CAPITAL MARKETS IN EMERGING ECONOMIES

A CASE STUDY OF THE NAIROBI STOCK EXCHANGE

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ABSTRACT

Over the past two decades, capital markets in developing countries have experienced a rapid evolution. The aggregate market capitalization of countries classified by the IFC as emerging markets rose from $488 billion in 1988 to $2,225 billion in 1996.[1] Trading on these stock markets rose in similar magnitude, growing from $411 billion to $1,586 billion in that period.[2] International donors, governments in developed countries and international financial institutions seem to pay more attention to the Asian and Latin American emerging capital markets in contrast to the African markets (particularly in Sub-Saharan Africa) as evidenced by few studies and literature on the development of capital markets in Sub-Saharan Africa. This study will, therefore, focus on capital market development in Africa, with the Nairobi Stock Exchange (NSE) as a case study. The NSE has continued to increase in importance in economic growth and capital market development in Kenya and the East Africa region. The study will, therefore, explore the path of its development with an emphasis on its structure and organization; rules, regulations and practice; trend in market performance; recent developments; challenges to development; and the way forward in the new millennium. The lessons from this study as well as the recommendations for the future will contribute to the understanding of the development of other capital markets in Africa and other developing regions of the world.

[1] Enrico C. Perotti & Pieter van Oijen, "Privatization, Political Risk and Stock Market Development in Emerging Economies," *Tinbergen Institute Discussion Papers*, (1999).
[2] Ibid.

INTRODUCTION

Prior to the late 1980s, international donors and governments in developing countries held the notion that entrepreneurial functions could be served better by the state through state ownership of the means of production, taxation, licensing and regulation. Individual entrepreneurs were perceived to be few and local subsidiaries of multinational firms formed a large part of local private sector activity. Poor performance of the public sector, misallocation of resources, market distortions and negative economic growth influenced a re-evaluation of the state-led development strategy. In the past 15 years, liberalization and privatization have become dominant themes in development strategies particularly in Africa. Donors, governments and development practitioners have exhibited changing attitudes towards the role of the private sector in the development of African economies and acknowledged the need to facilitate private sector development.[3]

Promotion of economic growth led by the private sector requires the creation of an enabling environment within which the private sector can flourish. A key factor is the healthy growth of a nation's financial sector, which in turn improves the private sector's access to services such as bank credit, equity capital, payments and risk management services.[4] Generally, the development of financial sectors has followed a trend beginning

[3] Peter G. Rwelamira, "The Critical Role of the African Stock Exchanges in Mobilizing Capital for African Private Enterprises." (Nairobi: 1993)
[4] The World Bank, "Capital Market Integration in the East African Community." (Washington, DC: World Bank, 2002), 14

with channeling savings and investments through banks followed by the development of capital markets as savers search for higher returns and firms seek cheaper capital.[5]

Financial markets typically comprise of several institutions including banks, insurance companies, mutual funds, mortgage firms, finance companies and stock markets.[6]

In developing countries, particularly in Sub-Saharan Africa, financial markets are dominated by commercial banks, which have not been reliable sources of long-term financing. The non-bank sources of medium and long-term financing are generally, underdeveloped.[7] The short-term nature of commercial banks' assets and liabilities as well as regulatory reserve requirements in many countries render them (banks) incapable of supplying long-term capital. The high yielding short-term government treasury bills have, therefore, resulted in "crowding out" of the private sector as commercial banks hold large portions of their asset portfolios in the government bills.[8]

Heavy reliance on banks increases vulnerability of financial systems as exemplified by the Asian financial crisis in the 1990s. Having a multi-faceted financial system, which includes non-bank financial institutions, can protect economies from financial shocks.[9] In

[5]The World Bank, Financial Sector Learning Program, Discussion Abstract No. 5, *Proceedings from the World Bank, International Monetary Fund, and Brookings Institution Conference on The Future of Domestic Capital Markets in Developing Countries.* (Washington, DC: World Bank, 2003)

[6] Edward Odundo, "Overview and Evolution of Investment Instruments In Sub-Saharan Africa With Special Reference To Kenya" (Nairobi, Retirement Benefits Authority: 2004)

[7] World Bank, Capital Market Integration.

[8] Ibid.

[9] Jeffrey Carmichael , Michael Pomerleano, "Development and Regulation of Non-Bank Financial Institutions." *The World Bank Publications.* Accessed April 2, 2005. Available from http://publications.worldbank.org/ecommerce/catalog/product?item_id=478151.

this regard, capital markets are considered better avenues of mobilizing domestic and international capital.[10]

Capital markets have the potential to meet the fixed-capital needs of the private sector. They can ensure the efficient and sustainable funding of governments, corporations, banks, and large-scale or long-term projects.[11] In addition, capital markets facilitate the mobilization and allocation of medium and long-term funds for productive investment by:

a) Providing a simple mechanism for the transfer of funds;
b) Facilitating companies' access to a large number of local and foreign investors;
c) Widening the array of financial instruments available to savers and investors
d) Increasing the diversity and competition in the financial systems.
e) Providing market signals on current situations and future expectations.

Generally, the effective functioning of capital markets requires the following: [12]

a) Existence of an exchange, clearing and settlement system.
b) Existence of a legal system to enforce contracts.
c) Availability of information on financial soundness and future prospects of companies.

[10] Sam Q. Ziorklui, "Capital Market Development and Growth in Sub-Saharan Africa: The Case of Tanzania." *African Economic Policy Discussion Paper* 79. (2001).
[11] *Capital Markets.* (accessed April 2, 2005); available from http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/generaldescription/1Capital+Markets?opendocument.
[12] The World Bank, Financial Sector.

d) Governance of corporations in a manner that gives investors confidence that their funds will not be stolen or wasted.

Developing countries are working towards reforming and deepening financial systems, through the expansion of capital markets in order to improve their ability to mobilize resources and efficiently allocate them to the most productive sectors of the economy. A significant policy change has been the establishment privatization programs, which have facilitated reduction in public debt, improved incentives and efficiency in the operations of the privatized entities, and facilitated better access to capital through the floating of shares to the general public.[13] Over the past two decades, capital markets in developing countries have experienced a rapid evolution. The aggregate market capitalization of the countries classified by the IFC as emerging markets rose from $488 billion in 1988 to $2,225 billion in 1996. Trading on these stock markets rose in similar magnitude, growing from $411 billion to $1,586 billion in that period.[14]

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[13] S. Claessens, D. Klingebiel, and S. Schmukler, "FDI and Stock Market Development: Complements or Substitutes?". Accessed April 2, 2005. Available from http://wbln0018.worldbank.org/LAC/lacinfoclient.nsf/d29684951174975c85256735007fef12/f9dd2160146f4fb085256c60005275ac/$FILE/_t8p24i816419n8rr3dcg4qobiddin8spd8him6b9i60mj0c8_.pdf.

[14] Perotti and van Oijen.

PART I: CAPITAL MARKETS IN AFRICA

In the past 15 years (1990 – 2005), liberalization and privatization have become dominant themes in development strategies in Africa. The changing attitudes towards the role of the private sector in the development of African economies has facilitated the development of the capital markets. In the 1990s many countries in Africa set up stock exchanges as a precondition for the introduction of market economies under the structural adjustment programs propagated by the international monetary institutions and to facilitate the privatization of state owned enterprises. Currently, Africa has eighteen securities exchanges, eleven of which began operations in the 1990s.

The growth in market capitalization in Africa has been described as remarkable as more countries outside of the more advanced economies of the Maghreb region (Northern Africa) and South Africa venture into the development of their capital markets.[15]

Statistical Data on African Stock Markets (excluding South Africa)[16]

	1988	1997	2002
No of Stock Exchanges	6	14	18
Market Capitalization of African Stock Markets (US$ Billion)	5.5	49	66
Value traded (US$ Billion)	0.16	8.6	6.5
No of listed companies	788	1180	1760

[15] Sheehan and Zavala.
[16] Sunil Benimadhu, *Assessing African Equity Capital Markets: The Mauritius Stock Market*. Presentation at Corporate Council on Africa (New York, February 26, 2004) Accessed April 13, 2005. Available from http://www.africacncl.org/downloads/AssessCapMkt-Benimadhu.ppt.

Market capitalization of stock exchanges in Africa at the end of 2002:[17]

	Country	Name of Stock Exchange	Stock Market Capitalization for the end of Dec. 2002 (USD. Millions)
1	South Africa	JSE Securities Exchange	182,616
2	Egypt	Cairo and Alexandria Stock Exchange	26,245
3	Zimbabwe	Zimbabwe Stock Exchange	11,689
4	Morocco	Bourse de Casablanca	8,319
5	Nigeria	Nigeria Stock Exchange	5,989
6	Tunisia	Bourse de Tunis	1,810
7	Botswana	Botswana Stock Exchange	1,717
8	Kenya	Nairobi Stock Exchange	1,676
9	Cote d'ivore	Bourse Re'gionale Des Valeurs Mobilieres S.A[18]	1,329
10	Mauritius	Stock Exchange of Mauritius	1,324
11	Tanzania	Dar-es-Salaam Stock Exchange	695
12	Ghana	Ghana Stock Exchange	382
13	Zambia	Lusaka Stock Exchange	231
14	Namibia	Namibia Stock Exchange	201
15	Swaziland	Swaziland Stock Exchange	146
16	Algeria	Bourse d'Alger	145
17	Malawi	Malawi Stock Exchange	107
18	Uganda	Uganda Securities Exchange Ltd.	52

The growth has not only been in market capitalization, but also in innovation such as is characterized by the integration of regional markets in the francophone countries of West Africa. Eight (8) French-speaking members of the West African Economic and Monetary Union (UEMOA), namely, Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo created the world's first regional exchange, the Bourse Regionale des Valeurs Mobilieres (BRVM- Regional Stock Exchange).[19] The objective

[17] Data obtained from United Nations Development Program, African Stock Exchanges Handbook 2003.
[18] BRVM- Regional Stock Exchange in West Africa composed of eight (8) French-speaking members of the West African Economic and Monetary Union (UEMOA), namely, Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo.
[19] *Mbendi Information For Africa*. Accessed April 8, 2005. Available from http://www.mbendi.co.za/exch/25/p0005.htm

of the integration was the consolidation of the value of developing a common hub for capital market development in the geographical zone where these countries are located. The BRVM – Regional Stock Exchange has been innovative in using the most modern electronic and satellite communications equipment, which has enabled it to maintain performance despite the under-developed communications infrastructure in the individual countries comprising the exchange.[20] Another example of integration is in the East African Countries of Kenya, Uganda and Tanzania which are currently in the process of integrating their stock markets into a regional East African stock market.

The majority of the countries establishing new exchanges in Africa have established new legal and regulatory regimes. International financial institutions such as the International Finance Corporation of the World Bank and various bodies of experts belonging to national securities exchanges of industrialized countries have provided important assistance with a view to building the legislative, regulatory, and accounting basis for the proper running of African securities exchanges.[21] In addition, inflation rates are on the decline and currencies are generally considered stable.

The African markets are not closely linked to other international markets as is the case in Asia. While this is may be a disadvantage to their growth, this ‘independence’ has made them attractive to investors who are looking for markets that will not be significantly affected by shocks to major world markets as was the case during the Asian crisis in the 1990s. In addition, equity investors traditionally look for high growth opportunities and

[20] Sheehan and Zavala.
[21] Ibid.

"Africa offers an unparalleled opportunity in that regard."[22] The returns on investment in Africa are beginning to be very impressive despite weaknesses inherent in the capital markets.

Examples of African stock markets with impressive market performance:

The **Nigerian Stock Exchange** was established in 1960 and is an example of a stock market in Africa that has experienced tremendous growth in the last two decades. In June 2004, the all-share index stood at 27,692.36 points having risen from 100 in 1984, the base year.[23] In addition, the market turnover doubled in 2003 from N60.3 Billion in 2002 to N120.70 billion. The value of new issues rose from N67.4 Billion in 2002 to N185.02 Billion in 2003.[24]

The **Mauritius Stock Market** is an example of a 'young' African stock market that has also experienced significant growth. It was set up in 1989 and is currently operating in line with standards observable in well-established developed stock exchanges. It boasts a world-class stock exchange infrastructure with state-of-the art automated trading system, a modern central depository system and a demutualized[25] stock exchange structure which ensures proper monitoring and regulation of members and market participants, among others.

[22] Bryant W. Seaman III, New York Stock Exchange Group Executive Vice President, International to investment managers, financial experts and heads of African stock exchanges in New York's Wall Street District on April 16, 2003. *Global Policy Forum.* Accessed April 12, 2005. Available at http://www.globalpolicy.org/socecon/develop/africa/2003/0416stock.htm

[23] The Nigerian Stock Exchange, The Nigerian Stock Market Performance 1990-2003.

[24] Ibid.

[25] Benimadhu.

Mauritius Stock Market Statistics (1989 and 2003):[26]

	1989	**2003**
No. of traded securities	6	120
Market Capitalization (Rs)[27]	1,437,079,336.00	51,229,930,441.25
Annual Turnover (Rs)	14,259,850.00	2,989,174,317.00
Market Cap/GDP (%)	4.32	32.78
Liquidity ratio (%)	3.97	23.34

The development of African stock exchanges is growing in importance because of the important role they play in facilitating the:

- higher savings rate of the working population;
- offering of a variety of securities to as many people as possible;
- flow of foreign direct investment into long-established or recently introduced companies;
- distribution on capital in the most productive sectors of the economy
- redistribution of wealth in the economy
- improved corporate governance through increased transparency and access;

In addition, African stock exchanges have the potential to help create wealth and the long-term capital needed for development thereby facilitating poverty reduction and the improvement of living standards.[28] It has been stated that the

[26] Ibid.
[27] Mauritius currency: Mauritian Rupee.
[28] Statement by Ndi Okereke-Onyiuke, Chairperson of the African Stock Exchanges Association and Director-General of the Nigerian Stock Exchange to investment managers, financial experts and heads of African stock exchanges in New York's Wall Street District on April 16, 2003. *Global Policy Forum.* Accessed April 12, 2005. Available at http://www.globalpolicy.org/socecon/develop/africa/2003/0416stock.htm.

future of Africa's stock markets is the future of the poor in Africa.[29] The jobs, businesses, prosperity and future of the region lie in the stock markets' ability to mobilize capital for economic development and growth. The securities exchanges can be a powerful tool for growing indigenous capital that will attract international capital if they are well designed and set up, properly regulated and supported by appropriate governmental policies.[30]

CHALLENGES OF DEVELOPING STOCK MARKETS IN AFRICA

The political and economic decisions that were translated into legal framework for the establishment and operation of the stock exchanges were rushed in many African countries. Therefore, the exchanges have not been successful in attracting a large number of other market transactions in addition to the privatized public enterprises.[31]

Many of Africa's stock exchanges are small, underdeveloped and illiquid. They tend to operate in isolation from other markets, have low trading volumes, are sheltered from competition by national regulations and face barriers to capital mobility because of high costs of travel and communications.[32] African exchanges tend to be highly concentrated

[29] By UNDP Administrator Mark Malloch Brown to investment managers, financial experts and heads of African stock exchanges in New York's Wall Street District on April 16, 2003. *Global Policy Forum.* Accessed April 12, 2005. Available at http://www.globalpolicy.org/socecon/develop/africa/2003/0416stock.htm
[30] Michael Sheehan and Daniel Zavala, "African Securities Exchanges: Challenges and Rewards" *The Handbook of World Stock, Derivative and Common Market*. Accessed April 12, 2005. Available at http://www.exchange-handbook.co.uk/articles_story.cfm?id=5656.
[31] Responses by Kwama.
[32] Patrick Asea, "Promoting Regional Financial Market Integration", Presentation at the African Capital Markets Development Program in Johannesburg, South Africa, October 2003.

with the best shares being held by local pension funds, banks and insurance firms that do not want to sell because they have few alternative assets to buy with sales proceeds. In addition, the market infrastructure is underdeveloped particularly with regard to trading, settlement and delivery as manual systems and processes dominate their operations.

Bond markets are relatively underdeveloped in Africa's capital markets, yet they have the potential of mobilizing significant amounts of capital. They can also give African stock exchanges a tremendous boost in turnover as bonds are usually more attractive to investors than stocks. A well integrated and customized financial information service that provides timely and accurate information service to individuals and corporate institutions is necessary for the development of bond markets.[33]

Stringent eligibility requirements have discouraged local entrepreneurs and indigenous enterprises that wish to raise funds from capital markets. The eligibility requirements as exemplified in the requirements for listing at the NSE have created high barriers to potential entrants to the stock exchanges such as the numerous family owned businesses in Africa. Thus, the stock exchanges tend to operate like closed membership organizations.[34]

Limited presence of institutional investors is constraining equity demand. In addition, lack of an active role in the distribution of securities to the public by other financial

[33] NSE Handbook. 7.
[34] Asea.

institutions such as banks, venture capital funds, pension funds, building societies and insurance companies is constraining supply of equity.

Creating an efficient regulatory system for securities exchanges is a difficult goal to achieve and maintain. Hence, some African stock exchanges have limited institutional capacity to police and enforce rules. Most of the smaller African exchanges lack the trained manpower and experience to adequately police the modern regulatory regimes they have adopted. Consequently, enforcement actions are rare and abuses are not uncommon.[35] In addition, investors, particularly minority shareholders, lack confidence in the market as some listed companies continue to operate under poor corporate governance structures. In some stock markets, participants are subject to multiple regulators thereby causing regulatory complexities, uncertainties and increased costs of compliance with different regulatory regimes.[36] In Kenya, the NSE and CMA both serve as regulators of market participants. Each has its own requirements for membership, listing and participation in the market and though there are similarities, the multiplicity creates uncertainty as to which requirements are applicable in different situations.

Political uncertainties and economic policies in some African countries have facilitated the decline in confidence in and subsequent poor performance of the stock markets because of the risk of deterioration in the business climate. Before, the last general elections in Kenya in 2002, the Nairobi Stock Exchange experienced decline in market

[35] Sheehan and Zavala.
[36] Asea.

performance due to political and economic policies adopted by the government that led to the withdrawal of donor funding. However, there was renewed confidence in the market evidenced by improved performance in market capitalization and turnover when a new government came into power in 2003. In Zimbabwe, the Zimbabwe Stock Exchange was established in 1896. It has been a star performer among the emerging markets stock exchanges particularly towards the end of the last decade (1996 and 1997). However, its turnover and market capitalization has declined since 1998, due to the loss of confidence brought about by the present regime's political and economic policies.[37]

Low savings rate in many African countries has constrained demand and supply of equity in stock markets. Poverty, war, political unrest and disease have resulted in a large portion of the African population living on less than a dollar a day thereby constraining savings.

Most of the new African exchanges, apart from Johannesburg, Casablanca and Cairo securities exchanges, lack attractive and diverse types of securities to offer foreign investors. Generally, there may be only two or three corporations of interest to foreign investors and most of these may either be subsidiaries of major multinational corporations or recently privatized companies. Consequently fund managers choose the safer course and invest in parent companies listed nearer to home.[38]

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[37] Sheehan and Zavala.
[38] Ibid.

PART II: THE NAIROBI STOCK EXCHANGE

The NSE is an example of an emerging stock market that has been characterized by humble beginnings yet has grown considerably over time. It stands out as an average stock market with great potential for growth, one that is making considerable effort to be a more significant driver of economy in Kenya and the East African Region. In 1994 the NSE was rated by the International Finance Corporation (IFC) as the best performing emerging market in the world with a return of 179% in dollar terms.[39] In the past two years (2003 - 2005) it has experienced robust activity and high returns on investment. It accounts for over 90% of market activity in the East African region and is a reference point in terms of setting standards for the other markets in the region.[40] As an emerging capital market, it has faced challenges to its development and growth such as economic depression and political uncertainty, among others.

NSE facilitates the mobilization of capital for development and provides savers in Kenya with an alternative saving tool. Funds that would otherwise have been consumed or deposited in bank accounts are redirected to promote growth in various sectors of the economy as people invest in securities. Economic growth is promoted through improved efficiency in mobilization of savings[41] as capital is allocated to investments that bring the

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[39] Odundo.
[40] World Bank, Capital Market Integration.
[41], K. Schmidt-Hebbal, L. Serven and A. Solimano "Saving Investment: Paradigms, Puzzles, Policies," *The World Bank Research Observer* 1, no.1 (1996)

most value to the economy.[42] Long-term savings are, therefore, mobilized for financing long term ventures through competitive pricing mechanisms.

NSE provides enterprises with a non-bank source of financing through the sale of shares to the public. It provides not only the substitution but also diversification of risk to entrepreneurs as they raise capital through equity. [43] The government and local authorities use the NSE as an alternative source of funds to increasing taxes in order to finance development projects. Through the issue of bonds to the public, funds are raised for different types of projects.

As an instrument of privatization, the Exchange has provided an avenue of liberalization of sectors previously dominated by the government and facilitated public divesture of its shares in public enterprises such as the Kenya Airways, Mumias Sugar Company, Kenya Commercial Bank, among others.

NSE encourages the broader ownership of firms. The opportunity accorded the general public to have ownership rights over listed enterprises helps to reduce large income inequalities through the sharing of profits made by these enterprises, thereby facilitating the redistribution of wealth. The Exchange facilitates improved corporate governance. Public companies tend to have better management records than private companies[44] because of the improvement of management standards and efficiency to meet the demands of shareholders and the NSE under its corporate governance rules.

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[42] *Capital Markets Authority.* Accessed April 2, 2005. Available from www.cma.or.ke

[43] Mbui Wagacha, "Kenya's Capital Market: To list or not to list – A survey of Enterprise Attitudes" *IPAR Discussion Paper* 28 (2001).

[44] *Role of the Exchange in the Economy* (accessed July 10, 2004); available from www.nse.co.ke/Role.htm

Investors are accorded the opportunity to buy the number of securities that are affordable to them, thereby facilitating the small investor's source of extra income. This is in contrast to other means of investments that require large capital outlays that are not within the reach of small investors be they individuals or institutions.

The activity in the market serves as a 'barometer' for the performance of the economy. The movement of shares is an indicator of the general trend in the economy[45] because share prices tend to rise or be stable when the economy and the relevant companies are stable and growing.

HISTORY AND DEVELOPMENT OF THE NAIROBI STOCK EXCHANGE

Dealing in shares and stocks started in Kenya in the 1920s. At this time, Kenya was a British colony. Stock broking was conducted solely by Europeans in areas of specialization such as accountants, auctioneers, estate agents and lawyers who met to exchange prices over a cup of coffee. Trading took place on gentlemen's agreement in which standard commissions were charged and clients were obliged to honor their contractual commitments such as making good delivery and settling relevant cost.[46] There was no formal market, rules or regulations to govern stock broking.

Francis Drummond, an estate agent, established the first professional stock broking firm in 1951. He impressed upon Sir Ernest Vasey, the Finance Minister of Kenya at the time,

[45] Ibid.
[46] Nairobi Stock Exchange, *Handbook: An Authoritative 5-year Performance Results of Listed Companies.* 2002 Ed. (Nairobi, 2002), 164

the need to set up a stock exchange in East Africa. In July 1953, Sir Ernest Vasey and Francis Drummond made the proposal to the London Stock Exchange officials who accepted and recognized the establishment of the Nairobi Stock Exchange (NSE) as an overseas stock exchange.

In 1954, the NSE was constituted as a voluntary association of stockbrokers registered under the Societies Act. Africans and Asians were not permitted to trade securities at the NSE. Business was conducted by resident Europeans only until 1963 when Kenya attained independence from Britain. Before 1963, there were about 10 listed companies. Activity at the stock market slumped at the dawn of Kenya's independence due to uncertainty about Kenya's economic future. However, the first three years of independence were marked by steady economic growth and the restoration of confidence in the market, with the result that the NSE handled a high number of subscriptions of public issues.

By 1966, the NSE had begun measuring daily trading activity by computing the NSE Index. The index measured daily average price changes in 17 companies that were considered the most active stocks in the market. It was computed as a weighted average of price changes in the selected stocks and 1966 was used as the base year and set at 100 points.[47]

[47] Joseph H. Kimura and Yobesh Amoro, "Impediments to the Growth of the Nairobi Stock Exchange". *IPAR Discussion Paper Series.* 6.

The 1970s saw about 20 more companies listed on the NSE. This was the largest number of companies listed in a span of about a decade. The 1972 oil crisis dealt a blow to this growth due to the depression of share prices arising from inflation. In 1975, a 35% Capital Gains Tax was introduced, leading to further losses experienced by the NSE. Other factors that negatively affected the NSE include the nationalization and compulsory acquisition of companies quoted or subsidiaries of companies quoted at the NSE by Tanzania and Uganda, introduction of exchange controls and introduction of inter-territorial restrictions among the East African countries.

The 1980s recorded five new companies listed. In 1984, the Government of Kenya through the Central Bank of Kenya in conjunction with the International Finance Corporation (IFC) conducted a study dubbed "Development of Money and Capital Markets in Kenya". This study became a blue print for structural reforms in Kenya's financial markets and culminated in the establishment of the Capital Markets Authority (CMA) in 1989 as a regulatory body that would enable the development of Kenya's capital markets and the creation of a conducive environment for economic growth.

In 1988, the first privatization through the NSE was implemented when the government sold 20% of its stake at the Kenya Commercial Bank.

The 1990s saw ten more listed companies. In 1991 NSE was registered under the Companies Act[48] and also adopted a 20-share index and changed the computational method of the index to a geometric mean. On February 18, 1994 the NSE recorded an all record high of 5030 points on the 20-Share Index. The number of stockbrokers also

[48] Chapter 486, Laws of Kenya.

increased from six to fourteen when eight more were licensed. Subsequently, the IFC rated the NSE as the best performing market in the world with a return of 179% in dollar terms. [49]

In 1995, the government made changes with regard to the restrictions on foreign ownership of local companies from an aggregate limit of 20% and an individual limit of 2.5% to 40% and 5%, respectively with an objective of encouraging foreign portfolio investments. The Exchange Control Act was repealed. Seven more brokers were licensed, increasing the total to twenty brokers. Rates of commission were reduced from 2.5% to between 2% and 1% for equities and 0.05% for fixed interest securities. NSE had its largest share issue in 1996 when the Kenya Airways was privatized. About 110,000 shareholders acquired a stake in the airline. In 1998, a number of incentives were introduced by the government to encourage foreign investment such as tax-free Venture Capital Funds, removal of Capital Gains Tax on investments by insurance companies and allowance of beneficial ownership by foreigners in local stockbrokers and fund managers.

In 2000, Kenya, Uganda and Tanzania signed the Joint Stock Exchange Taskforce report on cross border listing. Subsequently, the East African Breweries Ltd. and the Kenya Airways proceeded to cross list at the Kampala and Dar es Salaam Stock Exchanges. In 2001, NSE was categorized into three market segments namely, the Main Investment Market Segment (MIMS), Alternative Investment Market Segment (AIMS) and Fixed

[49] NSE Handbook.

Income Securities Market Segment (FISMS). The first rights issue under the AIMS was implemented in February 2001.[50]

New foreign investor regulations were enacted in 2002. They provided that there would be a 25% minimum reserve of the issued share capital for locals while the balance of the 75% would be for all types of investors. A local investor is defined as an individual who is a citizen of Kenya, a company incorporated under the Companies Act of Kenya or any other body corporate established or incorporated in Kenya under the provision of any law in which Kenya citizens or the Government of Kenya have beneficial interest in 100% of its ordinary shares.[51]

In 2002, an agreement was reached for the establishment of the Central Depository and Settlement Corporation (CDSC). The CDSC is the legal entity that owns the automated clearing, settlement, depository and registry system (CDS).

STRUCTURE AND ORGANIZATION OF NSE

The Nairobi Stock Exchange was incorporated under the Companies Act of Kenya in 1991 as a company limited by guarantee and without a share capital.[52] Prior to 1991, it was registered as a voluntary association of stockbrokers under the Societies Act in 1954. Currently, fourteen (14) stockbrokers and three (3) investment banks form the membership of the NSE.[53]

[50] *History of the NSE.* Accessed June 20, 2004. Available from www.nse.co.ke/History.htm.
[51] Ibid.
[52] Nairobi Stock Exchange Memorandum of Association and Articles of Association.

Below is a hierarchical representation of NSE's organizational structure:[54]

11 members of the Board of Directors
⇓
1 Chief Executive
⇓
4 Heads of Department
⇓
4 Managers
⇓
7 Officers
⇓
12 Clerks
⇓
2 Support Staff

The Board of directors consists of eleven directors made up as follows: two directors representing listed companies, 2 directors representing public investors, 1 director representing institutional investors, 5 directors representing stockbrokers and dealers (members of the NSE) and the Chief Executive.[55]

NSE is categorized into three market segments:

i) Main Investment Market Segment (MIMS)

ii) Alternative Investment Market Segment (AIMS)

iii) Fixed Income Market Segment (FIMS).

[53] Ibid.
[54] *Nairobi Stock Exchange*. Accessed June 20, 2004. Available from http://www.nse.co.ke/MemberFirms.htm
[55] Article 32, NSE Articles of Association.

The MIMS is the main quotation market. Companies listed under this segment are further categorized in four sectors that describe the nature of their business, namely:

a) Agricultural

b) Industrial and allied

c) Finance and investment

d) Commercial and services.

The AIMS:

- Provides an alternative method of raising capital to small, medium sized and young companies that find it difficult to meet the more stringent listing requirements of the MIMS.[56]
- Is geared towards responding to the changing needs of issuers.
- Facilitates the liquidity of companies with a large shareholder base through ‘introduction’, that is, listing of existing shares for marketability and not for raising capital.
- Offers investment opportunities to institutional investors and individuals who want to diversify their portfolios and to have access to sectors of the economy that are experiencing growth.

The FISMS, on the other hand, provides an independent market for fixed income securities such as treasury bonds, corporate bonds, preference shares and debenture stocks, as well as short-term financial instruments such as treasury bills and commercial papers.

[56] NSE Handbook, 7.

There are 51 companies listed under the three market segments[57]:

Main Investment Market Segment:

Agricultural:	**Commercial and Services:**	**Finance and Investment:**	**Industrial and Alliance**
Brooke Bond (K)	Car & General (K)	Barclays Bank	Athi River Mining
Rea Vipingo	CMC Holdings	CFC Bank	BOC Kenya
Kakuzi	Kenya Airways	Diamond Trust Bank (K)	Bamburi Cement
Sasini Tea & Coffee	Marshalls (E.A.)	Housing Finance Co.	Carbacid Investments
	Nation Media Group	Jubilee Insurance Co.	Crown Berger
	TPS	Kenya commercial Bank	Dunlop Kenya
	Uchumi Supermarkets	National Bank of Kenya	E.A. Cables
	Hutchings Biemer (Suspended)	NIC Bank	E.A. Portland Cement
		Standard Chartered Bank	E.A. Breweries
		Pan Africa Insurance Holdings	Firestone E.A
			Kenya Oil
			Mumias Sugar Co.
			Kenya Power & Lighting Co.
			Total Kenya
			Unga Group
			British American Tobacco

Alternative Market Investment Segment:

City Trust
Eaagads
Express
Limuru Tea
Kapchorua Tea
Kenya Orchards
A. Baumann & Co
Williamson Tea Kenya
Standard Newspapers Group

Fixed Investment Securities Market Segment:

Safaricom
Shelter Afrique
Mabati Rolling
East Africa Development Bank

[57] *Listed Companies* (accessed April 9, 2005); available from http://www.nse.co.ke/ListedCompanies.htm.

MEMBERS AND PARTICIPANTS IN THE CAPITAL MARKET

The Capital Markets Authority

The Capital Markets Authority (CMA) was established in 1989 as a body corporate with perpetual succession through an Act of Parliament[58] to regulate and oversee the orderly development of Kenya's capital markets. The mission of Capital Markets Authority is to promote the development of orderly, fair, efficient, secure, transparent and dynamic capital markets in Kenya within a framework which facilitates innovation through an effective but flexible system of regulation for the maintenance of investor confidence.[59]

CMA has a board of directors consisting of:

a) A chairman appointed by the President of Kenya on the recommendation of the Minister of Finance.
b) Six members appointed by the Minister of Finance to serve for three years. These have experience and expertise in legal, financial, banking, accounting, economics or insurance matters, and are eligible for re-appointment for another three years.
c) The Permanent Secretary to the Treasury or his representative.
d) The Attorney General or his representative.
e) CMA'S Chief Executive who is appointed for four years and is eligible for a second four-year term.

CMA draws the bulk of its financial support from prescribed fees paid by licensed members of the CMA and NSE. The government of Kenya provides an annual grant of

[58] Capital Markets Authority Act, Chapter 485A Laws of Kenya.
[59] *CMA Annual Reports 2003* (accessed April 13, 2005); available from www.cma.or.ke.

about 5% of CMA's annual budget. Although the CMA is a statutory body, it is operates as an independent entity in contrast to a government department.

<u>Other Participants</u>

CMA is mandated by the Capital Markets Authority (Amendment) Act, 2000

to license participants in the capital markets. Presently, the following categories of participants have been licensed:[60]

- Four approved institutions:
    1. A credit rating agency to assess the credit worthiness of companies wishing to be listed at NSE.
    2. A stock exchange – the NSE.
    3. A venture capital fund to lend money to and acquire stake in newly established companies.
    4. A central depository.
- Two approved collective investment schemes.
- Thirteen stockbrokers
- Six investment banks – function as both dealers (buy securities on their own behalf) and brokers.
- Eight fund managers.
- Eighteen investment advisers.
- Four authorized depositories – all commercial banks.
- Three authorized securities dealers trading in the fixed market only.

[60] Capital Markets Authority, "Licencing Requirements." (Nairobi: 2004)

ROLE OF THE CAPITAL MARKETS AUTHORITY

Pursuant to its mission, the CMA is guided by the following objectives:

a) Facilitate the creation of incentives for and the removal of impediments to long-term investments in productive activities.

b) Facilitate the existence of a market in which securities can be traded in an orderly, fair and efficient manner, and ensure participation of the general public.

c) Protect investors from financial loss arising from failure of a broker or dealer to meet his contractual obligations through a guarantee embodied in the compensation fund.

d) Develop a framework through which electronic commerce may be used for the development of capital markets in Kenya.

e) Develop new financial products to diversify the market and attract investors.

f) Facilitating the training and education of investors and other market participants.

g) Participate in the integration of the East African capital market.

h) Develop a legal and regulatory framework for the market. In this regard, the CMA has formulated the following rules and regulations:

    a. Capital Markets (Licensing Requirements) (General) Regulations, 2002
    b. Capital Markets (Securities) (Public Offers, Listing and Disclosure) Regulations, 2002
    c. Capital Markets (Takeovers and Mergers) Regulations
    d. Capital Markets Authority, Foreign Investor Regulations, 2002
    e. Capital Markets Authority Fees Structure
    f. Collective Investment Schemes Regulations, 2001
    g. Corporate Governance Guidelines, 2002
    h. Rating Agency Guidelines, 2001

PART III: RULES, REGULATIONS AND PRACTICE

LISTING AT THE NSE

The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002, prescribes the eligibility requirements for companies listed under the different market segments at the NSE. It also provides the continuous reporting and disclosure requirements of listed companies. The following is a summary of the listing requirements under the different market segments.[61]

Main Investment Market Segment (MIMS)

1. Registration of the company under the Companies Act as a public limited company limited by shares.
2. Minimum authorized, issued and fully paid up share capital of Kshs. 50 million and net assets of Kshs.100 million before public offering of the shares.
3. Shares to be listed must be freely transferable and not subject to any restrictions on marketability or pre-emptive rights.
4. The company must have published audited and financial statements in line with international accounting standards for an accounting period ending not more than three months prior to the proposed date of the offer. If more than three months have lapsed, the company must prepare a set of interim un-audited financial statements for the period following the end of the financial period as long as the period does not exceed six months. If the period exceeds six months, the company must carry out an

[61] The Capital Markets (Licencing Requirements) (General) Regulations, 2002.

interim audit for the period, or plan a date of offer immediately following the completion of the next annual audit. The auditor's report unqualified

5. The company should be solvent.
6. The company must not be in breach of any of its loan covenants particularly the maximum debt capacity at the date of application for listing.
7. For a period of at least two years prior to the date of application, the directors of the issuer must not have:
    a. any proceedings in which he/she was convicted of fraud or any criminal offence, or be the subject of pending criminal proceedings (for individuals) or any action or offence within or outside Kenya (for corporate bodies).
    b. Been the subject of any ruling of a court or governmental body that permanently or temporarily prohibits him/her from engaging in any type of business practice or activity, or acting as an investment adviser or as a director, employee, broker, dealer of any financial institution.
8. The company must have declared positive profits after tax in at least three of the last five completed accounting periods to the date of the offer.
9. At least 20% of the shares must be held by not less than 300 shareholders excluding employees of the company following the public shares offering.
10. If the company is a banking or insurance company, it must obtain a clean certificate from the relevant regulatory authority.
11. The Capital Markets Authority must approve the company's information memorandum or prospectus.

Alternative Investment Market Segment (AIMS)

1. Registration of the company under the Companies Act as a public limited company limited by shares.
2. Minimum authorized, issued and fully paid up share capital of Kshs. 10 million and net assets of Kshs.20 million before the public offering of shares.
3. Shares to be listed must be freely transferable and not subject to any restrictions on marketability or pre-emptive rights.
4. The company must not be in breach of any of its loan covenants particularly maximum debt capacity at the date of application for listing.
5. The company must have at least two non-executive and independent directors.
6. For a period of at least two years prior to the date of application, the directors of the issuer must not have:

a. any proceedings in which he/she was convicted of fraud or any criminal offence, or be the subject of pending criminal proceedings (for individuals) or any action or offence within or outside Kenya (for corporate bodies).
b. Been the subject of any ruling of a court or governmental body that permanently or temporarily prohibits him/her from acting as an investment adviser or as a director, employee, broker, dealer of any financial institution or engaging in any type of business practice or activity.

7. For at least one year prior to the application for listing the company must have suitably qualified senior management with relevant experience. The management should not have committed any offence considered inappropriate for the management of a listed company.

8. The company should have a minimum of twenty-five investors. After listing, at least 20% of the paid up capital should be held by not less than twenty-five investors excluding any holding by employees or family members in a family owned enterprise. No investor should hold more than 3% of the 20% of paid up capital.
9. The company must ensure that the existing shareholders, related persons or such other group of controlling shareholders who have influence over the management, undertake not to sell their shareholding before the expiry of twenty-four months following the listing.
10. The company must have potential for growth and should have been in existence in the same line of business for a minimum of two years.
11. A subsidiary whose parent company has a five-year track record may list provided that the subsidiary has an operating track record of at least one year.
12. The accounts of the company must be audited and should not be older than four months prior to the date of offer. The auditor's report should be unqualified.
13. The company should be solvent.
14. The company should not use the proceeds of a public issue to redeem any loans obtained prior to the listing by the directors or shareholders.
15. The company must disclose a clear policy on dividends.
16. A company listed on AIMS may only change to MIMS after satisfying the relevant listing requirements and after a minimum of one year of listing on the AIMS.
17. The Capital Markets Authority must approve the company's information memorandum or prospectus.

Fixed Income Securities Market Segment (FISMS)

Companies intending to list commercial papers or corporate bonds in the FIMS must satisfy all the requirements under MIMS including the following:

1. The total indebtedness of the issuer, including the new issue of the commercial paper or the corporate bond shall not exceed 400% of the company's net worth as at the date of the latest balance sheet and as long as the commercial paper or corporate bond remains outstanding.
2. The ration of funds generated from operations to total debt for the three trading periods preceding the issue shall be maintained at a weighted average of 40% or more.
3. The directors and senior management of an applicant must have appropriate expertise and experience for the management of the group's business. Details of their expertise must be disclosed in the application's memorandum of information.
4. The directors must be free from any conflict of interest between the duties owed to the company and their private interest.
5. The consent of the CBK or Commissioner of Insurance is required where there is a guarantor who is either a bank or insurance company, except where the guarantor is an offshore bank or insurance company not subject to the regulation of the CBK or Commissioner of Insurance.
6. The guarantor is required to provide the CMA with a financial capability statement duly certified by its auditors.

TRADING AT THE NSE: RULES AND PRACTICE

Trading of securities[62] is conducted on Monday to Friday from 10.00am to 12.00pm at the NSE trading floor. Only authorized persons are permitted on the trading floor and these include registered floor traders, dealers, NSE staff, authorized officials of the CMA, directors of the NSE board and of firms that are members of the NSE, and any other person authorized by the Trading Floor manager or the NSE Chief Executive Officer. Clients are not allowed on the trading floor. However, the NSE has a public gallery above the trading floor from which members of the public, students, clients and any other persons can follow the conduct of business at the trading floor.

All authorized persons are required to dress formally and display their identification tags. Different groups of authorized persons are designated a jacket color to distinguish them on the trading floor. They are not allowed into the public gallery in their trading uniforms. The designated uniforms are as follows:

Board-writers and data clerks	- green
Stockbroker floor traders	- Red
Dealer floor traders	- Light Blue
Authorized securities dealers	- Dark Blue

English is the official language of communication at the trading floor. Before the start of each trading session, the trading boards are wiped clean. The only information that is permanently on the trading boards is the names of listed companies organized under the specific trading segments (MIMS – including sector categorizations of Agriculture, Commercial and Services, Finance and Investment, and Industrial and Allied, AIMS & FISMS).

[62] As prescribed in the NSE Trading and Settlement Rules.

Stockbrokers are required to make irrevocable arrangements with their clients for the payment or settlement at a confirmed price before authorizing a floor trader to buy or bid any security at the trading floor. In addition, stockbrokers are required to ensure that certificates of title have been verified by the respective shares registrar before a sale or offer of any security is made at the trading floor.

During trading, orders are communicated verbally and directly to the board writers by dealers and traders while standing in the trading zone. The trading zone is a restricted area delineated by banisters.[63] Only one trader from the same firm is allowed to call out prices. Negotiations are not allowed and floor traders are not allowed to move beyond the restricted area or have physical contact with the boards or the board writers during trading. The bids, offers and breakdown of lots or quantities of securities are recorded on the boards by the board writers and are not to be removed. In the event of an error, corrections will only be made if the error is pointed out within thirty seconds of placement on the boards and before other bids or offers are made against the erroneous position.

Trading orders are recorded on the basis of the first order called out, the highest bid price called out or the lowest offer price called out. The bid and offer prices are required to move in spreads stipulated below:

Security price	Spread
Below Kshs. 20	Kshs. 0.05
Kshs. 20 – 50	Kshs. 0.25
Kshs. 51 – 100	Kshs. 0.50
Over Kshs. 100	Kshs. 1.00

[63] NSE Trading and Settlement Rules, 3.2.5.

For example, if a trader was interested in a security whose price was below Kshs. 20, say Kshs. 15, the bid would move up or down with the difference between the prices offered being within six Kshs.0.05 spreads, that is, up to Kshs.0.30 at a time. This requirement is not applicable under when the: issuer announces its final results, security is yet to record a transaction trading ex entitlement, security has dual listing, security has not traded for over six months or a market clearing price cannot be established.

Share prices are not allowed to move more than 10% of the last transacted price in the previous trading session within one trading session (in one trading day).

Transactions may takes place at:

a) mid price when the bid and offer price for a share are two spreads apart.
b) the offer price when the bid and offer prices are only one spread apart.
c) par when both the bid and offer prices are similar.

Traders are allowed to transact across books, that is, bid and offer on the same security. In this case, the transaction is held for about thirty seconds before recording to allow other traders to over-bid or under sell. A trader over bids when he/she halts a transaction that is about to be concluded by another trader and offers to pay a spread higher for at least 50% of the lot and undersells when he/she halts a transaction about to be concluded by another and offers to sell at one spread below the outstanding price for at least 50% of the lot.

NSE uses tags of different colors or letters of the alphabet placed against securities listed on trading boards to signify specific information. The following table is a summary of the tags and their significance as stipulated in NSE's trading and settlement rules.[64]

Color of Tag	**Significance**
Red	Security has been suspended from trading and no transactions are to be recorded.
Green	A declaration of dividend. Security is trading cum dividend.
Yellow	Bonus issue. Security is trading cum bonus.
Black	End of trading cum dividend. Security is trading ex dividend. Tag remains until the dividend is paid.
Blue	Investors should be aware of new information that has been received about the issuer.
White	Closure of trading cum bonus. Security is trading ex bonus. Tag remains until the bonus certificates are dispatched.
Purple	A rights issue. Security is trading cum rights.
Grey	End of trading cum rights. Security is trading ex rights. Tag remains until the right is issued.
'CC'	Coupon payment. Security is trading cum coupon.
'XC'	End of trading cum coupon. Security is trading ex coupon.
'Q'	Auditor's opinion on the annual financial statements of the company is qualified. Tag is removed once the company produces an unqualified opinion of its auditor.
'd'	Auditor's have disclaimed or given an adverse opinion of the annual financial statements and the company's listing is under suspension.

[64] NSE Trading and Settlements Rules, 3.4.1 to 3.4.12.

After each trading session, the NSE publishes a 'Daily Price List' that indicates the current price of all listed securities shares, the highest and lowest price of shares within the last twelve months and the status of the security, for example, trading ex dividend. This list is available to the public at the NSE reception desk and on the Exchange's website.

DELIVERY AND SETTLEMENT

Prior to November 2004, NSE used a manual delivery and settlement system. The system involved the exchange of share certificates between stockbrokers, NSE and the relevant shares registrars of listed companies before a trading transaction could be completed and the buyer issued with a share certificate in his/her name. The delivery and settlement system was intended to take the T+5 cycle (day of trading plus five days). However, in practice it took an average of between eight (8) and fourteen (14) days.[65] In November 2004, an automated clearing, depository and settlement (CDS) system began operations.

CENTRAL DEPOSITORY SYSTEM (CDS)

The CDS is an automated clearing, settlement, depository and registry system that is for shares what a bank is for cash.[66] Central depositories may be classified from the perspective of physical certificates or from a functional perspective. There are two types of central depositories under the physical certificates existence perspective:

[65]Interview with NSE Delivery and Settlement Manager, conducted in July 2004.
[66] Peter Waiyaki, "Central Depository System and Regional Integration". Presentation at Africa Stock Exchanges Conference in Nairobi Kenya, November 24-25, 2004.

a) Dematerialized CDS – physical certificates are not issued at all to shareholders and change of ownership is by entries recorded in the central depository.
b) Immobilized CDS – physical certificates are issued but the certificates are held under the custody of the depository and not by the shareholders. Change of ownership is by entries recorded in the central depository.

Under the functional perspective, central depositories may provide;

a) only depository services where shares are deposited, transferred and withdrawn or
b) additional functions such as allotment of shares, processing of entitlements and transmission of notices.

A CDS is important because it provides a means through which the transfer of shares can be done in an efficient, safe and cost effective manner. This is in contrast to the problems associated with the use of physical certificates in the transfer of shares between sellers and buyers, which include:

- Mutilation, theft or loss of share certificates while in the personal custody of the shareholder.
- Loss of the certificates while in transit from seller to buyer during the process of verification, cancellation and issuance of a new certificate.
- Delays during the movement of the certificates between the seller and buyer.
- Wrong deliveries of share certificates in the event that the address of the buyer is incorrect or unclear.

The idea of a CDS in Kenya was put forward in 1994. It took about ten years from that time to November 10, 2004 when the first account was opened, thereby marking the realization of a CDS in Kenya.[67] The delay was due to:

- Lack of adequate legislation for implementation of a CDS between 1995 and 2000.
- Inadequacy of funds and efforts to source financial support for the infrastructure
- Issues of corporate governance in the entity that owns the CDS.
- The collapse of an initial agreement with the provider of the software that was to be used in the CDS and negotiations with another provider.

The legal and regulatory framework within which the CDS was established and continues to operate is embodied in the Central Depository and Settlement Act (CDS Act), 2000 and the Central Depositories (Capital Markets) Rules, 2004. The objective of the Act is "to facilitate the establishment, operation and regulation of central depositories, to provide for the immobilization and eventual dematerialization of, and dealings in, securities deposited therewith in Kenya, and for connected purposes."[68] Generally, the rules relate to safe custody and transfer procedures of deposited shares such as how a shareholder can deposit shares into the CDS, what safeguards assure entitlements and how to transfer, mortgage and withdraw shares from the CDS.[69]

CDS is owned and operated by the Central Depository and Settlement Corporation (CDSC), an associate company of the NSE. The design of ownership is intended to ensure independence in the process of settlement and delivery from the market players

[67] Waiyaki.
[68] Central Depository and Settlement Act, 2000.
[69] *What is a Central Depository System?* (accessed July 2004); available at www.nse.co.ke.

who control the exchange such as stockbrokers. The associate company is independent by virtue of its structure as a company limited by guarantee. However, to retain the necessary nexus with the stock market, the law requires that the stock exchange be a shareholder in the CDS entity. [70]

CDSC is composed of the following shareholders:

- Capital Markets Challenge Fund (made up of nine institutional investors) (50%).[71]
- The Nairobi Stock Exchange (20%).
- Association of Kenya Stockbrokers (18%).
- Capital Markets Authority Investor Compensation Fund (7%)

The shareholder agreement consisting of the abovementioned investors in the CDSC included two memoranda of understanding (MOU) between the Dar-es-Salaam Stock Exchange (DSE) and the Nairobi Stock Exchange (NSE) on one hand and between the Uganda Securities Exchange (USE) and the NSE on the other, in which the NSE agreed to invest and hold in trust for sale 2.5% of the shareholding at CDSC for each of the other exchanges (DSE and USE).[72]

The Capital Markets Challenge Fund was established by the CMA to draw financial support for the establishment and operation of the CDS from institutional investors. The Challenge Fund is composed of nine (9) institutional investors. They include: Apollo Insurance, Jubilee Insurance, Kenya Commercial Bank, Commercial Bank of Africa, Old Mutual, CFC Bank, East African Breweries Ltd., East African Development Bank and

[70] Waiyaki.
[71] The number in parenthesis is the shareholding of the entity in the CDSC.
[72] Kariithi.

ICDC Investment Company Ltd.[73] Of the Kshs.100 million required to initially fund the establishment and implementation of the CDS project, the NSE committed Kshs. 25.0 million while the other investors collectively contributed the balance of Kshs. 75.0 million.

The Investor Compensation Fund is a fund established under section 18 of the CMA Act[74] to grant compensation to investors who suffer pecuniary loss resulting from the failure of a licensed stockbroker or dealer to meet his/her contractual obligations. The fund is financed through required contributions from members and participants licensed by the CMA, fines and penalties paid by violators of rules and regulations, interest from investment of the fund and any other source approved by the Minister of Finance.

The CDS in Kenya is proceeding to immobilization. Therefore, once share certificates are deposited into the central depository, the delivery of shares after a trading transaction will be achieved through the change of records in the central depository instead of exchange of certificates.[75] It is intended that the CDS will move towards dematerialization where physical certificates no longer exist and if they do they will no longer be recognized as legal evidence of share ownership. The CDS is to provide additional functions such as mortgaging of shares as security for loans and receipt of entitlements such as dividends, bonus and rights from listed companies for onward transmission to shareholders.

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[73] Interview with NSE Research and Development Manager on April 8, 2005.
[74] Chapter 485A, Laws of Kenya
[75] *What is a Central Depository System?* (accessed July 2004); available at www.nse.co.ke.

Within two weeks of the implementation of the CDS in November 2004, the CDS recorded six hundred and seventeen (617) securities accounts, 113,266 deposited shares and Kshs. 3,833,698 worth of market capitalization.[76] By January 17, 2005, about 36 million shares were immobilized[77] at a rate of between 400 and 500 certificates immobilized in a day.[78] By February 2005, shareholders will not be able to sell their shares at the NSE unless they have opened an electronic account with CDS. It is intended that by this time all shares will have been converted to electronic records of ownership.

In January 2005, CDSC launched an undertaking with banks in Kenya in which the banks agreed to serve as custodians for the financial settlement of stock transactions and act on behalf of clients such as fund managers to ease settlement of transactions at NSE. The banks are authorized depositories and have online access to the CDS from their offices just like other stockbrokers and can therefore, open an account, deposit shares and pay or be paid for every transaction.[79]

Investors are concerned about the confidentiality of transactions and account information. In this regard, only the seller, stockbroker and CDS are to have details of a transaction. In the event of a breach of confidentiality the Central Depositories Act stipulates a fine of Kshs.5 million or a jail term of five years or both.

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[76] Geoffrey Irungu, "Banks to act as custodians of share transactions at the NSE," *Daily Nation Newspapers*, January 25, 2005.
[77] Immobilization is the conversion of share certificates into accounts in the CDS.
[78] Irungu.
[79] Ibid.

Although settlement under the new electronic system is intended to be on a T+1 basis (settlement of the transaction occurs on day of transaction plus one day), it is currently operating on a T+ 5 basis (settlement on day of transaction plus five days).[80] Once a transaction has taken place at the NSE, it takes five days for the relevant accounts to be debited and credited. In contrast, the manual system of settlement took about eight to fourteen days because the relevant shares registrars were required to verify the shares before and after trading. In the current system, the verification is done only once, before a transaction at the Exchange.

The Process of Settlement:[81]

On the day of a transaction, the seller and buyer’s accounts show ‘Pending Sell’ and ‘Pending Buy’, respectively. The securities are, therefore, not available for further trade before settlement. On the day of settlement, funds are transferred between the seller and buyer CDAs (Central Depository Agents) through the settlement bank, after which the seller’s account is debited and the buyer’s account is credited.[82]

For each trading session, the total purchases minus total sales by each CDA are computed and settlement reports are sent to the CDAs and the settlement bank. The new system operates on the basis of "multilateral netting" which implies that a broker or the CDA only pays net of what is due from him to other parties to a transaction at the NSE.[83]

[80] Waiyaki
[81] Vipin Mahabirsingh, “MIT/CDS Mauritius: The CDS Rules and Procedures.” Presentation at NSE in 2002.
[82] Ibid.
[83] Irungu.

The settlement mechanism is anchored on a common settlement bank in which every participant has a settlement account to which their net obligations are credited or debited on each settlement date.[84] On the date of settlement, each CDA with a debit position ensures that it has the required balance in its account with the settlement bank by a cut-off time. The settlement bank first debits the accounts of the CDAs with debit positions and then credits the accounts of CDAs with credit positions. The CDS operates through "cleared funds" rather than cleared cheques. Previously, settlement could not be reached until the cheque cleared. The current system, therefore, translates into payment on delivery.[85]

The system guarantees settlement by way of a guarantee fund, which ensures that failure of settlement does not occur due to illiquidity or insolvency of a participant. The guarantee fund is made up of pre-set stockbrokers contributions and an on-going levy paid by investors through their stockbrokers. [86] In the event of a default by a participant, the Guarantee Fund is used to make good the obligations of the defaulting participant and seizes unpaid securities.

Advantages of a CDS in Kenya:

1. In contrast to a manual system the CDS will contribute to the growth of the stock market. The manual system constraints growth in both products and volume because it is not elastic. The inelasticity of the system was exemplified when the NSE experienced tremendous growth in turnover and number of transactions at the

[84] Waiyaki
[85] Ibid.
[86] Ibid.

beginning of 2003. The sudden increase in activity in the market was attributed to renewed confidence in the Kenyan economy after the 2002 general elections that resulted in a change of government from the regime that had ruled for 24 years to a coalition of opposition parties. The manual settlement process failed to handle the upsurge in transactions without significant delays as it required the exchange and verification of physical certificates by the NSE and respective registrars of listed companies. The computer system in which information on transactions was recorded after trading 'crashed' as it could not handle the volume of information being stored. As a result of the delays, some dividends were issued to people who had already sold shares while buyers did not receive dividends entitled to them.[87] The automated system of delivery does not require verification and exchange of physical certificates between the NSE, stockbrokers and registrars of listed companies, thereby saving time and providing a system of settlement that can handle increased trading and growth in the market.

2. The CDS will facilitate the adherence to global standards of delivery and settlement such as a shortened settlement cycle. Compliance with the internationally recognized, set and expected standards will facilitate the attraction and retention of capital inflows into Kenya's capital markets. The CDS will therefore, assist in attracting more foreign investors to the region through a stock market that is globally competitive.[88]

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[87] Interview with NSE Delivery and Settlement Manager conducted in July 2004.
[88] Ibid.

3. It will facilitate regional integration through cross-border trading, clearing and settlement. Cross-border investment flows will enhance the economic development of the East African region.[89]
4. The CDS will reduce the possibility of mutilation, theft or loss of share certificates since shares are held in the custody of the depository. In addition, it will reduce the risk of fraud, fake certificates, duplicate certificates, non-settlement and non-delivery.
5. It will facilitate faster settlement through change of records in the electronic system, thereby reducing transaction costs associated with the transfer of share certificates. The large volume of paperwork involved in trading, settling and transfer of shares under the manual settlement system will also be reduced.
6. Investor confidence in the market will be boosted through knowledge by shareholders that their shares are held in a safe place.
7. The CDS will contribute significantly to transparency in the stock market.
8. The successful automation of the CDS will facilitate the automation of the trading section of the NSE.

Challenges of implementing a CDS in Kenya

Investors may not be able to get their money within five days (under the T+5 cycle – day of transaction plus five days) but rather much later because they are currently not adequately banked to help them realize real time payments. Even where they have bank accounts, the banking systems may not have real time payment systems hence delay in receipt of proceeds from sales. Delays in immobilization may also result from differences in names and signatures of shareholders in original and subsequent share certificates.

[89] Mahabirsingh.

FOREIGN INVESTORS AND THE NSE

The NSE categorizes investors into five groups:[90]

1. Local individual investor – a natural person who is a citizen of Kenya.
2. Local institutional investor – a company or body corporate incorporated under the Companies Act or any written law in Kenya in which Kenya citizens or the Government of Kenya have beneficial interest and whose ordinary business includes the management or investment of funds as principal such as financial institutions, collective investment scheme, fund manager, dealer.
3. East African individual investor – a natural person who is a citizen of the East African Community partner states of Tanzania or Uganda.
4. East African institutional investor – a corporate person incorporated or registered in the East African community states of Tanzania or Uganda.
5. Foreign investor – any person who is not a local or an East African investor

Any company incorporated in Kenya that issues securities to the public or that is listed at the NSE is required under the Capital Markets (Foreign Investors) Regulations, 2002. to set aside twenty five per cent of its ordinary shares for investment by local investors. This proportion of its ordinary shares is not to be offered for investment by East African or foreign investors. The remaining seventy-five percent is available for investment by the East African, local or foreign investors without any restrictions in the level of holdings other than what is stipulated under the Take over and Mergers Regulations.[91] The regulation is intended to ensure that Kenyan investors have the opportunity to invest in all

[90] Capital Markets Authority (Foreign Investor) Regulations, 2002.
[91] Capital Markets (Take over and Mergers) Regulations, 2002.

listed companies, to increase wider public ownership of listed companies and to encourage the distribution of wealth to local investors.

Listed companies are required under the regulations to maintain a register that indicates the holding of ordinary shares by each of the five groups of shareholders at all times. In addition, listed companies and authorized depositories are required to furnish the Capital Markets Authority and the NSE with a report showing the details of the holding of its ordinary shares or shares in their custody within ten days following the end of each month.

Every stockbroker who applies for shares or transfers shares of a listed company to an investor is required to declare, with supporting documentation, whether the applicant or transferee is a foreign investor, local individual or institutional investor, or East African individual or institutional investor. Company registrars are mandated to prevent the effect of any transfer that would result in investments by local investors falling below twenty-five percent. All transactions that result in foreign and East African investors holding seventy percent or more shares must be reported immediately to the NSE. Foreign investors are allowed to acquire up to 49% of local stockbrokers and up to 70% of local fund managers to encourage the transfer of technology and skills.[92] For as long as shares that are registered in the name of foreign or East African investors, they are to be held in the custody of an authorized depository unless they are transferred to a local investor.

[92] *Capital Markets Authority.* Accessed April 2, 2005. Available from www.cma.or.ke.

CORPORATE GOVERNANCE

Sections 11(3) and 12 of the Capital Markets Authority Act (the Act) empower the Capital Markets Authority to make rules and regulations to govern capital markets in Kenya. Pursuant to this authority, the Capital Markets Authority developed guidelines on corporate governance practices by public companies in Kenya, in 2002 [93] and incorporated them as a schedule in the Capital Markets Act. The guidelines were developed in recognition of the role of good governance in corporate performance, capital formation, maximization of shareholders value and protection of investors' rights.[94]

The main objective of these rules is to strengthen corporate governance practices in public listed companies in Kenya and to promote the standards of self-regulation so as to bring the level of governance in line with international standards. Some of the standards taken into account by the Authority while formulating the guidelines include those in the United Kingdom, Malaysia, South Africa, Organization for Economic Cooperation and Development (OECD) and the Commonwealth Association for Corporate Governance. The code of best practice for corporate governance in Kenya issued by the Private Sector Corporate Governance Trust, Kenya, (PRSCG) in 1999 was also useful in the development of the guidelines. This code has also been incorporated into the Act as recommended best practices in corporate governance by public listed companies.

[93] Kenya Government Printers, Gazette Notice No. 3362
[94] Capital Markets Act, Chapter 485A Laws of Kenya. G*uidelines on Corporate Governance Practices by Public Listed Companies in Kenya.*

The CMA has adopted a prescriptive and non-prescriptive (binding and non-binding) approach to the corporate governance guidelines. It is non-prescriptive in view of the fact it recognizes that good corporate governance practices must be nurtured and encouraged to evolve as a matter of best practice, in order to provide for flexibility and innovative dynamism to corporate governance practices by public listed companies. Therefore, the guidelines are a framework through which listed companies can develop best corporate governance practices. The prescriptive approach is exemplified in the CMA'S requirement that listed companies adopt minimum standards of good governance as prescribed in the guidelines and expects directors of public listed companies to adopt good corporate governance practices as part of their continuing listing obligations. Every public listed company is required to disclose whether it is complying with the guidelines on corporate governance through a statement of directors in its annual report with effect from the financial year ending during 2002.[95] In the event of non-compliance, a company is required to identify the reasons for non-compliance and indicate the steps taken to become compliant.

For purposes of the guidelines, the Authority has defined corporate governance as the process and structure used to direct and manage business affairs of the company towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholders long-term value taking into account the interests of other stakeholders.[96]

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[95] Capital Markets Authority Act, Corporate Governance Guidelines, 2002.
[96] Ibid.

The Authority has identified a number of principles as essential and critical foundations for good corporate governance practices. These are the minimum standards that public listed companies are expected to adhere to and they relate to directors, shareholders, auditors, public disclosure, chairman and chief executives.

Chairman and Chief Executive Officer: The guidelines prescribe a clear separation of the role and responsibilities of the chairman and chief executive officer (CEO) to ensure a balance of power of authority and to provide for checks and balances so that no individual has unfettered powers of decision-making. In the event that the role of the chairman and CEO are combined, disclosure of the same is required to the shareholders in the company's annual report. A chairman is precluded from holding a similar position in more than 2 listed companies at any one time to ensure effective participation in the board.

Board of Directors: Every public listed company is to be headed by a board of directors made up of both executive and non-executive directors with a specific requirement that at least one third of the directors should be independent and non-executive. The Authority justifies this requirement with the need to ensure that no individual or group of individuals can dominate the board's decision-making processes. An independent director is defined by the Authority as one who:

a) has not been employed by the company or affiliate of the company in an executive capacity within the last five years prior to appointment.

b) is not associated to or is a member of the immediate family of an adviser, consultant, senior management, significant customer or supplier of the company or with a non-profit entity that receives significant contributions from the company.

c) has not had a business relationship with the company within the last five years for which the company has been required to make disclosure.

d) has no personal service contract with the company or a member of the company's senior management.

e) is not employed by a public listed company at which an executive officer of the company serves as a director.

The procedure for appointment to the board should be formal and transparent, and prospective directors are required to disclose potential areas of conflict that may undermine their position as director.

The Authority restricts any person from being a director in more than five listed companies at any one time to ensure effective participation in the board. In addition, election of all directors, except the managing director, is to be conducted at regular intervals or at least every three years with present directors presenting themselves for re-election. Executive directors should have a fixed service contract not exceeding five years with a provision to renew subject to regular performance appraisal and shareholder approval.

The procedure for remuneration of directors and the remuneration package is to be approved by the shareholders. The executive directors' remuneration should be competitively structured and linked to performance while that of non-executive directors should be in line with that of other directors in competing sectors.

Directors are expected to be accountable to shareholders and to offer strategic advice, lead and control the company. In addition, they are to establish an audit and nominating committee and delegate specific mandate to these and other committees. In addition, they are to present an objective and understandable assessment of the Company's operating position and prospects, and ensure that accounts are presented in line with international Accounting standards.

Shareholders: The guidelines do not go into as much detail about shareholders as they do about directors. The main requirement is that shareholders of listed companies should participate in major decisions of the company and that they have a right to information relating to disposal of the company's assets, restructuring, takeovers, mergers, acquisition, reorganization, all directors approaching their seventieth birthday as well as other issues that require shareholder approval and that are to be decided during annual general meetings. These include the remuneration of directors, renewal of executive directors' service contracts and the appointment of independent auditors. The shareholders' main forum for participation is the annual general meeting.

Auditors: The Authority requires that auditors of public listed companies be members of the Institute of Certified Public Accountants and comply with the International Auditing Standards. Independent auditors are to be appointed by the shareholders at each annual general meeting.

Chief Financial Officers: The chief financial officers and persons heading the accounting department of a listed company is required to be members of the Institute of Certified Public Accountants.

Disclosure: The board is required to disclose in its annual report, its policies, incentives, quantum and components of remuneration for directors as well as the share options and other forms of executive compensation that have been made or are to be made during the financial year. Other forms of disclosure include the ten major shareholders of the company, the aggregate loans held by directors and any management or business agreements entered into by the company and its related companies that may result in a conflict of interest.

The system of corporate governance required by the Authority relies on the board of directors rather than the shareholder instruments of corporate governance. The focus on directors has been attributed to the fact that corporations need quality and effective leadership which is responsive, transparent and accountable in order to achieve their objectives, effectively discharge their responsibilities, create wealth and be sustainable in the long term.[97] It is also a combination of both the Anglo-American and European models of corporate governance in that, it prescribes a unitary board structure that deals with both oversight and management issues (Anglo-American), has the weaker shareholder rights characteristic of the European model, probably due to the narrow public ownership in Kenya, and has divided leadership in contrast to a single powerful leader (European). The guidelines are similar to the New York Stock Exchange rules in that, they apply only to a non-controlling group of shareholders.

In addition to the provisions described above that are considered minimum standards of corporate governance in public listed companies, the Authority recommends best practices that every public listed company should endeavor to achieve. They are designed as a basis to assist individual companies formulate their own specific and detailed codes. The best practices have been modeled after the code of best practice for corporate governance in Kenya that was issued by the Private Sector Corporate Governance Trust, Kenya, in 1999. Reference was also made to international standards such as those in the United Kingdom, Malaysia, South Africa, Organization for Economic Cooperation and Development (OECD) and the Commonwealth Association for Corporate Governance.

The recommendations of best practices, summarized below, relate to the role and responsibilities of the board of directors, the position of the chairman and chief executive, the rights of shareholders, the conduct of annual general meetings and the role of audit committees.

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[97] Karugor Gatamah, *Launching Corporate Governance in Africa with an Emphasis on Kenya.* Accessed February 28, 2004. Available from http://www.cipe.org/pdf/publications/fs/gatamah.pdf.

Rights of Shareholders:

Participation and voting at annual general meetings on matters such as the election of directors. A shareholder may vote in absentia by assigning necessary voting proxy. The voting by proxy envisioned is one in which someone else votes for the shareholder at the annual general meeting and not by sending one's vote by mail (post). (One of the listed companies at the NSE, The Standard Chartered Bank of Kenya Ltd. allows shareholders to register their proxy vote online to appoint someone to vote for them (shareholder) at company meetings);[98] equitable treatment of shareholders, including minority and foreign shareholders; receipt of half-yearly, and quarterly reports and accounts on the company's performance in addition to annual reports; receipt of a secure method of transfer and registration of ownership; entitlement to distributed profit in the form of dividend in proportion to the shareholding in the company; institutional investors are encouraged to make direct contact with the company's senior management and board members to discuss performance and corporate governance matters as well as vote during annual general meetings.

Role and Responsibilities of the Board of Directors:

Appoint a nominating committee consisting mainly of independent and non-executive directors to propose new nominees for the board and consider candidates for directorship proposed by the chief executive and shareholders. The proposed candidates should only be considered if they are persons of caliber, credibility and who have necessary skills and expertise to exercise independent judgment on issues necessary to promote the

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[98] Standard Chartered Bank of Kenya Ltd, *Electronic Shareholder Services*. Accessed on March 15, 2004. Available at http://www.standardchartered.com/global/investor/sharesvc/index.html.

company’s objectives and performance; appoint a remuneration committee or assign mandate to a nominating committee made up of independent and non-executive directors to recommend to the board the remuneration of the executive directors and the structure of their compensation package; the whole board should determine the remuneration of non-executive and independent directors. the consolidated total remuneration of the directors should be disclosed to the shareholders in the annual report; the structure of the board should reflect the company’s shareholding structure without being biased towards representation by a substantial shareholding (not less than fifteen per cent of the voting shares) structure and provide a mechanism for representation of the minority shareholders without undermining the collective responsibility of the directors.

Chairman and Chief Executive:

The role of the chairman and CEO should be separated, however where it is combined a clear rationale and justification must be for a limited period, be approved by shareholders, include measures to ensure no one individual person has unfettered powers of decision in the company and include a plan for separation in the future; the chairman should be an independent and non-executive director; a clear succession plan for the chairman and CEO should be put in place to avoid unplanned and sudden departures which could undermine the company’s and shareholders’ interest; the CEO is obliged to provide necessary information to the board in the discharge of the board’s business.

Audit Committee:

It should consist of at least three independent and non-executive directors who report to the board; the chairman of this committee should also be an independent and non-executive director; the board should disclose whether it has an audit committee and the committee's mandate in its annual report; the committee should obtain professional advice and invite or consult with outsiders with relevant experience; review the quarterly, half-yearly and year-end financial statements of the company.

IMPACT OF CORPORATE GOVERNANCE RULES

It is difficult to know the impact of the above regulations on corporate behavior because the corporate governance regulations have been adopted by NSE as guidelines and not obligations on corporate behavior. However, listed companies have made successful attempts to provide information on quarterly and annual performance, distribution of shareholder ownership and whether they are in compliance with corporate governance rules.

The following table summarizes compliance with specific corporate governance rules:

Corporate Governance Guideline	Listed Companies in Compliance	Total No. of Listed Companies
Establishment of audit committees	21	48
Detailed disclosure of directors' remuneration	38	48
Ownership details of the top ten shareholders	9	48
Timely release and submission of audited accounts	22	48
Timely submission of interim reports	37	48

Source: Capital Markets Authority, Annual Report 2003

COMPLIANCE AND ENFORCEMENT OF RULES AND REGULATIONS

CMA has a compliance and enforcement program that seeks to ensure that all market participants comply with the regulatory rules and requirements in order to protect investors, foster investor confidence and preserve the integrity and efficiency of the capital market. It seeks to achieve these objectives through a surveillance program and a comprehensive annual review of all market licensees. In addition, all listed companies are subject to quarterly and annual disclosures of financial statements, shareholder ownership and extent to which they are in compliance with the corporate governance rules. The NSE has a compliance department which is mandated to monitor compliance with rules and regulations by listed companies and other market participants. It receives complaints from aggrieved investors and channels them to the CMA for investigation and action.

The main issues investigated by the Authority during in 2003 include: [99]

- Compliance issues involving listed companies.
- Investor complaints on market manipulation.
- Complaints on mismanagement of listed companies.
- Violation of regulations.

When a complaint is filed and investigations reveal the violation or non-compliance of rules and regulations, the CMA demands corrective action from the relevant licensee. Failure to comply leads to penalties in the form of fines payable to the CMA, or suspension of license and prohibition from participation in the market.

[99] *CMA Annual Reports 2003* (accessed April 13, 2005); available from www.cma.or.ke.

Cases handled by the CMA between January and June 2003:

Nature of Case	**No. received and resolved:**
Legal issues involving listed companies	1
Investor complaints	7
Market manipulation	1
Complaints on mismanagement of listed companies	4
Market operators without a license	12
Violation of regulations	2
Complaint on listing of bonds	1
Fraudulent activities	2
Total	**30**

Source: Capital Markets Authority, Annual Report 2003

PART IV: ANALYSIS OF PERFORMANCE AND CHALLENGES

TREND IN LISTED COMPANIES

Before Kenya's independence in 1963, there were about 10 listed companies at the NSE. The period after independence, particularly the 1970s saw about 20 more listed companies. This was the largest number of companies listed in a span of about a decade. The 1980s recorded five new listed companies, a number which doubled in the 1990s.[100] Since 2000, there have been about five new listed companies. In total, there are fifty-one (51) listed companies. Of these, thirty-eight (38) are listed on the Main Investment Market Segment (MIMS), nine (9) in the Alternative Investment Market Segment (AIMS) and four (4) in the Fixed Income Securities Market Segments (FISMS).[101]

Of the companies currently listed, those listed before 1968 include, Marshalls (1954),[102] Limuru Tea (1967), Kenya Oil (1959), Consolidated Holdings - now listed as Standard Group - (1954), City Brewery (1950) currently listed as City Trust,
A. Baumann (1948), Sasini Tea and Coffee (1965), CMC Holdings (1950), and George Williamson (1951).[103]

In 1968, Kenya Orchards, Kapchorua Tea, Kenya Power (formerly E.A Power), E.A. Portland, E.A Breweries, Car and General, Industrial Commercial and Development Corporation Investment Company (ICDC - set up by the Government of Kenya to promote the African owned business sector) were all listed. All of these companies except Kenya Orchards and Kapchorua Tea had the Government of Kenya as a

[100] NSE Handbook.
[101] *Listed Companies* (accessed April 9, 2005); available at www.nse.co.ke.
[102] Year of initial listing in parenthesis.
[103] NSE Handbook.

shareholder. This implies that the government shareholding was either bought from the British government or from British investors who chose to leave after Kenya attained her independence in 1963.[104]

About two-thirds of the current listed companies are categorized as local companies, with the majority of shareholders being residents of Kenya or companies incorporated in Kenya under the Companies Act, while a third of the listed companies are categorized as foreign with the majority shareholders being companies incorporated and operating in a foreign country or with shareholders resident in a foreign country.[105]

Section 22 of the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002 empowers the licensed securities exchange (NSE) to suspend and de-list listed securities subject to the approval of the Capital Markets Authority in the event a listed company fails to adhere to the continuous listing obligations particularly the regular and timely public disclosure of financial and other price sensitive information. In this regard, one company (Hutchings Biemer Ltd.) has been suspended from trading at the NSE due to non-compliance with the statutory obligation for continuous reporting.[106] In addition, four companies and five fixed income securities have been de-listed for failure to meet the minimum listing requirements. The delisted companies include African Lakes Corporation and the East African Packaging Industries Limited.[107]

[104] Interview with NSE Marketing and Research Manager conducted in April.
[105] NSE Handbook.
[106] *CMA Annual Reports 2003* (accessed April 13, 2005); available from www.cma.or.ke.
[107] Ibid.

TREND IN MARKET PERFORMANCE

Generally, the NSE experienced bearish market activity prior to 2002. Although some market indicators such as volume of shares traded and market capitalization reveal growth between 1995 and 2002, the market experienced fluctuations, slow growth and at times decline in growth as a result of political uncertainties and poor economic performance, among other factors discussed in the under 'Challenges Facing NSE'. The following tables and graphs summarize the trends in the stock market performance between 1995 and 2002.

Listing of issues and companies at the NSE and licensing of market participants between 1995 and 2002:

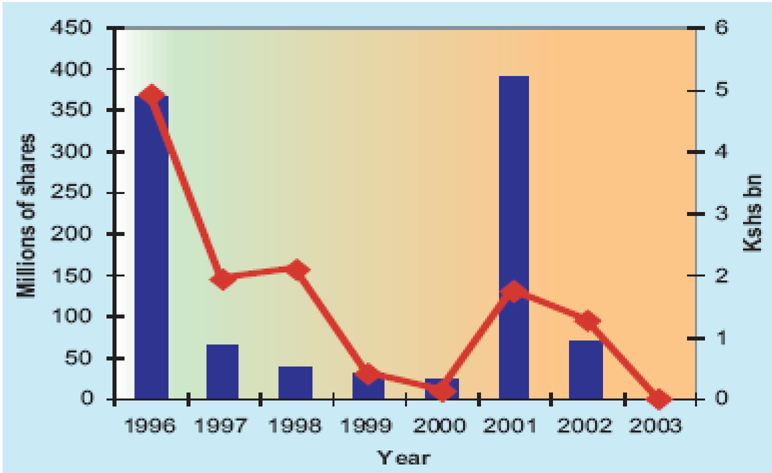
	1995	1996	1997	1998	1999	2000	2001	2002
New Issues	0	5	3	2	1	3	3	0
New shares[108]	0	366.9	63.89	37.42	26.58	22.61	404.97	0
Value of New shares[109]	0	4.93	1.94	2.1	0.37	0.45	2.4	0
Total Listed Companies	56	57	57	56	56	54	54	51
Listed Cos. In MIMS						39	40	40
Listed Cos. In AIMS						9	10	10
Listed Cos. In FIMS						7	13	3
Stockbrokers	12	20	20	20	18	18	18	18
Investment Advisors			19	19	22	22	26	25
Authorized Depositories			5	5	5	5	5	5
Dealers					1	1	1	1
Investment Banks								2
Collective Investment Schemes								2

Source: Capital Markets Authority, Annual Report 2002

Over the past 15 years, the NSE attracted thirteen (13) rights issues and twenty-one (21) Initial Public Offerings (IPOs) that raised Kshs.20 billion. Of these issues, only eight were for IPOs in the private sector which raised only Kshs.1.95 billion.[110] Many of the new issues were driven by the Government's privatization process.

[108] In Kenya Shillings (Kshs.) Millions
[109] Ibid.
[110] CMA Annual Report 2002 (accessed February 26, 2005); Available at www.cma.or.ke.

Shares and Rights Issues between 1996 and 2003:



Bars represent rights issues and the line represents share issues.
Source: Capital Markets Authority, Annual Report 2003[111]

Key market indicators and economic performance between 1995 and 2002:

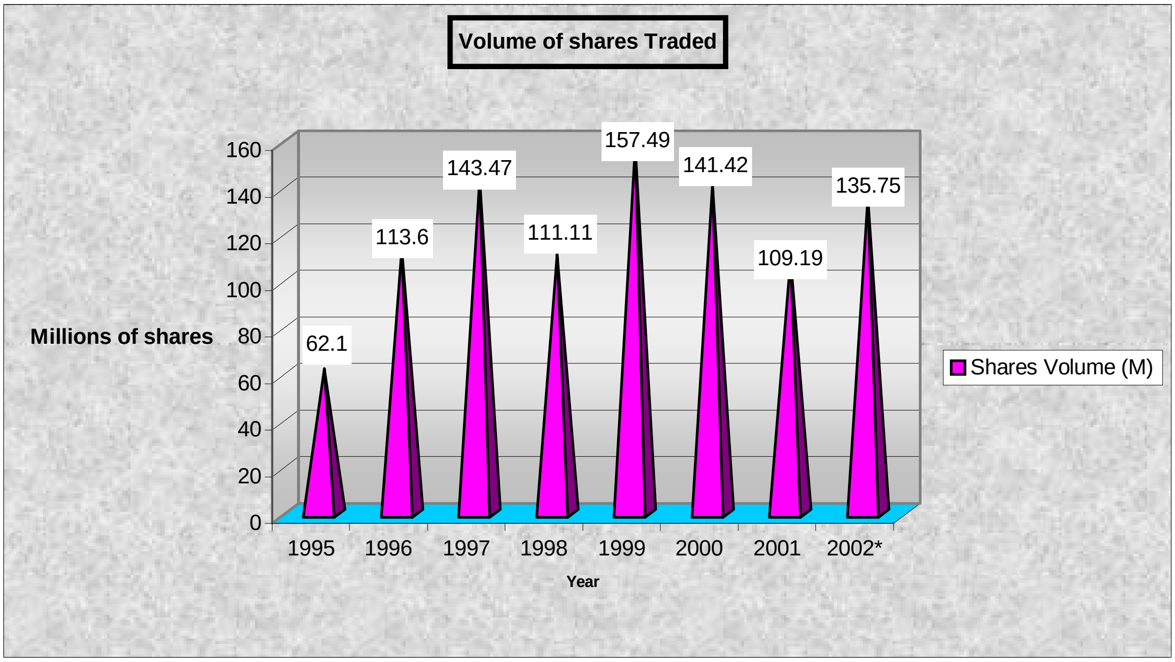
	1995	1996	1997	1998	1999	2000	2001	2002*
Shares Volume[112]	62.10	113.60	143.47	111.11	157.49	141.42	109.19	135.75
Shares Turnover[113]	3.34	3.96	6.15	4.58	5.16	3.63	3.12	2.88
Market Capitalization	107.20	98.68	114.31	128.94	106.74	101.42	86.10	112.31
Index (Year Close)	3469	3114	3115	2962	2303	1913	1355	1363
Av. T-Bill Rate (%)	21.67	21.60	26.40	12.60	20.00	11.20	11.50	8.40
Av. Base Lending Rates	33.14	34.58	30.30	28.80	24.80	19.90	19.60	18.60
GDP Growth Rate (%)	4.80	4.60	2.40	1.80	1.40	(0.20)	1.20	1.00
Av. Annual Inflation	1.60	9.00	11.20	6.60	3.50	6.20	5.80	1.80

Source: Capital Markets Authority, Annual Report 2002

The general trend in the market indicators was one of fluctuations between 1995 and 2002. However, volume of shares traded, market capitalization and average annual inflation were higher in 2002 than 1995 while shares turnover, year end index, average base lending rates, average treasury bill rates and GDP growth rate were lower in 2002 than 1995.

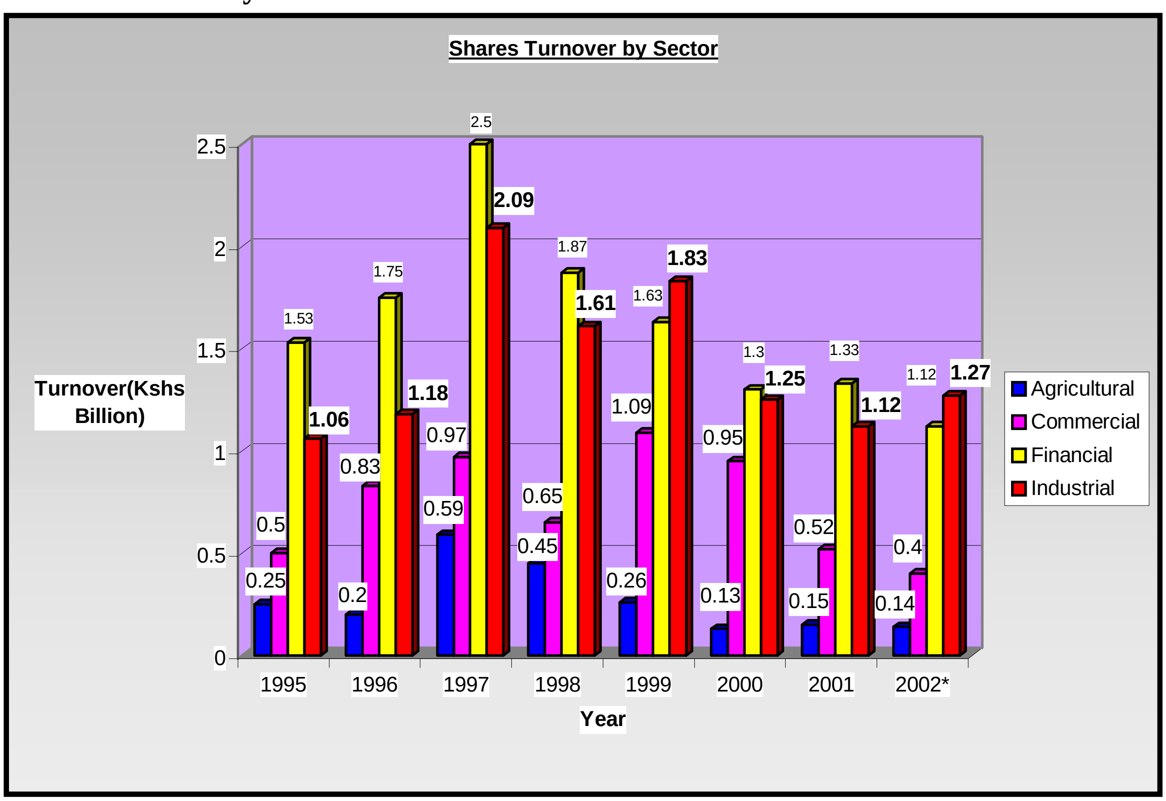
[111] Ibid.
[112] Kshs. Millions.
[113] Kshs. Billions.

Volume of shares traded between 1995 and 2002:



Source: Capital Markets Authority, Annual Report 2002

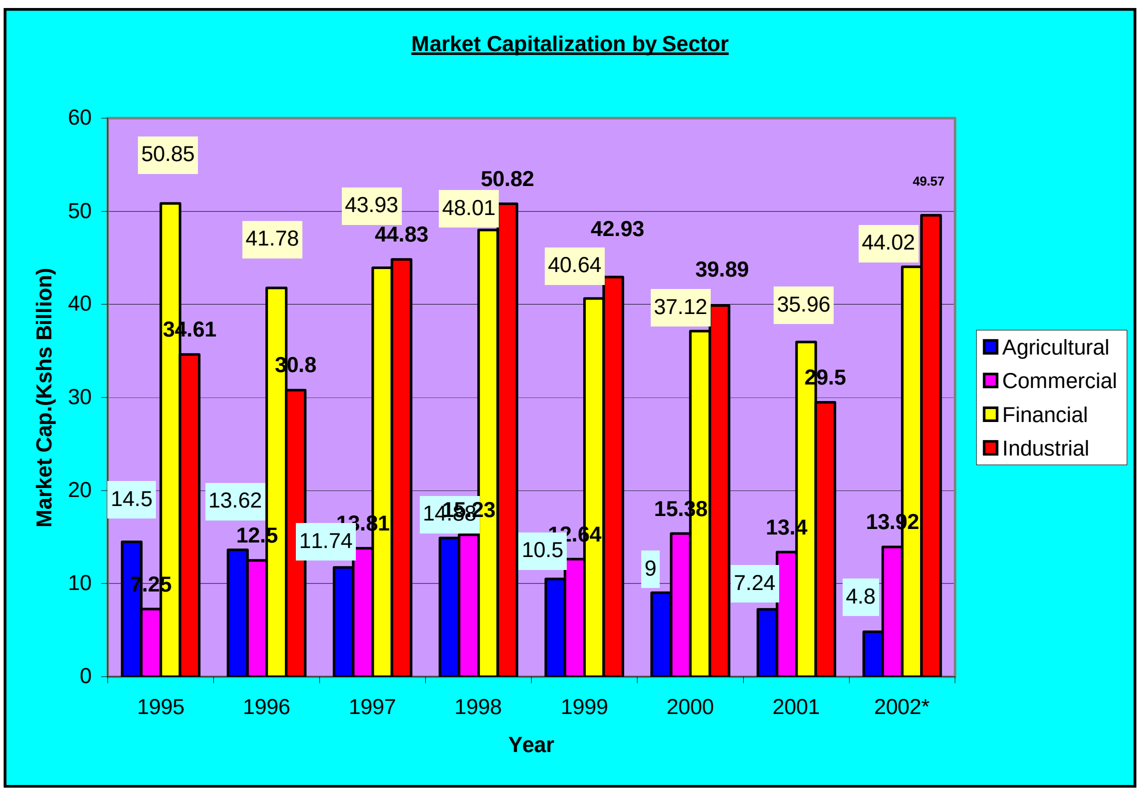
Shares turnover by Sector between 1995 and 2002:



Source: Capital Markets Authority, Annual Report 2002

The agricultural sector has been lagging behind the commercial and services, industrial and allied, and finance and investment sectors in shares turnover. On other hand, the finance and investment, and the industrial and allied sectors have consistently recorded the highest shares turnover. This may be attributed to the difference in market capitalization in the sectors as indicated in the graph below, slow growth in the agricultural and commercial and services sector as well as the difference in the number of listed companies from the different sectors. There are about seven (7) listed companies in the agricultural sector, nine (9) in commercial and services, ten (10) in Finance and Investment, and twenty (20) in industrial and allied.

Market Capitalization by Sector between 1995 and 2002:



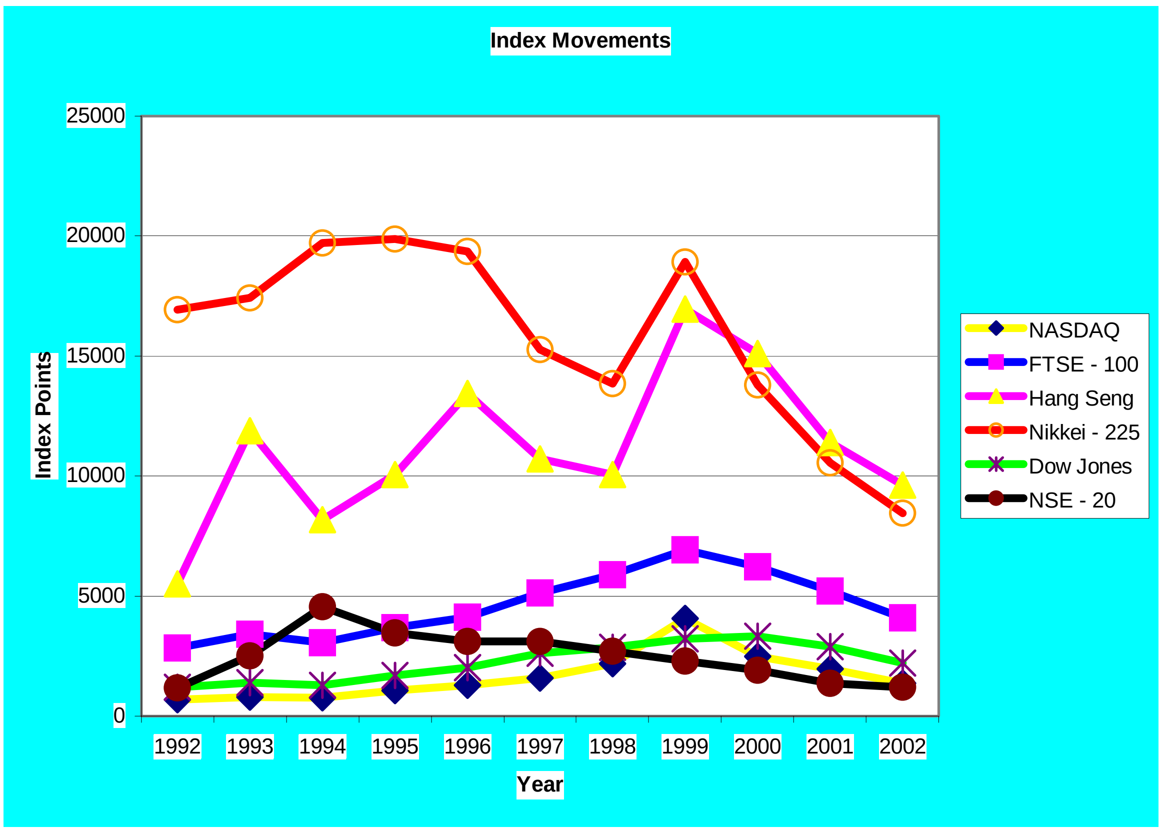
Source: Capital Markets Authority, Annual Report 2002

Foreign Investors Activity:[114]

	1995	1996	1997	1998	1999	2000	2001	2002*
Foreign Investors Turnover	0.22	0.99	2.23	1.16	1.13	0.70	0.39	0.42
Net Foreign Inflow	0.17	0.60	1.58	0.08	0.01	0.49	0.12	(0.06)

Source: Capital Markets Authority, Annual Report 2002

NSE index movement in comparison with other world exchanges from 1992 to 2002:



Source: Capital Markets Authority, Annual Report 2002

The NSE index increased between 1992 and 1994 followed by a steady decline between 1994 and 2002. It reflects the general trend in the other world stock market indices of a

[114] Kshs. Billions.

decline between 1999 and 2002 although the NSE began to decline earlier. However, its movement is not as erratic as the Nikkei and the Hang Seng.

In 2003, Kenya experienced general economic growth that had a positive effect on the securities market. The real GDP growth was 1.8% in 2003, up from 1.2% in 2002.[115] The growth may be attributed to a number of factors that facilitated improved macroeconomic conditions. These include:

- Positive sentiment and optimism in Kenya and internationally after the elections in 2002 that saw a new government come to power. The smooth transition boosted investor confidence, increased anticipation of economic recovery and lead to substantial resources being directed to investments through the capital markets. This is reflected in the expansion of key sectors of the economy: agriculture grew by 1.5% over 2002, manufacturing by 1.4%, telecommunications grew as mobile phone subscriptions increased to more than 2.7 million lines, the tourism industry that had experienced a significant decline as a result of the negative travel advisories by the United States of America and other European countries grew at 18.6% in 2002, building and construction grew by 2.2% and real estate by 3.0%.[116]
- The new government's economic policies and commitment to improve the investment climate and infrastructure, and stamp out corruption boosted market confidence.
- Higher capital inflows in the secondary market due to the return of institutional investors from the retirement benefits sector.

[115] *CMA Annual Reports 2003* (accessed April 13, 2005); available from www.cma.or.ke.
[116] Ibid.

- Stable foreign exchange market.
- Strong corporate earnings in 2003.
- Falling interest rates due to surplus liquidity in the financial sector. The yield on the 91-day Treasury bill stood at 1.3% in 2003 from 5.0% in 2002, thereby creating demand for equity in the secondary market.[117]

The securities market recorded improved performance as a result of the general economic growth. What had been a bear market experienced growth characteristic of a bull market:

a) NSE 20-share index gained 1292 points and stood at 2379 points in 2003 from 1087 points in 2002, a 119% increase. [118]

b) Volume of shares traded at NSE grew at 86.8% from 106 million in 2002 to 198 million in 2003.[119]

c) Market turnover increased at a rate of 275% from Kshs.2 billion to Kshs. 7.5 billion.[120]

d) Market capitalization increased at 117% from Kshs.83.30 billion in 2002 to Kshs. 180.65 billion thereby appreciating the net worth of investors by Kshs.97.35 billion.[121]

e) The secondary bond market turnover increased from Kshs.12 billion to Kshs.38.9 billion in 2003 despite the tendency by institutional investors to buy and hold bond securities.[122]

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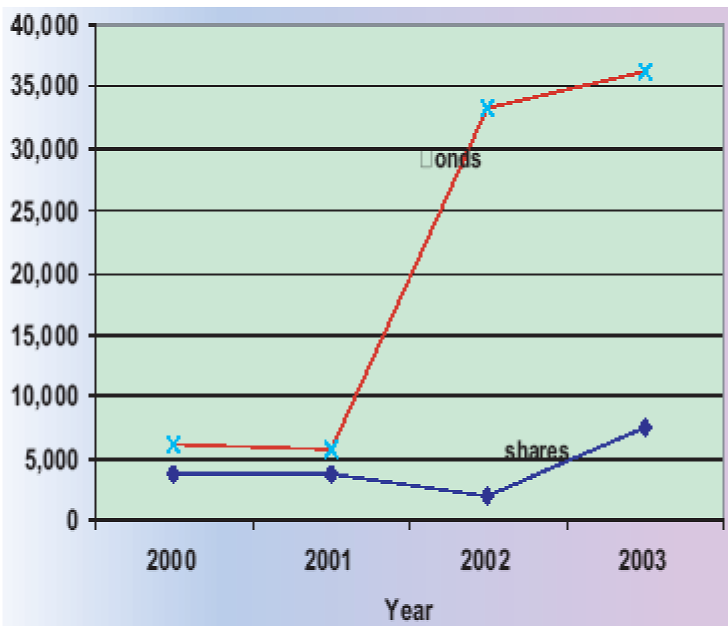
[117] Ibid
[118] Ibid.
[119] Ibid.
[120] Ibid.
[121] Ibid.
[122] Ibid.

The government embarked on a program to restructure its domestic debt from short-term treasury bills (90 day treasury bills) to long-term bonds in 2002 by increasing the maturity of government bonds up to 6 years. The stable yield curve generated as a result facilitated the development of the capital market as more investors participated in the purchase and trading of these bonds. In 2003, the bond turnover was about five times that of the equities.

Shares and bond turn over between 2000 and 2003:



Source: Capital Markets Authority Annual Report 2003[123]

[123] Ibid.

RECENT DEVELOPMENTS

The policy framework in Kenya is considered conducive for capital market development as a wide range of fiscal and other incentives have been put in place to encourage capital market activities. In addition, privatization policies are being implemented through the capital market to encourage wider ownership of public enterprises and to provide a key source of new listings.

Legal and regulatory framework for capital markets in Kenya experienced a major boost between 2000 and 2002 when the CMA released rules and regulations on different aspects of capital markets. The World Bank has indicated that this framework is reasonably sound and could serve as a basis for developing the capital market.[124]

With regard to **incentives**, in the 2001/2002 national financial budget, the government reduced the corporation tax rate from 30% (for local companies) and 32.5% (for foreign companies) to 25% on newly listed companies for three years from the date of listing. The companies are required to offer at least 20% of their share capital to the public.[125] In addition, companies interested in listing at the NSE that have not paid their due taxes are eligible for a tax amnesty (forgiving past evasions of tax) subject to their full disclosure of assets, liabilities and income during the period immediately following their listing and subsequent payment of taxes due in full.[126] Other incentives include:

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[124] World Bank, Capital Market Integration.
[125] *History of the NSE.* Accessed June 20, 2004. Available from www.nse.co.ke/History.htm.

[126] *About the NSE.* Accessed April 26, 2005. Available from http://www.nse.co.ke/AboutNSE.htm.

a) Reduction of withholding tax on dividend from 15% to 7.5% for foreign investors and 5% for local investors.[127]
b) Full tax deductibility of expenses related to issuing shares to the public.
c) Exemption from stamp duty for new and expanded share capital, the transfer of assets for the issuing of asset-backed securities and transfer of listed securities.
d) Ten-year tax holiday for venture capital funds.
e) Tax exemption on income accruing to registered collective investment schemes.
f) Negotiable commissions.
g) Free repatriation of capital and returns.
h) Sufficient brokerage services.
i) Up to date market information.
j) No Exchange Controls
k) Government commitment to market reforms.

Banks in Kenya have dominated long-term financial intermediation inspite of the presence of other financial institutions such as insurance companies, mutual funds, mortgage firms and the stock market. However, in the last decade there has been a gradual shift from an emphasis on the development of banks to the development of the stock market and other institutions alongside banks. [128]

In 2001 the securities market at the NSE was reorganized from two (bond and equity) to three independent **market segments** namely, the Main Investment Market Segment (MIMS), Alternative Investment Market Segment (AIMS) and Fixed Income Securities Market Segment (FISMS) in order to provide more companies with access to the capital

[127] Ibid.
[128] Wagacha.

markets and a suitable trading segment to the diversity of companies and entities desiring to trade at the NSE.

The process of structural adjustment and **privatization** due to fiscal deficit and government divesture programs has resulted in the entry of restructured firms in the stock market. In the 1990s, the NSE was driven to historic levels of activity when the Kenya Airways and Kenya Commercial Bank were listed in the NSE.[129] In the new Millennium, activity levels increased with the divesture of government holding through rights issues in Mumias Sugar Company and the Kenya Commercial Bank.[130]

Improvement of **market infrastructure** through the development of an automated central clearing, settlement and depository system (CDS) intended to serve the East African region. The central depository system is seen as one of the last frontiers in modernizing the stock trading process that has been mired in manual operations since the inception of the NSE in 1954.[131]

Pension reform in Kenya within the last seven (7) years through the requirement of mandatory professional management of pension funds has boosted the demand for equities at the NSE by institutional investors from the pension industry. An oversight body, Retirement Benefits Authority (RBA), was established as an oversight body to ensure the compliance of pension funds to the reforms and to regulate the pension fund industry.

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[129] History of NSE.
[130] CMA Annual Report 2003.
[131] Waiyaki.

Licensing of new categories of participants such as mutual funds, unit trusts, collective investment schemes, dealers, investment banks and investment advisors by the Capital Markets Authority. The effect of this has been the increased participation of **institutional investors** in the market such as mutual funds and retirement benefits funds. In June 2003, institutional investors dominated the Fixed Income Market Segment and accounted for 97%.[132]

Categories of investors and the outstanding corporate bonds as at June 2003:

Class of Investors	**Number**	**Amount (Kshs. Millions)**
Individuals	2	16
Banks and Non-Bank financial institutions	23	3298
Insurance Companies	15	400
Fund Managers	23	3635
Total	**63**	**7350**

Source: Capital Markets Authority 2003, Annual Report

Over-subscription of the government divesture of its shares at Kenya Commercial Bank in 2004 and the issue of Safaricom's corporate bond indicates the potential of the market to absorb new issues and is evidence of the existence of untapped potential in the mobilization of domestic resources.

In the last five years (2000-2005) activity in the **bond market** far exceeded the primary and secondary equity markets as a result of the introduction of treasury and corporate bonds. Between July 2002 and June 2003, the bond market traded five times the value of the equity market as government securities registered growth in number, amount and length of maturity.[133] In 2002 the government embarked on a program to restructure its

[132] CMA Annual Report 2003.
[133] CMA Annual Report 2003.

domestic debt from short-term treasury bills to long-term bonds by increasing the maturity of government bonds to 6 years.

Treasury Bond Issues at NSE between 2001 and 2003:

	2001		**2002**		**2003**	
Tenor	**No. of Issue**	**Value (Kshs. Billion)**	**No. of Issue**	**Value (Kshs. Billion)**	**No. of Issue**	**Value (Kshs. Billion)**
1 year	17	30.02	4	13.07	4	10.36
2 years	15	14.3	5	22.91	6	14.64
3 years	9	2.8	6	22.86	4	16.32
4 years			2	10	3	12
5 years			1	7	4	14.31
6 years			1	3	3	15
7 years					1	3
8 years					1	4
9 years					1	4
Total	**41**	**47.12**	**20**	**82.84**	**27**	**93.63**

Source: Capital Markets Authority, Annual Reports 2003

Commercial papers outstanding as at June 2003:

Company	**Amount (Kshs. Millions)**
Kenya Oil Company Limited	1000
CMC Holding Limited	350
TPS (Serena) Ltd.	200
Athi River Mining	50
Crown Berger Ltd	100
Pan Paper Mills Ltd.	500
Kenya Hotel Properties Ltd.	150
Ecta (Kenya) Limited	50
Mabati Rolling Mills Ltd.	500
Total Approved	**2900**

Source: Capital Markets Authority, Annual Reports 2003

Corporate bond issues at NSE:

Company	**Kshs. Millions (Outstanding)**	**Tenor Years**	**Maturity Date**
Shelter Afrique	350	3	July 04
E.A. Development Bank	2000	4	April 06
Safaricom Limited	4000	5	March 06
Mabati Rolling Mills	1000	5	October 07
Total	7350		

Source: Capital Markets Authority, Annual Report 2003

Three **rights issues** have been introduced to the market within the last four years. The last two rights issues were by Total Kenya in 2002 and Kenya Commercial Bank in 2004 and they were fully subscribed.[134] However, the primary market has not experienced new issues.

Cross boarder listing in the Uganda Securities Exchange and the Dar es Salaam Stock Exchange by Kenya Airways and the East African Development Bank, which are listed at the NSE.

Kenya**,** Uganda and Tanzania under the East African Community are currently working towards the establishment of a **regional market** that could benefit from economies of scale through increased competition, innovation, market participants, products transparency and efficiency. The EAC countries have recognized the limitations of a country-focused approach and have placed substantial emphasis on a regional approach, which is expected to provide long-term finance to support private sector activities in the EAC.[135]

Inflation has been low and in single digits and this has been conducive to the holding of long-term financial assets.[136]

[134] CMA Annual Report 2003.
[135] World Bank, Capital Market Integration.
[136] Ibid.

CHALLENGES FACING THE NSE

Increasing Listing at the NSE

Over the last fifteen years, the number of stocks traded at the NSE has stagnated at around 55 quoted companies.[137] Currently, there are forty-seven (47) listed companies in the MIMS and AIMS and four (4) in the FISMS[138] in contrast to the hundreds of companies incorporated in Kenya. The NSE has not had an initial public offering since 2001 when the government divested part of its holding in two companies (Mumias Sugar Company and the ICDC Investment Company). The divesture was not fully subscribed with both issues having a 60% and 64% success rate.[139] The limited supply of new equities in the capital market has restricted the use of the equity market as a source of financing. In view of the past failure to attract new equity, the most difficult hurdle for the NSE is increasing the number of medium-sized and large family-owned businesses and state-owned companies operating in Kenya listed at the NSE.

Generally, the main factors limiting the supply of equities include the reluctance of small, family-owned businesses to dilute ownership, the costly and tedious process of making public offers and the perception by many eligible companies that the risks associated with additional disclosure are not adequately compensated by additional returns.[140] In addition the government put on hold its privatization program to facilitate the formulation of a sound legal framework to facilitate the privatization process.

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[137] Kimura & Amoro. 2.
[138] *Listed Companies* (accessed April 9, 2005); available from http://www.nse.co.ke/ListedCompanies.htm.
[139] CMA Annual Report 2003.
[140] Wagacha.

When companies are considering whether to list their securities at the NSE, the factors inducing listing include:

a) Access to cheaper sources of financing.
b) Suitability of the NSE as a vehicle for trading equity.
c) The opportunity to share the risks associated with sourcing capital.

On the other hand the factors inhibiting listing include:[141]

a) Disclosure of information seems to be a major impediment to listing at NSE. The risks associated with additional disclosure are perceived to be inadequately compensated by additional returns. Some unlisted companies consider the cost of disclosure not commensurate with benefit accrued by listing.
b) The dual role played by commercial banks in Kenya as investment advisors and lenders has indirectly discouraged the use of the stock exchange as a means of raising capital. Since banks do not require public disclosure of a company's affairs like the NSE does, many firms prefer to remain unlisted and source their capital from the banks.
c) Fear of loss of control by opening up firms to public ownership particularly by family owned companies.
d) Limited diversity of products at the NSE to attract eligible firms. Currently, the market provides firms with the option of trading in ordinary and preference shares, commercial papers, government bonds and corporate bonds. More firms may opt to list on the NSE if other products are introduced such as a futures and options market, an over-the counter (OTC) market, and trading in asset-backed securities.

[141] Ibid.

e) The ability of firms to raise start-up capital from own savings, loans from domestic commercial banks and foreign sources. A study conducted in Kenya using a sample of twenty-four unlisted companies, indicated that about 60% of the firms used private savings as start-up capital for their business, 12% obtained loans from commercial banks while about 4% obtained loans from foreign sources.[142]

f) Stringent listing requirements before an entity can qualify for listing have contributed to the elimination or disqualification of many business enterprises.

g) Inadequate marketing of the NSE to eligible companies.

Liquidity

NSE is considered a more liquid and active market than those of its East African counterparts (Uganda and Tanzania) and in sub-Saharan Africa in general. However, by international standards, it is small, illiquid and volatile with regard to price and returns. Low liquidity is particularly evident in the secondary bonds and equity markets. The NSE is a highly concentrated market with most of its activity centered on a few listed companies. Out of the 47 equities listed in NSE, about 15 companies are regularly traded.[143] Trading on securities from the remaining companies is haphazard and irregular. The low turnover ratio, which is less than 5%,[144] may be attributed to the limited floatation of shares as only about 35% of market capitalization is available for trading. In addition, there is a high incidence of "buy and hold" particularly among institutional

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[142] Wagacha.
[143] Writer's observation of trading at NSE in July 2004.
[144] World Bank, Capital Market Integration.

investors who dominate the market. In 2002, institutional investors held 60% of equities listed at NSE.[145]

Public awareness

Generally, there is lack of awareness and information on the role, functions and operations of the stock exchange and the CMA among potential investors and business entities. Many Kenyans throughout the country do not know enough about the NSE and the CMA, and the market does not seem to market itself sufficiently to potential investors or provide a variety of products to attract companies. This may be attributed to financial and human resource constraints.[146] The lack of public awareness on NSE operations is a major hindrance to corporate participation in stock market.

Economic and political conditions

Kenya experienced poor output performance with an average GDP growth of about 1.3%[147] between 1997 and 2002. Listed companies experienced losses or low profits and individuals faced low income thereby resulting in low demand for equities. In addition, the foreign investors turnover and net foreign inflow declined between 2000 and 2002 due to political and economic uncertainties thereby reducing the amount of foreign portfolio investment that had been attracted into the country in previous years.[148]

[145] Ibid.
[146] Kimura and Amoro. 17.
[147] World Bank, Capital Market Integration.
[148] Interview with NSE Research and Marketing Manager conducted in April 2005.

Market Infrastructure

The current manual trading system is slow, costly and limits the range of products that can be provided. It has also hindered international integration of the market. The fact that the NSE is not linked to other international markets outside East Africa has attracted some foreign investors because shocks in other international markets do not significantly affect the NSE. However, this separation limits the growth, liquidity and expansion of the market. Prior to November 2005, delivery and settlement of traded shares was conducted manually. Although it was intended that transactions be conducted on a T+5 cycle (day of trading plus five days), investors waited for weeks, sometimes months on end, to receive their certificates after purchases.[149]

Interest rates

High real short-term interest rates have reduced the demand for capital market instruments and crowded-out substantial domestic savings to short-term government securities. This situation was particularly evident in 2001 when the Treasury bill (t-bill) rate was 12.6% compared to an inflation rate of 0.8%. However, the situation is being reversed as t-bill rates have fallen to about 8% resulting in increased demand for both equity and debt instruments.[150] Interest rate spreads are high and currently standing at about 13%. Deposit rates are too low and lending rates too high thereby discouraging domestic savings and investment. The domestic savings are less than 10% of GDP and

[149] Waiyaki.
[150] World Bank, Capital Markets Integration.

thereby insufficient to meet investment needs and generate demand for equities and debt instruments.[151]

Bond Market

Government bonds have dominated the debt market in the NSE. Until 2002, there was little trading in the bond market partly because institutional investors exhibited a "buy and hold" strategy. Since 2002 the issue of corporate bonds and the issue of longer-term government treasury bonds has increased turnover in the bond market. Lack of suitable pricing benchmarks for pricing of corporate bonds and the absence of rating agencies has hampered the development of the corporate bond market. However, CMA recently accredited Duff and Phelps (South Africa) to offer rating services.[152]

Insurance Industry

The insurance industry has played a relatively smaller role in the capital markets than it is capable of doing because it is dominated by non-life companies whose liabilities are short-term and not suitable for investment in capital markets.[153] Most of the reserves in the insurance industry have been utilized in short-term government securities and bank deposits. The few life insurance companies have utilized their reserves in real estate, t-bills and short-term bank deposits.[154]

[151] Ibid.
[152] Ibid.
[153] Ibid.
[154] Ibid.

CHALLENGES FACING THE CMA

CMA's main challenge remains to educate the public on the capital markets in Kenya and the opportunities that lie therein for long-term investment. It has a limited number of staff members available to conduct an aggressive marketing and education campaign. The CMA has responded to the challenge of investor education by hosting workshops on themes pertinent to the development of capital markets, giving presentations at professional and business functions and publishing an annual report that is available to all market players. In addition, it has made arrangements for its members of staff to visit other countries and learn how they have worked to develop their capital markets in an attempt to build its capacity and learn from other more successful markets.[155] However, there is need to improve the coverage of its investor education not only to large corporations and the business community in the city of Nairobi but also to the general public in other parts of the country.

FUTURE OF THE NAIROBI STOCK EXCHANGE

The future success and relevance of the NSE as a driver and participant in the growth of Kenya's economy will depend on how well and effectively new and innovative financial products are launched and attract new listings. In addition, there is need to diversify the sector representation at the NSE to include the insurance industry and the co-operative movement. In March 2005, NSE's new CEO, Mr. Chris Mwebesa indicated that his approach to the development of the NSE would be to facilitate growth by focusing on the

[155] Interview with a Legal Officer at CMA conducted in July 2004.

over-the-counter market (OTC) and the creation of a commodities exchange where cash crops such as coffee can be traded.[156]

An **Over the Counter Market** (OTC) is a securities market that exists for securities not listed on stock exchanges. It applies to the following firms:

- Unlisted public limited liability companies whose shares are transferable to any member of the public for example land buying companies.
- Cooperative societies with shares that are transferable between their members subject to the society's guidelines.
- Private companies whose shares are transferable between shareholders of the company or with other members of the public as approved by the company's directors.
- Financial institutions and banks.
- Delisted companies

It is anticipated that OTC requirements will include:[157]

- Minimum paid up share capital of Kshs.5.0 million.
- Admission of at least one class of shares.
- Not less than 10% of the paid up share capital held by more than 7 members.
- Adequate management capacity to maintain the business.
- Satisfactory track record.

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[156] Tom Mogusu, "Can He Fix NSE?" *Daily Nation Newspaper.* March 13, 2005.
[157] Responses to questions by Kenneth Kwama – East African Standard. Obtained from NSE Library.

- Good performance prospects for the firm in the absence of a profit history.

The current absence of such a market has resulted in the existence of an informal and inefficient market where investors intending to trade in unlisted securities search for buyers on their own, through their bankers or other members of the NSE.[158]

Comparison between Stock Exchanges and Over-the-Counter Markets[159]

Stock Exchanges	**OTC Markets**
Prices are determined daily when sessions are held (order driven)	Prices are negotiated and vary from one firm to another (quote driven)
There is a fixed market where parties transacting gather	There is no fixed market place
Trading is limited to members with specific qualifications	Trading is conducted through negotiations between a buyer and a seller
Trading is limited to listed stocks that meet certain requirements	Equity issues tradable over the counter are registered with a security dealers association
There is a centralized market where bids and offers converge	Transactions are executed over the counter
The stock exchange supervises trading	An association of dealers regulates trading activity

The **automation of trading** will be necessary to complete the process of modernizing the NSE, which is currently underway as evidenced by the automation of the automated clearing and settlement system. Transaction, settlement and exchange of shares will be conducted instantaneously. The success of the modernization process will require coordination, action and support by the various market players, including banks, brokers, shares or accounts owners, the CDSC, the NSE and the regulatory authorities including the Capital Markets Authority and the Central Bank of Kenya.

[158]Ibid.
[159] Ibid.

PART V: CONCLUSION AND RECOMMENDATIONS

CONCLUSION

The changing attitudes towards the role of the private sector in the development of African economies has facilitated the development of the capital markets because of the inherent potential of these markets to meet the fixed-capital needs of the private sector. Capital markets can ensure the efficient and sustainable funding of governments, corporations and banks for large-scale or long-term projects.[160] In this regard, developing countries are working towards reforming and deepening financial systems, through the expansion of capital markets in order to improve their ability to mobilize resources and efficiently allocate them to the most productive sectors of the economy.

Significant progress has been made in the development of many stock markets in Africa. The growth in market capitalization in Africa has been described as remarkable in the last decade, new legal and regulatory regimes are being set up and progress is being made in the development of market infrastructure such as the automation of trading and settlement. However, emerging stock markets face significant challenges to their development and growth as exemplified in the NSE and other African markets. Hence the need to ensure that legal, technical and operational structures are in place so that African and other emerging capital markets function like their counterparts in more developed countries.

[160] *Capital Markets.* Accessed April 2, 2005. Available from http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/generaldescription/1Capital+Markets?opendocument.

RECOMMENDATIONS

In view of the challenges discussed in the previous sections with regard to the NSE and African stock markets in general, the following recommendations are proposed. They make specific reference to the NSE but may be applicable to other emerging markets.

NSE should increasingly play an educational role and embark on a vigorous campaign to market itself and educate potential investors about the opportunities available in the market and how to effectively exploit them.[161] The efforts by NSE and CMA to improve public awareness of the opportunities available in the capital markets in Kenya need to be strengthened by using a variety of means of communication such as media campaigns through the radio, television and newspapers, engaging in one-on-one meetings with eligible firms and potential investors, and distribution of literature to firms and potential investors across the country. The NSE and CMA should compile a list of potential issuers of both equity and debt and initiate contact with them to educate and improve their awareness of the benefits and relevance of capital markets for their operations. In addition the two institutions should set up branch offices at the district and provincial levels to facilitate outreach to the general public.

Investor education may also be done through incorporating information on investment and the capital markets in the high school and college curriculum to enhance the awareness by the younger generation of Kenyans who make up more than half of the total population. Out of a total population of about 30 million in Kenya, it is estimated that

[161] Kimura and Amoro.

only about 580,000[162] are investors in the NSE. This is a very low rate and the number can be increased as more Kenyans are informed of the investment opportunities available to them at an early stage of their lives.

Capacity building at CMA and NSE is essential to facilitate the effective conduct of operations and implementation of the marketing campaigns. This may be achieved through hiring members of staff well trained in marketing, research and market analysis.

It is essential for the NSE to diversify the products available to potential issuers and investors. Examples of products that can boost activity in the market include a futures and options market that will be attractive to the agricultural sector and the establishment of an Over-The-Counter (OTC) market for companies that are currently ineligible to list at NSE such as medium-sized family businesses as well as eligible companies that issue shares but are not listed at NSE such as cooperative societies.

For the overall development of capital markets, NSE needs to relax the minimum requirements for trading securities in order to accommodate companies that have shares that are transferable to members of the public yet they do not meet the stringent listing requirements. The challenge will be to simplify and ease listing conditions without compromising investor protection. Streamlining public offering procedures and limiting the number of market agents involved in the issuing process are examples of simplification of the listing requirements.

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[162] NSE Handbook.

Continued privatization of state enterprises is essential as the most viable source of equity. In this regard, the implementation of the privatization bill through the stock exchange will increase the supply of equity in the market and trigger resurgence of primary equity activity. However, weak and non-performing public enterprises should not be dumped in the market in the guise of privatization.

Pursuit of the development of the life-insurance industry is important in order to generate long-term funds that can be invested in the NSE. Currently, there are only two life insurance companies listed at the NSE.

Encourage the free flow of capital across borders through the regional integration of capital markets in East Africa such as has been exemplified by the West African Economic and Monetary Union in the Bourse Regionale des Valeurs Mobilieres (BRVM- Regional Stock Exchange). In addition, NSE should pursue the continental and global integration to markets such as the Johannesburg, Nigerian, Cairo and Mauritius stock markets.

Modernization of the trading system to improve liquidity, attract foreign investors and reduce transaction costs is necessary. Automation of trading will complement the current automation of the depository, settlement and delivery and facilitate the ability of the market to cope with increase in new listings or increased trading and turnover particularly with the imminent privatization of many state-owned companies.

Continued macroeconomic stability and lengthening of maturity of government debt will encourage the development of the bond market. Economic and political policies directly affect confidence and activity in the market, hence the need for close public-private partnership between the government and the private sector to ensure that policies are formulated with guidance from both sectors with an objective to ensure the overall economic welfare.

The Capital Markets Authority has been criticized as being heavy-handed in its approach to regulation of the capital markets. Its relationship with the NSE has been described as adversarial.[163]A more supportive approach that is proactive and creative in enhancing a more vibrant environment will enable CMA to be a catalyst in rather than a hindrance to development of the market.[164]

Demutualization of the NSE is essential to ensure proper monitoring and regulation of members and market participants. Demutualization refers to conversion of a member-owned company to shareholder-ownership. Presently, the NSE is a member owned company whose board membership has more representatives of stockbrokers than other market participants. This has poses a challenge to the enforcement of regulations on errant stockbrokers.

[163] Interview with NSE Manager, Research and Development in April 11, 2005.
[164] Wagacha.

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