

TOPIC: GOING PAPERLESS: A GENERAL OVERVIEW OF THE
LEGAL FRAMEWORK GOVERNING THE ESTABLISHMENT AND
OPERATION OF A CENTRAL DEPOSITORY SYSTEM

By

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DECLARATION

This dissertation is my original work and has not been presented for a degree in any other university.

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This dissertation has been submitted for examination with my approval as a University Supervisor.

.....

MR KARIUKI RICHARD

DEDICATION

I dedicate this work to my parents for all the sacrifice they have put themselves into to see me go through school.

To my small sister, Mercy-your serene and cheerful way of looking at life inspired me a lot.

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ABSTRACT

This study is concerned primarily with the general regulatory measures for an efficiently run central depository system for a growing capital markets. The paper is divided in to four chapters.

Chapter one gives a general introduction of the topic. It also defines, states and explains the functions of a CDS while exposing the challenges faced in the implementation process.

Chapter two does focus on the legal measures put in place to ensure the implementation, efficient operation and sound administration and sustainable running of the CDS. This chapter evaluates the efficacy of the legal measures in protecting investors and providing necessary investor confidence.

Chapter three is a comparative study of the legal framework in place in Pakistan and Bangladesh securities market and the lessons to be learnt by the Kenya from the two countries.

Chapter four gives a general summary and conclusion and recommendations drawn from the findings in this study.

TABLE OF STATUTES

KENYAN STATUTES, RULES AND REGULATIONS

1. Capital Markets Act, Cap 485A
2. Central Depositories Act, 2000
3. Internal Loans Act, Cap 420
4. Banking Act, Cap 488
5. Central Bank Act, Cap 491
6. The Capital Markets (Collective Investment Schemes) Regulations, 2001
7. The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002
8. The Capital Markets (Licensing Requirements) (General) Regulations, 2002
9. The Capital Markets (Takeovers and Mergers) Regulations, 2002
10. The Capital Markets (Foreign Investors) Regulations, 2002
11. The Capital Markets Guidelines on Corporate Governance Practices by public Listed Companies in Kenya
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PAKISTAN STATUTES, RULES AND REGULATIONS

1. Securities and Exchange Ordinance, 1969
2. Securities and Exchange Commission of Pakistan Act, 1997
3. Central Depository Companies (Establishment and Regulation) Rules, 1996
4. Central Depositories Act, 1997

BANGLADESH STATUTES, RULES AND REGULATIONS

1. Securities and Exchange Ordinance, 1969
2. Securities and Exchange Commission, 1993
3. The Central Depository Act, 1999
4. Depository (User) Regulations

ABBREVIATIONS

- CDS: Central Depository System
- CMA: Capital Markets Authority
- CDA: Central Depository Act
- CBK: Central Bank of Kenya
- ASEA: African Stock Exchange Associations
- FESA: Federation of European Securities Exchanges
- WFE: World Federation Of Exchanges

CHAPTER 1

1.0 INTRODUCTION

In this chapter I will define and explain what a Central Depository System (CDS) is, outline its functions, explain its operation and the advantages expected to accrue from its implementation. It is also expected that I will evaluate the efficacy of the current system of manual transfer of shares pointing out the imperfections and weaknesses. The implementation process of the CDS has been dogged by many problems and challenges. These challenges will be put forth latter in the chapter. I will also give a general overview of the legal framework with a special emphasis on the ones governing the depository system specifically and the capital market generally. The introduction will seek to establish the interplay between, the capital market, the central depository system and the law. It will endeavour to explain the role of law and regulations in form of legislations for an efficient capital market.

The purpose of this study is to examine the nature, function and rationale for the Central Depository System (CDS) and examine the legal and regulatory framework in place for the effective growth and smooth operation of the same. It will be one of my main aims to show and prove the important role played by the depository in the growth of the capital market in Kenya. This chapter in a nutshell introduces the extent and content of my research. The setting up of central depositories was proposed by the Group of 30¹ to facilitate the settlement of stock trades through the electronic book entry transfer.

The tracing of the development of the securities market from the elementary legislations enacted during the colonial era, to the more elaborate and detailed Acts of parliament enacted in the post-colonial era, will seek to shed more light to the efficacy and efficiency of the regulatory framework in place in controlling, checking and guiding the securities market. This will be undertaken in a general manner in this chapter as it is envisaged that it will be critically examined at a subsequent chapter.

¹ This is an organisation sponsored by central banks and investment banks.

Lastly, the chapter will deal with the development of the securities market in Kenya from the time of the introduction of physical transfer of securities or manual system to the introduction and eventual implementation of the depository system. In the same vein it is intended that I will delve into the role to be played by the depository system when it is eventually implemented.

Over the last fifteen years the capital markets in emerging markets have been growing rapidly. This is true of such markets such as Bangladesh, Pakistan and India. Kenya's securities market has not been left behind. The Nairobi Stock Exchange (NSE) has grown to such an extent that it is now recognised as one of the leading stock exchange in Africa. The growth in the volume of securities dealt with at the stock exchange has not been at the same pace with other facilities necessary for the smooth operation of the exchange. This can be seen from the fact that currently there are 47 companies being listed on the NSE. The domestic capital market has remained underdeveloped. Since 1982 the government with the help of International Finance Corporation (IFC) has been looking at ways and means of making the stock exchange meet the challenges of an ever-growing capital market².

The capital market in Kenya has for a long time been characterised by few listed companies, low levels of capitalisation, low market turnover, general lack of investor education, inappropriate regulatory framework and lack of goodwill on the part of market players. These problems need a cure. The CDS has been proposed as one of the main ingredients for the cure of the painstaking delays involved in the trade of securities in the Exchange.

The CDS to be able to perform at the optimal level requires a legal framework to act as a guide and also to give it validity and legitimacy in order to be accepted by the players in the market. Also, the shareholders in order to have confidence in such a new system require it to be backed by law. This is because the shareholders have confidence in the current manual system in protecting their beneficial interest since they are the ones who have the custody of share certificates. The Government of

² This can be seen from the IFC/ report of 1984.

Kenya in order to allay such fears and also to give validity to the operation of the CDS passed the Central Depository Act (CDA) in 1 June 2000.

The capital market in Kenya is governed by various pieces of legislation. The main Acts being: The Capital Markets Act (Cap 485A), Central Depository Act 2000 (CDA), Central Bank Act, and Banking Act. The Capital Market Authority created under Cap 485A has led to the enactment of various Rules to facilitate the operation of the capital market. These include: Central Depositories Rules 2004; Capital Markets (Licensing Requirements) General Regulations 2002; Capital Markets (Securities) Public offers, Disclosures Regulations 2002; Capital Markets (Takeovers and Mergers) Regulations 2002; Capital Markets Authority Fees Structure 2002; Capital Markets Authority Foreign Investments Regulations 2002 and Collective Investment Schemes Regulations 2001.

1.1 WHAT IS A CDS?

Simply stated, a central depository can be compared to a bank. A central depository holds shares of shareholders in book entry form. Thus, it acts like a bank of shares. By depositing share certificates into a central depository, the delivery of shares in settlement of a transfer of shares executed between a seller and buyer can be easily achieved with change of records in the central depository instead of physically exchanging certificates, as has been the case hitherto³. The CDS is an electronic book entry system to record and transfer securities. In this system change of ownership of securities is achieved without having to physically move certificates or execution of transfer deeds, as is the case in the current physical mode of operation.

1.2 FUNCTIONS OF A CDS

The CDS plays a central role in the capital market since it acts as a conduit of securities transfer. When fully operational it will be expected to perform certain functions and provide certain facilities. These include:

- Immobilization of physical certificates where certificates deposited are held in a single batch and not desegregated to individual shareholders;

³ www.nse.ke.co (accessed on 24 June 2004).

- Withdrawal of deposited share certificates by the owners whenever they wish;
- Transfer of shares through entries in the CDS accounts;
- Settlement of trades executed at the Exchange;
- Procedures for mortgaging of shares as security for loans;
- Receipt for onward transmission to the shareholders of entitlements such as dividends, rights, etc from the listed companies⁴.

1.3 TYPES OF CENTRAL DEPOSITORIES

The classification can be approached in two main ways/perspectives. One can classify them from the perspective of existence of physical certificates and the other from a functional perspective.

- Physical certificate perspective: Under this classification there are two types:
 - Dematerialized: Shareholders are not issued with certificates at all and all changes in ownership are recorded in the electronic book entry;
 - Immobilized: Change of ownership is also by electronic book entry but the companies issue physical certificates that are held under the custody of the depository.
- Functional perspective: Under this system various systems are found depending on the particular stock exchange:
 - There are those that only provide depository services where shares are deposited, transferred and withdrawn.
 - There are also those others that provide additional services such as share administration.

1.4 ADVANTAGES OF A CDS

The introduction of a CDS will bring forth many advantages to the capital market.

These advantages include:

- There is immediate transfer of shares pursuant to trade since change of ownership is effected by a change in the entry book in the electronic record;

⁴ Ibid.

- The mere fact that shares are held in the depository gives shareholders some sense of safety from theft and misplacement;
- There is reduced risk of mutilation, theft or loss of shares;
- There is also reduced need for space to store shares held in physical certificates as this is now held in electronic entry form;
- CDS also reduces delays occasioned in the physical transfer of share certificates from one shareholder to another through the company;

1.5 CURRENT SYSTEM OF SELLING SECURITIES

The transfer of securities is by use of the manual system whereby physical certificates are exchanged from seller to buyer through the company. The transfer of ownership of shares between seller and buyers has therefore been effected through a process of executing transfer agreements between sellers (transferors) and buyers (transferees), verification of seller's bona fide ownership of the shares with the companies, then followed by payments and lastly by cancellation of seller's certificates by companies and issuance of new certificates to buyers. That is to say, for a shareholder to be able to sell his shares, he must possess a physical share certificate issued to him by the company⁵. The current holder of such securities is required to take them to the company physically so that the transfer to the new holder can be effected. This system has the advantage of giving shareholders a sense of security since they themselves hold the share certificates and hence do not worry as to their beneficial interest.

The physical handling of securities has with time encountered a myriad of problems in effecting transfers. These include:

- There is the risk of loss, mutilation or theft of physical certificates;
- There is delay and waste of time involved in the process of physical movement of certificates from seller via company to new buyer;
- There is increased volume of book keeping;
- Increased volume of paper work;
- There is also risk of forgery and wrong deliveries;
- Large space is needed to store and for safe custody of certificates;

⁵ www.nse.ke.co (accessed on 24 June 2004)

1.6 HOW FAR HAS THE IMPLEMENTATION PROCESS GONE?

In order to avoid the problems associated with physical handling of certificates the NSE is in the process of implementing the CDS. This is aimed at reducing if not eliminating altogether the aforementioned problems. The CDS is expected to be in place by early October 2004. The CDS is usually carried out by a public company incorporated for that purpose. The Central Depository and Settlement Corporation (CDSC) was incorporated in 1999 to carry out the function of running a CDS. The CDSC is meant to take over the Delivery and Settlement function from the NSE. This is the function that was to be converted into an electronic system. The CDA was passed on 1 June 2000 and came into effect on 14 May 2003. Since then much has been done to bring about the operation of the CDS. There has been the enactment of various rules and regulations either by the Capital Markets Authority (CMA) being the regulatory body or by the CDSC from powers granted to it by the Capital Markets Act and CDA.

1.7 CHALLENGES FACED IN THE IMPLEMENTATION OF THE CDS

In the last five years the CDSC has been involved in activities geared towards the establishment and operation of a CDS. *In the process many obstacles have been encountered.* Some of them are in respect of the legal, institutional and regulatory framework while others have to do with lack of technology and technological know how. The main challenges faced include:

Technology: Introducing the technology has been a major problem due to lack of knowledge and expertise to run the same. Also, the technology has to be sourced from outside and this brings in the element of high cost. In addition the players in the market have been against introduction of new technology. This is mainly due to fear of change.

Legal framework: Putting up a legal framework in place has taken quite a while. It took three years from the passing of the CDA before it came to force and thus the

CDSC during that time was operating outside the legal framework. The smooth operation of a CDS requires some Rules and regulations. Some of which are still in the preparatory stage and thus holding back the implementation process. The CMA and NSE have been commendable in the fast way in which they have tried to come up with the various rules and regulations to attain the much-cherished CDS.

Conflict in the regulatory laws: There are several Acts which deal with different aspect of securities market such as Central Bank Act, Banking Act, Capital Markets Act and CDS. There is an overlap in term of Acts and Regulations dealing with the same things. This hinders smooth operation of CDS. In other cases such as the Central Bank, trading in government securities has been taking place for about eight years in a manner similar to the depository without the legal framework and thus bringing this in congruence with the central depository may create new problems.

Managing the change: Players in the stock market have been against change. This has been the greatest problem since if the players do not agree to play the game with certain rules then the game cannot even start. The main people who have been against the depository have been the stockbrokers. They have seen it as a way of reducing their revenue. The shareholders on the other hand have been very skeptic towards the new system since they are more conversant with the physical system and this creates a lot of mistrust between the CDSC on the one side and shareholders and stock brokers on the other hand.

Investment habits of Kenyans: The general public has not fully appreciated the Stock Exchange as a market. Some people have been known to buy shares only to proceed to frame the share certificate and hang it on the wall in their house for the rest of their lives. Such habits inhibit the growth and optimal utilization of the CDS. Also many Kenyans lack a basic knowledge of the capital market and thus do not see it as an alternative place to invest and thus only deal with the traditional system of putting all their money in the bank for safe custody.

Problem of the Act: Section 15 of the Act provides for trading in both manual and electronic system during what it calls the transitional period without defining it

clearly. This does not give a bonus to the electronic system since people may continue to trade in manual system demanding physical certificates.

Stock Exchange as a shareholder of the Central Depository: This is a very serious drawback. The CMA envisages setting up of more than one Stock Exchange. These may eventually establish their own depository and thus the Stock Exchange will have to be a shareholder of these depositories also. The CDA allows the setting up of many depositories if granted approval by CMA. The Exchange is expected to buy some shareholding in all such depositories.

1.8 RELATIONSHIP BETWEEN THE CAPITAL MARKET, THE CDS AND THE LAW

The capital market has the role of providing investors an opportunity to invest in areas of their interest as well as an equal opportunity to divest and exit from a certain market. This is achieved by providing investors with an opportunity to sell their securities. The main vehicle used to achieve this is the stock exchange. The ease with which one can either buy or sell securities is paramount if investors are to be afforded the opportunities aforementioned.

In the last half a century, the NSE has been operating a physical or manual system of transfer of securities. This means that transfer of such securities is unduly delayed and thus at the present moment it takes T+8 days for a transfer to go through. This means that after trade in securities it will take eight days for the transfer to take effect. This period is unnecessarily long. It needs to be reduced significantly.

The CDS when implemented is expected to reduce the time it takes to transfer securities to T+5. This period can still be reduced further should the CDS be run professionally and efficiently to eventually when our capital market becomes as established as the one in New York. The basic international standard is T+3. In T+5 cycle one has until 6 days to deliver and pay. The seller delivers the certificate in T+4 and change of ownership takes place in T+6.

In order for the anticipated changes to fully take effect, there is need for a legal framework. This will ensure that the market operates as efficiently as possible due to the checks and balances put in place. The law must come in to ensure a level playing field and foster the development of depositories systems. The law gives validity to the actions of players in the capital market. Various laws have been passed to regulate the securities market. These will be discussed in detail in the next chapter.

1.9 INTERFACE BETWEEN THE NSE AND CDS

Traditionally, the NSE undertook both the trading function and the delivery and settlement function. The CDS is expected to take over the delivery and settlement function from the NSE. This means that the NSE will only carry out the trading function. Once shares have been traded the rest will be the work of the CDS. The delivery and settlement function encompasses paying up for shares traded on the floor, exchange of ownership and issue of certificates in the name of the new owner. Thus, the NSE will no longer be concerned with the function of taking the share certificates to the registrars - delivery and settlement will no longer be its function. This separation may create some friction between the CDS and the NSE. Such friction may lead to untold delays and inefficiency in the securities market. The law comes in to solve the problems that could arise. The CMA formulates rules to guide trade in securities as well as being a regulatory body charged with the responsibility of ensuring smooth and efficient operation of the capital market.

The old method of going to the registrar to verify will be done away with. Brokers will do this. Hence, as NSE sells securities, the CDS will be capturing the data and entering the same in the electronic book. This makes the selling of securities to be faster and efficient. In implementing the dematerialisation process, the investors may want to know how their beneficial interests will be protected. To realise this the law comes in to provide the necessary protection to investors. It is this law that will give shareholders confidence to invest and exit from a market that I am concerned with.

1.10 RECENT DEVELOPMENTS

The Authority over the last ten years has implemented specific measures to re-organise and strengthen the Nairobi Stock Exchange, build its own internal capacity, facilitate emergence of a number of capital markets institutions and seek to promote new vehicles to mobilise savings in financial assets⁶.

In 1980 the Kenya Government realized the need to design and implement policy reforms to foster sustainable economic development with an efficient and stable financial system⁷. In order to achieve this aim, the government emphasised the role of the private sector in shaping the future of capital markets. In 1984 International Finance Corporation and Central Bank of Kenya carried out a study⁸ whose recommendations resulted in the formation of The Capital Markets Authority (CMA) as a regulatory body. The CMA is the one charged with creating an enabling environment for the growth of a capital market in Kenya. The CMA has as its objective - to promote and facilitate the development of orderly, fair and efficient capital markets in Kenya.

In 1988 the first privatisation through the NSE was carried out with the Government selling out 20% of its stake in Kenya Commercial Bank. In 1991 the NSE was registered under the Companies Act and the "call over" trading system phased out in favour of the more convenient floor based Open Outcry System.

In July 1994, extensive modernisation was undertaken including the move to bigger and more spacious premises at Nation Centre Kimathi Street, Nairobi and setting up of computerised delivery and settlement system (DASS) and modern information system.

In 1996, the largest share issue in the history of NSE took place with the privatisation of Kenya Airways. In 1998 the government expanded the scope for foreign investment by introducing incentives for capital markets growth including the setting

⁶ Capital Markets Authority Annual Report 2002 page 17.

⁷ www.cma.or.ke (accessed on 24 June 2004)

⁸ Study was titled 'Development of Money and Capital Markets in Kenya'.

up of tax-free Venture Capital Funds, removal of Capital Gains Tax on insurance companies' investments, allowance of beneficial ownership by foreigners in local stockbrokers and fund managers and the envisaged licensing of Dealing Firms to improve market liquidity⁹. In 1999 Kenya adopted the International Accounting Standards (IAS).

In 2000 the CDA was passed. This came into force on 14 May 2003. The Capital Markets Authority Act was also amended. It was renamed the Capital Markets Act.

New provisions in the amended Act are:

- Provisions relating to the establishment of collective investment schemes (CIS).
- Provision for the establishment of a Capital Markets Appeals Tribunal.
- Expanded powers for the Authority to intervene in the management of a licensee by way of appointing a statutory manager.
- Powers for the Authority to license approve or accredit new institutional players in the market, including investment banks, authorized securities dealers, credit rating agencies and registered venture capital funds.
- Tightening of the provisions dealing with insider trading.
- Powers for the Authority to regulate e-commerce activities relating to securities.
- Separation of the functions of general investment advisers and fund managers.
- Powers for the Authority to issue its own rules, regulations and guidelines, except for those relating to its fees and on participation of foreign investors, which shall be issued by the Minister for Finance.
- Powers for the Authority to institute special audits on listed companies to serve investors and public interest¹⁰.

⁹ www.cma.or.ke (accessed on 24 June 2004)

¹⁰ Ibid.

In February 2001 the capital markets was reorganised into four independent market segments: the Main Investments Market Segment (MIMS), the Alternative Investment Markets Segment (AIMS), the Fixed Incomes Securities Market Segment (FISMS) and a Future and Options Market Segment (FOMS).

On 5 August 2002, the Nairobi Stock Exchange, the Capital Markets Authority of Kenya, the Association of Kenya Stockbrokers, the CMA Investor Compensation Fund, and 9 institutional investors through the Capital Markets Challenge Fund came together as investors in the Central Depository and Settlement Corporation (CDSC). The CDSC being the legal entity that will own the clearing, settlement, depository and registry system of the capital markets will be automated and operated¹¹.

Since 2002, the CMA has made many Rules and Regulations, guidelines, directives and orders to regulate the CDS. It is intended that I should consider these in chapter two of this study.

¹¹ Ibid. The material under the topic of recent developments was adopted from the CMA website.

CHAPTER TWO

2.0 INTRODUCTION

The existence of an apparently extensive and comprehensive legal framework for the regulation and supervision of the capital markets generally and CDS in particular has not solved the need for investor confidence and investor protection. The ramification of every major breach of this confidence necessitates the amendment of the capital markets legislation, ostensibly, to seal loopholes, which facilitated such breach to occur. It would seem that the strengthening of the capital markets legislations and institutional framework through amendments and creation of new institutions would provide the requisite investor confidence; but this has not been the case. The existing capital markets regulations have the fundamental aim of protecting investors. They seek to ensure that investors get returns to their investments. The nature and content of securities market is ever changing with the developments that occur with change in technology. Suffice it to say, securities regulation must be kept apace with the developments in innovations in the capital markets to be able to sustain their functions.

This chapter is concerned with the regulatory framework for the CDS. The emphasis is on the legal mechanisms put in place to effect the mission of the CMA: to promote the development of orderly, fair, efficient, secure, transparent and dynamic capital markets in Kenya within a framework which facilitates innovation through an effective but flexible system of regulation for the maintenance of investor confidence and safeguards the interests of all market participants. The capital markets regulations are in the form of legislations, CMA policies, Rules and Guidelines and self-regulation. An incisive study of the securities regulation structure will entail a special emphasis on specific provisions of the CDA and Capital Markets Act as well as policies geared towards investor protection and efficient and smooth operation of the capital markets.

A robust and facilitative regulatory environment is critical for the maintenance of investor confidence as well as investor protection¹². There are various pieces of legislation concerned with the regulation of the capital markets and in effect the CDS. These laws will be considered individually in an attempt at evaluating the efficacy of the same in realising the mission of the CMA as aforementioned.

2.10 THE CAPITAL MARKETS ACT (CHAPTER 485A)

This is the main Act regulating the capital markets. It gives validity to actions undertaken by all bodies formed under it. The goal of this Act as outlined in its long title is: to establish a Capital Markets Authority for the purposes of promoting, regulating and facilitating the development of an orderly, fair and efficient capital market in Kenya and for connected purposes.

Part II of the Act deals with the Capital Markets Authority. Section 5(1) establishes the CMA. Section 11 provides for the objective of the Authority as being:

- The development of all aspects of the capital markets with particular emphasis on the removal of impediments to, and the creation of incentives for longer term investments in productive enterprise;
- The creation, maintenance and regulation, through implementation of a system in which the market participants are self-regulatory to the maximum practicable extent, of a market in which securities can be issued and traded in an orderly, fair and efficient manner;
- The protection of investors;
- The operation of a compensation fund to protect investors from financial loss arising from the failure of a licensed broker or dealer to meet his contractual obligation.

In order to carry out its objectives the Authority has been granted far reaching powers, duties and functions. These are provided for in section 11(2) and include:

- To advise the minister on all aspects of the development and operation of capital markets;

¹² CMA Annual Report 2002 at page 17.

- To implement policies and programmes of the government with respect to the capital markets;
- To frame rules and issue guidelines on all matters within the jurisdiction of the Authority under the Act;
- To grant approval to any person to operate as a securities exchange, central depository and credit rating agency;
- To prescribe the terms and conditions on which securities may be listed and de-listed, suspend or cancel listing of any securities or trading of any securities for investor protection.

Section 12 goes on to give the Authority more powers. It is empowered to formulate such rules, regulations and guidelines as may be required for the purpose of ensuring orderly and fair-trading in capital market instruments and protection of investors. This by extension means that CMA also regulates the CDS. This is because CMA regulates the securities clearing and settlement or depository organisation directly by formulating rules, regulations and guidelines to guide it. The CMA also has to approve rules made by the Central Depository and Settlement Corporation that runs the CDS.

Section 18 establishes an Investor Compensation Fund for the purposes of granting compensation to investors who suffer pecuniary loss resulting from the failure of a licensed dealer or broker to meet his contractual obligation. This provides investor protection and makes the securities market credible. The CDS Guarantee Fund Procedures that are in the process of being formulated provide that the lump sum that is currently the NSE Investor Compensation Fund will be paid into the Guarantee Fund. This gives investors confidence in the CDS since they are assured of compensation in case of loss occurring due to failure of a broker or central depository agent to meet his contractual obligation.

Section 23 requires the central depository to obtain a licence from the Authority before it can commence operation. This ensures compliance with requirements of the Capital Markets Act (hereinafter "the Act").

Section 35A creates a Capital Markets Tribunal to enforce the provisions of the Act, hear appeals and also carry out prosecutions of offences committed under the Act. One can infer from this section that appeals or resolutions of conflicts arising between CDS and other players in the capital markets are to be referred to the tribunal.

Section 38 provides that where there are conflicts between provisions of this Act and any other written law with regards to powers or functions of the Authority under the Act, this Act shall prevail. This means that if the CDA is in conflict with the Act then the Act will prevail.

In connection with the power to formulate rules, regulations and guidelines, the CMA has in the past four years put in place a new legal and regulatory framework that conforms to the best international practice and trends¹³. In order to achieve its regulatory function the CMA has formulated certain Rules and Regulations to govern players in the capital market. These regulations and guidelines include:

- The Capital Markets (Collective Investment Schemes) Regulations, 2001
- The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002
- The Capital Markets (Licensing Requirements) (General) Regulations, 2002
- The Capital Markets (Takeovers and Mergers) Regulations, 2002
- The Capital Markets (Foreign Investors) Regulations, 2002
- The Capital Markets Guideline on Corporate Governance Practices by Public Listed Companies in Kenya
- The Capital Markets Guideline on the Approval and Registration of Credit Rating Agencies

The Authority is committed to ensuring that the regulations it put in place are enforced to ensure full compliance with all aspects of the regulatory framework. The Authority in its Capital Markets Strategic Plan: Vision 2002 - 2005 under the theme 'Broadening and Deepening the Capital Markets Horizons in Kenya' has been implementing a series of measures aimed at revitalizing the capital markets as an

¹³ CMA Annual Report 2002 page 7.

integral part of Kenya's financial system¹⁴. In this regard the Authority has been implementing a Seven-Prong Strategic Reform Agenda¹⁵. One of these is the establishment of a robust and facilitative legal and regulatory framework. This is essential for the maintenance of investor confidence as well as investor protection. The CMA has formulated or led to enactment of various rules and regulations to bring into effect such a legal and regulatory framework. These include:

2.1.1 The Capital Markets (Licensing Requirements) (General) Regulations, 2002

A Securities Exchange is required to make an application seeking licensing from the Authority in the prescribed forms provided in the schedule to these regulations. Such an application should be accompanied by its rules, trading system and prescribed fee. Section 4 of the Regulations requires that the rules submitted by the Exchange should comply with the provisions of the Act. This works to avoid conflicts arising between CMA and bodies created under it. The result of such approval of rules by the Authority leads to an efficient capital market.

The CMA has to approve the trading system of an Exchange before it is implemented. This in essence means that the CMA has full control of the Exchange and by extension CDS since CDS is created for the purpose of handling securities listed in an exchange. The CDS operates as a trading system of the exchange. A regulation on the stock exchange by and large implies a regulation on its trading system.

The Regulations also provide for an Investor Compensation Fund to be held by the stock exchange. The Central Depository and Settlement Corporation is in the process of formulating CDS Guarantee Fund Procedures. The guarantee fund is expected to eventually absorb the lump sum currently constituting the NSE Investor Compensation Fund. This fund will be used to compensate depositors for losses incurred in securities maintained at the CDS for such acts like theft, damage to

¹⁴ CMA Annual Report 2002 page 14.

¹⁵ Ibid

certificates, computer system failure, fraud and failure by traders to meet their contractual duties among others.

2.1.2 The Capital Markets (Securities) (Public offers, Listing and Disclosures) Regulations, 2002

These provide in section 3(1) that these 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. The Regulations go on in section 3(2) to give the Authority power to grant approval for all public offerings and listings of securities on any securities exchange in Kenya. These securities will be deposited in the central depository. Hence, any regulation of the listing of securities by the Authority will in essence be a regulation of the CDS by the Authority. Such a regulation ensures that investors are protected at all times and thus the securities market can be relied upon to meet its obligations.

Section 6 provides for publishing of prospectus when securities are to be offered to the public. This should be done after seeking approval of the Authority to determine whether a prospectus has complied with these Regulations. This gives necessary investor protection and creates investor confidence. Such investor confidence and protection creates a very conducive environment for investors to infuse more money in the capital market thus bringing about growth of the capital market.

Section 7 seeks to regulate eligibility of persons who plan to issue securities to the public and list at a securities exchange. Such persons must comply with the requirements as provided in the schedule to these regulations. In regulating eligibility of such persons the Authority will in essence ensure that the securities deposited in the exchange comply with listing requirements and thus protect investors from fraud by unscrupulous agents and stockbrokers who may plan to sell non existing shares.

Section 12 provides additional obligations as to the general duty of disclosure in a prospectus. The prospectus should contain all such information as investors would reasonably require, and reasonably expect to find there, for the purposes of making an

informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the securities and the rights attaching to those securities. The information should be such as is within the knowledge of the person making the prospectus or that would be reasonable for him to obtain by making inquiries. This is a heavy burden on persons issuing prospectus and does give investors necessary protection to avoid scandals arising due to falsity of prospectus.

Section 16 regulates the issue of advertisement, notice, and poster or documents announcing a public offer of securities for which a prospectus is or will be issued under these regulations. The regulations require such a person to give an address in Kenya from which a copy of the prospectus can be obtained. This acts as way of limiting incidences of fraud where non-existing shares are advertised leading to loss of money by investors thus damaging the credibility of the securities market.

Section 17 gives out a list of persons who are responsible for prospectus. This creates an obligation on individual persons and thus should an offence be perpetrated then it is easy to deal with it since persons responsible can be traced easily. This creates a sense of personal responsibility in those responsible for issue of prospectus and acts to discourage commission of malpractice in issue of prospectus.

Section 18 regulates underwriting of the public offer of securities. This requires approval from the Authority. Section 19 creates a continuing obligation to disclose information that might have a material effect on market activity in and prices of its securities. This works to prevent fraud or cheating investors after initial offer has been approved.

The issue of securities by the government of Kenya, body corporate established by any written law in Kenya other than Companies Act and private offers are exempted from these regulations. The regulations provide further protection to investors in the six schedules to the Act.

2.1.3 The Capital Markets (Takeovers and Mergers) Regulations, 2002

These regulate the issue of acquiring an effective control in the shares of a listed company. Section 4 provides for the procedure to be followed in effecting such a takeover. A person who proposes to acquire an effective control shall not later than twenty-four hours from the resolution of its board to acquire effective control in the company or not later than twenty-four hours prior to making a decision to acquire effective control in the company in the case of any other person announce the proposed offer by press notice and serve a notice of intention, in writing of the takeover scheme. This is a further way in which investors are protected. There is protection afforded against acquisition of their shares against their will or adequate compensation at the market value.

2.1.4 The Capital Markets (Foreign Investors) Regulations, 2002

These require the approval and registration of the Authority before a person can issue to the public any shares or other capital markets instruments. They also require every listed company to reserve at least 25% its ordinary shares for investment by local investors. This is good in ensuring that citizens get an opportunity to invest in such companies and thus retain returns in the country. A problem may arise where there is no local investor who wants to commit his resources in securities of that company. Also, a situation may arise where local investors do not have sufficient funds to buy 25% of the ordinary shares. This is a limitation in the laws and should be amended to allow such companies to list their shares even in cases where there is no 25% holding by locals as long as locals are not denied a chance to buy such shares.

2.1.5 The Capital Markets Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya

These guidelines were developed for good corporate practices by public listed companies as a result of the growing importance of governance issues both in emerging and developing economies and for promoting growth in domestic and

regional capital markets. Good governance is a valuable tool in attaining corporate performance, capital formation and maximisation of shareholders value as well as protection of investors' rights¹⁶. Such practices give a good name to the firm putting them into practice and thus create confidence in its securities listed in an exchange and deposited in the CDS. In order to get foreign investment in securities such corporate governance practices are crucial. Such practices have become an international requirement.

2.1.6 Central Depositories (Capital Markets) Rules, 2004

Section 65 of the Central Depository Act empowers the Authority to make such CMA rules, as may be necessary or expedient for carrying out or achieving the objects and purposes of the CDA. The CMA in carrying out this function has formulated the Central Depositories (Capital Markets) Rules, 2004.

Part II of these rules deals with the central depository and nominee company. An application to operate a central depository shall be made to the Authority in the prescribed form. Secondly, rules for operating such a central depository should comply with the provisions of the Act. Further obligations of reporting to the Authority have also been imposed on the central depository. It is expected to submit a list of the central depository agents it has approved, report failure by such agents to meet settlement obligations and its activities during the past one year of operation.

Part III deals with central depository agents. An application to operate as an agent is to be made to the central depository. Central Bank can be appointed to operate as a central depository agent for government securities. This will create the necessary linkage between the central depository system run by CDSC and the central depository system run by the CBK. This creates harmony in the operation of the two depositories and thus efficiency and smooth operation of the capital market.

¹⁶ Adopted from the text of Capital Markets Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya.

Part IV establishes a central depository Guarantee Fund for the purposes of ensuring settlement of trade¹⁷ that has taken place through the central depository. The central depository is expected to make rules on the operation of the Guarantee Fund. These rules are in the process of being formulated.

Part V deals with insurance cover. In section 21 the rules impose an obligation on the central depository to maintain an insurance policy at all times to safeguard against loss or damage arising from:

- Computer crime, involving theft or criminal damage to the computer system;
- Theft, damage, falsification or alteration of any record or data kept within the computer system;
- Stolen, missing certificates which are under the physical control of the central depository, whether such certificates are kept on its premises or are in transit;
- Fire or theft of any records in any vault, premise or warehouse of the central depository where such records are kept pursuant to the Act;
- Professional negligence of its employees, agents or servants;
- Public liability
- Fraudulent or dishonest acts of its employees or agents with intent to cause or sustain loss.

Insurance cover provides investor confidence and protection since any loss that arises will be compensated and thus investors will be ready to commit their resources in the market. This eventually leads to growth of the capital market.

2.2 THE CENTRAL DEPOSITORIES ACT, 2000 (CDA)

This is the particular law regulating the CDS. The objective of this Act is to facilitate the establishment, operation and regulation of central depositories, to provide for the immobilisation and eventual dematerialisation of, and dealings in, securities deposited therewith in Kenya, and for connected purposes. It is quite clear from the objective of the Act that it is intended to bring about the operation of more than one depository.

This objective is far from being realised. The central depository is yet to be

¹⁷ Settlement of trade means that depository agents and other players are not only able to deliver

established. This in effect means that the process of immobilisation and eventually dematerialisation is also yet to take place. The CDS is expected to be in place by the end of the year (2004).

The CDA was enacted in 2000 but came into force on 14 May 2003. This means that the Central Depository and Settlement Corporation had been operating outside the law since its establishment in 1999. The settlement corporation was incorporated for the purposes of running the CDS.

Part II of the Act deals with the Central Depository. Section 3 restricts the establishment of a depository by making it an offence for someone to operate a depository without prior approval of the Authority. If convicted of contravening this section one is liable to a fine not exceeding 10 million shillings, or to imprisonment for a term not exceeding ten years, or to both. This gives some protection to investors and thus gives them confidence to invest in shares listed on the stock exchange and deposited in the central depository.

Section 4 provides that a company that proposes to establish and maintain a central depository shall apply to the Authority in writing for approval. Such application should be accompanied by CDS rules made by the applicant in such manner and form, as the Authority requires. This ensures that there is congruence between the rules propounded by the Authority and the ones made by the applicant seeking to establish a depository. The Authority is also able to ensure that the CDS are geared towards attainment of its objectives. This section envisages creation of more than one depository. There is no provision as to the relation between one CDS and another. There should be an interlinking or a nexus between the various central depositories that are envisaged by the Act.

Section 4 further grants power to the company running a central depository to prepare CDS rules. The CDSC has gone ahead to prepare the Central Depository Rules, 2004. These rules relate to appointment of central depository agents, nature of interests in central depository accounts, dispute resolution and mortgaging and pledging of

securities but that they are also able to put for the securities they have bought.

securities among others. The dispute resolution provided in section 41 of these rules goes a long way in providing an amicable way of resolving disputes that may arise and thus gives investors confidence in the capital market. The rules have not provided an option for an appeal to the courts. This denies the aggrieved parties a fundamental right provided for in the constitution (right to fair hearing and access to the justice system). The persons who have been given power to resolve disputes may also have some interest in the dispute and this may create some bias.

The Central Depository and Settlement Corporation is in the process of formulating the CDS Guarantee Fund Procedures. Stockbrokers will contribute Kenya Shillings one and a half million to the guarantee fund. Also, the lump sum currently constituting the NSE Investor Compensation Fund will be paid into the guarantee fund. This will go a long way in ensuring financial integrity in the securities market. This fund is meant to ensure that trades among central depositories agents will be settled. The CDSC will not protect investors against losses that they may suffer as a result of a stockbroker failure, malpractice or non-payment. This is protected by the investor protection fund contemplated in the Capital Markets Act. To guarantee settlement, the CDSC has put a number of financial safeguards that allow it to manage settlement risks. Risk management requires that CDS identifies risks, takes preventive measures to minimise the risk of settlement failure and puts in place a contingency plan in the event a central depository agent fails to honour its settlement obligations. This will provide the necessary investor protection and give investor confidence in the securities trade.

The CDS will regulate market capitalisation. You can only buy and sell so much so that the CDS can cover for that trading margin. This is done through bank guarantee. This calls for stringent control by the CDS on the trading margin so as to ensure investor protection in case of malpractice by stockbrokers.

Section 5 gives power to the Authority to approve the establishment of a central depository if satisfied that: a securities exchange is a shareholder of the applicant, that the CDS rules comply with the CMA rules prescribed by the Authority and that such establishment and maintenance of the central depository will promote a positive development of capital markets in Kenya and that the interests of the public dealing in

book-entry securities will be served by the Authority granting such approval. The Act requires as a condition precedent to approval that a security exchange should be a shareholder of the applicant. This requirement may not be tenable in a situation where there are many depositories. Also, the Capital Markets Act envisages establishment of more than one security exchange and thus it will be difficult to determine whether the exchange is meant to be a shareholder in all such depositories or only the ones accepting deposit of securities listed under it. This requirement of shareholding by an exchange is not necessary and should be done away with.

Section 6 requires the approval of the Authority before the rules of a central depository can be amended, varied or rescinded. The board of the depository that plans to amend its rules must submit the same to the Authority for approval. The Authority shall within 30 days of receipt of a notice of such intention to amend notify the central depository of its decision regarding the proposed amendments and where it does not approve, it shall specify the reasons for the same. It is worth noting that there is no provision as to appeal from the decision of the Authority or a provision for arbitration to iron out any disputes that may arise. This goes against the requirements of natural justice and the spirit of the constitution that provides for a fair hearing and access to justice system by all. It may also act as a deterrent to investors who may want to invest in setting up a depository. The Act should be amended to allow for appeal to the Capital Markets Tribunal and to the court system.

Section 7 gives the Authority power to amend the central depository rules after consultation with the central depository. This limits the freedom of such depository. The law should be amended to provide for the Authority to suggest to the central depository necessary amendments while leaving the central depository to carry out the actual amendments.

Section 9 deals with appointment of central depository agents. These are to be appointed by the central depository. The Authority also has control over all persons dealing with securities instruments and thus there may arise a conflict in terms of who gives the agent validity to act. Is it the central depository or the Authority?

Section 10 entitles the central depository to do all such things as are necessary to ensure orderly dealings in immobilised or dematerialised securities. Thus a central depository may give directions to an issuer or central depository agent either requiring them to perform a certain act or refrain from doing a particular act. Failure to comply is an offence, which on conviction is punishable by a fine of five million shillings or to imprisonment for a term not exceeding five years or both. There is no provision for appeal from this decision. The Authority is the one given powers of prosecution and enforcement by the Act. There is need to provide for an amicable way of dispute resolution.

Section 12 requires a central depository to provide the Authority with such assistance as is reasonably required for the performance by the Authority of its functions and duties under the Act. The Authority is empowered at all reasonable times to full and free access to any part of the premises of a central depository for the purpose of ensuring compliance with this Act. This power should be curtailed by providing for reasonable notice to be issued to the central depository by the Authority of its intention to enter any part of its premises. This power also limits the protection given to investors. Investors require protection from such disclosures of their person and particulars and this power if exercised will infringe on that protection. The law should require the Authority to seek permission from the depositors before they can make use of information gathered from such access unless this was done to prevent the carrying out of a crime.

Part III of the Act deals with immobilised and dematerialised securities.

Dematerialisation is a process by which physical certificates are converted into electronic form. Immobilised securities are securities where the underlying physical certificates have been deposited with and are being held by a central depository. The CDS is meant to provide for immobilisation and eventual dematerialisation of securities but at the same time the CDA envisions the trading in securities in both the manual and electronic systems. This can be read from section 15-transitional period. This works to defeat the purpose of the central depository.

Section 15 deals with transitional provisions relating to trading of eligible securities. The definition of transitional period is vague and incoherent and should be removed

from the Act. This definition acts as a hindrance to the objective of the Authority to remove impediments from the capital markets. This means that there will be trading in both the manual and electronic book at the same time. This defeats the purpose of setting up a central depository while at the same time it derails the aim of the Authority of promoting an orderly and efficient capital market.

In section 18 the central depository is entitled to prescribe a date following which no member of a securities exchange may receive a certificate representing an eligible security merely for safe custody. This acts as a way of ensuring efficiency in the central depository and by extension the capital market.

Section 19 makes the central depository or its agent liable for loss, damage or liability suffered or incurred by a depositor due to any disappearance, loss or destruction of any certificates deposited with the central depository. Insurance cover should be made mandatory before the central depository or agent can be registered. It should be noted that there are no insurance companies that provide for such cover in Kenya and thus it may be a bit difficult for a central depository to obtain such cover.

Part VI deals with secrecy provisions. This is a fundamental area in providing investor protection. An investor may buy shares using a nominee company desiring to hide his identity. This should be protected at all reasonable cost. Therefore, ensuring that there is no unauthorised access to the depositor's securities accounts is of utmost importance. This protection of investor may be curtailed by the provision in section 12 that allows access by the Authority to any part of a central depository. The Authority should be limited in what it can access unless it seeks permission from the depositor or in cases where an offence is suspected of having been committed or in the process of being perpetrated.

Part VII provides for offences and penalties. The sanctions provided are very harsh and may act as a deterrent to any person who may want to engage in unscrupulous activities. The Authority is empowered to carry out prosecutions. The Act should provide an active role for the Capital Markets Tribunal. The tribunal should be given the role of enforcing the provisions of the Act, carrying out investigations and prosecutions. This will ensure better compliance with the provisions of the CDA.

2.3 INTERNAL LOANS ACT (Cap 420)

This is the Act under which the government uses to borrow money in Kenya. This borrowing is given effect by issue of treasury bills and treasury bonds. When this Act was being enacted it was not envisaged that there would be a central depository. The Act was meant to apply only to physical certificates. Since 1996 the Central Bank of Kenya (CBK) has been operating a central depository system for issuing treasury bills and treasury bonds. There is no law that allows the CBK to operate such a central depository. There is a lacuna in law. There are no rules for Fixed Income Securities even though they are being issued by the CBK. In effect at the practical level the CDS under the CMA is operating alongside the one run by CBK. The custodian of equities from government is the Registrar of Internal Loans whereas the CDS nominee company is the custodian of securities held by the CDS.

The Registrar of National Debt is expected to keep confidentiality and if the central depository kept under the CBK comes under the CMA then this confidentiality will be breached. This is because many people have access to the computer in the CDS under the CDSC.

In addition there is no linkage between the central depository run by the CBK and the CDS operated by CDSC except in the case of government holdings or securities. The CBK may be appointed a custodian of government securities. There should be a link between the two depositories to ensure smooth operation of the securities market. Investors can buy or sell existing treasury bonds at the NSE through licensed stockbrokers. This calls for a review of the laws to link the CDS under the CBK and the one under the NSE. Also, dealings in treasury bills and bonds are completely paperless. Such a situation is fraught with many dangers and should be protected by stringent laws and regulations that are lacking in the CBK system of selling securities.

2.4 BANKING ACT (Cap 488)

The securities markets require financing in order to meet their financial needs. The source of the money is largely banks and other financial institutions. These

institutions are also necessary in providing bank guarantee for players in the capital markets. In the recent past banks have ventured into commercial papers to finance long-term investment. Such papers can and are being traded in the secondary market. Barclays bank has been instrumental in this area by the much-anticipated issue of a Kenya Shillings three billion corporate bond. This is yet to go through due to technicalities coupled up with reluctance on the part of Central Bank to authorise the issue. This commercial paper will be traded on the stock exchange. With time it is expected that many other financial institutions will get into this area and thus the same will be deposited in the CDS as happens in most developed countries.

2.5 CENTRAL BANK ACT (Cap 491)

The Central Bank's role in national debt management entails the issuance, interest and redemption payment of eligible Government securities in terms of the Central Bank Act section 45 (c). The cardinal responsibility of the National Debt Registry is to market and manage the negotiable instruments in consultation with the treasury by way of borrowing from the domestic market and capital markets in order to finance government short and long-term financing requirements as provided in the Internal Loans Act (Cap 420). Currently the main means of borrowing take the form of: issue of Treasury Bills and issue of Floating rate Treasury Bonds. Once a debt instrument has been issued, the purchaser may be able to resell it before maturity in the secondary market. The potential buyers and sellers of existing debt instruments converge either at the Nairobi Stock Exchange or informal dealer markets (mainly commercial banks including central bank).

The CBK in order to list the treasury Bonds usually seeks approval from CMA. These are then listed in the NSE. Investor's data is entered into the CBK central depository. When the central depository under the NSE eventually comes into operation, the central depositories will have to be connected. This can be realised by appointing the CBK to be a central depository agent for government securities.

CHAPTER THREE

A COMPARATIVE STUDY OF CENTRAL DEPOSITORY REGULATIONS REGIMES IN PAKISTAN AND BANGLADESH CAPITAL MARKETS

3.1 INTRODUCTION

The development of central depository law, the contribution of capital markets to the economy, and the efficacy of the regulatory mechanism in Kenya can best be understood by undertaking a comparative analysis of securities regulations in other economies. The reason for choosing Pakistan and Bangladesh as a basis for this comparative study is that both these countries are emerging markets like Kenya and also the fact that they unlike Kenya have been able to put their central depositories system in place. Pakistan was able to put its central depository within a short span of time, whereas the Bangladesh one took longer due to a myriad of problems similar to the ones encountered in bringing into operation the CDS in Kenya. These two countries began the implementation process more or less at the same time with Kenya. In addition, 30 or so years ago, the two countries were in the same economic position as Kenya but with time their capital markets have expanded considerably while that of Kenya has grown very slowly. Capital markets in both of these countries have been for long, viewed as a vehicle for economic growth and development.

This chapter will endeavour to study the regulatory processes in the two countries vis-à-vis Kenya's securities law. Kenya's capital market is slowly becoming a part of the regional as well as international capital market fraternity and thus a look into the operations appertaining to the international capital market will provide an incite on how we can enhance our capital market to be as competitive as the one in most developed countries. This will enable us attract investors to invest in our securities market. In evaluating the world stock markets this study will have a deeper look into the regional and international capital market associations in an attempt to outline their role in the growth and efficient operation of the capital markets in Kenya. Further, with the introduction of the East Africa Community, the study will take a look at the possibility of creation of Capital Markets for East Africa as a way of bringing about

growth of the capital markets in the three countries. It is worth noting that some companies such as Kenya Airways is listed on the exchanges in the three countries. Thus integrating the three exchanges will be of mutual benefit to the three partner states.

3.2.0 PAKISTAN CENTRAL DEPOSITORY REGULATORY FRAMEWORK

With the exponential growth in the Pakistani Capital Market in the late eighties and early 1990's resulting in manifold increase in trading volumes, the physical handling of paper certificates not only became laborious but also time consuming. The manual system was no longer feasible. It was in this perspective that the CDC was incorporated to implement and operate the CDS¹⁸. The mission of Central Depository Company (CDC) is to operate an electronic book entry settlement system for equity, debt and other financial instruments and to contribute to the country's ability to support and develop the Pakistani Capital Market as the hub of financial activities in the region. The CDC has as its goals the elimination of paper-based settlement, diversification of its services and becoming a leading institution in the region. The main laws dealing with regulation of CDS in Pakistan will be outlined briefly below.

3.2.1 SECURITIES AND EXCHANGE ORDINANCE, 1969

This is the main law governing capital market. The objective of this Ordinance is to provide protection of investors; regulation of markets and dealings in securities and for matters ancillary thereto.

Chapter II deals with registration and regulations of stock exchanges. There are three stock exchanges in Pakistan namely- Karachi, Lahore and Islamabad. Section 3 of the Ordinance provides that no stock exchange shall operate without registration. It goes on to limit even other persons from utilizing such facilities of the unlicensed exchange. This requirement is more stringent than that provided by the Capital Markets Act in Kenya. The Cap 485A does not provide for limitation on other persons from utilizing the facilities of the unlicensed exchange. This should be provided for as

¹⁸ About CDC Pakistan accessed from the internet at www.secp.govn/

a measure to protect innocent people who may lose their money from such illegal transactions. In Kenya there is only one stock exchange-Nairobi Stock Exchange-and thus it is easier for the CMA to regulate and monitor its activities.

Section 6 requires every exchange, director and member thereof to prepare and maintain such books of accounts and other documents as may be prescribed by the Act. This creates a heavy burden on the directors and members and thus will give more protection to investors.

Section 10 provides for compulsory listing of securities if in the opinion of the commission it is necessary or expedient in the public interest to do so. The issuer of such security must be given an opportunity to be heard. There is no equivalent provision in our capital market laws. This may be important in cases where a certain corporate entity is deemed to be too important to be left in the hands and whims of a few people. This may be the case where for example a private company control 90% of the production of an essential commodity such as sugar or maize flour and the government is in the opinion that such a company should be publicly owned.

Chapter III A deals with insider trading. In section 15A It prohibits any person who has been associated with a company in the last 6 months from dealing on a stock exchange in any listed securities of that or any other company if he has information that is not generally available; would, if it were available, be likely to materially affect the price of those securities and relates to any transaction involving such a company. This provision not only guards investors from malpractice by insiders but also acts to create credibility of the capital market and the securities listed therein.

Section 27 empowers the Commission to constitute an Advisory Committee for the purpose of obtaining advice and assistance in carrying out the purpose of the Ordinance. Such a provision does not exist in our capital markets regulations and should be added to assist the Authority in areas that need expertise and specialised knowledge. This brings about efficiency not only in the CDS but also in the capital markets generally.

The Securities Exchange Commission of Pakistan is given power to enforce the provision of this Act. This is similar to the enforcement power granted to the Capital Markets Authority in Kenya.

3.2.2 SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN ACT, 1997

This is the Act that establishes the Securities and Exchange Commission. Unlike in the Kenya Capital Market regime where the Capital Markets Act in section 5 establishes the CMA, in Pakistan an Act of parliament was passed solely for the purposes of establishing the Commission. This makes the Commission more independent and thus able to carry out its functions properly.

Section 3 establishes the Commission. Section 5 goes on to provide for the number of commissioners. It is worth to note that the Act requires that the majority of the members of the commission be drawn from the private sector. This is invaluable in ensuring that the Commission is run in an efficient and professional manner.

Section 9 empowers the commission to appoint advisors and consultants to transact any business or to do any act required to be transacted or done in the exercise of its powers, the performance of its functions or for the better implementation of the purposes of this Act. There is no equivalent provision in our Capital Markets Act. This is important in order to help the enforcement body carry out its functions efficiently. There are some areas of the securities market that are technical and thus the advise of experts can not be over emphasised.

Part III is concerned with the Securities and Exchange Policy Board. The board is made up of nine members appointed by the Federal Government. Five of the members are ex official while four are from the private sector. The ones from the private sector should be persons who are well known for their integrity, expertise and experience in the spheres of commerce and industry, corporate law and banking among others. The board is also empowered to allow other persons to attend its meetings and deliberations on an advisory role. Such measures will ensure that the board comes up

with policies that are geared towards the growth and development of the capital markets.

Part VI provides in section 20(4) for the powers and functions of the Commission. The powers of the Commission are wide and far reaching. It has power over stock exchanges, central depositories and regulation of issue of securities among others. Such powers are meant to ensure that the objectives of the Act are attained. Those powers if used properly will lead to protection of investors and integrity of the capital market and the CDS by extension.

Part VIII empowers the Commission to enforce the provisions of the Act. Section 33 provides for an appeal against an order of the Commission to an appellate body of the Commission. Section 34 provides for an appeal to the court. This is not the case in our capital markets laws. In our Capital Markets Act there is provision for a Tribunal to carry out investigations but the general power of enforcing the provisions of the Act is granted to the Authority. The Capital Markets Act does not provide for appeal against an order of the tribunal. The Act is silent on this issue. There should be provided for an opportunity for an appeal from the decision of the Tribunal to the Authority and eventually to the High Court with a further appeal to the Court of Appeal.

Part X provides in section 37 that no court other than the Court of Session shall have jurisdiction to try any offence under this Act. This is valuable in ensuring speedy resolution of disputes. Prosecutions under the Act are to be carried out by an officer of the commission. The Commission has to give its consent before any prosecution for an offence under this Act can be commenced against any person. This requirement for Commission to give consent is bureaucratic and should be removed. Bureaucracy acts as a disincentive to investors.

Part XI empowers the Federal Government to make Rules. The Board is to make regulations in consultation with the Federal Government and the Commission. In Kenya the Authority is empowered to make Rules and Regulations. Pakistan capital market has a lot of government control and that is why there is provision for the government to make rules.

3.2.3 CENTRAL DEPOSITORY COMPANIES (ESTABLISHMENT AND REGULATION) RULES, 1996

Section 3 provides for the eligibility requirements to be fulfilled before a company can be authorised to run a central depository. Like the CDA, this Act requires that at least one stock exchange be a shareholder of such a company. Section 4 requires such a company to apply to the Authority for registration.

Section 6 requires such a company to submit annual returns. These returns should be accompanied by such information such as names of issuers who are members of the company, names of participants who are members of the company, number of account holders, list of shareholders of the company and names of senior management staff of the company including their qualifications and experience. These requirements will provide investor protection as well as ensure that the company is run in such manner as will meet the objectives of the Act.

Section 7 empowers the Authority to give directions to a central depository company if it is satisfied that it is necessary or expedient to do so in the public interest or in the interest of capital market. In the Kenyan case the Authority is empowered to exercise, perform and discharge such powers, duties and functions as are provided in section 12(2) of the Capital Markets Act. Such powers ensure that the central depository company adheres to the objectives of the Act. This control by the Authority is a sure way of ensuring compliance on the part of the central depository company to the government policies on capital markets. Control by the Authority also acts as a bureaucratic measure. This should be limited. The current trend in free market economies is to leave market players to control themselves through what is called self-regulation. This means that players come up with guidelines and rules of procedure to ensure compliance with rules of fair-trading. This is more effective than bureaucratic control.

Section 8 provides for the establishment of an Advisory Committee to advise the central depository company on matters relating to services the depository provides and to make recommendations for improving the efficiency of the central depository company. This committee is of paramount importance in helping the depository

company acquire the necessary expertise to advise it on technical issues hence bringing about efficiency and smooth operation of the depository.

3.2.4 CENTRAL DEPOSITORIES ACT, 1997

Section 3 of this Act provides that the provisions contained therein shall have overriding effect notwithstanding anything contained in the Companies Act or any other law. This is essential in eliminating conflicts that may arise due to same area being governed by more than one piece of legislation. Such a provision is not provided for in our Central Depository Act. This should be a point of amendment to create necessary confidence in the CDS.

Section 4 goes on to provide for the establishment of a central depository system. Unlike in our laws where a nominee company is to hold the shares deposited in a CDS, this Act provides for the CDS to hold securities for account holders. The Act goes on to allow the central depository to hold book-entry securities as a beneficial owner of such securities in its own account opened and maintained in its own central depository system. This does not exist in the Kenyan case.

Section 8 discharges the CDS from liability if acting in good faith for any loss, damages, compensation, costs and expenses. This allows the CDS to operate without fear of incurring liabilities from its actions.

Section 20 imposes a duty on directors or other officers of the central depository from disclosing information relating to account holders. Section 21 goes ahead to provide for situations under which disclosure shall be allowed. These situations where disclosure is required are geared towards protection of investors and the capital market generally. It is worth to note that in Pakistan there is a lot of government control over the capital market and thus the requirement to disclose to the State Bank when required to do so. This should be done away with since it creates bureaucracy. Such bureaucracy do not augur well with investors who need a free hand in dealing with their investment.

Section 32 provides for the procedure of appealing against decisions of the Authority. The Kenya capital market can borrow from this system of appeal to ensure that the capital market is efficient and responsive to investor needs. This manner of seeking a review of the decision made by a member of the Authority is a faster way of resolving disputes. This system unfortunately can be abused if the person empowered to make such a review is biased or unprofessional and it thus requires checks and measures to avoid abuse of office by its holders. In addition, once someone makes a decision it is not easy for the same person to hold a different opinion given the same facts. The review should be undertaken by a different person to avoid bias.

Section 34 empowers the Authority to make rules for the purpose of carrying out the objectives of this Act. This is similar to the powers granted to the CMA by section 65 of the Central Depository Act.

Section 35 gives the central depository power to formulate its own regulations. This is paramount in order for the central depository to make regulations that are geared towards achieving its objectives. Also, the central depository can formulate regulations to curb or stop occurrence of a situation that had not been envisaged at the time the Act was enacted. This also makes the central depository responsive to market needs and change in technology. Section 35A gives the central depository power to formulate such regulations as it may deem necessary in a state of emergency in order to protect investors and the capital market. There is no equivalent provision in the Kenya laws.

3.3.0 BANGLADESH CENTRAL DEPOSITORY REGULATORY FRAMEWORK

The Capital Market in Bangladesh has grown considerably in the last 15 years. This growth has not been as significant as it has been for many of her neighbours in Asia. This has been due to a number of problems such as shallowness of the market, lack of investors' market awareness and market transparency, ... unprofessional approaches

by stockbrokers to their services among others¹⁹. Bangladesh capital market has two stock exchanges- Chittagong Stock Exchange and Dhaka Stock Exchange.

In order to overcome such factors inhibiting the realization of a vibrant capital market in Bangladesh, various pieces of legislation have been formulated to curb malpractices by market players as well as protect investors and integrity of the market while creating investor confidence at the same time. It is my intention to outline the various legal measures put in place while at the same time drawing a comparison with the legal framework in place in Kenya. This comparison is aimed at exposing the cause of the sluggish growth in the capital market in Bangladesh while providing lessons that Kenya may learn from the same.

3.3.1 SECURITIES AND EXCHANGE ORDINANCE, 1969

The objective of the Act is to provide for protection of investors, regulation of capital markets and issuers and dealings in securities. This means that the Act by extension when fulfilled will regulate the dealings in CDS either directly or indirectly. This is because such securities will eventually be deposited with the central depository.

Section 2A controls issue of capital. It provides that no company incorporated in Bangladesh shall issue capital either within or outside Bangladesh without the consent of the Commission. This is a very stringent control on the part of the Commission. It should be noted that in Bangladesh the state has a lot of control on market performance and hence such provisions. Such provisions do not auger well with liberalisation and thus should be done away to allow for foreign direct investment. This has been the trend in Kenya in the past but now the CMA is trying to bring about self-regulation by the market players as a way of enhancing integrity and confidence in the security market.

Section 2B provides for regulation on issue of prospectus. Such prospectus should not be issued without the consent of the Commission. There are similar provisions in Kenya in the Capital Markets (Securities) (Public offers, Listings and Disclosures)

¹⁹ The Capital Markets of Bangladesh: Present and Future.

Regulations, 2002. Section 6 of the aforementioned Regulations provides that approval of the Authority should be sought before issue of prospectus to the public. In regulating the issue of prospectus the integrity of the CDS will be enhanced and maintained due to the fact that the authenticity of securities will have been verified before they are sold to the public.

Section 2C requires consent from the Commission before one can offer consideration in respect of any issue of capital in Bangladesh. This should be done away with, as it does not operate to give effect to the objective of growth of the capital market but to regulate or control the persons who purchase securities in Bangladesh. Such control measures are not viable in a free market and thus should be removed. Instead to control ownership by foreigners the Commission should focus on percentage of share capital that can be owned by foreigners and percentage that must be sold to the local investors.

Section 3 requires registration of stock exchanges before they can commence operation. This is similar to requirements of the Capital Markets Act. By regulating stock exchanges, by extension the CDS will be regulated since it (CDS) handles securities deposited on it by such exchanges. The exchange is to make an application for registration to the Commission. In our case such an application is made to the Authority.

Section 6 requires every stock exchange, director, officer and member thereof to prepare and maintain such books of accounts and the same shall be subject to inspection at all reasonable times by any person authorised by the commission.

Section 33 empowers the Commission to make rules for carrying out the purposes of this Act. This in effect means that rules can be made which have effects on the operation of CDS. Section 34 on the hand grants the stock exchange power to make regulations, with the approval of the Commission, for carrying out the purposes of this ordinance. It is worth noting that there is no direct mention of the CDS in this Ordinance. This may be from the fact that the CDS is a new phenomenon in Bangladesh and as such the Ordinance did not envisage such a trading system.

3.3.2 SECURITIES AND EXCHANGE COMMISSION ACT, 1993

The Securities and Exchange Commission (SEC) that was established in 1993 by the Securities and Exchange Commission Act regulates the capital market in Bangladesh. Prior to its establishment the securities market was regulated under Capital Issues Act 1947. Section 3 of the Act establishes the SEC.

Section 8(1) provides for the functions of the Commission. It is expected to ensure the proper issuance of securities, to protect the interests of investors in securities, and to promote the development of and regulate the capital and securities market. Section 16 empowers the government to issue direction to the Commission in order to ensure the carrying out of the provisions of this Act. The Commission is bound by such direction. This may act as an infringement on the independence of the Commission. This ought to be done away with to avoid political interference in the securities market. This is different from the Kenyan situation where the CMA is more independent and can thus carry out its functions without political interference.

Section 20 provides for appeal against acts of members or officer of Commission. The appeal is to be referred to the Commission. This goes against the principles of natural justice that provide that no one shall be a judge in his own case. The Commission may be biased in passing judgements since it is the same body either directly or through its members that passed the judgement in the first instance. There is no provision for an appeal from the decision of the Commission.

Section 24 empowers the government to make rules to ensure enforcement of this Act. Section 25 on the other hand empowers the Commission to make regulations but with prior approval of the government. In Kenya the CMA is empowered to make such rules as may be necessary to orderly and fair-trading in capital market instruments and for protection of investors. In carrying out its function of formulating regulations as provided both by this Act and section 33 of the Securities and Exchange Ordinance 1969, the SEC has formulated a number of regulations.

In 1998 the SEC made the Rights Issue Rules. These rules provide in section 3 for conditions to be met prior to rights issue. Section 6 goes on to provide for the public

company making rights issues to appoint an underwriter to fully underwrite the rights issue. These rules are generally geared towards investor protection and maintenance of integrity in the capital market. Integrity in the capital market attracts investors to invest their money in the securities market.

Also, in 1998, the SEC made Public Issue Rules to govern issue of capital to the public. Section 4 of these rules provide for publication of prospectus and opening of subscription list. The rules are meant to ensure that investors make informed investment decisions. Thus it is paramount that prospectuses are widely published and information contained therein verified to be true. This function of verification is the work of SEC hence the stringent requirements provided in section 7 A and B on information to be contained in a prospectus.

In 1994 the SEC made the Securities and Exchange Commission (Meeting) Rules to govern the meetings of the Commission. It provides for the number of meetings, place of meetings and time of meetings among others. These Rules are meant to ensure that the activities of the Commission are carried out with the seriousness they deserve as well as avoiding situations whereby issues discussed are leaked to third parties and the press hence infringing on right to privacy from disclosure of securities details to unwarranted persons.

3.3.3 THE CENTRAL DEPOSITORY ACT, 1999

Section 3 provides that the provisions of this Act shall have overriding effect over any other law. This is similar to what is provided for in the Central Depository Act of Pakistan in section 3. The Kenyan CDA does not have a similar provision. This *should be included in order to provide additional protection to investors in case of conflicts between the various pieces of legislation governing the securities market.*

A depository is required by section 4 to seek registration before it can commence operation. This is similar to the law in Kenya. This ensures that investors are adequately protected. The practice is for the Central Depository Company to submit operational rules and requisite fees. The Authority then approves the rules with any changes if necessary. The section goes on to provide that no application shall be

rejected without reasons being given. This will help avoid whims of the Commission from interfering with the working of the central depository.

Section 5 envisages creation of more than one central depository. This is similar to the CDA. The various central depositories should be linked to ensure cooperation and exchange of information to make the capital market more efficient. This linkage may be used to transfer shares from one central depository to another should this be allowed. Also, in the case of companies which may have their securities deposited in various depositories, this may help in transfer of such shares between holders in different depositories.

Section 17 empowers the Commission to make regulations for purposes of giving effect to the provisions of this Act. It is further provided that the commission shall publish the intended Act in two dailies inviting opinions, advice or objections. This provision is limited by subsection 2 that allows the Commission in special cases in the interest of the public to publish the Act without inviting for opinions, advice or objections but after consultation with the government. Involvement of stakeholders is essential in order to ensure compliance with the regulations. Stakeholder's involvement makes them feel a part of the system and they will be ready to comply with regulations they were involved in formulation.

3.3.4 DEPOSITORY (USER) REGULATIONS, 2003

These regulations were made by the Securities and Exchange Commission in exercise of the powers conferred on it by section 17 of the Depositories Act, 1999. They are concerned with organizations that will become participants in the depository.

Section 3 provides for the declaration of a state of emergency. The depository is empowered to declare such a state and thus take such temporary measures on transaction processing details. There are no equivalent provisions in our User Regulations. These should be provided to forestall crisis that may arise in emergency situation should players be left to take individual decisions and measures. This will lead to greater level of investor protection.

Section 4 provides for disaster recovery system and procedures. This is essential not only for system security but also as a guarantee of integrity of the depository to survive a technological hitch. Section 5 on the other hand requires the depository to ensure there is security of depository data. This helps avoid breach of investor confidence and occurrence of incidents of fraud. In addition to these measures, section 6 requires arrangements by the depository for evaluation, monitoring and control system to ensure the security and control of the depository system and its procedures.

Section 8 goes on to require regular inspection to ensure smooth operation of its system, procedures, controls and safeguards and shall submit a copy of the inspection report to the Commission. There are no such measures in the Kenyan User Regulations. These should be amended to include the above measures to give a wider protection to investors.

Section 12 requires a depository to have a compensatory system such as an insurance cover to compensate persons who suffer losses on account of the depository. The Kenyan system provides for equivalent measures in addition to Guarantee Fund. These give investors necessary confidence to invest in the capital market.

3.4 CENTRAL DEPOSITORY FOR EAST AFRICA EXCHANGES

The exchanges in the three East African countries are still in their tender years of growth. The NSE has grown considerably as compared to the exchanges in Uganda and Tanzania. In Tanzania there are seven companies listed in their Exchange while in Uganda there are five companies in the Uganda Stock Exchange. The Tanzania situation in terms of a central depository is quite different from Kenya due to the fact that Tanzania started with an electronic depository.

At the present moment the three East African Countries are working at reviving the East African Community (EAC) in all its aspects. One of the areas that can be looked at is the possibility of having a stock exchange for the EAC with one CDS. This will make cross-border listing easier and faster. The CDS for the EAC can work as a linkage for the three exchanges. Currently Kenya Airways is listed in the three stock exchanges and such cross-border listings may increase in the near future if companies

such as East African Breweries that operate in the three countries decide to list their securities in all the exchanges in the three exchanges.

3.5.0 WORLD STOCK MARKETS

The growth and development of world stock markets has to a great extent been influenced by the evolution of national capital markets in various countries. As capital markets develop in each country, these changes and developments are connected to form an international capital market fraternity. I will now proceed to evaluate a number of international organizations involved in the area of stock markets and their role in the development of the capital markets and by extension the CDS.

3.5.1 AFRICAN STOCK EXCHANGE ASSOCIATIONS (ASEA)

The African Stock Exchanges Association (ASEA) was incorporated in 1993 in Nairobi, in the Republic of Kenya. Its main aim is to provide a formal framework for the mutual co-operation of stock exchanges in the African region through the various processes encompassing the exchange of information and assistance in the development of member exchanges²⁰. ASEA has the following main objectives²¹:

- To provide systematic mutual co-operation, exchanges of information materials and provide mutual assistance and joint programmes between members.
- To assist members in the establishment of Stock Exchanges, the development of financial instruments and promotion of stockbrokers and dealers.
- To develop and establish standards of training and professionalism amongst stockbrokers and dealers and personnel associated with members.
- To develop and establish standards of listings, maintenance of listings, issuing trading and settlement of securities.
- To assist member in the development of self-regulation to the greatest possible extent and assist members in representations to the national and international bodies in this regard.

²⁰ www.jse.co.za accessed on 11 September 2004 ➤

²¹ Ibid

- To assist member in the promotion and development of services associated with the capital markets.
- To promote and develop the establishment of a data bank and information system for the mutual benefit of members.
- To study research and investigate matters of interest to members.
- To disseminate information.

In realizing its objectives, ASEA will by and large lead to an efficient and investor friendly CDS. In pushing its members to co-operate in exchange of information one of the main area of concern is the CDS. Its membership is open to any Stock Exchange or nascent stock Exchange located in the African region. Since many African countries are yet to implement the operation of a depository, ASEA is on the frontline in the fight to ensure that its members do implement a CDS.

3.5.2 FEDERATION OF EUROPEAN SECURITIES EXCHANGES (FESE)

FESE has as its mission: to represent the interests of European securities exchanges as regulated markets. Thus, the Federation in its work represents and promotes the common interests of securities exchanges in Europe. In seeking to inform the decision-making process at European level and to influence European policies and legislative proposals, the Federation produces a wide range of reports and FESE representatives speak on policy issues²². Every year since 1997 the Federation has organised an international conference on European capital markets. In fulfilling its mission, FESE has a direct impact on development of use of CDS in the world arena. The policies enunciated by the Federation are usually adopted by other countries mostly in Africa since these becomes the policies of the particular countries and thus when those countries either give loans or grants to countries like Kenya, such policies are part of the package.

3.5.3 WORLD FEDERATION OF EXCHANGES

The World Federation of Exchanges in order to ensure that members maintain high standards in their capital markets has set Market Principles 2002. The Market

Principles provide for World Federation of Exchanges Market Structure Best Practices which provide guidance as to the minimum level of organisation, regulation and supervision a securities market needs to have in order to qualify as organised market. They also serve as checklist for those securities market wishing to become a member of World Federation of Exchanges. In setting such standards, the securities exchange will be run more efficiently and in extension CDS will also benefit.

The Market Principles point number 6 on clearing and settlements provides that-The clearing and settlement facilities provided by the exchange, its subsidiaries and others must provide for the efficient, safe and prompt settlement of transactions within the internationally accepted standards of the G-30²³ and ISSA²⁴, or be better. This is a very high standard. Compliance with these standards will lead to a more reliable and efficient CDS. The Exchange²⁵ will:

- Make adequate arrangements for safe and timely clearing, and correct and final settlement of the transactions concluded on the market;
- See to it that cross-border clearing and settlement activities are facilitated;
- Be instrumental in the development of national central securities depositories, immobilisation, dematerialisation of securities, lending and borrowing contracts and arrangements;
- Contribute to the standardisation and implementation of securities industry processes;
- Assure that ownership of securities should be explicitly embedded in national law. A well-defined system of laws relating to property, contracts, securities, trusts, bankruptcy and taxation should exist.

²² This is published on the home page of FESE

²³ This is an organisation sponsored by central banks and investment banks

²⁴ International Securities Services Association

²⁵ Market Principles point number 6

CHAPTER FOUR

CONCLUSION AND RECOMMENDATIONS

This research paper has sought to identify certain issues that challenge and impede the establishment of an efficient CDS in Kenya vis-à-vis the regulatory framework currently in place to deal with the same issues. The capital market, which is seen as a vehicle for economic growth, needs an efficient settlement vehicle. This can be achieved by instituting watertight regulatory measures. It was noted that the CMA has been instrumental in ensuring that the various Regulations are in place to ensure smooth operation of the CDS. The problem of delay in coming into effect of Acts means that the players will be unregulated and unprotected from unscrupulous traders.

The research in its long excursion through the many Acts and Regulations emphasised the need for self-regulation as a way of promoting efficiency in the capital market generally and CDS in particular. The world is moving towards self-regulation. The Kenyan capital market cannot be left behind in its bureaucratic control of the private sector. Self-regulation requires the players in the field to be left free to come up with rules and guidelines to govern them.

The study traced the developments in the capital markets, its regulatory history and the challenges faced to the present date. This excursion helped to bring to light the efficacy of the regulatory measures in place as an effective means of protecting investors and providing investor confidence in the CDS. The role and functions of a CDS together with expected benefits to be derived thereof were outlined in chapter one. In order to ordain the activities of the CDS to achieve its objectives there is need for regulatory framework. This brings legal machinery into play. In this paper it was intended also to show the relationship between the capital market, the CDS and the law. The CDS is meant to ease the delay between the trading time and changer of ownership. This brings efficiency in the capital market. The law comes in to give validity to the actions of the players in the field.

This dissertation did not dwell on the narrow aspect of the Central Depository Act as the law in charge of CDS but concentrated on the broader aspect of regulatory measures governing the capital markets. Such a general overview of the regulatory framework was intended to look at all aspects of the securities market that may have an impact on the CDS. This is because a CDS does not operate in a vacuum but as one of the institutions of the capital market. Hence, the writer was of the view that such a study would be more comprehensive and analytical.

The research identified lack of appropriate technology, delay in putting a legal framework in place, conflict in the regulatory laws, managing the change and investment habits of Kenyans as some of the problems facing the implementation of the CDS. The paper sought to come up with solutions to the problems faced in the growth of the capital market. These challenges and problems require the concerted efforts of all market players to be eliminated.

In chapter two the paper undertook an incisive study of the different pieces of legislations that regulate the securities market and the CDS. The research conducted by the writer showed that there was a lot of bureaucracy in the Acts, which limits smooth operation of the securities market. The Capital Markets Authority, which is empowered with the regulatory and supervisory powers by the Capital Markets Act, lacks the requisite independence to carry out its work effectively. It was also shown that there is a lot of interference in the capital markets by the executive. This usually arises on the pretext of formulation of policies. In addition, it was noted that there is an overlap in term of Acts and Regulations dealing with the same things.

In looking at the various legislative measures put in place to regulate the CDS and capital markets generally, the study showed that there exists a number of lacunae and hiatuses in such regulatory measures. This can be glimpsed from the fact that even though the CMA is empowered with the regulatory and supervisory powers, its independence is wanting.

This paper also undertook a comparative study of the regulatory measures in Bangladesh and Pakistan. The Pakistani capital markets regulatory measures were enlightening on measures that can be put in place to ensure an efficient and investor

friendly CDS in Kenya. It was noted that the CDS in those two countries handled a lot of securities deposit. The level of technology is also very advanced especially in Pakistan. The numbers of companies listed in the stock exchanges in the two countries were also large unlike the 47 companies listed in the NSE.

The writer also felt the need to evaluate the role played by various regional and international organisations in the development and enhancement of efficiency in CDS. Such organisations such as African Stock Exchange Association, Federation of European Securities Exchange and World Federation of Exchanges were studied and their role examined. It was noted that Kenya has been instrumental in this arena. The ASEA was established in Kenya and has held at least two of its annual meetings in Kenya.

The research also had a short but helpful incite on the case for a CDS for the three exchanges in the EAC partner states. The three countries since the inception of the EAC have been negotiating various areas of cooperation. The area of capital market is an important factor not only to ensure growth of foreign direct investment but also to ensure cross-border investment by local people and companies.

From this research the writer pinpointed certain areas that need legal reforms and came up with the following recommendations:

- The various Acts and Regulations overlap in their effort to regulate the capital market and CDS. This calls for harmonisation of the different pieces of legislation to ensure that there is no conflict in their operation as well as overlap in their operation.
- The Central Bank of Kenya has been operating a CDS since 1996 without a legal framework in place. Such a CDS should be brought within the ambit of Capital Markets Authority. This calls for establishment of the CBK as a depository agent to handle Government securities. This CDS should be linked to the CDS under the Capital Markets Authority for efficient performance.

- Public Education and awareness. The knowledge of Kenyans on the CDS and capital markets generally is wanting. This has led to weird investment habits and investment in traditional areas of the banking sector. The Capital Markets Act should be reviewed to provide for active education and public awareness as a way of promoting acceptance of the CDS.
- There is need for self-regulation. The CMA mainly does the regulation and formulation of policies for the CDS. The trend currently is to move away from governmental control to self-regulation. The market players are more conversant with their needs and thus they can best regulate such a market.
- The CDA in section 15 provides for trading in both the manual system and the electronic system during a vague period that it calls the transition period. A review of the Act will be quite valuable to provide for a clear guide as to when trading in manual certificates shall cease and the conversion dates from manual to electronic system.
- The Stock Exchange is required to be a member to the central depository. The CDA envisages creation of many central depository systems and this means that the Exchanges have to have some shareholding in all these exchanges. This requirement is not necessary and should be removed from the Act.
- Section 18 of Capital Markets Act provides for establishment of Investor Compensation Fund. The CDS Guarantee Fund Procedures that are in the process of being formulated provide that the lump sum that is currently the Investor Protection Fund should be paid into the Guarantee Fund. It is not stated whether the Investor Protection Fund will be done away with or whether it will continue protecting persons who buy securities in the Exchange. This should be made clear to create investor confidence in the capability of the stock market to compensate investors in case of loss occasioned by negligence or malpractice by stockbrokers and other players.
- There is a lot of bureaucracy in the regulatory measures in place. The same should be removed since it acts as a disincentive to investment. Bureaucracy

leads to waste of time and money and thus should be removed immediately for a faster growth in the capital markets and CDS.

- The numbers of companies that are listed in the Stock Exchange are not enough to spur the desired activity level in the CDS. This calls for more incentives to encourage companies to list their securities in the Exchange. This will lead to more utilisation of the central depository system. Currently listed companies pay 25% corporation tax as compared to 30% paid by other companies not listed.
- The re-establishment of the EAC calls for re-thinking in areas that the businesspersons in the three countries can cooperate in. Securities market is one such area. The possibility of establishing an East African Stock Exchange with a CDS should be looked into as a way of enhancing and promoting growth of the CDS and capital markets generally.
- The Pakistan Securities and Exchange Ordinance prohibit utilisation of the services of an unlicensed Exchange. This should be provided for in the Capital Markets Act in Kenya as a way of protecting investors.
- Compulsory listing of securities in sensitive and other areas of national importance. This will ensure that such enterprises are not left at the whims of a few individuals motivated by personal gain. This does not mean that private property should not be protected. Compulsory listing should be done only after such an enterprise has been declared vital to the national economy.
- The Cap 485A should be amended to provide for appointment of advisors and consultants to give advises on technical issues to the CMA and institutions registered under it. This will ensure smooth and efficient operation of the capital market.
- The Cap 485A should be amended to provide for most members of the CMA to come from the private sector. This will ensure that the CMA is run professionally. The private sector has people with the requisite qualification

that is needed to bring in efficiency in the capital market. The current members are appointees of the executive if not members of the executive such as the Attorney General and the Permanent Secretary Treasury.

- The CDA should be amended to allow a CDS to hold book entry securities as a beneficial owner of such securities in its own account opened and maintained in its own central depository system. The current situation calls for a nominee company to hold such securities.
- The procedure for appealing from the decision of CMA should be provided for in the Act. The procedure of having a review as practiced in Pakistan would be helpful in ensuring speedy resolution of disputes. The Act should consider providing for arbitration as a way of resolving disputes between players in the capital market since this is faster and cheaper.
- The requirement of a reserve of 25 % of shares of a company for locals though well intentioned may act as a disincentive to some foreigners who want to invest in the country. This percentage should be reduced or limited to companies in key sectors of the economy such as banking and insurance. This should also be extended to Initial Public Offers in order to attract some of the private companies to be listed.
- The time it takes to effect a transfer of ownership currently is extremely long- it may take as long as twenty days. This should be reduced to T+1²⁶ in due course. This will ensure compliance with the G-30 recommendations.
- The participation of stakeholders in formulation of laws and regulations is of essence in ensuring full compliance with the regulatory measures. The CMA before formulating regulations should consult capital market players to get their input. Also, the market players should make guidelines and rules of conduct.

²⁶ T+1 means that settlement of payment and transfer of ownership for securities bought or sold should be made one day after trading.

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