

**FACTORS AFFECTING DEMUTUALIZATION OF THE NAIROBI  
SECURITIES EXCHANGE**

**BY**

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A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILMENT OF  
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## DECLARATION

This research project is my original work and to the best of my knowledge has not been presented for the award of a degree in any other university.

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## **DEDICATION**

I dedicate this work to my family and all those who supported me in the completion of this project.

## **ACKNOWLEDGMENT**

Firstly, my sincere gratitude to Our Almighty Father who by His grace I was able to do and complete this study.

Secondly, for the development and production of this work I feel a deep sense of gratitude to my supervisors, Mr. Duncan Elly, Mr. Odipo and Mr. H. Ondigo, for their guidance and supervision.

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## **ABSTRACT**

The objective of this study was to determine the factors affecting demutualization of the Nairobi Securities Exchange. The study adopted a descriptive research design. The target population comprised of all 25 stakeholders at the NSE. This included: Capital Markets Authority (CMA), Central Depository Systems (CDS), Stock Brokerage firms, and mutual companies. Primary data was collected by use of a semi structured questionnaires with both open and closed ended questions. Data analysis was done using SPSS and Microsoft Excel to generate quantitative reports which were presented in the form of tabulations, percentages, mean and standard deviation. Multiple regression analysis between different variables related to demutualization of the NSE was also conducted.

The study found out that factors that affect demutualization of the NSE include ownership structure, government policy and regulatory framework and also corporate governance.

The study recommends that the current owners who include the stockbrokerage firms should commit to relinquish some of the ownership to the government and to the general public so that the stock exchange can be listed to trade like any other company. To ensure successful demutualization, the Government should work in collaboration with other stakeholders to ensure there is no resistance to the whole process of demutualization. The study recommends during the whole transition period on demutualization, the stock exchange should maintain high level of corporate governance to ensure that the interests of both the current mutual owners and investors are not affected. This is because high levels of corporate governance ensure that market confidence is held high.

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## **ABBREVIATIONS AND ACRONYMS**

SGX: Singapore Exchange Limited

SES: Stock Exchange of Singapore

SIMEX: Singapore International Monetary Exchange

SEHK: Stock Exchange of Hong Kong Limited

HKFE: Hong Kong Futures Exchange Limited

HKSCC: Hong Kong Securities Clearing Company Limited

NYSE: New York Stock Exchange

CBOE: Chicago Board Options Exchange

CBOT: Chicago Board of Trade

CME: Chicago Mercantile Exchange

SFE: Sydney Futures Exchange

WFE: World Federation of Exchanges

SIMEX: Singapore International Monetary Exchange

SES: Stock Exchange of Singapore

SGX: Singapore Exchange Limited

HKEx: Hong Kong Exchange

NSE: Nairobi Securities Exchange

LSE: London Stock Exchange

MIMS: Main Investment Market Segment

AIMS: Alternative Investment Market Segment

FIMS: Fixed Income Market Segment

IPO: Initial Public Offer

ITS: Inter-market trading systems

CMA: Capital Markets Authority

CDS: Central Depository Systems

SPSS: Statistical Package for Social Sciences

ECN: Electronic Communications Network

# CHAPTER ONE

## INTRODUCTION

### 1.1 Background of the study

Demutualization of a stock exchange is the entire process by which a non-profit member-owned mutual organization is transformed into a for profit shareholder corporation (Akhtar, 2002). Exchanges around the world have been demutualizing because of international competition and technological challenges to traditional modes of trading securities. Stock exchanges are now increasingly changing their business model and restructuring themselves across the world due to the simultaneous convergence of a number of powerful developments. The most notable of these has been the: rapid advancement and innovation. Historically, most exchanges were not-for-profit organizations owned by their members. Early securities markets were associations of securities traders who met to buy and sell securities. For example, the London Stock Exchange started in coffee houses in Change Alley, moving to a building marked as "The Stock Exchange" in 1773, and charging an entrance fee for admission. Prior to 1990s, stock exchanges all over the world used to operate as mutual organizations. Early 1990s, stock exchanges started to undertake major organizational and operational changes. One of the most noted changes was the trend towards demutualization (Arwa and Kami, 2010).

The demutualization trend started in 1993 by the Stockholm Stock Exchange. It was followed by several others, including the Helsinki Stock Exchange in 1995, the Copenhagen Exchange in 1996, the Amsterdam Exchange in 1997, the Australian

Exchange in 1998, and the Toronto, Hong Kong and London Stock Exchanges in 2000. In Asia-Pacific, Singapore Exchange Limited ("SGX") was the first stock exchange to demutualize in December 1999. End of 2000, SGX's shares were listed on its own market place, after the merger process of the Stock Exchange of Singapore ("SES") and the Singapore International Monetary Exchange ("SIMEX"). In 2000, HKEx was also created as a result of the merger and demutualization of Stock Exchange of Hong Kong Limited ("SEHK") and the Hong Kong Futures Exchange Limited ("HKFE") and the Hong Kong Securities Clearing Company Limited ("HKSCC"). Mid 2000, HKEx shares were listed on its own marketplace, following the merger. In 2000, Tokyo Stock Exchange; one of the largest exchanges in the world completed its demutualization (Arwa and kami, 2010). In 2006, the New York Stock Exchange (NYSE), comprising 30.46% of world market capitalisation, converted its governance structure via a backdoor listing facilitated by its merger with Archipelago Holdings, a rival electronic exchange. The demutualization of the Bourse de Montreal, Chicago Board Options Exchange (CBOE), Chicago Board of Trade (CBOT), Chicago Mercantile Exchange (CME) and the Sydney Futures Exchange (SFE) shows that this process also takes place amongst derivatives and commodity exchanges (Hughes and Zargar, 2006). In 2005, about 60% of the World Federation of Exchanges' (WFE) members were either demutualized or listed (Arwa, 2010).

The change of a stock exchange from a member-owned organization to a for-profit shareholder corporation triggers a number of questions about regulatory oversight. When a demutualized exchange is listed on its own board, some regulatory oversight needs to

be transferred to a government regulator. In many countries, demutualization of the major national stock exchange has been accompanied by general securities regulatory reform (Serifso, 2005). A demutualised exchange may take many forms, each raising its own issues. Some exchanges have demutualised and become public companies listed on their own exchanges. Other exchanges have demutualised but have remained private corporations. Still others are subsidiaries of publicly traded holding companies.

### **1.1.1 Demutualization**

Demutualization refers to the change in legal status of a securities exchange from a mutual association with one vote per member (and possibly consensus-based decision making), into a company limited by shares, with one vote per share (with majority-based decision making). Demutualization makes sense if it induces a change in the exchange's objective from managing the interests of a closed member-based organization with a central focus on providing services for the benefit primarily of the members/brokers and keeping costs and investments limited to financing agreed by members, into a company set up with the objective of maximizing the value of the equity shares by focusing on generating profits from servicing the demands of their customers (brokers and investors) in a competitive manner (Hughes and Zargar, 2006).

Process of demutualization varies from one exchange to other. Integration, mergers and issuing shares have been used by the exchanges to become for profit companies. Singapore Exchange Limited (SGX) was formed on December 1, 1999, following the merger of the Stock Exchange of Singapore (SES) and the Singapore International

Monetary Exchange (SIMEX). It was Asia Pacific first exchange to demutualized, integrated and derivative exchange and on November 23, 2000 SGX's shares became listed on its own marketplace. As a result of the merger of Hong Kong Futures Exchange (HKFE) and the Hong Kong Securities Clearing Company (HKSCC), The Hong Kong Exchange (HKEx) was created in 2000 (Hughes and Zargar, 2006).

Demutualization is about changing the ownership structure of the stock exchange; from a mutual association with one vote per member and possibly consensus-based decision making, into a company limited by shares, with one vote per share (with majority-based decision making) (Aggarwal, 2002). Many studies and reports pointed out that the ticket to successful growth of stock exchanges in today's competitive environment lies in demutualization (Mendiola and O'Hara, 2004). The program shifts the interest of the stock exchange from satisfying financial intermediaries to satisfying market participants. They argue that demutualization and self listing can free up the ability of stock exchanges to engage in many commercial activities. In addition, demutualization can allow the stock exchange to modernize its technology, create a management structure that is more responsive to market conditions and, get an initial infusion of capital and allow for easier access to capital. It also enhances financial decision making by allocating resources to business initiatives and ventures that increase the shareholder value (Lee, 2002). Thus, demutualized stock exchanges are in general expected to bring better performance of exchanges.



Demutualization would restructure governance at the stock exchanges on a sustainable basis (LSE, 2007) as the ownership rights will be delinked from trading rights. It would increase the role of non-member stakeholders in the affairs of the exchange. Management would be in the hands of professional people selected by the directors. Management looks after the day to day management of the exchange and the board of directors (BODs) will be separated from that. There would not be involvement of BODs in decision making; this would result in transparency, efficiency and independence (IOSCO Emerging Markets Committee, 2004). Another advantage of demutualization is access to economic capital. After demutualization stock exchanges can raise capital from many sources as normal for profit organization. Most important source of income would be new share holders, institutions and individuals.

Demutualization would also enhance the profit motive for growth and development. After demutualization exchanges have to earn their own bread and butter. This will have a constant pressure on the exchanges to grow and develop their businesses which will increase profitability. It should work as an incentive to enhance liquidity in the market and to introduce new products and services. Demutualization would also help an exchange to attract listings. Better and efficient system of a demutualized exchange would increase the confidence of other companies (Hart and Moore, 1996) and this would result in greater listings. Demutualized exchange can go for international alliances (Akhtar, 2002) and such alliances provide openings for investments and cross border listings (Hughes and Zargar, 2006).

### **1.1.2 Nairobi Securities Exchange**

The Nairobi Securities Exchange (NSE) has a long history that can be traced to the 1920's when it started trading in shares while Kenya was still a British colony (IFC/CBK, 1984). While share trading was initially conducted in an informal market, there was a growing desire to have a formal market that would facilitate access to long-term capital by private enterprises and also allow commencement of floating of local registered Government loans (Ngugi, 2003). The NSE was constituted in 1954 as a voluntary association of stockbrokers registered under the Societies Act.

The main feature of this period (1953-1963) is the establishment of the NSE which marked the formalization of share trading. The desire to establish a formal market was initiated by stockbrokers who desired to have a stock exchange that facilitated access by private enterprises to long-term capital. In addition, the Minister for Finance desired to have a formal market that facilitated floating of locally-registered Government loans, which would be unattractive without a stock exchange. This saw the constitution of the Nairobi Stock Exchange in 1954 as a voluntary association of stockbrokers registered under the Societies Act (NSE, 1997a). To facilitate the registration, stockbrokers obtained clearance from the London Stock Exchange (LSE), which recognized the NSE as an overseas stock exchange, effectively enabling the NSE to gain value and credibility (Ngugi, 2003). The newly established stock exchange was charged with the responsibility of developing the stock market and regulating trading activities.

The period immediately after independence (1963-1970) saw the Government adopt the Kenyanisation policy with a primary goal of transferring economic and social control to citizens by ensuring that majority of businesses were in the hands of citizens except where some overriding national advantage was otherwise demonstrated. Kenyanisation of businesses involved transfer of existing firms to citizens and the creation of new enterprises in the hands of citizens. Foreigners held majority interest in companies if sufficient capital was not available from domestic sources or so long as other advantages to the country, such as technology and skills, could only be obtained this way. This was achieved through trade licensing legislation under which lists of businesses owned by non-Kenyans and targeted for transfer to Kenyans by sale within a specified period were published periodically. Kenyans able to take over such businesses were provided with loan assistance by the Government. Therefore, the Kenyanisation policy saw a change in the ownership structure of various businesses. The previously foreign-dominated market saw an increased share of locally-controlled firms.

The Nairobi Securities Exchange was incorporated under the Companies Act of Kenya in 1991 as a company limited by guarantee and without a share capital. Prior to 1991, it was registered as a voluntary association of stockbrokers under the Societies Act in 1954. NSE is categorized into three market segments: Main Investment Market Segment (MIMS), Alternative Investment Market Segment (AIMS) and Fixed Income Market Segment (FIMS). The MIMS is the main quotation market. Companies listed under this segment are further categorized in four sectors that describe the nature of their business, namely: Agricultural; Industrial and allied; Finance and investment; and Commercial and

services. The AIMS: Provides an alternative method of raising capital to small, medium sized and young companies that find it difficult to meet the more stringent listing requirements of the MIMS; AIMS is geared towards responding to the changing needs of issuers; facilitates the liquidity of companies with a large shareholder base through 'introduction', that is, listing of existing shares for marketability and not for raising capital; and offers investment opportunities to institutional investors and individuals who want to diversify their portfolios and to have access to sectors of the economy that are experiencing growth.

## **1.2 Research Problem**

The demutualization trend has been that attributed to a number of reasons that include: improved governance, investor participation, competition, globalization and consolidation and unlocking stock exchange value. While demutualized stock exchanges continue to provide most of the same services, they have different governance structures in which outside shareholders are represented by boards of directors. The mutual association model functions well if an exchange is a provider of trading services with limited competition and the interests of members are homogeneous (Ngugi, 2003). Demutualization provides an opportunity to unlock the value of a stock exchange though the realization of the value would ultimately depend on the listing of the exchange. In the majority of exchanges, the value of the exchange is usually distributed to member brokers. Demutualization and listing provides an exit mechanism for former brokers to sell down equity thereby broadening the shareholder base and decoupling of broker interests from that of the exchange (Mensah, 2005).

The NSE has by a resolution voted to demutualise which is regarded as a panacea to all mutual exchange problems. This means that its membership, direction and management functions would be separate in terms of composition. The Roles of a stock exchange can be categorized into Regulatory, Commercial and Public Interest Role. There are numerous challenges facing stock exchanges in implementing an effective demutualization program. Ngugi (2003) observes that exchanges that simply view demutualization as a legal maneuver court disaster because the landscape for demutualized exchanges would be saturated within a short time and only the aggressive commercial and innovative demutualized exchanges would succeed. Accordingly, there are a whole range of issues that need to be considered in the demutualization process which includes: the objectives that the exchange hopes to achieve from demutualization and how far its management is prepared to commit to the achievement of the complete demutualization process; the infrastructure that needs to be in place to achieve the desired results; establishment of the appropriate corporate governance structure for an exchange; the mode for delivering stakeholder value and profitability, unlocking the hidden value within the organization before an IPO takes place i.e. pre-demutualization valuation, protection of the entity's brand in a post-demutualized environment, the stakeholder's awareness of what the demutualization process and its implications and achievement of the entity's business goals, and in particular the target earnings rates when regulators are setting moving targets.

Several studies have been done on demutualization of stock exchange. Schmiedal (2002) employed frontier efficiency methods in order to derive relative efficiency values of an

exchange, In this study, he employed two different methods of frontier analysis. While Schmiedel (2001) employed a parametric stochastic frontier model to evaluate the cost efficiency of European stock exchanges, he applies a non-parametric method in the second paper (Schmiedel, 2002). Schmiedel's findings on stock exchange governance are not clear, however. Schmiedel's (2001) which controls for demutualized exchanges within the regression, displays a positive impact of demutualization on cost efficiency, whereas his second paper indicates that the mean of productivity gains is higher for mutual exchanges. On an Africa scale, Mensah, (2005) did a study on demutualizing African Stock Exchanges where he investigated on the challenges and opportunities of demutualization and established that stock exchanges would perform better on demutualization due to improved corporate governance. In Kenya, Ngugi (2003) did a study on development of the Nairobi Stock Exchange from a historical Perspective. Kiruthi (2007) concludes that there is need for demutualization in the NSE to address structure weaknesses. From the above discussion, it was clear that there were limited studies if any that had reviewed the factors affecting the demutualization of the Nairobi Securities Exchange. This study therefore sought to fill this research gap by answering the following question: what are the factors affecting demutualization of the NSE?

### **1.3 Objective of the Study**

The general objective of this study was to determine factors affecting demutualization of the Nairobi Securities Exchange, with the following specific objectives:

- (i) To establish the extent to which the various factors affected demutualization of NSE.

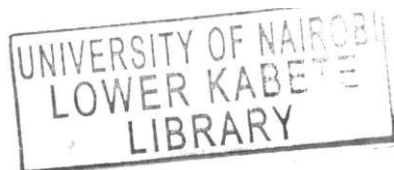
#### **1.4 Significance of the Study**

The research findings will be useful to various stakeholders, including:

The Governments of Kenya and East African countries and other interested stakeholders could use the findings of this research to work on a strategy aimed at ensuring that capital markets in Kenya and the greater East Africa region operate under acceptable and international capital markets standards that foster growth and expansion of the capital markets.

The Nairobi Securities Exchange had resolved to demutualise and there was universal agreement that demutualization of an exchange had a number of challenges. There was little information on potential conflicts of interest demutualization would usher at the NSE. This study could therefore provide the NSE with a clearer picture of the impact of demutualization on its operations and this knowledge could form a critical guidance tool in the restructuring and reorganization of the NSE.

Kenyan institutions of Higher Learning and those of its African counterparts seem to lack academic courses or educational programmes embedded on capital market studies. There was a general lack of specialized studies in stock markets yet there was universal consensus that capital markets played a critical role in economic development and transformation. There existed a relatively slim body of academic literature on stock markets and more particularly demutualization. This study could therefore provide a basis and blueprint for academic institutions to inculcate this crucial area of study in their curriculum.



# CHAPTER TWO

## LITERATURE REVIEW

### 2.1 Introduction

This chapter presented the literature review; specifically the literature review focused on the theoretical framework, empirical literature and chapter summary. The review of literature focused on the factors that affect demutualization of securities exchanges.

### 2.2 Theoretical Review

#### 2.2.1 Transaction Costs Theory

Literature on transaction costs provides an explanation of why firms exist. Pioneers in transaction costs theory argue that firms exist in order to reduce transaction costs and thus increase the volume of trade and economic value creation (Arwa, 2010). Arwa (2010) confirms that the early work of Coase (1937) explains that firms exist where it is profitable to establish them as there are costs to conducting transactions in the market.

The most obvious cost is discovering what the relevant prices are. There are also costs related to negotiating and concluding transactions for each transaction. The firm is a 'series of contracts' that reduces and economizes on transaction costs. The transaction costs theory explains the worldwide move towards demutualization. The new changes in today's competitive environment, that resulted from the introduction of new electronic systems have led to lower transactions costs of trading for investors, allowed for better price determination, and lowered the chance for market manipulation - that existed under the mutual structure of stock exchanges. The new advances in technology and globalization have also facilitated cross-border trading and over time the development of

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inter-market trading systems (ITS) (Claessens, et al., 2000). Therefore the shift towards demutualization of stock exchanges becomes a natural response to the new technological advances, where the mutual structure became less appealing and more costly for investors.

On the nature of transaction costs, Claessens, et al. (2000) also points out that the importance of transaction costs increases when transaction specific investments are involved. Transaction costs come when the market is characterized by asymmetric information, uncertainty and when there is a room for opportunistic behavior. This situation and behavior exists under the mutual structure, where members of the exchange enjoy such opportunistic behavior. In the past, without members of the exchange, investors had to search for prices and investment in legal skills in order to invest in the market. Such costs mean that only large amounts of transactions are paid to the members because these were the only transactions that were economically viable. Under the mutual ownership structure of stock exchanges, people have to pay members of the exchange because it is usually only these members that know more about the trading of the exchange have better knowledge of prices and have access to the services of the exchange. Such opportunistic behavior is not anymore justified under the new worldwide technological advances. Advances in telecommunications, and the growth of the Internet and wireless communication technologies are dramatically changing the structure and nature of financial services. Internet and related technologies have evolved as new different means for providing financial services (Claessens, et al., 2000).

### **2.2.2 Property Rights Theory**

Property rights explains why a particular form of ownership takes place in a given organization as it comes as a result of the bargaining strength of those affected. Decision makers in an organization usually want to adopt, or modify property rights to alleviate the harmful impact of economic losses of the common pool. According to Demsetz (1995), the need for new property rights reflects the need to include new market prices and production possibilities that cannot be attained under the old arrangement. Davis and North (1971) provide more clarification of this point by saying that; 'It is the possibility of profits that cannot be captured within the existing arrangement structure that leads to the formation of new institutional arrangements'. Orwa (2010), the ideas of Libecap (1989), North (1971) and Demsetz (1988) can be linked to the main reason of demutualization - as a new form of ownership; the previous mutual structures have failed to respond to the new advancement in technology and new changes in the global market. Investors want to have a new ownership structure that improve their exchange and as a result can provide them with higher yields.

Mahoney (2004) noted that 'the greater the size of anticipated aggregate economic benefits of institutional change, the more likely the new property rights would be sought and adopted'. Similarly North (1990) addressed an important question on why societies experience long-term stagnation or an absolute decline in economic well-being. Orwa (2010), North and Thomas (1973) considered institutions as the determinant of economic performance and relative price changes the main reason that accounts for institutional change. As North and Thomas (1973) explained, changes in relative prices provide an

incentive to create more efficient institutions (Mahoney, 2004). These arguments can be related to the trend on demutualization. The remarkable change in the ownership and organizational structure of the demutualized stock exchanges was mainly motivated by some intense global competition and advances in technology.

Decisions to demutualize usually happens when the old member-owned organizational structure fails to provide the flexibility and finance needed to improve the stock exchange, which in turn affect the profit-seeking investors and might drive them to seek other stock exchanges. Mendiola and O'Hara (2004) pointed out that updating trading platforms is capital intensive and this need had required many large and small stock exchanges to look for ways of finance such investments. Also, the lack of liquidity problem had posed a threat on smaller businesses to go out of business. It was seen that the demutualization program and listing can allow the stock exchange to raise capital by selling shares in the public market and can also motivate the management of the exchange to seek more business initiatives. The ability to raise capital IPO private investment and the increased responsibility to stakeholders were viewed as convenient ways to respond to the global competitive pressures as it allows for the resources and incentives needed for investment in competitive products and information systems (Hughes and Zargar, 2006).

The property rights theory also helps to understand another question: Can members of the exchange under the mutual structure protect their economic rights? Brazel (1989) argues that; 'legal rights are neither necessary nor sufficient for the existence of the economic

rights'. Barzel (1989) looks at the concept of property rights to be closely related to the concept of transaction costs. He defined the transactions costs as those costs that are associated with the transfer, capture, and protection of rights. Because transacting is costly, property rights are never delineated (Mahoney, 2004). Under the mutual governance structure and with the arise of competition, ECNs and changes in the global market, the member (broker) - investor relationship cannot be guaranteed, For the investor, the transactions costs are more costly in his home exchange or is cheaper elsewhere. Unless members can guarantee that investors would deal with them, there is no guarantee of income.

### **2.2.3 Agency Theory**

Agency relationship is very important to the study of corporate governance in strategic management (Rediker and Seth, 1995). The theory was used by scholars in accounting, economics, finance, marketing, organizational behavior, and sociology (Arwa, 2010). The agency theory ideas on risk, outcome uncertainty, incentives, and information systems are novel contributions to organizational thinking, and the empirical evidence is supportive of the theory, particularly when coupled with complementary theoretical perspectives. The theory views the agency relationship, in which one party (the principal) delegates work to another party (the agent), who performs that work. This involves delegating some decision making authority to the agent. The agency theory describes this relationship between the two parties through the metaphor of a contract (Jensen and Meckling, 1976).

The principle concern for the agency relationship is to solve two main problems. First, the agency problem that takes place when there is a conflict between the goals of the principal and those of the agent, and when it is hard or costly for the principal to monitor the agent in order to prove whether or not the agent is working in an appropriate manner. Second is the problem of risk sharing which occurs when the principal and agent have different approaches toward risk; actions of the principal and agent may differ because of their different risk preferences (Eisenhart, 1989).

### **2.3 Factors Affecting Demutualization**

There are different and continuous discussions in research about the forms of stock exchange ownership, its efficiency and effects although in general the most often used perspective in analysis are the social welfare (Hart and Moore, 1996). In their paper they discussed the competition conditions needed in order to make a stock exchange to change its organizational structure from mutual to an outsider- owned, showing that a for-profit exchange increases social welfare. Their pricing models show that, when there is a relatively high competition level, an outsider- owned structure is more socially preferable than a mutual structure.

#### **2.3.1 Ownership Structure**

Traditionally, the stock exchange was primarily a physical location for trade where trade was conducted in person and multiple securities were traded at the same location to maximize liquidity (Homem, 2009). The core operations were strictly related to listing and membership fees, transactions, clearing and settlement services, and data

dissemination. In the last two decades financial markets and financial institutions have undergone a process of radical readjustment spurred on by changing regulatory environments, technological innovation and the globalization of financial system (Keneley and Verhoef, 2008). As the global economy evolved, the trade volumes experienced in exchanges were increasing at astonishing rates. Furthermore, the limited access to the trading floor resulting from space constraints enabled the members to impel higher brokerage commissions to the exchange users and a privileged view of the trading flow. This gave the stock exchange members market power and, consequently, they were able to extract monopoly rents from the venue. As a result of this phenomenon, more and more traders wanted to join the trading floor, but, in the majority of cases this was not possible, due to the high initial and annual fees to access the trading floor (Steil, 2002a).

It is widely acknowledged that the greater the number of traders, the better the price discovery; which in turn motivated more brokers to join the trading venue (Lee, 1998). Demutualization is a process by which such a member customer-owned cooperative or mutual organization is transformed into a shareholder-owned company raising capital with shares issued and providing services to customers as well as returns to shareholders. Demutualization is about changing the ownership structure of the stock exchange; from a mutual association with one vote per member and possibly consensus-based decision making, into a company limited by shares, with one vote per share (with majority-based decision making) (Aggarwal, 2002). In the business world, a change in the ownership structure usually reflects a change in the assets and the strategy adopted by the firm to

respond to certain changes in the business environment such as, the globalization, the rise of global competition and technological advances.

Ramos (2006), states that demutualization separates trading and ownership rights, diversifying the exchanges' shareholder base. The outcome of this structure change for the venue itself is extremely beneficial, due to the fact that it increases trading volume and order flow. As a result, the profits of the exchange also increase. On the other hand, the members of the traditional mutual structure loses out immensely. Firstly, as they try to resist demutualization, their revenues are continuously eroded as a result of a more contestable market, where a monopoly can no longer enjoy its advantageous position due to the threats of competition (Aggarwal, 2002). Secondly, with demutualization, members of the traditional exchanges also witness a loss of benefits: their power inside the exchange diminished as a result of the increasing foreign members and, later on, with the new outside members, whose fraction of capital gradually increased, diluting the power of the predecessor members.

Krishnamurti, Sequeira and Fangjian (2003) provide an empirical contribution for the area of stock exchange ownership forms by comparing the market quality of National Stock Exchange, a demutualized exchange, with that of the mutually owned Bombay Stock Exchange. One important and interesting aspect in analyzing demutualization is the impact of demutualization on stock exchange operating performance. Domowitz and Steil (1999) in their work analyzed the impact of introducing automated systems on trading costs and organizational structure of stock exchange. The paper by Mendiola and O'Hara

(2003) analyzes the share price performance of publicly listed exchanges after their IPO. From their findings and results, it was very difficult to measure the difference or just to compare the performance of for-profit stock exchanges and mutual stock exchanges because of the insufficient share price information for mutual exchanges. Also it was difficult to say anything about the performance of a for-profit stock exchange prior to its public listing just as the paper of Aggarwal (2006), which employs different accounting profitability measures as indicators for operating.

### **2.3.2 Demutualization and Corporate Governance**

Today, stock exchanges are no longer structured as cooperative venues due to a variety of reasons, such as competitive pressures. Instead, today, trading venues are for-profit enterprises, whose capital is detained by external ownership. This new structure is a result of demutualization. Demutualization consists of the introduction of a residual claimant into the exchange which maximizes the venues' value. Furthermore, demutualization is aligned with a structure change, which brings into the exchange a governing board and a separation of ownership and membership rights (Mensah, 2005).

In a mutual exchange, the main problem is the balance between members/owners' interest with that of the investors. Just as stock exchanges become more and more sophisticated, the interests of various member groups began to diverge. This has led to tremendous tensions in the governance and decision making of stock exchanges. In a way, demutualization can be perceived as a solution of conflict of interest by segregating the ownership from the membership and trading rights thus allowing a proper running of the stock exchanges' management. Also by transforming itself into a for-profit investor



owned organization, the managers of the stock exchange are able now to focus on a single group, its owners (Cospormac, 2009). This simplification of governance structure allows for faster decision making. The performance improvement could be explained by the fact that self-listing is a perfect opportunity for managers of the stock exchange to accept profitable projects that they would have not taken under the mutual structure.

Exchanges, when run as mutual associations, clubs and cooperatives of traders and brokers allow members exclusive rights of access to trading systems and platforms. Operating under this mutual structure, exchanges enjoy quasi or full monopoly on trading and they derive profits from the intermediation of nonmember transactions (Ramos, 2006). Since members under the mutual structure were owners of the exchange, they imposed rights to trading and disallowed direct access to the trading floor to any outsiders. Brokers inadvertently resisted changes if these entailed additional costs, loss of revenue or competitive threat. This resistance eventually impeded the ability of the company to react quickly to a rapidly changing market environment. Also, in some developing countries, if the exchanges enjoyed a legal or decreed national monopoly, government-appointed officials and stakeholder representatives were often represented on the board. While in the short-run such appointments may have proved conducive to mitigating entrenched vested interests, in the long-run these can prove counterproductive leading to unhealthy government interference (Chesini, 2001).

With the changing economics of automated auction trading and its easy access electronically, the economics of member-cum-trading floor based exchanges has lost its merit. As a result, it has generated pressures to replace the age-old reliance on one

member, one vote and the committee-based decision structure where control is vested with the interest groups that have exclusive rights of intermediation at exchange (Mensah, 2005). Under demutualization, there is increased acceptance to separation of ownership from membership that automatically provides trading rights. This segregation helps introduce effective corporate governance if: there are accompanying improvements in the incentive structure, which allow the exchanges to sell their equity stakes to nonmembers and outsiders, decision making is based on this new ownership structure (not on rights of intermediation), and when there is an effective oversight of a governing board and a company structure.

Since under demutualization the economic ownership of the exchange is separated from trading membership, it is not appropriate that interest groups (such as the trading members) have exclusive authority over the decisions of exchange. After demutualization, some exchanges have granted less than 50% of the voting rights to the broker members on the board of the exchange. To gradually decrease broker influence on the board, the exchanges have appointed independent directors or directors that are non trading owners (Keneley and Verhoef, 2008).

After demutualization, the appointment of government appointed officials (a common feature of exchanges in developing economies) has by and large been viewed as controversial given that the demutualized exchange is a private sector company operating in a competitive environment. In environments where broker influences are often daunting, the continued role of the representative(s) of the securities regulator can

support the transition of exchange till such time as the regulation is changed to allow the exchanges to operate in a fully competitive manner. Besides appropriate board representation, it is important that the management of the exchange is fully qualified and motivated to act not only in the best interests of the shareholders, but also to conduct the business in a prudent manner so as not to disrupt the orderly and fair trading in the capital markets. To ensure that this public interest is satisfied, "fit-and-proper" screening of the board and management, similar to tests put in place in the banking regulations of many jurisdictions, could be undertaken (Mensah, 2005).

The management should be accountable to the board, which would determine management's appointment and remuneration, supervise the strategic direction and audit the financial and operational results, including risk management, and if needed, effect the removal of management (Keneley and Verhoef, 2008). To ensure the effective supervision and auditing of management, it would seem prudent to ensure that a majority of board members are truly independent directors. To remain competitive, a stock exchange must follow international best practices in ethics and procedures. This is necessary in order to ensure that institutional investors do not shift their investments to other alternatives perceived to be more fair or secure. Therefore, it is in the profit-motivated exchange's best interest to ensure fair and transparent practices; and, as such, good corporate governance needs to be an integral part of the exchange once it is driven by the profit motive (Shariful and Mohammad, 2011).

### **2.3.3 Government Policy and Regulatory Framework**

Demutualization raises many questions about the regulation of stock exchanges: what role should government play in regulating private stock exchanges; what role should private stock exchanges play in regulating exchange activities and members; and stock exchanges usually operate as self-regulatory organizations (Mensah, 2005). The self-regulatory functions usually consist of: Trading which involves setting rules for trading, conducting surveillance and enforcing the rules; market manipulation: overseeing the trading system to avoid abuses; membership: Establishing rules to govern the conduct of members and monitoring compliance with and enforcement of rules (Mensah, 2005).

Demutualization of stock exchanges leads to a legal status of the stock exchanges being changed from company limited by guarantee to a public company limited by shares. In addition, the majority ownership may be segregated from the right to trade on the stock exchange as shareholdings of the stock exchanges were before the demutualization process (Hughes and Zargar, 2006). Another issue that is raised by demutualization is whether attempts to maximize profits will undermine self regulation. New regulatory models are emerging in the wake of the demutualization movement: a demutualized exchange continues to perform all of its regulatory functions even after demutualization. Concerns have been raised as to whether a demutualized exchange will take enforcement actions and impose penalties on those who are major providers of revenue; for-profit exchanges can establish a separate entity to conduct regulatory functions, thereby avoiding conflict-of-interest issues (Mensah, 2005).

Elliot (2002) and Karmel (2000) devoted themselves in studying the effect of regulatory issues after the demutualization process, because after demutualization, stock exchanges are regulating their trading markets by themselves. As a result of demutualization, there is a collision between the interests of a for-profit exchange and the fair conduct of trading. The securities market regulation is critical to ensure efficiency, integrity and fairness of the markets that together lend credibility to markets and safeguard investor interest and confidence. To achieve this, the regulators have to perform adequate oversight of exchanges in order to deal with: the conflict of interest between owners of exchange and the business they offer, rules governing primary and secondary market trading, qualification, operative and ethical practices of market participants in particular brokers and dealers, investor protection, and transparency of market transactions, among others (Pirrong, 2000).

#### **2.4 Empirical Review**

Treptow (2006) presented a detailed analysis on the consequences of demutualization of securities exchange on liquidity. In order to capture the demutualization impact on liquidity, Treptow (2006) examined securities that are listed on two markets simultaneously. He used a quasi-experimental framework, as all securities are listed in primary markets that demutualized during the study period. All securities share the NYSE (which was not yet demutualized at the time of conducting the study), as a common second trading venue. The data consists of various liquidity measures for 156 dually listed equity issues on the New York Stock Exchange and 12 non-U.S. exchanges, and spans across a ten-year period. Treptow (2006) found out that demutualization brings

significant beneficial effects on demutualizing exchange's liquidity. In comparison to pre demutualization levels, turnover and resiliency increase, while spreads tighten. He also concluded that the liquidity gap between a demutualized and an undemutualized exchange increases due to the transformation.

Krishnamurti, Sequeira & Fangjian (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. 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 Hasbrouck (1993)<sup>1</sup> measure of market quality, they show that NSE provides a better market quality than BSE.

Serifsoy (2005) also conducted an efficiency analysis that focuses on the exchange governance and uses more recent data than that used by Schmiedel. Similar to Schmiedel (2002), he also employed a non-parametric approach to calculate relative efficiency scores. Serifsoy (2005) calculates in a first step individual efficiency and productivity values via the Data Envelopment Analysis (DEA). In a second step, Serifsoy (2005) regresses the derived values against variables that form the institutional arrangement of the exchanges in order to determine efficiency and productivity differences between

mutual, demutualized but customer owned exchanges and publicly listed exchanges. This step allows understanding whether there is a significant impact of different governance structures on the impact on the performance of stock exchanges. Serifsoy (2005) concludes that demutualized exchanges exhibit higher technical efficiency than mutual ones. However, demutualized exchanges perform relatively poor as far as productivity growth is concerned. There is no evidence that publicly listed exchanges achieves higher efficiency and productivity values than demutualized exchanges with a customer-dominated structure (Serifsoy, 2005).

## **2.5 Chapter Summary**

From the literature review it can be observed the factors affecting the demutualization of the NSE include: Ownership structure, corporate governance and government policy and regulations. The NSE has by a resolution voted to demutualise which is regarded as a panacea to all mutual exchange problems. This means that its membership, direction and management functions would be separate in terms of composition. The Roles of a stock exchange can be categorized into Regulatory, Commercial and Public Interest Role. There are numerous challenges facing stock exchanges in implementing an effective demutualization program. Ngugi (2003) observes that security exchanges simply view demutualization as a legal maneuver court disaster because the landscape for demutualized exchanges would be saturated within a short time and only the aggressive commercial and innovative demutualized exchanges would succeed. Kiruthi (2007) concludes that there is need for demutualization in the NSE to address structure

weaknesses and promote corporate governance. From the preceding literature, it is clear that a few issues remain unresolved as regards the demutualization of NSE.

From the literature reviewed, the existing literature has been done in different settings like the London Stock exchange and Africa in general. Mensah (2005) concentrated on demutualizing African Stock Exchanges: Challenges and Opportunities. While Homem (2009) studied corporate governance: demutualization of stock exchanges; an analysis of its benefits. From the above literature, it is evident that Nairobi Securities Exchange is unique and has not been studied in depth especially as to why it has not demutualized despite the declaration by the government of Kenya of the intention to demutualize it by September 2011. However, the position still remains by the time of this study (2012). Therefore this study seeks to fill this research gap by establishing the factors affecting the demutualization of Nairobi Securities Exchange.



## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter set to review the research methods that were used to explore the factors affecting the demutualization of the NSE. The chapter provided a description of the research design, the target population, data collection methods and data analysis.

#### **3.2 Research Design**

Research design is the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure (Kothari, 2004). The study adopted a descriptive research design. According to Cooper and Schindler (2003), a descriptive research design is concerned with finding out the what, where and how of a phenomenon. This study sought to find out the factors affecting demutualization of the Nairobi Securities Exchange.

#### **3.3 Target Population**

Mugenda and Mugenda (2003) define population as the entire group of individual's, events or objects having a common observable characteristic. Mugenda and Mugenda (2003) further defines target population as that population the researcher studies, and whose findings are used to generalize to the entire population. The target population of this study comprised all 25 stakeholders at the NSE. This included: Capital Markets Authority (CMA), Central Depository Systems (CDS), Stock Brokerage firms, and mutual companies. One questionnaire was administered to each organization.

**Table 3.1: Target Population**

<b>Organization Group</b>	<b>Number of Firms</b>
Nairobi Stock Exchange	1
Central Depository System	1
Capital Markets Authority	1
Stock Brokerage firms	12
Underwriters	4
Fund management companies	6
<b>Total</b>	<b>25</b>

**Source: Author,2012**

### **3.4 Data Collection Methods**

The study used primary data. Primary data was collected by use of a semi structured questionnaires. The questionnaire made use of both open and closed ended questions. A five point likert scale was used where respondents were required to fill in the level of their agreement with the various statements under each variable. The questionnaires were administered to respondents in person to ensure a high response rate.

### **3.5 Data Analysis**

Before processing the responses, data preparation was done on the completed questionnaires by editing, coding, entering and cleaning the data. Data collected was analyzed using descriptive statistics. The descriptive statistical tools helped in describing the data and determining the respondents' degree of agreement with the various

statements under each factor. Data analysis was done using SPSS and Microsoft Excel to generate quantitative reports which was presented in the form of tabulations, percentages, mean and standard deviation.

Equally, multiple regression analysis between different variables related to demutualization of the NSE was conducted. According to Mugenda and Mugenda (1999), multiple regression analysis attempted to determine whether a group of variables together predict a given dependent variable. The model was as follows:

$$Y = a + b_1X_1 + b_2 X_2 + b_3X_3 + e$$

Where Y = Demutualization of NSE

a = constant

b<sub>1</sub>, b<sub>2</sub>, b<sub>3</sub>, and b<sub>4</sub> are co-efficient associated with X<sub>1</sub>, X<sub>2</sub>, X<sub>3</sub>, and X<sub>4</sub> respectively.

X<sub>1</sub> = Ownership Structure

X<sub>2</sub> = Corporate Governance

X<sub>3</sub> = Government Policies and regulations

e - the error term

## CHAPTER FOUR

### DATA ANALYSIS, PRESENTATION AND INTERPRETATION

#### 4.1 Introduction

This chapter presents analysis and findings of the study as set out in the research objective and research methodology. The study findings are presented on factors affecting demutualization of the Nairobi Securities Exchange.

##### 4.1.1 Response Rate

The study targeted 25 respondents who included: Capital Markets Authority (CMA), Central Depository Systems (CDS), Stock Brokerage firms, fund management companies and underwriters. From the study, 18 out of 25 target respondents filled in and returned the questionnaire giving a response rate of 72%. This commendable response rate was made a reality after the researcher made personal calls and visits to remind the respondent to fill-in and return the questionnaires. This response rate was excellent and representative and conforms to Mugenda and Mugenda (1999) stipulation that a response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent.

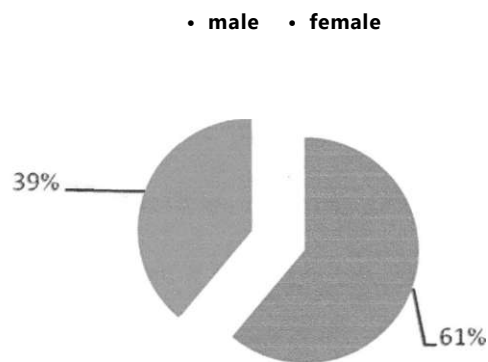
**Table 4.2: Response Rate**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Responses	18	72
Non-responses	7	28
<b>Total</b>	<b>25</b>	<b>100</b>

Source: Research Data, 2012

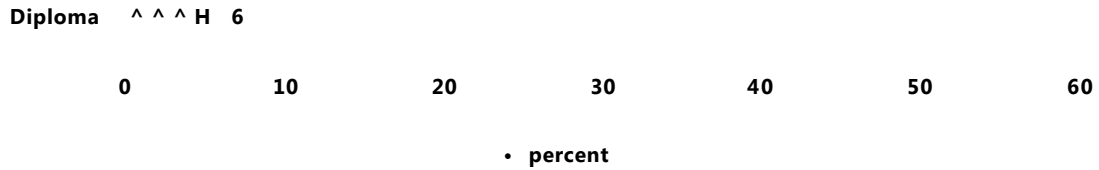
## 4.2 Demographic Information

The study sought to establish the gender distribution of the respondents. From the findings in figure 4.1 below, 61% of the respondents were male while 39% were female. This tallies with the gender distribution in most companies where there are more men in leadership position than women. In most of the organizations where data was collected, it was a male manager who served as the Chief executive officer.



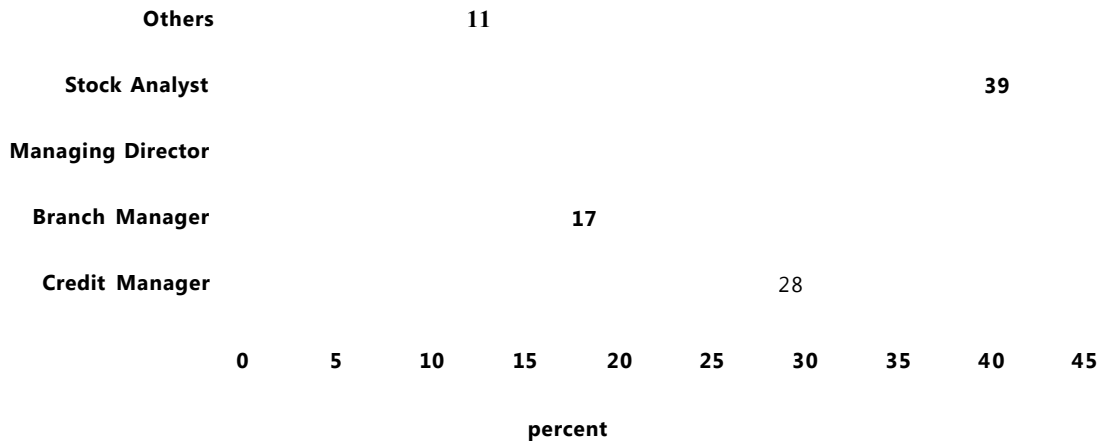
**Figure 4.1: Gender of the Respondents**

On the respondents' level of education, the study established that most of the respondents had masters' degree at 50% followed by those with undergraduate degrees at 22%; the respondents who had PhD and other qualifications were 11% each while those with diplomas were 6% as shown in figure 4.2 below.



**Figure 4.2: Level of Education**

The study further sought to determine the respondents' current designation within the organization. According to the findings, majority (39%) of the respondents were stock analyst, 28% were credit managers, 17% were branch managers whereas 11% and 6% were others and managing directors respectively as illustrated in figure 4.3 below.



**Figure 4.3: Designation of the Respondents**

The study also sought to establish the period the respondents had been in the securities industry. From the findings in figure 4.4 below, 39% of the respondents had been in the securities industry for a period of 6-10 years followed by 28% who had been in the securities industry for a period of 11-15 years and 17% who had been in the securities industry for a period of 16-20 years while 11% and 6% had been in the securities industry for a period of 1 -5 years and above 21 years.



**Figure 4.4: Period in the Securities Industry**

### **4.3 Ownership Structure**

On whether ownership structure of an organization affected demutualization of NSE, the study found that all respondents agreed that ownership structure affected demutualization of NSE as shown in table 4.3 below. The stock Exchange is currently owned by stockbrokers on a mutual basis. The current owners felt that the demutualization would see the Nairobi Securities Exchange restructure ownership, in a move aimed at loosening the grip of stockbrokers.

**Table 4.3: Ownership Structure**

	Frequency	Percent
Yes	18	100
No	0	0
Total	18	100

Source: Research Data, 2012

The study further required the respondents to indicate the extent to which they agreed with aspects about organizational ownership structure and how they affect demutualization in the NSE. According to the findings, the respondents agreed that demutualization changed the ownership structure of the stock exchange as shown by a mean of 4.2802 and std. deviation of 0.684; demutualization diversified the exchanges' shareholder base at a mean of 4.2391 and std. deviation of 0.467; demutualization separated trading and ownership rights as indicated by a mean of 4.3750 and std. deviation of 0.593; and a change in the ownership structure usually reflected a change in the assets and the strategy adopted by the firm to respond to certain changes in the business environment as shown by a mean of 4.3468 and std. deviation of 0.536. (See table 4.4 below). According to Aggarwal (2002) Demutualization is about changing the ownership structure of the stock exchange; from a mutual association with one vote per member and possibly consensus-based decision making, into a company limited by shares, with one vote per share (with majority-based decision making). In the business world, a change in the ownership structure usually reflects a change in the assets and the strategy adopted by the firm to respond to certain changes in the business environment



such as, the globalization, the rise of global competition and technological advances. Ramos (2006), states that demutualization separates trading and ownership rights, diversifying the exchanges' shareholder base. The outcome of this structure change for the venue itself is extremely beneficial, due to the fact that it increases trading volume and order flow. Krishnamurti, Sequeira and Fangjian (2003) provide an empirical contribution for the area of stock exchange ownership forms by comparing the market quality of National Stock Exchange, a demutualized exchange, with that of the mutually owned Bombay Stock Exchange.

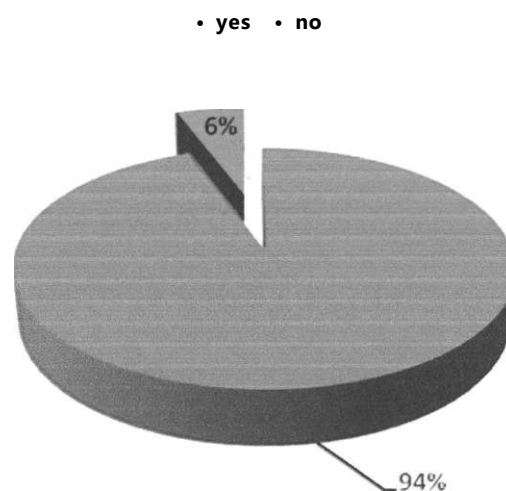
**Table 4.4: Aspects of Ownership Structure**

<b>Aspects of ownership structure</b>	<b>Mean</b>	<b>Standard deviation</b>
Demutualization changes the ownership structure of the stock exchange	4.2802	0.684
Demutualization diversifies the exchanges' shareholder base	4.2391	0.467
Demutualization separates trading and ownership rights	4.3750	0.593
A change in the ownership structure usually reflects a change in the assets and the strategy adopted by the firm to respond to certain changes in the business environment	4.3468	0.536

Source: Research Data, 2012

#### 4.4 Government Policy and Regulatory Framework

On whether demutualization was affected by government policy and regulatory framework, the study found that most (94%) of the respondents agreed demutualization was affected by government policy and regulatory framework while 6% disagreed as indicated in figure 4.5 below. This is because of the key role that the government plays in safeguarding investors' interests and ensuring that the confidence is not lost.



**Figure 4.5: Government Policy and Regulatory Framework**

The study also required the respondents to indicate their level of agreement on statements about government policy and regulatory framework. According to the findings in table 4.5 below, the respondents agreed to a very great extent that the securities market regulation was critical to ensure efficiency, integrity and fairness of the markets that together lend credibility to markets and safeguard investor interest and confidence at a mean of 4.6271 and std. deviation of 0.497; It curbed the conflict of interest between owners of exchange and the business they offered as shown by a mean of 4.5463 and std.

deviation of 0.574; It set the rules governing primary and secondary market trading as indicated by a mean of 4.5329 and std. deviation of 0.539; It defined the qualification of organizations to participate in demutualization at a mean of 4.5468 and std. deviation of 0.498; it guided the operative and ethical practices of market participants in particular brokers and dealers as shown by a mean of 4.5905 and std. deviation of 0.588; and it ensures investor protection, and transparency of market transactions as shown by a mean of 4.6197 and std. deviation of 0.499. Demutualization of stock exchanges leads to a legal status of the stock exchanges being changed from company limited by guarantee to a public company limited by shares. In addition, the majority ownership may be segregated from the right to trade on the stock exchange as shareholdings of the stock exchanges were before the demutualization process (Hughes and Zargar, 2006). Elliot (2002) and Karmel (2000) devoted themselves in studying the effect of regulatory issues after the demutualization process, because after demutualization, stock exchanges are regulating their trading markets by themselves. As a result of demutualization, there is a collision between the interests of a for-profit exchange and the fair conduct of trading. The securities market regulation is critical to ensure efficiency, integrity and fairness of the markets that together lend credibility to markets and safeguard investor interest and confidence. To achieve this, the regulators have to perform adequate oversight of exchanges in order to deal with: the conflict of interest between owners of exchange and the business they offer, rules governing primary and secondary market trading, qualification, operative and ethical practices of market participants in particular brokers and dealers, investor protection, and transparency of market transactions, among others (Pirrong, 2000).

**Table 4.5: Statements about Government Policy and Regulatory Framework**

<b>Government policy and regulation</b>	<b>Mean</b>	<b>Standard deviation</b>
The securities market regulation is critical to ensure efficiency, integrity and fairness of the markets that together lend credibility to markets and safeguard investor interest and confidence	4.6271	0.497
It curbs the conflict of interest between owners of exchange and the business they offer	4.5463	0.574
It sets the rules governing primary and secondary market trading	4.5329	0.539
It defines the qualification of organizations to participate in Demutualization	4.5468	0.498
Guides the operative and ethical practices of market participants in particular brokers and dealers	4.5905	0.588
Ensures investor protection, and transparency of market transactions	4.6197	0.499

Source: Research Data, 2012

On the extent the respondents agreed with challenges facing Kenyan Government policy and regulation framework. The study found that the respondents strongly agreed that the existing situation failed to agree with the basic requirement that regulatory provisions should be simple and flexible as shown by a mean of 4.5945 and std. deviation of 0.567; compliance with such a diverse set of regulatory provisions might lead to increased costs of compliance because of the possibility that the requirements might be in conflict with

one another at a mean of 4.4831 and std. deviation of 0.538; and issues of compliance were necessarily complicated because each of the individual regulators had specific regulatory goals as shown by a mean of 4.5871 and std. deviation of 0.553 (see table 4.6 below).

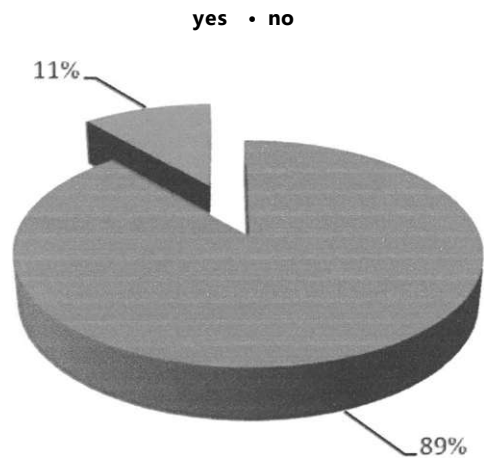
**Table 4.6: Challenges facing Kenyan government policy and regulation framework**

<b>Challenges</b>	<b>Mean</b>	<b>Standard deviation</b>
The existing situation fails to agree with the basic requirement that regulatory provisions should be simple and flexible	4.5945	0.567
Compliance with such a diverse set of regulatory provisions may lead to increased costs of compliance because of the possibility that the requirements may be in conflict with one another	4.4831	0.538
Issues of compliance are necessarily complicated because each of the individual regulators has specific regulatory goals	4.5871	0.553

Source: Research Data, 2012

#### **4.5 Corporate Governance**

On whether corporate governance affected demutualization in the NSE, the study established most of the respondents agreed that corporate governance affected demutualization in the NSE at 89% while 11% disagreed as illustrated in figure 4.6n below.



**Figure 4.6: Corporate Governance**

In addition, the study required the respondents to rate their level of agreement on aspects of corporate governance. From the findings, the respondents strongly agreed that demutualization, a change in the corporate governance structure of an exchange, was not an end in itself at a mean of 4.5678 and std. deviation of 0.576; Exchanges, when run as mutual associations, clubs and cooperatives of traders and brokers allowed members exclusive rights of access to trading systems and platforms as shown by a mean of 4.5426 and std. deviation of 0.549; and it was in the profit-motivated exchange's best interest to ensure fair and transparent practices and, as such, good corporate governance needed to be an integral part of the exchange once it was driven by the profit motive as shown by a mean of 4.6258 and std. deviation of 0.586. Similarly, they agreed that demutualized stock exchanges would continue to provide most of the same services; they would have different governance structures in which outside shareholders are represented by boards of directors at a mean of 4.4834 and std. deviation of 0.498; and under demutualization,

there was increased acceptance to separation of ownership from membership that automatically provided trading rights as shown by a mean of 4.4839 and std. deviation of 0.498 (see table 4.7 below).

**Table 4.7: Aspects of Corporate Governance**

<b>Corporate governance</b>	<b>Mean</b>	<b>Standard deviation</b>
Demutualized stock exchanges would continue to provide most of the same services, they would have different governance structures in which outside shareholders are represented by boards of directors	4.4834	0.498
Demutualization, a change in the corporate governance structure of an exchange, is not an end in itself	4.5678	0.576
Exchanges, when run as mutual associations, clubs and cooperatives of traders and brokers allow members exclusive rights of access to trading systems and platforms	4.5426	0.549
Under demutualization, there is increased acceptance to separation of ownership from membership that automatically provides trading rights	4.4839	0.498
It is in the profit-motivated exchange's best interest to ensure fair and transparent practices and, as such, good corporate governance needs to be an integral part of the exchange once it is driven by the profit motive	4.6258	0.586

Source: Research Data, 2012

#### 4.6 Regression Analysis

The researcher conducted a multiple regression analysis so as to test relationship among variables (independent). The researcher applied the statistical package for social sciences (SPSS) to code, enter and compute the measurements of the multiple regressions for the study.

**Table 4.8: Model Summary**

Model	R	R Square	Adjusted Square	R	Std. Error of the Estimate
1	0.8998	0.80964	0.286		0.65323

Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (demutualization of NSE) that is explained by all the three independent variables (government policy and regulatory framework, ownership structure and corporate governance).

The four independent variables that were studied, explain only 81.0% of the factors affecting demutualization of the Nairobi Securities Exchange as represented by the R . This means that other factors not studied in this research contribute 19.0% of the factors



affecting demutualization of the Nairobi Securities Exchange and therefore, further research should be conducted to investigate the other factors (19.0%) that affect demutualization of the Nairobi Securities Exchange.

**Table 4.9: Coefficient of determination**

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.394	0.300		5.264	.371
	Ownership structure	0.565	0.061	0.390	3.123	0.028
	Government policy and regulatory framework	0.549	0.082	0.346	2.484	0.035
	Corporate governance	0.536	0.096	0.005	2.752	0.047

As per the SPSS generated table above, the equation ( $Y = p_0 + p_1X_1 + p_2X_2 + p_3X_3 + e$ ) becomes:

$$Y = 2.394 + 0.565X_1 + 0.549X_2 + 0.536X_3 + e$$

The regression equation above show that taking all factors into account (government policy and regulatory framework, ownership structure and corporate governance) constant at zero, demutualization will be 2.394. The findings presented also shows that taking all other independent variables at zero, a unit increase in ownership structure will lead to a 0.565 increase in demutualization; a unit increase in government policy and regulatory framework will lead to a 0.549 increase in demutualization; and a unit increase

in corporate governance will lead to a 0.536 increase in demutualization. This depicts that ownership structure contributes most to demutualization followed by government policy and regulatory framework. At 5% level of significance and 95% level of confidence, ownership structure had 0.028 level of significance; government policy and regulatory framework showed a 0.035 level of significance, and corporate governance showed a 0.047 level of significance hence the most significant factor is ownership structure.

## **CHAPTER FIVE**

### **SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS**

#### **5.1 Introduction**

This chapter discusses the overall findings with the aim of answering the research questions. The chapter also presents conclusions and recommendations from the current study based on the objective of the study and recommends future possible studies.

#### **5.2 Summary of the Findings**

On the ownership structure, the study found that all respondents agreed that ownership structure affected demutualization of NSE. They felt that the demutualization would see the Nairobi Securities Exchange restructure ownership, in a move aimed at loosening the grip of stockbrokers. The study further established that the respondents agreed demutualization changed the ownership structure of the stock exchange; demutualization diversified the exchanges' shareholder base; demutualization separated trading and ownership rights; and a change in the ownership structure usually reflected a change in the assets and the strategy adopted by the firm to respond to certain changes in the business environment.

On government policy and regulatory framework, the study found that most (94%) of the respondents agreed demutualization was affected by government policy and regulatory framework. The study also found that the respondents agreed to a very great extent that the securities market regulation was critical to ensure efficiency, integrity and fairness of the markets that together lend credibility to markets and safeguard investor interest and

confidence; it curbed the conflict of interest between owners of exchange and the business they offered; it set the rules governing primary and secondary market trading; it defined the qualification of organizations to participate in demutualization; it guided the operative and ethical practices of market participants in particular brokers and dealers; and it ensures investor protection, and transparency of market transactions. The study further established that the respondents strongly agreed that the existing situation failed to agree with the basic requirement that regulatory provisions should be simple and flexible; compliance with such a diverse set of regulatory provisions might lead to increased costs of compliance because of the possibility that the requirements might be in conflict with one another; and issues of compliance were necessarily complicated because each of the individual regulators had specific regulatory goals.

On corporate governance, the study established most of the respondents agreed that corporate governance affected demutualization in the NSE at 89%. In addition, the study found that the respondents strongly agreed that demutualization, a change in the corporate governance structure of an exchange, was not an end in itself; exchanges, when run as mutual associations, clubs and cooperatives of traders and brokers allowed members exclusive rights of access to trading systems and platforms; and it was in the profit-motivated exchange's best interest to ensure fair and transparent practices and, as such, good corporate governance needed to be an integral part of the exchange once it was driven by the profit motive. Similarly, they agreed that demutualized stock exchanges would continue to provide most of the same services; they would have different governance structures in which outside shareholders are represented by boards

of directors; and under demutualization, there was increased acceptance to separation of ownership from membership that automatically provided trading rights.

### **5.3 Conclusions**

This study concludes that the demutualization of the Nairobi Securities Exchange is mainly affected by the ownership structure, government policy and regulatory framework, and corporate governance. On the effect of ownership structure to demutualization in the NSE, the study concludes that ownership structure determines demutualization as the current owners felt that demutualization would see the NSE ownership restructured, in a move aimed at loosening the grip of stockbrokers.

This study also concludes that government policy and regulatory framework affects demutualization of the NSE as the government is involved in ensuring that the consumers, investors and all the players in the Stock market are protected from exploitation and unfair treatment. The study further concludes that corporate governance affects demutualization of the stock market, the study concludes that profit-motivated exchange's have the best interest to ensure fair and transparent practices and, as such, good corporate governance needs to be an integral part of the exchange.

### **5.4 Recommendations**

For demutualization to materialize at NSE, the study recommends that the current owners who include the stockbrokerage firms should commit to relinquish some of the ownership to the government and to the general public so that the stock exchange can be listed to

trade like any other company. Unless these current owners are committed to ceding some of their ownership in favor of the Government and the Public, the demutualization of the NSE would not be achieved.

The government and a regulator also need to stand its ground and pass laws favoring the demutualization process. To ensure successful demutualization, the Government should work in collaboration with other stakeholders to ensure there is no resistance to the whole process of demutualization. A demutualized exchange would have greater flexibility to accommodate the needs of institutional investors as customers, and potentially as owners.

On corporate governance, the study recommends during the whole transition period on demutualization, the stock exchange should maintain high level of corporate governance to ensure that the interests of both the current mutual owners and investors are not affected. This is because high levels of corporate governance ensure that market confidence is held high.

### **5.5 Recommendation for Further Studies**

This study has explored factors affecting demutualization of the Nairobi Stock Exchange. The study explored the effect of ownership structure, stakeholder awareness, and corporate governance on the demutualization process at NSE. There are other Stock markets in Africa which are still operating as mutual organization. This study recommends that another study be done to assess the factors affecting the demutualization of stock exchanges in Africa so as to enable the generalization of the findings.

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## APPENDICES

### APPENDIX 1: QUESTIONNAIRE

#### Demographic Information:

1. Gender:

Male  Female

3. What is your highest qualification achieved?

Diploma  Degree

\*

Masters  PhD

Others (please specify)

4. What is your current designation within the organization?

Credit Manager  Branch Manager  Managing Director

Stock Analyst  Others (please specify)

5. How many years have you been in the Securities industry?

1 - 5 years  6 - 10 years  11 - 15 years

16 - 20 years  above 21 years

**I. Ownership Structure**

1 - Does the ownership structure of an organization affect demutualization?

Yes ( ) No ( )

2. To what extent do you agree with the following aspects about organizational ownership structure and how they affect demutualization in the NSE? Use a likert scale of 1-5 where 5= strongly agree, 4= agree, 3= Neutral, 2= disagree, 1=strongly disagree

<b>Aspects of ownership structure</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
Demutualization is about changing the ownership structure of the stock exchange					
A change in the ownership structure usually reflects a change in the assets and the strategy adopted by the firm to respond to certain changes in the business environment					
Demutualization separates trading and ownership rights					
Demutualization diversifying the exchanges' shareholder base					

3. In your own words, explain how organizational ownership structure affects demutualization in your organization

## II. Government Policy and Regulatory Framework

4. Is demutualization affected by government policy and regulatory framework?

Yes (        )        No (        )

5, To what extent is demutualization of the NSE affected by Government Policy and Regulatory Framework? Use a likert scale of 1-5 where 5= Very great extent, 4= to a great extent, 3= a moderate extent, 2= little extent, 1=no extent

<b>Government policy and regulation</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
The securities market regulation is critical to ensure efficiency, integrity and fairness of the markets that together lend credibility to markets and safeguard investor interest and confidence.					
Curbs the conflict of interest between owners of exchange and the business they offer					
Sets the rules governing primary and secondary market trading					
Defines the qualification of organizations to participate in Demutualization					
Guides the operative and ethical practices of market participants in particular brokers and dealers,					
Ensures investor protection, and transparency of market transactions					

6. To what extent do you agree that the Kenyan Government policy and regulation framework faces the following challenges? Use a likert scale of 1-5 where 5= strongly agree, 4= agree, 3= Neutral, 2= disagree, 1=strongly disagree

<b>Challenges</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
Issues of compliance are necessarily complicated because each of the individual regulators has specific regulatory goals					
Compliance with such a diverse set of regulatory provisions may lead to increased costs of compliance because of the possibility that the requirements may be in conflict with one another					
The existing situation fails to agree with the basic requirement that regulatory provisions should be simple and flexible					

7. What is your opinion of the effect of government policy and regulation framework to demutualization in the NSE

### **III. Corporate governance**

8. Is Demutualization in the NSE affected in any way by organizations' corporate governance?

Yes (     )     No (     )



To what extent do the following aspects of corporate governance affect demutualization in the NSE? Use a likert scale of 1-5 where 5= Very great extent, 4= to a great extent, 3= a moderate extent, 2= little extent, 1=no extent

<b>Corporate governance</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
Demutualized stock exchanges would continue to provide most of the same services, they would have different governance structures in which outside shareholders are represented by boards of directors					
Demutualization, a change in the corporate governance structure of an exchange, is not an end in itself					
Exchanges, when run as mutual associations, clubs and cooperatives of traders and brokers allow members exclusive rights of access to trading systems and platforms					
Under demutualization, there is increased acceptance to separation of ownership from membership that automatically provides trading rights					
It is in the profit-motivated exchange's best interest to ensure fair and transparent practices and, as such, good corporate governance needs to be an integral part of the exchange once it is driven by the profit motive					

10. Explain how corporate governance affect demutualization in the NSE

11. What is your general overview on the aspects of a demutualized stock exchange?

**THANK YOU**

## **APPENDIX 2°. LIST OF FIRMS**

1. Nairobi Stock Exchange
2. Central Depository System
3. Capital Markets Authority
4. A A Insurance Brokers Ltd- Insurance Brokers & Agents
5. A C I Brokers Ltd -Insurance Brokers & Agents
6. A M S Insurance Brokers Ltd -Insurance Brokers & Agents
7. Abdi Insurance Agencies -Insurance Brokers & Agents
8. Acropolis Insurance Brokers Ltd- Insurance Brokers & Agents
9. Acu-Rate Insurance Agencies-Insurance Brokers & Agents
10. Adept Insurance Brokers Ltd-Insurance Brokers & Agents
11. Admiral Insurance Brokers Ltd-Insurance Brokers & Agents
12. Advent Insurance Brokers Ltd-Insurance Brokers & Agents
13. Aegis Insurance Agency Ltd- Insurance Brokers & Agents
14. African Crown Insurance Brokers- Insurance Brokers & Agents
15. African Development Insurance Agent
16. Afrishield Insurance Agencies Ltd - Insurance Brokers & Agents
17. Agravat Insurance Agencies- Insurance Brokers & Agents
18. A1 - Bariq Insurance Agencies- Insurance Brokers & Agents
19. Alabang Insurance Agency - Insurance Brokers & Agents
20. Al-Amin Insurance Brokers - Insurance Brokers & Agents
21. Alexander Forbes Insurance Brokers Kenya Ltd
22. Al-Fawzein Insurance Agency Ltd- Insurance Brokers & Agents

23. Alican Insurance Agency - Insurance Brokers & Agents
24. AON Minet insurance brokers
25. Bafana Insurance Brokers Ltd- Insurance Brokers & Agents
26. Chancery Wright Insurance Brokers
27. Macly Insurance Brokers Ltd
28. Pacific Insurance Brokers (EA) Ltd