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Financial Sector-Development Project II

ISN 90861

FINAL REPORT

Kenya: Evaluation of Capital Markets Authority

September 1994

The Capital Markets Authority project in Kenya, as supported by a long-term advisor provided by USAID, made considerable progress toward developing the Kenyan capital markets, particularly the Capital Markets Authority (CMA) and its rules and regulations governing capital markets activities and the Nairobi Stock Exchange (NSE). The project can continue to assist the CMA and NSE by improving their organizational structures, the Securities Act and particular rules and regulations, and market liquidity.

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EXECUTIVE SUMMARY

A. Objectives of the Technical Assistance Program

Capital markets play an important role in structural adjustment processes. Assistance to their development can be a legitimate and useful component of foreign assistance structural adjustment package. Such has been the case in Kenya, where the SAAPTAP (Structural Adjustment Assistance Program-Technical Assistance Project) had a "Capital Markets Authority" component, with a broad objective of assisting the development of capital markets in the country. The evaluation of this component is the objective of this Report. This Report is not, nor does it claim to be, a full analysis of the current situation of the capital markets in Kenya; neither does it attempt to propose a complete or even preliminary overall strategy for their further development.

Capital markets did not really exist in Kenya before the initiation of the component. There was neither a Securities Act nor a regulatory agency; the Nairobi Stock Exchange was a private association or club whose six members of long standing did not trade among themselves and it could not be termed a "stock market" in the accepted sense of that term. There was also no clearing/settlement institution.

SAAPTAP was intended to provide technical assistance to strengthen the institutional framework and for planning and policy analysis necessary for the implementation of the Structural Adjustment Assistance Program (SAAP), which was a major country objective for Kenya. In addition, SAAPTAP was to assist the Government of Kenya "in the creation of a functional capital market". That additional assistance was provided through a special project or activity within SAAPTAP's broad "Sectoral Policy Analysis and Planning" component entitled the CMA for which a Grant Agreement was signed in June 1986; the total funding of the project ultimately reached $775,000. The purpose of the project was spelled out to "finance long term technical advisors to the Ministry of Finance, and associated costs, to assist the Government of Kenya in the creation of a functional capital market development authority as well as funding selected in country consultants".

B. Purpose of the USAID Evaluation

The purpose of the USAID evaluation was to:

- Determine the impact of the project on the capital markets in Kenya and look into its effects on the Kenya economy.

- Assist USAID/Kenya to determine the best and most useful way of extending further assistance to develop the capital markets Authority and whether the assistance so far provided or any that might be contemplated can contribute to the private enterprise development objectives of USAID Kenya.

- Analyze the capital markets in Kenya and identify issues/problems that impinge on or have influenced (i.e. facilitated and impeded) its growth. Recommend how these issues/problems can be dealt with.

- Provide general lessons learned for USAID in how assistance to stock markets such as Kenya's may best be provided and assess (or critique) such assistance as a vehicle for development aid.

It should be noted that a key objective of any structural adjustment program (SAP) is to shrink the role of the State in economic development and to correspondingly expand the role of the private sector. Without the mechanism of a well functioning capital market, SAPs will not be able to proceed as smoothly or as effectively as they need to. Hence the need in Kenya to have a CMA component and project.

C. Main Evaluation

The remainder of the Executive Summary will be organized principally along the lines of the four main purposes of the USAID evaluation terms of reference. itemized above. We will treat each institution covered in the terms of reference.

1. Determine the impact of the project on the capital markets in Kenya, and look into its effects on the Kenyan economy.

USAID's Contribution A reasonably well-formed capital market has been put in place. With some additions, a fairly favorable economic and market environment, and a modicum of care and advice, the Kenya capital market should grow quite nicely over the years, both in absolute terms and by comparison with its regional competition. Prior to project commencement, capital markets in Kenya were not effective; subsequently they were. The generally successful outcome of the project, for its part, has certainly and well contributed to the broader SAAP and country objectives.

Capital markets center around three core institutions: The regulatory authority, stock exchange, and clearing and settlement facility. During the tenure of the USAID CMA project, two of these core institutions were built from the ground up in Kenya: Regulator (CMA) and

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stock exchange (NSE). These institutions have a brief but nonetheless real history of visible accomplishments which, though still modest, reflects the level activity generated by the local capital market. Furthermore, the building of institutions is a complex undertaking which can only be implemented and tested over a reasonably long time frame. Thus, a final judgment will not be possible for some years to come.

The USAID-funded advisor to the CMA has played an important and fruitful role in these developments. While no one can say with absolute certainty what would have happened if no advisor had been available, it appears likely that much less progress would have taken place. The advisor had to convince the various actors to create a stock exchange more or less from nothing and then teach every one, regulator, stock exchange and brokers alike, how to make it work.

Unfortunately, the deterioration of the relationship between the CMA and NSE made the advisor's position increasingly untenable, eventually forcing him to curtail and then stop his work with the exchange. It remains that the training the advisor has been able to give and the market philosophy he has tried to impart, must still be merely "skin deep." They have been tested only slightly so far, although more so in the case of the NSE which passed through the market boom. It cannot be said whether the two institutions will stand the test of time and truly challenging market or regulatory events. It is doubtful whether the two institutions have matured sufficiently by now to be left to their own devices with confidence. It is likely that both would find the going very tough in policy terms as well as in technical and administrative matters.

In any case, there can be little doubt that the USAID assistance to the NSE was critical to getting it off the ground at an early date. Certainly the broker community was not of a mind to finance startup costs for a proposed stock exchange, without which they had been able to function for years. This contribution was therefore strategic and timely. What would have happened to the CMA if there had been no USAID contribution is more difficult to gauge: At a minimum it would not have moved from its previous quarters, which would have prejudiced if not prevented the establishment of the NSE, or at least forced it to incur much higher costs, and its image would not have been the same. However, it must also be noted that certain major projects of the CMA, such as its Information Center for users of the capital market, have not yet been implemented.

In regard to the project's contribution to the economy of Kenya; the setting up of capital markets does create some direct jobs (at the CMA, the NSE, and later on in the clearing and settlement institution--possibly 70 in all so far), and a potentially much larger number of semi-direct jobs as brokerage firms and other market-related institutions expand and new ones are created. These also tend to have a reasonably high and quality multiplier, since capital markets call on a wide range of specialized professional services including lawyers, analysts, data and computer experts, accountants, printers of high-grade security paper, etc. over and above the indirect jobs included in a standard multiplier. Capital markets function especially in their initial stages of development, through a rapidly expanding number and network of small and micro enterprises. Experience has shown that a dynamic capital market is normally a high jobs-creating small business, which does not require any subsidies from the state.

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CMA The CMA needed considerable outside expert assistance in at least four areas: Legal, regulatory, strategic and organizational. The project's long-term advisor helped to create and shape the CMA in these areas.

The regulatory output of the Authority has been at once impressive . The regulations go some way towards remedying the deficiencies of the Securities Act as analyzed in more detail in the body of the report. For example, the regulations are forthcoming on the organization and responsibilities of stock exchanges, which must neither distribute their profits nor restrict their membership. They also touch on most important issues directly affecting the capital markets: Stock exchanges, licensing of brokers and other intermediaries, investment advisers, primary market, off-exchange transactions, complaints and compensation.

However, the regulations remain silent on the clearing and settlement institution; have little to say on the primary market; do not clarify the decisional hierarchy which may exist among the Government, the Minister, the CMA, and other parties or groups as mentioned above; and have nothing to say on the important policy issues of the required initial and continuing capital of securities firms. Thus, they require some further modification.

The general lines of authority in the regulation of capital markets also need to be resolved. The Securities Act fails to specify the hierarchy of responsibility which is to exist between the CMA and the Minister of Finance to which the CMA reports and answers. In other words, it is important for the CMA to know with precision the areas where it is "supreme" and may act without reference to the Minister. It appears that the Securities Act is not entirely satisfactory in these matters, and that many gray areas remain.

The NSE The NSE has benefitted from USAID assistance for the establishment of its first physical facilities as well as for training and publicity purposes. USAID provided a long-term advisor who devoted most of his first 18 months to the Exchange. That made it possible for him not only to help organize the stock exchange as a physical and functioning entity and train its members but also, and perhaps more importantly, to observe at first hand the real state of affairs in the capital markets. He could thus be guided in his later advice to the CMA by very concrete and empirical knowledge of the "real" situation on the ground.

The NSE was restructured in 1990 from a private association into a private limited liability company. It established an executive secretariat in 1991, which manages the Exchange, and is organized into four divisions: Trading; Public Relations and Training; Finance, Clearing and Settlement; and Administration. Until the Exchange was reorganized into its present form, it was hardly a stock market at all. Moving from what was essentially that pseudo-stock exchange to a "real" one, however tiny, was therefore a delicate exercise. It effectively called for the retraining more or less from zero of the complete capital markets industry as it then existed.

The acid test of the success of the NSE transformation happened when the market took off in June 1993: The NSE and its members "held" and were able to cope. That is an accomplishment whose importance can hardly be overstated, and it provides the necessary foundations on which further developments can be built.

The NSE has now put together an ambitious expansion program, under which it is moving to large new facilities with a trading room capable of accommodating 100 traders and clerks and some 25 large trading boards, a public gallery and an auditorium, a dedicated clearing and settlement area, and adequate office space. Although the cost of this expansion will represent a financial challenge for the Exchange, there is no reason to believe that it should not be able to meet its budgets over time.

Government of Kenya Contribution The Government of Kenya has ***kept its part of the legislative bargain*** in the strenthening of their capital markets through the passage of the Securities Act and the tabling of the recent amendments. Notably also, the CMA was constituted almost immediately after the Act was approved; the Chief Executive appointed in very short order, and the Authority was soon made modestly operational with initial office space, staff and budget. This is almost lightning-like speed in traditional terms. Moreover, considering the immense needs of the country and the extreme paucity of public resources, the CMA has been generously funded.

The Government also took a ***number of other steps designed to facilitate the expansion of the capital markets:*** Equalization of tax treatment for interest and dividend income; reduction of the withholding tax; removal of the stamp duty on exchange transactions; issue costs made deductible for companies; block funds freed; privatization of some SOEs through the equity markets; strengthening of the quality of accounting information; and the issuance of administrative regulations under the Securities Act.

These are all important measures, implemented within a relatively brief period of time. What one might call the administrative "bargain" has thus been more than substantially honored. Still, there remains work to be done on legal and administrative issues regarding the capital market.

Other analyses in tabular on employment impact, number of shares, NSE statistics, and recent public issues on the NSE are presented in appendices in the back of the report.

2. **Assist USAID/Kenya to determine the best and most useful way of extending further assistance to develop the Capital Markets Authority (CMA) and whether the assistance so far provided or any that might be contemplated, can contribute to the private enterprise development objectives of USAID/Kenya.**

See the attached box on Recommendations

3. **Analyze the capital markets in Kenya and identify issues/problems that impinge on or have influenced (i.e. facilitated and impeded) its growth. Recommend how these issues/problems can be dealt with.**

Market Activities The growth of the NSE over the last three years has been in some ways impressive. For instance, there are now some one billion shares outstanding from 50 listed companies with an average value of KShs 80 per share. The volume of trading has soared, albeit from a tiny base and still small in absolute terms. Also, the market index has climbed quite dramatically--it more than doubled in 1993 alone, and has almost tripled since June of last year. These figures are quite impressive considering that the activity occurred during a period of high inflation, a monetary devaluation, an epidemic of damaging financial scandals, record interest rates, a freeze on donor funds, and unpredictable shifts in macroeconomic policy.

Nonetheless, the issue remains whether that growth reflects a real deepening and maturing of the market or is still in the nature of welcome but not yet truly substantial activity. It would be prudent to think of the NSE and of the capital markets institutional complex as still being in their infancy and in need of nurturing rather than on the verge of joining the ranks of strongly emerging markets such as Thailand or Indonesia.

The quality of trading on the NSE is another vital issue. It is immediately clear that the NSE is not, by any reasonable benchmark, an active stock exchange and therefore cannot claim to provide a liquid market with quality trading. To illustrate that point, one may note that there are at the moment more shares traded in one day on the Jakarta Stock Exchange than there were during all of last year on the NSE.

Obstacles to Growth In regard to the CMA, it can correct some of the environmental obstacles to capital markets growth. CMA contributions can include the following:

- Creating and maintaining a level playing field. This involves an identification of the major fiscal, regulatory and legal impediments to further development which fall in the category of administrative practices and decisions.

- Attracting more listings. Steps have to be taken on a priority basis to attract more listed companies to the market. The issues discouraging private companies from going public will need to be inventoried and dealt with head-on. These issues include the public and tax scrutiny that accompanies an IPO, and administrative red tape.

- Strengthening clearing and settlement. A major challenge facing the capital markets is the organization of the now entirely informal clearing and settlement system, and the related improvement in the share registration system.

- Maintaining the quality and effectiveness of regulatory implementation. It is very important to have in place from the outset simple but adequate and well-monitored entry or ex-ante requirements for active involvement in the capital markets, whether it be for companies which want to go public, for securities firms which want to open their doors or for individuals who wish to enter the brokerage industry.

- Educating the public and responsibility promoting the stock exchange. The CMA should play a role in this function, principally monitoring, but proceed with caution so as not to mislead potential investors.

- Dealing with the political environment. While capital markets are not above politics, their excessive politicization would make it difficult if not impossible for their various component parts to work together and with the Government.

In regard to the NSE, Its obstacles to growth include:

- Clarifying the NSE's legal standing, as it will lose regulatory authority over its members under amendments to the Capital Markets Authority Act.

- The structure of the NSE must be determined by deciding issues such as whether the Exchange will have a small or large number of members; the size of minimum capital which a member firm must have and maintain; and the price at which an Exchange membership or seat should be sold.

- Dealing with the effective absence of corporate finance/underwriting capability in existing securities firms.

- Market illiquidity. The quality of trading on the NSE is a vital issue. But given the very short history of the NSE, one should not expect especially high-order trading on the NSE floor; in fact it will likely be quite some time before that can happen. This illiqudity can be cured by a broad-based increase in the number of companies listed; quantity of the "float" (i.e., the number of shares actually available for trading); and the number and level of activity of investors.

- Improving clearing, settlement and registration (see CMA section).

It should also be noted that both the CMA and the NSE could benefit from organizational evolution. The CMA, for its part, is still too undifferentiated in some units of its organization. A sharper distinction should be introduced between matters concerning the primary and secondary markets; and CMA units should be assigned total responsibility for categories of activity. The structure of the NSE could also be more clearly organized into three line directorates in accordance with the three major functions of a stock exchange: Listing, trading, and membership. Here again, each directorate should be responsible for the totality of the related activities of the Exchange, including supervision, complaints, investigations and discipline, and would relate to its counterpart unit in the CMA.

Critiques dealing with the CMA, NSE and Government of Kenya are presented above in the "Impact" section of the Executive Summary.

4. **Provide general lessons learned for USAID in how assistance to stock markets such as Kenya's may best be provided and assess (or critique) such assistance as a vehicle for development aid.**

Positive Lessons Learned Several positive lessons have been learned. These include:

- Capital markets can be developed in most adverse economic, financial and political circumstances, which might seem unlikely. Yet, it was done in Kenya from practically a zero base.

- The process can be quite rapid, as it was in Kenya.

- Even embryonic and completely unstructured capital markets can play an effective role in the mobilization of savings and the allocation of capital.

- The transfer of knowledge and expertise is entirely feasible in the field of capital markets development.

- An effective capital markets assistance program does not have to be particularly expensive or all-encompassing. In Kenya, a long-term advisor and other technical support was provided, as well as modest financial assistance for the establishment of the Authority and the NSE, with considerable impact.

Negative Lessons Learned The negative lessons learned include:

- The Kenyan experience has made it clear again that capital markets regulation is not an instantaneous process and that it requires time to unfold and take hold. A strong self-regulatory philosophy and practice will have to be nurtured until a "culture of compliance" has begun to take root.

- It has been confirmed that capital markets, particularly during their "emerging" phase, have a powerful political component which can either speed up progress, and bog it down. Local conflicts can slow progress considerably or even arrest it altogether.

- It has been shown again that clearing and settlement (along with other associated processes such as transfer and registration) is usually the forgotten "orphan" in capital markets development programs.

General Conclusions

- The degree of development of the market is an important component of its evaluation; prescriptions about solutions will to in large measure depend on this.

- Geography matters. Emerging markets are competing among themselves, and even at that on a regional rather than a global scale. The Kenya capital markets are thus not competing against Thailand or Chile but against their East or other African neighbors. In this context, the Kenyan capital markets do not fare poorly.

- **Overall Conclusions**

Overall, it can be concluded that a reasonably well-formed and functioning, if still embryonic, capital market has been implemented in Kenya over a remarkably short period, and in a very adverse economic, financial and political context. That market should be capable of

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sustained growth. It can also be concluded that the assistance provided by the component has been critical to both the quality and the timeliness of the development, which would likely have been placed in serious jeopardy if the assistance had not been available.

The Report looks into several key elements of the capital markets -particularly the Law, the Authority and the Stock Exchange - and analyzes their current situation as well as their shortcomings. Avenues for remedy are proposed, particularly concerning the lack of liquidity of the market. Recommendations are put forward for further action including possible USAID assistance, and certain lessons of general applicability are drawn from the Kenyan experience.

KEY RECOMMENDATIONS

The recommendations below flow from the body of the Report, where they are more fully discussed. They are therefore presented here in point form only, except for those which touch the possible US AID assistance.

The Capital Market Authority Act

Improve/clarify the sections and/or dispositions concerning:

- the primary market
  - the most significant deficiency is that the Act does not satisfactorily address the issue of distributing securities to the public. Since one is dealing here in considerable part with private and still unlisted companies,this is an area that can be only handled by a Government agency. The key concept of *"full,true and plain disclosure"* does not appear in the Act
- the concept of "public company"
  - the Act does not define what a public company is, how a "private" company becomes a "public one" and what the "continuous disclosure" practices are which a public company must adhere to; the vagueness of the Act leaves a regulatory vacuum in a period of rapid expansion in the number of companies and potential IPOs
- the stock exchanges
  - the Act is sparse about the various aspects stock exchange activities institution.
- the clearing and settlement institutions
  - the Act should define at least in broad outline the capital, membership, structure, mandate and powers of the clearing and settlement institution and its supervision by the regulatory authority
- the concepts of self-regulation, self-regulatory organizations and delegation of authority to SROs
- the relationships between the Government, the Minister and the Authority

The 1992 Ministerial Regulations

Improve/clarify the sections and/or dispositions concerning:

- the primary market
- public companies
- underwriters
  - the Authority should organize the required dialogue and even possibly sponsor the creation of an association of underwriters
- stock exchanges
- clearing and settlement institutions
- capital requirements of underwriters, brokers, dealers, etc.
- delegation to the Authority, self-regulation and delegations to SROs
- the recognition of training courses and examinations for market professionals
- preparation and issuance of Ministerial Regulations
- initial public offerings of parastatals

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The 1992 Authority Rules

Improve/simplify the sections and/or dispositions concerning:
- preparation, discussion and issuance of Authority Rules
- allotment of shares in primary distributions
- stock exchanges and clearing/settlement institutions
- recognition and surveillance of SROs

The Capital Market Authority

- structure itself more clearly in relation to its primary and secondary markets mandates
- bolster its capability for regulation of the primary market
- improve the time-frame for approval of IPOs and new issues
- work on the unit trust and investment fund problem
- mount a campaign in conjunction with NSE to attract companies to the market
- identify ways of promoting the development of underwriting and corporate finance capability
- define the major parameters for an effective clearing and settlement institution and for an improved share transfer/registration system
- prepare a discussion paper on major parameters for the SRO system
- implement an information program for the public on the specific role and mandates of the Authority
- create its Committee on Shareholders' Complaints
- prepare a discussion paper on the funding and functioning of the Investor Compensation Fund
- study modalities for the financial "autonomy" of the Authority
- establish an internal calendar of regulatory actions

NOTE: many of the above items are preparatory to the issuance of suggested Regulations and Rules

The Nairobi Stock Exchange

- structure itself more clearly in function of its three major rules
- introduce a "book" for each listed stock
- charge a transaction fee to members on each trade
- set a membership fee for joining the exchange, based on a clear formula
- consider the concept of "introducing" brokers ("remisiers")
- put in place an improved information and data program
- activate a program of public education in "investment practice"
- set up an Investors Complaints Committee of its Board
- improve the clearing/settlement process and work for the creation of a clearing/settlement entity
- look into ways of improving the share registration process
- mount a campaign and program to convince and help companies to become listed on the exchange
- encourage the creation of underwriting and corporate finance capability within existing securities firms

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I. INTRODUCTION

A. The Kenyan Economy

1. Kenya is a landmass of approximately 583,000 sq km. It's population is estimated at 25 million with an annual growth rate of 3.3 percent. Kenya's economy depends largely on agriculture, which accounts for over one third of GDP and approximately two thirds of exports. Agriculture is supplemented by manufacturing, commerce and tourism, which collectively accounts for an additional one quarter of GDP. The economy registered a 0.1 percent real growth rate in 1993, compared with 0.4 percent the previous year.

1. General Situation

1. Kenya's economic slow down during the past few years can be attributed to several factors:

- A prolonged drought which significantly reduced agricultural output.
- Low aggregate domestic demand which resulted in sluggish growth in output of manufacturing.
- A shortage of foreign exchange during the first half of the year.
- High inflation which was principally a result of the drought, excessive growth in money supply, massive depreciation of the Kenya shilling, and liberalization policies pursued by the government.

2. The agricultural sector's real GDP grew by a negative 4.1 percent, compared to negative 3.7 percent recorded in 1992. Transport and communications grew by 0.8 percent. The trade sector stagnated by 0.1 percent. However the manufacturing sector rose by 1.8 percent. This was a result of higher export demand for non-traditional manufactures, especially textile and manufactured food products, and also partly due to an increased inflow of foreign exchange, especially during the second half of 1993.

2. Financial Sector

1. The financial sector recorded a real growth of 7.5 percent in 1993. The sector mainly benefited from exchange control liberalization and the introduction of weekly Treasury bill auctions. This mainly took place during the period of March through December. The government also introduced significant economic reforms in 1993 to correct some of the macroeconomic imbalances which had accrued in the recent past. the reforms included:

- Liberalization of foreign exchange controls.
- Abolition of import licensing.
- Introduction of export retention account scheme for exporters (abolished in May 1994).
- Removal of price controls particularly on maize, wheat and sugar.
- Tighter controls in the entire financial management system of the government itself. (Inflation based on revised Nairobi consumer price indices was recorded at 27% in 1992 and 46% in 1993. At the end of May 1994 inflation was about 50%.)

Key Economic indicators for Kenya

	1991 (Actual)	1992 (Actual)	1993 (Estimated)	1994 (Projected)
Population (Mill)	23.5	24.3	25	25.5
GDP (FC) $ (Mill)	7,102	7,233	4,280	5,143
Real GDP Growth	2.3	0.4	0.1	2.9
Average Annual Inflation	19.6	27.3	46.1	22
Balance of trade $ (Mill)	-999	-906	-494	-779
Foreign Debt $ (Mill)	5,178	4,916	5,114	5,142
Foreign Reserves $ (Mill)	256	342	882	918
Gross Saving % GDP	17.6	14.5	17.6	19.1
Interest Rates	20.4	22.34	38.55	38

2. The money supply slowed from 35 percent in 1992 to 28 percent in December 1993. A surplus of K£ 1,28 million in the balance of payments was recorded in 1993. The current account, which has been in the red since 1977, was also in surplus of K£ 288 million. This performance is attributed to strong growth in export earnings, large short term capital inflow and unfreezing of loan disbursement programs. Further accumulation of debt service arrears also contributed to the current account surplus.

3. Kenya recorded a trade deficit of K£ 166 million in 1993 (and K£ 119 in 1992). Although export earnings from coffee, cement, soda ash, tea, horticulture and pyrethrum products more than doubled, expenditures on imports still outstripped total export earnings. The drought in 1993 significantly contributed towards the import bill since Kenya had to import substantial amounts of maize and wheat to meet domestic demand.

4. Activity in the capital markets remained high in 1993. A total of 27,425,147 shares worth K£ 41.3 million were traded in the Nairobi stock exchange (NSE). A total of 18,019 deals were recorded during the year and the market capitalization at the NSE stood at K£ 3,620 million at the end of the year. No government stocks were traded in the NSE in 1993. Under the on-going government privatization program, 3,602,720 government shares worth K£ 3.1 million in two companies that were already listed at the NSE were privatized. The NSE price index which continues to reflect an upward trend rose from 1,176.0 in December 1992 to 2,522.9 in December 1993.

5. Three conferences were convened by the NSE and capital markets authority (CMA) in Nairobi in 1993. In April 1993, the NSE hosted the first African Stock Exchange Association Conference of fourteen sub-sahara African stock exchanges. The Capital Markets Authority in May, 1993 hosted the International Organization of Securities Commissions (IOSCO) conference, drawing delegates from 45 member countries of the Organizations Development Committee. In August, 1993 the CMA in conjunction with the US based Finance and Economic Association hosted the first African Capital Markets Conference in Nairobi.

By the end of December 1993, seven new professional firms had been licensed by CMA as Investment Advisers (list in Appendix). All these led toward development of a sound and efficient capital market.

B. USAID Technical Assistance

1. SAAP AND SAAPTAP

The purpose of the Structural Adjustment Assistance Project (SAAP) which began in 1986 is to provide Kenya with balance of payments and technical assistance support while the Government of Kenya implements the policy changes necessary to accelerate the structural adjustment of the economy. The SAAP called for "institutional change" in several sectors including:

- The private sector: stabilization and development of financial institutions and markets; development of equity capital and term-credit

- The parastatals: reduction of their role in directly productive activity, including additional divestiture.

The total budget for SAAP was set at $12.8m, with a GOK additional contribution of $4.3m (of which $775,000 was to be given to capital market development).

2. The purpose of the Technical Assistance Project in support of the Structural Adjustment Assistance Program (SAAPTAP) which began in 1988 is to provide technical assistance for planning and policy analysis as necessary for implementation of the Structural Adjustment Assistance Project (SAAP). The purpose of the component entitled Structural Policy Analysis and Planning was to finance long-term technical advisors to The Ministry of Finance and to assist the Government of Kenya in the creation of a functional capital development authority as well as to fund selected in-country consultants.

2. Government Efforts To Develop The Stock Market

1. The necessity to establish a special lead institution on capital markets development and regulation can be traced to the recommendation of a joint study by the International Finance Corporation and the Central Bank of Kenya in 1984. This recommendation was further translated into a policy commitment in the Sessional paper No.1 of 1986 on "Economic Management for Renewed Growth".

2. The Government of Kenya constituted the Capital Markets Development Advisory Council in November 1988. Its task was to develop ways and means to further improve the capital Market infrastructure. This included drafting of the Capital Market Authority Act, for consideration by the Parliament.

3. The Act received presidential assent in December 1989. The Authority was constituted in January 1990 and formally launched in March 1990. The Capital Markets Authority was created with the objectives of promoting, regulating and facilitating the development of an orderly and efficient capital market in Kenya. The functions of the Authority include:

- Developing all aspects of the capital market.

- Creating a thriving capital market by removing impediments to their development.

- Mobilizing savings for long term investments in productive enterprises by issuing corporate securities.

- Protecting capital market investors by ensuring orderly and transparent dealings via the establishment of an investor compensation fund.

- Developing an appropriate regulatory framework that ensures orderliness, fairness and efficiency in the issuance and subsequent trading of securities in the secondary market.

- Providing effective liaison between the private and public sector in all matters relating to the development and regulation of Capital Markets.

SELECTED AFRICAN STOCK EXCHANGES -COMPARATIVE DATA

Stock Exchange	Number of listed companies		Market Capitalization (millions of US $)		Value of Trading (millions of US $)	
	1988	1992	1988	1992	1988	1992
Zimbabwe	53	62	774	528	39	20
Ivory Coast	24	24	437	331	9	4
Mauritius	13	22	265	377	6	10
Morocco	71	62	446	1076	33	70
Nigeria	102	153	960	1243	5	23
KENYA	55	57	47	607	N.A.	12

Note: for Mauritius, 1990 instead of 1988

Source: International Finance Corporation

3. USAID Assistance to Stock Market Development

The effort to create a functional capital market, although focused on creating the CMA, also meant support of the Nairobi stock exchange which from 1954 has been the only stock exchange in Kenya. Until September 1993, when USAID/NSE executed a direct agreement, assistance to the NSE by USAID has been via CMA. The general purpose of the direct assistance to the NSE is to support the development of the capital market in Kenya. In particular it is to increase the number of investors using the NSE as well as the number of companies listed. This will be accomplished by improving the brokerage services of the NSE. As a result it is expected that more private companies and government parastatals will use it as the mechanism through which they can raise capital to finance the private sector in Kenya.

4. The CMA Project

1. This is a project component under the Structural Adjustment Assistance Program- Technical Assistance Project (SAAPTAP) AID project No.615-0240. The project Grant Agreement under which AID assists the CMA is the first Amendatory Agreement to the Project Grant Agreement between the Republic of Kenya and the United States of America for SAAPTAP signed August 19, 1988. The project Grant number is 615-K-607E. The total funding for "The Capital Markets Authority Component is $775,000. The funds for this Component were first budgeted at $600,000 and increased by $100,000 and then by $75,000 under successive amendments. The project assistance completion date for this component is December 31, 1993. The assistance was then taken over by the PEO and is to expire on September 30, 1994.

2. The purpose of the Capital Markets Authority component was to finance long term technical advisors to Ministry of Finance, and associated costs, to assist the GOK in the creation of a functional capital development authority as well as (funding) selected in-country consultants. Desirable policy studies would be identified and as feasible would be financed through the project.

C. Purpose of Evaluation

The purpose of this evaluation is to:

- Determine the impact of the project's assistance to the Kenyan capital markets and examine its effects on the Kenyan economy including employment creation.

- Assist USAID/Kenya to determine the best and most useful way to extending further assistance to the Capital Markets Authority and whether the assistance so far provided or any that might be contemplated can contribute to the private enterprise development objectives of USAID Kenya.

- Analyze the capital markets in Kenya and identify issues/problems that impinge on or have influenced (i.e. facilitated and impeded) in growth. Recommend how these issues/problems can be dealt with.

- Provide general lessons learned for USAID in how assistance to stock markets such as Kenya's may best be provided and assess (or critique) such assistance as a vehicle for development aid.

II. THE CAPITAL MARKETS AUTHORITY

A. Securities Act

1. Basic Rationale

1. Capital markets in general and equity markets in particular have two main inter-related components: the "new issue" or PRIMARY market, and the "trading" or SECONDARY market. The dependence of the secondary market vis-a-vis the primary one is quite clear, since shares traded on the former are first sold to initial buyers on the latter. The dependence of the primary market on the secondary one is equally important: the latter provides the liquidity which the primary market needs if it is going to attract large and steady numbers of purchasers for its new issues.

2. Given the ultimately separate nature of these two components, each tends to be "organized", in its own fashion and around different public and/or private institutions, and to be regulated or supervised in its own way. The nature and extent of the differentiations provides a rough indicator of the stage of maturity and of development of a capital market. It is not uncommon in emerging markets, for instance, for both components (primary and secondary) to be regulated and run by the same organization, normally a unit of the Government (most often a part of the Ministry of Finance). Even in more developed markets, where the two components have become clearly separated, the governing bodies of the central institutions of the secondary market (the Stock Exchange and the Clearing/Settlement entity) are often composed of Government appointees or comprise a significant number of such appointees, or are at least subject to some sort of formal or informal Government vetting process.

3. Each component thus has to face specific challenges and uncertainties. The major ones which confront the primary market (investors <u>and</u> issuers alike) concern the quality and quantity of the information available on the issue being offered to potential purchasers, with the competence, financial soundness and integrity of the various intermediaries which take the issue to market, and with the obligations or commitments which issuers assume vis-a-vis those who buy their shares.

4. These uncertainties are especially relevant for initial public offerings ("IPOs") since IPO issuers, by definition, do not yet have any <u>market</u> track record from which interested purchasers can draw investment conclusions. A subsidiary if important concern has to do with the quality and integrity of the secondary market where the shares at stake will be traded, and of the central institutions which manage that secondary market. In order to address all these legitimate concerns, rules and regulations have to be promulgated, requirements have to be defined, surveillance and compliance mechanisms and procedures have to be put in place, and appropriate penalties and sanctions must be made available.

5. It has been concluded in most jurisdictions that the above can be achieved effectively only through a special piece of legislation which will focus more or less exclusively on these complex issues (a "Capital Market" or "Securities" law). A central feature of such legislation is normally the creation of a governmental entity which is entrusted, with the mandate of supervising and regulating both primary and secondary markets, along with the required powers. The possibility of delegating these powers in whole or in part to selected capital market institutions, thus providing the legal foundations for a so-called "self-regulatory" process, can also be foreseen. The quality and scope of the law, as well as the credibility and perceived effectiveness and fairness of the regulatory entity, will all be key elements in meeting the uncertainties and concerns alluded to above. If indeed they cannot be allayed in a sufficiently visible fashion, the market will either not develop or its development will rest on crooked or at "best" manipulated deals, which in turn will thwart its effectiveness and growth. In either case, the capital markets will remain stunted: the financial needs of the country and of its economy will not have been met as they could.

6. The framing of that law, including the composition and mandate of the regulatory entity, is a delicate exercise which must balance several competing factors. It must also reflect and take into account the actual state of development of the capital markets themselves and of the broader legal and regulatory environment of the country. For instance, an overly detailed and heavy legal and regulatory framework could cripple the growth of a still embryonic primary market by forcing on it burdens which it is not yet in a position to face or even to finance (all regulations impose costs on the regulated). An unduly vague or ineffective framework, on the other hand, could retard the development of serious and competent public as well as private institutions capable of attracting and retaining both domestic and foreign equity capital: that would be an equally negative situation. Similarly, a regulatory approach which explicitly or even implicitly calls for a strong and independent judiciary when such does not yet exist runs the risk of proving at once irrelevant and useless, however complete and demanding it may appear at first sight. Such situations should be seen as challenges to be met (and they have been met elsewhere). They should not be allowed to be turned into convenient pretexts for legislation which does not meet minimum requirements or standards, for inaction or paralysis on the part of the regulatory entity, or for lack of progress generally.

7. It must also be underlined that a Capital Markets law does not exist in isolation from the rest of the legal environment of the country. On the contrary, it extends it and must build upon it. Yet, that broader environment may provide insufficient or even crumbling foundations on which to erect the desired Capital Market law "superstructure". For example, the country's basic Company Law may be old or even obsolete, imposing on all companies certain specific organizational forms or modus operandi which may be quite counterproductive from a capital markets point of view. Possible cases in point would be requirements that all shares have a fixed par value or that all shareholders enjoy strong pre-emptive rights when new issues of shares take place. Worse still, the broader environment may have features which inhibit the development or functioning of the capital markets. Thus, existing tax laws may in fact penalize the holding of equity instruments by taxing dividends more heavily than interest income or by providing for generous tax-free savings accounts; weaknesses in trust law may obscure the

concepts of "beneficial ownership" and make the transfer of ownership of capital market instruments legally uncertain or extremely cumbersome. The extent to which a Capital Market law should be used to rectify situations of that type or resolve these difficulties (thereby becoming a sort of "omnibus" legislation amending a number of existing laws) is a complex and delicate politico-legal issue, to which there is no ready or universal answer.

2. The Kenya "Securities Act"

1. Fully assessing a Capital Markets law may therefore prove much more complicated and demanding than may appear at first sight. The exercise could easily and legitimately be made to incorporate very wide ranging legal and socio-cultural variables and considerations which could take one quite far afield. The present Report takes a more focused approach, based essentially on an overview of "The Capital Markets Authority Act, 1989" (the "Act") and the very recently tabled Amendments to that Act. It will also be mindful of relevant "external" or "peripheral" considerations which will have been brought up in the course of discussions with market participants.

2. The Act is the result of a process which may be said to have begun with the Development Plan of 1984-1988, which called for development of capital and money markets. A study carried out jointly by the Central Bank of Kenya and the International Finance Corporation between April and June 1984--almost 10 years ago to the day--yielded a 105-page document dated 9 October 1984 and entitled "Report and Recommendations on the Development of the Money and Capital Markets in Kenya" Some of the recommendations of that Report are as follows:

> "It is recommended that a formal body to be called the Capital Markets Development Authority be established to focus on developing the market, and where needed provide usual securities regulatory measures" (pp. 40 and 41) (That the Authority's regulatory role is seen as a secondary, almost accidental, mandate is worth underlining.)
>
> "It is recommended that a Capital Markets law be adopted to establish the Capital Markets Development Authority, regularize the functions of the Stock Exchange, address developmental questions and authorize appropriate regulation as needed" (p. 51)
>
> "It is recommended that in order not to delay implementation of those recommendations which will not fall under [the] legislation, a Capital Market Development Committee be established (...) (p. 42)

3. The 1986 Sessional Paper re-affirmed the need for capital and money markets. In June 1987, the Government created a Capital Markets Development Committee (as suggested three years earlier in the IFC - CBK report) involving the Ministries of Finance and of Planning and the Central Bank, with the mandate of drafting a Capital Markets Authority Act. That Committee benefitted from USAID assistance in formulating its program of action and for securing technical advice. This led to tabling of the Act, which was passed by Parliament in 1989 and assented to in December of that same year and to the establishment of the Authority in January 1990. It

should be underlined that this is not at all a bad track record for the unfolding of as complex a set of policy, legislative and administrative initiatives as the one under consideration. This is the more so as it called for abandonment of entrenched (even if ineffective) previous practices, such as pricing of new equity issues by a formal Government body (such a body still existed in Malaysia until the recent enactment of that country's first Securities Act).

4. The Act is composed of six Parts, of which four are substantive. Part I is preliminary and provides definitions, including very extensive ones for "associated persons" and for "interest in securities" (these definitions are in turn crucial to the definition and prohibition of "insider trading"). Part II creates the Capital Markets Authority and defines its objectives, mandates and powers; it also creates an "Investor Compensation Fund". Part III deals with the approval and powers of Securities Exchanges. Part IV deals with the licensing of securities companies and of their personnel. Part V deals with transactions in securities. Part VI contains miscellaneous provisions. It also prohibits insider trading and defines various offenses as well as consequent penalties.

3. Weaknesses of the Act

1. It is not proposed here to offer an extensive or detailed commentary on the Act. It may nonetheless be relevant and useful to note that the Act is somewhat deficient in several respects.

2. First, ***the most significant deficiency is that the Act does not satisfactorily address the issue of distributing securities to the public.*** This is a fundamental consideration in the regulation and organization of the primary (or "new issue") market in general, and of the IPO one in particular. Furthermore, since one is dealing here in considerable part with private and still unlisted companies (thus not yet subject to supervision by a stock exchange or similar self-regulatory organization) this is an area of regulatory activity which can be handled only by a Government agency. By the same token, the key concept of "full, true and plain disclosure" does not appear in the Act; the duties and responsibilities of issuers, underwriters and other intervenors in the primary market are therefore not defined nor are the rights and recourse of buyers of new securities.

3. Second, ***the Act does not define what a "public company"*** is (thus subject to the Act and to the jurisdiction of the Authority), how a "private" company becomes a "public" one, and what the "continuous disclosure" practices are which a public company must adhere to. ***It is reasonably standard practice for Securities Acts to devote a full Chapter, Section or Part (as the case may be) to the regulation of the primary market: that gap in the Act should be filled as a matter of some priority and urgency.*** This is the more so as a major development thrust for the country's capital markets will be a rapid expansion in the number of listed companies, which will in turn call for a sustained flow of IPOs. Yet such a flow, in the current scheme of things, could remain poorly regulated or with an unnecessarily weak regulatory framework reflecting the vagueness of the Act. New investors, many of whom would be first-time and relatively unsophisticated ones, would thus be left bereft of strong protection, while unscrupulous or incompetent issuers and underwriters would remain unchecked.

4. Third, *the Act is sparse about the two key institutions of the secondary (or "trading") market:* the Stock Exchange(s), where the actual trading takes place between members acting as agents or on their own behalf, and the Clearing and Settlement Institution, where trades executed on the floor (whether physical or electronic) of the Stock Exchange are cleared and settled between members of the Institution.

5. The Clearing and Settlement Institution is barely mentioned and then more or less in passing, which is unsatisfactory. Clearing and Settlement is where true and considerable financial risks associated with the secondary market are concentrated and handled--such as failure to deliver shares which have been sold, to deliver funds for shares which have been bought, or to submit invalid or stolen certificates. The credibility, efficiency and financial strength of the Clearing and Settlement Institution are vital elements for an active secondary market where investors will trade with confidence. *Therefore, the Securities Act should define at least in broad outline the capital, membership, structure, mandate and powers of the Clearing and Settlement Institution, as well as how it will be specifically supervised by the regulatory authority.*

6. A parallel set of considerations applies to the Stock Exchange itself, whether there be one or many. The capital, membership, etc., of the Stock Exchange should be defined. Furthermore, and of great import, a Stock Exchange is by its nature a monopoly organization, in that investors cannot access it directly but must deal through a member of that Exchange. That unusual (and potentially quite lucrative) privilege must be counterbalanced by a set of quasi-public responsibilities and duties placed on the Stock Exchange and on its members. In particular, the Stock Exchange and its members must be required to meet clear and stringent standards of competence, solvency and integrity, as well as prevented from abusing their position in the market. All these in turn have to be closely monitored by the regulatory authority. *While the Act (and also the 1994 Amendments) does address the issue of Stock Exchange licensing and supervision (art. 19-22 incl.), the treatment is most succinct;* by way of comparison, more "legislative" space is devoted to the definitions of "associated persons" (art. 3) and of "interest in securities" (art. 4) than to the mandate etc. of Stock Exchanges.

B. The Kenyan Securities Commission

1. The general underlying philosophy of the Act is to have in place a strong regulatory body (the Capital Markets Authority), provide it with considerable powers and then allow it maximum flexibility to do its job through the more or less untrammeled issuance of rules and regulations. The Act is therefore more an enabling legislation than a comprehensive blueprint or road map of what may or may not be done and by whom; much less does it offer clear, precise constraints, requirements or choices.

2. If one imagines a "legislative flexibility continuum", *the Act would certainly be placed towards its "most flexible" end.* Such an approach is most certainly not illegitimate, but it carries certain inherent risks which must be recognized and guarded against, as will be noted below.

- *It can be argued that a first Securities law should not plunge head first into a full blown set of rigidly detailed requirements and practices, and impose micro-managed models* (by necessity imported since local ones do not yet exist) which may well prove poorly adapted to the actual realities of the capital markets. In such a context, taking into account the fact that rules and regulations are inherently more flexible and adaptable than laws, and thus can be much more readily amended if they turn out to be mistaken or counterproductive, the general philosophy noted above can be defended.

- *It must at the same time be recognized that such an approach does place a heavy responsibility on the Authority,* which finds itself obliged to proceed without any substantive guidance to speak of from the legislator, save that it can and must regulate. Furthermore, the Authority is essentially supreme, in the sense that the Act does not allow for much of a supervisory or other role for the Minister responsible, nor does it foresee appeals except to its own Minister from its rulings and decisions. These, as well as the underlying rules and regulations, must therefore be very carefully considered since they will to all intents and purposes be "final".

3. The Authority thus finds itself in a position which is continuously challenging as well as exposed. The difficulties inherent to that particular legislative design were aggravated, as far as the newly established Authority was concerned, by the fact that it had quite literally to start from ground zero in all respects, whether administrative or substantive, and without the benefit of much (if any) previous local experience or body of knowledge in its many mandated areas of intervention. Yet its initial decisions, which were eagerly anticipated, would be critical in establishing the new Authority's seriousness, competence and credibility. They were also bound to have a profound impact on the organization and structuring of the capital markets, and on the position of various powerful persons and groups within it. By the same token, they were certain to be controversial and subjected to much critical comments, both positive and negative. It can be argued not unreasonably that the Authority was faced with a situation akin to the crossing of an uncharted mine field: should caution and deliberateness be the order of the day, or should one charge forward with regulations and decisions blazing away, as it were, in all directions?

4. *The challenge confronting the Authority is compounded by the organizational structure chosen for its governing board by the Act* (see Appendix--for more details).

- The CMA is a large and heterogeneous body composed of 11 persons of varying backgrounds and tenures, and serving on a part-time basis only (save for the Chief Executive.) At the outset and by definition, none of them had much if any knowledge or expertise in the complex field they were designated to regulate. They all had to learn while on the job. Its non-executive Chairman (owner of an IBM franchise) is appointed by the President of the Republic on the recommendation of the Minister responsible; three senior public servants (or a specifically designated alternate) serve ex-officio (Treasury, Central Bank, Attorney-General Chambers); six "lay" members are appointed by the Minister for renewable 3-year terms; the chief executive of the Authority is also appointed by the Minister but without fixed term or any security of tenure.

- The Authority meets once a month and all decisions are taken by majority vote of those present, with the quorum set at 50% of the membership. ***This is a ponderous structure***, clearly designed for deliberate and consensus oriented rather than swift or expeditious decision-making. It does not appear particularly well-suited to dealing with fast moving events or markets, or to handling in timely fashion highly technical, if not indeed arcane, capital market and regulatory issues. It also makes for very complex dynamics between the governing Board and the Chief Executive, who is in some ways more its servant than its leader since the Board must approve his decisions before they become effective. It may be significant that the Chief Executive is not the Vice Chairman of the governing Board.

5. Further, ***the assigned objectives of the authority are very broad*** (as spelled out in art. 11.1 of the Act) and added to in the Amendments. They range from "the development of capital markets" and "the creation of incentives for longer term investments" to "the operation of a compensation fund". The breadth and scope of these objectives are considerable and they are not necessarily inter-related or mutually reinforcing.[1]

C. Assistance to and Outputs of the CMA

1. General Overview

1. Given the above, considerable outside expert assistance was needed in at least four areas: legal, regulatory, strategic, and organizational. Legal assistance was required to assist the Capital Markets Development Committee in conceptualizing and drafting the Act. Strategic advice was required to help the now established Authority in deciding how it was going to approach its market-building mandate. Organizational support was needed to bring rapidly its staff to a minimum size and level of competence, and then to upgrade it and enable it to learn from the experience of others. Regulatory help was required to assist the Authority in the conceptual and operational task of writing the vast body of rules and regulations called for by the act.

2. It is now possible, given the passage of time, to express some preliminary views on how these requirements were met and on the outcome of the assistance program.

- On the ***legal*** front, an Act was indeed drafted with expert assistance (and passed by the Legislature). It is commented upon above and more will be said about it in the various sections of this Report.

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[1] Again, it has to be kept in mind that these mandates were thrust upon an organization with little or no relevant experience or capability, and which has to operate within a young and struggling market. The Authority has thus been forced to create, to a large extent, the environment and institutions which are required accomplish of its mandate, and which it then has to regulate.

- On the ***strategic*** (and regulatory) issue a foreign advisor was provided. He counseled a "go slow" approach and that the Authority should first attempt to improve, through training and courses made easily available, what one might call the "human infrastructure" of the market (defined in its broadest sense), so that it might reach modest quantitative and qualitative levels.

- On the ***organizational*** front, space was found and furnished, staff was recruited and trained internally through study sessions and the like, and externally through numerous sponsored trips and seminars abroad (USA, Thailand, Malaysia, Korea, etc.) These trips and seminars are still on-going.

3. Such improvements (for instance in the analytical capability of the local financial press) were seen as conditions precedent to any worthwhile regulatory or developmental thrusts by the Authority. A strategy of that type, it was argued, was in any event the only practical one given the catastrophic economic and financial situation of the country, extremely high interest rates, and other contextual elements which together were seen as totally inimical to any real progress of the capital markets themselves. It was therefore useless, and may well have proven detrimental, to try and move them forward, while they were in such an enfeebled state, by "aggressive" regulatory pushes.

2. Regulatory Outputs: Strengths and Weaknesses

1. The regulatory output of the Authority, for its part, has been at ***once impressive and quite modest***, even though the markets have markedly recovered, from the difficult situation which had been used in part to justify the "go slow" strategy. There was reasonably early on a considerable, regulatory output embodied in the very extensive as well as comprehensive Ministerial Regulations and Authority Rules (altogether a 65-page printed document) of 19 November 1992. Since then however, and surprisingly, the regulatory output of the Authority has been negligible. It must be said at the same time that even partial implementation of the 1992 "package", given its all-embracing scope and degree of detailed prescriptions, can only have been a most demanding and energy consuming task for a young and inexperienced organization.

2. The initial regulatory package is, as mentioned above, composed of two parts: a 22-page Ministerial Regulation (including 14 pages of prescribed administrative forms) and a 43-page Authority Rule (including a 5-page substantive Schedule on take-over offers) which both cover essentially the same grounds but at different levels of details. The latter document has a section on "Take-overs and Mergers" which does not have a parallel in the Regulations.) The general division of labor between the two documents is that the Regulations aim at stating "<u>what</u> has to be done" while the Rules try to define "<u>how</u> it will be done".[2]

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[2] To take only one instance, Art. 9 of the Regulations states that "A securities exchange shall make public its transactions in such a manner as may be required by the Authority". Art.

3. On the *positive* side, the Regulations go some way towards remedying the deficiencies of the Act which were noted above. They are, for example, much more forthcoming on the organization and responsibilities of stock exchanges (Part II, art. 3 - 12 inclusive) which must not distribute their profits nor restrict their membership, etc. They touch on most important issues directly affecting the capital markets: stock exchanges, licensing of brokers and other intermediaries (firms and individuals), investment advisers, primary market, off-exchange transactions, complaints and compensation. This they achieve within the general philosophical bias of the Act itself, namely by delegating (in predictably much more detail than the Act) regulatory and enforcement powers to the Authority, but still without, generally speaking, offering much in the way of guidelines or principles.

4. On the *negative* side, the Regulations:

- Remain silent on the Clearing and Settlement Institution, on delegations of authority to SROs, and on self-regulation in general.

- Have markedly little to say on the primary market, to which they devote a mere 3 out of a total 34 articles. Indeed, listed companies are not even obliged to disclose material information to the Authority (art. 32).

- Do not clarify either the decisional hierarchy, if any, which exists between the Government, the Minister, the Authority, and other parties or groups, which, as will be seen later, could become a serious question.

- Have nothing to say on the important policy issue of the required initial and continuing capital of securities firms, which is presumably left entirely to the discretion of the Authority[3]

5. The Authority's ***Rules*** are considerably more detailed than the Regulations on which they expand. The Rules discuss at considerable length the important topic of the primary market. The requirements are quite standard, but have to accommodate the standard form to an unusual situation in the local capital markets which is the absence of "underwriters" (in the North

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8 of the Rules then goes on to require that the securities exchange publish daily and monthly lists of transactions in a clearly specified format.

[3] Art. 16.1 simply states that "every broker or dealer shall at all times maintain such liquidity ratios and net capital (both otherwise undefined) as may be specified by the Authority". One then has to read Form 4 to discover in the fine print that a bank guarantee or deposit of KShs 500,000 has to accompany the application for a license as a securities firm. That is not the same, however as permanent or net capital.

American sense of the term.)[4] [5] This they do effectively. The Rules may in fact be guilty of some excessive detailing, which must by way of necessary consequence put correspondingly heavy monitoring and surveillance burdens on the Authority itself.[6]

6. The Rules also expand at considerable and justified length on the books and records which have to be kept by securities firms, on the stringent prudential and financial limits to which they are subject in their trading operations, and on the modus operandi of investment advisers.4

7. *If and as* (all regulatory requirements have to be so qualified) ***these several requirements become reasonably well met, the capital markets will unfold within a sound and more than adequate regulatory framework. The Authority, on the other hand, will be extremely busy and*** will regularly find itself buffeted by conflicting forces. Nor should one underestimate the considerable difficulty of putting in place the needed surveillance apparatus and of instilling in the capital markets that possibly alien compliance "culture" without which the apparatus, however well meaning, cannot be effective.

8. ***In any event, nobody should expect instant and full implementation of the whole complex of Regulations and Rules.*** Gradual build-up will be required and sustained regulatory pressure over a period of years, as well as strong symbolic interventions or gestures by the Authority, before overt as well as covert resistance begins to crumble and people realize that all these

[4] Application forms for new securities are provided by the issuer itself rather than by the underwriters. The issuer is also directly responsible for sending out prospectuses (previously vetted by the Authority) to prospective purchasers and for the allotment process. Oddly enough, underwriting is allowed (art. 31.3) and certain burden and duties are placed on the "managing underwriter(s)". At the same time, underwriting activity is exclusively restricted to <u>insurance companies</u> and <u>banks</u>, which are not otherwise regulated under the Act, Regulations, or Rules, while the underwriting commission has to be arrived at in "an acceptable (to the Authority) actuarial or financial risk calculation method".

[5] Underwriting is clearly an exceptional practice in the capital markets, as confirmed by participants, as well as a very expensive one: it is in fact perceived as a form of "insurance" against a disastrous share issue, not unlike fire or casualty insurance. It is therefore ideally to be dispensed with if at all possible. More will be said about this in other parts of this Report.

[6] To take one example, article 2 of the Rules states that a securities exchange shall make rules on 22 different topics, including among others listing and delisting. Part III of the Rules (entitled "Listing Rules"), after stating in art. 9.2 that the Authority can require the exchange "to adopt any rule or guideline which it deems necessary", goes on to enumerate in art. 9.3 a further 12 specific items which should be in the exchange's listing rule (which the Authority will also have later to approve formally) leaving very little leeway for the stock exchange to devise its "own" listing rule.

bothersome Regulations and Rules are "for real". In that context, the Authority's decision not to allow the IPO of the extremely well connected Trade Bank (since defunct) has to be applauded as an excellent and auspicious start, almost a test by fire.

D. Future Development Efforts of the CMA

1. On the development side of its mandate, the Authority has to move simultaneously on several interrelated fronts.

1. Creating and Maintaining a Level Playing Field

1. A "level-playing field" has to be created and then maintained for the capital markets. This involves an identification of the major impediments to further development of the markets which it is in the direct or autonomous power of the Government to correct. Such impediments will generally be legal, regulatory and fiscal, and will be found in a wide variety of statutes and administrative practices/decisions. Once they will have been identified and prioritized, corrective measures should be defined and put forward for consideration. At the same time, a watching brief has to be put in place in order that future laws and regulations, to the extent possible, do not purposely or unwillingly introduce new obstacles.

2. Considerable progress has already taken place on that score, in part because of "lobbying" by the Authority. For instance, dividends and interest payments now enjoy the same tax rate (if one excludes apparently inconsequential tax-free interests from limited Postal savings accounts); double taxation of dividends has been effectively abolished with the introduction of a 10% "final" withholding tax, etc. The absence of any form of capital gains tax (whether direct or through adding some portion of these gains to ordinary taxable income) has to be underlined as an unusually strong incentive for both companies to go public and savers to invest in listed shares (whether IPOs or simply new issues of already listed issuers).

2. Attracting More Listings

1. Steps have to be taken on a priority basis to attract more listed companies to the market. The reasons which private companies fall back on to explain their lack of interest in going public will have to be identified and dealt with. A concerted campaign, involving the Authority (perhaps the Government itself), the Nairobi Stock Exchange and the more aggressive members of the brokerage community, will have to be mounted with the clear goal of overcoming that resistance.

2. However,

- It should be kept in mind that it cannot be in the purview or power of a regulator, however mandated and well-meaning, to force private companies to go public and become listed. There are inherent limits to what the Authority can do and this is one of them.

- The general principle should be established that no direct subsidies or grants will be given to companies which elect to go public or to investors who buy their shares. The fact that hitherto private, indeed secretive, family companies would have to open their books to public and particularly tax scrutiny is normally anticipated with a great deal of trepidation by those concerned. Subsidies will not allay those fears and will moreover introduce needless distortions in the capital allocation process. Public scrutiny of public companies is an inevitable "cost" of going public and is indeed central to any legitimate capital market process.

- Tax issues and specifically the taxation of previously undeclared corporate profits (thus likely to attract penalties in addition to the taxes themselves) which become visible when a company goes public and opens its accounts, can be handled in a variety of positive ways without impugning unduly the integrity of the tax system.

3. To attract more firms to the market, the Authority can and should put in place a regulatory process which is sufficiently "user friendly" and does not turn into a deterrent, however subtle, to the development of markets and to IPOs. In the last analysis, the roles of "regulator" and of "developer" cannot coexist forever within the same institution: one cannot push and pull at the same time. As time moves on and as markets develop, the personality of the "regulator" will have to become the dominant one, but never to the point of insensitivity to the ever changing requirements of markets. We are far from that point yet and the Authority will have to keep an effective balance between "pushing" and "pulling" for some time still.

3. Strengthening Clearing and Settlement

1. A major challenge facing the capital markets is the reorganization (or perhaps more appropriately, the organization) of the now entirely informal clearing and settlement system, and the concurrent and related improvement in the share registration system.

2. This will call for setting up a reliable clearing and settlement institution. That topic is discussed further in the section of this Report which deals with the Nairobi Stock Exchange. As that discussion will hopefully make clear, the clearing and settlement issue has to be dealt with as an institutional priority: ***it may well be the most important matter which will have to be correctly addressed in the next year*** or so in the context of expanding capital markets.

3. Given the central importance of sound clearing and settlement for capital markets generally (equity as well as fixed income) the Authority will inevitably be drawn into the debate and will have to assume a leadership role in its resolution, taking into account the fact that there is no relevant technical expertise available in the country at the moment (for obvious reasons!). The further fact that the Act, the Regulations and the Rules are all essentially silent on the topic means that the clearing and settlement institution will have to be set up entirely under the Authority's general developmental and regulatory powers, and without any guidance from the legislator. Here again, the Authority will have to work in virgin territory.

4. Maintaining the Quality and Effectiveness of Regulatory Implementation

1. Since the Authority's publicly available output has been simultaneously extensive and slight, it is not easy to assess the true quality and effectiveness of its regulatory performance or the extent to which it has bolstered the clear intentions of the Act (and of the Regulations) regarding for instance confidentiality of information, curbing of insider abuse, and transparency and competitiveness of markets and of the securities industry.

2. It is even less possible to form a final view on the enforcement philosophy, capability or effectiveness of the Authority. All these are currently at an essentially normal and expected embryonic stage. Experience elsewhere, as well perhaps as common sense, suggest that enforcement will initially be fairly weak and that time as well as the gradual accumulation of both expertise and experience (and possibly other factors) will be needed before the enforcement impact of the Authority is felt on a day-to-day basis and through the occasional "dramatic" ex post gesture.

3. This makes it more important to have in place from the outset simple but adequate and well monitored entry or ex ante requirements for active involvement in the capital markets, whether it be for companies which want to go public, for securities firms which want to open their doors or for individuals who wish to enter the brokerage industry. The 1992 Regulations and Rules provide an entirely suitable, if not perfect, framework to that effect. If they are well publicized and implemented in a reasonably efficient manner, they will go a long way towards preventing the most egregious (and thus immediately damaging) forms of abuse.

5. Educating the Public and Responsibly Promoting the Stock Exchange

1. The issue of the proper role of a supervisory and regulatory body like the Authority in educating actual and potential investors is a delicate one: the Authority should proceed with caution and not move too boldly in that area, as it seems intent upon doing. The reasons for this caution are:

- Investing in shares embodies real risk which should not be assumed indiscriminately by one and all, even when one is looking at shares of "senior" (and presumably "safe") companies;[7]

[7] It is enough here to recall the famous initial public offering of Nippon Telephone and Telegraph whose shares, after a few short weeks of upward movement, settled for the next few years into a pattern of apparently inexorable decline to less than one half their original cost. Similarly, first time buyers of IBM two years ago, when it was trading above $150 and strongly recommended by many serious analysts, have now lost almost two-thirds of their investment (and at a point had lost three-fourths).

- From an educational point of view, the major message from the Authority has to be that ***direct stock exchange investments*** (as opposed to those which take place through pension funds and similar collective instruments) ***are but for a small minority of "well-to-do" Kenyans*** who can afford them, and that even those should proceed with care.

- Forceful and broadly-broadcasted investment messages from the Government appointed regulatory body and watchdog can only convey to the population at large the lasting impression that investing in shares (and especially in IPOs) is not only safe and certain to be profitable almost overnight, but also is somehow strongly endorsed by the Government and therefore implicitly if not explicitly guaranteed by it. That is a good and well tested recipe for considerable grief for all concerned (including the Authority, its Minister, and the Government) at a later date.

2. Such a promotion is better left to those who stand to benefit directly from it: Stock Exchange, brokers, underwriters, and so forth. ***The substantive and unique responsibility of the Authority, in that context, will be to watch these promotional efforts,*** put them into proper focus, this is an important, and at first sight contradictory, facet of the legislatively prescribed promotion mandate of the Authority.

3. The Authority has an important promotional role to play, especially in the formative stages of the capital markets. But its major thrust should be to fully inform those who enter the market of their rights as investors in the primary market and as buyers/sellers in the secondary or Stock Exchange one, and to make it easy for them to exercise or satisfy these rights in practice, especially when it comes to the inevitable complaints against entrenched institutions or interests. That must be particularly the case for emerging markets, where the dice are in so many ways loaded against the smaller investor, and where SROs, when they exist at all, are still fledgling bodies unsure of themselves or simply not much interested in the effective enforcement of their own rules against themselves. In such a context, the one entity capable of ensuring a minimal degree of real as well as perceived fairness in the market is the regulatory authority.

4. At the same time, we must remember that "fairness" is an essential ingredient (over and above any ethical considerations, important as they are) for the sustained growth of markets: unfair and manipulated ones will in fact neither prosper for long nor attract or hold quality investors. Providing increasing amounts of "fairness" in the market must therefore be a major and singular contribution of the Authority to its own developmental mandate.

- Hence the importance for the Authority to move ahead quickly and forcefully with its Committee on Shareholders Complaints. The establishment of that Committee is in many ways more urgent, and will prove more relevant, than organization of the Investor Compensation Fund.

- That latter body is almost certain to get bogged down in interminable, and discrediting disputes when it begins operating. That will be even more so when the Fund will be called upon to pay out funds to aggrieved clients, with the consequent necessity of having to be replenished by disgruntled market participants who will have done nothing wrong but will still end up forced to more money to the "benefit" of incompetent or crooked competitors and their speculator clients.

6. A Final Challenge: Dealing with the Political Environment

1. A final, potentially more damaging challenge looms ahead for the capital markets and for the Authority. In fact it may already be upon them. There are indications that politics, which many observers have noted seem to be gaining since the introduction of multi-partyism, is starting to affect the capital markets. Its institutions and intervenors are increasingly characterized by one another as belonging to this or that "group" and accordingly treated with deep suspicion or complete distrust. There are signs of creeping systemic paralysis with important or urgent decisions continuously postponed or else taken for reasons which are seen as narrowly partisan in nature rather than in thoughtful answer to the needs of the market as a whole. While capital markets are not above politics by any means, their excessive politicization (and consequent polarization a la political system) makes it difficult if not impossible for their various component parts to work together and with the Government of the day. However, such cooperation is as essential as it is fragile. If it is important to the smooth functioning of already mature markets, it is even more critical for a young market which is going through a delicate "emergence" where so many things are just waiting to go wrong and derail the whole process.

2. The required confidence and trust cannot be expected to appear spontaneously as if by magic. They will have to be returned through carefully selected joint endeavors and common projects. Some such endeavors and projects are suggested in the Report and a few are highlighted in the recommendations for the USAID programs. A conscious attempt has been made to keep these suggestions concrete, down to earth and non-controversial so as to make them "reasonable" in what is an otherwise delicate context.

APPENDIX TO CHAPTER II
Organizational Structure of the CMA

1. The Authority is composed of four departments: Operations, Secretariat and Legal, Financial Analysis, and Economic Research (still inoperative.)

2. These departments purposely do not have professional support staff of their own. Instead, and in order to foster a joint approach to problems and issues, their heads draw as needed on a multidisciplinary pool of some 30 professionals (accountants, lawyers, economists, etc.) including 2 trainees and 10 who are "graduating" from various courses. The rest of the Authority's 50-strong complement is accounted for by secretaries, messengers, etc. There is no deputy chief executive; coordination is achieved through a Senior Management Committee chaired by the Chief Executive or, in his absence, by the Director of Operations.

3. The Authority operates through two major regulatory vehicles: Regulations proper, which have to be signed by the Minister and which say "what" has to be done, and Rules, which are signed by the Chairman of the Authority and support or detail the Regulations ("how" it will be done); both are first discussed and approved by the Authority before being sent to the Minister or the Chairman for signing. The legal drafting of these documents is done by the Secretariat and Legal department and vetted by a legal officer in the Attorney General Chambers for conformity with other laws and statutes.

4. All ***surveillance and enforcement*** activities and responsibilities lay within the overall responsibility of the Operations Department, including oversight of the Stock Exchange, licensing and supervision of brokerages and brokers, and handling of complaints from the public, whether from trading or new issues. The major investigative action so far has dealt with the CMC affair and is not yet completed. The ***Secretariat and Legal Department***, as it names indicates, handles meetings of the Authority, prepares and circulates agendas and minutes, drafts regulations and rules based on "policy" positions prepared by the line Departments concerned, etc. The ***Economic Research Department*** is currently headed on an ad hoc basis by the Advisor to the Authority. Once operational (a two-year search for a Director has been unsuccessful so far) it will do what such departments normally do. It will also be responsible for the Authority's planned Financial Information Center, where the public will have access to a range of information on the economy, companies, and markets. That Center, which was supposed to be in place on the fifth floor of the Authority's premises some months ago, is now "scheduled" to open before the end of the year. How it will relate with the Information Center which the NSE also proposes to set up remains to be seen.

5. The ***Financial Analysis Department's*** major mandate is to review draft prospectuses for new issues and to monitor compliance of listed companies with the Authority's regulations and rules and also, curiously perhaps, with the listing requirements of the NSE as (to be) approved by the Authority. Draft prospectuses, once they are in appropriate shape, are submitted to the Chief Executive for his review and then to the Authority itself for final consideration. There is an

unofficial commitment, which seems to have held so far, that the whole prospectus analysis process will not take more than five or six months: such a time-table may be acceptable during an organizational and learning period, but will clearly (and soon) have to be considerably shortened in the normal course of events, and even more rapidly so if new listings are to be aggressively wooed. While the 1992 Regulations and Rules deal extensively but in technical language with IPOs and subsequent share offerings, the Authority has published a simplified 13-page booklet entitled "Procedures and Guidelines for Companies Going Public" which is widely available. There seems to be as yet no agreed upon or prescribed allotment procedures for IPOs and new issues. A Public Relations Officer has just been hired and will be attached to the office of the Chief Executive. That person will be responsible for the multi-faceted investment education program which the Authority has been intending for some time already to launch on a nationwide scale.

6. A professional staff of thirty and executives should be sufficient for the supervision of a tiny stock exchange, a small number of small securities firms, and a few new issues a year, now that the "crush" of writing the initial regulations and rules has been over for some time. ***The challenge then becomes to keep these people in place*** (so that scarce accumulated expertise, small as it may be, is not lost) and to ***continue upgrading their skills.***

- An important step in that regard has already taken place in the recent re-appointment of the members of the Authority for a further three-year term.

- On the staff side, there will be a permanent "temptation" for the brighter or more dynamic ones to move from regulators to regulated, i.e. to brokers and other capital markets entities which will solicit them and offer vastly more interesting remuneration packages. That will be particularly the case if the market continues to expand and/or new securities firms are licensed by the Authority. A large or steady exodus of staff from the Authority could be devastating at this stage, as there is no second line expertise yet available, nor will there be much of one for some years.

- There is no easy or automatic way out of that quandary. The Authority might be able to offer less uncompetitive working conditions if it were self-financing and did not ask anything from the Treasury. There is no reason why it should not become so over the next few years, especially if the market expands, through a tiny levy on new offerings and on stock exchange transactions. Such a market-financed independence for the Authority might form the basis of a reasonable quid pro quo for the abandonment by the Government (which would no longer have to budget for the Authority) of the needlessly irritating stamp duty it currently collects on all capital increases, at least for listed companies and those going through an IPO.

APPENDIX TO CHAPTER II
Privatization

As was made clear to the writers in the course of preparing this Report, it does not appear likely that the unfolding privatization of State-owned enterprises will contribute many new listings to the market. This is not a surprising conclusion and may, in a roundabout way, prove quite fortunate for the Authority.

- The privatization of State-owned companies, wherever it takes place and whatever the context, must indeed be as much a political as an economic or financial exercise.

- Specific privatizations may not conform in all respects with the general "going-public" and other criteria laid down by the Authority in its various regulations and/or with the Stock Exchange's own listing requirements (themselves defined and approved by the Authority). Yet the Government may well insist, for reasons of its own, on these privatizations going ahead anyway.

Such situations, which have happened elsewhere, could put the Authority in very awkward positions from which it would not necessarily emerge with its credibility intact. One way of handling such a problem, should it be thought likely to arise, is *to have the Authority, or preferably the Minister, prepare a specific regulation providing a special regulatory regime for Government-sponsored privatizations.* In that way, the potential damage is circumscribed and contained, while the legitimate objectives and concerns of the State are taken into account.

III. THE NAIROBI STOCK EXCHANGE

A. Background

1. The Nairobi Stock Exchange ("NSE") was originally established as a private association and was restructured into a private limited liability company in 1990. An important element of its Articles of Association, for the purposes of the present Report, is clause 9 which sets out two excellent provisions:

- The company will not pay any dividends to its shareholders and all profits will be re-invested in the company.

- Personnel of member firms will not receive any remuneration, except for out-of-pocket expenses, when they serve on a NSE committee or carry out a task mandated by the Exchange.

2. The Act foresees that a Stock Exchange has to be approved by the Authority before it is allowed to operate and that the applicant must meet conditions set out in rules issued by the Authority; similarly for the Exchange's Articles of Association, by-laws, rules and regulations. Such approval has not yet been secured by the NSE (even though the relevant CMA regulations and rules have been outstanding since November 1992) and the six-month grace period foreseen by the Act has long since expired. Thus, ***at least in pure theory, the legal standing of the NSE is uncertain and it is operating without binding rules and regulations***, including clause 9 above.

3. ***The recently introduced Amendments to the Capital Markets Authority Act put further constraints on the NSE, which will consequently have to alter its statutes significantly.*** In particular, the NSE will have to:

- Reorganize itself into a limited liability company without share capital (thus the NSE will have no shareholders as such).

- Elect its Board of Directors in conformity with the Amendments. The Board will then have a majority of non-broker members--a not unusual situation. The Amendments also foresee a 90-day period for the NSE to arrange its affairs under penalty of automatic forfeiture of its license to operate. The Chairman of the NSE has since indicated that the Exchange will reorganize itself accordingly.

4. ***That legal vacuum, unsettling as it may be, has not prevented the NSE from forging ahead.*** It established an executive secretariat in 1991, from which the present management of the Exchange is issued, and has assumed the secretariat of the recently created Association of African Stock Exchanges. The company is organized into four divisions: Trading; Public Relations and Training; Finance, Clearing and Settlement; and Administration. It currently has a staff of some fifteen (compared to the Authority's 50) including two trading clerks who write

the 'bids'/ 'asks' and the 'fills' with colored felt pens on the trading boards during the daily morning session. ***The NSE has benefited from USAID*** assistance for the establishment of its first (and most humble) physical facilities as well as for training and publicity purposes. The Authority also made available its own US AID-funded expert advisor, who in fact devoted most of his time to the Exchange during his first 18 months or so.

5. It must be kept in mind that until it was reorganized in its present form the NSE was hardly a stock market at all.[8] Open trading, however, is in many ways the essence of a stock exchange. Moving from what was essentially that pseudo stock exchange to a "real" one, however tiny, was therefore a somewhat delicate exercise. It effectively called for the retraining more or less from zero (at least as far as trading was concerned) of the complete capital markets industry as it then existed. The industry also had to become convinced that the "new system" would be beneficial to them and that it could work; an actual trading room had to be built and brokers as well as stock exchange staff (recruited in the meantime) literally showed how to use it both in theory and in practice.

6. ***Such transformations require time and patience, and that is essentially what the Advisor devoted his efforts to during his initial period at the NSE.*** The acid test of the success of the transformation happened when the market took off in June 1993: the NSE and its members "held" and were able to cope. That is an accomplishment whose importance can hardly be overstated, and it provides the necessary foundations on which further developments can be built.

B. The NSE's Expansion Program

1. The NSE has now put together what can only be called an ambitious expansion program, under which it is moving to new facilities (9000 sq.ft) with a trading room capable of accommodating 100 traders and clerks and some 25 large trading boards, a public gallery and an auditorium each large enough for 100 persons, a dedicated clearing and settlement area, adequate office space, etc. It should then become possible for the NSE to structure itself in more or less standard fashion around the three major operational and regulatory functions (and corresponding rules) of a stock exchange: listing (which deals with listed companies), membership (which deals with member firms) and trading (which deals with how the shares of listed companies are bought and sold by members on the floor of the exchange). The capital

[8] The agents of its six "member" brokers would meet daily in a well-known downtown hotel and essentially confirm, on a roll call basis, the bid and ask figures for the various counters "listed". No actual buying and/or selling took place there or at that time between those agents, and the bid/ask figures tended to fluctuate little over the weeks and months. Once these confirmed ranges were in hand, the brokers called their established clients and enquired whether they might be buyers or sellers at those prices; if so, they tried to find the other side, also within their existing clientele. There was intact hardly any trading at all between brokers, and what trading there was between them took place in private.

costs associated with that move have been budgeted at KShs 22.3M (of which listed companies are expected to bear KShs 12M) and the annual operating budget has been set at KShs 17M (including salaries at KShs 5.2M and monthly rent of KShs 327K).

2. While none of these figures appear outlandish, they will represent a daunting financial and management challenge for the Exchange. To meet the KShs 17M operating budget for instance, assuming a relatively high transaction charge of 2 per mil (i.e. 2 shillings for each 1000 shillings trade) and a target of meeting 70% of the budget through that charge (with the rest coming from listing fees, more or less in line with international experience in that latter regard) the NSE would require an annual turnover of KShs 6B. That cannot be achieved if one extrapolates for the year the actual turnover (KShs 905M) for the first quarter of 1994. A similarly worrisome picture emerges if one uses the week of 13 June, which would also yield an annual turnover of less than KShs 4B.

3. At those levels of activity, ***the transaction charge would pay neither the anticipated salaries nor the rent.*** The NSE may thus find itself for a while in a struggling situation, not dissimilar from that of most small enterprises in their early days (which is what the NSE in fact is). ***There is no reason to believe, however, that the NSE should not be able to meet its budgets over time,*** using reasonable growth assumptions.

4. It is also planned to put in place a junior or "B" Board, to accommodate companies which do not meet the requirements of the senior or "Main" Board but are deemed capable of accessing the equity markets and of "graduating" later to the senior board. The low average value of shares traded on the NSE (see below) may make such a junior board a bit theoretical at the moment. The challenge in setting up a junior board concerns, in any event, much less the price of shares than the special types of investors, security firms, companies and regulatory regime which it calls for.

5. The growth of the NSE over the last two or three years has been in some ways impressive:

- There are now some 1 billion shares outstanding from 50 listed companies (of which however only around 20% are actually available for trading, the rest being closely held) with an average value of some KShs 80 per share.

- The Volume of trading has soared, albeit from a tiny base and still small in absolute terms.

- The market index has climbed quite dramatically (it more than doubled to 2,523 in 1993 alone and has almost tripled since June of last year.) As a mathematical consequence, the market capitalization has exploded from KShs 12B in 1990 to KShs 120B at the end of 1993.

6. These figures are quite impressive when one considers that they occurred during a period of high inflation, a monetary devaluation, an epidemic of damaging financial scandals, record interest rates, a freeze on donor funds, and unpredictable shifts in macro-economic policy. It is difficult for stock exchange to survive such a period. That the NSE was able to thrive and

expand is an achievement .

7. *The issue remains whether that growth reflects a real deepening and maturing of the market or is still in the nature of welcome but not yet truly substantial activity,* from which one should not draw instantly optimistic conclusions. That is a critical question, whose answer to will (or should) have considerable bearing on the contents and thrust of the NSE's development strategy. Without going into a thorough analysis of the question, it can be noted that over the same period:

- The number of members of the Stock Exchange did not rise.
- The staff still averaged some 12 persons each.
- The NSE developed neither research capability, retail clientele, nor underwriting/corporate finance expertise.
- The number of listed companies actually decreased (from 53 at the end of 1991 to 50 at the beginning of June 1994) even though the number of shares listed increased (from 668M to 1B).
- The number of market-related institutions did not change significantly, except for the appearance of some new Investment Advisors (which do not require any sizeable capital).

8. Thus, it is not wholly evident that the market has truly matured and deepened. It would be prudent, in that regard, to think of the NSE and of the capital markets institutional "complex" *as still being in their infancy and in need of nurturing rather than on the verge of joining the ranks of strongly emerging markets such as Thailand or even Indonesia.*

C. Areas in Need of Additional Work

1. A first concern is that the NSE's legal standing needs to be clarified. That should happen through the just tabled amendments to the Capital Markets Authority Act.[9] The almost necessary corollary is that the NSE's regulatory authority over its members will be lessened and its role as an SRO diminished (a situation not that dissimilar from what was noted earlier concerning listings and listed companies).

2. Second, the principle now seems clearly established that no licensed securities firm "may" (as the amendments put it) be refused membership in the Stock Exchange once it has paid the admission fee prescribed by the Authority. While this does open up the hitherto "closed" membership of the Stock Exchange, it seems to do so through a de facto abrogation of at least

[9] That the indisputably broad powers of the Authority itself proved insufficient to that task says something about the strength of the interests which were widely alleged to be opposed to the "reforms", at least as they were contemplated by the Authority.

some key elements of the NSE's own requirements as expressed in its forthcoming membership rule. The Authority will now be confronted with the important policy issue of deciding whether the Exchange should have a small or large number of members. It will answer either by stating its criteria for admission to the NSE or simply by de facto approving a smaller or larger number of NSE members without any overt rationale. An indication of its thinking may possibly be found in the 1992 Rule which calls for a minimum net monthly capital of KShs 100,000 for a licensed securities company--truly a very small amount and in reality an encouragement to wide entry. That may explain some of the reluctance or even the opposition of the more "established" members of the NSE, over and above the likelihood that the current size of the market cannot support additional brokerages. In any event, that is a policy issue which properly belongs to the Authority rather than to a private body such as a stock exchange.

3. Third is the size of the minimum capital which a member firm must have and maintain. This is linked to the first question in the sense that very high minimum capital requirements could be interpreted as "unfair" obstacles to entry into the securities business.

- One has to distinguish here between capital needed to secure a license as a securities firm from the Authority and capital required to join the Stock Exchange. The two can easily be different, with the Exchange's own requirements considerably higher and less capitalized firms having to transact through more strongly capitalized members of the Exchange.

- Such a system exists in many countries (in North America it is called a "jitney" or "introducing broker" arrangement) and can be quite profitable for all concerned.

- Here again, however, ***minimum capital*** of firms, which affects the solidity of the markets, the capital base of the clearing and settlement institution and the consequent risk level and size of the Compensation Fund, ***is a policy question which should be decided by the Government rather than left to the discretion of a private entity.***[10]

4. Fourth concerns the price at which an Exchange membership or seat should be sold. That

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[10] As indicated above, the Authority would seem to lean in the direction of an almost minimal capital requirement. This may be seen as a means to foster the "existence of a nationwide system of stock brokerage services", which the recent amendments to the Act have added to the previous list of "principal objectives of the Authority". The counterpart of such a liberal approach, on the other hand, has to be a very effective and strict monitoring of the capital positions of securities firms by the Authority and/or the Stock Exchange, since firms will have little if any cushion against errors, poor management practices or downright fraud on the part of their clients. They could thus easily run into serious financial difficulty at the first "adverse" blow, with severe consequences for the financial stability and indeed the survival of the Compensation Fund and of the clearing/settlement institution.

should be settled through market forces once the market for seats will have started to exist, i.e. when all authorized seats will have been spoken for. At that point, a securities firm wishing to join the Exchange will have to buy a seat from a current owner: the price of seats will therefore fluctuate with, and reflect, the fortunes of the markets themselves.

- On the other hand, it would be disingenuous to claim that a "market" for seats exists when their total authorized number is extremely limited (thus reducing supply) or if draconian conditions have to be met by would-be members (thus choking demand).

- ***Until a true market has appeared, available "treasury" seats should be sold at book value***, reflecting the contributions of current and past members to the actual situation of the NSE.

5. Fifth is the effective absence of corporate finance/underwriting (the two go hand in hand and are inseparable) capability in existing securities firms.

- The peculiar limited treatment given to "underwriters" in the 1992 Rules has already been noted. It is in all likelihood more a reflection of the prevailing situation than a statement of policy concerning that important segment of activity. There can be little doubt that the lack of underwriters must be detrimental to the process of bringing new companies to the market, as this is the specific task of underwriters and one which they normally pursue in very dynamic and profitable fashion.

- Without going into a "chicken and egg" analysis, ***developing corporate finance/underwriting competence has to be addressed as a matter of joint urgency by the Authority and by the Stock Exchange. It may well be that this will require "importing" foreign expertise*** by allowing foreign or joint venture securities firms and/or letting banks enter the underwriting area and the stock exchange. As mentioned later, those are far reaching decisions which should not be taken lightly.

6. A vibrant and competitive NSE, and its membership, will continuously demand progress on the various capital market fronts and stimulate the leadership capabilities of the Exchange. It will also, given minimally effective surveillance by the Authority and by the NSE itself within their respective fields, offer the best guarantee that clients (institutional and especially retail) will be sought after and well served on the one hand, and that new listings will be aggressively pursued, brought to market on sound terms and well treated by the Exchange on the other. ***A quasi-oligopolistic NSE membership, however, will be predictably lethargic on these several fronts***, from the activation of which it will have little to gain.

D. The Quality of Trading on the NSE

1. Market Illiquidity

1. The quality of trading on the NSE is a vital issue. As has been pointed out earlier, trading is at the very core of the secondary market, and stock exchanges exist in good part to provide

organized and supervised secondary markets (which in turn support the primary market and make its expansion possible). All stock exchanges large and small, the NSE included, must therefore continually strive to improve the quality of their trading.

2. Given the very short history of the NSE, and the difficulties inherent in ensuring quality trading even in the best of circumstances, ***one should not expect especially high order trading on the NSE floor; in fact, it will likely be quite some time before that can happen.*** That is not however automatically a cause for concern. The quality of trading on a stock exchange, other things being equal, is a direct function of the liquidity of the market, which itself reflects its degree of activity. An active and liquid market will be difficult to manipulate by definition. A broadly inactive market will by definition be illiquid and offer little opportunity for quality trading. Similarly, even within a generally active and thus liquid market, inactive counters will be illiquid and trading in them will be slow and difficult. A simple--simplistic even--measurement of activity is that two-thirds of all listed companies trade actively, on average, every day.

3. It is immediately clear that the NSE is not, by any reasonable benchmark, an active stock exchange and therefore cannot claim to provide a liquid market with quality trading.[11]

2. Curing Market Illiquidity

1. The fundamental cure for illiquidity will come from a broad based increase in the:

- Number of companies listed,
- Quantity of the "float" (i.e. the number of shares actually available for trading),
- Number and level of activity of investors.

2. The need for corporate finance/underwriting expertise and for aggressive brokerage activity, in that respect, has already been underlined. Many straightforward and inexpensive measures, which do not need to be spelled out in detail here, can also be taken by the NSE and its

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[11] To illustrate that point, one may note that there are at the moment more shares traded in one day on the Jakarta Stock Exchange than there were during all of last year on the NSE (a banner year). Equally interesting is the fact that fewer shares were traded daily in Jakarta at the beginning of 1989 than here today. At the same time, and perhaps even more telling, the Jakarta Stock Exchange is still considered a basically illiquid market by comparison with some other South East Asian ones (particularly Thailand, Malaysia and Singapore), while the latter are judged as offering quite unsatisfactory liquidity by New York or London standards. Activity and liquidity are thus, to some extent at least, relative rather than absolute concepts and have to be assessed in part within the context of competing stock markets. No one will claim that the NSE is, or should aim at, competing with the NYSE, the LSE or the SET; from that point of view, the NSE does not fare at all badly in its immediate East African context or in its broader African one.

members to affect the above factors and gradually improve the underlying situation.

3. At the same time, immediate and relatively simple steps, both positive and negative, can be implemented to improve current *trading* practices.

- No "book" or reserve of buy/sell orders at various prices is currently shown on the NSE boards. It is therefore not possible to gauge the extent of buying/selling interests for a given counter (and estimate its liquidity).[12]

- The cumbersome way in which shares are made eligible for trading and the paper work involved could be streamlined and made much more "user friendly".

- A market commentary could be issued at the end of each trading day and made available to the written and electronic media. A monthly bulletin with comprehensive trading statistics and news from listed companies, including dividends and other corporate actions, could be published; such a bulletin has to be forwarded to the Authority in any event.

4. Several "negative" steps or impediments could be removed, such as removing from the Exchange list those counters which never or almost never trade and forcing listed companies which are months late in reporting their financial statements to meet the deadlines or face penalties. The NSE would clearly need support from the Authority if it were to act in such "aggressive" fashion.

5. The above short term measures do not form an exhaustive list. ***Even if they were all implemented tomorrow, they would not by themselves produce a truly liquid and transparent market. They would nonetheless yield visible improvements*** and expand the foundations which already exist and which, over time, will increase the level of activity in the market. There is indeed no reason to believe that there is not a good domestic demand for equity shares. Surveys carried out by the Authority support that view, while several recent issues have been well received and even oversubscribed. However, the market capitalization of the NSE, at its 1994 high, stood at a striking 50% of provisional 1992 market prices GDP. Even allowing for some growth in GDP during the subsequent period, that represents a very high and likely unsustainable ratio: the sustainable "maximum" is generally set at around 70%, which is the proportion observed in the USA over the years. The poor performance of the economy these last years may well be frustrating the potential growth of the capital markets. It is indeed unlikely that companies, confronted with stagnant or declining demand and a morose overall economic situation, would want to rush to the capital markets in order to raise capital for expansion or for

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[12] It should be easy to provide that important information once larger boards become available in the new trading floor. This would also make it possible to do away with the "three-day offer" mechanism for larger blocks. All trades could be in standard board lots only; incomplete lots would be traded on the odd-lot board by especially appointed traders. Spreads between bids and asks should be monitored and gradually narrowed.

altogether new ventures. By the same token, renewed economic growth will likely accelerate the development of the capital markets or at least provide a much more positive environment.

6. ***Increasing the number of listed companies is by any measurement a critical priority.*** In the current situation of scarcity of merchandise and limited liquidity, any significant increase in the demand for listed shares would cause an immediate and sharp increase in their price (and in the market index generally). That would in turn generate overly inflated price/earnings ratios quite disconnected from any financial realism. This sort of speculation-driven market inevitably ends in a correspondingly sudden and sharp correction that can be devastating both to securities firms, which would see their business dry up all of a sudden (some of them would probably go under), and to investors, who would see the value of their portfolio plummet.

7. The latter development could have particularly serious consequences if securities firms have been allowed to provide generous financing (or "margin") to their clients for the purchase of securities, even if these loans had been carefully monitored by the regulators (a difficult undertaking) and the margin regulations sternly enforced by the firms themselves (even more unlikely) The standard scenario here, which has been observed in other markets which allow margin trading, is for weakened investors not to repay their borrowings to their brokers, who then cannot honor their own bank loans, to say nothing of their mandated capital ratios, and are forced to close down by the regulator or simply declare bankruptcy. This in turn causes large losses for the banks involved, which find themselves in a very exposed position. In the meantime, continuing liquidations of portfolios into the illiquid market by both borrowers and lenders aggravate the market collapse, which leads to further losses for investors, brokers and banks alike.

8. Stimulation of trading activity, and particularly of speculative trading, must therefore be approached with caution. This applies also to potential trading by foreign investors, which is all too often imagined as a sort of panacea for all the ills (real and imagined) which plague the market. The behavior of foreign investor is however inherently more unpredictable and volatile, and thus more capable of significantly distorting (upwards and downwards) an emerging market. A similar line of reasoning applies to mutual or open-ended funds as opposed to closed-end ones, the "panic" selling of whose shares does not automatically weigh on the market as a whole.

3. Improving Clearing, Settlement, and Registration

1. Of the three "central" capital markets institutions mentioned above (regulator, stock exchange, clearing and settlement) the clearing and settlement one, being less visible to the public and less glamorous, is easily taken for granted or left unattended to. Yet, that highly specialized entity is as critical as the other two and in some ways the more complicated to establish and to manage. ***It also raises complex as well as technical policy issues concerning its appropriate ownership, capital and structure, which will have to be carefully considered by the Authority and by market participants.***

2. At the present time, there is no real "clearing" carried out in the market place. No one

body authoritatively tells members of the NSE what they have bought and sold to/from one another. and what precisely they will in consequence have to deliver to one another (cash and/or shares) on "settlement" (or delivery) day. As for the settlement itself, which is where cash (from buyers) and shares (from sellers) actually change hands, it is carried out on an informal, unsupervised and unregulated basis between the brokers concerned. The consequent registration of shares to the name of their new owners is for its part an unpredictable process at best which may require months before it is completed.

3. These are not necessarily causes for immediate alarm in a market where only a few thousand shares are traded every day and where everyone knows everyone else. ***As the market expands, however, such a situation will rapidly become increasingly problematic***. It will constitute an increasingly strong impediment and deterrent to the market's further development. In particular, it will present a serious obstacle to any significant participation by foreign institutions and funds, which must by definition be extremely concerned with these complicated technical/mechanical issues.

4. Creating a small clearing and settlement institution should be looked into in the near future. Any lull in trading should be seized upon as offering a window of opportunity for its establishment rather than as a convenient pretext for delaying it further. One of the first tasks of that institution, once it has begun operating in a modest fashion, should be to look into ways and means of improving the currently disorganized and unreliable registration process.

APPENDIX TO CHAPTER III
Role of a Stock Exchange in Capital Market Development

1. A functioning capital market does not consist of just one or two institutions such as a stock exchange and a securities regulator. While these two entities may be necessary to a functioning capital market (and may even suffice for an embryonic stage which may last for a considerable period of time), they are far from sufficient for a capital market which wants to serve as an efficient and attractive mechanism for mobilizing and allocating of savings. That will be the more so if the market intends to attract sustained flows of international capital and wishes to become part of the international network of capital markets.

2. In assessing a given capital market, then, one has to look first at the quality of its **central** institutions: securities regulatory agency, stock exchange, clearing and settlement entity. If these institutions are either lacking or seriously ineffective, one does not have to look much further and the first order of business will be to create and/or reform them, as the case may be. One then looks at the key **supporting** institutions: brokers, underwriters, transfer agents, registrars, custodians, accountants, lawyers, appraisers, etc., and assesses their availability, integrity, quality, competence and effectiveness. Concurrently, one analyzes the legal, regulatory, corporate and fiscal frameworks which underpin the capital markets and determines how supportive, complete and effective they are.

3. The above exercise is necessarily complex and laborious, and will not be attempted in this Report, whose the aims are more modest and focused. It is mentioned not only to remind the reader that capital markets are multi-faceted and evolving constructs, but more importantly to underline the crucial fact that an infant capital market (or a mature one, for that matter) can never rest on its first laurels. It must keep strenuously moving forward in its several interdependent parts and recognize that it will continuously have to face new challenges. Such progress in turn will be possible only if there is somewhere in the system a determined institutional "**champion**" which will carry on the struggle and devote its energies to the further growth and development of the markets. Absent such a champion, normal systemic inertia will tend to prevail and progress will be sporadic and disjointed or even grind altogether to a halt.

4. That champion could initially be, and often is, a Government body or a senior Government official (who could be the Head of that body) who takes it upon himself to play that role and becomes instrumental in getting the minimum number of new listings needed to get the Stock Exchange "going", as it were. For a variety of reasons some of which will be examined in other sections of this Report, ***leadership must nonetheless pass at some reasonably early stage to a more driven private entity: that is normally the Stock Exchange*** itself. Hence the importance of its being designed and operated in a sound fashion, as it will become along with its member firms (which must themselves be proportionately entrepreneurial) the main engine of the growth of the capital markets. If it falters because of a serious flaw in its structure, organization, finances or modus operandi, capital markets as a whole will suffer, and the progress which will have been secured on other fronts could be undermined. Consequently, what we might call the "quality" of the NSE is of considerable import.

IV. RELATIONS BETWEEN THE REGULATOR AND THE REGULATED

A. General Philosophy on the Relationship

1. The relationship between the "regulator" (the Authority) and the "regulated" (the NSE in this instance) hinges on two sets of considerations. Underlying these considerations is the extent to which a so-called self-regulatory ("SRO") model is recognized and applicable:

- First, the situation of the Authority and the extent to which it is autonomous and in a position to delegate any of its own responsibilities.

- Second, whether and how the NSE can receive any delegation and what it can achieve with such delegations.

2. As mentioned in an earlier chapter, the general philosophy of the Act is one of very broad principles accompanied by an equally broad delegation of powers and responsibility to the Authority. Such an approach, if it is to prove reasonably comfortable for the Authority, needs to specify the hierarchy of responsibility which is to exist between the Authority and the Minister responsible for the Act (the Minister of Finance) to which the Authority reports and answers. In other words, it is important for the Authority to know with sufficient precision the areas where it is "supreme" and may act without reference to the Minister, and which of these areas if any are subject or not to his later concurrence or disavowal;

- It should formally inform the Minister, consult with him, or obtain his previous approval.

- It is subject to binding ministerial directives which are reserved to the exclusive jurisdiction of the Minister or of the Government itself.

3. Similarly, there should be clear indications as to the decisions of the Authority which are subject to appeal, how and to whom. Finally, it would be useful to all concerned if the Act spelled out with sufficient clarity which powers of the Authority can be delegated, to whom, and how. This may prove particularly important if decisions or sanctions taken by an SRO under a delegated power were later to be challenged in court as illegitimate.

4. ***It appears that the Act is not entirely satisfactory in these matters, and that many grey areas remain.*** For instance,

- The only occasions when the Authority is required to consult with the Minister have to do with the approval of a stock exchange (art. 11.2.e) and of a unit trust or mutual fund (art. 11. 2.f.ii) (why this latter requirement, which is striking in its uniqueness, is not immediately obvious.) The Act is silent on any other type of relationship between the Authority and the Minister, except that the Minister may request the Authority to provide him with information on its work (art. 36.1), hardly an unusual or excessive request.

- The Act also gives the Minister the standard power to make Regulations (art. 36.1) but does not specify the role if any of the Authority in that respect. The Minister has in fact issued a set of substantive Regulations under the Act (November 1992) and upon the formal recommendation of the Authority. That particular procedure, as well as the practice that the Authority issues "Rules" rather than Regulations (these being reserved to the Minister) appear however to flow from practical rather than legal considerations.

- The Act also gives a right of appeal to the Minister (art. 35) from practically <u>any</u> decision and direction of the Authority; whether any or all subsequent ministerial decisions can in turn be appealed to the courts is not made explicit, although it could be reasonably assumed.

- Finally, the capability of the Authority to delegate to other bodies any of its own regulatory powers is far from clearly established in the Act. The only explicitly authorized delegation is to a "committee" appointed by the Authority (art. 14.1). Delegations to SROs, as well as the otherwise undefined concept of self-regulation itself, will have to rely on the broad statement in the "principal objectives of the Authority" (Art. 11.1) which includes in para. (b) "the creation (...) through implementation of a system in which the market participants are self-regulatory to the maximum practicable extent..." While that is interesting, it does not really say very much, nor does it offer a very solid hook on which to hang large scale delegations to SROs or the SRO concept itself for that matter.

5. One can conclude ***that the relationships between the Authority and the Minister should be clarified; similarly, the extent to which, to whom and under what conditions the Authority can delegate its surveillance and regulatory powers.*** If the latter is not defined in some clear-cut fashion, there is a real risk that a true delegation of supervisory powers to SROs (and the sought after self-regulation explicit in such delegation) may prove difficult to achieve in practice.

6. In any event, the Authority should consider suggesting to the Minister, in the absence of, or until, relevant amendments to the Act, a specific "Delegation Regulation" which would address that issue. Such a Regulation should define what is an SRO, prescribe the tests or qualifications which a would-be SRO would have to pass or meet before being awarded "SRO status", indicate the reports which the SRO will have to make to the Authority on the exercise of its delegated powers (including the circumstances when appeals to the Authority and/or the Minister will be authorized), give the Authority the power to audit the SRO and to suspend or revoke its status in specified circumstances, prescribe the sanctions the SRO and its officers will be liable to if they abuse their delegated powers or <u>fail</u> to use them when they should, etc. Preparing that Regulation is a reasonably delicate exercise which ought to be conducted in discussion with the potential SROs concerned.

B. The Extensive Powers of the CMA

1. If the respective roles of, and consequent relationships between, the Minister and the Authority remain somewhat vague, the same cannot be said about the relationships between the Authority and the Stock Exchange(s) it licenses. It is made quite clear in Part III of the Act, and

amplified in the recent Amendments, that stock exchanges are essentially under the thumb of the Authority. Article 12.1.a of the Act further specifically obliges the Authority to formulate rules to "regulate listings of securities on a securities exchange" while art. 11.1.p gives it the power to "regulate and oversee the issue and subsequent trading both in primary and secondary markets of capital market instruments". Yet, listing of companies and trading in their securities form the very core of stock exchange activities. ***The Regulations and Rules of 1992 expand upon and amplify these already broad provisions in almost minute detail. In fact, so all-encompassing is the potential supervision of the Authority that the stock exchanges it licenses could end up looking more like administrative extensions of the Authority than even modestly bona fide SROs.***

2. Such extensive powers may well prove impractical, unwieldy and, in the last analysis, not very useful because of their very extensiveness. Actually deploying them in practice would likely bury both the regulator and the regulated under an overwhelming mass of papers and reports to be produced, read, and acted upon in some fashion. The probable result would be more a paralyzed and passive stock exchange than a well supervised and dynamic one.

3. It is also difficult to see how such a microscopic level of sustained scrutiny, if really put into practice, could generate the climate of trust and cooperation which is essential if both the Authority and the stock exchange are to fulfill their respective and mutually dependent mandates. One should not forget, in that respect, that Article 11.1.a of the Act imposes on the Authority a very clear and strong mandate for the "development of all aspects of the capital markets". The stock exchange and its members, for their part, have a clear vested interest in the dynamism of these same markets, from which they draw their own living.

4. There is thus a commonality of interest between the two parties which calls not only for a "live and let live" attitude but also for something approaching a real partnership between associates which have distinct (and the distinctiveness is essential) but nonetheless complementary tasks to perform. This is particularly so in young markets where the imperative of strong but orderly growth is paramount. While growth at any cost (which can only be achieved through a speculative bubble) is ultimately self-defeating and cannot be accepted, built-in regulatory antagonism can also be saved for a later period. Hence, the considerable powers of supervision of, and intervention in, the affairs of the stock exchange (which are not that dissimilar from what may be found in comparable pieces of legislation elsewhere) should be seen as tools available and to be used selectively if, as and when necessary, rather than to be fully deployed and applied at once.

5. Inevitable conflicts and differences of views should be resolved through discussion and compromise rather than through heavy-handed diktats from the regulator or a confrontational, unbending attitude on the part of the stock exchange. In that context, the monthly meetings between the respective senior staffs of the Authority and of the NSE should be allowed to play an important role.

C. Delegating Power and the Self-Regulatory Issue

1. In the absence of the broad "delegation regulation" suggested above, the Authority will be forced to proceed by way of its own Authority-issued Rules. One might well be concerned here that the legal foundation for any such Rule, especially as it will claim to delegate to some private body the power of meting out potentially severe civil and/or financial sanctions, could be effectively challenged by affected parties.

2. As already mentioned, it is to say the least unusual for a private company to have the power of disciplining, fining or firing its own shareholders: it is normally rather the other way around, with the shareholders enjoying the power of chastising or dismissing the management. The Authority's delegation of regulatory power to the NSE (or to any other SRO) should therefore be very carefully circumscribed as to its object and modus operandi, and the enabling Rule as specific as possible.

3. It will be particularly important for the Authority, before it proceeds with any delegation to the NSE, to assess the extent to which the NSE will be able effectively to discharge that additional responsibility (it is currently nil) and to tailor the actual delegation to that capacity. It should be underlined here that one purpose of self-regulation is to simplify the life of the senior regulator as well as that of the ultimately regulated (a brokerage firm or an individual broker for instance): the latter must still end up dealing with only one regulator, albeit a different one and one presumably "closer" to him. If for instance the Authority delegates to the NSE the surveillance of the capital position of its members, those members should no longer have to send capital position reports (weekly, monthly, etc.) to the Authority: they will be forwarded only to the NSE, which must therefore have the capability (and determination) of dealing with them and of taking appropriate and timely measures whenever a capital deficiency is uncovered. On the other hand, delegation does not mean abdication: the Authority has no choice but to remain ultimately responsible under its Act irrespective of any delegation it may itself have made. A failure in the NSE surveillance of the capital position of one of its members, to stay with that example, must reflect on the Authority itself, which should not be allowed to hide behind the body to which it will have delegated a given task or responsibility.

4. Given the history and current situation of capital markets, of securities firms and of the NSE, all of which are still quite unused to any level of real surveillance, ***the Authority*** (which also still has to prove itself) ***should proceed with great caution as far as any significant delegation of authority is concerned.*** The NSE, which is the only existing entity with potential SRO status (the clearing and settlement organization, once it will have been set up, will be another one) has at the moment by its own admission no surveillance record or capability. It is therefore quite incapable of receiving any delegation from the Authority. It is furthermore likely to remain so for some time as it must first build up its own operational staff and capability before it takes on surveillance related mandates.

5. A conscious effort will therefore have to be made if the NSE's regulatory or SRO function is to develop. The Authority and the NSE should agree on a medium term program to that end with milestones and targets, including, at the appropriate moments, the transfer of trained Authority surveillance personnel to the NSE.

6. It must also be remembered that being an effective SRO is an exacting and in many ways an unpleasant as well as contentious job, which will periodically embroil the chief executive of the SRO in disputes, sometimes quite bitter, with his own members (and with the Authority, if for opposite reasons.) The NSE itself would thus be well advised not to jump head first into that thorny thicket and to concentrate initially on affirming its competence and reputation as a well-run, dynamic stock exchange. That will easily take a couple of years. In the meanwhile, it can well afford to leave divisive enforcement responsibilities to the Government body which was set up for that very purpose and which itself has to nurture its own capability and reputation in that crucial field of endeavor.

7. As was pointed out earlier, a stock exchange can become involved, however willing and effective it may otherwise be, only in the regulation of the secondary or "trading" market: the primary or "new issue" (and particularly "IPO") market escapes it entirely and by definition. That segment of the market must therefore become the area of particular concern and involvement for the Government mandated regulator, since no one else can intervene in it. The "regulated", here, will be the companies which come to the market and the underwriters who take them to it. It is difficult to visualize the emergence of one or more SROs at that level, unless a special category of "underwriters" and/or "merchant bankers" <u>not</u> members of the stock exchange were to be created (otherwise they would fall within the SRO "net" of the NSE.)

8. There are nonetheless important and continuing issues to be discussed between the Authority on the one hand and companies as well as underwriters on the other, having to do with the "going public" public process, the legal and ethical duties of issuers and of underwriters, and the protection and recourse of investors. It will be incumbent upon the Authority to organize the required dialogue and even possibly to sponsor the creation of Associations of Listed Companies and of Underwriters, with which the Authority will be able to interact even though these do not have formal SRO status.

V. PROJECT SUCCESS AND USAID'S CONTRIBUTION TO KENYAN CAPITAL MARKETS DEVELOPMENT

A. Objectives of the USAID Project

1. SAAPTAP was intended to provide technical assistance to strengthen institutions and for planning and policy analysis necessary for the implementation of the Structural Assistance Adjustment Program (SAAP), which was a major country objective for Kenya. "In addition" (to quote from an official document)[SAAPTAP] "was to assist the Government of Kenya in the creation of a functional capital market". That additional assistance was provided through a special project or activity within SAAPTAP's broad "Sectoral Policy Analysis and Planning" component, entitled "The Capital Markets Authority" and for which the Grant Agreement was signed in June 1986; the total funding of the project ultimately reached $775,000. It may be assumed that assistance to capital market development was not initially part of the technical assistance package. The purpose of the project was spelled out as "to finance longterm technical advisors to the Ministry of Finance, and associated costs, to assist the Government of Kenya in the creation of a functional capital development authority as well as [funding] selected in-country consultants. Desirable policy studies will be identified and as feasible will be financed through the project."

2. Taking a mechanical view of what has been achieved under the Capital Market Authority project, we see that:

- "longterm advisor" has been provided,
- A "functional capital development authority" has been created,
- "Desirable policy studies" have been identified and financed. ***Thus, the project has clearly met its objectives.***

3. One can conclude further that the start of a sound and reasonably well-formed capital market has been put in place and that with some additions, a bit of luck in the economic and market environment, and a modicum of care and advice, that market should grow quite nicely over the years, both in absolute terms and by comparison with its regional competition. Such an assessment does not however address the more fundamental issue of whether the project has contributed to the SAAP objectives themselves.

4. It must be noted first that functioning capital markets can be legitimately put forward as important and to some extent essential components of any structural adjustment program. Without going here into a long dissertation on that point, a key objective of any SAP is to reduce and role of the State in economic development and to correspondingly expand the role of the private sector. Effective and sound capital formation/allocation mechanisms are intrinsic to economic development. If these are no longer to be provided mostly by the State, or at least closely controlled by it, and are instead to be largely turned over to the private sector, capital markets have to be put in place as a matter of some priority, for they stand at the heart of any "private" capital formation/allocation process. Without the mechanism of functioning capital

markets, SAPs will not be able to proceed as smoothly or as effectively as they can and need to. To the extent therefore that Kenya did not enjoy effective capital markets (which was the case) it was appropriate for SAPTAAP to have a "Capital Markets Authority" component and project. ***The generally successful outcome of the project, for its part, has certainly and well contributed to the broader SAAP and country objectives.*** Even at a micro level, it has made possible a number of privatizations (irrespective of what may be thought about their scale and sufficiency) and will play an essential role in the few still to come.

5. The above analysis does not attempt to deny or minimize the complete validity of concerns about employment, income, foreign exchange earnings and receipts, etc., within the broad SAAP strategy. ***The setting up of capital markets does create some direct jobs*** (the Authority, the NSE, later the Clearing and Settlement Institution -possibly 70 in all so far), ***and a potentially much larger number of semi-direct ones*** as brokerage firms and market-related institutions expand and new ones are created (as is already happening); these also tend to have a reasonably high and "quality" multiplier, since capital markets call on a wide range of increasingly specialized professional services (lawyers, analysts, data and computer experts, accountants, printers of high grade security paper, etc.) over and above the indirect jobs included in a standard multiplier. Capital markets, especially (but not exclusively) in their initial stages of development, function through a rapidly expanding number and network of small and even very small enterprises. The stock exchange itself should remain a small business with less than 25 or so employees for quite some time and so will the Clearing and Settlement Institution, while most new brokerage and advisory firms will begin with a total personnel of less than 10 persons; supporting "low tech" service enterprises, such as messengers, reprography operations, etc. can start with similar or even fewer peoples.

6. All these employment impacts can be measured and experience has shown that a dynamic capital market is normally a high jobs-creating small business, which does not require any subsidies from the State. Capital markets nonetheless play a "deeper" role in structural adjustment and economic reform, which must be underlined and which in itself justifies a degree of support to their early stages of development, over and above the employment impacts of that support.

7. Finally, active capital markets make it possible for firms to raise new capital for consolidation and expansion purposes. Existing jobs are made more secure against economic downturns, new jobs are created, small suppliers appear and grow. Investors enjoy new wealth, part of which is spend on consumer goods, again fueling the economy and its "smaller" sectors. These impacts are all well documented and will not be developed further in the Report.

B. USAID's Contribution to Building Capital Market Institutions

1. As has already been noted, capital markets center around three "core" institutions: regulator, stock exchange, clearing and settlement institution. None of these institutions existed on any truly functioning basis when the US AID "Capital Markets Authority" project was conceived and later began; they therefore had to be "built" from the ground up. Now, as the project is coming

to an end (including its PEO-funded extension) there is in place a functioning regulator and a functioning stock exchange, both built up from essentially nothing, installed in their respective quarters and with a brief but nonetheless real history of visible accomplishments. While these accomplishments have been modest so far, it must be noted that the capital markets involved are themselves still modest. Furthermore, the building of institutions is a complex undertaking which can only be implemented (and tested) over a reasonably long time frame. This is not yet available, obviously, and a considered "final" judgment will therefore not be possible for quite some time. This leaves the commentator with two convergent lines of enquiry:

- Do the institutional foundations which have been put in place look like the right ones?

- Do they seem to be evolving (to the extent that foundations can be said to evolve) in the right direction?[13]

2. Institutional foundations have to do, in good part, with organizational structures. From that point of view, both the Authority and the NSE still have some initial--if different--ground to cover. (The clearing and settlement institution, since it does not yet exist even in a pre-embryonic stage will not be mentioned further in this section of the Report.)

1. Appropriate Institutional Foundations:

a. Concerns about the Capital Markets Authority

1. The Authority still suffers from an understandable excess of undifferentiation in some of its units on the one hand, while the immediate usefulness of some others can be questioned.

- A sharper distinction should be introduced between those matters which concern the primary or new issues market and those which concern the secondary or trading market

- More clearly defined organizational units of the Authority should then be assigned "total" responsibility for each group of matters.

- Conceptually then, there should be within the organization two "line" directorates: a "primary market directorate" and a "secondary market directorate".

The former would handle all matters which have to do with IPOs and new issues (including allotments), listed companies (including reports, disclosures, mergers and acquisitions), unit trusts and investment funds, and primary market-related investigations and prosecutions, plus new Regulations and/or Rules to be put forward concerning the primary market; as the capital markets expand, that directorate could gradually be split into sub-directorates dealing with

[13] The legitimate and important further question of what if anything should or could be done now, will be addressed in a separate section of this Report.

specific segments of its mandate.

2. The second ("secondary market") line directorate would handle all matters concerning the stock exchange (including trading issues), investment advisers, securities firms and their employees (including licensing, capital, etc.), the clearing and settlement entity (including the Compensation Fund), related investigations and complaints (including the Complaints Committee), and relevant new Regulations and Rules; once an SRO policy and operational framework will have been decided upon by the Authority, the directorate would implement it and ensure the necessary oversight of approved SROs. Here again, that directorate could eventually spawn a number of sub-directorates as the secondary market and its participants grow.

- Supporting these two line directorates, would be the standard Office of finance/personnel/administration, the Office of Secretary and Counsel (which could be responsible for overseeing the training and examination system already in place for brokers and investment advisors) and a Public Relations/Information Office.

- Whether the Authority truly needs at this time an Economic Analysis Department is far from clear and the resources conceptually allocated to that unit could well be transferred to the line directorates.

The above conceptual structure can function, at least until the activities of the Authority expand substantially, with the "professional pool" arrangement currently in place.

b. Concerns about the NSE

1. The structure of the NSE could also be more clearly organized, as suggested previously, into three line directorates in accordance with the three major functions (each defined and supported by a specific Exchange Rule) of a stock exchange:

- Listing
- Trading
- Membership.

2. Here again, each directorate should be responsible for the totality of the related activities of the Exchange, including supervision, complaints, investigations and discipline, and would relate to its counterpart unit in the Authority:

- The Listing directorate to the "primary market" one,
- The Trading and
- Membership directorates to the "secondary market" one.

3. The Trading directorate should be responsible on an interim basis for clearing and settlement functions until a separate specialized entity is created, to which its clearing and settlement personnel should then be transferred. Staff units similar to those proposed for the Authority

would be put in place, with the important difference that the NSE is a business enterprise which has to market its services to its various clienteles (and develop new ones as well.) It therefore requires a sales/marketing "unit" to take on that important mandate, and work closely to that end with member firms, other market participants and with the Authority. *That unit would also organize classes on "investing" for the general public as well as more advanced technical ones for market professionals*, produce relevant statistical and interpretative data, and various NSE publications.

4. It should be kept in mind here that a stock exchange is in theory as well as in fact a small business (indeed a very small business in the case of the NSE) which can and should be managed like one. That it is intimately connected to the capital markets may give it an exotic aura of mystery, but its reality remains quite straightforward and down to earth. In any event, the NSE will have to live within its income, and its budgets will be scrutinized and then watched carefully by its members.

5. The existing organizational structures of both the Authority and the NSE can be easily made to conform to the above "models" through relatively modest changes or additions. Both institutions are in fact almost "there" at the moment.

2. Issues Concerning the Evolutionary Growth of the CMA and the NSE

1. This leads us to the second question of whether the CMA and NSE are evolving in the appropriate direction from a substantive point of view. This is particularly relevant in the case of the Authority since it is an official body created by law, whose mandate and initiatives must have a profound and lasting effect on the evolution and progress of the markets. As was noted earlier, the Authority's basic law does suffer from some flaws, which have not been fully remedied (nor could they have) by the 1992 Regulations and Rules, and the recent Amendments to the Act. Since it is doubtful that the Act will be re-visited in the near future, the Authority will have to make do with what it has. That should prove, all things considered, quite sufficient, especially given the vast discretion which it enjoys at least in the abstract.

2. The next challenge that it will face concerns the much-delayed organization of the NSE and of the brokers which form it. The final decisions of the Authority in that respect are said to be imminent but are not completely in hand at the moment of writing. They will provide useful indications of the extent to which it will play a serious and constructive role, as opposed to a purely or excessively "political" one, in the development of the capital markets. A parallel situation obtains for the NSE as well, now that its long and acrimonious stand-off with the Authority has been brought to a conclusive end (in theory at least) by the Amendments to the Act and the concurrent licensing of seven new brokerages. It may thus be that the next few weeks or more likely months will be critical ones for the credibility of the two institutions, for the type of relationships which will obtain between them, and for the continued progress of the markets themselves.

C. Contribution of the USAID-Funded Advisor

1. *The USAID-funded longterm advisor to the Authority has played an important and fruitful role in these developments.* While no one can say with absolute certainty what would have happened if no advisor had been available, it does look extremely probable that much less progress would have taken place. The delicacy of the task that confronted the advisor has already been noted and should be underlined again: ***he had to convince the various actors to "create" a stock market more or less from nothing and then teach every one, regulator, stock exchange and brokers alike, how to make it work*** (and make money from it, at least for the brokers.) It was particularly fortunate that the advisor was able to spend a considerable amount of time, at the outset, at the NSE. That made it possible for him not only to help organize the stock exchange as a physical and functioning entity and train its members but also, and perhaps more importantly, to observe at first hand the real state of affairs in the capital markets. He could thus be guided in his later advice to the Authority by very concrete and empirical knowledge of the "real" situation on the ground.

2. It is unfortunate, at the same time, that the deterioration of the relationships between the Authority and the NSE (a development quite beyond his control) made his unusual but workable and very useful dual status increasingly untenable, eventually forcing him to curtail and then stop his work with the exchange. In all this, the advisor worked essentially by himself and without much outside substantive assistance (whether from USAID officials or others) as could be expected given the highly specialized and technical nature of his work as well as the unusual market and "political" circumstances in which he quickly found himself. ***It remains nonetheless that the training the advisor has been able to give***, either through his own informal seminars and courses (now systematized at the College of Banking into a curriculum for those who want to become market professionals) or through the multitude of seminars both here and abroad which USAID funded at his suggestion, ***and the market "philosophy" he has tried to impart, must still be merely skin deep***. They have been only slightly tested so far, although more so for the NSE which had to go through the market boom, and one cannot be certain that they will stand the tests both of time and of truly challenging market and/or regulatory events. It is doubtful whether the two institutions have matured sufficiently by now to be left to their own devices with confidence and allowed to face the forthcoming music on their own; it is likely that both would find the going very tough in policy terms as well as in technical and administrative matters.

D. Other Accomplishments and Contributions of USAID

1. USAID also provided funding for installing both the Authority and the NSE in their "new" quarters, with the Authority moving into former World Bank space from rather poor accommodations which the NSE then settled into as it became a physical entity for the first time. In neither case can one talk about luxurious, ostentatious, or visibly over-equipped facilities, almost to the contrary.

2. ***There can be little doubt that the assistance to the NSE was particularly critical to getting it off the ground at an early date.*** One can well imagine that the existing six brokers, a rather conservative lot, would have shown no great enthusiasm for themselves funding these expenses

(the "NSE" at that time having of course no money of its own) since they were incurred for an entity (i.e. a trading floor and an organized exchange with staff) of which they had no previous experience and without which they had been able to "function" satisfactorily for years. That contribution was therefore strategic and timely. What would have happened to the Authority if there had been no AID contribution is more difficult to gauge. It certainly would not have moved from its previous quarters (which would have prejudiced if not indeed prevented setting up the NSE, or at least forced it to incur much higher costs) and its "image" would not have been the same. Image is however a subtler, if valid, kind of consideration, as is the extent to which reasonably modern accommodations enhance the credibility of a Government regulatory agency, especially one which deals with capital markets and important players. It must also be noted that certain "major" projects of the Authority, such as its Information Center for users of the capital markets, have not yet been implemented.

VI. GOVERNMENT OF KENYA CONTRIBUTION

A. General Priority of Capital Markets in Emerging Market Countries

1. In analyzing the Government of Kenya's contribution to development of the capital markets, one must recognize that as a general proposition, capital markets seldom constitute, for any Government, a high priority area for policy, legislative or administrative intervention. The broad reasons for this factual state of affairs are two fold, and are quite unrelated to what one might argue (as other sections of this Report do) is the objective importance of the area under consideration.

2. *First*, capital markets and their development seldom enjoy much political/electoral "sex appeal":

- Political parties and individual candidates will not much advance their chances of election or re-election by drawing attention to their manifold accomplishments or commitments in that area. Indeed, such could well work to their detriment. Capital markets (and stock exchanges in particular) are "popularly" held to be the special preserve of the powerful and rich on the one hand, and of crooks, speculators and get-rich-quick schemes on the other:

- A political party (and politicians) which becomes too identified with such a crowd is therefore itself at some risk. Hence capital markets will tend not to figure prominently on **political** platforms, unless it becomes a matter of "cleaning them up" -quite the opposite of what one has in mind here...

3. *Second*, capital markets issues are normally quite complicated.

- Ministers will thus understandably see them as "technical" problems to be handled by "technocrats" and civil servants; they will fully expect to be bothered with them as little as possible, especially as they already have to deal with a number of "political" issues of immediate relevance to themselves and to the Government. Hence, capital markets will seldom appear at or near the top of the **legislative** agenda.

B. Putting the Laws and Regulations in Place

1. The most one can therefore realistically expect, in the absence of some great crisis, is for the Government to pass one or at best two pieces of "capital markets" legislation, and then only after a prolonged period of deliberation, the "excessive" duration of which (in the eyes of interested parties) is not due to utter laziness or to a conspiracy but rather to the factors mentioned in the above paragraphs. The whole area is at that point turned over to a Minister (most often the Minister of Finance) with the hope that capital markets will not resurface for a long time and that the Government can now move on to more fruitful topics. That is what has happened in Kenya; in fact, as mentioned earlier, the "deliberation process" was neither unduly nor particularly protracted, quite to the contrary. ***We can therefore conclude that the***

Government has kept its part of the legislative "bargain" through the passage of the Act and the tabling of the recent Amendments.

- One should not expect any important further direct legislative action for some time, barring unexpected negative developments.

2. Governments do not only legislate, they also administer: the laws have to be implemented and their substantive intent must be achieved. The Capital Market Development Act, once passed by Parliament, could easily have remained unproclaimed for a long period or, once in force, the actual organization of the Authority, including the appointment of its members, could have been delayed or postponed for months or longer (such things have been known to happen everywhere.) In fact, the Capital Market Authority was constituted almost immediately after the Act was assented to, its Chief Executive was appointed in very short order, and it was soon made modestly operational with initial space, staff and budget. ***This is almost lightning-like speed in traditional terms***: Moreover, considering the immense needs of the country and the extreme paucity of public resources, ***the Authority has been "generously" funded.***

3. The Government concurrently took a number of other steps designed to facilitate the expansion of capital markets:

- Tax treatment for interest and dividend income was equalized,
- The withholding tax was reduced to 10% and made "final",
- The stamp duty on exchange transactions was removed,
- Issue costs were made tax deductible for companies,
- Blocked funds were freed,
- A handful of parastatals were privatized through the equity markets,
- The quality of accounting information was strengthened, etc.
- The Minister of Finance issued his 1992 Regulations, which provided a first comprehensive administrative framework under the Act.

These are all important measures, implemented moreover within a relatively brief period of time. Their difficulty or complexity, as the case may be, should not be minimized. ***What one might call the administrative "bargain" has thus been more than substantially honored.***

C. Remaining Work to be Done

1. The above does not imply, far from it, that everything is perfect and that one can now relax

with the satisfaction of one's work being completed. Much indeed remains to be done by all concerned including the Government itself.

- On the ***legal*** side, the Government will have at some points to tackle the insufficiencies of the Act, many of which have been pointed out in the course of this Report and do not have to be recited again here.

- On the ***administrative*** side, the outstanding Ministerial Regulations have to be completed (again as indicated) while some further impediments and irritants to the continued development of markets will have to be dealt with.

2. Among the impediments, one might list such diverse items as the:

- Current equity investment restrictions placed on NSSF and NHIF,

- Non-deductibility of individual and company contributions to private pension funds,

- Continuing control of capital accounts transfers and the still incomplete convertibility of the currency,

- Refusal to have Government bonds listed on the stock exchange and sold by brokers,

- Legal and administrative difficulties involved in setting up unit trusts, etc.

3. Irritants involve such practices as the stamp duty on increases in capital, the unclear status in the flow-through of dividends between subsidiaries and parent companies or unit trusts and invested companies, the excessive reliance on pre-emptive rights, the continuing use of par value for the shares of listed companies, etc.

4. All these will have to be dealt with over the coming months and years; the need for a "champion" and the respective roles of the Authority and of the NSE in those regards have already been discussed. This will leave outstanding a few major and pervasive issues such as the proper places and roles of banks as well as of foreign investors and foreign securities companies in the capital markets. These raise complex policy considerations which warrant careful analysis, and should not be rushed into on some sort of unthinking "me too" basis.

5. *In the last analysis, the most fundamental contribution (and in some ways the most difficult one) the Government will be able to make to the on-going development of capital markets will simply be to let them work in reasonably untrammeled fashion.* A key characteristic of functioning capital markets is that they are "self-correcting" mechanisms: they deal effectively and quite ruthlessly, in their own way, with their own excesses and follies, as has been amply demonstrated time and again. That is not a call for the State to abandon or neglect its essential roles as regulator of markets and protector of their integrity, quite to the contrary. The Government should however strenuously resist the ever present temptation (and

political pressure in that direction) of intervening directly in the markets, under the pretext that it knows better what the markets should be doing, or what investors should be buying/selling, when and at what price. Bureaucrats, experts and ministers alike do not enjoy any particular, much less superior, insight into these questions. Their interferences, however well-meaning, will normally end up distorting the capital allocation process and thus doing more harm than good to the very markets and investors they were intending to "save" from themselves.

VII. RECOMMENDATIONS

1. The recommendations below flow from the body of the Report, where they are more fully discussed. They are therefore presented here in point form only, except for those which touch the possible US AID assistance.

The Capital Market Authority Act

Improve/clarify the sections and/or dispositions concerning:

- the primary market
  - the most significant deficiency is that the Act does not satisfactorily address the issue of distributing securities to the public. Since one is dealing here in considerable part with private and still unlisted companies,this is an area that can be only handled by a Government agency. The key concept of *"full,true and plain disclosure"* does not appear in the Act
- the concept of "public company"
  - the Act does not define what a public company is, how a "private" company becomes a "public one" and what the "continuous disclosure" practices are which a public company must adhere to; the vagueness of the Act leaves a regulatory vacuum in a period of rapid expansion in the number of companies and potential IPOs
- the stock exchanges
  - the Act is sparse about the various aspects stock exchange activities institution.
- the clearing and settlement institutions
  - the Act should define at least in broad outline the capital, membership, structure, mandate and powers of the clearing and settlement institution and its supervision by the regulatory authority
- the concepts of self-regulation, self-regulatory organizations and delegation of authority to SROs
- the relationships between the Government, the Minister and the Authority

The 1992 Ministerial Regulations

Improve/clarify the sections and/or dispositions concerning:

- the primary market
- public companies
- underwriters
  - the Authority should organize the required dialogue and even possibly sponsor the creation of an association of underwriters
- stock exchanges
- clearing and settlement institutions
- capital requirements of underwriters, brokers, dealers, etc.
- delegation to the Authority, self-regulation and delegations to SROs
- the recognition of training courses and examinations for market professionals
- preparation and issuance of Ministerial Regulations
- initial public offerings of parastatals

box continued...

continued box...

The 1992 Authority Rules

Improve/simplify the sections and/or dispositions concerning:

- preparation, discussion and issuance of Authority Rules
- allotment of shares in primary distributions
- stock exchanges and clearing/settlement institutions
- recognition and surveillance of SROs

The Capital Market Authority

- structure itself more clearly in relation to its primary and secondary markets mandates
- bolster its capability for regulation of the primary market
- improve the time-frame for approval of IPOs and new issues
- work on the unit trust and investment fund problem
- mount a campaign in conjunction with NSE to attract companies to the market
- identify ways of promoting the development of underwriting and corporate finance capability
- define the major parameters for an effective clearing and settlement institution and for an improved share transfer/registration system
- prepare a discussion paper on major parameters for the SRO system
- implement an information program for the public on the specific role and mandates of the Authority
- create its Committee on Shareholders' Complaints
- prepare a discussion paper on the funding and functioning of the Investor Compensation Fund
- study modalities for the financial "autonomy" of the Authority
- establish an internal calendar of regulatory actions

NOTE: many of the above items are preparatory to the issuance of suggested Regulations and Rules

The Nairobi Stock Exchange

- structure itself more clearly in function of its three major rules
- introduce a "book" for each listed stock
- charge a transaction fee to members on each trade
- set a membership fee for joining the exchange, based on a clear formula
- consider the concept of "introducing" brokers ("remisiers")
- put in place an improved information and data program
- activate a program of public education in "investment practice"
- set up an Investors Complaints Committee of its Board
- improve the clearing/settlement process and work for the creation of a clearing/settlement entity
- look into ways of improving the share registration process
- mount a campaign and program to convince and help companies to become listed on the exchange
- encourage the creation of underwriting and corporate finance capability within existing securities firms

It can be concluded that a reasonably well-formed and functioning, if still embryonic, capital market has been implemented in Kenya over a remarkably short period, and in a very adverse economic, financial and political context. That market should be capable of sustained growth. It can also be concluded that the assistance provided by the component has been critical to both the quality and the timeliness of the development, which would likely have been placed in serious jeopardy if the assistance had not been available.

The Report looks into several key elements of the capital markets-particularly the Law, the Authority and the Stock Exchange - and analyzes their current situation as well as their shortcomings. Avenues for remedy are proposed, particularly concerning the lack of liquidity of the market. Recommendations are put forward for further action including possible USAID assistance, and certain lessons of general applicability are drawn from the Kenyan experience.

US Aid Assistance

1. One has to assume that the NSE must be capable of standing on its own two financial feet. That should indeed be the case in the reasonably near future, assuming modestly favorable market conditions, as long as it does not get carried away by delusions of grandeur or into grandiose schemes (for instance, the acquisition of a completely automated trading system, which it neither needs nor can afford). The likelihood that it will find itself in a tight financial situation for the next year or so is, from that point of view, an excellent discipline which will goad it to action on a variety of fronts. *The financial "plight" of the NSE (should any develop) should therefore not be alleviated by any ODA help for what we might call the routine or normal operations of the company.* There are however a few of areas where the NSE will need highly specialized help (thus "expensive" by its standards) if it is to progress.

2. The major such area concerns clearing and settlement: there is obviously no expertise available locally on the setting up and running of a sound clearing process leading to an effective settlement one later on. Much less is there any on the creation of a specialized clearing and settlement institution. Much grief and many costly mistakes will be avoided if the NSE and the Authority **jointly** have access to the same reasonably continuous source of specialized clearing and settlement expertise.

- That does not call for an expert from the NSCC in New York or a similar massive clearing entity to spend a year in Nairobi, but rather for someone who can do for clearing and settlement (and later for share transfer and registration) something similar to what the US AID-funded Advisor did for the trading: progressing from the non-existent to the "simple" but on sound foundations which can be expanded upon later on.

- Establishing a hand-driven clearing and settlement system (parallel to the manual trading system) will require close cooperation between the NSE and the Authority if the system is to rest, as it must, on solid financial and regulatory footings: a joint "appointment", if such was to prove possible, would be excellent and could provide some needed grounds for concrete cooperation between the two bodies.

3. A similar situation could obtain on two other fronts, which should concern the Authority and NSE equally:

- The definition of what is meant by a **self-regulatory** regime and how such a regime can be set up and administered in an effective and satisfactory fashion, by both the regulator and the regulated.

- The ***Complaints Committees*** and the more or less parallel Compensation Fund.

Both the SRO regime and the Complaints-Compensation organizations are very tricky to put in place. They have a natural tendency to turn into a highly visible sham, and/or a financial and organizational disaster. They can also become the arena for major confrontations between the regulator and the regulated. Here again, there is obviously no local expertise available and some expert advice would be most useful.

4. ***Finally, the Authority is likely to need continuing assistance for some time still in its own regulatory field***. Now that several large roadblocks appear to have been removed, the regulatory output of the Authority (both Regulations and Rules) can be expected to expand significantly; indeed, it must. Yet, the Authority does not have much experience in drafting Regulations, Rules, Directives, Interpretations, etc., nor in preparing the kind of "calendar" of forthcoming regulations which is necessary if it is going to husband its meager human resources and utilize them optimally. It does not enjoy either any experience in the defining and nurturing of those participatory processes which should be useful (within the cultural and other constraints which undoubtedly exist) in ensuring that Regulations and so forth are sufficiently agreed to or at least well aired among the affected parties, and thus better understood and rapidly effective. Here again, similar issues have been met elsewhere and the Authority should not have to re-invent the wheel.

5. Along a different front, it has been mentioned that an active capital market could be a powerful generator of micro enterprises. The newly approved brokerages, for instance, are unlikely to have initial staff of more than 3 or 4 persons (the six established firms have an average staff of 12). The NSE itself, as noted, will be a "small business" for many years. There could thus be some very fruitful grounds, for a small enterprise support program if such becomes available.

VIII. LESSONS LEARNED

A. "Positive" Lessons

1. Several major lessons can be learned from the US AID involvement in the Kenyan capital markets.

2. First is that capital markets can be developed in most adverse economic, financial and political circumstances, which one might think (based on "conventional" thinking and analysis) would make their survival, much less their growth, unlikely if not indeed impossible. Yet, it was done in Kenya from a practically zero base. It should now be more difficult for any one to argue convincingly that the economic situation of a country is such that it must eschew the development of even embryonic capital markets. Given the important role of capital markets in SAPs, that is a pivotal conclusion.

3. Second is that the process (and progress) can be quite rapid. In the Kenyan case, the seminal CBK-IFC study was completed in mid-1984. Within five and a half years, a (first) "Capital Market Law" had been prepared and passed: within six years the "Regulatory Agency" had been established; and within seven years the "Stock Exchange" was up and running and new issues were being taken to the market.

4. Third is that even embryonic and still incompletely structured capital markets can play an effective role in the mobilization of savings and the allocation of capital. A few "major" private issues were successfully floated in the Kenya markets, with surprisingly strong participation of retail investors, whereas previously institutional interest was almost totally predominant. Some "large" "privatization" issues were floated as well, again with considerable retail interest. Hence, the fledgling market place has already been serving both private and public purposes.

5. A further and important lesson is that the transfer of knowledge and expertise is entirely feasible in the field of capital markets development. In that respect, it is important that the knowledge and technology being transferred be sufficiently co-terminus with the state of affairs on the ground; the transfer agent (expert or advisor) for its part, should be defined as a "change agent" willing to teach and demonstrate as well as an advisor in the standard sense of the term. An interesting aspect--a fortunate peculiarity perhaps--of the Kenyan experience was that the same person ended up both advising the regulator and "teaching" the stock exchange and brokers. Whether that can be generalized into a "lesson" or is too tied up with the personality of the specific advisor cannot be determined at this point.

6. Fifth is that an effective capital markets assistance program does not have to be particularly expensive and/or all-encompassing. In the case at hand, some technical support and a longterm advisor were provided, as well as modest financial assistance for the initial setting-up of the Authority and of the NSE. These expenses accounted for a small proportion of total SAAPTAP budgets but should nonetheless have a considerable impact.

B. "Negative" Lessons

1. Negative lessons are in their own way as important as positive ones. The Kenyan experience has made it clear again that capital markets regulation is not a lightning-like process and that it requires time to unfold and take hold. There is little *a priori* reason to believe that prudential regulation of markets by the newly-established regulatory body will proceed significantly or necessarily faster than the comparable regulation of commercial banks by the various Central Banks did in its own time. Nor should one expect a strong self-regulatory philosophy and practice to emerge quickly or spontaneously (even when mandated by law, as is the case here): this will have to be nurtured until a "culture of compliance" has begun to take root.

2. It has been confirmed that capital markets, particularly during their "emerging" phase, have a powerful political component which will at times speed up their progress (when these forces can be harnessed) and at times bog it down in a lot of surrogate political infighting. New capital markets will very often provide a new and convenient arena for the playing out of ancient or continuing bitter conflicts which have little if anything to do with their overt objects, but reflect more deeply seated internecine struggles for power or prestige. Such a situation will greatly complicate the life of advisors, assistance officials and others who may be trying to help. A first difficulty will be to decipher the hidden meanings of the conflicts; the second, greater one, will be to determine what if anything to do about them, to the extent that one can do anything except witness the unfolding of events. It remains nonetheless that such conflicts, unless resolved in some way, can slow progress down considerably or even arrest it altogether.

3. It has been shown again that clearing and settlement (along with its associated processes such as transfer and registration) is usually the forgotten "orphan" in capital markets development programs. That is not surprising given the relative invisibility and lack of "sex appeal" of that administrative function, however critical it may be. A simple but sound clearing /settlement system and institution are nonetheless essential to the second phase of development of emerging markets, i.e. when trading volumes start to go up, the number of trades increases, and retail interest (including foreign one) begins to perk up. That phase is in its own way as delicate as the first one. The stakes are in some aspects higher however, because one is dealing here with markets which have already gathered a head of steam: their implosion or explosion, would thus have more serious consequences for all concerned.

C. General Conclusions

1. It must be remembered throughout that capital markets are not a homogeneous lot. They cover a wide spectrum, from barely embryonic to full fledged and from North to South (in the developmental meaning of these two terms). In looking at a given market, therefore, one has to locate it on two axes.

- First is the degree of development of the market, as indicated at the beginning of this paragraph. This will lead to the prescription of solutions (and expectations) which correspond to its particular stage of development.

- Second is a geographical one. Emerging markets (even "fully" emerging ones) are competing among themselves and then on a regional rather than on a global scale. Thus, institutional funds investing in "emerging markets" will normally define regional sub-categories (South East Asia, North Asia, Middle East and North Africa, South America, etc.) and earmark specific funds for each of these regions. The Kenya capital markets, from that point of view, are not competing against Thailand or Chile but against their East African (and possibly African) counterparts. These are the ones they have to be compared with in the first instance and against whom their quality has to be judged in both absolute and relative terms. In that context, they do not fare badly at all.

APPENDIX
EMERGING CAPITAL MARKETS: GENERAL OVERVIEW

What is now called "emerging markets" used to be called "developing countries". The change from "developing" to "emerging" occurred in the 1980s. This concept emerged as part of the capitalist 1980s. It reflects the more laissez-faire mood of the period, in comparison with the activist intervention implied by "development". But it really began with markets, and was only then applied to economies (rather than vice versa): emerging was extended from "markets" to emerging "economies" and "markets" is now often more important than economy.

The first public use of the term "emerging markets" was the launch of the "Emerging Markets Growth Fund Inc" by the IFC and the Capital Group in 1986. The investment objective of the fund was to seek long term capital growth through investment in developing country equity securities. The fund raised first U$ 50m and it was calculated in the prospectus that it could take at least one year before it would become fully invested in developing country securities. By contrast, in an Institutional Investor article of April 1993, Capital Group estimates it would now take just one month to invest the same amount.

In 1986, the countries with markets that were considered to qualify for investment by the Fund were: Malaysia, Korea, Thailand, Philippines, Brazil, Mexico, Chile and Jordan. The countries that were considered potential candidates during the succeeding five years were: India, Indonesia, Pakistan, Colombia, Venezuela, Turkey, Ivory Coast, Nigeria and Kenya. Since then, most foreign institutions began taking a look at emerging markets only after the crash of 1987, when they discovered that there was little correlation between major markets and emerging markets. Many emerging markets fell much less than major markets and recovered more quickly, and some totally ignored the tremor.

Since 1984, when the IFC first began keeping its data base on emerging markets, foreign investments in these markets have grown from $500 million to an estimated $30 billion, including $22.7 billion invested in mutual funds devoted to one or more of the markets. Much of the growth has occurred in the last three years. By the year ending 1991 the number of country funds, both closed and open end, had increased from one to a staggering 373, according to Lipper Analytical Services. During that time the market capitalization of the 20 most important emerging markets has increased by more than 600% from $88 billion to $630 billion.

Emerging markets have been defined according to two main quantitative criteria: economic and stock market indicators. There are also ratios that combine the two measures.

A. Economic Indicators

The main economic indicator for the definition of an emerging market is GDP per capita. Five stages of economic growth have been identified by Walter Rostow: Pre-take off, take off, the drive to technological maturity, high mass consumption, and the search for quality. These different stages can be linked to GDP per capita. Emerging economies are defined as those that are between U$ 400 and U$ 8,000 per capita ("take off and drive to industrial maturity") as indicated in the following table.

TABLE 1

STAGES OF ECONOMIC GROWTH
GDP PER CAPITA (U$)
(end 1992)

Stage 1- Pre-take off		Stage 2-Take off		Stage 3-Drive to industrial maturity	
Nigeria	276	Indonesia	602	Chile	2,191
Kenya	298	Zimbabwe	665	Malaysia	2,440
China	326	Philippines	755	Venezuela	2,544
India	359	Jordan	956	Mexico	2,814
Pakistan	369	Colombia	1,364	Argentina	3,302
		Thailand	1,450	Brazil	3,328
		Turkey	1,940	Portugal	15,717
				Greece	6,582
				Korea	6,689
				Taiwan	7,890

***source: Baring Securities**

B. Stock Market Indicators

Two stock market indicators are the daily value of shares traded and market capitalization as they measure the amount that could be bought on a daily basis and the absolute amount that can be bought in a market. Table 2 below highlights these indicators in the emerging markets.

TABLE 2

EMERGING MARKETS (Value traded and market capitalization end-1992)			
	Market capitaliz. (US$bn)	Avg. Daily Value (4th Quarter 1992)	Value Traded in 1992 (US$m)
Argentina	18.6	61.37	15,679
Brazil	45.3	45.3	20,525
Chile	29.6	.73	2,029
Colombia	5.7	6.93	554
Greece	9.5	1.68	1,605
India	65.1	6.43	20,597
Indonesia	12.0	31.65	3,903
Jordan	3.4	18.07	1,317
Kenya	.6	7.33	12
Korea	107.4	712.65	116,101
Malaysia	94.0	179.50	21,730
Mexico	139.1	169.75	44,582
Nigeria	1.2	0.08	23
Pakistan	8.0	2.20	980
Philippine	13.8	11.45	3,104
Portugal	9.2	16.23	3,455
Taiwan	101.1	459.97	240,667
Thailand	58.3	365.37	72,060
Turkey	9.9	22.25	8,191
Venezuela	7.6	5.35	2,631
Zimbabwe	0.6	0.06	20
TOTAL	739.4	2,150.91	579,765

***source: IFC Emerging Markets Database**

However, while the GDP criteria may be a necessary condition for emerging markets definition, it is not a sufficient condition for investing in an emerging market. From an investor's point of view, identification of a market as "emerging" implies that it will have a faster economic growth rate than a developed market, and that this will be reflecting higher profit growth, and ultimately stock price appreciation.

C. Towards the Emergence of a Capital Market

Capital markets deal in longer-term financial instruments. These instruments are issued and traded through institutions the nature of which depend on whether they deal in debt, equity, or any other combination.

The capital market is characterized by non-securities and securities segments. The non-securities segment is dominated by institutions of a banking nature, including savings and loan institutions, housing finance institutions and commercial banks. Typical instruments within the non-securities market are debt-related such as term loans and mortgages.

The securities segment is mainly made up of equity, debt or quasi-equities. The exercise and success of capital markets depends upon an active private enterprise sector. and the role of the government authorities is largely to create the appropriate enabling environment. This needs to include a stable macroeconomic environment, the removal of any obvious legal, fiscal, and other obstacles to the success of the markets, and the provision of an adaptable regulatory and supervisory framework that provides a balance between market freedom and investor protection.

If the markets can be encouraged the emergence of capital and equity markets greatly improve the management of risk in individual enterprises. This is essential when the degree of uncertainty in economic activity is high.

The capital markets help to inject a higher degree of competition into financial markets; this will normally be welfare-enhancing. The presence of appropriate securities markets is an essential prerequisite for the move to more indirect and efficient mechanisms of monetary control. The players here are mainly investment bankers, brokers and venture capitalists.

The following are the objectives of capital markets:

- To mobilize long term savings in order to finance long term investment.
- To provide risk capital in the form of equity or quasi-equity to entrepreneurs.
- To encourage broader ownership of real and financial assets, indirectly improving the distribution of income.
- To improve the efficiency of capital allocation through a competitive pricing mechanism.
- To improve the efficiency of the allocation of savings to investment in the public and private sectors.
- To make investment capital available to a broader range of the population.
- To ensure the availability of long term financial resources, while minimizing the risk of

financial instability, by lengthening the term of financial assets acceptable to savers and establishing a proper framework for term transformation by financial institutions.

- To widen the range of financial services available through financial institutions.
- To improve the operational effectiveness of financial institutions.
- To improve the terms under which foreign funds are raised and reduce relatively the amounts required.

Important Factors for Capital Market Development

The following are important for capital market development:

- Sufficient supply and demand for securities.
- Tax neutrality toward financial instruments.
- A critical mass of merchant banks/brokers/dealers other market participants.
- Adequate information standards including proper auditing, accounting capacity and information flows.
- A minimum population of enlightened investors.

D. Promotion of the Supply and Demand for Financial Instruments in Capital Markets

The development of the capital markets is dependent on the health of the economy, which implies that policies for efficient economic development have an important bearing on their future. Investors who have to face market risks are very sensitive to additional non-market risks such as political or economic uncertainty.

A combination of macro-economic and sector policies aimed at the maintenance of political stability, steady economic growth, and comparatively low inflation is necessary to foster an environment conducive to the harmonious development of capital markets. This also means that government policies must promote the efficient allocation of resources, in accordance with market forces rather than government directives, and allow enterprises and entrepreneurs to respond to undistorted market signals. Policies that interfere with market signals lead inevitably to distortions in the risk/return relationships of different investment choices. The effect of these distortions is to prevent resources from being channelled into the highest return investments and to reduce the supply and demand for securities, hence thwarting a balanced development of capital markets.

Policies for developing capital markets require a long term approach that consists of the systematic removal of impediments to their development as well as the establishment of an adequate framework of policies, laws and regulations.

The following is a checklist of the most common impediments to the increase in supply and demand for financial instruments in the field of finance that are meant to have rapid, punctual effects.

1. Obstacles to Larger Supply of Financial Instruments

While measures should be formulated to encourage an increase in the use of the markets, the following tend to limit the supply of securities:

- Tax limitations and policies that are more favorable to debt than to equity. Interest on debt is tax deductible, while dividends are not tax deductible and are taxed twice--once at the company level and once at the share holder level.
- Credit polices that give priority of access to a certain sector or type of investment.
- Blanket insurance of bank deposits.
- Fixing of issue prices or arbitrary determination by the authorities of the price at which an issue can be offered in the market.
- Listing requirements that are excessively constraining.
- Excessive limitations on foreign share holding.
- Pre-emptive rights, such as the practice of granting pre-emptive rights to existing shareholders to purchase all new financial instruments issued by a company.
- Queuing--for example, companies that plan public offerings are subjected to government enforced share-offering procedures that favor government rather than market priorities.

2. Obstacles to a Stronger Demand for Financial Instruments

Countries with under developed markets can also suffer from limited demand for financial instruments. The main reasons are:

- Tax laws, including more advantageous taxation of interest income.
- Lack of transparency and information .
- Lack of adequate mechanisms to finance securities transactions.

- Lack of a secondary market ensuring an adequate degree of liquidity.
- Constraints on foreign exchange convertibility and repatriation of dividends and capital.
- Lack of adequate accounting and auditing standards.
- Weaknesses in the legal system and in the mechanisms available to enforce contracts.
- Lack of confidence in market institutions and operations.

3. Developing a Critical Mass of Regulations, Institutions, Markets and Skills.

There are legal and institutional factors critical to the successful development of capital markets. They include:

- The existence of a sufficient number of market intermediaries such as brokers, dealers and underwriters.
- Reasonably well developed accounting, auditing and disclosure standards so that all needed financial information may be available, transparent and accurate.
- Establishment and vigorous enforcement of rational and comprehensive legal and regulatory frameworks, so that abuses are prevented and investors protected. This is extremely important for maintaining the integrity of the financial system and sustaining investor confidence.

4. Price Determination and Discovery

There may always be problems with the pricing of shares of newly floated companies. The possibility exists that especially because of competitive pressure many of the new issues are somewhat underpriced. Underpricing distorts the distribution of risk bearing, thereby undermining one of the main benefits of innovation, namely apportionment of risk according to the comparative advantage for risk tolerance. At the same time this distorting could also undo another benefit of market liberalization, which is more efficient allocation of domestic financial resources. However, a proper gauge of supply and demand forces in the market would tend to give proper settlement on price.

It has been possible to issue and underwrite new equities in Kenya at prices higher than par value. In the case of an initial public offering, the issuer may request authorization and be able to place an issue at a price higher than par if he can justify such a higher price through comparisons with the market price for shares of other companies engaged in identical or similar activities. As an alternative price base, the issuer may assess his own performance record in terms of an earnings related value and an asset related value prescribed on a formula basis.

E. Mechanisms and Institutional arrangements for capital market development

Certain mechanisms and institutions can be developed so as to steer towards the development of capital markets in the country. They include:

1. Strengthening and Expanding the Market Intermediation Function

Functions that are essential to the operation and development of capital markets and that can be transferred without too much change to securities and capital markets are those involving market intermediation and, in particular, those leading to provision of liquidity and term transformation and matching of supply of, and demand for, various financial instruments. The promotion of these functions towards dealing in longer term instruments should be actively pursued. In particular, the matching and trading functions can gradually be extended from the private placement of shares. The operation, the first one that usually appears in the process of capital markets development, consists in the sale of shares to a pre-identified group of purchasers, such as institutional or wealthy investors. In general, a private placement does not require a prospectus because the purchasers have sufficient information and experience on which to base their investment decisions.

2. Extending the Maturity of Finance Instruments

To create a demonstration effect and introduce trading in longer maturities the government may issue longer term bonds. To ensure their liquidity, the central bank may accept them for rediscounting. Another option is that the central bank backs a discount house that, with or without a government deposit, would act as a lender of first resort.

3. Promoting Venture Capital Companies

This is where development of a capital market is steered toward the supply of risk capital. Venture capital companies are institutions that specialize in the latter function. There are many different types of venture capital companies, some catering to large ventures, some fostering small entrepreneurs. In developed countries they tend to specialize by sector, products, technologies or clientele. Experience with venture capital companies operating in developing countries is emerging only now. Perhaps the main difference with those in developed countries is the degree of involvement of the venture capital company in the implementation of the project. Without getting into sweeping generalization it can be noted that in developed and developing countries alike, the decision to invest in a project is taken accordingly to a number of criteria, including the quality of the technology, and the management, the market potential, and other similar elements. But once the project is approved in developed countries, it is often left to mature by itself or with very modest supervision.

In contrast, in developing countries, it appears that successful venture capital companies are those that assume most of the functions needed to design, start, and bring the project to maturity, until such times as these functions are developed within the project and can be taken from the venture capital company. It is a formula that is close to the project financing activity and project support that many development financial institutions carry out already in developing countries. It is also a formula suitable for the development of medium and small enterprises.The difference is, of course, the degree of risk-taking, the provision of risk capital, and the willingness of the venture company's management to take losses.

Usually an over-the counter market is needed for venture capital companies to sell shares in successful companies it financed, so as to recycle its capital and take its profit. Until an over-the-counter market emerges, this trading function can take place, first on a private placement basis. Finally the establishment of venture capital companies may require specific legal provisions. Two of them are essential: tax deductibility of capital losses and favorable taxation of capital gains.

There are financial institutions in countries of sub-Saharan Africa that could almost immediately or in the near future assume a venture capital function independently or within a merchant banking function, drawing on their experience with project financing or their contacts with entrepreneurs from the sector of medium and small enterprises.

4. Formalizing Investment Finance and Trading

Once private placement has led the way to over-the-counter trading there is room for merchant banks and other financial institutions to establish private investment funds and unit trusts. Gradual formalization of these institution mechanisms and investment vehicles will pave the way for the establishment of a stock exchange on which all types of securities should be traded.

5. Developing An Adequate Regulatory And Prudential Framework

Early in the process of fostering the development of capital markets, authorities must give consideration to the formulation and adoption of a comprehensive securities market law. This will ensure the necessary degree of uniformity of regulations for closely related primary-issue and secondary-trading markets. It is of utmost importance that the regulatory, supervisory, and prudential framework does not fall too far behind the development of the markets themselves. This will prevent insider trading, other irregularities and bust-and-boom cycles, all adverse developments that, because of their deleterious impact on public confidence, can set the development of financial markets back by months or even by years.

F. Capital Markets And Contractual Savings

Contractual savings institutions such as pension funds, social security schemes, and life insurance companies, are natural providers of long-term funds. Such institutions can provide term financing in the shape of equity and loans, and of all the intermediate instruments that combine some features of each of these. Contractual savings institutions in most developing countries, however, suffer from several problems that constrain their growth as active actors in a nascent capital market.

- Pension funds are often based on the pay-as-you-go principle, which eliminates their roles as mobilizers of funds.

- Frequently, when pension funds have reserves, they and life insurance companies are forced to invest all or a very substantial portion of them in low-yielding Government paper that is used to finance the government or preferred development finance institutional borrowers.

- As a result of their low-yielding investment portfolios, they cannot offer attractive savings plans to their potential customers, and they experience low or zero growth in real terms. This is a problem specially in countries with high rates of inflation, where the yields of contractual savings plans are frequently negative in real terms.

Solving the problems of contractual savings institutions, enabling them to mobilize resources in free competition and investing the proceeds judiciously would have a stronger developmental impact than providing direct financing to enterprises. As in the case of floating rate deposits and bonds, contractual savings instruments work better in stable than in our inflationary monetary environment. Institutions can nonetheless develop instruments ensuring that the returns on their saving plans are competitive with other market instruments.

G. Providing a Critical Mass for the Development of Capital Markets

An efficient capital market needs to have a critical mass of sellers and buyers to give liquidity to instruments. The mass of savings can be provided by contractual savings institutions, which would be joined in time by increasing numbers of individual savers. Pension funds can grow at a very fast pace when the right conditions for their growth are set. The critical mass of users is more of a problem because industrial companies are not used to raise funds from capital markets, while savers may be initially wary of investing in such firms.

This problem was solved a century ago in many developed countries by financing large infrastructure projects and housing through the capital markets. In most developing countries, utilities and other infrastructure projects are being financed largely with budgetary funds, complemented with foreign borrowing. The large amounts required to finance infrastructure and the collateral would provide the initial critical mass to the new capital markets. If the terms offered to domestic investors for this financing match the foreign financing, bonds issued for these purposes could attract substantial amounts of savings.

H. Capital Markets and Structural Adjustments

The level of development of financial markets is an important determinant of the flexibility and pace with which financial systems can adjust to internal and external changes and absorb shocks. This is because money and capital markets represent the deep end of the financial system. and the deeper the system, the greater its stability and resilience.

However, growth of financial markets in developing countries has been generally constrained. Abetted by the availability of cheap or subsidized loan funds, enterprises in developing countries have tended to become excessively reliant on short to medium term debt financing from banks. This over-reliance proved to be a particularly painful mistake during the world economic recession of the early 1980's.

In addition to the general economic environment, there are other legal and institutional factors that are critical to the successful development of capital markets. A sound and rational development of capital markets, therefore, requires not only favorable policies. but also the establishment of the legal and institutional infrastructure to support the operation of such markets.

The role played by the authorities in the evolution of financial markets has been significant in most countries. A majority of developing countries have laws governing their financial systems that have been enacted with the aim of structuring and guiding financial markets activities and development. However, while the predominant experience in capital market development has been evolutionary, some countries have taken a more actively planned approach, that is, consciously using policy instruments to stimulate the development of capital markets in specific directions.

This approach has proved to have the important advantages of accelerating and strengthening financial deepening as well as market development. More specifically, a planned, active approach provides the following advantages:

1. Allows a more rational planning of long term industrial development, since long term sources of funds. both debt and equity, can be tapped to match long term investment commitments.

2. Stimulates financial resource mobilization by offering savers more varied risk/return choices and a more efficient means to adjust their portfolios to meet changing circumstances. For institutional investors. the ability to adjust portfolios through liquid markets means lower cash liquidity requirements and thus a lower intermediation cost.

3. Forestalls the emergence of unofficial markets, usually characterized by wide spreads, high risks and tax evasion.

4. The broad range of market instruments and participants involved in a highly visible market allows capital flowing through it to be priced rationally and, therefore, to flow to the most productive opportunities, improving the efficiency of resource allocation and augmenting economic growth. Also, securities markets broaden the range of financing alternatives open to both private and government enterprises and allow a more rational planning of long-term

industrial development, since long-term sources of funds (both debt and equity) can be tapped to match long-term investment commitments.

5. For savers, financial markets provide more varied risk/ return choices and a more efficient means of adjusting their portfolios to meet changing circumstances. By providing a broader, more convenient range of savings opportunities, financial deepening and diversification increase aggregate financial savings. For institutional investors, the ability to adjust portfolios to liquid markets means a lower cash liquidity requirement and thus, a lower intermediation cost to the benefit of both savers and users of capital.

6. Where policies or rules regarding financial markets have been negative or neutral, an unofficial market has often developed alongside, or instead of, an official regulated financial market. These unofficial markets have been characterized by wide spreads, high risk and tax evasion as standard practices. Where the policies and rules have been more favorable to financial development, the financial markets have tended to be more orderly, with returns (especially to savers) and the profit margins of financial intermediaries more consistent with the risks involved. In most countries, strong vested interests soon become entrenched in certain segments of the financial system, which makes reform later much harder to accomplish. A well thought-out action program can help avoid these pitfalls which harm financial development, by establishing reasonable rules before vested interests become a problem.

7. Perhaps the best case for an "active" approach to developing financial markets is the fact that the use of the most efficient technology, in any sector, adapted according to local conditions, has always helped to increase the GNP per capita beyond what it would otherwise be. Since there is little argument that an efficient system, or an efficient securities market, can speed real economic growth, an active approach to financial market development is every bit as valid as for any other sector. For those countries at an early stage of financial development, an active approach is needed if such markets are to emerge effectively within a reasonable time frame.

I. Risk and Return

Capital markets are used as conduits for sharing risk. Through the primary markets alone (issue of new shares) the risk of physical investments is transferred to financial investors. The public issue of shares offers a means of allowing a large number of small investors to supply the risk capital required by industries. It also implies that suppliers of investment capital become able to choose between alternative ventures, an efficient allocation of resources. Investors will use the capital markets to allocate their funds to the companies which provide the best returns given the risk involved, thus bringing the most financial benefit to the economy.

J. Spreading (or Distributing) Wealth for Development

Governments aim at the realization of growing per capita income and at the same time at greater equality in the distribution of this income. On the other hand business concerns endeavor to increase productivity so as to maximize profitability with a view to improving the general welfare of their shareholders and employees. The capital markets provide investors with an opportunity to share in the fortunes of business concerns and in the process ensure that there is more equitable distribution of national wealth. The capital markets thus contribute to the government's mission of narrowing the gap between the rich and the emerging middle class.

K. Exit Mechanism

Capital markets can be used as a mechanism through which promoters or founders of businesses can off-load their ownership (or equity holding) i.e find exit from ownership. Apart from the promoters, even the government and venture capitalists may equally find the market useful for exit purposes. To satisfy financial backers, venture capital requires an ability to liquidate investments with reasonable certainty within five to seven years. Normally, the most visible potential exit is the capital market, apart from sale of shares to another company to other owners of portfolio companies, including management.

An evaluation of the Kenya Trust for private enterprises development carried out in Kenya in February 1994 by Chemonics International (Washington DC) for USAID/Kenya, indicates that though there is a market for venture capital in Kenya it is not mature enough to support a firm or activities devoted primarily to venture capital investments even with the level of support USAID provided in the past.

L. Control of Abuses in the market

Proper administration of capital market rules and regulations tend to deter insider trading, manipulation and other market abuses which have surfaced in some of the global markets like the U.S and U.K. This, in fact, tends to put into focus the role of the government regulator in enforcing securities law. There should be enforcement options sufficiently flexible to adjust sanctions to the specific violations. There should also be broad authority to impose fines and halt illegal trading activities.

1. Regulation

The government usually undertakes the responsibility to establish a legal framework to structure domestic capital markets so as to ensure that its financial system functions in an orderly and efficient manner. The government may also seek to protect investors and issuers through regulations that penalize fraud, trading manipulation and other unfair practices that could be used by participants in the capital markets. The challenge is to provide sufficient regulation to promote stability, development and confidence in the integrity of the markets.

Stock market crises are common in the early stages of development of capital markets. Lack of transparency and inadequate control of price manipulation are commonly found in this respect in developing countries. Emphasis should be placed in ensuring the development of:

- An information system that permit brokers and investors to assess the performance of individual stocks and the market in general.

- Simple but secure settlement systems.

- Minimum professional and financial solvency requirements to engage in brokerage business.

- Accurate financial disclosure requirements for listing.

2. Self-Regulation

While the presence of a government regulator created by a specific capital markets law is essential, especially for the primary market, it is possible to have two-tier regulatory systems. The first, and senior one, is provided by the official agency appointed to supervise the markets. The second, and junior one, operates by regulation of the senior level and is based on the principle of regulation of market participants by those participants themselves. The participants will then be grouped in so-called "self regulatory organizations", to which wide ranging powers of surveillance and intervention will be delegated by the government regulator. The major self-regulatory organization will tend to be stock exchanges (regrouping brokers and dealers) and clearing and settlement institutions (regrouping their users); they will impose standards of acceptance and conduct on their members and will discipline them if they do not abide by these standards. Such an approach is thought to foster a sense of discipline and responsibility among the participants, to lighten the surveillance burden placed on the official regulator, and to favor standards which more closely reflect the real nature and evolving problems of the markets (as opposed to the slower approach of a government agency). Other benefits are:

- ability to improve ethical standards
- accountability to the government and to the members
- acceptability by professional peers
- sensitivity to know when a regulation will be workable
- participation by persons subject to the regulation
- checks and balances which lead to practical regulations
- responsiveness to meet changing needs and developments
- expertise in financial matters consciousness of the need to be cost-effective use of government resources by sharing the regulatory responsibility.

3. Evaluation Criteria for International Securities Regulation

It is important to recognize the need for regulation as market forces and competition alone cannot adequately meet all the needs for fair treatment of investors in all instances. In determining actions to be taken or recommended be taken, by a self-or government regulatory authority, criteria for international securities regulation have been developed upon which a course of action or recommendation can be evaluated.

It is recommended that solutions or actions to be taken should:

- Be market driven, that is the action should be in recognition and in response to needs of the markets and should be flexible, practical and represent the minimum burden on free market forces necessary to accomplish the desired identified objectives for the protection of investors and the maintenance of fair, orderly markets.

- Be undertaken, in so far as is feasible, through a regulatory process which is responsive to customers and user needs, recognizes and is responsive to competitive factors and brings to the regulatory process the technical knowledge and expertise necessary to assure that regulatory intervention takes the form least disruptive to market efficiency.

- Generally promote competition to enhance efficiency and the quality of markets and services provided investors and users of the markets.

- Assure that transactions are handled fairly and conducted in a manner which is consistent with the high standards of professional conduct to merit investors and public confidence in the integrity and fairness of the markets.

- Be structured in a manner to foster and maintain ethical conduct to assure fair and equitable treatment of investors and users of the markets and transactions conducted on their behalf.

- Be achievable in determinable time and at a reasonable cost-rather than any cost-to investors, issuers, intermediaries, market participants and the markets themselves.

M. Privatization

A number of developing countries created state owned enterprises for a variety of good reasons: to replace weak private sectors, to transfer technology to strategic sectors, to generate employment, to make goods available at lower cost, to achieve regional balance, local participation and control of the economic development, etc. By December 1991, Kenya had 240 commercially oriented enterprises with government equity participation. While some public enterprises have been profitable, most have been economically inefficient, incurred heavy financial losses and absorbed disproportionate share of domestic credit.

Since the 1970's there has been a change in economic policy worldwide regarding the role of public enterprises. A number of countries have launched privatization programs to sell their public enterprises to the private sector. In Kenya, a privatization program was launched in November 1991 by the establishment of Parastatal Reform Program Unit and Executive Secretariat and Technical Unit.

This represents a major shift in policy in that the private sector is now made the engine of growth for economic development. Privatization is still at early stage in Kenya and much learning is going on.

In terms of employment the parastatals employed a total of 170,000 people. Between 1986-1990 the parastatals accounted for 11% of GDP and 16% of gross capital formation. The privatization program is thus going to have a large impact on the economy as a whole.

Depending on the degree of ownership and size, role, and sophistication of the state-owned enterprises involved, each country carries out its privatization program differently. The basic methods of privatization commonly used are:

- Public offering of shares
- Private sale of shares through pre-emptive rights
- Sale of assets through receiverships
- New private investment
- Management or employee buyouts
- Lease and management contracts

With the exception of management or employee buy-outs, all these methods of privatization have been applied in Kenya.

Substainability of the privatization process is the strategy in the long run. This sustainability is linked to the scope and speed of the program. Experience in other countries shows that rapid and large scale divestiture is unlikely in developing countries owing to the complexity of the process and to limits on the absorptive capacity of the local financial markets. Success of the privatization program is also critically dependent on public acceptance and participation. To elicit and maintain public support, transparency must be a governing principle of the program. Dialogue with the private sector and labor unions and publicity campaigns to stimulate interest in the sale of assets and shares must be launched and sustained throughout the process. To reinforce the objective of transparency and fair pricing of the assets to be privatized, the capital markets offer one of the best outlets.

In conjunction with the Capital Markets Authority and the Nairobi Stock Exchange, five companies have already been privatized through public flotations of shares: Uchumi Supermarkets, Housing Finance company of Kenya, CMC, Kenya Commercial Bank and E.A. Oxygen Ltd. One of the objectives of the public flotation of public enterprises is to achieve as wide a distribution of ownership as possible at a price the "ordinary man" can afford. The price and the number of shares to be acquired by individuals from public enterprises floated are dealt with by a Privatization Implementation Team (PIT). Public flotations in Kenya have been constrained by CMA and NSE rules, and limited by pre-emptive rights.

N. Stock Prices and Market Efficiency

Market efficiency refers to the speed and competence with which information is incorporated in stock prices. The term "efficient capital markets" has been used in several contexts to describe the operating characteristics of a capital market. There is a distinction, however, between an operationally (or internally) efficient market and a pricing (or externally) efficient capital market. In an operationally efficient market, investors can obtain transaction services as cheaply as possible, given the costs associated with furnishing those services. Pricing efficiency refers to a market where prices at all times fully reflect all available information that is relevant to the valuation of securities. When a market is price efficient, strategies pursued to outperform a broad-based stock market index will not consistently produce superior returns after adjusting for risk and transactions costs.

Tests so far carried out on pricing efficiency investigate whether it is possible to generate abnormal returns. An abnormal return is defined as the difference between the actual return and the expected return from an investment strategy. The more quickly and completely information is impounded into share prices, the less likely it is that investors will be able to earn excess return from using that information to pick winners.

The efficient market hypothesis has had a confusing history. It started out as the "random walk" theory, concerned only with trends in share prices. In its present form, it is concerned with a wide range of information, from past share prices to inside information, and with whether investing in shares is a fair game with respect to each particular set of information. Prof. Fama has defined three main levels of pricing efficiency with respect to three types of information. The weak form considers past share prices (as does the random walk theory). The semi-strong form is concerned with all publicly available information, and the strong form with all information, including information known only to a few insiders.

The evidence in general supports both the weak and the semi strong forms, but not the strong form. Publicly available information therefore, appears to be quickly incorporated into share prices (at least in developed markets), so quickly that excess returns, given the risk, cannot consistently be made over a substantial period of time. This result suggests that the use of both chartist and fundamental analysis will not in the long run produce undeserved (in terms of risk) returns.

The implication of this theory for investors, in particular naive investors, is that they can, without needing to analyze or acquire costly information, adopt a fair risk/return strategy, by holding either a well-diversified portfolio or an index fund. Investment analysts, on the other hand, should switch emphasis from a straight "picking winners" approach to concentrating on analyzing shares in the light of market expectations already incorporated into share prices and other ability to select winners. They should also construct share portfolios for investors which take into account the investors' risk/return preferences rather than trying to earn excess return for everyone, regardless of risk.

O. Emerging Markets and Foreign Investment

Most developing countries have not yet fully opened up to foreign investment in their stock markets. Because of balance of payments problems, every effort was traditionally made by these countries to minimize capital outflows. This has been almost automatically translated into restrictions on stock exchange investments. Kenya, for example, does not allow direct foreign investment in the stock exchange. In Chile, foreign funds must remain in the country for three to five years and foreign institutions or individual investors can hold no more than 10% of a company's stock. Malaysia allows foreigners to own up to 30% of any listed or unlisted company. In Zimbabwe, foreign investors need government approval before they can buy, and then can buy "B" shares only. In Nigeria, no foreigner can own more than 40% of any company's shares. Once the limit is reached, foreign investors have to trade among themselves, usually at a premium, and markets have developed to handle foreign shares, with price quotes readily available. Some countries have set up funds for such trading or have simply removed the restrictions, like India. Some countries even have separate trading desks at the stock exchange for foreigners.

USAID OBJECTIVES

1. Mission Goals

Primary: promote sustainable, broad-based economic growth.
Secondary: increase production, employment, income and foreign exchange earnings.

2. Technical Assistance Program

Technical assistance has been an important and successful component of structural adjustment to Kenya in recent years. An additional $6 million of such assistance is proposed over the three years of Program 615-0240 to maintain the quality and quantity of U.S. technical assistance support for structural adjustment. Technical assistance funds will support studies, consultancy, draft legislation, draft administrative orders, training, and microcomputer hardware and software. Principal areas include: reduction of administrative controls on investment; reduction of price controls; review of taxation and financial incentives; and stabilization and development of financial markets. 90 person-months of technical assistance and 36 person-months of short term training
Source: USAID, PAAD No. 615-0240, Kenya, 3 January 1986

An Amendment to the original project proposes to assist the Government to implement and accelerate the evolution of sound capital and money markets. A.I.D. proposes to use the technical assistance component of the SAAP together with the Private Enterprise Development Project to pursue the dialogue and to ensure that necessary policy actions are taken. The Kenyan authorities have already requested A.I.D. to finance a long-term policy advisor. The long-term technical advisor will be complemented by short-term consultancy as needed.
Source: USAID, PAAD 615-0240, Kenya, 18 June 1988

The Project has assisted with development of the legal framework which underpins Kenya's capital markets and the establishment of the Capital Markets Authority as a regulatory body. With this amendment, the Nairobi Stock Exchange will be assisted with the preparation and release of educational/promotional material to stimulate greater use of the NSE by entrepreneurs and the GOK (for divestment). By educating potential investors and divestors on the role of capital markets, specifically the NSE, the GOK expects to stimulate demand for new investment instruments at a level at least equivalent to the anticipated expansion of stock offerings occasioned by the privatization of parastatals and the increase in private capitalization. With the technical assistance and advertising support included in this Project amendment, all six currently licensed brokerage firms will have been trained in broker sales courses, a press kit will have been prepared for the NSE to distribute to the media, a public information hand-out on the NSE will be available and a modest advertising program will have been completed.
Source: USAID, PAAD 615-0240, Kenya, 31 December 1993

LIST OF PERSONS MET

Government

Mr. Meshack Jamasai Onyango, Central Bank of Kenya
Mr. F. Awuor (?) Under-Secretary to the Treasury
Mr. F.I. Ojow, Executive Secretariat and Technical Unit, Parastatal Reform Program Committee
Mr. William Arap Chelashaw, Chief Executive, Capital Markets Authority
Mr. Paul M. Melly, Operations Manager, id.
Dr Darin C. Gunesekera, Advisor, id.
Mr. Yusuf Abdulrahman Nzibo, Managing Director, Industrial Development Bank Ltd Mr E.C.A. Saina, Deputy Managing Director, id.

Private Sector

Mr. J.M. Mbaru, Chairman, Nairobi Stock Exchange
Mr. J.K. Kihumba, Chief Executive, id.
Mr. T.S. Chana, Managing Director, Francis Thuo & Partners (NSE Member)
Mr. Marion, Francis Drummond (NSE Member)

Mr. James R. Dry, Managing Director, Dry Associates Ltd
Mr. G.M. Chamungwana, Managing Director, Standard Chartered Investment Services
Mr. B. Ochweri, Senior Manager, Fund Management, id.
Mr. D. Mboi, Operations Manager, id.
Mr. D. Madan, Director, General Food (Kenya) Ltd
Mr. Charles Appleton, Partner, KPMG Peat Marwick

International Institutions

Ms Nancy E. McInerney-Lacombe, Public and Private Enterprise Division, Eastern Africa Department, The World Bank
Mr. Satyan R. Patel, Regional Mission in East Africa International Finance Corporation

USAID

Private Enterprise Office: Mr. Hopgood, Ms McVay
Banking and Finance Adviser: Mr. Khasiani
Office of Programs

Appendix 1

IMPACT ASSESSMENT

This section highlights the possible benefits from the Public issue of shares by two companies through the Nairobi Stock Exchange--Kenya Commercial Bank and Standard Bank. These companies made public issues of shares in 1990 and 1989

Employment

The table below indicates employment before and after the issue of new shares for the two companies.

	1989	1990	1991	1992	1993
KCB	3339	3386	3514	3604	3841
Standard Bank	2081	2198	2497	2629	2569

The figures above show an increase of 455 employees in Kenya Commercial Bank (from 1990) and 488 in Standard Bank (from 1989) after the public issue of shares on The Nairobi Stock Exchange.

Based on this analysis the increased capital as a result of issue of capital combined with the management objectives based on high productivity clearly indicate (other factors aside) that employment increased. These numbers do not take into account jobs created among suppliers and customers of the companies under review.

Output

Output here is defined in terms of profits before tax. The table below shows that the combined profits before tax for the two companies rose Shs. 1,942,439,000 after the public share issues.

Profits Before Tax

	1988	1989	1990	1991	1992	1993
KCB	264,679,000	375,221,000	463,752,000	609,640,000	808,789,000	2,041,324,000
Standard Bank	267,485,000	274,195,000	410,578,000	545,821,000	837,816,000	644,062,000

Appendix 2

OUTLINE OF THE HISTORY OF THE NAIROBI STOCK EXCHANGE

1954 - Nairobi Stock Exchange came into being as a loose society of members with Francis Drumond being a founder member.

1964 - Exchange Control Act was passed. This among other things prohibited foreign investment in stock exchange.

1971 - Capital Issues Committee came into being to take responsibility of pricing and issues.

1973 - Capital Gains tax was introduced in Kenya by Act of Parliament. This affected gains made in the stock exchange.

1977 - East African Community broke up and some Ugandan firms and Tanzanian firms registered in the Nairobi Stock Exchange moved out.

1981 - Rules and regulations of the Nairobi Stock Exchange amended.

Nov. 1988 - The GoK constituted the Capital Markets Development Advisory Council.

Dec. 1989 - Capital Markets Act received presidential assent.

Jan. 1990 - The CMA was constituted.

Mar. 1990 - CMA was formally launched

1991 - Nairobi Stock Exchange was transformed from society of members to Limited Liability Company.

1992 - Trading was centralized with an auction floor based on open outcry method.

1993 - Realized the highest Nairobi Stock exchange Index and trading volume - 3,700 contracts (4 months average).

NAIROBI STOCK EXCHANGE MARKET STATISTICS

	1986	1991	1992	1993	1994 (April)
NSE index (End Of)	506	958	1167.29	2513.74	3558.51
Market Capitalization (Kshs)		12,705,968,480	23,062,793,020	72,394,794,200	91,348,181,740
U.S. $ Million	N/A	302	400	N/A	1,627(1)
Number of Listed Companies	53	53	57		50
No. of shares traded		16,648,404	14,810,890	22,292,007	13,926,533
Total shares Outstanding		668,429,849	745,083,539	890,833,931	1,007,591,441
Value of shares traded (Kshs.)		301,519,180	384,572,445	825,193,893	1,168,349,135
US $ Million	N/A	11	12	N/A	18(1)
Turnover (5/2)		2.49	2.13	2.19	1.28
No. of deals (Sales only)		8.742	12,020	18,018	13,358
Price/Earnings Ratio	N/A	5.2x	5.8x		N/A

(1)As of June

Source: International Finance Corporation
Nairobi Stock Exchange

ppendix 4

ecent public issues on the NSE

	No. of shares	Amount of capital Kshs.
1986 - Barclays	5,000,000	80,000,000
1988 - KCB	7,500,000	150,000,000
1989 - Std Chartered		
1989 - Nation Newspapers	2,500,000	28,750,000
990 - KCB	9,000,000	297,000,000
991 - KFC	3,261,970	41,000,000
991 - HFCK	18,000,000	
992 - Uchumi	16,000,000	232,000,000
992 - Crown Berger	8,600,000	137,600,000

Appendix 5

SELECTED AFRICAN STOCK EXCHANGES - COMPARATIVE DATA

Stock Exchange	Number of listed companies		Market capitalization US $ M		Value of trading US $ M	
	1988	1992	1988	1992	1988	1992
Zimbabwe	53	62	774	528	39	20
Ivory Coast	24	24	437	331	9	4
Mauritius	13	22	265	377	6	10
Morocco	71	62	446	1076	33	70
Nigeria	102	153	960	1243	5	23
Kenya	55	57	47	607	N.A.	12

Note: for Mauritius, 1990 instead of 1988

Source: International Finance Corporation

Appendix 6

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