CS

CERTIFIED SECRETARIES (CS)

PART III

SECTION 5

FINANCIAL MARKETS LAW

STUDY TEXT

Revised: July 2019

PAPER NO.14 FINANCIAL MARKETS LAW

GENERAL OBJECTIVE

This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to comply with the regulatory framework governing financial markets.

LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Comply with the legal provisions relating to financial markets, including the laws of contract and agency
- Comply with the licensing regulations of the securities exchange
- Comply with the guidelines and rules of the central depository system
- Identify the offences and penalties relating to trading in securities
- Demonstrate an understanding of the processes and law of anti-money laundering
- Maintain securities registers, accounts and records

CONTENT

1. Regulation of financial services

- Historical development of the law and regulations governing financial markets
- Need for regulation
- Regulatory strategies in financial services
- Financial regulators
- Central Bank of Kenya
- Capital Markets Authority
- Deposit Protection Fund
- Insurance Regulatory Authority
- Retirement Benefits Authority
- Sacco Societies Regulatory Authority
- Institute of Certified Investment and Financial Analysts(ICIFA)
- Professional bodies in financial services
- Regulations in the international financial markets
- The International Organisation of Securities Commissions(IOSCO) principles for self regulation

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- Capital Markets Authority
- Investor Compensation Fund Board
- The Capital Markets Tribunal
- The Capital Markets Fraud Investigations Unit
- The International Organisation of Securities Commissions principles relating to the regulator

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- Stock dealers
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- Credit rating agencies
- Collective investments schemes
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- The International Organization of Securities Commissions(IOSCO) principles for credit rating agencies, collective investment schemes and market intermediaries

4. Central depository system

- The Central Depository Settlement Corporation
- Establishment of the central depository
- Duties of a central depository
- Central depository agents
- Rules and regulations of the central depository
- Remedies for breach of duties
- Security measures
- Disclosure of information by central depository agents
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- Counter Financing of Terrorism Inter-Ministerial Committee: objectives, functions and powers
- The Financial Reporting Centre: objectives, functions and powers
- Due diligence requirements
- Wire transfers

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TOPIC 1: REGULATION OF FINANCIAL SERVICES

- Need for regulation
- Regulatory strategies in financial services
- Financial regulators
- Central Bank of Kenya
- Capital Markets Authority
- Insurance Regulatory Authority
- Retirement Benefits Authority
- Sacco Societies Regulatory Authority
- Deposit Protection Fund
- Professional bodies in financial services
- Regulations in the international financial markets
- IOSCO principles of self-regulation

THE NEED FOR REGULATION

What is regulation?

Regulation refers to a set of binding rules issued by a private/public body to achieve stated objectives. Such rules are applied by all regulators in the fulfillment of their functions.

There are two major types of regulation:

- **Prudential regulation**- mainly concerned with consumer protection, the safety and soundness of financial institutions
- **Conduct of business regulation**- concerned with how financial institutions carry on their operations. It is composed of regulations on fairness, disclosure of information among others.

The body issuing such regulations must be given the authority to do so. It should also have the authority to supervise and issue sanction against breach of the regulations. The regulatory framework for financial services in Kenya is normally found in the following:

- Primary enabling legislation e.g. the Central Bank Act
- Secondary legislation e.g. the regulations of the minister

- Principles, rules and codes issued by the regulators e.g. CMA regulations

Rationale for regulation of financial services:

Vision 2030 identifies financial services as one of the six sectors that are the key drivers of the economy. Regulation enhances financial stability to benefit consumers of financial services. There are several reasons for regulation of financial services:

1. ***Prevention of market failures-*** the global economic crisis was partly attributed to a failure of the regulators to regulate the financial institutions. Regulation comes in to ensure that certain risks that may lead to market failure are managed accordingly.
2. ***Protection of consumers***

   The need to protect consumers arises for the following reasons:
   - Inadequate information available to the investors
   - Unequal information between the consumers and the institutions acting as intermediaries in the financial sector. The interests of consumers can also be prejudiced by the superior bargaining power of large financial institutions, which are naturally in a position to exploit their more vulnerable customers. For example, the unsophisticated consumer can suffer from bad advice due either to inadequate staff or adviser training within financial organisations, or to undeclared conflicts of interest on the part of persons selling a product or service.
   - They can also be victims of misrepresentation or fraud. These market imperfections and the scope for incompetent and unethical practices can be substantially reduced, however, by information disclosure requirements and codes of practice relating to business behaviour.
   - The purpose of consumer protection is to redress the market imperfections which arise from inadequate and unequal information, and to thereby allow consumers to properly assess the risks, quality, and relative prices of diverse and often complex financial products and services.

Discussion Question: explain the risks faced by consumers in the financial services industry:

The principal risks that consumers may face in their financial affairs are:

- the prudential risk that a firm collapses, for example because of weak or incompetent management, or lack of capital;
- the bad faith risk from fraud, misrepresentation, deliberate mis-selling or failure to disclose relevant information on the part of firms selling or advising on financial products;
- the complexity/unsuitability risk that consumers contract for a financial product or service they do not understand or which is unsuitable for their needs and circumstances; and
- the performance risk that investments do not deliver hoped-for returns

2. ***Promotion of stability of the financial markets-***
   This is done especially to achieve the safety and soundness of the payment system.
3. ***Preservation of orderly markets***- there is need to ensure that the market is orderly in its operations and this involves the use of proper regulation.
4. **Promotion of efficiency**
   Regulation promotes competition which encourages institutions to become strong, profitable and dynamic, and leads to more satisfied customers.
5. **Financial stability**
   Financial system stability is the reason why certain financial institutions, particularly banks, have been supervised especially closely. The need for stability is based on the notion that the failure of a financial institution could, through confidence and contagion effects, undermine the functioning of the financial system as a whole. Care should be taken to avoid creating the impression that there is no risk associated with financial products or that financial institutions will never be allowed to fail. In pursuing the stability objective, it is also important to recognise the potential for conflict with the efficiency objective. The imposition of unnecessarily high prudential standards and over-intrusive monitoring of institutions and markets can seriously inhibit competition, innovation and flexibility in the marketplace.

REGULATORY STRATEGIES IN FINANCIAL SERVICES

Strategies for regulation can be categorized in various ways. Regulation may be *government-led* or *self-regulation*.

Direct regulation- direct government involvement through its departments and statutory corporation

It may also adopt various models that are applicable to the whole financial services sector. In this regard, the financial services regulatory framework may take the several approaches.

Advantages of self-regulation

- Dynamic
- Higher standards
- Compliance
- Professionalism

It should be noted that there is no one optimum model of regulation that can be proposed for all jurisdictions and therefore the various models depend on the circumstances of each country.

The existing models can be broadly categorized as traditional approaches and objective- based approaches.[1] The traditional approaches to financial regulation are institutional and functional approaches. However, it is instructive to note that these traditional approaches are now viewed as one.

Institutional Regulatory System

An institutional regulatory model consists of distinct regulatory agencies such that the focus is on the institution rather than on the product being regulated. Consequently, each institution has its own regulatory agency for the regulation of its entire activities.

The institutional model aims at achieving the safety and soundness of institutions involved in the provision of financial services. This means that it focuses on ensuring that the particular institutions concerned are regulated in a way to guarantee safety and soundness.

Disadvantages: