Combating Insider Trading in Securities Markets: A Review of Kenya's Legal Framework

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DECLARATION

This thesis is my original work except for relevant sources referred and appropriately acknowledged, and it has not been submitted to any University or institution for any award.

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APPROVAL

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DEDICATION

This work is dedicated to my father, Mr. Patrick Muhati Makanga, for his love of education and the great lengths and sacrifice that he went to see me get a decent education.

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ABSTRACT

The idea of a fair market is dependent on all parties to a transaction possessing similar information when executing a transaction or trade. However, because of unfair market practices such as insider trading, this is rarely the case. Insider trading is a form of market abuse where one party deals in the securities of a public company while in possession of material non-public information. Often, a person practicing insider trading gains an advantage because of the information they possess over the other party. Today, insider trading is one of the most condemned corporate vices. As a result of its adverse effects on the market, insider trading has been prohibited by many countries in the world. In Kenya, insider trading is contemplated as an offence that attracts criminal sanctions under the Capital Markets Act 2013. However, as jurisprudence witnesses, it is difficult to sustain a conviction on a charge of insider trading in Kenya. As a result, the practice of insider trading often goes unpunished. The purpose of this paper is to examine the effectiveness of criminal sanctions in prohibiting the practice of insider trading in Kenya. The researcher also assessed the feasibility of employing alternative sanctions, that is, administrative and civil sanctions, in place of criminal sanctions in an effort to curb the practice of insider trading in Kenya. This paper argues that non-criminal sanctions are a more effective deterrent to insider trading than criminal sanctions. The study, therefore, suggests that the Capital Markets Authority should put emphasis on the use of non-criminal sanctions in the prohibition of insider trading rather than criminal sanctions.

LIST OF ACRONYMS

CMA	– Capital Markets Authority
NSE	– Nairobi Securities Exchange
IPO	– Initial Public Offering
JSE	– Johannesburg Stock Exchange
RSA	– Republic of South Africa
FSB	– Financial Services Board (South Africa)
FSCA	– Financial Sector Conduct Authority (South Africa)

LIST OF CASES

Republic versus Terrence Davidson, Nairobi CMCR 1338/2008 (Unreported).

Republic versus Bernard Mwangi Kibaru, Nairobi CMCR 1337/2008 (Unreported).

Republic V Christopher Joseph Kirubi and 13 Others Nairobi CMCR 908/2008(Unreported).

United States v. O'Hagan, 521 U.S. 642, 652 (1997).

Dirks v. SEC, 463 U.S. 646, 647 (1983).

SEC v. Yun, 327 F.3d 1263, 1280 (11thCir. 2003).

SEC v. Sargent, 229 F.3d 68, 77 (1st Cir. 2000).

SEC v. Maio, 51 F.3d 623, 632 (7th Cir. 1995).

Chiarela v United States 445 U.S. at 224.

Attwood v Small (1838) 6 Cl & F 232.

Redgrave v Hurd (1881) 20 Ch D 1.

TABLE OF CONTENTS

CHAPTER ONE
GENERAL INTRODUCTION

1.1 Background

The world was in shock when celebrated American television personality Martha Stewart was sentenced to prison. Martha Stewart was accused of insider trading after she sold four thousand Im Clone shares one day before that firm's securities' price plummeted. But this has not been an isolated case. In the recent past, cases of insider trading have been rampant worldwide. Insider trading has become a sickening corporate vice that diminishes investor confidence and preys on unsuspecting traders.

In the economy, information is power.[1] Whoever has more information in a transaction possesses the bargaining power and can tilt the balance of trade in his favour.[2]Fair trade thus demands there should be information symmetry between parties in a transaction.[3] Nevertheless, this has never been the case. In most instances, the vendor always has more information than the buyer. Thus, the vendor can manipulate price to his advantage and to the detriment of the buyer.[4]

No more is this clear than in the corporate world.[5] Investors in the corporate world depend on information in the public domain to make decisions on which transactions to proceed with and which to forego.[6] They do this with the faith that the information in the public domain is a true representation of the situation *in terram.*[7]Even where it is not, there is the confidence that other people willing to stake their funds on the same transaction possess the same information. This phenomenon has been dubbed as information asymmetry.[8]

In this vein, under common law, directors or company executives owe a fiduciary duty to the company. This duty imposes an obligation on the directors or executives to disclose

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[1] Zhang Ye-Cheng, The Information Economy, J. Johnson et al. (eds.), *Non-Equilibrium Social Science and Policy,*
Understanding Complex Systems, (2017) DOI 10.1007/978-3-319-42424-8_10.
[2] Zhang Ye-Cheng, The Information Economy, J. Johnson et al. (eds.).
[3]Alao, Adeniyi A, Issues in Information Asymmetries and Financial Markets: A Review of Literature, *Journal of Accounting and Financial Management*, Vol. 4 No. 2 (2018) 59 -71.
[4]Alao, Adeniyi A, Issues in Information Asymmetries and Financial Markets:59-71.
[5]Zainabu Tumwebaze et al., Information Asymmetry and Stock Market Participation: Evidence from the Uganda Stock Exchange, *Operations Research Society of Eastern Africa (ORSEA) Journal* (2014) 21-42Vol. 4 Issue No. 2 at 21.
[6]Zainabu Tumwebaze et al., Information Asymmetry and Stock Market Participation,21.
[7]Zainabu Tumwebaze et al., Information Asymmetry and Stock Market Participation,21.
[8]Zainabu Tumwebaze et al., Information Asymmetry and Stock Market Participation,21.

such information that is material to the securities of the company. Consequently, a breach of this duty by any such director or executive could be remedied by an action of fraudulent misrepresentation under common law. Moreover, when such an action was initiated, principles of company law would apply.

While these are the realities of modern-day trade, the law has attempted to control information asymmetry in economic transactions by imposing regulations such as financial reporting, prohibition of insider trading and enforcing the principle of*uberrimaefidei* during disclosure. Such laws are aimed at eliminating several forms of market abuse that ultimately diminish the integrity of securities markets.

Of particular interest to this discourse is insider trading. The classic definition of insider trading is the use of non-public information in trading shares of a company by someone who owes a fiduciary duty to the company.[9] It is an economic vice that preys on the aforementioned information asymmetry for unfair gains. Many countries have prohibited insider trading through legislation. Most of these countries have empowered an authority to oversee securities markets and prevent forms of market abuse such as insider trading.

There have been debates as to whether or not laws prohibiting insider trading are merited. The main argument justifying regulation is that insider trading is inherently unfair. Another school of thought argues that the regulation of market securities and thus prohibition of insider trading is a justifiable exercise. This argument is premised on investor protection in the sense that "*effective investor protection mechanisms play an indispensable role in bolstering investor confidence and retention*."[10]Thus, regulation of market securities is essential in protecting the interests of investors who place reliance on information in the public domain. The latter argument professes aspersions of the public interest theory.

A small minority resists government regulation of market securities and in particular insider trading. These isolated groups posit that practices such as insider trading are of immense benefit to corporations as they spur innovation and constitute an efficient

[9] Brian A. Garner, editor in chief. Black's Law Dictionary. St. Paul, MN: Thomson Reuters, (2014).
[10]Gakeri K Jacob, Calibrating Regulatory Disclosure in Kenya's Securities Markets: Challenges and Opportunities for Investors, *International Journal of Humanities and Social Science* (2014) 133-145 Vol. 4 No. 5 at 133.

means of compensating executives.[11] They further argue that the profits realized by insider traders are rarely significant enough to cause a massive exodus of investors.[12]

Despite these arguments, the vast majority of jurisdictions have elected to regulate insider trading. Regulation varies in forum and approach. Countries that prohibit insider trading may choose to enforce those regulations through criminal sanctions or civil liability.[13]Japan for instance, purely enforces these regulations by the force of criminal law.[14]Jurisdictions like Australia and the USA use both criminal and civil sanctions to deter and punish insider trading.[15] As regards approach, some jurisdictions such as United States of America regulate insider trading on account of the fiduciary relationship an insider owes to their company. Such regulation may be termed as relationship-based. In other jurisdictions such as the United Kingdom, regulation is market-based in that the rationale for regulating insider trading is to facilitate the smooth functioning of securities markets.

It is important to note however, that in most jurisdictions, institutions marketing securities are regulated by independent bodies, to wit, a separate entity is usually given supervisory jurisdiction over all institutions trading securities. In the United States of America, this function is exercised by the Securities Exchange Commission while Japan has the Securities Exchange Council. Here in Kenya, the Capital Markets Authority is the statutory body mandated to oversee and regulate the trading of securities among other functions.

The Capital Markets Authority has enacted several regulations and continuously amended the Capital Markets Act to adequately regulate securities market trading.[16]The earliest codified regulations were the Rules and Regulations of the Nairobi Stock

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[11]Dent, George W., "Why Legalized Insider Trading Would Be a Disaster" (2013). Faculty Publications. 27.
[12]Dennis W. Carlton & Daniel R. Fischel, The Regulation of Insider Trading, 35 *Stanford Law Review* 857, 860 (1983).
[13] Joshua Mitts & Eric Talley, Informed Trading and Cybersecurity Breaches, 9 *Harvard Business Law Review* 1 (2019).
[14] Michael Whitener, "Japan Tackles Insider Trading," International Financial Law Review 7, no. 6 (June, 1998): 15-17.
[15] Victor Lei and Ian Ramsay, 'Insider Trading Enforcement in Australia' (2014) 8 *Law & Finance Market Review* 214.
[16]Mwaniki Gillian, Effect of Insider Trading Prohibitions: Regulation on Security Market Returns in Kenya, *The University Journal* Volume 1 Issue 2 (2018) 77-96.

Exchange which were published in 1954[17] while the most recent among these regulations is the Capital Markets Act.[18] One of the core objectives of this Act is to protect investor interests. In lieu of this, the law criminalizes insider trading.[19] Thus, the sanctions emanating from the offence of insider trading are criminal in nature.

Many authors have noted that insider trading is difficult to detect and even harder to prove.[20] Moreover, and in most cases, the capabilities of enforcement agencies are often insufficient to match those of the perpetrators.[21]In light of this therefore, it becomes increasingly difficult to prosecute cases of insider trading under criminal law. It is trite that the burden of proof in criminal cases is “beyond reasonable doubt”. By any standard, this burden is difficult to discharge. It is for this reason that Capital Markets Authority of Kenya has on many occasions failed to secure a conviction on a charge of insider trading.

A prosecutor in insider trading offences before a Kenyan court has to construct a coherent narrative that subscribes and manifests all the facets of interconnecting facts in order to prove his case beyond reasonable doubt. In apt illustration, the prosecution in the case of *Republic v Terrence Davidson*[22]failed to secure a conviction because they could not prove that information had not been made public. In rendering its decision, the court held that “*the fact that Uchumi’s poor performance and the pulling out of its major shareholders was a matter that had been publicized in the newspapers*. “Similarly, in the case of *Republic v Bernard Kibaru*[23]in acquitting the accused person, the court stated that “…*the prosecution had not proved beyond reasonable doubt that the accused exploited information not generally available to the public that Uchumi was performing poorly, when he sold his shares*.”

This predicament is not unique to Kenya. As of 2019, the Security Exchange Commission of Zimbabwe had yet to successfully prosecute a single case of insider

[17] These rules preceded the establishment of the Capital Markets Authority but were amended to what now is known as the Capital Markets Act.
[18] Capital Markets Act Chapter 485A Laws of Kenya.
[19] Section 11 (1) (a) and Preamble of the Capital Markets Act.
[20] Ryan, Deirdre. "Dealing with the Market Abuse Regulation: A Case for Modernisation." *King's Inns Law Review*, 8, (2019), p. 60-87; See also Howard Chitimira & Pontsho Mokone, "An Analysis of the Role-Players in the Enforcement of the Zimbabwean Insider Trading Laws" (2019) 9: Special Issue *Juridical Tribune* 134.
[21] Ryan, Deirdre. "Dealing with the Market Abuse Regulation:134.
[22]*Republic versus Terrence Davidson*, Nairobi CMCR 1338/2008 (Unreported).
[23]*Republic versus Bernard Mwangi Kibaru*, Nairobi CMCR 1337/2008 (Unreported).

trading.[24]In the same vein Japan has also been struggling to prosecute insider trading without accomplishment.[25]In fact, this failure is widespread and has been noted in several literature canvassing the subject of insider trading.[26]

1.2 Statement of the problem

Since its inception, the Capital Markets Authority has found it difficult to sustain a conviction when prosecuting an offence categorized as insider trading under the Capital Markets Act.[27]Legal commentators have argued that this difficulty arises due to the nebulous nature of the provisions creating the offence of insider trading.[28] Thus, it is herculean a task to dispense the burden of proof imposed on the prosecution in the event of a criminal trial.[29]

While it is laudable that such provisions exist within the legal framework, it is irking to prove the existence of certain facts based on the criteria set out in the Act. For instance, it is nearly impossible for the Capital Markets Authority to objectively prove, in a court of law, that a complaining company was in possession of certain sensitive information or whether such information was sensitive in the first place. When and how is information considered to be in the public domain? How does one prove that the accused had knowledge of such information which eventually informed his decision to trade?

These challenges have and continue to plague the Capital Markets Authority in the pursuit of bringing unscrupulous traders to book. If this situation is left unchecked, insider traders will continue to exploit the lacuna in the legal framework to get away with crime. The ripple effect will erode investor confidence in the capital markets and ultimately wreak havoc on financial markets in Kenya.

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[24] Howard Chitimira & Pontsho Mokone, "An Analysis of the Role-Players in the Enforcement of the Zimbabwean Insider Trading Laws" (2019) 9: Special Issue *Juridical Tribune* 134.

[25] Michael Whitener, "Japan Tackles Insider Trading," *International Financial Law Review 7*, no. 6 (June, 1998): 15-17.

[26]Uptal Bhattacharya and Hazem Daouk, 'The World Price of Insider Trading' (2002) 57(1*)The Journal of Finance**75,*** 104.

[27] The CMA has had little success in prosecuting insider trading offences. Since it was founded a successful prosecution was witnessed in 2019 when Andre DeSimone, Aly Khan Satchu and Kunal Bid were found guilty of insider trading of Kenol Kobil Shares. Save for this instance, many attempts to prosecute have been unsuccessful.

[28]Muindi Brian and Mbabu Oscar, Insider Trading and the Restoration of Investor Confidence, *The Above Standard: Climate Change Compliance and Private Entities* Volume 004 [May 2019], The authors liken the prosecution of insider trading to a Gordian knot which the Capital Markets Authority is yet to unravel.

[29]*Republic V Christopher Joseph Kirubi and 13 Others* Nairobi CMCR 908/2008(Unreported). While acquitting the accused persons, the Chief Magistrate noted that that the Authority had failed to establish his culpability beyond reasonable belief and had not dispensed with their burden of proof. As such, the Court saw it unfit to convict them of insider trading.

Although contemplated as a criminal offence, the Capital Markets Act empowers the Authority to take other punitive measures against offenders. These measures range from administrative sanctions, admonishment and the suspension of licenses. The literature reviewed suggests that criminal sanctions on insider trading have been less than fruitful in prohibiting insider trading. On the other hand, civil and administrative sanctions have been seen, in the reviewed literature, to better deter insider trading.

Where the latter measures exist in law, it flies in the face of logic why the Authority would still insist to take a criminal approach that has not yielded the deterrent function it was meant to achieve. There is an urgent need for a change in tact when dealing with cases of insider trading. The Authority should consider the feasibility of enforcing non-criminal sanctions and possibly emphasize their use.

1.3 Purpose of the Study

The main objective of this research is to critically assesses the adequacy of the current legal framework regulating insider trading in Kenya.

The researcher will be guided by the following specific objectives;

i. To appraise the effectiveness of the obtaining legal and institutional framework regulating insider trading in Kenya.
ii. To interrogate and compare the efficacy of criminal and non-criminal sanctions in prohibiting insider trading in Kenya.
iii. To compare the legal and institutional framework in Kenya with that of South Africa
iv. To identify areas of reform in the legal and institutional framework and suggest recommendations where necessary.

1.4 Research Questions

Throughout the course of this study, the researcher will be guided by the following research questions;

i. How effective is the obtaining legal and institutional framework in regulating insider trading in Kenya?
ii. How efficient are non-criminal sanctions imposed by the Capital Markets Authority in deterring insider trading in Kenya?
iii. How has South Africa addressed issues of insider trading?

iv. Is there need for reform in the legal and institutional framework governing insider trading in Kenya?

1.5 Hypothesis

To give credit where its due, the Capital Markets Authority, in 2019 sanctioned Aly Khan Satchu, Andre DeSimone and Kunal Bid after finding the three individuals guilty of insider trading of KenolKobil shares.It is important to note, however, that the aforementioned sanctions emanated from the determination of an ad-hoc committee appointed by the Capital Markets Authority. So far, no individual or corporate entity has been found guilty in a court of law on a charge of insider trading.

For this reason, the researcher will proceed on the assumption that the Capital Markets Authority has been unsuccessful in prosecuting cases of insider trading in Kenya. Moreover, Kenyan courts in making determinations on insider trading charges have noted with concern that the prosecution had failed to discharge the burden of proof.

The researcher further hypothesizes that the non-criminal sanctions are a more effective way of deterring insider trading in Kenya. This sentiment follows the premise that a criminal approach on deterring insider trading has failed. Thus, the Capital Markets Authority should place an emphasis on non-criminal sanctions especially since they are empowered by the Act to do so. 1.6

1.6 Theoretical Framework

Over the years, many legal theories have been propounded by scholars and other legal commentators to justify the imposition of liability on an insider. These theories are informed by the arguments against insider trading. The bulk of these arguments are either moral or economic.[30]Moral arguments suggest that insider trading is unfair in the sense that it does not allow every person to profit equally.[31] Economic arguments are premised on pricing efficiency and desertion of investors.

Various jurisdictions have formulated their own theories on insider trading based on their peculiar prevailing circumstances. The public interest theory borrows from the argument that insider trading is inherently unfair and thus justifies government regulation. Other theories focus on their relationship between the issuer and the insider. In the United

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[30] Cox Charles &Forgaty Steven, Bases of Insider Trading Law, *Ohio State Law Journal* (1977) Vol. 4 343-363.

[31] Cox Charles et al, Bases of Insider Trading Law,343-363.

States of America for instance, three theories have emerged in an effort to standardize how to impose liability on perpetrators of insider trading. These are the classical, tipper/tippee and misappropriation theories.[32]In this section of the thesis, the researcher will highlight these theories in an attempt to justify regulation and prosecution of insiders for the offence of insider trading.

1.6.1 The Public Interest Theory

In general terms, the Public Interest theory postulates that government regulation seeks to protect and benefit the public.[33]According to this theory, government regulation is instrumental in overcoming the disadvantages of imperfect competition, unbalanced market operation and undesirable market results. Thus, the theory assumes that markets are extremely fragile and likely to operate very inequitably if left alone, resulting in market failures.[34]

Insider trading when defined under this theory would have a focus on the effect of market failures on the public. Thus, priority would be given first to the interests of investors who are more likely to suffer as a result of such market failures and second to the market generally. Ultimately, this theory can be termed as a market-based theory.

The Public Interest theory is criticized for its ambiguity. Critics suggest that it is difficult to determine when the interests of the public have been served when many other governmental interests are being served as well.[35] Another criticism is that it is also difficult to tell how much regulation is optimal for the best performance of markets. [36]

This theory is of particular importance since it provides a point of reference when justifying the prosecution of insider trading offences in Kenya. That the law prohibiting insider trading was enacted as a result of market failures which were not in the best

[32] Cox Charles et al, Bases of Insider Trading Law,343-363.
[33]Hantke–Domas, Michael, The Public Interest Theory of Regulation: Non-Existence or Misinterpretation", *European Journal of Law and Economics* (2003)15 (2): 165-194.
[34]E.O George, R.O Akingunola and J.E Oseni, 'The Influence of Information Asymmetry on Initial Public Offers in the Nigerian Stock Market' [2012] (92) *International* Research *Journal of Finance and Economics*
32-42, 33, 34. < http//www.internationalresearchjournaloffinanceandeconomics.com> on 20 June 2020.
[35] Smyth Russell, Soderberg Magnus, Public Interest versus Regulatory Capture in the Swedish Electricity Market, *journal of Regulatory Economics* (2010) 38 (3): 292-312.
[36] Smyth Russell et al, Public Interest versus Regulatory Capture in the Swedish Electricity Market,292-312.

interests of the public. The theory also reflects the objects of the legislation in Kenya which is to protect investors.

1.6.2 The Classical Theory

The classical theory is an American theory of insider trading law that proceeds on the premise that corporate insiders, such as the directors, officers, agents and employees of a company, are prohibited from trading based on material non-public information that they have obtained in connection with their positions in the company. This theory applies where an insider is in breach of their fiduciary duty to their own company or another company to which they owe a fiduciary duty. The theory was restated in the case of *United States v. O'Hagan*[37] where Justice Ruth Bader Ginsburg held that an individual maybe held responsible for misappropriation of confidential information even where there was no duty to disclose such information.

This theory derives from the common law doctrine of fraudulent non-disclosure. Under common law, a representation or concealment of a fact is material if it operates as an inducement to the other party to enter into the contract, where, except for such inducement, it would not have done so.[38]Thus, where a party acted on confidential information to the detriment of another party who had placed reliance on disclosed information, the injured party could seek remedial action under common law.

The classical theory has however fallen into disuse for its several shortcomings. The theory only applied to insiders who owed a fiduciary duty to the company. The absence of a fiduciary duty to any parties in a transaction therefore invalidated the application of this theory. Consequently, no liability could be impugned against a party that did not owe a fiduciary duty to the other party in the transaction. Further, it could not apply in cases where a company was repurchasing its own stock since a company does not owe a fiduciary duty to its shareholders.

The theory does not apply to persons who are not insiders. It therefore does not apply in instances such as where an employee of a company would share the confidential information with another person and the third party acted on that information.

[37]*United States v. O'Hagan*, 521 U.S. 642, 652 (1997).
[38]*Attwood v Small* (1838) 6 Cl&F 232; See also *Redgrave v Hurd* (1881) 20 Ch D 1.

1.6.3 The Tipper Tippee Theory

This theory was an extension of the application of the classical theory in response to the shortcomings imposed by a mandatory existence of a fiduciary duty. This theory would operate under certain circumstances only. Firstly, there had to be a tipper- an insider in the traditional sense who possess material non-public information and disseminated this information to another party, the tippee.[39]The theory still placed great significance on fiduciary duty. For liability to be imposed, the tipper, according to this theory, has to have breached their fiduciary duty to a company; the tippee knew or had to know that the breach had occurred; the tippee acted on the information from the tipper to trade in securities and; the tipper received some personal benefit in return.[40]The theory's maiden articulation was in the case of *Dirks v. Securities Exchange Commission*[41].

One of the criticisms of this theory is that it was difficult to ascertain the legal standard of what constitutes "personal benefit" to the tipper.[42]Courts in the United States of America have therefore taken a broad view on what constitutes a personal benefit.[43]It is important to also note that this theory still faced the same shortcomings as the classical theory since it was bound by the requirement of a fiduciary relationship.

1.6.4 The Misappropriation Theory

The misappropriation theory postulates that a person, who is not an insider and who comes and transacts on the basis of confidential information is liable for insider trading.[44]The misappropriation theory covers the lacuna left by classical theory. The theory was first articulated in *Chiarela V United States*[45]in Justice Burger's dissenting opinion thus;

> "… when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means… then [that party] has an

[39]Cox Charles &Forgaty Steven, Bases of Insider Trading Law, *Ohio State Law Journal* (1977) Vol. 4 343-363.
[40] Cox Charles et al, Bases of Insider Trading Law,343-363.
[41]*Dirks v. SEC*, 463 U.S. 646, 647 (1983).
[42] Drummonds Katherine, *Resuscitating Dirks: How the Salman 'Gift Theory' of Tipper-Tippee Personal Benefit Would Improve Insider Trading Law*, (2016) Available at https://www.law.ox.ac.uk/business-law-blog/blog/2016/07/resuscitating-dirks-how-salman-gift-theory-tipper-tippee-personal on 20 June 2020.
[43]*SEC v. Yun*, 327 F.3d 1263, 1280 (11thCir. 2003); See also *SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000); SEC v. Maio, 51 F.3d 623, 632 (7th Cir. 1995).
[44]*United States v. O'Hagan*, 521 U.S. 642, 652 (1997).
[45]*Chiarela v United States* 445 U.S. at 224.

> absolute duty to either disclose that information to the other party of the securities transaction or refrain from trading"[46]

This theory thus imposes a duty to any person who comes across confidential information to keep it confidential or abstain from transacting using that information. Thus, the liability is no longer restricted to the traditional insider but to every person who acts on material non-public information to obtain a personal benefit by trading on the basis of such information.

1.6.5 Application

The classical, tipper/tippee and misappropriation theories are relationship based, in that, for insider trading to be proved against an individual, a fiduciary relationship has to subsist between the parties in the securities exchange transaction. Thus, for one to be liable for insider trading, there must be a breach of fiduciary duty. This requirement has been problematic since in the contemporary corporate world, inside trades could be perpetrated by parties who owe no fiduciary duty to the company.

As Gakeri posits, the main objective of a securities' regulatory framework should be to protect investors. The argument is echoed in the Capital Markets Act as one of the objectives of the Act. In this light, the researcher is moved to appreciate the philosophical underpinnings of the Public Interest Theory in the course of this study. First, the theory appreciates the importance of regulation. It suggests that government is involved in regulation to protect public interests. The practice of insider trading poses a threat to market integrity and holds a looming danger of investor losses. Ultimately, it causes the market to depreciate to the detriment of the public.

Secondly, the criticism of the theory addresses the possible dangers that come with regulation. For instance, where the government is waist-deep in regulation, the line between government interests and public interests is blurred. Consequently, regulation loses its meaning.

The classical, tipper/tippee and misappropriation theories show the evolution of jurisprudence on insider trading particularly with regarding to culpability. The three theories will be useful in the instant thesis as the researcher attempts to show the difficulty encountered in sustaining convictions on a charge of insider trading. The

[46] *Chiarela v United States* 445 U.S. at 239.

theories are also helpful in that they show the dynamic and broad interpretations that come with assigning insider trading liability. Thus the law may not be able to capture essence of the offence of insider trading while contemplating all the exactitudes.

1.7 Literature Review

Many authors, local and foreign, have made contributions on the subject of insider trading. It is universally recognized as an economic vice that significantly affects the balance of power between shareholders of a company and investors. To this end, most of the literature reviewed herein will reiterate that insider trading needs to be stopped at all costs in order to promote investor confidence. However, more central to this discourse, authors will comment on how difficult it is to prosecute cases of insider trading.

It will emerge, in this review of literature, that there are two major approaches to defining insider trading. These approaches largely determine the letter of the law and prosecution of the offence of insider trading.

1.7.1 Defining Insider Trading

The definition of insider trading is relatively universal. Henning suggests that the term is now common parlance *"to describe situations in which previously undisclosed information is used to gain an unfair transactional or tactical advantage*."[47] Many definitions have fallen in the parameters laid out in Henning's rudimentary definition.
Doffou[48] defines insider trading as the sale or purchase of securities by corporate insiders, using monopolistic information to their advantage to generate abnormal returns. The author continues to define monopolistic information as that which is privileged, price sensitive and material non-public. Doffou further identifies insiders as those persons who have easy access to the monopolistic information. The International Organization of Security Commissions concurs with Doffou's definition of an insider.[49] The organization suggests that before defining who an insider is, it is important to consider two issues namely confidentiality and materiality of the subject information.[50] Wang deems insider trading to be "*trading by anyone (inside or outside of the issuer) on*

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[47] Henning, Between Chiarella and Congress: A Guide to the Private Cause of Action for Insider Trading Under the Federal Securities Laws, 39 *University of Kansas Law Review.* 1, 1 (1990).
[48]Doffou Ako, Insider Trading: A Review of Theory and Empirical Work, *Journal of Accounting and Finance Research*, Vol. 11, No 1, (2003).
[49] The Organization of Securities Commissions, Insider Trading: How to Regulate It, A Report of the Emerging Markets Committee of the International Organization of Securities Commissions (2003).
[50] The Organization of Securities Commissions, Insider Trading: How to Regulate It, A Report of the Emerging Markets Committee of the International Organization of Securities Commissions (2003).

any type of material non-public information about the issuer or about the market for the security."[51]

Similarly, Ventoruzzo and Mock state that insider trading involves "the 'trading [of] securities while in possession of material nonpublic information' that is, information capable of affecting the price of a security if made available to other investors." While the authors add a different paradigm to the definition, that is "price sensitive information", the definition still exhibits the basic facets as in Henning's generic description.

Many authors have however abstained from defining insider trading. They instead opt to define the various terms that constitute insider trading. The reason for this is that, as Henning puts it, the term "insider trading" as commonly used is a misnomer since it also applies to persons who are not corporate insiders.[52] Thus, in a bid to transcend this limitation, it is prudent to define the constituent terms of what is traditionally known as insider trading.

1.7.1 Regulating Insider Trading

The subject of insider trading is highly controversial around the world. The term cohabits the echelons of newspaper headlines undetached from other vices such as financial greed and wheeler dealing. It is also a central focus in the spheres of academia and policy circles where debates revolve around the desirability of regulating insider trading.[53]

Those in favour of regulation of insider trading have always insisted that insider trading is inherently unfair and that legislation promotes market efficiency. Gakeri notes that it is unfair because it places investors at a disadvantaged position.[54] He adds that investors need protection since such protection forms the baseline line of financial market security.[55] He particularly notes that in Kenya, there are exceedingly low levels of financial literacy. Consequently, it is crucial to afford some protections to parties who wish to invest their money into different entities for the betterment of the economy.

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[51] Wang S. William, *Introduction: Insider Trading*, University of California, Hastings College of the Law (2010) Available https://www.researchgate.net/publication/228273857 on 20 June 2020.
[52] Henning, Between Chiarella and Congress: A Guide to the Private Cause of Action for Insider Trading Under the Federal Securities Laws, 39 University of Kansas Law Review. 1, 1 (1990).
[53] Benny N Laura, *The Political Economy of Insider Trading Legislation and Enforcement: International Evidence*, Discussion Paper No. 348, Harvard Law School, The Harvard John M. Olin Discussion Paper Series (2002). Available at http://www.law.harvard.edu/programs/olin_center/ on 20 June 2020.
[54]Gakeri J, Calibrating Regulatory Disclosure in Kenya's Securities Markets,133-145.
[55]Gakeri J, Calibrating Regulatory Disclosure in Kenya's Securities Markets:133-145.

Gakeri's work, however, only covers disclosure of information as a means of investor protection. The author does not delve into the intricacies of insider trading.

Manove advances the argument that insiders appropriate the advances of trade to the disadvantage of shareholders.[56] In this sense, as Manove argues, investors are discouraged from putting in more investment and further that there is a manifest reduction in the economic efficiency. The author proceeds with an in-depth analysis of the impact of insider trading on the market as well as the issuing entity. He discusses the roles played by both insiders and outsiders. However, while some of Manove's arguments still reverberate in the modern-day market outlook, most fail to appreciate the role technology has played in shaping up the dynamics of the contemporary financial market.

The main argument against regulation of insider trading, as Benny suggests, is that such legislation favors special interests at the expense of efficiency.[57] In this sense, Bainbridge argues, regulation and thus the prohibition of insider trading, lacks a rational economic basis.[58] Manne advances the argument that insider trading has the ability to generate significant benefits without necessarily causing damage.[59] The author adds that the benefits that may accrue may be the best ways to compensate company executives and to enhance innovation. Accordingly, insider trading spurs economic advancement and promotes efficiency in business. Manne stated thus;

> [An] entrepreneur's contribution to the firm consists of producing new valuable information. The entrepreneur's compensation must have a reasonable relation to the value of his contribution to give him incentives to produce more information. Because it is rarely possible to ascertain information's value to the firm in advance, predetermined compensation, such as salary, is inappropriate for entrepreneurs. Instead, claimed Manne, insider trading is an effective way to compensate entrepreneurs for innovations.

The problem with this line of argument, as Dent puts it, is that in the contemporary corporate world, it is not the executives alone who create valuable information for them

[56]Manove Michael, The Harm from Insider Trading and Informed Speculation, *Quarterly Journal of Economics*, (1989) 823-845.
[57]Manove Michael, The Harm from Insider Trading and Informed Speculation,823-845.
[58] Bainbridge Stephen, Insider Trading, UCLA School of Law (1999).
[59] Henry Manne, Insider Trading and The Stock Market, 172-73, 178 (1966).

to be incentivized.[60] More so, Dent adds, many cases of insider trading today are not perpetrated by executives who create and possess valuable information but rather by employees. Thus, the use of insider trading to reward innovation would occasion huge logistical problems since companies would be required to designate who would conduct such trades when they occur and also monitor compliance.[61]

Wang argues that insider trading positively affects the accuracy of prices in the financial markets.[62] A similar argument is advanced by Leland who contends that the prohibition or regulation of insider trading may prevent effective price discovery and have undesirable effects on innovation.[63] The premise of this argument is that insider trading quickly reveals information to the public thus improving on the in formativeness of prices.[64]

Levine *et al*., approach the subject of insider trading laws in an empirical study conducted in 103 market economies.[65] The authors' analysis is premised on a quantitative study previously conducted by Bhattacharya and Daouk. Levine *et al*, find that corporates begin experiencing a surge in IPOs and SEOs when their local jurisdictions begin to enforce insider trading regulations. The authors also note that legal systems that impede insider trading and thereby encourage investors to acquire information and value firms more accurately exert a material impact on innovation. The researcher however notes that these findings were biased to companies and corporates that utilized technology in one way or the other.

1.7.2 Enforcement of Insider Trading Laws

Gakeri emphasizes the importance of regulating financial markets.[66] He discusses different paradigms of regulation and enforcement to wit government regulation, government-led regulation, self-regulation or a hybrid of the foregoing. The author then

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[60] Dent, George W., "Why Legalized Insider Trading Would Be a Disaster" (2013). Faculty Publications. 27.
[61] Dent, George W., "Why Legalized Insider Trading Would Be a Disaster",27.
[62] Wang S. William, Introduction: Insider Trading, University of California, Hastings College of the Law (2010) Available at https://www.researchgate.net/publication/228273857 on 20 June 2020.
[63] Leland, H.E., Insider Trading: Should It Be Prohibited? *Journal of Political Economy*, (1980) 859-887.
[64] Grossman, S.J., Stiglitz, J.E., On the Impossibility of Informationally Efficient Markets. *The American Economic Review* 70, (1980) 393-408.
[65] Levine et al, Insider Trading and Innovation, Working Paper 21634, National Bureau of Economic Research (2015) Available at http://www.nber.org/papers/w21634 on 20 June 2020.
[66]Gakeri Jacob, Regulating Kenya's Securities Markets: An Assessment of the Capital Markets Authority's Enforcement Jurisprudence, *International Journal of Humanities and Social Science, Vol. 2 No. 20 (Special Issue – October 2012).*

discusses enforcement of insider trading laws and deems it to determine the efficaciousness of regulation. In doing so, he highlights the roles of the Capital Markets Authority of Kenya and comments that the CMA enjoys the full complement of powers needed to effectively carry out its enforcement mandate. He assesses the scope of the roles of the CMA and in particular the roles of inspection and investigation. In conclusion, Gakeri notes that the CMA lacks an elaborate enforcement philosophy which in turn has impacted negatively on securities markets confidence. He attributes these challenges to the absence of securities litigation citing the lack of jurisprudence from the Kenyan judiciary. While Gakeri delves into the institutional shortcomings in the enforcement of insider trading laws, he fails to identify any concerns with regard to prosecution and the provisions of law. The researcher intends to address these issues in the immediate study.

Nyangau reiterates similar sentiments in his work.[67] He suggests that the Kenyan judiciary has failed to convict persons accused of insider trading. However, Nyangau suggests that this trend is caused by the high standard of proof imposed on prosecutors by the provisions of the Capital Markets Act. He argues that it is difficult for the prosecution to produce evidence in court since the perpetrators of insider trading take serious precautions to cover their tracks. Thus, the author adds, the bulk of evidence produced in such cases is either superficial or circumstantial but ultimately not enough to sustain a conviction. Nyangau insists that it is difficult to find direct evidence in insider trading cases. In conclusion, Nyangau states that the employment of technology in insider trading has made it increasingly difficult to discover, investigate and prosecute. He recommends an amendment of the law in response to these advancements.

Muindi and Mbabu poetically analogize the prosecution of insider trading to the proverbial Gordian knot.[68] The authors convey the difficulty that the Capital Markets Authority has faced in prosecuting cases of insider trading. They, like Nyangau above, attribute such difficulty to an impossible standard of proof to be discharged by the prosecution. However, the authors also highlight significant steps that have been taken by the Capital Markets Authority in a bid to ease the yoke that is producing evidence. The authors prospect that the CMA will achieve success in near future.

[67]Nyangau Shem, A Peek into Insider Trading in India and Kenya; a Critique of the Legal Regime, *Journal of Research in Business and Management*, Volume 7, Issue 5 (2019) pp: 69-73.
[68]Muindi Brian and Mbabu Oscar, Insider Trading and the Restoration of Investor Confidence.

1.8 Justification of the Study

This study intends to unravel the challenges that haunt the Capital Markets Authority when prosecuting cases of insider trading. The study will therefore identify various aspects of the law that have impeded successful prosecution of insider trading cases. The challenges will also be addressed in the study. In this light, the study will be a useful reference tool for legal reform. Data collected will be a useful foundation for future academic pursuits in insider trading. The findings of this thesis will benefit further research by academic. It will also be a basis and/or a reference point for policy making by the Capital Markets Authority, the Nairobi Securities Exchange and other stakeholder in the expansive field of financial markets.

1.9 Scope of the Study

The study will be limited to the prosecution of insider trading cases in Kenya only. As such, the researcher will evaluate case law emanating from the auspices of the Capital Markets Authority and judicial decisions touching on the subject at hand. Accordingly, the researcher will place reliance on Kenyan law with comparative references being made to other jurisdictions.

1.10 Research Methodology

The researcher will employ a doctrinal methodology. Reliance will be placed on secondary sources of data. The researcher will refer to books, journal articles and international reports containing literature on the immediate study. The study will focus on current literature.

The study will draw inferences from literature emerging from the European Union and the United States of America which offer a much-needed perspective on how developed economies regulate insider trading. The study will also analyse literature from Kenya to gain an understanding on the prevailing situation with regard to insider trading.

Document analysis will be made of various international instruments to better understand the contemplation of their provisions. The researcher will also conduct an evaluation of existing jurisprudence, local and foreign. This will be achieved by analyzing decided cases in Kenya since the enactment of the Capital Markets Act. The study will also analyze foreign case law with focus on particular legal principles to understand how these principles have been applied over time.

Reference will also be made to empirical studies conducted by other authors on the instant subject.

The study will compare South Africa's financial markets' legal regime with that of Kenya. The South African securities market presents an ideal comparative study subject for various reasons. Firstly, the Johannesburg Stock Exchange (JSE), South Africa's premier securities market, is the largest of its kind in Africa and the 14th largest in the world with a market capitalization of over US $900 billion.[69]

Secondly, with regard to their respective economies, South Africa ranks slightly above Kenya. South Africa has the 35th largest economy in the world with a gross domestic product of $368 billion while Kenya ranks 66th on the global scale with a gross domestic product of $87 billion. In this sense, Kenya has something to learn from South Africa. In contrast, however, Kenya is ranked 4th in Africa with regard to ease of doing business while South Africa 6th.

1.11 Chapter Breakdown

This thesis is divided into five thematic chapters that relate to the regulating and prosecution of insider trading cases in Kenya as follows;

Chapter one is a brief introduction into the subject of insider training. It contains the background against which this study was conducted, a statement of the problem being addressed and the objectives of the research. The chapter also contains a review of relevant literature on the instant research topic and the theories which inform the researcher's school of thought.

Chapter two entails an assessment of the efficacy of the legal and institutional framework regulating insider trading in Kenya. The chapter identifies how insider trading is contemplated under the law. It also assesses how the relevant institutions have implemented the provisions of the Act.

Chapter three interrogates the efficiency of non-criminal sanctions in prohibiting insider trading. This is achieved by assessing jurisprudence emanating from Kenyan courts and other adjudicating tribunals.

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[69]Segun Olarinmoye, *Top 5 Stock Exchanges in Africa,* Available at https://nairametrics.com/2017/07/23/the-top-5-stock-exchanges-in-africa/ on 5August 2021.

Chapter four is a comparative study that aims at identifying the best practices in the regulation of insider trading.

Chapter five concludes on various aspects of the study, reports findings and suggests recommendations on the various issues identified.

CHAPTER TWO

REGULATORY FRAMEWORK FORINSIDER TRADING IN KENYA

2.1 Introduction

The classic definition of insider trading is the use of non-public information in trading shares of a company by someone who owes a fiduciary duty to the company.[70] The ethics of insider trading have long been the subject of considerable academic debate among business and legal scholars.[71] Some commentators advocate for the practice to be unregulated since "*the practice does not harm anyone in the strict sense.*"[72]They argue that no one in particular suffers any "*actual loss*" as a result of insider trading and further question whether an insider owes any legal duty to any person who actually suffers loss.[73]

In the past two decades, discussions on the utility of insider trading have subsided with a general consensus that the practice should be banned.[74] Those who favour the regulation of insider trading have often argued along two schools of thought; that the practice is unethical and that it hampers economic growth of a free market. However, both these schools of thought have had their criticisms over the years. Those who argue that the practice of insider trading is unethical, as Lawson points out, often have undeveloped premises to support their arguments. Ultimately, the argument on ethics is reduced to a mere exclamation with no empirical substance to support their premise. On the other hand, those who rely on an economic premise often lack empirical evidence to advance their argument.

Despite the foregoing, today insider trading is an illegal business practice which is now widely considered to be unethical.[75] This notion stems from the assertion that traditionally, insiders have had a fiduciary relationship with the complaining company.[76] Insider trading breaches this relationship of trust and confidence in favour of profit.

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[70] Brian A. Garner, editor in chief. Black's Law Dictionary. St. Paul, MN: Thomson Reuters, (2014).

[71] Klein, William A.; Ramseyer, J. Mark; Bainbridge and Stephen M, Business Associations: Cases and Materials on Agency, Partnerships, LLCs, and Corporations (2018) University Casebook Series (10th ed.)

[72]Klein et al, Business Associations.

[73] Klein et al, Business Associations.

[74]Engelen, PJ., Van Liedekerke, L. The Ethics of Insider Trading Revisited. *Journal of Business Ethics* 74, 497–507 (2007). https://doi.org.ezproxy.library.strathmore.edu/10.1007/s10551-007-9532-z

[75] Moore, J. What is really unethical about insider trading? *Journal of Business Ethics* (1990) 9, 171–182. https://doi.org/10.1007/BF00382642

[76]Mwaniki Gillian, Effect of Insider Trading Prohibitions: Regulation on Security Market Returns in Kenya. *The University Journal*, (2018) 1(2), 77-96.

However, as the researcher will note in the foregoing discussions, jurisprudence has since shifted away from this traditional view that an insider must have a fiduciary relationship for them to commit the offence of insider trading. It is against this background that the chapter will analyze the legal and institutional framework prohibiting insider trading in Kenya in this chapter.

2.2 The Regulatory Framework of Insider Trading in Kenya

Gakeri argues that a strong securities market largely depends on a facilitative legal and regulatory framework. Such framework, as Gakeri states should stimulate and encourage private sector investment, protect minority shareholders and facilitate transparent and timely resolution of disputes. [77] The foregoing discussion reviews various provisions regulating insider trading under the Capital markets Act with a view to establish whether they meet Gakeri's threshold of a good regulatory framework.

2.2.1 Legal Framework: An Overview of the Capital Markets Act, CAP 485 A Laws of Kenya

The Capital Markets Act is the primary legislation regulating securities in Kenya.[78] The Act came into force on 15th December 1989.[79] In 2000, the name of the Act was changed to the Capital Markets Act from the Capital Markets Authorities Act. The objective of the Act as captured 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 market in Kenya and for connected purposes.[80]

In 2013, the Cabinet Secretary for National Treasury called for amendments to the Capital Markets Act while speaking to the Budget and Appropriations Committee of the National Assembly. Among his proposals was the broader definition of the term "insider trading". These amendments acquired the force of law vide the Capital Markets (Amendments) Act[81] which came into force in December 2013. The Act now broadly provides for insider trading and other market abuses under Part VI.[82]

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[77]Gakeri Jacob, 'Enhancing Securities Markets in Sub-Saharan Africa: An Overview of the legal and Institutional Arrangements in Kenya' *International Journal of Humanities and Social Science* (2011) Vol. 1 No. 9,140.
[78]Gakeri J, Enhancing Securities Markets in Sub-Saharan Africa,140.
[79] Preamble, *Capital Markets Act*, Cap 484A Laws of Kenya.
[80] See Preamble, *Capital Markets Act.*
[81]*Capital Markets (Amendment) Act*, 2013.
[82]*Capital Markets Act* Section 32A-L and 33.

2.1.1.1. Definition of insider trading

Conventionally, insider trading has been defined to mean the use of non-public information in trading shares of a company by someone who owes a fiduciary duty to the company. However, this definition has been problematic over the years, mainly because it assumes that an insider must have a fiduciary relationship with the company. As Henning aptly put it, the term *"insider trading"* is a misnomer because it is also applicable to persons who are not corporate insiders.[83] The Capital Markets Act borrows a leaf from this sentiment.

Although criminalized, the practice of insider trading is not expressly defined under the Capital Markets Act. Section 32B of the Act instead stipulates instances which would amount to the offence of insider trading. Under this section, a person commits the offence of insider trading if they *"[encourage] another person to deal in securities or their derivatives which are price-affected securities in relation to the information in the possession of the insider, knowing or having reasonable cause to believe that the trading would take place"* or "*discloses the information, otherwise than in the proper performance of the functions of his employment, office or profession, to another person*."[84]

Before amendment, Section 32A prohibited the use of unpublished inside information in the following terms;

> *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; or*
> c. *Counsel or procure any other person to deal in securities of any company on the basis of unpublished price sensitive information*.

[83] Henning, Between Chiarella and Congress: A Guide to the Private Cause of Action for Insider Trading Under the Federal Securities Laws, 39 University of Kansas Law Review. 1, 1 (1990).
[84] *Capital Markets Act* Section 32B.

Notably, Section 32B excludes the use of the term "*unpublished".* The Act, unlike its predecessor, has broadly and generously defined "inside information" and what constitutes "public information" under Section 32C and D. According to the Act, inside information is information "*which relates to particular securities or issuer of securities; has not been made public and where if it were made public is likely to have a material effect on the price of the securities."*[85] Information is deemed by the Act to be public if it can readily be acquired by those likely to deal in any securities or it is published in accordance with the rules of a securities exchange for the purpose of informing investors and their professional advisers.[86]

Perhaps this amendment was informed by the difficulty by the prosecution to prove that certain information was unpublished as was the case in *R v Terrence Davidson.*[87]In that case, the accused person was charged with insider trading particulars being that the accused person was privy to the financial status of Uchumi Supermarket being the CEO of the retailer's bank. The prosecution maintained that the accused person acted on the information to instruct his stock broker to sell his shares a few days before the retailer collapsed. In acquitting the accused person, the court stated that the financial status of the retailer was something of public knowledge noting that the company's information memorandum indicated that the company had been making severe losses and the fact that major shareholders were pulling out was information in the public domain.

Another notable difference is the substitution of the words "*on the basis of*'" with the words *"in relation to".* In the repealed Section 32A, a person would only be guilty of the offence if they acted "*on the basis"* of non-published information. The phrase "*on the basis of"* denotes that the insider placed reliance on such information to make a trade. This means that not only should the prosecution show that the accused person dealt in certain securities, they also have to prove that such a dealing was informed by inside information that was known by the insider. To this end, the prosecution had the extra burden of proving *mens rea* of an offence which ordinarily is a strict liability offence. The absence of this nexus would result in an acquittal.

[85] Section 32C, *Capital Markets Act,* 2013.
[86] Section 32D, *Capital Markets Act,* 2013.
[87]*Republic vs. Terrence Davidson*, Nairobi CMCC 1338 of 2008 (UR).

In contrast, the drafters of section 32B elected to use the words "*in relation to*". This phrase connotes some relativity and not compulsion.[88] It should be sufficient for the prosecution to demonstrate the mere possession or knowledge of non-public information by an insider at the time of the offending transaction in order to ground liability.[89]

A reading of section 32B reveals that the offence of insider trading is designated as a strict liability offence. This means that when prosecuting a charge under this section, the state does not have to show *mens rea* on the part of the accused.[90] The strict liability approach therefore means that once it is established that insider trading has occurred, the burden of proof lies with the offender to prove that the motive of carrying out the subject trade does not touch on inside trading.[91]

It is also important to note that the stipulations under section 32B do not make it mandatory for an insider to have a fiduciary relationship with the complaining company. The approach taken by the Act has some benefits. Most importantly, it eradicates the deficiencies of the classical definition of insider trading. Secondly, it is immaterial whether or not the insider benefits from information. An offence is committed on the premise that the insider used non-public price-sensitive information to make a trade or shared the information with a third party who made a trade on the basis of that information. Another important addition under section 32B is its application to derivative securities.

Conversely, the approach also limits its scope of application. Under section 32B, only two precise instances amount to insider trading. Anything falling outside these two instances would strictly not qualify as insider trading under the Act. Moreover, the instances provided under the section have a great many qualifications which make it exceedingly difficult to prove in a court of law. The latter will be illustrated in the next section.

[88]Kotonya Anne, Combating Insider Trading in Kenya's Capital Markets: Challenges and Opportunities for Reform, (2012) Unpublished Thesis. Available at http://erepository.uonbi.ac.ke/handle/11295/9404on 25 February 2021. Kotonya argues that the phrase "*on the basis of*" underscores the mental disposal of an insider which is very difficult to show.
[89]Kotonya A, Combating Insider Trading in Kenya's Capital Markets.
[90] Wasserstrom Richard A, "Strict Liability in the Criminal Law." *Stanford Law Review* (1960)12 No. 4 at 73
[91]Ondari Ian, How Effective is the Legal Framework on Insider Trading? *Nairobi Business Monthly* (November 2016) Available at https://www.nairobibusinessmonthly.com/how-effective-is-the-legal-framework-on-insider-trading/on 25 February 2021.

2.1.1.2. Scope of Application

The operation of section 32B of the Capital Markets Act extends to listed securities or their derivatives and any derivatives traded on any market regulated by the Authority. As of 2021, the Nairobi Securities Exchange (NSE) is the sole securities market licensed to operate in Kenya. All listed securities are traded on the NSE. The Act in general, and thus section 32B, applies to all securities that are traded on the NSE. The derivative market in Nairobi began trading in 2019, a few years after the amendments were included in the Act.[92]

The broad definition of an "insider" and "inside information" extends the application of the Act to many individuals other than those directly linked with a company. Under section 32A, an insider is a person in possession of inside information.[93] Inside information is defined under section 32C as information which (a) *relates to particular securities or to a particular issuer of securities; (b) has not been made public; and (c) if it were made public is likely to have a material effect on the price of the securities.* Pursuant to this description, any person may be liable for insider trading as long as they could reasonably access information that had not been made public.

This deduction is in consonance with the description of an "insider" under section 2 which deems an insider to be 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.

In strict conscription, the term would apply to members of the issuing entity, professionals who ordinarily carry out business with the issuing company such as lawyers and bankers, friends and family of corporate employees, government officials who may come across confidential information in the course of their duties and hackers.[94] These individuals, by dint of the Act, are presumed to have reasonable access to confidential information. However, when prosecuting the offence, the state still has to

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[92]Cytonn Investments, *Understanding the Derivatives Markets*, (July 2019) Available at https://cytonn.com/topicals/understanding -the-derivatives-1on 25February 2021.
[93] Section 32A 2(h).
[94] James Wairoto and Bernard Musyoka, Insider Trading in Kenya, MWC Newsletter (2019) Available at https://mwc.legal/insider-trading-in-kenya/on 25 February 2021

discharge the burden that the individuals had access to that information, the information was not made public, it was price-sensitive and the persons acted on the basis of that information.

To give credence where it is due, the Act has made forward steps in providing a guide to what inside information is. Before the 2013 amendments, it was difficult to know what information would amount to inside information. This was problematic because proof of possession/knowledge of information was central to prosecuting a charge of insider trading. This requirement was reflected in section 32A of the Act which made reference to insider trading as trading "*on the basis*" of unpublished insider information. With the introduction of section 32C, it is now possible to succinctly describe inside information.

Concerns however emanate from the requirement that for such information to qualify as inside information, it should not have been made public. Thus, information in the public domain cannot, under any circumstances, be inside information.[95] This begs the question, when is information deemed to be in the public domain?

Section 32D outlines various instances when information may be deemed to be public. These are: if it is published in accordance with the rules of a securities exchange; for the purpose of informing investors and their professional advisers; it is contained in records which by virtue of any law are open to inspection by the public; it can readily be acquired by those likely to deal in any securities to which the information relates or of an issuer to which the information relates; or is derived from information which has been made public.

The researcher takes great exception to the notion that information is deemed public merely by the fact that it can readily be acquired by those likely to deal in securities or that information has been made public.[96] This objection is premised on the fact that not all information in the public domain is there legally. For instance, confidential company information may be leaked to the public by an insider for the sole purpose of conducting a certain trade. This situation is further convoluted by the provision that information is still deemed to be in the public domain even where it is released to only a segment of the public.[97] Furthermore, a newspaper or tabloid article may speculate, without cause,

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[95] Section 32C, *Capital Markets Act*, 2013.
[96] Section 32D (1) (c), *Capital Markets Act*, 2013.
[97] Section 32D (2), *Capital Markets Act*, 2013.

information which turns out to be true. Such speculations, although baseless, are protected by Section 32D (a) and (c). The Act fails to take into account the reliability of the source of information and thus gives a lot of leeway for culprits to claim that the subject information was in the public domain.

Like in the case of Terrence Davidson above, the court in the case of *Republic v Bernard Kibaru*[98]noted that the prosecution had failed to prove beyond reasonable doubt that the accused person had exploited information not generally accessible to the public when disposing of his shares in the company. In the case, the accused person was an employee of the issuing entity and regularly attended board meetings regarding the financial prospects of the company.

The Capital Markets Act extends the culpability of insider trading to persons connected to a body corporate. Under the Act, a person who is 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.[99] Such a person is also barred from communicating such material non-public information with any other person if trading in those securities is permitted on any securities exchange; and 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.[100]

The Capital Markets Act defines a person connected with a body corporate as a natural person who is an officer of that body corporate or of a related body corporate; or is a substantial shareholder in that body corporate or in a related body corporate; or occupies a position that may reasonably be expected to give him access to information by virtue of his professional or business relationship; or being an officer of a substantial shareholder in that body corporate or in a related body corporate.[101]

[98]*Republic versus Bernard Mwangi Kibaru*, Nairobi CMCR 1337/2008 (Unreported).
[99] Section 33 (1) *Capital Markets Act*, 2013. Section 33 (2) describes “information” as information not generally available to the public and if it were it would materially affect the price of the subject securities. Information falling under this description is also information that relates to any transaction (actual or expected) involving both bodies corporate or involving one of them and securities of the other.
[100] Section 33 (5) *Capital Markets Act*, 2013.
[101] Section 33 (9) *Capital Markets Act*, 2013.

Generally, a body corporate is prohibited from dealing in securities where any officer in the body corporate has in his possession information which is not in the public domain and would affect the price of those securities if it were public.[102] However, there are some exceptions to this rule. A company is not barred from trading by reason only of information in the possession of an officer of that body corporate if the decision to enter into the transaction was taken on its behalf by a person other than the officer.[103]

2.1.1.3. Penalty for Insider Trading under the Capital Markets Act

Insider trading under the Capital Markets Act is contemplated as a criminal offence of strict liability. Under various provisions, the Capital Markets Act prefers a custodial sentence or a fine upon conviction on charges of insider trading. Among these provisions is Section 32E which stipulates that first offenders convicted of insider trading are liable to a fine not exceeding two million five hundred thousand Kenya Shillings or a custodial term of two years for natural persons. In addition, the convicted person will also pay the amount of the gain made or loss avoided through the act of insider trading.[104] Bodies corporate will, upon conviction, be liable to a fine of up to five million shillings and payment of the amount of the gain made or loss avoided.[105]

Natural persons found guilty of a subsequent offence are liable to a fine not exceeding five million shillings or to an imprisonment for seven years and payment of twice the amount of the gain made or loss avoided. Companies found guilty of insider trading after the first offence are liable to a fine not exceeding ten million shillings and payment of twice the amount of the gain made or loss avoided.[106]

There seems to be some contradiction in terms of the sentence imposed to a natural person where they are convicted on insider trading charges. As above, section 32E (a) (i) of the Act provides for a punitive fine not exceeding two million five hundred thousand shillings. This sanction is replicated in Section 33 (12). However, under section 32L, the Act provides that any person who contravenes the provisions of Part VI is liable to a fine not exceeding five million shillings.

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[102] Section 33 (6) *Capital Markets Act*, 2013.
[103] Section 33 (7) *Capital Markets Act*, 2013.
[104] Section 32E (a) (i) *Capital Markets Act*, 2013.
[105] Section 32E (a) (ii) *Capital Markets Act*, 2013.
[106] Section 32E (b) *Capital Markets Act*, 2013.

A reading of section 33 (13) reveals that the drafters of the Act contemplated civil action by a complaining company for the recovery of loss. In addition, subsection 14 stipulates that conviction under the Act does not absolve the offender of liability accruing from any other written law.

The Capital Markets Authority, exercising its mandate of enforcement, is also empowered to impose addition penalties other than those highlighted above.[107] The Authority may reprimand, suspend, revoke a license, remove one from directorship, levy a financial penalty or recover twice the amount of money lost or gained from a person found in contravention of the provisions of the Capital Markets Act. In addition, the Authority also has the power to make orders of restitution or require a certain company to take action against one of its employees. The Act requires the Authority to publish the names of offenders and the actions taken against such offenders in the Authority's annual report.[108]

To some extent, insider trading is considered a white-collar crime. Sutherland defined white-collar crime as "crime committed by a person of respectability and high social status in the course of his occupation".[109]Many perpetrators of insider trading are usually corporate executives high up the social and corporate ladder who get access to inside information by virtue of their positions. As in many white-collar crimes, the offence of insider trading is difficult to prosecute because perpetrators are sophisticated criminals who have attempted to conceal their activities through a series of complex transactions.[110]

2.1.1.4. Enforcement

The Capital Markets Act and its licensing regulations advocate for self-regulation of securities exchanges in Kenya.[111]However, this is hardly the situation on the ground. The NSE operates under heavy oversight of the Capital Markets Authority which is an authority established under the Capital Markets Act.[112]One of the core objectives of the Capital Markets Authority is to implement a system of self-regulation "to the maximum

[107] Section 25A *Capital Markets Act*, 2013.
[108] Section 25A (4) *Capital Markets Act*, 2013.
[109] Sutherland, Edwin H. The White-collar criminal. *American Sociological Review* (1940) 5:1–12
[110]White Collar Crime/Fraud Statistics Available at http://www.diogenes llc.com/ whit ecollarfraudstats.htmlon 25 February 2021.
[111] Section 11A (1) (b) *Capital Markets Act*, 2013.
[112] Section 5 *Capital Markets Act*, 2013.

practicable extent."[113] In this regard Gakeri argues that the regulation of securities markets in Kenya is government led.[114]

Being a statutory authority, the CMA is imbued with executive powers delegated by the Ministry of Finance (Treasury). It is thus responsible for the implementation and enforcement of the regulations under the Capital Markets Act. To discharge its mandate, the Authority is empowered to prevent, license, authorize, investigate, inspect and sanction all players in the securities market. Exercising its full complement of powers, the Authority is the primary institution responsible for regulating securities markets and thus prohibiting insider trading in Kenya.

2.1.1. Institutional Framework: An Overview of the Capital Markets Act, CAP 485 A Laws of Kenya

Fishman argues that the effectiveness of the regulatory scheme rests upon the nature and scope of enforcement tools.[115] In the same vein, Gakeri suggests that the interface between regulation and enforcement manifests itself through supervision which broadly encompasses: licensing or authorization, inspection, investigation and sanctioning.[116] From the foregoing, it is then trite to conclude that the enforcement of legislation is heavily dependent on the effectiveness of the institutional framework. In Kenya, the Capital Markets Authority personifies this institutional framework. In this section, the researcher will assess the effectiveness of the Authority in discharging its statutory mandate. In this pursuit, the researcher will look at the extent of the powers devolved to the Authority through the Capital Markets Act and how the Authority has exercised those powers in the prohibition of insider trading.

2.1.2.1. Capital Markets Authority

In the 1980 of Kenya, the government of Kenya embarked on a quest to enhance the role of the private sector in the economy, reduce the demands of public enterprises on the exchequer, rationalize the operations of the public enterprise sector to broaden the base of ownership and enhance capital market development. To help further along this objective, the government set up the Capital Markets Development Advisory Council in

[113] Section 11 (1) (c) *Capital Markets Act*, 2013.
[114] Gakeri J, Regulating Kenya's Securities Markets,270 and 271.
[115] James J. Fishman, *Enforcement of Securities laws Violations in the United Kingdom*, 9 International Tax and Business Law 131 (1991).
[116] Gakeri J, Regulating Kenya's Securities Markets, 270 and 271.

1988 which was charged with the responsibility of creating a regulatory body for the capital markets in Kenya. The Council drafted the first Capital Markets Bill which was passed by Parliament in 1989.[117]

The Capital Markets Authority was established in 1989 by this Act of Parliament in a bid to enhance the development of capital markets. It began its operations in 1990 as a statutory agency charged with the "*primary responsibility of regulating the development of orderly, fair and efficient capital markets in Kenya*."[118] This maiden Act was merely a framework and was not intended to interfere with the operations of markets significantly.[119] Over the years, the Act has seen several amendments that have widened the powers of the Authority and fortified its position from a development facilitator to a market regulator.

2.1.2.2. Composition of the Authority

Section 5 of the Capital Markets Act, 2013 establishes the Authority as a body corporate with perpetual succession. The Authority is composed of a chairman appointed by the President of Kenya; six members appointed by the minister; the Permanent Secretary of the ministry or his delegate appointed in writing; the Governor of the Central Bank of Kenya; the Attorney General and a Chief Executive Officer.[120] The Act requires that the chairman and all six members appointed by the minister to have experience and expertise in legal, financial, banking, accounting, economics or insurance matters.[121] The Act also prescribes that the Chief Executive Officer of the Authority must be a person with at least ten years' experience at a senior management level in matters relating to law, finance, accounting, economics, banking or insurance and has expertise in matters relating to money or capital markets or finance.[122] The chairman and members have a renewable three-year tenure of office. It is a requirement that the appointment of

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[117] Capital Markets Authority Handbook, Available at https://www.cma.o .ke/index.php?option=com_phocadownload&view=category&download=140:cma-handbook-complete&id=45:information-for-investors&Itemid=222on 25 February 2021.

[118]Rothwell Kevin, Regulations and Market Practice, *Chartered Institute for Securities and Investments* (2016)

[119]Gakeri Jacob, Enhancing Securities Markets in Sub-Saharan Africa: An Overview of the Legal and Institutional Arrangements in Kenya, *International Journal of humanities and Social Science,* Vol 1 No. 9 (2011).

[120] Section 5 (3) *Capital Markets Act*, 2013.

[121] Section 4 *Capital Markets Act*, 2013.

[122] Section 8(2) *Capital Markets Act*, 2013.

members of the Authority takes place at different times so as to foster continuity of operations of the Authority.[123]

The composition of the Authority has often been criticized for being inordinately large.[124] This criticism best manifests in the quorum of six required for any decision to be taken by the Authority. Furthermore, it has been argued that the financial implications of a large membership defeat the objects of efficiency where such monies used to pay allowances may be used for civic education. Heavy board memberships in government agencies are often seen as pervasive and to entrench political patronage.[125] This concern is further compounded by the fact the appointments to membership are not subjected to any form of vetting by statute.

The composition of the Authority draws members from the industry. In this light, it is inevitable that some of these members, at one point or the other, have a conflict of interest. The Act fails to expressly provide for such a situation.

The Authority and its members are shielded from liability arising out of any act which is done in good faith or purported to be done by such person, on the direction of the Authority or in the performance or intended performance of any statutory duty.[126]

2.1.2.3. Powers of the Authority

One of the objectives of the CMA is to formulate rules and guidelines on various aspects of the securities markets, license, approve and supervise all market intermediaries. This full complement of powers is characteristic of any regulator of securities markets. The Authority’s powers fall into three distinct categories. These are prevention, monitoring and information gathering and power of intervention, sanctions, penalties and judicial proceedings.

Prevention

The Authority is the gate-keeper of securities markets. It is empowered by statute to restrict entry into the industry to only persons with unquestionable business history and conduct. This is achieved through the Authority’s powers of registration, authorization, approval and licensing. In furtherance of this mandate, the Authority is also empowered

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[123] Section 4A *Capital Markets Act*, 2013.
[124] Gakeri J, Enhancing Securities Markets in Sub-Saharan Africa,134-169.
[125] Kiarie Mwaura, Regulation of Directors in Kenya: An Empirical Study, 13 (12) ICCR, 465, 479 (2002).
[126] Section 10 *Capital Markets Act*, 2013.

to set industry standards and maintain such standards in a bid to protect the unsuspecting public.

In relation to insider trading, the Authority has the power to approve certain transactions.[127] If a certain transaction is suspect, the Authority may refuse to authorize dealing in those securities pending further investigation. Along with the registration and licensing functions, the Authority has the power to deregister as well as revoke licenses of offenders. These powers were exercised in the case of Aly Khan Satchu and Andre De Simone. In that case, the Authority, in addition to cash penalties banned the offenders from dealing in securities for three and one year respectively.

Monitoring and Information Gathering

The Authority may require any person under its district to furnish information.[128] Further, the Chief Executive Officer of the Authority may authorize any senior officer or manager of the Authority to inquire into the affairs of any person under the Act.[129] Where such an authorized officer has reason to suspect that a person has committed an offence under the Capital Markets Act, they may apply to a magistrate for a warrant to search that person's premises. The warrant, if issued may empower the officer to seize relevant documents, money or assets, to enter premises within reasonable hours and to direct any person to take action to protect assets until the court makes a determination on a matter.[130]

These powers of monitoring and information gathering are further enhanced by a Memorandum of Understanding signed by the Authority, the Central Bank of Kenya, Retirement Benefits Authority and the Insurance Regulatory Authority on information sharing.[131] The multi-agency co-operation was also included in the Capital Markets Act where the Authority may co-operate with other agencies to gather information.[132]

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[127] Fifth Schedule to *the Capital Markets (Securities) (Public Offers, Listings and Disclosure) Regulations*, 2002.
[128] Section 13 (1) *Capital Markets Act*, 2013.
[129] Section 13A *Capital Markets Act*, 2013.
[130] Section 13A (3) *Capital Markets Act*, 2013.
[131] The Kenya Financial Sector Stability Report, 2015 Issue No. 7 (August 2016) Available at https://www.centralbank.go.ke/uploads/financial_sector_stability/2057936782_Financial%20Stability%20Rpt%202015.pdf on 25 February 2021.
[132] Section 13 (3) *Capital Markets Act*, 2013.

Inspection

As discussed above, the Authority may demand from any person certain information at any time. Further to this power, the Authority may also inspect the premises of any of its licensees.[133] These powers are exercised to ensure conformity to set standards and compliance with the law. Inspection may be spurred by the Authority *suo moto* or from a complaint by the public or any other person.

Investigation

Under section 13B of the Act, the Authority is empowered to investigate where there is reason to believe that an offence has been committed under the Act.[134] Investigations may also be conducted where the Authority believes that a licensee is not acting in the best interests of the public.[135] These powers also allow the Authority to engage other professionals to assist in the investigations.

The Authority has previously engaged Price Waterhouse Coopers (PwC) a reputed audit firm, to perform a forensic audit on Francis Thuo and Partners Co. Ltd. [136] When Uchumi Supermarkets Co. Ltd (a publicly held company) ceased to carry on business on May 31st 2006, the Authority engaged a constellation of advocates, auditors, receivers and capital markets specialists to investigate the circumstances leading to the closure and in particular transactions involving the company's securities.[137] In 2009, the Authority established the Fraud Investigations Unit whose mandate was to investigate suspected violations. Many cases investigated by this unit have since been taken to court albeit unsuccessfully.[138]

Powers of Intervention, Penalties and Sanctions

In the final limb of enforcement, the Authority has powers to intervene in the business of its licensees and impose penalties and sanctions. It is interesting to note that the Authority is empowered to impose sanctions and penalties without prosecution.[139] Questions have however arisen on the legality of the Authority acting as an assessor or court of law when passing sanctions or penalties.

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[133] Section 11 (j) and 33A *Capital Markets Act*, 2013.
[134] Section 13B *Capital Markets Act*, 2013.
[135] Section 13B (1) (c) *Capital Markets Act*, 2013.
[136] James Anyanzwa, *CMA to Investigate troubled Broker*, The Standard, June 2, 2009, at 26.
[137]Gakeri J, Enhancing Securities Markets in Sub-Saharan Africa,134-169.
[138] Washington Gikunju, *Police turn the heat on Stock mart fraudsters*, Business Daily, Oct. 26, 2010 at 31;
Washington Gikunju, Crackdown on Fraudsters, Business Daily, Oct. 27, 2010 at 19.
[139] Section 25A Capital Markets Act, 2013.

2.2. The Quest for Self-regulation

The Capital Markets Act envisages the self-regulation of securities markets in Kenya.[140] In its classic definition, self-regulation is a regulatory regime under which an organization or industry sector establishes its own rules and regulates itself accordingly.[141] Self-regulation denotes an element of autonomy.[142] It is premised on the reasoning that individuals and firms strive to uphold positive norms, practices and standards set by the industry.[143] The justification for self-regulation in securities markets has often been that security exchanges have capacity to exercise dominant market power acquired through their monopoly in securities' dealing.[144] As such, there is a need to benefit from their superior knowledge and skill in the industry.

On the other hand, government-led regulation is a regime where the central government regulates all aspects of the industry. Conventionally, in this regulatory regime, the governmental power over the industry players is exercised through executive authority- that is- through a minister or an administrative agency or both.

In Kenya, although the Capital Markets Act aims at achieving self-regulation for security exchanges, government involvement is overt. The Capital Markets Act establishes the Capital Markets Authority with a main objective of promoting, regulating and facilitating the development of an orderly, fair and efficient capital market in Kenya and for connected purposes.[145] Thus, the regime of regulation in Kenya is nothing short of government-led. This conclusion is derived from the following premise;

The Nairobi Securities Exchange is the main securities market in Kenya and the East African region in *extenso.* The powers of NSE can be found in its constitutive documents, regulations of the Capital Markets Act, Membership and Trading Rules and its Listing Manual. However, the exercise of these powers is subject to the Capital Markets Act. Ultimately, the Capital Markets Act will always take precedence over any

[140] Section 11 and 11A *Capital Markets Act*, 2013.
[141]Gakeri J, Regulating Kenya's Securities Markets, 270 and 271.
[142] William L. Cary, Self-Regulation in the Securities Industry, 49 *American Bar Association Journal* 244, 244 (1963).
[143] James J. Fishman, *Enforcement of Securities laws Violations in the United Kingdom*, 9 International Tax and Business Law 131 (1991).
[144] Andreas M. Fleckner, *Stock Exchanges at Crossroads*, 74 *Fordham Law Review*.2541, 2553 (2006).
[145] Preamble, *Capital Markets Act*, 2013.

regulations made by the NSE.[146] The oversight role of the CMA makes the autochthonous regulations of the NSE ineffectual. For instance, it is mandatory for the NSE to admit all firms approved by the CMA as full or associate members without any further consideration. Moreover, the NSE cannot amend, vary or rescind any of its rules without prior approval by the Authority. Finally, it is the Authority that approves the annual budget of the NSE.

2.3 Conclusion

The Capital Markets Act has adapted to the dynamic nature of securities markets through several amendments over the years. More particular, the provisions on insider trading have become more robust and have a wider application. The Act grants the Capital Markets Authority the full complement of powers necessary to discharge its mandate efficiently. However, as seen from earlier discussions, the Authority is yet to obtain a successful conviction on a charge of insider trading under the Act.

Regrettably, the Authority has been intent on following the criminal route in attempting to curb instances of insider trading. The researcher has established that the Authority is empowered to impose other sanctions without necessarily going to court. The researcher posits that the Authority should lay an emphasis on non-criminal sanctions which will better serve the deterrent objective so required.

[146] For instance, although the exchange is empowered to promote any other company to facilitate acquisition of property or acquire or hold shares in other companies, the CMA has restricted its shareholding to the Central Depository and Settlement Corporation Ltd (CDSC).

CHAPTER THREE

CRIMINAL SANCTIONS AGAINST INSIDER TRADING: THE PHILOSOPHY OF DETERRENCE

3.0 Introduction

In the previous chapter, the researcher found that insider trading is contemplated as a criminal offence under the Capital Markets Act of Kenya. The researcher also found that despite robust broad and definitive provisions encapsulated under the Act, criminal proceedings against insider trading offenders have always faltered for one reason or another. This chapter interrogates the status of insider trading as a criminal offence in Kenya, its constituent elements and practicability in deterring mischief. This chapter also considers the pitfalls of relying on criminal sanctions and will also make a case for emphasis on administrative and civil sanctions.

3.1 Insider Trading as a Criminal Offence

In Kenya, the offence of insider dealing is committed when an insider acquires or disposes of price-affected securities while in possession of unpublished price-sensitive information**.** It is also an offence to encourage another person to deal in price-affected securities, or to disclose the information to another person other than in the proper performance of employment.[147] The offence attracts both custodial and non-custodial penalties under the Capital Markets Act.[148]

3.1.1 Insider Trading as a Strict Liability Offence

Insider trading is contemplated as a strict liability criminal offence.[149] It is not necessary to prove criminal intent for one to be convicted of insider trading. It is neither necessary to show any gains accrued by the offender or any loss caused through insider trading.[150] Once the prosecution demonstrates that an accused person was in the possession of inside information and traded while in the possession of this information, then a charge of insider trading will be proved. Section 32A (2) of the Capital Markets Act provides as follows:

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[147] Capital Markets Authority, *Regulations and Market Practice (Kenya)* Learning Manual Ed.1 2016 Available at https://www.cma.or.ke/ind ex.php?option= com_phocadownload &view=catego y&download=163:regulations-and-markets-practice-kenya-edition-1&id=6:certification&Itemid=314on 1 May 2021.

[148] Section 33 (12) *Capital Markets Act.*

[149] Section 32A and 33 *Capital Markets Act.*

[150] It is only necessary to prove a benefit or gain for purposes of victim compensation and the appropriation of relevant pecuniary sanctions.

> 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...

It is a general rule in criminal law that the essence of an offense is the wrongful intent, without which it cannot exist. [151]Simply put, there can be no crime without an evil mind. The concept of strict liability thus goes against the grain since it abdicates the concept of *mens rea* as an essential element in proving the commission of an offense. Various legal scholars have criticized strict liability as a straightforward case of punishing the blameless.[152]

Strict liability is generally tolerated as it brings practical benefits and is often used to provide a greater level of protection to the public in areas where it is perceived that there is a need to provide such protection.[153] Often, in criminal law, strict liability will only be applicable where the crime is of a regulatory nature as opposed to a true crime.[154] In some cases strict liability offences may also assist prosecuting agencies where offences need to be dealt with expeditiously to ensure public confidence in the regulatory regime.[155] Professor Richard Singer defends the doctrine of strict liability by advancing the argument that such offences would inordinately exhaust the courts if an inquiry into *mens rea* were to be required.[156] He further adds that it is often onerous for the prosecution to prove the state of mind of the accused.[157]

The approach to designate an offence as a strict liability offence can therefore be said to be taken in a bid to enhance deterrence and ensure compliance.[158] Strict liability eliminates the arduous task of proving criminal intent from a prosecutor. This means that the mere commission of the prohibited act may impugn liability upon an offender.

[151] Eugene J. Chesney, Concept of Mens Rea in the Criminal Law, 29 *Amsterdam Institute of Criminal Law & Criminology* 627 (1938-1939).
[152] Kenneth W. Simons, When is Strict Criminal Liability Just, 87 *Journal of Criminal Law & Criminology* 1075 (1996-1997).
[153] Available at http://www.e-lawresources.co.uk/Strict-liability.phpon 1 May 2021.
[154]*Gammon (Hong Kong) Ltd v Attorney-General of Hong Kong* [1985] AC 1.
[155] Australian Senate Standing Committee for the Scrutiny of Bills, 'Sixth Report of 2002: Application of Absolute and Strict Liability Offences in Commonwealth Legislation' (26 June 2002) 263.
[156]Richard Singer, 'The Resurgence of Mens Rea: The Rise and Fall of Strict Liability' (1989) 30 *Boston College Law Review* 337, 389.
[157157] Richard S, The Resurgence of Mens Rea,337,389. While citing R v Woodrow (1846) 15 M & W 404, 153 ER 907 913
[158] Australian Senate Standing Committee for the Scrutiny of Bills, 'Sixth Report of 2002: Application of Absolute and Strict Liability Offences in Commonwealth Legislation' (26 June 2002) 263.

Ultimately, sustaining a conviction becomes easier. This in turn causes the public to fear the penalties upon conviction.

The European Court of Justice in *Spector Photo Group NV and Chris Van Raemdonck Versus Commissievo or het Bank*[159]stated thus in this regard:

> *The fact that Article 2(1) of Directive 2003/6 does not expressly provide for a mental element among the constituent elements of insider dealing can be explained ... by the purpose of Directive 2003/6, which, as is pointed out, inter alia, in the second and twelfth recitals in the preamble thereto, is to ensure the integrity of financial markets and enhance investor confidence in those markets ... the effectiveness of which would be weakened if made subject to a systematic analysis of the existence of a mental element. The effective implementation of the prohibition on market transactions is thus based on a simple structure… not only to enable sanctions to be imposed but also to prevent effectively infringements of that prohibition*.[160]

Following the above, it can therefore be said that the rationale of designating insider trading as a strict liability offence under the Capital Markets Act was for deterrence and to ensure compliance with regulatory regime.

3.1.1 The Philosophy of Deterrence of Insider Trading using Criminal Sanctions

Other than retribution, rehabilitation, incapacitation and denunciation, deterrence is another aim of criminal law.[161] The theory of deterrence postulates that the threat of punishment will deter people from committing crimes.[162] Deterrence is two-pronged: individual deterrence and general deterrence. General deterrence is meant to dissuade the general public from committing a crime similar to the crime committed by the individual punished. Individual deterrence is directed at the person being punished and aims to teach them not to repeat criminal behavior.

The strongest argument why criminal sanctions are employed in the enforcement of insider trading laws is based on a deterrence philosophy. This argument suggests that criminal sanctions, in contrast to other sanctions, are apt to promote compliance and prevent would-be offenders from violating insider trading laws.

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[159]*Spector Photo Group NV and Chris Van Raemdonck Versus Commissie voor het Bank* ECR [2009] 1-12073.
[160]*Spector Photo Group NV and Chris Van Raemdonck* ,37.
[161] Valerie Wright, Deterrence in Criminal Justice, The Sentencing Project, November 2010,5-12.
[162] Valerie Wright, Deterrence in Criminal Justice, 5-12.

The European Commission proffers three reasons why criminal sanctions are dissuasive. Firstly, the prescription of insider trading offences as criminal, clear boundaries in law are expressed that certain behaviour is designated as unacceptable. Secondly, the prosecution of insider trading offenders through a potential highly publicized trial sends a message to the general public that the offence is taken very seriously by society. Thirdly, the European Commission asserts that the stigma that accompanies criminal sanctions enhances their deterrent function.[163]

In jurisdictions such as Australia, the courts have embraced the role of criminal law in deterring insider trading offenders. The Victoria Supreme Court has held that "white collar criminals are first time offenders who fear the prospect of incarceration. They are rational, profit seeking, and can weigh the benefits of committing a crime against the costs of being caught and punished."[164] Therefore, it is understood that general deterrence is likely to have a more profound effect on insider trading. In the same vein, Australian courts have also observed that;

> *one might properly assume that given the increase in prosecutions for insider trading offences in recent years and the attendant publicity that goes with those prosecutions, a true insider may be reluctant to personally trade whilst in possession of inside information, because to do so may significantly increase the chance that they will be detected by the authorities.*[165]

In the United Kingdom, the Director of Financial Services (FSA), has stressed the importance of having deterrent sanctions available and using them. The Director suggests that criminal sanctions achieve greater compliance since the threat of a custodial sentence is a much more significant and credible deterrent than civil fines. [166]

Taking a contrary school of thought, the editors of the University of Chicago Law Review Journal[167] opined that a regulatory scheme placing primary reliance on criminal sanctions to deter insider trading is unlikely to be successful. This opinion was premised

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[163] European Commission Staff Working Paper, Impact Assessment, Accompanying the document Proposal for a regulation of the European Parliament and of the Council on Insider dealing and Market manipulation and the proposal for a directive of the European Parliament and of the Council on criminal sanctions for insider dealing and market manipulation, SEC (2011) 1217 Final. 164.

[164] *DPP v Gregory* (2011) 34 VR 1.

[165] *Khoo v R* [2013] NSWCCA 323.

[166] Margaret Cole, 'How Enforcement makes a difference' FSA Enforcement Law Conference of 18 June 2008

[167] Editors, Law Review "Deterrence of Tippee Trading under Rule 10b-5," *University of Chicago Law Review*: Vo l. 38: Iss. 2, (1971) Article 5.Available a t: https:// chicag ounbound .uchi cago.edu/uclrev/ vol3 8/iss2/5

on the background that a criminal sanction imposed against a person found guilty is often lenient and thus insufficient to curtail the most serious violations.[168] In reinforcing this suggestion, the editors cited an example of the 1934 Securities Exchange Act of the United States, where under Section 34 it provides for a maximum fine of $10,000. This fine, as they suggest, is insignificant compared to the profits of insider trading which far exceed the fine.[169] While not expressly referenced by the authors, the foregoing argument draws analogies from the rational choice theory.

The rational choice theory suggests that a person violates insider trading laws in order to make a profit and makes a rational calculation by weighing the expected benefits against the expected penalties when considering committing the offence. This calculation takes into account the probability of detection, the celerity of the sanction, the probability of successful prosecution and the severity of the potential sanction.[170] This theory goes hand-in-hand with Backer's formula for determining the optimal penalty for a criminal offence. In its most elementary version, the optimal penalty is decided by the probability that an offence is detected, and the offender is convicted, the severity of the expected punishment for those convicted and the expected gain from the offence.[171]

This theory is especially relevant in the context of insider trading. In Geis and Szockyj's study aimed at characterizing insider trading offenders, they found that insider trading is a profit-driven offense.[172] The authors posit that the motivation for insider trading is purely financial and thus strictly driven by self-interest. Geis and Szockj further state that the gains made from insider trading appear to be quite substantial. In their study they found that the median amount of profit made by offenders was US $50,000 with a range of US $ 0-50 million.[173]

Some commentators have suggested that imprisonment for insider trading offences is still likely to be deterrent regardless of the amount of profit to be earned from insider

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[168] Editors, Law Review "Deterrence of Tippee Trading under Rule 10b-5," *University of Chicago Law Review*: Vol. 38: Iss. 2, (1971).
[169] Editors, Law Review "Deterrence of Tippee Trading under Rule 10b-5.
[170] Marleen A. O. Connor, 'Toward a More Efficient Deterrence of Insider Trading Section 16 (b)' (1989) 58 *Fordham Law Review* 309, 314 .
[171] Gary Backer, "Crime and Punishment: An Economic Approach" (1968) 76 *Journal of Political Economy* 169, 207-208.
[172] Elizabeth Szockyj and Gilbert Geis, "Insider Trading: Patterns and Analysis" (2002) 30 *Journal of Criminal Justice* 273, 273.
[173] Elizabeth Szockyj et al, Insider Trading: Patterns and Analysis, 273.

trading.[174] The suggestion is premised on the argument that the imposition of a custodial sentence on a convicted person serves as a deterrent to other persons who become aware that the offence is taken seriously by society. The underlying assumption in these arguments, as McDermott suggests is that the offenders have much to lose in terms of status and reputation if convicted of a criminal offence.[175]

The stigma of convicted persons is often argued to be another effective way of deterring the individual offender and the public. This argument is justified by the characterization of insider trading as a white-collar crime. The efficacy of stigma as a deterrent is pegged on the effect on the social standing of the offender and the humiliation that is brought about by imprisonment. It also relies on the assumption that the criminal process conveys public censure far more effectively than civil-law process.[176] Media coverage of the criminal proceedings further reinforces the effect of stigma since more people are likely to follow the proceedings through media. Most important of all, however, is that enhancement of deterrence through stigma of conviction is only effective when and where there is a successful conviction.

3.1.2 Questioning the Effectiveness of Criminal Sanctions in Regulating Insider Trading

Many legal commentators have questioned the effectiveness of criminal sanctions in regulating insider trading. The main argument to support this opinion is that there is no empirical evidence to show that criminal sanctions deter insider trading. Based on empirical research carried out on the United States population, Seyhun suggests that corporate executives earned more abnormal profits after the introduction of the 1980 Insider Trading Sanctions Act.[177]Seyhun adds that following the introduction of tighter regulations, there was a larger volume of insider trading activity followed by an increased frequency of large volume trading.[178] In the same vein, Frijns alluded that the

[174]Rokiah Kadir and Suriyani Muhamad, 'Insider Trading in Malaysia: Sanctions and Enforcement' (2012) 6 Advances in Natural and Applied Sciences 904, 906.
[175] Martin F. McDermott, 'Occupational Disqualification of Corporate Executives: an innovative Condition of Probation' (1982) 73 *Journal of Criminal Law and Criminology* 60, 614-615.
[176] John C Coffee Jr. 'No Soul to Damn- No Body to Kick- an Unscandalized Inquiry Into the Problem of Corporate Punishment' (1981) 79 *Michigan Law Review* 386, 389.
[177] Nejat Seyhun, 'The Effectiveness of the Insider Trading Sanctions' (1992)35 *journal of Law and Economics* 149, 169.
[178] Nejat Seyhun, 'The Effectiveness of the Insider Trading Sanctions', 169.

introduction of criminal sanctions for insider trading in New Zealand increased the cost of trading and the cost of information asymmetry.[179]
In Kenya, Mwaniki suggests that although the introduction of the Capital Markets Act, enhanced market efficiency, there still existed abnormal returns after the regulations were introduced. Mwaniki concedes that there is more to be done in enforcement of regulations for there to be a significant decrease in cases of insider trading.[180]

Oberg suggests that criminal sanctions are ineffective because of the assumption that offenders are rational actors who make the decision to commit a crime based on a series of complex calculations.[181]The author suggests for an individual to be deterred from criminal behaviour, they must know the type of behaviour that is prohibited and have the capacity to evaluate the risks associated with that behaviour. This is not always the case.

Criminal law has been in existence for a long time. However, individuals still commit crimes. In the case of insider trading as illustrated above by Mwaniki and Seyhun, introduction of law does not necessarily affect the disposition of an offender. One reason advanced for this is that the theory of rational choice does not fully account for an individual's perception of risks and rationality.[182] Perception of risks may be altered by events in the offender's personal life or overzealousness that leads to a judgement bias. For instance, a corporate executive would be more inclined to commit insider trading where they risk dismissal from work for not meeting a sales quota. In this scenario, the risk of conviction for the offence of insider trading is much less than the looming risk of dismissal. Thus, in this sense, what is traditionally rational in society is obscured by the pressing fear of job loss.

The deterrent effect of criminal sanctions is largely dependent on the likelihood of detection and imposition of a custodial sentence. Where the threat of imposition of a prison sentence is perceived to be remote or unlikely, then that sanction will not have a deterrence effect.[183] In simple terms, if the risk of detection and incarceration does not

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[179] Bart Frijns, aaron B Gilbert and Alireza Tourani-Rad, 'Do Criminal Sanctions Deter Insider Trading?' 24
Available at http://ssrn.com/abstract=1785873on 1 May 2021

[180]Mwaniki G. Effect of Insider Trading Prohibitions: regulations on Security Market Returns in Kenya. *The University Journal*, (2018)1 (2) 77-96.

[181] Oberg J, 'Is it essential to imprison insider dealers to enforce insider dealing laws?' *Journal of Corporate Law Studies* (2014) 14 (1): 111-138.

[182] Gary Backer, "Crime and Punishment: An Economic Approach" (1968) 76 *Journal of Political Economy* 169, 207-208.

[183] Oberg J, 'Is it essential to imprison insider dealers to enforce insider dealing laws?'111-138.

exist, then an offender's disposition will always be to commit the crime. Oberg further suggests that having a barrage of harsh sanctions is not useful in influencing behaviour if such sanctions are not followed by rigorous enforcement.[184]Insider trading is arguably difficult to prosecute. State law prosecutors find it difficult to obtain direct evidence and testimonies. This difficulty stems from an equivalent difficulty in detecting the offence and further from the high standard of proof of criminal proceedings. As a result, it is astoundingly difficulty to sustain a conviction on criminal insider trading. Ultimately, the likelihood of imposition of criminal sanctions are perceived as remote.

The innate challenges encountered in detection and prosecution of criminal insider trading affect the calculations of the rational person in the rational choice theory. The low probability of conviction of offenders encourages a reading for potential offenders who engage in a rational cost-benefit analysis.[185]

Criminal law generally fails to inculcate social norms requisite to enhance compliance. In this regard, Moohr argues that criminal law impacts good behaviour to a greater extent than it discourages bad behaviour.[186]She suggests that it is more important to tackle the cultural influences that influence individuals to commit a crime rather than sanction the individual. In essence, Moohr argues that displacing the motivation behind a criminal offence reduces the attraction towards committing the offence.[187]

Drawing from this argument, it can be said that since insider trading is a profit-driven or loss-avoidance venture, it will be more prohibitive to eliminate these motivations for any offender. If an offender does not earn a profit or avoid a loss from insider trading, then they will not be motivated to commit the crime. The researcher acknowledges that profit or loss avoidance can only accrue after the offence of insider trading is committed. Thus, it might be difficult to eliminate the motivation before the crime actually occurs. However, where the profit gained or loss avoided can be retrieved from the offender,

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[184] Oberg J, 'Is it essential to imprison insider dealers to enforce insider dealing laws?',111-138.
[185]Emilios Avgouleas, 'The Mechanics and regulation of Market Abuse: A Legal and economic Analysis, (OUP 2005), 464-65.
[186] Geraldine S Moohr, 'An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime' (2003) 55 *Florida Law Review* 937, 957.
[187] Geraldine S Moohr, An Enron Lesson, 957.

then insider trading becomes unattractive since it is not profitable. This is not a feat that can be achieved by criminal law; only civil action/administrative functions.[188]

The notion that the threat of criminal sanctions deters criminal behaviour is rejected. Societal norms have a huge role to play in human behaviour and interaction. For instance, people do not kill other people because killing is prohibited by the law; it is because over time society universally condemned killing. Thus, the predisposition to avoid killing arises out of a moral obligation rather than the fear of sanctions. In an empirical study, Scholz and Pinney suggest that compliance with tax laws in the United States arises from a feeling of responsibility rather than the fear of criminal penalties. The authors argue that individuals adhere to the law because of normative reasons.[189]They add that compliance with the law depends largely on how well state policies articulate societal preferences.[190]

The deterrent function of criminal law is contingent on enforcement. Where the sanctions are not properly enforced or perceived to be improbable to succeed, then criminal sanctions will not be deterrent. For criminal sanctions to effectively deter criminal behaviour, it is paramount that the offences are swiftly and efficiently detected, prosecuted and punished. A gap in this chain will ultimately water down the effect of criminal sanctions.

3.2 The Use of Alternative Sanctions in Regulating Insider Trading

The imposition of criminal sanctions on insider trading offences is relatively new. At common law, insider trading was considered as a representation or concealment of a fact where it is material if it operates as an inducement to the other party to enter into the contract, where, except for such inducement, it would not have done so.[191]Thus, where a party acted on confidential information to the detriment of another party who had place reliance on disclosed information, the injured party could seek remedial action under common law.

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[188] In criminal proceedings, the fines imposed during sentencing are property of the state. The fines should also be commensurate to the offence and thus cannot exceed a certain threshold. It is therefore impossible to recover the entire profit gained or loss avoided through court fines.

[189] John T Scholz and Neil Pinney, 'Duty, Fear, and Tax Compliance: The Heuristic Basis of Citizenship Behavior' (1995) 39 *American Journal of Political Science* 49, 508-509.

[190] John T Scholz et al, Duty, Fear, and Tax Compliance,508-509.

[191]*Attwood v Small* (1838) 6 Cl&F 232; See also *Redgrave v Hurd* (1881) 20 Ch D 1.

In this vein, directors or company executives under common law, owe a fiduciary duty to its shareholders. This duty imposes an obligation on the directors or executives not to disclose such information that is material to the company. Consequently, a breach of this duty by any such director or executive could be remedied under the common law fraud. Moreover, such an action would be brought under the auspices of company law. Emergent from this background were civil sanctions- which accrued after civil action and administrative penalties that are enforced by regulating authorities. These sanctions are alternative to criminal sanctions.

In Kenya, the Capital Markets Act contemplates these alternative remedies under Sections 25A and Section 33 (3).[192]

3.2.1 Civil Sanctions

Civil sanctions are enforced after successful civil litigation. Causes of action in civil litigation lie in common law and company law.[193] The remedies may include damages for breach of fiduciary duty, compensation for loss and/or restitution.[194] Civil action may be brought by an individual or a complaining company.

There are several advantages in using civil action to sanction insider trading. Some commentators have argued that civil action has a more deterrent effect than criminal sanctions. Other have argued on the basis of celerity of civil processes and the low costs of enforcement of these sanctions. However, the most common universal advantage of civil action is the burden of proof which is much lower than that required in criminal proceedings.[195]

From an economic standpoint, civil sanctions provide incentives which encourage both companies and individuals to bring suits against offenders. In this regard, the challenge of detection of insider trading by regulatory authorities is averted. Thus, the threat of such litigation serves as a deterrent to insider trading. Moreover, the remedies of civil action are in most cases of a pecuniary nature. Therefore, imposing a penalty that could

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[192] Section 25A of the Capital Markets Act envisages admistrative sanctions while Section 33(3) contemplates civil action.

[193] *Attwood v Small*, 232; See also *Redgrave v Hurd*, 1.

[194] *Attwood v Small*, 232; See also *Redgrave v Hurd*, 1.

[195] Richard Macrory, 'Regulatory Justice- Making sanctions effective' Final report, November 2006, 10,15 Available at http://www.bisgov.uk/files/file44593.pdfon 21 May 2021.

surpass the gains made from insider trading will definitely have a deterrent effect on a prospective offender.[196]

Despite their numerous advantages, civil sanctions are not without their shortfalls. Firstly, civil action will not always yield positive results. This is more prolific where the offenders are individuals with no wealth. If a claimant is successful in litigation, they may be awarded damages or compensation which they have to pursue against the offender. It will be difficult to recover compensation or damages where the offender does not have assets to offset the judgement debt. Secondly, excessive litigation may dilute the deterrent effect and upset the financial market economy. Oberg suggests that too much litigation may impose substantial costs on companies issuing new securities in the form of investing in "due diligence".[197] Thirdly, since no social stigma is connected with civil action, the deterrent effect of civil sanctions may be watered down.

3.2.2 Administrative Sanctions

Administrative sanctions are measures taken by a regulatory body against an individual or company found in breach of regulations.[198] The purpose of administrative sanctions is not to punish but rather serve to regulate with a mind to prevent future offences and to enforce the law.[199]Administrative sanctions may range from the imposition of fines; confiscation of assets; disqualification for offices or to practice activities in the financial markets sector.[200] It can be distinguished from civil action since it is conducted by the regulator rather than private persons. No damages can be recovered through administrative sanctions.

The most commonly advocated alternative to criminal sanctions is the imposition of administrative fines.[201]There are numerous advantages of administering fines. Fines are levied in monetary form. Therefore, they eliminate the motivations of an insider trading

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196 Mark Spitz,"recent Developments in Insider Trading Laws and Problems of enforcement in Great Britain' (1989) *Boston College International and Comparative Law Review, 265,290, 297.*

197 Oberg J, 'Is it essential to imprison insider dealers to enforce insider dealing laws?',111-138.

198Lexology, '*Administrative Penalty for Insider Trading- Criteria to Set the Penalty*' Available at https://www.lexology.com/library/detail.aspx?g=d03bfc66-83da-480d-928f-85cec40b6e5aon 29 May 2021.

199Lexology, '*Administrative Penalty for Insider Trading- Criteria to Set the Penalty*' Available at https://www.lexology.com/library/detail.aspx?g=d03bfc66-83da-480d-928f-85cec40b6e5a .

200 Salvatore Provident, '*Administrative and criminal Sanctions and ne bis in idem: How to reconcile the Views of the CJEU, the ECHR and the National Constitutional Courts?*' Lecture at the University of Bologna on 17 September 2016.

201 Dan Kahan, 'What do Alternative sanctions Mean?' (1996) 63 *University of Chicago Law review* 593, 599, 603.

offender by taking away the profit gained or loss avoided. Through the lens of the rational choice theory, a rational actor making calculations would anticipate that the fine levied administratively may surpass the amount of profit gained or loss avoided. On account of this, it would be irrational, in the circumstances, to offend insider trading regulations. Subject to the condition that optimal fines are imposed, administrative fines serve a great deterrent function.

The administration of fines requires the regulator to incur nominal if no costs at all. In this regard, Posner posits that in a cost-benefit analysis between the cost of fines and imprisonment, the imposition of fines should always be preferred by a regulatory body since the cost of collecting a fine is lower than the cost of imprisonment.[202] With regard to the benefit, Posner argues that administrative fines achieve the same deterrent effect as imprisonment.[203]It is therefore more feasible for regulators to embrace administrative fines rather than imprisonment.

Another administrative sanction is the disqualification from office. Such a sanction prohibits a person from serving as a company director or otherwise taking part in the management of a company.[204] It is severe and effective as it serves both a preventive and punitive purpose. Disqualification from office is preventive because it removes unfit and unscrupulous actors from the financial markets preventing future misconduct from such individuals. It is punitive since it takes away any benefits such an offender enjoyed by virtue of their office; impairs the future prospects of employment of such an individual and interferes with the livelihood of that individual. Moreover, disqualification is accompanied by societal stigma which may also serve to reinforce deterrence. In some jurisdictions such as the UK and Canada, disqualifications are succeeded by public shaming by entry in a register of disqualified directors.[205]

Salvatore has argued that the purpose of administrative sanctions "*seems to be mainly that of restoring confidence in the markets, affecting the factors (the economic resources and the professional employment or position held by the offender in the financial markets sector) which such offenses normally make possible, thus stimulating honest investors to*

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[202] Richard Posner, 'Optimal Sentences for White Collar Criminals' (1980) *American Criminal Law Review* 409,410.
[203] Richard Posner, 'Optimal Sentences for White Collar Criminals',410.
[204] Oberg J, 'Is it essential to imprison insider dealers to enforce insider dealing laws?',111-138.
[205] Jasmine Girgis,' Corporate Directors' disqualification: The New Canadian Regime?' (2009) 46 *Alberta Law Review* 677, 684-85.

operate, guaranteeing public confidence in the markets and in the correct trading in those markets."[206]

3.3 The Effectiveness of Criminal Sanctions against Insider Trading in Kenya

From the outset, the study acknowledges that it might be difficult to assess the effectiveness of criminal sanctions in prohibiting insider trading in Kenya. This notion is informed by two factors. Firstly, it is difficult to evaluate the Capital Markets Authority's track record since the Authority neither has an enforcement pyramid nor an elaborate reporting system.[207] Secondly, there is no optimal gauge for effectiveness and any assessment done is subjective. In measuring the effectiveness of criminal sanctions, the study will assess existing local jurisprudence on insider trading offenses emanating from the courts and the Authority.

3.3.1 Criminal Jurisprudence

In the 65 years of Kenya's security exchange history, the first criminal trial on insider trading charges was witnessed in 2008. Bernard Mwangi Kibaru was accused of insider trading after it was alleged that he instructed a stockbroker to sell 111,400 shares of the ailing retailer, Uchumi Supermarket.[208] The prosecution alleged that the accused person, who was the general manager of the supermarket chain, had by virtue of his position, acquired non-public information which enabled him to conduct an irregular trade. The prosecution further alleged that Mr. Kibaru had attended a meeting where the company's challenges had been discussed. It was after this meeting that Mr. Kibaru disposed of all his shares in the company.[209]

The prosecution witnesses confirmed that the accused person was privy to confidential information regarding the performance of the company. The accused person also admitted in his testimony that he was privy to the company's accounts and signed cheques to suppliers. He however denied that he had seen the company's financial

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[206] Salvatore Provident, '*Administrative and criminal Sanctions and ne bis in idem',* on 17 September 2016.

[207] Gakeri J, Regulating Kenya's Securities Market,270 and 271.

[208] 'Verdict on Uchumi Insider Trading Monday' *Business Daily* Sunday, 19 September 2010. Available at https://www.businessdailyafrica.com/corporate/Verdict-on-Uchumi-insider-trading-Monday/539550-1014014-view-asAMP-993bd5/index.htmlon 7 June 2021.

[209] 'Verdict on Uchumi Insider Trading Monday' *Business Daily* Sunday, 19 September 2010. Available at https://www.businessdailyafrica.com/corporate/Verdict-on-Uchumi-insider-trading-Monday/539550-1014014-view-asAMP-993bd5/index.htmlon 7 June 2021.

statements. The accused person earned over 1.5 million Kenya shillings from the disposal of the shares.[210]

The magistrate acquitted the accused person stating that the information regarding the company's poor state and losses was a matter that was already in the public domain. Thus, the information the accused was in possession of was not inside information. The court held that the prosecution had not proved its case beyond reasonable doubt.[211]

A similar determination was reached in the case of Terrence Davidson. In this case, the accused person was the Managing director of Uchumi Supermarkets which at the time was close to insolvency. The prosecution alleged that the accused person had disposed of his shares just two days before the company failed. The prosecution further alleged that by virtue of his position, the accused person was able to access the company's financial information and thus knew that the company was struggling. With this knowledge, the accused person instructed his stockbrokers to sell all of his shares in the company. The accused person had sold the shares for over 14 million Kenya shillings.[212]

The acquittal of the two accused persons were a devastating loss to the Capital Markets Authority enforcement regime. Some commentators noted that it was difficult to prosecute the charges because the law was not clear.[213] There were also concerns that the prosecutors leading the state's case were not well equipped to handle the complex nature of insider trading charges.[214]

3.3.2 Jurisprudence on Administrative Sanctions

The most resounding victory, albeit short-lived, was the decision of the Aly Khan Satchu and two others. After an unsuccessful bid in criminal prosecutions, the Capital Markets Authority managed to punish insider trading offenders who were found culpable after a trial by the tribunal.

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[210] 'Verdict on Uchumi Insider Trading Monday' *Business Daily* Sunday, 19 September 2010. Available at https://www.businessdailyafrica.com/corporate/Verdict-on-Uchumi-insider-trading-Monday/539550-1014014-view-asAMP-993bd5/index.htmlon 7 June 2021.
[211] *Republic versus Bernard Mwangi Kibaru*, Nairobi CMCR 1337/2008 (Unreported).
[212] *Republic versus Terrence Davidson*, Nairobi CMCR 1338/2008 (Unreported).
[213] Peter Wanyama 'Court rulings Expose Vacuum in War Against Insider Trading' *Business Daily.* 25 November 2010. Available at https://www.businessdailyafrica.com/bd/markets/capital-markets/court-rulings-expose-vacuum-in-war-against-insider-trading-1974086%3fview=htmlampon 7 June 2021.
[214] Peter Wanyama 'Court rulings Expose Vacuum in War Against Insider Trading' *Business Daily.* 25 November 2010. Available at https://www.businessdailyafrica.com/bd/markets/capital-markets/court-rulings-expose-vacuum-in-war-against-insider-trading-1974086%3fview=htmlampon 7 June 2021.

In May 2019, the Authority formed an ad-hoc committee to hear and determine the allegations of insider trading of KenolKobil shares. Two stock brokers, Aly Khan Satchu and Kunal Bid, and a CEO of a leading brokerage firm Kestrel Capital Andre DeSimone were faced with charges of insider trading after the Authority had detected suspicious transactions conducted by the three with regard to KenolKobil shares.

After hearing the accused persons' statements, the committee noted that the Andre DeSimone had disclosed non-public material information on the impending takeover of KenolKobil by RubisEnergie to Aly Khan Satchu and Kunal Kamlesh. The two stock brokers then used that information to trade 59 million shares a week before the information was made public.

The ad-hoc committee found the three guilty of insider trading and imposed administrative sanctions. Andre DeSimone was fined 2.5 million Kenya Shillings and also disqualified from holding office in any public company for one year. Aly Khan Satchu and Kunal Bid were fine 4.7 million and 23.4 million respectively. They were also barred from trading for three years. The three successfully managed to quash the committee's decision citing the improper composition of the committee. Regardless, this case has become the emblem of the Capital Markets Authority's enforcement regime.

3.4 Conclusion

Kenya's enforcement jurisprudence is thin. However, it is clear from the available literature that the nadir of enforcement occurred when criminal sanctions were used to enforce insider trading laws. Administrative sanctions have proved to be more effective for their punitive as well as deterrent function. However, while there is still a place for criminal sanctions in prohibiting insider trading, emphasis should be given to alternative sanctions that have a more immediate effect in curbing insider trading.

CHAPTER FOUR

COMPARATIVE ANALYSIS: REGULATION OF INSIDER TRADING IN SOUTH AFRICA

SOUTH AFRICA

4.1 Introduction

Like many other jurisdictions, South Africa has struggled with prohibiting the practice of insider trading. This struggle has been attributed to less deterrent criminal sanctions contained in South Africa legislative framework on insider trading.[215] Over time, South Africa, like Kenya, has amended its legislative framework in a bid to better regulate insider trading. While these amendments make for more robust regulation, they still fall short of the deterrent function that they were enacted for. South Africa's legislative framework has faced similar shortcomings as those witnessed in Kenya. However, despite these shortcomings South Africa's financial market has blossomed into the largest securities exchange market in Africa and the seventh largest in the world.

The choice of South Africa for a comparative analysis is informed by the burgeoning financial market that the Johannesburg Stock Exchange presents. The South Africa bourse has been lauded the world over and plays host to many international blue-chip companies. This could only mean that South African financial markets have instilled confidence in investors who ultimately invest in the economy. As discussed above, South Africa has in the past faced the same challenges that Kenya is facing today. However, South Africa has managed, through adapting to the dynamic nature of the financial market. South African legislation on insider trading thus seems to be a more refined version compared to Kenyan legislation both in spirit and implementation. South Africa thus offers a blue print for Kenya in the quest to perfect the regulation of insider trading. This makes South Africa a unique case study for the foregoing chapter.

4.2 Background

South Africa's 1926 Companies Act[216] did not expressly prohibit insider trading. Legislative efforts to combat insider trading in South Africa were manifested for the first time in the 1973 iteration of the Companies Act.[217] Section 223 of the 1973 Companies

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[215]Osode PC. Defending the Regulation of Insider Trading; A Public Choice Perspective 303; 1999 *AfricanJournal of International and Comparative Law* 688-708.

[216] South Africa *Companies Act* No. 46 of 1926.

[217] South Africa's *Companies Act* No. 61 of 1973.

Act expressly prohibited insider trading and imposed criminal sanctions on certain persons that were found culpable. However, the legislation was overwhelmingly inadequate in prohibiting insider trading. The provisions of the 1973 Act focused on insider trading activities carried on by primary insiders[218] and left out secondary insiders who came across inside information whether deliberately or inadvertently.[219] Moreover, insider trading regulations under the 1973 Act were only applicable to regulated financial markets in South Africa. Under the Act, insider trading could only attract criminal liability thus imposing a higher burden of proof than was necessary to deter the now rampant practice of insider trading.[220]

Owing to these and other flaws, the 1973 Act proved to be ineffective in regulating insider trading in South Africa. Consequently, the Companies Act was amended and section 233 was repealed. In its place, the Companies Act Amendment Act introduced Section 440F.[221] Most notably, section 440F of the Companies Amendment Act of 1989 extended the application of insider trading laws to secondary insiders.[222] The provision also introduced civil liability in addition to criminal sanctions in the regulation of insider trading and imbued executive functions to the Securities Regulation Panel.[223]

While the Amendment Act addressed the shortcomings of the 1973 Companies Act, it still fell short in curbing the unethical practice of insider trading. It was still unclear, under section 440F whether a transaction in contravention of the said provision was void or voidable. The result was many unsuccessful prosecutions.[224] It became imperative therefore, to enact legislation that was specific to the regulation of insider trading.

In 1995, the King Task Group was directed by the Minister for Finance to review the existing insider trading regulation under the Companies Act. The joint task force included representation from various stakeholders such as the Johannesburg Stock

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[218] Primary insiders in this context refers to the traditional definition of an insider which includes directors, employees, officers or shareholders of an issuing company.

[219] See Sections 162, 224, 229 and 233 of the South Africa *Companies Act* 1973.

[220]Sibani Mngomezulu. "The Journey from Insider Trading to Market Abuse- Have we Succeeded in Curbing the Scourge? Presentation made on the 13th September 2011, Available at https://www.chartsec.co.za/documents/2011SpeakerPresentations/TheRegulationOfInsiderTrading.pdfon 1 April 2021.

[221]*Companies Amendment Act No.* 78 of 1989.

[222] Botha D. Control of Insider Trading in South Africa; A Comparative Analysis, 1991 *SA Mercantile Law Journal,* 1-18.

[223]Osode PC. Defending the Regulation of Insider Trading,688-708.

[224]Nothemba Lugaju. *The Effectiveness of Insider Trading Regulations in South Africa,* LLM Thesis University of Pretoria (2018).

Exchange, South Africa Futures Exchange, the Financial Services Board, the Securities Regulation Panel, the South African Reserve Bank, the Department of Finance, the Life Office's Association, the South African Institute of Chartered Accountants and the Council of South African Banks.[225] In 1997, the King Task Group released their draft report and recommended among other things the enactment of a consolidated legislation to regulate insider trading practices.

In the report, the King Task Group highlighted how many criminal trials regarding insider trading had failed to achieve convictions. They resoundingly stated the following;

> *"It was well known that there has not been one prosecution for alleged insider trading in the RSA since prohibition against insider trading was first introduced into our law in 1973 by the Companies Act, 61 of 1973;*
>
> *In the context of the RSA's re-integration into the international financial markets and the Government's desire to create an environment conducive to foreign investment, there was justified concern over the adequacy of the existing insider trading regulations in the RSA;"*

In this regard, the task force strongly suggested that the new legislation incorporate civil sanctions in addition to possible criminal sanctions.

The Insider Trading Act[226] came into operation in 1999 and repealed the consonant sections of the Companies Act 1973. The objective of the Insider Trading Act was to broaden the scope of prohibition of insider trading.[227] This Act retained civil and criminal liability for insider trading which had been introduced in the Companies Act of 1973. It established the Financial Services Board and empowered it to investigate and adjudicate over disputes relating to the contravention of insider trading regulations. The Financial Services Board was also empowered to levy administrative and financial sanctions against offenders.[228] The Insider Trading Act also established the Insider Trading Directorate whose function was to exercise the power of the Financial Services

[225] Memorandum on the objects of the Insider Trading Bill, 1998.
[226]*Insider Trading Act* No. 135 of 1998 South Africa.
[227] Preamble, *Insider Trading Act, 1998* South Africa.
[228] Section 11, *Insider Trading act, 1998 South Africa.*

Board to institute any civil proceedings as contemplated in this Act in the name of the Financial Services Board.[229]

The Act, in its definition of who an "insider" was contemplated both primary insiders and secondary insiders. Primary insiders by definition are directors, employees or shareholders of an issuer of securities to which the inside information relates, and which may include insiders or individuals who, by chance as a result of their employment, had access to the inside information, but who were not necessarily the employees of the company itself.[230] Secondary insiders on the other hand are individuals who knew their source of inside information whether direct or otherwise was a primary insider.[231]

Despite achieving these milestones, the Act had its limitations as well. Firstly, the Act failed to define key terms prevalent in insider trading discussions. Terms like "material effect", "insider trading", "inside information", "specific" or "precise" and "publication" were noticeably undefined in that Act. Particularly, the failure to define the term "individual"[232] in the Act created a lacuna in the law where an offence was committed by a juristic person.

The consequence, as Chitimira suggests, was that the law was enforced inconsistently.[233] Moreover, The Financial Services Board and Insider Trading Directorate had overlapping mandates which caused bureaucratic hurdles on numerous occasions. The capacity of the Insider Trading Directorate was also limited since it was highly dependent on the Johannesburg Stock Exchange Limited's Surveillance Department for the detection of insider trading contraventions.[234]

The Gordian knot however was the element of knowledge when prosecuting offences of insider trading. Under the Act, it was a prerequisite that for one to be found culpable of the offence of insider trading, the prosecution had to demonstrate that the accused person had the knowledge that he/she was in possession of inside information.[235] Of course, this

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[229] Section 12, *Insider Trading Act, 1998 South Africa.*

[230] Chitimira, "A historical overview of the regulation of market abuse in South Africa", (2014) 17 *Potchefstroom Electronic Law Journal* 937 at 956.

[231] Chitimira, "A historical overview of the regulation of market abuse in South Africa", 956.

[232] The term "individual" was also used in the definition of an "insider" thus; "an insider is an individual who had inside information through…." Often this definition was used to the exclusion of corporeal persons, trusts and other entities which would not ordinarily be termed as individual using the golden rule.

[233] Chitimira, "A historical overview of the regulation of market abuse in South Africa", 956.

[234] Nothemba Lugaju. *The Effectiveness of Insider Trading Regulations in South Africa,* LLM Thesis University of Pretoria (2018).

[235] Section 2, *Insider Trading Act, 1998 South Africa.*

became a stumbling block for many a prosecutor causing many accused persons to go free.

This concern persisted after the Insider Trading Act was repealed by the Securities Services Act of 2004. However, the Securities Services Act expanded the definition of an insider and provided for more penalties than its predecessor. Notably, it abolished the Insider Trading Directorate and, in its place, established the Directorate of Market Abuse with enhanced executive powers. The Securities Services Act was often criticized for failing to provide for instances where insider trading is committed by a person (agent) acting on the instructions of an insider.[236]

The Financial Markets Act[237] repealed the Securities Services Act as the former came into operation in 2013. The impetus of the drafters of the Financial Markets Act was to align South African legislation with international standards. It is the primary legislation governing insider trading in South Africa. This section will analyze the various provisions of the Financial Markets Act 2012 in a bid to draw best practices that can be imported to the Kenyan jurisdiction.

4.2.1 Regulation of Insider Trading in South Africa

The Financial Markets Act consolidates the law relating to the regulation and control of financial markets and ancillary purposes. As such, it is the primary legislation that regulates insider trading in South Africa. Section 2 of the Financial Markets Act states that the aim of the legislation is to ensure the South African financial markets are fair, efficient and transparent; increase confidence in the financial markets; promoting the protection of regulated persons, clients and investors; reduce systemic risk; and promote the international and domestic competitiveness of the South African financial markets and of security services.[238]

The Financial Markets Act has allowed for the licensing of new exchanges other than the Johannesburg Securities Exchange. It has also created a regulatory framework for unlisted securities and has attempted to align South African law on financial securities

[236] Du Plessis &Cassim, "The Security Services Act", 17 May 2005, available at https://www.bowmanslaw.com/insights/the-securities-services-act-rudolph-du-plessis-and-rehana-cassim/ Accessed 1 May 2021.
[237]*Financial Markets Act* No. 19 of 2012 South Africa.
[238] Section 2 *Financial Markets Act*, 2012 South Africa.

with international law. In a glance, the Act has been centre-piece of the development architecture that South Africa has witnessed since its promulgation in 2013.[239]

4.2.2 Definition of Insider Trading

Like the Kenyan Capital Markets Act, the South African legislation is an omnibus instrument that regulates financial markets. It therefore makes provision for many forms of market abuse including insider trading.[240] While insider trading is not expressly defined, the Act describes instances that would be construed as insider trading much like its Kenyan kin. It also defines the terms "insider" and "inside information".

Per the Act, inside information is "*specific or precise information which has not been made public and which is obtained or learned as an insider; and if it were made public would, be likely to have material effect on the price or value of any security listed on a regulated market or any regulated market of any derivative instrument related to such a security*."[241]

While the definition captures all elements of "inside information" in a similar manner to Kenya's Capital Markets Act, it adds the requirement that the information has to be specific or precise. In common parlance, something is specific if it is clearly defined. On the other hand, something is precise when it is marked by exactness and accuracy of expression of detail. Jurisprudence from South African courts however, has shown that specificity and precision is subjective.

In the case of *Zietsman and Harrison and White Investments v Directorate of Market Abuse,*[242]the accused persons were charged with insider dealing because they traded in the shares of a company having knowledge that the company would receive a loan that would revive the struggling company. The accused persons argued that the information in their possession was not specific or precise. They argued that the information was vague since no loan agreement had been concluded in writing; there were unfulfilled conditions precedent; and there was uncertainty over whether the issuing company would

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[239] South Africa National Treasury. Building Competitive Financial Markets for innovation and Growth, A work Programme for Structural Reforms to south Africa's Financial Markets, (2020 Available at http://www.treasury.za/comm_media/press/2020/FINANCIAL%2520MARKETS%2520REVIEW.pdf&ved=on 1 May 2021.

[240] Preamble, Financial Markets Act, 2012 South Africa. One of the objectives of the act in the preamble is to prohibit insider trading.

[241] Section 77, Financial Markets Act, 2012 South Africa.

[242]*Zietsman and Harrison and White Investments v Directorate of Market Abuse* [2015] ZAGPPHC 651 (24 August 2015).

actually ever be able to access the funds, the loan only having been approved provisionally.

In convicting the accused persons, the High Court stated that in assessing whether information would likely to have a material effect on the price or value of a share or security, the information has to be assessed in the context that it is used. The court found that despite the fact that the identity of the lender and the terms of the loan were unknown, the possession of the information that the issuing company was receiving a loan was material enough to affect the share price. The court added that the loan embodied a significant lifeline for the embattled company which when viewed by a "reasonable investor" would be sufficient funding for a small company. The High Court also considered the actual increase of the share price of the issuing company to conclude that the information materially affected the share price.

The import of the court's decision was thus "for information to be specific or precise, it is not required that the circumstances or event to which it relates be final. Information relating to circumstances or an event in an intermediate phase could still be specific and precise and constitute inside information."[243]

South African law also provides that inside information has "*to be learned or obtained by an insider*".[244] This means that for information to be classed as inside information under South African law, the individual who learns or obtains the information must be an insider at the time he learns or obtains it. Conversely, if such information is obtained by someone who is not an insider at the time, then it would not qualify as inside information even where the information meets all other requirements under section 77.

Some scholars have suggested that the inclusion of the words "learned" and "obtained" connotes that the legislature contemplated that mere possession of inside information would not suffice to impugn any information as inside information.[245] This imposes an extra burden on the prosecution to prove that whoever acquired the information did so

[243] E Rosenthal on 'Change through the Years' (1968) 9–10.
[244] Section 77 (1) (a) *Financial Markets Act,* South Africa.
[245] Johann Nico van der Walt the definitions of 'inside information' and 'insider' in the Financial Markets Act 19 of 2012, (2019) Available at https://scholar.sun.ac.zaon 1 May 2021.

when they were insiders. In the South African case of *John M'Tali v R*[246]the court extended the meaning of obtaining beyond its dictionary meaning thus;

> the word "obtain" has not this restricted meaning in the dictionary, and from the original derivation of the word we could not arrive at that meaning. Anyone who holds anything has obtained it. He may have acquired it through natural agencies.

Similarly, in *Minister for Provincial and Local Government of the RSA v Unrecognised Traditional Leaders of the Limpopo Province, Sekhukhuneland*[247] the court held that the term "obtain" is open to a broad interpretation and may be interpreted to mean procuring of information.

With the foregoing judicial decisions, it is clear that the words learned and obtained as used in section 77 include the acquisition of such information through a natural process without necessarily having another individual present. The source of information or the manner it was obtained might play a role in an enquiry on whether the information was lawfully made public or not. However, this is not a requirement under section 77 of the Act and as such the inclusion of these words is problematic in South African law.

The inclusion of these words creates a connection between the person in possession of the information and the complaining company. There is an underlying assumption that if this connection does not exist, then insider trading cannot occur. This is a misplaced assumption considering the *tipper-tippee* theory herein above explained. Moreover, the term "obtain" as used in the Act does not endorse any positive action on the part of the recipient of the information. This leaves the definition open to an interpretation that information obtained by experience or study is included within the definition. Similar criticisms have been allayed on the use of the term learned.

All in all, the definition of inside information is pegged on who is defined to be an insider in the Act. The Financial Markets Act defines an insider as a person (a) who has inside information through; (i) being a director, employee or shareholder of an issuer of securities listed on a regulated market or an issuer of derivative instruments related to such securities to which the inside information relates; or (ii) having access to such

[246]*M'Tali v Rex* 1908 ORC 24.
[247]*Minister for Provincial and Local Government of the RSA v Unrecognised Traditional Leaders of the Limpopo Province, Sekhukhuneland* 2005 (2) SA 110 (SCA).

information by virtue of employment, office or profession; or where such person knows that the direct source of the information was a person contemplated in paragraph (a).[248]

Whereas the definition of the term insider in the Act includes the term inside information and vice versa, the meanings of both words throw one into a circular argument. This notwithstanding, the South African definition of who an insider is depicts an element of finality which is absent from the Kenyan meaning. This finality creates certainty and predictability which is an essential component of law and is also subject to a narrow construction. However, it severely limits instances where one may be termed as an insider under the law even where such instances are justifiable.

4.2.3 Scope of Application

One of the deficiencies of repealed Acts regulating insider trading in South Africa was that the legislations' scope was limited.[249] The Financial Markets Act attempted to remedy this situation by broadening the scope of the Act.[250] Firstly, the Act defines the term "individual" with regard to insider trading to include a partnership and a trust. This implies that market-abuse offences could be committed by an insider or a "person" as defined who misuses inside information and not by "individuals" alone.[251]

Section 78 of the Act, for instance, introduces criminal liability to persons who are considered secondary insiders in academia, that is, persons who may have acted on insider information not obtained by them forthwith.

Initially, the Act regulated listed securities only. However, over-the-counter markets for financial instruments were left unregulated. It was only until 2018 that the Financial Market Regulations[252] provided a framework for over-the-counter derivative providers. Moreover, the provisions of the Act are extra-territorial. A regulated market under the Act is defined as any market, whether domestic or foreign, which is regulated in terms of the laws of the country in which the market conducts business as a market for dealing in securities listed on that market.[253] This implies that any person who contravenes the

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[248] Section 77 *Financial Markets Act*, 2012 South Africa.
[249] Repealed legislation are used to regulate conduct of criminal offences that occurred before the enactment of the *Financial Services Act.*
[250] Nothemba Lugaju. *The Effectiveness of Insider Trading Regulations in South Africa,* LLM Thesis University of Pretoria (2018).
[251] Section 77 *Financial Markets Act*.
[252] Financial Markets Act, 2012 Regulations (February 2018) Available at http://www.treasury.gov.za/otc/41433_9-2_NationalRegulation_DS.pdf Accessed 1 May 2021.
[253] Section 77 *Financial Markets Act.*

provisions of the Act while domiciled in South Africa could be prosecuted in South Africa.[254] This is a sound provision for cross border insider trading practice which is overtly lacking in the Kenyan system.

4.2.4 Penalties for Insider Trading

Insider trading is prohibited in South Africa and attracts either criminal, civil or administrative sanctions. Any person who violates the provisions of the Act prohibiting insider trading is liable to a criminal offence.[255] Upon conviction on an insider trading charge, an accused person may receive a 10-year prison sentence, a fine not exceeding 50 million Rand or both.[256]

Over the years, several concerns with interpretation of insider trading prohibitions have made it difficult to prosecute suspected insiders in South Africa. Most notably, the element of knowledge has been difficult to prove in a court of law and has thus led to numerous acquittals on insider trading charges.

Increasingly, more cases of insider trading are handled by the Financial Services Board which is an executive arm that has the power to impose administrative sanction against offenders. The Financial Services Board also has the mandate to take civil action against any person who contravenes the relevant provisions of insider trading in the Financial Markets Act.[257] Civil liability is imposed on an insider who made a profit or would have made a profit if he had sold the securities at any stage, or avoided a loss through such dealing. Such civil action may be brought by the Financial Services Board in any court of competent jurisdiction or at the instance of the enforcement Committee.

Upon determination of a civil claim by the Financial Services Board, a person found to be involved in insider trading will be liable to pay the Financial Services Board an amount equivalent to the profit made or loss avoided or a penalty for compensatory and administrative purposes, but not exceeding three times the amount of the profit made or loss avoided plus any other amount for interest and legal costs as determined by a competent court or the Enforcement Committee.[258]

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[254] Jooste "The regulation of insider trading in South Africa – Another attempt" 2000 SA Merc LJ 284.
[255] Section 78 *Financial Markets Act.*
[256] Section 109 *Financial Markets Act.*
[257] Section 82 *Financial Markets Act.*
[258] Section 82 *Financial Markets Act.*

Persons to whom the benefits of insider trading accrue are jointly sued in a civil claim and such decretal sums as determined by the adjudicating authority may be executed jointly and severally against these persons and the insider.[259] Additionally, any person who knowingly encouraged or caused another person to deal in securities listed on a regulated market will incur civil liability.[260] It is not a defence that a person in possession of inside information actively discouraged another person from dealing.[261]

Prejudiced persons are compensated by the Financial Services Board after successful civil litigation. However, the compensation only occurs after the Board has recouped all of its expenses.

Administrative penalties may also be imposed against offenders under the Financial Markets Act. These administrative penalties are enforced by the Enforcement Committee. The Act provides for a range of such measures such as monetary penalty, an order for remedial action, an administrative sanction, costs orders, separate order for legal costs, remuneration costs orders and a fine for compensatory purposes.

4.2.5 Regulatory Institutions

4.2.5.1 The Johannesburg Stock Exchange

The JSE is the largest securities exchange in Southern Africa and Africa. Its core purpose is market regulation which entails, *inter alia,* the monitoring of trading on the various JSE market segments to identify possible market abuse and oversight of JSE members' compliance with their regulatory obligations.[262] In exercise of this mandate, the JSE lists requirements which all regulated entities are required to comply with. The JSE then conducts surveillance to monitor and analyze trading of listed securities. Suspicious transactions are reported to the Directorate of Market Abuse which then decides whether to conduct investigations or not.

4.2.5.2 The Financial Services Board

The Financial Services Board was established in 1990 by the Financial Services Board Act.[263] It is an independent body that supervises all non-bank financial institutions in South Africa. The Financial Services Board discharges the mandate of the Directorate of

[259] Section 82 (3) *Financial Markets Act.*
[260] Section 82 (2) as read with subsection (3) *Financial Markets Act.*
[261] Section 82 (2) as read with subsection (3) *Financial Markets Act.*
[262] Available at https://www.jse.co.za/regulation/markets-regulation/market-regulation Accessed 1 May 2021.
[263] The *Financial Services Board Act* 97 of 1990.

Market Abuse.[264] It is charged with the mandate of supervising and enforcing compliance with specific laws regulating financial institutions and to promote financial education and awareness on related legislation. The board is also empowered to investigate all cases of suspected insider trading. [265] The board has jurisdiction to adjudicate insider trading offences, enter into settlement agreements, and to impose appropriate penalties guided by the penalty clause of the relevant legislation.[266] The Financial Services Board is self-sustainable as it is fully funded by the fees and levies imposed by this industry.

In February 2005, the Capital Markets Enforcement Committee was established as an administrative body to adjudicate on all forms of market abuse. The Financial Services Board extended its mandate to this committee.

Where the Registrar of Security Services or the Directorate of Market Abuse detects that a law administered by the Financial Services Board has been contravened, they may refer the matter to the Enforcement Committee, the National Prosecution Authority for criminal prosecution, or apply to the court to interdict the suspected persons and attach the subject property.

In 2018, the Financial Services Board Act was repealed by the Financial Sector Regulation Act of 2017. The new Act effectively established the Financial Services Conduct Authority which now succeeds the Financial Services Board. The 2017 Act also established the FSCA Tribunal which has the jurisdiction to hear appeals from decisions of the FSCA.[267]

4.2.5.3 Discussions from South Africa

Most commentators have emphasized the importance of insider trading cases being dealt with internally rather than prosecuting them under criminal law in South Africa. Lugaju, for instance, states that preference has historically been given to the Financial Services

[264] The Directorate of Market Abuse is a committee appointed by the Minister of Finance, to investigate and enforce the market abuse contraventions.
[265] Section 84 *Financial Markets Act*. The Financial Services Board is not required to investigate insider trading offences committed before the repeal of section 440F of the *Companies Act* 61 of 1973.
[266] Section 84 *Financial Markets Act, 2012*.
[267] Section 219 of the Financial Sector Regulation Act 9 of 2017

Board rather than the National Prosecution Authority since the latter lacks the relevant expertise in these specialized cases.[268]

Chitimira also observes that there is an overwhelming backlog of insider trading cases in criminal courts in South Africa. He attributes this to a prohibitively high standard of proof that is near impossible to discharge. Chitimira suggests that to resolve this backlog and to further curb insider trading, it is imperative that additional specialized market-abuse courts or tribunals and self-regulatory organs be established to complement the enforcement efforts of the Financial Services Board.

Van Deventer advocates for the harnessing of administrative law in curbing insider trading practices in South Africa.[269] The author suggests that administrative sanctions have proved to be more effective than criminal sanctions in regulating cases of insider trading. Rather than being punitive after the fact, Van Deventer suggests that the purpose of administrative penalties is to encourage compliance with the law. In fairness towards compliant industry professionals, offenders' penalties should be substantial.[270]

Empirical evidence from South Africa also suggests that administrative sanctions have led to more concluded cases of insider trading. According to Van Deventer, no convictions were obtained of the 32 cases of insider trading brought by the Financial Services Board between 1999 and 2007.[271] In 2018, after an empowered FSCA came into operation, there has been a steady rise of completed insider trading cases in South Africa. In 2018, the FSCA concluded 11 cases; 2019 98 cases, 2020 208 cases and in 2021 107 cases so far.[272] As per the FSCA annual report 2019/2020, the FSCA had recovered 104 857 500/= Rand in penalties for contravention of various provisions of the Financial Markets Act.[273]

[268]Nothemba Lugaju. *The Effectiveness of Insider Trading Regulations in South Africa,* LLM Thesis University of Pretoria (2018).
[269] Van Deventer "Harnassing Administrative Law in Encouraging Compliance" 2009 FSB Bulletin 3 3–4.
[270] Van Deventer "Harnassing Administrative Law in Encouraging Compliance", 3–4.
[271] Van Deventer "Harnassing Administrative Law in Encouraging Compliance", 3–4.
[272] Available at https://www.fsca.co.za/Enforcement-Matters/Pages/Financial-Service-Tribunal-Decisions.aspxon 1 May 2021.
[273] Financial Sector Conduct Authority Annual Report 2019/2020. Available at https://www.fsca.co.za/Annual%20Reports/FSCA%20Annual%20Report%202019-2020.pdf Accessed 1 May 2021.

4.3 Conclusion

The researcher appreciates that South Africa has had its fair share of challenges in prosecuting insider trading. However, the country has risen above these challenges to maintain a favourable economic atmosphere for investors. Many key lessons can be drawn from South Africa’s regulation of insider trading. The most germane to the instant study, however, is that administrative and civil sanctions work better to prohibit cases of insider trading compared to criminal sanctions. The case study of South Africa also shows that implementation of existing laws is highly paramount to achievement of a deterrent function. These among other many other practices highlight the success of the South African financial market.

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter summarizes the researcher's findings guided by the objectives of the research. The researcher also draws conclusions from the findings and makes recommendations based on the comparative analysis canvassed in the preceding chapter.

5.2 Summary of Findings

From the outset, the researcher identified the problem that criminal sanctions were not effective in curbing the practice of insider trading. This problem, as hypothesized by the researcher is attributed to the high standard of proof in criminal proceedings and the difficulty in obtaining evidence in such proceedings. In chapter two, the researcher sort to assess the efficacy of the obtaining legal and institutional framework regulating insider trading in Kenya. The researcher found that the legislation was at par with international standards. Kenya's legislation is also adequate and comprehensive to properly regulate insider trading.

The researcher also found that the Capital Markets Authority, which carries out the executive mandate of the Capital Markets Act, has been imbued with a full complement of powers necessary for a legislator to discharge its functions. Despite this, however, incidences of insider trading have been difficult to detect and even more difficult to prosecute.

In chapter three, the researcher sought to assess the efficacy of criminal sanctions in prohibiting insider trading. The researcher found that the rationale behind criminal sanctions in insider trading is the deterrent function. The researcher also found that this deterrent function is premised on an offender's deliberate choice to commit on an offense based on a rational calculation of the celerity of prosecution, severity of punishment and probability of detection. Moreover, an offender is purely motivated by financial gain or loss avoidance. In this vein, the offense of insider trading is characterized as a white-collar crime-committed by members of a higher social class in society. It is from this assumption that the criminal sanctions seek to deter criminal behaviour through the fear of stigmatization of the offenders.

The deterrent function of criminal sanctions, however, as the researcher found, is only effective where there is empirical evidence that such sanctions work. By using the rational choice argument, an offender will always choose to commit a crime where the probability of detection and success of prosecution is minimal. The researcher also found that deterrence is only effective where offenders are aware of the threat of the sanctions.

Locally, it was found that the success of prosecution of criminal insider trading is minimal. It was also found that insider trading criminal proceedings take place in the magistrates' courts which do not report their decisions. Because of the minimal success in prosecuting insider trading crimes, the deterrent function of criminal sanctions does not work. In the same vein, since these cases are conducted in magistrates' courts, the decisions are not readily accessible by the public since they are not reported in the Kenya Law Reports. Thus, deterrence through stigma also fails.

In chapter four, the researcher compared the legal and institutional framework regulating insider trading in South Africa with that of Kenya. The researcher found that South Africa had strong institutions that enhanced the enforcement of insider trading laws. The researcher also found a keen insistence on the use of administrative and civil sanctions to curb insider trading rather than criminal sanctions. The rationale behind this insistence is that criminal cases are difficult to successfully prosecute given the high standard of proof and the vast amounts of evidence produced in insider trading criminal proceedings. Moreover, the prosecutors empowered to conduct these trials are not adequately trained to handle the nuances of the very complex criminal insider trading offences.

In summary, the researcher found that criminal sanctions carry the potential to deter insider trading. However, unless positive action is taken to increase the success rate of prosecution of criminal insider trading, the deterrent function will remain ineffective.

5.3 Conclusion

The general objective of this study was to critically assess the adequacy of the current legal framework regulating insider trading in Kenya. This was carried out by assessing the existing legal and institutional framework; interrogating the efficacy of the legal regime and criticizing the effectiveness of criminal sanctions in the prohibition of insider trading. In a nutshell, the study concluded that although Kenya has robust laws to regulate insider trading, it lacked the necessary enforcement impetus to detect and prosecute criminal insider trading. In this sense, the researcher concluded that criminal sanctions are an ineffective way of regulating insider trading in Kenya.

The researcher concluded that the obtaining legal and institutional framework is comprehensive and robust in regulating insider trading. Through various amendments, the Act has been able to address its deficiencies and come up to speed with international practices and standards. Considering that the Kenyan financial markets are still growing, the Act strives to achieve optimum regulation that does not otherwise impede the development of the fragile financial markets through overregulation.

The researcher also found that criminal sanctions in Kenya have failed to achieve the desired effect of deterrence. The researcher found that while there is need to have these sanctions, placing reliance on these sanctions where its enforcement is wanting is a counterproductive exercise. The Capital Markets Authority has seen little success in prosecuting criminal insider trading despite having a full complement of powers that any regulator requires to execute its mandate. This has been a drawback to the prohibition of insider trading in Kenya since seemingly the law does not deter criminals from committing insider trading offenses.

The objective of the Capital Markets Act is to promote, regulate and facilitate the development of an orderly, fair and efficient capital markets in Kenya.[274] Thus, the primary goal of the Capital Markets Authority is to ensure that financial markets in Kenya are free of unfair and unethical practices that will shift the bargaining power in favour of an individual or entity. The desire to prosecute and incarcerate offenders should be secondary if this first objective is impeded by the former.

In any event, the Capital Markets Authority, under Section 25A of the Act, is empowered to use other measures to discharge its mandate. These measures, when employed, have been largely successful and more beneficial to the victims of insider trading. Some administrative penalties such as the revocation of licenses have a more direct impact in reducing the practice of insider trading since they bar the offenders from taking part in financial market dealings. Moreover, because of specialization of the Capital Markets Tribunal and the Appeals Tribunal, cases of insider trading dealt in-house tend to be resolved much faster than criminal trials.

[274] Preamble, *Capital Markets Act*

While the researcher concedes that there are benefits in using criminal sanctions to deter insider trading, local jurisprudence has shown us that they are not an effective method in Kenya. There are still several institutional reforms that Kenya needs to enforce in order to make criminal sanctions more effective and thus achieve the much sought-after deterrent function. Before this is achieved, the researcher concludes that civil and administrative remedies should always be given priority over criminal prosecution in cases of insider trading.

5.5 Recommendations

5.5.1 The Shift to Administrative and Civil Sanctions

In chapter three of this study, it was concluded that alternative sanctions such as administrative sanctions and civil sanctions were more effective in prohibiting the practice of insider trading. Civil and administrative sanctions are cheaper to impose and when applied correctly have a more deterrent effect than criminal sanctions. Until such a time that proper infrastructure is put in place to sustain a conviction on insider trading charges, it will be difficult to deter insider trading using criminal sanctions. On the other hand, administrative sanctions such as fines and disqualification require less infrastructural adaptation and work efficiently in prohibiting present and future criminal conduct. This study thus recommends the employment of civil and/or administrative sanctions as the primary enforcement mechanism for regulation.

5.5.2 Training of Prosecutors on Insider Trading and Other Market Abuses

The effectiveness of criminal sanctions may be improved if the state can sustain more prosecutions. One of the main challenges encountered in prosecution is the lack of skill and knowledge required by prosecutors to conduct an insider trading trial. Prosecutors should thus be equipped with proper knowledge and skill through training.

5.5.3 Enhancing Multi-agency Relations

There are various stakeholder holders in the financial markets industry in Kenya. While it is the Capital Markets Authority that is empowered to regulate these markets, other stakeholders also play a significant role in the fight against insider trading. The Nairobi Securities Exchange for instance, enjoys a degree of autonomy in creating rules that regulate listed companies. The NSE also monitors the exchange and is best placed to detect suspicious activity that could be indicative of insider trading. The Central Bank of Kenya, which regulates the Kenyan banking sector is also a key stakeholder that could help the Authority in detecting suspicious transactions and reporting them to the Authority for investigation. This goal can only be achieved through multi-agency relations.

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APPENDICES

Appendix 1: Ethical Clearance

Strathmore
UNIVERSITY

11th November 2021

Ms Makanga, Silvia
silvia.makanga@strathmore.edu

Dear Ms Makanga,

<u>RE: Combating Insider Trading in Securities Markets: A Review of Kenya's Legal Framework</u>

This is to inform you that the Research Services Office has received your above research proposal along with a request for exemption from Ethical Approval.

The office notes that: On the grounds of not having submitted your research proposal for ethical approval, with reason of having already collected data for your study and thus negating the need for ethical approval for your research study in the University. This office grants your request.

This is a letter for you to proceed with the next steps of your academic requirements.

Please be advised, that in future, all research proposals should be submitted to the SU-IERC through the RHInnO Ethics platform before receiving a NACOSTI permit to collect data.

Disclaimer: This is not in any way an ethical approval letter.

Yours sincerely,

STRATHMORE UNIVERSITY * DEAN, (RESEARCH AND INNOVATION)
11-Nov-2021

Prof Rachel Mbogo
Dean Research and Innovation

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Appendix II: Plagiarism

Curiginal

Document Information

Analyzed document	Combating Insider Trading A Review of Kenyas Legal Framework.docx (D118485075)
Submitted	2021-11-14 09:46:00
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Submitter email	Silvia.Makanga@strathmore.edu
Similarity	13%
Analysis address	library.strath@analysis.urkund.com

Sources included in the report

W	URL: http://erepository.uonbi.ac.ke/bitstream/handle/11295/99526/Kyalo_Corporate%20Governance%20in%20Kenya-%20a%20Case%20for%20Review%20of%20the%20Legal%20Framework%20on%20Insider%20Trading.pdf?sequence=1&isAllowed=y Fetched: 2021-11-14 09:47:00	21
W	URL: https://su-plus.strathmore.edu/bitstream/handle/11071/3790/Combating%20insider%20trading%20in%20Kenya%E2%80%99s%20capital%20markets.pdf?sequence=1&isAllowed=y Fetched: 2021-11-14 09:47:00	20
SA	**DISSERTATION modified[3145].docx** Document DISSERTATION modified[3145].docx (D40292816)	9
SA	**Full Project-Orenge-2017.doc** Document Full Project-Orenge-2017.doc (D28909559)	1
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