CAPITAL MARKETS AUTHORITY

CMA Forum

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EXCHANGE TRADED FUNDS (ETFs) MARKET IN KENYA;

IS IT TIME?

Chief Executive's Message

As part of the efforts in effectively playing its role towards achieving the Vision 2030 objectives, the Capital Markets Authority (CMA) co-hosted a County Government Conference on Corporate Governance and Financing, October 30 to November 1 2013 in Nairobi with the Institute of Certified Public Secretaries of Kenya, where opportunities for counties to raise funds through the capital markets were discussed.

The capital market offers opportunities for long term capital rising to support development needs through instruments such as Infrastructure Bonds, Asset-Backed Securities (Securitization), Real Estate Investment Trusts (REITS). Investing in any such instruments would require county governments to engage Transaction Advisors to provide technical support to structure the transactions with the support and approval of the Authority.

Some of the projects that would be considered for financing through the capital market include; construction of special economic zones, irrigation projects, power generation projects at county level, and construction of roads and health facilities. Counties may also need support to put develop structures to finance implementable projects that are sustainable to enable them tap into the opportunities to raise long term funds in the capital markets.

Asset Backed Securities (Securitization) would be best suited for county infrastructure projects including; roads, railway, bridges, health facilities, and recreation facilities. This allows the projects to be funded based on their future income generation potential.

County are set to benefit from the upcoming Commodities Futures market which is expected to facilitate; price discovery; price stabilization; value chains in lengthy and complex, production and manufacturing activities; balancing of supply and demand positions throughout the year; increased competition; and acts as a price barometer to farmers and other trade functions.

Issuers such as county governments and county-based companies that use the capital market would benefit from; cheap and long term capital; improved corporate governance; separation of ownership and management; an enhanced public profile; and enjoy public support and accessibility.

Small and Medium Sized Enterprises (SMEs) at county level, with a high potential for employment and wealth creation, can also access the capital market by listing on the Growth Enterprise Market Segment (GEMS) at the Nairobi Securities Exchange. Companies listed on GEMS are required to comply with different listing requirements. The market segment is also intended to cater for venture companies that are targeting capital raising to finance projects at the county level such as mining or exploration companies with a limited track record.

In recognition of the important role of the capital markets in facilitating development, the Government offers several policy incentives to companies that raise funds through the capital markets. These include; Cost of rating tax deductible in order to encourage credit rating of debt instruments; Interest income from infrastructure & social services bonds with at least a maturity of 3 years is tax exempt; Stamp duty is exempt for purposes of transferring assets for issuing Asset Backed Securities; and Interest earned by Asset Backed Securities is tax exempt.

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Kenya's Vision 2030 which seeks to position the country as a regional economic hub identifies the financial sector as one of the priority sectors playing a critical enabling role in the economy. Capital markets which form a key part of the financial sector are identified in the Vision as one of the subsectors with ample room for further development.

To this end, there are ongoing efforts to expand the scope of capital market products available in Kenya, one of which is the planned establishment of an Exchange Traded Funds (ETFs) market in Kenya. The end result would be improved capital market liquidity. The key questions for an audience new to ETFs include the following; What is an ETF, How and where did it all begin? How does it work? Who are the key players? How does an ordinary investor participate in ETF trades? What are the expected roles of a regulator? Is it the right time to establish ETF markets in Kenya? Etc.

What an ETF is

An ETF is a unique financial instrument that is created out of a mix or portfolio of stocks of shares, bonds, and commodities, traded like other securities on securities exchanges. An ETF typically trades close to its Net Asset Value (NAV) over the course of the trading day.

How and where it all began

The idea of investing in a composite financial instrument like an index that further minimizes risk exposure dates back several decades. The creation of such instruments was however far from the current ETFs as we know them. The first real attempt at creating an ETF was done by Standard & Poor's (S&P) - an American financial services company after it launched an Index Participation Shares for the S&P 500 in 1989. Unfortunately, despite some investor interest, the Chicago Mercantile Exchange successfully sued to stop them.

In January 1993 however, S&P 500 Depository Receipt (called the SPDR or "spider") - the first of its kind, aiming to track the Standard & Poor's (S&P) 500 index began trading. A similar product, 'Toronto Index Participation Shares', began trading on the Toronto Stock Exchange in 1990. These shares, which tracked the TSE 35 and later the TSE 100 stocks, proved to be very popular with investors. Since then, the market for ETFs has phenomenally grown across the world. The common denominator has been that the design of ETFs offers investors access to an increasingly complex selection of regions, sectors, commodities, bonds, futures, and investment strategies, on a real-time basis and at a lower cost than many other forms of investment.

The growth of ETFs has been stellar over the past two decades. In early 1990s, only one Canadian and one U.S. ETF were available to the market. Today, ETFs are listed on over 50 exchanges around the world, providing exposure to many capital market environments. As of December 2012, there were over 4,500 ETFs listed globally, with over US$1.8 trillion in Assets under Management (AUM).

How ETFs work

ETFs are part of a bigger group of financial instruments known as Exchange Traded Products (ETPs).

To engage in ETFs trade, the following key questions must be put into perspective;

i. Does the ETF have a sponsor?
ii. What is the fund's objective?

Is it clearly set?

iii. Exactly what securities will be represented in the ETF?

iv. Have all Participant Agreements been signed between/with the key stakeholders including Authorized Participants (APs)/Market Makers (MMs), Fund Manager(s) (if different from Sponsor) and Custodians, among others.

v. Do the stakeholders know how ETFs are Created and/or Redeemed?

vi. What are some of the considerations of a regulatory framework for ETFs?

After explaining all these considerations, we answer the question on whether Kenya's capital market is ready for ETFs trading.

I. There must be a sponsor;

This refers to the company or financial institution that creates and administers the exchange-traded fund. It may be a unit trust company, Mutual Fund Company, an investment company or an institution in any other approved form.

II. The fund's objective must be clearly set

When the fund is set up, its objectives should be clear. Different ETFs are set up for different reasons including diversification across sectors, industries, countries, securities, currencies etc.

III. A decision must be made on exactly which assets/ commodities will be represented in the ETF.

The decision as to which securities would be represented in the ETF closely ties-in with the fund's objective. An equity ETF would for instance derive its price from a portfolio of shares, just as a currency ETF would derive its price from a bundle of different currencies.

IV. Participant Agreements must be signed with the key stakeholders including Authorized Participants (APs)/ Market Makers, Fund Manager(s) (if different from Sponsor) and Custodians among others.

There are a number of parties involved in ETF transactions with whom agreements must be signed. These are as summarized below:

- **Issuer/Fund Manager:** Ensures that the ongoing management and operation of the ETF complies with all regulatory requirements and that the fund operates according to the offer terms.
- **Authorized Participants (APs):** APs are usually large institutions or investment banks approved by the issuer and the regulator that have the capacity to not only transact in a basket of securities and blocks of ETF units in the primary market, but also sell/ buy securities to/from the secondary market.
- **Market Makers (MMs):** MMs play a slightly different role to APs, though in some jurisdictions, some MMs can be licensed as APs. MMs ensure there is sufficient liquidity on the secondary market by providing continuous bid and offer prices, and applying for additional ETF units, where necessary, to meet investor demand, or mopping out excess ETFs to stabilize demand. Issuers generally appoint a dedicated MM for their ETFs to ensure investors can enter and exit their investment at a fair price.
- **Custodians:** They hold the underlying assets of the ETF, on behalf of the fund and for the benefit of investors, ensuring that investor or unit holder interest is protected.
- **Registrars:** The Registrar is appointed by the Issuer to manage the registry of unit holders, distributions, taxation information and investor communications.

V. Creation and Redemption of ETFs

Unless the issuer decides to issue more securities (because ETFs are open-ended), the supply of the underlying assets of the stock of securities trading in the marketplace would be finite. However, when demand increases for units of an ETF, APs have the ability to create additional units on demand through a process an ETF creation process. Creation and issuance ETFs involves two markets:

a) **The primary market** – where issuers through a process, build-up stocks of assets and convert them into ETFs and APs receive the created ETFs after delivering a block of securities and/or redeem ETF units.

b) **The secondary market** – where authorized MMs seek to provide liquidity and investors buy and/or sell ETFs on a securities exchange (e.g. NSE) through brokers.

The primary market (where ETFs are created and redeemed).

1. The issuer identifies or constructs an index based on

an investment objective then builds an ETF that invests in a basket of underlying securities reflecting the index

2. The Issuer creates and lists the ETF on the exchange;

3. APs receive ETF units, through a transfer mechanism, whereby they:

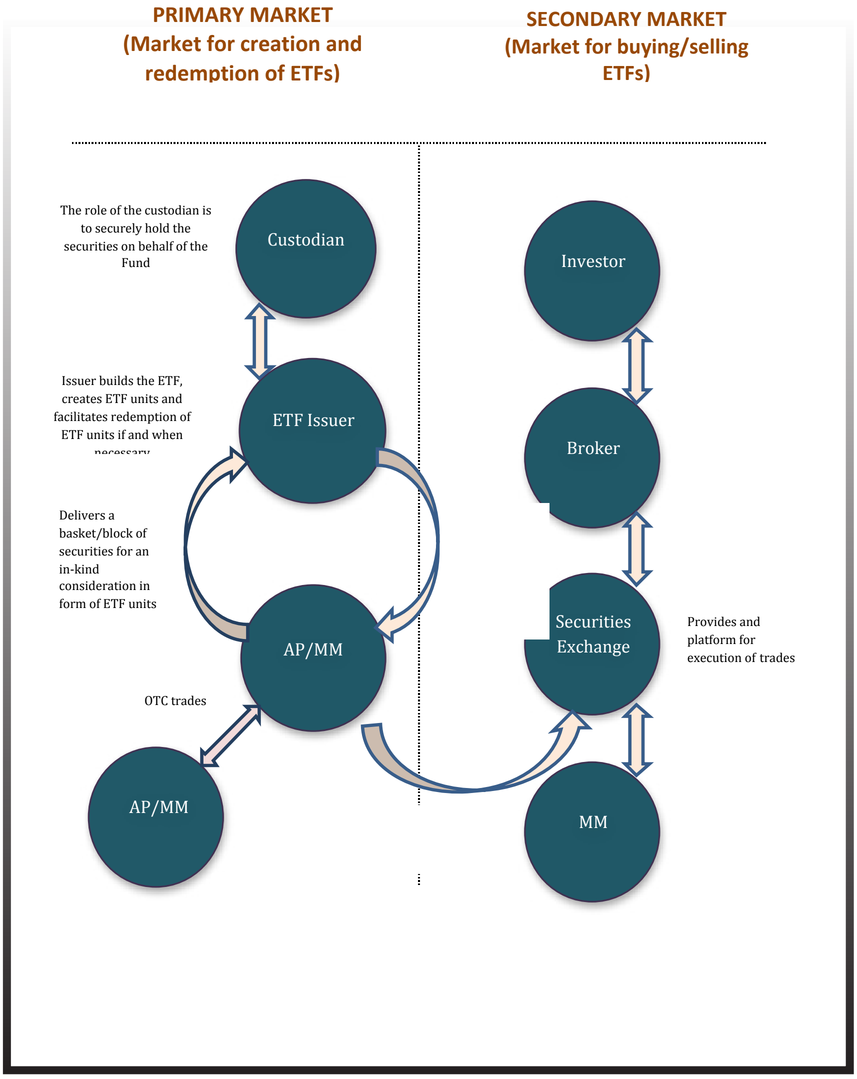
   a) apply to the ETF Issuer to receive ETF units;
   b) deliver a basket of the underlying securities and/or any cash component to the Issuer, as specified by the Issuer;
   c) in return, the Issuer delivers a large block of ETF units (called a Creation Units which typically holds 50,000 shares or any other acceptable block of shares) to the AP.

4. The underlying securities and/or any cash are transferred to the Fund's custodian appointed by the Issuer

5. The AP is then able to on-trade the ETF units on the secondary market, with each unit representing a proportional holding in the underlying securities

Often, an AP also acts as an MM on the secondary market.

The redemption process is effectively the creation process in reverse, where an AP gathers the minimum block of units in the ETF to form what is called Redemption Units and then exchanges this with the Issuer for the underlying securities. It is also noteworthy that individual investors cannot buy ETFs on the primary market and must therefore transact on the secondary market.



The secondary market – buying and selling ETF units

The secondary market is where investors can buy and sell ETFs units, just like shares.

1. ETF investors can use all the trading strategies associated with shares such as market orders, limit orders, stop orders etc.
2. The ETF unit price, which is also known as the 'Net Asset Value' (NAV) is based on the total value of the underlying holdings of the ETF divided by the number of outstanding units on issue. The NAV is declared each day after the market close. Due to the transparency of the holdings and the fact that the units on issue can change with supply and demand, this generally ensures that ETFs will trade at prices throughout the day close to the NAV of the ETF.
3. When trades are completed, unit holding information is recorded by the Registrar. The Registrar manages the ongoing administration of unit holder records and provides investor services on behalf of the Issuer.

How liquidity is created in

the secondary market

- Market Makers (MM) who are professional traders appointed by the Issuer to provide liquidity in the secondary market for their ETFs publish an offer price (the price investors can buy units for) and a bid price (the price investors can sell their units for).
- Every day, a full list of the underlying holdings of the ETF is provided to the market, meaning, investors are able to see the exact nature of the underlying exposure. Market Makers use these holdings to calculate a price that reflects the underlying securities. As the underlying securities change in value throughout the day, so does the ETF price, to reflect this movement.

VI. Some of the expected considerations of the regulatory framework of ETFs

a. **Clear labeling of product structure and investment objectives** - Investors should know what they are buying and what the ETF product's investment objectives are.

b. **Frequent and timely disclosure for all holdings and financial exposures** – for ease of calculation of Net Asset Value, to avoid unwarranted deviations from fair price.

c. **Disclosure of all fees and costs paid** - Investors should have complete clarity regarding all the costs and revenues associated with any fund they buy, so they can clearly establish the total cost of ownership.

d. **Trade reporting** - to reduce systemic risk and increase transparency.

VII. It is the right time to establish an ETFs market in Kenya

ETFs enable investors to gain exposure to a diversified portfolio of securities by trading in an index composed out of those securities. In the jurisdictions they are already operational, ETFs have provided investors with a low cost and transparent way of accessing a wide variety of asset classes. In Kenya, all the requirements for the establishment of an ETFs market are in place, save for the provision of an enabling regulatory environment ideal for an ETFs market to flourish. The Authority is currently working with the relevant stakeholders to bring this new product to the market, as a step towards improving capital market liquidity.

By Justus Agoti Regulatory, Policy, and Strategy Directorate

THE JOURNEY TOWARDS FINANCIAL INDEPENDENCE

Financial education is increasingly important, not just for investors. It is becoming essential for the average family trying to decide how to balance its budget, buy a home, fund the children's education and ensure a consistent retirement income. The growing sophistication of financial markets means consumers and investors are not just choosing between interest rates on two different bank loans or savings plans, but are rather being offered a variety of complex financial instruments for borrowing and saving.

Responsibility and risk associated with financial decisions that have a major impact on an individual's future life are moving towards workers and away from government and employers. As life expectancy is increasing, the investment option question is particularly important as individuals enjoy longer periods of retirement. The Authority therefore continues to play its role in the promotion of investor education.

During the first quarter of the financial year 2013/2014, we embarked on several initiatives targeted at stakeholders identified in our investor education strategy. The Authority held a workshop for members of the Finance, Trade and Planning Committee of the National Assembly on August 21, 2013. The workshop was aimed at enhancing understanding of capital markets issues, existing and upcoming products and services by legislatures.

Counties remained a major target group of the Authority's investor education strategy. We spent the better part of the quarter on investor education outreach programmes at County level. The county events we participated in include: Kisumu Regional Show, Mombasa International Show and Nairobi International Trade Fair. The Authority participated in the Agricultural Society of Kenya (ASK) events in collaboration with other Financial Sector Regulators: Central Bank of Kenya, Insurance Regulatory Authority, Retirement Benefits Authority and Sacco Societies Regulatory Authority.

The Authority collaborated with other industry stakeholders such as the Central Depository and Settlement Corporation (CDSC), Madison Asset Management Limited and Old Mutual. These collaborations proved effective in supporting our investor education outreach initiatives.

The Authority's officers participated in several radio programs on vernacular stations as part of the on-going vernacular outreach initiative. The stations visited included: Sayare FM (Kisii community), Radio Lake Victoria and Radio Namlolwe (Luo community) and Bahari FM (coastal community).

The Authority also participated in the Financial Services Conference held between 10 and 13 July, 2013 at Kenyatta International Conference Centre (KICC). The Financial Services Conference was organized by Institute of Certified Public Accountants of Kenya (ICPAK) and brought together professionals from the financial sector to deliberate on issues affecting the sector and chart the way forward. The objective of the conference was to enlighten the public on the critical role played by the financial services sector in the Kenyan economy. The Authority used the opportunity to inform the public about the recent developments in the capital market industry.

The youth are a crucial stakeholder of the Authority as key drivers of the economy. We have therefore revamped our youth engagement program to include hosting interactive sessions with university students from various parts of the country, at the Capital Markets Authority premises. During the quarter, we hosted students from University of Nairobi School of Business and Finance Students Association (FSA).

Our goal is to empower individuals and groups to make informed and beneficial financial decisions on investments and investment vehicles.

Faith Mwende, Regulatory, Policy, and Strategy Directorate

PRIVATE TRANSFER AMENDMENTS TO BENEFIT INVESTORS

There was a time when the Authority would receive more than five investors in a day in not so friendly circumstances. Some of these investors would mention big names in the public and private sector and threaten dire consequences if their concerns were not dealt with immediately. Yet others would plead and give very convincing justification on why their cases merited quick action. The justifications ranged from need for school fees, sickness in the family or even intended relocation to other countries. All this was because the process of transferring securities from a deceased person to the beneficiary was simply agonizing and punitive. It was not encouraging at all, that for some, this was their first experience in the capital markets.

> Some of these investors would mention big names in the public and private sector and threaten dire consequences if their concerns were not dealt with immediately

The process began by ascertaining what the deceased owned and then moving to court to obtain letters of administration, assuming there were no family disputes to cause delay. The lucky beneficiaries already knew the shares that were held by their loved ones. However, some uncovered this information by chance, in keeping with the habit of most Kenyans of guarding their investments as top secret even to their spouses. It is only after going through the documents that were hitherto inaccessible or receiving a dividend notification through the post office that such a spouse realized that the deceased had invested in securities, and then the struggle to have them registered in the spouses name began.

Obtaining letters of administration from the court is a challenge on its own. The alternative is to have the estate administered by the Public Trustee if the value is less than Kshs500,000. District Commissioners also administer estates valued at less than Kshs100,000 in their capacity as ex-officio agents of the Public Trustee.

After obtaining the necessary legal documents, the beneficiary was required to lodge an application for transfer through a stockbroker. In most cases this required travel to Nairobi as most brokers had no presence in the rural areas. This has been alleviated somewhat with the licensing of various banking institutions as Central Depository Agents and the recruitment of agents by stockbroking firms. The broker would then send the documentation to the respective Share Registrar for verification and confirmation that the securities are available for transfer. The documents would thereafter be returned to the broker for onward transmission to the Nairobi Securities Exchange. The Exchange was then expected to forward applications valued at over Kshs100,000 to the Authority for approval.

All the above players had their own requirements for approval and it was not unusual for an application to be rejected at least once at every level. The outcome was that an application would take months and sometimes years before the securities were registered in the name of the beneficiary. It was hard to convince such a client that all the parties involved were acting in their best interest and indeed most thought that there was a wider conspiracy to disinherit them.

Initially, it was envisaged that there would be no charge for these kinds of transfers, however with time, capital markets players started charging different fees as they deemed appropriate. The beneficiaries could therefore, and rightfully so, not understand why a service that they were paying for took ages to conclude.

The cry is heard

The Authority became very concerned about the state of affairs described above and in consultation with stakeholders, sought to streamline the process of private transfers to make it shorter, more efficient and to set a standard approval fee to guard against exploitation of beneficiaries. It was agreed that fees would be clearly prescribed while nonetheless enabling a market intermediary to recover costs relating to processing of the applications.

It is against this background that amendments were introduced to the relevant sections of the Capital Markets (Licensing Requirements) (General) Regulations 2002, as they relate to private transfers. Regulation 57 was amended to introduce a new Regulation 57(e) and a new proviso was introduced to Regulation 58. The previous Regulation 59 was deleted in its entirety and replaced by a new Regulation 59. Part III of the Second Schedule to the above cited Regulations, relating to fees was also amended to accommodate the changes highlighted below. These amendments were gazetted through Legal Notice No. 112 of June 2013. The amendments have the following implications on the processing of private transactions:

1. The Nairobi Securities Exchange (NSE) was empowered to process and approve transfers relating to deceased estates and gifts to close relations where the securities are held in certificate form;

2. The Central Depository and Settlement Corporation (CDSC) was empowered to process and approve applications relating to deceased estates and gifts where the securities are immobilized;

3. The NSE and CDSC are only required to notify the Authority when they approve an application under the above two categories;

4. The Authority only considers applications falling under exceptional cases, such as transfer with no change in beneficial ownership, transfers as a result of re-organization, mergers & acquisitions etc.;

5. The NSE and CDSC are required to issue guidelines to their members on the processing of private transfers, with the approval of the Authority;

6. The following fee structure is applicable:

a) Transfers as a result of a gift are levied an amount equal to the prevailing brokerage commission. Transfer by way of a gift is only allowed when it is to a close relative as defined under the regulations;

b) Transfers relating to deceased estates are charged a nominal fee of Kshs1,500. Where the value of the securities falls below Kshs10,000, the fee shall be waived in the interest of not prejudicing the smallest shareholders;

c) Transfers with no change in beneficial interest, are charged Kshs1,500;

d) The above fee is shared among brokers and NSE at the rate of 55 percent and 45 percent respectively in case of certificated cases, and between brokers and CDSC at the rate of 55 percent and 45 percent respectively in the case of immobilized securities.

The above changes have shortened the process of private transfers and eliminated duplication of roles on the part of CMA, NSE and CDSC. Most applications for private transfers are from deceased estates and the amendments have made it possible for them to be dealt with in an expeditious manner. The impact of these amendments is already apparent as evidenced by the reduced complaints in relation to delayed transfers.

By Timothy Kaaria, Directorate of Market Operations

CMA goes paperless…

The Authority recently implemented the Risk Based Supervision System. The system strives to create a regulatory environment that is conducive to business operation as well as improving the way of doing business in the capital markets sector by leveraging technology.

Prior to the year 2009, the Authority used a compliance-based method of supervision. This supervision model was manual and was weighed down by challenges in consistency due to subjectivity as well as inefficient allocation of resources.

The Authority has now changed from this mode of supervision to a Risk-Based Supervision (RBS) model. The RBS System is not an off-the-shelf system but a system that has been carefully designed and custom made specifically for the Authority over a period of close to one year.

The RBS System, through the in-built Risk Based Capital Adequacy calculator assists market intermediaries to identify their areas of risk early and encourage them to enhance their risk management systems. The capital adequacy calculation, which is a key component of the RBS system, reflects the true risk position of an organization. While using the RBCA methodology only collectable debtors are considered and long term non-trading securities & fixed assets are discounted. The RBSS also incorporates an interactive online system that provides efficient and timely interface between the Authority and its key stakeholders.

The Online Services Portal, which is the customer-facing side of the RBS system will see the automation of the licensing process as well as the application and approval for the issue of securities to the public.

Through the system, applicants will submit applications for licenses to conduct business as fund managers, investment banks, stockbrokers, investment advisors, authorized securities dealers, authorized depositories and dealers in general. Applicants will also use the system to apply for any new categories of licenses such as REIT Manager and REIT Trustees.

The system is designed to only accept complete applications including all necessary supporting information to reduce the back and forth, thereby improving turnaround times.

Applicants will also be able to lodge applications for approval to issue and list securities such as conduct Initial Public Offers (IPOs), Rights Issues, Listing by Introduction, take overs, mergers and acquisitions, private transfer of securities, issue Corporate Bonds, Commercial Papers, authorization of REITs and so on.

Applications for No Objection to effect changes in market intermediaries such as changes in shareholdings, changes in the composition of the Board of Directors and other material changes will also be submitted through the online portal.

All market intermediaries will be expected to file their returns and meet all other reporting obligations online.

The system is set to run concurrently with the manual process of making applications and submitting returns until December 31, 2013. Effective January 1, 2014, all manual applications and submissions will no longer be received at the Authority.

The system also supports online updating of market intermediaries' details by the intermediaries themselves. The online portal will support a complaint mechanism wherein complains can be lodged and handled as well as a whistle blowing service that will allow the anonymous reporting of any suspicious, illegal or other form of irregularity to the Authority.

The internal end of the RBS system provides an automated platform on which all applications will be reviewed internally. This makes it easy to track the progress of the review of any application that is before the Authority. It also means that all those voluminous information memoranda and related documents will no longer be sighted on our desks!

By Mary Njuguna, Directorate of Market Operations

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