CAPITAL MARKETS AUTHORITY

A Study on the Impediments to Growth of Collective Investment Schemes Industry in Kenya

Submitted by

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1.0 Executive Summary

- Vista Capital Limited was hired by the Capital Markets Authority to undertake a study on the Impediments to Growth of Collective Investment Schemes Industry in Kenya. As part of the Study a market survey and workshop were undertaken to seek opinions of the investing public as well as research undertaken to understand how a CIS market operates in other more developed capital markets.

- The objective of the Study was to build a foundation towards putting in place a policy and regulatory framework so as to:

  a) Strengthen the CIS Industry;
  b) Promote the use of CIS by small savers;
  c) Facilitate the listing of the CIS units; and
  d) Promote a robust and competitive operating environment for mobilization and distribution of resources through CIS.

- CIS are recognized as suitable financial products for all investors and are very suitable for retail investors to help control risk through greater diversification. However, many retail investors in Kenya are not familiar with this type of investment product. Therefore, the increased need for investor education must be addressed as the lack of awareness of CIS is considered to be one of the biggest hindrances of CIS growth in Kenya.

- Another impediment may be the lack of supply of financial assets for CIS to include in their portfolios. Therefore the CMA should encourage more splits amongst listed companies, provide additional incentives for non-listed companies to list on the exchange and encourage listed companies to increase their free float. In addition, the bond market must be further developed with the need for more corporate bond issues as well as municipal issues.

- CIS is seen as having great potential to mobilize and distribute financial assets as well as increase the nation's investment/savings rate. To encourage less speculation and to increase the awareness of CIS amongst the retail sector, IPO allocations should favour CIS allotments rather than retail individual allotments. Individuals however, should not be restricted to participate directly in IPOs.

- The following is the recommendations made as a result of the survey, workshop and global research to meet the CMA objectives:

- The CMA should work with the RBA and the KRA to encourage individuals to set up individual retirement benefit schemes through use of a CIS. In addition, as only 15% of employees are covered by occupational schemes the CMA should work with the RBA to encourage companies to start contributing to an individual's personal retirement benefit scheme (similar to 401K programmes in the USA). This would effectively create an occupational scheme without the cost, expense and potential liability to the company.

- Close-ended funds should also be promoted by stockbrokers in order to develop the CIS industry. Most investors are already fully aware as to how the stock market works so the level of investor education would be less than that required for unit trusts. Closed ended listed CIS would also minimize fee structure: i.e. commissions as opposed to high front load fees existing amongst unit trusts in today's market. Stock broking commissions (2.1%) are considerably lower than commissions paid to sales agents (6.5%).

- It would also be advantageous to encourage the creation and approval of close-ended funds as the concept of stocks listed on an exchange in addition to lower commission fees may encourage more retail investors to invest in CIS companies.

- The CMA should require stockbrokers and investment banks to set up completely separate legal entities to operate CIS businesses. All new CIS should be run by separate companies and existing CIS run by stockbrokers and investment banks should be given three years to transfer the business to a sister company.

- Each CIS should have a compliance officer and a Compliance and Risk Management Board Committee to assure investors ethical abuses are prevented, monitored and abusers are terminated.

- CIS should be required to:
  - Have all sales agents undertake a Know Your Client exercise when giving investment advice to potential investors.
  - Hire only professional fund managers with fidelity insurance or professional indemnity insurance.
  - Fully disclose their underlying investment portfolio in terms of types of assets (e.g. equity, fixed income, property etc.), geographical diversification, top ten holdings, etc.
  - Fully disclose the top 10 shareholding and their percentage stake
  - Disclose the names of the professional managers and advisors and any changes that have taken place over the last one-year.
  - Utilise GIPS Performance measurements standards so Investors should be able to determine:
    - How long the fund has been operating and the performance over the period as well as incremental performance measurements for 1 year, 3 years, 5 years and 10 years.
    - What performance measurement standards are met: i.e. type of measurement used (time-weighted or money weighted), cost vs. market value etc.
    - The movement of fund managers to determine if the historical returns were obtained with a particular manager and it that manager is still employed and managing the fund

    - The use of a composite subject to international standards regarding composites when the Fund Management Company is citing returns for the Firm as a whole rather than a particular CIS product.
    - Establish codes of conduct and have a separate compliance department
    - Hire a separate administration company to unitise and confirm performance measurements.
    - Hire a separate custodian company to hold the assets of the fund.
    - Meet minimum advertising standards in regards to full disclosure as well as performance measurement standards.

- CMA should enhance its ability to supervise, monitor, and enforce its rules and regulations. It should be publicly seen to be taking strong steps to protect the investing public by disciplining licensees who abuse their clients' interests.

- In addition, the CMA should establish a web page on its homepage whereby investors can look to see who is licenced to carry out CIS business, and what the past performance of the various CIS products has been over previous periods of time, fee structures, and any other data pertinent to assessing the appropriateness of a CIS product for an investor. This should not be seen as marketing of any particular CIS product but more of an investor education format, similar to how the CBK publishes fee structures of the commercial banks.

- A Better Business Bureau (BBB) should be established to help protect consumer rights whereby any complaints by members of the public could be registered. This information would in turn be given to others when seeking information on any service provider. The BBB would not only be for CMA licensed service providers but for all businesses.

- Impediments identified and potential solutions are:
    - Limited number of CIS funds
        - Tax incentives for introducing new funds including a lower corporate tax rate for close ended fees, education and marketing material allowable tax deductions.
    - Expensive fee structures
        - Encourage more close ended funds to be developed as there are no entry or exit fees other than normal equity trading commissions.
        - Encourage more open-ended funds to be created to enhance competition so existing funds will be forced to lower their front load fees and annual fees in order to stay competitive.
    - Limited distribution channels
        - Give financial advisors tax breaks for the marketing of CIS funds to their clients.
        - Encourage stockbrokers to market closed ended funds.

  - Encourage insurance companies to tie up with banks to sell open-ended funds.
  - Too high of entry levels
  - Encourage closed ended funds whereby the entry value is only determined by the price of one share.

- Market participants feel the key challenge for the development of the CIS industry is predominately the lack of investor awareness. Therefore, tax incentives should be given to help encourage investor education programmes and even marketing expenses. All investor education and marketing expenses should be allowable tax deductions.

- Those service providers who undertake management, administration and/or unitisation services to other CIS operators should be encourage to further market these services. VAT on these services should be exempt as well as the service costs be allowable tax deductions.

- Close-ended funds should be encouraged to be developed and listed on the exchange. A minimum capitalization should equal Ksh 100m, enough to ensure a well-diversified portfolio while low enough not to establish a barrier to entry. While the fund doesn't need to have a track record, the fund manager managing the fund should have a minimum track record of three years.

- Fund management companies must be licensed by the CMA. The CMA should also require individual managers to be accredited either through a CMA sponsored programme or through a minimum pass rate of a professional investment designation programme.

- The current CIS regulations are confusing and insufficient to protect the interest of the investing public. The regulations need to be rewritten as per the section below.

- Best practices entail full disclosure regarding asset allocations, governance issues, risk management issues, valuations based on current market valuations, and time weighted measurements, etc.

  - The CMA should require funds to adopt GIPS valuation standards within a three -year time frame.
  - CIS funds should also adopt a strong code of conduct – ideally the CFA Institute code of conduct
  - Strong governance standards should be implemented at all CIS funds including a separate compliance department/manager and a board compliance and risk management committee – the OECD guidelines should be the basis for governance programmes with CIS funds.

- To encourage the further development of the CIS industry the following tax incentives should be forthcoming:

- Expenses associated with investor education should be tax exempt on the basis the CIS fund carries out a minimum of four investor education seminars per year in the presence of CMA

- Marketing expenses are an allowable tax expense

- VAT on professional services are waived

- Dividend distributions on CIS funds are tax exempt as they have already paid withholding tax on dividends and interest income

- In addition, CIS funds should receive higher allocations than retail investors during the IPO process to encourage retail investors to invest in CIS rather than directly in IPO offerings

2.0 Reliances and Limitations

2.1 In preparing the Study on the Impediments to Growth of Collective Investment Schemes in Kenya (herein referred to as the “Study”), Vista Capital Limited and its director, relied on information and opinions given by the CMA staff and directors, representatives of the Governement of Kenya, Capital Market Stakeholders, and Capital Market Participants in other markets as well as undertaking extensive Internet research.

2.2 This confidential Study is intended solely for use by the CMA, the sponsor of the Study. Vista Capital Limited does not take any responsibility for any use of this Study nor does it take any responsibility for the consequences of acting on this Study. The CMA and its stakeholders must assess for themselves the appropriate actions needed and applicable to their environment to achieve its objectives. It may also be prudent to seek legal council in determining the legal suitability of suggestions made within the Study.

2.3 It is of utmost importance for the CMA to continually undertake assessments of the changing environment within the local capital market as well as globally, particularly as it strives to achieve its mission and objectives, recognising that capital markets are dynamic. As a result, the CMA, its staff, and its development partners must recognise the changing environment, both internally and externally, and the impact it could have on the operations of Kenya’s Capital Markets.

2.4 Vista Capital Limited shall not be responsible for the results of any action of the CMA in following or declining to follow any advice or recommendations Vista Capital Limited might make to it. In accepting this Study the CMA indemnifies Vista Capital Limited and holds it harmless against all costs, expenses, damages, loss or any liability of whatever nature. Vista Capital is not an agent of the CMA nor is this Study an offer of management and/or financial consultancy on the part of Vista Capital or any of its affiliates.