

**INVESTOR PROTECTION IN KENYA: AN
EXPOSITION INTO THE LEGAL REGIME AND
POLICIES FOR THE PROTECTION OF
INVESTORS IN THE STOCK MARKET IN KENYA.**

BY

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DEDICATION

Mum and Dad

**You have strengthened me with your prayers,
blessed me with your love and encouraged me
with your hope.**

“I’ll give thanks to God always for you”

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INTRODUCTION

1.1 STATEMENT OF THE PROBLEM

The realm of investment covers many things, art, machinery, stock, and bonds among a multitude of others. Some people even consider marriage to be an investment. Practically investments can be broadly classified as real and financial. Real assets are a physical commodity or a tangible asset such as land, building or a car. On the other hand a financial asset represents a claim in money terms on some other economic entity. Finance was recognized by early economist as the most significant catalyst to economic development. The late Indra Gandhi a former prime minister of India was asked upon her visit to an African nation what she considered the most important aspect of her countries development. Without hesitation she replied 'finance'. She explained that any country that loses control over its financial status loses its sovereignty.

In this study our focus will be aligned to financial securities or investing in the stock market.

Stock market investment is not a deeply entrenched culture in Kenya. Investment is viewed to be very risky. It is seen more as a speculative venture or preserve for sophisticated investors, rather than as a long-term investment and savings in financial assets. This is a major problem as to why very few people invest in the stock market.

In this dissertation I seek to define financial markets and explain its constituents. The core of it is to critically make an analysis of the legal frameworks and policies in Kenya that seek to protect an investor who has ventured into such a market. An analysis shall be made on the various statutes and other laws put in place to secure the investors interest. A

comparison of such laws and those adopted by other developed and developing countries shall also be made for purposes of coming up with comprehensive recommendations to ensure that an investor is adequately protected.

1.2 JUSTIFICATION OF THE STUDY

African stock markets are emerging markets. Specialists believe that these are the last undiscovered stock markets in the world. They also believe that most African economies have performed so poorly since they gained independence from European colonial powers and so their economies will have to boom with time. Recently Ghana's stock market rose by 80% in one year and that of Kenya doubled. It is believed that it is just the beginning of even greater performance from Africa's fledging stock markets. The change in world politics since the collapse of communism has created a background opportunity within African Capital markets.¹ As a result since the mid 1980s many states Kenya been one of them, have undertaken programs designed to strengthen their economies, moving then away from central planning and towards a more conventional capitalistic model. Kenya presently aims at promoting the commercial and industrial sector and a slight backward truck on heavy reliance on the agricultural sector. Having in mind that investment into the commercial world carries with it a bundle of advantages which advantages include: that a person can be able to spread his or her risk; it is easier using such securities as collaterals for getting loan from banks; in Kenya taxation on capital gains has been suspended; there is no further tax on dividends after withholding tax; shares are easily divisible as compared to other real assets like land; it is only a small

¹ Nic Olderft e.d African Stock Market Exchange Handbook 1999. Profile Media Johannesburg 1999

percentage of the Kenyan population who trade in the stock market. Among the reasons why people do not venture is the fact that they lack an understanding on how the market operates and lack of a full force front push from the government.

The fundamental question that this paper seeks to answer therefore is whether the legal provisions, which underpin the vast categories of securities adequately, protect the investor. Hence this paper shall identify the laws and make an analysis for purposes of identifying whether they have attained their goal and what could be done to improve them.

CHAPTER ONE

INVESTMENT CLASSIFICATION IN FINANCIAL MARKETS

2. I INVESTMENTS

The investment Promotion Centre Act² defines an investment in **Section 2** as the purchase of shares, bonds, land, property rights which gives the purchaser certain claims to the income produced by the shares, bonds and property rights.

Investments could be broadly classified as money markets, capital markets or derivative markets. The purpose of discussing these categories is to look at the options to an investor in the financial markets and to understand the characteristics of the various options.

2.1.1 MONEY MARKET SECURITIES

Money market securities are short term, low risk, highly liquid securities that offer yields to the investor³. Although this short term securities are attractive investments because of their relatively low risk, their yields are usually lower than other fixed income investments with longer maturity.

The feature common to many market securities is that they pay interest to their investors by selling at a discount from their principle value. Investors who opt to invest in the

² Chapter 485 of the Laws of Kenya

³ R. STEPHENS SEARS, investment management, the Pyden Press, Harcourt Bruce College Publishers Pg 38

money market would have to consult various financial institutions, which include the central bank of Kenya, commercial banks and Savings and Credit Cooperative Organizations.

The categories of money market securities are:-

2.1.1.1 TRESURY BILLS

These securities are non interest bearing and are sold in principal amount denominations of KSH50,000 , KSH 100,000. They are issued at a discount from their face value. The amount of the discount is determined through bill auctions conducted by the treasury.

They have maturity periods of 91 and 182 days.

2.1.1.2 COMMERCIAL PAPERS

A commercial paper is a short-term unsecured promissory note issued mainly by large and most financially secured firms. Commercial papers are issued by corporations rather than by the treasury. There is an element of default risk that is not present in treasury bills. However, for commercial papers this risk is minimal because of this extra risk element, commercial papers generally carry a yield that is slightly higher than that of treasury bills.

2.1.1.3 BANKERS ACCEPTANCES

This is a promissory note whereby the borrower promises to repay borrowed money to the bank that holds the note. It is a security that is created when the bank accepts responsibility on behalf of the borrower to repay the investor. As such, the bank in the event of default by the borrower protects the investor. A banker's acceptance is often preceded by a written promise by the borrower. They are short-term, and are issued at a

discount. These instruments are held by the accepting bank and are sold through dealers or placed directly with investors.

2.1.2 CAPITAL MARKETS

This represents both the markets for long-term securities and long-term funds. Examples of long term funds include government bonds, debentures, shares, warrants and options while examples of long-term funds includes leases and mortgages. Our main concern in this paper will be geared look at the categories of long-term securities.

Key players in this market are financial institutions like banks insurance companies and the Central Bank of Kenya. Most of these institutions if public float their shares at the stock exchange where investors can buy and sell. The Nairobi Stock Exchange is governed through the Capital Markets Act.

2.1.2.1 BONDS

A bond is fixed income investment for which the issuer promises to pay a fixed amount of interest periodically and to repay the principal or par amount at the maturity date of the bond. Interest on bonds is normally paid on a semi annual basis.

Institutions that issue bonds include, the government and commercial banks.

2.2.2.2 STOCK

Section 2 of the **Companies Act**⁴ refers to a share as ‘*a share in the share capital of a company*’

⁴Cap 486 Of the laws of Kenya

In *Borland's Trustee V.S Steel Brothers and Company*,⁵ Farwell J makes a more definite definition as follows:-

“a share is the interest of a shareholder in the company, measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all shareholders interest in accordance with the Company's Act. The contract contained in the Articles of Association is one of the original incidences of the share. A share is not a sum of money but an interest measured and made up a various rights contained in the contract, including the right to a sum of money of a more or less amount.”

Stock is ownership in a company, with each share of stock representing a tiny piece of ownership. An investor will derive a wide range of advantages which will vary depending on what category of stock he or she invests in. The most common category of stock are:-

a) Preferred stock

Are also referred to as preference shares. It is a mercantile phrase which denotes a class of shares which have some preference over other shares. This usually arises from a provision expressly given in the company's Articles of Association or in the terms of issue of the shares to receive an annual dividend of a fixed amount before any dividend may be paid on ordinary shares or any other class of shares.

Preferred stock promises guaranteed dividends and a claim on the companies' assets that is above that of common shareholders. A limitation to making such an investment would be that the investor cannot vote or share other specified rights in the company.

There are three categories of preferred stocks these are:-

⁵ (1901) 1 CH 279 pg 288

a) ***Cumulative preferred stocks***: this accords its owners a continuous claim to his or her dividends. Any unpaid dividends accumulate until the corporation resumes paying them. Since the cumulative preferred owner is entitled to all past and present dividends, he or she is paid before common shareholders once payment is resumed. If the board suspends dividends, the shareholder still has a claim on them.

b) ***Non-cumulative preferred stocks***: it does not confer a steady claim on dividends in the event of a dividend suspension. Shareholders of this type may not be paid any missed dividends prior to payments being made to the common shareholders.

c) ***Convertible preferred stock***: this may be converted to a certain number of shares of common stock. An investor who wants to share in the appreciation of the company's common stock may find this option attractive.

Preferred stock sometimes referred to as a hybrid security because in some ways it resembles a bond and in other ways it resembles common stock. Regarding its bond like characteristic, the word preferred is derived from the fact that preferred shareholders have priority over common stockholders in the event of the company's liquidation or bankruptcy. In addition, when dividends are paid to its preferred stockholders and common stockholders, preferred stock holders receive their dividends first.

b) Ordinary share capital

Investors of ordinary shares are the owners of the company and are entitled to share the company's profits, which remain after the dividends have been paid on other classes of shares. The dividends paid are not limited but vary according to the company's profits.

Dividends may be paid either in form of cash, stock or property. An investment in ordinary share capital confers unto the investor the power to control the company since he has voting rights. During the winding up of the company, ordinary share holders are paid last. This is one major disadvantage.

A person investing in shares is allowed to transfer his shares. **Section 75** of the Companies Act provides that the shares of any member in a company ‘shall be movable property transferable in a manner provided by the articles of the company. A restriction in transferability was seen in *Smith v Fawcett LTD*⁶ where **Lord Green M.R** said as follows:-

“One of the nominal rights of a shareholder is the right deal freely with his property and to transfer it to whomsoever he pleases. When it is said... that regard must be had to this last consideration, it means, I apprehend nothing more than the shareholder has such *prima facie* right and this is not to be cut down by uncertain language or doubtful implications. The right, if it is to be cut down must be cut down with satisfactory clarity. If certainty does not mean that articles, if appropriately framed, cannot be allowed to cut down the right of transfer to any extent which the articles on their true construction permit.”

2.2.2.3 DEBENTURES

There is no legal definition of a debenture. In *Levy v Abarcorris Slate and Slab Company*⁷ Chitty J state that he could not find any precise legal definition of the term debenture and went to observe that the word,

‘Is not either in law or commerce, a strictly technical term or what is called a term of art.’

With the passage of time the word debenture acquired the meaning it generally has today, namely a document issued by a registered company to acknowledge or evidence an indebtedness. In *Edmunds v Brown and Tilland*⁸ it was said that the term itself imports a debt or an acknowledgement of a debt.

The legal relationship between a company⁹ and its debenture holder is simply the contractual relationship of debtor and creditor, coupled, if the debt is secured on some or all of the company's assets, with a shareholder, the debenture holder is in law not a member of the company having the rights in it but a creditor having rights against it.

Section 2 of the companies act defines a debenture as including debenture stock, bonds and any other security of a company whether constituting a charge on the assets of the company or not. This definition is not very elaborate.

Debentures can be categorized as follows: *convertible or non convertible*, the former contains an option which enables the holder to convert his debt within a stipulated period of time into ordinary shares or preference shares of the company at stated rates of

⁷ (1887) 37 CH pg 260

⁸ (1968) 11ev 237

⁹ the word debenture is not restricted to securities of companies or body co-operate clubs not infrequently issue debentures and the name may even be applied to bonds issue by individuals

exchange but not below the par value of the share. With the latter this option is not available. It remains a debenture forever; *redeemable or irredeemable*, the former may be bought back by the company within a stipulated time whereas with the latter, it becomes payable at the winding up of the company; *Registered or Bearer*, the registered debenture is issued to the registered holder in whom it vests. It is transferable by the execution of an instrument of transfer by the parties. The bearer debenture is issued to the bearer in whom it vests. It is a negotiable instrument transferred by mere delivery; *Secured or naked*, the secured debentures contain a charge on the assets of the company. It may be secured by either a fixed or floating charge¹⁰ or both. The distinction between the two charges was highlighted in extension by **Lord MacNaughten** in the *Illingworth V Houldsworth Case*¹¹

“ A specific charge is that which, without more, fastens on ascertained or defined property or property capable of being ascertained and defined.. a floating charge, on the other hand, is ambulatory and shifting in nature, and hovering over, and so to speak floating with the property which causes it to settle and fasten on the subject of the charge within its reach and grasp”

2.4. DERIVATIVE MARKETS

A derivative security is an investment whose value is primarily dependent on the value of another security. The security to which the value is tied is usually referred to as the underlying security. Since these securities cost but a fraction of what the underlying security costs, the investor has a considerable amount of leverage in those instruments.

¹⁰ The floating charge is only available to companies and not any other form of business organization

¹¹ (1904) A.C 355

However, because these derivative securities are such low cost investments, their values can fluctuate considerably thus making them the riskiest of all financial assets.

The instruments in the market represent a **forward transaction**¹². These markets have been growing enormously recently. Competition in this exploring market is fierce.

Exchanges in different countries compete with another as the market becomes increasingly globalized.

In Kenya the derivative market is not well established and only a few people put their money in this market. There are three categories of instruments in this market. These are:-

2.4.1 FUTURES

A future is a legally binding contract to deliver or take delivery of a given quantity of an underlying asset at a fixed price on a specified date.¹³ Thus a future engages a right and an obligation. It is different from an option which is the right to buy or sell a given quantity of an underlying asset at a fixed price and is normally exercisable at any time up to a specified date. The underlying asset of a future may be any commodity, currency, and abstract financial instruments.

An example of a futures contract is where the buyer of a treasury bill futures contract, with the delivery price of 90 agrees to buy Ksh 50,000 (face value) in treasury bills for a price of Ksh 40,000 beginning on the security date which is about three days following the last day of trading in the contract. Similarly the seller in this contract agrees to deliver 50,000 at a price of 40,000 on the delivery date.

¹² transactions in which two parties agree to advance on the terms of a trade to be executed later

¹³ MIER KONN, Financial Institutions and Markets.

warrant.¹⁵ This enables the holder of the warrant to have the opportunity to participate in the growth of the firm either by holding on to the warrant or by purchasing the stock through exercise of the warrant.

Warrants are characterized by several features. First, warrants have a limited life over which they can be used. Most warrants will be usable for at least 2 year, although some are perpetual and have no maturity.

Second, most warrants are tied to a specific common stock and are issued by the company. Any stock purchased via the warrants is purchased through the company.

Third, most warrants are distributed with new bond issues as sweeteners to attract purchasers of the firm's bond. The warrants, in turn, often enable the firm to issue the bonds at a lower yield, thereby lowering the firm's interest costs.

Fourthly, although the common stockholders may receive dividends, warrants do not pay dividends nor do they carry voting rights. It is not until warrants are exercised by the owner that these rights come.

Fifth, although warrants may have been originally issued to bondholders, these securities are assets that can be bought and sold as separate securities therefore the investor has liquidity with this securities. Finally, the warrant's value is a function of the underlying stock's price, along with other variables. As the price of the stock goes up (down), the value of the warrant goes up (down) all other things been equal.

¹⁵ R, STEPHEN SEARS, investment Management, the Dryden Press p.g 125-126

2.4.4 OPTIONS

There are two types of options calls and puts.¹⁶

A **Call Option** gives the right holder the right to buy a certain amount of an asset at a specific price over a defined period of time.¹⁷ The amount of the asset that can be purchased depends on the asset involved. For example, for individual common stocks, the holder has the right to purchase 50 shares of the underlying common stock. An individual who buys a call option has the right and not the obligation, to purchase the asset according to the terms of the option. The seller of a call option has the obligation to sell the asset and this obligation receives a selling price for the option, sometimes called the option premium.

A **Put Option** on the other hand gives its holder the right to sell a certain amount of an asset for a specific price during a defined period of time. For example, for common stocks, the holder of a put option has the right to sell 50 shares of the underlying stock. An individual who buys a put option has the right, but not the obligation, to sell the asset according to the terms of the contract. The seller of a put option receives a premium for the sale and takes on the obligation to buy the asset.

While options appear to be very similar to warrants, these two securities differ in many respects. The term of maturity for options is much shorter than that of warrants. Unlike warrants they are typically issued by a particular corporation, puts and calls are bought and sold among investors. Finally, whereas most corporations issue warrants that have a

¹⁶ supra

single exercise price and maturity date, investors in options can choose among many available exercise prices and maturities.

With a clear understanding on the various categories of investments that are open to an investor and the advantages that accrue from these categories it is my view that the investor needs to be protected to safeguard his interest and to make him a more vigorous participant in this sector. A discouragement in an investment will definitely drive out such a person from imputing his savings in such a sector and in the long run it leads to the decline in the countries economy.

CHAPTER TWO

JUSTIFICATION FOR PROTECTION

2.1 HISTORY TO THE NEED FOR PROTECTION

In the words of **Louis Ross** in his book *Fundamentals of Security Regulations* says

‘The problem at which modern securities regulation is directed is as old as the cupidity of sellers and gullibility of buyers.’

The justification of protection could be traced to the South ^{COA} Company Incorporated in 1690 with a monopoly to trade in the South America and Pacific Islands. There was a problem in ¹⁷²⁰ 1920 ruining the investments of many. The South Bubble saga demonstrated the danger of lack of regulation and the **South Bubble Act** was enacted and was intended to curb such excesses.

Under the statute recitals, persons who continued or attempted such dangerous and mischievous undertakings or projects under false pretence were liable to penalties. It was unlawful to open books for public subscription and draw in many and worried persons to subscribe their in sums of money.

The statute prohibited the use of force and or irregular charters and taking of subscriptions for such enterprises. Such matters were declined to be of public nuisance subject to penalties and forfeitures. Brokers trading in such unlawful shares were liable to lose their licenses while traders and merchants whose businesses were injured by such unlawful organizations were entitled to sue for damages.

The South Bubble Act gradually withered away and was repealed in 1844. The **Joint Stock Company Act** enacted the first modern prospectus requirement. The statute

provided for the principle of Compulsory disclosure through registration of corporate securities. Subsequently, the **Directors Limited Liability Act 1870** was enacted to modify the common law. In Kenya the Capital markets Authority is the Main regulatory body. The Companies Act also plays a major role in the protection of investors and regulation in general. The rules of equity also act as a source of law. The specific provisions will be considered in the next chapter.

3.2 Case for Security Regulation and Investor Protection

Regulation should pervade every financial activity. Security market participants like brokers should be subject to both stock and the Kenyan Government regulation. In the United States they are subject to both state and federal regulation through the so called blue sky laws that were generally put in place after the 2nd world war. In *Hall v Guinea Jones Company*¹⁸ the term blue sky's was said to have been derived from a famous citation that refers to speculative schemes which have no more basis than so many feet of blue sky.

Investors are entitled to limit their liability or loss of amount invested in companies or other institutions. Regulation is important to make securities fully marketable through maintenance of capital principles to prevent shareholders from withdrawing their capital from companies. A market is necessary where these securities can fully be traded and investments deposited. Raising of business capital and trading in securities are the

¹⁸ 242 US 539 (1977)

principle purposes of public stock exchange by making shares and other securities marketable.

The stock exchange facilitates investments and hence the growth of commerce and industry. For a stock exchange to operate effectively there ought to be adequate liquidity in a sufficient number of transactions accordingly to enable their market price to be ascertained and facilitate day-to-day transactions at an appropriate price.

Market price ought to be established on the basis of undisturbed supply of demand though regulations ought to penalize persons who maneuver the price artificially by misrepresentation or creating an impression of active trading. Holders of identical securities should be equally entitled to the same price for their shares. Demand for individual securities ought to be perpetually stimulated by ensuring that investors have equal access to full information about the company to enable an investment decision at an appropriate price to be made thus when shares are offered to the public, a prospectus has to be issued freely providing a range of specified information to enable prospective investors decide whether or not to apply for the shares.

Regulations ensure the flow of capital and facilitate investor protection since investors must be put in a position where full and accurate information is available to them to facilitate decision-making.

There are two primary requirements for the protection of the interests of investors in financial assets. The first is to ensure that financial markets operate as efficiently as possible without favour or bias. The second requirement is to prevent investors and market traders being the victims of fraudulent practice.¹⁹

¹⁹ ANDREW ADAMS, *Investment Banking and Finance Series*

No market can operate efficiently without a large measure of trust between buyers and sellers.

Trust may be created either by law, custom or tradition or some combination of both.

Whatever system of regulation and supervision is in place, it has to be seen to be effective in dealing with malefactors if the essential ingredient of trust is to survive. In Kenya this is achieved to some extent through the Capital Markets Act²⁰ It defines the stock market in **section 2** as a market, or other place at which, or a facility by means of which, offers to sell, purchase or exchange securities are regularly made; or information is regularly provided concerning the prices at which the securities are to be sold, purchased or exchanged.

Under **section 11** of the Act it outlines some of its objectives to include, the development of all aspects of the capital markets, the creation, maintenance and regulation of a market in which securities can be treated in an orderly, fair and efficient manner. There is an incomparable legacy of trust in Kenya's financial markets despite recent cases of fraud. These objectives are realisable only if every market player plays his role diligently and with the aim of developing a strong stock market.

Professor Gower²¹ shows the system of investment to be dependent on disclosure of information rather than on any rigorous system of supervision statutory or otherwise.

Regulation may be called for, for various reasons. One major reason is Informational Efficiency. Efficient security markets reduce the costs of lending and of trade risk. They

²⁰ CHAPTER 485A of The Laws Of Kenya

²¹ in his book Principles of Modern Laws a Stevens & Sons Publication 1979

result in more lending and consequently greater productivity for the economy as a whole. The three conditions for efficiency are comparative pricing, minimization of risk and integration.²²

Market forces promote the satisfaction of those conditions. Inefficiencies create profit opportunities; exploiting these profit opportunities tend to eradicate the inefficiencies.

Beyond facilitating lending and trade risk securities markets make an additional contribution to the productivity of the economy. They provide price information, finding a fair price for securities, which benefits those buying and selling the security. A security market exhibits informational efficiency if the prices it generates accurately reflect prevailing information. There are several different levels of informational efficiency:

- A market displays weak informational efficiency if current prices reflect all information contained in the record of past prices.
- A market displays semi strong informational efficiency if current prices reflect all generally available information.
- A market displays strong informational efficiency if current prices reflect all information, even if that information is not generally available. Traders have a strong incentive to gather the best information they can and to trade on it. The lower the cost of trading in the market, the greater will its informational efficiency. If trading is expensive investors will not find it profitable to trade.

The second reason why regulation is of ^{utmost} utmost importance is for purposes of protecting the investor. Such an investor is less well informed than market professionals and is therefore in danger in being cheated. The idea that trade is beneficial rest on the assumption that buyers and sellers know what they are doing. This assumption fails when

²² MIER KONN *financial Institutions and Markets* p.g 125-126

one of the parties is much better informed than the other. This situation is called asymmetric information. It may be as a result of difference in expertise. The average investor is less well-informed and less financially sophisticated than large financial institutions and is therefore at a disadvantage in trading in the stock market.

Investors should be protected from misleading manipulative or fraudulent practices, including insider trading, front running or trading ahead of customers and the use or misuse of clients assets. Where a breach of the law occurs, investors should be protected by strictly enforcing the law through procedures and courts. Full disclosure of information material to investor's decisions is the most important means of ensuring investor protection. Investors are thereby able to assess the potential risks and records of their investments and thus to protect their own interests. Risk is an inherent part of investing. Generally investors must take greater risks to achieve greater returns. Those who do not tolerate risk very well have a relatively smaller chance of making high earnings than do those with a higher tolerance for risk. There are various levels of risk this are:-²³

- **PERSONAL RISKS:** this category of risk deals with the personal level of investing. The investor is likely to have more control over this type compared to others.

-Timing risk is an example of this. It refers to buying the right security at the wrong time or selling the right security at the wrong time.

²³ Internet

-Tenure risk also fall here which refers to the losing of money while holding onto the security. During the period of holding, markets may go down, inflation may worsen or a company may go bankrupt.

- **COMPANY RISK:** there are two common risks on the company level.

-financial risk is the danger that a corporation will not be able to repay its debts. This has a greater effect on the bonds, which finance the company's assets. The more assets financed by debt, the greater the risk. Studying financial risk involves looking at a company's management, its leadership style and its credit history.

- Management risk which is the risk that a company's management may run the company so poorly that it is unable to grow in value or pay dividends to its shareholders. This greatly affects the value of its stock and the attractiveness of all the securities it issues to investors.

- **MARKET RISKS:** Fluctuation in the market as whole may be caused by the following risks:-

- Market risk, which is the chance that the entire market will decline , thus affecting the prices and values of securities.

- Liquidity risk is the risk that an investment, when converted into cash, will experience loss of value.

-Interest rate risk is the risk that interests will rise, resulting in a current investment loss of value.

-Inflation risk is the danger that the shilling one invests in will buy less in the future because prices of consumer goods rise. When the rate of inflation rises, investments have

less purchasing power. This is especially true with investments that earn fixed rates of return. As long as they are held at constant rates, they are threatened by inflation.

-Reinvestment risk, is the danger that reinvested money will fetch returns lower than those earned before reinvestment. Individuals with divided reinvestment plans are a group subject to this risk.

- ***NATIONAL AND INTERNATIONAL RISKS***

National and world wide events can have profound effects on investment markets.

Economic risk is the danger that the economy as a whole will perform poorly.

When the whole economy experiences a downturn, it affects stock prices, the job market, and the prices of consumer products.

-Industry risk is the chance that a specific industry will perform poorly. When problems plague one industry, they affect the individual business involved as the securities are issued by those businesses. They may also cross over into other industries.

-Tax risk is the danger that rising taxes will make investing attractive. In general, nations with relatively low tax rates are popular basis for investing. Businesses that are taxed heavily have less money available for research, expansion and even dividend payments.

-Political risk is the danger that government legislation will have an adverse effect on investment. This can be in the form of high taxes, prohibitive licensing, or the appointment of individuals whose policies interfere with investment growth. Political risks involve wars, changes in government leadership and political motivated embargoes.

With a clear picture of the major risks that are involved in investing it is my view that the investor should be endowed with a wide range of protection to ensure that his interests are protected for the ultimate growth of the economy as a whole.

Government intervention may be justified to ensure that small investors get a fair deal.

The first requirement of a fair deal is that securities trade at a fair price. One reason they might not do so is that better informed traders might sell securities for more than they are worth or buy them for less. For example, issuers might mislead investors about potential risks and returns or insiders knowing that a company is doing better than generally believed, might buy its securities.

Another reason the price of a security might not be fair is manipulation of the market.

Market prices respond both to new information and imbalances of liquidity. It may be manipulated by either channel misleading information or information can be released with the deliberate aim of causing the price to rise and fall. Or a trader can buy a large part of a particular issue to create an artificial security that drives up its price. This is referred to as a squeeze or a corner.²⁴ A fair market price is not the only requirement for a fair deal. Small investors do not trade in the market themselves. They delegate the task to professionals. These professionals are in a position to abuse this trust. For example, a broker can trade a customer's account exclusively to generate commissions. In practice this is referred to as chunning²⁵

²⁴ Refers to the creation of an artificial liquidity imbalance designed to raise the market price of assets.

²⁵ The unjustified trading of customers account by a broker to generate commission for the broker.

The problem facing the investor could be solved through government intervention and self regulation. While cheating promises profits in the short run, providing the investor with a fair deal promises profits in the long run. Individual brokers or issuers can reap short run gains for themselves by cheating investors but the whole community of brokers and issuers will suffer from the consequent loss of faith in the market. Small investors will be more likely to trade in the interests of market professionals to ensure that investors are indeed treated fairly. Market professionals should get together to enforce standards on all market participants. Codes of conduct have been put in place. Various institutions have also been put up through which investors can delineate their investments in securities examples include life insurance companies, pension funds and mutual funds.

The underlying question is whether the legislations, codes and institutions put in place are sufficient in protecting an investor. In chapter 3 we shall look at the various legal frameworks and how this laws seek to safeguard an investor's interests.

3.3 INSIDER TRADING/DEALING

It denotes the purchase or sale of securities of by a person where his relationship to the company is such that he is likely to have access to reserve material information concerning the company not known to the general public. It occurs when an individual or organization buys or sells securities to which he is knowingly in possession of some piece of confidential information which is not generally available and which is likely to affect the price of the security.

This practice is deemed to be prejudicial and needs to be controlled.²⁶ This is because the acquisition of information about the performance of a company and an economy makes it possible to come to better investment decisions.

The challenge posited by investor trading has an old history. In 1934 the report of the **Senate Banking Committee** observed that among the most vicious practices unearthed was the fraudulent betrayal of the fiduciary duties by directors and officers of corporations who used their positions of trust and confidential information which came to them in such positions.

Insider dealing has been viewed to have both merits and demerits. **Professor H.G Maine**²⁷ in defense of insider trading holds that it is positive due to the following reasons:-

1. long term investors suffer no loss from it
2. There is a beneficial effect from insider trading which otherwise would be an unnecessarily expense. He further argues that there is an increased capital market deficiency in that new information about a company which his reflected in the corporation's securities prices more rapidly and accurately if insiders are permitted to use it.

His arguments have been countered on the grounds that:-

1. Insider trading does not reward efficient management but the possessing of confidential inside information whether it is favorable or unfavorable to the companies prospectus.

²⁶ Regulation of Insider Trading , 35 Stanford Law Review 857 (1983)

²⁷ In his book *Insider Trading and the Stock Exchange*, New York, 1966

2. Whilst it is true that insider decision to buy or sell a company security does not provide information about its prospectus and thus allows an accurate revaluation of the company's security, this advantage must be weighed against the loss of efficiency.

It is generally acknowledged that insider trading is unfair and damages the confidence of investors in the integrity of security markets. It is now evident that the reasons for prohibiting insider dealing are that the use of insider information is detrimental for other investors who do not deal with the insider. The major reason is based on the fact that an insider with access to confidential information thereby places himself in a potentially conflict of interest situation and it may dictate or influence the disclosure of price sensitive information.

Such a conduct is likely to bring not only to the reputation of the company concerned but also that of the securities market into disrepute and this will affect investments since the stock exchange is a market place for pursuing and selling securities and persons are more inclined to use it if they are satisfied or believe that it currently represents the value of what is bought and sold.

Ford C.J in *Diamond V Oreamuns*²⁸ says,

“It is well established as a general proposition that a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own principle for profits derived there from”

²⁸ 248 N.E 2d 1964

The reason for regulating insider trading is for the purpose of promoting public confidence in the securities markets²⁹. In my study I shall observe how the provisions encompassed in the legal regime aim at controlling directly or indirectly the practice of insider trading.

3.4 DISCLOSURE

The general philosophy of disclosure adopted by company law may be justified by various policy grounds:-

- It leads to a better informed and more efficient stock market
- It minimizes the risk of fraud.
- It prevents excessive secrecy.
- It facilitates equality of opportunity.

The purposes of disclosure provide the public with information as to the quality of performance of specific business enterprises and provide interested sectors of society with adequate facts to commend or condemn the performance.³⁰

It is true that the requirement of frequent periodic disclosure generally minimizes the likelihood of corporate fraud and scandals or inappropriate corporate behavior and contributes to law enforcement by facilitating detection of improper behavior at an early stage.

For purposes of investor protection disclosure by enterprises serves two additional purposes:-

²⁹ This argument stressed in the preamble to Council Directive 89/592 Regulations on insider dealing

³⁰ Boston R, **Required Disclosure And The Stock Market: an evaluation of the securities Exchange Act of 1934**, 63 *American Economic Review* (1973)

1. It facilitates effective assessment by the investors' prospective investments of the value and price of securities offered for the purchase in the market price. The advent of modern corporate legislation in the middle of the 19th century provides for an easy method of interpretation coupled with the requirement of disclosure by co-operate entities particularly where they sought to interest the public investment in the enterprise. This concept is based on the assumption that only investors who had adequate information could make a rational decision as to whether or not to invest in a company security. Disclosure in this case will be seen to be in two levels. First, the secondary market is an integral part of the primary market. Its function is to facilitate trading in issued securities which enables an investor to disclose his original investment before its maturity date.

The ready marketability of security market is due to its liquidity which is an advantage from an investor's point of view. Indirectly there is an advantage to the issuer as the existence of a trading market ensures that a person with funds available on short term basis, can invest in the securities with long term maturities. However, in terms of the basic economy, only new infusions of money on a primary issue resorts to an increased capital in the operating sector. Hence the need of full disclosure to investors who are therefore enabled to allocate resources effectively.

A new issue generally resorts in substantial purchases of identical securities by investors within a reasonable short period of time. A continuous flow of new primary share issue means that shares are available for trading in the secondary market. Such disclosure ought to be made by persons with accounts to the funds.

2. The second major purpose of disclosure on securities regulation is to contribute to the effective use of contractual and statutory rights which the security holder has with respect to the enterprise. The commonest right is that of voting.

To inform the security holder on a regular basis of material facts concerning the enterprise is critical since it enables the investor to purchase or sell securities.

It is generally accepted that disclosure by itself is an insufficient regulator of security market. Direct regulation is therefore necessary. Have the laws in place adequately achieved the disclosure principle?

CHAPTER THREE

THE LEGAL REGIME, INSTITUTIONS AND POLICIES FOR PROTECTION OF AN INVESTOR IN THE STOCK MARKET IN KENYA

4.1 INTRODUCTION

“The mission of the capital markets authority is to preserve the development of orderly, fair, efficient, secure, transparent and dynamic capital markets in Kenya within a framework which facilitates innovation through an effective but flexible system of regulation for the maintenance of investor confidence and safeguards the interest of all market forces.”³¹

The present chapter aims at analyzing the various legal provisions relating to investor protection in the stock market. As has been established, there are various risks that an investor could be exposed to. These include political, financial, market risks etc. and investors’ needs to be protected from all corners. Parties that would contribute to the risks include the government, stockbrokers or even other investors.

All these parties have diverse interests irrespective of their sizes, ability and strength. Therefore regulation is set out to provide both foreign and domestic investors with a safer platform to invest on, therefore protecting and safeguarding their interests. In this chapter, we shall categorize investors into two categories that are foreign and local.

³¹ Capital Markets Authority Mission Statement

4.2 FOREIGN INVESTORS

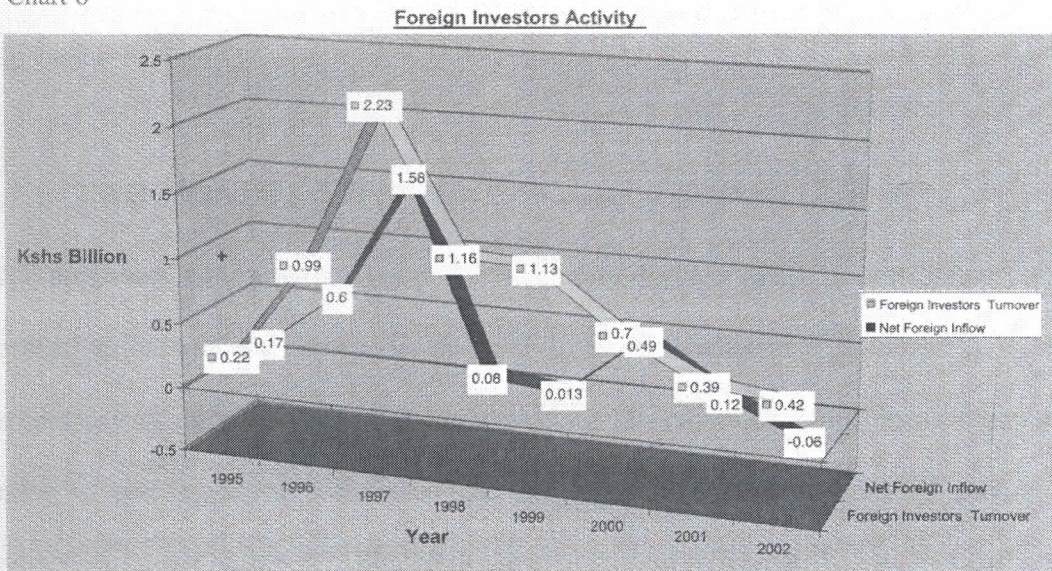
This occurs when private firms or individuals from foreign states invest directly in an enterprise in another state. So much has been debated with regard to foreign investment from its necessity in developing nations to criticisms over its exploitative nature. The former Malaysian Prime Minister, Muharir Muhammad once described foreign investors as '**Agents of the Devil**'³². It is evident that it has contributed greatly to the development of many economies. Kenya in particular relies to a great extent on foreign investment. Different modes have been adopted aimed at attracting more and more investment from abroad. The following graph represents foreign investors' activity for the periods 1995-2002

TABLE 1- FOREIGN INVESMENT ACTIVITY KSHS BILLION

	1995	1996	1997	1998	1999	2000	2001	2002
Foreign investors	1.022	0.99	2.23	1.16	1.13	0.70	0.39	0.42
Net foreign inflow	0.17	0.60	1.58	0.08	0.01	0.49	0.12	(0.06)

³² Newsweek 12-19 January 1998

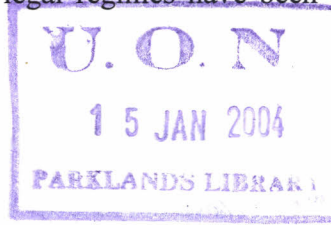
Chart 6



As we can observe from the graph the volume of foreign investment has decreased as years went by. The variation in foreign investment could be attributed to various reasons. Some writers have argued that the 'well' of foreign investors has dried up. One of the many cases usually cited for the shortage of private foreign investments in the underdeveloped countries is the unfavourable investment climate existing in a great number of those countries.³³ They include legal, political, taxatory and other elements. To a prospective foreign investor, the existing legal situation regarding foreign investment is very important this would be, duration of the investment, levels of tax imposed amongst other factors. With regard to the issue of investment climate, it is crucial to most investors that they have some reasonable certainty as to future conditions. They must be able to believe that there is little or no possibility of the creation of an unfavourable legal or other conditions at a future date which will be detrimental to the

³³ ARGHYRIS *A Legal Securities for international investment.*

investment. To ease these fears different legal regimes have been put in place to help solve the problem.



4.2.1 THE CONSTITUTION

“No approved enterprise or property belonging thereto shall be compulsory taken possession of and no interest in or right over such enterprise or property shall be compulsory acquired except in accordance with the provisions concerning compulsory taking of possession or acquisition and the payment of full and prompt payment of compensation as contained in **Sec 75** of the constitution of Kenya.³⁴

A question may arise as to whether there is protection afforded for non- approved enterprises. Are they offered protection under any other statute or are they perse illegal in themselves and therefore couldn't be awarded any protection? The constitution is silent on this issue and so is the Foreign Investment Act. It is my view that no protection is offered for them.

A state may place conditions on the entry of foreigners in its territory and may restrict acquisition of certain kinds of property by foreigners. The subject matter may be shares in an enterprise, single items such as estate factories or on a monopoly basis. The problem that arises here is the deprivation by state organs of a right of property either as such or by segment transfer of the power or management. This process is known as expropriation. If compensation is not provided or the taking is regarded as unlawful, then the taking is referred to as confiscation.

³⁴ Section 8 of the Foreign Investment Act

The compensation rule states that expropriation of foreign property is lawful if prompt adequate and effective compensation.³⁵

The justification for the rule is based on the assumption prevalent in a liberal regime of private property in the principle that foreign owners are to be given protection according to private rights of Nations provided that the protection involves the provision of compensation for any taking. The emphasis is in respect for property rights as acquired rights³⁶ and as an aspect of human rights. The statement of the court on the principle of respect of vested or acquired rights occurs in the context of state succession. A number of international tribunals have supported the compensation rules and the principle of acquired rights.³⁷

The problem that arises is with the understanding of prompt and full compensation. Compensation to be paid for a lawful expropriation is the object of heated controversy with fundamental disagreement between developed and developing states. The long standing view of developed states was expressed in a note from the US Secretary of State Hull to the Mexican Government in 1940 on the expropriation by Mexico of foreign oil interests:

“... The right to expropriate property is coupled with and conditioned on the obligation to make adequate, effective and prompt compensation. The legality of an expropriation is in fact dependent upon the observance of the requirement.”³⁸

By ‘adequate’ compensation we mean the value of the undertaking at the moment of disposition plus interest to the day of payment.³⁹ There have been pronouncements that a

³⁵ formulae appears in a note from the US Secretary of state Cadil Hill to the Mexican government dated 22 august 1938

³⁶ Additional protocol to the European Convention on Human Rights article J

³⁷ Norwegian ships Arbitration 1921 PCA pg 507

³⁸ 3 Hackworth 662

prompt compensation means payment in cash. With regard to 'effective' it means that the recipient of the compensation must be able to make use of it. He must, for instance, be able to use it to purchase more investments in another company.

More often than not, when foreigners are compensated on expropriation, the compensation is based on the value of the investment as at that time. It is basically valued at the historical cost of the asset. Rarely are the future returns accounted for or even the losses suffered due to lack of the opportunity to reinvest. This therefore by and large increases the reinvestment risk and may act as deterrence to foreign investment. With regard to promptness, there is no straight line drawn as to when the compensation should be done. Prompt could vary from one individual to another and it depends on various circumstances.⁴⁰

4.2.2 FOREIGN INVESTMENT PROTECTION ACT

The foreign investment Protection Act of 1964 is the main regulatory framework as relating to foreign investment in Kenya. An investor wishing to invest in Kenya must prior to applying for protection under the Foreign Investment Protection Act obtain the Central Bank of Kenya approval, for the CBK grants the foreign investor the right to purchase foreign exchange for the repatriation of dividends. Dividends are transferable upon their final declarations. Interim dividends are not eligible for transfer. Investors need to apply for protection under the Foreign Investment Protection Act only if they wish to secure the right to repatriate the initial investment and capital gains. The Foreign Investment Protection Act grants an investor the right to repatriate the initial investment

³⁹ per the PCIJ in the Chorzow Factory (claim for indemnity merits case)

⁴⁰ SHAW, *Public International Law* 2ND Edition

amount immediately upon the sale of shares and capital gains after a period of 5 years. These proceeds of the capital gains can be reinvested in government bonds with interest transferable upon maturity of the bond.

It is my view that the impediments to foreign investment protection should be removed. This would act as a booster to foreign investment. The five year waiting period for the repatriation of capital gains should be eliminated and foreign investment should automatically qualify for protection under F.I.P.A without the need for specific application.

4.2.3 OTHER LEGISLATIONS

Kenya is a member of the World Bank Affiliated Multilateral Investment/Guarantee Agency which issues guarantees against non commercial risk. It is also a member of the International Center for the settlement of investor dispute.

4.3 LOCAL INVESTOR

Before we consider the laws that aim at protecting a local investor let us first observe the performance of the stock market for the period 1995-2002

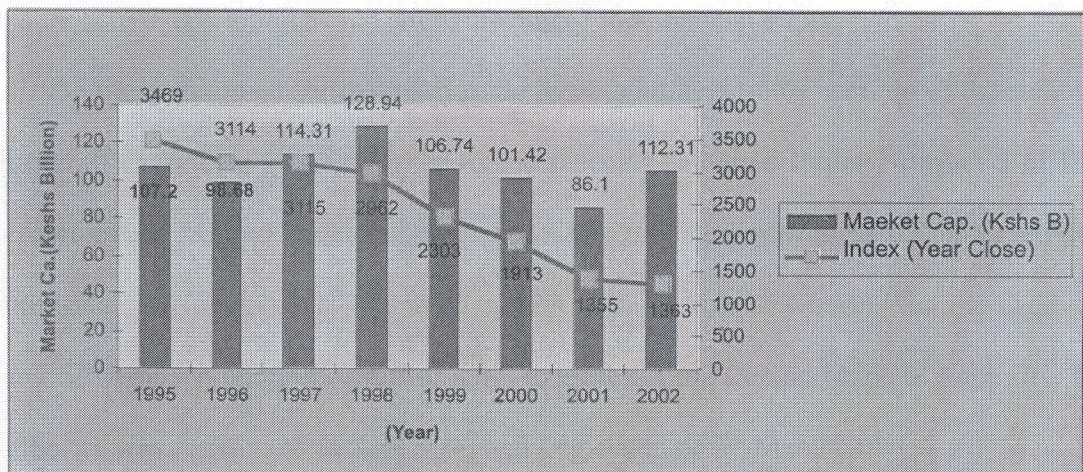
TABLE 2 GROSS MARKET STATISTICS

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002*
ShareVol(m) ⁴¹	27.30	42.76	62.10	11360	143.47	111.11	157.49	141.42	109.19	135.75
Shares turn- Over (KShs B)	0.82	3.08	3.34	3.96	6.15	4.58	5.16	3.63	3.12	2.88

⁴¹ Share volume in billions

Market Cap ⁴²	72.00	136.83	107.20	98.68	114.31	128.94	106.74	101.42	86.10	112.31
Index (close)	2514	4559	3469	3114	3115	2962	2303	1913	1355	1363
Av.T-bills ⁴³										
Rate (%)	43.54	18.70	21.67	21.61	26.60	12.60	20.00	11.20	11.50	8.40
Av base lending										
Rates (%)	38.55	30.93	33.14	34.58	30.30	28.80	24.80	19.90	19.60	18.60
GDP Growth										
Rate ⁴⁴	0.20	3.00	4.80	4.60	2.40	1.80	1.40	(0.20)	1.20	1.00
Av Inflation	45.60	6.70	1.60	9.00	11.20	6.60	3.50	6.20	5.80	1.80
Mean kshs/US										
exchange rate	68.70	44.80	51.40	57.10	58.80	60.40	70.30	76.10	78.60	78.60

*Provisional (data from the CMA Annual Report 2002)



⁴² Market capitalization

⁴³ Average treasury bills

⁴⁴ Gross Domestic Product

These statistics reveal that the market capitalization has been increasing with increase in years. This could be as a result of many reasons. It is my view that among the major reasons is as a result of structuring and implementation of legal frameworks that ensure regulation of the stock markets resulting to an improved investor confidence and protection.

4.3.1 THE CAPITAL MARKETS AUTHORITY

The body that regulates and protects a local investor is the Capital Markets Authority. It was established through Chapter 485A of the Laws of Kenya.

The events leading to the formation date back in 1984 when the Government of Kenya commissioned a special study on the financial sector. The study was jointly undertaken by the CBK with the International Finance Corporation and covered specifically the capital markets with the objectives of making recommendations on measures that would ensure active development and strengthening of the financial sector.

In 1986 the government further reaffirmed its commitment to the creation of the authority as part of the reform focused for the financial sector **Sessional Paper Number 1 of 1980 on Economic Management for Renewed Growth**. The government set up an advisory committee in November 1988 and charged it with the role of working out the necessary modifications including the draft of a bill to establish the Capital Markets Authority. The authority was constituted in June 1990 and Legislated on 7th March 1990.

The Authority has an important role of ensuring that all market players comply with the requirement of regulatory framework set for the purpose of ensuring market discipline

and investor confidence. In this regard the authority has developed broad rules and regulations which control the conduct of market players. A robust and facilitative regulatory environment is critical for the maintenance of investor confidence as well as investor protection. The authority has implemented far reaching reforms aimed at strengthening its legal and regulatory frameworks.

The gazetted regulations are:-

- 1. The Capital Markets Collective Investment Schemes Regulation**
- 2. The Capital Markets Securities, Public Offers, Listing and Disclosure Regulations**
- 3. The Capital Markets licensing Requirements General provisions**
- 4. The Capital Markets Take Over and Mergers Regulations**
- 5. The Capital Markets Foreign Investments Regulations**

The guidelines are:-

- 1. The Capital Markets Guidelines on Corporate Governance Practices by the Public Listed Companies**
- 2. The Capital markets Guidelines On the Approval and Regulations of Credit Rating Agencies.**

Although this pieces of regulations and guidelines accommodate provisions aimed at protecting an investor either it been directly or indirectly, the core of this chapter is to visualize on those that envisage specific provisions aimed at protecting an investor.

4.3.1.1 THE CAPITAL MARKETS SECURITIES PUBLIC OFFERS, LISTING AND DISCLOSURE REGULATIONS 2002

Section 10 of the Act provides as follows

‘the form and contents of the prospectus shall comply with (a) part A of the Third Schedule where the issuer seeks to list in the main investment market, (b) part B of the Third Schedule where the issuer seeks to list in the alternative investment market segment. Part C of the Third Schedule where the issuer seeks to list in the fixed income market segment’

These regulations are set to help ensure that public investors get the information they need to assess the investment opportunity adequately. In the case of public issue of shares, this information is usually presented to potential investors in the form of a prospectus or a statement in lieu of a prospectus. Any such prospectus must meet the minimum legal requirements for a prospectus as set out in the Capital Markets Authority Act and the rules and regulations as may be amended from time to time.

The underling assumption here is that investors are able to determine the risk involved in an investment if they are well informed about the financial position and stability of the enterprise and its prospects for future growth. Such an informed judgment is only possible on the basis of the availability of the information provided by the issuer companies. Accurate and adequate information is needed not only for the outside investors but also to managers as well as market players. For this reason it is a paramount importance that the principle of disclosure be strictly and constantly enforced through this regulation.

4.3.1.2 INVESTOR EDUCATION

Although there are no provisions as relating to investor education the Authority aims at making the investor knowledgeable on issues that pertain to financial markets. The maintenance of a high quality team of market professionals and informed investors is seen to be critical to the development of the capital markets and this would be aimed at empowering the investor and making him self protected.

The authority has therefore, developed an investor education program and is initiating measures to develop an appropriate curriculum programme on financial service proficiency certification.⁴⁵ The programme will also entail the sensitization of the general public as well as focus on shareholders rights and other good corporate /governance practices.

4.3.2 CAPITAL MARKETS ACT CHAPTER 485A

The Capital Markets Act is the parent umbrella legal framework established in 1989 that governs the Capital Market in Kenya and under which Capital Market Players and instruments operate. The Act establishes the Authority and gives provisions for its membership, meetings and operations, appointment of chief officers, objectives powers and an investor protection fund.⁴⁶

The Act provides the basis for the operational and regulatory framework for securities markets. The operational efficiency of the Capital Markets depends to a great extent upon laws and regulations pertaining to companies, banks, investment firms, securities exchange, taxation and business associations. The legal framework provides for

⁴⁵ Capital Market Strategic Plan 2002-2005

⁴⁶ see the CMA Act

acquisition and protection of property rights, contractual relationships and rights and liabilities of market players. The market is aimed at facilitating investor confidence.

Section 11 declares the principle objectives of the Authority. In relation to flotation, section 11(1) (c) declares ‘**the protection of investors interests**’ to be one of the objectives of the authority. It is yet not clear as to how this protection will be achieved.

Section 12 empowers the Authority to formulate such rules and regulations as may be required for the purpose of ensuring orderly and fair trading in the Capital Markets instruments and investor protection. The rules regulate, *inter-alia*, disclosures about securities transactions by brokers, dealers, persons who acquire or dispose of securities and a security exchange.

With regard to investor protection **section 18** of the Act establishes a fund known as the investor compensation fund for the purposes of granting compensation to investors who suffer pecuniary loss resulting from the failure of a licensed stockbrokers or dealers to meet his contractual obligation.

The leading case that would clearly illustrate the application of this section is the suit filed by the *National Social Security Fund against Shah Munge and Partners* in October 2002 after the controversial transfer of Kenyan shillings 256 million to Euro bank, which has since collapsed.⁴⁷ The company was suspended for one month and was required to pay a penalty of Kenyan Shillings 1.5 million to the Capital Market Authority Investor Compensation Fund. This led to the suspension of the company for one whole month. The directors of Shah Munge would collectively take responsibility for the irregularity involved the controversial transaction through the company. The CMA

⁴⁷ Daily Nation Thursday May 27 2003

Chairman Executive then, Mr. Paul Melly said that the directors would be ineligible for directorship in the stock broking or any other activity of CMA and listed companies for a period of one year.⁴⁸

The stock brokers got embroiled in the transaction mid year 2002 when the former NSSF trustee, Mr. Ben Mtweta, instructed it to source from the secondary market treasury bonds with a yield of 10% in which the money could be invested.

It is my view that the actions by Shamunge are likely to erode the confidence of the public in stock brokers as intermediaries in the capital markets. But I also feel that the penalty by CMA was too harsh and was likely to kill the company which had served as a role model in the entire brokerage industry.

Section 23 of the Act provides that no person shall carry on business as a stock broker, dealer, investment advisor, manager, investment bank, authorized security dealers, or hold himself out as carrying on such a business unless he holds a valid license issued under the act. This is aimed to prevent the exploitation of an investor from fraudulent activities carried out by parties. Licensing enables the regulation of activities of the payers in the stock market

Section 30 and 50 provides for the disclosure requirement. This principle is very crucial to the effectiveness of legal and regulatory framework. This becomes important for the prevention of fraudulent behavior such as misstatements, misrepresentations⁴⁹ insider

⁴⁸ East African Standard Friday October 2002

⁴⁹ This refers to false or misleading statements which are made in prospectus in breach of the disclosure requirements with a view to inducing another person to enter into an acquisition agreement to acquire shares. These include false misleading or deceptive promises and forecasts as well as mistatments of fact and

dealing and trading, deceptive malpractices such as short selling,⁵⁰ false trading⁵¹, and stock market manipulation.⁵²

Part 6 of the Act prohibits insider trading. As observed in my previous chapter insider trading has both advantages and disadvantages. But the Act specifically prohibits this.

Do unlisted companies fall under the ambit of the Capital Markets Act? I ask this question to determine whether the provisions in the Act as relates to investor protection and the whole Act generally are applicable to unlisted companies. The Act mainly regulates the listed companies. An issue may arise which involves a listed and unlisted company. A good example is regards the acquisition of **Castle Brewery by the East African Brewery**. The Authority claimed to have authority to oversee the process of acquisition arguing that it had a sole duty of protecting E.A.B.L shareholders interests.

4.3.3 THE CENTRAL DEPOSITORIES ACT 2000

The Central Depository Act 2000⁵³ is the law that is intended to facilitate the establishment, operation and regulation of central depositories, provided for the immobilization and eventual dematerialization of dealings in the securities in Kenya.

The CD Act was enacted to establish a Central Depository system for the securities exchange in Kenya. This was a result of the ever increasing need to establish a robust

attract both civil and criminal liability for the deceptive prospectus. See Eilis Teran, Company law and Corporate Finance page 596-605

⁵⁰ This arise where there is a sale of security which is not owned by the seller that is where the seller has no existing and unconditional right to transfer or vest the securities in the purchaser.

⁵¹ Occurs when it involves a misleading impression that trading is going on or it is going at a particular price when it is in fact not.

⁵² This arises where a person carries out some security transactions with a view to raising, lowering, maintaining or stabilizing the price of those securities so as to induce other persons to sell purchase or subscribe to those sellers

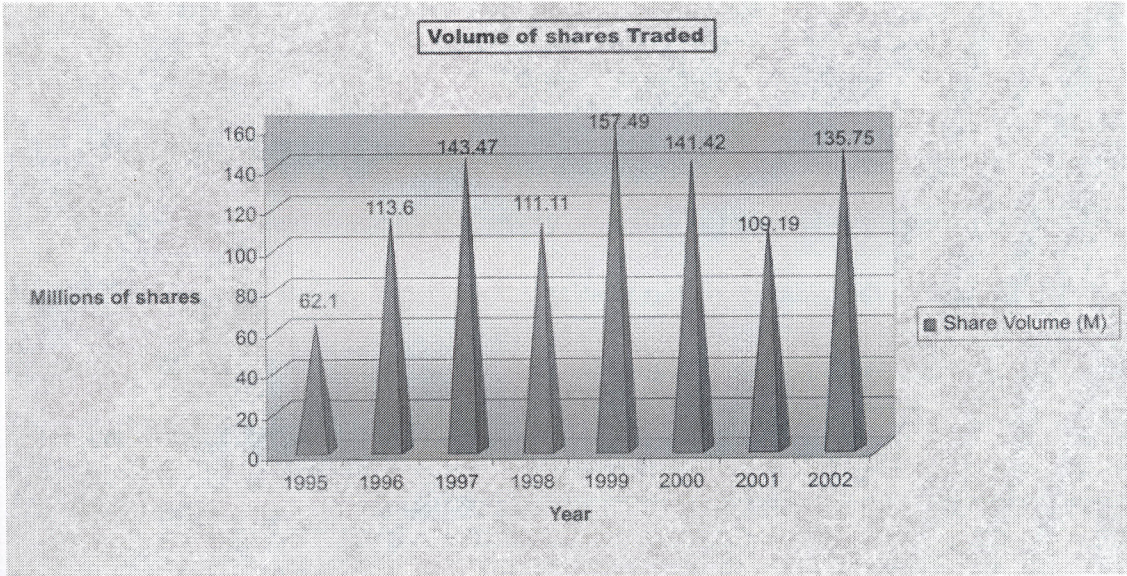
⁵³ Act No 79 2000 (Kenya gazette supplement No 59 of 2000)

infrastructure for clearing, settlement and registration activities within Kenya's and the East African Regions Capital Markets.⁵⁴

Accordingly the CDA 2000 lays down provisions to regulate the installation and operation of a CD system in Kenya. These range from the establishment of a central depository, immobilization of securities, dematerialization of securities, accounts and records, confidentiality and secrecy in dealings, investigation powers, and other provisions.⁵⁵ When fully operational the CD system will facilitate delivery verse payment (DvP) for the securities. The CDA 2000, is however yet to come into force.

4.3.3 COMPANIES ACT

A brief look at the performance of the quantity of shares traded at the Nairobi Stock Exchange shall be doe before we look before we look at the provisions of the Act that aim at protecting the investor.



⁵⁴ CMA annual report 1999 p.g. 50-53 highlighting the background to the CPA, key benefits, functioning and operation of a CDS

⁵⁵ the CPA 2000 details the meanings, interpretation, functioning, and operation of the Central Depository system.

The graph shows that the year with the list stock turnover was in 1995. There are many reasons that could be attributed to this. It could be argued that at this time, very few investors were interested in being participants of the securities market and they mainly invested in real property. It could also be argued that fixed incomes e.g. treasury bills were really doing well and most investors pulled out their investments in shares and stock and put them into treasury bliss. It is my view that although there are various reasons that may be attributed to the decrease most of the reasons are pinned to the analogy that an investor finds the market very risky and to their lack of knowledge of the market. The basis of my opinion is that between 1996 and the year 2000, the volume of the shares has increased with in some years decreasing but by a very small difference. It is at this time that the Capital Markets Authority rejuvenated having the effect of promoting investor confidence and protection.

The companies act with the aim of protecting an investor contains special provisions relating to share floatation and briefly on minorities protection in a company.

4.3.3.1 SHARES FLOATATION

Before shares are issued to the public, every company is required to prepare a prospectus.

Section 2 of the Act defines a prospectus as ‘any notice, circular advertisement or other invitation, offering to the public for the subscription or purchase of any shares or debentures of a company’

The offer must be made to the public. **Section 57 (1)** provides that “the public” includes any section of the public, whether selected as members or debenture holders of the company concerned or as clients of the person issuing the prospectus or in any other

manner” these provision have been amplified by a number of English cases of which *Nash V Lynde* is an example.

In this case several copies of documents marked ‘*strictly private and confidential*’ and containing particulars of a proposed issue of shares were sent, accompanied by a form of application, by the managing director of a company to a coordinator who sent a copy to a solicitor, who in turn, gave it to a client who passed it on to a relative. The documents were signed by all the directors and concluded with a statement that the writer was willing to discuss the proposition with anyone interested. It was held that there had been no offer to the public. The essence of this section is to protect an investor from parties who have insider information therefore been detrimental to the investor.

The prospectors should contain investor information that will be important for him in decision making. This information include, the minimum subscription ;the amount payable on application; the time of the opening of the subscription lists; voting, capital and dividend rights attached to different classes of shares if any.

The intended protection of the investor is as it were made absolute by the provision in **section 40 (2)** that ‘a condition requiring or binding an applicant for shares in or debentures of a company to waive compliance with any requirement of section 40(1), or purporting to affect him with notice of any contract, document or matter not specifically referred to in the prospectus, shall be void.’

In practice however, the average investor:

- never bothers to read the prospectus

- lacks the competence to make the correct inferences from the plethora of facts and data that are contained in the prospectus
- Lacks the financial resources required to pay the fees payable to the accountants or lawyers to whom he might have resorted for the professional advice.

Does the Act need to provide for more provisions to adequately protect the investor or is it that it is almost impossible to protect an investor adequately?

4.3.3.2 *LEGAL PROTECTION OF MINORITIES*

A company is a democratic organization whose affairs are to be managed by the directors according to the provisions of the Companies Act, the companies memorandum and articles of association and, where a decision of the members is required, according to the majority of the company's members expressed as an ordinary or special resolution. The minority of members who have been outvoted during the passing of the relevant resolution must be prepared to abide by the decision of the majority of the company's members.

There are significant instances in which the Companies Act prescribes certain legal limits on the power of the majority to bind the minority of the company's members. In particular a resolution passed by the majority would not be allowed to prevail in certain circumstances if it is unfair or prejudicial to the minority, such as a resolution which,

1. alters the companies objects **section 8**
2. requires a member to take or subscribe for more shares than the number held by him at the date on which the resolution was passed (**section 24**)

3. Reduces the company's capital in a way which is 'not fair and equitable' between the different classes of shareholders. The leading case to illustrate this section is the *British And American Trustee And Finance Corporation Ltd V Couper*⁵⁶
4. empowers the company to embark on, or continue with, a course of trading which was not contemplated by the minority at the time the company was being formed
5. Constitutes a fraud on the minority.

Section 211 (1) of the Act provides that any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members, including himself, may make an application to the court by petition for an order under the section. The court has powers to make orders as it things fit with a view to bringing to an end the matters complained of if on any such petition is of the opinion that: the company's affairs are being conducted as alleged by the applicant and to wind up the company would unfairly prejudice the applicants but the proved facts would have justified the company's winding up on the 'just and equitable' grounds.

A minority of members of a company may in some instances rely for protection on "the rule in *FOSS V HARBOTTLE*". This rule is based on the statement of Vice- Chancellor Wingram in the case of *Foss v Harbottle*⁵⁷:

"In law the corporation and the aggregate members of the corporation are not the same thing for the purpose like this; and the only question can be

⁵⁶ House of Lords 1894

⁵⁷ House of Lords 1904

whether the facts alleged in this case justify a departure from the rule which, prima facie, would require that the corporation should sue in its own name and in its corporate character or in the name of someone whom the law has appointed to be its representatives”

The provisions of the Act as regards the protection of the minority aim at encouraging an investor to buy shares regardless of the number since if he can only afford few shares he is well protected since he has a say in the company in reference to important issues.

I feel that the Companies Act does not fully address the issue of corporate governance and the protection of the minority shareholders. The issue of minority interest is most important in cases where public enterprises have been sold through public issues and no directors are appointed to specifically represent the interests of minorities on the board of directors. This Act should be reviewed comprehensively to provide legal framework for the protection of minority shareholders.

4.3.3.3 CIVIL LIABILITY

Section 45 of the Act provides that in a case where a prospectus invites persons to subscribe in or debentures of a company, every person who is a director of the company at the time the prospectus is issued, every person being a promoter of the company and every person who has authorized the issue of the prospectus shall be liable to pay compensation to all persons who subscribe for the shares or debentures on the faith of the prospectus for the loss or damage they may have sustained by reason of any untrue statement included therein.

Purchasers of shares in a company may find out that they have been misled about the performance and prospects of a company and as a result of this they have suffered injury.

A person in this position may have the right under common law and misrepresentation to rescind the contract or to seek damages. The prospectus is essentially the advertisement for the company's shares for the information of potential investors. However the difficulties of providing a purchaser of shares with a damages remedy at common law where he had purchased shares on the basis of false statements in a prospectus, were revealed in *Derry V Peek*⁵⁸

In this case the plaintiff had purchased shares in a company relying on statements in a prospectus concerning the rights enjoyed by the company which turned out to be false. It was too late for the plaintiff to rescind the contract because the company had gone into liquidation, so an action in the tort of deceit was brought against the directors. This was unsuccessful because it was held that in order to succeed in deceit, fraud must be proved which required actual dishonesty. Here the directors had only been careless and honestly believed the statements to be true. The Companies Act imposes liability on promoters, directors and others who authorize the prospectus, for any loss caused as a result of an untrue statement in a prospectus.

The liability has also been extended to experts who consent to the use of the reports in the prospectus unless the experts could prove there were reasonable grounds for believing that the statements in their reports were true. in the case of fraudulent misrepresentation the plaintiff must show that the defendant made the untrue statement in the prospectus fraudulently.

As regards the level of damages, where a plaintiff proves that he or she has acquired shares on the basis of a fraudulent misrepresentation and suffered loss as a result, the person is entitled to be put in the position he or she would have been had the

⁵⁸ 1889 14 Appeal Case 337

misrepresentation not been made. The landmark case of *Hedly Bryne and Company Ltd v Heller and Partners Limited*⁵⁹

It was held that an action would lie for damages where loss was sustained as a result of a negligent misrepresentation, where there was a duty of care owed by the proprietor.

It has really been decided that whether or not there is a duty of care owed by the person preparing and issuing a document will depend on the purpose for which the document was produced.⁶⁰

4.3.3.4 CRIMINAL LIABILITY

section 46 provides that where a prospectus includes an untrue statement, any person who authorizes the issue will be guilty of an offence and liable to imprisonment for a term not exceeding two years, or to a fine not exceeding ten thousand shillings or to both unless he proves that the statement is immaterial or that he had reasonable ground to believe and did, up to the time of the issue of the prospectus, believe that the statement was true.

4.3.4 THE PREVENTION OF FRAUD (INVESTMENTS) Act 1997

In order to ensure that the intended statutory protection is not frustrated by the attitude, condition or circumstance of the 'average investor' **section 4** of the Prevention of Fraud (investments) Act 1977 established a committee which consists of not less than five members appointed by the minister of finance. The committee is empowered by Section 5 to refuse to grant approval of the issue of, *interalia* any securities by a local company or statutory corporation, or make such issue subject to such conditions as it may deem

⁵⁹ 1964 A.C 465

⁶⁰ Caparo plc v Dickman (1990) A.C 605 P. 314

necessary in the public interest. **Section 5(1)** provides that ‘no local company shall issue ... any prospectus unless the issue of the securities to which the prospectus relates has been approved by the committee.’

The philosophy of the aforesaid provisions of the Act seems to be that ‘**prevention is better than cure**’. These seem to be aimed at ensuring that a prospectus is subjected to an official scrutiny before it is released.

4.3.5 THE NAIROBI STOCK EXCHANGE

It was established in 1954 as a voluntary association of Stock brokers registered under the Societies Act. In 1990 the NSE was registered as a limited company with a full time secretariat being created. In 1991 it closed down the over system in favor of the open outcry system which has been in application since then. To date it remains the sole registered securities exchange in Kenya. It derives its authority and recognition or approval from the CMA. It acts as self regulatory organization charged with fulfilling public functions of providing fair and orderly secondary markets and enforcing its own and others legal requirements as members. It operates on the rules and regulations which are subject to approval by CMA.

The objects and functions of the stock exchange are spelt out in its Memorandum and Articles of Association which include regulating and controlling the secondary markets in Kenya; protecting the interests of members of the Exchange; recording transactions between the member firms and furnishing quotations of shares as translated at the exchange; providing investor services protecting and promoting their interests in the securities market as a whole (investor education); working in close corporation with the

CMA and all the market players to develop the securities markets; interpreting and enforcing the rules and by-laws of the exchange; preparing , publishing and evaluating reports and records pertaining to securities market operations; providing and enacting listing requirements; enunciating and enforcing a code for mergers, take-overs and acquisitions and instituting a policy of market surveillance and corporate disclosure.

The governance of the NSE comprises the members of the stock exchange and a board of directors constituted in accordance with section 20 of the Capital Markets Act as amended by section 4 (a) and (b) of the CMA (amendment, 1994). The board consists of 5 persons elected from amongst the brokers and dealers who are members of the Stock Exchange; two persons elected by the members of the stock exchange, to represent listed companies; three persons who are knowledgeable and experienced in investment appointed by the Stock Exchange with approval of the CMA to represent individual investors, institutional investors and the general public and a chief executive of the Stock Exchange.

As a capital market institution the stock exchange plays an important role in the process of economic development. It helps in the mobilization of domestic savings thereby bringing about the reallocation of financial resources from dormant to active.

Long-term investments are made liquid as the transfer of securities between shareholders is facilitated. The exchange has also enabled companies to engage local participation in their equity; thereby companies can raise extra finance essential for expansion and development. Presently the NSE is made up of 20 brokers, they include, Francis Drummond and Co ltd, Dyer and Blair, Francis Thuo and Partners, Ngenye Kariuki and company among others. They transact most of the business at the stock exchange with a

limited proportion of the overseas agents. The stock brokers act as financial advisers to their clients and also carry out their orders.

The NSE categorizes shares traded in it into different sectors to enable an investor spread his risks. One can opt to invest in one or more sectors at the same time. The following graph represents the performance of the different sectors for the years 1995-2002

TABLE 4

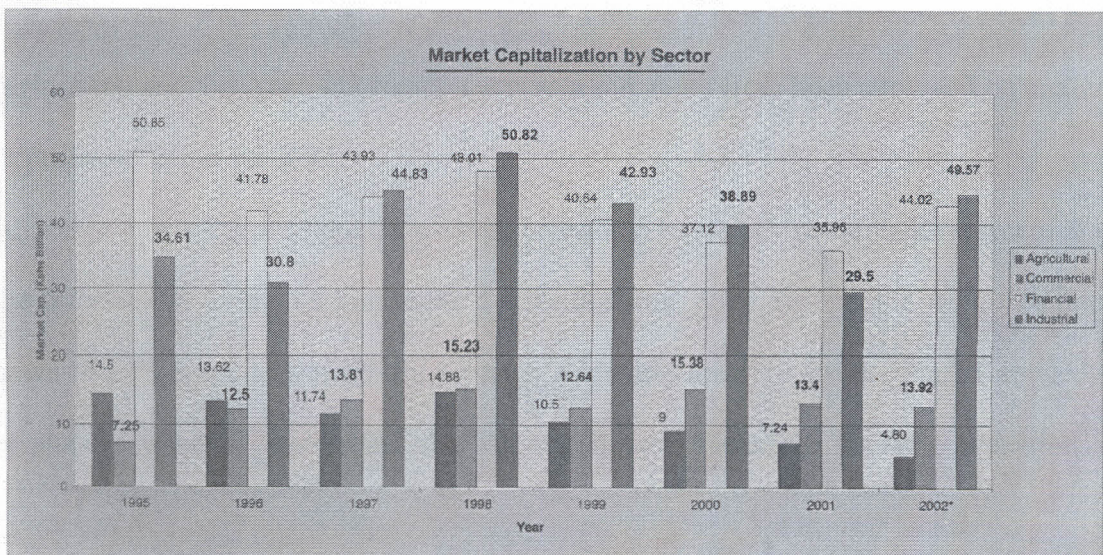
MARKET CAPITALISATION BY SECTOR (KSH Billion)

	1995	1996	1997	1998	1999	2000	2001	2002*
Agricultural	14.50	13.62	11.74	14.88	10.50	9.00	7.24	4.80
Commercial	7.25	12.50	13.81	15.23	12.64	15.38	13.40	13.92
Financial	50.85	41.78	43.93	48.01	40.64	37.12	35.96	44.02
Industrial	34.61	30.80	44.83	50.82	42.93	39.89	29.50	49.57

112.31

*provisional

(data from CMA Report 2002



The graph represents a scenario in which our financial market is dominated by the industrial and financial sectors. Investment in the agricultural sector has been decreasing as years go by. This could be attributed to the uncertainty pegged to agriculture. Agriculture is susceptible to various risks for example floods, drought, poor market opportunities e.t.c various agricultural based companies have been wound up with a result that investors have lost enormous amounts of money leading them to reinvest in other sectors of the economy.

The industrial sector seems to be thriving. This shows that there are greater opportunities for investors in the industrial and financial sectors where there returns are high. The good thing about the NSE, is that it gives you one a wide choice of where one can put his money making him spread his risks therefore helping him to reduce the probability of losing.

The Nairobi stock exchange informs the public through daily newspapers the television, the radio and its monthly bulletins of very relevant information that would be very vital to any investor when making any decision. An investor gets to know how the market is performing and also such information acts as a safeguard from been exploited be brokers or professionals in the field.

Although this is the position, the average investor is rarely at a position of reconstructing the information to enable him make a wise decision. Very few people would be sited down in a TV room to watch business news since they are very disinterested. Knowledge is also required to understand the various figures disclosed. Investor education is

therefore very important to enable the growth of this industry. It is my view that regulations should be put in place to promote investor education.

All companies are required to notify the Nairobi Stock Exchange immediately on information which could have impact on the prices of the shares. The information is known as price sensitive information. Public announcements are required in the following instances:

- major developments in the companies activities such as new products
- significant acquisition or disposals
- a change in directors or change in functions or executive responsibilities of a director
- decision to pay dividends
- half yearly results and preliminary reports
- changes in the interest of major shareholders
- Further issues in securities and changes in the company's capital structure.

Having analyzed the various legal provisions that seek to protect an investor I am of the view that Kenya has tried in its protection but more reforms need to be made on the current statutes and more legislation should be enacted. In my next chapter I shall observe various regimes in three countries for purposes of making a comparative analysis to see what we can adopt for purposes of strengthening the financial market sector as regards improving investor confidence and protection.

The NSE has a **manual** which sets out the operational and procedural rules issued by the Nairobi Stock Exchange, for the purposes of ensuring orderliness, efficiency of the market, admission of securities to the official lists of the Exchange, the listing of additional shares and the continuing listing obligations in compliance with the Capital Markets Act and the regulations and guidelines there under. Part three of the manual explains the methods of listing securities on the exchange, the market segments, eligibility and disclosure requirements for listing of securities. This part describes the general obligation of disclosure. An issuer shall, as soon as possible release announcements giving details of circumstances or events that have or are likely to have a material effect on the financial markets, the financial position or cash flow of the issuer and any other information which is necessary to enable holders of the issuer's listed securities and the public to make informed decisions on the issuer's performance and operations, trading and financial performance or any information whatsoever considered by the issuer to be sensitive or could lead to material movements in the price of its listed securities.

The NSE also has **Trading Rules**. The rules regulate and supervise the trading sessions. They also make provisions for the conduct of all persons on the trading floor which area is restricted to duly registered floor traders, authorized clerks, dealers, staff of the exchange, directors of the board and of member firms, authorized officials of the authority and any person authorized by trading floor manager of the Chief Executive. This is important since it shall ensure that trade is done by the right person and also makes it possible to determine against whom proceedings should be brought against. The rules also provide that every stock broker needs to maintain a separate record of all transactions which shall

indicate the name of client, date of transaction, price which transacted and the last trade price if the security. This is aimed at protecting the investors' confidence since it avoids instances of stock brokers been fraudulent.

4.3.6 CREDIT RATING AGENCIES

It constitutes an important Capital Market institution. Without credit rating agencies, it is virtually impossible to develop a viable corporate bond market including securitization. They perform the role of enhancing and fostering an active corporate securities debt market and in the process deepen the capital markets. Credit rating is an objective and independent process where opinion is given on the general credit worthiness of an issuer of a debt instrument and its ability to meet its obligations in a timely manner over the life of the financial instrument. This is usually based on the relevant risk factors including the ability of the issuers to generate cash in the future. The objective of credit rating is hence to provide independent high quality, value added quantitative and qualitative review as well as analytical information on the risk profile assessment of the issuers of financial instruments ⁶¹

The principle possible contribution of credit rating agencies is that they secure to promote investor protection and confidence in the capital market by enhancing transparency through increase of investor awareness of the underlying risks of an issuer or issued financial instrument through assignments of ratings. The CMA has gazetted guidelines and rules governing the registration, approval, establishment, capital requirements, operations, confidentiality of credit rating agencies in Kenya. This therefore, marks the

⁶¹ see guidelines on the Approval and Registration of credit Rating Agencies L.N No 8512 Kenya

beginning of the promotion of Institutionalization of credit rating agencies in Kenya.

These rating agencies have not started operation in Kenya

CHAPTER FOUR

A COMPARATIVE ANALYSIS

Statutory Enhancement in Taiwan: Towards Better Investor Protection.

5.1 INTRODUCTION

I make a choice of Taiwan for my comparative analysis due to the fact that its securities market has lived for a period of time almost equal to Kenya's stock market which was established in 1954 as an association of brokers secondly Taiwan is based in Asia whose economy is not as much developed as that of Europe or America. It is a more realistic country to compare with.

Taiwan Stock Exchange Corporation was established 40 years ago on Feb 9, 1962, it has been performing its duties as a centralized securities market in Taiwan. Compared with other developed countries, the history of the market development is rather short and its economic scale is also limited. However, statistics reveal that Taiwan's securities market is fast developed and full of momentum.

As far as the number of the listed companies is concerned, there were 595 in April of 2002. In contrast with ten years ago, in which only 221 companies listed, the number expresses that 372 more companies have joined the market with an increment of 168%. The value of shares listing is around US\$ 330 billion in April of 2002. In contrast with ten years ago, in which the value of the market capitalization only reached to US\$ 92

billion, the figures show an increment of 258% with the market capitalization standing for 120% of GDP bringing Taiwan closely to the level of maturity market. Based on a newly updated statistic data from FIBV ⁶²as of April of 2002, Taiwan's securities market is ranked as the 16th of the world in terms of the number of 595 listed companies and the 13th in market capitalization of US\$ 329,740.52 million.

The current number of investors stands for 1/3 of total population in Taiwan. Apparently, trading securities is popular in the country. In 1991, retail investors accounted for 96.9% of the market participation. However, in 2002, the proportion reduced to 84.7%. The information interprets a phase that individual investors still play the major role of the market participation. In Jan of 2000, there was a phenomenon of a daily trading value gaining closely at around US\$ 10 billion. Thereafter, referred by FIBV's report in April of 2002, Taiwan's securities market ranked the 7th of the world in terms of shares trading with traded value reaching at US\$ 280,956.28 million. From Jan to April of 2002, accumulation of the market's turnover rate was 84.32% and daily turnover rate in average was 1.11%. Comparing with past 10 year records, annual average turnover rate sustained at about 250 %. FIBV's statistics, therefore, make Taiwan's securities market the 3rd of the world in terms of turnover velocity, and also implicitly tell us that Taiwan stock market is still full of speculation.

It is clear from the above that the retail investor is the key participant in the market and he plays a major role. Therefore, how to protect less-privileged investors well is a challenge of market regulators in the country.

5.2 Mechanism for Investor Protection in Taiwan

A sound market should possess not only the function of offering enterprises a place for fund raising, but also the function of providing investors with a fair and efficient marketplace for trading. With both of these functions, a stock market can help a country's economy development. The regulatory objectives and scopes of securities authorities may vary widely among different securities markets, but investor protection is always what they have in common. Investor protection is the center philosophy of all regulators' administrative measurements. For instance, Taiwan's Securities and Exchange Law, states clearly in its first article that investor protection is one of two purposes of its enactment. We shall have an overview on how Taiwan's market implements investor protection.

5.2.1 STATUTORY PROVISIONS / DIRECT INSTRUMENTS

5.2.1.1 Operation bond

The Law prescribes securities firm must deposit an operation bond after its incorporation and registration.⁶³ Creditors whose claims arise from the specially approved business of a securities firm shall have preferential right of payment from that bond. It is the essence of securities business that debts and credits always occur in a securities firm's normal operations. The deposit of operation bond can enhance the firm's solvency credit and assure creditors' right of claim for they are given superior priority.

⁶³ Article 4 Taiwan Securities Exchange Act

5.2.1.2 Clearing and settlement fund.

The fund is used as coverage for securities firm's obligation to market and investors, while the securities firms fail to fulfill the duty of settlement. The Law prescribes such order of priority of claimants that the stock exchange is in first place, the customers of the securities firms violating the responsibilities of settlement, the second place, and the other affected securities firms, the third. In the event that the fund is insufficient to meet such claims, the rest of the claims may be compensated according to the provisions of operation bond. The Law stipulates the process of the use of fund as well, if any transacting party fails to fulfill its payment and delivery obligation. In the case of a securities firm's failure of the obligation, the Exchange shall first designate other members to make payment and delivery in place. The losses and expenses incurred can be compensated by the fund. In other word, the Exchange is entitled to use the fund to maintain the market's settlement in a better order and as a result assure investor's right of claim in a better priority.

A special committee is set up within the Exchange to manage the fund. The present amount of fund is about NT\$8.7 billion; the committee may compulsorily advise the member to deposit additional fund to the pool, depending on member's different level of risk exposure. If a securities firm fails to abide by this rule, the Exchange can suspend its participation of the market trading.

5.2.1.3 Investor Protection Fund

In addition to the above mentioned bond and fund, the Exchange established an investor protection fund According to the rules governing this fund, the fund subsidizes only those uncompensated portion of the investor claims, and the investor is limited to those who

has performed the obligation relative to securities trading while whose brokers default in the subsequent settlement obligation. The subsidy rule also applies to an investor who exercises derivative product's rights to buy or sell through securities broker and is unable to get the payment. The fund's reimbursement to each investor shall be limited to NT\$1 million; the maximum amount paid to all investors of a single securities firm shall not exceed NT\$100 million.

Note that the compensation does not apply to investors who are insiders and related persons of the securities firm; the fund pays only to investors who have fulfilled obligations of payment/delivery of the transaction while the securities firm defaults. Currently the fund has a total amount of around NT\$1 billion. This fund has never been used since its establishment in 1993, though there were some critical events of market default happened since then. It was because the clearing and settlement fund had taken over the transaction obligations due to be paid to investors.

5.2.2 INDIRECT INSTRUMENTS

5.2.2.1 Public offering and listing

There are provisions of the Law regarding issuers of securities and company disclosure that are designed to prevent investor's damages indirectly from listed company's unjustified activities.

Article 20 forbids fraudulent conduct and false settlement involved in public offering, issuance and trading of securities, and violation of the Law will be punished with imprisonment or substantial amount of fine.

Article 32 prescribes that the issuer, its responsible persons, employees, underwriters, accountants, attorneys, and other professional persons must be responsible for the information contained in prospectus, which they have signed to certify the accuracy of the information. In the event that there are misrepresentation, false statement, and material omission in the prospectus, which results in misleading effect, they are jointly and severally liable for investor's damages.

According to **Article 36**, listed company must periodically disclose CPA audited and/or reviewed financial reports to the public; and if there is an event that has occurred which may have material impacts on shareholder's equity or the stock price, it must be disclosed two days within its appearance.

Furthermore, the Law forbids insider's unfair or unjustified conduct of securities transaction. **Article 157** requires that the profits resulted from insiders' (director, supervisory director, executive staff, shareholder holding more than 10% of company's outstanding shares, etc) buying and selling stock within a period of 6 months, belong to the company. The board directors, on behalf of the company, are obligated to implement the restitution.

The **article 157-1** also forbids the insiders' securities trading by taking advantage of undisclosed information. Violation of the Law shall be liable for civil damages and criminal action.

TAIWANS EXCHANGE RULES

So as to prevent issuing company from fraudulent and illegal activities, after its listing, which could damage an investor the Exchange's rules of listing consider lots of qualifications in addition to financial requirements for a company that applies for listing. The Exchange would take account of the facts, such as the company's independence of financial operation, the company's history of doing material transaction with its related persons, the company's compliance with its internal control system and accounting system and its faithful implementation on auditing system. The Exchange is also concerned with the board directors' and top management's conduct. The conduct and activities regarded as not qualified for listing include:

the board members' and responsible persons' involvement in activities that is against integrity principle for past 5 years, the board members' and big shareholders' transferring substantial amount of share in the applying year and previous fiscal year, the number of board members less than five or independent directors less than two, the board of directors' inadequacy of independence, and so on.

DISCLOSURE

Full and timely disclosure of company information is also an important measure for investor protection. What the listing company should disclose includes six categories this are:-

- a) Financial and investment related matters
- b) Legal actions,
- c) Material events related to operation and production,
- d) Changes in management and board members

d) Decisions related to dividend and shareholders' right

e) other matters that may have impacts on stock price or shareholders' equity.

The company accordingly shall file its financial reports including quarterly, semi-annual and annual reports, and report of monthly revenue as well. And, if there are any information related to company's significant decision, or any events that may affect stock price, on the day of events or before the next trading day if it has been reported by media, the company must input the information into the **Market Observation System (MOS)**.

5.2.2.3 Market Examination

Securities firms function as intermediaries in the market. Therefore, the soundness of a securities firm really is critical to the fairness and efficiency of market. The Securities Company Regulation requires that securities firms must establish a sound internal control and auditing system which should consist of every aspect of the company's business, operation, and related rules and regulations. A company that has a good compliance with its control system reduces the disputes and conflicts with investor's. With the SFC's authorization, the Exchange is in a position to examine how well the securities firm complies with the securities related rules and regulations, and its own control system. TSEC normally conducts field examination on each securities firm once a year. It may also conduct extra or special examination on the basis of the SFC's instruction, securities firm's deteriorating financial condition, and/or investor's act of disclosing and appealing. If it is found that securities firm is financially embarrassed or involved in risky trading, it can restricted in its market transaction to a limited amount. The statistics show the

Exchange's auditors carried out 167 annual routine examinations and another 335 examinations for investors' disclosing/appealing and other causes.

I am of the view that examination measurement is advantageous to investor protection, investor confidence helpful to securities firms' risk prevention as well.

5.2.2.4 Market Supervision

Market surveillance is another important vehicle for the TSEC to maintain the market in good order and protect investors accordingly. The surveillance operation is implemented through on line monitoring and off line investigation as well, with an aim to discover and prevent from manipulation and insiders trading. For some information that may have substantial impact on the market, the surveillance department also makes immediate investigation and verification so as to stop the scattering of rumors and further manipulation.

Prevention of securities firm's likely default in the market is another objective of the surveillance operation. If any securities trading are found unusual in its price or quantity, the TSEC takes preliminary actions such as adjusting margin ratio, delaying time of matching cycle, restricting securities firms' amount of trading for that particular securities, and demanding delivery and payment in advance. If the unusual trading is found having influences on market order or damages to investors' interest, the TSEC may make temporary halts for a particular stock or the whole market's trading. Once there is evidence of illegality, the Exchange will further turn the case to the SFC or authority of justice. Last year, the TSEC totally conducted 112 investigations among which 16 cases were suspected manipulation and insider trading.

5.3 Legislation of Investor Protection Law

Although there are various measurements and regulations to protect investors as seen from the above, it is still not good enough for investors to fight against malicious behaviors of listed companies and securities firms. According to Taiwan's judiciary, business malice can be a criminal charge rather than a civil responsibility, in which the integrity of the company owner is hardly defined by law. Therefore, once owners of either listed companies or securities firms illegally transfer the companies' assets to their own accounts, which cause investors' financial damages, capacity of the current funds is not full enough to cover whole compensation of investors' loss.

In order to be more thoughtful to protect investors, the SEC has, for years, been working on the legitimacy of Investor Protection Law (hereinafter referred as the Protection Law), a bible of protecting bona fide investors.⁶⁴

The Protection Law contains 56 provisions, which can be categorized into several focuses as follows:-

a. A specific administrative body is established to serve investors. The entity is organized as a trustee with financial supports from contributions of each securities related institution. A board of trustee is formed and board of directors should be assigned by

⁶⁴ The draft of the Protection Law was formalized in 1999, and, finally, in May 2002, the Financial Committee of the Legislature Yuan passed the primary testimony of the legislation of the law.

contributors and appointed by the Authority from scholars, professionals and fair-minded people.

b. A maximum of NT\$ 5 billion protection fund is reserved to protect bona fide investors whose losses are not covered by the securities settlement fund or other compensations.

The sources of the fund are from the primitive contributors and securities related sectors.

c. A service of consultation is imposed to advance investors' claims and help negotiating with troubled securities companies.

d. Litigation of Class Actions is provided for investors to fight against the fraud. Class Actions, which are referred from the promulgation of Securities Investor Protection Act of U.S.A., 1970, provide investors with a channel of group appeal to the court. Additionally, the Protection Law mandates independency of corporate governance of public as well as listed companies.. The law also requires that documentation of securities related firms particular to business operation and financial statement must be saved properly for investigation uses, with no rejection whatsoever.

5.4 CONCLUSION

It is right to conclude that regulatory mechanism contains many measurements of investor protection. Under such circumstances, there is much likelihood that investor can be faced with some market participants' malicious conducts as fraud and embezzlement, and suffer substantial losses as a result. The Taiwan market is characterized of individual retail investors. The investors are in such disadvantageous positions relative to securities brokers-dealers and issuing companies as the incapacity of presenting satisfactory evidence, insufficient accessibility of information and high cost of proceedings, that they

are unable to get indemnity of loss by way of judicial remedy. All these bring about society's injustice.

At present stage Taiwan endeavors to improve the investor protection mechanism in the market. One of the main achievements is the pursuance of the Investor Protection Law which has been under legislation, and which will provide damaged investors with legal remedies in the aspects of consultation, litigation and subrogation of compensation.

This lawmaking will surely assist in the adequacy and completeness of the protection system. However, the adequacy and completeness of investor protection depends not only on statutory enhancement, but also on regulator's effective administration and self-regulation of market participants and enterprises.

In view of this, I believe that their mechanisms are much ahead as compared to those existing in Kenya but there is still room for improvement. In my next chapter I will be making recommendations picking on the strong points that exist in the Taiwan markets.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

6.1 CONCLUSION

The study sets out to investigate various issues. In chapter one, we laid the foundation for this study. We clearly looked at the various categories of investments that are open to an investor. This was very vital since it gave as a picture of the extent to which our capital markets have grown. The various characteristics of investments were also determined.

In the second chapter, I examined the justification for protection beginning with the history to the need for investment protection. The chapter further discussed the case for securities regulation and investor protection. In this chapter it was established that investor protection is not aimed at exempting an investor from his own errors of judgment rather it is aimed at providing a level of play field to all. It is neither aim at ensuring that an investor makes profit nor is it to prevent losses. The regulation exists in order to provide an environment that facilitates fair play, protect and compensate investors who become victims of fraud, dishonesty and unfair practices in the market.

We also observed the risk to which an investor is susceptible. Extensively insider trading and the disclosure principle were also discussed. It is clear that the spirit behind the general prohibition and regulation of insider dealings is the need to protect investors from unfair trading practices and enhance and rebuild investor confidence in the securities market. With regard to disclosure, entities issuing bonds and equities are required to disclose information, which the public deemed material. This information is essential to

enable the investors to make well-informed investment decisions. Its major purpose is to encourage investment of capital in debt or shares of a company through establishment of a free market for such investments.⁶⁵

Chapter three focused on examining the existing legal regime that seeks to protect an investor in the stock market. This chapter was the bulk of my thesis. We evaluated the adequacy of the laws and briefly we looked at the institutions existing which aim at protecting investors. For this purpose we looked at the Acts, which Acts, include the Capital Market Act, the Companies Act, the Foreign Investment Protection Act, The Central Depositories Act and The Prevention of Fraud Act. Among the institutions are the Capital Markets Authority, the Nairobi Stock Exchange and The Credit Rating Agencies. This chapter identifies the various deficiencies in the existing laws. The chapter further established the performances of the Capital Markets with regard to the number of shares traded, number of investors trading, and the performance of different sectors of the economy.

In chapter four we examined the existing system for investor protection in the stock market in Taiwan. Taiwan securities market has grown at a very high rate within a very short period. As was noted the greatest percent of investors are individual investors. They are able to invest due to the confidence and protection offered in the market. Taiwan was used for purposes of comparative study since its securities market is one with a difference.

⁶⁵ Eilis Ferram, *Company Law and Corporate Finance* (Oxford University Press, 1999) p.g 569

On the whole, this study has examined the place of law and to an extent institution as determinants of investor protection and investor confidence and in the long run the growth of capital markets.

6.2 RECOMMENDATIONS

In view of the conclusion and findings from this study a number of reforms are recommended. These entail legal, institutional and policy reforms that I believe will provide answers to a better mode of protecting investors.

6.2.1 LEGAL REFORMS

6.2.2.1 CAPITAL MARKETS AUTHORITY ACT.

The Act as observed has too much regulatory power. It is my view that some of this power should be vested onto the Nairobi Stock Exchange. Secondly, the Nairobi Stock Exchange should be made self-regulatory and it should be removed from the ambit of the CMA. These will ensure that the problem of investor protection will be tackled much closely.

Kenya's Capital Market has adopted both the Government and self-regulatory approaches to investor protection. The government approach is one where the government passes legislation which seeks to control access to and activity on the trading markets. This control may be exercised directly under legislation or may call for the creation of a Central Authority to regulate the securities market. In Kenya the Capital Markets Authority was established under the CMA Act. Self-regulatory on the other hand refers to associations of industry members who agree as a condition to membership

of the organisation to submit voluntarily to common rules and requirements. An example of this is the Nairobi Stock Exchange but 'just in theory'. **Why do I say this?** The CMA has regulatory power not only to intermediaries but also to the Nairobi Stock Exchange which in theory is a self regulatory organisation. The CMA dominates the securities market in Kenya. For the NSE to operate as a self- regulatory organisation, regulatory control and powers of the CMA over the NSE should be confined to the least minimum so as to allow the NSE function as a self- regulatory organisation.

6.2.1.2 COMPANY LAW

It is established that most provisions that aim to protect an investor in equities are also envisaged in the Capital Markets Act. In view of this I recommend that this provisions for example those that relate to issuing of prospectus should be harmonized with those formulated by the Capital Markets Authority for ease of regulation and administration of new issues. I also propose that company laws should be reviewed and amended to incorporate corporate governance rules and protection of minority shareholders.

6.2.1.3 CENTRAL DEPOSITORIES ACT

From the previous chapter (chapter 3) we looked at the importance of the Central Depositories and it is clear that its establishment was of great importance in protecting investors. The Nairobi Stock Exchange should expedite the process of institutionalizing the CDS and ensuring that the Act put into operation. This will increase efficiency of settlement and reduce transaction costs.

6.2.1.4 THE PREVENTION OF FRAUD (INVESTMENTS)

Its date of commencement has never been announced. Secondly the Act needs to be amended to incorporate provisions emanating from the Kenya Anti- Corruption Unit.

This will ensure that the laws in place do not conflict with each other.

6.2.1.5 FOREIGN INVESTMENT PROTECTION ACT.

Presently in Kenya, liberalization of markets is taking place. Any impediments to foreign investment should be done away with. This Act should be amended and reformed to be able to encapsulate liberalization.

6.2.2 INSTITUTIONAL REFORMS

There are various institutions that exist and others that need to be introduced for purposes of protecting an investor.

6.2.2.1 THE NAIROBI STOCK EXCHANGE

It plays a key role in investor protection. Its recommendations have been considered in article 6.2.1.1 that aim at making it self-regulatory not only in theory but also in practice.

6.2.2.2 CREDIT RATING AGENCIES

These institutions are very vital to the development of a bond market. Its presence is imperative. No credit licenses have been licensed as yet. The government should hasten establishment of reliable Credit Rating Agencies who can assess the issuers credit risk. Rating is essential to provide investors with an objective and independent opinion on the relative credit risk of financial instruments generally and in particular bonds. For a

successful bond market development, the country should encourage the initial issue of guaranteed bonds or enhanced assets-backed bonds to generate initial confidence in those instruments. Thereafter non-guaranteed bonds but rated should follow. These would allow orderly development and acceptance of rating services. The initial rating agencies should be formed in partnership with internationally reliable agencies such as **Standard and Poors or Moodys** to provide their acceptance, transfer their technology and develop manpower capacity. All commercial banks should be rated since in this process the investor will appreciate the different profiles for different banks.

6.2.2.3 CAPITAL MARKETS PROFESSIONALS

Institutions should be established to provide people with knowledge that relates to capital markets. The country really needs professionals in this field and this will increase the level of investor protection. Universities and colleges should provide a curriculum for this group of professionals. The NSE has tried to do this by providing a course known as Certified Financial Analyst. More needs to be done to improve investor education.

6.2.2.4 OVER THE COUNTER MARKET (OTC)

The OTC is an incubator for companies prior to getting listed on the stock exchange. It also constitutes the second path which family owned enterprises follow before going public. Venture capitalists often also use OTC market to exit from their investments. The death of these institutions in 1954 and its continued absence is critical to the continued underdevelopment of the equities markets in Kenya. A policy decision to revive the OTC market is crucial to the re-emergence of a viable equities market.

As a whole the prospective efforts possibly we can make comprise: constructing competent authority's management goals and strategies, intensifying market regulators' independence and function, establishing complete and integrated enforcement system, enhancing corporate governance, requiring independent directors, cultivating legal and regulations compliance, promoting credit rating, and building up sound market self-regulatory system. I am convinced only with all these aspects being evenly and steadily developed, can a thorough investor protection be accomplished.

It is good to recognize that only a market where investors are effectively protected, can the corporate fund raising be made easily, and thus, the securities market facilitates the country's economy development. As former U. S. Securities Chairman Mr. Arthur Levitt remarked in the "S. E. C. Speaks" Conference in 1998 Washington D. C.,

"Investor protection is our legal mandate. Investor protection is our moral responsibility. Investor protection is my top personal priority."

It is the responsibility and top priority of all market players to pursue a better investor protection.

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