CS

CERTIFIED SECRETARIES (CS)

PART II

SECTION 5

FINANCIAL MARKETS LAW

STUDY TEXT

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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

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- Need for regulation
- Regulatory strategies in financial services
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- Retirement Benefits Authority
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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

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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:

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- 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*.

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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

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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:

[1] Christine Fay and Nicolas Parent, 'The Organizational Structure of Financial Market Regulation: Highlights from Literature' <www.bankofcanada.ca/wp-content/.../fsr-0604-fay.pdf> accessed 12th February 2015.

- Inefficient resource utilization compared to a single regulator which makes better use of the resources available.
- It also leads to fragmentation in supervision and it is ill-equipped to regulate financial conglomerates. It encourages the formation of departments that deal separately with all aspects of specific types of business activities.
- It may lead to competing regulators especially with the increased blurred differences between various financial institutions as a result of similar functions being regulated by different regulators.

Advantages:

- It limits double regulation since the entire range of activities offered by a particular institution is regulated by the same regulator.
- It can be said to nurture specialization, borrowing from the approach that like functions should be regulated alike

This type of regulatory model has been practiced in Brazil and also Thailand. Brazil's financial regulatory model is based on specialist agencies. These include the Securities Commission (CVM) to take care of the securities and others to deal with banking, insurance and retirement funds.

Functional Regulation

In this model *similar functions are regulated by the same agency*. The focus here is on the function of the type of product or service being offered rather than the institution offering it.

It is based on the premise that no single regulator can have or easily develop expertise in regulating all aspects of financial services.

The conduct of business regulation is the concern of this model, whereby the financial intermediaries need regulation on how to conduct their various activities and how to behave towards their customers.

It has been said that this model is based on the premise that the regulation of functions is more important than the types of institutions that undertake the particular functions. Kenya partly has this model whereby the same institution regulates the same functions regardless of the institution

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offering the same. *The focus in this model is on how an institution conducts its functions towards the customers and the regulators consider this regardless of the institution offering the functions.* For instance, the Capital Markets Authority in Kenya regulates the capital markets even where other financial institutions such as banks and insurance companies are involved.

Case study

The UK has recently shifted to this type of regulatory model although it had noticeably adopted a single regulator model previously. The UK's model consists of two regulators, one handling the prudential regulation while the other handles conduct of business.

***Advantages of this type of financial model of regulation*:**[2]

- it applies same rules to all intermediaries performing same activity,
- it allows firms to select the precise services they wish to offer
- it best supplies the process of financial innovation by providing the right flexibility for the creativity of competitors.

Disadvantages

- It is costly due to the use of many regulators
- Overregulation

Single Peaked Regulator (Unified Vs Integrated)

This is a model based on the unification of supervisory responsibilities of all sectors of the financial industry into a single regulator although the extent of consolidation may differ. This can be represented in a continuum with multiple regulators being on one extreme end and a unified model being on the other extreme end.

As opposed to a two peaked model which has two regulatory institutions, this regulatory model is based on one major regulator, through some kind of consolidation of the existing regulators.

Advantages

- Saves on Costs

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[2] Macey and O'Hara