

**MAURER SCHOOL OF LAW, INDIANA UNIVERSITY ENHANCING SECURITIES MARKETS IN SUB-SAHARAN AFRICA: AN OVERVIEW OF THE LEGAL AND INSTITUTIONAL ARRANGEMENTS IN KENYA****Dr. Jacob K. Gakeri**

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**Abstract**

*This paper explores the role of legal norms in the enhancement of securities markets in Sub-Saharan Africa where the markets are still nascent with specific reference to Kenya. Part I highlights the critical role that the legal and institutional framework plays in securities markets governance and investor protection. It postulates that for securities markets to thrive and deepen, countries must endeavor to create appropriate legal and institutional arrangements. Part II is an elucidation of the legal structures on securities markets and the financial services sector in Kenya. From the discussion, it is clear that the framework is characterized by gaps, duplications, inconsistencies and restrictions on investment. More importantly, there has never been a comprehensive approach to the promotion of financial services in Kenya. Part III examines the institutional arrangements and assesses their contribution to the enhancement of securities markets. Evidently, the multiplicity of regulatory bodies has not endeared the securities markets and there is need for reforms.*

**Why the legal and institutional framework matters**

Sub-Saharan African countries have been continually searching for opportunities to transform their economic fortune.<sup>1</sup> Among the central components for the envisioned transformation is the development of viable securities markets.<sup>2</sup> These countries envision that the increasing demand for domestic and foreign capital can be satisfied by robust and efficient securities markets.<sup>3</sup> Consequently, no effort has been spared in an attempt to actualize this dream. Countries that did not have stock exchanges in the 1980s now have the institution.<sup>4</sup> These countries “look with ardor to establishing attractive capital markets in order to procure sought-after capital from private sources, frequently from abroad.”<sup>5</sup> The securities markets are perceived as the *panacea* for unlocking these countries’ economic potential.<sup>6</sup> The role of securities markets in financing economic growth is well documented.<sup>7</sup> These markets have the potential to become powerful engines for economic growth in Sub-Saharan African countries.<sup>8</sup> The presence of robust and vibrant securities markets has a positive impact on society.<sup>9</sup> Studies have shown that there is an intimate relationship between deep securities markets and economic growth.<sup>10</sup> These markets facilitate the raising of capital which is efficiently allocated to productive sectors of the economy thus promoting growth. This disintermediation function is critical to economic development.

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<sup>1</sup> See generally Note, Securities Markets and Stock Exchanges in Black Africa, 67 COLUM. L. REV. 892 (1967). See also, Andrew T. Guzman, Capital Market Regulation in Developing Countries: A Proposal, 39 VA. J. INT’L L. 607, 610 (1999).

<sup>2</sup> See Celia R. Taylor, Capital Market Development in the Emerging Markets: Time to teach an old dog some new Tricks, 45 AM. J. COMP. L. 71, 71 (1997).

<sup>3</sup> Troy A. Paredes, A Systems Approach to Corporate Governance: Why Importing U.S. Corporate Law is not the Answer, 45 WM. & MARY L. REV. 1055, 1056 (2004).

<sup>4</sup> Evelyn Bradley, A Regional Stock Exchange: Hope for Sub-Saharan Africa Stock Markets, 8 MSU-DCL J. INT’L L. 305, 305 (1999).

<sup>5</sup> Marc I. Steinberg, Emerging Capital Markets: Proposals and Recommendations for Implementation, 30 INT’L LAW. 715, 716 (1996).

<sup>6</sup> See Capital Market Development: The Road Ahead, available at <http://www.unitar.org/pft/sites/default/files/DocSeries13.pdf>, p.12 (visited on May 14 2010).

<sup>7</sup> Collin Kirkpatrick, Does Financial Development Contribute to Poverty Reduction? 42 J. DEV. ST. 631 (2005); Strahan Spencer & Adnan Wood, Making the Financial Sector Work for the Poor, 42 J. DEV. ST. 657 (2005)., Wagacha M. Mobilizing Domestic Resources in Kenya: A Survey of Shareholder Strategies in the Capital Markets, INSTITUTE OF POLICY ANALYSIS AND RESEARCH, Discussion Paper No. 022/2000 (2000), Cross, Law and Economic Growth, 80 TEX. L. REV. 1737, 1769-70 (2002), Rafael La Porta et al, Investor Protection and Corporate Governance, 58 J. FIN. ECON. 3, 16-17 (2000).

<sup>8</sup> John Fagan, The Role of Securities Regulation in the Development of the Thai Stock Market, 16 COLUM. J. ASIAN L. 303, 305 (2003).

<sup>9</sup> See Collin Kirkpatrick & Christopher Green, Finance and Development: An Overview of the Issues, 14 J. INT. DEV. 207 (2002).

<sup>10</sup> See Michael S. Bennett, Securities Regulation in Singapore: The City-State as an International Financial Center, 12 UCLA PA. BASIN L. J. 1; Yohane Khamfula, African Capital Market and Real Sector Investment, 17 J. INT. DEV. 512 (2005). Bashar H. Malkawi & Haitham A. Haloush, Reflections on the Securities Law of Jordan, 23 AM. U. INT’L L. REV. 763, 764 (2008).

Robust and efficient securities markets enable entrepreneurs' to access financial resources necessary to commercialize innovation, expand production of goods and services, invest in capital improvement and new technologies and increase employment. Relatedly, these markets promote mobilization of domestic and foreign financial resources. Finally, they facilitate privatization of state enterprises.<sup>11</sup> However, available evidence is explicit that Sub-Saharan African countries have yet to realize the benefits that accrue from securities markets.<sup>12</sup> The markets are undeveloped in every respect and remain an insignificant part of the national economies. They are characterized by high transaction costs, illiquidity, poor settlement and delivery systems, volatility, lack of information and few investors.<sup>13</sup> Although some of the markets are seemingly competitive in terms of returns to investors, the overall picture for the region is unimpressive. Market performance has been lackluster. Excluding South Africa, the total number of listed companies in all the stock exchanges is still below 500 which is the average number of listed companies in most jurisdictions in South East Asia. In addition, the markets have remained shallow. What emerges is that most countries rushed to establish stock exchanges without taking stock of the prerequisites for thriving securities markets. The private sectors, for example, remain small and most businesses are family owned. More importantly, no tangible efforts were made to make these countries exceedingly friendly to local and foreign investors.<sup>14</sup> Undoubtedly, securities markets cannot thrive in investor unfriendly environments. The dream of using securities markets as a vehicle for growth in most Sub-Saharan African countries is proving rather elusive.<sup>15</sup>

These countries have no alternative but to acknowledge that "creating strong securities markets is hard."<sup>16</sup> A number of scholars opine that securities markets are notoriously difficult to develop and characterize financial markets only at the high level of development.<sup>17</sup> There is credibility in this argument. A stock exchange, for example, is a symbol of wealth and exemplifies capitalism.<sup>18</sup> Arguably, securities markets can only thrive in countries that have adopted the capitalistic mode of production.<sup>19</sup> This is because the lifeblood of capitalism is capital.<sup>20</sup> The establishment of deep, robust and efficient securities markets is a herculean task for many Sub-Saharan African countries. This is because it demands an assemblage of the necessary institutional infrastructure which takes time and sustained effort to develop. Aggregating the multifarious structures and mechanisms is a painstaking task<sup>21</sup> and developing jurisdictions cannot leapfrog the process. One of the principal challenges a country must grapple with in the development of deep and vibrant securities markets is how to constitute an effective legal and institutional framework.<sup>22</sup> The centrality of the securities regulatory regime is well documented.<sup>23</sup> The "law matters" thesis postulates that the law has a central role to play in the development of securities markets.<sup>24</sup> Efficient and robust securities markets are dependent on institutional building blocks and the mainstream institution is the legal architecture.<sup>25</sup>

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<sup>11</sup> See Benjamin Lubinda Ngenda, *Comparative Models of Privatization: A Commentary on the African Experience*, 21 *BROOK J. INT'L L.* 179 (1995).

<sup>12</sup> See Phillip C. Aka, *Corporate Governance in South Africa: Analyzing the Dynamics of Corporate Governance Reforms in the "Rainbow Nation,"* 33 *N.C. J. INT'L L. & COM. REG.* 219 (2007); Rose Ngugi, *Capital Markets: Financial Deepening and Economics Growth*, available at <http://www.csae.ox.ac.uk/conference2009/EDI>, (visited on May 10, 2010); Ali Adnan Ibrahim, *Developing Governance and Regulation for Emerging Capital and Securities Market*, 39 *RUTGERS L. J.* 111 at 114-115.

<sup>13</sup> See generally Iwa Salami, *The Financial Crisis and a Regional Perspective for Emerging Economies in Africa*, 25 (3) *J.I.B.L.R.* 128 (2010); Bishwambhar Pyakuryal & Kishor Uprety, *Nepal, The Emerging Securities Markets (Legal and Policy Aspects)*, 9 *TRANSNAT'L LAW.* 421 (1996).

<sup>14</sup> See Carol Lancaster, *Economic Development and Investment in Sub-Saharan Africa*, 30 *L. & POL'Y INT'L BUS.* 679, 681-83 (1999).

<sup>15</sup> See generally, KENNETH KAOMA MWENDA, *ZAMBIA'S STOCK EXCHANGE AND PRIVATIZATION PROGRAM: FINANCE LAW IN EMERGING MARKETS*, 2001.

<sup>16</sup> Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 *UCLA L. REV.* 781, 782 (2001).

<sup>17</sup> See Thandika Mkandawire, *The Political Economy of Financial Reform in Africa*, 11 *J. INT. DEV.* 321, 339 (1999); Ajit Singh, *Should Africa Promote Stock Market Capitalism?* 11 *J. INT. DEV.* 343, 345 (1999); P.J. DRAKE, *MONEY, FINANCE AND DEVELOPMENT*, Oxford, 1980.

<sup>18</sup> *Id.* See Bradley, *supra* note 4 at 328.

<sup>19</sup> This argument is borne by the fact that before the collapse of the Berlin Wall and communism, Eastern European countries including Russia and China had no substantial securities markets.

<sup>20</sup> See generally HERNANDO DE SOTO, *THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE*, (Basic Books, 2000).

<sup>21</sup> See Black, *supra* note 16.

<sup>22</sup> See Andrew T. Guzman, *Capital Market Regulation in Developing Countries: A Proposal*, 39 *VA. J. INT'L L.* 607, 611 (1999); Curtis Milhaupt, *Beyond Legal Origin: Rethinking Law's Relationship to the economy-Implications for Policy*, 57 *AM. J. COMP. L.* 831 (2009); Rosa Lastra, *Financial Law Reform in Emerging Economies*, 23(8) *J.I.B.L.R.* 413; Laurent Garzaniti, *Single Market-making: EC Regulation of Securities Markets*, 14 (3) *COMP. L.* 42 (1993).

<sup>23</sup> *Id.* See also Solaiman S. M., *Investor Protection and Civil Liabilities for Defective Prospectuses: Bangladeshi Laws Compared with their Equivalents in India and Malaysia*, 25 *J. L. & COM.* 505, 509 (2006).

<sup>24</sup> See Stephen J. Choi, *Law, Finance and Path Dependence: Developing Strong Securities Markets*, 80 *TEX. L. REV.* 1657 (2002); Robert B. Ahdieh, *Making Markets: Network Effects and the role of the law in the Creation of Strong Securities Markets*, 76 *S. CAL. L. REV.* 277 (2003); Robert B. Ahdieh, *Law's Signal: A Cueing Theory of law in Market Transition*, 77 *S. CAL. L. REV.* 125 (2004); John Coffee Jr., *The Rise of Dispersed Ownership: The Roles of law and the state in the separation of Ownership and Control*, 111

Countries with deep securities markets have legal regimes that fulfill key functions in support of the markets and protection of property rights while retaining the capacity to adapt to new market realities and shifts in demand for legal governance resulting from social and economic circumstances.<sup>26</sup> Studies have shown that the legal regime plays a central role in the development of securities markets.<sup>27</sup> The importance of an optimal mix of legal and institutional arrangements cannot be overemphasized. The legal framework determines the efficiency of the securities markets including how efficient capital can be raised and allocated. It determines the intensity of regulation to ensure that there is no over or under-regulation.<sup>28</sup> Despite the fact that there are varying levels of enforcement between jurisdictions, the underpinning reality is that as long as the system is deemed protective of investors, securities markets will thrive. Some scholars have developed a laundry list of the requisite laws and institutions.<sup>29</sup> Arguably, deep and vibrant securities markets are a function of appropriate legal, institutional arrangements and a host of other factors, including local culture and institutions.<sup>30</sup>

Since the legal regime is the bedrock of robust securities markets, there is need to establish a regulatory arrangement that meets the needs of investors and issuers, generates capital inflows and promotes growth. Strong securities law presupposes substantive law on disclosure, transparency, prohibition of all forms of market abuse and minority protection against coercive takeover bids and expropriation.<sup>31</sup> For instance, the groundwork of the United States and United Kingdom securities markets has been the robust legal and regulatory framework. The legal regime fosters certainty and continuity which is essential for investment.<sup>32</sup> Investor protection is the linch pin of deep securities markets.<sup>33</sup> Investors typically rely on experience and continuity. Arguably, countries that are able to establish such legal regimes can expect growth in investment. This is because investor protection imbues market confidence which is a critical ingredient for market growth.<sup>34</sup> For instance, despite large scale privatization by the government, the Czech securities markets failed in the 1990s because investors had no confidence in the entire system.<sup>35</sup> To an increasing extent, the goal of the legal regime is protection of the securities markets. As exquisitely observed:

“In sum, capital markets cannot flourish without an appropriate legal framework that reduces subjective decision making and encourages transparent and objective enforcement of laws and related regulatory framework. Certainty as to the working and fairness of the systems will attract more participation in financial markets and will curb interest groups that benefit from its weaknesses. Law should also build upon social and cultural factors that enjoy similar force or obedience such as customary law.”<sup>36</sup>

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YALE L. J. 1 (2002); John C. Coffee, Jr. Racing Towards the top? The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance, 102 COLUM. L. REV. 1757 (2002); John N. Drobak, Law Matters, 76 WASH. U. L. Q. 97 (1998).

<sup>26</sup> See Troy Paredes, The Importance of Corporate Law: Some Thoughts on Developing Equity Markets in Developing Countries, 19 PAC. MCGEORGE GLOBAL BUS. & DEV. L. J. 401 (2007).

<sup>27</sup> See Curtis J. Milhaupt, Beyond Legal Origin: Rethinking Law's Relationship to the Economy-Implications for Policy, 57 AM. J. COMP. L. 765, 842-3 (2009).

<sup>28</sup> See generally, William J. William, Jr., Securities Regulation in Emerging Markets, 743 PLI/ CORP. 213; Simeon Djankov et al., The law and Economics of Self-Dealing 37 (Nat'l Bureau of Econ. Research, Working Paper No. 11883, (2005), available at <http://www.papers.nber.org/papers/w11883>; Paul Latimer, Regulation of Securities Markets in the twenty-first Century: An Australian Perspective, 21(2) COMP. LAW. 53, 53 (2000).

<sup>29</sup> See generally Cristie L. Ford, Towards a new Model for Securities law Enforcement, 57 ADMIN. L. REV. 757 (2005). See also Paul G. Mahoney, The Exchange as Regulator, 83 VA. L. REV. 1453 (1997); A.C Pritchard, London or Delaware, 78 U. CIN. L. REV. 473 (2009).

<sup>30</sup> See generally Black, supra note 16.

<sup>31</sup> See Mark J. Roe, Legal Origins: Politics and Modern Stocks Markets, 120 HARV. L. REV. 460. See also, Amir N. Litch, The Mother of all Path Dependencies: Towards a Cross-Cultural Theory of Corporate Governance Systems, 26 DEL J CORP L. 147 (2000); John C. Coffee, Jr. Do Norms Matter? A Cross-Country Evaluation, 149 U. PA. L. REV. 2151 (2001),

<sup>32</sup> See Stephen Choi, Regulating Investors not Issuers: A Market-Based Proposal, 88 CAL. L. REV. 279 (2000).

<sup>33</sup> See Camilo Andres Rodriguez, Bringing Legal Certainty to Foreign Investors: The Role of a Regional Organization, (July 2009) (unpublished S.J.D. dissertation, Indiana University) (on file with Michael Maurer School of Law Library, Indiana University).

<sup>34</sup> See generally William W. Bratton & Joseph A. McCahery, Comparative Corporate Governance and the Theory of the Firm: The Case against Global Cross Reference, 38 COLUM. J. TRANSNATIONAL L. 231 (1999); Cally Jordan, The Conundrum of Corporate Governance, 30 BROOK J. INT'L L. 983 (2005); Katharina Pistor et al., Law and Finance in Transition Economies, 8 ECON TRANSITION 325 (2000); Lawrence Juwah, Securities Regulation: Issues of Ethics in the Capital Markets of Nigeria, 20(4) J.I.B.L.R. 193, 2000 (2005).

<sup>35</sup> See Lynn A. Stout, The Investor Confidence Game, 68 BROOK. L. REV. 407 (2002); Tamar Frankel, Regulation and Investors' Trust in the Securities Markets, 68 BROOK. L. REV. 439 (2002); Raymond H. Brescia, Trust in the Shadows: Law, Behavior and Financial Regulation, 57 BUFF. L. REV. 1362 (2009); supra note 344; Allan R. Roth, Capital Market Development in Israel and Brazil: Two Examples of the Role of Law in Development, 19 STAN. L. REV. 1277 (1967); Brian R. Cheffins, Does Law Matter? The Separation of Ownership and Control in the United Kingdom, 30 J. LEGAL STUD. 459 (2001).

<sup>36</sup> See John C. Coffee Jr., Privatization and Corporate Governance: The Lessons from Securities Markets Failure, J. CORP. L. 1, 9-14 (1999).

<sup>37</sup> See Ali Adnan Ibrahim, Developing Governance and Regulation for Emerging Capital and Securities Markets, 39 RUTGERS L. J. 111, 119 (2007).

Put differently, the legal framework must facilitate the proper functioning of the securities markets by ensuring that relevant disclosure requirements are complied with and the necessary institutional framework is in place. This will boost investor confidence, and maintain market stability and growth. More importantly, the legal regime should assimilate supportive cultural and institutional structures.<sup>37</sup> In the search for legal regimes for the nascent securities markets, Sub-Saharan African countries have had three alternatives: replicate other countries laws, domesticate such laws or originate indigenous laws. The last alternative has been largely ignored.<sup>38</sup> In the scramble to institutionalize the necessary arrangements, most developing jurisdictions 'copied and pasted' legal regimes of jurisdictions with deep and vibrant securities markets without testing their appropriateness. The rough logic being that by adopting such laws, deep and vibrant securities markets would be replicated within their borders.<sup>39</sup> This has not happened and is unlikely to happen. Arguably, rules and institutions that function well in one country may be inappropriate in another because of the absence of supportive norms and corresponding institutions. Regulatory systems of countries with deep and vibrant securities markets are a culmination of many years of reactions and counter reactions to a dynamic business environment. Since the regimes are based on the current levels of sophistication of the markets, they may be unsuitable for nascent markets.<sup>40</sup> Although developing jurisdictions may learn from experiences of developed jurisdictions, they must be cautious when importing legal regimes because of the underlying variations and differences. Admittedly, most developing countries lack the full complement that facilitates deep and vibrant securities markets.

Sub-Saharan African countries adopted the capitalistic mode of production without establishing the foundation for its sustenance. As a consequence, securities markets in the region are a preserve of the elite who also enjoy political and economic power.<sup>41</sup> Other classes are excluded from utilizing the products of the securities markets.<sup>42</sup> The system has created the proverbial bell jar with a few insiders and millions of outsiders.<sup>43</sup> Securities markets in the region are emblematic of the classical trap of capitalism i.e. concentrating capital in the hands of a few who can concretize their property rights.<sup>44</sup> What is puzzling is that these countries have large amounts of domestic capital that can be captured and applied to productive use. In Kenya for example, untapped capital amounting to billions of shillings is used for speculative purposes in the property market or remains in bank accounts or is invested in fraudulent schemes. The absence of an integrative legal system has perpetuated marginalization of the bulk of the population from the securities markets.<sup>45</sup> It is imperative that the legal framework be redesigned to ensure that the bulk of the population have a stake in the capitalistic system. This demands tampering with the *status quo* which has economic and political implications and could be resisted by those with vested interests.<sup>46</sup>

The fundamental challenge for these countries therefore is to create an integrated and effective property rights regime, rule of law and other institutions that will encourage and promote investment and free market. Since there is no one-size fits all legal regime, these countries should sagaciously adopt other countries laws but blend them with local customs and institutions in order to meet their particular needs.<sup>47</sup> The foregoing discussion establishes the context in which this paper analyzes Kenya's legal and institutional framework on securities markets.

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<sup>37</sup> Id.

<sup>38</sup> See Mark Gillen & Pittman Porter, *The Convergence of Securities Laws and Implications for Developing Securities Markets*, N. C. J. INT'L L. & COM. REG. 83 (1998). (making a strong and persuasive argument why developing countries copy other countries securities laws)

<sup>39</sup> See Troy A. Paredes, *The Importance of Corporate Law: Some Thought on Developing Equity Markets in Developing Countries*, 19 MCGEORGE GLOBAL BUS. & DEV. L.J. 401, 403 (2007); Jeswald W. Salacuse, *The legal Architecture of emerging Markets*, in Rosa Lastra (ed.) *THE REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE*, Kluwer International Law, The Hague, 2001. Rosa Lastra, *Financial Reform in Emerging Markets*, 23 (8) J.I.B.L.R. 413, 418-420 (2008); Alan Dignam & Michael Galanis, *Australia Inside-out: The Corporate Governance System of the Australian Listed Market*, 28 MELB. U. L. REV. 623 (2004); Jospoeh E.O. Abugu, *Technology, Globalization and the Nigerian Securities Markets*, 18 (7) J.I.B.L.R. 284, 284 (2003); S.M. Solaiman, *Investor Protection by Securities Regulators in the Primary Share Markets in Australia and Bangladesh: A Comparison and Contrast*, 16(4) J. F. C. 305 (2009).

<sup>40</sup> See Emil Bukhman, *The Cart before the Horse: Anticipatory Securities Regulation in Kazakhstan*, 22 BROOK. J. INT'L L. 535 (1997).

<sup>41</sup> See John M. Lutz, *Institutions and Economic Performance: Implications for African Development*, 21 J. INT'L DEV 58 (2009); Charles R. C. Pouncy, *Stock Markets in SSA: Western Legal Institutions as a Component of the Neo-colonial Project*, 23 U. PA. J. INT'L ECON L. 85 (2002).

<sup>42</sup> See De Soto, *Supra* note 20 at 159.

<sup>43</sup> Id. at 210

<sup>44</sup> Id. at 211

<sup>45</sup> Id. at 143

<sup>46</sup> Id. at 162

<sup>47</sup> A Ganesh Kumar et al., *Does the Source of Finance Matter? Financial Markets, Financial Intermediaries and Investment in India*, 14 J. INT. DEV. 211 (2002).

The growth and development of Kenya's securities markets is impacted by an impressive panoply of statutes and delegated legislation. This is legislation enacted at different times and informed by policies to develop and regulate distinct segments of financial services as opposed to the entire sector. Implementation of the statutes is overseen by a plethora of administrative bodies with divergent policies, orientation and standards. The sectoral approach has led to balkanization of the banking, insurance, pension, savings and credit and the securities markets. The lack of a comprehensive policy on financial services has contributed to its poor performance. The institutional framework for the securities markets comprises the Capital Markets Authority, Nairobi Stock Exchange, Collective Investment Schemes, Credit Rating Agencies, Ministry of Finance (Treasury), Registrar of Companies and the Central Depository and Settlement Corporation (CDSC). The Central Bank of Kenya is included in the institutional matrix because of its crucial role in the bond market and the banking sector generally. For purposes of this paper, institutional framework denotes legally established or sanctioned institutions.

### Legal framework

The legal framework governing Kenya's securities markets consists of numerous Acts of Parliament, delegated legislation, Guidelines and rules promulgated by the legislature, Capital Markets Authority (CMA), Nairobi Stock Exchange (NSE) and the Central Depository and Settlement Corporation. It replicates developments in the United Kingdom and South East Asia notably Malaysia, Singapore and Hong Kong. It is sophomorically believed that since Singapore and Malaysia were at the same level of economic development as Kenya in the 1970s, adopting similar laws could hasten the "catching up" notwithstanding the diverse political, social and economic and geographical circumstances. In addition, current thinking is that law is the only mechanism capable of facilitating the growth and development of the sector. Studies have shown that a facilitative legal and regulatory framework on securities markets should among other things: facilitate, stimulate and encourage private sector investment,<sup>48</sup> protect the minority, facilitate transparent and timely resolution of disputes, provide flexible tax systems and reasonable tax on dividend, favorable investment rules for foreigners, free and equal access to investment opportunities for foreigners and local investors (subject to reasonable exceptions, if any), provide for adequate disclosure by issuers, proscribe all forms of market abuse and provide effective enforcement mechanisms, user friendly laws governing establishment of business entities and a cost effective compliance system.<sup>49</sup>

The current legal framework on securities markets in Kenya is traceable to 1907 when the United Kingdom Parliament promulgated an Order-in-Council declaring that the sources of law of Kenya would henceforth be the Statutes of General Application, the Common law as modified by the doctrines of equity and judicial precedent<sup>50</sup> This transplanted United Kingdom law to Kenya and generally remains the state of affairs. For purposes of corporate law, the United Kingdom Companies Act of 1907 was adopted in 1922 and remained in force until January 1962 when the Companies Act 1948 was adopted and remains the operative statute.

From their inception in the 1950s to 1989, Kenya's securities markets operated privately with no significant government interference until 1971 when the Capital Issues Committee was established for purposes of approving listings on the Nairobi Stock Exchange. The Nairobi Stock Exchange operated as a self regulatory organization. Companies wishing to listing had to prepare prospectuses in accordance with the provisions of the Companies Act<sup>51</sup> and submit copies to the Ministry of Finance and the Nairobi Stock Exchange for approval. Additionally, a copy had to be delivered to the Registrar of Companies for registration. Registration of prospectuses by the Registrar of companies is a mere formality. On listing, companies were subject to the Listing Rules of the Nairobi Stock Exchange.<sup>52</sup> The self regulatory structures appear to have served the market well.<sup>53</sup> However, it was characterized by inefficiencies in enforcement.<sup>54</sup> The Capital Issues Committee retained its role as the principal regulatory institution for the primary market until March 1990 when the Capital Markets Authority was inaugurated.

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<sup>48</sup> PAATII W. OSOFU-AMAAH, REFORMING BUSINESS RELATED LAWS TO PROMOTE PRIVATE SECTOR DEVELOPMENT: THE WORLD BANK EXPERIENCE IN AFRICA, WORD BANK, 2000 at 34.

<sup>49</sup> International Finance Corporation (IFC), Investment Funds in Emerging Markets: Lessons of Experience Series, World Bank, 1996 at 14.

<sup>50</sup> § 3(1) Judicature Act, Cap. 8.

<sup>51</sup> See Muthua N.T., Trading in Company Shares: A Study of the Nairobi Stock Exchange, (June 1995) (unpublished) LL.B Dissertation, University of Nairobi (on file with Parklands Library, University of Nairobi).

<sup>52</sup> The Rules create a contractual relationship between the company and the stock exchange. The listed company is contractually bound to comply with the rules.

<sup>53</sup> Between 1967 and 1973, 26 companies listed on the Nairobi Stock Exchange.

<sup>54</sup> See Nixon Kareithi & Seneiya Waiganjo, ICDC Shares Puzzle, KENYA TIMES, Oct. 11, 1989 at 10; Nixon Kareithi, Stock Exchange turn down Timsales plea, KENYA TIMES, Mar. 29, 1990 at 15.

In 1965, the government amended the Exchange Control Act to limit the amount of foreign exchange a person could repatriate abroad. This amendment impacted negatively on investment and the securities markets.<sup>55</sup> Foreign companies could only remit earnings on capital which had been brought from abroad in the first place. Relatedly, passage of the Prevention of Frauds (Investment) Act in 1977<sup>56</sup> was an anticlimax. Although the Act was intended to formalize operations of Capital Issues Committee<sup>57</sup> and address certain aspects of the securities markets including market integrity,<sup>58</sup> it was never operationalized and thus had no effect on the markets. This was circumstantial evidence of governments' indifference towards securities markets. Nevertheless, it is important to acknowledge that this was the first significant attempt to establish some semblance of a public regulatory framework for the securities markets. Attempts to institutionalize governmental regulation of the securities markets came to fruition in 1989 when the Capital Markets Authority Act was promulgated.

### **Constitutional basis of securities markets**

The constitution of Kenya was promulgated by the President of the Republic of Kenya on August 27th 2010 ushering in a new constitutional dispensation for the country since 1963 when the first constitution was enacted by the United Kingdom Parliament for purposes of granting the country independence. The Constitution creates a presidential system with substantial parliamentary checks on executive power. It also provides for a devolved government and a robust bill of rights. Although the Constitution makes no specific reference to financial services in general or securities markets in particular which is not unique, it remains the legal predicate for the securities markets. This is because it is the supreme law and all other laws derive their validity from it. Since the Constitution vests the sovereign power in the people of Kenya, they have the constituent power to engage in commercial and other lawful transactions. This power is manifested in the constitutional provisions which guarantee the right to private property,<sup>59</sup> personal liberty,<sup>60</sup> equal protection,<sup>61</sup> freedom of speech,<sup>62</sup> assembly and association<sup>63</sup> among others.<sup>64</sup> The High Court of Kenya has interpreted the right to property as the foundation of capitalism in Kenya<sup>65</sup> and because the Constitution has preeminence over all other laws, their provisions must be consistent with the Constitution.<sup>66</sup> The principle of private property is essential for the accumulation of capital.

Put in context, since securities markets facilitate mobilization of capital and its efficient allocation in productive sectors of the economy, they are an integral part of capitalism which has its legal justification in the foregoing constitutional provisions. As intimated above, the stock exchange is a symbol of wealth and typifies capitalism. This argument is further fortified by the emergence of the company in Europe during the 17th and 18th centuries. The joint stock company is hailed as having been instrumental in the transformation from feudal to corporate capitalism. The real capitalist in today's world is not the individual businessperson, but the corporation. The utility of the joint stock company as the engine of the capitalist economy is well documented.<sup>67</sup> It is the most conspicuous feature of the capitalistic mode of production.<sup>68</sup> Undoubtedly, the limited liability company is inextricably interwoven with capitalism. Corporations play a fundamental role in Kenya's industrial and commercial sectors and the economy as a whole. They are essential tools for wealth creation.<sup>69</sup>

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<sup>55</sup> Listed companies devised various ways to disguise repatriation of profit abroad.

<sup>56</sup> Act No. 1 of 1977.

<sup>57</sup> § 4 (1)

<sup>58</sup> § 16

<sup>59</sup> Art. 40.

<sup>60</sup> Art. 28 & 29.

<sup>61</sup> Art. 27.

<sup>62</sup> Art. 33 & 34.

<sup>63</sup> Art. 36 & 37.

<sup>64</sup> Other Articles guarantee the right to life, privacy, and protection of law in criminal cases, movement, freedom from slavery servitude and forced labour, consumer rights, economic and social rights, and access to information.

<sup>65</sup> See Justice Nyamu J.G. (as he then was) in Republic v. Minister for Finance & Another ex parte Nyong'o & 2 others, HOWARD SHERMAN, RADICAL POLITICAL ECONOMY: CAPITALISM AND SOCIALISM FROM A MARXIST-HUMANIST PERSPECTIVE 19-21 (1972) arguing that private property is absolutely necessary for the accumulation of capital. He posits that: "In all capitalistic countries, the right to private property has attained a high degree of inviolability. It is everywhere treated as a natural right without specific functional obligation associated with it." See also CALVIN B. HOOVER, THE ECONOMY, LIBERTY AND THE STATE, 14-29 (1959); JOHN CHRISTMAN, THE MYTH OF PROPERTY: TOWARDS AN EGALITARIAN THEORY OF OWNERSHIP 29 (1994).

<sup>66</sup> See Art. 2; Justice Nyamu, Id.

<sup>67</sup> See generally B. HUNT, THE DEVELOPMENT OF THE BUSINESS CORPORATION IN ENGLAND, 1800-1867.

<sup>68</sup> See Andrew Hicks, Corporate Form: Questioning the Unsung Hero, J.B.L. 306, 308 (1997).

<sup>69</sup> See Department of Trade and Industry, Government Gazette No. 26493, South African Company Law for the 21st Century: Guidelines for Corporate Law Reform (2004) available at <http://www.info.gov.za/gazette/notices/2004/26493.pdf>.

Unmistakably, corporations, partnerships, cooperative societies, investment clubs and other informal associations are manifestations of peoples' enjoyment of the rights and freedoms guaranteed by the Constitution. In sum, utilization of products of the securities markets is an expression of sovereignty by the people. Although the rights and freedoms guaranteed by the constitution are couched in absolute terms, they are derogable where legislation expressly provides but only to the extent that the derogation is reasonable and justifiable in an open and democratic society based on human dignity, equality and freedom.<sup>70</sup> For instance, the right to property does not extend to circumstances in which it has been ascertained that the property was unlawfully acquired. The historical development of the statutory framework on financial services generally and securities markets in particular has been haphazard. Both are impacted upon by a legion of statutes which unfortunately reflect no coherent underlying philosophy. A similar observation may be made with regard to investment generally. Before 2004, Kenya had no specific legal regime an investment. Astonishingly, the Investment Promotion Act, 2004 does not recognize securities markets as an investment avenue and makes no reference to other statutes. Although the Companies Act was the oldest statute to make reference to securities markets, its provisions on the subject were too imprecise to make any substantial impact. The most recent statute on financial services was the Sacco Societies Act, 2008. To facilitate systematic presentation of data, the statutory framework is bifurcated. Part one analyzes the legislation on securities markets and financial services while part two examines the statutory framework which impacts on investment generally. However, as the discussion illuminates, this categorization is not mutually exclusive.

### **Framework on securities markets and financial services**

#### **Capital Markets Act<sup>71</sup>**

This is the principal legislative framework on securities markets in Kenya.<sup>72</sup> It is the statutory basis upon which the markets are administered. The objective of the Act as encapsulated by its preamble is to “establish a Capital Markets Authority for the purpose of promoting and facilitating the development of an orderly, fair and efficient capital markets in Kenya.” The Ugandan and Tanzanian statutes on securities markets have identical preambular provisions. Implicitly, the focus of the statute was the Authority not the securities markets. This is further exemplified by the fact that the provisions of the Act are devoted to procedural as opposed to substantive law. The most important innovation of the legislation was the establishment of an administrative structure for the securities markets. Creation of the Capital Markets Authority appears to have been inspired by the Malaysian and Nigerian Securities and Exchange Commission's which were modeled on the United States experience.

The Act establishes the Capital Markets Authority as a body corporate with all attributes of an incorporated association.<sup>73</sup> In addition, it prescribes the composition of the Authority including a chairman and a chief executive both appointed by the president on recommendations of the Minister of Finance for a period of three and four years respectively.<sup>74</sup> Both office holders are eligible for re-appointment for a second term of office. The minister is empowered to appoint six members of the Authority on the basis of their expertise and experience in legal, financial, banking, accounting, economics or insurance matters.<sup>75</sup> This is intended to imbue professionalism in the operations of the Authority. The Act provides that a public company wishing to offer its securities to the public or a section of the public for subscription or sale must prepare an information memorandum and file a copy with the Authority.<sup>76</sup> The Authority may approve or reject the proposed issue or sale. The statute establishes an Investor Compensation Fund to compensate investors who suffer pecuniary loss resulting from the failure of a licensed stockbroker or dealer to meet his contractual obligations.<sup>77</sup> Under the previous legal regime, the fund was managed by the Authority.<sup>78</sup> It is now under the superintendence of an independent board comprising eleven persons. As the Nyaga Stockbrokers Ltd debacle illustrates, the Investor Compensation Fund is grossly inadequate.<sup>79</sup>

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<sup>70</sup> Art. 24; An Act of Parliament making provision for derogation of any right or freedom guaranteed by the Constitution must take into consideration certain circumstances including: the nature of the right or freedom, importance of the derogation, nature and extent of the derogation, protection of rights and freedoms of other and whether there are other less restrictive means to attain the purpose of the derogation.

<sup>71</sup> Cap. 485A, Laws of Kenya.

<sup>72</sup> The Act came into force on Dec. 15th 1989.

<sup>73</sup> § 5

<sup>74</sup> § Id.

<sup>75</sup> This requirement was added by the amendments to the Act in 2000.

<sup>76</sup> § 30A

<sup>77</sup> § 18

<sup>78</sup> § 11 (1) (e)

<sup>79</sup> Some investors are yet receive the Kshs. 50,000 (\$625) which is the maximum amount recoverable from the Investor Compensation Fund.

Investors who have suffered loss through fraud and other malfeasances by stock brokers or dealers have no effective remedies.<sup>80</sup> However, granted that investors' losses are to a particular extent inevitable, a safety net in the form of an investor compensation fund enhances the credibility of the regulatory regime.<sup>81</sup> Interestingly, although the statute reproduces the anti-fraud mandate in section 10b of the Securities Exchange Act 1934, in section 31, it additionally criminalizes insider trading and prescribes moderate penalties for those convicted.<sup>82</sup> It is important to highlight that section 10b confer upon the Securities and Exchange Commission (SEC) of the United States extensive latitude to root out abusive and fraudulent practices from the securities markets. The breadth and flexibility of the antifraud clause enables the SEC to *inter alia* institute proceedings against fraudsters in the market. It is the foundation of the famous Rule 10b-5. Apparently the CMA does not appear to have appreciated the full import of section 10b in relation to market integrity. With its plenary law making power in section 12 of the Capital Markets Act, the CMA should have done more in terms of law making to prohibit abusive and manipulative behavior in Kenya's securities markets. However, the dual approach appears to work well in view of the conservative character of the judiciary. It is imperative that the statute be amended to expressly outlaw other forms of market abuse.<sup>83</sup>

Finally, persons aggrieved by decisions of the Capital Markets Authority on certain specific matters may appeal to the Capital Markets Tribunal within fifteen days from the date on which the decision was communicated and a further appeal lies in the High court. This provision restricts the decisions or directions that are amenable to appeal which gives the Authority unfettered discretion in other matters.<sup>84</sup> In order to hold the Authority accountable, all decisions affecting other parties should be rendered appealable.

#### Amendments to the Act

Before delving into the specific amendments, it is instructive to underline the fact that as enacted in 1989, the Capital Markets Act was a framework statute whose overriding goal was the establishment of an administrative structure to promote the development of the securities markets. It was not intended to interfere with the operations of the markets substantially.<sup>85</sup> This policy is underscored by the fact that the principal mandate of the Capital Markets Authority was to spearhead the development of deep securities markets.<sup>86</sup> Consequently, the Nairobi Stock Exchange retained part of its autonomy and stockbrokers retained their firm grip of the exchange albeit with fewer directorships on the board of directors. The first amendment to the Act was effected in 1994 to streamline the organizational structure of the Nairobi Stock Exchange and improve corporate governance. Unfortunately, it did not fundamentally affect stockbroker's control of the stock exchange.

The circumstances culminating in the 1994 amendment merit recapitulation. The Government published a Bill which sought *inter alia* to restructure the Nairobi Stock Exchange and extend stockbrokerage services throughout the country.<sup>87</sup> Additionally, the Bill sought to confer upon the Capital Markets Authority power to participate in allotment of securities to the public by issuers ostensibly to ensure that they were allotted broadly throughout the country. The Bill generated unprecedented opprobrium and the government had to abandon the provisions on allotment.<sup>88</sup> Incidentally, neither the Government nor the Capital Markets Authority attempted to justify the proposed amendments. Had this particular proposal been enacted, there was a likelihood that companies would have shied away from listing since they would have lost their freedom to allot securities. This further illustrates the government's lack of commitment to the development of securities markets. Substantial amendments to the Act were effected in 2000.<sup>89</sup> The amendments were justified on the grounds of: removal of exchange controls, deregulation of interest rates, removal of price controls and increasing awareness of corporate governance.

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<sup>80</sup> Id.

<sup>81</sup> See Patricia Shine, *The Role of the Investors' Compensation Scheme*, J.B.L. 262 (1998).

<sup>82</sup> §§ 32 & 33. See also, Johnstone Ole Turana, *CMA moves to curb stock Broking Fraud and Insider Trading*, BUSINESS DAILY Apr. 17, 2007 at 1.

<sup>83</sup> The Tanzanian statute has provisions on other forms of market abuse such as market manipulation.

<sup>84</sup> For example, refusal to grant a license, suspension or revocation of license, imposition of limitations or restrictions on a license, refusal to admit a security to the official list of a securities exchange, suspension of trading of a security on a securities exchange and requiring the removal of a security from the official list of a securities exchange.

<sup>85</sup> See IFC/ CBK Report and Recommendations of the Money and Capital Markets in Kenya, Oct. 9, 41 (1984).

<sup>86</sup> This is explicit from the preambular paragraph and section 11.

<sup>87</sup> Capital Markets Authority (Amendment) Act, 1994, (Act No. 10 of 1994).

<sup>88</sup> Editorial, *What Does the CMA Bill 1994 Hope to Achieve?* DAILY NATION, Aug. 2, 1994 at 2; Daniel Kamanga, *More Block new Capital Markets Bill*, DAILY NATION, Aug. 25, 1994 at 13; Charles Munyaka, *Changes in the Financial System take root*, DAILY NATION, Aug. 16, 1994 at 2; Daniel Kamanga, *Debate on new CMA Bill Ranges*, DAILY NATION, Aug. 30, 1994 at 12.

<sup>89</sup> Capital Markets Authority (Amendment) Act, 2000, (Aug. 22, 2000).



These changes had widened the scope of corporate financing and financial products necessitating the adoption of appropriate regulatory tools to nurture their growth and protect investors.<sup>90</sup> The amendments are notable in various respects.<sup>91</sup> Although the title of the statute was changed to Capital Markets Act, the preambular provision remained unchanged. The amendment formalized the appointment of the chief executive of the Authority and attempted to professionalize the office.<sup>92</sup> Certain aspects of corporate governance were also incorporated.<sup>93</sup> Among the most fundamental changes was the creation of the Capital Markets Tribunal to adjudge appeals by persons aggrieved by decisions of the Capital Markets Authority in certain matters. True to its tradition, regulation is crisis driven.<sup>94</sup> The 2007,<sup>95</sup> 2008<sup>96</sup> and 2009<sup>97</sup> amendments to the Capital Markets Act and Regulations were an indignant response to the collapse of stock broking firms.<sup>98</sup> The overall effect of these amendments was the consolidation of the Capital Markets Authority as a market regulator as opposed to both regulator and development facilitator as ordained by section 11.

#### Shortcomings of the statute

First, from the preambular provision it is discernible that the underlying objective of the Act was the establishment of an institutional framework for the securities markets as opposed to consolidating and harmonizing the substantive law on securities such as, disclosure, prospectuses and investor remedies. Even after substantial amendments in 2000, the statute remains inadequate on substantive aspects. For example, no provision addresses professional standards of markets intermediaries or their obligations. Similarly, the statute lacks specific provisions on other forms of market abuse other than insider trading despite concerns about their existence in the market.<sup>99</sup> Furthermore, the revamped definition of “securities” in section 2 of the Act fails to capture the panorama of what constitutes a security. For instance, “investment contracts” are excluded yet they are a common feature in Kenya.<sup>100</sup>

Second, the fact that the CMA consists of eleven members and quorum to transact business is six members including the chief executive is unsettling. This is an inordinately big number of persons to assemble regularly, to deliberate constructively, exhaustively and arrive at a consensus on many and often complex issues since the Authority must meet at least once every two months.<sup>101</sup> Records indicate that CMA has been meeting every month.<sup>102</sup> The principal drawback of the bloated membership is that the Authority spends more than twice on member’s allowances than on investor education. For example, in 2008, while member’s allowances accounted for 6.5% of the total annual expenditure, investor education accounted for a paltry 2%.<sup>103</sup> The enlarged membership of the Authority undermines its efficiency and should be reduced to a reasonable level. Optimal membership should have been five. The Monetary Authority of Singapore (MAS) which oversees the entire financial services sector has only ten members.<sup>104</sup>

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<sup>90</sup> Capital Markets Annual Report, 2002 34 (2002).

<sup>91</sup> The amendment enhanced the definitional provisions of the Act to include; agent, authorized securities dealers, collective investment schemes, credit rating agencies, fund managers, investment adviser, investment bank, mutual fund, registered venture capital, unit trust and insider. It revamped the provisions on insider trading and enhanced the penalties. It provided for the Gazetteing of name of licensee annually and for the publication of information memorandum by public companies offering securities to the public for subscription or sale. Finally, the amendments gave the Authority power to intervene in the management of a licensee in certain circumstances by way of appointment of statutory managers to assume the management, control and conduct of the affairs of a licensed person, remove an officer or employee of a licensed person as well as appoint competent persons to the boards of directors of licensees.

<sup>92</sup> § 8

<sup>93</sup> §§ 5(4), 6 & 14

<sup>94</sup> See Mads Andenas, Crises and Regulation, 30 (3) COMP. L. 65, 65 (2009); Charles Whitehead, Reframing Financial Regulation, 90 B.U.L.REV.1 (1999).

<sup>95</sup> § 34A

<sup>96</sup> §§ 13A, 25A & 33A

<sup>97</sup> See regulations, 21, 22A, 32, 39, 51, 51A, 51B, 51C, 53A, 53B, 53C and 55A of the Capital Markets (Licensing Requirements General) Regulations, 2002 and regulations 5A of the Capital Markets (Securities) (Public Offers, Listings and Disclosure) Regulations, 2002

<sup>98</sup> This amendments include; power to inquire into the affairs of a person by a senior officer appointed by the chief executive, power to impose financial penalties on licensees, approved persons, listed companies as well as their directors or employees for violating provisions of the Act, rule, or procedures of the Authority of any stock exchange and the creation of an independent Investor Compensation Fund Board. Others changes included, restructuring the ownership of certain market intermediaries and professional indemnity.

<sup>99</sup> See James Makau, CMA opens Probe into Kenol Share Price Jump, BUSINESS DAILY Nov. 14, 2008 at 7; Peter Warutere, KCB under Scrutiny, DAILY NATION June 24, 1991 at 11; Samuel Nduati, CMC Cries Foul over 25,000 Shares Deal, DAILY NATION Feb. 5, 1994 at 12.

<sup>100</sup> See for example, Securities and Exchange Commission v. J.J. Howey Co. et al., 328 U.S.293 (1946).

<sup>101</sup> § 6

<sup>102</sup> Capital Markets Authority Annual Report, 40 (2008).

<sup>103</sup> Id. at 20

<sup>104</sup> See Monetary Authority of Singapore available at [http://www.mas.gov/about\\_us.mgtstructure/board\\_and\\_management.html](http://www.mas.gov/about_us.mgtstructure/board_and_management.html) (visited on May 5th, 2010).

In Malaysia, the Securities Commission (SC) which oversees the securities and futures markets has eight members.<sup>105</sup> In the United States, the Securities and Exchange Commission consists of five commissioners only.<sup>106</sup> However, membership of the CMA is consistent with directorships in the corporate sector where the largest company has a board membership of eleven. Equally confounding is the fact that a similar number of directors will superintend the Investor Compensation Fund, a small outfit whose sole mandate is to oversee the compensation of investors whenever circumstances demand. Whereas from a purely political perspective the number makes sense because the executive has the opportunity to appoint individuals of its choice, it is economically and functionally unjustifiable. Noteworthy, the practice of having governmental agencies with heavy board membership is pervasive and apparently not intended to promote efficiency but to entrench political patronage.<sup>107</sup> This challenge is compounded by the fact that board membership in these agencies is not subject to any qualifications and there is no statutory mandated vetting process.

Third, the statute does not establish an objective criterion for the licensing of stockbrokers and other market intermediaries. The number of stock brokers has oscillated between eighteen and twenty two since 1995. The Authority is inundated with applications dating as far back as 1990s but is incapable of responding to them effectively. Incessant calls to open up the market for new players have elicited no action from the Authority. This has perpetuated exclusivity in the securities market.<sup>108</sup> The Capital Markets Authority has been ambivalent on the matter which is not uncharacteristic of the Authority.<sup>109</sup>

Fourth, the Act does not confer a private right of action on investors for violations of securities law, for example, non-disclosure, misrepresentation or insider trading. This partially accounts for the dormancy of the antifraud provisions.<sup>110</sup> Given the general reluctance of the judiciary to recognize rights not expressly conferred by statute, it would be exceedingly onerous for an investor to expect the courts to imply a personal right of action under the antifraud provisions. It is plausible to surmise that a statutory right of action may be the better alternative. Whereas making provision for a private action would not necessarily lead to an avalanche of civil actions, its presence would be reassuring on investors and indirectly discourage listed companies and intermediaries from flagrant violations of law. Arguably, it could also encourage the filing of test suits by sophisticated investors. However, public enforcement remains the best option in the short term.<sup>111</sup>

Fifth, the statutes' reticence on investor education is disconcerting. The omission is conspicuous because majority of the retail investors in Kenya are illiterate on investment and finance and arguably cannot fend for themselves.<sup>112</sup> Undeniably, investor education is instrumental to the creation of deep and vibrant securities markets. It is a key component of investor governance. Educated investors ensure optimal capital allocations<sup>113</sup> and are less likely to be defrauded. It is axiomatic that the bulk of the population in Kenya has little or no knowledge on securities markets which restricts their investment portfolio. Most individuals, private companies, co-operative societies, investment clubs and social groups raise or borrow funds for purposes of speculating in real estate.<sup>114</sup> Investing in the securities markets is seldom considered as an option. Investor education is an important public policy issue.

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<sup>105</sup> See Securities Commission of Malaysia available at <http://www.sc.commission/my/main.asp/pageid=linked>. (visited on May 5, 2010).

<sup>106</sup> § 4 of the Securities Exchange Act, 1934.

<sup>107</sup> See Kiarie Mwaura, Regulation of Directors in Kenya: An Empirical Study, 13 (12) I.C.C.R. 465, 479 (2002). For example: the NSSF Board of Trustees consists of 11 member, the Central Bank of Kenya board of directors is constituted by 8 members, the Insurance Regulatory Authority consists of 11 members, the Retirement Benefits Authority consists of 10 members while the Savings and Credit Societies Regulatory Authority consists of 9 members.

<sup>108</sup> It is estimated that the market can accommodate an additional 5-8 stockbrokers or investment banks.

<sup>109</sup> In early 2010, newspaper reports indicated that CMA was considering liberalizing the stock brokerage market for any willing participant but stockbrokers and investment banks were opposed to the idea, arguing that the market was too small for such a move. A more structured licensing mechanism would serve the market better. Singapore which has large securities markets liberalized the stock brokerage business and as many as 65 stock brokers were licensed. However, the country has since reverted to the old system.

<sup>110</sup> § 31(5) prohibits licensed persons, brokers and dealers from effecting or inducing securities transactions by means of manipulative deception or other fraudulent device or contrivance. Section 31(7) makes it unlawful for any person to: employ any devise, scheme or artifice to defraud or make any untrue statement of material fact or omit to state a material fact.

<sup>111</sup> Unfortunately the Capital Markets Authority does not appear to have the expertise and gumption to enforce the provisions of the Act unscrupulously. The first criminal case on insider trading and the first civil case against the proprietor of a stockbrokerage firm are pending in court. See generally Nancy L. Wong, Easing down the Merit-Disclosure Continuum: a Case Study of Malaysia and Taiwan, 13 L. & POL'Y INT'L BUS. 49 (1996).

<sup>112</sup> See generally James A. Fanto, Comparative Investor Education, 64 BROOK. L. REV. 1083 (1998).

<sup>113</sup> See generally Lawrence A. Cunningham, Behavioral Finance and Investor Governance, 59 WASH. & LEE L. REV. 767 (2002).

<sup>114</sup> See Bashar H. Malkawi, A Practitioners Guide to the Jordanian Securities Law 42 COMP. & INT'L L. J. S. A 36 (2009).

Before 2009, the Capital Markets Authority had a moribund corporate affairs department and had not developed a structured investor education program. In its 2009 Annual Report, the Authority reported that it had conducted “seminars and workshops” in furtherance of investor education. Argument can be made that since investor education is not an explicit regulatory objective of the Authority, it has no legal obligation to expend a large portion of its annual budget on it. Such an argument has little practical appeal and is patently unsustainable because investor education and “protection of investor interests” are entwined. Evidently, there is need not only to aggressively market the securities markets as an alternative avenue for investment but also to deepen investor understanding on its operations.

Finally, the Act makes no provision for the avoidance of conflict of interest between employees of the Authority and their duties and no guidelines have been promulgated. For members of the Authority, the Act confers upon the Authority unfettered discretion to make the determination.<sup>115</sup> Such a provision is necessary to protect employees of the Authority against allegations of bias. This could become more acute particularly in relation to imposition of penalties. Although the “revolving door” phenomenon is currently not a major challenge for the Authority, it could be in future because many employees of the Authority do not remain for the duration of their professional career.<sup>116</sup> Relatedly, with improved conditions of service, the Authority will attract professionals from the market.<sup>117</sup> It is imperative to incorporate provisions on avoidance of conflict of interest in the Act. Alternatively, the CMA could promulgate regulations or guidelines to that effect.<sup>118</sup>

### Regulations and Guidelines

Section 12(1) of the Capital Markets Act confer upon the Authority power to formulate rules, regulations and guidelines as may be required for the purpose of carrying out its objectives. In exercise of its expansive legislative mandate, the Capital Markets Authority has promulgated a plethora of regulations and guidelines on various aspects of the securities markets. In several cases, the regulations or guidelines were promulgated in anticipation.<sup>119</sup> Adoption of some of the regulations appears to have been motivated by the anxiety to keep pace with global developments as opposed to demands by local constituencies. The paragraph below provides a snapshot of the Regulations and Guidelines promulgated by the Capital Markets Authority. The objective of the summaries is to underscore the specific aspects of the securities markets in respect of which legislative intervention has been made. The regulations include: Capital Markets (Securities) (Public Offers, Listings and Disclosures) Regulations 2002,<sup>120</sup> Capital Markets (Collective Investment Schemes) Regulations 2001,<sup>121</sup>

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<sup>115</sup> § 6(7).

<sup>116</sup> See Norman S. Posner, Why the SEC failed: Regulators against Regulations, 3 BROOK J. CORP. FIN. & COM. L. 289, 319-21 (2009) (On the effect of the “revolving door” on SEC); Michael Lewis & David Einhorn, The end of the Financial World as we know it N.Y. TIMES, Jan. 4, 2009 at 9, available at <http://www.nytimes.com/2009/01/04/opinion/04lcwisehorn.html>. (visited on September 8, 2010).

<sup>117</sup> At least one senior manager has rejoined the Capital Markets Authority after working with local investment bank for a long time.

<sup>118</sup> See for example, Capital Markets and Securities (Conflict of Interest) Guidelines, 1996 (Tanzania)

<sup>119</sup> The most recent illustration relate to the regulations on securitization, the Capital Markets (Asset Backed Securities) Regulations, 2006.

<sup>120</sup> Legal Notice No. 60 of 2002. These are the most important regulations in relation to public offers, disclosure and listing of securities. They broadly describe the approval process for public offers of securities, requirements of information memoranda, preparation, contents, distribution and delivery for approval, eligibility requirements for public offers and listing of securities for each of the market segments of the Nairobi Stock Exchange, namely Main Investment Market Segment (MIMS), Alternative Investment Market Segment (AIMS) and the Fixed Income Securities Market Segment (FISMS). In addition to the contents prescribed by the Schedules for the respective market segments, the Regulations provide that a prospectus must contain “all such information as investors would reasonably expect to find therein for the purpose of making an informed assessment.” In addition to historical information about the company, the regulations require companies to make forward looking statements about finance, trade, profit forecast, principal assumptions, risk factors and an opinion of the directors setting out the grounds for the prospects of the business. Under the regulations, only public companies incorporated pursuant to the provisions of the Companies Act can list securities. The minimum paid up capital is Kshs. 50 million (\$ 625,000) and 20 million (\$ 250,000) respectively. The company must have reported profits in the last three or two years for the MIMS and AIMS respectively for the last five years. Directors must have had no criminal record for the last two years. Approval of rights and capitalization issues made by listed companies. In addition, they prescribe detailed disclosure requirements for each of the market segments. Finally, they prescribe the continuous disclosure obligations for listed companies. The most critical omission of these regulations is that they do not provide for transparent price discovery for initial public offerings. The issuer and the lead underwriter originate the price which in most cases has no bearing on the company’s fundamentals. The Safaricom IPO is the locus classicus case. It had different prices for local and foreign investors and none had been arrived at on the basis of the fundamentals of the company (Kshs.5) (\$0.06cents). One of the undesirable consequences of the disorganized manner of price discovery is that IPOs are always underpriced by inexplicable margins. It is suggested that the Regulations be amended to provide for transparent price discovery. See, Washington Gikunju, Brokers Vouch for Book building, THE STANDARD Feb. 13, 2007 at 5. Secondly, disclosure in annual reports has no value to the ordinary investor who can hardly understand a balance sheet. Innovative ways of communicating essential information about the company should be devised. In addition, disclosure in languages other than English should be provided for.

Capital Markets (Licensing Requirements General) Regulations 2002,<sup>122</sup>Capital Markets (Takeover and Mergers) Regulations 2002,<sup>123</sup>Capital Markets Regulations (Foreign Investors) Regulations 2002,<sup>124</sup>Capital Markets Tribunal Rules, 2002,<sup>125</sup>Guideline on Corporate Governance Practices by Listed Companies in Kenya, 2002,<sup>126</sup>Capital Markets Guidelines on the Approval and Registration of Credit Rating Agencies, 2002,<sup>127</sup> Central Depository (Operational) Rules, 2003,<sup>128</sup> Central Depository(Regulation of Central

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<sup>121</sup> Legal Notice No. 18 of 2001, Legal Supp. No. 59. These regulations were aimed at facilitating the establishment of specialized investment vehicles such as mutual funds, unit trusts or special form of collective investment schemes to offer investors new opportunities in terms of professional management, economies of scale and diversification of portfolio and risk. The regulations provide for registration, management, pricing, valuation and redemption. Additionally, they provide for employee share ownership schemes. Collective investment schemes have become an important investment avenue. Current thinking is that Unit trusts will play a critical role in transforming the securities markets from retail to institutional. By 2008, the Capital Markets Authority had approved ten unit trusts. Incidentally as early as June 1966, the First East African Unit Trust made an IPO and was listed on the NSE. Its object was to promote investment by Africans and small investors generally.

<sup>122</sup> Legal Notice No.125 of 2002. These regulations govern all market intermediaries who are licensees and approved persons of the Capital Markets Authority. They make provision for licensing, approval, capital requirements, code of conduct and reporting obligations of the stock exchange, stock brokers and dealers, investment banks, investment advisers and fund managers, authorized depositories; credit rating agencies registered venture capital as well as authorized securities dealers. They also prescribe rules for disbursement of funds from the Investor Compensation Fund. The regulations empower Capital Markets Authority to impose sanctions or financial penalties on licensees, approved persons, listed company or its director, or an employee or director of a licensee or approved person for breach of trading or non compliance with the regulations

<sup>123</sup> Legal Notice No.1260 of 2002. These regulations govern the procedure and timing of takeovers and mergers and prescribe the obligations of the parties to the transactions. A takeover occurs when a company (offer or bidder) acquires voting control of another company (offeree or target). The regulations are based on the United Kingdom's City Code on Takeovers and Mergers and only apply to listed companies. The rule underlying these regulations is that a person cannot acquire more than twenty five percent of the voting rights of shares of a listed company or increase his existing holding or control of voting rights beyond twenty five percent unless the person complies with the regulations or obtains an exemption from the Capital Markets Authority. The complexity of these regulations was illuminated by the proposed takeover of Carbacid Investment Co. Ltd by Boc Gases Co. Ltd. Both companies are listed on the Nairobi Stock Exchange. The Capital Markets Authority declined to approve the takeover on the ground that it had not attained the 80% threshold prescribed by the takeover offer. The offeror's appeal to the Capital Markets Tribunal was successful. The Tribunal was persuaded that because this was the first transaction under the regulations, the Capital Markets Authority should have invoked its extensive mandate and facilitated the transaction. The Capital Markets Authority appealed to the High Court. A merger or acquisition must be approved by the particular industry regulator, for example Central Bank of Kenya in the case of banks, CMA and the Commissioner of Monopolies and Price Control. See Washington Gikunju, CFC, Stanbic merger gets approval, *THE STANDARD*, Oct. 16, 2007 at 8; Emmanuel Were, Centrum's bid for Carbacid offers Investors a lifeline, *BUSINESS DAILY*, May 18, 2009 at 15; Justus Ondari, Centum stays quiet on BOC bid, *DAILY NATION*, May 20, 2009 at 30; Jackson Okoth, Centum: Carbacid deal raise questions, *THE STANDARD*, May 19, 2009 at 17.

<sup>124</sup> Legal Notice No. 134 of 2002. These regulations were promulgated by the minister to facilitate foreign investors' participation in the domestic securities markets. They were designed to open up the securities markets to international capital and foreign investor participation in the markets has been phenomenal. The first securities markets boom in the 1990s is attributable to foreign investor participation. The current version of the regulations replaced the 1995 version. Under the regulations, the phrase "local investor" encompasses citizens of the East African Community partner states. Issuers or listed companies are required to reserve at least forty percent of their ordinary shares for investment by local investors. Before 2008, the restriction was pegged at twenty five percent. This restriction is inimical to promoting foreign investment in the domestic securities markets. However, a foreign investor is free to acquire as much as forty nine percent of a stock brokerage firm and up to seventy percent of a fund management company.

<sup>125</sup> Legal Notice No. 357 of 2002. These rules govern the procedure of appeals to the Capital Markets Tribunal by persons aggrieved by decisions of the Capital Markets Tribunal. As noted above, before 2000, the appellate function was vested in the minister. Since its establishment, the tribunal has heard and determined two appeals.

<sup>126</sup> Gazette Notice No. 3362 of 2002. These guidelines prescribe the best corporate governance practices for listed companies to promote performance and accountability. They also provide for the enhancement of shareholder participation in general meetings and the formation of shareholder associations. Most importantly, they provide for limited professionalization of the board of directors but total in the case of the chief accountant, auditor and company secretary. As mentioned above, while these guidelines may work in markets with dispersed ownership, listed companies in Kenya are characterized by concentrated ownership and the controlling shareholders dominate the board of directors. Minorities have no voice. As Chapter Three illustrates, although these Guidelines are an important milestone in the journey towards good corporate governance practices, they do not institutionalize continuous education for directors and lack effective enforcement mechanisms. Moreover, they only regulate listed companies.

<sup>127</sup> Gazette Notice No. 8512 of 2001. These guidelines provide for registration, accreditation and approval of credit rating agencies for purposes of rating issuers of debt securities. They were intended to promote the growth of an active corporate debt market to deepen the securities markets in Kenya. Credit rating provides an impartial opinion on the creditworthiness of an issuer of debt securities and its ability to meet its obligations over the life of the security. Only one credit rating agency has been registered. The guidelines restrict entry into credit rating business by demanding ownership or association with an internationally recognized rating agency. Companies that have issued debt securities in Kenya are well known in the market and rating has not been instrumental in securing subscription. Rating will become critical when the issue of asset backed securities becomes a reality.

<sup>128</sup> These rules provide for: eligibility, application and appointment of Central Depository Agents, interest in central depository accounts, structure of central depository accounts, opening and maintaining of securities accounts, transfer of central depository accounts, withdrawal of securities, and deposit of securities during IPOs and additional issues.

Depositories) Rules, 2004,<sup>129</sup> Capital Markets (Asset Backed Securities) Regulations, 2007<sup>130</sup> and the Capital Markets (Registered Venture Capital Companies) Regulations, 2007.<sup>131</sup> The legislative framework makes no provision or regulations on professional standards of market intermediaries and recognition of self regulatory organizations in the securities markets.

#### Central Depositories Act<sup>132</sup>

This statute was enacted in 2000 in an effort to revamp market infrastructure. It provides for the establishment, operations and regulation of Central Depositories and Central Depository Agents. Most importantly, it makes provision for immobilization (mopping up of share and debenture certificates) and eventual dematerialization of securities in Kenya.<sup>133</sup> The objective of the Act was to upgrade market infrastructure by *inter alia* replacing paper certificates with securities accounts and facilitating electronic trading in securities. Electronic trading commenced in September 2006. The Act provides the legal framework for operationalizing the central depository system by the Central Depository and Settlement Corporation (CDSC), a private company incorporated in 1999 to host the system.<sup>134</sup> This company is an affiliate of the Nairobi Stock Exchange. The Act provides the necessary framework for clearing, settlement and registration activities for the securities markets. It makes provision for the establishment of central depositories,<sup>135</sup> immobilization<sup>136</sup> and dematerialization of securities,<sup>137</sup> securities accounts,<sup>138</sup> records and confidentiality.<sup>139</sup> Central Depositories are approved and licensed by the Capital Markets Authority. Any registered company desirous of maintaining a Central Depository may apply to the Authority for approval.<sup>140</sup> The Authority has approved the CDSC as the only Central Depository in the country. Although Central Depositories have law making powers, any rules made must be sanctioned by the Authority before coming into operation. Additionally, rules approved by the Authority cannot be amended, varied or rescinded without prior authorization.<sup>141</sup>

The Act adopts the inexhaustive definition of the “securities” contained in section 2 of the Capital Markets Act.<sup>142</sup> Second, it confers substantial power on the Capital Markets Authority. For example, the Authority may by written notice amend the rules of the Central Depository.<sup>143</sup> Central Depositories are at the beck and call of the Authority. Third, disciplinary powers of Central Depositories over central depository agents are not clearly delineated. This has precipitated conflicts between Central Depositories and the Authority implicating securities market governance in the Kenya.<sup>144</sup>

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<sup>129</sup> These rules make provision for: registration of Central Depositories by CMA, appointment of Central Depository Agents by the Central Depository, establishment of the Central Depository Guarantee Fund to ensure settlement of trades through the depository, recognition of the Central Bank of Kenya as a central Depository agent of the Central Depository and insurance.

<sup>130</sup> Legal Notice No. 184 of 2007. These regulations make provision for: the issue of asset backed securities, assets capable of being securitized, parties to securitization, servicing agent, liquidity provider, trustee, credit rating and enhancement, fees and charges, listing, suspension of dealing and de-listing.

<sup>131</sup> Legal Notice 183 of 2007. These rules make provision for registration of venture capital companies, payment of annual fees to the CMA, restrictions on changes of directors, shareholders and fund managers, eligible venture capital enterprises, approval and obligations of fund managers, prohibition of public fund raising, continuous reporting obligations and deregistration. The Income Tax (Venture Capital Company) Rules, 1997, provide that investors may apply for a tax waiver on income accruing venture capital investments. By 2008, the Authority had registered one venture capital company (Acacia Fund Limited).

<sup>132</sup> See Central Depositories Act, 2000. The Act came into operation on June 1st, 2003.

<sup>133</sup> See Preamble to the Act.

<sup>134</sup> The company’s fully paid capital is Kshs. 100,000,000 (\$1.25 million). Its shareholders are: Capital Markets Challenge Fund 50%, Nairobi Stock Exchange 20%, Kenya Association of Stockbrokers and Investment Banks 18%, Capital Markets Investor Compensation Fund 7%, Dar es Salaam Stock Exchange 2.5% and Uganda Securities Exchange 2.5%.

<sup>135</sup> § 4

<sup>136</sup> § 13

<sup>137</sup> § 24

<sup>138</sup> § 30

<sup>139</sup> §§ 46 & 47

<sup>140</sup> § 5

<sup>141</sup> § 6

<sup>142</sup> See § 2

<sup>143</sup> § 7

<sup>144</sup> The most notable was when the Central Depository and Settlement Corporation (CDSC) suspended Equity Bank Limited (a central depository agent) from accessing securities accounts of its customers maintained by the former for two weeks. The bank owed the CDSC a large sum of money it had allegedly collected on behalf of the depository from Safaricom IPO applicants. The Capital Markets Authority immediately directed the CDSC to reinstate the depository agent pending determination of the dispute. The Authority defended its intervention on the ground that it was necessary to protect investors and preserve market integrity. See Joseph Bonyo, CMA blocks bid to throw Equity out of stock market, DAILY NATION, Apr. 9, 2009 at. 6; Emanuel Were, Stock Market Investors Locked out as Equity Bank row rages, BUSINESS DAILY, Apr. 13 2009 at 8; Joseph Bonyo, Equity, CDSC to Resolve Dispute, DAILY NATION, Apr. 9 2009, at. 7; Jackson Okoth & James Anyanzwa, Unresolved Regulatory Matters Keep NSE Investors Guessing,

Finally, the Act prescribes no duration within which all securities must be immobilized in order to implement the central depository system fully. Many investors are yet to immobilize their securities many years after the automated trading system was inaugurated. The desire to automate trading in securities was motivated by several factors, for example, reduction of risk by phasing off paper certificates which are susceptible to forgery and theft, enhancement of efficiency, adherence to global standards of delivery and settlement, advantages of new products and to promote transparency in the markets.<sup>145</sup> Although the idea was conceived in 1994, the first securities account was opened in 2004.<sup>146</sup> Implementation of the Act had positive effects on the market. Trading, delivery, registration and settlement improved, market turnover increased, market efficiency improved and transaction costs have been lowered. Moreover, it heightened the move towards market integration in East Africa. But technological development has a price. The risk of fraud by dishonest employees of stockbrokers increased and many investors lost their investments.<sup>147</sup> As intimated above, the provisions of the Central Depositories Act vest substantial power in the Capital Markets Authority giving it overwhelming control over the CDSC, Central Depository Agents and by implication the Nairobi Stock Exchange. Whether the overarching control of the Authority is congenial for the securities markets remains uncertain.

#### National Social Security Fund Act<sup>148</sup>

The purpose of the Act was to establish the National Social Security Fund (NSSF), provide for contributions to the fund by eligible employees and payment of benefits out of the fund.<sup>149</sup> NSSF is a state corporation and its principal administrative organ is the Board of Trustees.<sup>150</sup> Its day-to-day affairs are managed by the Managing Trustee.<sup>151</sup> The Act empowers the NSSF to collect contributions from eligible employees and invest the same for the benefit of all members.<sup>152</sup> Although membership of the fund is currently voluntary, it was mandatory for all public and private sector employees before 1997. However, all government employees and thousands of corporate employees are still members of NSSF. It is estimated that its membership is currently over one million<sup>153</sup> making it the most capitalized retirement benefit scheme. Section 27 empowers the Board of Trustees to invest all surplus funds in accordance with the provisions of the Trustee Act subject to approval of the ministers of labour and finance. As explained elsewhere, provisions of the Trustees Act are very restrictive on investment. Additionally, the power of investment of the corporation's funds is vested in the Board of Trustees which consists of political appointees' majority of whom have no investment, management or entrepreneurial skills. Closely related, the NSSF is subject to the direction and control of the Ministers for Labor and Finance. This exposes the management to political manipulation which could have deleterious effects on investment and financial stability of the fund.<sup>154</sup> This proposition is borne by facts.

Before 2003, successive Boards of Trustees of the NSSF invested most of its resources in worthless pieces of land "sold" by politicians and influential persons in the government in brazen violation of the Act. The corporation was for many years a cash cow for politicians and influential government officials.<sup>155</sup> For instance, in 2002, the Managing Trustee facilitated the misappropriation of more than \$3.2 million of the corporation's funds held by the Central Bank of Kenya through a stock broker. Although the stock broker was suspended from trading on the Nairobi Stock Exchange and its directors disqualified from directorship for five years, the amount was never recovered.<sup>156</sup> Another challenge is that although the NSSF is subject to the provisions of the Retirement Benefits Act, the Retirement Benefits Authority has been unable to exercise its regulatory mandate over the NSSF.

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THE STANDARD, May 19, 2009, at 12; Joseph Bonyo, Equity Bank Ordered to pay Kshs. 40 million IPO Cash, DAILY NATION, May 26, 2009 at 24.

<sup>145</sup> See Peter M. Waiyaki, Chief Executive, Central Depository and Settlement Corporation, Address at a Regional Workshop on Capital Markets in East Africa: The Central Depository System and Regional Integration (Oct. 6, 2006).

<sup>146</sup> Challenges associated with ownership of the CDSC, finance, legal framework and the source of the requisite software delayed the process.

<sup>147</sup> See Financial Post Team, Taming Wayward Stockbrokers, FINANCIAL POST Apr. 6, 2008 at 2.

<sup>148</sup> Cap 258, Laws of Kenya.

<sup>149</sup> Preamble.

<sup>150</sup> § 4

<sup>151</sup> § 33

<sup>152</sup> §§ 5 & 6

<sup>153</sup> See National Social Security Fund available at <http://www.nssf.or.ke/index.html> (visited on Apr. 28th 2010).

<sup>154</sup> For example, the turnover of Managing Trustees has been extra ordinarily high.

<sup>155</sup> Reports of the Public Investments Committee of Parliament. In one case, the Corporation bought a quarry for a piece of land and the politician involved went free. The Fund is reported to have lost 1.2 billion shillings (\$15million) invested through Discount Securities Limited (under statutory management); James Anyanzwa, NSSF among losers at Discount under statutory management, THE STANDARD, Mar. 17, 2009 at 24.

<sup>156</sup> Benson Wambugu, High Court Confirms Shah Munge Suspension, BUSINESS DAILY May 19, 2009 at 1.

Incredibly, as late as 2009, the NSSF had neither a fund manager nor a custodian.<sup>157</sup> The Board of Trustees performed both roles. Because of these shortcomings, the Act should be amended to professionalize the Board and the Managing Trustee and accord them sufficient flexibility to determine how surplus funds of the corporation should be invested.<sup>158</sup> An alternative would be to provide that surplus funds be invested through professional investment or fund managers. The Board of Trustees or professional managers should then be obligated to invest a specified portion in the securities markets. Regarding compliance with the Retirement Benefits Act, the Board of Trustees and the Managing Trustee of NSSF should be held personally liable for non-compliance. Streamlining operations of the NSSF and professionalizing the management of its enormous surplus funds would by diversifying its investment mix bolster the securities markets.

#### Insurance Act<sup>159</sup>

This Act regulates the conduct of insurance business in Kenya and impacts on securities markets significantly. Because of the important role that the insurance industry could play in the securities markets, the IFC/CBK report of 1984 was categorical that the laws governing insurance should not compel insurance companies to invest in low yield securities or be unduly restrictive in the choice of investment. On the contrary, the report pitched for the adoption of a regime that was flexible enough in terms of investment and character of securities.

As custodians of large pools of financial resources, insurance companies have the potential to play an important role in the development of securities markets. In most countries, they are major institutional investors and hold government and corporate securities. The insurance Act which consolidates the law on insurance<sup>160</sup> contains various provisions which restrict investment by insurance companies thereby constricting investment in the securities markets.<sup>161</sup> It is informative to indicate that although the Act was promulgated in 1984 before the country embraced the market economy fully, subsequent amendments have not fundamentally changed its original conception. For instance, sections 32, 34, and 36 provide that the deposit held by the Central Bank of Kenya which is 5% of each of the insurance company's admitted assets can only be invested in Government securities. Insurance companies underwriting life insurance business are required to invest at least 50% of their total admitted assets in Government securities.<sup>162</sup> Similarly, at least 10% of their life fund must be invested in two year Treasury bonds or longer term government securities. These provisions deny insurance companies the flexibility necessary in investment to promote the securities markets. Investment by insurance companies is further restricted by the levels of admitted assets,<sup>163</sup> approval or disapproval of investment of admitted assets by the Commissioner of Insurance, restrictions on mortgages,<sup>164</sup> re-insurance business<sup>165</sup> and direct or indirect investment in private companies other than banks or financial institutions.<sup>166</sup>

Cumulatively, the foregoing restrictions preclude insurance companies from enjoying the flexibility necessary to facilitate investment in the securities markets according to their business plans and needs. Statutory requirement that insurance companies invest in Treasury bonds compels them to compete for the securities with commercial banks which monopolize this market segment. Commercial banks dominate this segment because of their high capitalization, guaranteed returns and minimal risk. Because insurance companies hold large pools of investible funds, restrictions on investment impede their ability to maximize returns to policy and stockholders to the detriment of the securities markets. While it is conceded that limited restrictions on investment is essential in the public interest, a more balanced and flexible legal regime is imperative to empower insurance companies invest in more securities markets' instruments and list on the Nairobi Stock Exchange.<sup>167</sup>

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<sup>157</sup> See Joachim Mwachube, Role of Fund Managers in Investment Performance, FINANCIAL POST, Aug. 19, 2007 at 22; Kaburu Mugambi, At NSSF, loose investment takes early retirement, DAILY NATION, Apr. 28, 2008 at 10-11.

<sup>158</sup> See Morris Aron, Boardroom Wrangles over Reforms rock NSSF, THE STANDARD Aug. 31, 2010 at 1

<sup>159</sup> Cap. 487, Laws of Kenya.

<sup>160</sup> Preamble to the Act.

<sup>161</sup> §§ 48, 49 & 50

<sup>162</sup> See Finance Act, 1999 (Provisions on insurance Companies).

<sup>163</sup> § 42

<sup>164</sup> § 51

<sup>165</sup> § 145

<sup>166</sup> An insurance company cannot invest more than 5% of its funds in a subsidiary. See, Fredrick Okello, Association of Kenya Insurers Pressure the Government over Laws, THE STANDARD Jan. 15, 2002 at 1-2; Peter Macharia, Insurers Oppose Restrictions: Association of Kenya Insurers Seek Change to Allow Investment, DAILY NATION Mar. 19, 2002 at 12.

<sup>167</sup> See Tom Mogusu, Kimunya urges Insurance Companies to List, THE STANDARD, Apr. 2, 2007 at 27.

## Banking Act<sup>168</sup>

This statute was enacted in 1989 to amend and consolidate the law on banking business in the country.<sup>169</sup> All banks are licensed by the Central Bank of Kenya.<sup>170</sup> For purposes of regulation, banking business encompasses, accepting money or cheque deposits from the public, accepting cash deposits payable on demand or at the expiry of a fixed duration or after notice or lending or investing money held on deposit.<sup>171</sup> The Banking Act restricts beneficial interest in commercial banks. For instance, an individual cannot hold beneficial interest of more than 25% of the share capital of any bank.<sup>172</sup> Similarly, a bank cannot transfer more than 5% of its share capital to an individual or entity without written approval of the Central Bank of Kenya.<sup>173</sup> Banks are also required to maintain a prescribed minimum of liquid assets.<sup>174</sup> To encourage commercial banks to lend, the minimum liquid assets has been reduced to 10%. All commercial banks in Kenya are required to have attained a capital base of Kshs. 1 billion (\$12.5m) by 2012.<sup>175</sup> This requirement may lead to mergers and acquisitions of small banks thus reducing the number of banks in the market.<sup>176</sup> Although only 30% of the country's population is banked, the 43 registered banks hold large deposits which are available for investment. The bulk of these funds are invested in treasury bonds which are less risky and have consistently given banks superior returns.<sup>177</sup> Apart from lending to enable investors to acquire securities in selected IPOs, which are few and far between, banks have not significantly enhanced securities markets in Kenya. They seldom trade in bonds or lend to facilitate the purchase of securities in the market.

Interestingly, capital markets regulations are explicit that banks and insurance companies in Kenya are at liberty to hold beneficial interest or acquire stockbrokerage firms. Consequently, several banks hold beneficial interest in stock broking firms.<sup>178</sup> A question that has arisen is whether this policy will engender securities markets in the country particularly over the long term.<sup>179</sup> Restrictions on ownership and operation of the banking business in Kenya have discouraged investment in banks in Kenya. This has resulted in the over concentration of banks in major towns leaving the rural areas with no banking services.<sup>180</sup> Allowing agency banking is intended to ameliorate the situation.<sup>181</sup>

## Retirement Benefits Act<sup>182</sup>

This Act constitutes the Retirement Benefits Authority the principal administrative body to promote, supervise and regulate retirement benefit schemes in the country.<sup>183</sup> It establishes the infrastructure for the regulation of the retirement benefits sector. It was deemed necessary to establish a supervisory body to oversee the management and investment of the large pools of funds held by retirement schemes to maximize returns for the benefit of all parties involved. One of the main short comings of the statute is that it is a standalone Act.<sup>184</sup> No meaningful attempt was made to harmonize its provisions with those of the Capital Markets, Insurance or the Trustees Acts to ensure that a significant portion of the funds held by institutional investors in the pension sector was invested in securities markets. Relatedly, it duplicates existing regulatory regimes, for instance, custodians and fund managers of retirement benefit schemes are regulated by both the Retirement Benefits Authority and the Capital Markets Authority which increases compliance costs.<sup>185</sup>

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<sup>168</sup> Cap. 488, Laws of Kenya.

<sup>169</sup> Preambular provision.

<sup>170</sup> § 5

<sup>171</sup> § 2

<sup>172</sup> § 13

<sup>173</sup> Id.

<sup>174</sup> § 19

<sup>175</sup> Finance Act, Act No. 8 of 2008, §72. The increase is graduated as follows: Dec. 31st 2009, Kshs. 350 million (\$4,375,000), Dec. 31st 2010, Kshs.500 million (\$4.25m), Dec. 31st 2011, Kshs. 700 million (\$8.75m) and Dec. 31st 2012, Kshs. 1 billion (\$12.5m).

<sup>176</sup> See Moses Michira, Equatorial and Southern Credit Merger gets nod, BUSINESS DAILY June 2, 2010 at 9.

<sup>177</sup> See Jackson Okoth, Commercial Banks rule Treasury bills Market, THE STANDARD Dec. 8, 2009 at 9. Interest on government securities has been the major source of income for banks since the early 1990s. This accounts for the severe competition for them.

<sup>178</sup> For example, CFC Stanbic bank, Co-operative bank, NIC bank and Africa Banking Corporation.

<sup>179</sup> See Oliver Kamwaro, Banks Barge on Exclusive Stock broking Club, DAILY NATION. Mar. 30, 2009 at 4. Joseph Bonyo, Cooperative Bank buys out broke stock broker, DAILY NATION, Mar.25, 2009 at 11.

<sup>180</sup> § 3

<sup>181</sup> In early 2010, the Central Bank Amended Banking Regulations enabling banks to establish agencies in any part of the country. This is intended to extend banking services to rural areas.

<sup>182</sup> Act No. 3 of 1997.

<sup>183</sup> § 3

<sup>184</sup> See Andy Mullineux, Financial Sector Convergence and Corporate Governance, 15(1) J.F.R & C. 8 (2007). (on the contribution the pension sector could make to the growth of securities markets.

<sup>185</sup> See The Retirement Benefits (Managers and Custodians) Regulations 2000, Regulations 4 & 7.



With regard to investment, the Act provides that fund managers can invest up to seventy percent of the funds held in government securities or equities and up to fifteen percent in commercial paper and corporate debt.<sup>186</sup> Although this provision was intended to boost both the debt and equities markets, records reveal that the funds are almost exclusively invested in corporate debt and government securities. In the spirit of diversification of investment, the law should require fund managers to invest a defined minimum in either market. To facilitate growth of the pension sector, the Retirement Benefits Authority should originate mechanisms to ensure that people in the informal sector who account for more than seventy five percent of the employed work force join retirement schemes.<sup>187</sup> This will unlock more funds for investment in generally and facilitate financial planning. A portion of these funds could be invested in securities markets. Arguably, a vibrant pension sector portends well for the securities markets. To guarantee accountability by fund managers, the law should adopt a graduated investment scale which permits untested fund managers to invest in government securities only while those with sufficient experience (number of years the manager has been in the business) enjoy unrestricted flexibility. This recommendation is cognizant of the fact that there should be an optimal balance between risk and reward. With proper oversight, it is possible to accord retirement schemes more flexibility in investment.

#### Micro Finance Act<sup>188</sup>

This Act makes provision for the licensing, supervision and regulation of microfinance businesses in Kenya and applies to both deposit-taking and non deposit-taking microfinance businesses.<sup>189</sup> It prescribes the minimum capital requirements<sup>190</sup> and liquidity.<sup>191</sup> The purpose of microfinance institutions is to extend short term credit facilities to small enterprises. A salient short coming of the Act is that it makes no provision on how deposit taking businesses should invest their capital and surplus funds. The proliferation of small enterprises and the exponential increase in demand for credit has fuelled the growth of microfinance institutions. As one of the fastest growing segments of the financial services sector in the country, microfinance businesses have the potential to impact positively on the securities markets.<sup>192</sup> The Act should be amended to provide that part of the capital and surplus funds of these institutions be invested in the securities markets. These businesses can also be incentivized in various ways to advance longer term loans to enable their customers deal in securities in the secondary market since they have no security to qualify for bank loans.

#### Corporate Law

The salient sources of Kenya's corporate law are the substance of common law as modified by the doctrines of equity and the Companies Act.<sup>193</sup> The Companies Act is a carbon copy of the United Kingdom's Companies Act, 1948 which was a consolidating statute. The basic principles and propositions of corporate law are judicial enunciations. Corporate law typically regulates formation of companies, management, floatation's and prospectuses, raising of capital, rights and duties of members, transfer and transmission of shares, allotments, liability of the company and its officers, reporting, auditing, reconstructions and insolvency. Before the Capital Markets Act was promulgated, Kenya's securities regulation was its corporate law. A company wishing to offer securities to the public had to prepare a prospectus containing the particulars of Part I and II of the Third Schedule to the Act in accordance with section 40(1) of the Companies Act. The contents included an auditor's report on the financial position of the company for the preceding five years highlighting the profit or loss and rate of dividend in each financial year.<sup>194</sup> The prospectuses had limited utility to potential investors because of the historical character of the information they provided. The Act requires all companies to hold the annual general meetings,<sup>195</sup> keep proper books of accounts<sup>196</sup> and prepare financial reports for submission to members in general meeting<sup>197</sup> and, maintain registers of members,<sup>198</sup> directors<sup>199</sup> and creditors.<sup>200</sup>

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<sup>186</sup> § 37

<sup>187</sup> See Jim Onyango, Pensions Regulator Plans Retirement Schemes for Informal Sector Workers, BUSINESS DAILY, Jan 25, 2010 at 10; John Oyuke, Pension still a dream for most Kenyans, THE STANDARD, Feb. 23, 2010 at 7.

<sup>188</sup> Act No. 19 of 2006. The Act came into force on May 2, 2008.

<sup>189</sup> See preambular provision

<sup>190</sup> § 11

<sup>191</sup> § 12

<sup>192</sup> See Daniel Kamanga, Small and Medium-sized Enterprises in Kenya: Saviours of the Economy, KENYA TIMES, June 25, 1989 at 22.

<sup>193</sup> Cap 486, Laws of Kenya.

<sup>194</sup> See Alistair Alcock, The rise and fall of UK quoted Company Regulation, J.B.L. 733, 734 (2007)

<sup>195</sup> § 131

<sup>196</sup> § 147

<sup>197</sup> §§ 148-158

The Act contains no specific provisions for listed companies and arguably impedes the development of securities markets in various ways.

First, the Companies Act pays scanty attention to corporate bonds as a resource generating mechanism by companies. Section 2(1) defines a debenture to include: debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not. The reference to “charge” is important because it underlines the general character of debentures contemplated by the definition. Similarly, the provisions of section 40(1) mention debentures perfunctorily. A host of other provisions of the Act make reference to debentures.<sup>201</sup> Viewed panoramically, the provisions of the Companies Act envisage the issue of debentures to specific persons typically, banks as opposed to the public. The superficial approach of the legal framework partially explains why no corporate bond was issued to the public before November 1996.<sup>202</sup> The Capital Markets Authority promulgated the requisite rules thereafter.<sup>203</sup>

Second, the traditional dichotomy between public and private companies has not engendered securities markets. Although this challenge is not unique to Kenya, its impact on the country’s securities markets is more profound. Studies have shown that the limited liability company was designed to facilitate the raising of capital by public companies to promote large scale production and construction.<sup>204</sup> Regrettably, the framework is predominantly used by private companies for other purposes.<sup>205</sup> The provisions of the Companies Act are explicit that the statute was intended to regulate public companies.<sup>206</sup> But since private companies are easier to incorporate and enjoy all the attributes of incorporation without any substantial corresponding obligations, they are irresistible to commercialists. Deregulation of the private company has therefore become a standing incentive for potential incorporators. Records show that private companies account for about 99% of all newly incorporated companies. “The rise of the private limited company is numerically a huge success story.”<sup>207</sup> Implicitly, public companies are hardly incorporated. The private company has become the hallmark of business in East Africa. The situation is exacerbated by the fact that despite their eligibility, private companies seldom go public. The fear of loss of control, mandatory disclosures and tax implications militate against listing. There is need to abolish this antiquated distinction for easier administration of the Companies Act and expose more companies to the possibility of listing. By prescribing the threshold for listing and instituting significant fiscal and other incentives, more companies would be motivated to list. This would place all companies on a similar footing with regard to listing and the only distinction would be between listed and unlisted companies.<sup>208</sup>

Third, corporate law prohibits share buy-back by companies. It is a cardinal principle of Kenya’s corporate law that a company cannot buy back or repurchase its own shares. This prohibition has its origins in the authoritative House of Lords decision in *Trevor v. Whitworth*<sup>209</sup> which was first embodied in section 45 of the Companies Act, 1929<sup>210</sup> and subsequently reproduced in the Companies Act, 1948.<sup>211</sup> Companies are permitted to reduce their capital through a formal procedure which requires authority of articles, special resolution, approval by the court and registration by the Registrar of Companies<sup>212</sup> The prohibition was justified on the need to safeguard creditors.

“The stringent precautions to prevent the reduction of capital of a limited company without due notice and judicial sanction would be idle if the company might purchase its shares whole sale... [t]he creditors of the company which is being wound up, who have a right to look to the paid up capital as the fund out of which their debts are to be discharged.”<sup>213</sup>

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<sup>198</sup> § 112

<sup>199</sup> § 201

<sup>200</sup> § 88

<sup>201</sup> See §§ 89, 91, 96-104.

<sup>202</sup> See Alfred Omondi, East Africa Development Bank bonds now launched in Nairobi, DAILY NATION Dec. 18, 1996 at 12.

<sup>203</sup> See Capital Markets Authority Guidelines on the Issue of Corporate Bonds and Commercial Paper, 1997. (Revised in Jan. 2000).

<sup>204</sup> See generally H.R. HAHLO & M. J. TREBILCOCK, CASEBOOK ON COMPANY LAW, LONDON, 1977.

<sup>205</sup> The private company has been described as a “historical accident.”

<sup>206</sup> This is decipherable from the fact that only a few provisions of the Act relate to private companies conjured as either qualifications or provisos.

<sup>207</sup> See Hahlo & Trebilcock, supra note 206 at 312.

<sup>208</sup> The possibility of creating a legal framework for a close corporation with unlimited liability to replace the private company should be explored. It has worked fairly well in South Africa.

<sup>209</sup> [1887] 12 A.C. 409.

<sup>210</sup> See generally Maisie Ooi, The Financial Assistance Prohibition: Changing Legislative and Judicial Landscape, SING. J. LEGAL STUD. 135 (2009).

<sup>211</sup> § 56

<sup>212</sup> Companies Act §§ 68-71

<sup>213</sup> Lord Herschel, Supra note 211 at 445.

Share buy-backs are now a common phenomenon in many securities markets. Many jurisdictions<sup>214</sup> that adopted the United Kingdom's Companies Act, 1948, have since amended the relevant provision to provide for share buy-backs by listed companies. Share buy-backs enable companies to reduce their outstanding shares which concomitantly increases earnings per share reflected in higher share prices.<sup>215</sup> Kenya Airways Co. Limited, a listed company once sought approval of the Capital Markets Authority to purchase some of its outstanding shares. The Authority rejected the application citing the restrictions imposed by section 56 of the Companies Act.<sup>216</sup> Safaricom Co. Limited has also expressed an interest in share buy-back. Since the need has arisen and does not unfairly prejudice the minority, the Companies Act should be amended to enable listed companies to buy-back their outstanding shares. The amendment should provide for the procedural and other requirements.

Fourth, the statutory framework for the protection of minority interest is notoriously inadequate and the Guidelines on the principles of corporate governance are largely ineffective. The challenge of minority protection in listed companies is compounded by the concentrated ownership structure where controlling shareholder(s) dominate the board of directors and thus exercises almost unfettered discretion in managing the affairs of the company.<sup>217</sup> The problem is exacerbated by the fact that the law allows the holding of shares through amorphous entities referred to as nominees who are deemed to be shareholders.<sup>218</sup> Furthermore, no member of the board represents the minority. This poses serious challenges to corporate governance. The minority cannot influence the appointment or removal of directors or other major decisions of the company. The possibility of expropriation or related party transactions passing unnoticed particularly if the controlling shareholders are anxious to extract private benefits of control cannot be underestimated.<sup>219</sup> This is illuminated by the provisions of the Companies Act governing disclosure of interest in contracts made by the company. A director who has a personal interest in a contract made by the company is required to disclose the nature of his interest at a meeting of the board of directors.<sup>220</sup> The director is not required to disclose the extent of his interest. Furthermore, the law does not require notice to or ratification of the transaction by members in general meeting. Arguably, the breadth of the current provision is too restrictive to champion minority interest or promote corporate governance.

Closely allied to the foregoing argument is the fact that although the Companies Act contains several provisions<sup>221</sup> which minorities can rely on for specific purposes, the provisions are largely ineffective and remedies are essentially nonexistent. For instance, shareholders cannot generally sue to remedy wrongs afflicted on the company since the right is vested in the company as a legal person. This is the celebrated rule in *Foss v. Harbottle*.<sup>222</sup> Exceptions to this rule are permitted through a derivative action.<sup>223</sup>

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<sup>214</sup> For example, Australia, Singapore, New Zealand and Malaysia. See Chee Keong Low, Refining the Share Buy-back Regime in Singapore, *SING. J. LEGAL STUD.* 325 (2001).

<sup>215</sup> See Chee Keong Low, Refining the Share buy-back in Malaysia, *SING. J. LEGAL STUD.* 325, 326 (2001).

<sup>216</sup> In its strategic plan for 2002-2005, the Capital Markets Authority had proposed to have the Companies Act amended to enable listed companies to buy back their shares. See Capital Markets Authority Annual Report, 2008; John Oyuke, National Bank of Kenya (NBK) considering share buyback, *THE STANDARD*, June 23, 2007 at 19.

<sup>217</sup> In most listed companies, the majority shareholders own at least 40% of the company. In one foreign owned bank, the majority hold 73% of the company's shares.

<sup>218</sup> § 119. See also King'ori Choto, Billions Hidden in Secret Accounts in Stock Market, *FINANCIAL POST*, June 8, 2008 at 2; Jackson Okoth, Foreigners Controlling the Nairobi Stock Exchange, *FINANCIAL POST*, Jan. 15, 2007 at 2.

<sup>219</sup> See generally Say H. Goo & Rolf H. Weber, The Expropriation Game: Minority Shareholders Protection, 33 *HONG KONG L. J.* 71 (2003); Rita Cheung, Corporate Governance in Hong Kong: Certain issues of minority shareholders' rights and protection in listed companies, 19(6) *I.C.C.L.R.* 181 (2008) (on minority expropriation on Hong Kong).

<sup>220</sup> § 200

<sup>221</sup> Section 132 enable minorities to instigate the convention of an extra ordinary general meeting against the wishes of directors or the majority, section 211 provides a remedy which is an alternative to winding up in cases of oppression of the minority, section 210 enable dissenting minorities to challenge a takeover bid, section 8 enable minorities to apply to court to prevent a proposed alteration of the objects clause, section 74 permit the dissenting members holding a particular class of shares to object to a proposed variation of class rights, section 137 allow the minority to demand voting by poll in general meeting, section 131(2) allow the minority to petition the registrar of companies to summon an annual general meeting in the event of default by the company, section 135 allow a minority shareholder to apply to the court for an order to the company to hold and conduct a meeting in accordance with the Act and its articles, section 165 allow the minority to apply to court for the company's affairs to be investigated by an inspector appointed by the court, section 219(f) enable the minority to petition for the winding up of the company on the just and equitable ground in cases of oppression of the minority. Although this list looks impressive, these supposedly protective provisions are more apparent than real. They are difficult to invoke because, minority shareholders seldom attend general meetings or keep abreast of company affairs, most of them are uninformed and uninspired to participate in company matters and are disunited which works in favour of the majority. Listed companies are reluctant to facilitate the formation of shareholder associations which could promote shareholder activism. But more importantly, the majority shareholders in most companies dictate the terms.

<sup>222</sup> (1843) 2 Hare 461. This rule states that when a wrong is committed against the company, the company is prima facie the proper plaintiff for redress. It is also referred to as the majority rule. It re-asserts the rule in *Salomon v. Salomon and Co*, promotes democracy

This procedural device provides a window through which shareholders can sue wrongdoers on behalf of the company. Its purpose is to ensure that improprieties against the company which otherwise would have gone unremedied are remedied. The party suing must establish the procedural and substantive safeguards of the rule and remains a nominal plaintiff since the action belongs to the company. Finally, any amount recovered belongs to the company. Complexity of the law, cost, free-riding and other impediments disincentivise shareholders from instituting derivative actions.<sup>224</sup> Judicial authority in East Africa suggests that a minority shareholder can only sue for violations of individual membership rights.<sup>225</sup> The derivative action is virtually nonexistent in East Africa.<sup>226</sup> The law should provide for a statutory derivative action with less procedural and substantive hurdles.<sup>227</sup> Identifying the circumstances in which a derivative action is sustainable and prescribing the requisite procedure would streamline the legal framework, imbue certainty and discourage vexatious actions.

Relatedly, courts have not been instrumental in championing minority interest. Apart from requiring the majority to exercise their voting power in good faith for the benefit of the company as a whole, no other propositions have been developed.<sup>228</sup> Courts will only interfere with a decision of the majority if it is not “*bona fide* for the benefit of the company as a whole.”<sup>229</sup> One of the seminal decisions in this respect is *Cooks v. Deeks*<sup>230</sup> where the majority had passed a resolution to confer a benefit on themselves to the exclusion of the company. The court was satisfied that the majority had not acted *bona fide* for the benefit of the company as a whole.<sup>231</sup> Arguably, Kenya’s corporate law has not been instrumental in the promotion of the primary or secondary markets. It is inadequate in many respects. It is imperative to highlight the fact that a corporate law that is clear, facilitative, predictable and consistently enforced can create a protective and fertile environment for economic activity.<sup>232</sup> It is not implausible to surmise that Kenya’s corporate law lacks these attributes and has endeared neither the securities markets nor investor protection or corporate governance.

### **Framework on investment**

Trustee Act<sup>233</sup>

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in company management, prevents multiplicity of actions by overzealous shareholders and discourages frivolous and vexatious actions.

<sup>223</sup> This is an action instituted by an individual shareholder in his own name, to remedy a wrong done to the company. It is available for the enforcement of duties owed to the company. It is ordinarily available where the directors or the persons against whom relief is sought hold and control the majority of the shares in the company and cannot permit an action to be brought in the name of the company. It is unavailable to enforce the rights of individual shareholders. It is representative in character.

<sup>224</sup> Goo & Weber, supra note 214 at 85.

<sup>225</sup> See *Musa Musango v. Eria Musigire* [1966] E. A. 390.

<sup>226</sup> See *Bugerere Coffee Growers Ltd v. Sebaduka* [1970] E. A. 147.

<sup>227</sup> Such actions have been institutionalized in Australia, Singapore and Hong Kong. See also, John Paterson, *Corporate Governance in India in the context of the Companies Bill 2009: Part3: Proposals*, I.C.C.L.R. 21(4) 131, 138 (2010)

<sup>228</sup> In *Menier v. Hooper Telegraph Works* (1874) 9 Ch. App. 350, Hoopers Company was a substantial shareholder in European Telegraph Company and had contracted with it to make and lay a cable to South America under certain concessions granted to the European Company by the foreign governments concerned. Menier, a minority shareholder claimed that Hoopers Company had used its votes to procure the diversion of this business to a third company, to cause the abandonment of proceedings brought by the European Company to assert its right to the concessions and to have the European Company wound up. The court held that a minority shareholders action had been properly instituted. Observed Mellish L. J: “I am of the opinion that although it may be quite true that the shareholders of a company may vote as they please and for the purpose of their own interests, yet that the majority of shareholders cannot sell the assets of the company and keep the consideration, but must allow the minority to have their share of any consideration which may come to them.”

<sup>229</sup> In the words of Evershed MR in *Greenhalgh v. Arderne Cinemas Limited* [1950] 2 All E.R. 1120 at 1126: “It is now plain that *bona fide* for the benefit of the company as a whole” means not two things but one thing. It means that the shareholder must proceed on what, in his honest opinion, is for the benefit of the company as a whole. Secondly, the phrase “the company as a whole” does not mean that the company as a commercial entity is distinct from the incorporators. It means the incorporators as a general body... a special resolution of this kind would be liable to be impeached if the effect of it were to discriminate between the majority shareholders and the minority shareholders so as to give the former an advantage of which the latter were deprived. When the cases are examined where the resolution has been successfully attacked, it is on that ground that it has fallen down.”

<sup>230</sup> [1916] A.C. 554

<sup>231</sup> Lord Buckmaster observed: “This means that while entrusted with the conduct of the affairs of the company, they deliberately designed to exclude and used their influence and position to exclude the company whose interest it was their first duty to protect... men who assume the complete control of a company’s’ business must remember that they are not at liberty ...to divert in their own favour business which should properly belong to the company they represent...if directors have acquired for themselves property or rights which they must be regarded as holding on behalf of the company, a resolution that the rights of the company should be disregarded in the matter would amount to forfeiting the interest and property of the minority shareholders in favour of the majority.” Id.

<sup>232</sup> See generally Henning J. J., *The Enduring South African Close Corporation: 21 Years of Simply Thinking Small* first successfully, 28 (8) COMP. LAW. 253 (2007).

<sup>233</sup> Cap 167, Laws of Kenya.

This Act makes provision for the incorporation of certain trustees for purposes of perpetual succession to property. § 4 of the Act prescribe the various securities in which a trustee can legally invest trust funds. Although trustees are free to invest in government treasury bonds, investment in corporate securities is severely restricted. A trustee can only invest in equity and corporate bonds issued by companies that meet a prescribed threshold in terms of share capital and payment of dividend in the preceding five years.<sup>234</sup> It is suggested that restrictions on investment should be relaxed to enable trustees utilize the securities markets more robustly. It is imperative that trustees be accorded more breadth in making investment decisions.

#### Co-operative movement and the Co-operative Societies Act<sup>235</sup>

Pursuing human endeavours in formal or informal groupings has a long tradition in Kenya. It is part of the national psyche encapsulated by the “Harambee” spirit which literally means “working together.” One of the enduring hallmarks of the people of Kenya is the co-operative movement.<sup>236</sup> This concept has been used in agriculture (production and marketing), housing, finance, transport and craft. Co-operative societies are either primary, where the membership is restricted to individuals or a union whose membership is restricted to primary co-operatives. Co-operative societies are guided by basic principles such as, open and voluntary membership, democratic member control, independence, economic participation, co-operation and concern for community.<sup>237</sup> In a nutshell, co-operative societies enable individuals engage in activities they otherwise would not as individuals. To strengthen and maximize the benefits of the co-operative movement, the Government of Kenya established a network of co-operative offices throughout the country. Proliferation of co-operative societies in both traditional and nontraditional ventures and the need for accountability necessitates regular review of the law on co-operatives. The current version of the Co-operative Societies Act came into operation on November 5th, 2004.

Basically, the Act provides for the establishment, registration and regulation of primary, union and apex co-operative societies in Kenya.<sup>238</sup> An examination of its provisions reveals that it was not conceived as a framework that could play any significant role in the development of securities markets. Its provisions restrict the capacity of co-operative societies to invest member’s funds. For instance, section 45 is explicit that, a co-operative society may invest or deposit funds only in the stock of any statutory body established in Kenya or a limited company incorporated in Kenya or in any other manner approved by a resolution of a general meeting of the society. This provision does not obligate co-operative societies to invest member’s funds in securities markets.<sup>239</sup> Additionally, the implication that shareholders have the wisdom to determine how the society’s funds should be invested is unrealistic. Most co-operative societies are based in the rural areas and do not consider securities as constituting part of their investment portfolio. Typically, society’s funds are ordinarily reinvested in the society or advanced to members as short term loans.

Since there is no over-the-counter market (OTC) for co-operative societies’ shares, they are not freely transferable. Section 20 provides that only persons who have been members of a society for at least one year can transfer shares and the transfer must be made in favor of another member of the society or the society itself. Closely related to the forgoing argument, since most cooperative societies are not registered under the provisions of the Companies Act, they cannot utilize the securities markets to raise capital by way of debt or equity. This restriction excludes the cooperative sector from the securities markets. The law should be reviewed to accommodate the listing of eligible co-operative societies. Companies such as Co-operative Bank of Kenya (listed on the NSE) started operations as cooperative societies. A considerable number of societies are eligible and could access capital by issuing securities.

#### Income Tax Act<sup>240</sup>

The Income Tax Act makes provision for the ascertainment and collection of tax from individuals, corporations and other eligible entities. A country’s tax policy is an encapsulation of economic, social aspirations and goals of the people. The tax structure is of key importance in the drive for development. Ordinarily, taxation should not operate as a disincentive or discourage investment.

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<sup>234</sup> § 4(1)

<sup>235</sup> Cap 490, Laws of Kenya.

<sup>236</sup> See Fredrick O. Wanyama, *Surviving Liberalization: The Co-operative Movement in Kenya*, available at <http://www.ilo.org/wcmsp5/groups/public---ed---emp---ent---co-op/documents/publication> (visited July 24th 2010).

<sup>237</sup> See *Co-operative Movement in Kenya: Celebrating 100 Years*, available at <http://www.sceportal.org/projects/Article-archive.aspx=News &PID=1534nEWSid=1934>

<sup>238</sup> See Preamble to the Act.

<sup>239</sup> See Alex Chege, *CMA wants Co-operative Societies Act to be Reviewed*, DAILY NATION, May 12, 1993 at 13.

<sup>240</sup> Cap. 470, Laws of Kenya.

As part of the liberalization package, Kenya abolished capital gains tax in 1995. This was intended to boost investment in the equity markets. Although the country's tax regime is not exceedingly adverse to securities markets, it can be improved to play an enhancing role. First, the double taxation of dividend is inequitable to equity holders because they have already paid the same corporately as corporation tax. Dividend tax should be treated as an allowable tax expense to encourage investment in equities. This would create a level playing field between equities and bank borrowing since interest on debt is tax deductible. Certainty of tax laws is critical for purposes of investment. A dispute pitting Unit Trusts and the Kenya Revenue Authority over the formers tax liability since their inception could have far reaching implications on the viability of Unit Trusts as investment avenues. Section 20 of the Income Tax Act exempts Unit Trusts from payment of income tax other than withholding tax on interest income and dividend. Consequently, Unit Trusts had been paying withholding tax at the rate of 8% but in 2010, the Kenya Revenue Authority raised the amount to 15%. The potential impact of the increment was to reduce the rate of return to investors by 2%.<sup>241</sup> The dispute is pending in court. It is envisaged that the construction of section 20 will not adversely alter the landscape of Unit Trusts as investment avenues. But tax incentives have limitations too. The use of fiscal incentives to entice companies to list on the Nairobi Stock Exchange has largely been ineffectual.

#### Privatization Act<sup>242</sup>

This Act lays down the framework for the establishment of a Privatization Commission and the privatization of government assets and operations including state corporations.<sup>243</sup> The Privatization Commission is mandated to formulate, manage and implement the privatization program.<sup>244</sup> The Commission is required to formulate the privatization programme which must be published in the Kenya Gazette.<sup>245</sup> In formulating the programme, the Commission is duty bound to take into consideration the desired benefits of the program which include the enhancement and development of the securities markets.<sup>246</sup> Although this is not the only desired benefit, the Commission has a statutory endorsement to justify countless initial public offerings on this basis. This would increase the number of listed companies and liquidity in the securities markets. The downside of the Act is that it prescribes various methods of privatization and the Commission can adopt any of them for any state corporation being privatized.<sup>247</sup>

This may include, leasing, concessions, management contracts or public-private partnership. Besides, it is empowered to use "any other method approved by the cabinet in the approval of the specific privatization."<sup>248</sup> Similarly, the Act authorizes divestitures outside the privatization programme.<sup>249</sup> In addition, provisions of the Act allow the minister to direct the Commission to limit participation in any privatization to Kenyans only or ensure that there is a minimum level of participation by Kenyan citizens.<sup>250</sup> This provision is inimical to the promotion of foreign investment and contrasts sharply with the Singaporean experience where openness towards foreign investment in securities markets has been an enduring policy.<sup>251</sup> Unsurprisingly, securities markets in the two jurisdictions are miles apart. A panoramic view of the Act reveals that the Privatization Commission lacks independence to conduct privatization of government assets and state corporations professionally because it is susceptible to political meddling both by the executive.<sup>252</sup> Nevertheless, it is anticipated that the Commission will through its privatization programme enhance the development of the securities markets by proposing more listings of eligible state corporations.

#### Investment Promotion Act<sup>253</sup>

This statute was enacted in 2004 to promote and facilitate local and foreign investment in Kenya by assisting investors obtain the necessary licenses and other forms of facilitation and incentives.<sup>254</sup> To undertake any form of business in Kenya,

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<sup>241</sup> See James Makau, Tax threaten returns from Unit Trusts, BUSINESS DAILY, Feb. 25, 2010 at 5.

<sup>242</sup> Cap 485C, Laws of Kenya.

<sup>243</sup> Preamble

<sup>244</sup> § 3

<sup>245</sup> § 17 (2)

<sup>246</sup> § 18(2) (g)

<sup>247</sup> § 25

<sup>248</sup> Id.

<sup>249</sup> § 22(1)

<sup>250</sup> § 29(1)

<sup>251</sup> See Douglas Sikorski, The Perspective for Privatization in Singapore, available at <http://sunzi.libhku/hkjo/view/50/5000300.pdf> (visited on March 18, 2010).

<sup>252</sup> See James Anyanzwa, Privatizations must be Transparent, THE STANDARD, Jan. 1, 2009 at 4.

<sup>253</sup> Cap 6, Laws of Kenya

<sup>254</sup> Preambular provision

the Trade Licensing Act requires an investor to secure a trade license from the District Trade Licensing Officer.

In addition, to carry on any business within a City, Municipality or County Council, By-Laws require an annual license. Furthermore, certain types of businesses such as mining, petroleum products, education, hotel, restaurant and catering require business-specific licenses from relevant Government ministries or administrative agencies.

The Investment Promotion Act was intended to facilitate investment by establishing a one-stop shop for investors. It is the main investment avenue for local and foreign investors. The Act establishes the Kenya Investment Authority as the principal administrative body to implement the Act.<sup>255</sup> Authority membership comprises eighteen high ranking Government officials.<sup>256</sup> It is doubtful whether this number of officials infuses efficiency in the Authority's discharge of its mandate. To invest in the country, foreign investors are required to apply for an investment certificate from the authority.<sup>257</sup> Local investors are exempted.<sup>258</sup> Furthermore, the Act prescribes different thresholds of investible amounts for local and foreign investors.<sup>259</sup> Puzzlingly, the Act does not envisage investment in the financial services sector by foreign investors. The catalogue of possible spheres of investment prescribed by the Second Schedule to the Act excludes the sector. Being the vanguard of investment promotion in the country, the Act creates a discreditable impression of the draftsman and the legislature. It should have been more comprehensive and elaborate on pertinent matters. It denies foreign investors liberty to invest in sectors of their choice and is ambiguous on exempted investments. Relatedly, it does not guarantee that investments especially by foreigners will not be nationalized or expropriated by the Government or surrendered to any person.<sup>260</sup> The Act establishes no mechanisms to facilitate liaison with other Governmental bodies or departments. The Nigerian equivalent for instance, is reasonably elaborate on areas of investment, exemptions and is extremely comprehensive.<sup>261</sup>

#### Sacco Societies Act<sup>262</sup>

This statute makes provision for the licensing, supervision, promotion and regulation of Savings and Credit Cooperative Societies (Saccos).<sup>263</sup> The policy underlying its passage was to create a separate legal framework for Saccos which are radically different from traditional produce and marketing cooperatives. Although Saccos have been instrumental in raising huge amounts of money for their members, governance has been a major challenge. It was envisioned that a separate legal framework would galvanize the sector for the benefit of members and the economy. The Act establishes the Sacco Societies Regulatory Authority (SSRA) as the principal administrative body for the sector.<sup>264</sup> The Authority licenses, supervises and regulates all Saccos.<sup>265</sup> To be licensed by the SSRA, a Sacco must have a minimum capital of Kshs. 10m (\$ 125,000)<sup>266</sup> and must maintain the prescribed minimum liquid assets.<sup>267</sup> Similarly, the Act establishes the Deposit Guarantee Fund which insures each members deposit up to a maximum of Kshs 100,000 (\$ 1,250).<sup>268</sup> Although Saccos are free to invest in government securities, equities and corporate bonds,<sup>269</sup> most of them do not since the funds are typically invested in real property, public transport vehicles or lent to members as short term loans.

Given that Savings and Credit Cooperative Societies are the most common method of pooling resources for the bulk of the population throughout the country, and have raised more funds than any other sector of the economy, it has potential to enhance the securities markets. It is suggested the Act be amended to require all Saccos to invest a specified minimum of their capital and surplus funds in government securities, corporate bonds and equities.

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<sup>255</sup> § 14

<sup>256</sup> § 16

<sup>257</sup> § 3

<sup>258</sup> Id.

<sup>259</sup> Under § 4 (1) while a local investor must propose to invest at least \$62, 500, a foreign investor must have at least \$ 500,000.

<sup>260</sup> Although the Constitution guarantees the right to private property, foreign investors need reassurance of the safety of their investment. .

<sup>261</sup> See Jospeoh E.O. Abugu, Technology, Globalization and the Nigerian Securities Markets, 18 J.I.B.L.R 284, 289 (2003). See generally Jospeoh, E.O. Abugu, Promoting Investment in Nigeria 1 MODUS INT'L L. & Q. J.47 (1996), See also, Oluwole Obayomi, Recent Developments in Securities Laws in Nigeria, J.I.B.L. 128 (1996).

<sup>262</sup> Act No. 14 of 2008. The Act came into force on Sept. 26th 2009 and applies to deposit taking and specified non deposit taking saccos

<sup>263</sup> Preamble

<sup>264</sup> § 4.

<sup>265</sup> § 5.

<sup>266</sup> § 29.

<sup>267</sup> § 30.

<sup>268</sup> § 59.

<sup>269</sup> § 38.

This would compel them to diversify investments to cushion members against loss and maximize returns to members.<sup>270</sup>

Finally, because Cooperatives and Sacco's fall under the Ministry of Cooperative Development, there is need for collaboration between the Ministry and the Ministry of Finance in order to make the sector a more effective tool in the development of securities markets. In sum, the legal framework impacting on securities markets in Kenya is an unsophisticated patchwork of disjointed, duplicative, cost ineffective infrastructure replete with restrictions on investment and arguably substantially inadequate for the creation and sustainability of deep and vibrant securities markets. Although the statutes have the potential to transform the securities markets and the financial services industry into a growth sector in Kenya, they do not augment each other.

### **Institutional framework**

Securities markets are not created, deepened and sustained by substantive law alone. A complement of other institutions must exist for the markets to deepen and thrive.<sup>271</sup> Principal among them is the administrative infrastructure. Authoritative scholarship on securities markets is unshakable that strong securities markets are anchored on equally strong and diverse institutional arrangements which coevolve and complement each other.<sup>272</sup> It is an aggregation of diverse organizations including: the stock exchange, stock brokers, dealers and investment banks, investment advisers, collective investment schemes, unit trusts, credit rating agencies, over the counter market, self regulatory organizations, regulators and securities markets professionals.<sup>273</sup> These diversified institutions constitute a complex and intricately intertwined structure which facilitates optimal operation and regulation of the securities markets for sustainability. It provides the operational basis for the markets.

Abrahams and Taylor report that in order to create an effective institutional framework for securities markets, the agencies involved must: have clear objectives, be independent and accountable, have the necessary resources to perform the tasks commended, have effective enforcement powers, have comprehensive rules covering all aspects, be cost effective and have a structure that reflects the structure of the industry.<sup>274</sup> This is complemented by sound practices of corporate governance, rule of law and efficacious dispute resolution mechanisms.<sup>275</sup> It is important to emphasize that any analysis of the institutional framework on securities markets overlaps with the legal framework ostensibly because the institutional infrastructure is a creation of the law. Before 1990, the responsibility of overseeing Kenya's securities markets fell variously on the Registrar of Companies, Capital Issues Committee, Nairobi Stock Exchange and the Ministry of Finance. The need for a different institutional mix was recommended by the IFC/CBK Report on the Development of Capital Markets in Kenya.

#### **Capital Markets Authority**

This is the principal administrative body in the institutional infrastructure of Kenya's securities markets. It is a body corporate established by section 5 of the Capital Markets Act. Its mandate is to promote and facilitate the development of orderly, fair efficient, secure, transparent and dynamic securities markets in Kenya.<sup>276</sup> The Act envisions that the mandate is accomplished in the context of a regulatory framework which nurtures innovation, promotes flexibility and self regulation in order to maintain investor confidence and safeguard the markets. The Authority consists of eleven members including the chief executive officer who is responsible for the day-to-day operations of the Authority. The Governor of the Central Bank of Kenya, Permanent Secretary to the Treasury and the Attorney General are standing members of the Authority. The principal objectives of the Authority are: to promote the development of all aspects of the securities markets, mobilize incentives for long term investments, protect investors' interests, facilitate the establishment of an Investor Compensation Fund, create, maintain and regulate a system where market participants are self regulatory to the maximum extent practically possible, facilitate the development of a nationwide system of stock market and brokerage services, advise the government on all matters germane to securities markets,

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<sup>270</sup> In 2007, for instance, the Ministry for Co-operative Development estimated that Savings and Credit Co-operative sector was growing at the rate of Kshs 13 billion (\$949 million) annually. See Peter Ndwiga, *Creating a Positive Impact on our Development*, FINANCE June 12, 2007 at 76.

<sup>271</sup> See Black, *Supra* note 16.

<sup>272</sup> *Id.* at 785

<sup>273</sup> *Id.*

<sup>274</sup> Richard K. Abrahams & Michael W. Taylor, *Issues in the Unification of Financial Sector Supervision*, 5-9 (Int'l Monetary Fund, Working Paper No. WP/00/213, 2000); MARIA LASTRA, *LEGAL FOUNDATIONS OF INTERNATIONAL MONETARY STABILITY* 346-47 (2006).

<sup>275</sup> See INT'L ORG. OF SEC. COMM'NS, *OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION*, Annexure 3 (2002).

<sup>276</sup> This preambular provision is borrowed from the Malaysian equivalent.



formulate rules and guidelines on various aspects of the securities markets, license, approve and supervise all market intermediaries. It is empowered to approve all new and additional issues of securities to the public and oversee activities in the primary and secondary markets.<sup>277</sup> Evidently, the Capital Markets Authority has an unenviable dual statutory mandate of promoting the development of securities markets and regulating them.<sup>278</sup> Interrogating the objectives of the CMA reveals that they are disproportionately in favour of market development as opposed to regulation. This appears to have been informed by the recommendations of the IFC/CBK Report. It is imperative for the Authority to ensure optimal regulation of the securities markets, promote and facilitate listings on the stock exchange to enhance liquidity, enhance meaningful corporate disclosure, nurture the development of reputational intermediaries and promote the growth of other securities markets institutions such as over-the-counter market. These activities are the *sine qua non* for investor protection, market integrity and investor confidence which is the bedrock of securities markets. However, the Authority appears to lay less emphasis on market development. This assertion is bolstered by the Authority's annual reports. On average, it has been spending less than 4% of its total annual expenditure on "market development services" and investor education activities<sup>279</sup> and over 6.0% on rent and maintenance.<sup>280</sup>

To facilitate the discharge of its statutory mandate, the Authority has overwhelming powers<sup>281</sup> including the power "to do all such other acts as may be incidental or conducive to the attainment of its objectives." This amorphous provision constitutes the Authority both judge and jury in determining what acts are "incidental or conducive" to the attainment of its objects. Similarly, the Authority enjoys extensive legislative powers in relation to the securities markets generally and its licensees, approved persons and listed companies in particular. It is empowered to inquire into the affairs of persons through an officer appointed by the chief executive officer, intervene in the management of a licensee, impose financial penalties for violations of the provisions of the Act, regulations, rules or procedures of any securities exchange by licensees, approved persons, listed companies or their directors or employees.<sup>282</sup>

Analogous to the Authority, the Minister of Finance is also empowered to prescribe penalties for violations of provisions of the Act.<sup>283</sup> Moreover, he is empowered to demand returns from the Authority and make rules to regulate certain aspects of the securities markets, such as participation of foreign investors. This duplicates the powers of the Capital Markets Authority and undermines its independence. Notably, the establishment of the Capital Markets Authority was inspired by the Securities Commissions of Malaysia and Nigeria which are modeled on the Securities and Exchange Commission of the United States. As scholars have convincingly argued, administrative structures in developed jurisdictions have evolved over time and are predicated on well developed regulatory capacity with sufficient numbers of professionals and other supportive institutions.<sup>284</sup> Such institutional mix is largely nonexistent in developing jurisdictions. Replicating such administrative structures does not guarantee the development of deep and vibrant securities markets. The Capital Markets Authority commenced operations in 1990 with a staff of thirty in five departments.<sup>285</sup> The number has since risen to over sixty in seven departments.

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<sup>277</sup> §§ 11 & 12

<sup>278</sup> See Role and Objectives of CMA: DAILY NATION, July 9, 1993 at 14-15.

<sup>279</sup> Capital Markets Authority Annual Reports, 1991-2008.

<sup>280</sup> Id.

<sup>281</sup> For instance, it is empowered to: advise the minister on all aspects of the development and operation of the securities markets, implement government policies on securities markets, employ officers and servants, frame rules and guidelines on matters within its jurisdiction, grant licenses to market intermediaries, approve securities exchanges, central depositories, credit rating agencies and registered venture capital funds. Additionally, it is empowered to: register, approve and regulate collective investment schemes, inquire into the affairs of any person the Authority has approved person its licensee or listed company or give directions to such persons, inspect activities, books and record of approved persons and licensees, publish findings of malfeasance by any approved persons, licensee or listed company, suspend or cancel listing of any securities, appoint auditors to carry out specific audit of any collective investment scheme or listed company, act as an appellate body in respect of appeals against decisions of any stock exchange or central depository, co-operate or enter into mutual agreements with other regulatory authorities, oversee the issue of securities and regulate trading in both primary and secondary markets, trace assets, including bank accounts of any person engaged in fraudulent dealings in securities or insider trading and order caveats to be placed against titles to such assets, prescribe rules or guidelines on corporate governance for public companies.

<sup>282</sup> § 25A

<sup>283</sup> § 36

<sup>284</sup> Philip N. Pillai, Securities Regulation in Malaysia: Emerging Norms of Government Regulation, 8 J. COMP. BUS. & CAPITAL MARKETS L. 39, 45 (1986).

<sup>285</sup> Operations/ Market surveillance, Secretary/Legal Affairs, Financial Analysis/Corporate, Economic/ Research, Administrative support services/ Personnel, Salaries and Accounting. The management was subsequently re-organized into department and divisions, namely; Legal Affairs Division, Market Supervision, Research and Development, Human Resources and Administration Division and the Corporate Affairs Division.

It was then fully dependent on the government for funding but is currently financially self sustaining from licensing, approvals and trading levies.<sup>286</sup> To promote expertise among its staff, the CMA expended a disproportionate amount of its budgetary allocation on training, attendance of conferences, study tours and internships with established regulators.<sup>287</sup> Since its inauguration in 1990, the number of employees stagnated at 46 for a long time. The Authority has been characterized by an extraordinarily high manager turnover that it perpetually has vacant positions.<sup>288</sup> Its inability to attract and retain top notch professionals in law, finance, accountancy, economics and actuarial science has impacted negatively on its organizational capacity.<sup>289</sup> It lacks sufficient in-house capabilities and cumulative expertise or experience to discharge its mandate effectively and efficiently. Approvals take inordinately long and the Authority's indisposition to decide controversial questions is palpable. This is vividly demonstrated by *inter alia*, the quagmire involving the licensing of new stock broking firms, Safaricom Co. Ltd IPO refunds of 2008, relisting of Uchumi Supermarkets Co. Ltd shares after receivership was lifted and the threshold of individual shareholding in stock brokerage firms and investment banks.<sup>290</sup> Closely allied to this argument is the fact that for many years before 2003, the CMA could not marshal sufficient resources to balance its budget and operated on deficits. Since then, it has been realizing substantial surplus from levies.<sup>291</sup> However, it is still plagued by shortages of essential human capital.

Before 1989, regulation of Kenya's securities markets was more aligned to the British self regulatory model with the Nairobi Stock Exchange as a self-regulatory body in charge of listed companies and market intermediaries. The provisions of the Capital Markets Authority Act attempted to establish a hybrid system which appears to have failed. The Act and its regulations accord the CMA primacy over all matters concerning the securities markets. For instance, all stockbrokers licensed by the Authority acquire full membership of the Nairobi Stock Exchange and authorized securities dealers become associate members.<sup>292</sup> The NSE has no discretion in determining who qualifies to become a full or associate member.

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<sup>286</sup> In June 1995, the minister authorized CMA to levy fees on services rendered to diversify its revenue streams. It was authorized to charge fees on approval on listings, issue of rights or bonus shares and transactions on the Nairobi Stock Exchange. This did not significantly boost its revenue and continued relying of the government. However, due to increased market activity from 2003, the Authority has been recording a huge surplus annually.

<sup>287</sup> Capital Markets Authority Annual Report, 53 (1990-91).

<sup>288</sup> For example, only two managers who were working for the Authority in the early 1990s are still in employment. In 2007, the Authority had an establishment of 46 employees but 16 of them were vacant. In 2008, the establishment was raised to 89 with 45 positions vacant. In 2009, it had 19 vacant positions. See Advertiser Announcement, Capital Markets Authority: Expression of Interest, DAILY NATION, Mar. 29, 2007 at 39. (Inviting Human Resource Firms to assist in the recruitment of ten managers)

<sup>289</sup> The Authority has been recruiting inexperienced staff virtually every year. See Joseph Bonyo, Plan to alter CMA Staff Terms, DAILY NATION Nov. 27, 2007 at 27.

<sup>290</sup> See Muna Wahome, Capital Markets Authority mulls over lifting of broker licensing freeze, DAILY NATION, Feb. 28, 2010 at 27; Jane Njeru, KASIB'S Position on Recent Developments in the Capital Markets Industry, DAILY NATION, Feb. 12, 2010 at 31; Joseph Bonyo, Quarrel between Citibank and Stock brokers grows, DAILY NATION, Mar. 4, 2009 at 19; Jackson Okoth, What went wrong in Safaricom Refund Process? THE STANDARD, Mar. 4, 2009 at 30; Joseph Bonyo, CMA on the spot over Safaricom Refunds: Shillings 141 million IPO refunds put CMA in a fix, DAILY NATION, Mar.16, 2010 at 18; Jackson Okoth & James Anyanzwa, Brokers demand audit of Safaricom refunds, THE STANDARD, Mar. 12, 2009 at 19; James Anyanzwa, Citibank fights back on Safaricom IPO allegations, THE STANDARD, Mar. 13, 2010 at 13; Kevin Mwanza, Stock market barons get ownership reprieve, BUSINESS DAILY, June 28, 2010 at 20; Johnstone Ole Turana, CMA should stick to rule, BUSINESS DAILY, June 29, 2010 at 16 (On CMA's proposal to increase shareholding in stock brokers and Investment banks from the current 25 per cent to 33.3 per cent); Michael Omondi, CMA Policy vacuum ties Kengen to low-value issue, BUSINESS DAILY, Apr. 4, 2007 at 1 (On CMAs acknowledgement that it had no policy on book building in IPOs); Wachira Kang'aru, Shs 250m IPO Refunds still pending, DAILY NATION, July 16, 2009 at 28; Joseph Bonyo, Kshs. 141 million IPO refunds put CMA in a fix, DAILY NATION, Mar.16, 2010 at 18; Editorial, CMA sending out confusing signals, THE STANDARD, Apr. 29, 2008 at 8; Kenneth Kwama, Post-recovery Uchumi seeks return to NSE, THE STANDARD, Nov. 24, 2008 at 19; Jevans Nyabiage, Uchumi seeks trade its shares again, DAILY NATION, Jan. 7, 2009 at 25; Jackson Okoth, Uchumi Shares could begin Trading at NSE in October, THE STANDARD, July 29, 2009 at 32; Michael Omondi, Uchumi Investors face longer wait for Bourse trade, BUSINESS DAILY, Mar. 13, 2010 at 20; James Anyanzwa, Old Mutual Insurance Company to raise Kshs. 700 million (\$8,750,000) from the market, THE STANDARD, Oct. 30, 2010 at 27 (on private issues and the ambivalence of the CMA on their procedural requirements); Geoffrey Irungu, CMA Cautions transaction Advisers on Private Offers, BUSINESS DAILY, Nov. 1 2010 at 8; James Anyanzwa, PSV Insurer launches bid to raise capital, THE STANDARD, May 4, 2010 at 18; Washington Gikunju, Queries over delay in re-listing of Uchumi Super markets Co. Ltd at Nairobi Bourse, BUSINESS DAILY, Dec. 9, 2010 at 11(explaining that the company's application to have its trading suspension lifted has been pending for over five months yet the company has been making profit for the last three years, 95 million (\$1, 187,500), Kshs. 421 million (\$5,262,500) and Kshs. 865 million (\$10,812,500); Mwaniki Wahome, Shillings 2.6 billion (\$32,500,000) held up in Uchumi Shares, DAILY NATION, Nov. 9, 2010 at 17; Phillip Ngunjiri, CMA finally allows Kenya Oil to buy up Kobil assets, THE EAST AFRICAN, Dec 3-9, 2007 at 23; James Anyanzwa, Regulator undecided on Co-operative Bank public Offer, THE STANDARD, Oct. 14, 2008 at 27; Patrick Muriungi, Fate of Uchumi relisting at NSE to be known next week, THE STANDARD, Jan. 29, 2011 at 32.

<sup>291</sup> In 2008 for instance, it realized a surplus of about \$6,250,000 compared to \$ 175, 500 in 2007 but by 2009 the amount had dropped to \$ 70,000 due to the increasing wage bill and reduced market activity.

<sup>292</sup> Regulation 5 (2)

Although this has implications on NSE's disciplinary powers, it may be justified on the need to harmonize responsibility and accountability. Similarly, the Authority approves all rules of the stock exchange including any variation or rescission. The CMA must be notified of any disciplinary action taken by the stock exchange against a member or listed company within seven days and the Authority is empowered to overrule the exchange. Additionally, the Authority has independent jurisdiction to take disciplinary action against listed companies as well as the stock exchange and its members. Undoubtedly, market intermediaries operate under the heavy oversight of the Authority. However, this is not unique in securities markets and is intended to promote accountability and protect investors. In sum, it is evident that the CMA has been grappling with the challenge of establishing an appropriate balance between regulation and market development. Such a balance is necessary for the development of a dynamic and stable environment in which all stakeholders benefit. Whereas it is conceded that substantial oversight over market intermediaries promotes accountability and enhances certainty and predictability, involving market intermediaries in governance may be necessary for strategic reasons such as taking advantage of the expertise and cumulative experience they possess.

How can the CMA be rendered more responsive to market needs?

There are various ways of making the CMA more efficacious in the discharging of its dual mandate.

First, it is necessary for the CMA to streamline its enforcement philosophy. It is currently too erratic and intermittent which creates uncertainty in the securities markets. The Authority should endeavour to develop an enforcement philosophy consistent with market needs. A clearly defined and implemented enforcement philosophy imbues certainty which promotes investor confidence. Whereas egregious conduct must be unhesitatingly punished for deterrence, the penalty should be procedurally fair.<sup>293</sup> It is submitted that the CMA should enlist the support of market intermediaries in its effort to nurture a culture of compliance. An amiable working relationship between the Authority and market intermediaries would enhance certainty.

Second, with the advent of financial independence, the CMA should reorganize its management structure by designating departmental managers and their deputies as directors and deputy directors in conformity with market trends. The designation of "manager" is no longer fashionable to incentivize accomplished professionals to apply for appointments.<sup>294</sup> The Authority has been attracting newly qualified and inexperienced professionals who leave after a short stint. Most importantly, the Authority has not established a reputation of professionalism, thoroughness and efficiency in discharging its mandate. It is submitted that with the appropriate designation, better remuneration packages and clearly defined career progression, the Authority will attract high caliber staff to strengthen its in-house capabilities.

Third, to promote investor awareness, the Act should be amended to include investor education as one of the principal regulatory objectives of the CMA. To actualize the mandate, the Authority should have a fully fledged and proactive investor education or marketing department.<sup>295</sup> Investor education plays a double role of enhancing investor protection and developing the securities markets.

Fourth, because of its extensive mandate and pervasive powers, it is important to hold the CMA accountable. It is indubitable that the enormous legislative, investigative and disciplinary powers of the Authority have political and economic implications in Kenya and beyond. Entrenchment of effective accountability mechanisms in the legal framework would enhance its performance. Current mechanisms are inadequate. For instance, the Act requires the Authority to submit annual reports on its operations and activities including audited accounts to the minister within six months after the close of the financial year. The minister is then required to table the report before National Assembly within three months. It will be recalled that the minister is also empowered to demand any return, account or other information from the Authority at any time. Since the executive appoints members of the Authority and supervises the financial services sector, reporting to it is ineffectual because members of the Authority owe allegiance to the appointing authority.

Additionally, executive reporting to parliament is largely a formality. Inherent and operational weaknesses of the legislature undermine its capacity to hold the CMA or any other state corporation accountable. Reports submitted to the legislature by the Treasury are seldom analyzed, vigorously debated or acted upon and if they do, political machinations inhibit decisive action.

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<sup>293</sup> Editorial, CMA must enforce the law in an even-handed manner, BUSINESS DAILY, Apr. 22, 1009 at 12.

<sup>294</sup> The current trend among state corporations (Commissions) is to designate its principal officers and their deputies as directors and deputy directors which are more attractive to professionals.

<sup>295</sup> See James Anyanzwa, Future of Retail Investors not Secure, THE STANDARD, Oct. 10, 2009 at 8; Jackson Okoth, CMA seeks new options to win retail investors, THE STANDARD, Oct. 13, 2010 at 14; James Anyanzwa, NSE to lure more investors to the bourse, THE STANDARD, Oct. 19, 2010 at 17.

It is submitted that state corporations should be made accountable to a constitutionally established commission of experts with *inter alia* power to recommend dismissal and prosecution of the chief executive, board of directors and managers. Another accountability mechanism relate to appeals. Persons aggrieved by decisions or directions of the Authority or the Investor Compensation Fund Board on the matters set forth in section 35 may appeal to the Capital Markets Tribunal and a further appeal lies in the High Court.<sup>296</sup> The principal weakness of this provision is that its breadth is too narrow in view of the multifarious decisions the Authority is empowered to make. The Tribunal and the High Court are yet to grapple with the question whether imposition of financial penalties is a “direction” of the Authority within the meaning of the Act. Due to their passivity, procedural requirements and conservatism, courts can only act as control mechanisms of the last resort.

One of the most draconian powers vested on the Capital Markets Authority without corresponding accountability mechanisms is the appointment of statutory managers for licensees. Provisions of the Capital Markets Act empower the CMA to appoint any competent person or persons as statutory managers for a licensed person.<sup>297</sup> The appointee is required “to assume the management, control and conduct of the affairs and business of the licensed person and discharge his duties with diligence in accordance with sound investment and financial principles...”<sup>298</sup> The appointment is initially for a period not exceeding six months but may be extended by the High Court on application by the Authority.<sup>299</sup>

Although the provisions do not prescribe the qualifications of the statutory manager or disqualify certain persons, the CMA has in vagrant disregard of the principles of natural justice appointed itself statutory manager or as was the case in Nyaga Stock brokers limited, as joint statutory manager with the NSE. Disconcertingly, both the CMA and the NSE had unsuccessfully attempted to salvage the firm by advancing it Kshs. 100 million (\$ 1,250,000) and were therefore interested parties. More objectionable is the fact that the CMA appear to have equated statutory management with liquidation or winding up. Its statutory managers have without exception closed the businesses of licensees without first ascertaining whether they are capable of being revived.<sup>300</sup> Consequently, none has been salvaged. In the case of Ngenye Kariuki Stock brokers Limited, the proprietor and the Kenya Association of Stock brokers and Investment Banks (KASIB) pleaded with the CMA to reverse the order for statutory management after creditors agreed to restructure the firm’s debts but the CMA adamantly refused leading to the closure of the firm’s business on February 5th, 2010.<sup>301</sup>

The current statutory management paradigm has impacted negatively on market confidence and should be restructured. There is no reason why statutory managers should not carry on the business of the licensed person as the law ordains and ascertain the question of indebtedness simultaneously. It is a trite principle of law that statutory management is not liquidation. The latter can only be decreed by the High Court on a petition by the statutory manager. To ensure independence, professionalism and objectivity, the Act should be amended to prescribe the qualifications and disqualifications of statutory managers. More importantly, the CMA and stock exchanges should be disqualified from appointment. In a nutshell, the statutory manager should be required to carry on the business of the licensee until it is ascertained that the business is incapable of being salvaged. Such innocuous statutory requirements would render the CMA more accountable to investors and the securities markets generally.

Similarly, the Act requires all regulations made by the Authority to be exposed to stakeholders and the public for comment for a period of thirty days. The objective is to involve stakeholders and the public in the legislative process. The reality is however different. The regulations are displayed on the Authority’s webpage which is inaccessible to the majority.

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<sup>296</sup> These matters include: refusal to grant a license, imposition of limitations or restrictions on a license, suspension or revocation of license, refusal to admit a security to the official list of a stock exchange, suspension of a security on a securities exchange or requiring the removal of a security from the official list of a securities exchange.

<sup>297</sup> § 33A (2).

<sup>298</sup> *Id.*

<sup>299</sup> See Benson Wambugu, Court extends broker’s Statutory Manager Term, BUSINESS DAILY, May 14, 2010 at 10. (On the extension of the term of the statutory manager for Discount Securities Limited to facilitate the transfer of securities accounts of investors to another stock broker (Kingdom Securities Limited).

<sup>300</sup> See James Anyanzwa, Ngenye Kariuki Investors in the dark as CMA awaits broker’s revival, THE STANDARD, Sept. 6, 2010 at 20.

<sup>301</sup> See James Anyanzwa, CMA Takes over Another troubled Stock broker, THE STANDARD, Feb. 6, 2010 at 8; Washington Gikunju, CMA finally moves on Stock broker, BUSINESS DAILY, Feb 8, 2010 at 14; James Bonyo, Broker Ngenye Kariuki Falls, DAILY NATION, Feb 8, 2010 at 4; Washington Gikunju, Broker Petitions CMA to lift Order after debt reprieve, BUSINESS DAILY, Feb 11, 2010 at 11; James Anyanzwa, Ngenye Crisis stirs wars of words at NSE, THE STANDARD, Feb 16, 2010 at 16; James Anyanzwa, CMA take over draws fire from brokers and Investment banks, THE STANDARD, Feb 12 2010 at 7; Jane Njeru, Why Brokers face challenges, BUSINESS DAILY, Feb 15, 2010 at 16.

Moreover, one month is relatively short and should be extended. The fundamental challenge posited by the legislative power of the CMA is that it is a *carte blanche*. Section 12 prescribes no limitations subject to which the power is exercisable rendering it susceptible to abuse. Furthermore, the Authority is not required to engage stakeholders including the Nairobi Stock Exchange on matters germane to securities markets or have regard to the markets or investors when exercising its powers. The law should require the CMA to invite comments on draft regulations and guidelines from market intermediaries and the public. Second, the Authority should be required to publicize the nature of the comments received and how it reconciled any conflicts in arriving at the regulations or guidelines it is proposing. Third, the Act should expressly prescribe the overriding principles which the Authority must take into consideration when exercising its powers.

Finally, because of the centrality of the Authority in the enhancement of securities markets, it is submitted the Capital Markets Authority should be accorded sufficient independence to facilitate the effective execution of its mandate. It is desirable to shield the Authority from political interference by the executive arm of government.<sup>302</sup> The chief executive officer should be accorded security of tenure of office analogous to the Governor of the Central Bank of Kenya.<sup>303</sup> As suggested elsewhere, the number of members of the Authority should be reduced to a sustainable number. Similarly, the Authority should be accountable to a single institution, preferably, a Constitutional Commission. Financial and functional independence will imbue professionalism and accountability.

#### Central Bank of Kenya

The Bank is created by the Central Bank of Kenya Act.<sup>304</sup>

The principal functions of the Central Bank of Kenya are: to formulate and implement monetary policies aimed at achieving and maintaining stability in price levels, foster the liquidity, solvency and proper functioning of a stable market based financial system and to support economic policies of the government for growth and employment.<sup>305</sup> It is also the function of the bank to formulate and implement policies to promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems. It is important to note that Kenya does not have an electronic payment system. Operations of the Central Bank of Kenya impact on the securities markets in various ways and could contribute to the growth and deepening of the markets.<sup>306</sup>

First, in order to maintain a sound monetary policy in the country, the Central Bank influences the money supply and concomitantly the interest rates which have a direct effect on the markets.<sup>307</sup> By selling treasury bonds, the Central Bank reduces money supply and interest rates rise. By redeeming the instruments, it increases the money supply and interest rates fall, which induces activity in the securities markets. The Central Bank endeavors to maintain the optimal interest rate for overall growth of the economy.<sup>308</sup>

Second, since the Central Bank is the financial agent of the government, it issues treasury bonds in the primary market either to finance budget deficit or development. The bonds are subsequently traded in the secondary market. The fact of borrowing makes the Central Bank a major participant in the securities markets.<sup>309</sup> Its effect on the bond market is more profound because it is the main borrower.<sup>310</sup> Treasury and infrastructural bonds<sup>311</sup> issued by the Central Bank in the recent past have been oversubscribed heralding a new era for the bonds market.<sup>312</sup> Reduction of the minimum threshold has encouraged retail investors to claim a share of a market previously monopolized by banks.<sup>313</sup>

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<sup>302</sup> See Jaiindi Kiseru, Let's free the Capital Markets Authority so it can do its job, DAILY NATION, Mar. 19, 2008 at 10; James Anyanzwa, Uhuru's Promise: I will dissolve CMA Board, THE STANDARD, Feb. 21, 2009 at 7; Jackson Okoth, Thumbs up to Cheserem's Appointment, but what next for Capital Markets Reform? THE STANDARD, Feb. 24, 2009 at 13.

<sup>303</sup> See James Anyanzwa, Cheserem must give CMA strength, THE STANDARD, May 4, 2009 at 14.

<sup>304</sup> Cap. 491, Laws of Kenya.

<sup>305</sup> § 4

<sup>306</sup> S Geoffrey Irungu, Central Bank seeks bigger role in Capital Markets, DAILY NATION, Dec. 8, 2008 at 6.

<sup>307</sup> §§4B, 4C & 4D

<sup>308</sup> See Geoffrey Irungu, Low Cost Bond Floated in bid to cut Interest rate, BUSINESS DAILY, Mar. 22, 2010, at 13; T-Bills lose appeal as interest rate falls, THE STANDARD, May 5, 2009 at 13.

<sup>309</sup> See Washington Gikunju, High Interest Paid on Treasury bonds under Spotlight, BUSINESS DAILY, Dec. 7, 2009 at 9.

<sup>310</sup> The Central Bank has issued 86 bonds compared to 11 corporate bonds.

<sup>311</sup> See Joseph Bonyo, Government Infrastructure bond a success, DAILY NATION, Feb. 20, 2009 at 15, See also, Odhiambo Ochola, What is an Infrastructure Bond: Is time ripe for Companies to tap into bond market? THE STANDARD, Mar.4, 2009 at 14.

<sup>312</sup> See Central Bank of Kenya available at <http://www.centralbank.go.ke/securities.bonds/manual/result.aspx> (visited on My19, 2010) explaining that in May 2010, the Central Bank of Kenya offered a five year Treasury Bond for a total amount of up to Kshs. 12 billion (\$ 1.5 billion) which was oversubscribed by 156%.

<sup>313</sup> See <http://www.centralbank.go.ke/securities/bond/Introduction.aspx> (visited on May 13, 2010).

It is envisaged that when securitization is finally institutionalized, the bond markets will become more vibrant. Third, the Central Bank is responsible for the clearing and settlement for bonds traded in the secondary market. Before 2009, traders in treasury bonds could only open accounts with the Central Bank. The bank is now linked with the central depository system of the NSE and any person with a securities account can now trade in bonds through commercial banks, stockbrokers or investment banks.<sup>314</sup> Improved market infrastructure has facilitated trading in government and corporate bonds<sup>315</sup> and opened the market to a wider clientele.

Finally, the Central Bank develops the risk free yield curve and thus facilitates the pricing of corporate bonds. The yield curve is the relationship between interest rates and the date of maturity of the instrument.<sup>316</sup> While to the issuer it is the cost of borrowing, it represents the measure of return on investment for the investor. The yield curve of government bonds is the benchmark for pricing corporate bonds. The curve is therefore an important ingredient for the development of the corporate bond market. Unfortunately, there is no well developed yield curve. This is because the government has not issued benchmark bonds. Currently, the yield curve is based on the 91, 182 and 364 days government Treasury bill rate.<sup>317</sup> It is incumbent upon the Central Bank of Kenya to develop a competitive benchmark yield curve to foster the development of the corporate bond market which remains miniscule.<sup>318</sup>

The absence of primary dealers in government securities has been a major challenge for the secondary market. With no principal dealer system, the Central Bank issues bonds directly to investors. To promote the secondary debt market, stockbrokers and investment banks have been competing for the few knowledgeable dealers.<sup>319</sup> The need for expertise in this area cannot be overemphasized. Relatedly, the absence of primary dealers in government securities has restricted the vibrancy of the secondary market. The licensing of this category of market intermediaries is behindhand. Finally, the country needs an electronic national payment system.<sup>320</sup>

#### Ministry of Finance (Treasury)<sup>321</sup>

This is the government ministry which supervises the financial services sector. Its responsibility is to formulate financial and economic policies, develop and maintain sound fiscal and monetary policies that facilitate economic development.<sup>322</sup> It is responsible for overseeing the growth and development of modern and vibrant banking, insurance, pension and securities markets. Being the policy formulating institution, its decisions impact on the securities markets and could enhance or impede their growth. Although the ministry spearheaded the enactment of the Capital Markets Authority Act in 1989, which heralded a new dawn for the regulation of securities markets, it has eschewed formulating an elaborate policy on the markets. Furthermore, the ministry has over the years paid asymmetric attention to the banking sector at the expense of securities markets which are still nascent.<sup>323</sup>

Arguably, since legislative Bills are tabled before the National Assembly by the minister, the executive's regulatory approach can greatly inform the law. Political interference with the securities markets by the executive has attenuated the Authority's ability to discharge its mandate professionally and independently.

#### Registrar of Companies

The office of Registrar of Companies is established by the provisions of the Companies Act as a repository for all public documents of companies in Kenya.<sup>324</sup>

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<sup>314</sup> See James Anyanzwa, Central Bank of Kenya to Exploit Bourse Facility to Trade its Bonds, *THE STANDARD* Oct. 6, 2009 at 8; Geoffrey Irungu, Treasury Bonds enter automated trading era, *BUSINESS DAILY*, Nov. 30, 2009, at 4. See also, <http://www.centralbank.go.ke/securities/cdsaccounts.aspx> (visited on May 12, 2010).

<sup>315</sup> See Geoffrey Irungu, Electronic System spurs trade in Bond Market, *BUSINESS DAILY*, Dec. 10, 2009 at 12; Washington Gikunju, Retail Investors get Better access to bonds market, *BUSINESS DAILY*, Dec. 8, 2009 at 11.

<sup>316</sup> See Central Bank of Kenya available at [http://www.centralbank.go.ke/securities/Yield curve.aspx](http://www.centralbank.go.ke/securities/Yield%20curve.aspx) (visited on May 14, 2010).

<sup>317</sup> *Id.*

<sup>318</sup> See Jackson Okoth, Launch of Safaricom Bond turns Spotlight on CMA, *THE STANDARD*, Oct. 8, 2009 at 10; Morris Aron, Safaricom Bond Debuts at the Bourse, *THE STANDARD*, Dec. 10, 2009 at 12.

<sup>319</sup> The competition is so intense that in early 2010, Standard Investment bank successfully enticed the entire bonds department of Faida Securities Ltd. See James Anyanzwa, Battle for the Bonds Market, *THE STANDARD*, Mar. 9, 2010, at 14.

<sup>320</sup> See Okuttah Mark, Lack of On-line pay System hampers eTrade, *BUSINESS DAILY*, Apr. 8, 2010 at 16.

<sup>321</sup> This is one of the Ministries established by the President in accordance with § 16(1) of the Constitution which provides that: "There shall be such offices of ministers of the Government of Kenya as may be established by Parliament or, subject to any provision made by Parliament, by the President"

<sup>322</sup> See Ministry of Finance available at <http://www.treasury.go.ke> (visited on May 2, 2010).

<sup>323</sup> See National Development Plan, Government printers, Nairobi, 1989-93 at 11.

<sup>324</sup> § 382

The overall responsibility of the office is to administer and enforce the provisions of the Companies Act. It registers new companies,<sup>325</sup> resolutions,<sup>326</sup> alterations of the memorandum<sup>327</sup> and articles of association,<sup>328</sup> charges,<sup>329</sup> prospectuses,<sup>330</sup> change in company directorship,<sup>331</sup> reduction of capital<sup>332</sup> and annual returns.<sup>333</sup> The office must be notified of the physical and postal address of the company,<sup>334</sup> any alteration of share capital<sup>335</sup> or change of name,<sup>336</sup> allotment of shares<sup>337</sup> and dissolution.<sup>338</sup> In addition the office is empowered to strike defunct companies off the register of companies,<sup>339</sup> appoint an auditor if the annual general meeting of the company defaults and none is deemed to have been reappointed,<sup>340</sup> call or direct the convention of an annual general meeting in the event of failure by the company,<sup>341</sup> investigate the affairs of a company<sup>342</sup> or appoint a competent inspector to do so,<sup>343</sup> act as official receiver in a compulsory winding up<sup>344</sup> and authorize the company to lay its annual accounts before a general meeting held outside the stipulated time.<sup>345</sup> Evidently, the office of Registrar of Companies has extensive powers over the affairs of companies in Kenya. These powers overlap with the provisions of the Capital Markets Act and its Regulations particularly on disclosure. There is need to harmonize these statutes to eradicate duplication and minimize compliance costs. A more radical approach would be to transfer the office of the Registrar of Companies to the Capital Markets Authority to centralize the administration of company affairs.<sup>346</sup> This could bolster efficiency and promote professionalism.

Other statutory bodies whose mandate impact on the securities markets are the Insurance Regulatory Authority which regulates the conduct of insurance business, Retirement Benefits Authority which regulates retirement benefit schemes and the Sacco Societies Regulatory Authority which regulate savings and credit cooperative societies. Surprisingly, of the forty three insurance companies doing business in the Kenyan market, only two are listed. Out of a similar number of banks, nine are listed. Since insurance companies and fund managers are the principal institutional investors in the securities markets in Kenya, regulation of the insurance and retirement benefits sectors is critical to the growth and development of the markets. In March 2009, the Central Bank of Kenya, Insurance Regulatory Authority, Retirement Benefits Authority and the Capital Markets Authority entered into a memorandum of understanding to cooperate and share information. Although the memorandum is not binding, it underscores not only the interconnectedness of the sectors but also the need for these regulatory agencies to work harmoniously to galvanize the financial services sector to the next level. It is also an indication of the shifting regulatory paradigm in the financial services sector.

#### Nairobi Stock Exchange

The NSE was initially registered as a voluntary association of stockbrokers governed by Rules of the London Stock exchange. Its legal status changed in 1991 when it was incorporated as a private limited company in accordance with the provisions of the Companies Act.<sup>347</sup> A further modification was effected in April 1995 when the stock exchange re-registered as a company limited by guarantee in compliance with the 1994 amendments to the Capital Markets Authority Act. The amendment also re-constituted the composition of its board of director.<sup>348</sup>

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<sup>325</sup> § 16 (1)

<sup>326</sup> § 143

<sup>327</sup> § 8

<sup>328</sup> § 13

<sup>329</sup> § 96

<sup>330</sup> § 43

<sup>331</sup> § 201 (4)

<sup>332</sup> § 71

<sup>333</sup> § 124 & 125

<sup>334</sup> § 108

<sup>335</sup> § 64 & 65

<sup>336</sup> § 20 (3)

<sup>337</sup> § 54

<sup>338</sup> § 269 (2)

<sup>339</sup> § 339

<sup>340</sup> § 159 (3)

<sup>341</sup> § 131 (2)

<sup>342</sup> § 164

<sup>343</sup> § 173 & 174

<sup>344</sup> § 236 (e)

<sup>345</sup> Proviso to § 148

<sup>346</sup> See, Yutaka Shimomoto, *The Capital Markets in Malaysia*, available at <http://www.abd.org/Documents/Books/Raising to the challenge/Malaysia/malaysp.pdf> (visited on May 7, 2010).

<sup>347</sup> File No. 64609, Company Registry, Nairobi.

<sup>348</sup> § 20 (3)

Before the amendment, the constitution of the NSE was in conformity with the provisions of the Companies Act except that the board of directors had to consist of stockbrokers, dealers, representatives of listed companies and investors as were acceptable to the Capital Markets Authority.<sup>349</sup> The governance institutions of the Nairobi Stock Exchange are its members in general meeting<sup>350</sup> and the board of directors. The articles of association of the exchange provide that subscribers to the memorandum and other persons admitted to membership by directors are members of the stock exchange.<sup>351</sup> The board of directors consists of five persons elected from amongst the stockbrokers and dealers who are members of the stock exchange, two persons elected by members of the exchange to represent listed companies, three persons who are knowledgeable and experienced in investments, appointed by the exchange to represent individual investors, institutional investors and the general public and the chief executive of the stock exchange.<sup>352</sup> Directors of the stock exchange other than the chief executive elect a chairman from among themselves.<sup>353</sup> The board of directors is mandated to oversee the administration and operations of the stock exchange.

As the only registered securities exchange in Kenya, the NSE derives its legitimacy from the Capital Markets Act which recognizes securities exchanges and their rules.<sup>354</sup> As contemplated by the IFC/CBK report, the NSE performs a public function by providing orderly and fair secondary markets for securities. Its operations are governed by the Listing and Membership Rules approved by the CMA. The objects and responsibilities of NSE are set forth by its constitutive documents and include: regulating and controlling the secondary market, protecting the interests of members of the Exchange, recording transactions, promoting securities markets through education, prescribing rules to protect investors from misleading information, deceit and other adverse practices,<sup>355</sup> providing advise on financial services, carrying on the business of an investment company, co-operating with other stock exchanges, prescribing membership rules and listing requirements, instituting policies on market surveillance and disclosure and enforcing all rules and regulations of the Exchange.<sup>356</sup> Additionally, the NSE is the only vehicle through which securities markets instruments can be traded. It enables retail and institutional investors to acquire proprietary interests in listed companies. Similarly, it facilitates acquisition of funds by issuers of equities and bonds. The extensive mandate of NSE presupposes that it is a self regulatory organization.<sup>357</sup>

Notwithstanding the fact that the NSE approves listings and is empowered to impose sanctions on its members and listed companies, it operates under heavy oversight of the CMA.<sup>358</sup> The CMA is empowered to reverse any disciplinary action taken by the NSE and may impose sanctions on members of the exchange and listed companies without reference to the NSE. Relatedly, the NSE is required to submit its annual budget to the Authority for approval not later than thirty days before the commencement of its financial year.<sup>359</sup> As highlighted above, the enveloping powers of the CMA render the NSE toothless in the discharge of its functions. There are notable instances in which NSE's decisions have been ignored by the CMA.<sup>360</sup> Increased CMA oversight over the securities markets has been necessitated by the latent failure of market intermediaries to stem the tide of professional decadence, decay and lack of standards.

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<sup>349</sup> See, paragraph 3 (5) 9(c) Capital Markets Authority Regulations, Legal Notice No.428 Of 1992.

<sup>350</sup> Articles 2, 5 & 7, membership is either full or associate. All stockbrokers and investment banks licensed by the Capital Markets Authority are full members while authorized securities dealers and other financial institutions approved by the Authority are associate members and have no voting rights for purposes of decision making.

<sup>351</sup> Article 3

<sup>352</sup> Article 32

<sup>353</sup> Article 34

<sup>354</sup> § 19

<sup>355</sup> Paragraph 4

<sup>356</sup> See Regulation 4

<sup>357</sup> See Regulation 9

<sup>358</sup> But See Isabella Mukumu & Emmanuel Were, NSE Petitioned following move to penalize Sasini Co. Ltd. BUSINESS DAILY, Feb. 12, 2008 at 20.

<sup>359</sup> Regulation 8 (2), Regulation 12 imposes upon the NSE daily reporting requirements of happenings on the market for example, delays in opening or closing, unusual activities or on request.

<sup>360</sup> In September 1993, Barclays Bank Ltd announced that it was negotiating with CFC Bank Ltd to purchase its 51% stake in NIC Bank Ltd. The NSE recommended to the CMA that NICs share be suspended from trading pending the acquisition, but CMA refused on the ground that it would be interpreted negatively by the market and ordered trading in the company's shares to continue. Suspension may have been necessary because of the uncertainty created by the negotiations. See Alex Chege, NIC Public Issue to Liven up Activity on the Market, DAILY NATION, Aug. 2, 1994 at 11. However, the CMA's refusal to allow Trade Bank Co. Ltd list its securities on the NSE was indicated. In April 1993, Trade Bank Ltd submitted prospectuses to both NSE and the CMA for approval. The NSE approved the listing but CMA declined citing non disclosure with disclosure regulations. On numerous occasions stockbrokers and the NSE urged CMA to approve the listing but the Authority was adamant. Six weeks later, the Trade Bank Co. Ltd was closed down by the Central Bank of Kenya allegedly for fraud and money laundering. Its proprietors fled the country to escape prosecution. See Francis Makokha, Players at Stock Exchange Lack Technical Ability, DAILY NATION, July 13, 1993 at 4.



It is arguably a function of failure of self regulation. Regarding enforcement of Membership and Listing Rules, the NSE has not established a reputation of aggressiveness which is not anomalous of stock exchanges. This is primarily because it has remained a closely-knit association of business associates and a conscientious enforcement policy would not augur well with their business interests. Historically, the stock exchange has operated as a nontranslucent organization comprising a few stockbrokers who only sought public attention when urging new listings<sup>361</sup> or defending their domain.<sup>362</sup> Notwithstanding the paucity of information, records show that the NSE acted as a self regulatory organization from 1954 to 1990. While other dynamics may have played a significant role, more companies listed on the Exchange than has been the case since the CMA was established. Experience elsewhere shows that self regulatory organizations seldom enforce rules against listed companies overzealously as it would impact negatively on their business.<sup>363</sup> Overall, the NSE remains the most conspicuous and influential reputational intermediary in Kenya's securities markets. Closely intertwined with the NSE is the Central Depository and Settlement Corporation which is the only authorized central depository in Kenya and is thus the custodian of all securities accounts and immobilized securities. It is a licensee of the CMA.

#### Collective Investment Schemes

These are mutual or managed funds pooled from different investors for collective investment. They act as a vehicle for consolidating individual investments in order to obtain professional management of the pooled resources. Investors are thus able to participate in a wide range of investments not feasible to most individual investors, which results in the sharing of costs and benefits.<sup>364</sup> The company pooling the funds determines how they are invested. Consequently, it is essential that a robust governance framework be instituted to protect the pooled resources from negligence or expropriation by the persons involved.<sup>365</sup> The legal framework must provide for adequate disclosure on risks and returns, accounting, auditing and valuation. A collective investment scheme may adopt a contractual or corporate model of operation<sup>366</sup> and may be a unit trust.<sup>367</sup>

The Capital Markets (Collective Investment Schemes) Regulations, 2001, make provision for the registration and operation of collective investment schemes in Kenya. A collective investment must be registered by the CMA,<sup>368</sup> have a registered fund manager,<sup>369</sup> a trustee and a board of directors.<sup>370</sup> To offer its shares for sale to the public, a collective investment scheme must issue an information memorandum approved by the Authority.<sup>371</sup> By 2008, the Capital Markets Authority had registered ten schemes. Collective investment schemes are becoming an important investment vehicle for retail investors and will play an important role in the institutionalization of the securities markets.<sup>372</sup> In June 2010 for instance, a *shariah* compliant Unit Trust was registered and licensed by the CMA to enable the Muslim community in East Africa invest in the equities market.<sup>373</sup> One of the major challenges facing these schemes is that the regulations are not in consonance with the Trustees Act in relation to formation and operations. It is suggested that the regulations be harmonized with the other laws to obviate conflicts in the formation, management and supervision of the schemes.

#### Credit Rating Agencies

These institutions rate the creditworthiness and ability of issuers of corporate debt to meet their contractual obligations at the time of issuer and in future.

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<sup>361</sup> Kauli Mwembe, Parastatals ought to go Public, KENYA TIMES, Jan. 20, 1984 at 18.

<sup>362</sup> See Samuel Nduati, Nairobi Stock Exchange tells Government off over Firms, DAILY NATION, May 21, 1993 at 11.

<sup>363</sup> See generally Onnig H. Dombalagian, Self-Regulation: Resolving the SRO Identity Crises, BROOK. J. CORP. FIN. & COM. L. 317 (2007).

<sup>364</sup> See [http://www.wisegeek.com/wriacollective\\_investment\\_scheme.html](http://www.wisegeek.com/wriacollective_investment_scheme.html) (visited on May 12, 2010).

<sup>365</sup> See generally Examination of Governance for Collective Investment Schemes, OICU-IOSCO available at [http://www.sec.gov/about/offices/ia/investment/investment\\_scheme.pdf](http://www.sec.gov/about/offices/ia/investment/investment_scheme.pdf) (visited on May 13, 2010).

<sup>366</sup> Id. See also Pamela Hanrahan, Collective Investment Schemes: A new Regulatory Approach for Australian Managed Investment Schemes; Part 1 & 11, 22(8) COMP. L. 249 (2001).

<sup>367</sup> The Regulations provide that an Employee share Ownership scheme must be a unit trust i.e. a tripartite agreement between the fund manager, the trustee and unit-holders.

<sup>368</sup> Regulation 3(1)

<sup>369</sup> Regulation 15

<sup>370</sup> Regulation 19(1)

<sup>371</sup> Regulation 12

<sup>372</sup> See Geoffrey Irungu, Zimele Unit Trust collects Kshs. 200 million in its first month, BUSINESS DAILY, Apr. 19, 2007 at 16; Johnstone Ole Turana, Unit trust proposed to curb Speculative Trade, BUSINESS DAILY Nov. 27, 2009 at 11 quoting industry sources explaining how these schemes could play a critical role in reducing the large number of retail speculators currently dominating the market. See also, Felix Otieno, Future of Retail Investors not Secure, THE STANDARD, Nov. 10, 2009 at 16; Tom Mogusu, CFC's new man plans Unit Trust Revolution, THE STANDARD, May 1, 2007 at 3.

<sup>373</sup> Geoffrey Irungu, Shariah guided Unit Trust set to enter East Africa, BUSINESS DAILY, June 8, 2010 at 10.

The assessment is based on attendant risk particularly the capacity of the issuer to generate cash in future. Rating thus determines the worth of the security. The purpose of credit rating is to provide a highly independent, qualitative and quantitative review on the risk profile assessment of issuers of financial instruments.<sup>374</sup> Credit rating agencies offer an alternative means of reducing asymmetry between borrowers and creditors. By creating awareness on the underlying risks of an issuer of debt instruments, credit rating enhances investor confidence in the securities markets. Credit rating agencies thus play a critical role in the health and stability of the securities markets. By facilitating, and fostering the development of vibrant corporate debt securities markets and securitization, credit rating deepens the markets. To enhance integrity of credit rating, the Capital Markets Guidelines on the Approval and Registration of Credit Rating Agencies require applicants to demonstrate objectivity and independence.

First, an applicant must not be associated with persons with conflicting interests in credit rating business. Second, a credit rating agency must be a body corporate with a preponderance of “reputable international shareholding.” Third, the board of directors, managers and professional staff must be persons of “impeccable character.” Finally, the rating agency must be partially owned by an internationally recognized rating agency or have a contractual arrangement with an agency that provides technical and strategic support drawn from international experience. Arguably, these requirements are too general and nebulous to guarantee independence and integrity of credit rating in Kenya. For instance, they do not address the inherent challenge of conflict of interest, “shopping” for rating, rating models, transparency and liability of rating agencies.<sup>375</sup> The Capital Markets Authority has approved and registered one credit rating agency to carry on business in Kenya.<sup>376</sup> Although the debt securities market is still miniscule and the secondary mortgage market is nonexistent, institutionalization of credit rating portends well for the securities markets.

### **Conclusion**

The preceding analysis shows that Kenya’s legal and institutional framework on securities markets is for the most part statutory. However, both the common law and doctrines of equity play a significant role particularly with regard to investor remedies. What emerges is that there has never been a systematically conceived and comprehensive approach on securities markets or financial services generally. The fact that a large number of statutes make desultory reference to securities markets in an uncoordinated fashion while others do not remotely recognize the markets as an important avenue for investment is perplexing. The legal framework is characterized by gaps, overlaps, duplication, inconsistencies and most importantly, restrictions on investment. For example, insurance companies have been urging the Minister of Finance to facilitate the amendment of section 50 of the Insurance Act to enhance flexibility in investment.<sup>377</sup> Although it would be unwise to accord insurers unfettered discretion in the investment of policy holders money, some flexibility is essential for business.

First, the Capital Markets Act has several weaknesses which can be remedied by simple amendments. For instance, reduction of number of members of the Authority, establishment of a department to administer the Investor Compensation Fund, provisions on accountability and conflict of interest.

Second, there is too much unnecessary duplication which increases compliance costs. For instance, copies of prospectuses must be delivered to the Capital Markets Authority, Nairobi Stock Exchange and the Registrar of Companies. Similarly, Fund managers are regulated by the CMA and the Retirement Benefits Authority. Listed banks and insurance companies are regulated by the CMA as well as the Central Bank of Kenya and the Insurance Regulatory Authority respectively. To promote efficiency and growth, there is need to harmonize the statutory framework on financial services under a coherent and systematic policy.

Third, it is incontrovertible that Kenya’s corporate law has not played an instrumental role in the promotion of securities markets. It is antiquated in various respects and should be replaced with a more dynamic framework. It is particularly inadequate in relation to investor protection, minority rights and corporate governance. There is need to align Kenya’s corporate law with the securities markets.

Finally, it is undeniable that facilitating access to the primary and secondary markets by issuers and investors is critical to the success of securities markets.

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<sup>374</sup> See Guidelines on the Approval and Registration of Credit Rating Agencies

<sup>375</sup> See generally Yair Listokin & Benjamin Taibleson, If you misrate, then you lose: Improving Credit Rating Accuracy through incentive Compensation, 25 YALE J. REG.91 (2010); Lynn Bai, On Regulating Conflicts of Interest in the Credit Rating Industry, 13 N.Y.U. J. LEGIS & POL’Y 253 (2010).

<sup>376</sup> Capital Markets annual Report 68 (2007).

<sup>377</sup> The latest appeal was made in May 2010. See John Oyuke, Insurance Firms reveal their budget day wish list, THE STANDARD, June 1, 2010 at 9.

However, one of the major impediments to growth of securities markets in Kenya is the stringent eligibility requirements for listing on the Main and Alternative investment market segments of the NSE. The high thresholds prescribed by the regulations render startup companies, small and medium enterprises ineligible.<sup>378</sup> These companies cannot therefore take advantage of the markets to raise capital which they urgently need for growth. The current framework serves the interests of the large and well established companies.<sup>379</sup> To encourage more listings, the eligibility criteria should be reevaluated to make it accommodate a wider spectrum of capital seeking companies. Alternatively, a new market segment should be created for the small and medium enterprises which undoubtedly have become the hallmark and bulwark of business in East Africa.<sup>380</sup>

On the institutional platform, the multiplicity of regulators in the securities markets and the financial services generally has not engendered the securities markets. The uncoordinated segments of the financial services sector on which the markets depend have undermined their growth. The principal drawback is the lack of coordination and information sharing between the various administrative agencies. Consequently, there is need to harmonize the operations of these agencies to ensure that the various sectors not only complement but reinforce each other. Although the memorandum of understanding between the Central Bank of Kenya, Capital Markets Authority, Insurance Regulatory Authority and the Retirement Benefits Authority is undoubtedly positive, the need for an enduring structure cannot be overdramatized.<sup>381</sup> The law should impose obligations on these bodies to share information and cooperate in the discharge of their respective mandates. With regard to securities markets, there is need to harmonize the relationship between the Treasury, Capital Markets Authority and the Registrar of Companies. It is cost ineffective for publicly held companies to file annual returns, and other notices including copies of resolutions with multiple governmental agencies.

As noted elsewhere, to ensure that the Capital Markets Authority discharges of its statutory mandate more effectively and efficiently, it should be granted more autonomy. Executive's interference with its operations should be eradicated. Autonomy may be bolstered by instituting the measures outlined above. This will reduce the magnitude and frequency of executive intermeddling with the affairs of the Authority.<sup>382</sup> Enhanced powers and autonomy for the Authority should be countervailed by more accountability to the markets, investors and the public. This can be accomplished by an assemblage of accountability mechanisms as suggested above. The Capital Markets Act should prescribe the overriding principles subject to which the Authority should exercise its legislative disciplinary and other powers. Additionally, section 35 of the Act should be amended to enhance its breadth. This will ensure that a panorama of directions of the CMA is amenable to appeal. Although involving market intermediaries in certain aspects of securities markets governance is positive, the CMA should retain primacy for purposes of responsibility and accountability.

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<sup>378</sup> Justus Ondari, Coming up: Junior Stock market for Small firms, DAILY NATION, June 28, 2010 at 16; Hse-Yu Chiu, Can U.K. Small Businesses obtain Growth Capital in the Public Equity Markets? An overview of the shortcomings in the U.K. and European Securities Regulation and considerations for Reform, 28 DEL J. CORP L. 933 92003) (Arguing that U.K. listing requirements are too onerous for small businesses in need of external equity financing and proposes the adoption of a tiered disclosure regime); Moses Michira, Relatives Finance most SMEs at the start-up stages, BUSINESS DAILY, Oct. 8, 2010 at 7; Emmanuel Were, Start-ups face challenges in paying off loan obligation, BUSINESS DAILY, May 10, 2011 at 30.

<sup>379</sup> See John Gachiri, Bourse plans to Lower Barriers and Attract Small and Medium Enterprises (SMEs), BUSINESS DAILY, Apr. 7, 2010 at 10; Johnstone Ole Turana, CFC Stanbic Seeks Regulator Reprieve to list on Bourse, BUSINESS DAILY, Sept.1, 2010 at 21; Gitahi Njeri, CIC Insurance mulls over NSE listing, THE FINANCIAL POST, Sept. 5, 2010 at 3; Steve Mbogo, NSE Plans to open gates for small Businesses to go public, BUSINESS DAILY, Oct. 3, 2007 at 1; Moses Michira, Relatives finance most SMEs at the start-up stages, BUSINESS DAILY, Oct. 8, 2010 at 10;

<sup>380</sup> See generally Jevan Nyabiage, Small firms play big role in growth, DAILY NATION, June 2, 2010 at 12; Nicholas Waitathu, Buoyed by strong assets growth, Family bank sharpens focus on SMEs, THE FINANCIAL POST, Sept. 5, 2010 at 5; Victor Juma, Small Businesses bag goodies from banks on growing Loan books, BUSINESS DAILY, June 28, 2010 at 19; George Omondi, Small firms shy away from private equity lenders, BUSINESS DAILY, May 4. 2010 at 11; Dinfin Mulupi, Credit Rating to boost SME Banking-Bank of Africa CEO, FINANCIAL POST, Aug 30,2010 at 2;Johnstone Ole Turana, Bank tightens race for promising medium-sized firms, BUSINESS DAILY, July 6, 2010 at 19; VICTOR Juma, Kenyan SMEs tap across border trade for growth, BUSINESS DAILY, Oct. 8, 2010 at 15; Victor Juma, Bourse boosts top 100 SMEs contest, BUSINESS DAILY, Oct. 6, 2010 at 17; Moses Michira, Private financiers see potential in SMEs, BUSINESS DAILY, Oct. 21, 2010 at 22; Luke Mulunda, Kenya's Budget for Business, DAILY NATION, June 11, 2010 at 30; Moses Michira, PTA Bank raises Kshs. 24 billion (\$300,000,000) for Lending to small firms, BUSINESS DAILY, Nov. 10, 2010 at 18; Moses Michira, Private Financiers see potential in SMEs, BUSINESS DAILY, Oct. 21, 2010 at 9; David Mugwe, Kenya Revenue Authority (KRA) sets up office for medium sized enterprises, BUSINESS DAILY, Nov. 23, 2010 at 8; Abdulrazaq Adan Ali, SME Sector Vital to Kenya's Development, DAILY NATION, Nov. 22, 2010 at 10; Geoffrey Irungu, Mid-sized banks drive Growth of Lending to SMEs, BUSINESS DAILY, Dec. 1, 2010 at 8; Winfred Kagwe, SMEs to list at NSE under new segment, BUSINESS DAILY, Oct. 6, 2010 at 9.

<sup>381</sup> See Geoffrey Irungu, Plans to form financial crisis task force underway, BUSINESS DAILY, Mar. 24, 2009 at 26. Memorandums of Understanding (MOUs) are typically associated with the management under which they were negotiated and future managers who do not share a similar philosophy may be less inclined to observe them enthusiastically.

<sup>382</sup> See James Anyanzwa, Uhuru's Promise: I will dissolve CMA Board, THE STANDARD, Feb. 21, 2009 at 16.

For greater strength, credibility and independence, the board of directors of the Nairobi Stock Exchange should be reconstituted to include independent nominees of professional association such as, Kenya Medical Association, Law society of Kenya, Certified Public Secretaries of Kenya, Institute of Surveyors or Engineers or the Institute of Certified Public Accountants of Kenya.<sup>383</sup> Such a radical departure would reduce the influence of market intermediaries and imbue professionalism. Although the CMA has initiated the process to demutualize the NSE, and the necessary legislation has been drafted, the process is unlikely to come to fruition in the short term. One of the most challenging aspects of the institutional infrastructure of the securities markets is the absence of certain reputable intermediaries essential for market deepening and development. For instance, securities markets professionals, over-the-counter market (OTC) and dealers in government securities. Relatedly, the country cannot boast of skilled and honest prosecutors and judicial officers. The need to assemble the missing components of the infrastructure cannot be overemphasized.

First, although the East African region has professionals in fields such as law, accountancy, management and finance, there are no securities market professionals.<sup>384</sup> It is submitted that if the securities markets are to grow and deepen, these professional are a necessary prong. Unfortunately, no institution in East Africa has developed a credible and comprehensive curriculum on the various aspects of the securities markets.<sup>385</sup> Institutional investors have been competing for the few individuals who have qualified as United States of America Certified Financial Analysts.

Second, the absence of primary dealers in government securities has hampered the growth of the secondary debt market for government securities. These are the persons who participate in auctions, act as market makers in the secondary market and underwrite new issues. The major challenge is that the number in the market is far below the threshold to make trade in government securities vibrant. The need to train and license such dealers is overdue.

Finally, the absence of an over-the-counter market (OTC) which could act as the incubator for companies planning to list denies the NSE a critical source of potential listings.<sup>386</sup> The comparatively relaxed listing and reporting requirements of the market would incentivize medium enterprises and family owned private companies to issue securities to the public. In addition, it would provide venture capitalists with an exit from their investment where the company is not being listed. The argument in favor of an OTC market is strengthened by a previous postulation that the eligibility requirements for the Main and Alternative market segments of the NSE do not accommodate many capital seeking companies. Furthermore, studies commissioned by the CMA have conclusively established that an OTC market is viable in Kenya.<sup>387</sup> What remain disputatious are the structure, ownership and its relationship with the NSE and the CMA.<sup>388</sup> It is contemplated that contentious matters will be resolved expeditiously to hasten the establishment of the market.

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<sup>383</sup> These professional bodies are established by Acts of Parliament to ensure that respective members exhibit the requisite standards of integrity and are accountable. Both bodies are established by Acts of Parliament; Editorial, NSE Board Should Eradicate Conflicts of Interest in Markets, *BUSINESS DAILY*, May 3, 2009 at 11.

<sup>384</sup> See James Makau, Wanted: Qualified Investment Professionals, *BUSINESS DAILY*, Mar. 28, 2008 at 18.

<sup>385</sup> The Securities Industry Training Institute (S.I.T.I.) based in Nairobi, conducts residential Seminars on various introductory aspects of securities markets and awards certificates. See John Oyuke, New License to boost East Africa Capital Markets, *THE STANDARD*, Dec. 7, 2010 at 13 (reporting that the S.I.T.I. had secured a ten year license to use the IFC training materials); CMA, Public Notice, *DAILY NATION*, Jan 25, 2011 at 32. See also *THE STANDARD*, Jan. 25, 2011 at 34.

<sup>386</sup> See Kenneth Kwama, Delayed Hatch, *FINANCIAL STANDARD* May 13, 2008 at 1, 8-9.

<sup>387</sup> See Vas Consultants Ltd, Study on the Viability and form of an OTC Market in Kenya (Feb. 18, 2008) available at [http://www.cma.or.ke/index.php?option=com\\_docman&task=cat\\_view&gid17&itemid=32](http://www.cma.or.ke/index.php?option=com_docman&task=cat_view&gid17&itemid=32), (visited on May 21, 2010).

<sup>388</sup> An OTC market can be: a segment of an established securities exchange, an association of stock brokers and dealers to facilitate trading in the securities or a formal exchange for small and medium enterprises.