

# Investigating Fraud in the Capital/Securities Markets

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# Opening Remarks



- Have you heard of a phrase “ Make your money work for you”  
“Save, Invest, Returns” who utter this phrase???
- Fraudsters also wants you to invest so that your money work for them
- Securities Fraud has existed for as long as people have been investing
- Globalization and Technology allow more people to access investments
- Same advantages are exploited by Fraudsters to access more investors
- Reinforcing the need for diligences from Regulators and Investigators

# Capital Markets/CMA

## Objectives



- It's a market for Capital= those who have capital and those who need capital
- Long term in nature and financial instruments (securities) either through bonds or stocks
- Regulated by CMA whose principle objectives is to ensure orderliness, fairness, transparent and efficient market and protection of investors interests
- Investor protected before purchasing securities and as long as he/she holds the securities to the trading of the securities
- Securities are rights or interest in something. How about Investment Contract ( Howey test). Is it expandable?

# Securities Fraud



- All Securities that are issued to the public must be approved and its trading regulated
- Qualified for exemption (Advertisement and Solicitation) versus qualified for loopholes
- Deceptive practices in the purchase, holding and sale of securities
- Involves Deception of investors and manipulation of the financial markets
- Categorised into:
  - Scheme by Registered persons and entities
  - Scheme by unregistered persons and entities

# Effective Investigation of Securities Fraud



- Philosophy behind securities regulatory framework
- Laws and Regulations
- Modus Operandi
- Standard Investigation Methodologies

# Key Issues



- What are the potential violations
- What are the elements or components of the violations
- What documents need or testimony needed to prove each element
- Quantum of evidence needed= Standard of Proof
- Determination of breach = Admin/Criminal
- Sanctioning

# Major Threats



1. Financial Statement Fraud and Concealment of Material Facts
2. Insider trading (including Front running) and Market Manipulation
  - Embezzlement of Investors Funds/Misappropriation of client assets
  - Unapproved Issue/Unlicensed entities

# 1. Fraudulent Misrepresentation of material facts



Ingredients/Elements of the offence

- Made False Statement
- False Statement was material
- Knowledge of false representation
- Victim relied on the misrepresentation
- Victim suffered damages as a result

Criminal/ Civil/Admin

Existing facts versus opinion/speculative statements on future

What about professional opinion???



# Misrepresentation of material facts



- This mainly covers Accounting Fraud or Financial Statement Fraud
- During normal reporting and prospectus period
- An Informed investor is a protected investor
- More than 50% of the information needed by investors is financial information
- Hence the need for complete and accurate financial information= Complete assurance

# Misrepresentation of material facts



- Companies are working under inaccurate assumption that auditors are finding fraud
- But Auditors have professional obligation to consider risk of Fraud in their engagement –
- Why aren't audit procedures effectively finding Fraud
- Is there disconnect between standards and the realities of audit procedures???

# Misrepresentation of material facts



## Probable Reasons why Audits don't Find Fraud

- Materiality thresholds- Far greater than where frauds are happening
- Random Sample versus systemic look of transaction over a period of time
- Over reliance on checklists
- Budget and resource constraints
- Lack of interview and investigative skills

# Items prone to accounting fraud



- Recognition of Fictitious Income
- Pre mature Recognition of Income
- Over stating receivables
- Under stating payables
- Under provisioning

# Expectation from Auditors



- Audit critical on credibility of financial information= Reasonable assurance
- This bring about the expectation gap between complete assurance and reasonable assurance= How do we close or narrow the gap?
- Auditors Issues= Independence and Negligence ( Audit not in compliance with ISA)

In case of accounting fraud, who is responsible? Who is liable?

- Apportionment of responsibilities = Board, Audit Committee, CFO, CEO
- How about apportionment of liabilities ?

# Where does the buck stop



## Regulators Criteria

- What happened and how did it happen
- What did you know and when did you know
- What did you do or not do for that thing to happened/ or when you knew what you knew
- What did you do or not do after the thing happened

The buck stops where the evidence takes us

# Concealments of Material Facts



- Philosophy is disclosure based not merit based
- Complete, accurate and TIMELY- Necessary for market stability
- Objective is to maximise disclosure and minimise information asymmetry
- What to disclose , when to disclose and how to disclose ????

# Concealment of Material Facts



## Elements

- Knowledge of material facts
- Duty to disclose material facts
- Failed to disclose
- Victim Suffered

Should the duty be specific ?????



## 2. Insider Trading



- Successful securities transactions requires astute use of confidential information
- Insider trading is abuse of confidentiality about factors affecting market value of securities
- Undermines public confidence because insiders reap profits based on unfair advantage
- Lower number of investors, lower demand for securities, lower stock value, deflated market

# Insider Trading and Front Running



## Elements

- Insider or a person connected to the insider
- Possession of inside information (material and non public information )
- Trades with the inside information in a security for gain or to avoid loss
- Front Running is a Type of insider trading
- Use of privileged knowledge of customer orders and trades a head of customers

# Market Manipulation



- Series of transaction designed to artificially raise or lower price of securities
- Designed to give appearance of trading activities for purposes of inducing others to buy or sell

Manipulation is done by:

- Information
- Trading activities
- Other deceptive acts

# Market Manipulation



## By Information

- Disclosure of false and misleading information
- Giving false signal to the market

## By Trading activities

- Wash Sales- Without change of beneficial owners
- Pre arranged trades

## By other deceptive means

- Pump and Dump
- Poop and Scoup

# Sources of Investigation



## External Sources

1. Complaints by investors
2. Social media
3. Newspaper publications
4. Whistle blowing system;  
<https://www.cma.or.ke/index.php/investor-protection/whistleblower-portal>

## Internal Sources

1. Market supervision
2. Market surveillance
3. Financial analysis
4. Any other source

# Investigations



- Understand scope and focus of investigation
- Secure all relevant documents
- Review all documents seized- piece up the picture
- Conduct money trail on transactions involved
- Interview witnesses involved the transactions
- Build a story based on documentary and oral evidence
- Determine adequacy of evidence vis a vis elements of the offence

# Investigations powers



- Obtain documents and Data
- Examination of witnesses
- Entry to premises
- Search and seizure
- How about seize travel documents and arrest ????

# Common Evidence Gathered



- Communication records
- Trading Records
- Financial Records
- Company records
- Experts records
- Professional records
- Oral Evidence



# Challenges



- Voluminous Documents
- Anonymous complaints
- Protracted Investigation process
- Cross border transactions
- Neutral Witnesses
- Privileged information
- Bank records availability
- Constitutional Challenges

# Q and A



# THE END