Review Of The Regulatory Framework Of Insider Trading In Kenya

Introduction

Background

Dealing in shares in Kenya began with trading taking place on a gentleman's agreement with no physical trading floor. London Stock Exchange (LSE) officials accepted to recognize the setting up of the Nairobi Stock Exchange as an overseas stock exchange in 1953. In 1954 The Nairobi Stock Exchange, the country’s only securities exchange was established through registration as a voluntary association of stockbrokers under the Societies Act and was then incorporated as a company limited by guarantee. The Nairobi Stock Exchange (now referred to as the Nairobi Securities Exchange) was a mutual exchange owned by its members who acquired membership by owning seats on the exchange. The business was transacted by telephone and prices were determined through negotiation. After independence, the stock exchange continued to grow and became a major financial institution. The facilities have modernized since the original 'handshake over coffee' method of trading.

However, over the years, there have been concerns over inadequate regulation and weak corporate governance of the securities exchange. This has led to the NSE becoming a fertile ground for securities fraud, market manipulation and insider trading.

The term insider is normally used to describe people who have access to privileged information about the company by virtue of their relationship with the company that are not generally known to the public or the securities market. This information may be used by a person to gain profit by either buying securities at their present price before the information becomes public and causes the price to rise, or avoiding loss by selling securities at their present price before the price falls when that information is made public.

Insider trading can therefore be defined as the buying or selling of securities by a person who by virtue of their relationship with the company is reasonably expected to have access to unpublished information. The persons could be employees of the company, directors or any other persons connected with the company such as auditors, consultants, lawyers, analysts who possess material inside information that is not available to the public.

Dealings led by insiders, for example, directors, based on information that’s not public amount to a breach of the fiduciary duty owed to the company, which states that directors being the key leaders should act to the best interest of the company and not in their own interests. Fiduciary obligations incorporate the duty of good faith , duty to avoid conflict of interest and the rule against managerial opportunism. The obligation of good faith, expects directors to exercise their powers to the greatest advantage of the company while, the duty to avoid conflict of interest requires them not to position themselves in a situation where their interests may strife with the interests of the company.

In Kenya the law prohibits and criminalises insider trading under the Capital Markets Act. The

CMA made amendments to the Act to strengthen the laws on insider trading leading to the Capital market (Amendment) Act 2013. The Act made the offence a strict liability one where intent is not a requirement in proving the offence. The Act also gave the body more powers including freezing accounts of persons charged with the offence. This was due to the decisions in the Uchumi insider trading cases involving Mr. Terrence Davidson and Mr. Bernard Kibaru who were tried on allegedly using insider information to avoid losses and were acquitted.

To carry out investigation on securities fraud of a criminal nature such as insider trading, theft and employee pilferage, the CMA in partnership with the Kenya police established the Capital Markets Fraud Investigation Unit (CMFIU) in May, 2009. The primary role of the unit is to investigate securities fraud, identify the culprits and gather evidence for their prosecution.

Statement of the problem

A developed financial market is a major requirement in creating a vibrant financial sector. Kenya aims to achieve this goal. It is however threatened by market abuses such as insider trading. Such market abuses reduce investor confidence and render capital markets unattractive to potential investors which could lead to the loss of existing investors.

The main legislative framework on insider trading in Kenya is the Capital Markets Act as previously mentioned. The Act establishes the Capital Markets Authority (CMA) for the purpose of promoting, regulating and facilitating the development of an orderly, fair and efficient securities market. In fulfillment of its objective the Act provides for the regulation of market abuses such as insider trading and fraud. The Act expressly prohibits and criminalizes insider trading.

Insider trading regulatory framework is however plagued by various challenges. The first challenge is the disclosure obligations provided for in the Act are non-exhaustive and limited to issuers of securities that lack penalties to those who do not comply. Another challenge is in-exhaustive definitions of insider trading terms, such as ‘insider’, ‘dealing’ and ‘inside information’. The Act also lacks provisions on an enforcement structure compared to other developed jurisdictions, for example the US where the enforcement structure is clearly provided for.

The institutional framework on insider trading is plagued with inadequacies such as poor investor education, poor monitoring and surveillance techniques, weak whistleblowing system, and lack of an insider trading policy that can offer guidance on insider trading regulation. The most likely result of these challenges is the pervasiveness of insider trading and subsequently a lowered investor confidence.

Justification of the study

Given that the capital market plays a key role in Kenya’s economy and getting foreign investors to invest in the country it is imperative that hurdles to the attainment of a fair and efficient market are examined and rooted out through legal reform.

In view of this, the concerns that there might be loopholes in the legal provisions of insider trading ought to be studied and the relevant law subjected to reform. It is therefore anticipated

that this study will add to the body of knowledge that will inform the reforms in the existing regulatory framework.

Objectives of the study

The objectives of this study are:

1. To assess the efficiency of the existing regulatory framework on insider trading,
2. To scrutinize the extent to which the above-mentioned challenges impede successful prosecution of the insider trading offence and
3. Determine the lessons that Kenya can acquire from other jurisdictions with more effective regulatory frameworks on insider trading such as; the US and based on the discoveries, make recommendations for reforms.

Research Questions

1. How efficient is the current regulatory framework of insider trading in Kenya?
2. How do the challenges to regulatory framework impede the successful prosecution of insider trading?
3. What lessons can be acquired from other jurisdictions with more effective regulatory frameworks?
4. What reforms can be implemented to curb the offense of insider trading?

Theoretical Framework

The justification for criminalising insider trading is premised on the debate between the two schools of thought on insider trading. On the one hand, that insider trading improves market efficiency and on the other hand that it is a demonstration of a lack of market integrity. The main reason for criminalisation is to discourage insiders from obtaining an unfair advantage of inside information and obtaining profits from the lack of knowledge of the outsiders who don’t have access to the information.

Therefore, parties are held responsible for insider trading because of obtaining information in a fiduciary capacity, information which was intended for a company purpose and not for trading for personal gain.

Various theories have been propagated to explain the government’s regulation of the economy. We shall look at two main classes of theories of regulation on this study. The first class is the ‘public interest’ theories. These theories assume that regulators have sufficient information and enforcement powers to effectively promote the public interest. It also assumes that regulators are benevolent and aim to pursue the public interest.

It is generally assumed that all economic agents pursue their own interest, which may or may not include elements of the public interest. Under these assumptions there is no reason to conclude that regulation will promote the public interest. The theories that ensues from these latter assumptions is therefore often called ‘private interest’ theories of regulation. An example of the private interest theory is the ‘capture theory’. Espoused by an odd mixture of welfare state liberals, muckrakers, Marxists, and free-market economists, this theory holds that

regulation is supplied in response to the demands of interest groups struggling among themselves to maximize the incomes of their members. The economic theory, which at first glance seems as a refined version of the capture theory, propagated by George Stigler, is committed to the strong assumption that people seek to advance their self-interest and do so rationally.

However, we will explore the problem under study under the public interest theories as they best explain insider trading in the Kenyan context.

The public interest theory embraces the idea that people need protection from business abuses and market failures. The regulatory body is, therefore, considered to represent the interest of the society in general in which it operates rather than the private interests of the regulators. Richard Posner holds the view that regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market practices. The theory embraces the correction of market failures as the main reason for market regulation.

Research Methodology

The principal approach to this research is based on secondary data. In that regard, the bulk of the information is sourced from books, journals, law reports, physical libraries and electronic libraries. The library and internet research provide a background understanding of previous literature published on the subject which set the foundation for the study. The use of qualitative research helped in the analysis of the framework and its import to regulation

Literature Review

There is an apparent inadequacy in the literature regarding the regulatory framework of insider trading in Kenya. This is the chink this paper seeks to fill.

Gillian Mwaniki in his article ‘Effect of Insider Trading Prohibitions: Regulation on Security Market Returns in Kenya’ states that regulation of securities market is to primarily protect the investors, provide stability of the financial system and bring all the market players to a level playing ground. The security market is controlled by the government by creating rules, reforms, guidelines and regulations in response to the disruption in financial markets. These measures are expected to unfreeze markets and restore confidence in the financial system. The government regulates the security market to bring a level playing field for all the investors when accessing information on investment decisions. Failure to have equal access to information leads to market manipulation, corruption and insider trading profit-making. This issue affects negatively the stability of the market, market manipulation and price distortions which leads to an inefficient market.

Jacob Gakeri writes that Sub-Saharan African countries have yet to realize the benefits that accrue from securities markets. 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. It appears that most countries rushed to establish stock exchanges without taking note of the basic requirements of a thriving securities market. He goes further goes on to state that 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. He believes that 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.

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