TOWARDS AN EFFICIENT CAPITAL MARKET

An Assessment of Regulations at the Nairobi Stock Exchange

By

Racheal Wambui Mwangi

USIU-A in Nairobi
August 2000
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A Research Project Presented to the Graduate Faculty of the School of Business, United States International University - Africa in Partial Fulfillment of the Requirements for the Degree of Masters in International Business Administration.

USIU-A in Nairobi
August 2000
I hereby declare that this project is my original work and has not been submitted, either in the same or in different form to this, or any other University or Institution for a degree.

Signed: ___________________________  Date: 29 Aug 08
Racheal Wambui Mwangi

This project has been submitted for examination with my approval as the supervisor

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Dean, School of Business, USIU-A in Nairobi

_______________________________  Date: ___________
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DVC, Academic Affairs, USIU-A in Nairobi
DEDICATION

I would like to dedicate this research to my family: Dad, Mum, Maich, Kesh, Jimu and Muthoni, I could never have done it without your support. My friends: David, thank you for your patience and support Gichinga and Kevin, I appreciate your help.

Most of all, this goes to the Almighty God; without His Grace I would have given up on this research.

Wambui
ACKNOWLEDGEMENT

I would like to recognize the efforts of Dr. Pius Owino, Faculty at the USIU-A, who taught me about research methods. His immense contributions guided me through the process of getting a research topic and in the theoretical aspect of carrying out a research including this project. Mr. Timothy Oketch was also of great help in data analysis and putting together this document. I would also like to appreciate the efforts by the different market players who took their valuable time to fill out the questionnaires and gave more information than had been asked for.
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# LIST OF ABBREVIATIONS AND ACRONYMS

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<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>CDS</td>
<td>Central Depository System</td>
</tr>
<tr>
<td>CFC</td>
<td>Credit Finance Corporation</td>
</tr>
<tr>
<td>CMA</td>
<td>Capital Markets Authority</td>
</tr>
<tr>
<td>GoK</td>
<td>Government of Kenya</td>
</tr>
<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commission</td>
</tr>
<tr>
<td>NSE</td>
<td>Nairobi Stock Exchange</td>
</tr>
<tr>
<td>USAID</td>
<td>United States Agency for International Development</td>
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ABSTRACT

The Capital Markets Authority (CMA) governs the Nairobi Stock Exchange (NSE) with the purpose of facilitating the maintenance of appropriate regulatory environment essential for the growth of the stock market. Among the rules and regulations set out is the licensing requirements. Additionally, the CMA plays a vital role in the development of long-term financial instruments and the institutions necessary for efficient monitoring of the market. Since the inception of the CMA very little, if any has been conducted to examine how this affects the efficiency of the market players.

The main objective of the study was to bridge this gap by investigating how the licensing regulation affects the efficiency of the CMA. Other objectives included investigating duplication of services and liquidity of the market; examining the views of market participants on self-regulation; and investigating whether the CMA should license more dealers.

In addressing the above objectives data was sourced from secondary sources that included documented academic research on the efficiency of capital markets. This was complemented with primary data obtained through such instruments as questionnaires, observation guides on focused group discussed guides with key market players. The market players included stockbrokers, investment advisors and dealers.

Data analysis reveals that most market players preferred fewer licenses to be issued which allowed them to offer varied services as offered by investment advisors, stockbrokers and dealers. The ability to operate this way would create more liquidity at the stock market as more market players can act as dealers who primarily are ‘market makers’. Dealers contribute to increased liquidity at the bourse.

The research concludes that the licensing regulation should be altered to suit more players in the market. It is therefore recommended the CMA regulators should ensure efficiency in markets since markets are important national assets, investors will seek out efficient and fair markets. Additionally, the services offered on each license ought to be more specific for this will enhance the level of surveillance and thus increases efficiency.
Chapter One
INTRODUCTION

1.1 BACKGROUND
Meaning and Scope of the Stock Exchange Market

A stock exchange market deals in the exchange of shares of publicly quoted companies, municipal stocks and government stocks for money. As defined by Simiyu (1992), it is a place where investors register their opinions on the future of the economy and a barometer that reflects important economic changes. The stock exchange is of vital importance to the government and industry because they can raise new long-term capital voluntarily from the public and on a large scale and in a short space of time. It bridges the gap between the government and companies which need to borrow money for long periods or to raise permanent capital, and investors who only wish to put up money for a comparatively short time. The stock exchange embodies fund-raising mechanisms for large corporations and, in addition, provides an arrangement for those who have put up the money in stocks to get it back when they want it by selling their holding to fresh investors. If the market is not available, many well-known enterprises could not have come into being.

Nairobi Stock Exchange: Brief History

The Nairobi Stock Exchange was established in 1954 as a voluntary association of stockbrokers registered under the Societies Act. In 1990, the NSE was registered as a Limited Company operating under the Call-Over system which changed to Open Outcry system the following year. In December 1995, the Kenyan government removed exchange controls and also allowed foreign participation in the exchange1. The Exchange is sub-Saharan Africa's fourth-largest bourse. By 1995, twenty brokers had been licensed to operate with over 50 companies listed, with a total capitalization of approximately $1.9 billion. Trading at the bourse takes place on Mondays through Fridays between 10.00 am and 12.00 noon.

1 http://www.africaonline.co.ke/AfricaOnline/nse/historynse.html
Capital Markets Regulatory Framework

As a regulatory body, the Capital Markets Authority (CMA) was launched in 1989 to assist create a conductive environment for growth and development of the country's capital markets. The NSE falls under the Authority's regulatory scope.

The Capital Markets Authority Act Cap 485A of 1989 governs the capital markets regulatory framework and its subsequent promulgated Rules and Regulations. This framework has facilitated the maintenance of appropriate regulatory environment essential for the growth of the capital markets.

The Authority's regulatory structure entails the building of an effective system of market oversight including the mechanism for monitoring compliance with specific regulatory requirements. It also includes a strong enforcement program, all of which are aimed at safeguarding the integrity of the market.

The regulatory framework also entails an annual licensing program for all market practitioners in order to ensure that they continue to comply with oversight regulations as well as the self-regulatory rules of the stock exchange in the case of brokers and dealers.

1.2 The Problem

The CMA plays a crucial role in the development of long term financial instruments and the institutions necessary for efficient functioning of the market (GoK, 1997). The institutions include service security firms, debt and equity underwriters, merchant bank, investment advisors and specialized market information agencies like stockbrokers and dealers. These different institutions (market players) require operational licenses as stipulated in the CMA Act.

The licensing and supervision of market intermediaries should set minimum standards for market players and provide consistency of treatment for all similarly situated intermediaries.

2 The Authority herein refers to the Capital Markets Authority.
3 CMA Act 485A.
4 These will include stockbrokers, investment advisor and dealers.
This implies that regulations should set conditions of entry that make clear the basis of participation. The market players can in turn provide autonomous services to the investors (IOSCO, 1998). However, the players licensed by the CMA give interrelated services; e.g. dealers, stockbrokers and investment advisors all give investment advice. For the CMA to be efficient in terms of reducing surveillance costs and time, it may need to review how it issues licenses to allow for better participation in the market. This means that all players can act autonomously if operating under different licenses or can offer different services but under one license.

Currently, the market lacks enough dealers since only Credit Finance Corporation (CFC) bank is licensed to operate as a dealer. This limits the liquidity position of the stock exchange since many dealers create liquidity position of the stock exchange (Weston, 1996; East African, January 1999). To date very little, if any, has been done to examine efficiency and surveillance that leads to this scenario.

The study aims to examine how the licensing regulation affects efficiency of the CMA in relation to the NSE.

1.3 Objective of the Study

The main study objective was to examine how the licensing regulation affects the efficiency of the Capital Market Authority (CMA) in relation to the Nairobi Stock Exchange (NSE). Other objectives include:

i. To examine how the rules and regulations governing the NSE affect the efficiency of the CMA in relation to the problem of duplicity and regulation of services and liquidity of the stock market.

ii. To examine whether the current system allows market participants to be self regulatory.

iii. To examine whether the current number of dealers are adequate.

iv. To investigate whether the market is in need of facing toward a price driven system as opposed to the "open outcry " system.

v. To suggest recommendations in light of the study findings.

\footnote{Liquidity refers to the ability to convert an asset to cash on short notice and reasonably capture the amount initially invested (Weston 1996:48)}
1.4 Research Questions

Is the current regulatory system of issuing different licenses for each of these services offered by market players appropriate?
- Will fewer licenses affect the surveillance level of the CMA?
- What is the role of dealers in creation of liquidity at the stock exchange?
- What is the role of the CMA on the services offered at the NSE?

1.5 Importance of Study

The capital market plays an important role in financial inter-mediation "to marshal resources for the envisaged industrial take off and management of financial resources" (GoK, 1997). It is entrusted with this role solely because it performs better than individuals (including institutions) in that it incurs less transaction costs - time and money. Its ability to transact quickly justifies the existence of capital markets. This in turn ensures that sellers of securities acquire liquid assets almost instantaneously hence reducing liquidity risks. Efficiency ordinarily is attained in an environment of total freedom (assuming ability of players to self-regulate). In this era where the investors want a quick return for their investments, the CMA can play a role in enhancing the effectiveness of market players thereby streamlining their activities. The players can then satisfy investors through provision of better services.

The results of this study will benefit the CMA and market players to create an environment acceptable for the regulator and the effectors of the regulations by providing routes to increased efficiency.

1.6 Organization of the Study

The study has six chapters. In Chapter one, the background of the Nairobi Stock Exchange (NSE) and the role and functions of the capital markets are presented. Following this is the research problem where the rules and regulations of the Capital Markets Authority (CMA) are investigated for their efficiency in terms of licensing of market players at the NSE. The objectives of the study aim to find out whether the different licenses issued to the market players affect the efficiency.
In chapter two there is review of literature on capital efficiency. Thereafter, chapter three presents the methodology for the study including the study design, data sources, sampling procedures and study limitations.

Chapter four presents the analytical model, while conclusion drawn from the research and recommendations made are discussed in chapter five.
Chapter Two
LITERATURE REVIEW

This section introduces literature about licensing and operations of market players as well as other studies done on capital markets efficiency, the regulatory framework and the stock exchange. The chapter includes some guidelines given by the CMA on licensing and operations of market players and the general role and objectives of the CMA. Efficiency of capital markets is briefly defined. The last section of this chapter is a review of other studies done on capital markets.

2.1 The Role and Objectives of the Capital Markets Authority

According to the CMA Act\(^6\), the Authority was formed as a state corporation under the Ministry of Finance. It was charged with developing all aspects of capital markets with particular emphasis on removal of impediments to and the creation of incentives for long term investments in productive enterprise; facilitating the existence of a nationwide system of stock brokerage services so as to enable wider participation of the general public in the stock market; creating, maintaining and regulating, through the implementation of a system in which the market participants are self-regulatory to the maximum practicable extent, of a market in which securities can be issued and traded in an orderly, fair and efficient manner; and operating a compensation fund to protect investors from financial loss arising from the failure of a licensed broker or dealer or broker to meet his contractual obligations.

Specifically, as a regulatory body, the CMA’s role is to devise, enact, monitor and enforce market regulations that enhance stability of the systems supporting the market, effective, rapid resolution of settlement and trading issues; efficiency of the market, customer protection and fairness of the market.

Regulation of the market is critical to its success while over-regulation will cause stagnation and tend to raise unduly the cost of trading. Lack of regulation may drive investors from the market. According to Mayo (1989), the division of regulatory oversight outlined above, with

\(^6\) Section II of Cap 485A
clear terms of reference for the exchange and the regulators will tend to enhance the efficiency of the market while lowering the cost of operation. It will also minimize the difficulties caused by lack of clarity in jurisdiction for administration over the rules and present a coherent and attractive framework in which investors may be confident that their interests are being looked after. Additionally, United States Agency for International Development (USAID, 1994) notes that the regulations laid down by the Authority touch on most important issues directly affecting the capital markets: stock exchanges, licensing of brokers and other intermediaries (firms and individuals), investment advisers, primary market, off-exchange transactions, complaints and compensation.

By virtue of its role in financial intermediation that the developments of a capital market in a country is considered a reflection of the country’s prosperity, modernity, and economic prospects. In late 1989 and in 1990 Kenya took some important policy steps to establish and develop its capital markets, including a secondary securities market. This forms part of the financial reforms program on which the Government is embarking in order to promote the development of the private sector. The Capital Market Authority Act was enacted early in 1990 with the objectives of:

"Developing all aspects of the capital markets; creating, maintaining and regulating a system in which the market participants are self-regulatory; protecting investor interests; and operating a fund to compensate investors if a licensed broker or dealer fails to meet his contractual obligations." (Source: http://www.nationaudio.com/kenyafiles/capital.htm)

2.2 Role of Regulators in an Efficient Market

IOSCO (1998) describes the desirable attributes of a regulator and the potential role of self-regulatory organizations, the enforcement and compliance work of the regulator as follows:

- **First, the responsibilities of the regulator should be clear and objectively stated:** the responsibilities should preferably be set out by law (CMA Act) and there should be adequate legal protection for regulators to discharge of their functions and powers.

- **Secondly, the regulator should be operationally independent and accountable in the exercise of its functions and powers:** the regulator should be independent from external political or commercial interference in the exercise of its functions and powers and
accountable in the use of its powers and resources. Independence will be enhanced by a stable source of funding for the regulator.

Accountability implies that the regulator operates independently of sectoral interests; have a system of public accountability and permitting judicial review of decisions of the regulator.

- **Thirdly, the regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers:** this includes powers of licensing, supervision, inspection, investigation and enforcement. The regulator should retain experienced staff who receive ongoing training as required to operate efficiently.

- **Fourthly, the regulator should adopt clear and consistent regulatory processes:** these processes ought to be transparent to the public, fair and equitable.

- **Fifthly, the staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality:** this is in the areas of avoidance of conflicts, appropriate use of information obtained in the course of exercise of powers and the discharge of duty; proper observance of confidentiality and secrecy provisions and the protection of personal data and; the observance of procedural fairness.

### 2.3 Guidelines for Operators in Kenya’s Capital Markets

The CMA Act requires that any person carrying on a business as a broker, dealer or investment advisor must be a holder of a valid license issued under the Act (CMA Act 485A, Part IV, Section 25). The Act further states that an application for a license or for the renewal of a license shall be made to the Authority in a prescribed manner by filling out a form. The Authority will grant a license if the applicant meets and continues to meet such minimum financial and other requirements as may be prescribed.

#### 2.3.1 Capital Markets Authority Guidelines on Operations of Market Players\(^7\)

Prior to the Amendment of the CMA Act in 1994, the stockbrokers were allowed to perform dual roles as brokers and dealers. Thus they acted as agents of the investors (in brokerage role) and as principals. However, it was found out that there was potential for conflicting objectives of acting as an agent on behalf of clients as well as acting principal (trading on their account). Dealers act as independent market makers whose trading activities at the stock exchange are

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\(^7\) CMA Act, Section IV of Cap 485A
exclusively on their own account (as principal). Dealers play an important role of generating both demand and supply of securities that help improve liquidity at the Stock Exchange and maintain relative price stability.

Brokers do not deal in securities in their own account. The stock account operated for persons associated with the broker are operated by a principal officer duly authorized by the Broker firm's board of directors and is made available for inspection at any one time by the Authority. Brokers charge their clients on whose behalf they deal (buy or sell) brokerage commissions whose rate is prescribed by the NSE with the approval of the Authority. Brokers also are appointed by a company to support its floatation at the NSE and subsequent public issue of securities, rights, and offers for sale, placing or tender.

The practice of investment advisors is simple and appealing. The advisor's firm receives funds from many investors, pools them, and purchases securities. The individual investors receive:
- professional management of their money,
- ownership in a diversified and hence less risky portfolio,
- savings in commissions, as the investment company buys and sells in large blocks, and
- custodial services (e.g., the storing of certificates and the collecting and disbursing of funds).

2.4 Capital Markets Efficiency

One of the objectives of the International Organization of Securities Commission (IOSCO) is to ensure that markets are fair, efficient and transparent. In the commission's document (IOSCO, 1998), fairness of the market is closely linked to investor protection and to the prevention of improper trading practices. Efficiency is referred to as the dissemination of relevant information that is timely and widespread and is reflected in the price formation process. It further states that regulation should promote market efficiency. Transparency is defined as the degree to which information about trading is made publicly available on a real-time basis. Again, "regulation should ensure the highest level of efficiency " (IOSCO 1998, p8).

This study focused on factors influencing the market players and the services they are licensed to perform. Regarding licensing and supervision, IOSCO (1998) states that, "it should set minimum standards for market participants and provide consistency of treatment for all
similarly situated intermediaries." This means that regulation should set conditions of entry that make clear the basis of market participation.

2.5 Regulations of the CMA and the NSE

In the section that follows we review related studies of the CMA and NSE:

Kibicho (1998), in a study on the NSE and the economic fundamentals, found that the exchange rate is a decision variable for foreign as well as local investors in a liberalized economy where there is to some extent free movement of capital across borders. Large fluctuations in the nominal exchange rate increase investor uncertainty about the return to investment. This in turn increases the level of speculation in the country as investors use the share as a temporary-stopping place until foreign exchange settles. Lower exchange rate for domestic currency boosts supply of foreign currency to the country which increases the demand for shares and hence pushes share prices up. In testing for the Weak Form Efficiency of the NSE, Kibicho adopted time series data from 1992 to 1997. She found the NSE to be weak form efficient implying inability to generate abnormal returns based on past trends.

Kimura and Amoro (1999) examined the impediments to the growth rate of the NSE by interviewing market participants. The study reveals that the regulatory environment tends to be of the traditional faultfinding and heavy-handed type. They contended that if the regulatory authority in Kenya is to be seen as an effective partner in growth and development, it must adopt a more supportive, educational and progressive approach. Keane (1985), in his study of market efficiency, used time series data to analyze the behavior of the vast majority of stock market participants and the proposition of efficient markets. In light of this, he considered the aspect of how prices reflect information availability. He found that there are three potential levels of efficiency namely: weak-form, semi-strong form and strong-form with each level relating to a specific set of information which is increasingly more comprehensive than the other one (Keane 1985:10).

On the other hand, Dixon and Holmes (1995) in their attempt to explain the principles surrounding the role and efficiency of financial markets found that efficiency is primarily concerned with the availability of information in financial (stock) markets. Mainly, operational efficiency that requires the participants supplying and demanding funds to carry out transactions
cheaply and, allocational efficiency that requires "prices of securities to be such that they equalize the risk-adjusted rates of return across all securities" (Dixon & Holmes 1995:11). Under this condition, they argued that prices are set such that securities with the same level of risk offer the same expected return. Their study was done using techniques and processes of finance and financial markets. This study will allude to operational efficiency.

Pratten (1993) interviewed and studied market players and their views of the market mainly through questionnaires. He was noting the contemporary relevance of Keynes's analysis. He notes that fund managers (investment advisors) are not market makers (dealers). He further notes that, although they do not make markets in the strict sense, they announce prices at which they are obliged to deal and fund managers to participate in market making.

Wagacha (2000) studied the behavior and strategies of shareholders in Kenya as key players in the capital market. He reviewed literature and various documents that provided a basis for describing the capital market that investors face. His research findings revealed that the shareholding population was dominated by employees in the 20-37 years age bracket. He further found out that the motives for sale of shares were influenced by the need to make profits and to re-invest in other shares or government securities. While shareholders were key players in the market, stockbrokers and other market players played an important role in the acquisition of shares though the former rarely used investment advice provided.

The regulatory authority, CMA, was poorly rated by shareholders in terms of its ability to deal with complaints, although the disapproval rating was less severe in terms of their role in protecting investors.

Paul Greatbatch", in his workshop "Competing for Foreign Portfolio Investments: Issues of Concern to Investors and Ways of Encouraging Local Investments", noted that a stock market cannot function satisfactorily in the absence of a clearly defined legal, economic and institutional infrastructure. The main aim of the workshop was to try and identify the preconditions for reintegrating a stock market into an economy as a capital raising forum and

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8 This is an analysis done on understanding the stock market and the ways in which economic agents deal with uncertainty.
9 Genesis Investment Management Director.
those which will in turn encourage both domestic and international portfolio investment in the country concerned.

On regulation, he said a regulatory body should be able to attract individuals working within the securities and investment industry so as to imbue it with an understanding of commercial practice. It is also important that substantive consultations should take place with stock market users such as stockbrokers, dealers, investment advisors and even both domestic and international investors before new legislation or regulations are promulgated. He further added that indiscriminate legislation of immature capital markets runs a severe risk of stunting their expansion and diminishing their usefulness to the economy. In addition, a vital role of the regulator is to protect the minority shareholder who is of critical importance to a stock markets' growth. Prices and volumes traded at the stock exchange should be monitored by the regulatory authorities to ensure transparency.

Greatbatch concluded the workshop by suggesting that an economy would be enhanced if the stock exchange was repositioned at the center of economic life.
CHAPTER THREE
METHODOLOGY

This chapter presents the methodology adopted to addressing the study objectives. To start with, we present the data collection techniques including the sampling sizes and procedures. This is followed by and examination of study limitations and a definition of the study variables.

3.1 Data Collection and Sampling Procedure

In this study the population of interest consisted of the market players involved with the NSE by means of trading activities and services offered and are regulated by the CMA. Data was obtained from both Primary and Secondary sources.

3.1.1 Primary Data

Primary data was collected using structured questionnaires administered individually to the respective informants who included stockbrokers (n=8), investment advisors (n=6) and one dealer (n=1). A list of market players was prepared\textsuperscript{19} from the NSE. A random number table was used to select a sample for the survey. After selecting the sample, appointments were booked by telephone. Thereafter, the researcher delivered the questionnaires and administered the tools. In the event that the respondents were busy, the interview was rescheduled to a more appropriate date. Generally, the interviews lasted for one hour.

3.1.2 Secondary Data

This was obtained from various libraries like the NSE, USIU-A, Nairobi University, and Kenyatta University. It included manuals, texts, write-up and other relevant materials. Reference material used included texts, finance journals and magazines.

Internet Browsing was also a relevant tool used in obtaining data. Various sites were useful especially on market information about the NSE and other international stock markets. The most relevant site was http://www.stockexchange that led to other relevant sites.

Data collected was formatted, coded, and analyzed using Microsoft Excel.

\textsuperscript{19} See Appendix I.
3.2 Study Limitations

Some issues were considered to be too sensitive and respondents were not willing to provide answers. In such cases however, confidentiality was guaranteed by the researcher, which made them more responsive.

Other respondents took a lot of time to respond to the questionnaire thereby delaying the data collection period. However, this was resolved by the extension of the time frame for the research.

It was initially assumed that there were many market dealers, however, at the time of the survey, only one dealer was found to be operating at the NSE, hence reducing the sample size. In spite of that, the study benefited from the dealer's contribution. The market is still substantively small.

3.3 Definition of Variables

<table>
<thead>
<tr>
<th>VARIABLE</th>
<th>DESCRIPTION</th>
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<tbody>
<tr>
<td>Market participants</td>
<td>The market participants relevant to this research are investment advisors, stockbrokers and dealers. They are considered in light of the services they offer in regard to the NSE and the regulations set by the CMA.</td>
</tr>
<tr>
<td>Participation</td>
<td></td>
</tr>
<tr>
<td>Liquidity of the market</td>
<td>This is the ability or rate at which assets can be converted into cash by investors in any sort of market.</td>
</tr>
<tr>
<td>Operating licenses</td>
<td>These are issued to the market players depending on the services that they offer. In effect there are three licenses - Investment Advising license, Stockbroking license and Dealership license.</td>
</tr>
<tr>
<td>Vibrancy in the market</td>
<td>This is the intensity of trading activity at the bourse. It is dependent on among other things the liquidity of the market and investors participation.</td>
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Chapter Four
DATA ANALYSIS AND INTERPRETATION

In this section the study findings are presented. We first describe the categories of license issued by the CMA, then make a comparison of the services offered by the market players. This is followed by a discussion on the preferred size of dealership, surveillance and the level of liquidity at the stock market. We conclude the chapter by analyzing the role of the CMA on the services offered at the NSE.

4.1 Categories of Licenses Issued by the CMA

In an attempt to find out whether the CMA should issue different licenses for the different services, the respondents responses are summarized in the table below:

<table>
<thead>
<tr>
<th>Response</th>
<th>No. of Respondents</th>
<th>% of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Different licenses for different services</td>
<td>14</td>
<td>93%</td>
</tr>
<tr>
<td>One license for all services</td>
<td>1</td>
<td>7%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>15</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Survey conducted on Market Players

The survey reveals that 93% of the respondents affirmed that the different licenses were necessary while 7% were of the view that different licenses are not necessary. According to the respondents, different licenses were necessary because: licenses make the services discreet thereby allowing the market players to have autonomy over their specialization; different licenses create job opportunities and promote efficiency within the various services - thus better/efficient stockbrokers, investment advisors and dealers; different licenses define the roles of each player and avoid duplication of services; different licenses protect investors; multiple licensing would lead to self-regulation as in developed stock markets. On the other hand, a few reasoned that one license was enough to carry out these services in a stock market such as the NSE which is still too small. If the NSE grows, then there will be need to diversify through specialization and therefore require more licenses.
4.2 Services Offered

The survey reveals that duplication of services is common as summarized in the table below:

Table 2: Services Offered by Market Players

<table>
<thead>
<tr>
<th>Service Offered</th>
<th>Investment Advisor</th>
<th>Stockbroker</th>
<th>Dealer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Advising</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Trading (buying and selling shares on behalf of investors)</td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Management of a portfolio of securities</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Arranging commercial issuance programs and new public offers</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

Source: Survey conducted on Market Players

The majority (97%) of the respondents agreed that duplication was common among the market players. However, about 3% denied that there was duplication of services. The main reason behind this view is that the various market players have different client niches.

4.3 Number of Dealers Preferred

Through a probe, it was established that CMA had only licensed CFC bank as a dealer although other applications were still being processed. Most respondents reiterated that this move was a positive step as shown in the table below.

Table 3: Number of Dealers Preferred

<table>
<thead>
<tr>
<th>Response</th>
<th>No. of Respondents</th>
<th>% of those in agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-5 dealers</td>
<td>5</td>
<td>39%</td>
</tr>
<tr>
<td>6-10 dealers</td>
<td>7</td>
<td>45%</td>
</tr>
<tr>
<td>&gt; 10 dealers</td>
<td>3</td>
<td>13%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>15</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

Source: Survey conducted on Market Players

Various reasons were given by respondents for the need of more dealers in relation to the role of dealers in a stock market like NSE. According to the respondents, dealers are market makers.
who create supply and demand of securities and they ensure stability in the market by supplying stocks to the bourse when they are limited and clearing it when it is flooded with shares. In addition, dealers provide stockbrokers with avenues to dispose of shares without restriction and provide liquidity when the normal market flow disequilibrium between supply and demand exists. Also more dealers would promote competition in the market and hence avoid monopoly.

Despite being in agreement with the proposal for more dealers, some respondents were not in favor of increasing the number of dealers beyond five. For this category, it was argued that it is not practical for a dealer at the NSE to be a specialist in only one stock or counter. This is because the number of outstanding shares for most NSE stocks is far too few. In relation to the above, the NSE is a relatively small and unsophisticated market with only about 50% of listed securities actively trading. Arguably, the value of the entire stock market cannot accommodate or support many dealers.

About 3% of the respondents did not share the opinion that the NSE should be serviced with more dealers. They argued that the market is still too small to have the specialized role of a dealer.

4.4 Surveillance

The survey reveals that the number of licenses issued does not determine the level of surveillance. In fact, all respondents agreed that surveillance would only be enhanced if the CMA has adequately trained officers to conduct the surveillance. The CMA is responsible for ensuring that it has adequate capacity for market surveillance otherwise it should allow market participants to self-regulate. Surveillance would not be paramount if true professionals and people of integrity are licensed. Licensing removes focus on surveillance though it is necessary in all organizational settings despite the number of players in order to ensure growth.

4.5 Liquidity at the NSE

On the issue of Liquidity at the NSE, the respondents responses are summarized in Table 4.
Table 4: Level of Liquidity at the NSE

<table>
<thead>
<tr>
<th>Level of Liquidity</th>
<th>No. of Respondents</th>
<th>% of the Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>12</td>
<td>90%</td>
</tr>
<tr>
<td>Fair</td>
<td>3</td>
<td>10%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>15</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Survey conducted on Market Players

About 90% of the respondents held that the level of liquidity at the bourse was quite low ranging between 3.4% - 4.5% while the remaining respondents (10%) gave the same range of liquidity as being fair. The low level of liquidity was attributed to difficulty in moving a substantial lot of stock without affecting the price of a share at the market consequently, investors have poor access to the market due to lack of information flow, slow paperwork (in terms of share certificate transfers), slow funds transfer.

The respondents said liquidity in a stock market will cause more quality listed stocks and elimination of non-active stocks. In addition there will be purchase of sizeable blocks of stock without changing their prices leading to stability of stock prizes. Liquidity facilitates exit and entry of investors at will and for sophisticated investors, liquidity of any investment instrument is a key ingredient in determining the risk of that investment. (Iliquid investments are more risky). Companies can use the bourse to raise capital cheaply for expansion instead of borrowing money expensively from financial institutions. Most important, profitability of market players is increased and confidence in the market is created.

4.6 CMA's Role on Services Offered at NSE

As asked about the CMA's role on the issue of services offered at the bourse and the liquidity of the market, the respondents gave the following views:

*Services offered:* CMA should ensure that investors and other stakeholders are protected from dishonest market players. As long as the CMA rules do not go far beyond meeting this goal, they are perfectly in order. CMA should monitor personnel and ethics of market players and quoted companies compelled to issue to the investors their financial results periodically and on time. Both the CMA and NSE should create a more enabling environment and keep up with
trends as is happening in other more advanced markets while maintaining a high degree of integrity of the entire market as one of the most important issues.

**Trading System at the Stock Market.** An efficient system like the CDS improves a bourse's performance or capacity by reducing cycle time thereby increasing output. This is the type of system that the CMA ought to encourage, support and hasten its implementation. CMA should monitor transactions to ensure rules are followed and amend any rule that is retrogressive. Further, the CMA should facilitate the provision of more services like Over the Counter (OTC) for companies which do not meet the existing listing requirements.

**Liquidity at the stock market.** the CMA should facilitate the opening of the stock market to more participants, especially dealers. In addition, more financial instruments like mutual funds/unit trusts/collective investment schemes, secondary mortgage markets/secondary Treasury bill markets should be introduced and implementation of the Central Depository System (CDS).

### 4.7 The CMA as an Agent for Market Players

In regard to the CMA acting on behalf of the Market Players, the respondents said that the regulations set by the CMA should make it [CMA] act like a facilitator in monitoring and effecting the services offered by the various market players. The respondents also said that the regulations should be reviewed in consultation with the market players so that all opinions could be shared. The implementation of the rules and regulations was said to have been poor due to lack of experience in skills by both the NSE and the CMA personnel.

Some respondents said that the CMA should prosecute the offenders in the market. They said that the CMA should enhance market surveillance especially in the case of brokers by regular inspection of their order books so as to avoid distorted trading practices such as front-running, price fixing and price distortion.

### 4.8 Pricing

On the issue of pricing, the general consensus from the respondents was that the current system at the NSE of order-buyer match up basis should be revised. The new move by the CMA and NSE regulators to install the Central Depository System (CDS) is a step in the right direction. Respondents said they favored this system because it would create efficiency in terms of reducing the paper work and thus cut down on time and costs of operation.
Chapter Five
CONCLUSION AND RECOMMENDATIONS

Based on the study findings, the following are some conclusions drawn.

The market players want the different licenses as issued by the CMA. This will give them the autonomy to operate in their areas of specialization i.e. investment advising, stockbroking or dealing. However, the research revealed that some of the services offered by the said market players were similar, e.g. investment advising, trading at the bourse, and arranging for commercial issuance programs. This contradicts with the need for different licenses as desired by the market players.

The market needs more dealers whose main role is 'market making’. As market makers the dealers will improve liquidity in the market while stabilizing the price. The NSE will benefit from this in terms of liquidity which gets rid of inactive stocks and facilitates exit and entry of investors at will. In addition to this, companies can use the bourse to raise capital cheaply for expansion instead of borrowing money expensively from financial institutions.

As revealed by the survey, the NSE needs to improve its liquidity levels that lie between 3.4 - 4.5%. This level, as termed by most market players, is too low. The liquidity problem is as a result of slow paper work, insufficient information to the investors, slow transfer of funds and lack of dealers among other issues.

Market players are dissatisfied with the surveillance carried out by the CMA yet they still want more firms to be licensed to operate in the market. The CMA surveillance department requires trained officers to enforce the rules and regulations, as noted by most respondents.

With regard to the CMA's role in enhancing of the interest of market players, most market players were of the opinion that they should be involved in the review of the current regulations so that all opinions can be shared. The market players were also of the opinion that as the stock market grows, the CMA should create an environment that will enhance greater transparency and tighten loopholes within the market.
Finally, the market players ranked the services offered at the bourse and the liquidity of the stock market as generally tending toward fair. It was argued that the areas of operations at the bourse need more improvement before the market can achieve higher levels of efficiency.

In light of the study findings, the following are recommended:

1. The regulatory environment (in the stock exchange) tends to be of the traditional fault-finding, heavy-handed type. It is based on the presumption that people "out there" are basically dishonest, untrustworthy and must be policed and brought in check in order to conform. This will permeate the functioning of securities regulatory system in terms of perceptions of both the investor and those of companies polled. The rules and regulations of the CMA are largely set out on this presumption11. By refining the rules and regulations governing the NSE and its players, the CMA will earn a good reputation with efficient markets of the day. This will protect the integrity of the marketplace, member firms, and most importantly, the customer.

2. Markets are important national assets essential to economic growth and prosperity. Investors will seek out markets they perceive as fair, honest and orderly. Regulators should strive to make markets fair, honest and orderly through regulation of sales practices, prohibitions against fraudulent, manipulative and improper risk havens for illegal activities. Market abuses result in less efficient markets, higher transactional and systemic costs, losses to investors, and most important, the absence from those markets of individuals and institutional investors who consider market integrity to be an essential characteristic. Regulations set by the CMA should not make the CMA regulators act as watchdogs rather as facilitators; a review of the current regulations ought to be done in consultation with the market players so that opinions of various stakeholders are considered.

3. On the issue of licensing, and how many are needed for any function, the study suggests that the CMA ought to be more specific on the services offered on each license. For instance, the services offered by stockbrokers and dealers tally at some point. Similarly, the requirements for licensing the stockbrokers and dealers are related in terms of the requirements and rules to be met12. In that case, the CMA should issue one license for operation as a Broker-Dealer. Additionally, the firms that meet the requirements of

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11 See also Kimura and Amoro 1999:23
12 CMA Act. Section IV of Cap 485A

21
Investment Advising, Stockbroking and Dealership should be issued one license. In other regional stock markets, like Dar-es-Salaam and Kampala, stockbrokers are licensed to transact as brokers dealers and investment advisors\(^\text{13}\). The benefits of allowing players at the NSE to trade under conditions similar to those of their colleagues in Tanzania and Uganda, regional exchange and integration is likely to be harmonized.

4. An additional benefit of single licensing for multiple functions is regulating. In as much as the current surveillance level is okay, fewer licenses issued to firms will mean fewer firms to monitor. The level of surveillance will be enhanced as the CMA personnel can be absolved of supervision of similar licenses. Additionally, the CMA can encourage more firms to register as market players as they meet the requirements. The issue is not the absolute removal of the distinct licenses, (there are still those that want to operate on the single license), rather it is the creation by the CMA of an opportunity for those that have the capacity to offer all these services to be able to do so.

As revealed by the research, the issue of licensing more dealers has not been a problem with the CMA. However, there is need to license more firms to act as dealers. The current market players should consider applying for this license and start the operations of dealing as soon as possible. If the CMA can issue one license for stockbroker-dealer, the market will then start to reap the benefits of dealers.

Even though the CMA was to implement the recommendations, it still would need to do more so as to meet the levels of efficiency for the NSE that other developed markets have attained. The CMA regulators have to look into other research areas that other institutions, researchers and students interested in the efficiency of the CMA have tackled. The recommendations given in this research, though not exhaustive, would make the CMA more efficient because the CMA would be addressing issues that the market players are in need of. Efficiency is a matter of delivering to the interested parties what they need. In this case the market players need clarity on licensing.

\(^{13}\) The East African. Jan 21-30, 1999
Areas for further research include:

- Market participants response to regulation through surveillance or self-regulation.
- How does the CMA rank against regional and global regulatory bodies?
- What is the role of operational efficiency in the development of stock markets?
### APPENDICES

**Appendix I:**

**List of Stock brokers and Investment advisors**

<table>
<thead>
<tr>
<th>Investment Advisors</th>
<th>Stock Brokers</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Alico Assets Management Ltd.</td>
<td>1. Ashbhu Securities Ltd.</td>
</tr>
<tr>
<td>2. Amicable Investments Ltd.</td>
<td>2. Dyer &amp; Blair Securities Ltd.</td>
</tr>
<tr>
<td>3. Barclaytrust Investments Ltd.</td>
<td>3. Discount Securities Ltd.</td>
</tr>
<tr>
<td>4. Bond and Equity Ltd.</td>
<td>4. Equities Stock brokers Ltd.</td>
</tr>
<tr>
<td>5. Bridges Capital Ltd.</td>
<td>5. Faida Securities Ltd.</td>
</tr>
<tr>
<td>6. CBA Capital Ltd.</td>
<td>6. Francis Thuo &amp; Partners Ltd.</td>
</tr>
<tr>
<td>7. Cambridge Assets Management Ltd.</td>
<td>7. Hak Securities Ltd</td>
</tr>
<tr>
<td>17. Trust Capital Services Ltd.</td>
<td>17. Suntra Stocks Ltd.</td>
</tr>
</tbody>
</table>

**Dealer**

1. CFCBank
Appendix II:

RESEARCH QUESTIONNAIRE

To Whom It May Concern:

I am a student of the United States International University - Africa (USIU-A). I am conducting a research relating to the Capital Markets Authority. The research title is: "Toward an Efficient Capital Market: An Assessment of the Nairobi Stock Exchange (NSE)."

The aim of the questionnaire is to gather information from the market players about their experiences and opinions about the market. This information will be analyzed only on the basis of the research title. The outcome is anticipated to be of use to the CMA and the market players in general.

This research is purely for academic purposes and the information gathered from you will be treated in confidence. Your assistance in answering the questionnaire will be highly appreciated.

Sincerely,

R. Wambui Mwangi
1. The CMA gives licenses for the various services offered, i.e. investment advising, brokerage and dealership. In your view, are all these licenses necessary?

2. In which areas can you say that a duplication of services is found among investment advisors, brokers, and/or dealers?

3. Dealers are normally termed as the market makers. Currently, the CMA has only licensed CFC bank to operate as a dealer. What is your opinion about this?

4. The CMA acts as the regulatory body for the NSE. In regard to licensing, do the rules and regulations set by the Authority adequately satisfy the operations of the said market players? What can the CMA do to ensure that the interests of investment advisors, dealers and brokers are met in regard to licenses?

5. In your opinion, would fewer licenses create more efficiency in the surveillance carried out by the CMA?

6. Vibrancy in a stock market is dependent on the level of liquidity. How does the NSE fare in terms of its liquidity level?

7. Apart from creating vibrancy in a market, of what other importance is liquidity in a stock exchange?

8. Dealers are market makers for particular counters. Is the CMA fair in licensing only one dealer? How many more dealers would the market need?

9. The NSE trades securities on an order-buyer "match-up" basis. Is this form of trading restrictive in terms of finding a matching order? In relation to this, would you consider a price driven system (where the share price movements are not reliant on offers or bids rather the market forces) a more effective method to be implemented at the bourse?

10. What is your opinion about the CMA in regard to its role in regulating
   a) Services offered at the bourse (NSE)?
   b) The trading system?
   c) The liquidity of the stock market?
REFERENCES


