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The Rogue Stock Brokers Scandal: A case of the Nairobi Stock Exchange

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Introduction

The Kenyan Capital Markets Authority (CMA) has recently experienced cases of dubious stock brokers, who in their operations have led to the loss of clients' money and in extreme cases folding of the involved companies. In this paper, we look at the case of three such stock brokers namely; Discount Securities Limited, Nyaga Stock Brokers and the Francis Thuo Stock Brokerage firm. Discount Securities went down after it became apparent they were facing serious corporate governance and liquidity problems while the other two found themselves going down due to allegations of unauthorized trading in clients' shares. The three firms went down with an estimated \$34 million of investors' funds.

There have also been cases of irregular trading in the bonds market where commercial bank dealers collude with dealers at the Nairobi Stock Exchange (NSE) to artificially inflate Treasury bond prices for personal gain¹. For the purposes of this paper we shall focus on the former ill alone.

Problem statement

Key to the success of any securities market is an up to date legal and regulatory framework that will guide the operations of all stakeholders. A regulatory organ is therefore mandatory as it protects the interests of all stakeholders involved in the operations of any bourse. The regulatory

¹ BUSINESS DAILY: - MONEY MARKETS |ROGUE STOCKBROKERS NOW TURN TO BONDS MARKET. (N.D.). . RETRIEVED APRIL 5, 2011, FROM [HTTP://WWW.BUSINESSDAILYAFRICA.COM/-/539552/617472/-/VIEW/PRINTVERSION/-/J1ES4L/-/INDEX.HTML](http://www.businessdailyafrica.com/-/539552/617472/-/VIEW/PRINTVERSION/-/J1ES4L/-/INDEX.HTML)

authority acts as referee to ensure that competitors have a level playing field as well as sets standards that will protect investors' monies. This ensures growth of the market by building investor confidence, safeguarding investments, punishing dubious stock brokers and promoting a free market. It may be argued that the presence of a regulator in a free market is a paradox but we choose to look at the regulator as a facilitator and not controller as per their mandate. The NSE is lacking in this aspect or at least the existing regulator, the CMA, is seen to be failing in this aspect as evidenced by the recent rise in rogue stock brokers at the bourse in the past few years. The details of this follow below

Presentation of the case

Francis Thuo and Nyaga Stock brokers

In March 2008 Nyaga Stock brokers, went into receivership putting the savings of about 130,000 investors at risk. This happened hardly a year after Francis Thuo stock brokerage firm went under and led to the CMA suspending it from trading in the NSE. A forensic audit was initiated to investigate the cause of its demise as well as investigate the alleged misappropriation of clients' funds.

It had been reported that the firm was trading in customers' shares without their consent, and would restore them after individual customers noticed the practice and lodged complaints. The audit report revealed that the company would sell clients' shares illegally and then

subsequently buy the same quantity of shares through the normal board. The broker also sold client shares through the NSE prompt board where it takes only one day to settle but instead of passing the proceeds to clients they would take four days to settle purchase orders for the same shares this time through the normal board. In the process, the company benefitted from the profits that accrued from the change in prices during those four waiting days. The biggest indictment to the CMA as regards this story is the fact that it was a déjàvu of events of the previous year when Francis Thuo brokerage firm went down in exactly the same circumstances

Following the scandal at Nyaga Stock brokers, the NSE moved with speed to pump Kshs 100M to the broker to help it meet its fiduciary duty. The broker held a fiduciary relation or acted in a fiduciary capacity to its clients whose funds were entrusted to it for investment but failed to uphold the required level of integrity. The perpetrators of the malpractice (owners and some staff) were later investigated and charged but the fact that affected clients were quickly compensated using the Kshs 100M fund and the matter shelved for some time before the prosecutions leaves a lot to be desired

It is noteworthy that after Francis Thuo stock brokerage firm was suspended in 2007 and in the entire year to the fall of Nyaga Stock brokers, the CMA got numerous complaints about Nyaga's conduct and was well aware of the client complaints at the firm. Nothing was done to address this matter until a month before it went into receivership, when the story was already public knowledge and was doing its rounds in the

local dailies. Only then did the NSE come to the aid of one of its own by pumping the Kshs 100M into the broker smack in the middle of investigations on the stockbrokers' conduct

Going back to the introductory remarks of this paper, we noted that key to the success of any securities market is an up to date legal and regulatory framework that will guide the operations of all stakeholders ensuring an even playing field and the realization of a free market. The perceived preferential treatment given to Nyaga Stock brokers can be seen as an abuse of a free and efficient market. The NSE had a turnover of Kshs 100 Billion at the time and one would expect that such a bourse would at least be well regulated. Leaving rogue stock brokers to manipulate the market and in some cases being seen as facilitating their improper conduct does not go down well with the industry stakeholders. According the stakeholder theory, corporate conscience is as important if not more important than the goal of maximizing financial return to stockholders. The NSE is however seen to violate this theory by focusing on its image and future profitability at the expense of corporate conscience

Discount Securities

Exactly a year after Nyaga Stock brokers were placed under receivership and therefore two years after Francis Thuo stock brokers went down, Discount Securities started its journey down. The brokerage firm was placed under statutory management with effect from March 16, 2009. This time however, the cause was serious corporate governance and liquidity problems.

As regards corporate governance, the two majority shareholders, William Githaiga Murungu and Peter James Kiragu Mwangi, had been locked in a bitter dispute of the shareholding of the firm since 1997 and it was left to the courts to arbitrate. Mr. Githaiga who was at the time the chairman of the board and Mr. Kiragu who was a director each subscribed to 250 shares of the company's 500 shares upon inception thereby being sole owners. Githaiga claimed that Kiragu willingly and officially resigned both as a director and shareholder of the company in October 2006, an allegation Kiragu vehemently denied. Githaiga also claimed that he had bought Kiragu's shares at the time although the transaction had failed to go through initially. Determination therefore of the directorship and shareholding of the company had become a legal issue

As regards liquidity, Discount Securities was unable to meet its financial obligations to its clients leading to customer complaints. Simply put, the company was not able to pay its clients their money when they needed it. It did not have enough money in the bank to pay clients who were redeeming their shares, having invested in the NSE through them. Similar to the previous cases, the company had failed in its fiduciary duty, which was the reason for its existence in the first place

The CMA moved in as regulator, to act in the interest of all stakeholders first appointing KPMG as an Independent Executive Managing Director to replace Githaiga. The broker was then placed under statutory management on March 16th 2009. At the time it was placed under statutory management, the company had a total of Kshs 15.2 million in investments which the statutory manager was tasked to refund. To do

this, he opted to liquidate the company and invited bids to buy the company's fixed assets including office furniture and cars.

Governance or ethical problems

A fiduciary should not have a conflict of interest, however the stories of Nyaga Stock brokers and Francis Thuo before it show that although they were to trade in the markets on behalf of their clients, they had personal interests too and participated in the market as their clients' competitors. The saying goes that fiduciaries must conduct themselves at a level higher than that trodden by the crowd and with integrity that like Caesar's wife is beyond reproach but these two clearly did not

According to the principle of natural moral law, simply doing the right thing is not enough; to be truly moral one's motive must be right as well². The reason the NSE pumped in Kshs 100M into Nyaga Stock Brokers despite both it and the CMA being well aware of the malpractices at the firm leaves a lot to be desired. Clients were quickly compensated using the money, which is a good thing, but the matter shelved for some time before the prosecutions commenced as a result of pressure from other quarters. The reason for this can only be the bourse's desire to maintain investor confidence and avoid a backlash from them, which would terribly dent its ambitions. What followed though was an attrition of investor confidence, as local investors, who drive the bulk of activity at the NSE, fled. This they did because the NSE and CMA were seen to be

² NATURAL LAW - WIKIPEDIA, THE FREE ENCYCLOPEDIA. FROM [HTTP://EN.WIKIPEDIA.ORG/WIKI/NATURAL_LAW](http://en.wikipedia.org/wiki/Natural_Law)

compromising investors' money in order to remain relevant and look good

The NSE had a turnover of Kshs 100 Billion at the time and one would expect that such a bourse would at least be well regulated. The regulator should be able to apply the cardinal values of natural law which are prudence, justice, temperance and more importantly in our case fortitude. Fellow stock brokers did not get justice as a competitor, Nyaga Stock Brokers, was bailed out after blatantly being involved in malpractice while the investors did not see the strength of mind displayed by the CMA. The CMA simply could not endure adversity with courage on this matter

In the case of Discount Securities, it was a clear failure of corporate governance. It is absolutely ludicrous that one of the biggest stock brokerage firms in Kenya could have a dispute of ownership right under the noses of the CMA. That they came in to appoint an independent Executive Director as the two directors fought it out in court should not have been allowed to happen in the first place. The CMA cannot dictate who owns a company and how boards are structured but it has the mandate to ensure all players are compliant and investors' interests are catered for.

Analysis of the Problems

According to Stakeholder theory, a stakeholder is anyone who affects the company's bottom line thus their needs should not be ignored. The CMA ignored the needs of the clients in the cases of Nyaga stock brokers until

it was too late. The NSE therefore had to intervene and inject Kshs 100M to bail them out yet if they had reacted soon after the fall of Francis Thuo stock brokers they would have saved the situation before much damage. Nyaga Stocks Brokers should have been suspended immediately, since their operating capital has not only been in the negative but they have been using gains made from illegal trade in clients' shares to prop up their operating capital. What followed though was an attrition of investor confidence, as local investors, who drive the bulk of activity at the NSE, fled

In the case of Discount securities as mentioned earlier, it was the failure of the theories of Democracy and Corporate governance. Corporate Governance is the means by which corporations establish order between the different parties i.e. the firm's owners or shareholders and its top-level managers. There was absolutely no order in the governance structure of Discount Securities and this in my opinion was allowed to happen by the weak CMA. There was conflict between the two directors and this was allowed to fester over the years without intervention. Conflict occurs between two parties when one party perceives the other party as interfering with the satisfaction of the one's needs, wants or objectives. Githaiga felt that Kiragu interfered with his satisfaction while Kiragu felt that Githaiga was doing the same

Conclusion

Both these cases point towards a weak regulatory framework that compromises the stakeholders' interests. The CMA has been seen to act

late and more often than not its actions are geared towards saving face rather than the interests of stakeholders. The he CMA is therefore to blame for the underdeveloped capital market in Kenya. Kenyans are shying away from the bourse and opting for other investment avenues, especially the real estate market, which spells doom for the NSE

The securities market is not static, a new challenge presents itself every day and the CMA has the role of ensuring that it is profitable and sustainable. To achieve this, the CMA needs to be innovative as regards market regulations. They should be dynamic and constantly reviewed to ensure they remain relevant. This way, investors will be protected from imminent mal-practice from the industry players

The CMA plays a similar role to the Central Bank in terms of mandate and duty. Since great strides have been made by the central bank in regulating the banking industry, a lot can be borrowed from them. Some effort has gone into his and the different financial services regulators in the country now want to adopt a risk-based supervision approach. By bringing their heads together they want to incorporate Risk management requirements for each financial institution. The regulators, including the CMA, will carry out risk profiling and continuously review the risks independently as the current over reliance on the institutions' themselves to do this has proven catastrophic

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