AN EXAMINATION ON EFFICACY OF DISCLOSURE REQUIREMENTS IN CAPITAL MARKETS AUTHORITY
CASE STUDY: KENYA

BY

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DECLARATION

I hereby declare that this is my own work to the best of my knowledge and belief. It contains no material previously published nor material which to a substantial extent has been accepted for the award of any other degree or diploma of the university or other institute of higher learning, except where due acknowledgement has been made in the text.

63%

Signed:...

Candidate....Wahome Martin Gitahi..........

Date ....

Signed ....

Supervisor..... Ajayi E. Gbenga...............

Date .....1/11/2011...

DEDICATION

I am indebted to my family for the unreserved support and encouragement during the entire programme of Bachelor of Laws.

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I acknowledge the support given to me by my parents, sister and brothers for their endless love, encouragement and unconditional support, and to my friend Leah for proof reading my work.

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May God bless you all.

LIST OF STATUTES

The Capital Markets Act, Cap 485(A) Laws of Kenya

The Companies Act, Cap 486 Laws of Kenya

CHAPTER ONE

INTRODUCTION

1.0 BACKGROUND OF THE STUDY.

World over, most securities investors stay glued to the affairs at the stock exchange markets. In Kenya, the situation is not different as one can easily find the investors either watching at the live trading of securities at the Nairobi Stock Exchange (NSE) or following up on the progress in the media. All these constitute the 'appetite' to know the affairs of their investment.

Most of the investors in the securities market are yet to come to terms with the happenings at the Nairobi Stock Exchange for the past two years where a drop in the volume of trade has been witnessed.

Most small investors are yet to return in large numbers due to experience of the last eighteen months where the market experienced high volatility in prices, with share prices dropping by almost forty per cent during the period.[1]

Securities exchange can be defined as the mutual organization which provides "trading" facilities for stock brokers and traders, to trade stocks and other securities.[2] This kind of "trading" is conducted by professional stockbrokers.

Kenya's securities market has emerged from a state of sluggish decline in June 2008 when Safaricom broke records by launching East Africa's largest stock market

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[1] Dominic Kiarie, *Retail investors weigh options as NSE picks up;* Financial Journal; the Standard, Tuesday April 20, 2010 (pg 5)
[2] en.wikipedia.org/wiki/Securities_exchange>accessed on 28th March, 2010.

floatation[3]. The growth of capital markets in Kenya has been largely attributed to private investment initiatives.[4] However, there is still an erosion of investor confidence in securities investment in Kenya.

With the agricultural sector becoming an insecure form of investment by each day because of changing climatic patterns, there is a need to divest from the agro-based investment; which is the main form of investment in Kenya to other forms of secure investments.

The current trends of investing even in pyramid schemes shows that Kenyans have the requisite capital to invest but are not properly guided on what and where to invest. Because of this lack of credible information, they have been swayed to invest millions of shillings in some dubious schemes.

Investing in the securities market in Kenya provides an alternative to agro-based economy which is the main investment in Kenya. This dissertation shall focus on disclosure requirements on the stock market and the ways the market can be regulated using such requirements in order to gain investors' confidence so as to provide an alternative source of investment.

In the recent past, there has been an illustrious response to Initial Public Offers (IPOs), particularly, those for the Kenya Electricity Generating Company (Kengen)[5] and Safaricom Limited.[6] These two corporations were able to meet their targets. This

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[3] Deepen Shah: *Going Public: changes in capital markets regulation, 2009.* Walker Kontos, Nairobi.

[4] Edward A. Arowolo; *The Development of Capital Markets in Africa, with Particular Reference to Kenya and Nigeria*: (pg 420)

[5] 2006 IPO

[6] 2008 IPO

demonstrates the capacity as to Kenyan capital markets to raise funds. However, the processing of refunds for the over-subscribed shares has come into the limelight following these successful Initial Public Offers of both Kengen and Safaricom IPOs. Such refunds were marred by delays in the processing of investors' monies.

Throughout the twentieth century, the capital markets have played an increasingly important role in the development of market economies all round the world. Various governments around the world are recognizing that efficient securities regulation is critical to the development of any market based economy.

While fostering the development of the entire economy, the capital market also plays an important equalizing role. They permit a much wider participation in the economy by greater numbers of people who share in the investment opportunities, as well as business and market risks.

Barry and Lockwood observe:[7]

"In many developing nations, security markets are either lacking entirely or are poorly developed. Further, financial reporting may be unreliable and access to company information highly limited. In such nations, banks and other financial intermediaries take on especially important roles. In order to secure investment capital from banks, firms often must concede a strong role for the lenders, such as presence on the Board of Directors and access to inside information. In a market in which asymmetric information is especially problematic, the market can break down altogether without some way in which providers of capital can gain access to information and a degree of control."

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[7] C.B. Barry and L.T. Lockwood, *"New Directions in Research on Emerging Capital Markets," Financial Markets, Institutions and Instruments,* Vol. 4, No. 5, (Oxford: Blackwell Publishers, 1995), p. 15.

Ngenye Kariuki stock brokerage firm has joined the list of stock brokerage firms which are experiencing problems in the market. The stock brokerage firm has since 5th February 2010 been put under statutory management. Also, Discount Securities Limited was put under statutory management and Nyaga stock brokers that has since collapsed.[8]

This has a negative impact on the confidence of most investors and would-be investors in the securities or stock market. With this continued collapse of more and more stock brokerage firms, the question remains; how can disclosure requirements be used to foster investors' confidence?

It has also been argued[9] that the threat posed to transparency and standards of disclosure in the securities market by the emergence of insider systems and 'closed shop' practices has adversely affected the market. It is therefore of utmost importance that confidence in the standards of fairness, accountability and protection of rights given by law is upheld in the process of exchange of contracts giving ownership title to productive assets.

Also, the disclosure and reliability of information regarding the operations of major market participants, including potential conflicts of interest, is important for attracting funds from domestic and foreign investors alike.

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[8] Ngenye Kariuki and Company limited was found not to be in compliance with the legal and regulatory provisions as outlined in the Capital Markets Authority Act for some time and as a result put under statutory management with effect from 5th February, 2010.

[9] Eva Thiel Blommestein: *Capital market development in transition economies: country experiences and policies for the future* (pg 20)

There are three primary means used to promote public confidence in securities traded on exchanges.[10] These are;

a) full disclosure at the time of the initial offering,

b) continuous disclosure requirements, and

c) surveillance of trading activity.

1.1 Definitions

1.1.1 Capital Market

A capital market is a market for securities (debt or equity), where business enterprises (companies) and governments can raise long-term funds. It is defined as a market in which money is provided for periods longer than a year, as the raising of short-term funds takes place on other markets (such as the money market).

"capital market instrument" means any long term financial instrument whether in the form of debt or equity developed or traded on a securities exchange or directly between two or more parties for the purpose of raising funds for investment

1.1.2 Dealer

Dealer means a person who carries on the business of buying, selling, dealing, trading, underwriting or retailing of securities; whether or not he carries on any other business;

[10] Michael J. Watson Q.C. *The Regulation of Capital Markets: Market Manipulation and Insider Trading*; British Columbia Securities, 2008.

"dealing in securities" means making or offering to make with any person, or inducing or attempting to induce any person to enter into or to offer to enter into any agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities; or any agreement the purpose or intended purpose of which is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the price of securities.

1.1.3 Initial Public Offer

An initial public offering (IPO), referred to simply as an "offering" or "flotation", is when a company (called the *issuer*) issues common stock or shares to the public for the first time. They are often issued by smaller, younger companies seeking capital to expand, but can also be done by large privately owned companies.

1.1.4 Insider

Insider means any person who is or was connected with a company, or is deemed to have been connected with a company and who is reasonably expected to have access, by virtue of such connection, to unpublished information which, if made generally available, would be likely to materially affect the price or value of the securities of the company, or who has received or has had access to such unpublished information.

1.1.5 Insider Trading

Insider trading is the trading of a corporation's stock or other securities such as bonds or stock options by individuals with potential access to non-public information about the company.

1.1.6 Issuer

An issuer is a company or municipality offering (or having already offered) securities for sale to investors. Examples include corporations, investment trusts, and government entities.

1.1.7 Listed Company

A company is said to be "listed", "quoted" or "have a listing" if its shares can be traded on a stock exchange.

1.1.8 Securities

Securities means debentures or bonds issued or proposed to be issued by a government; debentures, shares, bonds, commercial paper, or notes issued or proposed to be issued by a body corporate; any right, warrant, option or futures in respect of any debenture, shares, bonds, notes or in respect of commodities; and any unit, interest or share offered under a collective investment scheme or other similar vehicles, whether established in Kenya or not.

1.1.9 Stock broker

A stock broker is a regulated professional broker who buys and sells shares and other securities through market makers or Agency Only Firms on behalf of investors. A broker may be employed by a brokerage firm.

1.1.10 Stock Exchange

Stock exchange means a market, exchange or other place at which securities are offered for sale, purchase or exchange, including any clearing, settlement or transfer services connected therewith.

1.1.11 Stock Market

Stock market means a market, or other place at which, or a facility by means of which offers to sell, purchase or exchange securities are regularly made or accepted; offers or invitations are regularly made, being offers or invitations that are intended or may reasonably be expected to result, whether directly or indirectly, in the making or acceptance of offers to sell, purchase or exchange securities; or information is regularly provided concerning the prices at which, or the consideration for which, particular persons, or particular classes of persons, propose, or may be reasonably be expected, to sell, purchase or exchange securities.

1.1.12 Underwriting

Underwriting means the purchase or commitment to purchase or distribute by dealers or other persons of issue or offer of securities for immediate or prompt public distribution by or through them.

1.2 STATEMENT OF THE PROBLEM

The problem under study is the lack of sufficient and timely disclosure surrounding the stock exchange market which has led to the loss of confidence by the investors in the market.

The securities market is part of the capital markets which is concerned with the trading of securities of a listed company. In order to transact `business in the securities market, an investor must use the facilities of a stock brokerage firm unless he himself is a registered member of the exchange or is a registered dealer in securities. The brokerage firms in return earn a commission and build goodwill.

However, these brokerage firms face various challenges while discharging their functions; ranging from corporate governance issues to handling of their clients' investment, unbridled speculation, lack of transparency in their dealings and rampant insider trading activities among others. But the major challenge in the securities market is the principle of full, frank, accurate, plain and timely disclosure of all material facts relating to investing in the market.

Without stringent regulatory mechanisms in place to guide proper disclosure, stock brokerage agencies are likely to engage in activities inimical to the interests of investors and as a result the investors shall lose confidence in the securities market.

1.3 JUSTIFICATION OF THE STUDY

Securities exchange plays a critical role in the development of most economies in the world. Therefore, it is of paramount importance that the securities market must be regulated because it plays the following role in the economy of any given country:-

1. It promotes a culture of thrift or saving: This is the major role that the securities market plays in any economy. The very fact that institutions exist where savers can safely invest their money and in addition earn a return, is an incentive to people to consume less and save more.

2. The stock exchange assists in the transfer of savings to invest in productive enterprises as an alternative to keeping the savings idle. Even in a case where the economy is developed but lacks established mechanisms for channeling those savings into activities that create wealth, the savings will either be misallocated or wasted.

3. Capital is a scarce resource which means that systems have to be developed where capital goes to the most deserving user. A robust stock market will assist in the rational and efficient allocation of the scarce resource.

4. Stock markets promote division of labour, higher standards of accounting, resource management and transparency in the management of business. Financial markets encourage the separation of owners of capital from the managers of capital. This separation is important because of the appreciation of the fact that the owners of capital may not necessarily be the best managers.

5. Stock exchange improves access to finance for different types of users by providing the flexibility for customization. This is made possible as the financial sector allows the different users of capital to raise capital in ways that are suited to meeting their specific needs.
6. Stock exchange provides investors with an efficient mechanism to liquidate their investments in securities. The very fact that investors are certain of the possibility of selling out what they hold as and when they want, is a major incentive for investment as it guarantees mobility of capital in the purchase of assets.

1.4 OBJECTIVES OF THE RESEARCH

1. To critically analyze the current regulatory mechanisms available under the Capital Markets Act[11] concerning disclosure requirements and present a strong and convincing case; the need for stringent regulatory measures.
2. To present a case for investing in the stock market by allaying fears of the market as being an insecure investment option.
3. To identify ways by which the existing legal and institutional framework could be improved in order to regain the diminishing investors' confidence in Kenyan capital markets.

1.5 SCOPE OF THE STUDY

Generally, securities market form part of the capital markets. The securities market comprises of both the trading of shares and fixed income securities like bonds trading. This study will mainly focus on the trading of shares as a form of security in the stock

[11] Cap 485A Laws of Kenya

exchange market and therefore present a special bias on disclosure regulations especially before, during Initial Public Offers and afterwards (continuous disclosure).

This dissertation will cover a period of one and a half academic years; July 2010 to November 2011.

1.6 RESEARCH QUESTIONS

Some of the research questions that are intended to be answered in this dissertation include the following:-

1. Is there actually loss of investors' confidence in the securities market?
2. Under what circumstances could investors lose confidence in the securities market?
3. Are there any regulations in the securities market concerning disclosure requirements and if affirmative, are the same sufficient to guarantee investors' confidence?
4. Has the Capital Markets Authority established under the Capital Markets Act achieved its objectives in terms of disclosure regulations in the securities markets?
5. What sanctions, if any, are prescribed for flouting the regulations of disclosure requirements?
6. What roles does prosecution and the courts play in the enforcement of sanctions imposed by the regulations and has this role served the purpose of deterrence?
7. In view of the foregoing, is there a need for the sanctions to be made more stringent?

characterized by high average returns, high volatility, and excellent diversification prospects in combination with portfolios from developed markets.

From the foregoing, it is justifiable to analyze different publications and works of different scholars in order to appreciate the need for securities regulation in order to improve market confidence. This shall be comprehensively covered in chapter two of this dissertation.

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[13] C.B. Barry and L.T. Lockwood, *"New Directions in Research on Emerging Capital Markets," Financial Markets, Institutions and Instruments,* Vol. 4, No. 5, (Oxford: Blackwell Publishers, 1995), p. 15.

CHAPTER TWO

LITERATURE REVIEW

2.0 INTRODUCTION

The key to a successful securities trading system is that all investors share the risks depending on the level of their individual investment. Fundamental principles have been developed in securities regulation to ensure fairness in the market. For example, the principle which ensures equal opportunity is that all trading in securities must take place in an environment where there has been full, true and plain disclosure of all material facts. This is brought about through a set of rules which impose significant disclosure requirements upon businesses that seek to raise finances from the members of the public through the capital market, as well as their controllers and insiders, and rules which ensure fair trading practices among all those who trade in the market.

This is brought about through a set of rules which impose significant disclosure requirements upon businesses, which seek to raise finances from the public through the capital market, as well as their controllers and insiders, and rules which ensure fair trading practices among all those who trade in the market.

2.1 GENERAL PRINCIPLES OF SECURITIES MARKET REGULATION

In most of the cases, for a securities market to flamboyantly engage in the market, regulators prefer not to substitute their judgment of market participants for the business judgment of the business people. The availability of decision useful information promotes market integrity which translates into trust and confidence in the market.

This principle has as its primary objective the protection of investors by ensuring that there is integrity in the market hence promoting investor confidence in the market.

The disclosure of accurate, comprehensive and timely information about security issuers is to build sustained investor confidence and allow for an informed assessment of their business performance and assets is necessary. This enhances both investor protection and market efficiency. To that end, security issuers should ensure appropriate transparency for investors through a regular flow of information. To the same end, shareholders, or natural persons or legal entities holding voting rights or financial instruments that result in an entitlement to acquire existing shares with voting rights, should also inform issuers of the acquisition of or other changes in major holdings in companies so that the latter are in a position to keep the public informed.[14]

It has been argued by ***Barry and Lockwood***[15] that emerging capital markets (EMs) have recently attracted the attention of global investors and scholars alike. The markets are characterized by high average returns, high volatility, and excellent diversification prospects in combination with portfolios from developed markets.

The idea that capital markets accurately incorporate all relevant publicly available information has become enshrined as the "efficient markets" theory, with wide and influential support (***Fama 1970***).

[14] http://ec.europa.eu/internal_market/securities/docs/esme/tdcash_en.pdf > accessed on 27th April 2010.

[15] C.B. Barry and L.T. Lockwood, *"New Directions in Research on Emerging Capital Markets," Financial Markets, Institutions and Instruments,* Vol. 4, No. 5, (Oxford: Blackwell Publishers, 1995), p. 15.

The basic justification of such a theory lies in the demonstrated difficulty investors have in consistently achieving abnormally high returns through any trading strategy. Its obverse, that capital markets will not accurately incorporate information that is *not* publicly available, is central to the disclosure requirements embedded in securities laws.

Information disclosure is central to the smooth operation of the capital markets. In the United States, for example, disclosure is the dominant regulatory mechanism underlying the Securities Act to promote capital market efficiency. "At its core, the primary policy of the federal securities laws today involves the remediation of information asymmetries." (***Seligman 1995; p. 604).***

These requirements include not only information about current conditions affecting the firm that investors would consider relevant, but also any known risks and uncertainties that might have future material financial effects.

In analyzing the literature review and the theories on disclosure requirements in the securities market, this chapter will be concerned with the analysis of the disclosure regulations on the legal, economic, philosophical and historical need for regulation of capital markets as provided for under the various areas of regulation.

Therefore, the theories for market disclosure are divided into three main areas; legal, economic and historical need for disclosure.

2.2 THEORIES ON DISCLOSURE

Disclosure requirements in the securities market has presented a serious case for study and the theories on disclosure can broadly be categorized into three main classifications; the legal, economical and historical theories.

2.2.1 Legal basis for disclosure.

There are a number of legal studies that emphasize the role of disclosure in mitigating agency problems. An agency conflict can arise when one party (the agent) is hired to carry out a task by another party (the principal), but the objectives of the agent are not aligned with those of the principal.

Such principal-agent conflicts often arise between shareholders who own a public company and the managers who are hired to run it. For example, ***Mahoney 1995 and Ferrell, 2004*** argue that the agency costs are mitigated by stringent disclosure requirements.[16]

Many studies in agency theory suggest that more transparency and better corporate governance increases firm value by improving managers' decisions or by reducing the amount that managers appropriate for themselves (***Lambert, 2001***).

[16] Agency problems and any costs appurtenant thereto are as a result of the effect of the alteration of the managers' decisions and hence altering the distribution of future cash-flows.

2.2.2 Economical basis for disclosure.

Merton (1987) develops a model where (some) investors have incomplete information and are not aware of all firms in the economy. As a result, risk sharing is incomplete and inefficient. Disclosures by these lesser-known firms can make investors aware of their existence and enlarge the investor base, which in turn improves risk sharing and lowers the cost of capital.

Although this effect is fairly straightforward and plausible for small firms (such as the small firms that trade in the U.S. over-the-counter (OTC) markets), it seems less relevant to large firms with a substantial analyst and investor following.

Moreover, the investor base effect is susceptible to arbitrage if some investors know which of the stocks are not known by all investors (***Easley and O'Hara, 2004***).

Thus, the extent to which the investor base effect is priced in equilibrium is an open and empirical question.

Lambert, Leuz and Verrecchia (2006) model estimation risk using a more conventional information-economics approach in which information signals are related to realized or future cash flows. This approach allows for more general changes in the information environment and can accommodate an analysis of firm-specific disclosures.[17]

Based on this information structure, ***Lambert et al.*** shows that the assessed covariances of a firm's cash flows with the cash flows of other firms decrease as the

[17] Christian Leuz and Peter Wysocki; *Capital-Market Effects of Corporate Disclosures and Disclosure Regulation* (A research study)

quality or precision of disclosures increases, and that this effect unambiguously moves a firm's cost of capital closer to the risk-free rate.[18]

Garleanu and Pedersen (2004) show that, in equilibrium, investors also need to be compensated for the costs associated with the inefficient allocation of securities in the economy, which again increases the required rate of return or cost of capital.[19]

Disclosures can have indirect costs that stem from the fact that information provided to capital market participants can also be used by other parties like the competitors, labour unions, tax authorities. These costs are often called proprietary costs, thereby capturing the idea that these costs arise from the disclosure of proprietary information.

For instance, detailed information about the profitability of particular business segments can be competitively sensitive because it may reveal the operating margins of, and investments in, different lines of business ***(Feltham et al., 1992; Hayes and Lundholm, 1996).***[20]

2.2.3 Historical need for disclosure.

Information signals are typically modeled as arising from a historical time-series of returns. In particular, ***Barry and Brown (1985) and Coles et al. (1995)*** compare two

[18] *Ibid* note 4

[19] The assumption is that disclosure of private information must be costless and truthful (or verifiable at low cost), and an investor must know that the firm possesses private information in the first place. Without these assumptions, the described full disclosure equilibrium may not prevail (*Verrecchia, 1983; Kwon and Jung, 1988*).

[20] The fact that other parties - such as competitors, employees, regulators and tax authorities - may use public information to their advantage can dampen firms' disclosure incentives (*Verrecchia, 1983*).

information environments: an "equal" information case where the same historical time-series of returns is available for all firms in the economy and an "unequal" information case where some firms have longer time-series of returns than others.

They find that the betas of the "high information" securities in the unequal information case are lower than they are in the equal information case. However, they cannot unambiguously sign the difference in betas for the "low information" securities in the unequal- versus equal-information cases.

2.3 POTENTIAL BENEFITS VERSUS COSTS OF DISCLOSURE

There are also many theories about the potential costs and benefits of corporate disclosure. On the benefit side, disclosures are expected to improve market liquidity and to lower the cost of capital. In addition, increases in disclosures can potentially improve corporate governance and managers' investment decisions. Other indirect and possibly reinforcing capital market benefits include greater analyst following and the attraction of certain investor clientele, such as institutional investors.

On the cost side, there are the direct costs of preparing, certifying, and disseminating corporate information. In addition, disclosures may have indirect costs, for instance, because the information could also be used by other parties, such as competitors, employees, politicians and regulators. The confluence of costs and benefits of particular disclosures ultimately determines whether they are beneficial to the firm; that is, whether they increase firm value.

The benefit of disclosure that is arguably best supported by theory is the link between disclosure and market liquidity (***Verrecchia, 2001***). At the core of this link is the insight that information asymmetries among investors introduce adverse selection into share markets.

With information asymmetry, uninformed or less-informed investors have to worry about trading with privately or better informed investors. In essence, an uninformed investor fears that an informed investor is willing to sell or buy at the market price only because the price is currently too high or too low relative to the information possessed by the informed trader (***Glosten and Milgrom, 1985***).

As a result, the uninformed investor lowers or increases the price at which he is willing to buy or sell to protect against the losses from trading with an informed counterparty. The price adjustment reflects the probability of trading with an informed investor and the potential information advantage of an informed trader.

Corporate disclosure can mitigate the adverse selection problem and increase market liquidity by leveling the playing field among investors (***Verrecchia, 2001***). Its effect is twofold. First, more information in the public domain makes it harder and more costly for traders to become privately informed. As a result, fewer investors are likely to be privately informed, which reduces the probability of trading with a better informed counter party.

Secondly, more disclosure reduces the uncertainty about firm value, which in turn reduces the potential information advantage that an informed trader might have. Both effects reduce the extent to which uninformed investors need to price protect and hence increase market liquidity.

Merton (1987) develops a model where investors have incomplete information and are not aware of all firms in the economy. As a result, risk sharing is incomplete and inefficient. Disclosures by these lesser-known firms can make investors aware of their existence and enlarge the investor base, which in turn improves risk sharing and lowers the cost of capital.

Although this effect is fairly straightforward and plausible for small firms (e.g., such as the small firms that trade in the U.S. over-the-counter (OTC) markets), it seems less relevant to large firms with a substantial analyst and investor following. Moreover, the investor base effect is susceptible to arbitrage if some investors know which of the stocks are not known by all investors (***Merton, 1987; Easley and O'Hara, 2004***).

Emerging companies usually obtain outside equity financing from specialized investors, through formal and informal venture capital (VC) networks. These investors have developed skills, methods and tools to select, fund and monitor the most promising ventures. For these ventures, the growth path leads to the initial public offering (IPO) and exchange listing, which is the ultimate mark of success for venture capitalists. The company must then fulfill the disclosure and the minimal listing requirements, including having a track record of positive earnings and sufficient capitalization and float.

The first rationale for mandatory disclosure is that large shareholders and corporate insiders may extract private benefits from controlling the firm (***La Porta et al., 2000; Shleifer and Wolfenzon, 2002***).

Given these benefits, controlling insiders may be reluctant to commit to corporate disclosures that limit their ability to extract private benefits, even if such disclosures increase firm value and reduce the cost of capital. Outside investors are likely to price protect, so the controlling owners bear the costs of extracting private benefits, providing insufficient disclosures and foregoing profitable investment opportunities (***Doidge et al., 2004***).

The second rationale for mandatory disclosure is that externalities[21] arise whenever the social and private values of information differ. In such a case, firms trading off the private or firm-specific costs and benefits do not provide the socially optimal level of disclosure (***Hirshleifer (1971***) who argues that private information acquisition for speculative gains in securities markets is socially wasteful.

Dye (1990) and Admati and Pfleiderer (2000) argue that firms' disclosures have positive externalities in the form of information transfers and liquidity spillovers. The information disclosed by one firm can be useful in valuing other firms and increase investors' willingness to hold positions in other firms.

2.4 INVESTOR PROTECTION

Strict disclosure requirements ensure that investors in the securities market are effectively protected. Recent research suggests that the extent of legal protection of investors in a country is an important determinant of the development of its financial

[21] Externalities are the side effects (positive or negative) faced by other parties resulting from the actions of another party or parties. The existence of externalities can lead to market failures and result in inefficiencies in the economy.

markets. Where laws are protective of outside investors and well enforced, investors are willing to finance firms and financial markets are both broader and more valuable.

In contrast, where laws are unprotective of investors, the development of financial markets is stunted. Moreover, systematic differences among countries in the structure of laws and their enforcement, such as the historical origin of their laws, account for the differences in financial development (***La Porta et al. or LLSV 1997, 1998***).

How does better protection of outside investors (both shareholders and creditors) promote financial market development? When their rights are better protected by the law, outside investors are willing to pay more for financial assets such as equity and debt. They pay more because they recognize that, with better legal protection, more of the firm's profits would come back to them as interest or dividends as opposed to being expropriated by the entrepreneur who controls the firm.

By limiting expropriation, the law raises the price that securities fetch in the marketplace. In turn, this enables more entrepreneurs to finance their investments externally, leading to the expansion of financial markets.

From the foregoing, it is imperative to look at the legal and regulatory mechanisms put in place to ensure that trading in securities takes place in an environment where there has been full, true and plain disclosure of all material facts relevant to the making of informed investments decisions in the securities market.

CHAPTER THREE

LEGAL AND REGULATORY FRAMEWORK

3.0 INTRODUCTION.

The legal and regulatory framework of the securities market in Kenya is scattered in various legislations. However, the main legal instrument governing the operations and implementation of the securities market is the Capital Markets Act (Cap. 485A) of the Laws of Kenya and the various Capital Markets Act Regulations; for example;

- The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002;
- The Capital Markets (Foreign Investors) Regulations, 2002
- Nairobi Stock Exchange Listing Manual;
- The Capital Markets Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya.

The other pieces of legislation that provide the subsidiary legal and regulatory framework of the securities market include the the Companies Act (Cap 486) and the Central Depositories Act, 2000.

3.1 DISCLOSURE PRINCIPLE UNDER THE CAPITAL MARKETS ACT[22]

The governing law concerning disclosure requirements, for the issuance of securities in Kenya, takes the form of subsidiary legislation promulgated by the Capital Markets Authority (CMA). The powers of the Authority to make rules governing disclosure requirements are sourced from section 11(3)(d)(iii) of the Capital Markets Act.

3.1.1 Disclosure under the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002.

In a bid to extend the degree of investor protection, these Regulations as promulgated pursuant to the powers vested under section 11(3), pertaining to disclosure, apply both to companies listed at the Nairobi Stock Exchange (NSE) and companies that do not have such listing.[23]

a) Disclosure through the Prospectus

Before an issuer is permitted to distribute its securities through an exchange, disclosure of material information through an information memorandum or a prospectus must be done, pertaining to all such information as investors would reasonably require and expect to find for the purpose of making an informed assessment.

[22] Cap 485A, Laws of Kenya.

[23] Section 3(1) of the Regulations provides that the Regulations shall apply to all offers of securities to the public in Kenya whether or not the issuer is seeking a listing on any securities exchange in Kenya.

A business listing for the first time on an exchange is subject to substantial disclosure requirements.[24]

Generally, in determining the exact nature of disclosure required, regard is had to the nature of the securities and the nature of the offeror of the securities. There may also be a requirement for additional disclosure where it is in the public interest that such additional information be disclosed. This can be done through a supplementary prospectus, or an information memorandum.

b) General duty to disclose

Under section 12 of the Regulations, where one is making a public offer of securities, such a person is required to make disclosure as per the prescribed terms of the Regulations and also to make further disclosure pertaining to all such information as investors would reasonably require and reasonably expect to find therein for the purpose of making an informed assessment of:-

- The assets and liabilities, financial position, profits and losses and the prospects of the issuer of the securities.
- The rights attaching to those securities.

c)Documents for making public offers

Section 16 of the Regulations provides that an advertisement, notice, poster or any document including a bridge prospectus, relating to a public offer of securities, shall

[24] Michael J. Watson Q.C.; *The Regulation of Capital Markets: Market Manipulation and Insider Trading:* British Columbia Securities Commission; 2008 pg. 4

state that a prospectus is or will be issued free of charge at a given address in Kenya on demand.

Furthermore, at least 48 hours prior to publication, such notices or other similar documents relating to a public offer of securities, shall be submitted to the Capital Markets Authority and the Authority may make such amendments to them as it deems necessary.

Moreover, it is required that the prospectus be in English language, in black and white, except for the issuer's logo, which may be in full colour.

Also, where a person seeks to offer securities through electronic form, such offer must be based on a prospectus approved by the Authority.

d) *Persons responsible for disclosure*

While the CMA approves and regulates the contents of a prospectus, it bears no liability relating to its contents. Under section 10(2) (a), the Authority provides a disclaimer for any liability concerning the contents of a prospectus;

"As a matter of policy, the Capital Markets Authority assumes no responsibility for the correctness of any statements or opinions made or reports contained in this prospectus. Approval of the issue and/or listing is not to be taken as an indication of the merits of the issuer or of the securities".

Section 17 of the Regulations provides for naming of responsible persons who are to be liable for any misrepresentation or any other harm caused by the inaccuracies of the contents of the prospectus. These include;

(a) the issuer of the securities to which the prospectus or supplementary prospectus relates;

(b) where the issuer is a body corporate, each person who is a director of that body corporate at the time when the prospectus or supplementary prospectus is published;

(c) where the issuer is a body corporate, each person who has given his consent to be named and is so named in the prospectus or supplementary prospectus as a director or as having agreed to become a director of that body corporate either immediately or at a future time;

(d) each person who accepts, and is stated in the prospectus or supplementary prospectus as accepting, responsibility for, or for any part of, the prospectus or supplementary prospectus;

(e) the offeror of the securities, where the offeror is not the issuer;

(f) where the offeror is a body corporate, but is not the issuer and is not making the offer in association with the issuer, each person who is a director of that body corporate at the time when the prospectus or supplementary prospectus is published; and

(g) each person not falling within any of the foregoing paragraphs who has authorized the contents of, or of any part of, the prospectus or supplementary prospectus.

e) ***Change in circumstances and the need for additional disclosure***[25]

In case of substantial change in circumstances, there are cases of additional disclosure in three cases;

- Further disclosure is required in case of additional issues. Section 11 of the Regulations states that an issuer whose securities are listed at a securities exchange shall not issue or authorize its registrar to issue or register, by way of capitalization, scrip dividend, rights issue or additional shares of the class listed, to a greater amount than the number hitherto authorized for listing except in accordance with the disclosure requirements for additional listing prescribed in the Fourth schedule to the Regulations.

- Where there is need for further clarification of the contents of a prospectus, the publishing of a supplementary prospectus containing particulars of the change and correcting any inaccuracies that may be contained in the original prospectus, may be undertaken.

- Where there is change in the circumstances, altering the basis of approval of a public offer, before the allotment date or the date of listing in the case of an introduction, which renders the information memorandum inaccurate.

- Where there is significant inaccuracy in the prospectus.[26]

[25] Section 13(1) of the Regulations, 2002.
[26] Section 13(1)c of the Regulations, 2002.

f) *Continuous obligations of disclosure*[27]

According to Section 19 (2) of the Regulations, continuous disclosure is necessary because as time passes from the act of prospectus distribution, the disclosure contained in the prospectus becomes of decreasing relevance to the investor. If investors are to have access to information sufficient to allow informed investment decisions past the initial distribution, clearly issuers must continue to provide relevant information accessible to investors as long as the securities of the issuer continue to be available for trade in the public market.

Sub-section 3 provides that such information to be disclosed should be done within twenty-four hours of the event.

3.1.2 Disclosure obligations under the Capital Markets (Foreign Investors) Regulations, 2002.

The Investment Regulations are geared towards regulating foreign investments in the country. According to the Regulations, there are some percentum reservations for both local and foreign investors. Local investors are specifically reserved twenty-five percentum of the total securities issued by a listed company.[28]

Regulation 4(1) provides that a company should maintain a register of its shareholders with the necessary categorization of whether such investors are local, institutional, East African or foreign investors.

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[27] Part III of the Regulations provides for continuous disclosure obligations for the issuers of securities.
[28] Section 3(1) of the Investment Regulations, 2002.

Sub-regulation 2 provides that a report on the categories of the shareholders should be submitted to the Authority within ten days following the end of each month;

Regulation 5 provides specifically for the declaration by the stockbroker of investor status, that is, as to whether such an investor is local, East African or foreign.

Also, Regulation 6 makes provisions for reporting by listed companies of all transactions that result in the per centum of ordinary shares held by foreign investors and East African investors to reach seventy per cent or more specifying the per centum attained by each such transaction. This is aimed at regulating the level of foreign investments in the country.

3.1.3 Disclosure requirements under the Nairobi Stock Exchange (NSE) Listing Manual, 2002.

There are other disclosure obligations imposed by the Listing Manual as seen hereunder;

a)*Disclosure Requirements in the Main Investment Market Segment (Part A)*

Rule 8 of the NSE Listing manual provides that this segment should contain information on the issuer, including a place where relevant documents regarding him maybe inspected, such as his memorandum and articles of association, any trust deed referred to in the prospectus, material contracts, copies of service agreements with managers or secretaries, underwriting and any vendors' and promoters' agreements entered into in the preceding two years among others.

It also prescribes that the issuer should publish audited financial statements for an accounting period ending on a date not more than three months prior to the proposed date of the offer for issuers whose securities are not listed at the securities exchange and six months for issuers whose securities are listed at the securities exchange.

b) Disclosure requirements in the alternative investment market segment (part b)

Where not more than nine months have elapsed since the end of the financial year to which the last published annual accounts relate, issuers whose securities are not listed at the securities exchange are expected to prepare an interim audited financial statement covering at least the first six months following the end of that financial year which must be included in or appended to the prospectus, or time the issue to coincide with the next audited annual accounts.

Also, where not more than nine months have elapsed since the end of the financial year, issuers whose securities are already listed at a securities exchange in Kenya should prepare unaudited financial statements covering the period preceding the six months which must be included in or appended to the prospectus or time the issue to coincide with the next audited annual accounts.

This is necessary to enable potential investors to make an informed assessment of the prevailing conditions in the securities market.

c)Continuing Listing and Disclosure obligations

Part IV sets out the issuers' continuous listing obligations including disclosures on periodical financial information and general disclosures to ensure that the investors and shareholders have access to information on the issuer.

The general obligations of disclosure are provided for under Rule 10.1 which provides that an issuer shall, as soon as possible but not later than twenty four hours, release an announcement giving details of circumstances or events that have or are likely to have a material effect on the financial results, the financial position or cash flow of the issuer and new developments which impact on the issuer's operations, trading and financial performance.

Continuing disclosure obligations relating to information to be disclosed include, but are not restricted to any major development in the issuer's sphere of activity or expectation of performance which is not public knowledge.

d)Disclosure requirements for additional issues.

An issuer of securities to the public must ensure equality of treatment for all holders of such securities of the same class in respect of all rights attaching to such securities.

Under the Fourth Schedule, an issuer intending to make an additional issue should make an announcement within twenty-four hours from the board's resolution to recommend the additional issue to the shareholders and such announcement shall state that the issue is subject to the approval of the shareholders and the Authority.

e)Disclosure of periodic financial information

This information relates to especially disclosures made concerning dividends and interest.[29] Announcements of dividends and/or interest payments on issued securities should be notified to the securities exchange, the Authority and the holders of the relevant security within twenty four hours following the Board's resolution in the case of an interim dividend or recommendation in the case of a final dividend, by means of a press announcement.

The resolution must be at least twenty one days prior to the closing date of the register and shall contain at least the following information:

(a) the closing date for determination of entitlements;

(b) the date on which the dividend or interest will be paid; and

(c) the cash amount that will be paid for the dividend or interest.

3.2 DISCLOSURE PRINCIPLE UNDER THE COMPANIES ACT[30]

In terms of disclosure requirements, the Act mandates disclosure of all material facts in the prospectus, annual returns, accounts and audit, disclosures on matters pertaining to directors, registers and inspections, and also at the general meetings.

However, for the purpose of securities disclosure requirements, disclosures in the prospectus are quite relevant.

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[29] According to Rule 19 of the Regulations, 2002 and the Fifth Schedule of the NSE Listing Manual, 2002.

[30] Cap 486, Laws of Kenya.

a) Disclosure requirements in the prospectus

Section 42(1) provides that a prospectus inviting persons to subscribe for shares in or debentures of a company and including a statement purporting to be made by an expert shall not be issued unless:-

(a) he has given and has not, before delivery of a copy of the prospectus for registration, withdrawn his written consent to the issue thereof with the statement included in the form and context in which it is included; and

(b) a statement that he has given and has not withdrawn his consent as aforesaid appears in the prospectus.

(2) If any prospectus is issued in contravention of this section the company and every person who is knowingly a party to the issue thereof shall be liable to a fine not exceeding ten thousand shillings.

Section 43(1) further provides that no prospectus shall be issued by or on behalf of a company or in relation to an intended company unless, on or before the date of its publication, there has been delivered to the registrar for registration a copy thereof signed by every person who is named therein as a director or proposed director of the company, or by his agent authorized in writing, and having endorsed thereon or attached thereto -

(a) any consent to the issue of the prospectus required by section 42 from any person as an expert; and (b) in the case of a prospectus issued generally, also -

(a) any consent to the issue of the prospectus required by section 42 from any person as an expert; and (b) in the case of a prospectus issued generally, also -

(i) a copy of any contract required by paragraph 14 of the Third Schedule to be stated in the prospectus, or, in the case of a contract not reduced into writing, a memorandum giving full particulars thereof; and

(ii) where the persons making any report required by Part II of that Schedule have made therein, or have, without giving the reasons, indicated therein, any such adjustments as are mentioned paragraph 29 of that Schedule, a written statement signed by those persons setting out the adjustments and giving the reasons therefore.

3.3 INSIDER TRADING ISSUES AND THE NEED FOR DISCLOSURE.

3.3.0 Introduction

Issues of insider trading can also be attributable in some aspects to disclosure requirements in the securities market. In the recent past, insider trading has become an issue that calls for immediate strict regulation in Kenya.

Insider trading is the trading of a corporation's stock or other securities such as bonds by individuals with potential access to non-public information about the company. In most countries, trading by corporate insiders such as officers, key employees, directors, and large shareholders may be legal, if this trading is done in a way that does not take advantage of non-public information. However, the term is frequently used to refer to a practice in which an insider or a related party trades based on material non-public information obtained during the performance of the insider's duties at the corporation, or otherwise in breach of a fiduciary or other relationship of trust and confidence or where the non-public information was misappropriated from the company.

In the absence of regulation, insider trading will be an inherent risk of holding shares in companies and outsiders will build this risk into their investment decisions, by lowering the price they are prepared to pay for companies' shares. This in turn will increase the companies' costs of capital because they will be able to issue shares on less favorable terms than if investors could be assured that there was no little insider trading in the market. This means that companies should have an interest in insider trading activities.

In Kenya, trading conducted by corporate officers, key employees, directors or significant shareholders must be reported to the regulator or publicly disclosed, usually within a few business days of the trade. This is on the basis that many investors follow the summaries of these insider trades in the hope that these will be profitable.[31]

Kenya, like most of other jurisdictions around the world has provisions relating to the prohibition of illegal insider trading.[32] Insider trading is prohibited under sections 32A and 33 of the Capital Markets Act.[33]

Illegal insider trading is believed to raise the cost of capital for securities issuers, thus decreasing the overall economic growth.

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[31] While "legal" insider trading cannot be based on material non-public information, some investors believe corporate insiders may have better insights into the health of a corporation and that their trades otherwise convey important information.

[32] The US is viewed to have one of the strictest laws against illegal insider trading and makes the most serious efforts to enforce them.

[33] Cap. 485A, Laws of Kenya.

Insider trading injures the proper interests of the company in whose securities the insider dealing takes place; if a person takes advantage of the information as a director or officer of the company or in a clearly defined relationship involving confidence and trust within the company, the potential injury is even greater.

It is disadvantageous for a company to acquire the reputation of being an insider's company. Such a company is likely to have problems in securing finance on competitive terms. In addition, it suffers in the market as a consequence of loss of respect in the integrity of its management.

It is always argued that where a person in a position of trust abuses the confidence reposed in him, of duty, the injury is in breach of trust. It is proper therefore that he be required to yield up any benefits obtained by virtue of the breach.[34]

Although the proper desire is to draw as much information as possible to allow investors to make sensible decisions, many investment decisions are made on the basis that the investors consider that an insider has superior information.

Insider dealing should be regulated because of its perceived adverse effect on confidence. If enough opinion forming persons consider it wrong, it has the effect of alienating investors as well as potential investors and this has adverse consequences for the society as a whole.

[34] As per Fulo C.J. in ***Diamond v. Oreamuno (1969) 248 N.E 910***; where it was held that in breach of a fiduciary duty a company does not need to show that it has suffered loss as a result of the insider dealing, simply that the insider fiduciaries have made an undisclosed profit.

3.3.1 Measures by companies to control insider trading.

a) Judicial interventions

Company officers are free to hold and deal in its securities. However, the use of certain confidential information of the company can be actionable, such as trade secrets and lists of customers. Also, if a director or officer of the company has made use for his own purpose price sensitive information acquired in his capacity as such, this amounts to breach of his fiduciary obligations and will be liable to the company which is entitled to recover any profits made.

b) Disclosure

The company can ensure that price-sensitive information which is withheld from the market is kept to minimum. Insiders are likely to manipulate events to avoid prompt disclosure of information so as to exploit it for personal gain. Hence it is critical to encourage disclosure as much as it is relevantly possible to facilitate sensible investment decisions.

c)Legislative intervention

The company can also invoke section 32A of the Capital Markets Act on the prohibition against the use of unpublished insider information.

Section 33 prohibits insider dealing and in case of contravention, sub-section 12 provides the sanctions which a company can invoke.

3.3.2 Kenyan Law on Insider Trading

Kenyan insider trading prohibitions are based on English common law prohibitions against fraud. The Capital Markets Act provides for the penalties for illegal insider trading. This therefore means that the Kenyan law on insider dealings only prohibits but does not substantially regulate it.

a)Section 32A

Under this section, an insider is prohibited from doing any of the following and if he/she does any of it, will be held to be in contravention of the Act and thus guilty of insider trading;

(a) either on his/her own behalf or on behalf of any other person, deal in securities of a company listed on any stock exchange on the basis of any unpublished price sensitive information; or

(b) communicate any unpublished price sensitive information to any person, with or without his request for such information, except as required in the ordinary course of business or under any law; or

(c) counsel or procure any other person to deal in securities of any company on the basis of unpublished price sensitive information.

b)Section 33

Section 33 prohibits insider trading by providing that a person who is, or at any time in the preceding six months has been, connected with a body corporate shall not deal in any securities of that body corporate or of any body corporate if by reason of his being, or having been, connected with that body corporate he is in possession of information that is either;

- not generally available to the public but, if it were, would be likely to materially affect the price or value of those securities; and
- relate to any transaction (actual or expected) involving both bodies corporate or involving one of them and securities of another.

Also, where a person is in possession of any such information referred to in subsection (2) which if made generally available, would be likely to materially affect the price of securities but is not precluded by that subsection from dealing in those securities, he shall not deal in those securities if :-

a) he has obtained the information, directly or indirectly, from another person and is aware, or ought reasonably to be aware, of facts or circumstances by virtue of which that other person is himself precluded from dealing in those securities; and

b) when the information was so obtained, he was associated with that other person or had with him an arrangement for the communication of information of a kind to which that subsection applies with a view to dealing in securities by himself and that other person or either of them.

Any person is precluded by subsections (1), (2), or (3) from dealing in any securities, cause or procure any other person to deal in those securities.

However, by virtue of subsection 5, a person shall not, at any time when he is precluded by subsection (1), (2), or (3) from dealing in any securities by reason of his being in possession of any information, communicate that information to any other person if -

(a) trading in those securities is permitted on any securities exchange; and

(b) he knows, or has reason to believe, that the other person will make use of the information for the purpose of dealing or causing or procuring another person to deal in those securities.

Subsection 6 makes provisions to include the liability of bodies corporate by providing that a body corporate shall not deal in any securities at a time when any officer of that body corporate is precluded by subsections (1), (2), or (3) from dealing in those securities.

An exception for a body corporate is provided for under subsection 7 which provides that a body corporate is not precluded by subsection (6) from entering into a transaction at any time by reason only of information in the possession of an officer of that body corporate if -

(a) the decision to enter into the transaction was taken on its behalf by a person other than the officer;

(b) it had in operation at that time arrangements to ensure that the information was not communicated to that person and that no advice with respect to the transaction was given to him by a person in possession of the information; and

(c) the information was not so communicated and such advice was not so given.

Also, under subsection (8) a body corporate is not precluded by subsection (6) from dealing in securities of another body corporate at any time by reason only of information in the possession of an officer of that first mentioned body corporate, being information that was obtained by the officer in the course of the performance of his duties as an officer of that first mentioned body corporate and that relates to proposed dealings by that first mentioned body corporate in securities of that other body corporate.

3.4 LISTING REQUIREMENTS

The CMA prescribes that no person may offer its securities for subscription or sale to the public or a section of the public in Kenya unless, before the offer, it publishes an information memorandum and files a copy of it with the Authority.

Companies have the option of raising finance from the Main Investment Market Segment, the Alternative Investment Market Segment or the Fixed Income Securities Market Segment (for corporate and treasury bonds). Shares or bonds can be traded on the NSE (Nairobi Stock Exchange).

The listing of bonds or shares on the NSE is regulated by the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations 2002 (the Listing Regulations).

The Listing Regulations require a company seeking approval for offering securities to the public to publish a prospectus, to issue the prospectus free of charge to the members of the public, and to ensure that the prospectus complies with the detailed provisions set out in the Listing Regulations.

The Listing Regulations also set out in detail the eligibility requirements for a company to issue securities, which vary according to the type of security being offered and the market segment on which the securities are to be listed.

The Authority considers any applications for approvals of offers of securities to the public, taking into consideration any comments from the NSE.

To apply for the listing of securities on the NSE, a company is required to appoint a sponsoring stockbroker and notify the NSE.

The NSE has its own listing rules. It is through the sponsoring stockbroker that all applications, presentations and ancillary matters will be presented to the NSE.

The Listing Regulations do not apply to private offers (which are defined in the Listing Regulations), or to securities offered by the government or by entities that are not companies.

The most recent addition to legislation relating to listed shares in Kenya is the Central Depositories Act (the CDA). Under the CDA, a securities exchange can prescribe that a listed security is immobilized. Immobilized securities can only be dealt with using a securities account opened with a central depository (to date, only the Central Depository and Settlement Corporation has been approved as a central depository under the CDA).

The central depository is authorized under the CDS to appoint central depository agents (stockbrokers, banks and so on), through whom some functions are carried out.

The NSE has immobilized shares of all companies listed on the NSE. Partly due to this, trading of shares on the NSE has become more efficient, and trading volumes have increased, while at the same time encouraged investors' confidence in the Kenyan securities market due to transparency in dealings.

CHAPTER FOUR

EFFECTIVENESS OF THE LEGAL AND REGULATORY MECHANISMS

4.0 INTRODUCTION.

The Kenyan securities laws are designed to ensure the protection of investors in Kenya. There is a need to critically analyze the legal and regulatory mechanisms to find out whether they pass or even meet the set international standards in the international securities market, and whether they have been successful in promoting investors' confidence in the Kenyan securities market.

4.1 EFFECTIVENESS OF DISCLOSURE MECHANISMS UNDER THE CAPITAL MARKETS AUTHORITY

The Capital Markets Authority (CMA) has governed disclosure requirements in the securities market through the various subsidiary legislation, and the various regulations have had various impacts on the securities market.

Under *The Capital markets (Securities)(Public Offers, Listing and Disclosures) Regulations, 2002 (herein referred to as Regulations),* it is mandatory for a company seeking a public offering to publish a prospectus in the required format and disseminate it to the public for the public to make an informed choice about investing in the company. This requirement has enabled the CMA to effectively regulate transactions in securities by stock brokers and persons who acquire or dispose of securities in a securities exchange.

This has also enabled the CMA to regulate even those companies that are not listed, hence protected the investors from misrepresentation and false information given through the prospectus. This has in turn boosted their confidence in the securities market since they can get recourse from the persons liable for any information in the prospectus.

On the other hand, public corporations and parastatals established by an Act of parliament do not fall within the ambit of these regulations regarding prospectus.[35] This therefore means that an investor seeking to acquire securities in such corporations does not enjoy the protection from misrepresentation, and this has discouraged investments in such corporations.

By the dint of Regulation 10(2), the CMA provides a disclaimer for any liability concerning the contents of a prospectus , thus it is evident that the CMA only assumes a regulatory role and it has been argued that it does not assume the responsibility of ensuring the accuracy of the information disclosed. This has hence not offered investors the necessary confidence to invest in the capital markets.

General duty to disclose under Regulation 12(1) only relate to information within the knowledge of any person responsible for the prospectus or which could be reasonable for him to obtain by making inquiries. Thus, many makers of the prospectus who are

[35] Section 20 of the Regulations

accused of giving false information material to investment usually give the defence that certain information (which is correct and material to investment) was not within their actual information and this has been used to circumvent the duty of disclosure, making investors vulnerable to misrepresentation.

Disclosure obligations under *The Capital Markets (Investment) Regulations, 2002* have succeeded in regulating foreign investments in the country through adherence to the per centum reservations for both local and foreign investors.

The information required by *The NSE Listing Manual, 2002* to be disclosed on the issuer's prospectus for at least the current financial year has enabled potential investors to assess trade factors or risks which are not mentioned elsewhere in the prospectus and which are unlikely to be known or anticipated by the general public, thus improving investors' confidence in Kenyan securities market.

4.2 DISCLOSURE UNDER THE COMPANIES ACT (CAP. 486)

The object of the Companies Act is to compel a company to disclose in a prospectus all the necessary information which will enable a potential investor in deciding whether or not to subscribe for a company shares or debentures.

These requirements have cushioned the interested investors from fraudulent dealings that may result in the investors investing in a company that they do not have any profile of. This is because company documents are mandatorily filed with the registrar so that they effectively become public documents and open to the public for their perusal.

However, this is only a presumption that all the interested investors are able to go through the prospectus and comprehend by their own the matters and reports set therein. Very few of them do this and a majority just either uses the media publicity to invest in a given company.[36]

Under this principle, third parties who deal with the company are deemed to know the contents of the company's public documents and are deemed to appreciate its capacity. In reality, whereas persons whose livelihoods require them to digest the information contained in the prospectus may have the required inspiration, it would be unrealistic to expect the public to be equally motivated. There is a general consensus that investors seldom read lengthy disclosure documents.

Section 43 intended that the prospectus issued by companies be regulated through the office of the Registrar. This may not be the case especially on two grounds; firstly that there is no timeline set between the delivery to the Registrar and the issuance of the prospectus to the public; secondly, the Registrar may not have time to critically go through the whole prospectus noting every detail and ensuring that there is compliance. It could therefore mean that the Registrar is only meant to rubberstamp and register the prospectus without necessarily going through it.

It is understandable that the Registrar of companies may lack the necessary expertise to know every detail of the 'bulky' prospectus. This therefore hampers effective regulation of disclosure requirements under the Companies Act.

[36] A good example is the Safaricom IPO which was given too much media publicity until people even without any company profile leading to massive oversubscription.

The section also imposes a requirement that a copy of the prospectus must be delivered to the registrar for registration on or before the date of publication. It is not clear as to when a prospectus is deemed to have been issued to the public.

Under section 43(5) the penalty for non-compliance with the requirements of registering a prospectus is a fine not exceeding one hundred shillings for everyday from the date of the issue of the prospectus until a copy thereof is so delivered with the required documents endorsed thereon or attached thereto. Such a fine is 'a part in the back' since as a company there is very high capitalization as compared to the cash penalty imposed. This has left room for some companies not to comply with this requirement thus denying investors the necessary protection from fraudulent information in the securities market.

4.3 REGULATIONS AGAINST ILLEGAL INSIDER TRADING

Whilst possession of information may potentially occur without actual knowledge of the existence of the information, due to the requirements of other elements of the offence, it is unlikely to be proved without some form of actual knowledge of the information and its importance. Clearly, it must be demonstrated that a person had knowledge of the relevant information in order to satisfy the other elements of insider trading.

There are many circumstances in which information may conceivably enter a person's possession, the fact that the 'possession' element of the insider trading offence is not exhaustively defined has conceivably provided flexibility, thus denied investors equal opportunities while trading in the securities.

Secondly, this prohibition against insider trading does not necessarily apply for legal persons, such as companies. It is certainly possible that a company may be considered to be 'guilty' of insider trading where the person who possesses the information is not the person who trades, or procures the trading, in the relevant securities. Therefore a person accused of insider trading may not be the person who must 'have knowledge' that the information is price-sensitive and not generally available. Thus, the issues of proof which may apply where the accused insider trader is a natural person do not necessarily apply to corporate insider traders.

It is a well established general proposition that a person who acquires special knowledge or information by insider trading is free to exploit that knowledge or information for his own personal benefit but must account to his principal for the profit derived therefrom, this approach is limited to cases of definite fiduciary obligation, and thus persons with insider information but are not in any fiduciary relationships have succeeded in engaging unfair trading in the securities market.

4.4. LISTING REQUIREMENTS

Listing requirements obligating a company seeking approval for offering securities to the public to publish a prospectus, issue the prospectus free of charge to the members of the public, and to ensure that the prospectus complies with the detailed provisions in the listing regulations has successfully ensured that investors are fully informed about the issuer's profile thus enabled them make informed trading decisions.

The appointment of Central Depository Agents through whom some functions in the securities market are carried out has caused trading in shares in the NSE to become more efficient, and has in fact increased trading volumes due to improved investors' confidence in the Kenyan securities market.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.0 INTRODUCTION

Questions have arisen as to whether stock trading in securities market ought to be regulated through disclosure obligations. There is unanimity that some regulation is necessary.

Whereas Company Law facilitates enterprise by enabling investors in a separate corporate entity to limit their liability or loss to the amounts invested in the securities of the company; Securities Law provides the necessary requirements and criteria to be met before one makes a public offering and trades the securities in the securities market.

Additionally it makes securities fully marketable. It is argued that since the principle of maintenance of capital prevents companies from returning capital to members, there ought to be a market where securities are freely traded and investments disposed off. It therefore follows that the raising of business capital and trading or dealing in securities are the principle purposes of a public stock exchange. By making shares and other securities marketable, the stock exchange stimulates investments in companies, as well as in commerce and industry.

However for a stock exchange to operate efficiently there ought to be adequate liquidity. A sufficient number of transactions in securities enable day-to-day transactions at an appropriate price. The market price ought to be established on the basis of undisturbed supply and demand.

Regulations should therefore penalize attempts to support the price of a security artificially by misrepresentation or creating an impression of active trading. It therefore follows that holders of identical securities should be entitled to the same price for the securities.

Demand for individual securities ought to be appropriately eliminated by ensuring that the investors have access to full and timely information about the company through disclosure obligations to enable them make investment decisions at appropriate prices.

When securities are offered to the public, a prospectus or listing particulars ought to be issued freely providing a range of specified information to enable prospective investors to decide whether or not to apply for the securities.

Regulation ensures that companies honour their continuous obligations of disclosure to facilitate a flow of information to investors. The use by the company insiders of confidential information not publicly available to make an investment decision ought to be prohibited by making insider trading a criminal offence.

5.1 CONCLUSION

It is contended that if creditors cannot enforce against their parent wealth of major shareholders, then they need to assess how credit worthy the company in question is. They need to access a public register to ascertain who the owners and directors of the company are and obtain details of its financial position. Arguably therefore the price of limited liability is the burden of complying worth a mass of statutory disclosure requirements and the consequent loss of privacy.

The road to the establishment of an efficient securities market that will ensure investor confidence greatly is pegged on various factors. These factors are to be found in the various institutions involved in the securities market which include the CMA, NSE and CDSC both working as one mutual group.

The existence of a strong regulatory framework governing disclosure at the bourse market is essential to the creation of a credible capital market which is attractive to both investors seeking to find a legitimate place to invest their money, and issuers seeking to attract capital to support legitimate businesses.

The existence of credible rules must be supported by a vigorous enforcement program which has the ability to respond to misconduct in the market, and sanctions which will ensure the credibility of the market is maintained and deter the unscrupulous from abusing the market in dishonest and fraudulent schemes.

Potential disclosure regulations cannot be considered in isolation from other current or proposed legal, enforcement, governance, and regulatory elements in our country as well as other countries. These elements interact with, reinforce, and in some cases substitute each other.

Research shows that stringent regulations on disclosure are costly to firms, resulting in avoidance strategies; one of which is non-full disclosure of the information required by investors. Costs and benefits of disclosure regulation differ widely across firms and it is unlikely that a regulation and enforcement system can be designed to meet the needs of all firms. Therefore, a "one-size fits all approach" would likely impose significant costs on certain groups of firms.

5.2 RECOMMENDATIONS

Regulation of disclosure requirements for the securities market plays an important role towards maintaining the critical confidence of investors in investing in the market. Though there are some disclosure regulations, it is recommendable that the following additional recommendations be adopted to ensure a more efficient market.

a. Enactment of the Nairobi Stock Exchange (NSE) Act.

Enactment of the NSE Act will ensure the Exchange has powers to deal independently with the market players.

Inefficiency arises as a result of lack of laws that empower the NSE since every time incidents occur, the CMA and the NSE run parallel operations to solve problems.

Under the proposed Act, the NSE will be able to discipline its members and it would also be required to present audited quarterly financial statements that match international standards. The work of the CMA would then be to check how well the NSE is self-regulating.

The new regime will also allow shareholders to share profits;; which is currently restricted, while at the same time opening shareholding to the public under the demutualization process.

At the moment, the NSE shareholding is restricted to stockbrokers, dealers, investment banks, and authorized securities dealers.

b. Demutualization of the bourse market.

On 4th March 2010, the members of the Nairobi Stock Exchange approved a proposal for the demutualization of the market. Demutualization will enable the Nairobi Stock Exchange to effectively play its role in sustainably developing the Kenyan economy.[37] Demutualization will also transform the Exchange and position it to realize its vast potential and attain its vision.

The demutualization of stock exchanges is a recent new phenomenon in the economic world which means that till the early 1990s, most of world stock exchanges were non-profit, mutual organizations with monopoly power, owned by their members. It has been a common phenomenon that the owners of capital in the market are at the same time investors and clients, sharing the profits of the company in accordance with the level of their participation in the ownership. Due to changes especially in the world stock exchange trends, the market has to change the ownership organizational form.

[37] Under this arrangement, stock brokers would cede ownership of the bourse from 80 per cent and would be left with 25 per cent.

In general, the demutualization of stock exchanges would offer a certain range of advantages:

- Abolishment of the member's intermediation monopoly.

- A more effective and better response to the investors (direct and cost effective exchange access).

- Generation of required level of investments that offer the appropriate returns to their owners.

- Demutualization would lead to improved governance.

The CMA has published draft proposals meant to give powers to the NSE which will make the NSE a self regulatory organization.[38] This would free the CMA from the exercise by delegating authority to the NSE, which is better placed to police trading activity given the closeness between investors and the bourse.

The self-regulatory organisation shall promote investor protection, fair treatment of its trading or settlement participants, and devise appropriate standards of conduct for its members.

c. Ensuring sound corporate governance and disclosure.

The external drivers of good corporate governance are laws, rules and institutions that provide a competitive playing field and discipline the behaviour of insiders, whether managers or shareholders. With efficient capital markets, companies that are perceived

[38] John Gachiri; *CMA Seeks Proposals On Instilling Integrity*; Business Daily, 4th Feb. 2010 (pg 24)

to have poor corporate governance are punished in the market place with low share prices.

Public companies have a wider range of opportunities open to them than private companies. They may offer their shares to the public and their shares may be traded on the stock market. These offer benefits in terms of greater access to finance. But this comes at a price in the form of more rigorous regulatory obligations.

These tougher demands affect everyone connected with the company: the company itself, its directors, its shareholders and its advisers. For these, the Company Laws in most countries have additional provisions that apply to public companies which do not apply to private companies. The overriding policy is to build in special safeguards for investors.

Governance disclosures are mandatory disclosures about the relationship between a company and its directors. In Kenya, disclosure requirements covers related party transactions and also requires companies to state in the Annual Report whether they are in compliance with the governance guidelines of the regulatory authority (the capital Markets Authority).

However, it is recommendable that strictier measures on corporate governance and disclosures should be put in place and which are commensurate with the changing investment world.

d. Surveillance mechanisms.

The Capital Markets Authority (CMA) should put in place more stringent mechanisms of dealing with fraud at the market. Such mechanisms should include; reducing the market dominance of a few players, flagging out former employees accused of fraud and the launch of a surveillance system to keep tabs on peculiar trades at the bourse.

Also, the control of all licensed institutions should be prioritized to shatter the strangleholds that have led to market players running firms as personal businesses. A case in point is a vast number of brokerage firms in the Kenyan capital market whose owners are also managers in the outfits and the cartel-like behaviour among certain market players that has raised suspicions of insider trading.[39]

e. Anti-fraud Unit.

The Capital Markets Fraud Investigation Unit (CMFIU) was launched in March this year. The unit's top priority would be to complete investigations on past fraud cases that saw investors lose billions of shillings to stockbrokers and their staff.

This was on the basis of a forensic audit report carried out by PricewaterhouseCoopers (PwC) on Nyaga Stockbrokers revealing that there was much more to the collapse of the broker than just diversion of funds by the management. Collusion by other stockbrokers, the report said, played a part as well as fraud by staff.

The unit will also be drafting suitable strategies to manage risks associated with fraud through prevention, detection, and response mechanisms. The unit is part of CMA

[39]James Makau; *Capital Markets Regulator Moves To Curb Fraud At Bourse Market*; Business Daily, 11th March 2010 (pg 6)

efforts to deepen and widen its regulatory role aimed at restoring public confidence in the capital markets.

f. Increased Public Education

On top of the list of the CMA's agenda to restore investor confidence in the market, should be public education programs aimed at promoting an understanding of capital markets and how they operate. The Authority should aim at implementing a comprehensive and targeted investor education and public awareness programmes. This is due to a realization that investors' knowledge of the workings of capital markets has not been kept in pace with the changing economic trends.

g. Other remedies.

The Stock Exchange should consider other remedies that could be deployed without the intervention of policymakers. The following possibilities could be considered:

a) *The "name and shame" approach*: This involves publicizing the names of companies that fail to publish annual accounts on time, insider dealing cases and failure to observe listing and other stock exchange rules. The threat of publicity may scare enough directors to insist on regulatory compliance.

b) Directors should start signing a declaration assuming personal obligation for compliance with the listing rules at the risk of personal liability. They should also be required to complete a "fit and proper" declaration that is not validated by the regulator but is made public. This can cause considerable embarrassment where false declarations have been made.

c) Various mandatory disclosures associated with attendance at board and committee meetings, personal biographical details when standing for re-election.

d) Disclosure of the award and exercise of executive stock options.

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