INSIDER TRADING: A CASE FOR REGULATION.

A DISSERTATION SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENT FOR THE AWARD OF BACHELOR OF LAWS DEGREE OF UNIVERSITY OF NAIROBI.

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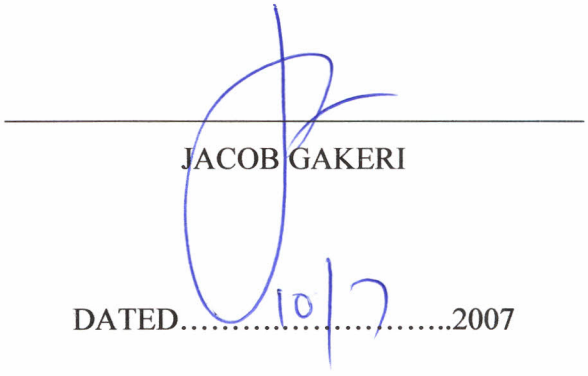
DECLARATION

I, ANNETTE MUKAMI GIKUYA do hereby declare that this dissertation is my original work and has not been submitted and is not currently being submitted for any award in any other University.

ANNETTE MUKAMI GIKUYA.

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



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DATED.....10/7.....2007

UNIVERSITY OF NAIROBI.

DEDICATION

The voice of parents is the voice of gods, for to their children they are heaven's lieutenants.

-William Shakespeare.

This dissertation is dedicated to Dad and Mum, Njoki, Njeri and Nyaga.Thanks for being mine.

ACKNOWLEDGMENTS.

I first want to acknowledge the almighty God for being the wind beneath my wings and the lifter up of my head.

My gratitude goes to my supervisor **Mr. Jacob Gakeri**, who tirelessly guided me through this dissertation. He consistently and diligently corrected me through my draft dissertation chapters into what it is now. Thank you and God bless you.

For my family, God sure did give me the best.

I also wish to thank my friends who played a major part in the fulfillment of this dissertation. **Wangu**, **Julio**, **Karofio**, **Yvonne**, **Clarice, Sophie, Lorna, Peter** and **Kamotho.** May you all live to find the beautiful and precious things that life holds for you.

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ABBREVIATIONS AND ACRONYMS

CMA	Capital Markets Authority
SEC	Securities Exchange Commisiion
NSE	Nairobi Stock Exchange

CHAPTER ONE: THE PROPOSAL.

"We have always known that heedless self-interest was bad morals; we know now that it is bad economics."[1]

— Franklin Delano Roosevelt

INTRODUCTION:

This dissertation is concerned with the concept of insider trading, with main focus on insider trading in relation to the persons who owe a fiduciary duty to the shareholders and an ethical duty to the general public.

WHAT IS INSIDER TRADING?

Insider trading is the trading of a corporation's stock or other securities[2] by corporate insiders[3].

Kenyan Law does not define insider trading.

According to Charlesworth & Morse[4], insider dealing occurs where an individual or organization buys or sells securities while knowingly in possession of confidential

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[1] Franklin Delano Roosevelt, Second Inaugural Address (Jan. 20, 1937), available at http://www.americanpresidents.org/inaugural/31b.asp (accessed March 23rd, 2007).

[2] Sec 2(1) of the Capital Markets Act defines securities as; Bonds, stock, shares, bonds or notes issued or proposed to be issued by a body corporate or the government, debentures, rights, warrants, options or features in respect of any debenture, stock, shares, bonds, notes or in respect of commodities or any instruments commonly known as securities. However, they do not include bills of exchange, promissory notes or certificates of deposits issued by a bank or financial institutions licensed under the Banking Act 1989.

[3] Lawyers, accountants, investment bankers, employees of the regulator or the state, brokers and dealers who may be privy to private information by virtue of a contractual relationship with the firm or its shareholders.

[4] Geoffrey M: *Company Law*, (16th Edition Sweet & Maxwell) at 349.

information which is not available to the public and if made available to the public, the information will materially affect the price of securities.

Insider trading may be perfectly legal but the term is frequently used to refer to a practice, illegal in many jurisdictions, in which an insider or a related party trades based on material[5] non- public information obtained during the performance of his/her duties at the corporation, or otherwise misappropriated that can materially affect the value of its securities.

Legal Insider Trading[6] may not be based on non-public information. This occurs when corporate insiders –officers, directors and employees buy and sell stocks in their own companies and report their trades within the specified time allocated for reporting such trades.

Illegal Insider Trading refers to buying or selling a security in breach of a fiduciary duty or other relationship of trust and confidence while in possession of material non-public information about the security. Illegal insider trading in many jurisdictions requires participation (even indirectly) of a corporate insider or other person in violation of his fiduciary duty or misappropriating private information and trading on it or secretly relaying it.

INSIDERS.

A common misconception is that only directors and upper management can be convicted of insider trading. Anybody with material non-public information can commit such an act: brokers, family members, friends can be considered insiders.

In relation to company officers, insiders are considered to be company directors, officials or any individual with a stake of 10% or more in the company.

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[5] Information is deemed material if it's release could affect the current security price in the market.

[6] Uncovering Insider Trading –http://www.investopedia.com/articles (accessed on the 13th February 2007.)

Section 2(1) of the Capital Markets Act defines an insider as any person who, is or was connected with a company or is deemed to have been connected with a company, and who is reasonably expected to have access, by virtue of such connection to unpublished information which if made generally available would be likely to materially affect the price or value of the securities of the company, or who has received or has had access to such unpublished information.

Generally, insider trading may involve a tipper and a tippee. A tipper is the person who breaks his/her fiduciary duty by revealing inside information. The tippee is the person who knowingly uses such information to make a trade (in turn breaking his confidentiality)[7]. If one is caught "tipping" an outsider with material non- public information, the tipper can be found liable. The Securities Exchange Commission uses the Dirks Test[8] to determine if an insider gave a tip illegally. The test provides that if a tipper breaches his/her trust with the company fully understanding that that constituted a breach, she/he will be liable for insider trading. Both parties usually do so for monetary reasons.

Directors and Employees as insiders

Directors are duty bound subject to the provisions of the Companies Act to act bona fide in the best interests of the company as a whole. This fiduciary duty of loyalty and good faith requires that directors should not improperly utilize their position for personal gain. As fiduciaries, directors must not place themselves without the company's consent in a position in which there is conflict between their duties to the company and their personal interests.

[7] Reem H.; *Defining Illegal Insider Trading*-, October 2003.
[8] Ibid.

Any information concerning the activities or proposed activities of the company, which has not been made public and could significantly affect the price of the company's shares must only be used for valid company requirements.

According to the Securities Exchange Commission of the United States, trades made by these types of corporate insiders in the company's own stock based on material non -public information is considered fraudulent since the insiders are violating the trust or fiduciary duty they owe to the shareholders.

The corporate insider simply by accepting employment makes a contract with the shareholders to put their interests before his own. When the insider buys or sells based on company owned information, he is violating his contract with the shareholders.

Insider trading among corporate insiders especially directors and employees arises when the Articles of Association allow directors to hold a certain number of shares as qualification for their appointment. Additionally, employees are also permitted to own company shares as this acts as an incentive for working harder since they own part of the company.

An example is where a director knows that the company is in a poor financial position and sells his shares knowing that the news will be released and sells them before the prices go down. Similarly, if there is information available to only the directors that the company has discovered oil in one of its lands, based on that information buys company shares with expectation that the market prices will rise after such material information has been released to the public insider dealing has taken place.

HISTORICAL BACKGROUND.

The law and economics on the insider trading debate has been long and outstanding.

To ordinary persons, such dealing can be described as involving the deliberate exploitation of information by dealing in securities or other property to which the information relates having obtained that information by virtue of some privileged relationship or position. It involves taking advantage of an opportunity to profit which is not available to others.

Prior to 1903, neither state corporate law nor state common law imposed a duty on corporate insiders to abstain from material, non- public information for their own benefit. The conventional wisdom of the day held that the benefits of inside information were a normal emolument of being a corporate insider[9].

Legal prohibitions against trading by corporate insiders were either non-existent, covered by state securities laws, or founded on common law theories of fraud. Trading on United States securities markets, which dates from the earliest days of the republic, was an open, unregulated affair. As trading was predominantly limited to select groups of merchant and investment bankers, regulation was largely self imposed[10].

The first prosecution of insider dealing occurred in the United States under state law as early as 1903 in *Oliver v. Oliver*[11]. The United States Supreme court ruled that a corporate director who bought the stock when fully aware that the prices were bound to go up committed fraud by buying while not disclosing his inside information. Insider trading, market manipulation was still widespread and this among other causes resulted in the great crash that resulted in the great depression in the late 1920s. There was therefore need to regulate insider dealing.

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[9] Geyer T.E. "Insider Trading: Evolution, Prevailing Theories and Recent Developments". February 14th 2003.

[10] James P.J. "Proposals for Insider Trading Regulation after the Fall of the House of Enron". *Fordham Journal of Corporate and Financial Law* Vol VIII at 691-692.

[11] 45, S.E 232 Georgia, 1903.

History in Kenya:

Kenya began trading in shares in the 1920s while it was still a British colony[12]. There was an informal market and there were no rules or regulations to govern the trade. Trading was based on a gentleman's agreement where a standard commission was charged and clients obliged to honor their obligations and settle relevant costs.

Due to lack of regulation, dealers who had access to information would buy stock in the hope that prices were about to increase and sell them off if there was information that the prices were about to drop thus the inception of insider trading.

The Nairobi Stock Exchange was developed in 1954 and among its objectives was the need to regulate the dealings of its members and clients.

Currently, there are no conclusive decisions on insider trading in Kenya. The principle legislation regulating the issue of shares and other securities is the Capital Markets Act.

In July 2000, the Capital Markets Authority Act[13] was amended to the Capital Markets Act responsible for maintaining confidence, promoting public awareness of the market system protecting consumers of such services and minimizing financial crime. Among the new provisions was one that tightened provisions dealing with insider trading. It has been argued that the development of public regulation of stock market is a consequence of their extra-ordinary success as well as their growing significance to world economies[14].

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[12]Rose N; *Development of the NSE a Historical Perspective*, a Masters Thesis.

[13] Cap 485A, Laws of Kenya

[14] World Bank's Financial sector "Capital Markets in Emerging Economies, A case study of the Nairobi Stock Exchange."

There has been need to take a closer look at regulation of insider trading in Kenya especially with the sudden interest in the stock market in Kenya through the Initial Public Offers and stock splits.

STATEMENT OF THE PROBLEM.

This dissertation proposes to demonstrate that the existing legal and institutional framework for the regulation of insider trading in Kenya is inadequate.

RESEARCH QUESTIONS:

The study will seek to establish:

- Is insider-trading regulation efficient or is it merely an inefficient redistributive policy?
- If insider trading is perfectly legal, why do those who engage in it trade with so much discretion and fear?
- What is really unethical or immoral about insider trading?
- What harm is there in participating in insider trading and informed speculation.
- Is the current legislation sufficient?
- What are the recommendations and amendments that can be made to the existing laws?

SIGNIFICANCE OF THE STUDY.

The purpose of this study is mainly threefold.

- To shed light on the rather controversial topic both in the legal and corporate sector in terms of what legal and illegal insider dealings entail, who exactly is an insider, what information is categorized as material and non-public.
- To illustrate the need to protect investors and the general public from insiders. This will be through enforcement of laws and regulations that are punitive and deterrent, clearly setting out the fiduciary duties of insiders and punitive measures if contravened.
- To illustrate that the existence and enforcement of insider dealing laws matter and make recommendations on any gaps in the law.

LITERATURE REVIEW:

Thomas E. Geyer[15] explains the historical background of insider trading in the securities markets in the world.

David H. argues that insider trading undermines public confidence in the market, and that companies prefer that their securities trade in thick markets[16]. Efficient securities markets, he argues, require a "level informational playing field" to avoid frightening away speculators, who contribute to securities market liquidity, and investors, who could invest their savings in markets with less risk of insider predation.

Morse G. and Charlesworth[17] are of the view that apart from the legal reasons that prohibit insider trading, there are moral and ethical reasons that make such dealings unfair to those

[15] Geyer T; "Insider Trading, Evolution, Prevailing Theories and Recent Developments" February 14th 2003.
[16] Markets with many traders, substantial capital available and frequent opportunities to trade at readily observable prices.
[17] Morse G.: *Company Law*, (16th Edition Sweet & Maxwell).

who deal with the insider. In addition, a more significant reason is that the insider with access to confidential information is thereby in a potential conflict of interest situation.

Laura Nyantung Beny[18] proposes that countries with more prohibitive insider rules have more liquid stock markets; diffuse equity ownership and more accurate stock prices.

Easterbrook, Frank H.& Daniel Fischel[19], hold that securities laws are either damaging or irrelevant to the extent that codify already existing arrangements and damaging in so far as they raise costs and interfere with the optimal fixing of markets. They argue that such laws should be revoked. Insider trading based on material information benefits investors by quickly introducing such information to the market.

The late Milton Friedman a Nobel Memorial Prize laureate on Economics argued that there is need for more insider trading, and there was no need for a trader to make his trade known to the public since buying and selling in itself is information for he market.

Henry Manne[20] proposes that no one is injured by insider trading and it is an appropriate method of compensating the experimental efforts of corporate management.

He further argues that, insider trading should not be regulated in that is serves certain purposes[21].

i. Long term investors suffer no loss from it as they select stocks on the basis of fundamental factors like the dividend history, earning potential and growth prospects among others. The investors do not generally buy and sell on the basis of short swing fluctuations in the price of securities.

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[18] Beny L. "Do Insider Trade Laws Matter? Some Preliminary and Comparative Evidence."
[19] Easterbrook, Frank H.& Fischel D. " Mandatory Disclosures and the Protection of Investors" Virginia Law Review (1984)
[20] Manne H. *Insider Trading and the Stock Market,* New York Free Press(1966)
[21] Manne H. " Events of Insider Trading" (1966) *Harvard Business Review113.*

ii. There is no substantial relation between rigorous insider trading registration and public confidence in the markets.

iii. Insider trading compensates entrepreneurial achievements of investors which would otherwise be necessary expense f the corporation. He argues that profits from insider trading constitute the only effective compensation scheme for entrepreneurial services in large corporations.

iv. There is an increase in capital market efficiency in that new information about a corporation is reflected in its securities more rapidly and accurately if insiders are permitted to use it.

Rose W. Ngugi[22] provides a background on the trading of securities in Kenya. The article provides a brief history of how trading took place before the inception of a regulatory body.

ASSUMPTIONS:

- that there will be a problem of collecting information regarding insider trading in Kenya since there are no precedents in court or any conclusive decisions on companies or individuals that have engaged in the vice though it is widely practiced in the securities markets.
- that developed countries are far ahead of Kenya with regard to legislation though the practice is more rampant in these countries.

HYPOTHESIS

This dissertation will test the following hypothesis:

[22] Ngugi R, " Development of the NSE: A Historical Perspective" a masters thesis.

- that there are inadequate laws in our system that address the insider trading vice.
- that insider trading regulation and the imposition of deterrent measures will go a long way in reducing insider trading occurrences.
- that insider trading does not in any way offer optimal market efficiency, instead it causes inefficient markets since not all the buyers have access to information(read inside information) hence the market tends to be biased.

RESEARCH METHODOLOGY.

This study is both historical and analytical. It will entail an analysis of the current Kenyan laws relating to insider trading: - Companies Act[23] and the Capital Markets Act[24], Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya[25], Capital Markets(Securities) (Public Offers, Listing and Disclosures) Regulations, 2002.

It will also rely on library research and borrow heavily from legal and economics scholars who have studied and written on insider trading.

ABSTRACT:

This dissertation takes a close look at insider trading in the Kenya's securities markets. I exemplify the need for regulation of insider dealing[26] as opposed to non-regulation. I will give the arguments for and against regulation of insider trading that have been brought forward by

[23] Chapter 486 Laws of Kenya.
[24] Chapter 485A, Laws of Kenya.
[25] Gazette Notice No.3362, of May 14th 2002.
[26] Insider dealing and insider trading are used interchangeably and they mean the same.

various scholars. I will seek to analyze insiders, the duties they owe to the company and their acts that constitute illegal insider dealing and the various judicial authorities. By analyzing the existing legislative and institutional regulations in Kenya that govern insider trading, I find that the current legislation is unsatisfactory and needs to be amended to keep up with the global securities markets. I will further make recommendations and reforms on insider dealing regulation in Kenya.

CHAPTER BREAKDOWN.

CHAPTER ONE:

PROPOSAL:

The dissertation proposal forms chapter one of the dissertation and gives an introduction of the topic, the historical background, a statement of the problem, hypothesis and assumptions. Additionally, it illustrates the research methodology and the literature review.

CHAPTER TWO:

REGULATION OF INSIDER TRADING.

This chapter makes a case for regulation of insider trading. It entails arguments for and against insider dealing that have been posited by various scholars.

CHAPTER THREE:

DIRECTORS AND OTHER INSIDERS.

This chapter addresses the concept of directors and employees as insiders. It discusses the acts that constitutes insider dealing and analyses the various judicial authorities relating to the vice.

CHAPTER FOUR:

THE LEGAL AND INTISTITUTIONAL FRAMEWORK IN KENYA.

It provides an analysis on the statutory framework of insider trading, and the institutions that govern securities markets in Kenya. It elucidates the roles played by the regulatory bodies in enhancing free and efficient market securities. Further, it demonstrates the challenge of detection of insider dealing that has remained elusive in many jurisdictions.

CHAPTER FIVE:

RECOMMENDATIONS AND REFORMS ON INSIDER TRADING REGULATION.

This chapter makes recommendations and identifies reforms that will enhance effective regulation of insider trading in Kenya. Such recommendations will promote investor confidence, fair market practices and even encourage the public to invest more in the securities markets and enhance investor protection from unfair trade practices

CHAPTER TWO: REGULATION OF INSIDER TRADING.

INTRODUCTION:

This chapter will examine the arguments that have been advanced for and against the need to regulate insider dealing. This will involve an analysis of what various authors or economic scholars have posited as justification for regulation or non- regulation of insider trading.

This chapter will shed light on the case for insider trading regulation by interrogating the (un)intended effects of insider trading to its victims(usually the shareholders and the general public).

As early as 1934, the Senate Banking and Currency Committee observed that:

> *"Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by the directors and officers of corporations who used their positions of trust and the confidential information, which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse of was the unscrupulous employment of insider information by large stockholders who while not directors and officers exercised sufficient control of their companies to enable them acquire and profit by information available to another."*[27]

At the core of the law and the economic debate is question whether insider trading is economically inefficient and thus ought to be subject to government regulation or whether it is economically efficient and thus ought not to be regulated. One school of thought supports unregulated insider trading. Another school contends that the property right to inside

[27] Stock Exchange Practices, Report on Banking & Currency, S.Rep No.1455,73d Cong.,2d Sess(1934) 55

information should be assigned to the corporation and not subject to contractual reassignment[28].

Insider trading regulation is an integral part of corporate governance regulations aimed at improving the efficiency of financial markets. Insider trading is difficult to measure directly. The practice is illegal and victims (the shareholders) seldom know when they have been defrauded.

ARGUMENTS FOR REGULATION.

Arthur Levitt, the chairman of the US Securities and Exchange Commission posits that:

> *"Trading based on privileged access to information can demoralize investors and destabilize investment. It has utterly no place in any fair-minded, law-abiding economy. It's a chronic danger. It's all too evident in today's marketplace. And it's a crime. The American people see it, bluntly, as a form of cheating. They along with the S.E.C. have zero tolerance for the crime of insider trading. Let's state it clearly, and in the un-ambiguous terms that it deserves: Insider trading is legally forbidden. It's morally wrong. And it's economically dangerous."*[29]

Medieval common law permitted insiders to trade in a firm's stock without disclosure of inside information. Over the last three decades, prohibition of insider trading emerged as a central feature of modern securities regulation.

The basic principle behind insider trading legislation is to impose liability upon directors and employees who have price-sensitive information by reason of their position in a public

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[28] Bainbridge S., "Insider Trading", in *III Encyclopedia of Law and Economics* 772, (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

[29] Levitt A., "A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading", Remarks of Chairman to the "S.E.C. Speaks" Conference, Washington, D.C., February 27, 1998.

company and trade in its securities or "tip" others to do so before that information is published or otherwise reflected in market prices.

In Re Cady, Roberts & Company[30], the court held that:

> *Analytically, the obligation [not to engage in insider trading] rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus, it is our task here to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited*[31].

MORAL OR ETHICAL OBJECTIONS:

In *Chiarella v United States*[32], Justice Blackmun expressed the view that:

> *"The Court has observed that the securities laws were not intended to replicate the law of fiduciary relations. Rather, their purpose is to ensure the fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate. As Congress itself has recognized, it is integral to this purpose to assure that dealing in securities is fair and without undue preferences or advantages among investors.*[33]"

The moral or ethical reason for prohibiting insider dealing is that the use of insider information is unfair to those who deal with the insider. Prohibiting insider trading is usually justified on fairness or equity grounds.

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[30] [1961] SEC 40.
[31] Ibid at 907.
[32] [1980] 445 U.S. at 245-252
[33] Ibid at 250

Insider trading promotes unfairness by allowing corporate insiders to selfishly abuse their position of trust and leads to an unfair skewing of availability of market profits in favor of insiders which can be characterized as unfair.

The grievous defect of the strictly economic arguments against insider trading is their apparent scorn for the moral or public opinion factor, which is relegated to the "it's just not right" proposition[34] .

This overlooks the fact that it is important for the markets, as it is for the courts, not merely to do equity but *to appear* to do equity[35].

LEGAL OBJECTIONS:

Breach of confidence:

An agent who acquires confidential information in the course of his employment or in violation of his duties has a duty to disgorge any profits made by the use of such information .Profits made by such a person in stock transactions undertaken because of his knowledge are held in constructive trust for the principal.

When the duty of confidence attaches, the holder of the information may not use it (for example by trading in securities) or disclose it (to another person so that the person can trade) without permission of the confider[36].

Breach of a fiduciary duty:

Insiders owe the corporation a fiduciary duty to act bona fide in the best interests of the organization. The corporate insider by accepting employment makes a contract with the

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[34] Manne H, *Insider Trading and the Stock Market* (1966).
[35]Loss L, *Fundamentals of Securities Regulation* (2ed. 1961) at p.608.
[36]Gower and Davies, *Principles of Modern Company Law* (7th ed. Sweet & Maxwell 2003) at p.756

shareholders to put their interests before his own, when the insider buys or sells based on company owned information, he is violating his contract with the shareholders.

In *Boardman and Another v Phipps*[37], Lord Upjohn observed thus;

> *The relevant rule for the decision of this case is the fundamental rule of equity that a person in a fiduciary capacity must not make a profit out of his trust, which is part of the wider rule that a trustee must not place himself in a position where his duty and his interest may conflict.*

Similarly, in *Brophy v. Cities Service Co.*, the Chancery court stated that;

> *Public policy will not permit an employee occupying a position of trust and confidentiality toward his employer to abuse that relation to his own profit, regardless of whether the employer suffers a loss.*[38]

Political Economy of Insider Dealing Legislation:

Governments undertake reforms in order to correct market failures and to enhance economic efficiency. Hence, insider-trading regulation might be an attempt by the government to correct a socially inefficient market failure that market participants are unwilling or unable to solve through private contracting. The government does this by enacting legislation that prohibits insider dealing and by having institutions that regulate and govern the securities market.

ECONOMIC OBJECTIONS:

Market confidence

Insider trading reduces public confidence in the capital markets thereby reducing the amount of capital available for investment and therefore harming the economy, it is seen as an externality-where insiders profit while society as a whole loses[39].

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[37] [1965] 3WLR 1009 p.420.
[38] 31 Del. Ch. at p.246

Building public confidence is central to market development. Without active, continuous public support and participation, markets will flounder for lack of products and liquidity[40].

To restore trust and confidence in the securities markets, the investing public must correctly perceive that the securities markets are indeed a level playing field. Additionally, they must perceive that investors privy to information not available to the investing public will not use that information to gain an advantage.

David D. Haddock in his article Insider Trading argues that insider trading undermines public confidence in the investor market.

He posits that securities markets require a level playing field to avoid frightening away investors who contribute to securities market liquidity and investors who would invest their savings in markets with less risk of insider predation.

Injury to Reputation:

Insider trading more often than not shows harm not to the issuer but the issuer's shareholders.

In *Diamond v Oreamuno*[41] Presiding Justice Botein aptly put it in the course of his opinion for the Appellate Division,

> *[t]he prestige and goodwill of a corporation, so vital to its prosperity, may be undermined by the revelation that its chief officers had been making personal profits out of corporate events which they had not disclosed to the community of stockholders.*[42]

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[39] Bauman T: "Insider Trading at Common Law" (1984) *The University of Chicago Law Review* (1984) at p.840.
[40] United Nations Institute for Training and Research (UNITAR): "Capital Markets Development, The Road Ahead", 2000 www.unitar.org/dfm (accessed on 17th May 2007)
[41] [1969] 248 NE 290.
[42] Ibid p.287.

When officers and directors abuse their position in order to gain personal profits, the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities.

Market Efficiency:

Efficiency-based arguments for regulating insider trading (as opposed to those grounded on legislative intent, equity, or fairness) fall into three main categories:

- insider trading harms investors and thus undermines investor confidence in the securities markets;
- insider trading harms the issuer of the affected securities; and
- insider trading amounts to theft of property belonging to the corporation and therefore should be prohibited even in the absence of harm to investors or the firm.

Insider trading decreases market efficiency. In a study of 54 securities markets, Julan & Shang-Jin[43] found that insider trading dramatically increases volatility in stock markets (after accounting for the impact of liquidity, maturity and macroeconomic fundamentals). Securities that offer similar returns but with differing risk profiles essentially share price volatility are priced at different levels.

Furthermore, insider trading decreases investors' confidence in the market by creating an unfair playing field, making it harder for companies to attract funds. Fishe & Robe[44], in a unique study of United States companies' shares in which insider trading had taken place,

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[43] Julan & Shang-Jin, 2003 "Does insider trading raise market volatility?" available on http://www.nber.org/papers/9541 (last accessed 19 May 2007)

[44] Fishe & Robe, 2002 "The Impact of Illegal Insider Trading in Dealer and Specialist Markets: Evidence from a Natural Experiment" available on http://som.yale.edu/jfm/ProgramPDFs/BWPaperv11b.pdf (last accessed 19 May 2007)

showed that they had less liquid shares than unaffected market equivalents, raising the cost of capital for the affected firm. This is also true for stock markets as a whole.

Property rights in Corporate Information:

Another justification for regulating insider trading is that it protects the property rights of the firm in inside information[45]. The law of insider trading is one way society allocates the property rights to information produced by a firm.

Insider trading legislation is fundamentally about the allocation of the property right in corporate information and hence about the distribution of rents derived from the use of such information. The State creates and protects property rights. This makes a political economic framework an appropriate way to understand a country's decision to enact and/or enforce insider trading legislation. When insider trading is legal, the State assigns (by default) the property right in and associated private rents from corporate information to corporate insiders[46].

The Misappropriation theory:

The misappropriation theory hinges on the principle that all information generated by or through the company belongs to the company. Consequently, persons who come into possession of such information in circumstances that warrant confidentiality are not permitted to misappropriate that information for their personal gain. This is based on the premise that

[45] Kelly W. Jr., Nardinelli C, and Wallace M. "Regulation of Insider Trading, Rethinking Sec Policy Rule."
[46] Beny L. "The Political Economy of Insider Trading Legislation and Enforcement: International Evidence", 2002.

liability is consequential on the existence of some relationship between the insider and the corporation that results in fiduciary duties or duties of confidence being owed to the corporation. The existence of such a relationship gives rise to a legal obligation not to act in a manner that would cause harm to the corporation[47].

In *Canadian Aero Service v O'Malley*[48], the court based its decision on misuse of a corporate opportunity. On this Laskin J. posited:

> *"An examination of the case law ...shows the pervasiveness of a strict ethic in this area of law. In my opinion, this ethic disqualifies a director or a senior officer from usurping for himself or diverting to another person or company with which he is associated a maturing business opportunity which his company is actively pursuing; he is also precluded from so acting even after his resignation where the resignation may fairly be said to be prompted or influenced by a wish to acquire for himself the opportunity to be sought by the company, or where it was his position with the company rather than a fresh initiative which led him to the opportunity which he later acquired*[49]*."*

The Unfair Advantage theory.

This argument stems from a policy that trading should only take place between parties where there is equal access to information[50] and the function of insider trading regulation is to allow fair-play in the market place.

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[47] Yeo V, " A Comparative Analysis of Insider Trading Regualtion- Who is Liable and What are the Sanctions?" 15th January 2001.
[48] [1973]40 D.L.R. (3d.) 371, Can.SC.
[49] At p.382.
[50] Brundy T, "Insiders, Outsiders and Informational Advantages under the Federal Securities Laws" (1979) 93, *Harvard Law Review* 322.

An insider trading on the basis of inside information would have an informational advantage over the other trading party, hence a regulatory and contractual framework dictated for securities is required to reduce opportunistic behavior.

ARGUMENTS FOR NON- REGULATION.

> *You want more insider trading, not less. You want to give the people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that." (CNN interview, January 17, 2002)*
>
> -Milton Friedman, laureate of the Nobel Memorial Prize in Economics,"

Arguments made for unregulated insider trading are typically premised on the claims that insider trading promotes market efficiency or that assigning the property right to inside information to managers is an efficient compensation scheme. Proponents of this argument are led by Henry Manne an economic scholar.

Is Insider Trading Fraudulent?

St. Thomas Aquinas argues that fraud can be perpetrated in two ways, either by selling one thing for another or by giving the wrong quality or quantity.[51] A more modern definition is "intentional deception to cause a person to give up property or some lawful rights."[52]

A more general definition is that fraud is perpetrated when a person knowingly or intentionally makes a false representation of fact to another with the intent that the other party

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[51]Dalcourt G, *The Philosophy and Writings of St. Thomas Aquinas* (1965), at 105; St. Thomas Aquinas, Summa Theologica, II-II, Q.77.

[52]Webster's New World Dictionary of the American Language, college edition (1964).

relies on the representation of the false statement to his loss, detriment, or damage occurs.[53] Some courts have extended liability to include negligent or inadvertent misrepresentation.[54] According to this theory, there is no fraud if there is no loss. And since insider trading does not involve any identifiable loss, the practice is not fraudulent. Even in cases where there is loss, it still has to be proven that all the elements of fraud are present before an inside trader can be found guilty of the offense. Furthermore, according to Aquinas, there is no moral duty to inform a potential buyer that the price of the good you are trying to sell is likely to change in the near future.[55]

In the case Aquinas discusses,

> *a wheat merchant carries wheat to a place where wheat fetches a high price, knowing that many will come after him carrying wheat.., if the buyers knew this they would give a lower price. But... the seller need not give the buyer this information.., the seller, since he sells his goods at the price actually offered him, does not seem to act contrary to justice through not stating what is going to happen, If however he were to do so, or if he lowered his price, it would be exceedingly virtuous on his part: although he does not seem to be bound to do this as a debt of justice.*[56]

A similar example was discussed by Cicero, in which a merchant was bringing grain from Alexandria to Rhodes, whose residents are starving. He knew that other grain merchants would arrive shortly. If he disclosed this fact, the price for his own grain would fall. Should he have disclosed?[57]

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[53]Foley, "Insider Trading: The Moral Issue," The Freeman 37 (November 1987): 409, at note 7.

[54]*Weiss v. Gumbert*, 191 Or. 119, 227 P.2d 812, 228 P.2d 800 (1951); 3 Restatement 126-45, Torts Second §§ 552-552C, cited in Foley, "Insider Trading: The Moral Issue," Freeman 37 (November 1987): 409, at note 8.

[55] St. Thomas Aquinas, Summa Theologica, II-II, Q.77, art. 3(4); Barath, "The Just Price and the Costs of Production According to St. Thomas Aquinas," New Scholasticism 34 (1960): 420; Bartell, "Value Price, and St. Thomas," The Thomist 25 (July 1962) at 359-60.

[56] St. Thomas Aquinas, Summa Theologica, II-II, Q.77, art. 3(4).

[57][7] Cicero, De Officiis Bk. III, ch. xiii (W. Miller trans. 1968). G. Lawson discusses this passage in "The Ethics of Insider Trading," Harv. J.L. & Pub. Pory 11 (1988): 727, at 738-39. This passage is also mentioned in Barry, "The Economics of Outside Information and Rule 10b-5," U. Pa.L. Rev. 129 (1981): 1307, at 1361 n. 206. For a

An insider who knows the stock price is likely to change in the near future has no "moral" duty to inform potential buyers of this fact. Where there is no moral duty, certainly there should be no legal duty either[58].

Law and economics scholars who favor unregulated insider trading typically argue that efficiency is the sole basis for analyzing a legal regime, and that the prohibition lacks any rational economic basis.

Insider trading as compensation to top management:

Some argue that insider trading is a legitimate form of compensation for corporate employees, permitting lower salaries that, in turn, benefit shareholders who pay lower salaries[59].

Henry Manne has been a major proponent of unregulated insider trading posited insider trading is an efficient way of compensating managers for having produced information so as to guarantee the uninterrupted flow of enterprenual abilities into the business enterprise.

The firm thus benefits directly (and society indirectly) because managers have a greater incentive to produce additional information of value to the firm.

Insider trading compensates entrepreneur achievements of investors which would otherwise be a necessary expense for the corporation. He argues that profits from insider trading constitute the only effective compensation scheme for entrepreneurial services in large corporations and added that those who have discovered this information have a stronger claim to profit than those who did not contribute to it[60].

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critique of the Lawson article, see J. R. Macey, "Comment: Ethics, Economics, and Insider Trading: Ayn Rand Meets the Theory of the Firm,"' Harv. J.L. & Pub. Pol'y 11 (1988): 785.

[58] Robert W. McGee and Walter E. Block, *Business Ethics and Common Sense*, edited by Robert McGee, Westport, CN: Quorum Books, 1992.

[59] Ibid at n.11, p.4.

[60] Manne H, Article on the "Events of Insider Trading" (1966), *Harvard Law Review* at 113.

This theory tends to look at insider trading from the insider's point of view only and being oblivious of the shareholder who is the principal to the insider. Shareholders more often that not are encouraged to pay hefty packages to top management and rarely if ever does top management accept to have lower salaries in turn to benefit from any inside information that comes their way.

The concept of free market economy.

Free market or free trade economy is an idealized form of a market economy in which buyers and sellers are permitted to carry out transactions based on mutual agreement on price without government intervention in the form of taxes, subsidies, regulation, or government ownership of goods or services[61]. Economists argue that government should not be allowed to regulate insider dealing and should leave such regulation to the market forces of demand and supply. They opine that property in information comes from natural law therefore it is incorrect to see government regulating inside information. The concept for the functioning of a free market includes no artificial pressures from government regulation.

Manne adds that long term investors suffer no loss from insider trading as long term investors select stock from the basis of fundamental factors such as dividend history, earning potential, growth prospects among others and not on the basis of short-swing profits[62] and fluctuations in the price of securities.

In my opinion, the free market concept fails because in a free market, buyers and sellers both have perfect and equivalent access to information. When insiders engage in trade when they

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[61] Adam Smith: "The Free Market Economy" http://www.en.wikipedia.org/wiki/free_market (accessed on 15th May 2007)

[62] These are profits realized in any period less than six months by corporate insiders in their own corporation stock.

have access to material non-public information, this theory does not suffice as both parties do not have equal access to information. One party is more advantaged at the expense of the other party, and a free market does not operate in such circumstances.

Insider trading: the Victimless Crime

Proponents of unregulated insider trading argue that if no one's rights are violated, the act is not unjust; if someone's rights are violated, the act is unjust. The obvious question they raise is: "Whose rights are violated by insider trading?"

The most obvious potential "victims" of insider trading are the potential sellers who sell their stock anonymously to an inside trader. But they would have sold anyway, so whether the inside trader buys from them or not does not affect the proceeds they receive from the sale[63].

If the sellers are hurt by having an inside trader in the market, it is difficult to measure the damage, and it appears that there is no damage. In fact, the academic literature recognizes that insider trading does not result in any harm to any identifiable group[64].

Those who sell to inside traders may actually be helped rather than harmed because they received a better price; it appears illogical to allow them to sue for damage if in fact there are no damages. In any event, there appears to be no violation of anyone's rights in such instances of insider trading.

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[63] Ibid at note 27, p.8

[64] Manne H, "Insider Trading and Property Rights in New Information," *Cato Journal* 4 (Winter 1985): 933 reprinted in Dom and Manne, eds., Economic Liberties and the Judiciary~(1987) at 317-27; Morgan, "*Insider Trading and the Infringement of Property.-"rights*," Ohio St. L. J. 48 (1987): 79.

Cost-Benefit Analysis.

> *"Talking to folks in Silicon Valley, they say it (insider trading) is rampant. Despite increasingly severe penalties, people say 'I can make a million dollars and I have a million-in-one chance of getting caught'. They may be willing to take that risk."*
>
> -Stephen Bainbridge, the University of California, Los Angeles
> Financial Times, June 20, 2002

Insider trading is a victimless offense and that enforcing insider trading prohibitions is simply not cost effective; the amount of money recovered does not justify the money and human capital spent on investigating and prosecuting insider traders[65].

Easterbrook, Frank H. and Daniel Fischel[66] are of the opinion that securities laws are either damaging or irrelevant to the extent that they raise costs and interfere with the optimal fixing of markets. They argue that such laws should be abolished.

Similarly, insiders who engage in insider dealing prefer to trade illegally since their chances of getting caught are slim and the benefits from such dealings are far more enticing than the deterrent nature of insider laws.

Manne adds that insider dealing increases capital market efficiency in that new information about a corporation is reflected in its securities if insiders are permitted to use it. According to this school of thought, insider trading enhances rather than disrupts efficient operation of capital markets. The primary argument is that insider dealing increases the amount of information about a firm that is incorporated into the price of its securities. In their opinion, this therefore improves the effectiveness of the market's process of stock valuation by reducing the risk of erroneous valuation. This benefits individual firms as well as the market

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[65] www.sec.gov (accessed on 13th February 2007)

[66] Easterbrook, Frank H. and Fischel D. "Mandatory Disclosure and the Protection of Investors", *Virginia Law Review* (1984) at 669-715.

as a whole[67]. Under this analysis, injured public buyers and sellers are sacrificed to a greater goal—market efficiency.

Insider trading laws result in compliance and escape costs. The legal and accounting fees involved in complying with or circumventing the law can be fairly expensive, an expense that would not be incurred in the absence of insider trading laws. Using indirect means to accomplish what could otherwise be accomplished directly also leads to unnecessary costs.[68] The delay in disclosure that results from using indirect means of accomplishing the goal also increases market inefficiency. There may also be other transaction costs, such as using an obscure mutual fund or a foreign bank or broker, when a more direct purchase would be less costly.

Taxpayers are adversely affected by insider trading laws, as enormous resources must be placed at the disposal of the regulatory power to do any kind of insider trading regulation. The resources used to police the insider trading laws might be better used to prevent some real criminal activity from being committed. For any use of government resources, there is a cost and a benefit. Because insider trading can be regarded as a victimless crime, if indeed it is a crime at all, an argument can be made that the resources government uses to enforce the insider trading laws can be better employed elsewhere.

I strongly disagree with Manne's proposition that there is no substantial relation between rigorous insider trading regulation and public confidence in the market. I am of the view that

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[67] Arturo Bris: "Do Insider Trading Laws Work?" June 2001.

[68] H. Demsetz, "*Perfect Competition, Regulation, and the Stock Market*," in H. Manne, ed., *Economic Policy and the Regulation of Corporate Securities* (1969); H. Manne, "Insider Trading and Property Rights in New Information," *Cato Journal*. 4 (Winter 1985): 933 reprinted in Dom and Manne, eds., *Economic Liberties and the Judiciary* (1987), 317-27.

investors will not be ready to invest in markets where corporate and constructive insiders use the inside information they have obtained for their personal gains.

CONCLUSION:

This chapter sought to make a case for regulating insider dealing and has demonstrated that there is an overwhelming case for the regulation of this vice.

It has illustrated that the securities markets could do with the confluence of legal, financial, political and institutional factors. This will aid in the development of a financial system that will enhance effective insider trading legislation or regulation.

States cannot afford to turn a blind eye to insider trading if they hope to promote vibrant securities market and attract investment.

CHAPTER THREE: DIRECTORS AND OTHER INSIDERS.

INTRODUCTION:

In this chapter, I will seek to demonstrate the concept of directors and employees as insiders as well as elucidate the principle of constructive insiders with focus on the fiduciary and confidential duties owed to the company.

I will discuss the various acts that constitute insider trading with reference to the disclosure principle, material non- public information and the requirement of securities to be listed in the stock exchange.

I will further analyze the various judicial authorities relating to insider trading.

WHO IS AN INSIDER?

Sec 2(1) of the Capital Markets Act[69] defines an insider as any person who is or was connected with a company or is deemed to have been connected with a company and who reasonably expected to access, by virtue of such connection to unpublished information which if made generally available, would be likely to materially affect the price or value of the securities of the company, or who has received or has had access to such unpublished information. The Act is not exhaustive in the definition of an insider; it narrows its definition to corporate insiders and does not give regard to an insider who acquires information from a corporate insider and trades on the basis of such information (constructive insiders.)

[69] Cap 485A, Laws of Kenya.

Under the Criminal Justice Act 1973 of the United Kingdom, a person was treated as an insider only if he knowingly had inside information and had obtained that information either directly as a director, shareholder or employee of the company or indirectly from such an inside source.

Insiders are often defined as officers[70], directors and employees of a company and anyone else who as material inside information about a company's securities[71]. Insiders have independent fiduciary duties to their company and its stockholders not to trade on material non-public information relating to the companies securities.

There is a common misconception is that only directors, employees and senior management can be convicted of insider trading. Any person with material, non-public information is capable of committing such acts: brokers, family members, friends can also be considered insiders.

As far as companies are concerned, insiders are considered to be company directors, officials, or any individual with a stake of 10% or more in the company. Insider trading among corporate insiders especially employees and directors arises when the articles of association of the company allow directors to hold a certain number of shares as qualification for their appointment. The employees on the other hand are permitted to own company shares under

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[70] For the purpose of Sec33(11) of the Capital Markets Act, an officer in relation to a body corporate includes a director, secretary, executive officer or employee of the body corporate, receiver, or receiver and manager, of property of the body corporation, official manager or a deputy official manager of the body corporate, liquidator of the body corporate, and a trustee or other person administering a compromise or arrangement made between the body corporate and another person or other persons.

[71] Beny L. "The Political Economy Of Insider Trading Legislation and Enforcement: International Evidence" 2002.

Employee Share Ownership Plan (ESOP) which acts as an incentive to work harder as they own part of the company's shareholding.

Under the Capital Markets Act Sec 33(9)

> *(9) For the purpose of this section, a person is connected with a body corporate if, being a natural person -*
>
> > *(a) he is an officer of that body corporate or of a related body corporate;*
> >
> > *(b) he is a substantial shareholder in that body corporate or in a related body corporate; or*
> >
> > *(c) he occupies a position that may reasonably be expected to give him access to information of a kind to which subsections (1) and (2) apply by virtue of -*
> >
> > > *(i) any professional or business relationship existing between himself (or his employer or a body corporate of which he is an officer) and that body corporate or a related body corporate; or*
> > >
> > > *(ii) his being an officer of a substantial shareholder in that body corporate or in a related body corporate.*

Such persons are considered to be insiders with respect to material non-pubic information about the companies securities. They should not trade while in possession of material non-public information relating to the company nor tip (or communicate except on a need to know basis) such information to others.

In *Moss v Morgan Stanley Inc*[72] it was held that;

> *"...it is a well settled that traditional corporate insiders-directors, officers and persons who have access to confidential information must preserve the confidentiality of non-public information that belongs and emanates from the corporation."*

Trading by insiders does not always amount to illegal insider trading.

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[72] 719 F.2d 5, 10(2d Cir.1983) at 101.

It is illegal when securities are traded in breach of a relationship of trust and confidence (a fiduciary duty) on the basis of material non-public information that can reasonably be expected to affect the price of the securities being transacted. In addition to trading; it is also illegal to tip information in violation of a fiduciary duty and to misappropriate confidential information[73].

DIRECTORS AS INSIDERS:

Under the Companies Act "director" includes any person occupying the position of director by whatever name called; Browne- Wilkinson V-C in *Re Le-Line Electric Motors Ltd*[74] opined that:

> *"...in my judgment, the words 'by whatever names called' show that the subsection is dealing with nomenclature, for example where the company's articles provide that the conduct of the company is committed to 'governors' and 'managers.' "*

Every director of a company regardless of whether it is listed or not is a fiduciary of the company and is bound to act in the best interests of the corporation[75].This duty is grounded on the basic principles of good faith, stewardship and accountability. Requirements imposed both by common law and various statutes seek to establish the parameters of this duty without limiting the flexibilities of these principles.

The duty to act in the "best interests of the corporation" means that a director must act in the interests of the corporations as a whole, rather than in the best interests of any particular

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[73] Macey J's testimony at the United States Senate Committee on the Judiciary- Professor of Law, Yale University, September, 2006.
[74] [1988] Ch.477 at 488
[75] Gower and Davies' *Principles of Modern Company Law*, (Seventh Edition; Sweet & Maxwell 2003) p.391-392.

shareholder or group of shareholders. At common law, the duties of directors are owed to the shareholders alone so long as the company is a going concern. This duty is however owed to the shareholders collectively and not individually.

In *Percival v Wright*[76], certain shareholders wrote to the company's secretary asking if he knew anyone wiling to but their shares. Negotiations took place and eventually the company chairman and two other directors bought the plaintiff's shares at £12,10shs per share. The plaintiff later discovered that prior to and during their own negotiations for sale, the chairman and the Board of Directors had been approached by third parties with a view to the purchase of the entire company's assets at more than the price of £12,10shs per share. The Plaintiff brought an action to set aside the share sales on the ground that the directors owed them a duty to disclose the negotiations with the third party. It was held that directors were not agents of individual shareholders but the company as a whole therefore they did not owe the plaintiffs a duty to disclose. If a director or officer of the company has made use for his own purpose of price sensitive information acquired in his capacity as such, amounts to a breach of his fiduciary obligations and is liable to the company which is entitled to recover any profit made.

WHAT CONSTITUTES INSIDER TRADING?

What constitutes insider trading can be inferred from the definition of insider trading.

Insider trading entails:

- trading in information which is:

[76] [1902] 2 Ch.421

material, and

non-public.

- dealing in securities when one is under a fiduciary duty or when there is a duty to keep the information confidential.
- the securities should relate to a public company.
- the securities should relate to a company quoted and listed on the stock exchange.

DISCLOSURE:

Disclosure in relation to securities held:

Section 32(4) of the Capital Markets Act provides that any person licensed under this Act to trade in securities should maintain a register of the securities in which he has an interest[77] and enter any change in interest in the register within seven days of the acquisition or change in interest.

A person who becomes a director of a company whether it is listed in the Stock Exchange or not is required to notify the company of his interest in the company's securities or any company that is associated with the company in which he is director[78].

Directors as potential insider traders may be required to disclose dealings in the companies' shares on the theory that if they know the fact of their dealings will be public knowledge, they will be less likely to trade on the basis of inside information[79].

The principle of disclosure was introduced as a result of the recommendations of the Cohen committee[80] where it was decided that the beneficial ownership of shares was to be disclosed

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[77] What amounts to interests includes restricted right of ownership, right of control over shares or debentures and the right to acquire or dispose of any of the companies securities. This also relates to interests of securities in associate companies.

[78] The Disclosure Requirements of the Cohen Committee.

[79] Gower & Davies', *Principles of Modern Company Law*, (Seventh Edition Sweet & Maxwell, 2003) at 752.

to the public, the speed of disclosure increased and the range of disclosure made more sophisticated[81]. The sole purpose of this rule is to enhance market transparency.

The disclose or abstain rule:

Sec 33(1) and (2) of The Capital Markets Act is an abstaining provision as it prohibits a person from trading in that companies securities if at any time in the preceding six months he has been connected with the corporation's securities and during that period he was in possession of information that is not available to the general public and would materially affect the price of those securities.

Regulation 19(2) of the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002[82] provides for prompt disclosure of information which might be reasonably expected to have material effect on the market activity and the price of the securities on a continuous basis. Under Regulation 19(3), such information ought to be disclosed to the Capital Markets Authority and the Nairobi Stock Exchange within twenty-four hours of the event. Regulation 20(a) and (b) exempts information relating to securities issued by or on behalf of the Government of Kenya or a body corporate established under any written law in Kenya other than the Companies Act; and to private offers.

Disclosure rules aim at those who have inside information and require them to disclose it whether or not they are likely to trade on the basis of it. The rationale behind this is that putting the information into the public domain reduces the opportunities of others to engage in

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[80] A committee on the United Kingdom's Company Law Amendment.
[81] Gower and Davies, *Principles of Modern Company Law,* (Seventh edition, Sweet & Maxwell, 2003) at 594.
[82] Legal Notice No. 60, May 3, 2002 (Kenya Gazette Supplement No. 40)

insider dealing. Though directors are not the only persons who can engage in insider trading, they are at a greater risk since their relationship with the company may lead to insider dealing as they have information that is available to them that is not available to the general public.

According to the Cohen committee,

> *" the best safeguard against improper transaction by directors and against unfounded suspicions of such transaction is to ensure that the disclosure is made of all their transactions in the shares or debentures and the right to acquire and dispose of any of the company's securities."*

Similarly, the obligation to disclose extends to the interests of the director's spouse, children under the age of majority since such interests are treated as the director's interests[83].

Regulation 21(1) (e) (ii) of the Capital Markets (Securities) (Public Offers, Listing and Disclosures) provides disclosure exemptions for employees and members of their families when such a company is a private company. If the company is a public company, then the interests of employees and directors' spouse and children under the age of majority should be disclosed.

In *Re Cady, Roberts & Co*[84]. The Securities Exchange Commission recognized that common law in some jurisdictions imposes on corporate insiders particularly the officers, directors or controlling shareholders an affirmative duty to disclose when dealing in securities.

In *Securities Exchange Commission v. Texan Gulf Sulphur Co*.[85] it was established that there was a disclose or abstain rule by holding that an insider who possesses material non-public information must either disclose such information before trading or abstain from trading until the information has been disclosed.

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[83] Schmidt H., *European Insider Dealing*.(Butterworths, 1991)
[84] [1961] 4 SEC 907.
[85] 401 F.2d 833(2d.Cir1968)

A duty to disclose or abstain from trading does not arise from the mere possession of non-public market information.[86]

FIDUCIARY RELATIONSHIP.

Professor Austin Scott, who for many years was the leading American scholar in the field of trust law, has defined the term *fiduciary* to mean: "a person who undertakes to act in the interest of another person"[87]

In *Aberdeen Railway Co. v Blaikie*[88] Lord Cranworth .L.C. was of the view that:

> *"A corporate body can only act by agents, and it is of course the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting. Such agents have duties to discharge of fiduciary nature towards their principal. And it is a rule of universal application that no one, having such duties to discharge, shall be allowed to enter into agreements in which he has, or can have a personal interest conflicting, or which may probably conflict, with the interests of those he is bound to protect...*[89]"

Kim Lane Schepple[90] opines that a fiduciary relationship creates an obligation not to use any information acquired within the relationship for personal purposes because such relationships provide privileged access to information. If an insider uses information acquired in the course of carrying out their duties, he will be acting in breach of his fiduciary duty.

Consequently, it is well settled that traditional corporate insiders; directors, officers, and persons who have access to confidential information must preserve the confidentiality of non-public information that belongs to and emanates from the corporation.

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[86] *Dirks v Securities Exchange Commission* 463 U.S 646[1983]
[87] Joseph F. Johnston, "Natural Law and Duties of Business Managers."
[88] (1854) 1 Macq. H.L. 461, HL.Sc.
[89] At 471-472.
[90] Schepple K. "It's Just Not Right: The Ethics of Insider Trading," 56 Law & Contemporary Problems (1993).

When a company brings a civil suit against an insider for breach of fiduciary duty, it does not have to show that it has suffered loss as a result of such dealings but simply that the fiduciaries have made an undisclosed profit.

It was so held in *Diamond v Oreamun*[91] where directors of a company were aware that due to an increase in expenses, profits had fallen drastically and they sold their shares at £4.25 per share before the information was made public. Subsequently, the price of the shares dropped to £4.11. The directors were held liable to account to the company for the difference for breach of their fiduciary duties, although the company had suffered no loss.

In *Industrial Development Consultants v Cooley*[92] and *Canadian Aero Service v O'Malley*[93], the companies concerned had been eager to obtain highly remunerative work in connection with impending projects. In both cases, it was unlikely that the companies could have obtained the work, but in each there was a director whose expertise the undertaker of the information was anxious to obtain. Accordingly, each of the directors resigned his office and later joined the undertaker of the project. They were both held accountable for the profit made for unjust enrichment.

In the words of Roskill J. in *Industrial Development Consultants v Cooley*,

> "*It is an overriding principle of equity that a man must not be allowed to put himself in a position where his fiduciary duty and interest conflict. It was the defendant's duty to disclose to the plaintiff the information he had obtained from the Gas Board and he had to account to them for the profits he made and will continue to make as a result of allowing his interests and duty to conflict. It makes no difference that a profit is one which the company itself could not have obtained. The question being not whether the company could have acquired it but whether the defendant acquired it while acting for the company.*[94]"

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[91] [1969] 248 NE 290.
[92] [1972]1 W.L.R.443.
[93] [1973]40 D.L.R. (3d.) 371.
[94] At 451.

A similar holding was made in *Boardman v Phipps*[95].

The existence of a fiduciary duty creates a duty to disclose. This was evidenced in *Percival v Wright*[96] where the directors had purchased a member's shares in the knowledge that there was a ready buyer of all the shares at a higher price than they had paid him. It was held that the transaction could not be set aside for the directors' failure to disclose the negotiations that were already taking place at a higher price. There was no duty to disclose because there was no fiduciary relationship between the directors and individual shareholders.

However in *Allen v Hyatt*[97], the directors had profited through share purchases from members and were held accountable to them because they had purported to act as agents for the shareholders. Unless some special relationship could be shown so as to establish a legal duty to disclose all relevant information, the officer retained his profit without adverse legal consequences.

The courts did recognize special but very limited circumstances in which directors may owe a duty to individual shareholders. They were found liable for the breach of duty and had to account for the profit made.

In *Regal Hastings v Gulliver (1942)*[98], the directors benefited from the sale of shares they previously held in their capacity as directors, it was held that they were liable to account. In the words of Lord Sankey,

> *"As to the duties on liabilities of those occupying a fiduciary position... in my view the respondents were in a fiduciary position and their liability to account does not depend upon prove of "mala fides". The general rule of equity is that no one who has duties of a fiduciary nature to perform is allowed to enter into engagements in which he has or can have a personal interest conflicting with the interests of those*

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[95] [1967] 2 A.C. 46, HL.
[96] [1902] 2 Ch.421.
[97] [1914] 30 T.L.R. 444.
[98] [1942] 1 All E.R.

whom he is bound to protect. If he holds any property so acquired as trustee, he is bound to account for it.[99]

INFORMATION:

Material Information;

Regulation 2 of the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002 has defined material information as any information that may affect the price of an issuer's securities or influence investment decisions.

Sec 56 of the Criminal Justice Act of the United Kingdom defines inside information as information which: relates to particular securities or to a particular issuer of securities and not to the securities generally or to issues of securities, is specific or precise, has not been made public and if it were made pubic would likely have significant effect on the price of the securities.

Information is material if there is substantial likelihood that a reasonable investor would consider the information important in deciding how to act or if the release could affect the current security price in the market[100].

Liability for insider dealing arises only when the insider trades while in possession of material non- public information.

Non-Public Information.

Sec 32A of the Capital Markets Act prohibits the use of non-published insider information. It prohibits the insider from dealing on his own behalf, communicating such information except

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[99] Ibid at 378.

[100] Myburgh A. and Davies B." The Impact of South Africa's Insider Trading Regime," A report for the Financial Services Board, March 2004.

in the ordinary course of business or counseling or procuring another person to trade on the basis of such information.

In his article; Insider Trading, The case Against the Victimless Crime, Norman S. Douglas[101] observes that inside information exists when management has developed information concerning a change in the value of the firm but has made no general public disclosure of this information.

OFFER OF SECURITIES MUST RELATE TO THE PUBLIC.

Regulation 5 of the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002 provides that an offer which is made to any section of the public, whether selected as members or debenture holders of a body corporate, or as clients of the person making the offer, or in any other manner, is to be regarded as made to the public; and the term public offer is construed. The Act does not regulate securities of a private company.

SECURITIES MUST BE QUOTED ON THE STOCK EXCHANGE:

The securities that relate to the public should be quoted on the Nairobi Stock Exchange (NSE) and should be listed in the Alternative Investment, Fixed Income or the Main Investment Market segments. Securities that are not listed are not regulated by the Capital Markets Authority with regard to insider dealing[102].

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[101] Douglas N., "Insider Trading: The case Against the Victimless Crime", *The Financial Review* Vol. 23 No.2 May 1998.

[102] Sec 32(3) of the Act, transaction in securities refers to securities quoted on a stock exchange.

CONSTRUCTIVE INSIDERS:

These are persons other than corporate insiders.

"Constructive" or "secondary" insiders include lawyers, accountants, investment bankers, employees of the regulator or the state, brokers and dealers, who may be privy to private information by virtue of a contractual relationship with the firm or its shareholders. To the extent that they may have access to non-public information from insiders, relatives, personal and political associates of insiders, they are also classified as insiders[103].

One is considered a constructive insider under the following circumstances:

- the outsider must contain non-public information from the issuer.
- the issuer must expect the outsider to keep the disclosed information confidential.
- the relationship must imply such a duty.

Dirks v Securities Exchange Commission defined constructive insiders as lawyers, investment bankers and others who receive confidential information from a corporation whilst providing services to the corporation.

They are liable for insider trading violations if the corporation expects the information to remain confidential since they acquire the fiduciary duties of the true insider, provided the corporation expected the constructive insider to keep the information confidential. Tippees inherit an insider's duties and are also liable for trading on material non-public information illegally tipped to them by an insider. Sec 32A(1)(b) and(c) of the Capital Markets Act prohibits an insider from communicating insider information, procuring or counsel another person to deal in the securities of any company on the basis of unpublished price sensitive information.

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[103]Beny L; "The Political Economy of Insider Trading Legislation and Enforcement: International Evidence" (2002) at page 8.

Just as an insider is liable for insider trading of their tippees, so are the tippees who pass the information along to others who trade.

In 1984, the Supreme Court of the United States ruled in *Dirks v Securities Exchange Commission* that tippees (receivers of second-hand information) are liable if they had reason to believe that the tipper had breached a fiduciary duty in disclosing confidential information and the tipper received any personal benefit from the disclosure.

This case was significant because it addressed the issue of trading liability of "tippees". It was held that tippees are liable if they know or had reason to believe that the tipper had breached a fiduciary duty in disclosing the confidential information and the tipper received a direct or indirect personal benefit from the disclosure.

A similar position was held in *Schering Chemicals Ltd. v Falkman Ltd*[104] where the recipient of the information (the tippee) would also be in breach of duty by using or disclosing the information if aware that it had been communicated in breach of the duty imposed on the tipper.

The nature of the relationship between the tipper and the tippee is important in determining whether one is a constructive insider.

A tip by itself is not sufficient to result in liability, and neither is the breach of the duty of loyalty imposed on all fiduciaries to avoid profiting from information entrusted to them. A tippee can only be liable when the tipper has reached a fiduciary duty by disclosing information to the tippee, and the tippee knows or has reason to be aware of such a breach of duty.

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[104] (1982) Q.B. 1,CA.

CONCLUSION:

This chapter has explained the concept of corporate insiders and insider trading. It has demonstrated how insider trading takes place, its perpetrators and the legal framework evolving to regulate it.

It has demonstrated that perpetrators of insider dealing are persons who owe the corporation a duty of confidence and a fiduciary duty. The foregoing discussion demonstrates that there is a need to regulate such duties in a more efficient and effective manner so as to reduce the instances of insider dealing by insiders.

CHAPTER FOUR: INSIDER TRADING; AN ANALYSIS OF THE LEGAL AND INSTITUTIONAL FRAMEWORK IN KENYA.

"Lawgivers make the citizen good by inculcating habits in them, and this is the aim of every law-giver; if he does not succeed in doing that, his legislation is a failure. It is in this that a good constitution differs from a bad one"

-Aristotle.

INTRODUCTION:

This chapter will examine the statutory framework on insider dealing in Kenya and the institutions that deal or govern securities markets. It will also focus on the regulatory bodies that govern securities and trading in the Kenyan market and their development.

It will take an in-depth look at the Companies Act and the Capital Markets Act, with regard to the sections that govern insider trading. The Capital Markets (Securities) (Public Offers, Listing And Disclosures) Regulations, 2002, provide guidelines on the disclosure principal.

It will further lay out the various roles played by the regulatory bodies play in ensuring that the securities market is free, fair and efficient.

KENYA'S LEGAL POSITION:

In Kenya, insider trading is governed by the Capital Markets Act Cap 485A, Companies Act, the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002

and the guidelines on Corporate Governance Practices by Public Listed Companies[105]. The guidelines set precedence on corporate governance practices that should be observed by management and such practices reduce occurrences of insider dealing.

COMPANIES ACT[106]:

This is an Act of Parliament enacted in 1962 to amend and consolidate the law relating to the incorporation, regulation and winding up of companies and other associations, and other matters relating thereto and connected therewith.

The Act does not however expressly provide for the regulation of insider trading. Though it is based on the disclosure principle, Sec 200 provides that it shall be the duty of a director who is in any way directly or indirectly interested in a contract or proposed contract with the company to declare the nature of his interest at a meeting of the directors of the company.

However, the disclosure principles provided for under this section cannot safeguard the interests of shareholders.

CAPITAL MARKETS ACT:

History;

In 1984 the Government of Kenya commissioned the study of money and Capital markets and the report became the basis for structural reforms in the financial markets. This report and other developments led to the enactment of the Capital Markets Authority Act in 1989 Cap 485A.

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[105] Gazette Notice No 3362 of May 14th, 2002.
[106] Cap 486 Laws of Kenya.

The objective of the Capital Markets Act, Cap 485A as set out in its preamble is to establish a Capital Markets Authority for the

> *" purpose of promoting, regulating and facilitating the development of an orderly, fair and efficient Capital Markets in Kenya and for connected purpose"*

The 1989 Act only had one section (Section 33) that prohibited insider trading. The Act was silent on the aspect of unpublished inside information that was the centre of insider dealing and this was a critical oversight.

In July 2000, the Capital Markets Authority Act was amended and renamed the Capital Markets Act. Among its new provisions in the amended Act was the need to tighten the provisions dealing with insider trading. It had new provisions and among them were:

- Section 30A that provides for the publication of information memorandum which complies with the requirements of the authority before securities of such an organization are sold to the public or a section of the public.
- Section 32A that prohibits the use of unpublished insider information.
- Section 35 was amended. It now provides for appeals from actions by the Authority in matters such as:
  i. refusing to admit a security to the official list of a securities exchange, suspending trading of a security on a securities exchange,
  ii. removal of a security from the official list of a securities exchange and provides that such appeals should be appealed to the Capital Markets Tribunal and not the Minister of Finance as was the case before.
- Section 35A provides for the establishment of the Capital Markets Tribunal.

The Act borrows heavily from the Criminal Justice Act of 1973 of the United Kingdom.

Sec 30A ensures that the publication of an information memorandum in regard to securities is true and fair to prevent misleading the general public.

> *(1)No person shall, in Kenya, offer its securities for subscription or sale to the public or a section of the public unless prior to such offer, it publishes an information memorandum signed by or on behalf of its officers and files a copy thereof with the Authority.*
>
> *(2) Every information memorandum shall comply with such requirements as may be prescribed by the Authority:*

Sec 31 provides for transaction in securities and gives special regard to market manipulation.

> *(6) No person holding shares in a public company listed on an approved securities exchange shall sell or transfer such shares except in compliance with the trading procedures adopted by such securities exchange.*
>
> *(7) No person shall, directly or indirectly, in connection with the purchase or sale of any security -*
>
> > *(a) Employ any device, scheme or artifice to defraud;*
> >
> > *(b) Engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person;*
> >
> > *(c) Make any untrue statement of a material fact; or*
> >
> > *(d) Omit to state a material fact necessary in order to make the statements made in light of the circumstances under which they were made, not misleading.*

Sec 31(7) gives special regard to cases of securities manipulation where insiders give untrue statements on the financial position of the company so as to make their shares in the market more appealing and this mainly occurs where the company is doing poorly financially and there may be a risk that the shares may not be attractive to the public in their true state.

Sec 32(4) provides for the need to register any interests in the securities or any changes thereon. This ensures that there is disclosure on any changes in the securities, when they happened and it would be easier to detect if the change in securities was due to some inside information that the company had and the insider took advantage of.

> *(4)A person to whom section (1)[107] applies shall maintain a register of the securities in which he has an interest and such interest or any changes in such interest shall be entered in the register within seven days[108] of the acquisition or change in the interest.*

Such securities must be quoted in the Stock Exchange for this section to apply.

Sec 32A of the Act prohibits use of unpublished price sensitive information.

> *(1) No insider shall-*
>
> > *(a) either on his own behalf or on behalf of any other person, deal in securities of a company listed on any stock exchange on the basis of any unpublished price sensitive information; or*
> >
> > *(b) Communicate any unpublished price sensitive information to any person, with or without his request for such information, except as required in the ordinary course of business or under any law;*
> >
> > *(c) Counsel or procure any other person to deal in securities of any company on the basis of unpublished price sensitive information.*
>
> *(2)Any insider, who deals in securities or communicates any information or consults any person dealing in securities in contravention of the provisions of subsection (1), shall be guilty of insider trading.*

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[107] Sec 32(1)applies to any person registered under the Act and a photojournalist(a person who contributes advice concerning securities or prepares analyses or reports concerning securities for publication in a newspaper or periodical)

[108] Under The Capital Markets (Securities) (Public Offers, Listing And Disclosures) Regulations, 2002, "days" means calendar days excluding Saturdays, Sundays and public holidays.

Section 32A (1)(b) prohibits breaching one's duty of confidence by communicating inside information to other people except in the ordinary course of business. This includes relaying such information to one's family, friends or colleagues.

Sec 33 generally prohibits insider trading.

> *(1) A person who is, or at any time in the preceding six months has been, connected with a body corporate shall not deal in any securities of that body corporate if by reason of his being, or having been, connected with that body corporate he is in possession of information that is not generally available but, if it were, would be likely to materially affect the price of those securities.*
>
> *(2) A person who is, or at any time in the preceding six months has been, connected with a body corporate shall not deal in any securities of any body corporate if by reason of his so being, or having been, connected with that first mentioned body corporate he is in possession of information that -*
>
> *(a) is not generally available but, if it were, would be likely materially to affect the price or value of those securities; and*
>
> *(b) Relate to any transaction (actual or expected) involving both bodies corporate or involving one of them and securities of other.*

The above sections provide a time limit within which an insider cannot deal in securities when (s)he is or was in any way connected to the corporation or was or is in possession of inside information. This reduces the chances of an insider from dealing in the securities of a company illegally.

> *(3) Where a person is in possession of any such information referred to in subsection (2) which if made generally available, would be likely to materially affect the price of securities but is not precluded by that subsection from dealing in those securities, he shall not deal in those securities if;*
>
> *(a) he has obtained the information, directly or indirectly, from another person and is aware, or ought reasonably to be aware, of facts or circumstances by virtue of which that other person is*

himself precluded by subsection (1) from dealing in those securities; and

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

Sec 33(3) relates to the aspect of tippers – tippees and constructive insiders[109].

(4) A person shall not, at any time when he is precluded by subsections (1), (2), or (3) from dealing in any securities cause or procure any other person to deal in those securities.

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

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

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

(6) when any officer of that body corporate is precluded by subsections (1), (2), or (3) from dealing in those securities.

(7) A body corporate is not precluded by subsection (6) from entering into a transaction at any time by reason only of information in the possession of an officer of that body corporate if -

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

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

[109] Lawyers, investment bankers and others who receive confidential information from a corporation while providing services to that corporation.

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

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

Secs 33(7) and (8) are especially important when an insider tips the tippee, where they in turn open a company that can deal anonymously on the stock exchange following the tips and they hide behind such companies so that no fiduciary is created. It's the corporation itself that buys and sells stocks with the insiders' manipulation[110].

Sec33 (12) provides penalties for persons involved in insider dealing. Insider Dealing in Kenya is generally a criminal offence.

(12)A person who contravenes this section shall be guilty of an offence and shall be liable -

(a) on a first offence -

(i) in the case of a body corporate, to a fine not exceeding five million shillings;

(ii) in the case of any other person, including a director or officer of a body corporate, to a fine not exceeding two million five hundred thousand shillings or to imprisonment for a term not exceeding five years or to both;

(b) on any subsequent conviction -

(i) in the case of a body corporate, to a fine not exceeding ten million shillings; or

[110] Readers Digest, Compiled Series, Long time no see.

(ii) in the case of any other person, including a director or officer of a body corporate, to a fine not exceeding five million shillings or to imprisonment for a term not exceeding seven years or to both.

The provisions of the Act are not extensive enough.

They don not define the phrase "insider trading or dealing". This would provide clear guidelines as to what specific acts or omissions constitute insider trading. Further, it would avoid over-reliance on the definitions of other jurisdictions.

Under the definition of "inside information", the Act is not specific in that the information should relate to a particular issuer of securities or particular securities and not to securities generally[111].

The Act does not provide that the information be of a precise nature. This is a serious omission in that for one to accurately identify inside information, it has to be specific and not of a general nature. This would also aid in identifying perpetrators on insider dealing as they would be acting n material inside information of a nature therefore easier to identify than when information relates to a general nature. The definition of information relating to an issuer should be expanded to include information about the company's business prospects as opposed to narrowing the definition to only information about the company.

The Act should provide how information becomes public. This includes:

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[111] The Criminal Justice Act 1973, of England defines inside information under Sec 56(1) as information which -relates to particular securities or to a particular issuer of securities or to particular issuers of securities and not to securities generally or to issuers of securities generally; is specific or precise; has not been made public; and if it were made public would be likely to have a significant effect on the price of any securities.

i. the duration of time that the information is disseminated into the market to amount to public information,

ii. should it be published in the local dailies for this to apply,

iii. should it be available to the general public or a section of the public for such information to amount to public information?

CAPITAL MARKETS (SECURITIES) (PUBLIC OFFERS, LISTING AND DISCLOSURES) REGULATIONS, 2002

These regulations were made by the Capital Markets Authority in exercise of the powers conferred upon it by Section 12(1)[112] of the Capital Markets Act.

The regulations provide clear guidelines in terms of disclosure of information by the company itself and insiders. It provides time limits, within which such information should be disclosed, and exceptions to the disclosure rule.

Regulation 3(1) provides that these regulations shall apply to all offers of securities in Kenya to the public whether or not the issuer is seeking a listing on any securities exchange in Kenya.

According to Regulation 5, an offer which is made to any section of the public, whether selected as members or debenture holders of a body corporate, or as clients of the person making the offer, or in any other manner, is to be regarded as made to the public.

Regulation 19(2) provides for the need to immediately and continuously disclose information which might be reasonably expected to have material effect on the market activity and the price of the securities. Under Regulation 19(3), such information should be disclosed within

[112] Power of the authority to issue rules, regulations and guidelines.

twenty four hours of the event to the Capital Markets Authority and the Stock Exchange which the issuer's securities are listed, and to the public during non-trading hours of the relevant market segment.

Regulation 20(a)and (b) provides exceptions to the disclosure rules(immediate and continuous disclosure) on securities issued by or on behalf of the Government of Kenya or a body corporate established under any written law other than the Companies Act; and to private offers.

Regulation 22 empowers the licensed securities exchange (Nairobi Stock Exchange) to suspend and de-list listed securities subject to the approval of the Capital Markets Authority in the event a listed company fails to adhere to the continuous listing obligations particularly the regular and timely public disclosure of financial and other price sensitive information.

In this regard, one company (Hutchings Biemer Ltd.) was suspended from trading at the Nairobi Stock Exchange for non-compliance with the statutory obligation for continuous reporting[113].In addition, four companies and five fixed income securities have been de-listed for failure to meet the minimum listing requirements. The de-listed companies include African Lakes Corporation and the East African Packaging Industries Limited[114].

There is need to disseminate material non-public information to the general public so that they can access the information in a timely manner. This can be through radio broadcasts; newspaper notices at least twenty- four hours after such information has been rendered material and non-public. There should also be a prohibition on trading on the basis until after

[113] Capital Markets Authority Annual Reports 2003; available from www.cma.or.ke (accessed on 10th May 2007).
[114] Ibid.

a week of publicizing the information. This ensures the information has been diffused into the public sphere.

GUIDELINES ON CORPORATE GOVERNANCE PRACTICES BY PUBLIC LISTED COMPANIES IN KENYA[115]

These guidelines define corporate governance as the process and structure used to direct and manage business affairs of the company towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholders' long-term value while taking into account the interests of other stake holders[116].

The Capital Markets Authority developed these guidelines in response to the growing importance of governance issues and also in recognition of the role of good corporate governance in protection of investor's rights[117].

The Authority has adopted a prescriptive and non-prescriptive (binding and non-binding) approach to the corporate governance guidelines. It is non-prescriptive in view of the fact it recognizes that good corporate governance practices must be nurtured and encouraged to evolve as a matter of best practice, in order to provide for flexibility and innovative dynamism to corporate governance practices by public listed companies. Therefore, the guidelines are a

[115] Gazette notice No.3362, OF May 14th 2002.
[116] Guideline 1.2
[117] Mensah S.; "Corporate Governance In Africa: The Role Of Capital Market Regulation" Presented at the 2nd Pan African Consultative Forum on Corporate Governance, Nairobi, Kenya, July 21-23, 2003.

framework through which listed companies can develop best corporate governance practices[118].

The guidelines need to include representatives of ordinary shareholders as part of the audit committee. Including independent and non-executive directors[119] is an serious omission, the shareholders need to ensure that their interests are served and protected. This can be done by including some of them in such committees. Similarly, members of the board should not be the ones that elect the audit committee. This should be done by the shareholders in an annual general meeting. Similarly, such a committee should have a specified term in office which after expiry, a new committee is elected.

INSTIUTIONAL FRAMEWORK:

CAPITAL MARKETS AUTHORITY

The capital market is part of the financial system that provides funds for long-term development. This is a market that brings together lenders (investors) of capital and borrowers (companies that sell securities to the public) of capital[120].

In 1984, a study on the Development of Money and Capital Markets in Kenya. This was jointly undertaken by the Central Bank of Kenya and the International Finance Corporation. The main objectives were to make recommendations on measures that would ensure active

[118]"Capital Markets Authorities, the Road Ahead". Papers written following a UNITAR Sub-Regional Workshop on Capital Market Development for West Africa (Accra-Ghana, 10 to 14 April 2000)

[119] Guideline 3.5.1 provides that the board should establish an audit committee of at least three independent and non-executive directors.

[120]"Capital Markets Authorities, the Road Ahead". Papers written following a UNITAR Sub-Regional Workshop on Capital Market Development for West Africa (Accra-Ghana, 10 to 14 April 2000)

development and strengthening of the financial sector. This became a blueprint for structural reforms in the financial markets. The Government further re-affirmed its commitment to the creation of a regulatory body for the capital markets in the 1986 Sessional Paper on "Economic Management of Renewed Growth"[121].

In November 1988, the Government set up Capital Markets Development Advisory Council. It was charged with the role of working out the necessary modalities including the drafting of a bill to establish the Capital Markets Authority (the Authority).

In November1989, the bill was passed in parliament and subsequently received Presidential assent .The Capital Markets Authority was set up in 1989 through an Act of Parliament[122]. The Authority was eventually constituted in January 1990 and inaugurated on 7th March 1990. The Authority is a body corporate with perpetual succession and a common seal. Although the Capital Markets Authority is a statutory body, it is operates as an independent entity in contrast to a government body[123].

Role of the capital markets authority on insider trading regulation.

- The Authority under Sec 12 of the Act has the power to develop a legal and regulatory framework for the securities market. Among the rules it has developed are the Capital Markets (Securities) (Public Offers, Listing and Disclosure) Regulations, 2002 and the Corporate Governance Guidelines, 2002. The framework ensures that all market participants comply with the regulatory rules and requirements in order to protect

[121] www.cma.or.ke (accessed on 10th of May 2007)
[122] Cap 485A,Laws of Kenya
[123] Sec 39 of the Capital Markets Act exempts the Authority form the provisions of the State Corporations Act Cap 446 which is an Act of Parliament that provides for the establishment of state corporations; for control and regulation of state corporations and for connected purposes.

investors, foster investor confidence and preserve the integrity and efficiency of the capital market. Penalties are provided in case of non-compliance.

- Facilitates the existence of a market in which securities can be traded in an orderly, fair and efficient manner and ensure participation of the general public. This is mostly with the regulations and guidelines the Authority is empowered in making.
- The Authority protects investors from financial loss arising from failure of a broker or dealer to meet his contractual obligations through a guarantee embodied in the compensation fund.
- The Authority facilitates the training and education of investors and other market participants. This educates the public and would help them identify instances of insider trading especially tips from insiders and therefore desist form trading.

Generally, the effective functioning of capital markets requires the following:[124]

- Existence of an exchange, clearing and settlement system.
- Existence of a legal system to enforce contracts.
- Availability of information on financial soundness and future prospects of companies
- Governance of corporations in a manner that gives investors confidence that their funds will not be stolen or wasted.

[124] Available from http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/generaldescription/1Capital+Markets?opendocument. (accessed April 2, 2007)

NAIROBI STOCK EXCHANGE.

History of the Nairobi Stock Exchange.

Dealing in shares and stocks started in Kenya in the 1920s. At this time, Kenya was a British colony.

Stock broking was conducted solely by Europeans in areas of specialization such as accountants, auctioneers, estate agents and lawyers who met to exchange prices over a cup of coffee. Trading took place on gentlemen's agreement in which standard commissions were charged and clients were obliged to honor their contractual commitments such as making good delivery and settling relevant cost[125].

There was no formal market, rules or regulations to govern stock broking.

Francis Drummond, an estate agent, established the first professional stock broking firm in 1951. He impressed upon Sir Ernest Vasey, the then Finance Minister of Kenya, the need to set up a stock exchange in East Africa. In July 1953, Sir Ernest Vasey and Francis Drummond made the proposal to the London Stock Exchange officials who accepted and recognized the establishment of the Nairobi Stock Exchange (NSE) as an overseas stock exchange[126].

In 1954, the Nairobi Stock Exchange was constituted as a voluntary association of stockbrokers registered under the Societies Act. The Nairobi Stock Exchange was incorporated under the Companies Act of Kenya in 1991 as a company limited by guarantee and without a share capital[127].

There was phenomenal growth of the Nairobi Stock Exchange from a small voluntary Association of stock brokers in 1954 to a company limited by guarantee in 1994. This

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[125] Nairobi Stock Exchange, Handbook: *An Authoritative 5-year Performance Results of Listed Companies.* 2002 Ed. (Nairobi, 2002), 164 .

[126] Ngugi R, Development of the Nairobi Stock Exchange : A Historical Perspective.(Masters thesis)

[127] Nairobi Stock Exchange Memorandum of Association and Articles of Association. Available from, www.nse.co.ke (accessed May 17th 2007)

demonstrated that the stock market had become an important sector of the economy that required an appropriate policy, legal and regulatory framework.

In 1994 the Nairobi Stock Exchange was rated by the International Finance Corporation (IFC) as the best performing emerging market in the world[128].

The requirement of an appropriate policy was inevitable as a regulated securities market engenders confidence as it enhances fairness, orderliness, efficiency and investor protection. There was a need for a legally sanctioned institutional framework with the market and international standards to streamline the industry. This was been achieved through the establishment of the Capital Markets Act and the Nairobi Stock Exchange Trading Rules.

The Nairobi Stock Exchange has a compliance department which is mandated to monitor compliance with rules and regulations by listed companies and other market participants. It receives complaints from aggrieved investors and channels them to the Authority for investigation and action.

The main issues investigated by the Authority include[129]:

- Compliance issues involving listed companies.
- Investor complaints on market manipulation.
- Complaints on mismanagement of listed companies.
- Violation of regulations.

When a complaint is filed and investigations reveal the violation or non-compliance of rules and regulations, the Capital Markets Authority demands corrective action from the relevant licensee.

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[128] World Bank Financial Sector's Learning Programme. "Capital Markets in Emerging Economies, A case study of the Nairobi Stock Exchange."

[129] Capital Markets Authority Annual Reports 2003 (accessed May 17th, 2007); available from www.cma.or.ke.

Failure to comply leads to penalties in the form of fines payable to the Capital Markets Authority, or suspension of license and prohibition from participation in the market.

CONCLUSION:

This chapter has demonstrated Kenya's legislative and institutional framework on insider dealing.

It has shown that the principal challenge remains detection of the crime and securing a conviction for offenders. This will serve as a punitive measure to the perpetrator and a deterrent measure to the public. What emerges is that not a single person has been prosecuted and convicted.

Like in other jurisdictions, it is apparent that the underlying challenge is not unique to Kenya only. In Britain, the prosecution of persons allegedly involved in insider trading has been very challenging. It is only in few cases that accused persons have been convicted.

CHAPTER FIVE: RECOMMENDATIONS AND REFORMS ON INSIDER TRADING REGULATION.

INTRODUCTION:

This chapter will make recommendations and identify the reforms necessary for the effective regulation of insider trading. It will cover the disclosure principle, principles of corporate governance, education and sensitization of the public, additional remedies and the need for specialized courts.

APPROACHES TO REGULATING INISDER TRADING:

This entails ways in which incidences of insider trading can be reduced or totally eliminated.

DISCLOSURE:

The disclosure principle was introduced as a result of the recommendations of the Cohen committee in 1945.[130] The committee posited that the beneficial ownership of shares was to be disclosed to the public, the speed of disclosure increased and the range of disclosure made more sophisticated[131].

The main purpose of this rule is to enhance market transparency. Putting the information into the public domain reduces the opportunities of others to engage in insider dealing.

[130] A committee on the United Kingdom's Company Law Amendment.
[131] Gower and Davies, *Principles of Modern Company Law* (Sweet &Maxwell , Seventh Edition 2003) at 594.

As the European Commission's High Level Group of Company Law Experts remarked:

> *"Information and disclosure is an area where company law and securities regulation come together. It is a key objective of securities regulation in general to ensure market participants have sufficient information in order to participate in the market on an informed basis"*[132].

The company must inform the public as soon as possible of any major developments in its sphere of activity which are not in the public domain. Such developments may by virtue their effect on its assets and liabilities or financial position or on the general course of its business, lead to substantial movements in the prices of its shares[133].

The company, its members and the public are entitled to prompt information on the acquisition of a significant holding in its voting shares. This enables existing members and those dealing with the company to protect their interests. The conduct of the affairs of the company is also not prejudiced by uncertainty over those who may be in a position to influence or control the company[134].

There is need to develop a culture among corporate and constructive insiders that concealing negative information is unethical and poor business practice.

If managers and other insiders work in an environment where disclosure is the norm and where others are occasionally disgraced and sent to jail for any illegal actions, a culture that practices and follows good business ethics will develop.

For disclosure to be effective, timeliness of disclosure is critical: the disclosure should not be premature which will result in speculations nor should it be too late such that the information

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[132] Report on the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe (Brussels, November 4th, 2002), Ch. II. 3

[133] Directive 2001/34/EC, [2001] O.J.L 184/1, Article 68

[134] Gower and Davies', *Principles of Modern Company Law*,(7th Ed. Sweet & Maxwell, 2003) P.593.

cannot materially affect the prices of securities. The disclosure should be such that it will materially affect the price of the securities at the time of dissemination of the information into the market.

An active financial press that can uncover and publicize incidences of insider dealing and its perpetrators is important.

Insiders will be more reluctant to engage in insider dealing. Independent directors, accountants and securities lawyers will be more vigorous in policing it if a country has a financial press that is ready and eager to publicize misdeeds.

The libel laws are important, they should be structured in such a way that press reporting is not unduly threatened by constant fear of libel suits from insiders; however, responsible journalism is necessary.

The press should report when they have concrete proof of the fact that insider dealing had taken place.

DISCLOSURE COMMITTEE:

Every public company should take the initiative to establish a disclosure committee that consists of both corporate officers and a few shareholders who will represent the general body of shareholders. The committee should also consist of an expert on securities who should be independent and have no beneficial holding in the organization nor its subsidiaries.

The shareholders should hold office for a maximum of one year and another set of shareholders take up office. The shareholders should be nominated at the annual general meeting.

The Disclosure Committee will have the responsibility to[135]:

(a) set benchmarks for a preliminary assessment of materiality, and review and approve, before they are Generally Disclosed, all written, electronic and oral statements (including all News Releases, Corporate Documents and Public Oral Statements) that may contain Material Information;

(b) make determinations about whether:

(i) any information is Material Information;

(ii) a Material Change has occurred;

(iii) selective disclosure has been or might be made; or

(iv) a Misrepresentation has been made; and, in this regard, consult with counsel or other appropriate expert advisors as the Disclosure Committee may deem necessary;

(c) determine the timing for public release of information,

(d) make all other determinations under this policy and grant any exemptions from this policy;

(e) monitor the effectiveness of and compliance with this policy;

(f) educate the directors, officers and employees of the organization, its Subsidiaries about the matters covered by this policy;

(g) monitor the organization's web site;

(h) where it is deemed that information should remain confidential, to determine how the inside information will be controlled and whether there is any need for discussions or filings with regulators on a confidential basis;

(i) regularly update this policy to take account of new developments and best

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[135] Foley M's letter to David Wright on the Implementation of the European Parliament and Council Derivative 2003/6, EC's Insider Dealing and Market Manipulation, April 30th 2003.

practices and ensure compliance with changing regulatory requirements; and

(j) report to the board of directors, the Audit Committee or another committee of the board of directors as contemplated by this policy.

The disclosure committee should then approve information before public disclosure.

KENYA'S CAPITAL MARKETS:

Compared to other countries on the continent, Kenya has a fairly well developed financial and capital markets, with its stock market rated by the International Finance Corporation (IFC) the most promising emergent market in 1994.[136]

However, there is need for reforms that ensure the capital markets authority is efficient, can inspire confidence in issuers and investors, stimulate competition and resilient enough so that it is not overrun by events.

There are two essential prerequisites for strong securities markets. A country's laws and related institutions must give minority shareholders:

(i) good information about the value of a company's business; and

(ii) confidence that the company's insiders (its managers and controlling shareholders) will not deceive investors out of most of the value of their investment. If these two steps can be achieved, a country has the potential to develop a vibrant stock market that can provide capital to growing firms, though still no certainty of developing such a market.

There is need for the willingness to enforce meaningful standard listings by fining or delisting companies that violate rules on insider dealing transactions. This can be effective with the financial resources and skill to run surveillance operations that can lead to

[136] The United Nations Conference on Trade and Development: "Disclosure in Kenya," 7th August 2003.

prosecution and conviction of perpetrators. Rules on paper are important but not sufficient. Enforcement is critical[137].

Developing capital markets cannot grow if norms such as the rule of law are not effective in society. A general tendency to disregard the rule of law shapes a culture of lawlessness that not only adversely impacts the growth of the capital markets but also the overall economic growth. The culture of lawlessness breeds expropriation in the developing capital markets. Therefore, for the transition economies, the legal culture of effective implementation and enforcement should receive greater attention, because no legal or regulatory measures would be fruitful in its absence[138].

EDUCATION:

There is need to campaign and educate the public on various aspects of capital markets, the harm occasioned by insider trading and encourage them to report any cases of insider trading they may come across.

There is also need to educate magistrates, judges, forensic investigators and prosecutors to enable them understand the financial markets and particulars of insider trading. In the Cairo and Alexandria Stock Markets, their stock exchanges provide courses for judges and prosecutors to help them understand financial markets[139].

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[137] Russian company law offers a good example. It contains reasonably strong procedural protections against self-dealing transactions. But in practice, Russian companies routinely ignore the rules on self-dealing transactions, because there is no enforcement. Insiders hide the transactions, and (sometimes corrupt) prosecutors and judges usually let the insiders off the hook in the rare case when a transaction is exposed. Bernard Black , "Corporate Governance In Asia: A Comparative Perspective -Creating Strong Stock Markets by Protecting Outside Shareholders". Seoul, 3-5 March 1999

[138] Ibrahim A. "Developing Governance and Regulations in Emerging Capital Markets", 2006 http://lsr.nellco.org/georgetown/gps/papers/2 (accessed on 28th May 2007.)

[139] Mensah S, "Corporate Governance in Africa: The Role of Capital Market Regulation" Presented at the 2nd Pan-African Consultative Forum on Corporate Governance, Nairobi, Kenya, July 21-23, 2003.

Insider dealing is a criminal offence in Kenya that is prosecuted by the Attorney- General. The officers in his department should be well versed with the particulars of the offence and especially the prosecutors who have to argue the case beyond a reasonable doubt. This requires prior and detailed knowledge of the offence and this will only suffice if the prosecutors are versed with what insider dealing is. Few prosecutors have the skill or experience to prosecute securities fraud cases. Specialization is needed.

Another important step is establishing or strengthening good learning institutions (for investment bankers and accountants) and law (for securities lawyers and regulators). The payoff for this investment in training of young people will be measured in decades. But if the investment isn't made, the decades will go by, and the country still will not have the prerequisites it needs[140].

SPECIALIZED COURT.

A judicial system that is honest and capable to handle complex cases on securities is critical. Cases in Kenya take long from institution of a suit to its conclusion. Similarly, an honest judiciary is a must for any investor's remedies to be meaningful, the same goes for honest prosecutors. The professionals that we have in the securities field can be chosen as prosecutors and judges, they should however be of high repute, and credible.

Disputes dealing with securities are usually complex, and require specialized skills in the field therefore the need for specialized judges and prosecutors. A specialized court that deals with a high number of securities cases and other complex commercial cases is also an acceptable substitute.

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[140] Simeon Djankov et al., "The Law and Economics of Self-Dealing" (Nat'l Bureau of Econ. Research, Working Paper No. 11883), available at http://papers.nber.org/papers/w11883 last visited on 25th May 2007

The time frame within which the case is decided is important. When insiders commit fraud, some of their assets or accounts can be frozen pending the outcome of a case that the prosecutors plan to institute. This prevents the insider from transferring funds from his account to another person's account where the funds cannot be accessed. An insider intelligent enough to conduct insider dealing is also intelligent enough to move his assets beyond the court's reach if given a warning that they may be seized or lost in a court action.

It should be noted that effective law enforcement is not a substitute for poor laws on the books and good laws cannot substitute for weak (legal) institutions in the transition economy[141].

REMEDIES:

The law should develop more remedies. These include:

i. Directors should also sign declarations assuming personal obligation for compliance with the listing rules and insider trading rules and regulations at the risk of personal liability. Directors are also required to complete a 'fit and proper' declaration that is not validated by the regulator but is made public when there false declarations made which can be quite embarrassing for the directors. The declaration shows that any information, accounts coming from the company are true and proper to be given to the public. The directors also indicate that they will also not engage in insider trading or any trade that will be of sole benefit to themselves as opposed to the general body of shareholders[142].

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[141] Katharina Pistor et al., *Law and Finance in Transition Economies*, 8 ECON. OF TRANSITION (2000) at 1152

[142] The Johannesburg Stock Exchange implemented such a declaration on all directors of listed companies from 1st of September 2003.

ii. Disclosure of the award and exercise of executive stock options. This will eradicate instances in which the executive exercises such awards especially when they have material inside information that will raise the prices of their stock when such information becomes public.

iii. Mandatory training of directors and induction,[143] could also serves as an accreditation process for the directors prior to being fully incorporated into the board.

iv. The Investor Compensation Fund under Sec 18 of the Capital Markets Act should be expanded to include compensation for shareholders who are victims of insider dealing. This will provide a form of assurance and cover for shareholders when insider trading takes place.

WHISTLEBLOWERS:

There is need for the Capital Markets Act to provide for and protect whistleblowers. Whistleblowers should be protected against criminal responsibility which should be available for mandated breach reporting.

Such persons should be protected from self-incriminations, defamation actions, and actions relating to breach of employment contracts or agreements such as confidentiality agreements and ensure that they are free from harassment or victimization. There should be rules that allow the whistleblowers to act in anonymity. The rules should also provide that the whistleblower should not be subject to any criminal or civil liability for the making of the

[143] The process used within many businesses to welcome new employees to the company and prepare them for their new role, it is mainly training oriented.

disclosure and no contractual or other remedy may be enforced or any other right exercised against the person on the basis of disclosure[144].

PRIOR NOTICE:

An insider who wishes to sell or but the shares of the company should give prior notice which should be made immediately public.(S)he should state the nature of the proposed transaction, the amount to be purchased or sold and the reasons for the transaction.

There should be a time limit within which trade on the proposed securities cannot take place until expiry of the time period of the notice being filed.

This would certainly make the price more efficient, and would thus address the concerns of other shareholders. The only difference would be that the stockholders, rather than the employees of the stockholders, would be the beneficiaries of the efficiency.

This proposal merely reverses the timing of the existing requirement to make public the details of purchases and sales by corporate insiders. Prior notification allows the market to react prior to the transaction rather than subsequent to it. This reverses the advantage and restores the concept that the corporation, including all information about it, belongs properly to its owners, the stockholders, and not their employees.

The proposal goes further to underscore this proper relationship by requiring the corporate insider to state the reason for the sale. Balancing the equities, it seems that the employers, the stockholders, should know why a member of senior management is purchasing or selling securities of their company.

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[144]Sam Mensah, "Corporate Governance in Africa: The Role of Capital Market Regulation" Presented at the 2nd Pan-African Consultative Forum on Corporate Governance, Nairobi, Kenya, July 21-23, 2003

VOLUME LIMITATION:

I recommend that within a particular period say three months; a corporate insider may sell no more than a specified volume of securities.

Volume limitations should not relate to the amount of securities outstanding or traded, but rather to the percentage of the ownership of the corporate insider.

Outstanding securities of many public companies are so large in number and trading so voluminous that many corporate insiders can sell their entire holdings, totaling massive amounts of securities, and still be within the required volume limitations.

Volume limitations can also be used to put the brakes on large unregistered sales by corporate insiders.

This proposal is intended to avoid massive sell offs that are below the volume limitations by limiting the amount of securities that a corporate insider can sell at one time. In the case of purchases, similar volume limitation would serve to discourage massive buying in advance of advantageous news. This is important because each purchase by the employee is a sale by one of her employers, a stockholder. Central to this proposal is the conceptual basis that corporate information, good, bad or indifferent belongs to all the stockholders, not any one employee or group of employees.

PRINCIPLES OF CORPORATE GOVERNANCE:

Corporate governance concerns the relationships among the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders.

Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital. For emerging

market countries, improving corporate governance can serve a number of important public policy objectives. Good corporate governance reduces emerging market vulnerability to financial crises, reinforces property rights, reduces transaction costs and the cost of capital, and leads to capital market development. Weak corporate governance frameworks reduce investor confidence, and can discourage outside investment.[145]

> *Transparency and governance is critical in delivering the knowledge, capital, and skills that will enable the region to diversify its economies... and to grow the wealth of its people, which will lead to political and social stability. As we raise our corporate governance levels, it will increase trust in the region's financial sector, and contribute to attracting foreign direct investment, as well as encouraging local and regional banks to provide financing to SMEs and entrepreneurs*[146].

In general, the foundations of the market systems include compelling transparency, prohibiting insider-dealing and policing self-dealing[147].

Quality of information regarding the value of company's business and confidence against self-dealing are the preconditions for strong public securities markets[148].Honest courts and government, regulators and prosecutors are important and should be domesticated

In the absence of substantive rights and their effective enforcement, the emerging capital markets are not likely be successful. Features such as market discipline, private litigation,

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[145] The World Bank Report on the Observance of Standards and Codes (ROSC) Corporate Governance Country Assessment, Malaysia, June 2005.

[146] Dr. Omar .B ., Director General of "Dubai International Finance Centre" announcing the establishment of a "Regional Institute of Corporate Governance" to serve at improving the regional securities and financial markets.

[147] Bratton W. & McCahery J, "Comparative Corporate Governance and the Theory of the Firm: the Case against Global Cross Reference", 38 *Columbia . Journal. TransnationalL L.* 213, 296-97 (1999).

[148] Bernard S. Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 *UCLA L. REV.* 781, 783 (2001)

private contracting, standardized disclosure and private dispute resolution within market-friendly standards of liability have been considered relevant for stock market development[149].

Effective and transparent accountability at the macro-level strengthens people's confidence on their rights, and discourages those who would benefit from the weaknesses of the system.

The Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya[150] need to be expanded to become more detailed on matters such as internal controls, audit committees and auditor's independence.

INTERNAL CONTROLS AND AUDITOR'S INDEPENDENCE:

In 2003, the International Federation of Accountants published "Rebuilding Public Confidence in Financial Reporting: An International Perspective", which recommended establishing and monitoring corporate codes of ethics, controls to reduce threats to auditor independence, and greater attention to audit quality control processes[151].

Effective internal audit controls call for auditor independence and responsibility for detecting and reporting on fraud or illegal acts. They also monitor compliance with insider laws, and detect conflict of interests. A strong internal control system minimizes the possibility of significant errors and irregularities. It also helps in detection of any irregularities in the organization's system and this keeps insiders on their toes and calls for responsible and ethical business practices in the corporation.

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[149] Pistor K. et al., "Law and Finance in Transition Economies," 8 ECON. OF TRANSITION 325, 356 (2000).
[150] Gazette Notice No.3362 of MAY 14TH 2002.
[151] Waring C. "Internal Auditors" December 2006, available from http://findarticles.com/p/search?tb=art&qt=colleen+G+Warring. (accessed n 31st May 2007)

For example, in the trial of former Enron CEO Jeffrey Skilling, the U.S. government contended that Skilling grossed nearly $63 million from Enron stock sales in 2000 and 2001, while holding material, non-public information about the company's fraud.

Skilling was not the only Enron executive whose selling seems well-timed. In all, 29 Enron executives and directors sold $1.1 billion in Enron stock from 1999 to mid-2001, while gross financial misreporting supported a soaring stock price[152].

The lack of such effective controls resulted into the Enron scandal where the internal auditors were aware of the declining position of the firm but they did not report the fraud and illegal acts that were taking place as they were compromised.

Auditors' independence is crucial for proper functioning of their duties, they cannot effectively disclose any illegal activities if they are largely dependent on their clients as they will avoid disclosing information that might prejudice their client.

There is need to strengthen public sector internal controls as this will act as a deterrent factor for insiders from engaging in insider trading as they might be discovered and reported.

Despite the proliferation of laws and authoritative guidance on strengthening the ethical climate, the crimes, irregularities, and greed continue unabated. Internal auditors can become agents of change.

Similarly, there is need to develop audit committees in public companies.

Under Section 301 of Sarbanes-Oxley Act, the audit committees of public companies are required to establish procedures for:

(a) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters;

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[152] Agrawal A. and Cooper T, "Insider Trading before Accounting Scandals," current version May 2007, previous version February 2006.

(b) for the issuer's employees to submit information about questionable accounting or auditing matters in a confidential, anonymous manner.

It would be satisfying to see effective prosecution and conviction of perpetrators of insider trading in Kenya. The law should adequately cover and protect shareholders regardless of the fact that they are usually not aware when insider trading takes place. It should also instill confidence in the securities markets. Insiders with ethical business practices will enhance fair and effective trading in the securities markets without fear of being defrauded.

CONCLUSION:

As demonstrated earlier, regulation of insider trading in Kenya is wanting in many respects. However, that is not all. Challenges such as inadequate funding, personnel, resources, and surveillance, ineffective enforcement generally have been predominant in our securities markets.

Statutes intended to enhance market integrity and investor protection have relatively negligible effect as there is widespread non-compliance.

Sufficient allocation of resources includes procuring adequate funding, personnel, and technological surveillance mechanisms. Educational or "enlightenment" missions should also be included to stress the importance of these statutory prohibitions to affected parties. They include corporate insiders, bankers, legislators, judges, and the investing public through public awareness programs and extensive public education drives.

Local draftsmen with the requisite skills on securities need to be closely involved in the drafting process, to ensure that the rules fit into an existing legal framework and that the rules build on existing terminology and practice to the extent possible.

Once reasonably successful enforcement of legal mandates ensues and is perceived in that fashion by market participants, the securities markets will be deemed more attractive as a forum for both capital raising and investment purposes.

The length of this list is intended to suggest that developing strong securities markets is a difficult task, but not an impossible one.

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