THE PERCEIVED BENEFITS AND CHALLENGES OF DEMUTUALIZATION OF THE NAIROBI STOCK EXCHANGE

BY

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DECLARATION

This management research project is my original work and has not been submitted for examination in any other University.

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This management research project has been submitted for examination with my approval as the University Supervisor.

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This project is dedicated to my dear husband Rodgers Mungumi who inspired, encouraged and supported me and;

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ABSTRACT

Demutualization of the Nairobi Stock Exchange (NSE) is one of the much discussed issues in the financial sector. It is an issue that is new to the whole of East Africa, and Kenya being one of the leading lights of the region, is attempting to do it. Stock exchanges in Kenya are formed as associations of stock brokers. All these associations are supposed to be not-for-profit mutual entities. They are supposed to manage their own affairs with the government never interfering with their internal functioning while laying down the broad rules of the game in which the stock market game can be played. This has perpetuated a strong control over the stock markets by the brokers but this is not the way stock exchanges operate in developed countries. Hence the need for demutualization was felt as a reform measure in government circles.

The study sought to understand the whole concept of demutualization and to find out the perceived benefits and challenges of the process. Questionnaires were used for data collection and the research design employed was a survey. The questionnaire had both open and closed ended questions where both the quantitative and qualitative information was provided. Statistical Package for Social Sciences (SPSS) 10.0 and MS Excel 1997-2003 was used to analyze the data. The results were then presented in form of charts and graphs.

The findings were that Kenya is ripe for the demutualization process from the support offered by the market players and the government as well as the technology that market players are experiencing. The main challenges were seen as squabbles between the

Capital Markets Authority (CMA) and NSE coupled with politicking of the NSE leadership.

The market players were however very optimistic about the process as they felt demutualization will lead to improved governance, increase market efficiency and make NSE more competitive against alternative trading systems.

The research recommends that the CMA should not overplay its supervisory role to interfere with NSE plans and the Government should also not sit aside but play its requisite role to facilitate the demutualization process. Further research can be carried out to ascertain the impact of demutualization of the NSE on investor confidence as well as lessons learnt from the NSE demutualization process.

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LIST OF ABBREVIATIONS

AOL	All Other Liabilities
BI	Borsa Italiana
BSE	Bombay Stock Exchange
CEO	Chief Executive Officer
CIC	Capital Issue Committee
CMA	Capital Market Authority
DE	Demutualized Exchange
EMH	Efficient Market Hypothesis
IFC	Investor Compensation Fund
IPO	Initial Public Offer
LSE	London Stock Exchange
MOU	Memorandum of Understanding
NIGB	Non Investment Grade Bonds
NOG	Net Operating Gain
NSE	Nairobi Stock Exchange
ROE	Return on Equity
SPSS	Statistical Package for Social Sciences
SRO	Self Regulatory Organization
TA	Total Assets
TR	Total Revenue

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Stock exchanges in the world provide a platform for investors to raise funds for financing investments (Scullion, 2001). They also provide a platform for trading in stocks and bonds as well as providing market liquidity. To achieve this purpose, the stock exchange has to have a set of rules that will govern the execution and clearing of trade. Some of the responsibilities of a stock exchange include enforcing standard rules to reduce transaction costs and monitoring of the trading to prevent manipulations like insider trading (Scullion, 2001). Traditionally, the exchange has been looked at as a guaranteed limited company, which means that a certain group of individuals came together and formed the stock exchange; and put the guarantee that they will contribute their share of the guarantee if the exchange failed to run as desired. The conventional view is that exchanges in the world are moving towards demutualization.

Demutualization is the approach that is utilized to convert a mutually owned company into a shareholder owned company. This type of conversion usually takes place when a company has grown to the point that it wishes to issue shares of stock as a means of expanding the company in some manner. Going through the process of demutualization enables to set the stage for making an initial public offering (Carson et al, 1998).

Not everyone understands the difference between a mutual company and a stock or share company. Scullion (2001) notes that while the day to day operations may be the same; the key difference has to do with who has ownership in the company. With a mutual company, the control of the company is vested in a small group of investors who often set company policy and procedures. The mutual company does not issue publicly traded stocks.

A share or stock company model does issue shares of stocks that are available through one or more stock market exchange. Shareholders purchase the shares of stock and become part owners in the company. This is a highly desirable status for many companies, as it can help generate significant amounts of revenue that make it possible for the company to grow in ways that would not be possible if the corporation remained privately held (Fama and Jensen, 1983).

Demutualization is supposed to bring in more efficiency to the management of the markets. With the public holding a major share in the equity capital of the stock exchanges, the brokers are expected to be in a less powerful position to manipulate the stock exchanges.

Delany (2005) states that there are three reasons advanced by exchanges for demutualization. Firstly, the desire to be more commercially nimble and respond to market needs more quickly, unimpeded by member committees and their diverse interests. Secondly, demutualization would give access to the capital markets for fund raising. Thirdly, being publicly quoted would also give exchanges and their management a clearer idea of what exactly they were worth. In addition to these, demutualization has increased competition between exchanges for market share, as investors demand a return on their investment.

Demutualization faces various challenges among them being; divergence of interest between shareholders and members. The loyalty of the new share holders in the national stock exchange is questionable. Empirical research on the effects of the loyalty of shareholders on the stock return volatility is limited. However, the pressure to maximize return for demutualized funds investors may have contributed to the current global financial turmoil by encouraging business decisions with higher risks (Delany, 2005).

Mellon (2001) asserts that demutualization is a complex and difficult process. The logistics of "going public"; data consolidation, mass mailings, proxy tabulation, and the issuance of securities; can put an enormous strain on the existing resources and easily distract the core business. Moreover, the process is rife with unexpected regulatory, business, and technological challenges.

Stock exchanges in Kenya are formed as associations of stock brokers (Dickinson and Muragu, 1994). All these associations are supposed to be not-for-profit mutual entities. They are supposed to manage their own affairs with government never interfering with their internal functioning while laying down the broad rules of the game in which the stock market game can be played. This has perpetuated a strong control over the stock markets by the brokers but this is not the way stock exchanges operate in developed countries. Hence the need for demutualization was felt as a reform measure in government circles. This is supposed to end the monopoly of the stock brokers. This was sought to be achieved through the transformation of the constitution of the exchanges into for-profit public limited companies. The demutualization in UK was not as a result of government mandate but of brokers' own volition (Dickinson and Muragu, 1994).

The members and directors of the Nairobi Stock Exchange approved the demutualization of the Nairobi Stock Exchange, subject to enactment of requisite laws that will provide the legal framework in March 2010 (Dickinson and Muragu, 1994). According to the latest weekly roundup from stockbroker Kestrel Capital, the NSE will change its name to Nairobi Securities Exchange and will have an approved share capital of KES 1bn (US$13 million). In the proposed ownership structure, Treasury will own 10%, the Investor Compensation Fund (IFC) 10% and stock brokers will collectively own 80%, which they will share equally.

1.1.1 Origins of the Nairobi Stock Exchange

Securities trading in Kenya can be traced as far back as the 1920's when European colonists traded shares informally pursuant to contractual commitments and physical settlement of trades. In 1953-54, local brokers in Nairobi obtained the London Stock Exchange's (LSE) recognition of the NSE as an overseas stock exchange and registered the NSE under the Societies Act as a ―voluntary association of stockbrokers. At that time and continuing to this day, the NSE operated as a self-regulatory organization (SRO).

Despite a substantial increase in regulation of business licensing and the ―Kenyanisation policies that arose after independence in 1963, the NSE enjoyed relatively independent self-regulation until 1971 with the establishment of the Capital Issue Committee (CIC). The CIC essentially vetted public offerings for the purpose of ensuring that capital raised on the NSE would not subsequently be sent outside of Kenya. This sounded the death knell for the regionalization of the NSE, as restrictions on repatriation, which generally were directed at foreigners who were divesting of Kenyan assets to protect themselves from Kenyanisation policies, applied just as easily to Ugandan or Tanzanian companies that otherwise would have raised capital on the NSE and brought that capital back to their home country to apply to operations there (Ibid).

The repatriation restrictions that accompanied the CIC's vetting of prospectuses, however, were primary market restrictions and as such impacted only the standards for admission to listing and not the rules for trading on the NSE. Throughout this period the NSE continued to operate as an SRO and, indeed, trading was not even organized around a floor on the basis of the open-outcry system until 1991. It was not until 1990, with the passage of the Capital Markets Authority Act (CMA Act) and the establishment of the Capital Markets Authority (Kenya CMA) that Kenya's securities markets gained a multi-tiered financial services regulatory model (Shipp, 2008).

1.2 Statement of the Problem

Most African stock exchanges operate as mutual companies. The basic characteristics of a mutual company are that the company does not have shareholders and share capital. The mutual company is a company owned and managed by the members.

Due to globalization, competition and advances in technology of trading securities, stock exchanges have been involved in the process of demutualization. Akpesey (2008) argues that mutually owned exchanges have served their purposes, and markets are increasingly recognizing that a trading infrastructure, as well as modern corporate and governance structure, is essential to reducing transaction costs, attracting the funds of investors, and attracting new firms to raise their capital requirements. Globally, stock exchanges have been involved in demutualizing. However, changes in the governance structure through demutualization are not without challenges. McDowall (2004) argues that while exchange demutualization may unlock capital and bring attendant benefits in terms of responsiveness to customers, rewarding participants for usage and improved decision making, it does pose challenges in terms of governance, reconciliation and management of a wider range of interests and stakeholders. Thus demutualization is not in itself a long-term panacea. In some instances, the historical mutual structure was considered to be a better business model.

The demutualization of the Nairobi Stock Exchange provided a good basis on which a study was undertaken to address the above assertions. The exchange provides the learning point for neighbouring countries wishing to follow the same path and the demutualization on the Nairobi Stock Exchange will be ideal as a learning point.

From the foregoing, a study was needed to determine the perception of the benefits and challenges of demutualization on the Nairobi Stock Exchange. Previous studies hypothesizes that demutualizing stock market will implement a new strategy which contrasts sharply with the old mutual strategy of limited growth, emphasis on insurance products, risk aversion and the traditional expense preference behavior of management. The new strategy should embody higher profitability and efficiency, shifts towards newer product lines, higher growth, and greater risk taking in asset management and capital structure.

Studies by Kippra (2005) covered the growth of the Nairobi Stock Exchange primary market; Gray and Bythewood (2005) on institutional characteristics of the Nairobi Stock Exchange; and Ndope (2009) on strategic change management process at the

Nairobi stock exchange, all had not exploited the benefits, challenges and the demutualization process of the Nairobi Stock Exchange and this research aimed at filling that gap. In this regard, little had been done to investigate the effect of demutualization on efficiency of stock markets, and specifically the Nairobi Stock Exchange. Studies available on the Nairobi Stock Exchange has mainly been on corporate governance, Initial Public Offer (IPO) success and market efficiency.

1.3 Objectives of the Study

1.3.1 General Objective

The general objective of this study was to determine the benefits and challenges of demutualization of the Nairobi Stock Exchange.

1.3.2 Specific Research Objectives

This study was guided by the following specific research objectives formulated to aid in gathering the information regarding the research topic.

1) To identify the benefits of demutualization of the Nairobi Stock Exchange
2) To analyze the challenges of demutualization of the Nairobi Stock Exchange

1.4 Importance of the Study

The information generated by this study will be important for the East Africa stock markets in understanding the industry’s effect of demutualization on its efficiency. This will benefit stock markets in Uganda, Tanzania and the wider Eastern Africa which has the stock markets at their infancy stages.

It will also assist investment managers who want to make use of efficiency capabilities of the stock market in advising their clients on investment prospects that may arise from a demutualised stock market. In addition, it will guide investment managers of new baselines to use when determining investment options for their clients.

Educators too in the education industry will find the information obtained from this study beneficial to their curriculum in imparting knowledge to students and researchers who are researching on the industry and how it can greatly benefit the country.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter reviewed the available literature of stock exchanges and demutualization. The study was guided by the following two research questions; to identify the benefits of demutualization of the Nairobi Stock Exchange and to analyze the challenges of demutualization of the Nairobi Stock Exchange.

2.2 Demutualization

Demutualization is the approach that is utilized to convert a mutually owned company into a shareholder owned company. This type of conversion usually takes place when a company has grown to the point that it wishes to issue shares of stock as a means of expanding the company in some manner. Going through the process of demutualization helps to set the stage for making an initial public offering (Carson et al, 1998).

Demutualization converts a guarantee limited company into a company limited by stocks as other listed companies on the exchange. It demutualizes a currently mutual exchange with one vote one member into a one vote per share and changes the decision making structure from “consensus based” to “majority based”. Thus, the exchange would become a profit oriented company rather than the existing not-for-profit orientation. Traditionally, the exchange gave trading rights to owners of the exchange. Demutualization would separate trading rights from ownership (Ibid).

Major drivers of demutualization are; globalization of the capital markets, competition especially from technology based systems which do not respect borders, creating an organization that is ready for mergers and strategic alliances, access to capital for development, adoption of new technology, spread ownership risks, adoption of the new corporate governance frameworks, and manage perception of conflict of interest more effectively. (Ibid)

2.3 Agency Relationship

Agency is a relationship established when two parties agree to have one party act on behalf of the other. The agency relationship exists between the Client (buyer or seller) and the agent (the brokerage, including its broker, associate brokers and associates). Members of the public at first point of contact with a brokerage representative are not in an agency relationship with the brokerage. It is important to note that an agency relationship can be created if either party acts in a manner that implies that such a relationship exists. There are two types of agency relationship: sole and dual agency. Sole agency occurs when one brokerage, its broker, associate brokers and associates represent only the seller or the buyer in a transaction while Dual agency arises when one brokerage represents both the buyer and seller in a transaction. Dual agency occurs whether one individual in the brokerage is working for both the buyer and the seller or different representatives from the same brokerage are working for the buyer and the seller (Jensen and Meckling, 1976).

2.4 Theories of Demutualization

Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation (or company) is directed, administered or controlled.

Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. The principal stakeholders are the shareholders, the board of directors, employees, customers, creditors, suppliers, and the community at large. The models of corporate control are identified in existing literature as the simple finance model, the stewardship model, the stakeholder model and the political model (Carson et al, 1998).

2.4.1 The Stewardship Theory

Stewardship theory stresses the beneficial consequences on shareholder returns of facilitative authority structures which unify command by having roles of Chief Executive Officer (CEO) and chair held by the same person. Stewards are company executives and managers working for the shareholders, protects and make profits for the shareholders. Unlike agency theory, stewardship theory stresses not on the perspective of individualism, but rather on the role of top management being as stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained (Zahra and Pearce, 1989).

2.4.2 Theory of Agency

Agency theory argues that in the modern corporation, in which share ownership is widely held, managerial actions depart from those required to maximise shareholder returns (Laffont and Martimort, 2002). In agency theory terms, the owners are principals and the managers are agents and there is an agency loss which is the extent to which returns to the residual claimants, the owners, fall below what they would be if the principals, the owners, exercised direct control of the corporation

Agency theory further specifies mechanisms which reduce agency loss. These include incentive schemes for managers which reward them financially for maximising shareholder interests. Such schemes typically include plans whereby senior executives obtain shares, perhaps at a reduced price, thus aligning financial interests of executives with those of shareholders. Other similar schemes tie executive compensation and levels of benefits to shareholders returns and have part of executive compensation deferred to the future to reward long-run value maximisation of the corporation and deter short-run executive action which harms corporate value.

2.4.3 Stakeholder Theory

Stakeholder theory can be defined as "any group or individual who can affect or is affected by the achievement of the organization's objectives". Unlike agency theory in which the managers are working and serving for the stakeholders, stakeholder theorists suggest that managers in organizations have a network of relationships to serve – this include the suppliers, employees and business partners. And it was argued that this group of network is important other than owner-manager-employee relationship as in agency theory (Donaldson, et al 1995).

2.4.4 Resource Dependency Theory

Another theory is the Resource Dependency Theory. Whilst, the stakeholder theory focuses on relationships with many groups for individual benefits, resource dependency theory concentrates on the role of board of directors in providing access to resources needed by the firm (Pfeffer and Salancik, 1978). The resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organization through their linkages to the external environment. Resource dependency theorists provide focus on the appointment of representatives of independent organizations as a means for gaining access in resources critical to firm success. For example, outside directors who are partners to a law firm provide legal advice, either in board meetings or in private communication with the firm executives that may otherwise be more costly for the firm to secure.

It has been argued that the provision of resources enhances organizational functioning, firm's performance and its survival. The directors bring resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy. Directors can be classified into four categories of insiders, business experts, support specialists and community influentials. First, the insiders are current and former executives of the firm and they provide expertise in specific areas such as finance and law on the firm itself as well as general strategy and direction. Second, the business experts are current, former senior executives and directors of other large for-profit firms and they provide expertise on business strategy, decision making and problem solving. Third, the support specialists are the lawyers, bankers, insurance company representatives and public relations experts and these specialists provide support in their individual specialized field. Finally, the community influential are the political leaders, university faculty, members of clergy, leaders of social or community organizations (Pfeffer and Salancik, 1978).

2.4.5 Transaction Cost Theory

A further theory, Transaction cost theory, attempts to view the firm as an organization comprising people with different views and objectives (Demsetz, 2003). The underlying assumption of transaction theory is that firms have become so large they in effect substitute for the market in determining the allocation of resources. In other words, the organization and structure of a firm can determine price and production. The unit of analysis in transaction cost theory is the transaction. Therefore, the combination of people with transaction suggests that transaction cost theory managers are opportunists and arrange firms' transactions to their interests (Demsetz, 2003).

2.4.6 Political Theory

Political theory brings the approach of developing voting support from shareholders, rather by purchasing voting power. Hence having a political influence in corporate governance may direct corporate governance within the organization. Public interest is much reserved as the government participates in corporate decision making, taking into consideration cultural challenges. The political model highlights the allocation of corporate power, profits and privileges are determined via the governments' favour. The political model of corporate governance can have an immense influence on governance developments. Over the last decades, the government of a country has been seen to have a strong political influence on firms. As a result, there is an entrance of politics into the governance structure or firms' mechanism (Ingo, 2004).

Other than the fundamental corporate governance theories, the rest include business ethics theory, virtue ethics theory, feminist ethics theory, discourse ethics theory, postmodern ethics theory.

2.5 Efficient Market Hypothesis (EMH)

Malkiel (2003) notes that it was generally believed that securities markets were extremely efficient in reflecting information about individual stocks and about the stock market as a whole. The accepted view was that when information arises, the news spreads very quickly and is incorporated into the prices of securities without delay. Thus, neither technical analysis, which is the study of past stock prices in an attempt to predict future prices, nor even fundamental analysis, which is the analysis of financial information such as company earnings, asset values, to help investors select "undervalued" stocks, would enable an investor to achieve returns greater than those that could be obtained by holding a randomly selected portfolio of individual stocks with comparable risk.

One of the famous definitions of EMH has been given by Jensen (1978). He opines: "A market is efficient with respect to information set it if it is impossible to make economic profits by trading on the basis of information set it."

Malkiel (1992) provides another closely related definition of EMH: "A capital market is said to be efficient if it fully and correctly reflects all relevant information in determining security prices. Formally, the market is said to be efficient with respect to some information set, it, if security prices would be unaffected by revealing that information to all participants. Moreover, efficiency with respect to information set, it, implies that it is impossible to make economic profits by trading on the basis of it."

Fama (1970) notes that the primary role of the capital [stock] market is allocation of ownership of the economy's capital stock. In general terms, the ideal is a market in which prices provide accurate signals for resource allocation; that is, a market in which firms can make productive-investment decisions, and investors can choose among the securities that represent ownership of firms' activities under the assumption that securities prices at any time 'fully reflect' all available information.

The link between an asset market that efficiently reflects available information (at least up to the point consistent with the cost of collecting the information) and its role in efficient resource allocation may seem natural enough. Further analysis has made it clear, however, that an informational efficient asset market needs not generate allocative or production efficiency in the economy more generally. The two concepts are distinct for reasons to do with the incompleteness of markets and the information-revealing role of prices when information is costly and therefore valuable (Stiglitz, 1981).

Dyckman and Morse (1986) observe that security market is generally defined as efficient if; the price of the security traded in the market act as though they fully reflect all available information and these prices react instantaneously, or nearly so, and in unbiased fashion to new information. Corollaries of the efficient market hypothesis include the following: Nobody, with a consistency greater than that of random chance, can successfully time short-term price moves in either securities markets or individual securities; a strategy of trying to exploit mispricings in securities (buying issues that appear to be undervalued and selling issues that appear to be overvalued) is futile; anomalies or "free lunches" in the securities markets do not exist; nobody, over time, can outperform the market sector in which he invests; aside from matters of efficiency, incremental return in investing is achieved by, and only by, taking on added uncertainty or sacrificing safety; and lastly, investors prosper by participating in markets, not by trying to outwit them.

Accepting the Efficient Market Hypothesis in its purest form may be difficult; however, there are three identified classifications of the EMH, which are aimed at reflecting the degree to which it can be applied to markets. First, strong efficiency is the strongest version, which states that all information in a market, whether public or private, is accounted for in a stock price. Not even insider information could give an investor an advantage. Secondly, semi-strong efficiency form of EMH implies that all public information is calculated into a stock's current share price. Neither fundamental nor technical analysis can be used to achieve superior gains. Lastly, weak efficiency claims that all past prices of a stock are reflected in today's stock price. Therefore, technical analysis cannot be used to predict and beat a market.

2.6 Measures of Efficiency

The new strategy can be characterized by the following five sets of quantifiable measures; which include profitability and cost efficiency measures. The variables that describe the changes in profitability and cost efficiency are net operating gain to total revenue (NOG/TR) net operating gain to total assets (NOG/TA), return on equity (ROE) and revenue to total assets (TR/TA). A successful implementation of the new strategy will show an increase in each of these variables in the post-demutualization period.

The growth measures as indicated by change in premiums written and deposits received (NPD), describes the growth in the firm’s revenues. It is expected that the growth rate will increase as demutualization allows the firms to increase their capital base and hence the capacity to expand. The companies are expected to shift their product focus after demutualization to newer and faster growing financial services products. Another measure is the debt management**.** Management may be willing to take additional risk in the capital structure in order to leverage up profitability for stockholders. Further, firms may increase the debt ratio to finance the needs of product innovation and expansion. Since demutualization increases transparency, the firms may find debt less costly and more convenient. The hypothesis is that the debt to asset ratio, and the use of long-term debt, as reflected in the ratio of all other liabilities to total assets (AOL/TA), will increase.

The asset risk management contends that in order to generate higher returns, management in newly demutualized firms, is expected to take additional risk in managing the firm's assets. The percentage of assets invested in non-investment grade bonds depicts the riskiness of the asset portfolio. The ratio of non-investment grade bonds / capital, (NIGB/ C), is a measure of asset risk management, and is expected to increase.
(Alexander et al, 2005).

Exchanges undergoing the demutualization process have done so in expectation of improved competitiveness. Scullion (2001) reveals the main motives of and expected benefits from demutualization include tapping new sources of capital which is possibly needed to modernize their trading systems, to pursue business opportunities unconstrained by vested interest issues, to achieve better cost control and to increase flexibility, efficiency and competitiveness. Scullion (2001) further argues in his contribution that demutualization is now regarded as the key solution to all the problems related with mutual exchanges. In order to achieve the full benefits of demutualization the author points out that "demutualization is not simply turning into a for profit entity owned by members. A truly demutualised exchange would be better placed if it were able to unlock its hidden value for all stakeholders in order to maximize its potential market capitalization and shareholder value".

2.7 Challenges of Demutualization

Despite its advantages, demutualization is not without its distinct regulatory challenges, such as how to rationally divide governance of the demutualized exchange (DE) among the exchange, the government and other self regulatory organizations (SROs). However, one of the most important regulatory challenges inherent in the demutualization of stock exchanges is the management of conflicts of interest. The for-profit nature of a DE raises the possibility that exchanges may be so preoccupied with profits that it may: (1) abuse its position as both market participant and market regulator to its own advantage; and (2) sacrifice effective regulation in order to achieve the short term goal of maximizing shareholder profits. Demutualization poses challenges for market supervision and regulations especially in Africa where markets are still not sufficiently liberalized, e.g. Ghana. Another factor is that, of the 20 exchanges, only about 7 are likely to be financially viable as demutualized exchanges. Also Governments who support exchanges financially are not in a hurry to demutualize if policy objectives are being met in mutual form (Mensah, 2005).

Mellon (2001) asserts that demutualization is a complex and difficult process. Moreover, the process is rife with unexpected regulatory, business, and technological challenges. These include government bureaucracies; regulatory complexities; disinterested market players who are indifferent to the process hence offering no support or input which is critical for the success of the process and lack of appropriate and sufficient technology to drive the process.

Mellon (2001) further states that demutualization by some key foreign exchanges has proceeded at a faster pace, demonstrating some of the challenges that demutualized exchanges face in today's new competitive climate. The first exchange to demutualize was the Stockholm Stock Exchange in 1993, but by the end of the year 2000 numerous additional stock and futures exchanges had demutualized, including the Amersterdam Stock Exchange, the London Stock Exchange, the Paris Bourse and the Capital Market of England. So far, only the Stockholm and Australian Stock Exchanges have gone public and listed on their own boards, but public offerings are planned by other demutualized exchanges (Mellon, 2001).

Dickinson and Muragu (1994) state that depending on the circumstances, the process of demutualization may take place in a short period of time or occur over several years. Generally, any company that is considering this type of conversion will take time to thoroughly weigh the advantages of undergoing demutualization to the potential liabilities that may occur. Once the company has determined that the benefits outweigh the possible disadvantages of the conversion, an escalation strategy is established to ensure that every legal and operational aspect of the demutualization process is handled in a timely and efficient manner. Demutualization is not an approach that only applies to company ownership. In recent years, many stock exchanges have also made the migration to being structured along the lines of a share company. Such venerable exchanges as the New York Stock Exchange, the London Stock Exchange, and the Toronto Stock Exchange have either completed the migration or have taken steps towards demutualization.

Shipp (2008) notes that creating an efficient regulatory system for securities exchanges is a difficult goal to achieve and maintain. Hence, some African stock exchanges have limited institutional capacity to police and enforce rules. Most of the smaller African exchanges lack the trained manpower and experience to adequately police the modern regulatory regimes they have adopted. Consequently, enforcement actions are rare and abuses are not uncommon. In addition, investors, particularly minority shareholders, lack confidence in the market as some listed companies continue to operate under poor corporate governance structures. In some stock markets, participants are subject to multiple regulators thereby causing regulatory complexities, uncertainties and increased costs of compliance with different regulatory regimes. In Kenya, the NSE and CMA both serve as regulators of market participants. Each has its own requirements for membership, listing and participation in the market and though there are similarities, the multiplicity creates uncertainty as to which requirements are applicable in different situations (Shipp, 2008).

Dickinson and Muragu (1994) note that political uncertainties and economic policies in some African countries have facilitated the decline in confidence in and subsequent poor performance of the stock markets because of the risk of deterioration in the business climate. Before, the 2002 general elections the Nairobi Stock Exchange experienced decline in market performance due to political and economic policies adopted by the government that led to the withdrawal of donor funding. However, there was renewed confidence in the market evidenced by improved performance in market capitalization and turnover when a new government came into power in 2003. In Zimbabwe, the Zimbabwe Stock Exchange was established in 1896. It has been a star performer among the emerging markets stock exchanges particularly towards the end of the last decade (1996 and 1997). However, its turnover and market capitalization has declined since 1998, due to the loss of confidence brought about by the political and economic policies (Dickinson and Muragu, 1994).

The authors further point out that low savings rate in many African countries has constrained demand and supply of equity in stock markets. Poverty, war, political unrest and disease have resulted in a large portion of the African population living on less than a dollar a day thereby constraining savings. Most of the new African exchanges, apart from Johannesburg, Casablanca and Cairo securities exchanges, lack attractive and diverse types of securities to offer foreign investors. Generally, there may be only two or three corporations of interest to foreign investors and most of these may either be subsidiaries of major multinational corporations or recently privatized companies. Consequently fund managers choose the safer course and invest in parent companies listed nearer to home, (Ibid).

2.8 Empirical Studies

Morsy and Rwegasira (2010) note that the impact of demutualization on the market performance of stock exchanges is not clear yet. Earlier literature that looked at the demutualization trend did not focus on the impact, largely because the trend of demutualization was very recent at the time of writing these studies. Subsequent studies on the impact of demutualization focused on very few measures. Some of them used very small sample sizes and others also analyzed the impact on only demutualized stock exchanges that were completely transformed into publicly listed companies. The authors note that consequently, there is little empirical evidence on the impact of demutualization on market performance. Their study aimed at addressing the shortcomings in the prior literature and investigating the impact of demutualization on the market performance of stock exchanges through analyzing a wide variety of market measures in the pre and post demutualization periods. Performance changes were tested on a matched pair basis in order to examine whether stock exchanges performed better after demutualization.

2.8.1 Australian Stock Exchange.

Few months after its demutualization, it announced a merger proposal (unsuccessfully) with the Sydney Futures Exchange. Within a year, the exchange formed a strategic alliance and created a joint venture with Perpetual Trustees in 2000, created an operational trading link with both North America and Singapore in 2001, launched a futures market in 2002, and by 2003 had entered memorandums of understanding (MOUs) with the Philippines, Thailand, Singapore, Tokyo, Hong Kong, Shanghai and Shenzhen exchanges (Lee, 2002).

2.8.2 Demutualized National Stock Exchange (NSE)

Krishnamurti et al (2003) show that the organization structure of a stock exchange matters through comparing two major stock exchanges in India; the mutualized - Bombay Stock Exchange (BSE) and the demutualized National Stock Exchange (NSE). These two exchanges adopt similar trading systems, trade essentially identical stocks and follow same trading hours, but they have different organizational structures. Krishnamurti et al. (2003) used trading data for 40 stocks listed on two Indian exchanges in the 1990s and found out that the demutualized National Stock

Exchange is able to pass on lower trading costs to investors than BSE. Using the market quality, they show that NSE provides a better market quality than BSE.

2.8.3 Borsa Italiana

Borsa Italiana (BI) was privatized by the Government in spite of members' resistance. The results highlighted the important role that competition plays in stock exchange markets. In the case of Borsa Italiana; which demutualized for reasons other than competition, the stock exchange captures the entire order flow and eliminates the little competition which is out there. Additionally, the owners of the demutualized stock exchange have no incentives to lower trading costs. This suggests that a demutualization with no competition actually leads to more or complete dominance by the primary exchange, making the introduction of potential competition even more difficult in the future. The results indicate that introducing a 'residual claimant' in the governance structure of stock exchanges is definitely better for the exchange. Demutualization leads to an increase in the order flow (Hazarika, 2005).

2.9 Summary of Literature Review

In general, empirical literature on the demutualization of stock exchanges is scarce. There are few academic studies that explain the impact of governance change on the exchange itself. Though there are many theoretical (non-empirical) studies that agree that demutualization should be a natural move to improve exchanges competitiveness in a changing business environment, it is still unclear in reality (empirically) how demutualization affects the stock exchange performance.

This review has seen corporate governance from various theoretical perspectives. Agency theory, stewardship theory, stakeholder theory, transaction cost theory and political theory addresses the cause and effect of variables, such as the configuration of board members, audit committees, independent directors and the role of top management. In addition, ethics in business has also been mentioned as playing a role in corporate governance.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the research methodology that was used in the study. It also discusses the research design, population of study, sampling procedure, data collection methods as well as data analysis and data presentation methods employed in the study.

3.2 Research Design

Research design constitutes the blueprint for collection, measurement and analysis of the data. The research design employed in this study was a survey.

3.3 Population

Population refers to an entire group of individuals, events or objects having a common observable characteristic (Mugenda and Mugenda, 2003). The population of the study of interest was 17 stockbrokers and investment banks. The study being census focused on all players. Census was suitable as it allowed the collection of opinions from all stakeholders in the investment industry that have great interests in the demutualization of the Nairobi Stock Exchange. Peterson (1999) claimed that if the study was not large enough to validate sampling then Census was the most appropriate technique to be used. Census was also found to be the most appropriate as according to Mugenda (1999), if the population is less than 30 then census should be used.

3.4 Data Collection Method

Data collection was mainly from primary sources collected through the use of semi-structured questionnaires. However, secondary data was also collected from other sources which included the Nairobi Stock Exchange handbook, database from the Stock Exchange and the CMA website. The semi-structured questionnaire was administered using the "drop and pick later" method to the respondents. The questionnaire used mainly the likert style and hence the data obtained was mainly of non parametric nature. Both ordinal data and non ordinal data were obtained. There were also qualitative data obtained by the use of open ended questions. These were meant to give more information about demutualization in order to get clarity of the perceptions of the market players.

3.5 Data Analysis

Descriptive statistics was used to analyze the data. According to Denscombe (1998) descriptive statistics involves a process of transforming a mass of raw data into tables, charts, with frequency distribution and percentages which are a vital part of making sense of the data. Data was analyzed using Statistical Package for Social Sciences (SPSS) version 17 and presented using tables and pie charts.

CHAPTER FOUR: DATA ANALYSIS, INTERPRETATION OF THE RESULTS AND DISCUSSIONS

4.1 Introduction

This chapter highlights the findings of the research. The chapter first looks at the demographics of the respondents before embarking on the analysis of the study results.

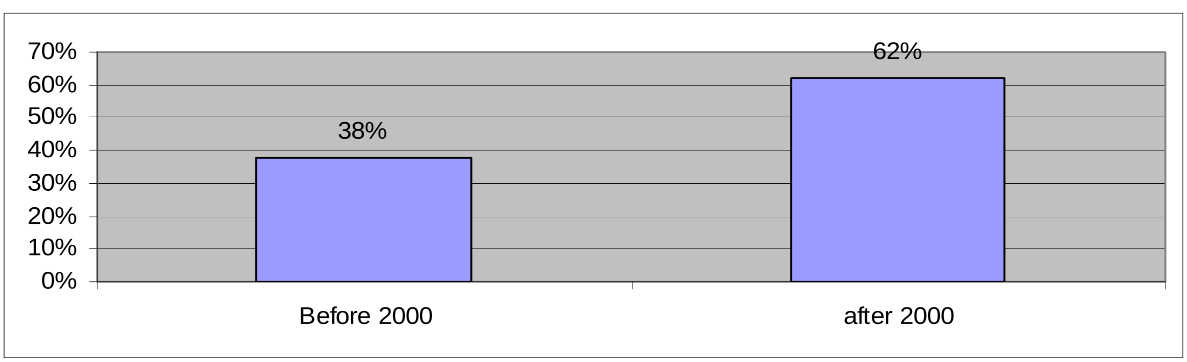
4.2 Respondents Demographics

The study looked at the respondent demographics by establishing the year their companies were established, nature of their business, gender, age and number of years worked amongst others.

4.2.1 Year of Establishment

Graph 1 shows that 38% of the respondents' companies were established before year 2000 while the rest were established later.

Graph 1: Year of Establishment

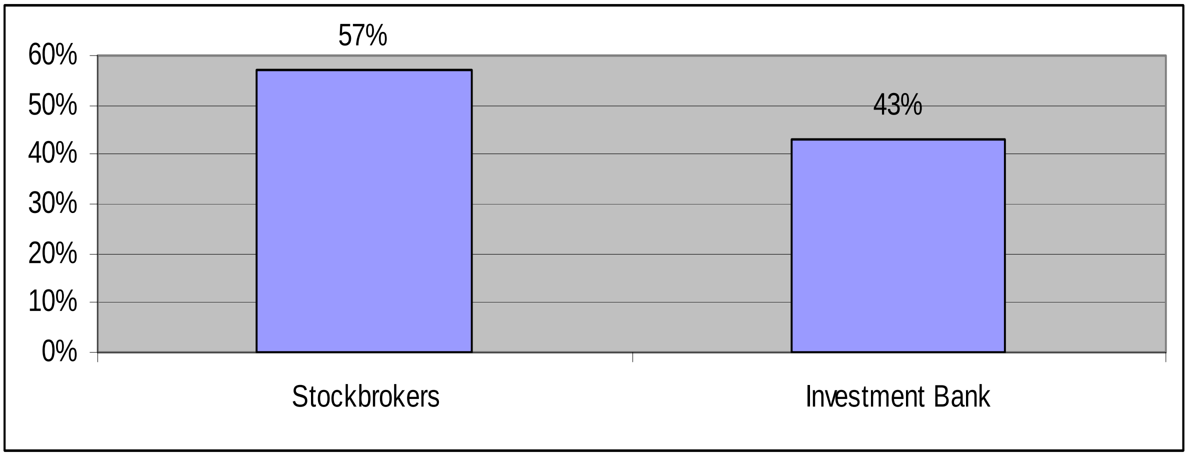


Source: Research Data

4.2.2 Nature of the Business

Graph 2 shows that 57% of the respondents companies were stockbrokers while the rest are investment banks.

Graph 2: Nature of Business

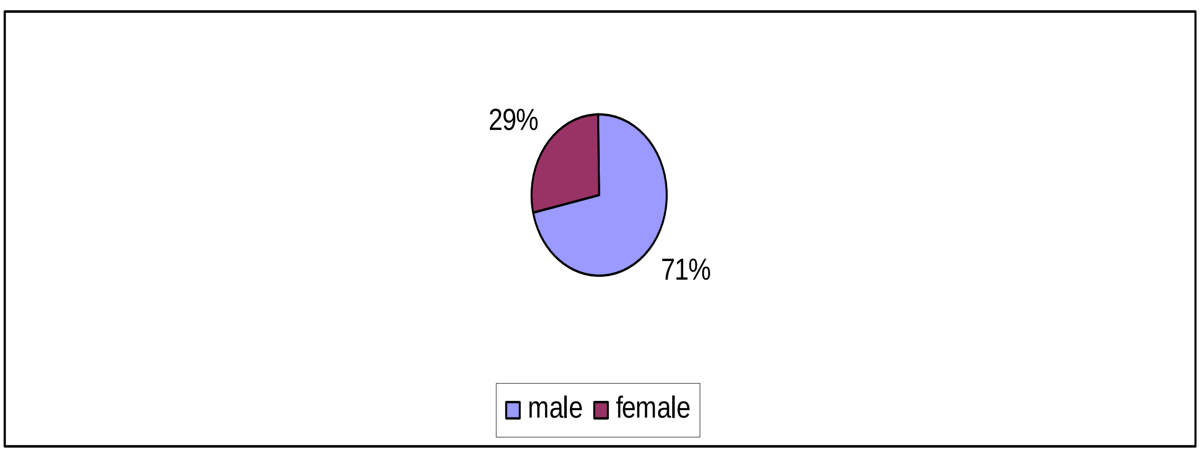


Source: Research Data

4.2.3 Gender

Graph 3 shows that 71% of the respondents are male and the rest were female.

Graph 3: Gender

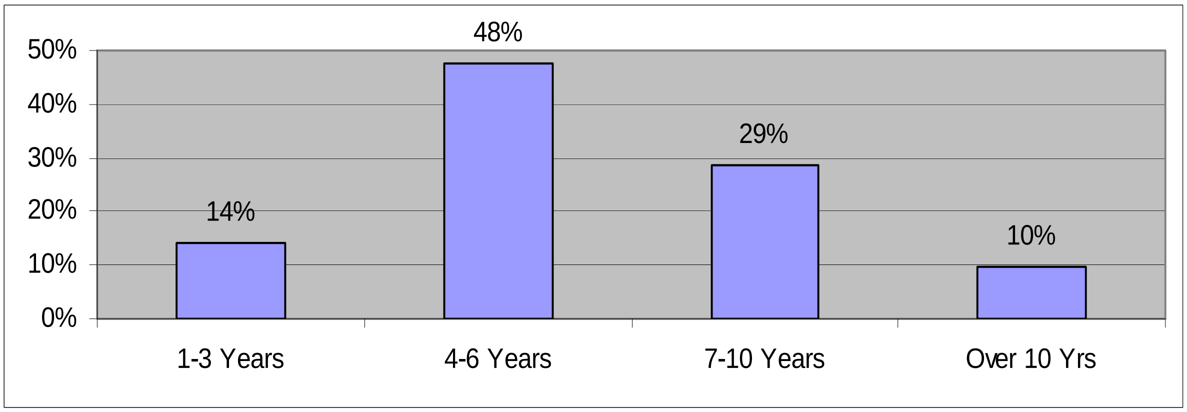


Source: Research Data

4.2.4 Number of Years Employed

Graph 4 shows that 14% of the respondents had worked for 1-3 years while 48% had worked for 4-6 Years and the rest had worked for over 7 years.

Graph 4: Number of Years Employed

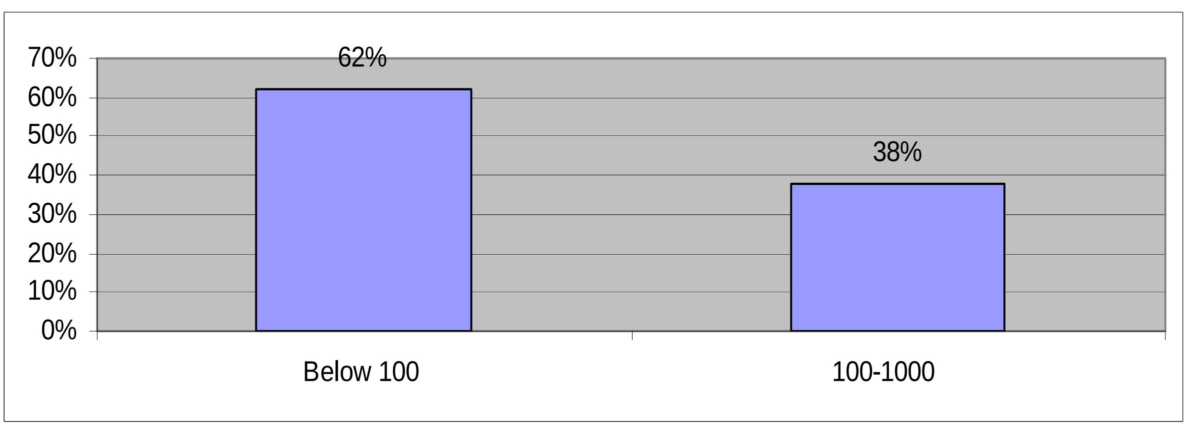


Source: Research Data

4.2.5 Number of Employees

Graph5 shows that 38% of the respondents companies had between 100 and 1000 employees while the rest had less than 100 employees.

Graph 5: Numbers of Employees

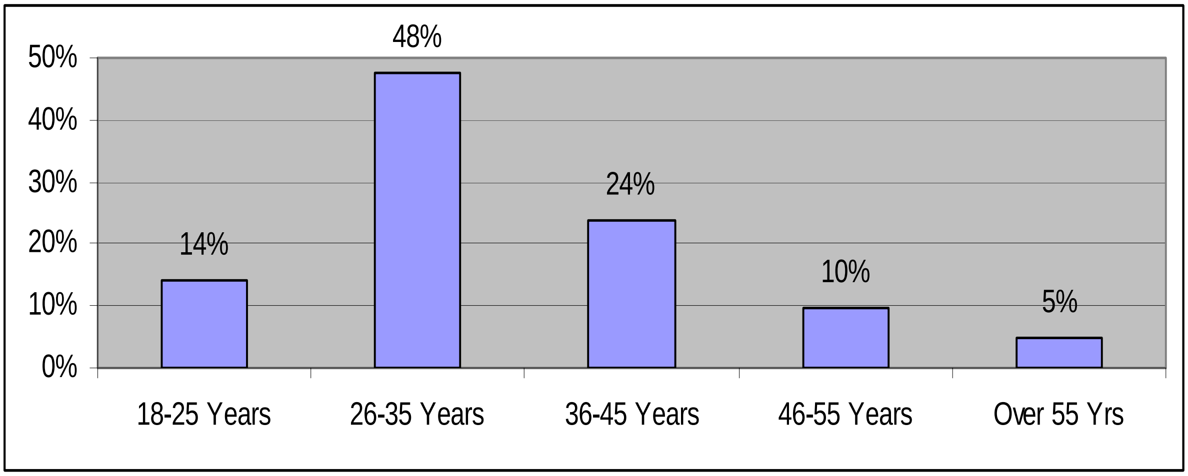


Source: Research Data

4.2.6 Respondents' Age

Graph 6 shows that 48% of the respondents were at the age bracket of 26-35 years, 39% were above 35 years and 14% were below 26 years.

Graph 6: Respondents Age



Source: Research Data

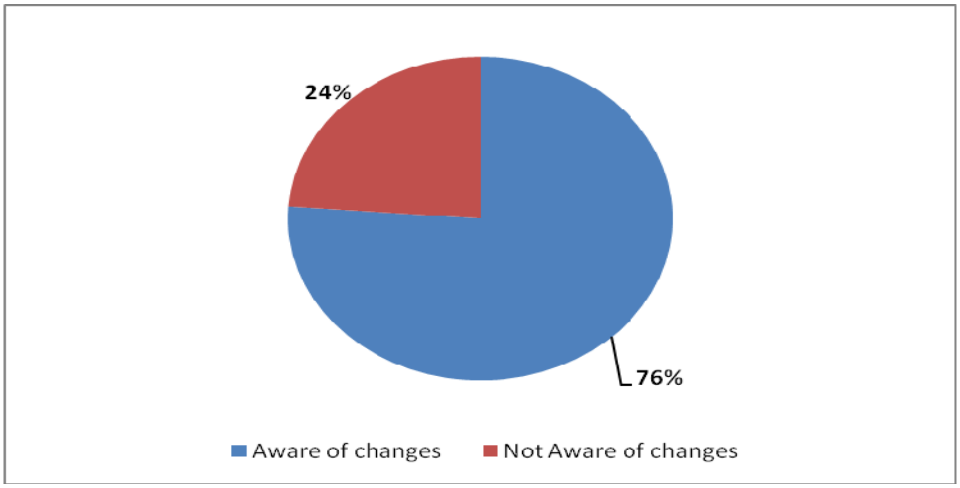
4.3 Study Results

The study results mainly focused on the awareness level of stock brokers as a preliminary, before looking at the benefits and challenges of demutualization of the NSE.

4.3.1 Respondents Change Awareness Level

Graph 7 shows that 24% of the stockbrokers claimed they were not aware of the changes that were ongoing at the NSE.

Graph 7: Respondents Change Awareness Level

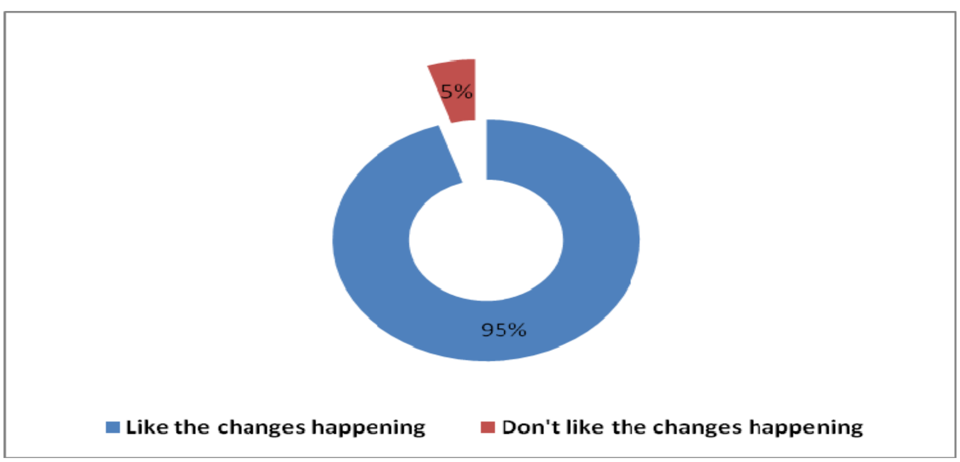


Source: Research Data

4.3.2 Respondents Approval of NSE Changes

Graph 8 shows that of the respondents who were aware of the changes at the NSE, 95% embraced them, these changes included introduction of electronic trading system, automation of secondary trading in the bond market and management and governance related changes that had occurred in the recent past or were on the pipeline of actualization.

Graph 8: Respondents Approval of NSE Changes

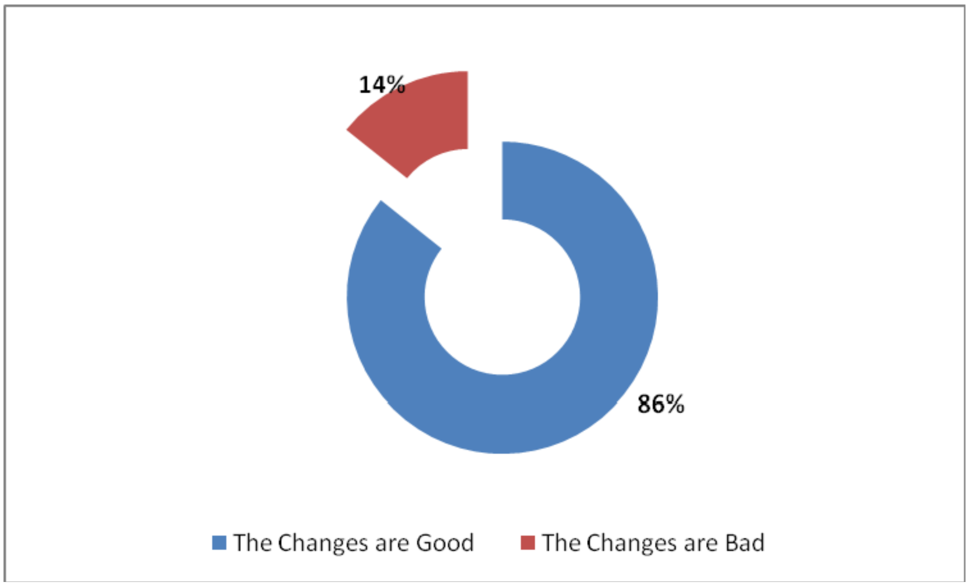


Source: Research Data

4.3.3 Respondents Perception of Demutualization

Graph 9 shows that 86% of the respondents felt that demutualization was expected to impact positively on the stock exchange.

Graph 9: Respondents Perception of Demutualization

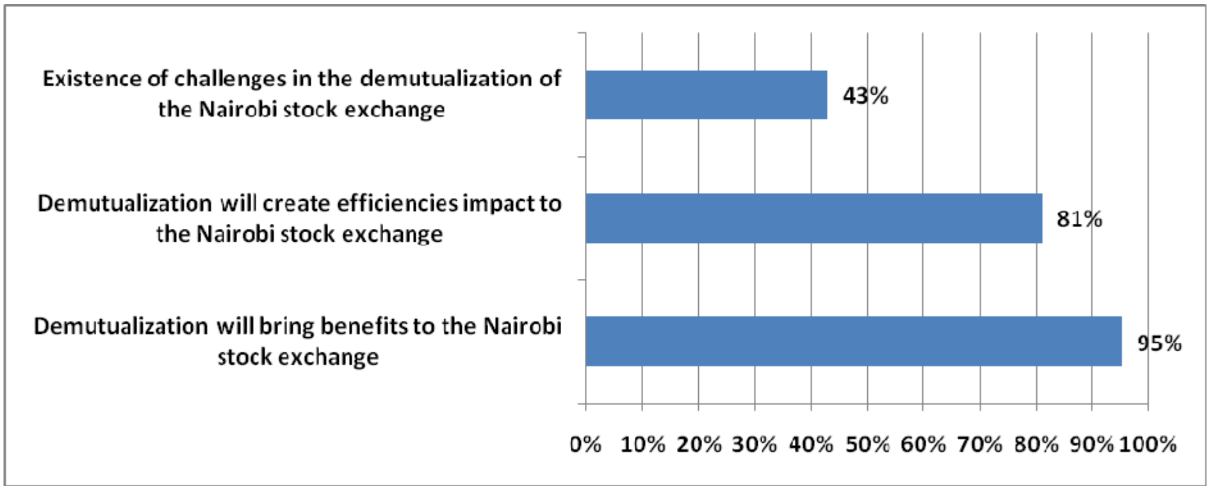


Source: Research Data

4.3.4 Respondents Attitudes on Demutualization Process

Graph 10 shows that 43% of the respondents were aware of the demutualization process at the NSE, 81% claimed that demutualization will particularly create efficiency in the NSE and 95% claimed that demutualization will bring other benefits to the NSE such as improved corporate governance, restoration of investor confidence brought about by increased transparency and unlocking the potential of the capital markets and the economy at large.

Graph 10: Respondents Attitude on Demutualization

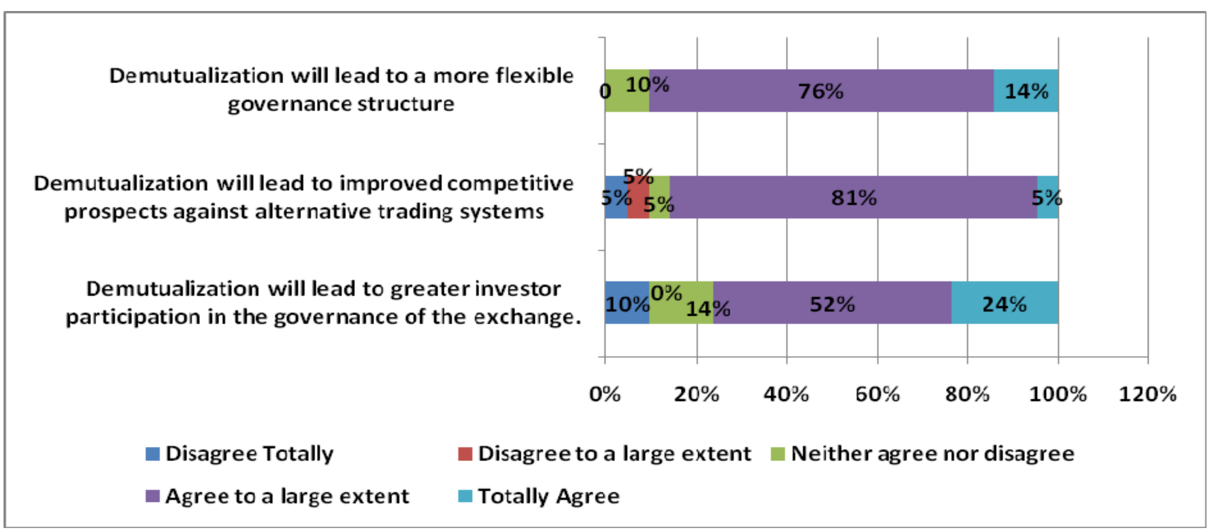


Source: Research Data

4.3.5 Benefits of Demutualization of the Nairobi Stock Exchange

Graph 11 shows that 90% of the respondents claimed that demutualization will lead to flexible governance, 85% claimed that demutualization will lead to improved competitive prospects to alternative trading systems and 86% claimed that demutualization will lead to greater investor participation.

Graph 11: Benefits of Demutualization of the Nairobi Stock Exchange

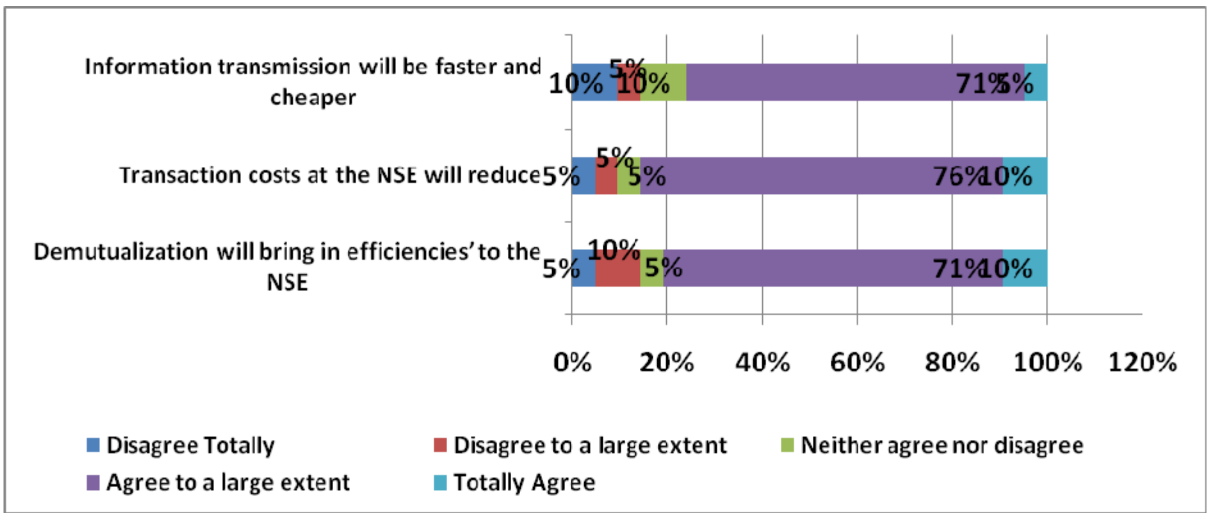


Source: Research Data

4.3.6 Implications of Demutualization on Efficiency of the Nairobi Stock Exchange

Graph 12 shows that 75% of the respondents felt demutualization will lead to faster information transmission which will also be cheaper, while 85% claimed transaction costs will reduce and 81% of the respondents thought that demutualization will bring in efficiencies at the NSE.

Graph 12: Implications of Demutualization on Efficiency of the Nairobi Stock Exchange

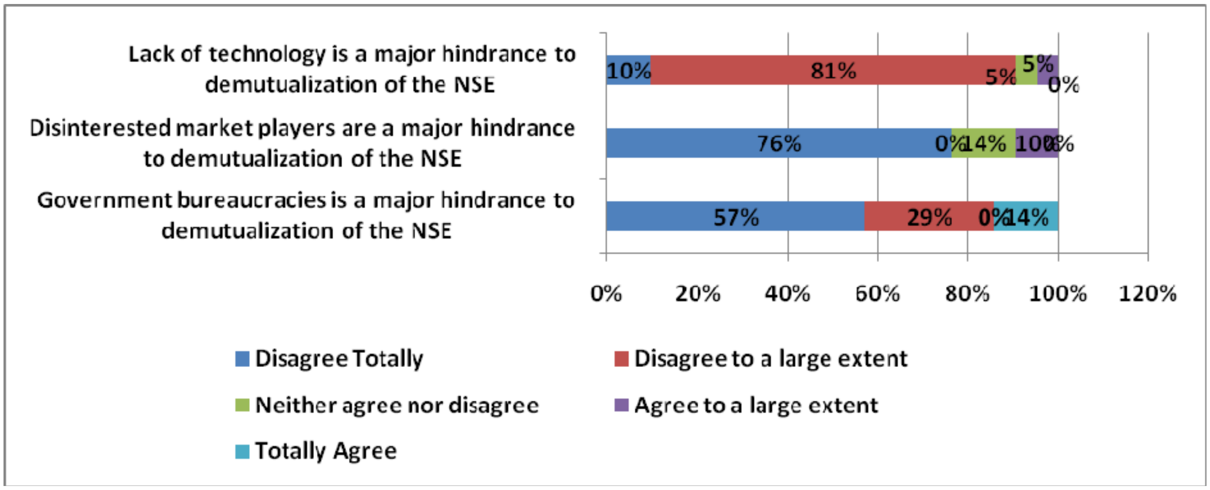


Source: Research Data

4.3.7 Challenges of Demutualization of the Nairobi Stock Exchange

Graph 13 shows that 91% of the respondents refuted that lack of technology was a major hindrance to demutualization, 76% did not agree that disinterest from market players was a challenge to demutualization while 57% disagreed that government bureaucracies caused problems to NSE demutualization process.

Graph 13: Challenges of Demutualization of the Nairobi Stock Exchange



Source: Research Data

Most of the respondents thought that the major challenges that would hold demutualization are mainly the politics behind demutualization, the squabbles between the CMA and NSE, creating unnecessary tension to the process. The government's back seat approach was also seen as good only to a certain extent but it should stand its ground when the set road map is not followed or the goal posts get shifted. Other challenges expressed were that existing member brokers may not be keen on giving up control of the market and concerns that foreigners may take control of the market and thus influence decision making in their favour.

CHAPTER FIVE: SUMMARY OF THE FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1. Introduction

This chapter is a summary of the results of the study. The chapter summarizes the general and specific objectives of the study, methodology used and the major findings. Discussions, conclusions, limitations of the study, recommendations and suggestions of further research are presented.

5.2. Summary of the Findings and Conclusions

5.2.1 Summary of the Findings

The objective of this study is to identify the benefits and analyze the challenges of demutualization of the Nairobi Stock Exchange. The methodology employed in this study was a census survey. Census was selected due to the fact that stock exchange brokerage firms and investment banks were less than 30 hence the population was considered too small for sampling but big enough for a census. The population was all the investment banks and stock brokerage firms existing during the period of research. There were a total of 17 active firms comprising both the investment banks and stock brokers.

Data collection was mainly from primary sources by way of the questionnaire while secondary data was collected from the Nairobi Stock Exchange handbook, database from the Nairobi Stock Exchange and the CMA website. A research instrument was developed based on the study objectives to help the researcher with a systematic and orderly data analysis. The researcher used Microsoft Excel and SPSS software for data analysis and presented the results using charts, tables and narratives on the findings.

The major findings were that the awareness level of the demutualization of the NSE was high and perception of the demutualization process was good. It was also found that most stock brokers embraced the move and efficiencies were perceived as one of the main benefits of the process while improved governance was perceived as the secondary benefit. Stock brokers thought that the NSE was ready for the demutualization process because of the high level of technology as well as government's and other market players' support.

Writers like Morsy, Rwegasira and Scullion claimed that demutualization had little benefits as far as the perceptions of the stock brokers was concerned. However, the research showed that the respondents' perception of demutualization was that it would lead to flexible governance, will lead to improved competitive prospects to alternative trading systems and also lead to greater investor participation.

Writers like Morsy and Rwegasira fronted that government bureaucracies, lack of technology and market players would be the main challenges to the demutualization process however the research showed that the same would not largely cause setbacks in the NSE demutualization process.

5.2.2 Conclusions

The NSE was set to benefit majorly from the demutualization process because the perceptions were that it would lead to greater market efficiency. This meant that transaction costs would be reduced, less risky and faster. Market information availability would be high and at minimal cost. The Stock Exchange was also set to benefit immensely as a result of increased investor confidence brought about by expectations that demutualization will lead to improved corporate governance.

The mood on the ground was that NSE was ripe for the demutualization and that there were no major challenges that were anticipated. The Government was seen to be very supportive and that the market had high expectation of the process. The (CMA) and NSE were however thought to be involved in unnecessary tussles that could delay the process and sanity needed to prevail for the process to succeed. CMA needed not to be overly involved and allow the NSE to drive the process as this would ensure they perform their supervisory role well without going over board and scatter the gains made in the recent years.

5.3. Limitation of the Study

The study was being conducted at a period when demutualization process was still a project, it had not been implemented and therefore the results obtained are perceptions and not the actual experience. This however would form a basis for a comparative research in the future where before and after perceptions can be measured.

5.4 Recommendations

Some of the recommendations fronted were that the NSE should speed up the process of demutualization in order to reap the benefits at the right time and that more education and sensitization as to what demutualization would not offer should be carried out in order to manage expectations from stock brokers and other stakeholders. The CMA, the regulatory body should play its regulatory role and stop micromanaging the NSE. Furthermore the NSE leadership ought to be open minded and not narrow minded into politicizing such an important process.

5.5 Suggestions for Further Research

One limitation of the study was that it was conducted before the actual demutualization process was concluded and therefore some of the studies that could be studied in the next five to six years are: The impact of demutualization of the NSE on stock markets; The impact of demutualization of the NSE on the stock exchange corporate governance; The impact of demutualization of the NSE on investors' confidence. Then, sufficient time would have lapsed to gauge the impact of demutualization on some of the benefits perceived to be derived from the process. Another study that could be conducted immediately after the demutualization of the NSE would be; how to reduce bottlenecks in the stock exchange demutualization process in Eastern Africa: lessons learnt from the NSE. At that point the scholars and implementers of the process would have travelled the demutualization journey and would know exactly what they could have done better to deliver the all the project objectives and what assumptions were not rightly taken and what other missing pieces needed to be added to ensure effectiveness.

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APPENDICES

APPENDIX I: LETTER TO THE RESPONDENT

Caroline Kajuju Kathurima

University of Nairobi

P.O. BOX 48400

Nairobi

September 2010

Dear Respondent**,**

<u>RE: RESEARCH ON DEMUTUALIZATION OF THE NSE</u>

I am a postgraduate student at UON pursuing a Master of Business Administration. I am carrying out the above mentioned study. The success of the research substantially depends on your help and co-operation.

I hereby request you to respond to the questionnaire items as honestly as possible and the best of your knowledge. The questionnaire is designed for the purpose of this study only therefore the response shall absolutely be confidential. No name shall be required from any respondent.

Thanking you in advance.

Yours faithfully,

CAROLINE KAJUJU KATHURIMA

APPENDIX II: QUESTIONNAIRE

Part A: Bio Data

1. Name of the Institution____

2. Year of establishment _______________________

3. Orientation (tick): Stock Brokerage Firm [ ] Investment Bank [ ]

4. Number of employees (Tick) Below 100 [ ]

100-1000 [ ]

1001-2000 [ ]

Over 2000 [ ]

5. Incorporation:

a) Name of Act of Parliament under which you operate

____

b) If not Act of Parliament, specify.

____

6. Ownership (Tick): Fully state-owned [ ]

Partially state-owned [ ]

Fully Private-owned [ ]

7. a How long have you been with the organization (Tick) 1-3 Years [ ]

4-6 Years [ ]

7-10 Years [ ]

Over 10 Yrs [ ]

7. b How old are you (Tick)

18-25 Years [ ]

25-36 Years [ ]

36-45 Years [ ]

46-55 Years [ ]

Over 55 Yrs [ ]

7. c Gender (Tick)

Male [ ]

Female[ ]

8. Are there changes that are happening within the Industry? (Tick)

Yes [ ] No [ ]

9. Do you like changes that are happening within the Industry? (Tick)

Yes [ ] No [ ] Not Applicable [ ]

10. What do you think of demutualization? Is it a good or a bad thing?

Good [ ] Bad [ ]

Part B: Assessing the Benefits of Demutualization of NSE

10. Do you think Demutualization will bring benefits to the Nairobi stock exchange? (Tick)

Yes [ ] No [ ]

Please explain your answer

Kindly indicate the extent at which you agree with the following statements. Tick as appropriate

10b: Assessing the benefits of demutualization on the Nairobi Stock Exchange	Disagree Totally	Disagree to a large extent	Neither agree nor disagree	Agree to a large extent	Totally Agree
10bi). Demutualization will lead to greater investor participation in the governance of the exchange.					
10bii) Demutualization will lead to improved competitive prospects against alternative trading systems					
10biii)Demutualization will lead to a more flexible governance structure					

Part C: To analyze the challenges of demutualization of the NSE

11. a) Are there challenges in the demutualization of the Nairobi stock exchange? (Tick)

Yes [ ] No [ ]

Please explain your answer

Kindly indicate the extent at which you agree with the following statements. Tick as appropriate					
12b: Challenges of demutualization of the Nairobi stock exchange	Disagree Totally	Disagree to a large extent	Neither agree nor disagree	Agree to a large extent	Totally Agree
12bi). Government bureaucracies is a major hindrance to demutualization of the NSE					
12bii) Disinterested market players are a major hindrance to demutualization of the NSE					
12biii) Lack of technology is a major hindrance to demutualization of the NSE					