A. INTRODUCTION

It is a fundamental truism that the existence of a robust, efficient and arguably ebullient capital market must of necessity be preceded by an established legal regime that not only provides for the establishment of a proper regulatory framework but also contains a set of rules and/or principles of law from where the rights of the various players can be easily ascertained without unnecessary litigation. On the contrary, poor legal regimes will more likely than not dampen the growth of the capital markets or at least ensure its collapse, a result that any investor would not want to hear.

We examine loosely provide a synthesis of the legal regime governing Capital Markets in Kenya on the basis of which we identify the nitty-gritty of risks arising in the trading of shares. We also attempt an identify the newest products of capital markets and evaluate how the same can be structured in the Kenyan market.

B. THE LEGAL REGIME GOVERNING THE CAPITAL MARKETS.

The Capital Markets Authority Act Cap.485A Laws of Kenya contain the substantive law governing the operations of the capital markets in Kenya. The object of the Act to establish a Capital Markets Authority for the purpose of promoting and facilitating the development of an orderly, fair and efficient capital market in Kenya and for connected purposes.¹

I. THE CORE FUNCTIONS OF THE CAPITAL MARKETS AUTHORITY

a. Approval Function

The Authority is empowered to grant approval to persons to carry on business as securities exchange, registered venture capital fund, collective investment scheme, ¹

¹ See Preamble.
central depository, credit rating agency, etc. The approval must be effected in accordance with the rules prescribed by the Authority.

b. Licensing

The Authority is mandated to license stockbrokers, dealers, investment advisers, fund managers, investment banks, authorized securities dealers, authorized depository, securities exchange, etc. A formal application for license must be made to the Authority in a prescribed form. The Authority is empowered to revoke any license granted if satisfied that the licensee has violated or failed to comply with its instructions or rules.

c. Registration.

The Capital Market Authority registers collective investment schemes. Promoters of the scheme are required to apply for consent from the Authority so as to register the scheme and once the consent is granted and on compliance with the Act and other requirements a formal application may be made to the Authority.

d. Intervention in the Management of a Licensee.

The Authority is empowered to appoint a statutory manager to assume the management, control and conduct of the affairs and business of a licensed person and exercise all powers of a licensed person to the exclusion of its board of directors. It has authority to remove any officer or employee of a licensed person if in its opinion he is responsible for any contravention of the provisions of the Act or any regulations thereunder or is to blame for the deterioration of the financial stability of the licensed person or has been guilty of conduct detrimental to the interests of investors.

The Authority has mandate to appoint a competent person familiar with the business or a licensed person to the Board of its Directors to hold office as a director. Such a director cannot be removed from office without approval of the authority or an order of the High Court. This power is exercisable if for example a licensed person’s license or approval is suspended, a winding up petition has been presented to the court, a resolution for winding up is proposed, a receiver or manager has been appointed, the Authority discovers or becomes aware of facts which in its opinion warrant the exercise of the relevant power in the interests of investors.

e. Regulation of Dealings in Securities
Under section 30 (a) of the Act, no person shall 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 with the Authority.

An information memorandum under this section must comply with the requirements prescribed by the Act. Under section 31(1) of the Act no licensed person, broker or dealer shall trade in listed securities outside the securities exchange of which he is a member, except as provided for by the Authority’s rules or as authorized by the Authority on a case by case basis and on payment of a prescribed fee. However, the Authority may authorize the transfer of a listed security outside the Securities Exchange if it satisfied that

(i) the transaction is a private transaction as prescribed by the Authority; and

(ii) it would be in the interests of the holders of ordinary shares of the company having regard to the prevailing conditions and all factors which are relevant in the circumstances to so authorize.


Under section 35(1) of the Act a person aggrieved by any direction given by the Authority to:

(1) Refusing to grant a license,
(2) imposing limitations or restrictions on a license,
(3) suspending or revoking a licensing,
(4) refusing to admit a security to the official list of the Securities Exchange,
(5) suspending trade of a security on a securities exchange,
(6) requiring the removal of a security from the official of Securities Exchange,

May appeal to the Capital Markets Tribunal against such directions, refusal, limitation or restrictions, cancellations, suspensions, or removal as the case may be within 15 days from date on which the decision was communicated to the person. The Tribunal may require the Authority to show cause for its action and may affirm or after affording the Authority an opportunity of being heard set aside the Authority’s decision.

Once an appeal is made in writing by any party or a reference is made to the Tribunal by the Authority or any Committee or Officer of the Authority, the Tribunal must inquire into the matter and make an award.\(^2\)

\(^2\) The tribunal has so far handles only one case: Shah Munge Partners v Capital Markets Authority
g. Investor Compensation Fund

This is a fund established by section 18(1) for the purpose of granting compensation to investors who suffer pecuniary loss by reason of failure of licensed stockbrokers or dealers to meet their contractual obligations.

II. SUBSIDIARY REGULATIONS.

To enable the authority perform its core functions effectively, the Minister for Finance has pursuant to section 36 of the Act made the following regulations.

a. Capital markets (Collective Investment Schemes) Regulations 2001

These regulations are aimed at facilitating mutual funds, unit trusts, investment trusts or special form of collective investment schemes for the purpose of mobilizing savings in financial assets and enhancing access to capital by small investors. Collective investment schemes offer a unique opportunity to investors in terms of professional management, economies of scale and diversification of portfolio and risk.

The regulations cover requirements for registration, management, pricing, valuation and redemption, etc. They also provide for requirements for employee share ownership schemes and special interest collective investment schemes.


These are comprehensive regulations to govern public offers, disclosure requirements and listing of securities. They prescribe the approval process for public offers of securities, requirements of information memoranda, eligibility requirement for public offers and listing of securities in each of the market segments of the Securities Exchange. They also detail the disclosure requirement for each market segment as well as the continuing reporting obligations for listed companies. They also prescribe the fees to be charged by the Securities Exchange for listing of securities.

The licensing requirements and general regulations are a set of comprehensive regulations prescribing the requirements for licensing in approval of capital markets, institutions, including securities exchange, stockbrokers, dealers, investment banks, investment advisers, fund managers, authorized securities dealers, authorized depositories, credit rating agencies, and registered venture capital funds. These regulations prescribe detailed financial requirements for the institutions, functions, code of conduct and reporting obligations.

d. Guidelines in Corporate Governance Practices by Public Listed Companies In Kenya.

Capital markets guidelines on Corporate Governance, practices by public listed companies. These guidelines prescribe requirements for corporate governance for public listed companies and issuance of securities in the capital market. The guidelines are consistent with the authorities endeavour to bring the legal corporate governance to international standards. They are based on the principle and virtues of good corporate governance including requirement for audit committees.

e. Guidelines On The Approval And Registration For Credit Rating Agencies 2002

These guidelines prescribe requirements for registration, accreditation and approval of rating agencies for the purpose of rating issuers of debt securities through the capital markets.


These regulations provide a legal regime for corporate take-overs and mergers and acquiring of shares by players in the Capital Markets.

g. Capital Markets, (Foreign Investor) Regulations 2002

These regulations provide a checklist of factors and sets minimum threshold to be met before a foreigner can be allowed to invest in Kenyan capital markets.

III. ELECTRONIC TRADING: THE OPERATIONALIZATION OF THE CENTRAL DEPOSITORY SYSTEM

The objective of this project is to create an electronic infrastructure for the market, to facilitate trading, clearing, settlement and depository services. The Central
Depositories Act 2000 provides the requisite legal framework. This system is intended to

(i) improve and enhance trading, delivery, registration, settlement and depository system of the market
(ii) enhance liquidity of the market, thereby increasing the turnover of securities in the market
(iii) improve the transparency of transactions in the market thereby minimizing instances of fraud as well as reducing the systematic risk
(iv) increase the market efficiency thereby lowering the transaction and operational costs which in the long term makes the market more attractive to investors and issuers
(v) improve the timeliness of communication and information flows in the market especially between issuers and investors
(vi) position the Kenyan market competitively in line with international practices and trends as well as enhance regional financial markets integration.

The Central Depository and Settlement Corporation, the body to spearhead the CDS was incorporated in March 2002. Shares are currently traded electronically at the Nairobi Stock Exchange as a result of the implementation of this system.

C. THE INTERMEDIARY RISK IN THE INDIRECT HOLDING SYSTEM

i. The Nature of the Risk.

Perhaps as a result of information asymmetry, many individual investors as opposed to corporate investors who have access to advice from a pool of lawyers, auditors, investment banks and other advisors have no clue that the issuance of shares in Kenya has in the recent times been undertaken by way of an indirect holding system. What then is this indirect holding system?
The indirect holding system, as a transactional pattern for the issuance of shares, principally involves the so-called securities intermediaries being used to make the issuance of shares to the investors easier. The securities intermediaries are normally investment banks, authorized depositories and brokers all of whom have different roles in the chain. In a large sense, the issuer of securities normally sells the stock to authorized depositories who in turn sell the stock to other intermediaries such as investment banks or brokerage firms who ultimately sell the to the investing public.

For example, consider an investor who wishes to invest in 500 shares of company A’s stock. In theory, that investor could purchase 1000 shares of the company’s
stock from a brokerage firm. However, for reasons discussed below, the broker may not directly hold individual shares; companies often issue securities in large blocks. For purposes of this example, assume that A issued a certificate for 1,000,000 shares of its stock to a depository. If a broker then wishes to purchase 50,000 shares of A, some perhaps for its own account and some for customers, it would pay the depository the market price of those shares. In return, the broker effectively receives a 5% undivided, or pro rata interest in the 1,000,000-share certificate held by the depository. If the investor then seeks to purchase 500 shares of A from the broker, the investor would pay the broker the market price of those shares, and, in return would effectively receive a 1% undivided interest in the brokers 5% undivided interest.

In this chain, intermediary risk therefore arises in the event of an intermediary’s failure where the creditors of the intermediary can then claim against the assets held by the intermediary for the benefit of investors. It is therefore crucial that the legal system is designed to contain rules that protect the investors fractional undivided interest in the securities held by the failed intermediary, an issue that the existing Kenyan legal regime does not tackle.

ii. Is the Existing Legal Regime Adequate?

It is a fundamental principle of Kenyan law enshrined in the doctrine of nemo dat quo non habet that a creditor quo cannot validly claim more rights than its debtor has in the property. Applied in the context of the insolvency of an intermediary, it means that, the liquidator of a failed intermediary takes the property owned by the intermediary “subject to equities,” in the sense that any imperfections in the title and any valid subsisting claims arising from the property or any security rights previously effected in relation to it, which interests are transmitted intact so as to become exercisable against the new owner. Consequently, the application of this principle suggest that if therefore, an intermediary only owns a partial interest (e.g. undivided) in the securities, then the intermediaries creditors in their capacity as such should be able to reach that partial interest.

Our argument is that despite the seductiveness of this legal position, a critical exegesis of the law of contract principles glaringly reveal that what exists between an investor and an intermediary is actually a contract and that the fact that it is difficult to ascertain the exact rights the intermediary or the investor as a debtor should have in the property renders the contract to lack an essential component, the requirement of certainty, and therefore unenforceable. The net result is then clear; an investor would only be left with in personam rights against the intermediary which would be in pari passu with other unsecured claims and effectively subordinate in priority to secured claims! The consequence then may be to discourage investors to participate in the capital markets, a fact that is not
good for the overall economic development given the role of the capital markets in the economy.

iii. Which Way for the Legislator?

It is the ultimate responsibility of the legislator to monitor and determine which path the law should take. In this era of inter-connected market, we shall be greatly left behind if we do not design proper laws that allow for the development of capital markets as experiences from the developed capital markets reveal. Indeed while we are still grappling with complexities of the IPOs other countries have moved forward by enacting laws that facilitate their companies to raise money in the capital markets through use of newest financing techniques. However, all is not lost. Our capital markets are still at the nascent state of growth and only with an appropriate legal reform can we ensure its growth.

In this part of the essay, we have specifically examined how the so called intermediary risk can ostracize investors from the capital markets and we therefore make the following recommendations to guide law reform

An amendment needs to be made in the Law of Contract specifically providing that investors have property interests (or interests therein) held for them by intermediaries, not merely in *personam* claims against the intermediaries. Accordingly, these securities and interests are not property of the securities intermediary, and are not subject to claims of the creditors of the securities intermediary (an approach employed in the Uniform Commercial Code of the USA). Alternatively, it should be legal militated in the proposed law, that parties are presumed to have joint ownership in deposited stocks according to records of their account books, an approach employed in Japan. In addition, the German approach can be also be embraced. It provides that investors have preference in certain circumstances over creditors of an insolvent custodian with respect to securities owned by the custodian.

D. UNTAPPED OPPORTUNITIES IN THE KENYAN CAPITAL MARKET.

a. Justification.

The Kenyan Capital Markets is far way behind in terms of embracing innovative techniques. In this part of the presentation we examine how the markets can be utilized to take on board what has now been referred to as structured Finance.

Structured Finance transactions, sometimes seen as a system of earnings management, are basically off-balance sheet financing techniques that enable a company to raise cheap funds from the capital markets than it would have had it issued securities directly. The typical examples of Structured Finance transactions include securitization (Asset-Backed
Finance), Leveraged Buy-Out (LBO) transactions, project finance and similar transactions that involve the origination of financial assets.

Perhaps it is useful at this point to briefly outline what each financial transactional pattern involves. In a typical securitization transaction, a company that seeks to raise cash from the capital markets may transfer certain of its assets to a special purpose vehicle (SPV) or a trust in a "true sale" legal arrangement. The transferred assets are referred to as receivables or financial assets while the company transferring these assets is known as the originator. The term obligors refer to the entities who are obligated to pay these transferred receivables. Upon this transfer, the SPV or trust can then issue securities or debt-like instruments in the capital markets. The holders of these securities are then paid from the proceeds received from the receivables.

The types of assets that have been traditionally securitized include mortgage loans, corporate loans, credit card receivables and other self-liquidating assets. In the Euro-Dollar markets, complex securitization structures have been developed that allow even risk in project lending to be securitized.

A Leveraged-Buyout Transaction on the other hand involves a group of investors, sometimes associated with the management of the company, taking control of that firm (referred to as the target firm) by indirectly causing it to borrow and then using its proceeds to purchase its stock. In a typical LBO transaction, the acquisition minded investors create a shell company and after obtaining commitment from lenders to borrow sufficient funds to purchase the stock of the target firm, the shell company makes a tender offer for those shares. The shell company then pays for the purchased shares by drawing down on its loan commitment. After purchasing those shares and thereby acquiring the target firm as a subsidiary, the shell company causes the target firm to merge into itself. The merged firm is then given the name of the target firm and pledges its assets to the LBO lenders to secure payment of the loan.

Project Finance in turn involves the financing of development, construction, and operation of capital-intensive facilities such as power plants, oil and gas pipelines, transportation systems, mining facilities and industrial and manufacturing plants. The key in project financing is that these projects must be expected to generate sufficient revenues to repay the financing. Project finance is principally undertaken in two phases, the construction phase and after the project completion. In the construction phase, financing is usually raised by secured borrowing with equity provided by general or limited partnerships while after the project's completion, permanent financing is raised in various ways, including secured borrowing or leveraged leasing.

It is important to note that in contrast to traditional financing where a company raises money by issuing securities that represent equity in it, or in the case of debt securities, that entitle the holders to claims of payment where sometimes payment of those claims is secured by a lien on all or certain of the companies properties, Structured Finance transactions provides an efficient and arguably better framework upon which the company can raise cheap funds from the capital markets without being untrammelled by liquidity credit and market risks.
In other jurisdictions, especially the United States, Structured Finance transactions have greatly enabled companies to grow, being facilitated by a predictable, systematic, consistent and conceptually satisfying legal regime. Both institutional and retail investors are therefore reposed with a large portfolio of investment that not only facilitates diversification of risk but also the growth of the capital markets in particular and the economy in general. That while these jurisdictions have moved from the traditional source of financing to structured financing and are reaping benefits associated with such transactions, Kenyan companies, courtesy of an outmoded legal regime and poor regulatory framework, have just discovered the magic of balance-sheet financing if at all the recent surge by investors to purchase the shares of companies seeking listing at the Nairobi Stock Exchange is anything to go.

Perhaps as a result of information asymmetry, retail investors are completely clueless that as opposed to the institutional investors who have substantial access to high-end advisory services probably from a pool of lawyers, investment bankers, credit rating agencies, auditors etc and coupled with a large capital base, in equity issued by the company in the nature of ordinary shares is at best risky. In the event the company becomes insolvent, the shareholders as residual claimants can only be paid from the funds that remain after the secured creditors as senior claimants have been paid. In addition securities, unlike other items of property such as real property, have no intrinsic value in themselves. Rather; they represent the right to something of values. In the case of insolvency an investor would be spellbound when told he is told that he cannot be paid anything. It is therefore a task of the legislator to design a conceptually satisfying and holistic legal regime that minimizes these risks. Transactional patterns such associated with Structured Finance that are clearly and expressly aimed at securing investments should therefore be embraced.

In this essay, we propose to examine the selected legal aspects of Structured Finance transactions with bias in securitization to just illustrate how our capital markets can be innovated.

b. The Legal Issues In Securitization

As noted above, the transfer of assets from the originator to the SPV or trust in a securitization transaction has to be structured in such a way that in the event of insolvency the transfer cannot be characterized a secured loan or better still a fraudulent transfer so as to be within the scope of the equitable powers of the High Court. This transfer can be legally perfected in three ways - assignment, novation ad participation.

i. Assignment.

Under Kenyan law, there is no specific statute that provides for assignment of choses in action (rights in a debenture, charge, mortgagee etc) making common law and equity (English law) to apply by default. Under English law, an assignment of contractual rights can be either by way of a legal assignment or equitable assignment. For a legal assignment to exist, it has been held in Jones -vs- Humphrey (1902) 2 KB 10, Forster -vs-
Baker (1910) 2 KB 636, Re Steel Wing Co. Ltd (1921) 1 Ch. 349 and Walter and Sullivan Ltd -vs- Murphy & Sons Ltd. (1955) 2 QB 584 that it must exhibit the following characteristics

- Be an absolute assignment
- In writing.
- Of the whole debt
- Notified expressly in writing to the underlying debtor.

An assignment that does not satisfy any of the above criteria operates as an equitable assignment. A legal assignment operates from the date the notice is given to the debtor to transfer and automatically transfers:

- The legal right to the debt.
- The legal and other remedies of the same.
- The power of the assignee to give a good discharge of the debt without the concurrence of the assignor.

An equitable assignment on the other hand will operate to transfer only the beneficial interest in the asset, and the legal title will remain with the assignor. (See Howard -vs- Miller (1915) AC 318, Holroyd -vs- Marshall (1862) 11 Eng. Reports 999, Tailby -vs- Official Receiver (1888) 13 AC 523.) The holder of the equitable title cannot therefore not legally resolutely and exclusively sue on the asset. Instead, he must join the owner of the legal title as a co-plaintiff (with his consent) or as a co-defendant (without his consent). (See Durham Bros -vs- Robertson (1898) 1 QB 765).

In addition, under English law, it is not possible to assign obligations without the consent of the debtor; only rights in assets can be assigned otherwise. (See Tollhurst -vs- Associated Portland Cement Manufacturers (1900) Ltd. (1902) 2 KB 660).

The application of these principles in securitization especially loan securitization means that where the originator will not want its customers to be aware of the securitization of their assets, it would be preferable to use equitable assignment as opposed to a legal assignment. Moreover, a conveyance of choses in action by an equitable assignment means that under the Kenyan Stamp Duty Act, a company would avoid paying stamp duty.

However, practical and legal complexities would arise if one does not evaluate the underlying loan, lease, or debenture instrument (underlying contract) with care and diligence required. For example, failure to notify the debtor of the assignment may legally permit the debtor to set-off claims that it has against the originator where securitization involves banks and the borrower maintains an account with the bank. In addition, under English law, an assignee (legal or equitable) takes "subject to equities" which means that the assignee acquires no better title than the assignor had prior to the assignment (see Dawson -vs- Great Northern & City Railway Co. (1905) 1 KB 260) which of necessity means that set-off rights will continue to exist and be binding on the assignee to the extent that they arise out of the same contract which gives rise to the loan despite the issuance of notice.
Under the model Uniform Commercial Code of the United States, once contractual privity is established between the SPV and the borrower set-off rights is not permissible.

Another difficulty arises where the underlying contract actual prohibits any purported assignment. Under English law, when the contract has such a clause, no contractual rights will be vested to the assignee whatsoever (see Lindenn Garden Trust Ltd. -vs- Lenesta Sludge Disposal Ltd. (1993) 1 AC 83). In other jurisdictions, the consequences do vary. It is therefore important to analyze the underlying contract before giving a legal opinion.

In terms of the priorities of competing assignees, it was held in Dearle -vs- Hall 738 Eng. Rep. 475 (Ch.1828) that priority as between bona fide assignees is determined by the first assignee to give notice to the debtor of the assignment. This rule appears to pose practical difficulties in securitization because of the cost and expertise needed for its compliance thus rendering securitization largely a preserve of a few companies that can afford. In recognition of this fact, the United Nations International Commission on Trade Law (UNICITRAL) has drafted a Convention on Assignment of Receivables in International Trade Law which provides for a regime of centralized registration of assigned receivables to allow perfection. (Perfection basically refers to the protection of an assignee's interest in the transferred assets as against the assignor's creditors and insolvency administrator) and priority between competing assignees allowing for constructive notice by registration. Analysis by experts reveals that a centralized registration system reduces the costs of securitization. Indeed countries such as Japan, U.S.A. and Canada have already adapted their own domestic registration systems that allow for a centralized registration for assignments of interests in receivables. It is suggested that this be the way for Kenya.

For the Kenyan companies to benefit from securitization, it is imperative that we provide not a legal regime that not only establishes a centralized registration that allows for the less costly constructive notice of assignments but also deal with all complexities of assignments that have been captured under English law and the Convention on Assignment of Receivables in International Trade Law, more particularly on the assignment of whether partial or otherwise of future payment streams. (Assignments in futuro).

ii. Participation.

A Participation is a contractual arrangement where a bank sells the undivided interests in its loan assets to another institution. A Participation can either be Funded or Unfunded. In a Funded Participation, the institution deposits money with the selling bank which may only be repaid as and when the underlying loan asset pays interest or principal. Unfunded Participation on the other hand the institution pays no money upfront but agrees to pay either as the related loan account is drawn down and if or when the underlying asset defaults. In economic terns the selling of loan participations may allow the selling bank to risk-based capital charges. Under English law, the institution does not acquire any proprietary interest in the underlying asset. Its rights are only represented by the Participation contract. This means that the institution is vulnerable to the set-off
rights available to the underlying debtors as against the bank selling the participation. See *Glegg v Bromley* (1912)3 K.B. 474.

iii. Novation

A novation is a tripartite agreement that can safely facilitate the transfer of an on-going commitment. In securitization, it involved two parties to an original contract, the Originator and the debtor agreeing with a SPV that the SPV shall become a substitute for the Originator, and assume the Originators rights and obligations under the original contract. This substitution process results in the termination of the original contract and therefore the extinguishment of any security or guarantee, and in the creation of a new contract between the SPV and the debtor. The requirements of the consent and adequate consideration are therefore important in such transactions.

E. CONCLUSION.

In this presentation we have attempted to lay down a broad understanding of the capital markets in Kenya and identified the key risks on the trading of shares which we submit should be rooted out before the burble bursts. We have also endeavored to examine innovative structured finance techniques which we argue represents the future of capital markets. The views contained herein are not in any way conclusive and should therefore provide a basis of dialogue among the stakeholders in this field.