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Going Long on the Nairobi Exchange

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Article

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I. INTRODUCTION

Western securities markets have experienced a wave of demutualization and consolidation in recent years.[1] Much of the industry consolidation can be attributed to technological changes in the markets. Some in the industry have suggested that the use of electronic communications networks have essentially rendered the exchange trading aspect of a developed securities market (the "location" where trading takes place) obsolete.[2] Further, securities exchanges have increasingly found their profit margins limited only by the trading volume they can achieve in their markets.[3] For-profit trading markets have thus endeavored to expand their pool of market participants while unifying the trading architecture of their expanded markets.[4]

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1. *See* Aaron Lucchetti, *Exchange World Shrinks; Stock-Market Tie-Ups are at a Fever Pitch, but Obstacles Abound*, WALL ST. J., Sept. 21, 2007, at C1 ("analysts and industry executives are sure the world will end up with a handful of big exchanges."). In the more developed economies, however, trading markets are tending towards consolidation and fragmentation simultaneously. Banking institutions are increasingly exploiting regulatory exemptions, contained in the SEC's Regulation ATS and the European Union's (EU) Markets in Financial Instruments Directive (MiFID), to avoid rules requiring the majority of securities trading to occur on registered exchanges. *See* Roberta S. Karmel, *Turning Seats into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 375-81 (2002) (discussing requirements for exemption under Regulation ATS for establishing a non-exchange trading system). The exemptions contained in Regulation ATS and MiFID essentially permit market players to set up their own small scale electronic securities exchanges. *See* Anuj Gangahar, *Nasdaq Chief Says Sector Will Fragment*, FIN. TIMES, Jan. 8, 2008, at 17; Simon Kennedy, *Nasdaq Plots Beachhead for Europe*, WALL ST. J., Mar. 20, 2008, at C7.

2. *See, e.g.*, *Hearing on What Constitutes a Board of Trade Located Outside of the United States Under the Commodity Exchange Act Section 4(a)*, at 9-10, COMMODITY FUTURES TRADING COMM'N 9-10, (June 27, 2006), http://www.cftc.gov/files/opa /opafbotpublichearingtranscript062706.pdf (statement of Walter L. Lukken, Commissioner, Commodity Futures Trading Commission, questioning how it is possible to ascertain the geographical location of securities exchanges that operate via electronic networks).

3. *See* Andreas M. Fleckner, *Stock Exchange at the Crossroads*, 74 FORDHAM L. REV. 2541, 2577-78 (2006) (quoting Richard Humphry, Managing Director of the Australian Stock Exchange as saying, "above a certain level, increased trading volumes in our markets don't just flow through to revenue, they largely flow through to profit").

4. *See, e.g.*, NYSE Euronext, Annual Report: Form 10-K 25 (2007) ("In furtherance of our business

But what impact do these technological innovations have on securities trading markets that exist on the fringe of global capital pools? It is often suggested that developing nations benefit by passing over entire generations of technology (e.g., telecommunications technology has seen widespread implementation in the developing world despite an underdeveloped traditional hardwired communications system in these countries). Can the benefits of technological change provide similar growth opportunities in the financial markets of developing nations? International financial institutions and wealthy capital exporting nations have pressed developing nations to strengthen their domestic capital markets for years.[5] However, it now appears that U.S. and EU mega-exchanges are threatening to render the domestic securities trading markets of developing nations superfluous.[6] It thus appears timely to evaluate the prospects for growth of developing country securities exchanges in light of the changed dynamic of global capital markets subsequent to the transatlantic stock exchange mergers that took place over the course of 2006-2008.[7]

This article attempts a practical application of these broader development finance issues via a study of the prospects for growth of the Nairobi Stock Exchange (NSE). Specifically, this article addresses whether the NSE should maintain its present course of integrating its trading market operations regionally with other East African securities exchanges. In the course of making this

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strategy . . . we are integrating our technologies globally to establish a single platform that enables market participants to trade across multiple asset classes, markets, geographies and time zones.").

5. *See, e.g.*, FELICE B. FRIEDMAN & CLAIRE GROSE, THE WORLD BANK, PROMOTING ACCESS TO PRIMARY EQUITY MARKETS: A LEGAL AND REGULATORY APPROACH 3; DONG HE & ROBERT PARDY, THE WORLD BANK , STOCK MARKET DEVELOPMENT AND FINANCIAL DEEPENING IN DEVELOPING COUNTRIES 1 (1993) (finding that a country's level of financial depth is correlated with the level of development of the country's stock market, and noting that World Bank structural adjustment loans ordinarily contain conditions related to capital market development); *see also* Charles R. P. Pouncy, *Stock Markets in Sub-Saharan Africa: Western Legal Institutions As A Component of the Neo-Colonial Project*, 23 U. PA. J. INT'L ECON. L. 85, 86 (2002) (claiming that sub-Saharan stock markets were created at the behest of western nations to facilitate the "recapture" of African natural resources).

6. *See* FRIEDMAN & GROSE, *supra* note 5, at 5 ("Thus, despite globalization and technology, and perhaps in part because of globalization and technology, most [developing country] equity markets have failed to generate significant capital development and growth."); *see also* Luchetti, *supra* note 1, (quoting NYSE Euronext Executive Lawrence Leibowitz as saying that small trading markets "will have to go away"). Although Mr. Leibowitz generally was referring to the bleak prospects for smaller US exchanges, the rationale also applies to fringe trading markets in developing and transitional economies. *See Survey: Capital Punishment*, ECONOMIST, Sept. 14, 2002 (expressing doubts about whether the national stock exchanges in Central and Eastern European countries could "survive [a] European consolidation."). Many feel that such fledgling exchanges require tie-ups with larger, established western exchanges to survive in the global financial services market. *See id.* ("because of the consolidation of exchanges in Europe, and the growing share of institutional trading, Central European exchanges will be increasingly isolated unless they have links into the West.").

7. *See generally* Ruben Lee, *Changing Market Structures, Demutualization and the Future of Securities Trading*, *in* THE FUTURE OF DOMESTIC CAPITAL MARKETS IN DEVELOPING COUNTRIES 283, 283 (Robert E. Litan ed., 2003) ("It is widely recognized that the pressures of competition, globalization, and technological change are threatening the development, and in some instances, the very survival, of many developing capital markets.").

evaluation, this article discusses the structure and regulatory environment of the NSE.[8]

II. THE ORIGIN, STRUCTURE AND REGULATION OF THE NAIROBI STOCK EXCHANGE

A. *Origins of the Nairobi Stock Exchange*

Securities trading in Kenya can be traced back to the 1920s when European colonists informally traded shares pursuant to contractual commitments and physical settlement of trades.[9] In 1954, local brokers in Nairobi persuaded the London Stock Exchange (LSE) to recognize the NSE as an overseas stock exchange, and registered the NSE under the Societies Act as a "voluntary association of stockbrokers."[10] At that time, and continuing to this day, the NSE operates as a self-regulatory organization (SRO).[11]

Despite a substantial increase in trade licensing regulations and the "Kenyanisation" policies enacted after independence in 1963,[12] the NSE enjoyed

8. This Article does not purport to provide a comprehensive guide to the structure and regulation of the NSE, but rather discusses the elements of structure and regulation that have a considerable impact on the NSE's prospects for growth.

9. *See* ROSE W. NGUGI, KENYA INSTITUTE FOR PUBLIC POLICY RESEARCH AND ANALYSIS, DEVELOPMENT OF THE NAIROBI STOCK EXCHANGE: A HISTORICAL PERSPECTIVE 10-11 (2003) (noting that the first brokerage firm was established in Nairobi in 1951). Local participation in the NSE was limited to approximately 5% of trading. *See id.*; *see also* Note, *Securities Marketing and Stock Exchanges in Black Africa*, 67 COLUM. L. REV. 892, 908 (1967) (stating that, as of 1967, the NSE "remains a white preserve").

10. *See* NGUGI *supra* note 9, at 11. Reference to the Societies Act is presumably to the English statute or a colonial Kenyan equivalent. *See* AFRICA REGION FINANCIAL SECTOR DIVISION, THE WORLD BANK, CAPITAL MARKET INTEGRATION IN THE EAST AFRICAN COMMUNITY 35 (2002) [hereinafter EAC CAPITAL MARKET INTEGRATION] (stating that Kenya's current Companies Act is based on the U.K. Companies Act of 1948); *but see* United Nations Conference on Trade and Development, Geneva, Switz., (Sept. 29-Oct. 1, 2003), *Case Study on Corporate Governance Disclosures in Kenya*, U.N. Doc. TD/B/COM.2/ISAR/19/ADD.3, 9 n. 8 (Aug. 7, 2003), http://www.unctad.org/en/docs/c2isar19a3_en.pdf [hereinafter UNTAD CASE STUDY] (citing the Societies Act as actually Cap 108 of the Laws of Kenya). Before being officially declared a British Protectorate in 1895, Kenya had no structured legal system. As a result when Kenya became independent in 1963, Kenyan law borrowed heavily from English law. English statutes in force on August 12, 1897 are recognized as the law in Kenya "unless a Kenyan statute, or a latter English statute made applicable in Kenya, [h]as repealed any such statute." *See generally* Tom Ojienda & Leonard Obura Aloo, *Researching Kenyan Law*, GLOBALEX, http://www.nyulawglobal.org/globalex/Kenya1.htm (last visited Dec. 20, 2010).

11. NGUGI, *supra* note 9, at 12 (indicating that a self-regulatory framework was instituted upon the establishment of the NSE in 1954). The NSE's SRO powers have diminished, as the Kenyan Capital Markets Authority (Kenya CMA) has increased its role in the securities market. *See* EAC Capital Market Integration *infra* note 28.

12. *See* NGUGI, *supra* note 9, at 14-18 (describing "Kenyanisation" as having "a primary goal of transferring economic and social control to citizens by ensuring that [the] majority of businesses were in the hands of citizens except where some overriding national advantage was otherwise demonstrated."). Although the NSE had already become a rather considerable regional securities trading market in the 1960's, post-colonial struggles with foreign asset ownership in Uganda and Tanzania wreaked havoc on cross-listed and foreign shares on the NSE. *See id.* at 17-18.

relatively independent self-regulation until the establishment of the Capital Issue Committee (CIC) in 1971.[13] The CIC vetted public offerings to ensure that capital raised on the NSE would not subsequently be sent outside of Kenya.[14] Restrictions on repatriation were generally directed at foreigners who were divesting of Kenyan assets to protect themselves from "Kenyanisation" policies.[15] These restrictions also applied to the Ugandan and Tanzanian companies who operated regionally and might have raised capital on the NSE, as well as used capital for operations in their home countries. These restrictions likely limited the ability of the NSE, at the time, to act as a regional capital raising center in East Africa.

The repatriation restrictions that accompanied the CIC's vetting of prospectuses were primary market restrictions and as such, impacted only admission standards for listing and not the rules for trading on the NSE.[16] Throughout this period, the NSE continued to operate as an SRO; trading was not even organized around a floor through an open-outcry system until 1991.[17] It was not until 1990, with the passage of the Capital Markets Authority Act (CMA Act)[18] and the establishment of the Capital Markets Authority (Kenya CMA),[19] that Kenya's securities market gained a multi-tiered, financial services regulatory model.

B. Structure & Regulation of the Nairobi Stock Exchange

1. The Organizational Structure of the Nairobi Stock Exchange

Under the CMA Act, the NSE was required to reorganize itself from a voluntary association of stockbrokers, as it had been since its establishment in 1954,[20] to a limited liability company under Kenya's Companies Act.[21] The CMA Act explicitly requires the board of directors of approved exchanges to elect five

13. *See id.* at 19.

14. *See id.* at 19-20.

15. *See id.* at 19.

16. *See id.* at 19-20.

17. *See* NGUGI, *supra* note 9, at 12-13, 28-29. The NSE's periodic call auction trading system has been described as a "coffee house forum. *See id.* at 28-29.

18. *History: Establishment of the Capital Markets Authority*, CAPITAL MARKETS AUTHORITY, http://www.cma.or.ke/index.php?option=com_content&task=view&id=16&Itemid=36 (last visited Dec. 20, 2010) (noting that the CMA Act was inaugurated March 7, 1990). The CMA Act is purported to have been modeled on Malaysian and Singaporean capital markets legislation. *See* EAC CAPITAL MARKET INTEGRATION, *supra* note 10, at 35.

19. The Capital Markets Act, (1990) Cap. 485A Cap. 485A § 5(1) (Kenya) [hereinafter CMA Act] (last amended 2008).

20. NGUGI *supra* note 9, at 11.

21. *Id.* § 20(2)(a). Kenya's Companies Act, has been criticized as outdated. EAC CAPITAL MARKET INTEGRATION, *supra* note 10, at 35.

directors from amongst the exchange's broker/dealer members. Two directors are elected as representatives of listed companies, and the other three directors are elected as representatives of the investing public.[22]

The Kenya CMA has issued regulations, under the authority of the CMA Act,[23] that prohibit securities exchanges from distributing profits to exchange members.[24] These regulations also require securities exchanges to submit their annual budget to the Kenya CMA, and to expend twenty percent of the exchange's annual listing fee income on investor education and upgrading exchange trading system architecture.[25]

The NSE is currently working towards demutualization;[26] however, such limitations on the corporate activities of exchanges create barriers to the development of the NSE as a for-profit institution.[27] In addition, the Kenya CMA has curtailed the SRO role of the NSE and limited the scope of financial services that exchanges may provide in order to incorporate the NSE in the CMA's capital markets development mandate.[28]

These developments in securities exchange regulation evidence some mixed trends in Kenyan finance. While the rationalization of market regulation in Kenya is certainly a positive development, many market participants complain about the CMA's "over-regulation." In particular, they complain that the agency's tendency to impose reporting and compliance requirements are too costly and complex to administer for a market as thin as the NSE.[29]

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22. CMA Act *supra* note 19 § 20(3).

23. The Kenya CMA has the power to promulgate regulations under the CMA Act and, in particular, to approve changes in SRO rules. *Id.* § 12.The Kenya CMA has a dedicated tribunal for appeals from administrative decisions of the CMA. *See* EAC CAPITAL MARKET INTEGRATION, *supra* note 10, at 35.

24. *Legal Notice No. 125: The Capital Markets Licensing Requirements*, CAPITAL MARKETS AUTHORITY, § 3(2), http://www.cma.or.ke/index.php (last visited Dec. 20, 2010) [hereinafter *Legal Notice No. 125*] (from the homepage select "Regulatory Framework." From the drop down menu select "regulations.").

25. *Id.* § 8.

26. *See* Press Release, Capital Market Authority, *Stakeholders Workshop on the Demutualization Of Nairobi Stock Exchange* (Nov. 24, 2009), *available at* http://www.nse.co.ke/newsite/pdf/Year%202009/General/PRESS%20RELEASE%20DSC%20workshop.pdf.

27. INT'L ORG. OF SEC. COMM'N, EXCHANGE DEMUTUALIZATION IN EMERGING MARKETS 9 (2005) [hereinafter EXCHANGE DEMUTUALIZATION] ("creating a for profit exchange where business strategies were constrained might undermine the viability of the exchange.").

28. *See* EAC CAPITAL MARKET INTEGRATION, *supra* note 10, at 34-35 (noting the rise of regulatory overlap between the NSE and the Kenya CMA, in particular the maintenance of investor compensation funds by both the NSE and the Kenya CMA); *id.* at 34, n. 29 (suggesting that one of the CMA's early goals was to break up a "brokers' cartel" on the NSE).

29. *See id.* at 35. The average daily trading volume on the NSE is approximately $5 million and the total market capitalization of NSE-listed shares is $15 billion. There is pressure on regulatory authorities to follow international "best practices" in regulation and model their regulatory framework on the framework their trading partners and the major developed markets use. *See generally* Kal Raustiala, *The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law*, 43 Va. J. Int'l L. 1 (2002); *see also* Mark Gillen & Pittman Potter, *The Convergence of Securities Laws and Implications for Developing Securities Markets*, 24 N.C. J. INT'L L. & COM. REG. 83, 108 (1998) (discussing the incentives of countries with developed financial markets to ensure that emerging markets develop a similar regulatory framework). In

More problematic, in terms of increasing liquidity on the NSE, is the CMA's prohibition on the distribution of profits to members of an exchange.[30] If regulations prohibit stakeholders in the NSE[31] from realizing profit out of the revenue that the exchange generates, the stakeholders will have a significantly diminished incentive to increase trading volume on the exchange.[32] Increased trading volume is necessary to enhance market liquidity, and enhanced liquidity is necessary to make the NSE an attractive primary market to issue and list new securities.[33] In turn, it is clear that the NSE would require more listings if investors were to view the exchange as an attractive market for investment alternatives.[34] There is thus a "virtuous cycle" of liquidity production[35] that the NSE has yet to trigger.[36]

2. *The Market Microstructure of the Nairobi Stock Exchange*

The open outcry system adopted in 1991, per the requirement of the Kenya CMA, did not last long. In 2006, the NSE switched to an automated trading

particular, the United States, using the International Organization of Securities Commissions ("IOSCO") as a forum, tends to place "peer pressure" on regulatory authorities in developing markets. *See id.*

30. *Legal Notice No. 125, supra* note 24.

31. As stated, it is not clear from the sources whether the prohibition on distribution of profits to "members of the exchange," is an *ipso facto* prohibition against the operation of the NSE as a for-profit institution. *See id.* The key inquiry into the corporate structure of the NSE after its re-organization as a limited liability company under Kenya's Companies Act is beyond the scope of this paper.

32. *See* Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Remarks to the Securities Industry and Financial Markets Association: More Efficient and Effective Regulation in the Era of Global Consolidation of Markets (Nov. 10, 2006), *available at* http://www.sec.gov/news/speech/2006/spch111006cc.htm (discussing how demutualization leads to increased competition between exchanges for volume). The SEC's major concern with demutualization is the extent to which exchanges will continue to fund their SRO operations. Prior to demutualizing, most U.S. exchanges have separated their SRO and trading operations into distinct legal entities. *See id.*

33. *See* FRIEDMAN & GROSE, *supra* note 5, at 6 (discussing the relationship between liquidity, trading volume, and supply of capital to the market).

34. *See* ROSE M. NGUGI & ROLINE NJIRU, KENYA INSTITUTE FOR PUBLIC POLICY RESEARCH AND ANALYSIS, GROWTH OF THE NAIROBI STOCK EXCHANGE PRIMARY MARKET 14 (2005) (finding that the regulatory reforms accompanying the establishment of the CMA have not succeeded in encouraging firms to issue and list new securities). The NSE currently lists 76 Kenyan government bonds, 51 equities, and 7 corporate bonds. *See* Chris Mwebesa, Chief Exec., Nairobi Stock Exch., Presentation at the Seminar on the Operations of Capital Markets & Securities Exchanges in East Africa (Oct. 2, 2006).

35. *See generally* JACK GLEN, INT'L FINANCE CORP., AN INTRODUCTION TO THE MICROSTRUCTURE OF EMERGING MARKETS 3-6 (1994) (discussing the relationship between liquidity, efficiency, trading costs, and volatility). The market "microstructure" theory proposes that the structure of trading markets has an effect on market volume and prices. Under this theory, regulatory authorities can enhance the liquidity of a market by adopting regulations that tweak trading systems and market institutions. *See id.* Market microstructure theory is a technocratic approach to capital market development.

36. It has not increased trading volume that would enhance liquidity on the NSE, however. Many factors contribute to this "virtuous cycle," such as: high listing costs may deter new issuances; listing rules may deter some firms from going public; and restrictions on foreign participation in the market can depress the value of listed firms by reducing effective demand for securities. These themes will be explored further below.

system (ATS).[37] The new NSE trading rules require continuous securities trading from 9:00 a.m. to 3:00 p.m.,[38] which was expanded from the 10:00 a.m. to 12:00 p.m. trading period that prevailed under the open outcry system.[39] These regulations also dictate how orders are matched in the ATS order book and how securities are priced.[40] To gain access to the ATS, a trader must be a member of the NSE, and all NSE members must be licensed by the Kenya CMA.[41]

Trading rules provide for remote trading by NSE members.[42] This provision is crucial to the success of the NSE as a regional exchange for the East African Community (EAC).[43] The trading rules also prohibit off-exchange trading,[44] which theoretically should improve price-formation in listed securities, but there are criticisms of this rule in the case of the NSE.[45] In particular, off-exchange trading prohibitions could deter firms from issuing securities and listing on the exchange, thereby reducing NSE liquidity. The deterrence to issuance could arise because smaller retail investors may not be able to afford brokerage commissions on the NSE. Thus, a firm listed on the NSE would have its potential investor base limited to those investors wealthy enough to afford brokerage costs on the NSE. This could have the effect of reducing the value of a listed firm as compared to unlisted rivals. The CMA might consider permitting off-exchange trades, or exempting certain classes of off-exchange trades, with a view to increasing competition among brokers. In any event, reducing the dominance of established brokers over issuance and trading has been a goal of the Kenya CMA since its inception.[46]

The switch to an automated system was part of a broader program instituted by the CMA to enhance efficiency in trading; in particular, the CMA desired to reduce settlement from T+14, which prevailed under the paper-intensive settlement system utilized under the open outcry and call auction systems,[47] to the current T+5 settlement achieved with the use of the new central depository system.[48] Although practices under the T+14 system had permitted purchasers to

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37. *See* Press Release, Millennium Info. Tech., Live Trading Commences At Nairobi Stock Exchange Using A System Developed By Millennium Information Technologies, Sri Lanka (Sept. 19, 2006) (on file with Pac. McGeorge Global Bus. & Dev. L.J.)

38. *Trading Rules*, NAIROBI STOCK EXCHANGE § 6.1.4 (Aug. 1, 2010), http://www.nse.co.ke/newsite/pdf/trading_rules.pdf [hereinafter *Trading Rules*].

39. Ngugi, *supra* note 9, at 29.

40. *Trading Rules*, *supra* note 38 § 7.4. Securities are priced using the volume weighted average price method. *Id.* § 7.6.

41. *Id.* §§ 4.1.1-4.1.2, 4.2.1.

42. *Id.* § 4.2.

43. *See infra* Part III discussing the NSE's prospects for success as a regional exchange.

44. *See id.* § 3.1; *see also* EAC CAPITAL MARKET INTEGRATION, *supra* note 10, at 35.

45. *See* EAC CAPITAL MARKET INTEGRATION, *supra* note 10, at 35.

46. *See supra* note 28 and accompanying text.

47. *See* NGUGI, *supra* note 9, at 29-30.

48. On average, settlement now takes place in under five days. *See* ROSE W. NGUGI, KENYA INST. FOR

trade in purchased securities via a special type of note that evidenced security ownership during the fourteen days prior to settlement, the long settlement period was clearly a significant impediment to increased trading volume and deterred many investors from choosing the NSE as a venue for investment. The NSE is currently striving to reduce the settlement cycle to the Group of 30's T+3 standard.[49]

3. *Securities Issuance, Listing, and the Relationship Between Kenya's Primary and Secondary Securities Markets*

The NSE has divided the market into three segments: Main Investment Market, Alternative Investment Market, and Fixed Income Securities Market. The NSE does not operate an over-the-counter (OTC) market; although, there are plans to establish one.[50] With so few listed securities, however, it seems unnecessary to compartmentalize trading in such a manner. Arguably, the small capitalization of listed firms and the low number of listings call for an OTC market alone;[51] nevertheless, the Kenyan government's desire to privatize state-owned enterprises[52] appears to be imposing itself on the NSE.[53] Kenya's privatization program dates to approximately the same period as the revitalization of the NSE,[54] and NSE membership rules specifically direct NSE board of directors members to lobby the Kenyan government for privatization of state-owned enterprises (SOEs) via securities issuances on the NSE.[55]

Tailoring NSE listing rules to large, privatized former SOEs is problematic. Although there appears to be a relatively large number of privatizations

PUB. POLICY RESEARCH AND ANALYSIS, WHAT DEFINES THE LIQUIDITY OF THE STOCK MARKET? THE CASE OF THE NAIROBI STOCK EXCHANGE 15 (2003). Uganda and Tanzania are stakeholders and participants in the central depository system. This system is central to the regional capital market integration project currently pursued by the Kenya CMA in conjunction with the regulatory authorities of Tanzania and Uganda.

49. *See id.* at 29, 32.

50. *See* JACQUELINE IRVING, IMF, REGIONAL INTEGRATION OF STOCK EXCHANGES IN EASTERN & SOUTHERN AFRICA: PROGRESS & PROSPECTS 31 (2005). The NSE hopes to open a derivatives segment as well. *Id.*

51. *See* EAC CAPITAL MARKET INTEGRATION, *supra* note 10, at 24-25 (noting that "the EAC is dominated by small and medium scale enterprises (SMEs), which are predominantly dependent on bank loans and informal sources for their financing.").

52. TRADE POLICY REVIEW: EAST AFRICAN COMMUNITY, WORLD TRADE ORGANIZATION Annex 1, p. 65 (2006) [hereinafter EAC TRADE POLICY REVIEW].

53. FRIEDMAN & GROSE, *supra* note 5, at 5, 12-13 (suggesting that privatizations do not provide a sustainable source of securities issuances).

54. *See* EAC TRADE POLICY REVIEW *supra* note 52, at 65-66 (stating that 207 of 240 SOEs were slated for privatization, of which 108 had been privatized by 2003).

55. *Management & Membership Rules*, NAIROBI STOCK EXCHANGE § 3(i), http://www.nse.co.ke/newsite/pdf/management_membership_rules.pdf. *See* EAC CAPITAL MARKET INTEGRATION, *supra* note 10, at 24 ("Privatization programs account for the bulk of new issues in [Kenya, Uganda, and Tanzania] and it is notable that outside the governments' respective privatization programs, the pipeline of new issues is thin.").

remaining,[56] the narrow focus on drawing privatized enterprises into the public securities market is not sustainable.[57] The primary market for securities in Kenya, which is impacted significantly by listing rules and issuance costs, should be geared toward attracting the type of enterprises that comprise the bulk of the EAC economy, namely small and medium scale enterprises (SMEs).[58] Evidence on the cost of issuance and listing suggests that this is a major, if not the chief, impediment to SMEs entering the NSE primary market. Initial costs of listing have been reported at 10-15% of the actual capital raised in an issuance.[59] The roles of brokers, counsel, and underwriters in the issuance process are legally ambiguous, adding uncertainty to the process.[60] Ongoing disclosure and reporting obligations for listed companies also entail significant costs.[61]

The focus on luring privatized SOEs into the NSE primary market appears to be a boon to brokers and the financial services industry, given the substantial fees they earn in the process.[62] There is, however, insufficient trading volume in former SOE securities to have any significant impact on NSE liquidity. The statistics bear this out: only thirty-five percent of NSE market capitalization is available for trading and, in 2001, the turnover ratio was as low as three percent.[63] The NSE ranks near the bottom of emerging market securities exchanges in terms of its annual turnover ratio.[64] Although SOE privatizations contribute substantial capitalization to the exchange, that capitalization does not significantly contribute to market liquidity unless investors regularly trade those securities. Experience with major institutional investors, who tend to purchase the shares of privatized former SOEs, shows that they are buy-and-hold investors.[65]

4. *Conflicting Rules Regarding Portfolio Investment & Direct Investment*

The CMA's stance regarding portfolio investment by foreign entities also has a significantly negative impact on market liquidity and the price a firm can

56. Of the originally planned 207 privatizations, approximately half had not been undertaken by 2002. *See generally* EAC TRADE POLICY REVIEW *supra* note 52, at 65

57. FRIEDMAN & GROSE, *supra* note 5, at 5, 12-13.

58. *See id.* at 4.

59. EAC CAPITAL MARKET INTEGRATION, *supra* note 10, at 25.

60. *See id.* at 25, 27.

61. *Id.* at 27.

62. *Id.* at 25, 27. If the Kenya CMA was so concerned about the domination of the NSE by member brokers, why not attack such domination as an unfair trade practice? *See id.* at 34 n. 29. Kenya has competition legislation. *See generally* EAC TRADE POLICY REVIEW *supra* note 52, at 67-68. The persistence of the high cost of financial services for an issuance will continue to pose a major problem for new listings and the growth of the NSE. The Kenya CMA should make the reduction of such costs a priority.

63. *See* EAC CAPITAL MARKET INTEGRATION, *supra* note 10, at 28.

64. *See* EXCHANGE DEMUTUALIZATION *supra* note 27, 35 tbl.6.

65. Pension funds play a substantial role in the Kenyan market for equities. *See* EAC CAPITAL MARKET INTEGRATION, *supra* note 10, at 28-29.

realize for an issuance on the NSE. CMA rulemaking has limited permissible foreign participation in a security issuance to seventy-five percent.[66] Foreign investors have only been permitted to participate in the NSE since 1995.[67] Since that time, the CMA has erratically begun to liberalize the regime for foreign participation in the securities market.

The anti-foreigner stance is understandable in light of Kenya's colonial past and "Kenyanisation," but the rules limiting foreign participation are problematic for a number of reasons. First, the NSE has historically had a significant volume of foreign participation, which has unquestionably increased liquidity on the exchange.[68] Second, regulation of foreign owned capital in Kenya is better done through Kenya's more highly evolved Kenya Investment Authority (KIA). For example, Kenya's rules on foreign direct investment generally permit one-hundred percent foreign ownership.[69] However, once that same foreign owned entity seeks to issue shares on the NSE, twenty-five percent of issued shares must be reserved for purchase by local investors pursuant to CMA regulations. This clearly reduces the exchange-listed value of firms with significant global ties and creates huge barriers for transnational companies that would like to set up subsidiaries in Kenya. Third, and more generally, the goal of capital markets development, and specific to the NSE, the goal of enhancing exchange liquidity, is flatly incompatible with outright restrictions on the supply of capital to the market.

The unease that developing nations, such as Kenya, feel toward foreign portfolio investment generally arises from concerns about volatility. This is an understandable concern given the financial crises of the '90s (and the '80s, and '70s, and '60s for that matter), during which many developing nations experienced frightful capital outflows. Volatility, however, is related to liquidity: volatility induces trading, trading attracts issuance, and issuance attracts investor capital. Modern trading systems have tools to control volatility. The NSE itself has specific rules for calling general market and trading halts in particular securities.[70] Moreover, volatility itself can be an investment vehicle in the derivatives markets, and the NSE is currently developing plans for an options and futures market segment.[71]

The crucial point is that volatility is a necessary element of a liquid market; it need only be priced correctly. The lack of derivative instruments in many developing securities markets leaves the potential for outflow of foreign portfolio

66. *See* The Capital Markets (Foreign Investors) Regulations, (2002) § 3 (Kenya).

67. NGUGI *supra* note 9, at 50.

68. *See* EAC CAPITAL MARKET INTEGRATION, *supra* note 10, at 29-30 tbl.5 (indicating that foreign investors were responsible for 36.6% of turnover on the NSE in 1997, up from 6.6% in 1995 when foreign participation was first permitted).

69. *See* EAC TRADE POLICY REVIEW, *supra* note 52, at 50-51.

70. NGUGI *supra* note 9, at 39.

71. See Irving, *supra* note 50.

investment without a market price. Restrictions on foreign participation in the market should be eliminated and the NSE should redouble its efforts to open a futures and options market segment.

III. PLOTTING A COURSE FOR THE NAIROBI STOCK EXCHANGE

Intensive regulation of the corporate structure of the NSE precludes the exchange from being a desirable acquisition target by its larger global counterparts. But if the CMA permits the NSE to reorganize on a for-profit basis, and lifts its extensive regulation of the structure of the exchange's board of directors, then much will be in place to make the NSE a desirable partner with another comparably regulated, but larger, exchange.

NSE trading and settlement systems are efficient enough to accommodate relatively modern market participants. Kenyan law provides for basic investor protections, including rules against market manipulation, prohibitions of insider trading, issuer disclosure, and broker/dealer prudential regulations. The Kenyan primary market for issuances, although very thin at present, has great potential for growth if certain key reforms are met, including those directed toward reducing the cost of issuance[72] and providing lower cost alternatives to issuer disclosure and reporting. Key to expanding the primary market for issuances is taking advantage of the regional EAC market and eliminating restrictions on participation of foreign capital in the market.[73] The harmonization of law provisions of the EAC Treaty, particularly the express mandate to integrate the capital markets of Tanzania, Uganda, and Kenya, provide a unique opportunity to expand the investor and issuer base of the NSE.

In terms of a hypothetical purchaser of the NSE, the most obvious candidate would be the LSE, who was the original sponsor of the NSE in 1954.[74] However, such a combination is unlikely due to the sophistication of the LSE in comparison with the NSE. Even so, other compatible candidates still remain. Given that trading partner nations are likely to establish subsidiaries in the economies of their larger trading partners, and given that such subsidiaries might look to local exchanges for their capital requirements, one might consider Kenya's main trading partners for candidate exchanges. Kenya's primary import markets, in order of importance, are the UAE, India, China, and Saudi Arabia. India's National Stock Exchange (Mumbai), which recently sold small stakes to a number of investors, including the New York Stock Exchange,[75] could itself be an interesting candidate for a future combination with the NSE. Indeed, there are

72. As discussed above, this can be achieved through regulatory means other than the securities authority, such as through competition policy. *See* EAC TRADE POLICY REVIEW, *supra* note 52, at 67-68.

73. This paper has not explored tax incentives to issue securities.

74. NGUGI *supra* note 9, at 11.

75. Kathrin Hille, *Taiwan Exchange to Sell Stake*, FIN. TIMES (Dec. 31, 2007).

twenty-three exchanges in India alone and further consolidation of that market is inevitable.[76]

IV. CONCLUSION

The NSE has much to gain from the CMA's continued pursuit of regional integration of capital markets under the 1999 EAC Treaty. Some interesting parallels could perhaps be drawn between the prospects for the growth of the NSE within a harmonized EAC capital market and the growth of the Euronext stock exchange in the separate EU member states. Perhaps, in five years, the NSE will have increased its liquidity and market capitalization sufficiently within the EAC to attract suitors from the LSE, just as Euronext became an attractive target for combination with the NYSE after only five years of operating as an exchange in Western Europe.

76. *See* EXCHANGE DEMUTUALIZATION *supra* note 27, at 8 n. 11. The Mumbai Stock Exchange lists more companies than are listed in the United States. *See id.* at 36 tbl.7.