REVIEW OF SECURITIES REGULATION

AfriCOG's comments on the draft Capital Markets Authority Regulations

Economic Governance Program

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OVERVIEW

The ability of an empowered CMA to carry out its supervisory and enforcement mandate effectively fosters public confidence in the securities industry. An effective regulator acts in the interest of the public and has processes that are open and accountable to the public and the regulated entities.

In 2008-2009, AfriCOG responded to a call for stakeholder input into the new proposed regulations developed by the CMA under the financial and legal sector technical assistance project. AfriCOG's response involved a study of the financial markets, with the capital markets as one of the sectors reviewed.

The general objective of AfriCOG's intervention was to contribute to the protection of the public interest and participation through improved institutional governance and accountability of all key players in the financial markets.

Some of the key challenges identified in AfriCOG's study of the capital markets sector include:

1. Low transparency and overall poor governance of stockbrokerage firms leading to their collapse and subsequent loss of investor funds.
2. Incidences of market manipulation/insider trading as evidenced by court proceedings.
3. Lack of adequate disclosure e.g. publishing of accounts and transparency in operations of regulated entities.
4. The Nairobi Stock Exchange (NSE) has undergone a period of depressed stocks, also known as a 'bear market', with many stocks trading at below listing price.
5. Unauthorised trading of client shares by stock brokers.
6. Latent conflict of interest/corporate governance concerns around ownership of regulated entities.
7. Lack of inter-agency cooperation and several overlaps, especially in the financial sector, have led to double licensing and uncertainties in the market.

There is a positive role and economic rationale for regulation in financial markets, more so where there are market imperfections and failures in financial sector players, for example, as seen in the collapse of Francis Thuo and Nyaga stockbrokers[1]. The creation of a properly regulated market does not only foster the growth of markets but creates an environment where competition and innovation can flourish.

[1]Llewellyn, D. (1999), The Economic Rationale for Financial Regulation, Financial Services Authority, London, Occasional Paper No. 1

Public interest theory proposes that the goal of regulation should be to maintain and protect the public good. Regulation of industry and organisation should protect and benefit all of society[2]

In reviewing the CMA regulations, AfriCOG attempted to gauge their effectiveness in addressing the challenges enumerated above. As a civil society organisation with governance as its area of focus, a number of concerns informed our comments and proposals:

- The need for transparency in the securities sector
- The need for accountability of the regulator
- The need for accountability of the regulatees
- Other public interest concerns

Comments and proposals on the securities regulation

It was noted that the proposed regulations were not accompanied by a background rationale. As such, they do not identify what mischief they seek to cure. It would be useful to provide backgrounds to each regulation and the entities subject to the provisions of such regulation so that their potential effectiveness can be properly assessed.

The regulations use of the term "reasonable", in several of the regulations, which, while it may be aimed at creating a level of regulatory flexibility, offers too much discretion to the regulated parties. For example, in disclosing information to the authority, a regulated entity may not find it "reasonable" to disclose information which may lead to its censure.

In addition, all regulations contain exemption clauses which could be abused to offer unfair advantage to certain players in the market. It is unclear in some of the regulations what criteria will be applied in offering the exemptions. In addition, the Authority seems not to be compelled to report on exemptions or to justify them.

In some instances, the imposition of penalties belies a targeted approach. For example, in the regulations, the penalties only seem geared to punish the regulated, and, with the exception of the CMA Act, little is said of the restorative capabilities of regulation to the victims of regulated entities' malfeasance.

[2] Deegan, 2005; Stigler, 1971 as quoted in On Foxes Becoming Gamekeepers: The Capture of Professional Regulation by the Australian Accounting Profession

The corporate governance regulations, while well intentioned, are couched as guidelines rather than regulations. The overall effect is that they appear aspirational and seem to leave a large margin of discretion to the market intermediaries. There is also a lack of adequate reporting requirements on corporate governance structures of the regulated entities.

In the absence of proper guidelines and increased capacity at the regulator, increased reporting requirements may defeat the aim of making targeted information available to the regulator and instead lead to blind reporting.

In conclusion, it would also be crucial for the CMA to examine the cost implications of the new regulations. With the degree of increased reporting required, a significant level of in-house personnel with a broad range of skills including economic, legal, financial, and accounting, among others, will be necessary to ensure efficient management and processing of the information received. Without this, increasing the burden of reporting may prove to be an exercise in futility.

Below are more detailed proposals and comments on the draft regulations. They cover the following areas:

1. Draft Securities Industry (Continuing Disclosure Obligations of Issuers) Regulations 2009
2. Draft Securities Industry (Advertising) Regulations 2009
3. Draft Securities industry (Public Offers) Regulations 2009
4. Draft Securities Industry (Disciplinary Proceedings) Regulations 2009
5. Securities Industry (Takeovers) Regulations 2009
6. Securities Industry (Licensing) Regulations 2009
7. Securities Industry (Investor Compensation) Regulations 2009
8. Central Depositories Amendment Act 2009
9. Capital Markets (Corporate Governance) (Market Intermediaries) Regulations 2009

1. **DRAFT SECURITIES INDUSTRY (CONTINUING DISCLOSURE OBLIGATIONS OF ISSUERS) REGULATIONS 2009**

Section	Comments	Proposals
Part II **General Obligations** **4(2)** "Impending developments"	it is not clear what developments may require this dispensation.	Clarity should be provided on the definition of "impending developments".
Information to accompany directors' report. **6 (c)(ii)**	This sub section places far too much discretion on the directors to decide which information of its subsidiaries to release.	This section should be scrapped.
6 (d)(i)(ii) to the standard for a reasonable enquiry	Uncertainty as to the standard for a reasonable enquiry. For example, in the event that a director's interests are tied in companies or proxies, would that be deemed reasonable enquiry?	A greater standard should be set for the statements of directors' direct and indirect interests. The above would ensure that conflicts of interests are clearly defined.
Interim Reports **7 (2) (m)**	Low standard of reporting.	Higher standards in respect of the interim reports.
Transactions **8**	Definition of the word "associate" is vague and open to broad interpretation.	Replace with: associates, affiliates or related parties.
13 Duty of substantial shareholder to disclose shareholding	Unclear to whom disclosure is owed, the issuer or the Regulator?	Clarify to whom disclosure should be made.
17 (d) ii) Periodic information for members	The provision neglects to address consolidation of shares.	Include consolidation of shares as well as share splits.
18 Meetings of the board of directors	10 days stipulation to release results may not avail enough time for the authority to effectively monitor trading of shares before full announcement	Increase reporting time.

2. DRAFT SECURITIES INDUSTRY (ADVERTISING) REGULATIONS 2009

In our view, the overall aim of advertising is to provide information to stakeholders. Consequently, the information must not be:

1. False
2. Misleading
3. Aimed at creating imbalance in securities concerned or destabilising the market.

Section	Comments	Proposals
3 Regulated persons	Financial institutions offering loans for purchase of security-related investments are not included under "regulated persons", yet they play a key role in investment advertising.	Include financial institutions and any other institutions advertising security investment in a stock exchange that falls under the ambit of the Authority.
4 Exceptions	In the last few years, the Government of Kenya has been the largest issuer of shares by way of IPO. Exempting the Government wholesale while not providing other guidelines on government advertising seems to be providing far too much leeway. In addition, there may be need to further justify exemptions of foreign central banks of any country or territory.	This particular clause should be redrafted to ensure that the exemptions do not limit adequate disclosure.
Schedule		
Omissions	It is crucial that information relied upon by investors offers no opportunity for detrimental interest to the individual relying on it.	The Advertisement shall not omit material facts which may cause persons to rely on the stated facts in ignorance of the omissions.

3. DRAFT SECURITIES INDUSTRY (PUBLIC OFFERS) REGULATIONS 2009

Section	Comments	Proposals
1. Citation	It is not clear whether the issue to be dealt with is prospectuses or public offers. It may be that it is combined with other regulations.	Clarity in regulation description.
2. Interpretation	Lack of background information or reasons for the enactment of the regulations which would aid interpretation of the regulations.	Clause 2 should include the statement "it is unlawful to request admission of transferable securities on a regulated market unless an approved prospectus has been made to the public". The aforementioned prospectus must first be approved by the regulator. Failure to do so should result in penalties.
3. (1) (a Form and content of prospectus)	The inherent risks of the organisation should be clearly highlighted.	Clause 3(1)(a) must include inherent risks in addition to financial positions.
3 (3)The information in a prospectus shall be presented in as user friendly and comprehensible a form as possible	The phrase "user friendly" may not lead to accessibility of information to the public.	Clause 3(3) include requirement of non-technical language.
3 (4)	The prospectus should include a summary.	A summary of the key issues should not only be be included, but presented in an accessible form, giving guidance on the format of the prospectus, for example, whether it is a single prospectus or

		whether there are other documents that different but related concerns.
3 (4) Omission from prospectus	Clarity needs to be provided on the omission provided in Clause 4. Is it a like for like for information?	Exclusion of information should be dependent on like for like substitution, or where no change has occurred, on previously dated information.
4 (1) (a) Exceptions	"Public interest" needs to be defined or situations where it is in the public interest not to disclose information. In addition, insiders of the issuer must not be able to use such information to the detriment of new subscribers or for their personal benefit.	Scenarios to illustrate where exceptions may apply should be included.
4 (1) (c) Disclosure of information that would be seriously detrimental to the issuer.	The concealing of information which may be deemed detrimental to issuer should not negate the public interest.	The clause should be rephrased to read, "provided that the omissions would be unlikely to mislead the public with regards to any facts or circumstances which are essential for an informed assessment."
Schedule		
Part 1 **General requirements** **5 & 6**	Possible conflict with advertising regulations schedule 5 that states that no investment advertisement shall contain any matter that states or implies that the securities investment has been approved by any government department or by the authority.	Clause 5 & 7 should be combined to ensure that while the statement may be a requirement, the disclaimer is also a requirement. Consider reviewing the advertising regulation in instances where approval is a procedure for the listing.

Part 111	A clear description of the allocation criteria under the various segments of applicants.	Separation of the classes of investors and their allocation criteria should be inserted.
Part IV **40**	In the event that the offeror is unable to ascertain persons who directly or indirectly, jointly or severally exercise control over the issuer, the offeror/issuer has to declare the same in the prospectus.	The following phrase should be included: if for whatever reason, the offeror is unable to identify such persons, a declaration shall be made in the prospectus.
Part V **The issuers Principal Activities** **44**	Use of the word "threshold" as a significant yet non – specific word.	A threshold limit should be specified e.g. 20percent of issued shared capital whether from own funds or borrowed capital.
45.	A declaration should be made as to whether provisions have been made to cater for future liabilities.	Current assets should not be included in reporting provisions for future liabilities.
Part VII **53.**	Profits forecast cannot predict all externalities that may affect future performance.	Profit forecasts should nonetheless be prominently displayed in the prospectus.
59	Where lock down clauses on current shareholding have been placed by the authority, the duration and conditions should be stated in the prospectus.	Lock down clauses or agreements should be included in the prospectus where they exist.

4. DRAFT SECURITIES INDUSTRY (DISCIPLINARY PROCEEDINGS) REGULATIONS 2009

Section	Comments	Proposals
2. Interpretation	The Misconduct Section mentioned is non-existent.	A misconduct section should be included instead of merely providing a linkage to the main Act.
3. Institution of disciplinary proceedings	The section omits incidences	The following should be considered for inclusion. 3 (d)Affects the stability of the market.
5 (1) Appointment of Disciplinary Committee	Selection of the panel is the prerogative of the Authority and no expertise is specified. For example, the UK financial services' equivalent to the disciplinary committee, the Regulatory Decisions Committee (RDC), comprises practitioners and non-practitioners, who all represent the public interest. It also ensures that the FSA staff who handle cases before they go to the RDC will not be involved in the RDC's decision making.	A more independent process should be ensured and clearer guidelines on the experience required and the selection process be elaborated. This should also be combined with Clause 7 (2) and the mandate clearly spelt out as acting in public interest.
6 Revocation of appointment to DCP	The independence of the Disciplinary Committee Panel (DCP) is not protected and this may hinder its operations if members can be	The Disciplinary Committee Panel is accountable to the CMA board for its decisions and is separate from the CMA's executive management structure. Apart from the Chairman, none of the members of the DCP should be employees of the CMA.

	dismissed at the whim of the Authority. There is no guidance in cases where a member of the panel may have a conflict of interest on a particular matter.	The following inclusion should be made: all members of the DCP are appointed for fixed periods by the CMA Board. The CMA Board may remove a member of the DCP, but only in the event of that member's misconduct or incapacity. There should also be an inclusion to the effect that the DCP staff are separate from staff involved in conducting investigations and making recommendations to the DCP. A section should also be included requiring a panel member to disclose any conflict of interest to the DCP.
9. Majority decision	It seems odd that decisions in the event of a deadlock should be adjudicated in favour of the regulated person. This provision will greatly hinder effectiveness of the disciplinary committee. The interests of the regulated persons are protected by their ability to appeal to the tribunal and this provision is therefore not necessary.	This regulation should be scrapped and it should be ensured that all rulings are by majority. As such, the disciplinary committee should comprise an uneven number of members.
14. Admission of Charges	The notice given of two days prior to hearing is very short.	The time limit for admission of charges should be increased to lead to a faster dispute resolution process.
16 & 17 Burden and Standard of proof	The acceptable standard of proof in some processes is not	The system of adjudication involves flexibility of evidence and thus should not be restricted by court admissibility.

	clear - hearsay may be inadmissible in civil court proceedings.	
18. (b) Conduct of hearing	Regulated persons have excessive leeway in proceedings.	Consent of the regulated entity should not be required where the Committee feels that written evidence is crucial to the determination of the matter.
18. (generally)	There is no guidance as to how the Committee will decide to take action or not.	The possibility of including a list of contributing factors should be included in this section, i.e. did the regulated person take all reasonable precautions and exercise "due diligence"
20. Penalties	A general introduction into this section may be useful.	The introductory passage should elaborate the purpose of this section in allowing the CMA to achieve its regulatory objectives. For example, "the principal purpose of imposing a financial penalty or issuing a public censure is to promote high standards of regulatory and/or market conduct by deterring persons who have committed breaches from committing further breaches, helping to deter other persons from committing similar breaches, and demonstrating generally the benefits of compliant behaviour."
	Again, there is no guidance as to how the Panel will decide whether or not to take action.	A sub-section outlining a non-exhaustive list where action may be taken should be included, i.e. (i) The nature, seriousness and impact of the suspected breach; (ii) The conduct of the person after the breach; (iii) The disciplinary record and compliance history of the person, etc
	Further guidance is required as to the appropriate level of	The level of financial penalty imposed should be informed by: effective deterrence; the nature, seriousness and impact of the breach; the extent to

	financial penalty.	which the breach was deliberate or reckless; and the financial resources of the person on whom the penalty is being imposed, amongst others.
22. Costs	The fear of getting costs awarded against it need not be a deterrent to CMA operations.	With the exception of frivolous actions parties to the proceedings should bear their own costs.
23. Alternative dispute resolution (Mediation)	In addition to the above comments, the regulations offer no suitable alternative dispute resolution process which may assist the CMA in resolving disputes.	An alternative dispute resolution process which will in turn offer incentives for the speedy resolution of disputes and settlements with regulated persons should be included.

5. SECURITIES INDUSTRY (TAKEOVERS) REGULATIONS 2009

Section	Comments	Proposals
Part II, 4 **Equality of treatment**	It may be useful to have general guidelines stated at the outset. See UK Takeover Code. A clause stating who is subject to the regulations would also be useful.	An introduction on the purpose of the Section should be inserted, i.e. "to ensure that shareholders are treated fairly and are not denied an opportunity to decide on the merits of the takeover and that shareholders of the same class are afforded equal treatment by the offeror".
5 (b) Take over offer		The following should be included: "If the offer, or approach with a view to an offer being made is not made by the ultimate offeror or potential offeror, the identity of

		that person must be disclosed at the outset".
6 Confidentiality	This section is too brief, considering the vital importance of secrecy/confidentiality.	This section should be strengthened and given greater emphasis.
47, Waiver by Authority	"Exceptional circumstances" is not defined.	The following should be inserted: "when the Authority is of the view that an exemption will be in the interest of the parties and there is no detriment to public interest, it may issue a waiver on some provisions of the regulations.

6. SECURITIES INDUSTRY (LICENSING) REGULATIONS 2009

Section	Comments	Proposals
Part II Licensing (5)(4)	The regulations do not contain provisions that would enhance transparency in licensing, especially regarding the decision process.	Clear guidelines should be provided establishing process, timelines and, where applicable, appeal procedures. In addition, a provision outlining reporting of the volume of applications received by the CMA, as well as the number of rejections for licensing should be included.
26 Acquisition of Controlling Interest in stockbroker	While the regulations make provision for the acquisition of a stockbroker, they place no restrictions which would prevent monopolistic behaviour by investment banks.	CMA should carry out adequate oversight of acquisitions to ensure fit and proper procedures as well as a competitive capital market.

Central depositories	While the depositories are also licencees, they are not included in the legislation (although they are covered in central depositories regulations).	Central depositories should be included in the Licensing Regulations

7. SECURITIES INDUSTRY (INVESTOR COMPENSATION) REGULATIONS 2009

It is not clear which legislation the Act is linked to - S 115, S 114 of the Act.

8. CENTRAL DEPOSITORIES AMENDMENT ACT 2009

Section	Comments	Proposals
4 Grant of License	There is no specific timeline for the license granted: "A central depository license shall be granted for a continuous period".	Specific timelines and processes of extension/re-application should be stipulated.
5 Determination of Fit and Proper	There is no minimum level of qualifications outlined in this section. The UK FSA offers main assessment criteria for ensuring that an individual is fit and proper including but not limited to: competence and capability, honesty, integrity, and reputation.	The following criteria should be included: "the applicants should not have been the subjects of disciplinary actions by the Authority"

8. CAPITAL MARKETS (CORPORATE GOVERNANCE) (MARKET INTERMEDIARIES) REGULATIONS 2009

Section	Comments	Proposals
Part II, The Board	"there shall be at least one director who is not related to the other", clearer definition of 'related' required, i.e. associates, familial relation, etc.	The following clarification should be included: There shall be a minimum of two non-executive directors. However, the intermediary shall have a proportional number of non-executive, independent directors relative to the size of the board.
	Specific requirements of disclosure of corporate governance structures to the authority	Implementation reporting requirements should be included.
	Fit and proper persons test for the board members	Minimum criteria highlighted should go beyond age limit and ensuring that persons are "fit and proper". Board members should be knowledgeable on management systems.