity' (2012) 54 Journal of Accounting and Economics 132.
[44]Gregory S Miller and Douglas J Skinner, 'The Evolving Disclosure Landscape: How Changes in Technology, the Media, and Capital Markets Are Affecting Disclosure' (2015) 53 Journal of Accounting Research 221.
[45]Thomas Lee Hazen, 'Are Existing Stock Broker Standards Sufficient - Principles, Rules, and Fiduciary Duties' (2010) 2010 Columbia Business Law Review 710.
[46]ibid.
[47]Prentice (n 22).
[48]James Angel and Douglas McCabe, 'Ethical Standards for Stockbrokers: Fiduciary or Suitability?' (2013) 115 Journal of Business Ethics 183.
[49]ibid.
[50]Prentice (n 22).

This study will, therefore, seek to highlight some of the challenges faced by stockbrokers in the securities markets and the regulatory responses to these challenges as well as the possible room for legal reforms.

1.2 Statement of the Problem

Whereas the new regulations have been put in place to increase accountability and transparency from stockbrokers, there already is a brewing conflict between the regulatory requirements and the unique and diverse needs and capabilities of the stockbrokerage firms. The inadvertent result of such a scenario is that there is no standardization of information that is to be disclosed to the individual investors and as such the information from these firms to investors is either too complex for ordinary investors or the information is almost completely immaterial for the more seasoned investors. Additionally, reports are fraught with several incidences of licensees making changes to Information Memorandum after the approval by the Capital Markets, a rampant failure to make disclosure of important information that can facilitate adequate decision-making by investors, inadequate disclosure of sale of assets and arrangements on leasebacks.[51]

Furthermore, market abuses such as churning, insider trading and the unresolved conflict of interest between the interests of stockbrokerage firms and their investors, have made it difficult for more investors as well as other stockbrokers to enter into the Kenyan capital markets. For instance,there are still a number of stockbrokerage firms that do not have an adequate conflict of interest management systems or where the systems have been put in place, some have been

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[51]Capital Markets Authority, 'CMA Takes Enforcement Action against Former Uchumi Supermarkets Ltd Directors and Connected Entities for Regulatory Breaches' (2018) <https://www.cma.or.ke/index.php?option=com_content&view=article&id=197:cma-takes-enforcement-action-against-former-uchumi-supermarkets-ltd-directors-and-connected-entities-for-regulatory-breaches&catid=12&Itemid=207> accessed 1 May 2019.

found to be inadequate for the protection of the interests of investors.[52] Additionally, despite the Capital Markets Act and the attendant regulations prohibiting insider trading, the Statute is somehow vague with regards to what information can be held as being price-sensitive or in the public domain and/or whether a stockbrokerage firm can be in possession of sensitive information. This has led to instances where stockbrokers have found themselves subjects of investigations into insider trading even as directors such as Mr. David Ohana of KenolKobil are cleared of any misconduct with regards to insider trading.[53]A review of the Capital Markets Authority Annual Reports for the period 2015-2018 provides that the most prevalent breaches committed by stockbrokers arise from mainly, liquid capital deficits, providing misleading information to issuers during offering of securities, amending information memoranda without approval of the Capital Markets Authority and loss of client funds due to failure to observe, know your client requirements and unauthorised dealing in client accounts.

Another growing concern among stockbrokers is that despite the ever-growing market capitalization of the capital markets in Kenya, very few firms such as Safaricom have dominated the already small market with the rest just owning quite a small share and this significantly reduces liquidity in the market.[54] Much of this domination is due to the fact that very few firms can manage the cost of listing and the stringent requirements for listing in the Kenyan capital markets.[55]The reduced liquidity of the capital markets due to the few dominant firms and stringent entry requirements have greatly reduced the profitability of the capital

[52]Capital Markets Authority, 'CMA CE'S SPEECH ON FRAUD 0N WEDNESDAY 4 MAY 2016 AT RADISSON BLU HOTEL' (2016) <https://www.cma.or.ke/index.php?option=com_content&view=article&id=235:cma-ce-s-speech-on-fraud-0n-wednesday-4-may-2016-at-radisson-blu-hotel&catid=13&Itemid=208> accessed 1 May 2019.
[53]Capital Markets Authority, 'CMA Recovers Ksh458 Million in Connection with Suspicious Trades in KenolKobil Shares' (2019) <https://www.cma.or.ke/index.php?option=com_content&view=article&id=532:cma-recovers-ksh458-million-in-connection-with-suspicious-trades-in-kenolkobil-shares&catid=12&Itemid=207> accessed 1 May 2019.
[54]James Anyanzwa, 'Stockbrokers, Investment Advisers Seek to Exit NSE Citing Low Returns - The East African' (2018) <https://www.theeastafrican.co.ke/business/Stockbrokers-investment-advisers-seek-to-exit-NSE/2560-4678338-lyd1l7/index.html> accessed 1 May 2019.
[55]ibid.

markets for stockbrokers. This has pushed a number of firms to seek the revocation of their licenses by the Authority as it is constantly becoming difficult to make any profits.[56]

This study, therefore, postulates that despite the existence of a legal, regulatory and institutional framework governing the operation of stockbrokers in Kenya, there are a number of gaps and inconsistencies in the law. These gaps and inconsistencies have become impossible to surmount in so far as enhancement of regulatory compliance by stockbrokers and the protection of the investors in the Kenyan capital markets are concerned.

1.3 Justification and Significance of the Study

The study is aimed at identifying the challenges faced by stockbrokers in the conduct of their businesses and in legal and regulatory compliance. Recognize potential gaps in the implementation of the relevant capital markets legal and regulatory framework with regard to stockbrokers and opportunities for reforms. The study will add information on the current emerging issues faced by stockbrokers in complying with the capital markets laws and regulations and propose areas for reforms.

The information obtained from the research can be utilized nationally in legal reforms in the capital markets by the Capital Markets Authority in order to enhance investor protection and improve the conduct of business of stockbrokers. The implications of the study outcomes may be enhanced legal and regulatory compliance and improved investor protection.

The findings of this study will also be instrumental in the shaping and framing of national policies on the development of the capital markets in Kenya. The findings of the study will most likely be used in addressing the current challenges and factors that inhibit the development of a robust legal framework to deal with market intermediaries in the Capital Markets in Kenya. The findings of this study will also most definitely help in the framing of

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[56]ibid.

an adequate policy and regulatory framework by the regulator-the Capital Markets Authority, Nairobi Securities Exchange and the national government - of capital markets in Kenya.

The information from this study should also prove to be crucial to investors seeking to invest in securities in Kenya and appraise them of the challenges that are plaguing intermediaries in Kenya. Finally, this research study is meant to add to the existing wealth of knowledge on the opportunities and challenges facing stockbrokers in Kenya.

1.4 Research Objectives

The aim of this research is to determine the challenges faced by stockbrokers in the implementation of capital markets legal and regulatory framework and the opportunities available for reforms. The main objective of the study is to determine the factors that affect the development of emerging capital market. The specific objectives of the research are: -

1. To assess the adequacy of the legal and regulatory framework governing the operations of stockbrokers in Kenya.
2. To determine challenges faced by stockbrokers in attempts to comply with the existing legal and regulatory framework.
3. To find out some of the best approaches in the US in the regulation of the activities of stockbrokers.
4. To determine if there are areas for reforms in the legal and regulatory framework governing stockbrokers, and if so identify them.

1.5 Research Questions

1. What is the legal and regulatory framework governing the operations of stockbrokers in Kenya?

2. What are the challenges faced by stockbrokers in their attempts to comply with the legal and regulatory framework governing their operations in Kenya?
3. What are some of the best approaches in the US in the regulation of activities of stockbrokers?
4. Is there room for reforms and if, yes, what are the possible reforms that can be introduced into the regulation of the operations of stockbrokers in Kenya?

1.6 Hypotheses

1. Stockbrokers are facing challenges in implementing and complying with capital markets legal and regulatory frameworks.

2. There is need for reform of the capital markets legal and regulatory framework to address emerging issues faced by stockbrokers in implementation and compliance with the law.

1.7 Theoretical Framework

1.7.1 The Theory of Economic Regulation

Economic regulation refers to intervention by the Government in a manner designed to regulate and influence the economic behaviour of individuals and firms[57]. The rationale for economic regulation by Governments include to improve efficiency for allocation of society's resources, prevent monopolies and ensure consumers are charged 'fair' and 'reasonable' rates for goods and services[58]. The central tasks of the theory of economic regulation are to explain the benefactors and the bearers of the burdens of regulation, what form regulation will take, and

[57]http://www.thecanadianencyclopedia.ca/en/article/economic-regulation accessed on 15 March 2018

[58] ibid

the effects of the regulation upon the allocation of resources.[59] Proponents of the theory of economic regulation argue that regulation and laws are developed in order to protect the interests of cartels at the expense of the consumers. In addition, politicians and policy makers are used to promote the promulgation of laws that cater to the interest of large industry players. This is in order for the industry players to make economic gains within a regulatory environment that protects their interests and promotes economic gains as well as profit making.

The state has one basic resource which in pure principle is not shared with the mightiest of its citizens: the power to coerce. [60] The powers of the state through its legislature and the attendant coercive powers of the state are the mechanisms through which the state orders society. Through licensing fees, taxation and the penalties that are meted out for failure to comply with the law by the state, it is able to exert its authority on any industry in the economy.[61] As opined by George Stigler, the rationale for the exertion of that regulatory authority has always been for the protection of the interests of the public who require the services of intermediaries in the financial markets.[62] Just as Thomas Hobbes asserted in his social contract theory, the people wilfully surrender their rights on behalf of the government which then protects the interests of the entire community. The electorate may not have any knowledge about the conduct of the affairs of stockbrokers and as such in order to protect them from being exploited, the state enacts and enforces laws and regulations to govern their conduct. According to Stigler, every industry in any given economy is capable of amassing enough power to control entry into the industry and develop rules and regulations to govern their affairs. The development of such

[59] George J. Stigler, 'The Theory of Economic Regulation' (1971) 2 The Bell Journal of Economics and Management 3.

[60] ibid. p.4.

[61] Peltzman Sam, "The Economic Theory of Regulation after a Decade of Deregulation," Brookings Papers: Microeconomics (1989) 14.

[62] Stigler (n 59) 3.

rules by the industry players may be acceptable in certain circumstances but more often than not leads to the exploitation of the public and as such the intervention of the government is called for. It also has the potential of stifling the growth of the industries and this is a situation that is undesirable for any government.[63] The government must, therefore, not only look out for the interests of the members of the public but it must also see to the development of the economy through the development of the different sectors within it.[64]

Stigler further argues that the costs of legislation probably increase with the size of the industry seeking the legislation.[65] For instance in Kenya, the introduction of the Capital Gains Tax on the gains made in the trade of the securities at the securities exchange led to lobbying by the securities industry and subsequent removal of the tax. In addition, the capping of interest rates issued by banks to consumers by the Central Bank of Kenya led to limitation of credit issued by banks to consumers leading to the subsequent removal of the capping of the interest rates.

A corollary of the economic theory of regulation is that the regulatory process can be expected to operate with reasonable efficiency to achieve its ends. [66] This is the case in the capital markets industry, where a licensed person is expected to comply with the legal and regulatory framework in order to conduct business and protect investor interests.

According to the International Organization for Securities Commission (IOSCO), the objectives of securities regulation are: - for investor protection, ensuring that markets are fair, efficient and transparent and reduction of systemic risks. The IOSCO principles for market

[63]ibid. p.5.

[64]ibid.

[65]ibid. p.12.

[66]Richard Posner, ‘Theories of Economic Regulation’ (1974) 5 The Bell Journal of Economics and Management Science 350.

intermediaries provide guidance on the key areas that a regulator should ensure that a market intermediary has complied with.[67]

Consequently, laws and regulations are developed by the regulators of the capital markets industry with a view to reducing systemic risks and capital outflows from the capital markets in the case of foreign investments. Following liberalization of the capital markets, there has been increased foreign investment in frontier markets like Kenya leading to growth in the volumes traded at the Nairobi Securities Exchange and increase in the number of listed companies.

1.7.2 Public Interest Theory

The public interest theory of regulation holds that regulatory agencies are created for bona fide public purposes, but are then mismanaged, with the result that those purposes are not always achieved.[68] It is arguable that in the absence of a robust regulatory and legal framework, the less informed members of the public are likely to be exploited by the providers of goods and services needed by the public.

This theory makes the assumption that most regulatory agencies are mismanaged because they are managed by public servants who lack incentives to work unlike their peers in the private sector. Therefore, they are not diligent in their work leading to loss of funds and mismanagement. However, it has been detected that this is an observation that cannot be supported by empirical evidence. Most of the employees of regulatory agencies work as professionals for the salary that they earn in addition to gaining expertise that can be used in the industry or for promotion. The boards of regulatory agencies are appointed by the executive

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[67] IOSCO Principles on Market Intermediaries are Principles 29, 30, 31 and 32; they provide for regulation on minimum entry standards for market intermediaries, initial and ongoing capital and other prudential requirements; internal organizational controls and procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risks.

[68]Posner (n 66) 337.

arm of government; they have a keen interest to ensure that the mandate of the respective agencies is executed in accordance with the law. In addition, no persuasive theory has been promoted on why agencies should be expected to be inefficient than other organizations. Richard Posner observes that, much of it is consistent with the rival theory that the typical regulatory agency operates with reasonable efficiency to attain deliberately inefficient or inequitable goals set by legislature that created it."[69]

A serious problem with any version of the public interest theory is that the theory contains no linkage or mechanism by which a perception of the public interest is translated into legislative action.[70] The public interest theory as reformulated has various weaknesses that have not been fully substantiated by empirical evidence.

1.7.3 Capture Theory

It singles out a particular interest group, the regulated firms, as prevailing in the struggle to influence legislation, and it predicts a regular sequence in which the original purposes of a regulatory program are later thwarted through the efforts of the interest group.[71] According to Posner the "capture theory" is actually a hypothesis that lacks any theoretical foundation. Posner, notes that no reason is suggested for characterizing the interaction between the regulatory agency and the regulated firm by a metaphor of conquest, and surely, the regulatory process is better viewed as the outcome of implicit (sometimes explicit) bargaining between the agency and the regulated firms. No reason is suggested as to why the regulated industry should be the only interest group able to influence an agency. Customers of the regulated firm

[69]ibid. p.33-38.

[70]ibid.

[71]ibid. p.342.

have an obvious interest in the outcome of the regulatory process, why may they not be able to "capture" the agency as effectively as the regulated firms, or more so?"[72]

The capture theory may be applicable in Kenya especially with regard to the securities industry where intense lobbying and litigation led to the scrapping of the Capital Gains Tax that had been introduced on the transactions of securities. However, in developed economies for instance in Europe and the United States of America, a great deal of economic regulation serves the interests of small, business or non-business, groups, including dairy farmers, pharmacists, barbers, truckers and in particular union labour.[73]

1.7.4 The Agency Theory

The relationships between stockbrokers with their clients (the investors) are governed by the agency theory. The former are agents of the investors in execution of orders issued by the investors on transactions in securities. The Agency theory relates to agency relationships which arise when persons (principals) engage other persons (agents) to perform some service on their behalf, which involves delegating of some decision-making authority to the agents. Issues associated with the separation of ownership and control is intimately associated with agency problems. The contract between the parties will typically contain a set of incentives in order to limit divergences between their interests. In order to ensure desirable outcomes, the principals will also be pay monitoring costs and bonding costs by the agents.

An intermediary is any actor that acts directly or indirectly in conjunction with a regulator to affect the behaviour of a target.[74] In the capital markets industry in Kenya, the CMA utilizes the market intermediaries in implementation of the legal and regulatory framework. The

[72]ibid.

[73]ibid. p.341.

[74] Abbott Kenneth et al 'Theorizing Regulatory Intermediaries: the RIT Model' (2017) 670 The Annals of the American Academy 19.

principal reason for regulators to incorporate intermediaries into the regulatory process is that intermediaries possess capacities relevant to regulation that regulators themselves lack, or that intermediaries can provide more effectively or at a lower cost.

The standard explanation or justification for governmental regulation of a market is that the market left to itself, it will not produce its particular goods or services in an efficient manner and at the lowest possible cost.[75] Regulations are developed in order to enhance compliance and prevent systemic risks. One reason why regulation is needed is that the abuses and failures of an organization can affect others with whom the organization does business.[76]Regulations are developed with an aim to protect investors and consumers of financial products.[77] The capital markets consist of sophisticated[78] and unsophisticated investors. Therefore, the regulations ensure that there is adequate protection of all investors and the funds that have been invested in the capital markets. This is in order to ensure that there is capital markets growth and enhanced investor confidence thus lead to increase in cash inflows to the equity and bond market.

New theoretical research works show that market development might boost economic growth and empirical evidence tends to provide some support to this assertion. Levine and Zervos,[79] find that stock market development plays an important role in predicting future economic growth. Capital markets are an essential part of the financial sectors of modern economies, providing alternative savings posts tools and nonbank sources for financing for enterprises, the

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[75] Fabozzi Frank and Modigliani Franco, Capital Markets (New Jersey, Prentice Hall Inc., 1996) 28.

[76] McInish Thomas H., *"Capital Markets: a Global Perspective"*, (Massachusetts, Blackwell Publishers Inc, 2000) 131.

[77] Ibid

[78] Section 2 of the Capital Markets Act states that, a sophisticated investor means a person who is licensed under the Act; an authorized scheme or collective investment scheme; a bank, a subsidiary of a bank, insurance company, co-operative society, statutory fund, pension or retirement fund; or an individual, a company, partnership, association or a trustee on behalf of a trust which, either alone or with any associates on a joint account subscribes for securities with an issue price as the Authority may prescribe from time to time.

[79] Levine, Ross and Sara Zervos, 'Stock Markets, Banks, and Economic Growth' (1998) 88 American Economic Review 537.

markets promote economic growth through improved efficiency in savings mobilization.[80] Porter[81] observes that over the past few years, investor interest in the world's emerging markets has expanded significantly. That has been fuelled by the relatively high return recorded by emerging markets and by their perceived potential for large returns in the future. Barry and Lockwood,[82] also noted that emerging capital markets recently have attracted the attention of global investors and scholars alike. The markets are characterized by high average returns, high volatility and excellent diversification prospect in combination with portfolios from developing markets. Kimura and Amoro[83] found that there was a poor degree of correlation between economic growth and growth of the stock exchange. The former averaged 3.8% in the period 1985 – 1996 while the later averaged only 0.6% as measured by the number of quoted companies. The results indicated that a major factor is general lack of awareness and information on the role, functions and operations of the stock exchange.

1.8 Literature Review

Both investors and other players such as the intermediaries in the financial markets are in agreement that in order to adequately protect the integrity of the markets and the interest of the investors, adherence to the strict dictates of the guidelines on corporate governance is imperative. The challenges evident in the Capital Markets is attributed to the inadequate regulatory framework that has been put in place to see the operation thereof. The upshot of this is that the problems of disclosure requirement with regard to the relevance of the information disclosed to investors and suitability of the investment options or advice issued to investors by

[80]Schmidt-Hebbal and others, '*Saving Investment: Paradigms Puzzles, Policies'* (1996)The World Bank Research Observer 1, No.1.
[81]M Porter,'*Closed end Emerging country Funds Review, in K.H.Park and W.VanAgtmael,*The World's Emerging Stock Markets' (Chicago:Probus Publishers,1993) 459.
[82]Barry Carmen and Lockwood Lott: *New directions in research on Emerging Capital Markets, Financial Markets, Institutions and Instruments* (Oxford: Blackwell Publishers, 1995) 15.
[83]J. Kimura and Y Amoro, '*Impediments to the growth of Nairobi Stock Exchange'* (1999) IPPAR Discussion Paper Series, Number 018/99.

stockbrokers on their buy or sell orders of securities have found root in the Capital Markets. Further, there are issues with regard to agency and conflict of interests in the advice issued by stockbrokers to investors.

1.8.1 The Disclosure Requirement

Accountability and transparency remains the cornerstone of corporate governance and generally, operations in the financial markets. However, these two tenets of corporate governance have caused much uproar from both the investors and the intermediaries in the securities markets. Intermediaries have often argued that the regulatory framework is too demanding on them and has the potential of exposing their trade secrets to their competitors in the market. Investors on the other hand, argue that intermediaries reveal way too little information and are more concerned about their own protection rather than advancing the interests of their client base. This highlights a major concern about the conflict of interest that intermediaries may experience with regards to their fiduciary duties to their clients and the pecuniary interests of the stockbrokerage business. Several literatures have ensued, which tempts to underscore the duty imposed upon the intermediaries to disclose information to investors.

Choi[84] attributes securities investment return values to information provided thereto. He notes that investment can only be fruitful when adequate information on the prevailing market and strategic plans are put into work, which information is availed by brokers.[85] A quite critical position that Choi takes is that it should be understood that investors do not operate on an equal informational footing.[86] He holds a presumptive view that insiders enjoy information advantage far much than outsiders.[87] In this understanding, investors acting individually do not have the

[84] Choi (n 21) 45.
[85] ibid. p.45.
[86] ibid.
[87]ibid. See Paul G. Mahoney, 'Mandatory Disclosure as a Solution to Agency Problems' (1995) 62 U. CHI. L. REV 1047, 1051.

capacity to engage in the same level of research as their corporate counterparts.[88] As a matter of filling this gap, he supposes that adequate and credible information ought to be availed to the public investors in entirety.[89] Undoubtedly therefore, a mandatory disclosure requirement should be entrenched in the attendant regulations.[90]

Choi however notes that disclosure in itself does not per se guarantee to the investor a well informed and thought investment.[91] Put in simple terms, there is more that needs to be done beyond mere disclosures to investors by intermediaries. This is because even after disclosure, investors, especially the individual ones face the daunting task of enduring to interpret the disclosed information.[92] Therefore, the information provided ought to encompass the virtues of clarity and simplicity. Otherwise, disclosure and non -disclosure shall speak the same language.

Kumpan and Leyens[93] provide a quite critical evaluation of conflicts of interest of financial intermediary in capital markets. The two gives a general assumption that the financial markets cannot efficiently operate without the input of intermediaries.[94] They thus opine that the capital markets participants, whilst effecting their transactions are assisted by intermediaries, with some acting as advisers.[95] They however note that during the provision of such services, the intermediaries are caught up in situations of conflict of interest as far as disclosure of information is concerned. Illustratively, Kumpan and Leyens say that such conflict may arise wherein there is third party interest in the same market, for instance, where the intermediary

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[88]ibid. See Jack Hirschleifer, 'The Private and Social Value of Information and Reward to Inventive Activity' (1971) 61 AM. ECON. REV. 561, 562-66.
[89]ibid. p.46.
[90]ibid.
[91]ibid.
[92]ibid.
[93]Christoph Kumpan and Patrick C Leyens, 'Conflicts of Interest of Financial Intermediaries- Towards a Global Common Core in Conflicts of Interest Regulation' (2008) ECFR 72.
[94]ibid. p.73.
[95]ibid. See Stark Davis, Conflict of Interests in the Profession (Oxford, 2001) 217.

has to serve multiple issuers or investors, whatever may be the case.[96] They state that this is further complicated wherein in assisting in one offering, the intermediary will not be able to completely ignore confidential information that has been employed in advising another investor.[97]

Nonetheless, Kumpan and Leyens take the stance that intermediaries must balance the various interests irrespective of the inevitable conflict.[98] They thus suppose that disclosure is the penultimate solution to information asymmetries existing between the parties to a transaction.[99] According to the two economists, the prevention of market failure and curbing against opportunism is achievable through ensuring that there is mandatory disclosure.[100] Their analysis does not stop there. They propose certain rules which they refer to as 'principles of disclosure'.[101] In this vein, they suppose that disclosure by brokers need to be 'timely, true, complete and sufficiently detailed.'[102] A key tenet of such principles is that the intermediary needs to have in contemplation the nature of the client to enable the latter to make informed decision with respect to the investment.[103]

Besides demanding disclosure as the only path towards a steady capital markets growth, Kumpan and Leyens introduce another, quite impressive path. In the event that a conflict of interest reaches an impasse, and thus not capable of being fairly tackled, the two supposes that the broker should refrain from acting in entirety.[104] This is in consonance with the desire that the interests of the investors at hand are prioritized. Despite being an option, Kumpan and

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[96]ibid. p.81.
[97]ibid.
[98]ibid. p.73.
[99]ibid. p.89.
[100]ibid.
[101]ibid.
[102]ibid.
[103]ibid.
[104]ibid. p.90.

Leyen are so critical that if misinterpreted by investors, the success of the securities offering can be derailed.[105]

Pacces[106] analyzes financial intermediation in the securities markets from a facilitative perspective. He says that the prime rationale behind having intermediaries in the securities markets is to facilitate financial exchange or transactions.[107] Therefore, in rare circumstances will one find individual investors perform the exchange of securities directly.[108] Instead, the investors engage in such transactions through intermediaries, such as brokers, asset managers or even investment companies.[109]Pacces takes a limited approach of the facilitative role by opining that the existence of intermediaries in securities markets is largely based on their informational role.[110] He is of the view that generally, intermediaries are obliged to provide investors with such optimal information at the very least.[111] This obligation he qualifies by stating that it is only when such information is disclosed, that the investor becomes equipped with the necessary knowledge to make rational investment decisions.[112]Pacces thus justifies business regulation by holding that regulation aims at ensuring quality information is offered to the public investors by these very intermediaries.[113] A recommendation is provided by Pacces that effective regulatory system should focus more on 'the alignment of the interests of the investors and financial intermediaries alike.[114]

[105]ibid.
[106]Pacces (n 20) 479.
[107]ibid. p.479.
[108]ibid. p.480.
[109]ibid.
[110]ibid. p.481.
[111]ibid.
[112]ibid.
[113]ibid. p.482.
[114]ibid. p.497. See also P.G. Mahoney, 'Is There a Cure for 'Excessive' trading?' (1995) 81 Va. L. Rev 744.

Gilotta[115] argues that stockbrokerage firms are more often than not faced with the challenge of having to protect their interests in so far as competition in the industry is concerned and the need to adhere to the principles of utmost disclosure in the securities markets.[116]Gilotta acknowledges the relative importance of the role played by disclosure in the protection of the investors and the maintenance of the integrity of the markets. Gilotta asserts that the availing of information about the markets is imperative in maintaining the confidence of investors in the security markets. Furthermore, according to Gilotta, utmost disclosure is important in the proper ordering and functioning of the markets. However, Gilotta also enunciates that despite the benefits of the principle of utmost disclosure in the efficient functioning of the markets, it may detrimentally affect the competitive capability of the stockbrokerage firms. Additionally, he asserts that the principle is likely to weaken the efficient and private systems that incentivize and reward innovative abilities of these firms in the securities markets. Gilotta argues that countries should follow the selective approaches taken by the United States of America and Europe that allows stockbrokerage firms to refrain from giving information that they consider sensitive and likely to weaken their competitive advantage in the markets. He argues that the competitive value of the information should be determined on the basis of its potential to adversely affect the ability of the firm at generating revenue. It can also be based on the ability of the information to affect the efficiency of the resource allocation process.[117] Where the information has the potential of affecting the ability of the firm to generate revenue or the process of resource allocation, selective disclosure should be applied by either completely withholding the information or causing the release of the information to be delayed for a while. At all times, disclosure should be a tool for the balance of the interests of the investors as well

[115]Sergio Gilotta, 'The Conflict between Disclosure in Securities Markets and the Firm's Need for Confidentiality: Theoretical Framework and Regulatory Analysis' (Social Science Research Network 2010) SSRN Scholarly Paper ID 1709334 <https://papers.ssrn.com/abstract=1709334> accessed 2 January 2019.
[116]ibid.
[117]ibid.

as those of the stock brokers.[118] This is considerably a desirable outcome as it allows the prices of securities to be determined by market forces and this ultimately makes the markets efficient without compromising the ability of the firms to generate revenue.

Hazen[119] argues that much of the rules and regulations are based on hard and fast principles and standards that do not take into consideration the intricate details surrounding the operation of stock brokers.[120] Hazen suggests that the development of regulatory framework that protects the interests of the consumers and intermediaries alike should be one that is pragmatic, iterative, innovative, based on utmost disclosure in order to be robust, effective and less burdensome on the intermediaries as well as the investors. Hazen propounds that the hard and fast rules are by and large on the principles of just and fair dealings in the trading of securities and are more concerned about the prevention and prohibition of fraudulent, manipulative, and deceptive practices. He suggests that the rule making should be centered on the development of rules that aim at the regulation of specific conduct by the stock brokers with the aim of ensuring that they at all times honour their fiduciary duties to their client base. However, these should serve to supplement the hard and fast standards and principles and not serve as a suggestion that they should be done away with in the regulatory framework.

In fact, Hazen concludes that the current hard and fast rules may be inflexible but they have relatively been effective in reassuring the public on the integrity of the financial markets with regards to the elimination of fraudulent dealings. He concludes that despite the existence of a number of scandals in the trading of securities, there is not much to warrant the development of laws and rules to create explicit fiduciary duties on stockbrokers in order to protect consumers. This study observes that the hard and fast principles and standards are imperative

[118]ibid.
[119]Hazen (n 45).
[120]ibid.

for the maintenance of the integrity of the securities markets as well as the protection of the investors. It also notes that these hard and fast principles and standards must be supplemented by rules that take into account the interests of the stockbrokers as well as the unique characteristics that stockbrokers find themselves in.

James Angel and Douglas McCabe[121] opine that stock brokers and stockbrokerage firms have both a legal and ethical duty to act in the best interest of investors by dint of owing them a fiduciary duty.[122] However, they appear to be advocating for the express creation of the fiduciary duty through the enactment of legislation to that effect. They opine that the existence of a conflict of interest between the interests of the brokerage firm and those of the investors is not healthy as it is detrimental to the interests of the public that the legal and regulatory framework seeks to protect. Whereas the payment of commissions acts as powerful incentives for stock brokers to execute their duties, it is the same commissions that result in the creation of the conflict of interests for stock brokers seeking to make a killing from the trade dealings.[123] However, they argue that the existence of a conflict of interest for stock brokers may be detrimental to the interests of investors but is one that the market can tolerate up to a certain levels to be determined by ethical standards. According to them, the relationship between the investor and stockbrokers should be one that is governed by legal and ethical standards. The best interest of the investors based on the legally created fiduciary duty must also be supplemented by the existence of an ethical standard to prevent against any potential greed from stock brokers.[124] According to this study, the legally created fiduciary duty on stock brokers alone is not enough to protect the interest of investors. This legally created fiduciary relationship must be supplemented by the existence of an ethical code of conduct to check

[121]Angel and McCabe (n 48).
[122]ibid.
[123]ibid.
[124]ibid.

against any form of greed that may arise during the duration of the business relationship of the stockbroker and the investor.

Franklin Strier[125] opines that corporate governance guidelines remain one of the most effective mechanisms that can be used in the prevention of market failures such as the pursuit of the interests of the intermediaries at the expense of investors.[126] He propounds that the existence of internal mechanisms such as corporate boards and external mechanisms such as non-governmental regulatory bodies capable of effectively acting as gatekeepers of the securities markets. These institutions are better positioned to deal with any conflict of interest arising in securities markets because according to Strier these market failures are rather obvious and, therefore, these institutional frameworks often anticipate them by the creation of corporate guidelines to deal with such conflicts without adversely affecting the interests of investors. The development of a code of ethical conduct and corporate guidelines for stockbrokers remains to be an effective way of regulating the conduct of business by stockbrokerage firms and the coercive power behind their proper, just and fair dealings in the securities markets.

While giving a definition to what constitutes fairness and efficiency in the financial market, Shefrin and Statman[127] introduce the aspect of disclosure. They hold that a fair and efficient market is one where all parties have equal access to information to enable asset valuation.[128] Therefore, any financial market aspiring to be effective has to consider inculcating 'mandatory disclosure' regulations.[129] They hold that mandatory disclosure regulation seeks to guarantee protection to investors from insufficient or misleading information.[130]

[125]Franklin Strier, 'Conflicts of Interest in Corporate Governance' (2005) 2005 Journal of Corporate Citizenship 79.
[126]ibid.
[127]Hersh Shefrin and Meir Statman, 'Ethics, Fairness and Efficiency in Financial Marktets' (1993) 49 Financial Analysts Journal 21.
[128]ibid. p.21.
[129]ibid.
[130]ibid. p.25.

According to Goldstein and Yang[131] disclosure of financial information by stockbrokers and other intermediaries may have both positive and adverse effects on investors in the financial markets especially with regard to their welfare.[132] They support the argument that disclosure may be good for the markets as it improves its integrity as well as the interests of the investors. However, the requirement of disclosure fundamentally reduces the chances of stockbrokers successfully managing to convince investors to invest in high-risk trade opportunities with the potential of significantly profiting both the investors and intermediaries.[133] According to them disclosure harms the stockbrokerage firms as investors are likely to shy away from high-risk opportunities in the markets owing to the information disclosed to them. This forces intermediaries to hide this information in order to protect their own interest which is contrary to their fiduciary duty and ethical relationship.

Laby's[134]analysis of the financial regulatory reform is of paramount importance in understanding the literature on the disclosure requirements imposed upon securities brokers. Laby introductorily opines that the harmonization of the law governing brokers and investment intermediaries is a very fundamental aspect of financial regulatory reform.[135] Reforming the capital markets is thus based on reorganizing the stockbrokerage law. Laby views a brokerage as a fiduciary relationship and consequently holds that a fiduciary is under the duty to act in the principal's interest, as opposed to the broker's.[136]

As a step towards resolving the fiduciary tension for brokers, Laby recognizes disclosure as one of the often employed tools.[137] However, Laby is so critical of the requirement that broker

[131]Itay Goldstein and Liyan Yang, 'Information Disclosure in Financial Markets' (2017) 9 Annual Review of Financial Economics 101.
[132]ibid.
[133]ibid.
[134]Arthur B Laby, 'Reforming the Regulation of Broker-Dealers and Investment Advisers' (2010) 65 The Business Lawyer 395.
[135]ibid. p.395.
[136]ibid. p.429.
[137]ibid.

disclose all relevant information to the consulting investors and opposes it altogether. First, he states that the philosophical concept of disclosure is presumptively premised on the belief that the disclosed information to individual investors will be filtered through advisory brokers.[138] Secondly, Laby thinks that the theoretical underpinning behind disclosure assumes that the recipient thereof is cognizant of the magnitude of bias occasioned by the conflict of interest.[139] On the contrary, he is of the view that despite the customer's appreciation of the biasness, nonetheless, the latter is not in position to verify what to discount in the advice.[140]

Again, Laby opines that disclosure may even end up being counterproductive since regulators are inclined towards investors' interests.[141] Regulators have a one sided view of disclosure, requiring that investors be given adequate information to make their decisions while unjustifiably paying little or no attention to the effects disclosure may have on the brokers.[142] According to Laby, empirical evidence illustrates that demanding disclosure have the effect of influencing the behavior of the brokers to larger extent compared to when they advice without making disclosure.[143]

1.8.2 Churning

Posner[144] regards churning as a type of securities fraud which is a synonym to overtrading. In Posner's view, churning is occasioned by securities brokers or dealers who are involved in the control of a customer's account to the extent of frequently trading with the motive inter alia of

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[138]ibid. p.429-30.
[139]ibid. p.430.
[140]ibid.
[141]ibid.
[142]ibid. See also Steven L Schwarcz, 'Rethinking the Disclosure Paradigm in a World of Complexity' (2004) IU Law Review 1, 7-17. The current disclosure requirements are overly geared towards ensuring the benefits for investors. The regulators are not concerned with the potential harm that the material information could inflict upon the brokerage firms. This indicates a lack of balance of the brokers as well as the investors' interests.
[143]ibid. See also Daylian M Cain, George Loewestein and Don A Moore, 'The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interests' (2005) 3 journal of Legal Studies 1, 7.
[144]Norman S Posner, 'Options Account Fraud: Securities Churning in a New Context' (1984) 39 Business Lawyer 571.

increasing their amount of commissions.[145] The brokers thus initiate transactions that are excessive, being considerate of the financial situation and investment objectives of the customer.[146] He notes that even though several cases and commentary define the offense of churning within the confines of trading in shares, the offense is nonetheless conducted in customers' accounts engaged in listed options.[147]

Posner attempts to demystify a misconception that excessive trading is what the offense of churning prohibits.[148] Instead, he supposes that the amount of trading in the customers' account only gain relevance since a broker is assumed to have disregarded their customer's interests whence the latter initiates excessive trading, thus fraudulently acting.[149] He opines that the critical inquiry to make is 'whether the broker was acting primarily for the purpose of generating commissions for himself or in the best interest of their customer.'[150]

Similarly, Posner attributes the occurrence of the offense of churning to two reasons. First, he say that the fact that many securities brokers plays dual role, acting as investment advisers and salespersons, and further regarding themselves as 'account executives' acts like an encouragement to the customers who entrusts them to manage the accounts on their behalf.[151] Secondly, he is of the opinion that the compensation system, payment of commissions, in the securities industry compels the brokers to indulge into numerous transactions.[152] The most vital information provided by Posner in his article is perhaps outlining what constitutes the offense of churning. In this vein, he opines that there are three elements that must exist in a construction

[145]ibid. p.571.
[146]ibid.
[147]ibid.
[148]ibid. p.572.
[149]ibid.
[150]ibid.
[151]ibid. p.573. See Packard, 'A Test for Churning in Stock Options' (1981) 4 Corp. L. Rev. 222, 232-44.
[152]ibid. Brokerage commissions are received only if the customer engages in transactions. Moreover, individual brokers working for brokerage firms often receive as their sole compensation a percentage of the brokerage commissions they produce.

of the offense of churning.[153] Therefore, it must be ascertained that the broker was in control of the investor's account;[154] that the trading was conducted in an excessive manner[155] and finally scienter must be proved on the part of the broker, which implies the intention to manipulate or simply defraud.[156]

Whilst defining churning, McCann[157] takes a quite similar approach to Posner's views. McCann holds that allegations that a stockbroker traded a customer's portfolio excessively with the objective of generating income for the broker without putting into care the customer's best interest is what constitutes churning.[158] Again, like Posner, he argues that proving the churning entails a three -fold test of evaluating the self interest of the broker, effective control and lastly excessive trading.[159] What is quite impressive about McCann's discussion is that he goes a step to enumerate what indicates excessive trading, which is regarded as key element of churning. McCann thus provides that excessive trading is indicated by turnover ratios and cost to equity ratios.[160]

Huang[161]regards the excessive securities trading or turnover, herein churning as one of the practices which connote actionable fraud in securities.[162] According to Huang, 'churning occurs when securities broker buys and sells securities for a customer's account, without regard

[153]ibid. p.578.
[154]ibid. p. 579. In order for churning to occur, it must be proved that the broker was in control of the account.
[155]ibid. p.582. At the heart of a traditional churning charge is that the trading was excessive. See the leading case of Hecht v Harris Upham & Co. 40 F.2d 1202 (9th Cir. 1970) where the court stated at para. 435 that the inquiry is "whether the volume and frequency of transactions, considered in the light of the nature of the account and situation, needs and objectives of the customer have been so 'excessive' as to indicate a purpose of the broker to derive profit for himself while disregarding the interests of the customer."
[156]ibid. p.585.
[157]Craig McCann, 'Churning' (1999) 9 Journal of Legal Economics 49.
[158]ibid. p.49.
[159]ibid. See Loss and Seligman, 'Fundamentals of Securities Regulation' (1995) 908
[160]ibid. p.50. Turnover ratios involves the number of times the equity in an account is traded in a year. Cost- to -equity ratios on the other hand are calculated by diving the commissions and mark-ups and mark-downs incurred in an account by its average equity.
[161]Peter H Huang, 'Trust, Guilt and Securities Regulation' (2003) 151 University of Pennslyvania Law Review 1059.
[162]ibid. p.1071.

to the customer's investments interests, for the purpose of generating commissions.'[163] Huang holds that even though Annualized Turnover Ratio (ATR) is the main measure for examining churning, certain patterns of securities trading by a broker may fall within the definition of churning despite low volumes of trading.[164] Patterns such as cross trading, out trading and switching are such suspicious practices that may allude to churning.[165]

Blodgett's[166] understanding of the offense of churning is limited to an interpretation that it is purely excessive trading, determined by the turnover rate on securities.[167] In pursuance of that view, the turnover rate reflects the number of times in a given period securities in the customers' account have been replaced by new securities.[168] So that, in actions relating to churning, the focus of the inquiry should be tilted towards finding whether the account was excessively traded and whether the broker acted for the purposes of getting commissions.[169]

The reviewed literature tends to view churning as being manifested through excessive trading by the brokers in the accounts of the investors. As pointed out, the concept of commissioning as a mode of payment in securities markets is indeed largely attributed to the increasing levels of this fraud in the securities markets.

1.8.3 The Suitability Rule

Cohen[170] attempts to derive the rationale behind the imposition of the suitability rule upon brokers by relying on the belief that brokerage comes with the duty of trust and confidence.[171] According to Cohen, rules that require that brokers recommend only 'suitable investments'

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[163]ibid.
[164]ibid. p.1073.
[165]ibid.
[166]Nancy Blodgett, 'CHURNING YOUR BROKER: How to identify excessive trading' (1988) 74 America Bar Association Journal 32.
[167]ibid. p.32.
[168]ibid.
[169]ibid.
[170]Hillary Huebsch Cohen, 'The Suitability: Defining Stockbroker's Professional Responsibilities' (1978) 3 Journal of Corporation Law 533.
[171]ibid. p.533.

arose out of the need to curb against broker's abuse of their position of trust and confidence.[172]It is thus a professional rule attributed to the investors' reliance on the professional advice issued by the brokers.[173]

Cohen posits that suitability rule is an extension of the brokers' recognized duty of fair dealing, which requires the stockbrokers to exercise their best professional judgement to avoid recommending to investors inappropriate investment strategies.[174] Cohen is quite categorical that the rule of suitability comes to play whenever a broker makes a recommendation to customer.[175] However, he notes that while the term 'suitability' may be used to allude to some kind of evaluation it is nonetheless unclear whether the subject of inquiry should be the investor, the securities or both.[176] In other words, Cohen is so concerned upon what criterion should the suitability test be based. Is it by evaluating the investor's position or the nature of the securities dealt with, or a conglomeration of the two?

Geckeler[177] outrightly regards disobedience to the suitability as an actionable fraud.[178] He opines that in the event that a broker knowingly recommends an investment that is manifestly unsuitable for a client, then the former is deemed to have committed an actionable financial fraud.[179] For avoidance of doubt, Geckeler provides that in establishing unsuitability, the plaintiff has to surpass proving that: the securities purchased were not suit to the investor's needs; the broker had the knowledge or reasonably believed the securities were unsuited to the

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[172]ibid. Brokers builds a relationship of special trust and confidence with the investors by holding out to the public as possessing specialized skills and knowledge in matters financial investments.
[173]ibid.
[174]ibid. p.546.
[175]ibid. p.547.
[176]ibid. p.548.
[177]Peter M Geckeler, 'Municipal Derivatives Use and the Suitability Doctrine' (1996) 49 Washington University Journal of Urban and Contemporary Law 285.
[178]ibid. p.303.
[179]ibid.

buyers needs; and the defendant recommended or purchased the unsuitable securities for the buyer regardless of its unsuitability.[180]

Geckeler further holds that the suitability rule imposes upon the broker the duty to inquire sufficiently about the client's financial situation and relevant information thereto.[181] It is only when so is done that the broker becomes empowered to make suitable securities recommendations.[182] In terms of discovering the foundational underpinnings of the suitability rule, Geckeler introduces the concept of access to information. In this vein, he holds that the doctrine is informed by the notion that buyers of securities have less access to market information and quite less sophisticated as contrasted to the brokers.[183] Therefore, it brings a balance in the inherent conflict of interest a broker may have in respect to a particular client.[184] Nonetheless, he is cognizant of the fact that there are in place exceptions to this doctrine which serves as a cure to brokers by protecting them from unwarranted exposure to liability.[185]

Lowenfels[186] gives a rather broad definition of the suitability rule as imposed upon the brokers. He states that the rule demands that the broker only recommend to the investors such securities as is suitable, considering the investment objectives and peculiar needs of that particular customer.[187] In his view, he sees suitability rule as encompassing matching two elements. To this end, he opines that the broker should match the investment objectives, peculiar needs, and other investment of the particular customer with the characteristics of the security which is being recommended.[188] Precisely, Lowenfels takes Cohen's stance that the obligation to

[180]ibid.
[181]ibid.
[182]ibid.
[183]ibid. p.304.
[184]ibid.
[185]ibid.
[186]Lewis D Lowenfels and Alan R Bromberg, 'Suitability in Securities Transactions' (1999) 54 Business Lawyer 1557.
[187]ibid. p.1557. See Willa E Gibson, 'Investor, Look Before You Leap: The Suitability Doctrine is Not Suitable for OTC Derivatives Dealers' (1998) 29 Loyola University Chicago Law Journal 527, 529.
[188]ibid.

guarantee suitability is imposed on the broker only in the context of a recommendation.[189]Again he points to a critical requirement that the broker ought to endeavour to obtain information concerning inter alia the customer's financial status and investment objectives.[190]

1.9 Research Methodology

This section introduces the research methodology that is used for this study. The bulk of data used for this study is obtained through secondary data collection methods. This implies that the study heavily relies on peer-reviewed journals, reports, textbooks, dissertations, online libraries, newspapers and magazines, and other texts on the challenges that stockbrokers face when going about their operations. The journals, textbooks, dissertations, newspapers and online libraries accessed while undertaking this study are sufficiently cited. The study thus adopts a doctrinal approach in the analysis of laws and statutes that govern the operations of stockbrokers.

1.10 Chapter Breakdown

Chapter One: This chapter constitutes the introductory chapter which gives the background to the study. It states the statement of the problem and presents the research questions to be addressed by the study. It as well include the hypothesis to the study, by arguing that stockbrokers have challenges in implementing and complying with capital markets legal and regulatory frameworks. It then discusses the theoretical framework and identifies the research methodology and literature review of the study.

Chapter Two: This chapter identifies and analyzes the relevant laws and legal provisions on regulation of the operations of stockbrokers in Kenya. It also examines some of the challenges

[189]ibid.
[190]ibid.

experienced by the stockbrokers in the conduct of their businesses in compliance with the laws and regulations that need to be assessed in order to improve their performance enhance regulatory compliance and promote investor protection. The chapter also underscores the scope of the jurisdiction of the Capital Markets Authority over licensed stockbrokerage firms in Kenya.

Chapter Three: The focus of this chapter is on the challenges experienced by stockbrokers under the current regulatory framework, which revolves around corporate governance, financial risk and management as well as those that are meant to protect the markets against market abuses such as churning, insider trading and conflict of interest.

Chapter Four: This chapter outlines the best practices in the US with a goal of identifying regulatory responses to the challenges identified in chapter three of this study. This is aimed at attempting to find solutions to the challenges identified within the legal and regulatory framework in Kenya. The study settles on the United States of America for the best practices due to its long history of dealing with the challenges identified and the rich jurisprudence that has been developed in the process from her courts.

Chapter Five: Chapter five concludes the research and provides recommendations on any further areas that need to be looked at for better development of the legal and regulatory framework governing stockbrokers in the securities' industry in Kenya.

CHAPTER TWO: THE LEGAL FRAMEWORK GOVERNING THE OPERATIONS OF STOCK BROKERS IN KENYA

Chapter one of this thesis generally introduces the study by discussing the approach that the study would take and giving an outline of each of the four chapters of the thesis. Most importantly, the literature review attempted to highlight some of the challenges that other scholars have identified as those that face stock brokers with regards to the compliance to the legal and regulatory framework. With that in mind, chapter one gives a detailed outline of each of the subsequent chapters of the thesis.

In this second chapter of the thesis, the legal and regulatory framework governing the operations of stock brokers and stockbrokerage firms is outlined. The chapter also examines the regulatory mandate and powers of the regulator, the Capital Markets Authority, over stockbrokers in Kenya. It also describes the nature of the duties and obligations that stockbrokers owe to their clients as well as their obligations to the regulator in so far as the law is concerned. Lastly, the chapter shall endeavour to analyse the institutional infrastructure that effectively facilitates the administration of the operations of stockbrokers in Kenya.

2.1 Introduction

Over the years, the financial markets, especially the capital markets, have grown exponentially and are close to, if not already, being ubiquitous in the nature of their operations. This has made a serious case for the need for newer approaches and strategies aimed at making the markets more efficient and reliable. Additionally, these approaches and strategies must be capable of adequately protecting the interests of the investors who are key to the existence of the capital markets. Fundamentally, this brings into light the role of the financial intermediaries, stock brokers in this case, in the growth and development of the capital markets. *The Capital Markets Act.*[191]defines a stock broker as a person who is engaged in the business of buying and or selling

[191] Caital Markets Act (n 9).

of securities on behalf of an investor(s) and is paid a commission for work done by the investor. Therefore, it follows that the nature of the relationship between an investor and a stock broker is that of an agent and principal with the stock broker as the agent and the investor as the principal. The role of stockbrokers is crucial to the efficient operation and existence of the capital markets. This is because stockbrokers facilitate the transfer of securities by connecting investors who are willing to sell their securities to those who express the desire to buy them. Stockbrokers are a conduit through which the capital markets receive investors. These investors are the source of a constant revenue stream and this is critical for the survival of capital markets. However, it is important that the investors do not lose confidence in the integrity of the capital markets. In order to instil and maintain the confidence of the members of the public investing in the capital markets, the regulator of the activities on the capital markets, the Capital Markets Authority, has developed rules and regulations that ensure utmost transparency. This is achieved through ensuring that stockbrokers and other players are able to meet the disclosure requirements to promote information symmetry between investors and the stockbrokers. Information symmetry is therefore deemed to be an effective way of guaranteeing stronger investor protection. Additionally, the availability of information to investors at all times is important in the decision-making process on whether to sell or buy shares. Information symmetry is, therefore, a tool that not only guarantees investors protection but also assists in the making of rational and informed decisions. The issuing of credible and reliable information to investors by stockbrokers on the previous and future performance of the shares issued in the market is critical in the decision-making process. Having laid out the functions and roles of stock brokers in the capital markets, the succeeding section will undertake to lay out this legal and regulatory framework governing the operations of stock brokers in Kenya.

2.2 The Legal Framework Governing the Operations of Stockbrokers in Kenya

2.2.1 The Constitution of Kenya, 2010

The Constitution of Kenya, 2010 is the supreme law upon which all laws in Kenya derive their existence, eminence and authority from. All laws that govern the operations of stockbrokers in Kenya must, therefore, be in strict conformity with the Constitution lest they be challenged on the basis of their constitutionality.

Article 35 of the Constitution of Kenya guarantees every Kenyan citizen the right to access information either from the state or from any person or institution holding the said information for the sole purpose of either exercising a right or freedom or protecting a right or freedom guaranteed under the Constitution. The right to information plays a fundamental role in the capital markets as it is the chief commodity that is used in the generation of wealth in so far as trading or dealings in capital markets are concerned. However, with regards to capital markets, there is limited access to information in the possession of stockbrokerage firms. This is because of the intrinsic value of the information that is determined by its ability to reduce risks, generate profits, and the ability to improve decision-making for investors. It follows, therefore, that the competitive edge needed by one stockbrokerage firm over another depends on the quality of the information and ultimately, the benefits that it reaps for the investors.

The wealth generated through acting on the information availed to investors in the capital markets most certainly are protected by Article 40 of the Constitution of Kenya, 2010. The Constitution decrees that every individual has the right to own property in any part of Kenya as long as the property is earned through lawful means. The national principles and values of governance as espoused under Article 10 of the Constitution dictate that principles such as accountability and transparency become part and parcel of the governance structures of public entities.

2.2.2 The Capital Markets Act

The Capital Markets Act[192] (herein referred to as the CM Act) defines a stockbroker as a person or entity engaged in the business of purchasing or selling securities on behalf of an agent for a commission.[193] The Capital Markets Act defines the nature of this relationship between a stockbroker and an investor as a principal-agent relationship.[194] Therefore, at all times, the licensed stockbrokers undertake to act on behalf of and in the best interest of the investors who have entrusted the purchasing and sale of securities to them.

The CM Act establishes the Capital Markets Authority[195] with the overall purpose of the development of an orderly and fair capital markets and the promotion of the same. In that regard, the CM Act makes it clear that the Capital Markets Authority shall be responsible for the regulation of all the players, including stockbrokers, in the capital markets in Kenya.[196] Stockbrokers are, therefore, required to obtain a license from the Authority before commencing any stockbrokerage activity given that stockbrokerage is a licensed activity that falls under the ambit of the Capital Markets Authority as the regulator of capital markets in Kenya.[197] Having issued such licenses the Authority also has the powers to enquire into the affairs of stockbrokers,[198] inspect the nature of their activities,[199] and give directions based on its findings.[200]

The CM Act prohibits any person, in this case artificial persons, from undertaking to carry on the business of a stockbroker in Kenya without a valid license from the Capital Markets Authority.[201] This valid license is, therefore, the approval needed from the Authority in order

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[192]ibid.
[193] ibid., Section 2.
[194] ibid.
[195] The Preamble of the Capital Markets Act and Section 5 of Cap 485 of the Laws of Kenya.
[196] Capital Markets Act (n 9) Section 11(c).
[197]ibid, Section 11(3) (e).
[198]ibid, Section 11(3) (h).
[199]ibid, Section 11(3)(j).
[200]ibid, Section 11(3) (i).
[201] ibid, Section 23(1).

to undertake and offer the services of a stockbroker to investors in the capital markets in Kenya. Additionally, such persons are expected to comply with all the conditions and requirements set out by the Authority for persons who wish to carry out the business of stockbrokerage in Kenya and should not undertake any other activity for which the license was not issued. One of those conditions is the payment of an annual fee to the Authority as it may prescribe for such licensed participants.[202] The CM Act goes ahead to impose additional requirements before a license can be issued to any participant in the capital markets in Kenya.[203] These include the requirement that only artificial persons or incorporated companies and not natural persons can engage in the business of selling or buying of securities on behalf of investors. Additionally, the Authority is given powers to determine the minimum share capital for such incorporated companies.[204] Furthermore, such companies are to be incorporated according to the procedures and requirements set out in the Companies Act which is the principle legislation for the registration of business organizations in Kenya.[205] Secondly, the CM Act requires that at least one director and chief executive of the company applying for the stockbrokerage business must meet the minimum qualifications as shall be determined by the Authority.[206] Section 24A of the CM Act dictates that these qualifications are but to ensure that the persons licensed are fully and competently capable of undertaking the business of stockbrokerage. Such persons or entities and their employees are, therefore, required to be solvent, reliable, competent, and possessed of the integrity required to run a stockbrokerage business in Kenya. Additionally, the Authority frowns upon persons who have been accused of financial impropriety or who have been directors of companies under statutory management.[207] The CM Act also requires that the company applying to ply the stockbrokerage business in Kenya must have an effective

[202] ibid, Section 23(3).
[203] ibid, Section 29.
[204] ibid, Section 29(1)(a).
[205] Act No. 47 of 2015 of the Laws of Kenya.
[206] Capital Markets Act (n 9) Section 29(1)(c).
[207] ibid, Section 24A (2).

administrative structure with the requisite capacity to undertake the stockbrokerage business.[208] This implies that the company must have adequate internal control mechanisms and procedures as well as risk management systems so as to shield the public from any unwanted eventualities. The CM Act also dictates that the sole purpose of a stockbrokerage firm must be to carry out the business on behalf and for the benefit of the investors.[209] Finally, before a license can be granted to a firm that wishes to engage in stockbrokerage, the CM Act requires the Authority to dictate a sum that shall be lodged as security with the securities exchange in which it shall be a participant.[210]

From the very onset, the CM Act is quite straightforward on its intention to protect investors from fraudulent stockbrokers and hence the requirement for mandatory licensing of stockbrokerage firms before they can participate in the Kenyan Capital Markets. This is brought out clearly by the creation of the Investor Compensation Fund for the purposes of compensating investors who suffer pecuniary losses as a result of stockbrokers failing to honour their contractual obligations.[211]

Additionally, the CM Act has put in place sanctions and penalties to be meted out on those who disregard the laws, regulations, rules, guidelines etcetera that have been put in place. Particularly, these are brought out in the form of a public reprimand, suspension of the trading license, a restriction on the trading license, suspension from the participation in the securities of certain listed companies, revocation of the license, recovery of twice the amount gained through the disregard for the law among others.[212] The sanctions and penalties also apply to the employees if they are found to have flouted the laws, rules, guidelines and regulations

[208] ibid, Section 29(1)(e).
[209]ibid, Section 29(1)(f).
[210] ibid, Section29(1)(d).
[211] ibid, Section 18.
[212] ibid, Section 25A (1)(a).

regulating the efficient and orderly operations of the capital markets in Kenya.[213] The penalties and sanctions for individual employees are laid out in the form of the employee having to face disciplinary action from the employer (stockbrokerage firm), the recovery of the twice the amounts gained from the said breach, termination of the employment contract of the employee found to have caused the breach as well as the imposition of a financial penalty that shall not exceed five million shillings.[214] Directors of stockbrokerage firms are also not shielded from liability for flouting the rules, regulations, and guidelines of the CM Act.[215] For breaching the regulations and provisions of the Act, the directors of licensed stockbrokerage firms are to be disqualified from any appointment to any company engaged in trading securities.[216] The CM Act also requires that from such directors be recovered twice the amount gained from such breaches of the law and lastly, the Authority may levy upon them such amounts as it may deem fit.[217]

However, under Section 33 of the CM Act, the Authority is given powers to intervene by appointing a statutory manager in instances where the license of a stockbrokerage firm has been suspended or in case of the occurrence of any of the eventualities contemplated under the section. The rationale for such intervention definitely arises out of the need to protect the interest of the innocent investors and the need to assure the investors of the integrity and robustness of the legal framework in protecting their interests.

2.2.3 The Companies Act, 2015

Stockbrokers are required to be registered companies with articles of association incorporated under the Companies Act.[218] The Companies Act provides for the formation and registration

[213] ibid, Section 25A (1)(b).
[214] ibid.
[215]ibid, Section 25A(1)(c) .
[216] ibid, Section 25A(1)(c)(ii).
[217] ibid, Section 25A(1)(C)(iii).
[218] Regulation 15(1) of the Capital Markets (Licensing Requirements) (General) Regulations, 2002.

of companies under Part II of the Act. Stockbrokerage firms are companies limited by shareholding in accordance with section 6 of the Companies Act. They are also required to have articles of association and audited financial statements when making application for approval by the Authority.[219]

2.2.4 The Central Depositories Act, 2000

This Act is relevant to the operation of stockbrokerage because they are authorized to act as Central Depository Agents (CDAs) for the Central Depository and Settlement Corporation. A central depository agent means a person appointed as an agent of a central depository to carry out one or more of the services provided by that central depository.[220] In their role as CDAs, stockbrokerage firms are required to comply with, enforce or give effect to the CDS rules to the extent to which those rules apply to them[221]. For the purposes of this section, "CDS rules" includes any direction given, from time to time, by a central depository to any person pursuant to any provision of this Act[222].

2.3 The Regulatory Framework Governing the Operations of Stockbrokers in Kenya

Section 12 of the CM Act bestows upon the Capital Markets Authority the mandate to develop rules, regulations, and guidelines for the efficient, fair, and orderly operation of the Capital Markets in Kenya. Therefore, the following section is going to be dedicated at the assessment of the regulatory framework governing the operations of stockbrokers in Kenya.

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[219] ibid.
[220] Central Depositories Act (n 10) Section 2.
[221]ibid, Section 11.
[222] ibid.

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

These regulations set about the procedures for licensing of stockbrokers, the fees they ought to pay, conduct that stockbrokers are proscribed from engaging in, the payment for stockbrokerage services as well as their disclosure requirements among others.

The Regulations dictate that an application for the license to be a stockbroker in Kenya must be submitted in the form prescribed in the First Schedule of the regulations.[223] The said application must be accompanied by the Certificate of Incorporation, the Memorandum of Association, the Articles of Association, a statement of the un-audited accounts for the period of the accounting year ending not earlier than six months prior to the date of application and audited accounts for the preceding two years, and a detailed business plan which among others includes the evidence of paid up share capital of at least fifty million shillings.[224] Additionally, the Regulations dictate that every person who shall be appointed to the management of the stockbrokerage company must be fit and properly qualified to hold the position for which they are appointed.[225] Every applicant is also expected to lodge a security of at least 1.5 million shillings with the securities exchange in which they wish to be registered with or a central depository. However, depending on the settlement record and the financial probity of the stockbroker the Capital Markets Authority may determine what amounts to a sufficient security to be lodged by the company.[226] Alternatively, they may provide a guarantee from a bank which they are a member of and this must be acceptable to the Capital Markets Authority.[227] Every license granted to any stockbrokerage firm must be accompanied by a letter of compliance with the licensing requirements from the Capital Markets Authority to the securities exchange that the broker wishes to be enlisted on upon the payment of the requisite admission fees.[228] During

[223] Regulations 14.
[224] Regulation 15.
[225] Regulation 15(2).
[226] Regulation 15(3)(a).
[227] Regulation 15(3)(b).
[228] Regulation 15(10).

the period of the existence of the stockbrokerage license, the firm is expected to maintain a minimum paid-up share capital of at least fifty million shillings.[229] The working capital of the stockbrokerage firm must always be above twenty percent of the prescribed minimum shareholders funds or must never be higher than three times the average operating costs of the firm on a monthly basis.[230] The stockbrokerage firm must also ensure that the ratio of its bank overdraft to the paid-up capital is not in excess of twenty percent at any one given time.[231]

Stockbrokerage firms are also expected to maintain all accounting documents including ledgers and the records of purchase and sale of securities for every single day for a period of seven years.[232] The stockbrokerage firms must also be ready to produce these accounting documents at any moment's notice as may be required by the Authority. This is because the Authority is empowered to inspect these books of accounts and the entire records without the issuance of any notice by the Authority or the securities exchange on which they are enlisted.[233] The stockbrokerage firm must also create, maintain and preserve records of each individual client from the day they set foot at their doorsteps and these records must include among other things any recommendations made to the client for the purchase or sale of any securities as well as any complaints made by the client.[234] It must be noted that the stockbrokerage is inclined to reject the business of any client who does not wish to have the above stated records of them being kept especially where such information relates to them directly and particularly on a set of instructions that they decide to give to the stock broker.[235]

Regulation 20 requires each stockbrokerage firm to create and maintain clearly designated client account with one or more banks. Each deposit and withdrawal from each of these bank

[229] Regulation 16(1).
[230] Regulation 16(3).
[231] Regulation 16(5).
[232] Regulation 19(1).
[233] Regulation 19(2).
[234] Regulation 19(3).
[235] Regulation 19(4).

accounts must be clearly recorded in the books of accounts. Additionally, each client's beneficial interests in the created accounts must be correctly indicated and proper records for the same maintained. Lastly, any execution in the name of any client must be in accordance with the express instructions from the client over the same.[236]

The Regulations place upon each stockbrokerage firm certain reporting or disclosure requirements. Each stockbroker is expected to furnish the Authority and the securities exchange for which they have been enlisted reports of their operations and their accounts on a quarterly, half yearly and audited annual accounts together with financial statements that comply with the dictates of the Fourth Schedule.[237] Every stockbroker is also expected to prepare monthly reports of their operations and activities and these must be furnished to the Authority at its request of them.[238]

The Regulations also prescribe and proscribe the nature of operations and activities that stockbrokerage firms can engage in. Stockbrokers are expected to operate independently of each other to prevent any form of collusion among them as this can be dangerous to the stability of the markets.[239] Based on the nature and the magnitude of their operations and activities, stockbrokerage firms are expected to conduct their affairs in an efficient, fair and honest manner devoid of anything that reeks of the absence of integrity and professionalism.[240] They must also avoid any form of association that may hamper their ability to deliver quality services to the clients or that may hamper the competitiveness of the markets or that may qualify as unfair trade practices.[241] The regulations dictate that the nature of the organizational and management structure of the firms, the level of compliance with the reporting and general

[236] Regulation 20.
[237] Regulation 21(1).
[238] Regulation 21(2).
[239] Regulation 22(a).
[240] Regulation 22(b).
[241] Regulation 22(c).

disclosure requirements, internal risk management mechanisms as well as the internal auditing procedures adopted are key in determination of whether an entity engages in the prescribed or proscribed activities and operations.[242]

There is also the requirement that whenever any stockbrokerage firm wishes to enlist the services of a stockbrokerage agent, it must be expressly provided for in writing and the register of agents forwarded to the Authority. In case of any changes to that register of brokerage agents, the Authority must be duly notified of the same within a period of five working days.[243] Stockbrokerage firms must also undertake to conduct due diligence and ensure that the persons they employ as their agents are possessed of the requisite skills, competence and professionalism required of in the stockbrokerage business. This must always be based on their ability to represent the best interests of the investors.[244] The licensed stockbrokerage firms must also undertake to ensure that they do not employ agents who are in the employment of any other stockbrokerage firm.[245] The stockbrokerage firm must also ensure that where their agents are involved in any form of misconduct, the same is reported to the Authority within forty-eight hours of the misconduct occurring.[246]

The Regulations further dictate that stockbrokers shall not execute any orders until the principal and agent have made sufficient arrangement on the transfer of the funds for that particular execution.[247] The principal must also unequivocally express the name of the securities, the quantity involved, the price range as well as the duration for which the execution orders shall last in writing.[248] The stockbrokers must also execute the orders of the clients in a chronological manner and must give priority to the orders of the clients before considering the orders made

[242] Regulation 21(d).
[243] Regulation 22A.
[244] Regulation 22A (3).
[245] Regulation 22A (5).
[246] Regulation 22A (8).
[247] Regulation 23(a).
[248] ibid.

by employees or shareholders of the stockbrokerage company.[249] It is also imperative that the stockbrokers maintain a daily record of all the transactions received and keep a record of the execution orders.[250] In addition to this, it is also imperative that the stockbrokers duly informs the clients of all the steps involved in the process of executing an order as well as taking due care and diligence not to misrepresent any facts to the clients or misdirect or misinform the client.[251] Finally, the stockbrokerage firm must undertake not to recommend any purchase or sale or exchange of securities that may not be in the best interests of the client.[252]

Further to the above mentioned proscriptions, the Regulations expressly outlaw the creation of artificial markets, negotiating on any issue pertaining to a trade with persons on the trading floor, being party to any manipulative schemes that are aimed at defrauding investors, making any form of recommendations to the public through any medium, selling securities which are not registered in the name of their client or any central depository, and the creation of corners or trades where there are existing corners.[253] The Regulations also dictate that the securities shall only be sold by the stockbrokerage firm once it has established that the principal is in a position and has the unconditional right to vest the securities in the purchaser.[254]

The Regulations also dictate that the establishment of a code of conduct for stockbrokerage shall not be complete without the approval of the Authority.[255] Additionally, the code of conduct shall in no way purport to restrict competition among the stockbrokers or restrict free negotiations amongst the shareholders in cases where an association of stockbrokers is formed.[256] Licensed stockbrokerage firms are also expected to pay certain fees including

[249] Regulation 23(c).
[250] Regulation 23(d).
[251] Regulation 23(e).
[252] Regulation 23(h).
[253] Regulation 24(1).
[254] Regulation 25.
[255] Regulation 26(1).
[256] Regulation 26(2).

membership to any licensed securities exchange as well as market development fees to the Capital Markets Authority.[257] This includes contributions by stockbrokers to the Investors Compensation Fund amounts which shall be dictated by the Authority.[258]

Finally, the Regulations dictate that a failure by the licensed stockbrokerage firms to meet their contractual obligations to the investor must be reported to the Authority.[259] The Authority may then elect to compensate the investor out of the Investor Compensation Fund either in monetary terms or the awarding of securities equivalent to the loss suffered by the investor.[260] It is important to note that the compensation of investors who suffer by reason of the failure of stockbrokers to honour their contractual obligations shall be limited to a maximum of fifty thousand shillings.[261]

2.3.2 The Capital Markets (Conduct of Business) Market Intermediaries Regulations, 2011

The Capital Markets (Conduct of Business) Market Intermediaries Regulations, 2011 defines a market intermediary as a business entity licensed to participate in the capital markets under Part IV of the Capital Markets Act, Cap 485A of the Laws of Kenya and this includes stockbrokers.[262]

The Regulations require stockbrokers to conduct the stockbrokerage business with due care, skill and diligence required of stockbrokers in so far as the international best practice is concerned.[263] In every transaction executed by stockbrokers, they are expected to exude a high

[257] Regulation 27.
[258] Regulation 64(1).
[259] Regulation 69.
[260] ibid.
[261] Regulation 70(1).
[262] Regulation 2.
[263] Regulation 3.

standard of integrity and fairness in their dealings without forgetting to always carry themselves with regard for the high standards of market conduct.[264]

The Regulations also require that stockbrokers must undertake to seek and find as much information on their clients in order to provide advise and recommendations that are in their best interests.[265] This includes taking all reasonable steps to ensure that any recommendation made to the client or on behalf of the client is the most suitable to the client in light of all the existing alternatives.[266] Additionally, there must be independence in the nature of the advice given to a client or any recommendation made to a client or any other transaction made on behalf of the client and the investor must be sufficiently made aware of any limitations in the abilities of the stockbroker.[267]

At all times, the Regulations require that information passed onto the investors must be unequivocally clear and fair to the client.[268] As such stockbrokers must take all adequately reasonable steps to ensure that their clients are appraised of the risks involved in every transaction before executing.[269] At no point, can they be found to have misled the client on the potential consequences of a transaction that is yet to be carried out.[270] Any guarantee of a return on the client's investment must therefore be given only when such a guarantee is actually secured under a contractual agreement.[271] Persons licensed to carry out the stockbrokerage business must, therefore, undertake to duly carry out their duty to ensure that the decisions of their clients are well informed.[272] This implies that the client must be aware of the nature, terms and conditions of the investment decision, the risks of undertaking it and consequences of

[264] ibid.
[265] Regulation 4(1).
[266] Regulation 4(2).
[267] Regulation 5.
[268] Regulation 6.
[269] Regulation 7(1)(a).
[270] Regulation 7(1)(b).
[271] Regulation 7(1)(c).
[272] Regulation 7(2).

deviating from the contractual terms and finally, the full charges and fees that particular transaction will attract.[273] It is imperative that at all times, having given the client all the necessary information and explanation in writing, the stockbroker should keep a written copy of the same.[274] Where such information is given orally, a written copy of the same must be sent to the client.[275] Where the stockbroker is of the opinion that based on past dealings, the client is knowledgeable enough and no information is needed, the same shall be duly recorded.[276]

The payment of fees and charges by the client to the stockbroker must and can only be done based on an express agreement between the client and the stockbroker or in accordance with the guidelines by the Authority.[277] The stockbroker must always ensure that the client at all times is aware of the charges and fees that the services will attract and at no point in time should the stockbroker ever charge their fees from the clients' funds or liquidate the securities of the client to recover their fees and charges unless it is an express term of the contractual agreement or the mode of payment prescribed by the Authority.[278]

The Regulations further create the rights of the investors under any contractual agreement with the stockbrokers. Fundamentally, Regulation 9 dictates that the stockbrokerage firm shall in no way abrogate from any duty or liability established under the law or by the regulations to the client.[279] Such duty shall include the duty to act with the skill, care and due diligence expected of a stockbroker[280] and that the failure to exercise such care, skill and diligence in the course of the contractual relationship cannot be protected by any provision in the contractual agreement or law or regulation.[281] In fact, Regulation 9(2) unequivocally dictates that any

[273] Regulation 7(3).
[274] Regulation 7(4).
[275] ibid.
[276] ibid.
[277] Regulation 8.
[278] ibid.
[279] Regulation 9(1)(a).
[280] Regulation 9(1)(b).
[281] Regulation 9(1)(c).

purported exclusion of liability of the stockbroker or restriction of the rights of the client is null, void and invalid.

The Regulations charge the stockbrokerage firms to identify any possible instances where a conflict of interest may arise in the course of carrying out their duties and obligations to the client.[282] Having identified the potential areas of conflict, the firms must undertake to develop and adopt policies to minimize the potential conflict of interests arising and refuse to take the business of a client where there exists a potential conflict of interest.[283] The Regulations prohibit a stockbroker from using information it obtained from one client for their own or another client's benefit and that in the event of such an eventuality, an information barrier must be erected to prevent the exploitation of such information for the benefit of another client or the stockbroker.[284] Regulation 12 further charges stockbrokers to train their employees on how to avoid conflict of interest. It also charges them to obtain undertakings from the employees that they shall not exploit information relayed to them by clients for their own benefits.[285] The Regulations further prohibit the stockbrokers from giving advise or making recommendations about certain transactions to clients where the stockbrokerage firm has an interest and the said recommendation or advise is likely to affect the client adversely unless the client insists on executing the transaction even after the information and nature of interest is relayed to them.[286] Finally, in so far as the duty to avoid a conflict of interest in dealings with clients is concerned, a stockbroker is expected to take all reasonable steps to prevent the firm or its employees or agents from receiving or accepting inducements that are likely to conflict with or jeopardize the duty to avoid conflicts of interest with regards to the duties the firm owes to their clients.[287]

[282] Regulation 12(1)(a).
[283] Regulation 12(1)(b) and (c).
[284] Regulation 12(2).
[285] Regulation 12(2)(b) and (c).
[286] ibid.
[287] Regulation 12(4).

The Regulations also require that a detailed contractual agreement be drawn and that it must be expressed in writing and the nature of the services to be provided by the stockbroker to the investor or client clearly outlined in the contractual agreement.[288] Additionally, the contractual agreement must clearly indicate the obligations of the stockbroker to the client as well as the rights of the client and the consideration being given for the honouring of those obligations.[289] The rights of the investor includes the right to receive title for the securities that he or she has purchased, the right to receive a detailed statement of all the fees and any other charges that he or she paid, and the right to be informed of all the fees and charges received by the stockbroker from third parties on account of the services provided to the client. The client also has the right to seek for any information on the past, present and future of the stockbroker, the right to earn interest on the funds deposited with the stockbroker, the right to receive payment for the securities sold by the stockbroker within specified periods of time, the right to have access to the stockbroker's conflict of interest policy, and the right to complain and have that complaint dealt with promptly and satisfactorily. Additionally, the client maintains the right to know of any potential conflict of interest that the stockbroker may have in so far as dealings with the client are concerned and the right to be made aware of the arrangements that have been put in place by the stockbroker with regards to securing the titles and the custody of the securities purchased.[290]

The Regulations further dictate that stockbrokerage firms shall ensure that their employees keep all information relating to any of their clients whether the said information was obtained from the client or from a third party.[291] Towards the realization of this objective, stockbrokerage firms are expected to come up with policies that dictate how the confidentiality

[288] Regulation 13.
[289] ibid.
[290] ibid.
[291] Regulation 15(1).

of the information obtained from clients will be protected and the duties that their staffs owes to clients in this respect especially those who have access.[292] However, stockbrokers may disclose this information at the request of the Capital Markets Authority or a licensed securities exchange to which they are members or upon the issuance of an order by a court of competent jurisdiction.[293]

The Regulations prohibit stockbrokerage firms from knowingly effecting own account transactions in securities where a client has given an order to be executed by the firm or where the stockbrokerage firm has made the representation that it will make a recommendation to a client based on certain securities until the client has had a reasonable opportunity to respond to the recommendation.[294] The Regulations expressly prohibit stockbrokerage firms from making recommendations to clients in circumstances where the recommendation does not suit a client based on the size, operations and objectives of the client.[295] This phenomenon is simply known as churning. Additionally, the Regulations outlaw insider trading and place a burden on stockbrokerage firms to ensure that none of their employees are insiders and to always keep an eye out for any suspicious activity that could result in insider trading.[296] The Regulations also charge stockbrokerage firms with the responsibility to ensure that at no point in time are they facilitating money laundering or dealing with proceeds of money laundering or any illicit activities.[297] They must, therefore, ascertain the source of the funds by liaising with relevant authorities to ensure that they aid in the fight against money laundering.[298]

The Regulations require stockbrokers to strictly comply with the provisions of the Capital Markets Act and all the regulations made to facilitate the operation of the Act as well as any

[292] Regulation 15(2).
[293] Regulation 15(4).
[294] Regulation 23.
[295] Regulation 24.
[296] Regulation 25.
[297] Regulation 26.
[298] ibid.

other regulatory requirements that the Authority may prescribe to facilitate the efficient administration of the capital markets.[299] In addition, the Regulations require stockbrokerage firms to cooperate fully with the Authority and that includes offering any form of reasonable assistance that would aid in the efficient administration of the capital markets by the Authority.[300] This cooperation is expected in terms of duly notifying the Authority or reporting any activity that may lead to an impropriety or mismanagement in the management of the firms, any breach of the laws or regulations in place, inability to meet their obligations to their clients including any shortfall in the clients' funds, any fraudulent activity, any disciplinary action against key employees, any activity that may lead to the firm being insolvent among others within a period of twenty-four hours.[301] Furthermore, stockbrokerage firms are expected to keep proper and daily records of all the transactions undertaken.[302]These records are then used as a tool for gauging whether the stockbrokerage firm is solvent enough to undertake the stockbrokerage business as well as meet its duties and obligations to clients as well as to the Authority.[303] The accounting records, in particular, are expected to be kept with a reasonable degree of accuracy in accordance with the International Financial Reporting Standards.[304] These records of all the transactions as well as the accounting records must be kept for a period of seven years from the date in which they were recorded.[305]

It is expected of the stockbrokerage firms that they shall strictly abide by the provisions of the Capital Markets Act as well as any other regulations and subsidiary legislation made in pursuant to the effective administration of the capital markets in Kenya. Therefore, liability shall be borne jointly and severally for any contravention with the primary aim of indemnifying

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[299] Regulation 27(1).
[300] Regulation 27(2).
[301] Regulation 27(3).
[302] Regulation 32.
[303] ibid.
[304] Regulation 35.
[305] Regulation 36.

the firms from the malpractices of its employees.[306] However, that is not to say that the stockbrokerage firm shall not suffer any sanctions or penalties that may be prescribed by the Authority where the firm negligently or recklessly contravened the laws and regulations or even failed to meet its obligations and duties as a stockbroker.[307]

2.3.3 The Capital Markets (Corporate Governance) (Market Intermediaries) Regulations, 2011

These regulations are made with the primary purpose of promoting accountability and transparency in the management of capital market intermediaries in Kenya with the hope of protecting the best interests of the individual investors. In ensuring proper and strategic management of stockbrokerage firms, these regulations make certain prescriptions on how the firms must be managed as well as regulations to ensure transparency and accountability in the management of these entities.

The Regulations require each stockbrokerage firm to have a board composed of at least two directors and a non-executive independent director.[308] However, the Regulations dictate that at no given time should more than a third of the directors be persons who are closely related by blood to any director.[309] Additionally, no director shall be a director in more than two stockbrokerage firms unless the firms are subsidiaries.[310] A stockbrokerage firm is also expected to seek the express and written consent of the Authority should it desire to change its board of directors.[311] In the event that a director of a stockbrokerage firm is assessed and found to be unfit to hold the office of director, the firm must terminate the services of such a director, take remedial measures to mitigate the potential losses to the firm resulting from the

[306] Regulation 47.
[307] ibid.
[308] Regulation 3(1).
[309] Regulation 3(1) (c).
[310] Regulation 3(2).
[311] Regulation 13(3).

incompetence of such a director or employee, and promptly inform the Authority of the same.[312]

The chief executive officer of a stockbrokerage firm is responsible for the day to day running of the company and ensuring that the firm complies with all the laws and regulations that govern its activities.[313] This is a duty that is shared with the entire management of the stockbrokerage firm.[314] In endeavoring to ensure compliance with all the laws and regulations governing the firm's operations, the board is expected to appoint a compliance officer who shall take all reasonable steps to rectify any non-compliance, report any non-compliance to the board especially those that cannot be rectified, report any material breaches of any regulatory requirement and submit an annual report on the regulatory compliance of the firm to the board.[315] The compliance officer bears any and all responsibility for the failure of the stockbrokerage firm to comply with the regulatory requirements.[316] However, it must also be noted that the directors of a stockbrokerage firm bear the responsibility to indemnify the firm from any potential losses that may be due to failure to comply with the legal and regulatory requirements.[317] Additionally, employees with the responsibility to supervise other employees bear liability for any actions that may be a contravention of the internal control mechanisms.[318]

The Regulations require that persons who are to be appointed as directors of stockbrokerage firms must have undergone proper training on corporate governance and must satisfactorily be fit and proper to be directors of stockbrokerage firms.[319] The board of directors of any stockbrokerage firm must provide leadership and be collectively responsible for the conduct of

[312] Regulation 37(1).
[313] Regulation 17(g).
[314] Regulation 20(e).
[315] Regulation 30.
[316] Regulation 30(2).
[317] Regulation 37(2).
[318] Regulation 37(3).
[319] Regulation 4.

business and the governance of the firm.[320] This includes the duty to properly assess and manage the risks associated with the business, ensure that the employees of the firms are competent enough to represent the best interest of their clientele, and that their performance is constantly reviewed.[321] Where the board chooses to delegate any function, duty or responsibility to any committee created under Regulation 13, it shall bear liability for any eventuality that arises as a result of that delegation.[322]

The board of directors is also expected to not only give strategic direction to the firm but also ensure the integrity of the firm by ensuring strict adherence to the disclosure requirements as well as ensuring the compliance with all laws and regulations regulating the operations of the firm.[323] The Regulations also require the board of directors to either come up with a code of conduct for the directors of the firm or adopt the code of conduct contained in the schedule of the Regulations.[324]

The firm is also expected to create committees such as the audit committee to review audit reports and the financial statements of the firm, the effectiveness of the risk assessment and management policies, monitor compliance with the code of conduct and ethics, review the operations of the firm and make appropriate recommendations to the board among others.[325] The decisions of these committees are not in any way binding on the firm unless the board has reviewed them and ratified them.[326]

In addition, the Regulations require the firms to develop corporate governance systems and mechanisms to hold the board of directors accountable and ensure that information about the

[320] Regulation 6.
[321] ibid.
[322] Regulation 10(3).
[323] Regulation 7.
[324] Regulation 8.
[325] Regulation 13.
[326] Regulation 13(4).

firm is always readily available.[327] Additionally, the corporate governance systems and mechanisms must be constantly assessed on an annual basis and the results of the reviews documented.[328] The shareholders are also taxed with taking an active participation in the affairs of the firm and this must be evident from their contributions such as the appointment of directors and holding directors accountable during the general meetings of the firm.[329]

2.3.4 Guidelines on Financial Resource Requirements for Market Intermediaries

They were developed under section 12(1) of the Capital Markets Act in order to enhance the implementation of risk based supervision of market intermediaries by the Capital Markets Authority. Liquid capital in relation to a licensed entity means the amount which the liquid assets of a licensed entity exceed its ranking liabilities[330]. As a licensed entity, a stockbroker is required to maintain at all times financial resources required under these guidelines.[331]Schedule 1 of these Guidelines stipulates that a stockbroker shall have a minimum of Kenya shillings fifty million paid up share capital and a minimum of Kenya shillings thirty million as required liquid capital. The required liquid capital deficit in relation to a licensed entity means the amount which the required liquid capital is less than the required liquid capital[332]

2.3.5 Central Depositories (Operational) Rules

They are developed in accordance with the Central Depositories Act, 2000. A stockbroker duly licensed by the Authority and a Member of the securities exchange qualifies for appointment as a Central Depository Agent (CDA)[333]. The role of a stockbroker as a CDA include the collection and submission to the Central Depository for deposit certificates for purposes of immobilization of securities, submission of requests for withdrawal of certificates in respect of

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[327] Regulation 14.
[328] ibid.
[329] Regulation 15.
[330] Paragraph 2 Guidelines on Financial Resource Requirements for Market Intermediaries.
[331]ibid, Paragraph 4.
[332]ibid, Paragraph 2.
[333] Rule 6(2) of the Central Depositories (Operational Rules).

immobilized securities, the opening, maintenance and closing of securities accounts; the allocation of trades to securities accounts and the collection of such fees and charges imposed by the Central Depository as may be provided by these Rules.[334]

2.4 The Institutional Framework Governing Stockbrokers in Kenya

The development and growth of the securities markets is dependent on a host of substantive and procedural laws as well as the existence of a properly robust institutional framework to enforce these laws. The development and existence of efficient, fair, robust and orderly securities market has been attributed to the equal existence of a strong institutional infrastructure to see to the implementation and enforcement of the laws, guidelines, rules and regulations in place. The efficient operation and the sustainability of the securities markets is pegged on the abilities of these functionally intertwined institutions to work in harmony with each other. However, this harmonious coexistence is highly dependent on the proper delineation of the powers, duties and objectives of the individual institutions. Additionally, these institutions must have both functional and institutional independence as well as systems of accountability complemented by a comprehensive set of rules to ensure the implementation of principles of corporate governance, expeditious resolution of disputes and the general reverence for the rule of the law as demanded by the law. Consequently, these institutions must be able to mirror the structural organization of the securities market if they are to adequately aid in the development of the market. This is because the institutional framework is nothing but a creation of the laws establishing the capital markets and it only becomes right if these institutions aid in the realization of the intent of the law.

[334]ibid, Rule 9.

2.4.1 The Capital Markets Authority

In so far as the institutional framework for the regulation of the activities and the operations of stockbrokers in Kenya is concerned, the Capital Markets Authority is the regulator tasked with the administration of the capital markets. The Capital Market Act establishes the Capital Markets Authority and designates upon it the duty to promote and facilitate the development and growth of the capital markets in Kenya. The proper execution of this mandate is seen as being chief in the realization of orderly, efficient, fair, transparent, secure and robust capital markets industry. Additionally, the proper execution of the aforementioned mandate is seen as being key in the maintenance and retention of the confidence of investors in the capital markets as well as protecting the markets from failing.

The Authority is constituted by eleven members. These include; a Chairperson appointed by the President of Kenya upon the recommendation of the Cabinet Secretary for Finance, the Attorney General of Kenya, the Governor of Central Bank of Kenya, a Chief Executive Officer of the Authority, the Permanent Secretary for Finance, and six other members to be appointed by the Cabinet Secretary for Finance.[335] It must be noted that the CM Act requires that persons to be appointed to the Authority must be persons experienced or well-versed in matters of the law, finance, accounts, banking, insurance or matters relating to economics.[336]

Primarily, the Authority is taxed with the promotion and the development of the capital markets in Kenya, the mobilization of incentives to induce investors into making long-term investments, the fundamental duty to protect the interests of persons who have invested in the capital markets, the creation and sustenance of the Investor Compensation Fund, the development of a regulatory framework for the stockbrokerage services, the formulation of

[335]Capital Markets Act (n 9) Section 5(3).
[336]ibid, Section 5(4).

rules and guidelines to facilitate the growth and development of the capital markets in Kenya.[337] These said rules and guidelines are imperative for the regulation of the capital markets, the licensing and approval of the market participants as well as their supervision.[338] It is also important to note that the Capital Markets Authority acts as the advisor of the Government of Kenya on all matters relating to the capital markets.[339]

The Capital Markets Authority can be said to have a dual mandate that include the creation, promotion and development of the capital markets in Kenya as well as the regulation of all the affairs of the capital markets. However, it is the regulation of the capital markets that the Capital Markets Authority has been famed for over the years especially with regarding to regulating the conduct of market participants. Particularly, this is seen in the CM Act bestowing upon the Authority unchecked powers to engage in any act that may be incidental and/or conducive to the attainment of the objectives set in Section 11 of the CM Act.[340] This coupled with the power to enquire into the affairs of any of the market participants,[341] the intervention into the management of the licensees through the powers to institute statutory management,[342] and the powers to impose sanctions, fines, and other penalties[343] serves only to buttress the point on the Authority being more of a regulator that the developer of the capital markets in Kenya.

2.4.2 The National Treasury

The National Treasury, alongside the Central Bank of Kenya, is chiefly tasked with the duty to supervise financial services in Kenya. This is evidenced in the powers to formulate and put into action economic policies for the country as well as the approval and maintenance of the fiscal

[337] ibid, Section 11.
[338]ibid, Section 11(3).
[339] ibid.
[340]ibid, Section 11(3)(w).
[341] ibid, Section 11(3)(h).
[342]ibid, Section 33A (2).
[343] ibid, Section 25A.

and monetary policies in Kenya.[344] Capital markets are quickly rising to be one of the sources of revenue generation in developing countries like Kenya; it becomes imperative that the formulation of fiscal and monetary policies take into account the need for the promotion and development of the capital markets. As such the decisions of the ministry highly impact upon the capital markets and sound policies from the ministry are likely to promote and facilitate the growth and development of strong capital markets in Kenya. However, it appears that the National Treasury in Kenya is more concerned about the banking sector than the capital markets. Despite the constant effect of general elections in Kenya being the plummeting of the performance of the capital markets, little has been done by the government to cushion the markets from such shocks. Much of the government's interests in envisaged in the policy responses with regards to the banking sector rather than the entire capital markets in Kenya.[345]

The National Treasury is also empowered to oversee the smooth and efficient operation of the capital markets in Kenya. The CM Act dictates that whenever the ministry shall deem it fit and at any other time, it shall demand to be furnished with books of accounts of the Capital Markets Authority and any other information and the Authority must comply with such direction.[346] Additionally, six months after the close of each financial year, the Authority is expected to furnish the National Treasury with reports of its activities during that particular year.[347] The report which shall be tabled before Parliament within three months from the day it is received from the Authority.[348]

[344]'The National Treasury' <http://www.treasury.go.ke/> accessed 14 February 2019.
[345]Robert Nyamweya Menge, 'Effect of Elections on Stock Market Returns at the Nairobi Securities Exchange' (University of Nairobi, LLM BA, 2013) 74.
[346] Capital Markets Act (n 9) Section 36(1).
[347] ibid, Section 36(2).
[348] ibid, Section 36(3).

2.4.3 The Capital Markets Tribunal

The Capital Markets Tribunal is established under Section35A of the Capital Markets Act. The Tribunal is composed of five members which include; a chairperson who shall be an advocate with at least seven years standing, a lawyer with at least seven years of experience in the corporate and commercial sector, an accountant who shall have plied their trade for at least seven years, two persons who are competent on matters securities, and a secretary who shall be an advocate with at least five years of experience in matters commercial law.[349] The appointment of these persons shall be done by the Cabinet Secretary for Finance[350] and shall hold office for a term not exceeding three years.[351]

The Capital Markets Tribunal has the mandate to resolve any matters relating to the decisions of the Authority with regards to the refusal by the Authority to grant a license, the imposition of any limitation on any license, the suspension or revocation of a license, the refusal by the Authority to grant an approval for the offer of securities to the public, the refusal to admit a security to the official list of security exchanges in Kenya, the removal of a security exchange from the official list of security exchanges in Kenya, and the suspension of the trading of any security on any securities exchange in Kenya.[352]

The Tribunal is also empowered to hear an appeal against a decision to refuse to grant investor compensation where an investor has suffered a loss arising out of a licensed stockbroker failing to honour the contractual obligations or a failure to pay unclaimed dividends to an investor who resurfaces.[353] However, the CM Act dictates that such appeals shall only be made within a

[349] ibid, Section 35A (1).
[350] ibid, Section 35A .
[351] ibid, Section 35A (2).
[352]ibid, Section 35(1).
[353] ibid, Section 35(1)(g).

period of fifteen days from the date the refusal or decision or direction was communicated to the person either by the Authority or the Investor Compensation Fund.[354]

The Tribunal has powers to inquire into any appeal made against the decision of the Authority or the Investor Compensation Fund and make awards as it may deem appropriate based on its findings.[355] The Tribunal also has powers similar to those of the High Court with respect to summoning witnesses, taking evidence, administering oaths or affirmations and the power to demand the production of books of accounts or any other document that may be needed in the hearing of the appeal lodged with them.[356] Whereas the Evidence Act, Cap 80 of the Laws of Kenya is referred to when questions of admissibility and relevance of evidence, the CM Act empowers the Tribunal to accept evidence which may not otherwise be admissible under Cap 80 for the purposes of making a determination on an appeal before it.[357] The Tribunal is also empowered to award the cost of proceedings instituted before it and dictate the taxation of the said costs.[358]

2.4.4 The Nairobi Securities Exchange

It serves as a Self-Regulatory Organization (SRO) for stockbrokers and other market participants in accordance with the provisions of Trading Participants Business Conduct And Enforcement Rules 2014 as well as Part IIA of the Capital Markets Act. As an SRO, the Nairobi Securities Exchange makes its rules which are subject to approval by the Authority[359] and takes administrative action against trading participants who have breached its rules.[360]

[354] ibid.
[355] ibid, Section 35A (4).
[356] ibid, Section 35A (5).
[357] ibid, Section 35A (7).
[358] ibid, Section 35A (8).
[359] ibid, Section 18C.
[360] ibid, Section 18E.

2.4.5 The Investor Compensation Fund

The CM Act establishes the Investor Compensation Fund with the sole purpose of compensating investors who have suffered some monetary loss arising out of the failure of a stockbroker to honour their contractual obligations or failing to pay unclaimed dividends to investors whenever they resurface.[361] In the event that the funds are unclaimed, then they ought to be remitted to the Unclaimed Financial Assets Authority (UFAA).[362] The Act defines "assets" to mean financial assets to which the Act applies and includes any income, dividend or interest thereon.[363] The Capital Markets Authority performs the function of managing the funds of the Investor Compensation Fund and reports the returns and financials of the Investor Compensation Fund in the Capital Market Authority Annual Reports.

Having laid out the legal, regulatory, and institutional framework governing the operations of stockbrokers in Kenya, the succeeding section is going to be dedicated towards a critique of the role of the Capital Markets Authority within the Kenyan Capital Markets.

2.5 A Critique of the Role of the Capital Markets Authority in the Regulation of Capital Markets in Kenya

The integrity of the capital markets ensures that the confidence of the investors making investment in the capital markets is always maintained. This integrity of the markets can only be maintained if the Capital Markets Authority stamps its authority and effectively roots out fraud and related market practices which can be termed as unfair and hazardous to the interests of the investors. However, at the same time, the duty to ensure that the markets remain clothed with integrity must always be balanced against the need to promote the development of the markets as well as the interests of participants such as stockbrokerage firms. This is not to

[361] ibid, Section 18.
[362] Unclaimed Financial Assets Act No 40 of 2011, s2.
[363] ibid, Section 2

suggest that the conduct of the market intermediaries should not be reined in where it is unbecoming but that the development of the laws and regulations must incorporate their views as they are directly affected by the said laws and regulations. Put otherwise, this study postulates that the Authority as a regulator must endeavour to promote the confidence of the investors in the markets by punishing stockbrokers who do not promote the interests of the investors on whose behalf they act. Consequently, the punishment to be meted out to rogue stockbrokers must be procedurally fair and that the development of the laws and regulations must also serve to look out for the best interests of market intermediaries. A culture of proper corporate governance and of compliance with the laws and regulations is easily attained if all the players in any particular industry support the law-making institutions. Additionally, a rapport between the Capital Markets Authority and the intermediaries is important in guaranteeing certainty.

The promotion of investor education is also fundamental with regards to protecting the interests of the investors. The Capital Markets Authority must avail as much information to the investors with the aim of ensuring that investor education and awareness becomes the first firewall against fraudulent stockbrokers who would wish to fleece them. Among the objectives of the Capital Markets Authority should be the objective of promoting investor awareness and education provided by the law. This would go a long way in ensuring both the protection of the investors as well as the development of the capital markets as more investors will be knowledgeable of the huge potential of the capital markets as a source of wealth generation.

It also appears that the mandate and the powers bestowed upon the Authority by the Capital Markets Act are quite pervasive and largely unchecked. This posts the question of who shall watch the watchers of the investments made by the investors. It is important to note that the drafters of the Capital Markets Act were quite foresighted in this respect and identified the National Treasury or Ministry of Finance as the one to hold the Authority accountable as the parent Ministry. The CM Act dictates that the Authority shall submit annual report on the activities and operations it has undertaken within the financial year including its audited accounts to the Cabinet Secretary at the close of the financial year.[364] The Cabinet Secretary thereafter tables the report before the National Assembly within the period of three months from the time of receipt.[365] The Cabinet Secretary may also demand any information from the Authority at any given time.[366] However, this study postulates that this mechanism of seeking to hold the Authority accountable is not only inadequate but ineffective. This is premised on the fact that the members of the Authority are more of political appointees whose allegiance is to the government of the day. Secondly, the Act does not prescribe any punitive actions for any malpractices or irregularities or any misdeeds for the Authority whenever the annual reports are tabled to the National Assembly. Therefore, the reporting to the National Assembly and the National Treasury appears to be a formality required by the law and not a thorough accountability mechanism. This is because the National Assembly bears its own weaknesses such as the division based on the party with the majority seats in the House. Consequently, it becomes very difficult for the party with the majority to question executive decisions and competence of its appointees as these appointees can be loosely said to be the appointees of the government. Instead of the National Assembly holding these appointees accountable, they are likely to defend them. Consequently, these reports are almost never analyzed or subjected to vigorous debate let alone acted upon because of political allegiances that almost always stand in the way of decisive and punitive measures.

The existence of the Capital Markets Tribunal as one of the accountability mechanisms is also flawed. This is because the objectives and mandate of the Tribunal is quite limited in respect of what it can do with regards to the misdeeds of the Authority and the Investor Compensation

[364]ibid, Section 36(2).
[365] ibid, Section 36(3).
[366] ibid, Section 36(1).

Board.[367] As if that is not limiting enough, the CM Act also sets out the nature of the corrective mechanisms that the Tribunal may grant. These are limited to confirming, setting aside or varying of the decisions of the Authority, the exercise of powers which the Authority could have granted based on the appeal and the making of orders that it deems just.[368] These are in no way meant to hold the Authority accountable as they require individuals to seek the assistance of the Tribunal only when affected on quite a limited number of matters. It would be prudent and reassuring to the members of the public or the investors had there been established an independent body to look into the affairs and conduct of the Authority objectively. After all, both the members of the Tribunal and the Authority are appointees of the government. Due to the relative importance of the Authority in the administration of the capital market through regulation and the development of the capital markets, the Authority ought to be granted a reasonable amount of independence. This would adequately shield the Authority from patronage and general political interference. This would be really instrumental in guaranteeing independence and create room for better accountability mechanisms.

The appointment of statutory managers is yet another concern in the wide and discretionary powers granted to the Authority. Whereas intervention in the management of the affairs of licensed participants seems to be aimed at achieving one of the objectives of the Authority, that is protection of investors, the CM Act does not prescribe any qualifications for such persons to be appointed as statutory managers.[369] This has almost always led to the winding up of these institutions without first ascertaining whether they can be revived. In most of the cases where statutory managers have been appointed for failing licensees, these have been eventually wound up.[370] It would be prudent if there were regulations on the appointment of statutory

[367] The jurisdiction of the Tribunal is limited to the matters listed under Section 35(1) of the Capital Markets Act.
[368] Capital Makerts Act (n 9) Section 35A (16).
[369] ibid, Section 33A (2).
[370] Cases in point; Nyaga Stock brokers Limited and Ngenye Kariuki Stock brokers Limited.

managers and the requisite qualifications for appointment as statutory managers even as the Authority endeavours to protect the interests of the investors.

2.6 Conclusion

Capital Markets, the world over, rely greatly on the existence of investors willing to invest in the securities availed to the markets. However, this study recognizes the unsophisticated nature of the investors in being able to access, synthesize and maximize to their benefit information on the securities available in the markets. This makes the case for the existence of an institution that is capable of accessing the information, synthesizing it and making the most favourable decision for furtherance of the interests of the investors. This institution is identified by the study as the stockbrokerage firms. The existence of stockbrokers to facilitate the purchase and sale of securities remains crucial in the efficient functioning of this ecosystem. This is because it is only through the services provided by stockbrokers that unsophisticated investors can take part in the capital markets without the fear of losing their investments due to their inability to access information on the capital markets and synthesizing that information. However, it is not reasonable to expect unsophisticated investors to be able to hold such sophisticated institution accountable by questioning the value of the information provided to them or even the quality of advice and services offered to them. This exposes investors to the risk that they could be short-changed without their knowledge.

Having acknowledged the importance of stockbrokers in this ecosystem, it is imperative that a system be established to ensure that they do not take advantage such unsophisticated investors. This is the role that the legal, regulatory and institutional framework created by the Kenyan capital markets regime seeks to achieve. The legal regime seeks to hold stockbrokerage entities responsible for the quality of advice that they offer to their clientele and the nature of transactions that they broker on the behalf of these unsophisticated investors. This is the exact reason why the legal regime is so concerned about the ability of persons appointed as directors of stockbrokerage firms as well as their employees. It is the same reason that the legal regime is quite tough on the quality of corporate governance systems adopted by these firms and their general internal control mechanisms and systems. The short and the long of it is that the law exists to ensure that the stockbrokers carry out their activities with the highest level of professionalism as dictated by the standards set by the law.

CHAPTER THREE: CHALLENGES FACING STOCKBROKERS IN KENYA

3.1 Introduction

The survival of the capital markets is predicated upon the existence of a robust legal framework capable of protecting the investors.[371] A robust legal framework is imperative in guaranteeing both the integrity of the markets as well as investor protection. This is because financial markets that have the best interests of investors and their protection at heart crucially boosts the confidence of investors who in turn continue to inject their financial resources in such markets in the name of making investments.[372] However, the structuring of the capital markets is built in such a way that individual investors must rely on the services of intermediaries if they are to carry out any transaction in the financial markets.[373] Intermediaries such as stockbrokers, therefore, exist to facilitate a number of transactions which includes but is not limited to the sale of financial products. It is the service provided by stockbrokers that enables ordinary investors to make rational investment choices and the efficient allocation of financial resources by almost all the players in the realm of capital markets.[374] The services of intermediaries such as stockbrokers are therefore crucial as it enables the continuous transacting in financial products. In this respect, the services offered by stockbrokers to participants in the capital markets can be considered to be the "lifeblood" of the capital markets.

Owing to the crucial importance of stockbrokers to the capital markets, there arises the need to ensure that a robust legal and regulatory framework is put in place. Some of the key aspects of the legal and regulatory framework include full disclosure to both the interested investors and the Capital Markets Authority through the availing of annual reports. Secondly, other regulations are meant to ascertain the financial soundness of stockbrokers to prevent systemic

[371]Strigler (n 59) 117.
[372] ibid. p.420.
[373]Franklin Allen and Anthony M Santomero, 'What Do Financial Intermediaries Do?' (2001) 25 Journal of Banking & Finance 271.
[374] ibid. p.273.

risk to investors as well as the financial markets sector in Kenya. Other regulations are meant to prevent market abuses such as churning and insider trading among others in the financial markets.

However, as will be demonstrated in this chapter, the current regulatory provisions regulating the provision of intermediary services are posing some challenges to stockbrokers in Kenya. Some of the challenges that this chapter will aim to address under the current regulatory framework will revolve around corporate governance, financial risk and management as well as those that are meant to protect the markets against market abuses such as churning, insider trading and conflict of interest.

3.2 The Suitability Rule

Pursuant to Section 12 of the Capital Markets Act[375], the Capital Markets Authority is mandated to develop regulations to govern persons engaging in the provision of stockbrokerage services in Kenya. Owing to this mandate, the Authority developed the Capital Markets (Conduct of Business) (Market Intermediaries) Regulations 2011 (hereafter referred to as the Regulations) which introduced the suitability rule. Regulation 4(1) of the Regulations dictates that market intermediaries must seek all relevantly sufficient information about a prospective client and they will only provide services that are tailor-made to suit the particular circumstance of each prospective client. Regulation 4(2) (a) unequivocally casts the suitability rule in stone by dictating that all persons providing intermediary services such as stockbrokerage must when making any recommendation to their client take all reasonable steps in ensuring that the said recommendation is the most suitable to the client in light of all the alternatives that might have been available for the client. In addition, Regulation 4(2) (b) expressly prohibits a market intermediary such as a stockbroker from executing a sale or purchase that would not suit the

[375] Cap 485A of the Laws of Kenya.

client. Further, Regulation 4(2) (c) expressly proscribes the execution of any sale or purchase that would be suitable for the stockbroker but adverse to the interests of the client.

This study wishes to postulate that despite the best interests of the client being put first by the regulations; the definition of what is suitable or unsuitable for the client is problematic or at best vague. The Regulations do not make any attempt at developing any clear criterion for the establishment of what is suitable or unsuitable for the investor. How then are stockbrokerages to quantify or measure unsuitability or suitability in the absence of a definition of suitability or a clearly established criterion for the determination of suitability or unsuitability?

Furthermore, the execution of sales and purchases of financial products by stockbrokers on behalf of their clients or recommendations made to clients by stockbrokers more often than not is a matter of speculation.[376] This study argues that any activity that involves speculation is filled with an unimaginable amount of uncertainty. That no matter how cautious a stockbroker may have been, in an effort to look out for the best interest of the clients, the activities at the bourse are almost always impossible to correctly predict. However, an argument can be advanced that it is for this exact reason that investors indulge the services of stockbrokers: imposing on stockbrokers a fiduciary duty to as correctly as is reasonably possible synthesize information and get clients the most out of the capital markets. Stockbrokers trade on having a good reputation and as such a breach of that fiduciary duty would greatly hamper their reputation and lead to mass losses for the firm.[377]

The absence of a definition of the suitability rule imposes an almost impossible duty on stockbrokers to guarantee profitable returns at all times for clients.[378] In a speculative activity,

[376]Dan Krier, *Speculative Management: Stock Market Power and Corporate Change* (SUNY Press 2012).
[377]Karen PY Lai, 'Financial Advisors, Financial Ecologies and the Variegated Financialisation of Everyday Investors' (2016) 41 Transactions of the Institute of British Geographers 27.
[378]Richard A Booth, 'The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk' (1999) 54 The Business Lawyer 1599.

success is not always guaranteed and it makes no sense imposing such a stringent requirement on stockbrokers. Furthermore, the assumption of a fiduciary duty by a stockbroker lends any investor or potential investor room to argue that the stockbroker did not act in their best interest even where a stockbroker did all that was humanly possible to get the best deal for such a client.[379] In a market that is filled with imperfections such as an unpredictable political climate, stockbrokers must be given at least some leeway to conduct their business and not constantly worry about having a noose around their necks in the event that clients suffer losses. Therefore, room should be created for honest mistake in the judgment of a stockbroker even where the fiduciary relationship is existent.[380] Regulation 4 as presently drafted imposes an undue burden on stockbrokers as it makes it impossible to adjudicate disputes where clients lose investments as a result of the negligence of a stockbroker and cases where the loss arises without the stockbroker being responsible for the loss.

Another problem with the suitability rule is that it is only limited to recommendations made by stockbrokers or in instances when a stockbroker is acting on behalf of a client. This limitation itself is problematic. The Regulations do not make even the faintest attempts at defining what amounts to a recommendation. This splits hairs as to what amounts to a recommendation and as such leaves a lot of room for several definitions. A huge concern would be in circumstances where a stockbroker is merely taking instructions from an investor who is highly knowledgeable and capable of synthesizing and understanding information about the markets on their own.[381] The problem with confining the suitability rule to these two instances is that it assumes that all the investors are not financially knowledgeable and as such must rely on the services of stockbrokers. Does it still count as a recommendation where the investor merely

[379] Angel and McCabe (n 48).
[380] ibid.
[381] Robert H Mundheim, 'Professional Responsibilities of Broker-Dealers: The Suitability Doctrine' (1965) 1965 Duke Law Journal 445.

brings a transaction to the attention of a stockbroker for purposes of execution having decided what is in their best interest beforehand? Do instances when an investor acts or relies on information that is purely meant for advertising the services of the stockbroker to make a purchase or sale still amount to a recommendation by the stockbroker? Do market projections or general information about the trends in the capital markets or objective statements about price quotations amount to recommendations? These questions only serve to explain the dilemma in which stockbrokers find themselves in the absence of unambiguous provisions of the regulations meant to protect investors and boost market integrity and confidence.

3.3 The Disclosure Requirement

The efficient working of the capital market is often predicated upon the existence of adequate information.[382] Information is deemed to be adequate if the information is sufficient enough to assist an investor in the making of informed decisions. Other than the crucial role, the enactment of legislation and the attendant regulation on disclosure in the capital markets goes a long way in the guaranteeing of the integrity of the markets.[383] This is yet another rationale for the enactment of legislation on disclosure in the capital markets. The promptness and adequacy of information to investors in the capital market can therefore be said to be the bedrock upon which a robust and sustainable capital markets is to be founded.[384] This is mainly due to the fact that investors when provided with adequate information are able to make their own informed decisions and as such it greatly reduces the chances of an investor being swindled off their hard-earned money.

The enactment of disclosure regulations can therefore be termed as a promise or an assurance to investors from the regulators (the Capital Markets Authority) of complete transparency and

[382]Kai Werner, 'Justifying Mandatory Disclosure in Contemporary US - Securities Regulation' (2008) 2008 Freilaw: Freiburg Law Students Journal 1.
[383]ibid.
[384]James D Cox, Robert W Hillman and Donald C Langevoort, *Securities Regulation: Cases and Materials* (Wolters Kluwer 2016).

accountability. This is because such legislation ensures that material information on whether an investor should invest or divest in a given set of securities available in the market is not only accurate but complete and timely.

The reporting requirements or rather the mandatory disclosure requirements are set out under Regulation 21 of the Capital Markets (Licensing Requirements) (General) Regulations, 2002. Regulation 21 dictates that every stockbroker shall submit to the Capital Markets Authority quarterly financial reports, half yearly financial reports, annually audited accounts and financial statements to show compliance with the disclosure requirements. Additionally, stockbrokers are expected by Regulation 21 to prepare monthly financial statements and reports which should be availed to the Authority as well as any other form of statements regarding the stockbrokers' financial position at its request.

A quick glance of Regulation 21 gives the impression that the mandatory disclosure requirement is perhaps the simplest to comply with and should not pose any challenges to stockbrokers. Theoretically, it appears that there is no undue burden being imposed on stockbrokers to fully comply and disclose all this information. However, the practicality of this requirement is highly doubtful. This study questions the practicality by asking if there can be a comprehensive meaning to the term full disclosure, the applicability of disclaimers from stockbrokers, the relevance of an investor's independent judgment in the making of investment decisions and if all disclosure including mere puffery should be disclosed? It further questions if there can be a set standard for disclosure by seeking to find out if there can be such a thing as too much disclosure or too little disclosure.

3.3.1 The Materiality of the Disclosed Information to Investors

Despite the comprehensive nature of Regulation 21, information asymmetry is still prevalent in the capital markets. In fact, as stockbrokers endeavour to comply with Regulation 21 investors have argued that the quality and value of the information being availed to them in these frantic efforts to comply with Regulation 21 have diminished considerably.[385] This has given the impression that the law of diminishing returns could be applying to the financial sector with regards to financial disclosures.[386] Additionally, other investors have complained about how awfully complex the information being fed to them by stockbrokers is and as such it does not help them in making informed decisions as it leaves them more confused than they initially were.[387] This is because as firms strive to comply with these mandatory disclosure requirements, the relevance of the information in the making of informed investment decisions is being lost gradually. It has been argued that firms are more interested in effecting regulatory compliance rather than meeting the objective of mandatory financial disclosures. Some investors have even suggested that it would be prudent for the regulators to set standards that would seek to eliminate irrelevant and immaterial information from being fed to investors.[388]

Whereas investors, stockbrokers and the regulators in the securities markets argue that the purpose of mandatory and full disclosure requirements should be to enhance the ability of investors to process financial information, too much information might just serve to undo that purpose.[389] This is because investors when given an information overload are most likely to process irrelevant information that is counterproductive to the whole purpose of full disclosure.[390] That the most important information to any class of investor, sophisticated and unsophisticated investors, only relates to a particular financial product, the quality of the product, the risks attached to the product and either a positive or a negative recommendation

[385]Troy A Paredes, ‘Blinded by the Light: Information Overload and Its Consequences for Securities Regulation’ (2003) 81 Washington University Law Quarterly 417.
[386]ibid.
[387] Gordon Walker, ‘Securities Regulation, Efficient Markets and Behavioral Finance: Reclaiming the Legal Genealogy’ (2006) 36 HONG KONG L. J. 481, 509. ; Ben Pettet, ‘Towards a Competitive Company Law’ (1998) 19 (5) COMP. L. 134, 139.
[388] ibid.
[389]Goldstein and Yang (n 131).
[390]Tina Harrison, *Financial Literacy and the Limits of Financial Decision-Making* (Springer 2016).

of the product. From the stockbrokers' perspective, it would help if the regulatory framework around mandatory disclosure requirements was developed in a manner that would only require them to disclose information that would eliminate ambiguities, complexities and redundancies in their reporting obligations.[391] The contention of stockbrokers as such is not that mandatory disclosures are burdensome. In fact, stockbrokers appreciate the necessity of disclosure and transparency in enhancing the integrity of the financial markets and the protection of investors. Their only contention is that the current framework is cluttered with an overload of information that ultimately buries information that would be more relevant to investors.[392]

In addition to the current overload of information, stockbrokers are also faced with a number of serious concerns with the disclosure requirements. First, there being no standard set for the disclosure, it is impossible to tell what information will adequately facilitate the making of informed investment decisions by investors.[393] In fact, the most common problem that stockbrokers are facing regards complaints by investors that the information being availed to them is not only irrelevant but also immaterial to the making of investment decisions.[394]Secondly, the current disclosure requirements are solely for the benefit of investors and the regulators may not be concerned with the potential harm that the information could inflict upon the brokerage firm. This is particularly in light of the requirement for publication of a stockbroker's full year audited financial statements within three months after the end of the financial year in two dailies of national circulation[395] thus this information is available to virtually everyone including a stockbrokerage firm's competitors. Thirdly, the current

[391]taejun Lee, Tai Woong Yun and Eric Haley, 'The Interplay between Advertising Disclosures and Financial Knowledge in Mutual Fund Investment Decisions' (2012) 46 The Journal of Consumer Affairs 260.
[392]Mariea G Hoy and May O Lwin, 'Disclosures Exposed: Banner Ad Disclosure Adherence to FTC Guidance in the Top 100 U.S. Web Sites' (2007) 41 Journal of Consumer Affairs 285.
[393]Paul M Healy and Krishna G Palepu, 'Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature' (2001) 31 Journal of Accounting and Economics 405.
[394]Fu, Kraft and Zhang (n 43).
[395] Regulation 51A (2) (b) of the Capital Markets (Licensing Requirements) (General) Regulations, 2002

regulatory framework is structured in such a way that it does not eliminate the individual stockbrokerage firm's biases during the reporting process. This study propounds that the availability of the information to virtually everyone including one's competitors does not provide an incentive for firms to be completely honest particularly when the information is meant to attract clients. This amounts to some of the unfair trade practices that can be propagated as a result of these blanket disclosure requirements that are highly lacking in establishing a standard of disclosure.[396]

Another concern from stockbrokers is that quality information often comes at a very high cost to investors because of the time and resources expended in researching and analyzing the information.[397] A majority of investors are in more cases unwilling to purchase costly information even when the benefits of such information are obvious to even the most unsophisticated investor.[398] Therefore, stockbrokerage firms are faced with the difficult choice of choosing between cheap and information of low quality and value or expensive and information of high quality and value because most investors are willing to appreciate the importance of quality information. This creates a scenario in which market intermediaries are likely to exploit the naivety of such investors and place the interests of the firm above those of clients.[399] Additionally, the stockbrokerage firms have no incentive for issuing out quality information as they are expected to produce thoroughly analyzed information for the consumption of investors through their reporting obligations without receiving anything in return for their efforts.[400]

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[397]Jeremy Bertomeu, Anne Beyer and Ronald A Dye, 'Capital Structure, Cost of Capital, and Voluntary Disclosures' (2011) 86 The Accounting Review 857.

[398]George J Benston, 'Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934' (1973) 63 The American Economic Review 132.

[399]Michael J Fishman and Jonathan A Parker, 'Valuation, Adverse Selection, and Market Collapses' (2015) 28 The Review of Financial Studies 2575.

[400]Dan S Dhaliwal and others, 'Voluntary Nonfinancial Disclosure and the Cost of Equity Capital: The Initiation of Corporate Social Responsibility Reporting' (2011) 86 The Accounting Review 59.

3.4 The Agency Problem and Conflict of Interest for Stockbrokers

The primary role of a stockbroker as an intermediary between purchasers and sellers of security can be defined as an agent-principal relationship.[401] This is because in most instances, the stockbroker who is the agent in these circumstances acts on behalf of the investors (both the sophisticated and unsophisticated investors) who are the principals in this agent-principal relationship.[402] To support, the existence of this agent-principal relationship it must be noted that it is always the assets of the principal that are at risk. As such the principal and not the agent bear all the risks and the agent only acts upon the instructions of the investor.[403] The relationship is therefore created through a contract that the agent will supply the principal with services such as facilitating transactions on the capital markets in addition to offering advisory and management services to the principal for which the agent receives a commission or the agreed fees as the consideration.

In the capital markets framework, this agent-principal relationship is justified based on two assumptions. Firstly, that the machinations of the capital markets are alien to the principal and it is only through the agent that the principal can be able to participate in the financial markets. Secondly, that it is only the agent who is privy to information about the capital markets and the principal has completely no access to this information. Thirdly, that there exists a statutorily created fiduciary duty owed to the investor and as such the stockbroker's duty will always be the pursuit of the investor's best interest at all times. Based on these assumptions, it is evident that a stockbroker has the legal authority to act on behalf of the investor in all matters regarding his/her investment in the capital markets. It is then from the foregoing that Regulations 3, 6, 9 and 12 of the Capital Markets (Conduct of Business) Market Intermediaries Regulations, 2011

[401]Angel and McCabe (n 48).
[402]ibid.
[403]Donald C Langevoort, 'Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated Customers' (1996) 84 California Law Review 627.

are founded. The mentioned regulations dictate that a stockbroker owes the client a duty to provide stockbrokerage services with due care, diligence and competence of a stockbrokerage professional and must at all times avoid any conflict of interest that may arise in the course of dealings.

However, within the realm of stockbrokerage services and transactions in the capital markets the cardinal doctrine of agent-principal as stipulated above is almost bereft of relevance. This is because a single stockbrokerage firm serves more than one principal. In doing this, it is impossible to expect that the interests of all the clients will be aligned and not be divergent. Accordingly, the agent will always be faced with the challenge of balancing the differing or divergent interest of the many principals a firm may have as its clients. This requires that a stockbrokerage firm must carefully manage different portfolio and have a system in place for efficient portfolio transformation if it is to remain solvent. This definitely requires the firms to reduce information asymmetries and transaction costs and always endeavour to execute only those transactions that are in the best interest of the investor always.[404] It is this desire of a firm to keep itself solvent and keep generating returns on client's investment that leads to situations of conflicting interest arising. A conflict of interest between the interests of a stockbroker as an agent arises when the interest of the stockbroker inhibits him/her from acting in the best interest of his/her principal. This conflict prevents the agent from honouring the fiduciary duty that is established by virtue of the existence of a contractually established agent-principal relationship.[405]

The operations of a stockbrokerage firm may give rise to a number of scenarios which can potentially lead to a clash between the interests of the firm and its clients. For instance, it is

[404]Shaun French and Andrew Leyshon, 'The New, New Financial System? Towards a Conceptualization of Financial Reintermediation' (2004) 11 Review of International Political Economy 263.
[405]Tamar Frankel, 'Fiduciary Duties of Brokers-Advisers-Financial Planners and Money Managers' (Social Science Research Network 2009) SSRN Scholarly Paper ID 1446750 <https://papers.ssrn.com/abstract=1446750> accessed 30 August 2019.

impossible to assume that all stockbrokers employed by a stockbrokerage firm work in the best interest of the firm.[406] In as much as they may wish to work in the best interests of the firm, these stockbrokers may actually have their own interests that compromise their decision-making processes as they undertake their obligations to the firm and its clients.[407] The agency problem is further exacerbated by the fact that stockbrokerage firms thrive on the existence of a credible and high reputation for guaranteeing returns on the investments entrusted to them.[408] Part of this credibility lies in the maintenance of a large share of investors as their clients. It is the desire to maintain a high reputation and credibility that may lead a firm to withhold information that may be damaging to that reputation even when withholding is not in the best interest of the investors.[409]

Given the legally established fiduciary relationship established between the stockbroker and the investor, the interests of the investor must always prevail over the interests of the stockbroker. Therefore, a failure by a stockbroker to give preference to the interests of the investor amounts to gross misconduct which is averse to the interests of investors, ruins the integrity of the markets and fundamentally breaches the agent-principal relationship. Within the realm of stockbroker-investor relationship, a conflict of interest can be defined as a situation in which a stockbroker as a fiduciary fails to honour his/her obligations to the clients as a result of commitments to either other clients or the stockbrokerage firm.

Conducts that promotes the interests of the stockbroker at the expense of the investors and amounts to professional misconduct include but is not limited to churning and insider trading. These are discussed in the following section.

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[406]ibid.
[407]French and Leyshon (n 400).
[408]Adrian Davies, *Best Practice in Corporate Governance : Building Reputation and Sustainable Success* (Routledge 2016) <https://www.taylorfrancis.com/books/9781317175094> accessed 27 September 2018.
[409]John Griffin, Richard Lowery and Alessio Saretto, 'Complex Securities and Underwriter Reputation: Do Reputable Underwriters Produce Better Securities?' (2014) 27 The Review of Financial Studies 2872.

3.4.1 Churning

Churning can be defined as a situation in which a stockbroker overtrades or initiates a series of transactions than is necessary by unduly disregarding the investment objectives of the clients who entrusted him/her with their investments.[410] It can also be defined as a situation in which a stockbroker disregards the interests of the client and acts only to advance their own interests by initiating a raft of transactions that exceed the frequency and size of a client's instructions.[411] The purpose for disregarding the instructions of a client, exceeding the frequency and size of a client's accounts are purely to increase their earning from the commissions that arise out of that overtrading.[412] It can therefore be defined simply as a situation in which a stockbroker fraudulently increases their commission earning by blatantly disregarding the circumstances around a client's account.

The Capital Markets (Conduct of Business) (Market Intermediaries) Regulations 2011 proscribes churning by prohibiting stockbrokers from exercising their discretion in the arrangement of any deal or dealing if the deal can be reasonably considered to be too frequent or too large in light of the investment objectives of the client.[413] In order to ascertain whether a stockbroker has breached their fiduciary duties to the client and engaged in churning, the test would be whether the stockbroker acted in pursuit of commissions or were the actions of the stockbroker meant to further the interests of the investor.[414] At times, the consideration moves from the number of transactions instituted on behalf of the stockbroker to the riskiness of the several transactions instituted on behalf of the stockbroker. Unjustifiable and excessive institution of transactions on behalf of the client in most cases than not leads to an inference

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[410]Marian V Heacock, Kendall P Hill and Seth C Anderson, 'Churning: An Ethical Issue in Finance' (1987) 6 Business & Professional Ethics Journal 3.
[411]McCann (n 157) 49.
[412]ibid.
[413] Regulation 24(a) and (b).
[414]McCann (n 157) 49.

that the broker has engaged in churning. A series of highly risky transactions is also likely to be construed as engaging in churning.[415]

The consequent challenges for stockbrokers that give rise to instance of churning are therefore that the remuneration system for stockbroker is commission based. It must be noted that despite there being other systems for the remuneration of stockbrokers, earnings generated through commissions can be considered as the major source of income for stockbrokers. Brokerage commissions are only earned when a stockbroker facilitates the sale and purchase of financial products. Furthermore, the stockbroker also plays the role of an adviser to investors on what financial products to buy or sell. However, the challenge for stockbrokers is that they earn or generate no commission if the investor holds on to their securities. This therefore forces the stockbroker to advise clients to sell or buy as much as they can in order for him/her to earn commissions from such transactions.[416]

3.4.2 Insider Trading

The Capital Markets Act[417] defines an insider as any person who is connected with a company and is reasonably expected to have access to unpublished information which if released would substantially alter the prices of the securities of that particular company.[418] The Act proscribes the dealing in listed securities and makes it an offence for a person to encourage another to deal in securities that are price-sensitive or disclosing the price-sensitive information to another person.[419] Within the context of stockbrokers as the agents of investors, the Act prohibits them from dealing in price-sensitive information even if it is on behalf of their clients.[420]

[415]Raphael Janove, 'All out of Chewing Gum: A Case for a More Coherent Limitations Period for ERISA Breach-of-Fiduciary-Duty Claims' (2014) 81 The University of Chicago Law Review 801.
[416]Jonathan R Kamisar, 'The Yearn To Churn' (1991) 77 American Bar Association Journal p66-99.
[417] Cap 485A of the Laws of Kenya.
[418] ibid., Section 2.
[419] ibid, Section 32B(1).
[420] ibid, Section 32B(2).

The Capital Markets (Conduct of Business) (Market Intermediaries) Regulations 2011 further require that stockbrokerage firms must put all reasonable effort into ascertaining if any of the persons they have taken as their clients are insiders and that these firms must see to it that they have properly maintained records that will aid the regulator in monitoring, identifying and punishing those engaged in insider trading.[421]

The rationale for the proscription of insider trading by the Capital Markets Act and the Capital Markets (Conduct of Business) (Market Intermediaries) Regulations is purely for the promotion of the integrity of the financial markets and the promotion of the confidence of investors. This is therefore meant to facilitate honest dealings by stockbrokers and other players in the financial markets. The promotion of efficient markets and fair dealings is done pursuant to the duty of the relevant Cabinet Secretary to develop rules and regulation for the same.[422] If insider trading were allowed insiders including stockbrokers would earn considerable profits from insider dealings than the investors who should be the ones to reap the benefits of investing in the financial markets. The consequence of such dealings would obviously discourage investors from participating in the financial markets as they would feel short-changed.

The conflict of interest arises for the stockbroker as they are forced to choose between abstinence from taking advantage of the privileged information until the information ceases to have any influence on the prices of securities and privately disclosing the information and taking home a huge pay cheque. The challenge for the stockbroker lies in the fact that there is not much in the name of incentives to prevent them taking advantage of the price sensitive information and taking the huge pay cheque.

[421] Regulation 25.
[422] Section 12.

3.5 Conclusion

The crucial role played by stockbrokers in the growth and development of the financial markets as well as the promotion of market efficiency is not in doubt. The role of a robust legal and regulatory framework to protect both the integrity of the markets and protect the interests of the investors is also seen as integral to the survival of the financial markets. However, the current legal and regulatory regime seems to be quite unfavourable to stockbrokers. This is because it appears that the legal and regulatory framework is centred on the protection of the interest of investors at the expense of the other stakeholders such as stockbrokers. This study postulates that there are ambiguities in defining the scope and relevance of the suitability rule and that there are no parameters upon which a stockbroker can gauge whether a recommendation to a client is suitable. Furthermore, the law just requires the stockbrokers to figure out what would be suitable to the interest and circumstances of a client without properly defining the requirements of this rule.

Additionally, there seems to be too much hullaballoo around the disclosure requirement and the protection of investors. This is because in as much as the disclosure requirements encourage transparency and accountability, the legal and regulatory regime does not factor in the financial cost of that disclosure on a stockbrokerage firm. Neither do the regulations bother about the potential effect that such disclosure has on the competitive edge of a firm against other stockbrokerage firms.

Finally, the agency-principal relationship that is created by the law and the fiduciary duties owed to a client constantly poses a conflict between an individual stockbroker and the client and is the reason for the continued existence of market abuses such as churning and insider trading that are a menace to the financial markets.

CHAPTER FOUR: REGULATORY RESPONSES TO THE CHALLENGES FACING STOCKBROKERS

4.1 Introduction

The preceding chapter of this study delved into the challenges facing stockbrokers in the financial markets in Kenya. The challenges identified were with the current legal and regulatory framework governing the operations of stockbrokers. The challenges identified included the imposition of the suitability rule on stockbrokers, the mandatory disclosure requirement and the problematic fiduciary duties arising out of the agency relationship between stockbrokers and their clients. The purpose of this chapter will, therefore, be to conduct a comparative analysis with goal of identifying regulatory responses to the challenges identified in chapter three of this study. This will be aimed at attempting to find solutions to the challenges identified within the legal and regulatory framework in Kenya. The study settles on the United States of America for the comparative analysis due to its long history of dealing with the challenges identified and the rich jurisprudence that has been developed in the process from her courts.

4.2 The Objectives of the Best Practices in the United States of America

The United States of America (US) has on numerous occasions been called to respond to market abuses in the form of insider trading, churning to name but a few.[423] These challenges go way back to as far as 1933 when the union woke up to the realization that consumers can be swindled off their hard-earned manner in a whiff in the absence of a robust regulatory framework.[424] It is the loss of stock to the tune of millions of US dollars that prompted President

[423]Viral Acharya and others, *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance* (John Wiley & Sons 2010).

[424]Stuart Banner, 'What Causes New Securities Regulation--300 Years of Evidence F. Hodge O'Neal Corporate and Securities Law Symposium: Markets and Information Gathering in an Electronic Age: Securities Regulation in the 21st Century' [1997] Washington University Law Quarterly 849.

Franklin D. Roosevelt to consider the creation of financial laws to regulate business entities.[425] This study, therefore, will rely on the lessons and circumstances that have informed the development of strong financial laws that are ranked as leading in guaranteeing, promoting and boosting investor confidence in the financial markets in the whole world.[426] Having set out the starting point of the regulation of securities in the United States of America, this study intends to draw important lessons on how the federal government has managed to protect both the financial intermediaries without compromising the interests of investors. Thereafter this study will attempt to draw important lessons that can address the challenges faced by stockbrokers and if possible, prompt reforms in the regulation of stockbrokers in Kenya.

4.3 Findings of the Best Practices in the United States of America

This section will quickly discuss the findings of the analysis of the securities laws of the United States of America with respect to the challenges identified within the legal and regulatory framework governing the operations of stockbrokers in Kenya. The laws analyzed include; the Securities Act, 1934, the Securities Exchange Commission Act, 1934, the US Gramm-Leach-Bliley Act of 1999 and Rules of Fair Practice of the National Association of Securities Dealers.

4.3.1 The Suitability Rule in the United States of America

This section will address itself to discussing the suitability rule, the challenges faced in its implementation and how those challenges have been dealt with from the evaluation of all the relevant laws in the United States.

The suitability rule is defined by the National Association of Securities Dealers as the requirement that when making recommendations to a client on what product to sell, exchange or buy, a member of the Association making that recommendation must ensure that the said

[425]ibid.
[426]Acharya and others (n 419).

recommendation is suitable to the needs of the client based on the facts disclosed to him/her by the client.[427] The client is required to volunteer this information and it should include his/her other security holdings, financial capabilities and most importantly, his/her needs at the time.[428] The rationale for the development of this rule was that investors are generally not sophisticated and as such they require protection when making financial investments in markets that are all too sophisticated for the unsophisticated investor.[429] The suitability rule is also entrenched in the Securities Exchange Act, 1934. The Act makes it an offence for any broker to sell or offer for sale any security or to attempt to induce an investor into purchasing any security without first obtaining personal information concerning the client's financial positions and needs and reasonably determining that the suitability of that transaction to such a client.[430] This rule therefore places an obligation on a broker or dealer of securities to reasonably determine the suitability of a financial product before offering such a product to a client. In enforcing this rule, the Securities Exchange Commission has held that it does not matter whether the client was sophisticated or not neither does it matter that the client disregarded a recommendation.[431] The test for the determination of suitability is therefore a subjective one and the burden is on the broker or dealer to prove that he/she made the recommendation and executed it after assessing all the other security holdings of the client, the needs and the financial situation of the client. The only defence available to a broker or dealer is that he or she disclosed all relevant information to the client and not that the client ignored or discarded his or her recommendations.[432] In fact, the Court of Appeal for the 9th Circuit has held that an agent who

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[427] Robert H Mundheim, 'Professional Responsiblities of Broker-Dealers: The Suitability Doctrine' (1965) 1965 Duke Law Journal 445.
[428] Article III, section 2 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. (NASD)
[429] Mundheim (n 423).
[430] Rule 15c2-5(a) (2).
[431] Gerald L Fishman, 'Broker-Dealer Obligations to Customers--The NASD Suitability Rule' [1966] Minnesota Law Review 233.
[432] Tamar Frankel, Arthur B Laby and Ann Taylor Schwing, *Regulation of Money Managers* (Wolters Kluwer Law & Business 2015) 16.

merely displays to a client a product cannot escape liability by claiming that the client exercised their own judgment in deciding on whether to buy or sell or exchange their securities.[433] This implies that the burden of proof rarely shifts to the clients except where it can be demonstrated that the client did not place any reliance on the representations made to him or her by the broker. Where it is doubtful whether the client placed reliance on the representation made by the broker or not, the burden of proof shifts back to the broker to demonstrate that they did not make any representation to the client as he or she was unqualified based on their reasonable assessment of the client's situation. This implies that the burden is neither beyond reasonable doubt nor is it on a balance of probabilities but just beyond the balance of probabilities and just short of beyond reasonable doubt.[434]

The suitability doctrine is based on the shingle theory which dictates that where there are set standards for a particular profession, a member of the profession must deal fairly with his/her clients per the set standards.[435] In fact, it is argued that disclosure alone is not sufficient to protect the clients in most circumstances and hence the need for the suitability rule.[436] For instance knowledge that a client may not be doing well financially would prompt the decision of a broker to avoid making recommendations that are highly speculative to such a client. Should a broker go ahead and make a highly speculative product for such a client, he or she or the entire stockbrokerage firm should be penalized, for example, through the suspension of their trading license.[437] Another rationale for the suitability doctrine is prevent situations in which brokers find low priced and highly speculative products and pressure clients into purchasing such products through telephone calls without considering the needs of the clients.

[433]Mundheim (n 423).
[434]*Mohamed Abdi Mahamud v Ahmed Abdullahi Mohamad & 3 others* [2019] eKLR.
[435] Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943).
[436]Frankel, Laby and Schwing (n 428).
[437]ibid.

Where a broker is inexperienced, the rule still holds as it is presumed that they are not fit enough to make suitable recommendations to the clients.[438]

Other factors that may come into play in the determination of the standard for suitability of a client include duration and stability of the broker-client relationship, the form of remuneration offered to the broker, whether the remuneration is offered for a single transaction or advice given over a period of time and whether or not the client solicited the advice of the broker.[439]

4.3.2 Mandatory Disclosure in the United States

The development of the legal and regulatory framework for disclosure was rather a knee-jerk reaction to the failure of the markets which led to an overvaluation of the stock prices and the subsequent crash with millions of investors' money.[440] The Securities Act, 1933 was therefore the fruit of the knee-jerk reaction.[441] The Act requires that companies wishing to raise funds through public offerings must make full and relevant disclosure of the securities it is offering to the members of the public.[442] Such information should be disclosed in a prospectus that should not only be easily accessible to the potential client but must be adequately informative.[443] This is the position in the Securities Exchange Act, 1934 which requires the same level of disclosure for securities being offered for sale, purchase or exchange on the secondary markets.[444] However, it goes ahead to place a further duty on offers of securities in the secondary markets. This is the requirement that information being disclosed to clients must be fair.[445] The question then shifts to what amounts to fair disclosure?

[438] SEC Exchange Act Release No. 7390, Aug. 14, 1964.
[439] Frankel, Laby and Schwing (n 341).
[440] Kai Werner, 'Justifying Mandatory Disclosure in Contemporary US - Securities Regulation' [2008] Freilaw: Freiburg Law Students Journal 1.
[441] Edmund W Kitch, 'The Theory and Practice of Securities Disclosure' [1995] Brooklyn Law Review 763.
[442] Werner (n 436).
[443] ibid.
[444] 'Regulation FD: 'Fair Disclosure for a Fairer Market Notes' [2000] International Financial Law Review 15.
[445] Stephen M Bainbridge, 'Mandatory Disclosure: A Behavioral Analysis Corporate Law Symposium: Contemporary Issues in the Law of Business Organizations' [1999] University of Cincinnati Law Review 1023.

4.3.2.1 The Materiality and Fairness of Disclosure

Disclosure is termed to be fair if it is not calculated to deceive an investor into taking a course of action that he would not have ordinarily taken were he or she provided with adequate information on the same.[446] Rule 10b-5(2) prohibits brokers from making untrue facts of a fundamental nature to a transaction or the deliberate omission of materially fundamental facts that would remedy the effect of any misleading information. However, it must be noted expressly that fairness in disclosure cannot be taken to mean the best offer that gives maximum returns to a client.[447] Fairness opinions are only at assessing the fairness of the financial terms on offer. Information such as a potential merger between two companies as well as the negotiations for the same, amounts to material information which in all fairness should be easily available to all stakeholders.[448] In order for financial terms to be deemed fair, the Delaware Supreme Court has held that the material statements upon which reliance was based were misleading.[449] Materiality is therefore important in the making of fair disclosure. Rule 408 dictates that in addition to information that is normally disclosed during the registration and in the press statements, issuers are required to make the further necessary statements that in light of the prevailing circumstances would not be interpreted as misleading in any way whatsoever. Information disclosed must give a full account of all material information.[450] In order to determine the materiality of information to a client, the information should be inclusive of the risks, opportunities and the management plans of the organization.[451] This will facilitate forecasting for better decision-making by both current and prospective investors. Furthermore,

[446]Werner (n 436).
[447]ibid.
[448]Kitch (n 437).
[449] Basic v. Levinson, 485 U.S. 224 (1988) (No. 86-279).
[450]Werner (n 436).
[451]Sergio Gilotta, 'The Conflict between Disclosure in Securities Markets and the Firm's Need for Confidentiality: Theoretical Framework and Regulatory Analysis' (Social Science Research Network 2010) SSRN Scholarly Paper ID 1709334 <https://papers.ssrn.com/abstract=1709334> accessed 24 September 2019.

Rule 408 essentially makes it an offence for an issuer as well as a broker to fail to disclose any piece of information that has the ability to impress upon the investor.

Rule 408 further demands that insiders must not use information that is not yet public to trade on the markets. However, it permits insiders to trade with information that despite not having been made available to the public is nonmaterial and cannot influence decisions to buy or sell or exchange a particular financial product for another. The rule can simply be referred to as the disclose-or-abstain rule.[452]

4.3.3 The Agency Problem and Conflict of Interest

The Agency problem as defined in the preceding chapter can be attributed to the existence of imperfect market conditions such as imperfect competition and information asymmetries.[453] Despite repeated calls that the promotion of corporate governance and market discipline for financial intermediaries, the agency problem has continually been exploited by financial intermediaries.[454] This is usually done despite the existence of a fiduciary relationship between the intermediaries and the clients which requires that agents must act in good faith and in the best interest of the principal.[455] Furthermore, the agent must act only within the scope of the authority given to him/her by the principal or where such authority was not given, the principal has ratified the actions of the agent.[456] However, the blatant disregard for the principles of that govern the agent-principal relationship necessitated the enactment of the US Gramm-Leach-Bliley Act of 1999.[457] This Act initially was thought to have torn down all the structural barriers that created loopholes for agents to exploit to their advantage at the expense of the principal.

[452]Kitch (n 437).
[453]Reena Aggarwal, Nagpurnanand R Prabhala and Manju Puri, 'Institutional Allocation in Initial Public Offerings: Empirical Evidence' (2002) 57 The Journal of Finance 1421.
[454]ibid.
[455]Roy C Smith and others, *Governing the Modern Corporation: Capital Markets, Corporate Control, and Economic Performance* (Oxford University Press, USA 2006).
[456]ibid.
[457]Meir Statman, 'Regulating Financial Markets: Protecting Us from Ourselves and Others' (2009) 65 Financial Analysts Journal 22.

The shortcomings of the Act have been that the indictment of stockbrokerage firms, the directors and employees, do not augur well for the financial markets as it may lead to undesirable consequences such as systemic risk.[458]

The hostile market conditions such as imperfect competition and information asymmetry have provided a fertile breeding ground for conflict of interest where stockbrokers are forced to either advance their own personal interests or flee from the market.[459]

4.3.3.1 Reining in rogue Intermediaries

Over and over again, it has been argued that the promotion of corporate governance, mostly the promotion of market transparency and efficiency, is the surest way towards protecting investors from rogue financial intermediaries.[460] This is grounded in the argument that the continued existence of information asymmetries and cost related with market inefficiencies are to blame for the continued existence of conflicts of interests in the financial markets.[461] In the United States, the regulation and periodic monitoring of the activities of licensees has been the preferred response in reigning in such financial intermediaries. The US Gramm-Leach-Bliley Act of 1999 and the Securities Exchange Commission's Regulation FD (Fair Disclosure), 1999 have been instrumental in the regulation of information asymmetries.[462] During such periodic monitoring, the regulator seeks to assess regulatory compliance with laid-down requirements such as mandatory disclosure.[463] In circumstances where such periodic monitoring and the requirement of a 'daily transactions ceiling' do not yield results, the regulator has tended to resort to external control mechanisms through the development of segment specific regulations

[458]ibid.
[459]John R Boatright, *Finance Ethics: Critical Issues in Theory and Practice* (John Wiley & Sons 2010).
[460]Amar Gande, Manju Puri and Anthony Saunders, 'Bank Entry, Competition, and the Market for Corporate Securities Underwriting' (1999) 54 Journal of Financial Economics 165.
[461]ibid.
[462]Björn Fasterling, 'Development of Norms Through Compliance Disclosure' (2012) 106 Journal of Business Ethics 73.
[463]ibid.

and the enforcement of mechanisms to promote internal control and discipline from the intermediaries through the creation of incentive structures and further compliance initiatives.

4.3.3.2 Regulatory constraints on rogue intermediaries

Fully aware that regulations developed for the financial services sector must be aimed at the promotion of efficiency in the markets, the Securities Exchange Commission has constantly endeavoured to create conducive atmosphere for financial service providers. This is done through ensuring that regulation does not go beyond the goal of promoting market efficiency, the prevention of systemic risks and the protection of investors. However, it places an obligation on the intermediaries and other stakeholders themselves work to realize efficiency in the cost of their operations and generation of revenues during each financial year.[464] Through such mechanisms firms have to work harder to ensure that they do not fall below the standards set by the SEC.[465]

Another mechanism through which the SEC reins in rogue brokers is through the establishment of SROs. Such organizations develop rules and regulations that govern the operations of their members and rogue members are easily identified and dealt with through this self-regulation mechanism.[466] Stakeholder in the banking, securities, insurance and other financial services are therefore responsible for taming rogue players and the regulator plays just an observer role and holding the SROs to account. This is one of the most effective ways of eliminating market abuses and creating efficient markets as the stakeholders are keen on maintaining the integrity of the markets for the sake of the entire industry.[467]

[464]Ingo Walter, 'Conflicts of Interest and Market Discipline Among Financial Service Firms' (2004) 22 European Management Journal 361.
[465]Smith and others (n 364).
[466]Walter (n 460).
[467]ibid.

4.4 Lessons Drawn from the US Responses

There are quite a number of lessons to be drawn from the comparative study:

i) It is high time to introduce voluntary disclosure and move away from the rigidity of the dictates of mandatory disclosure.

ii) A definition of the parameters of the suitability rule would go a long way in protecting both investors and stockbrokers.

iii) There ought to be a framework for the introduction of relevant disclosure and not just blanket requirement of disclosure to be filled in by the stockbrokers.

iv) The Capital Markets Authority should develop a plan to increase listings in the capital markets.

v) There should be developed a system of compliance and incentives to reward compliance with the legal and regulatory framework.

vi) The CMA should work on promoting market discipline through facilitating ease in the creation of SROs in different parts of the country.

4.5 Conclusion

The regulation of the securities markets in the United States has gone through a series of transformations which has generated key lessons for the development of financial markets the world over. It is for this reason that even the challenges that appear new to the Kenyan capital markets are old problems dating back to at least four decades ago. This, therefore, proves that the United States of America’s regulation of securities’ markets may prove to be the solution to the challenges beleaguering the operations of stockbrokers in Kenya.

CHAPTER FIVE: FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter is a conclusion of the study and includes recommendations on how the legal and regulatory framework governing the operations can be transformed for better. This study, therefore, makes a list of recommendations for the betterment of the services offered by stockbrokers and the protection of investors who have to relied on those services.

5.2 Findings

The study uncovers that the stockbrokers have certain challenges, ranging from insufficient or unsuitable regulatory frameworks to a failed corporate culture. The challenges arising from the seemingly inadequate regulations may be attributed to the fact that some are unenforceable, others are vague, while some may not conform to real problems evident in the securities industry.

The regulations do not adequately address the issue as to the relevance of information disclosed to the investors by stockbrokers. It is discernible from the study that the duty imposed upon the stockbrokers to adduce all relevant information to the investors do not per se guarantee that such information will be of value to the investors. The reason being that often, the disclosed information is generally complex, for instance in the publication of the stockbrokers' financial statements in national dailies vis a vis an investor's interests in sound financial advice on available securities for investment with high returns. The regulations thus fail to categorically and concisely state the nature of information, in terms of clarity, simplicity, that ought to be given to an investor for purposes of making an appropriate and informed investment decision.

Moreover, the disclosure requirement appears to be discriminatory, and leans more towards the protection of the investors as opposed to the stock brokerage firms. This is notwithstanding the fact that in order to be effective, the Capital Markets must embrace a balanced protection of both the investor and the stock brokerage firms. The information that a particular firm may disclose may have far much consequences to the firm, to the extent of outweighing potential benefit that the investors would have gained. Summarily therefore, it fails to strike any balance between the competing interests especially with regard to the publication of the stockbrokers' financial statements.

The agency problem and the conflict of interest is a challenge in the Capital Markets because there is often a compelling temptation on the part of the stockbrokers to engage in churning activities. As the study postulates, it is the desire to gain more commissions that drives the stockbrokers to indulge into unnecessarily excessive transactions. This arises due to the failure by stockbrokers to comply with the existing conduct of business requirements and corporate governance, which if effected, may discourage them from indulging in unnecessarily excessive trading in the investors' accounts.

The regulations require that stockbrokers only offer suitable investment advice to the investors. However, there is a gap in assessing the suitability of the information provided to the investors in relation to the nature of the investors' needs, financial position and desired outcome of the investment.

5.3 Conclusion

This study proceeded on the hypothesis that the current legal and regulatory framework governing the activities of stockbrokers poses a lot of challenges to stockbrokers. The study has managed to prove that to be true by identifying the problematic areas of the law. These included the applicability and the parameters of the suitability rule in Kenya, the agency problem that constantly puts stockbrokers in a position where they are conflicted between advancing their interests or those of the clients and the rather vague disclosure requirements.

The best practices of the regulatory framework of the United States regarding these challenges has proved instrumental in providing a basis by which this study intends to make recommendations for the reform of the laws on stockbrokers.

5.4 Recommendations

This section of the study endeavors to make both short-term and long-term recommendations in a bid to chart the way forward in terms of improving the legal and regulatory framework governing the operations of stockbrokers in Kenya.

5.4.1 Short-Term Recommendations

The existing regulatory framework has an overload of information on the part of the securities brokers. This has the inevitable effect of ultimately burying information that would otherwise be relevant to investors. In the alternative, the regulations should focus more on the provision of only relevant information. Again, this may be further buttressed by requiring the Capital Markets Authority to develop a disclosure requirement checklist for companies listing in the financial markets.

The regulatory framework has proved to be biased against the financial intermediaries. As at the moment, the current requirements of disclosure is to a large extent inclined towards guaranteeing protection to investors so as to enable them make rational decisions. This inevitably leads to the exclusion of the interests of brokers. The regulation should be reformed to encompass both the underlying interests of the two parties, otherwise, the disclosing broker risks harming their firms' competitive place in the capital markets.

The mere fact that information has been disclosed does not guarantee that the investors shall obtain successful investment plans. More has to be done beyond mere disclosures to investors. Therefore, the regulation ought to ensure that disclosure embraces the virtues of clarity and simplicity, or on the other hand, require brokers to perform interpretive role. It is unbalanced to relay to an investor, especially individual investors, complex information, whilst acting in the disguise of disclosure requirement. Without making such information simple and clear, it amounts to failure to disclose.

Selective disclosure should be incorporated by either completely withholding the information or causing the release of the information to be delayed for a while. This may be of value especially in the event where the information has the potential of affecting the ability of the firm to generate revenue. This comes in handy by being cognizant that some disclosure may be used by competitors, which may have the overall effect of stunting some stockbrokerage firms.

On the alternative, there ought to be established certain parameters, within a regulation, then acts as a guideline in determining what number of transactions a stockbroker can carry out in an individual investor's account. Otherwise, the vice of churning may continue. .

The Authority should consider developing a system of incentives that will reward stockbrokers who comply with the rigors and requirements of the legal and regulatory framework. This is because there are already in place sanctions against stockbrokers and this has not in itself deterred them from abusing their fiduciary duty. In fact, by employing incentives, there would be enhanced desire among the stockbrokers in abiding by the dictates of the law.

5.4.2 Long-term Recommendations

The challenges identified in this study touch on virtually all the operations of stockbrokers. This study argues that the provisions for the protection of investors in the capital markets were speedily developed. It is for this reason that a review of these laws becomes necessary.

The entire legal and regulatory framework must be reviewed in order to clear the ambiguities that are apparent because of the failure to define the parameters of the suitability rule and the disclosure requirements. The Authority must work round the clock to develop the parameters of what a suitable transaction would be to a potential client. It must also see to it that the parameters of disclosure are identified.

The Authority should consider introducing a system of mandatory disclosure with incentives and policy directives such as ‘comply or explain’ that makes it beneficial for stockbrokers to comply.

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