

**A SURVEY OF STAKEHOLDERS' OPINIONS ON THE
EFFECTIVENESS OF DEMUTUALIZATION IN SOLVING
AGENCY PROBLEMS AT THE NAIROBI STOCK EXCHANGE**

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**MANAGEMENT RESEARCH PROJECT SUBMITTED TO THE SCHOOL OF
BUSINESS IN PARTIAL FULFILMENT FOR THE REQUIREMENTS FOR
THE DEGREE OF MASTERS OF BUSINESS ADMINISTRATION (MBA) OF
THE UNIVERSITY OF NAIROBI**

DECLARATION

This research project is my original work and has not been presented for a degree in any other University.

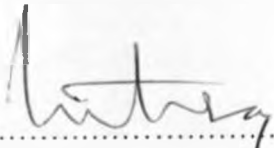
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DEDICATION

I dedicate this project to my family for their unrelenting support through out my academic life.

ABBREVIATIONS

ABC	African Banking Corporation Capital Ltd
BRVM	Bourse Regionale Des Valeurs Mobilieres
CBK	Central Bank of Kenya
CMA	Capital Markets Authority
EA	East Africa
ECN	Electronic Communication Networks
IFC	International Finance Corporation
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
(K)	Kenya
NSE	Nairobi Stock Exchange
NYSE	New York Stock Exchange
SIDA	Swedish International Development Cooperation Agency
SRO	Self-Regulating Organization

ABSTRACT

Demutualization is a term used to describe the transition of a securities exchange from a mutual association of exchange members operating on a not-for-profit basis to a limited liability, for-profit company accountable to shareholders. Demutualization challenges the traditional approach to supervision of securities exchanges and raises issues regarding their role in the regulation and supervision of capital markets.

Domowitz and Steil (1999) propose that demutualized exchanges have better incentives to provide innovative services that increase the value of the exchange. Their proposition implies that demutualized exchanges are superior to mutualized exchanges in governance. Another inference that can be drawn from Domowitz and Steil's work is that a demutualized exchange, due to its superior governance structure, should provide a better quality market.

This paper reports the findings of a survey of stakeholders' opinions on the effectiveness of demutualization in solving agency problems at the Nairobi Stock Exchange. Primary data was collected using structured questionnaires that were completed by respondents. The questionnaires comprised both open and closed ended questions and were administered through drop and pick. Some were sent to the respondent via electronic mail. The Microsoft Excel Program was used to carry out tests and derive frequency tables, mean score tabulations, and percentages to represent the response rate and information on the variables under study.

Demutualization being a new concept in our local market, it can not eliminate all the agency problems at the NSE hence a lot needs to be done especially on the enforcement of capital market rules and regulation in order to eliminate/reduce agency problems.

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CHAPTER ONE: INTRODUCTION

1.1. Background of the study

Capital securities market together with the banks plays a vital role in channeling savings of an economy into investments and lead to increased income, employment, and output for the country. The major role that the stock exchange has played, and continues to play in many economies is that it provides a platform for financial intermediation. Singh (1997), argues that the stock market is expected to accelerate economic growth by providing a boost to domestic savings and increasing the quantity and the quality of investment. Levine and Zervos (1998) paper stated that stock exchange is expected to encourage savings by providing individuals with an additional financial instrument that may better meet their risk preferences and liquidity needs. Better savings mobilization may increase the savings rate.

According to Capital Markets Authority (CMA) website, a robust stock market assists in resource mobilization and the rational and efficient allocation of scarce resource/capital. An efficient (informational, allocative & technical) stock market will have the expertise, the institutions and the means to prioritise access to capital by competing users so that an economy manages to realize maximum output at least cost (optimum production level).

Stock markets promote higher standards of accounting, resource management and transparency in the management of business by facilitating separation of owners of capital from managers (executives) of capital. The stock exchange improves the access to finance of different types of users by providing the flexibility for customization. It also provides

investors with an efficient mechanism to liquidate their investments in securities as well as an avenue for growing companies to raise capital at lower cost.

The stock market is supposed to ensure through the takeover mechanism that past investments are also most efficiently used. Theoretically, the threat of takeover is expected to provide management with an incentive to maximize firm value. The presumption is that, if management does not maximize firm value, another economic agent may take control of the firm, replace management and reap the gains from the more efficient firm. Similarly, the ability to effect changes in the management of listed companies is expected to ensure that managerial resources are used efficiently Kumar (1984).

Efficient stock markets may also reduce the costs of information. They may do so through the generation and dissemination of firm specific information that efficient stock prices reveal. Since stock markets are said to be efficient if prices incorporate all available information, reducing the costs of acquiring information is expected to facilitate and improve the acquisition of information about investment opportunities and thereby improves resource allocation. Stock market liquidity is expected to reduce the downside risk and costs of investing in projects that do not pay off for a long time. Bencivenga and Smith (1991) found out that with a liquid market, the initial investors do not lose access to their savings for the duration of the investment project because they can easily, quickly, and cheaply, sell their stake in the company.

1.1.1. The Organization of Traditional Stock Exchange

Traditionally, the stock exchange was primarily a physical location for trade. Trade was conducted in person, and multiple securities were traded at the same location to maximize liquidity. Karmel (2000), competition in stock markets was limited due to restrictions on the physical access to trading floors and to regulatory barriers that created regional or national monopolies. The limited access gave exchange members' market power. They collected brokerage commissions and had a privileged view of trading flows that enabled them to make monopoly rents. According to Macey and O'Hara (1999), this meant that historically the cost of transacting was high and those intermediaries such as Stockbrokers and Investment Banks could extract monopoly rents (Pirrong, 1999). The high barriers to entry caused by limited space and network externalities protected these rents – the more people traded on the exchange, the better the price discovery.

Mensah (2005) argued that as much as the majority of the developed exchanges have changed their status from mutual association of exchange members operating on a not-for-profit basis to a for-profit entity, demutualization is relatively a new concept in the developing economies especially in Africa. The distinguishing features of mutually owned exchanges are that the owners of the enterprise, its decision makers and the direct users of its trading services are the same entities. The owners of the stock exchange are usually the stockbrokers and investment banks and decisions are usually made on a democratic basis i.e. one-member, one-vote basis of course limiting the number of players and enhances value in membership. However, there is criticism that this form of exchange structure and governance tends to place members' interest above those of the market (economy) and the investors. Another criticism is that it also inhibits the exchanges from responding quickly

to changes brought by new technologies. In a traditional Stock exchange, ownership rights and trading rights are one and the same and not easily transferable.

1.1.2. Agency Problems Associated with the Traditional Stock Exchange

It may be noted that it is almost impossible to identify all the areas from where the Agency problems may arise in the traditional stock exchanges, however it is possible to identify those areas where the business and regulatory functions interface. Saha (2005) urges that conflicts of interests in listing activity and regulating market operations have been identified as some of the agency problems in the running of traditional stock exchanges. IOSCO (2000) state that in a traditional (not-for profit) stock exchange environment, the focus is on generating sufficient income to cover the budget for revenue expenditure, capital investments and other outlays hence the conflict of interest that may arise is attributed to the fact that members are asked to set rules in public interest, which may negatively affect their commercial interest.

1.1.2.1. Conflict of interest in listing activity

Traditionally listing has been viewed as a signaling function, endorsing the quality of the security and indicating that the security is above a certain benchmark set by the exchange. Steil (2002), argued that if the exchanges set the listing criterion too high then many firms who cannot meet the listing criterion would not be able to list their securities on the exchange platform and the exchange will lose its revenue from listing fees while on the other hand if the listing criterion is set too low then poor quality securities will be eligible to be traded on the exchange platform, which will lead to a deterioration of investors

returns resulting in an adverse effect on the reputation as a fair and efficient stock exchange as well as the order flows.

1.1.2.2. Conflict of interest in regulating market operations

Elliot (2002) argued that under the traditional model, regulators have grappled with the challenges of the exchange's self-regulatory role and the conflict of interest inherent in self-regulation. This has led in some cases to poor execution of regulatory responsibilities. For example, in the case of the Nasdaq market, the regulator authority failed to discipline market makers colluding on price (creating artificially wide spreads). These same market makers controlled the regulatory authority's board of governors and key committees that should have addressed the issues. Other exchanges have poorly funded their regulatory functions and focused on other operations at the expense of regulation. The Bombay Stock Exchange, the largest in India is another example-its failure to maintain adequate regulatory standards (a direct result of member self-interest) and under funding of its regulatory functions has led to a lack of regulation culminating in a number of market manipulation scandals which have caused market volatility and serious losses to investors, and which have undermined the Indian capital markets as a whole.

Saha (2005) argued that the stock exchange being a SRO (self-regulating organization) is responsible for regulating the trading activities, identify suspicious trading behavior like insider trading and market manipulation etc. Instances where a SRO detects misconduct by entities under its jurisdiction it is supposed to prosecute the entity and in cases where the SRO detects misconducts by entities out of its jurisdiction it is supposed to intimate the appropriate agencies (usually the stock market regulator) and assist the agency in the

investigating activity. He continues to state that with an increase in competition amongst the stock exchanges, conflict of interest between the exchanges regulatory interest and business interest have been witnessed. These conflicts of interest might manifest as discrimination through sanctions imposed in disciplinary proceedings, unfairness in not being permitted to participate in particular activities, discrimination with respect to fees charged or failure to make changes to accommodate an entity providing a competing service. Hence there is a clear divergence of business and regulatory interest as far as regulating the market operation by the stock exchange is concerned.

1.1.3. Demutualization of stock exchanges

IOSCO (2005) defines demutualization as the entire process of changing the legal structure of a stock exchange from a mutual association, with one-vote per member and usually consensus based decision-making to a company limited by shares, with one-vote per share and with majority decision-making. It involves the separation of trading rights from ownership, and in most cases the exchanges becomes a for-profit firm and even, self-lists (Akhtar 2002). As a result of demutualization, residual claim and control rights are reassigned among stakeholders with implications to firm behavior and performance. In particular, cooperative membership rights are converted to unrestricted common stock ownership rights in a corporate organization. More often than not, demutualization is followed by public listing either within the exchange itself or in another stock exchange which allows the firm to acquire additional risk capital from outside investors.

1.1.4. Demutualization in the International scene

Globally, there has been a dramatic change in the organizational structure of exchanges as they have converted into "for-profit" entities. This has often been accompanied by a public listing of shares on the exchange itself and cross-border exchange mergers. Technological and competitive forces have driven these changes. In 1993, the Stockholm Stock Exchange became the first exchange to demutualize. It was followed by a wave of other exchanges, including the Helsinki Stock Exchange in 1995, the National Stock Exchange of India (created as a demutualized exchange in 1995), the Copenhagen Exchange in 1996, the Amsterdam Exchange in 1997, the Australian Exchange in 1998, the Toronto, Hong Kong, and London Stock Exchanges in 2000, Nasdaq in 2000, the Bombay Stock Exchange in 2005, and the New York Stock Exchange (NYSE) in 2006 in the developed countries.

As at April 2005, exchange demutualization had been completed in only five jurisdictions out of a total of 76 emerging market jurisdictions. In Africa, only one exchange, JSE, was fully demutualized on 1 July 2005 JSE (2005) after 118 years as a mutual entity. JSE Limited joined the world's most prominent international exchanges in operating as a fully-fledged publicly-listed corporate. Demutualization has also put the JSE in a position to seek a listing, an exciting new phase in the life of the exchange.

1.1.5. The Nairobi Stock Exchange

In Kenya, the Nairobi Stock Exchange (NSE) is the only exchange licensed to provide stock exchange services. It has a mutual ownership (members owned) structure, functions as a not-for-profit organization and organized in the form of a company limited by

guarantee and incorporated under the Companies Act chapter 486 of the Laws of Kenya. The NSE and its members are licensed by the Capital Markets Authority (CMA) and currently, there are nineteen (19) licensed members comprising of 7 Stockbrokers and 12 investment banks. The NSE is governed by its Memorandum and Articles of Association and has rules and regulations. In addition, the NSE is a self regulating organization (internal mechanism to regulate the activities of its members) although its activities are subject to monitoring and supervision of the CMA and a system of regular audits by the CMA is in place to ensure that the necessary regulations are complied with. Trading rights are currently given only to member firms that form an exchange structure and governance that tends to place members' interest above those of the market and the investors. Ownership in the member firms is subject to the approval of the CMA and NSE and firms that are 100% owned by foreigners are not permitted.

According to NSE Annual report 2007, NSE is governed through the board committees and management and the role of the board is to ensure conformance by focusing and providing the company overall strategic direction, policy making and continuous performance review. The directors are chosen to represent a number of interest groups and chief executive is the only executive director. Currently, the board is composed of 10 directors with 5 representing the stockbrokerage fraternity, 3 for institutional investors and 2 for the listed companies. Over the past five years, NSE's operating income and total assets grew by over 240% from Kshs 85m and Kshs 71m in 2003 to Kshs.290 m and Kshs 372m in 2007 respectively while members' funds grew by 668% from Kshs 31m to Kshs 241m over the same period thus making it a viable venture.

According to NSE website, the core functions of the NSE include: Listing companies to raise debt and equity capital, providing trading facilities for the secondary trading of all the securities that are listed, providing on line market data and other market related products, posting trade clearing, settlement, registration and depository facilities for all secondary market transactions, transferring of securities and investor education. The key sources of income/revenues to NSE are the transaction fees, annual listing fees, quotation fees payable on new listings and membership subscription fees from stock brokering firms. The main items of expenditure are the establishment costs like rent, insurance, electricity, staff costs and information and technology costs. The NSE does not distribute profit.

1.2. Statement of the problem

Corporate governance is a broad term encompassing rules, structure and market practices, which determine how corporations are owned and managed, the transparency of their decision-making process, the accountability of their directors, managers and employees, the information they disclose to investors and the protection of minority shareholders. Failure in enforcement of corporate governance creates an agency problem between the principal and the agents in corporations.

By changing its governance structure from a mutual, member-owned not-for-profit company limited by guarantee to company limited by shares with separation of trading rights from ownership rights, the NSE will become more inclusive and accountable. There is a general view that NSE is being run by stockbrokers in their own interest and are unwilling or unable to supervise and discipline members hence creating an agency problem (as witnessed in the fall of Francis Thuo & Partners, Nyaga Stock brokers and

Discount Securities in 2006, 2007 and 2008 respectively) and listed companies like Uchumi Supermarket Ltd in 2006.

According to the Capital Markets Authority (CMA) website there is a general view that demutualization of Nairobi Stock Exchange is a key priority to address agency problems in the capital markets. This paper will explore these agency problems that are associated with the mutual structure of the market by carrying out a survey of stakeholders' opinion on the effectiveness of demutualization in solving these problems.

There have been limited studies in the demutualization of the NSE because only one study has been conducted on the topic Lumumba (2007), but the study was on challenges of demutualization strategy of the NSE. The study focused on institutional challenges including structural, leadership, cultural, policies, procedures and support systems. The study concluded that for an organization to successfully implement its strategy, it must ensure the existence and alignment of all strategy supportive aspects of the organization.

In the international arena, Elliot (2002) states over time, the regulatory function of exchanges was formalized and as government authorities strengthened their role in securities regulation, the exchanges become subject to increased supervision by regulatory authorities. She further stated that the shift from not-for-profit mutual organization to for-profit organization (demutualized) with ownership separated from access to trading may allow the exchange to respond more effectively to competitive pressure and to act separately from the interests of individual members thereby creating a more streamlined and market-oriented exchange.

1.3. Objective of the Study

This study seeks to carry out a survey of stakeholders' opinions on the effectiveness of demutualization in solving agency problems at the Nairobi Stock Exchange and highlight the corporate governance challenges that may not be addressed through demutualization.

1.4. Importance of the Study

There are various stakeholders who attach importance to the Stock market. Such Stakeholders include:

1.4.1 The Government

The government as a regulator will be able to appreciate the limitations of the current shareholding structure and its contribution in impeding the development of the Capital Market as an avenue to finance government's ambitious development agenda envisage in vision 2030, and ways to overcome the challenges through elimination infrastructural and regulatory bottle necks. This study will also give experts view on demutualization as a way of addressing these challenges.

1.4.2 Stockbrokers and Investment Banks

As the current owners, the study will enable the Stockbrokers to appreciate the limitation of the current set up and enormous benefits of demutualization in enhancing capital market development. It also elaborates the conflict of interest issues related with demutualized exchange and also highlight the challenges that may not be addressed through demutualization.

1.4.3 Investors

Investors as key stakeholders are very keen on efforts to enhance the capacity and performance of the stock market. The findings of this study will give investors insights on the current ownership structure with its limitations and the opportunities that comes with demutualization. It will also provide an update on the readiness of the prospective investment and also highlight the challenges that may not be addressed through demutualization.

1.4.4 Academicians

Academicians want to contribute to the body of knowledge; this research will help in opening up opportunities for doing further research.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

IOSCO (2005) defines demutualization as the entire process of changing the legal structure of a stock exchange from a mutual association, with one-vote per member and usually consensus based decision-making to a company limited by shares, with one-vote per share and with majority decision-making. Demutualization can improve governance structures at the exchanges, provide access to economic and human capital, generate commercial pressures for growth and development, allow entry of new and better intermediaries, unlock value of membership cards for members, provide domestic and international recognition, give opportunity for making equity cemented international alliances, and help change the perception and image of an exchange. International and in particular Asian experience of demutualization has demonstrated that after demutualization, the market capitalization, turnover, and products and services offered by exchanges have greatly increased to the benefit of all stakeholders. Brokers have benefited from demutualization through higher commission earned on increased trading volumes, and by capital gains on the shares, which they received on demutualization. The core concern about demutualization is that it causes conflicts of interest between the regulatory and commercial role of a stock exchange. A number of measures can be taken to address this conflict including separation of some regulatory functions within or from the exchange and greater transparency into how a demutualized exchange is run.

2.2 Empirical Studies on Demutualization of Stock Exchanges

Even though the number of empirical papers on governance of stock exchanges is relatively small, Hansmann (1996) found out that over the years, mutual ownership has been the dominant governance structure because stock exchanges have historically enjoyed monopoly power and the costs of ownership have been relatively low. Elliot (2002) on the other hand criticize the traditional mutual exchange governed by its members because of its inability to adequately respond to competitive pressures due to the fact that a governance structure that relies on member decision making is perceived to be slow and encumbered by the many, and often conflicting interests of the individual members.

In the last two decade, the governance structure of several stock exchanges has undergone a momentous change, they have moved from being member-controlled (owned) cooperative entities to demutualized exchanges. (Elliott 2002) states that the roots of demutualization can be traced directly to the enormous technological changes that have affected the securities industry in the past 15 years. She further argued that the market for markets competition, increasing divergence of member interests, new focus for exchange operations, alliances and mergers, capital and regulatory pressure are the key forces for demutualization. According to (Agrawal 2002), the Stockholm Stock Exchange became the first stock exchange to demutualize in 1993. 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. He further stated that in some cases, the demutualized exchanges took further step of becoming publicly traded companies. For

example, following a demutualization process that began in 1996, the Australian Stock Exchange issued shares to the public and began listing on its own exchange in 1998. And shares of the London Stock Exchange, which converted into a for profit corporation in June of 2000, became fully listed in July of the following year.

Krishnamurti, Sequeira, and Fangjian (2003) analyzed the market quality (in terms of informational, allocative and technical efficiency) of exchanges with different organizational form in India. They found evidence that the demutualized National Exchange of India provides a higher market quality than the mutual association not-for-profit form Bombay Stock Exchange. Stock exchanges are critical to an efficient financial system because their governance structure determines rules and regulations that influence price discovery and least-cost allocation of capital.

Theoretically, Hart and Moore (1996) show that as the exchange faces competition, outside ownership of the exchange becomes relatively more efficient (in terms of performance) than a members' cooperative. Domowitz and Steil (1999) provide convincing arguments in favor of demutualized exchanges. They reason that members of a mutualized exchange have incentives to provide innovation that increase the quality of its services, and hence the value of the exchange, while stakeholders of a demutualized exchange, are likely to favor any measure that enhances the value of the firm.

2.2.1 Factors Driving Demutualization

There are a number of factors driving demutualization in both the advanced and emerging economies, a paper by Pirrong (2000) states that a combination of factors led to increased pressure on the exchanges' businesses. According to Lee (2002) the key goal of demutualizing a securities exchange is to enhance the exchange's ability to react to competition from other exchanges and trading systems. Most importantly, demutualization may allow a securities exchange to be more responsive to the needs of its users and customers, and particularly investors and issuers, and to reduce the need for the exchange to satisfy the interests of the financial intermediaries who were previously its members and owners. Steil (2002) found that in Europe, the deregulation of the financial markets and wider market reforms opened the path for increased competitive pressure on the incumbent institutions while Mensah (2005) argue that, the trend towards stock exchange demutualization is largely driven by heightened competition and changes in technology, improved governance, investor participation, globalization and consolidation and unlocking stock exchange value. Increasing competition, whether between traditional exchanges or between exchanges and other trading systems, requires exchanges to become more efficient in all activities, including their decision making processes, IOSCO (2001).

2.2.1.1 Technology

The primary effect on stock exchange competition is due to the developments in information technology, which brings geographical neutrality to business and reduces communication costs, resulting in the emergence of new ways of trading. A recent paper by Ramos (2005) which employed univariate probit regressions to evaluate the propensity

of exchanges to demutualized found evidence that competitive pressure has a positive effect on the likelihood of exchanges to demutualize.

Traditionally, competition in stock markets was limited due to restrictions on the physical access to trading floors and to regulatory barriers that created regional or national monopolies. This meant that historically, the cost of transacting was high, Macey and O'Hara (1999) and that intermediaries could extract monopoly rents, Pirrong (1999). Krozer and Strahan (1999) state that aggregate forces such as technological changes affected all financial services and created increasingly strong pressures for regulatory regime change. In Karmel (2000) found out that in Sweden (Stockholm Stock Exchange), demutualization was motivated primarily by the need to compete with other exchanges, both conventional exchanges and alternative trading systems like Electronic Communication Networks (ECN). Macey and O'Hara (2002) refer that technology contributed to the demise of national boundaries, and stocks do not need to be listed where the companies operate. The traditional "floor markets" were replaced by powerful electronic trading systems, decreasing transaction costs and allowing remote access from foreign intermediaries. Also, the advent of technology permitted the emergence of exchanges at low cost.

2.2.1.2 Improved Governance

While demutualized stock exchanges will continue to provide most of the same services, they will 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 interests of

members are homogeneous. According to Karmel (2005), if greater competition exists and the interests of members diverge from one another and from the exchange, the mutual governance model consensus decision-making becomes slow and cumbersome. The exchange is unable to respond quickly and decisively to changes in the market. Therefore, they argued that the profit oriented corporate model will enable management to make actions that are in the best interests of customers and the exchange itself. With the separation of ownership and trading privileges, an exchange will achieve greater independence from its members with respect to its regulatory functions. Owner's interests will also be aligned with those of the exchange; both will seek to maximize the profits of the exchange. Strategic decisions will also be made by management in a much more efficient manner.

In his paper, Mensah (2005), he found that demutualized exchanges would be forced to account to their stakeholders not only regarding the bottom line, but also regarding issues arising in corporate governance. Elliot (2002) argues that because demutualization further separate the exchange from its members' control, it may have more professional management and may be more efficient in its decision making-allowing the exchange to respond quickly to change and to remain innovative and competitive.

2.2.1.3 Investor participation

According to Mensah (2005) a stock exchange must be responsive to the needs of its many stakeholders, including participating organizations, listed companies, and institutional and retail investors. Exchanges may perceive a need to shift within the exchange from one group of members to another and to afford institutional customers direct access to

exchange facilities. Separating trading rights from ownership may be a politically and economically feasible way to effect such a shift. Unlike a mutual structure where only stockbroker's dealers may be members, a demutualized exchange offer both institutional investors and retail investors with an opportunity to become shareholders. The assets managed by institutional investors and trading needs of institutional investors differ dramatically from those of retail investors. A demutualized exchange will have greater flexibility to accommodate the needs of institutional investors as customers and potentially as owners.

One of the most cited papers in this area is by Hart and Moore (1996), focusing on the user welfare of different governance setups for stock exchanges in US, the authors analyzed the relative merits of a mutual structure and outside ownership with respect to the level of competition and the diversity of member interests using simple pricing model. They obtained two main results: (1) Outside ownership becomes more efficient (operational and market performance) than a mutual structure as the members of the mutual become more diverse in terms of preferences. (2) Outside ownership becomes more efficient than a mutual structure as the exchange faces more competition.

2.2.1.4 Globalization and Consolidation

Competitive pressures have triggered a wave of restructuring and mergers and alliances among securities markets to maximize economies of scale, accessibility and market reach while providing global trading facilities. Exchanges have been pushed to demutualize as a result of global competition for order flow and the search for greater revenues.

Globalization has threatened or even decimated the exclusive franchise that exchanges once enjoyed.

According to Elliot (2002), alliances and mergers are made possible by demutualization which creates a more streamlined, operations-oriented approach to the business of running a market and which can move beyond its members. It is unlikely that a traditional mutual organization could move quickly enough to capture merger or alliance opportunities even if the interests of members could be satisfied. She continues to state that a small exchange threatened by larger exchanges or marketplaces may see an advantage in forming a partnership with others-the alliance or merger can pool listings and allow members of one exchange access to a larger variety of instruments.

The most successful example of this has been Euronext, the alliance of the Paris, Amsterdam and Brussels exchanges. Each of these exchanges faced stiff competition from the larger London Stock Exchange and Deutsche Bourse. Whereas a domestic exchange was once the only alternative for listing a particular financial product, now issuers have a variety of options. They may list on the domestic exchange, choose another exchange such as for a single listing, or have a dual listing to the advantage of both exchanges.

2.2.1.5 Unlocking Stock Exchange Value

Demutualization provides an opportunity to unlock the value of a stock exchange though the realization of the value will ultimately depend on the listing of the exchange. Demutualization offers an opportunity to buy out trader interests since they are no longer necessary and shift power to other firms, while raising capital for continued modernization of trading information systems. In the majority of exchanges, the value of the exchange is usually distributed to member brokers. Demutualization and listing provides an exit mechanism for the former brokers to sell down equity thereby broadening the shareholder base and de-linking of stockbrokers' interests from that of the exchange, Karmel (2005). Members are able to retain their trading rights and are free to sell shares of demutualized exchange. Currently, a member cannot sell his membership card without foregoing his trading rights.

Demutualization unlocks the value of membership cards for all members without loss of trading rights. Other studies shows that, in order to achieve the full benefits of restructuring, demutualization should not simply be a matter of turning into a for-profit entity owned by members. Scullion (2001) argues that a truly demutualized 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. OECD (2003) concurs that being listed is likely to improve the value of the exchange to operate more efficiently. Therefore, emerging exchanges should include self-listing in their demutualization plans.

2.2.2 Impediments to Demutualization in emerging markets

Various academic analyses (Elliot 2002; Krishnamurti et al. 2002; Hart and Moore 1996) point to the fact that, along with the above factors driving demutualization, some problems may confront the demutualization process. There are many obstacles on the way of demutualization of exchanges especially in the emerging markets. These obstacles stem from economic, political, and other non-economic factors (Mensah 2005; Mensah and Moss 2004; Moss 2003) like the nature of its rudimentary capital markets, and its ability to deal with problems inherent in demutualization. They include; cost of demutualization, Partial Market Liberalization, Exchange Financial Sustainability, Conflict-of-Interests, Political Bottlenecks, Dominance by Foreign Firms, Poor Macroeconomic and Regulation, Market Infrastructure, Poorly Trained Finance Staff, Thin Stocks Investor Base, Wrong Reasons for Setting up Exchanges

2.2.2.1 Partial Market Liberalization

Capital markets in emerging markets like Africa are not yet sufficiently liberalized to enable a for-profit stock exchange to explore an expanded opportunity set. For example, markets such as Ghana still have capital account restrictions that limit the ability of an exchange to implement cross-border strategies, such as cross-listing. Other markets, including Kenya, have stringent and expensive listing requirements, while others still have capital gain tax. The most important task to demutualized exchanges is remaining financially viable. The road to demutualization is a complex one that requires total commitment from former owners, managers and the government. IOSCO (2005) found that the process of demutualization has been uneven between developed and emerging markets. In emerging markets, the decision-making process is largely policy-led while in

developed markets it is market-led. Because the impact of market forces may not be at the same level as that of a developed market, exchange-restructuring issues are considered from the perspective of national policy.

2.2.2.2 Conflict-of-Interests

Ownership in demutualized exchange becomes problematic, as there are the difficulties in the choice of the financial institutions to become shareholders and marrying powers wielded by former member-owners and other new shareholders. The power wrangles in most developing economies may trickle into exchanges, thus increasing the possible effect of conflict-of-interests between firstly old owners and new shareholders, and secondly an exchange and its regulator. Pirrong (2000) in his paper focuses on different types of users that may organize their stock exchange either as a for-profit or as a not for-profit entity. He then describes governance mechanisms to mitigate conflicts of interests between the members.

The large amount of regulatory interest in the demutualization of securities exchanges has focused to date on whether demutualization is compatible with self-regulation, and if so how self regulation should be changed to adapt to take account of demutualization. Some people have argued that the emergence of demutualized for-profit exchanges exacerbates the conflicts of interests associated with running an exchange and being an SRO (self regulatory organization) and that because of their commercial incentives demutualized for-profit exchanges should relinquish their regulatory responsibilities.

2.2.2.3 Poor Macroeconomic and Regulation

Some factors impeding performance of emerging states especially in Africa may also influence their exchange demutualization. According to Mensah and Moss (2004), many African states still have high budget deficits, high and volatile inflation, volatile and fast depreciating exchange and interest rates. Policy inconsistency and macroeconomic instability undermine investor and issuer confidence, thus dampening business flow to stock exchanges. There are rules for members and listings for every stock exchange, shortage of experienced supervisors and the absence of a strong culture of compliance with rules (Vittas 2003). Such poor regulatory enforcement may increase the problem of conflict-of-interest common with demutualization.

Of course a demutualized exchange focuses on profit and wealth maximization of its shareholders. It has less incentive to take enforcement actions against its customers or users, who are a source of income. Given their rudimentary nature, most African exchanges would have the problem of balancing regulation by themselves and by their regulators. Self-regulatory functions of a demutualized exchange pose a challenge both for the exchanges themselves and the capital markets regulators.

2.2.2.4 Cost of Demutualization

Onyuma (2006) found out that the costs associated with stock exchange IPO are huge. Deutsche Borse and Euronext, respectively paid £36.8 million and £46 million euros for their quotation. Although the proceeds received from an IPO naturally more than recouped these costs, the IPO-costs amounted to 3.7% of the new proceeds in Deutsche Borse's case, and 12.7% for Euronext. Besides these one-off costs, there are also additional

running costs such as stricter disclosure requirements. A strategic implication is that African exchanges may become prone to be easily taken over by other giant foreign institutions with higher investment capital endowment.

2.2.2.5 Stock Exchange Financial Sustainability

According to (Mensah 2005), out of the 20 stock exchanges in Africa, only about 7 are likely to be financially viable. These are those exchanges with a combined market capitalization of at least \$2 billion and at least 40 listings Exchanges in Egypt, Kenya, Mauritius, Morocco, Nigeria, South Africa and Zimbabwe may have such critical mass. Financial sustainability is very critical in the success of a demutualized stock exchange because of the profitability motives where investors expect returns in terms of dividends and capital gains in the cases of listed stock exchanges.

2.2.2.6 Political Bottlenecks

Where they still provide financial support to exchanges, African governments may not be in a hurry to demutualize stock exchanges. Onyuma (2006) states that as long as exchanges are in their current mutualized form and seen as national symbols, governments will continue to provide financial support, with the usual under-funding and intermittent disbursements. They may only act when put under pressure by donors. After all, some donors have preference for supporting exchanges; for instance, the IFC (international finance corporation) provided seed money for the Ghana Stock Exchange and the BRVM (Bourse Regionale Des Valeurs Mobilieres), while SIDA (Swedish International Development Cooperation Agency) has long supported the Tanzania, Uganda and Zambia exchanges.

2.2.2.7 Dominance by Foreign Firms

African stock exchanges are dominated by foreign firm listings of local subsidiaries of multinationals like Standard Chartered Bank, Barclays Bank, Unilever and Guinness. While the parent company may be cross-listed in a number of developed markets, the subsidiary listing is domesticated, with no incentive for the listed local subsidiaries to migrate. A demutualized exchange focuses on profit and wealth maximization of its shareholders. It has less incentive to take enforcement actions against its customers or users, who are a source of income to it. Given their rudimentary nature, most African exchanges would have the problem of balancing regulation by themselves and by their regulators. Onyuma (2006) paper found out that self-regulatory functions of a demutualized exchange pose a challenge both for the exchanges themselves and the capital markets regulators.

2.2.2.8 Market Infrastructure

Given their sizes, African capital markets lack the resources needed to acquire the state of the art infrastructure for market operations. According to Onyuma (2006), Ten African exchanges do not have central depository systems. Although this is a positive drive force for demutualization, it is constrained by the limited profitability prospects of most African exchanges. Most emerging markets in the developing countries lack the necessary legal framework that is required developments in this area.

2.2.2.9 Poorly Trained Finance Staff

In more developed countries, a large part of the training in capital markets is done on-the-job. Working in modern capital markets (developed) requires fundamentally different

skills than working in rudimentary markets. Mensah (2005) paper found out that training in management of financial institutions is still inadequate in many African countries. With demutualization, exchange management staffs, who previously operated in a cooperative mode, might find it difficult to assimilate commercial mindset or develop the necessary capacity to execute sound business strategies. There is a high likelihood that these management staff would like to maintain status quo in the management and running of the Stock exchanges in the demutualized state hence posing a serious threat to successful implementation of the same.

2.2.2.10 Thin Stocks Investor Base

It is a fact that most African markets have small investor base resulting in limited activity in the in the stock markets. In his paper, Mensah (2005) argue that African markets are characterized by a small investor-base as most people have low incomes with little to save and invest. There is also a small institutional investor-base with most markets having as few as five institutional investors. This limited investor-base may influence the financial viability of demutualized exchanges. According to Elliot (2002), the concern that an exchange remains financially viable is perhaps a concern generated more by the advent of competition rather than by demutualization itself. However, as mentioned the viability of an exchange as a key institution in the financial sector has become an issue in demutualizations. In many countries, the winding-up of an exchange is likely to be intolerable to authorities, particularly if the exchange is regarded as the national exchange although it should be noted that where an exchange is not independently viable, a range of options including international alliances could be considered.

2.2.2.11 Wrong Reasons for Setting up Exchanges

An IOSCO (2005) survey established that the process of demutualization has been uneven between developed and emerging markets. In emerging markets, the decision-making process is largely policy-led while in developed markets it is market-led. With the exception of older exchanges like South Africa, Kenya, Egypt, Zimbabwe and Nigeria, most African exchanges have been set up as state initiatives, and benefit from state subsidies to cover operating costs. According to Moss (2003), the reasons why African states promote exchanges are both technocratic and political. The technocratic reasons are the standard economic reasons normally advanced by technocrats to justify formal capital markets like a source of long-term finance, improved capital allocation and savings mobilization. Other complex, non-economic factors that underpin government objectives for promoting exchanges are inconsistent with the market reasons for demutualization. Most exchanges emerged as symbols of international legitimacy of a country. The implication is that demutualization in Africa may not be driven by market-based reasons.

2.3 CONCLUSION

Demutualization-now a widespread global phenomenon-has been looked to as a means of meeting developmental and competitive challenges and even to address failure to carry out credible operations. Although the state of demutualization of stock exchanges in emerging markets appears to be in transition-with few exchanges fully demutualized, it seems clear that the trend will not be reversed. As Steil (2002) has observed, the extent of movement toward a demutualized structure is related to the competitive threat. Benefit from demutualization, will only occur when ownership actually changes hands and non-members become owners. Whether regulators play a role in determining the structure or

not, understanding the incentives at work will be important to understanding and assessing the continuing regulatory role exchanges play in the securities market. From the regulatory perspective, authorities must carefully consider the impact of the demutualization on the viability of the exchange as a key institution and the impact on the regulatory structure.

As exchanges move forward toward full demutualization, the regulatory role of the exchange becomes more difficult and yet the advantages of self-regulation are not easily discarded. New issues will arise as a result of demutualization including direct investor access to exchanges, global alliances, and cross-border ownership. These issues will challenge authorities to balance the public interest role of the exchange with its commercial goals and further challenges for the authorities to include their supervision of the exchange and their reliance on the exchange as a regulator.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1. Introduction

This chapter highlights the approaches through which the research was carried out and covers the research design, the population, sample, data collection method and data analysis.

3.2. Research Design

This research was conducted through a survey of stakeholders' opinions at the Nairobi Stock Exchange. To enhance reliability and validity of the data collected, the research was carried out through booking of appointments with key stakeholders and in some cases, questionnaires were sent to the stakeholders via internet to maximize on the limited time. The method of research was elected because the study required an in-depth understanding of the existing agency problems and the extent to which Demutualization of the Nairobi Stock Exchange can address them.

3.3. Population

The population of interest for this study consisted of all key stakeholders of the Nairobi Stock Exchange namely; Capital Markets Authority, Nairobi Stock Exchange, Central Depository & Settlement Corporation, Investment Banks, Stockbrokers, Investment Advisors, Fund Managers, Commercial Banks and Individual investors.

3.4. Sample

The sample targeted 80 Key stakeholders mainly the top-managers of key stakeholder institutions that would be affected directly by demutualization of NSE, private investment advisors and investors in the market. The target stakeholders were categorized based on the roles they play in the Kenyan capital market. The categories included; regulators

(consisting of Capital Markets Authority, Nairobi Stock Exchange, Central Depository & Settlement Corporation), 13 Investment Banks & 6 Stockbrokers all licensed to financially intermediate at the NSE, 15 licensed Investment Advisors, 13 licensed Fund Managers, 7 Licensed Commercial Banks as Central Depository & Settlement Corporation agents and 23 Individual investors through convenience sampling in the premises of some key stakeholders main stockbrokers and investment banks.

3.5. Data Collection

The survey used primary data from the key stakeholders and data was collected by use of questionnaires. The questionnaires were devised on key issues, which were likely to surface in demutualization of Nairobi stock exchange. The questionnaire approach helped gather better thought-out written input and provided an opportunity to a large number of stakeholders to express their views. Due to time constraints a number of questionnaires were sent to key stakeholders of Nairobi Stock Exchange via electronic mail and they responded promptly.

3.6. Data Analysis

Since this study was based on the stakeholders' views, the presentation of the findings was of quantitative form. The response of the various stakeholders were analyzed using Microsoft Excel program to carry out tests and extract frequency tables, mean score tabulations and percentages to represent the response rate and information on the variables under study were. This summarized the stakeholders views on the various agency problems through which inferences were derived.

CHAPTER FOUR: DATA ANALYSIS AND FINDINGS

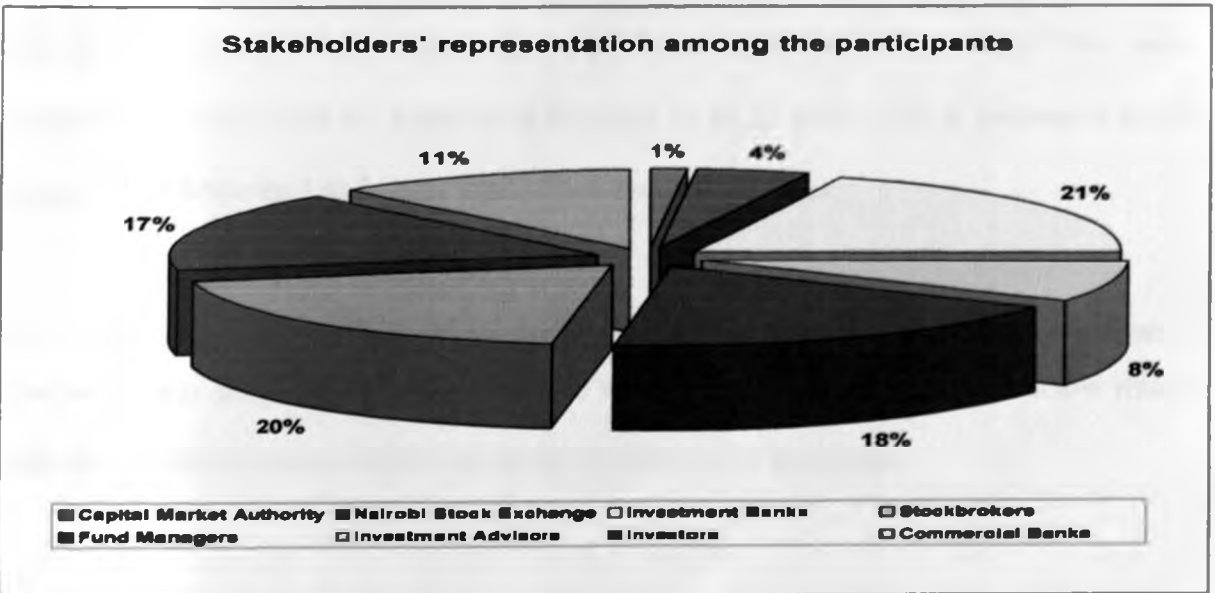
4.1 Introduction

The study sought to establish the effectiveness of demutualization in solving agency problems at the Nairobi Stock Exchange. The method of data collection was by use of questionnaires which were sent to the respondents via electronic mail and drop and pick method. The chapter presents the analyses and findings of the study. The results are presented to highlight the convergence of ideas from the respondents. Incorporated in the research findings is supplementary data provided by the respondents.

4.2 Stakeholders' participation in the research

The sample target was 80 participants comprising of Capital Markets Authority, Nairobi Stock Exchange, Investment Banks, Stockbrokers, Fund Managers, Investments Advisors, investors, and Commercial Bank who are agents of Central depository & Settlement Corporation. Out of the target 80, 71 responded representing an impressive rate of 89%.

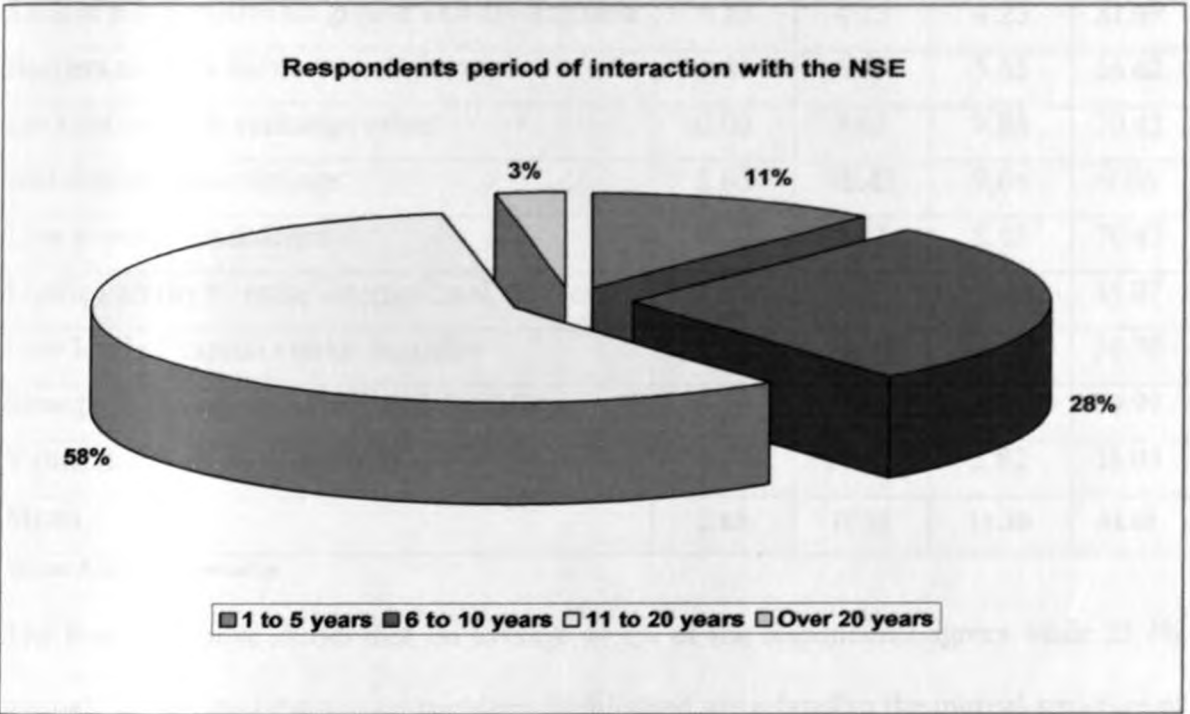
Chart I



4.3 Respondents' period of interactions with the NSE

The researcher sought to appreciate the knowledge and the period the respondents have interacted or transacted with the Nairobi Stock Exchange.

Chart II



The findings above shows that majority of the respondents representing 58% have interacted with the NSE for a period of between 11 to 20 years, 28% is between 6 to 10 years, 11% is between 1 to 5 years while 3% is for over 20 years.

4.4. Relationship between agency problems and NSE's mutual governance structure

The researcher sought to establish how the various agency problems listed below relate with the mutual governance structure at the Nairobi Stock Exchange.

Table I

Agency problems	Strongly disagree	Disagree	Neither	Agree	Strongly Agree
Lack of better governance structures	1.41	0.00	5.63	15.49	77.46
Limited access to economic capital	0.00	4.23	7.04	78.87	9.86
Limited access to human capital	8.45	73.24	11.27	7.04	0.00
Lack of profit motive for growth and development	4.23	4.23	4.23	81.69	5.63
Barriers to entry for new stockbrokers	1.41	5.63	5.63	36.62	50.70
Locking of stock exchange value	0.00	5.63	9.86	70.42	14.08
Inability to attract listings	5.63	70.42	9.86	9.86	4.23
Low investor confidence	0.00	4.23	8.45	70.42	16.90
Limited ability to make international alliances	1.41	4.23	46.48	45.07	2.82
Low level of capital market liquidity	7.04	18.31	19.72	50.70	4.23
Slow pace of innovativeness and flexibility	0.00	4.23	7.04	30.99	57.75
Vulnerability to market shocks	4.23	14.08	2.82	38.03	40.85
Mean	2.82	17.37	11.50	44.60	23.71

Source: Research Information

The findings above shows that on average 44.6% of the respondents agrees while 23.7% strongly agrees that the agency problems highlighted are related to the mutual structure of the stock market. From the findings, it also shows that 17.4% of the respondents disagreed and 2.82% strongly disagree.

There a clear indication that lack of better governance structures, limited access to economic capitals, lack of profit motives for growth and development,, barriers to entry for new stockbrokers, locking of exchange value, Low investor confidence, Low level of capital market liquidity, Slow pace of innovativeness and flexibility, Vulnerability to market shocks are agency problems that have strong relationship with the mutual governance structure of the NSE. The findings also indicate that a significant number representing 46.48% of respondents were neutral on the relationship between NSE's limited ability to make international alliances with its mutual governance structures. In

the list of agency problems highlighted in the table above, the findings shows that most of the respondents representing 70.42% disagree while 5.63% strongly disagree with inability of NSE to attract listings being related with its governance structure. Majority of the respondents representing 73.24% also disagree while 8.45% strong disagree that limited access to human capital is contributed by the NSE's mutual governance structure.

4.5 Effectiveness of Demutualization in solving agency problems

The researcher sought to establish the effectiveness of demutualization in solving agency problems listed below at the Nairobi Stock Exchange.

Table II

Agency problems	Strongly disagree	Disagree	Neither	Agree	Strongly Agree
Lack of better governance structures	0.00	1.41	1.41	59.15	38.03
Limited access to economic capital	0.00	7.04	5.63	60.56	26.76
Limited access to human capital	0.00	61.97	8.45	22.54	7.04
Lack of profit motive for growth and development	2.82	9.86	7.04	56.34	23.94
Barriers to entry for new stockbrokers	1.41	4.23	4.23	43.66	46.48
Locking of stock exchange value	2.82	5.63	26.76	57.75	7.04
Inability to attract listings	7.04	47.89	19.72	9.86	15.49
Low investor confidence	2.82	7.04	1.41	56.34	32.39
Limited ability to make international alliances	1.41	2.82	5.63	21.13	69.01
Low level of capital market liquidity	2.82	5.63	4.23	16.90	70.42
Slow pace of innovativeness and flexibility	0.00	0.00	4.23	43.66	52.11
Vulnerability to market shocks	0.00	33.80	8.45	11.27	46.48
Mean	1.76	15.61	8.10	38.26	36.27

Source: Research Information

The findings show that limited access to human capital and inability to attract listings as aspects of agency problems at the NSE cannot be eliminated through demutualization hence there are other approaches that need to be put in place to eliminate these agency

problems. In addition, a third of the respondents thought that vulnerability to market shock is also among the agency problems that cannot be eliminated by demutualization. The respondents further confirm that lack of better governance structures, limited access to economic capitals, lack of profit motives for growth and development, barriers to entry for new stockbrokers, locking of exchange value, Low investor confidence, Low level of capital market liquidity and Slow pace of innovativeness and flexibility can be eliminated through demutualization of NSE.

4.6 Potential concerns of a demutualized Nairobi Stock Exchange.

The researcher sought to establish respondents' views on various concerns of a demutualized Nairobi Stock Exchange.

Table III

Potential Concerns	Strongly disagree	Disagree	Neither	Agree	Strongly Agree
Public interest conflicting with the demutualized NSE's commercial interest	8.45	5.63	21.13	46.48	18.31
The for-profit demutualized entity not allocating sufficient resources in the regulation of stockbrokers and investment banks in light of the need to give a return to its owners	7.04	5.63	2.82	73.24	11.27
The manner of selection of directors for appointment so as to ensure that stockbrokers and investment banks do not again acquire control of the NSE	2.82	11.27	32.39	45.07	8.45
In the event that the NSE goes public and lists on its self, a potential conflict of interest is created as the NSE would need to regulate itself as a listed entity	4.23	2.82	7.04	18.31	67.61
The limits that should be imposed on stockbrokers and investment banks owning shares in the demutualized NSE	-	5.63	40.85	45.07	8.45
The possibility that a for-profit demutualized NSE could not be a financially viable entity	5.63	32.39	14.08	43.66	4.23
Entering into new business lines that may be in competition with entities that the NSE supervises	4.23	29.58	8.45	54.93	2.82
Mean	4.63	13.28	18.11	46.68	17.30

Source: research Information

When asked about the various potential concerns in a demutualized NSE, most of the respondents representing 46.68% agree while 17.30% strongly agree as depicted in table III that there are concerns with the possibility for profit demutualized NSE not being a financially viable entity, NSE entering into new business lines that may be in competition with entities it supervises, the for-profit demutualized entity not allocating sufficient resources in the regulation of stockbrokers and investment banks in light of the need to give a return to its owners, public interest conflicting with the demutualized NSE's commercial interest and the manner of selection of directors for appointment so as to ensure that stockbrokers and investment banks do not again acquire control of the NSE. 18.11% were neutral, 13.28% disagreed while only 4.63% strongly disagree.

4.7 Time frame for listing and where to list a demutualized NSE

The research sought to analyze respondents' opinions on the time within which a demutualized NSE should be listed and whether or not it can self-list.

Table IV

Time frame	Respondents
Immediately	32.4%
Within two years	66.2%
Within five year	1.5%
Self-listing	85%
List on another Stock exchange	15%

Source: Research Information

The findings in table V above confirms that majority of the respondents representing 66.2% would like to see listing of a demutualized NSE within two years of demutualization while 32.4% were of the opinion that listing should be done immediately

after demutualization. In addition, majority of the respondents representing 85% were also keen to see the demutualized NSE self list while 15% were in favour of list on another stock exchange.

4.8 Findings on various approaches in addressing agency problems at the NSE

The researcher sought to get opinions from the NSE stakeholders on the various approaches to be adopted in addressing the agency problems affecting the market.

Table V

Approaches	Strongly disagree	Disagree	Neither	Agree	Strongly Agree
Effective market surveillance by the CMA to mitigate conflict of interest in the market	1.41	-	2.82	29.58	66.20
Setting standards for the commercial & supervisory operations	1.41	-	1.41	81.69	15.49
Adoption of best practice corporate governance standards by all the market player	-	-	9.86	22.54	67.61
Creation of other exchanges to compete with the NSE in the country	5.63	11.27	21.13	46.48	15.49
Limits to be imposed on Stockbrokers & Investment Banks owning shares in the demutualized NSE	1.41	4.23	7.04	70.42	16.90
Deepening of the market by developing new products such as securitization, derivatives, options for both funding and risk management	2.82	2.82	4.23	59.15	30.99
NSE, Stockbrokers and Investment banks publishing their corporate governance reports	1.41	2.82	5.63	69.01	21.13
Elimination of external politics in the election of directors at the NSE	-	2.82	36.62	39.44	21.13
Mean	1.76	2.99	11.09	52.29	31.87

Source: Research information

On average, the findings in table V above confirms that 52.29% of the respondents agree while 31.87% strongly agreed that the approaches highlighted in the table can be adopted in eliminating or reducing agency problems at the NSE. 11.09% of the respondents were

neutral. Creation of other exchanges to compete with the NSE in the country and elimination of external politics in the election of directors at the NSE attracted a relatively high number of respondents taking a neutral position. 11.27% of the respondents were of the opinion that Creation of other exchanges to compete with the NSE in the country would not be the best approach in addressing agency problems in the market.

CHAPTER FIVE: CONCLUSION

5.1 Introduction

This chapter gives summary of conclusions drawn from the study. The chapter also covers the limitations of the study.

5.2 Conclusions

The collapse of Francis Thuo & Partners, Nyaga Stockbrokers and Discount securities in the recent past coupled with the general view that NSE is being run by Stockbrokers/Investment Banks in their own interest and are unwilling or unable to supervise and discipline detected misconducts among the members, Key stakeholders of the NSE have been watching the debate on demutualization of the market with keen interest. The research findings confirm that 83.33% of the agency problems under review can be addressed effectively through demutualization of NSE. The findings of the study shows the stakeholders desire to have the agency problems minimized through harmonizing of regulatory role of both CBK and CMA to ensure best corporate governance standards apply to all players. It is also critical that Stockbrokers and Investment Banks should recruit the best talent in the job market to take a leading role in product development and innovations in the market because limited access to human capital is not in any way related to the mutual governance structure of the NSE. It is also important that the government through CMA should provide incentives to attract more listings at the market by encouraging companies to consider capital markets in their resource mobilization because demutualization alone can not address this challenge.

5.3. Limitations of the study

The study was limited by scarcity of resources like time especially on the part of the respondents. Some respondents were also not willing to take part in the study.

5.4. Suggestions for further Research

The study was just an eye opener to the exciting process of demutualization of the Nairobi Stock Exchange. The researcher therefore recommends that further study be conducted on specific issues like the conflicts of interest and self regulatory enforcements in demutualized stock exchanges and the progress of demutualization of stock exchanges in the emerging markets

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APPENDIX: I INTRODUCTION LETTER

Felix Busienci,
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Department of Business Administration
University of Nairobi
P.O Box 30197
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October 2009

Dear Sir/Madam,

RE: COLLECTION OF SURVEY DATA

I am a postgraduate student at the University of Nairobi, at the faculty of Commerce. As part of my course work assessment, I am required to submit a management research project. In this regard, I am undertaking a research on effectiveness of Demutualization in solving agency problems at the Nairobi Stock Exchange.

This is to kindly request you to assist me by responding to the attached interview guide. The information you provide will be used exclusively for academic purposes.

My supervisor and I assure you that the information you give will be treated with strict confidence and at no time will your name appear in my report. A copy of the final paper will be availed to you upon request.

Your co-operation will be highly appreciated.

Thank you in advance.

Yours faithfully,

FELIX BUSIENEI

MBA Student

MR. JAMES KARANJA

Supervisor

Appendix II: QUESTIONNAIRE

Research Questionnaire of a survey of stakeholders' opinion on the effectiveness of demutualization in solving agency problems at the Nairobi Stock Exchange.

1. What category of stakeholders do you represent? (Tick one)

- a) Capital Markets Authority (CMA)
- b) Nairobi Stock Exchange (NSE)
- c) Investment Banks
- d) Stock brokers
- e) Fund Managers
- f) Investment Advisors
- g) Investors
- h) Commercial Banks (Custody services)

2. For how long have you/your firm been interacting with the NSE (Tick one)

- a) 1 to 5 years
- b) 6 to 10 years
- c) 11 to 20 years
- d) Over 20 years

3. To what extent would you agree that the following agency problems at the Nairobi Stock exchange are created by its mutual structure?

1 - Strongly disagree; 2 - Disagree; 3 - Neither; 4 - Agree; 5 - Strongly agree (Tick one)

- | | 1 | 2 | 3 | 4 | 5 |
|---|--------------------------|--------------------------|--------------------------|--------------------------|--------------------------|
| a) Lack of better governance structures | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| b) Limited access to economic capital | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| c) Limited access to human capital | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| d) Lack of profit motive for growth and development | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| e) Barriers to entry for new stockbrokers | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| f) Locking of stock exchange value | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| g) Inability to attract listings | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| h) Low investor confidence | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| i) Limited ability to make international alliances | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| j) Low level of capital market liquidity | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| k) Slow pace of innovativeness and flexibility | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| l) Vulnerability to market shocks | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |

Demutualization

Demutualization refers to the entire process of changing the legal structure of a stock exchange from a mutual association, with one-vote per member and usually consensus based decision-making to a company limited by shares, with one-vote per share. It involves the separation of trading rights from ownership, and in most cases the exchange becomes a for-profit firm and even, self-lists. It has more potential for profit, and also for failure, than before, and like any business, it must stand alone for financing.

4. To what extent would you agree that demutualization would solve the following agency problems of the Nairobi Stock Exchange? (Please tick as appropriate using the key below)

1 - Strongly disagree; 2 - Disagree; 3 - Neither; 4 - Agree; 5 - Strongly agree (Tick one)

	1	2	3	4	5
a) Lack of better governance structures	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
b) Limited access to economic capital	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
c) Limited access to human capital	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
d) Lack of profit motive for growth and development	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
e) Barriers to entry for new stockbrokers	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
f) Locking of stock exchange value	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
g) Inability to attract listings	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
h) Low investor confidence	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
i) Limited ability to make international alliances	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
j) Low level of capital market liquidity	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
k) Slow pace of innovativeness and flexibility	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
l) Vulnerability to market shocks	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

5. If demutualized NSE was to seek listing, what would be the best time frame (Tick one)

- a) Immediately
- b) Within two year
- c) Within five years

6. If demutualized NSE was to list, should it be allowed to self-list or only list on another exchange? (Tick one)

- a) Self - listing
- b) List on another Stock exchange

7. To what extent do you agree that the following pose potential concerns of a demutualized Nairobi Stock Exchange?

1 - Strongly disagree; 2 - Disagree; 3 - Neither; 4 - Agree; 5 - Strongly agree (Tick one)

- | | 1 | 2 | 3 | 4 | 5 |
|---|--------------------------|--------------------------|--------------------------|--------------------------|--------------------------|
| a) Public interest conflicting with the demutualized NSE's commercial interest. | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| b) The for-profit demutualized entity not allocating sufficient resources in the regulation of stockbrokers and investment banks in light of the need to give a return to its owners. | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| c) The manner of selection of directors for appointment so as to ensure that stockbrokers and investment banks do not again acquire control of the NSE. | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| d) In the event that the NSE goes public and lists on its self, a potential conflict of interest is created as the NSE would need to regulate itself as a listed entity | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| e) The limits that should be imposed on stockbrokers and investment banks owning shares in the demutualized NSE | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| f) The possibility that a for-profit demutualized NSE could not be a financially viable entity | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| g) Entering into new business lines that may be in competition with entities that the NSE supervises. | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |

8. To what extent would you agree that the following approaches will address agency problems at the NSE:

1 - Strongly disagree; 2 - Disagree; 3 - Neither; 4 - Agree; 5 - Strongly agree (Tick one)

1 2 3 4 5

- | | | | | | |
|---|--------------------------|--------------------------|--------------------------|--------------------------|--------------------------|
| a) Effective market surveillance by the CMA to mitigate conflict of interest in the market. | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| b) Setting standards for the commercial & supervisory operations | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| c) Adoption of best practice corporate governance standards by all the market players | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| d) Creation of other exchanges to compete with the NSE in the country | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| e) Limits to be imposed on Stockbrokers & Investment Banks owning shares in the demutualized NSE | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| f) Deepening of the market by developing new products such as securitization, derivatives, options for both funding and risk management | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| g) NSE, Stockbrokers and Investment banks publishing their corporate governance reports. | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| h) Elimination of external politics in the election of directors at the NSE | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |

9. Are there any other issues specific to demutualization that you would like to express your views on?

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APPENDIX III: STAKEHOLDERS' REPRESENTATION AMONG THE PARTICIPANTS

Stakeholders category	Number Of Respondents
Capital Market Authority	1
Nairobi Stock Exchange	3
Investment Banks	14
Stockbrokers	6
Fund Managers	13
Investment Advisors	14
Investors	12
Commercial Banks	8
Total	71

APPENDIX IV: LIST OF STAKEHOLDERS

Regulatory Stakeholders

- 1) Capital Markets Authority
- 2) Nairobi Stock Exchange
- 3) Central Depository & Settlement Corporation

Investment banks

- 1) African alliance Kenya Ltd
- 2) CFC Stanbic Financial services
- 3) Apex Africa Investment bank
- 4) Dyer & Blair Investment bank
- 5) Standard Investment bank
- 6) Drumond Investment banks
- 7) Kestrel Capital (EA) Ltd
- 8) Suntra Investment Bank ltd
- 9) Barclays Financial Services
- 10) Renaissance Capital Ltd
- 11) Faida Investment bank Ltd
- 12) Sterling Investment Bank Ltd
- 13) African Investment Bank Ltd

Stock Brokers

- 1) Ngenye Kariuki & Co. Ltd
- 2) Kingdom Securities
- 3) NIC capital
- 4) ABC Capital Ltd
- 5) Reliable Securities
- 6) Genghis Securities

Authorized Depositories

- 1) Barclays bank of Kenya
- 2) Kenya Commercial bank
- 3) National Industrial Credit bank
- 4) National Bank of Kenya
- 5) Cooperative Bank of Kenya
- 6) CFC Stanbic Kenya Ltd
- 7) Equity bank

Investment Advisors

- 1) First Africa (E.A) Ltd
- 2) Jani Consultancy Services Ltd
- 3) Winton Investment Services Ltd
- 4) Franklin Mgt. Consultants
- 5) Iroko Securities
- 6) Bridges Capital Ltd
- 7) Equilibrium capital Ltd
- 8) Inter-Alliance International (K) Ltd
- 9) Cititrust (K) ltd
- 10) V F S International (K) Ltd
- 11) Covebnant International
- 12) Loita Capital Partners Ltd
- 13) Dry Associates
- 14) Executive and Corporate advisory
- 15) Tsavo securities

Fund Managers

- 1) AIG Global Investments Co. EA Ltd
- 2) Old Mutual Asset Managers
- 3) Old Mutual Investment Services ltd
- 4) Aureos Kenya Managers
- 5) ICEA Investment services Ltd
- 6) Co-op Trust Investment services Ltd
- 7) Standard Chartered Investments
- 8) Affrica Alliance (K) Management Ltd
- 9) CFCStanbic Investment management
- 10) Genesis (K) Management Ltd
- 11) Amana Capital Ltd
- 12) British American Asset mangers Ltd
- 13) Zimele Asset Management