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**BUILDING CAPITAL MARKET REGULATORY
INSTITUTIONS IN DEVELOPING COUNTRIES:
THE NIGERIAN EXPERIENCE**

**George A Akamiokhor
Securities and Exchange Commission
Nigeria**

**JACK TAR VILLAGE
FRIGATE BAY
ST KITTS**



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BY

GEORGE A. AKAMIOKHOR
DIRECTOR-GENERAL
SECURITIES AND EXCHANGE COMMISSION,
LAGOS, NIGERIA

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INTRODUCTION

Mr. Chairman, distinguished ladies and gentlemen. I wish to begin my speech by thanking the Caribbean Centre for Monetary Studies and in particular Dr. Lawrence Clarke, for the invitation to address a select group at this XXVIIth Annual Regional Conference of Monetary Studies being held in the beautiful Island of St. Kitts.

As a securities market regulator, I have decided to focus my paper on issues of regulation of the capital market, with the Nigerian capital market and other emerging markets which I am most familiar with serving as the reference point. I have therefore, captioned my paper "**Building capital market regulatory institutions in developing countries - The Nigerian Experience**".

I would endeavour to address all the issues raised in the letter of invitation. In this regard, the paper would be divided into four principal sections covering the setting up and managing capital market regulatory institutions as well as strengthening and fostering of the capital markets in developing countries. I should however, point out that there are no **golden rules** to any of these. Nevertheless, certain policies, measures and actions have proven to be beneficial to some of these issues especially in respect of strengthening and fostering of capital markets.

The Capital Market

1.1 Global events in the past decade and half have in no small ways influenced the growth of capital markets around the world. The collapse of communism, **economic and financial market reforms, institutionalization, democratization and technological advancement** have perhaps been principally responsible for this development. Today, there are over sixty emerging stock markets across the globe, many of which were established in the past decade or so. In fact, in 1980 emerging markets numbered only about thirty, with none in the former communist countries and just eight in Africa. Presently, virtually every country in Eastern Europe has a functional stock market while seven new markets have opened in Africa (all during the last six years), bringing the total markets in

Africa to fifteen. In addition, three African countries have reached advanced stages of setting-up stock markets.

- 1.2 There are a few markets in the Caribbean, with the markets in Barbados, Jamaica and Trinidad and Tobago being probably the most active and developed. It is however, my belief that the region has the potentials for more markets and this should be pursued in view of the importance of capital markets as **efficient vehicles** for funds mobilization and allocation.
- 1.3 Emerging markets have not only grown in number, many have become more efficient, sophisticated, active, internationalised and established sound legal and regulatory frameworks to facilitate the protection of investors. Some of these markets by certain criteria are also comparable with mature markets.
- 1.4 The proliferation, and indeed progress made by emerging markets of late, obviously underscores the increased awareness of the **values** of the capital market by both policy makers and the private sector in developing economies.
- 1.5 The most important function of the capital market is, as was noted previously, its ability to **mobilize and channel savings into long term investment** for commercial and industrial development through the issuance and sale of new securities. This is the basic function of the primary securities market, but the secondary market which is a transfer market for existing securities also plays a vital, albeit indirect role in this respect. The reason for this is not far fetched. The fact that a secondary market such as a stock exchange exists would encourage the issuance of securities and the participation of the populace in new issues. Investors would participate, **confident** that their holdings could be disposed of in the secondary market whenever they wish to do so. In other words, the liquidity which the secondary market provides does contribute to interest in primary issues.

- 1.6 The capital market plays other important socio-economic functions such as:
- a) promoting solvency, efficiency and competitiveness of the financial system;
 - b) encouraging corporate financial discipline, accountability and transparency which could enhance the level of corporate tax to government,
 - c) creating an avenue for the populace to participate in the corporate sector of an economy and share in its wealth through ownership of securities,
 - d) encouraging venture capital development;
 - d) enabling investors adjust their portfolio of investment at will, thus maintaining desired level of portfolio mix;
 - f) reducing over-reliance of the corporate sector on debt financing by providing equity capital and thus improving its debt/equity ratio.

Setting-up Capital Market Regulatory Institutions

- 1.7 Most countries operate two layer market regulatory system. The first layer is **self regulation**, instituted by self regulatory organizations (SROs) such as stock exchanges and associations of securities dealers. The second layer, which is broader in scope and authority is **regulation by statute**, administered by government agencies such as securities commissions.
- 1.8 However, setting up a capital market regulatory institution, be it a statutory or self regulatory agency, could be **involving in terms of time and resources**. Relevant laws and rules would have to be drafted and put in place, the SRO's memorandum of association would have to be formulated and approved while the institution (SRO) would need to be incorporated. Furthermore, experienced and competent staff as well as suitable accommodation would be acquired while adequate and appropriate facilities should be

installed. It is obvious that these may not be easily accomplished and for a developing economy, government support may be required.

- 1.9 In actual fact, governments in many developing economies particularly the newer markets have played **promotional** roles in the establishment of stock exchanges in their jurisdictions. This was the case with Nigeria where the government pioneered the establishment of the then Lagos Stock Exchange (now The Nigerian Stock Exchange), and through the Central Bank of Nigeria and the Investment Company of Nigeria (now Nigerian Industrial Development Bank) provided operational and financial support to the young exchange.
- 2.0 In Ghana and many other African countries, one also observes this pattern of active government involvement in promoting the setting-up of stock markets. But perhaps government catalyst role in establishing or re-opening stock exchanges is most vivid in Eastern Europe's economies in transition.

PART I

SETTING UP A CAPITAL MARKET REGULATORY INSTITUTION - THE STOCK EXCHANGE

- 2.1 Stock exchanges usually pre-date securities commissions but in few cases like Mauritius and Taiwan, securities commissions have preceded stock exchanges. Of course, it makes sense to have a functional market before introducing statutory regulation otherwise one may wonder what the statutory regulatory agency regulates. A non-existent market?
- 2.2 While this sounds quite logical it has also been argued that both statutory and non-statutory regulations could be established simultaneously or as in the case of the examples cited earlier, the statutory agency could be set up before the non-statutory agency. The reasons for this are two-fold; it would provide better protection

of investors and eliminate possible rivalry or conflict between the two regulatory institutions. It is not unusual for a stock exchange which has been long in existence without a statutory agency watching over its activities, to resent the authority of a statutory agency established afterwards.

2.3 **Ownership, Membership And Management**

Although largely government promoted in developing economies, stock exchanges are **non-profit, private sector membership organisations** and operate as such. The exchanges are owned by their members who in most cases are the dealing members (i.e. stockbrokers) of the exchange.

In Ghana and Nigeria stock exchanges are incorporated as **companies limited by guarantee** under the companies laws.

2.4 The Nigerian experience shows three categories of membership of the Exchange viz.

- i) **dealing members** - these are ordinary members of the Exchange who may effect transactions on the floor by virtue of being licensed for that purpose as broker-dealers;
- ii) **ordinary members** - these are drawn from members of the public who have distinguished themselves in the area of finance, commerce, general business and indeed public service. They also include broker-dealers as was mentioned earlier. Such individuals or firms must have contributed a minimum of 5 shares to the paid-up capital of the Exchange.
- iii) **council members** - elected from among ordinary members for a period of one year but eligible for re-election to the council of the Exchange. This is the policy making body and is akin to a board of directors. It is chaired by a president who may act in that capacity if re-elected for a maximum period of three terms.

A Director-General and his management team ho oversee the day-to-day running of the Exchange

Departments

- 2.5 An exchange must create relevant departments and units to facilitate its operations. A small and relatively inactive market might not really require several departments as would probably an active and sophisticated market. The level of automation, facilities and trading system would also influence the types of departments to be created.
- 2.6 For instance, while some emerging markets have about four departments, the Thailand Stock Exchange operates fifteen. There are however similar operational departments in most markets, notwithstanding the nomenclature in use. These include:
- i) **Listing (Quotation)** department - for handling applications in respect of admission of new securities;
 - ii) **Market supervision** department - for the surveillance of trading activities;
 - iii) **Examinations** department - for book audit of the activities of operators; and
 - iv) **Investigation** department - for investigating rule breaches.
- 2.7 In addition to these, every market would require strong support departments such as **research** and **legal** departments as well as **administration** to service the institution. It would of course also require a **public relations** department to, inter alia, aid the dissemination of information. In Nigeria, the Stock Exchange has a department known as the **Second-tier Securities Market Department** because of the existence of a second market for the quotation of smaller companies.
- 2.8 The number of departments do not necessarily have to remain static, events and developments as the market progresses, would be a determining factor in expanding or shrinking departments.

- 2.9 A few standing committees e.g. disciplinary and arbitration committees could be established as they may be useful in dealing with certain defined issues. The committees could comprise both the exchange management staff and broker-dealers.
- 3.0 **Initial funding and staffing**
A problem which promoters of capital market regulatory institutions often face is where and **how to source initial capital** for the take-off of these institutions. Being government agencies, seed capital for take-off of securities commissions does not appear to be much of a problem, as governments usually assume this responsibility fully. The situation could be different for SROs, bearing in mind that they are private sector institutions. In Ghana the issue of funding stalled the early establishment of a stock exchange.
- 3.1 For a stock exchange, certain funding options would come to mind:
- i) **issue capital for subscription.** But the fact that stock exchanges are non profit making could discourage interest;
 - ii) **seek support from government;**
 - iii) **solicit assistance (financial and technical) from international agencies;**
 - iv) **seek contributions from a select group** of highly reputed institutions and industrialists who appreciate the importance of a capital market. These institutions/individuals may be honoured as "**founding members**". In some countries such "**founding members**" actually initiated and promoted the establishment of stock exchanges.
- 3.2 Any or a combination of options (ii) to (iv) could be explored. In Nigeria initial funding of the exchange was substantially from the government in form of annual subventions. In addition, accommodation was provided by the Central Bank of Nigeria and later by the Nigerian Industrial Development Bank. There were

also seven foundation members who contributed to its take-off.

The yearly government subvention lasted only a few years, and the Exchange is now purely market funded.

- 3.3 **Staffing and training** are matters which would confront a young exchange. Where does it draw its top and middle management staff with good understanding of capital market but in particular stock market operations? An obvious source would be from institutions in the financial system such as the central bank and merchant/development banks.
- 3.4 Training should be a main priority at that stage of development as staff need to be exposed to **practices in other countries** to enable them improve their skill and competence. For developing economies, the experience and practices in other emerging markets may be more relevant and adaptable than mature markets. That is not to say that practices in such markets would not be invaluable.

Trading System

- 3.5 The exchange would also have to determine the most suitable trading system for its operations. Should it begin with an **automated/computerized** system, a **continuous auction** trading system or an **order-driven call-over system**? For inactive markets with very few listings, the call-over system could be a starting point. Let me stress once again that there is no universally accepted trading system for commencing a stock exchange. However, most developing economies tend to lean towards call-over and auction systems, although China began trading with automation and it worked well. The point is that it is purely a **matter for the country**, taking into consideration its level of development and peculiarities. Nevertheless, advice could be sought in form of technical assistance from multilateral agencies on the best trading system to be introduced.

3.6 **Drafting Rules of the Exchange**

The exchange would have to draft and introduce **rules** and

regulations as well as **bye rules** to guide its operations and the behaviours of members. Rules to be formulated would include **listing, membership and trading rules**. A code of conduct would also be desirable for members as well as exchange staff. These rules should be approved by a securities commission or any statutory agency if one exists.

Practices in other countries may be useful in drafting exchange rules and indeed, securities laws.

3.7 **External Assistance**

Although this has been referred to earlier, it is appropriate to mention that **multilateral and bilateral** assistance could be invaluable in establishing capital market regulatory institutions. The assistance may be useful in the area of feasibility study before set-up, initial funding and training. Agencies such as the World Bank, UNDP, USAID, and the Commonwealth are known to have provided one form of assistance or the other to emerging markets.

PART II

SETTING-UP A CAPITAL MARKET REGULATORY INSTITUTION - THE SECURITIES COMMISSION

3.8 Regulation should be applied in the financial services industry as much as is necessary to provide **protection for users of financial services**, ensure the safety and soundness of the market and provide investors with adequate information to make rational investment decisions. In this regard, regulation should safeguard **the interest of market participants by emphasizing, full disclosure, and ensuring a fair and efficient market**. Outside that, regulation should not guarantee compensation for losses emanating from the **misjudgements** of investors. A fair and efficient market would **facilitate** capital formation and economic development.

3.9 As it is well known and earlier stated, securities commissions are government agencies established by statute to administer the

securities laws of a country which supersede rules of SROs and intermediaries. Indeed the rules of the exchange must be in **conformity** with the objectives of the securities laws and therefore require the prior approval of the securities commission which has primary responsibility for protecting the interest of investors - the main purpose of securities legislations.

- 4.0 Perhaps the first step in establishing a securities commission is the **enactment of relevant laws** which would create the institution and spell out its functions, powers etc.
- 4.1 Being the apex institution for the capital market, the securities commission must exercise **oversight** on the entire capital market; covering SROs, intermediaries, instruments and issuers.
- 4.2 Almost all securities commissions are supervised by a government ministry, usually finance or economy, but with **little or no interference** on their day-to-day activities. These institutions in other words, operate quite independently but within the bounds of their **enabling laws**. However, as in the case of Nigeria, the Ministry of Finance, its supervisory ministry, is as required by law periodically briefed about developments in the capital market.

The Role of Central Banks

- 4.3 Agencies such as central banks and finance ministries can by virtue of their functions and objectives in emerging markets, **play a propelling role** in the establishment, growth and development of securities commissions.
- 4.4 In Nigeria, the securities commission actually **evolved** out of the Central Bank of Nigeria under its aegis of promoting a sound financial system. The Bank in 1962 in conjunction with the Ministry of Finance, set up the Capital Issues Committee in the Central Bank with the sole purpose of timing public issues in the market, in a manner that would **discourage clustering** and ensure the **orderly growth** and development of the infant market. The thinking was that an uncontrolled issues market would over-stretch the absorptive capacity of the capital market, lead to large issue

undersubscription and in turn discourage issuer and investor participation in the capital market.

- 4.5 The committee was set-up with the hope that as market activities increase and the economy progresses the need for a statutory regulation of the market would be justified. This was to be in 1973 when the **Capital Issues Commission** Decree was promulgated, the first statutory regulation of the securities market. The Decree created the Capital Issues Commission but it operated as a department in the Central Bank.
- 4.6 As market activities accelerated further in the late 1970s, induced by the indigenization exercises, a **comprehensive securities** law largely patterned after the United States model was introduced. It established the **Securities and Exchange Commission (SEC)**, as a separate institution from the Central Bank of Nigeria, vested with extensive powers to protect investors and develop the Nigerian capital market for enhanced socio-economic development of the country.
- 4.7 After the establishment of the SEC, the Central Bank continued to provide **supportive role**, funding the Commission completely for many years thereafter. Now the Bank contributes less than twenty percent to the SEC annual budget while the balance is generated from industry fees (e.g registration fees and fees on market deals).

One should advise that whatever funding method is chosen for the securities commission, it should be **adequate** to enable it **employ** and **maintain** the desired calibre of staff. However, industry funded securities commissions must ensure that the market is not **over burdened** by such funding which could indeed impede its growth.

- 4.8 Apart from financing the SEC in Nigeria, the Central Bank also provided all of its **initial staff** including its chief executive, most of whom were drawn from the Capital Issues Department of the CBN which later **metamorphosed** to the present SEC. Owing to its history, the SEC at inception had a crop of competent staff who had acquired some skills and experience on capital market operations

and regulation. Notwithstanding that, an extensive overseas training policy was introduced. Most of the initial staff from the Central Bank are still with the SEC and constitute a good percentage of its executive staff strength.

Managing The Institution

4.9 This would be examined under the following sub-headings:

5.0 Structure

The board and management structure of securities commissions vary from one country to another and is probably a factor of the **corporate governance practices** in a country. The US structure with an executive chairman, however seems to be most favoured by emerging markets.

5.1 In Africa, the common practice is the vesting of the role of chairman and chief executive on **separate persons**. Most securities commissions in the region thus have part-time chairmen who concern themselves with board matters of policy formulation, while the day-to-day affairs of the institutions are the responsibilities of the chief executives. This practice is most probably borne out of the need to provide **adequate checks and balances** on executive behaviour.

5.2 Appointment of members is generally, the prerogative of the head of state but requiring the approval of the parliament in some cases. Where a board system exists, the **supervisory ministries** would almost always be represented on the board. Owing to the role of the Central Bank in Nigeria, the Deputy Governor of the Bank was for many years Chairman of the SEC. The chief executive of a securities commission must be supported by a highly professional team of deputies with specific responsibilities.

5.3 Departments

Given the similarity in functions and objectives, there are certain related departments which are common to most of these institutions. These are:

- i) **Corporate Finance** - responsible for matters of registration of securities issues and investment management (e.g. Unit and investment trusts).
- ii) **Market Supervision** - responsible for monitoring trading activities and behaviour of intermediaries, inspecting of books and records of intermediaries including SRO reports on intermediaries, and investigating perceived/suspected rule breaches.
- iii) **Enforcement** - responsible for initiating enforcement actions against violators of the securities laws and rules thereunder.
- iv) **Legal** - responsible for providing legal advice and services to management on matters relating to the securities laws and the general activities of the securities commission.
- v) **Research** - responsible for undertaking market studies and providing advisory services to management, producing publications and engaging in general market developmental activities.

PART III

STRENGTHENING THE CAPITAL MARKET

5.4 Measures to strengthen the capital market would require the firm establishment of relevant and adequate legal, regulatory and institutional framework which would enable the market operate efficiently to meet the purposes for which it exists.

5.5 Legal and Regulatory Framework

The legal and regulatory framework as earlier stated, could focus on securities law, rules of the SROs and setting up of agencies for their administration. The securities law should be broad based and comprehensible while the securities commission is given broad but

extensive powers to formulate detailed rules and guidelines to respond promptly to changing circumstances.

5.6 In drawing up the legal and regulatory framework which may not be an easy task, cognisance must be taken of the **general practices** and **peculiarities** of the country. It must be borne in mind that practices in one country cannot be **implanted** wholesale into another. It would most likely fail to achieve the desired results. Such practices must be fine-tuned to suit the country's environment. Adaptability of laws and regulations is therefore of utmost importance.

5.7 It must also be said that care must be exercised in formulating securities laws, in order not to **over-regulate** or **under-regulate** the securities market as both situations would be detrimental to its efficiency and development.

5.8 The legal framework to be established could, inter-alia, confer on the securities commission powers to perform the following functions:

- i) register and **supervise** stock exchanges, association of securities dealers, intermediaries, collective investment schemes, clearing and settlement companies (if separate from the stock exchange);
- ii) **register** all public offers of securities (i.e. distribution of securities);
- iii) protect the market from **unfair practices** such as illegal, deceitful and manipulative activities;
- iv) promote market integrity, ethical and **professional standards**;
- v) promote **orderly growth** and development of the market;
- vi) serve as **chief adviser** to government on matters relating to the securities market including appropriate legislative review of laws affecting the capital market;

- vii) regulate corporate **disclosure**;
- viii) **enforce** the securities law, rules and regulations thereunder;
- ix) embark on any **other function necessary** for the realisation of the objectives for which the market is set up.

In carrying out these among other functions, the securities commission must endeavour to **encourage** and not stifle **competition** and efficiency.

Registration (Authorization) of Exchanges and Intermediaries

5.9 Registration (authorization) is the first step in market regulation and perhaps the most potent of all the instruments of capital market regulation. Registration is intended to provide the authorities with information which would enable them determine the fitness or otherwise of prospective registrants. Specifically, the "fit and proper" test is to ensure that:

- i) prospective participants in the market are **financially, educationally, and professionally** sound to do business in it;
- ii) market participants are not persons of **questionable character and background**;
- iii) **adequate facilities** are provided for trading; and
- iv) offer documents contain information which are **timely and adequate** as stipulated by the securities commission.

6.0 It should be the responsibility of registrants to make sure that information they provide to the securities commission in respect of applications for registration are **accurate** while the securities commission must not hesitate to **revoke** a registration found to have been **fraudulently obtained**. Where operators act outside legally and **professionally accepted** rules and norms, sanctions should be swiftly and adequately applied.

- 6.1 Registration must be renewed at intervals to ensure that registrants **continue** to be "fit and proper" to conduct business in the market.
- 6.2 The law should prohibit and provide adequate punishment for the establishment and operation of an exchange or intermediary firm by any person or persons without obtaining the **prior approval** of the statutory regulatory authorities.
- 6.3 The stock exchange on its part, must **formulate admission requirements** for membership as well as rules and regulation to guide the professional conduct of members. In addition to these, it must formulate **trading and settlement rules**. Such rules should be submitted to and approved by the securities commission before they can become operational. All rule changes or additional rules must also be approved by the securities commission, which should have powers to direct an exchange to effect a rule change if it is of the opinion that such a change is desirable in the interest of investors and the market.
- 6.4 In approving the rules of an exchange, the securities commission must be satisfied that the exchange and clearing and settlement company (if separate from the former) provide adequate **safeguards to prevent market abuses**. It should also ascertain the capacity of the exchange in terms of personnel and financial resources to, inter alia, undertake effective monitoring of members.

Market Supervision

- 6.5 As part of efforts to protect investors, it is essential that the regulatory authorities evolve and maintain effective and **efficient monitoring** procedures for activities in the market. **Daily surveillance** of trading on the floor of the exchange as earlier mentioned, is inevitable to detect unfair trading practices, such as **price manipulation** and **insider dealings**. Linking the exchange with the securities commission would be an effective means of monitoring trading activities. Where this is not practicable, physical presence of staff of the securities commission at trading

sessions could be an alternative means of monitoring activities.

- 6.6 Apart from the surveillance of trading on an exchange, periodic inspection of the books and records of all intermediaries and the scrutiny of inspection reports are necessary. Usually, the exchange is **delegated** the responsibility of inspecting the books of its members but copies of inspection reports are forwarded to the **securities commission**. A follow up is then carried out by the securities commission as it deems necessary. For intermediaries not overseen by any SRO, the securities commission would have to carry out direct book audit of their activities.
- 6.7 The scrutiny of the books and records of intermediaries is important for a number of reasons:
- i) to ascertain the **financial state** of intermediaries which is vital to their ability to perform.
 - ii) to enable the authorities determine whether or not **proper records** are kept, **customers' mandates** are complied with and customers' accounts are **segregated** from those of the intermediaries. In other words, it should assist the authorities discover **rule breaches**; and
 - iii) to serve as an early **warning signal**, alerting the authorities of the **emergence of problems** in the intermediary institution which could lead to undesirable consequences for it and indeed the market as a whole.
- 6.8 Although no legal framework and regulatory system can provide **foolproof** mechanism against fraud, it is the duty of the regulatory authorities to be **vigilant in monitoring the conduct** of all intermediaries so as to promptly detect practices which are capable of jeopardizing the stability and development of the market.

Power of Investigation and Enforcement

- 6.9 Without the powers of investigation and enforcement, regulatory authorities would be **handicapped** in effectively performing their established functions. The securities law must therefore give the

securities commission powers to investigate any suspected violation of the securities law and rules and regulations thereunder. All **complaints** from investors, intermediaries and indeed the general public must as a consequence be promptly investigated. In the same vein, all **irregularities** discovered in the course of examination of the books and records of intermediaries should call for prompt investigation. Indeed, regulatory authorities due to their surveillance and inspection functions, are generally well placed to detect illegal activities.

- 7.0 Although one realises that investigations could be time consuming and financially demanding, the securities commission as a statutory regulatory agency, would owe the market and the public the duty to investigate to a logical conclusion every **suspected case of violation** of its enabling law and rules and regulations thereunder. It is only through investigations that most violations would be established and appropriate enforcement actions subsequently taken.
- 7.1 Investigations should be conducted **confidentially** to protect those who are likely to be found innocent and to prevent unnecessary publicity which could hinder the outcome of such investigations.
- 7.2 Information about any investigation should be a matter of **public interest** only at the end of its completion. The securities commission could also be given powers to conduct fair hearing of cases involving professional misconduct and suspected violations of laws affecting securities trading. To this end, it could establish an **administrative hearing committee** with power of sanctions. In hearing cases, the securities commission **must not only be fair but must be seen to be fair**, if it is to attract the desired confidence of market participants. In Nigeria, the Administrative Hearing Committee has been useful in resolving issues and imposing sanctions against offenders. It has had a deterrent effect on market abuses.
- 7.3 However, criminal violations are outside the jurisdiction of securities commissions but require prompt reference to the

authorities responsible for criminal actions when they occur. On the other hand, civil actions could be instituted as an effective enforcement mechanism.

- 7.4 Sanctions, as instrument of **punishment and deterrence**, help to keep market operators in check. In the application of sanctions, care must be taken to ensure that each sanction is commensurate with the offence. A **variety** of sanctions must therefore be available to the regulatory authority, given the fact that various types of violations ranging from **minor to serious offences** are likely to take place in the securities market. Sanctions could include **reprimand, disgorgement of proceeds, suspension, expulsion** from the market and **restriction of activities** in the market (e.g. an intermediary could be prevented from undertaking a particular function). In addition, criminal and civil sanction could be imposed by the courts, these would include order to comply with the law, fines and imprisonment.
- 7.5 It is important that the securities laws provide **broad liabilities for violations** while the securities commission should have the prerogative to **impose non-criminal and civil sanctions**. For instance, in Nigeria, while the provision of false and misleading statements in an offer document (prospectus) may attract both civil and criminal liabilities, the SEC may suspend or expel an intermediary for failure to keep-up with any of its registration requirements. Evidently, sanctions have proved to be an important tool of deterrence and ensuring stability in the Nigerian securities market.

Record Keeping

- 7.6 The regulatory framework must stress **proper record keeping** by intermediaries, of their activities, which should be available for inspection as and when required. In this regard the authorities could **specify the type** of records to be kept. Such records should include order and transaction registers, accounting ledgers, and any other document prepared or received in the course of business transactions.

Segregation of Clients' Accounts

- 7.7 To prevent possible **encroachment** on customers' funds, market intermediaries must be required to segregate customers' funds from those of intermediaries. This should be strictly enforced by the regulatory authorities. If adequate rules are not put in place, in this respect, **investors' funds could be misused**. The regulatory authorities must therefore formulate detailed rules to safeguard such funds. The rules should, inter alia, require intermediaries to **open separate accounts for customers**, promptly deposit funds into such accounts, and keep all records in connection with such accounts for inspection when called for. An intermediary would thus need to **build a strong record keeping audit trail**.

Prudential Requirements

- 7.8 Prudential requirements may be evolved and reviewed as and when necessary to **protect investors and guard the safety and soundness of the market**. The prudential requirements should be such that would ensure that the liquidation of an intermediary firm would not lead to **financial losses** to its clients or create a **systemic crisis**. The requirements could also cover settlement risk and risk arising from fraudulent practices by staff of the intermediary firm, among others. But such requirements are never intended to protect investors from normal investment (market) risk i.e. arising from usual fluctuations in the prices of securities. Guidelines could thus be introduced on the **minimum capital base and capital adequacy standards for intermediaries**. These could be **risk-based**. Also intermediaries could be required to take on fidelity insurance.

Institutional Framework

- 7.9 Financial markets cannot function without the presence of certain **key institutions**. In the long term arm of the market, intermediaries like **broker-dealers, issuing houses, underwriters and investment managers** are essential. The enabling environment must therefore be created for these institutions to thrive and efficiently too. The tendency in the past in a number of developing economies, particularly in Africa, was the promotion of commercial and development banks while much emphasis was not placed in the area of capital market intermediation.

- 8.0 With the increased awareness of the importance of capital markets, focus is now equally directed at the development of such institutions. However, the existence of **money market institutions** at the inception of a capital market, even if capital market institutions are absent, would **assist in facilitating** activities in the market. For instance, banks could establish corporate finance departments that would engage in issues and underwriting business. The development of **institutional investors** such as **pension funds** and **insurance companies** also strengthens capital markets. In some countries Nigeria included, these institutions are by law required to invest a stipulated percentage of their investible funds in capital market instruments.
- 8.1 In conclusion, the legal and regulatory environment should not stifle but encourage the growth and competitiveness of these institutions. Furthermore, **market facilities** should be **adequate** and **efficient** to enable intermediaries participate and perform their functions efficiently, and consequently stimulate investors' confidence and participation.

PART IV

CONDITIONS NECESSARY FOR FOSTERING CAPITAL MARKETS

- 8.2 Financial markets do thrive under certain basic macroeconomic, political, legal and regulatory environments. Some of these requisite environments are examined below:
- 8.3 **Government Commitment**
The commitment of government to the development of the securities market is essential for furthering capital markets in emerging markets. Obviously, a government which fully **understands** the merits of the securities market would be better disposed to **adopting favourable policies** to stimulate its growth. In contrast, where policy makers lack full understanding, they may not be too inclined to introduce promotional policies. For instance, without full understanding of the implications of a high tax policy on the growth

of the securities industry, governments may not be willing to provide tax incentive to boost the market. Consequently, the statutory regulatory body, if already established, should assume the responsibility of educating policy makers to appreciate the importance of the capital market to socio-economic development.

8.4 **Political Environment**

Political stability is a crucial factor in fostering economic and securities market growth and development, as an unstable environment would **mar confidence** and **discourage investment**. Generally, political instability exposes investment to **high risk**, encourages **capital flight** and inhibits economic and capital market growth as earlier stated, given the fact that investors would always consider the safety of their funds in deciding whether or not to invest or retain their investment in any country or geographic region.

8.5 Perhaps in appreciation of this, **political reform** was instituted along with economic reform in the 1980s and 1990s in many developing economies. Policies aimed at **democratization**, economic and political stability, particularly in Latin America encouraged the repatriation of flight capital and stimulated portfolio investment.

8.6 **Macroeconomic Environment**

The progress made by some emerging markets has shown that **sound and consistent** macroeconomic policies do impact positively on capital markets. Stability and growth in an economy would strengthen confidence and stimulate participation in it. Such an environment would in turn promote the development of financial markets. Anti-inflationary policies, good interest and exchange rates policies, as well as investment and entrepreneurial promotion policies would undoubtedly engender the progress of the market.

Other macro economic issues are discussed below:

8.7 **Savings and Credit Policies**

The securities market and indeed the financial system can not be fully developed without the introduction of policies which would

encourage private savings and investment. To this end, the capital market must not be seen as a "second fiddle" to the money market in savings mobilization and as a source of commercial and industrial capital. **Discriminatory policies** which favour the money market vis-a-vis the capital market would place the latter at a disadvantage and should be discouraged. Such practices as interest rate subsidy, withholding tax on capital market as opposed to money market instruments should equally be discouraged.

8.8 Financial market reforms should also eliminate **sectoral credit allocation** if the capital market is to compete effectively with the money market. Before the deregulation of the money market in Nigeria in 1986, interest rates were officially determined and **deliberately kept low** as government was the major borrower in the system. But this encouraged the **mismatch of term funds** as most companies sourced both short and long term funds through the money market while the capital market was considerably neglected. The introduction of market determined interest rates in 1986 revised interest rates upwards and enhanced both the competitiveness and interest in the capital market which consequently assumed considerable prominence.

8.9 Tax Environment

High withholding tax on dividend, capital gains and corporate taxes will definitely serve as a disincentive to both domestic and foreign investors from investing in a particular market. A foreign investor would always compare **prevailing tax rates** with those applicable in his home and other countries while domestic investors would seek investments with **less tax burdens**. Most emerging markets have abolished capital gains tax while withholding tax rates have been reduced. Also important is the **equal treatment** of domestic and foreign nationals in respect of taxes and investment.

9.0 Privatization Programme

Implementing privatization programmes through public offer and quotation on the stock exchange **stimulates** capital market activities and creates **awareness**. If privatization is via **global offering**, as had been done by some countries, it would improve international

visibility and interest in a country and its capital market. Nigeria was able to **deepen** her capital market through a privatization programme which has so far brought into the Stock Exchange 28 additional companies.

9.1 Foreign Investment Laws

Laws governing foreign investment are in some countries a major obstacle to foreign portfolio investment and thus to securities market development. Such laws sometimes **prohibit** foreigners from engaging in certain economic activities or **restrict** their equity holdings in domestic companies. Furthermore, governmental approval may be required before a foreigner can effect any investment while the **repatriation of earnings and principal** may be restricted. Even where repatriation is not restricted, the **cumbersome** procedures for remittance are sometimes discouraging to foreign investors. To attract portfolio investment, and stimulate the capital market, emerging markets must **eliminate or at least minimise barriers** to entry and exit from their markets as foreign investors would always prefer markets with the least hurdles to invest in. It is worthy of note that while restrictive policies still exist, **many** emerging markets including Nigeria have removed them.

9.2 Aware of the increasing global competition for foreign capital, especially in the wake of recent developments, the Nigerian government recently took some steps aimed at **creating an investor-friendly environment** with the ultimate objective of **accelerating off-shore investment** flow into the country.

9.3 Prominent among these was the **repeal of two laws** which had hitherto **hindered** the free flow of foreign direct and portfolio investment into the country. These were the Exchange Control Act 1962 and the Nigerian Enterprises Promotion Decree 1989. The government has also commenced a review of other laws which might **contain** restrictive provisions for possible **repeal or amendment**.

- 9.4 Two new decrees have been promulgated to replace the repealed ones. These are the **Nigerian Investment Promotion Commission and the Foreign Exchange (Monitoring and Miscellaneous Provisions) Decrees** of 1995. The former deregulates and debureaucratizes the investment environment by, inter alia, setting up the Nigerian Investment Promotion Commission (NIPC) whose duties as stated in Section 4 of the Decree include initiating and supporting measures to enhance the investment environment. The NIPC is also to promote investment through **effective promotional** means in and outside Nigeria.
- 9.5 The second decree, inter-alia, established the Autonomous Foreign Exchange Market (AFEM) and provides guidelines for dealing in it. The new decree enables any foreign investor to freely invest in Nigeria without reference to the Ministry for approved status or approval in principle. Similarly, the principal and dividends from investments may now be **freely repatriated** without reference to the Ministry. It is expected that foreign as well as local investors will find the ensuing liberalised environment conducive for their operations.
- 9.6 **Market Infrastructural Facilities**
A market without an efficient **clearing and settlement** system would definitely **lack appeal** to investors both domestic and in particular, foreign investors. The ease at which transactions are concluded would also impact on the willingness of investors to adjust their portfolio more frequently and consequently **stimulate liquidity**. It is of essence therefore that steps are taken by an emerging market to improve clearing and settlement procedures. Many have already taken such positive steps.
- 9.7 A settlement period as recommended by the Group of 30 should be strived at. Indeed some emerging markets have in recent times taken steps to reduce their clearing and settlement procedures to such **acceptable international standards**. In line with this, a **central depository system** and **custodial facilities** could also be introduced while trading practices are reformed if necessary, to improve the efficiency of the market. The **technical assistance** of mature markets

and more developed emerging markets can be sought in improving trading practices and standards. The report of the IOSCO Development Committee on clearing and settlement endorsed by the Presidents' Committee could also be useful in improving clearing and settlement systems in emerging markets.

9.8 Improving Market Awareness

The level of capital market awareness in many developing economies is low. And this affects the level of participation and the markets' growth. Regulatory authorities should, as part of their activities embark on **regular public education programmes**. These could take the form of supplying the public with free market **educational literature**, timely market releases, and creating **fora** for discussing issues of relevance to the capital market. The **media**, both print and electronic, can be good sources of enlightening the public. But financial journalists must also be well educated on matters of the capital market to enable them enlighten the public better.

9.9 Other Measures

The following measures are also desirable in fostering securities markets:-

- i) introduction of **collective investment vehicles** such as unit and investment trusts which play the important function of pooling resources from small savers. The funds are professionally managed and invested in securities market instruments;
- ii) introduction of **internationally acceptable auditing, accounting and disclosure standards**;
- iii) elimination of **repressive and out-date commercial/corporate laws**;
- iv) introduction of **tax incentives** to stimulate supply and/or demand for securities;

- v) putting in place an **efficient system of corporate and market information flow**; and
- vi) introduction of policies conducive to the **internationalization** of the securities market.

CONCLUSION

Building capital market regulatory institutions in developing economies obviously poses a number of challenges to both government and the private sectors. These challenges, equally require the collective efforts of the government and the private sector. An enabling environment is essential for the market to record substantial and sustainable progress.

The experiences of other markets should inspire and guide those economies yet to establish capital market regulatory institutions while the assistance of multilateral and bilateral agencies could be invaluable. Policy measures aimed at developing capital markets should not only be sound and clear but should be capable of responding quickly to the dynamics of the operating environment. This way, the capital markets and indeed the economies would benefit.

GEORGE A. AKAMIOKHOR
NOVEMBER, 1995

Appendix 1

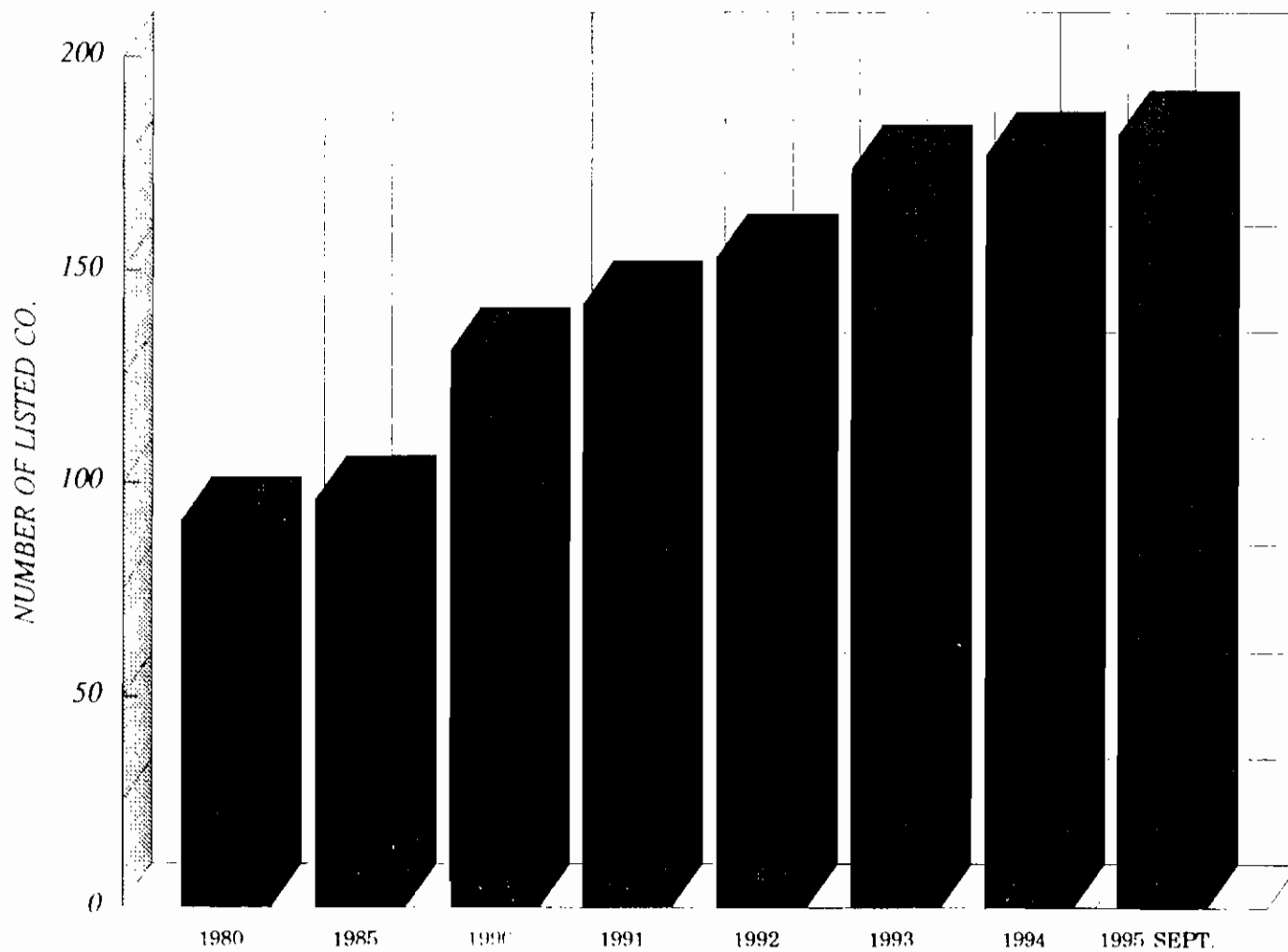
RECENT ECONOMIC REFORM MEASURES TAKEN BY NIGERIA

1. **Budget Deficit Cuts:** The budget deficit which stood at N81 billion at the end of 1994 had been reduced substantially to N16 billion at the end of June, 1995.
2. **Inflation Reduction:** Inflation rate was estimated at 57.2 percent at the end of 1993, fell marginally to 57.0 in 1994 and is expected to decline further in 1995 with government's macroeconomic policies.
3. **Exchange Rate:** The exchange rate policy has been liberalised. The dollar now exchanges for about N82.00 at the Autonomous Foreign Exchange Market. Before the rate was deregulated, US\$1 =N22.
4. **Liberalization of Trade:** Trade has been considerably liberalised. In 1995 duties were further reduced on some items.
5. **Price De-control:** Government has continued to pursue a policy of de-controlling prices while taking measures to combat inflation. Commodity Boards have been abolished while efforts are on to establish a Commodity Futures Exchange.
6. **Interest Rate Policy:** Maximum lending rate fixed at 21 percent in 1994 and retained in 1995.
7. **Civil Service Reform:** The programme of civil service reforms is still on course to create a more effective and responsive civil service.
8. **Public Enterprises Restructuring/Privatisation:** The first phase of the programme of privatisation/commercialisation of some public enterprises was concluded in 1993 with the privatisation of 54 enterprises. A number of public enterprises are earmarked for leasing while the government has continued to introduce measures to boost private sector competition.

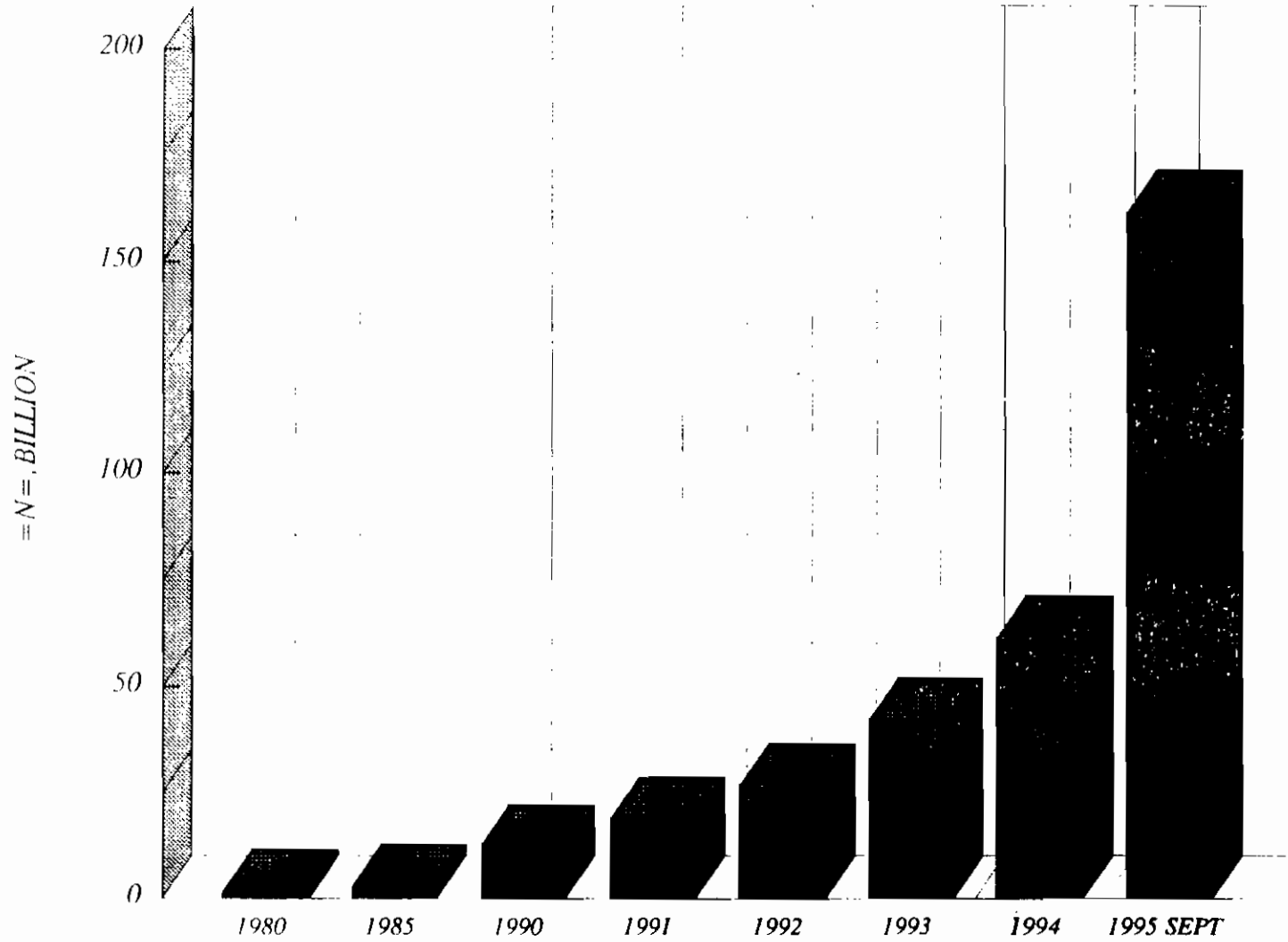
THE NIGERIAN CAPITAL MARKET: SOME INDICATORS

INDICATOR	1980	1985	1990	1991	1992	1993	1994	Sept. 1995
No. of listed Company (Equities)	91	96	131	142	153	174	177	182
Market Capitalisation (Equities)								
Local Currency (Naira Million)	1,698.0	2,742.0	12,135.0	18,447.5	26,245.8	41,830.9	61,023.9	161,046.6
U.S. Dollar (Million)	3,118.5	2,743.1	1,394.8	1,870.6	1,341.7	1,901.4	2,773.8	1,964.0
Trading Value: (Equities)								
Local Currency (Naira Million)	8.6	13.9	87.8	90.0	237.1	286.6	401.3	452.1
U.S. Dollar (Million)	15.7	13.9	10.1	9.1	12.1	13.0	18.2	5.5
Turnover Ratio: (%)	0.5	0.5	0.7	0.5	0.9	0.7	0.7	0.3
Local index-(1984 = 100)	N/A	127.3	513.8	783.0	1,107.6	1,543.8	2,205.0	4,858.1
Change in index (%)	-	-	303.6	52.4	41.5	39.4	42.8	120.3
New Issues Value								
Local Currency (Naira Million)	378.8	817.2	9,964.5	1,869.9	3,306.3	2,636.9	2,161.6	3,281.3
U.S. Dollar (Million)	695.7	817.5	1,145.3	189.6	169.0	119.9	98.3	40.0
Price/Earning ratio	4.9	4.3	7.0	5.7	6.8	6.0	6.0	6.9
Dividend Yield (%)	11.5	10.6	12.0	10.4	7.0	6.5	8.4	5.7
GDP (at 1984 factor cost)								
Local currency (Naira Billion)	49.6	68.9	90.4	94.6	98.0	100.8	101.0	N/A
U.S. Dollar (Billion)	91.1	68.9	10.4	9.6	5.0	4.6	4.6	
Market Capitaliation as percentage of GDP	3.4	4.0	13.4	19.5	26.8	41.5	60.4	N/A
Exchange Rate Per US\$1.00	0.5445	0.9996	8.7000	9.8619	19.5621	22.0000	22.0000	82.0000

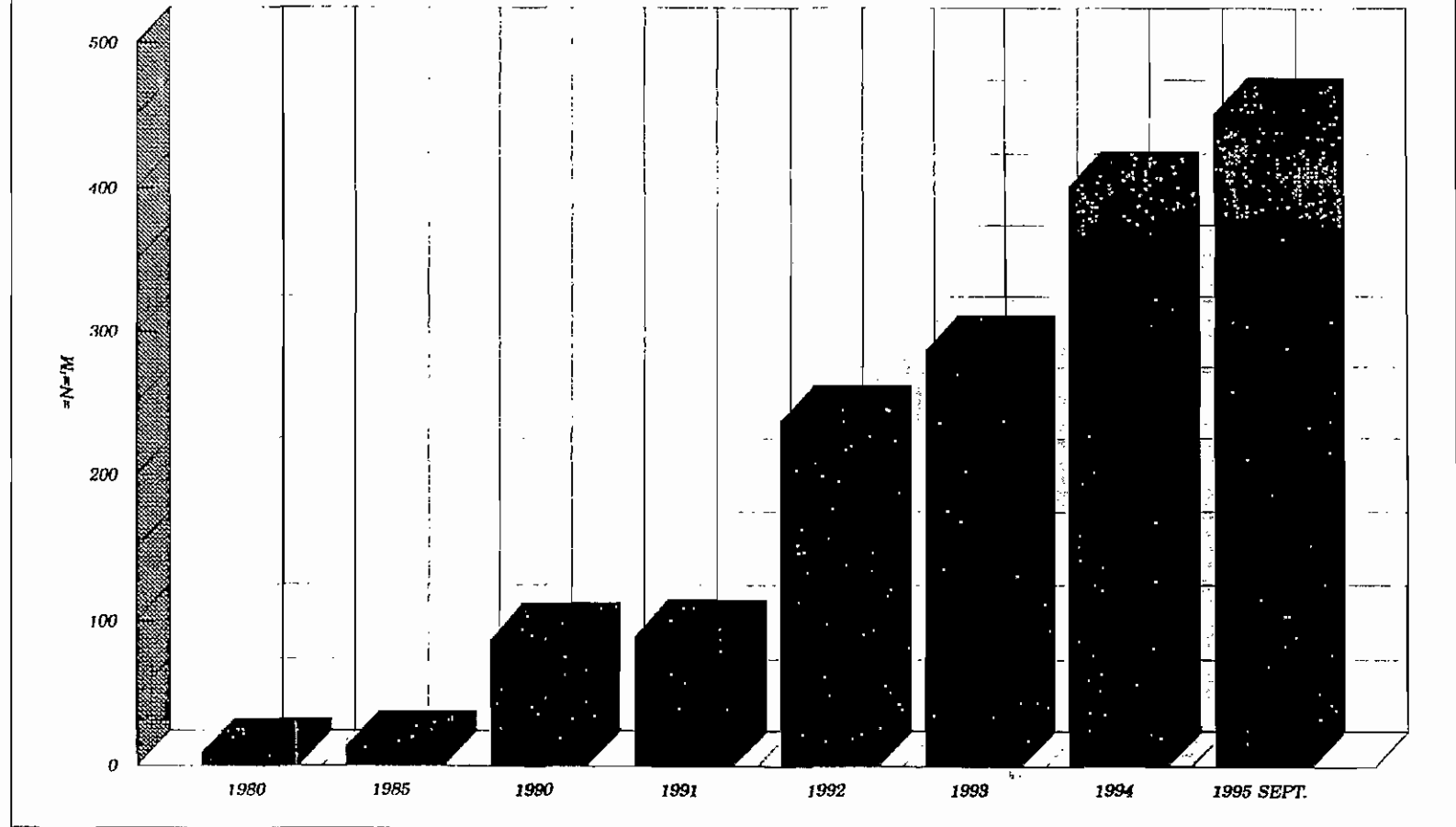
**NUMBER OF LISTED COMPANIES (EQUITIES) ON THE NSE
1980 - 1995 SEPTEMBER**



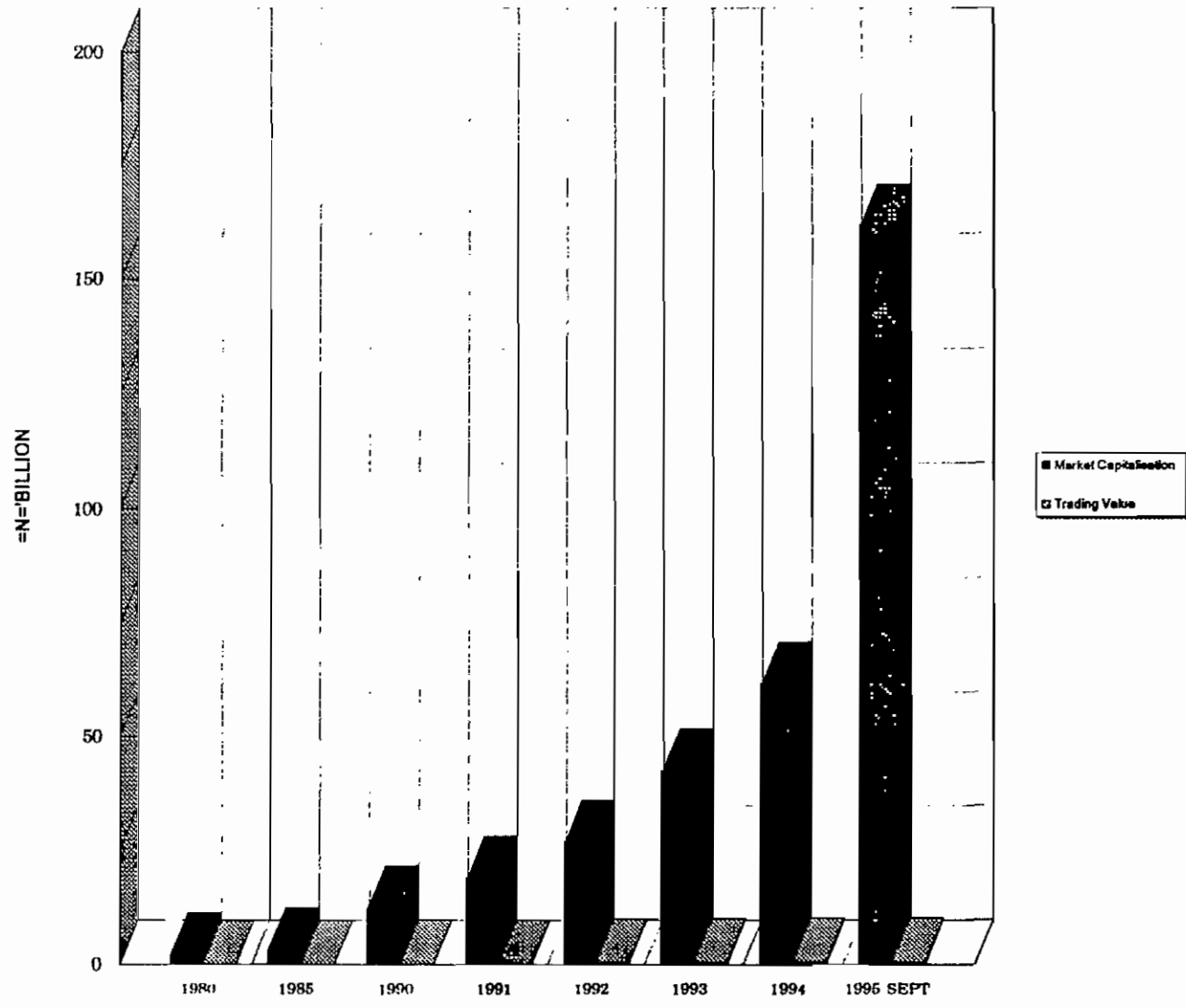
**MARKET CAPITALISATION (EQUITIES) ON THE NSE
FROM 1980 - 1995 SEPTEMBER**



TRADING VALUE (EQUITIES) ON THE NSE
FROM 1980 - 1995 SEPTEMBER



**TRADING VALUE AND MARKET CAPITALISATION
ON THE NSE 1980 - 1995 SEPTEMBER**



Tabel 2

MARKET CAPITALISATION ON THE NSE AND GDP 1995 - 1994

Year	Total Market Capitalisation =N=BILLION (1)	GDP at 1984 Factor Cost =N=,Billion (2)	(2) as % of (3) (3)
1985	6.67	68.9	9.7
1986	6.79	71.1	9.5
1987	8.30	70.7	11.7
1988	10.02	77.8	12.9
1989	12.85	83.5	15.4
1990	16.36	90.4	18.1
1991	23.13	94.61	24.4
1992	31.27	97.42	32.1
1993	47.44	99.66	47.6
1994	66.37	100.98	65.7

Chart 5

**MARKET CAPITALISATION ON THE NSE
AND GDP 1985 - 1994**

