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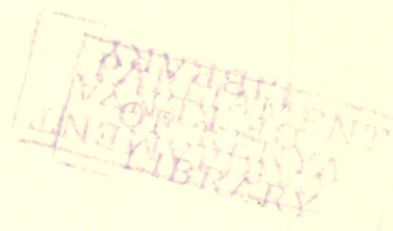
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Ref. No. ZZ/MOF/37/07

17th January, 2018

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Mr. Michael R. Sialai, EBS
Clerk of the National Assembly
Clerk's Chambers
Parliament Buildings
NAIROBI



25/1/18

Dear

Mr. Sialai

RE: THE CAPITAL MARKETS (SECURITIES LENDING, BORROWING AND SHORT- SELLING) REGULATIONS, 2017

The above regulations, issued under Legal Notice No. 295 appeared in the Kenya Gazette of 12th January, 2018.

Attached herewith please find copies of the regulations, an explanatory memorandum and the cover page of Kenya Gazette Vol. CXX- No. 4 of 12th January, 2018 for your necessary action, pursuant to section 11 of the Statutory Instruments Act, 2013.

Yours

Sincerely

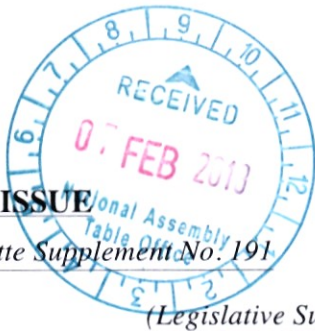
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DR. KAMAU THUGGE, CBS
PRINCIPAL SECRETARY/THE NATIONAL TREASURY

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(Legislative Supplement No. 96)

*Paper Laid
By LOM then Duale
on 13/2/2017*

2727

29th December, 2017



LEGAL NOTICE NO. 295

THE CAPITAL MARKETS ACT

(Cap. 485A)

IN EXERCISE of the powers conferred by section 12 (1) of the Capital Markets Act, the Cabinet Secretary for the National Treasury makes the following Regulations—

**THE CAPITAL MARKETS (SECURITIES LENDING,
BORROWING AND SHORT-SELLING) REGULATIONS, 2017**

PART I—PRELIMINARY

1. These regulations may be cited as the Capital Markets (Securities Lending, Borrowing and Short-selling) Regulations, 2017.

Citation.

2. In these regulations, unless the context otherwise requires—

Interpretation.

“lending agent” means a third party who is not a party to a securities lending agreement but who provides support services to securities lenders including the monitoring of loans, the negotiation of lending fees or rebate rates, and the management of collateral;

“lending agreement” means a written securities lending contract executed by both the securities lender and borrower;

“lending fee” means a fee charged by a securities lender to the borrower for the loan of securities under these regulations;

“margin” means the minimum amount of collateral required in a securities lending transaction above the value of the loaned securities as specified in the lending agreement;

“primary regulator” means the regulatory agency primarily responsible for regulating the business of the person;

“rebate rate” means part of the interest earned by the collateral held by the securities lender that is remitted to the borrower where the collateral is in the form of cash;

“regulated person” has the meaning assigned to it under the Act and includes pension funds, insurance companies, investment funds, exchange-traded funds and commercial banks;

“securities lending” means the temporary transfer of securities from a lender to a borrower with the concurrent written agreement to return the securities either on demand or at a future date;

“short position” means the net investment position in a security in which the security has been borrowed and sold but not yet replaced; and

"short sale" means any sale of a security which the seller does not own at the time of the sale

PART II—SECURITIES LENDING AND BORROWING

3 (1) A securities lending and borrowing transaction shall be carried out in accordance with these regulations

Securities lending and borrowing transactions

(2) The Authority may exempt a sell buy-back or any facility that is similar to a securities lending or borrowing transaction as contemplated under these regulations

(3) A person shall apply in writing to the Authority to exempt a sell buy-back or a facility that is similar to a securities lending transaction from the application of these regulations

(4) An application under subregulation (3) shall state the reasons for which the exemption is being applied for

(5) The Authority shall consider the application under subregulation (3) and make a decision within twenty-one days of receiving the application

4 The Authority shall prescribe the criteria for the identification of securities that may be lent under these regulations

Criteria for identifying securities to be lent or borrowed
Persons to undertake securities lending and borrowing

5 (1) A securities lending and borrowing transaction shall be carried out by —

- (a) a regulated person, or
- (b) any other person specified for that purpose by the Authority.

(2) A regulated person or a person specified by the Authority in accordance with subregulation (1) shall comply with—

- (a) these regulations,
- (b) any additional requirements that may be imposed by the Authority; and
- (c) any other requirements that may be imposed by its primary regulator

(3) A regulated person may act as an intermediary for a securities borrower or lender

Provided that the intermediary shall disclose any potential or actual conflicts of interest in relation to his or her role in the securities lending or borrowing transaction to the borrower or lender as the case may be

6 (1) The lender and borrower in a securities lending and borrowing transaction shall enter into a lending agreement before undertaking the securities lending and borrowing transaction

Securities lending and borrowing agreement

(2) A lending agreement shall include—

- (a) detailed identification of the lender,

- (b) detailed identification of the borrower;
- (c) the securities to be lent;
- (d) the number of the securities to be lent;
- (e) the agreed value of the securities to be lent for the purposes of the transaction;
- (f) the term of the transaction;
- (g) the method of calculating the lending fee or rebate and the payment schedule of the lending fee or rebate as the case may be;
- (h) the nature and value of the collateral;
- (i) the full transfer of the title and interest in the securities to be lent;
- (j) the full transfer of the title and interest in the collateral to be provided;
- (k) the methodology for the revaluation of the collateral;
- (l) the person who shall be responsible for the revaluation of the collateral;
- (m) the margin attached to the securities lending and borrowing transaction, if any;
- (n) the nature and consequences of default or other failures in relation to the terms of the lending agreement;
- (o) the exercise of voting rights associated with the securities to be lent;
- (p) the exercise of voting rights associated with the collateral to be provided where the collateral is a type of security that has voting rights associated with it; and
- (q) the procedure for recalling or returning the lent securities.

7. (1) A securities lending and borrowing transaction shall not be registered as a sale or purchase on a traded market.

Reporting of transactions.

(2) A market intermediary who carries out a securities lending and borrowing transaction shall, once in every month or in any frequency that may be determined by the Authority, submit to the Authority a report of securities lending and borrowing transactions the market intermediary has carried out in the period under review.

(3) The Authority may require each regulated person to report the net securities lending and borrowing position of each security held by the regulated person on a regular basis.

8. (1) A borrower in a securities lending and borrowing transaction shall provide the lender with collateral of at least one hundred per centum of the value of the borrowed securities.

Collateral for securities lending and borrowing transactions.

(2) The lender in a securities lending and borrowing transaction may require the borrower to provide an additional margin on the collateral provided under subregulation (1)

(3) The quality of the collateral required in a securities lending or borrowing transaction may include—

- (a) cash in Kenya shillings,
- (b) Government securities, or
- (c) any other type of security that may be specified by the Authority

(4) The lent securities and the collateral shall be revalued daily and the amount of the collateral held in relation to the lent securities shall be adjusted in relation to the revaluation.

(5) Where it is not possible to revalue the lent securities daily, the securities may be revalued on a weekly basis or more frequently as may be required by the Authority and the collateral held in relation to the securities shall be adjusted in relation to the revaluation

9 (1) The collateral provided by the borrower in a securities lending and borrowing transaction may be used by the lender as follows—

Other use of collateral

- (a) in the case of cash, it may be deposited in an interest bearing account,
- (b) in the case of Government securities, it may be used in overnight repo transactions, or
- (c) in any other case, it may be used as the Authority may prescribe

(2) The primary regulator of the borrower or lender may also impose additional restrictions on the use of the collateral held by a lender of securities

(3) The lender in a securities lending and borrowing transaction may appoint, in writing, a lending agent to manage the collateral provided by the borrower and shall specify, at the time of appointment, the uses to which the collateral may be put by the agent

10 (1) The lender in a securities lending and borrowing transaction shall continue to enjoy the economic benefits associated with the securities he or she has lent to the borrower during the period when the securities have been lent including dividends or interest

Rights and obligations of the lender

(2) The lender in a securities lending and borrowing transaction shall be entitled to a lending fee from the borrower for lending the securities

11 A borrower in a securities lending and borrowing transaction shall—

Rights and obligations of the borrower

- (a) have full legal title of the securities he or she has borrowed,
- (b) where the collateral provided is in the form of securities, continue to receive all economic benefits associated with

the securities given as collateral including dividends or interest; and

- (c) pay the securities lender such amount as may be needed to ensure that the collateral provided remains sufficient at all times.

PART III—SHORT-SELLING OF SECURITIES

12. (1) The short-selling of securities shall be carried out in accordance with these regulations. Short-selling.

(2) A seller may enter into a short-selling transaction if the seller provides documentary evidence that shows that he or she has—

- (a) entered into an agreement to borrow the securities to cover the short sale;
- (b) reasonable grounds to believe that the securities will otherwise be delivered to him or her in time to cover the short sale; and
- (c) entered into an arrangement with another party under which that party has confirmed in writing that it will have the securities and will deliver them in time to cover the short sale.

(3) A person who contravenes the provisions of subregulation (2) commits an offence and shall be liable, on conviction, to the penalty specified under the Act.

13. (1) The Authority shall prescribe the criteria to identify securities that may be subject to short sales. Securities permitted in short sales.

(2) Any prevalidation requirements or obligations applicable to securities transactions shall not apply to short-selling transactions.

14. (1) Short-selling transactions shall only be carried out by regulated persons or any other person specified by the Authority. Persons permitted to undertake short-selling.

(2) Each regulated person who intends to engage in a short-selling transaction shall comply with these regulations, any additional requirements imposed by the Authority and any other requirements imposed by the regulated person's primary regulator.

15. (1) A seller who engages in a short-selling transaction shall, when submitting an order, declare to the exchange or, if acting through a market intermediary, to that intermediary, that it is a short sale. Requirements for short-selling.

(2) Each short sale shall be carried out in the same trading environment as normal purchases or sales of securities.

(3) A securities exchange or a trading platform shall, for the purposes of facilitating short-selling transactions, formulate rules to provide for buying in.

(4) Despite the generality of subregulation (3), each short sale of securities shall be identified as a short sale by the selling broker under the rules of the exchanges or trading platforms contemplated in subregulation (3).

(5) For the purposes of this regulation, "buying in" means the buying of securities effected by a securities exchange which a seller has failed to deliver on the day fixed for settlement,

16 (1) A participant in an exchange or trading platform who holds a short position in a security of five per centum or more of the total amount of the security in issue shall report this position immediately to the relevant exchange or trading platform and the Authority

Reporting of and
limits on short
positions

(2) The Authority may revise the limit prescribed in subregulation (1) and may prescribe different limits for different categories of securities

(3) A short position in any security by a participant and related persons shall not exceed ten per centum of the total amount of the security in issue.

(4) The Authority may revise the limit prescribed under subregulation (3), and may prescribe different limits for different categories of securities, or prescribe the limits of short positions that specific participants or types of participants may hold

17. (1) The Authority may suspend the short sales of a security or impose controls on the prices that may be input on short sales of a security —

Suspension or price
control

- (a) where the price movements of the security meet the conditions set out in the relevant rules of a regulated securities exchange or other infrastructure provider for the imposition of price controls or suspension of trading,
- (b) where the short sales of the security have been temporarily prohibited under the rules of a regulated securities exchange,
- (c) where the short sales of the security that is trading in Kenya have been prohibited in another jurisdiction or have been made subject to price controls as a result of concerns about market order, or
- (d) to maintain or restore the fair, efficient and transparent trading in the security.

(2) The Authority shall review suspensions of shorts sales or impositions of price controls on short sales under subregulation (1) at least once a week

(3) Where the Authority has reviewed a suspension of a short sale or the imposition of price controls on a short sale under subregulation (2), it may —

- (a) maintain the suspension or the price control,
- (b) lift the suspension; or
- (c) remove the price control

18. A person who contravenes any provision of these regulations for which a specific penalty is not provided shall be subject to sanctions by the Authority as specified under the Act.

General penalty.

19. Any matter required to be prescribed or specified by the Authority shall be prescribed or specified by the Authority by way of a circular.

Matters to be prescribed by the Authority.

Dated the 27th November, 2017.

HENRY K. ROTICH,
Cabinet Secretary for the National Treasury.

EXPLANATORY MEMORANDUM TO THE CAPITAL MARKETS (SECURITIES LENDING, BORROWING AND SHORT-SELLING) REGULATIONS, 2017

LEGAL NOTICE NO. 295

PART I

Name of Statutory Instrument: The Capital Markets (Securities Lending, Borrowing and Short-Selling) Regulations, 2017

Name of the Parent Act : Capital Markets Act (Cap. 485A)

Enacted Pursuant to : Sections 12(1) of the Capital Markets Act

Name of the Ministry : The National Treasury

Gazetted on : January 12, 2018

Tabled on :

PART II

1. Purpose of the Statutory Instrument

The Capital Market (Securities Lending, Borrowing and Short-Selling) Regulations, 2017 (“The Regulations”) seek to create an efficient and transparent regulatory framework to enable and facilitate securities lending and short selling in order to foster liquidity and price formation without undue increase in volatility in the capital markets. This is in line with Capital Market Authority’s mandate to create deeper, more liquid domestic markets as recommended in the Capital Markets Master Plan.

2. Legislative Context

The Regulations are made in line with section 12(1) of the Capital Markets Act and the Statutory Instruments Act. The Regulations set out the permitted securities, securities lending, borrowing and short selling, reporting requirements, rights and obligations of the parties in securities

lending, borrowing and short selling and other connected matters in securities lending and borrowing and short selling transactions.

3. Policy Background

The Capital Markets Master Plan (2014-2023) seeks to position Kenya as the 'Heart of African Capital Markets'. One of the pillars in the Capital Markets Master Plan (CMMP) revolves around the creation of deeper, more liquid domestic markets. Liquidity within the capital markets is a key component in making Kenya an investment destination and hence was identified as one of the challenges to be robustly addressed in the Master Plan.

Liquidity is a function of an investors' ability to find a counter party for a reasonably sized trade in a timely manner but without compromising on time. As can be observed, the definition is founded on the ability to put safeguards around 'not compromising on time and price' when transacting in securities. Simply put, an investor should be able to sell or buy his or her desired quantities of securities at the time that they wish to and at a fair price. Making Kenyan capital markets a highly vibrant and liquid market is therefore a key priority in the Master Plan.

Experiences from other jurisdictions as well as studies have identified the role of Securities Lending and Borrowing (SLB), and Short Selling in addressing illiquidity. Securities lending and borrowing is the temporary transfer of securities from one party to another, with a simultaneous formal agreement to return the securities at a pre-agreed price either on demand or at an agreed date in the future. SLB transactions are governed by the terms of a master securities lending agreement approved by the securities regulator, and in line with international best practice. In real life situations, lenders and borrowers will always have unique characteristics that position them either on the borrowing side or lending side of the market.

Typically securities borrowers are market participants who identify trading opportunities that will more than make up for the lending fee costs. Most borrowers are therefore active market participants who will want to take advantage of price movements. They include market makers, arbitragers and directional short sellers among others. In the Kenyan market context a primary target would be market makers, who are expected to play a key role of making the market by way of providing two-way quotes with obligations to honour the quotes.

Securities lenders on the other hand are usually institutional investors, in particular pension funds and insurance companies that are long or medium term investors in the securities. In this category are also high net worth individual investors whose interest is to grow the value of their portfolios over medium to long term. These market players lend securities in order to earn a lending fee and thereby increase the return on their portfolio. The loaning of securities may be for a fixed term, or may at times be left open so that securities can be recalled by the lender or returned by the borrower as and when necessary. The terms are in all circumstances put in the lending agreement globally referred to as Global Master Lending Agreement (GMLA).

The National Treasury is currently spearheading reforms in the government debt market to ensure that debt is as liquid as possible. Among the reforms is the introduction of Government Securities Market Makers (GSMM) whose role will be to provide liquidity through market making in the Government Securities. In order for the GSMMs to effectively perform their duties, they will need to be in a position to borrow securities from time to time through an SLB arrangement to meet their settlement and trading obligations.

There are numerous drivers of securities lending and borrowing in both developed and developing securities market such as Kenya. By facilitating and encouraging SLB with appropriate regulatory controls, various opportunities and benefits are created for market participants and the general economy. Some of the key benefits of securities lending and borrowing and short selling include:

- (a) facilitating an increase in overall market liquidity and efficiency by allowing market-makers and investors to take on and cover short positions as part of their market-making activity. This has the effect of increasing the number of orders in the market and placement of orders for longer term investments;
- (b) aiding in efficient price discovery for securities thereby reducing the asymmetries in the ability of investors to express opinions on the value of assets;
- (c) increasing the flexibility of financing for market participants by facilitating the exchange of a broad range of securities that can be used in financing transactions;
- (d) enhancing low risk incremental returns to otherwise dormant securities which may be used to offset management and custody fees by the lender. This may also reduce the costs

involved in providing pension and long term savings to investors thereby increasing net investor returns; and

- (e) promoting the attractiveness of the Kenya's capital markets to foreign investors leading to the development and competitiveness of Kenya as an investment destination of choice regionally and globally. This will eventually promote the economic development of the country.

Ultimately this allows lenders to engage in alternative investments by allocating all or part of their holdings at the Central Depository and Settlement Corporation to a lending pool. Market participants are then be able to borrow stock from this pool for a fee paid to the holders of lent securities.

The SLB arrangement contributes to the fulfilment of economic pillar of Vision 2030 of 'creating a vibrant and globally competitive financial sector that will promote high level of savings to finance Kenya's overall investment needs' by diversifying investment options.

The Regulations provide for gradual uptake of the product to effectively manage risk in the SLB arrangement by allowing only regulated persons to engage in the securities lending. The criteria for identifying permitted securities for SLB and short selling has also been left to the Authority to prescribe. This ensures adequate framework and effective oversight and monitoring of the structure by the Authority.

The enactment and implementation of the Regulations will therefore go a long way in achieving Kenya's goal of becoming "the heart of African capital markets".

4. Consultation Outcome

The development of the Regulations was guided by a policy framework developed by the World Bank through its First Initiative Project followed by extensive discussions with market stakeholders during two separate missions in April and June 2016.

As required by section 12(2)(b) of the Capital Markets Act, the Regulations were exposed for public and stakeholder comments between October and November 2016 for a period of one month, following review and endorsement by the Working Groups II and III of the Capital

Markets Master Plan Implementation Committee (CMMP-IC). The Authority received invaluable comments, reviewed all of them and made the necessary refinements to the Regulations. Some of the comments received from the stakeholders include the following:

- (i) Market participants in the securities lending and short selling should not be restricted to regulated persons;
- (ii) The Authority should not restrict securities that can be subject of SLB transactions;
- (iii) The parties to SLB transaction should contract under their terms without standard agreement prescription from the Authority;
- (iv) The collateral and margining of SLB transaction should be left to the parties to determine rather than the Authority making the determination; and
- (v) The requirement of whether the underlying borrower can be unregulated person or not to be clarified by the Authority.

The Authority appreciated the comments and incorporated most of the proposals made as guided by the policy objectives and views of the stakeholders and the local circumstances. The Authority also clarified concerns. Over 70% of the stakeholder proposals were adopted and the regulations refined.

The Authority also benefited from additional technical assistance from a one-week mission by the Financial Services Volunteer Corps (FSVC) and representatives from the Securities and Exchange Commission of USA (USSEC) in the refinement of the Regulations in March 2017, during which capacity building for key market stakeholders including technical staff of the Nairobi Securities Exchange (NSE) and the Central Depository and Settlement Corporation (CDSC) was conducted.

5. Guidance

The Draft of the Regulations was uploaded on the Authority's website for ease of access by stakeholders and the public. Workshops and stakeholder sessions were organized to inform stakeholders on securities lending and short selling provisions considering the SLB structure is novel in Kenya. Further, the Authority occasionally posted update on capital markets products and services including securities lending and borrowing on its Facebook page.

6. Impact

6.1 The Impact on Fundamental Rights and Freedoms

The Regulations seek to enhance and promote the rights of persons (natural and juristic) involved in securities lending and short selling including consumer rights, right to property and social economic rights. The Regulations do not limit or infringe upon any right or fundamental freedom under the Bill of Rights. On the contrary, it ensures that there are fair market practices that promote transparency, efficiency and accountability.

6.2 The impact on the Private Sector

The Regulations promote investor confidence in the market and seek to ensure that the market is fair, orderly and efficient. It protects the lenders, borrowers and market intermediaries by setting out the requirements for securities lending and short selling, rights and obligations of the participants and effective protection mechanism such as collateralization, rebates and margining in SLB transactions. It therefore facilitates investments and liquidity in the market.

6.3 The impact on the Public Sector

The Regulations provide a framework for facilitative business environment while at the same ensuring that the market is orderly and transparent. The requirement for reporting of SLB transactions for instance, enables the Authority to supervise the market and prevent market manipulations and other market breaches.

6.4 Impact Assessment

It was noted during the stakeholder consultative forum that the Regulations will greatly promote market liquidity and prevent shortfalls or failed trades thereby enhancing attractiveness of the Kenya's capital markets to both local and foreign investors.

7. Monitoring and review

The persons engaging in securities lending and short selling are all regulated persons and by virtue of that they are bound by continuing reporting obligations to the Authority. In addition, the Regulations require monthly reports from market intermediaries who carry out securities lending and borrowing transactions. Gradual review and monitoring of the SLB transactions will further inform the Authority's course of action including, for instance, whether to remove restriction on securities permitted for SLB transactions.

- In addition, all the monitoring roles and powers of the Authority are still applicable including the power to take enforcement actions against market participants for breach of SLB Regulations.

8. Contact

HENRY K. ROTICH

Cabinet Secretary for the National Treasury

17th January, 2018



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