FACTORS AFFECTING DEMUTUALIZATION STRATEGY OF THE NAIROBI SECURITIES EXCHANGE

BY

KAMIRI MICHAEL GAKONDE
D53/OL/12661/2009

A RESEARCH PROJECT SUBMITTED TO THE DEPARTMENT OF BUSINESS ADMINISTRATION IN PARTIAL FULFILMENT OF THE REQUIREMENT FOR THE AWARD OF THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION (FINANCE OPTION) OF KENYATTA UNIVERSITY

OCTOBER, 2012
DECLARATION

This research Project is my original work and has not been submitted for a degree in any other university.

Michael Gakonde Kamiri
REG. NO. D53/OL/12661/2009

This research Project is being presented for defense with my approval as the appointed supervisor

James Kilika
Department of Business Administration
School of Business
Kenyatta University

Muathe SMA (PhD)
Chairman
Department of Business Administration
School of Business
Kenyatta University
DEDICATION

I dedicate this project to my wife Joyce, Children Cynthia and Immaculate, Maria and Anthony for their invaluable support, encouragement and inspiration throughout the research period.
ACKNOWLEDGEMENT

Special thanks to my supervisor James Kilika. The support and guidance provided helped me in writing this proposal, patience and understanding throughout this work. Thanks to the Almighty God for the life and energy to see this through.

I pay gratitude to Kenyatta University Open Learning staff for standing with me and encouraging me during the difficult times. Also thanks to friends for taking time to read through my work and all the support.
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>AIMS</td>
<td>Alternative Investment Market Segment</td>
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<td>CBK</td>
<td>Central Bank of Kenya</td>
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<td>CBOE</td>
<td>Chicago Board Options Exchange</td>
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<td>CDS</td>
<td>Central Depository Systems</td>
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<td>CMA</td>
<td>Capital Markets Authority</td>
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<td>CME</td>
<td>Chicago Mercantile Exchange</td>
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<td>FIMS</td>
<td>Fixed Income Market Segment</td>
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<td>HKFE</td>
<td>Hong Kong Futures Exchange Limited</td>
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<td>IFC</td>
<td>International Financial Corporation</td>
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<td>IPO</td>
<td>Initial Public Offering</td>
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<td>ITS</td>
<td>inter-market trading systems</td>
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<td>LSE</td>
<td>London Stock Exchange</td>
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<td>MIMS</td>
<td>Investment Market Segment</td>
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<td>NSE</td>
<td>Nairobi Securities Exchange</td>
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<td>NYSE</td>
<td>New York Stock Exchange</td>
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<td>SEHK</td>
<td>Stock Exchange of Hong Kong Limited</td>
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<td>SGX</td>
<td>Singapore Exchange Limited</td>
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<td>SIMEX</td>
<td>Singapore International Monetary Exchange</td>
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<td>SME</td>
<td>Small Medium Enterprises</td>
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<td>SRO</td>
<td>Self Regulatory Organization</td>
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<td>WFE</td>
<td>World Federation of Exchanges</td>
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<td>Term</td>
<td>Definition</td>
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<td>Capital Market</td>
<td>A market for securities where business enterprises and governments can raise long-term funds.</td>
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<td>Central Depository</td>
<td>A company formed to establish and operate a system for the central handling of securities, whether or not listed in a stock exchange.</td>
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<td>Demutualization</td>
<td>Refers to the change in legal status of the exchange from a mutual association with one vote per member (and possibly consensus-based decision making), into a company limited by shares, with one vote per share (with majority-based decision making).</td>
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<tr>
<td>Stock Exchange</td>
<td>A marketplace in which securities, commodities, derivatives and other financial instruments are traded.</td>
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ABSTRACT

Demutualization is about changing the ownership structure of the stock exchange; from a mutual association with one vote per member and possibly consensus-based decision making, into a company limited by shares, with one vote per share (with majority-based decision making). The demutualization trend has been attributed to a number of reasons that include: improved governance, investor participation, competition, globalization and consolidation and unlocking stock exchange value. Demutualization would restructure governance at the stock exchanges on a sustainable basis as the ownership rights will be delinked from trading rights and increase the role of non-member stakeholders in the affairs of the exchange. The objective of this study was to determine the factors affecting demutualization strategy of the Nairobi Securities Exchange. The study adopted a descriptive research design. The target population comprised of all 58 stakeholders at the NSE. This included: Capital Markets Authority (CMA), Central Depository Systems (CDS), Stock Brokerage firms, and mutual companies. Primary data was collected by use of a semi structured questionnaires with both open and closed ended questions. Data analysis was done using SPSS and Microsoft Excel to generate quantitative reports which were presented in the form of tabulations, percentages, mean and standard deviation. Multiple regression analysis between different variables related to demutualization of the NSE was also conducted. The study recommends that the current owners who include the stockbrokerage firms should commit to relinquish significant ownership to the government and to the general public so that the stock exchange can be listed to trade like any other company. To ensure successful demutualization, the Government should work in collaboration with all stakeholders to ensure there is no resistance to the whole process of demutualization. The study recommends during the whole transition period on demutualization, the stock exchange should maintain high level of corporate governance to ensure that the interests of both the current mutual owners and investors are not affected. This is because high levels of corporate governance ensure that market confidence is held high.
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1.1 Background of the Study

Demutualization of a stock exchange is the entire process by which a non-profit member-owned mutual organization is transformed into a for profit shareholder corporation (Akhtar, 2002). Exchanges around the world have been demutualizing because of international competition and technological challenges to traditional modes of trading securities. Stock exchanges are now increasingly changing their business model and restructuring themselves across the world due to the simultaneous convergence of a number of powerful developments. The most notable of these has been the: rapid advancement and innovation.

Historically, most exchanges were not-for-profit organizations owned by their members. Early securities markets were associations of securities traders who met to buy and sell securities. For example, the London Stock Exchange started in coffee houses in Change Alley, moving to a building marked as “The Stock Exchange” in 1773, and charging an entrance fee for admission. Prior to 1990s, stock exchanges all over the world used to operate as mutual organizations. Early 1990s, stock exchanges started to undertake major organizational and operational changes. One of the most noted changes was the trend towards demutualization (Arwa and Kami, 2010). The demutualization trend started in 1993 by the Stockholm Stock Exchange. It was followed by several others, including the Helsinki Stock Exchange in 1995, the Copenhagen Exchange in 1996, the Amsterdam Exchange in 1997, the Australian Exchange in 1998, and the Toronto, Hong Kong and London Stock Exchanges in 2000.

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

Mintzberg (1994) defines a strategy as a plan, a direction or a guide. Porter (1996) defines strategy as being different by deliberately choosing to do a different set of activities in order to deliver a unique mix of value. It involves doing activities differently than the competitors in order to gain competitive advantage. The demutualization of a stock exchange is a strategy in itself where the ownership and control is bound to change. The change of a stock exchange from a member-owned organization to a for-profit shareholder corporation triggers a number of questions about regulatory oversight. When a demutualized exchange is listed on its own board, some regulatory oversight needs to be transferred to a government regulator. In many countries, demutualization of the major national stock exchange has been accompanied by general securities regulatory reform (Serfiso, 2005).

Demutualization is literally the process of changing an organization from its mutual ownership structure to a share ownership structure. The process entails first converting memberships into shares, which step may or may not be followed by a public issue of shares. In this manner, a quasi-governmental institution transforms itself into a profit-oriented, publicly traded company. Ownership and trading privileges are effectively separated. Stockbrokers are no longer owners but customers of the exchange. Directors are elected by shareholders and answerable to them. Under the current system, the NSE is owned by its members only by virtue of them being members of the exchange.
Demutualization will separate ownership rights, with shares in the NSE able to be bought and sold. Although share-holders and members may be the same people, especially initially, demutualization opens up the possibility of non-members having an ownership share in the exchange.

A demutualised exchange may take many forms, each raising its own issues. Some exchanges have demutualised and become public companies listed on their own exchanges. Other exchanges have demutualised but have remained private corporations. Still others are subsidiaries of publicly traded holding companies.

1.1.1 Nairobi Securities Exchange

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

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

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

The Nairobi Securities Exchange was incorporated under the Companies Act of Kenya in 1991 as a company limited by guarantee and without a share capital. Prior to 1991, it was registered as a voluntary association of stockbrokers under the Societies Act in 1954. NSE is categorized into three market segments: Main Investment Market Segment (MIMS), Alternative Investment Market Segment (AIMS) and Fixed Income Market Segment (FIMS). The MIMS is the main quotation market (Ngugi, 2003). Companies listed under this segment are further categorized in four sectors that describe the nature of their business, namely: Agricultural; Industrial and allied; Finance and investment; and Commercial and services. The AIMS: Provides an alternative method of raising capital to small, medium sized and young companies that find it difficult to meet the more stringent listing requirements of the MIMS. Is geared towards responding to the changing needs of issuers. Facilitates the liquidity of companies with a large shareholder base.
through ‘introduction’, that is, listing of existing shares for marketability and not for raising capital; and offers investment opportunities to institutional investors and individuals who want to diversify their portfolios and to have access to sectors of the economy that are experiencing growth (NSE, 2012).

1.2 Problem Statement

The demutualization trend has been that attributed to a number of reasons that include: improved governance, investor participation, competition, globalization and consolidation and Unlocking stock exchange value. While demutualized stock exchanges continue to provide most of the same services, they have different governance structures in which outside shareholders are represented by boards of directors. The mutual association model functions well if an exchange is a provider of trading services with limited competition and the interests of members are homogeneous (Ngugi, 2003).

Demutualization provides an opportunity to unlock the value of a stock exchange though the realization of the value will ultimately depend on the listing of the exchange. In the majority of exchanges, the value of the exchange is usually distributed to member brokers. Demutualization and listing provides an exit mechanism for former brokers to sell down equity thereby broadening the shareholder vase and decoupling of broker interests from that of the exchange (Mensah, 2005).

Several studies have been done on demutualization of stock exchanges. Morsy and Rwegasira (2010) did a study to establish whether demutualization matter to the Financial performance of stock exchanges. They did an investigation of demutualized member stock exchanges of the world federation of exchanges. Their study established that demutualization resulted in significant improvement in only four out of the eleven financial measures used to test for change in performance. This result was noted in the basic earning power, earnings before interest and taxes (EBIT), profit margin and return on asset (ROA). Chesini (2007) did a study on from demutualization to globalisation where the study looked at the new challenges for stock exchanges. This study established that after the demutualization and the self listing of many Stock Exchanges; the proposed consolidations in the industry have accelerated, involving the denationalization of the
Exchange infrastructures. Cospormac (2009) did a study on demutualization of stock exchanges a case study: London stock Exchange and Hong Kong Stock Exchange. Cospormac (2009) established that demutualized stock exchanges hold a stronger operating performance and a better performance in term of shareholder’s return than mutual exchanges. Mensah (2005) did a study on demutualizing African Stock Exchanges: Challenges and Opportunities where he summarized those African stock exchanges should move cautiously on demutualization. In Kenya, the feasibility study on demutualization by KPMG established that through demutualization, efficiency and effectiveness at the NSE would be promoted. From the above discussion, it was evident that further research needs to be established on the factors affecting the demutualization strategy of the NSE. The demutualization process commenced in 2010 but has never been completed two years later on. This study therefore sought to fill this research gap by establishing the factors that affect demutualization of the NSE.

1.3 General Objective of the Study

1.3.1 General Objective

The general objective of this study was to determine factors affecting demutualization strategy of the Nairobi Securities Exchange.

1.3.2 Specific Objectives

i. To determine the effect of ownership structure on the demutualization of NSE.

ii. To determine effect of stakeholder awareness of the process of demutualization on NSE demutualization.

iii. To determine the effect of corporate governance on demutualization of NSE.

iv. To determine the effects of government policy and regulation on the demutualization of NSE.

1.4 Research questions

i. How does ownership structure affect the demutualization of NSE?

ii. How does stakeholder awareness of the process of demutualization affect NSE demutualization?
iii. How does corporate governance affect the demutualization of NSE?
iv. How does government policy and regulation affect the demutualization of NSE?

1.5 Significance of the Study

The research findings would be useful to various stakeholders, including:
The Governments of Kenya and East African countries and other interested stakeholders would use the findings of this research to work on a strategy aimed at ensuring that capital markets in Kenya and the greater East Africa region operate under acceptable and international capital markets standards that foster growth and expansion of the capital markets.
The Nairobi Securities Exchange has resolved to demutualise and there is universal agreement that demutualization of an exchange has a number of challenges. There is little information on potential conflicts of interest demutualization will usher at the NSE. This study would therefore provide the NSE with a clearer picture of the impact of demutualization on its operations and this knowledge could form a critical guidance tool in the restructuring and reorganization of the NSE.

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

A vast majority of Kenyan citizens lack an understanding and appreciation of the operations and functions of the capital markets. It is for this reason that for the last five years since Kenya’s ground breaking Initial Public Offering(IPO) of KenGen and subsequent IPOs that the NSE and the CMA have invested time and money to educate the general public and even small medium enterprises (SME) on the operations and functions of capital markets in Kenya. This study will be useful to those engaged in
capital market education as it gives more insight on the functioning a demutualised exchange. It will also be used as a resource material for public and institutional education.

1.6 Scope of the Study

The study focused on the members and participants in the capital market. This will include the Capital markets Authority (CMA), Central Depository System (CDS), Stock brokerage firms, Fund Managers, Commercial Banks, investment advisors, and public investors. The study aims at collecting data from the respondents with a view of determining the factors affecting the demutualization strategy of NSE.

1.7 Limitations of the study

A limitation for the purpose of this research is regarded as a factor that is present and is likely to contribute to the researcher getting either inadequate information or if otherwise the response given will be totally different from what the researcher is expecting. The main limitations of this study included: Some respondents refusing to fill in the questionnaires citing that the information was of a sensitive nature and could be used for other purposes other the intended one.

The study was also limited in terms of resources. The resource available to go to the field and ascertain whether the information being provided was the reality of whatever happens in real sense is limited. This forced the researcher to wholesomely rely on the information provided by the respondents.
CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter presents the literature review, specifically the literature review focuses on the theoretical framework, variables of the study, empirical review, research gap and chapter summary. The review of literature focuses on the effect of the factors that affect demutualization of stock exchanges. It begins with a brief history of the NSE, current structure and organization of the capital markets in Kenya and the challenges facing the Kenyan stock market. It then briefly reviews the driving forces, motivators and challenges that have driven some stock exchanges to opt for demutualization. It then introduces the subject of challenges in demutualization process of exchanges.

The demutualization of stock exchanges is a recent trend around the world. Yet whereas awareness of this trend among market participants and regulators has grown rapidly in recent years, the causes of the phenomenon are not widely understood. Indeed, there is even considerable confusion regarding what demutualization actually is, with regulators and scholars unhelpfully conflating the concept with for-profit legal status. Demutualization and listing of exchanges places a spotlight on challenges of the demutualization process.

2.2 Theoretical Review

2.2.1 The Transaction Costs Theory

Literature on transaction costs provides an explanation of why firms exist. Pioneers in transaction costs theory argue that firms exist in order to reduce transaction costs and thus increase the volume of trade and economic value creation (Arwa, 2010). Arwa (2010) confirms that the early work of Coase (1937) explains that firms exist where it is profitable to establish them as there are costs to conducting transactions in the market. The most obvious cost is discovering what the relevant prices are. There are also costs related to negotiating and concluding transactions for each transaction. The firm is a ‘series of contracts’ that reduces and economizes on transaction costs. The transaction costs theory explains the worldwide move towards demutualization. The new changes in
today's competitive environment, that resulted from the introduction of new electronic systems have led to lower transactions costs of trading for investors, allowed for better price determination, and lowered the chance for market manipulation - that existed under the mutual structure of stock exchanges. The new advances in technology and globalization have also facilitated cross-border trading and over time the development of inter-market trading systems (ITS) (Claessens et al, 2000). Therefore the shift towards demutualization of stock exchanges becomes a natural response to the new technological advances, where the mutual structure became less appealing and more costly for investors.

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

2.2.2 The Property Rights Theory

Property rights explains why a particular form of ownership takes place in a given organization as it comes as a result of the bargaining strength of those affected. Decision
makers in an organization usually want to adopt, or modify property rights to alleviate the harmful impact of economic losses of the common pool. According to Demsetz, 1995), the need for new property rights reflects the need to include new market prices and production possibilities that cannot be attained under the old arrangement. Davis and North (1971) provide more clarification of this point by saying that; ‘It is the possibility of profits that cannot be captured within the existing arrangement structure that leads to the formation of new institutional arrangements (p.39)’. According to Orwa (2010), the ideas of Libecap (1989), North (1971) and Demsetz (1988) can be linked to the main reason of demutualization – as a new form of ownership; the previous mutual structures have failed to respond to the new advancement in technology and new changes in the global market. Investors want to have a new ownership structure that improve their exchange and as a result can provide them with higher yields.

Mahoney (2004) noted that ‘the greater the size of anticipated aggregate economic benefits of institutional change, the more likely the new property rights will be sought and adopted (115)’. Similarly North (1990) addressed an important question on why societies experience long-term stagnation or an absolute decline in economic well-being. According to Orwa (2010), North and Thomas (1973) considered institutions the determinant of economic performance and relative price changes the main reason that accounts for institutional change. As North and Thomas explained, changes in relative prices provide an incentive to create more efficient institutions (In Mahoney, 2004). These arguments can be related to the trend on demutualization. The remarkable change in the ownership and organizational structure of the demutualized stock exchanges was mainly motivated by some intense global competition and advances in technology. Decisions to demutualize usually happens when the old member-owned organizational structure fails to provide the flexibility and finance needed to improve the stock exchange, which in turn affect the profit-seeking investors and might drive them to seek other stock exchanges. As Mendiola and O’Hara (2004) pointed out, updating trading platforms is capital intensive and this need had required many large and small stock exchanges to look for ways of finance such investments. Also, the lack of liquidity problem had posed a threat on smaller businesses to go out of business. It was seen that
the demutualization program and listing can allow the stock exchange to raise capital by selling shares in the public market and can also motivate the management of the exchange to seek more business initiatives. The ability to raise capital IPO private investment and the increased responsibility to stakeholders were viewed as convenient ways to respond to the global competitive pressures as it allows for the resources and incentives needed for investment in competitive products and information systems (Hughes and Zargar, 2006).

The property rights theory also helps to understand another question: Can members of the exchange under the mutual structure protect their economic rights? Brazel (1989) argues that; ‘legal rights are neither necessary nor sufficient for the existence of the economic rights’. Barzel (1989) looks at the concept of property rights to be closely related to the concept of transaction costs. He defined the transactions costs as those costs that are associated with the transfer, capture, and protection of rights. Because transacting is costly, property rights are never delineated (In Mahoney, 2004). Under the mutual governance structure and with the arise of competition, ECNs and changes in the global market, the member (broker) – investor relationship cannot be guaranteed, For the investor, the transactions costs are more costly in his home exchange or is cheaper elsewhere. Unless members can guarantee that investors will deal with them, there is no guarantee of income.

2.2.3 The Agency Theory

Agency relationship is very important to the study of corporate governance in strategic management (Rediker and Seth, 1995). The theory was used by scholars in accounting economics finance, marketing, organizational behavior, and sociology (Arwa, 2010). The agency theory ideas on risk, outcome uncertainty, incentives, and information systems are novel contributions to organizational thinking, and the empirical evidence is supportive of the theory, particularly when coupled with complementary theoretical perspectives. The theory views the agency relationship, in which one party (the principle) delegates work to another party (the agent), who performs that work. This involves delegating some decision making authority to the agent. The agency theory describes this
The principle concern for the agency relationship is to solve two main problems. First, the agency problem that takes place when there is a conflict between the desires/goals of the principle and those of the agent, and when it is hard or costly for the principle to monitor the agent in order to prove whether or not the agent is working in an appropriate manner. Second is the problem of risk sharing which occurs when the principle and agent have different approaches toward risk; actions of the principle and agent may differ because of their different risk preferences (Eisenhart, 1989).

2.3 Empirical Review

2.3.1 Ownership Structure

Traditionally world stock exchanges were run as mutuals or member customer owned organizations raising capital from members and providing them services. Demutualization is a process by which such a member customer-owned cooperative or mutual organization is transformed into a shareholder-owned company raising capital with shares issued and providing services to customers as well as returns to shareholders. Demutualization is about changing the ownership structure of the stock exchange; from a mutual association with one vote per member and possibly consensus-based decision making, into a company limited by shares, with one vote per share (with majority-based decision making) (Aggarwal, 2002). In the business world, a change in the ownership structure usually reflects a change in the assets and the strategy adopted by the firm to respond to certain changes in the business environment such as, the globalization, the rise of global competition and technological advances.

According to Ramos (2006b:3), demutualization separates trading and ownership rights, diversifying the exchanges’ shareholder base. The outcome of this structure change for the venue itself is extremely beneficial, due to the fact that it increases trading volume and order flow. As a result, the profits of the exchange also increase. On the other hand, the members of the traditional mutual structure loses out immensely. Firstly, as they try
to resist demutualization, their revenues are continuously eroded as a result of a more contestable market, where a monopoly can no longer enjoy its advantageous position due to the threats of competition. Secondly, with demutualization, members of the traditional exchanges also witness a loss of benefits: their power inside the exchange diminished as a result of the increasing foreign members and, later on, with the new outside members, whose fraction of capital gradually increased, diluting the power of the predecessor members.

2.3.2 Government Policy and Regulatory Framework

The securities market regulation is critical to ensure efficiency, integrity and fairness of the markets that together lend credibility to markets and safeguard investor interest and confidence. To achieve this, the regulators have to perform adequate oversight of exchanges in order to deal with: the conflict of interest between owners of exchange and the business they offer, rules governing primary and secondary market trading, qualification, operative and ethical practices of market participants in particular brokers and dealers, investor protection, and transparency of market transactions, among others (Mahoney, 2004).

In taking a glance of the regulatory structure, a number of challenges arises that need to be addressed before the exchange can respond to the changes taking place within the economy. The present regulatory regime in Kenya has resulted in the duplication and overlapping roles in various subsectors of the financial services industry. For instance, both the Retirement Benefits Authority and the Capital Markets Authority regulate the fund managers for pension’s funds. This means that issues of compliance are necessarily complicated because each of the individual regulators has specific regulatory goals. In addition, compliance with such a diverse set of regulatory provisions may lead to increased costs of compliance because of the possibility that the requirements may be in conflict with one another. More fundamentally however, the existing situation fails to agree with the basic requirement that regulatory provisions should be simple and flexible (Orwa, 2010).
Among the main consequences of the overlap of institutions and fragmented regulation is that there is apparent imbalance in growth of the related sub-sectors. For instance, since financial sector regulations commenced, the foreign exchange trading bureaus have grown considerably while the equally important mortgages sub-sector has not had any benefits from the process of liberalization and policy changes. In addition, the disarticulated regulation merely shows that the fact that the separate sub-sectors are mutually reinforcing is not taken into account by the policy and regulations (Orwa, 2010).

2.3.3 Shareholders’ involvement

On demutualization, the new corporation will be more profit-oriented due to shareholder accountability. However, in today’s competitive environment, a stock exchange must be responsive to the needs of its many stakeholders, including participating organizations, listed companies, and institutional and retail investors. Exchanges may perceive a need to shift power within the exchange from one group of members to another and to afford institutional customers direct access to exchange facilities. Separating exchange membership from ownership may be a politically and economically feasible way to effect such a shift and resolve conflicts of interest between exchange members and between exchanges and their members (Mendiola and O’Hara, 2004).

Unlike a mutual structure where often only broker-dealers may be members, a demutualized exchange affords both institutional investors and retail investors the opportunity to become shareholders. The assets managed by institutional investors have grown significantly in recent years and the trading needs of institutional investors differ dramatically from those of retail investors. In particular, institutional investors have a strong preference for anonymity when they are affecting large block trades. Institutional investors also require much greater liquidity to accommodate block trading and place far more emphasis on negotiating the lowest price. A demutualized exchange will have greater flexibility to accommodate the needs of institutional investors as customers, and potentially, as owners (Orwa, 2010).
2.3.4 Corporate Governance

While demutualized stock exchanges will continue to provide most of the same services, they will have different governance structures in which outside shareholders are represented by boards of directors (Mensah, 2005). Demutualization, a change in the corporate governance structure of an exchange, is not an end in itself. The exchanges that have demutualised have done so because they found that their mutual governance structure, which once served them well, had become a hindrance to positioning themselves competitively in a global trading environment (Shariful and Mohammad, 2011).

Exchanges, when run as mutual associations, clubs and cooperatives of traders and brokers allow members exclusive rights of access to trading systems and platforms. Operating under this mutual structure, exchanges enjoyed quasi or full monopoly on trading and they derived profits from the intermediation of nonmember transactions. Since members under the mutual structure were owners of the exchange, they imposed rights to trading and disallowed direct access to the trading floor to any outsiders. Brokers inadvertently resisted changes if these entailed additional costs, loss of revenue or competitive threat (Mendiola and O'Hara, 2004). This resistance eventually impeded the ability of the company to react quickly to a rapidly changing market environment. Also, in some developing countries if the exchanges enjoyed a legal or decreed national monopoly, government-appointed officials and stakeholder representatives were often represented on the board. While in the short-run such appointments may have proved conducive to mitigating the entrenched interests, in the long-run these can prove counterproductive leading to unhealthy government interference (Chesini, 2001).

With the changing economics of automated auction trading and its easy access electronically, the economics of member-cum-trading floor based exchanges has lost its merit. As a result, it has generated pressures to replace the age-old reliance on one member, one vote and the committee-based decision structure where control is vested with the interest groups that have exclusive rights of intermediation at exchange. Under demutualization, there is increased acceptance to separation of ownership from
membership that automatically provides trading rights. This segregation helps introduce effective corporate governance if: there are accompanying improvements in the incentive structure, which allow the exchanges to sell their equity stakes to nonmembers and outsiders, decision making is based on this new ownership structure (not on rights of intermediation), and when there is an effective oversight of a governing board and a company structure (Mendiola and O’Hara, 2004).

Since under demutualization the economic ownership of the exchange is separated from trading membership, it is not appropriate that interest groups (such as the trading members) have exclusive authority over the decisions of exchange. After demutualization, some exchanges have granted less than 50% of the voting rights to the broker members on the board of the exchange. To gradually decrease broker influence on the board, the exchanges have appointed independent directors or directors that are nontrading owners. After demutualization, the appointment of government appointed officials (a common feature of exchanges in developing economies) has by and large been viewed as controversial given that the demutualized exchange is a private sector company operating in a competitive environment (Mensah, 2005). In environments where broker influences are often daunting, the continued role of the representative(s) of the securities regulator can support the transition of exchange till such time as the regulation is changed to allow the exchanges to operate in a fully competitive manner. Besides appropriate board representation, it is important that the management of the exchange is fully qualified and motivated to act not only in the best interests of the shareholders, but also to conduct the business in a prudent manner so as not to disrupt the orderly and fair trading in the capital markets. To ensure that this public interest is satisfied, "fit-and-proper" screening of the board and management, similar to tests put in place in the banking regulations of many jurisdictions, could be undertaken (Mendiola and O’Hara, 2004).

The management should be accountable to the board, which will determine management's appointment and remuneration, supervise the strategic direction and audit the financial and operational results, including risk management, and if needed, effect the
removal of management. To ensure the effective supervision and auditing of management, it will seem prudent to ensure that a majority of board members are truly independent directors. To remain competitive, a stock exchange must follow international best practices in ethics and procedures. This is necessary in order to ensure that institutional investors do not shift their investments to other alternatives perceived to be more fair or secure (Mensah, 2005). Therefore, it is in the profit-motivated exchange's best interest to ensure fair and transparent practices; and, as such, good corporate governance needs to be an integral part of the exchange once it is driven by the profit motive (Mendiola and O’Hara, 2004).

2.4 Conceptual Framework of the Study

Conceptual Framework is defined as how one theorizes or makes logical sense of the relationships among the several factors that have been identified as important to the problem under study. The basic framework of this study is built around the conceptual model below (See Figure 1.0).

The Nairobi Securities Exchange is the organization being studied and our main interest is researching on the challenges of its demutualization process. The Nairobi Securities Exchange is the dependent variable that lends itself for investigation. The variables that influence the dependent variable (NSE) are the key factors that must be considered in the demutualization process i.e. Governance, Structures, Regulatory Framework, awareness, Revenues and Information Technology, Competition and the World Trends. These variables will influence both pre and post demutualization. Their influence will determine the NSE relationship with the Public; Investors; Government; Stock brokers and the proposed East Africa regional stock exchanges integration/consolidation.
2.5 Research Gap

Many scholars and researchers have studied demutualization of stock exchanges. Mensah (2005) did a study on demutualizing African Stock Exchanges: Challenges and Opportunities where he summarized those African stock exchanges should move cautiously on demutualization. The factors that have fueled demutualization in developed and the larger emerging markets are largely absent from Africa. In addition, the key preconditions such as a sufficiently liberalized market and critical mass of stock exchange trading and related services do not exist in most markets. Having sounded this note of caution, Mensah (2005) further hasten to add that there are a minority of African stock exchanges that are likely to meet the various tests of readiness for demutualization.
In my view, these are the larger stock exchanges with market capitalization and listings that are adequate to sustain profitable operations upon demutualization and whose markets are currently sufficiently liberalized.

Ngugi (2003) explored the evolutionary process of the stock market in Kenya and identified the institutional and policy changes that had shaped the development pattern of the Nairobi Securities Exchange (NSE). She provided a historical perspective in helping to trace developments in the regulatory system, trading system, market membership, composition of market investors and taxation policy. Three phases in the development process of the stock market were identified and distinguished by their unique institutional and policy environment characteristics. These phases are the initiation stage, the formalization stage and the revitalization/restructuring stage. The initial stage is mainly characterized by dominations of foreign investors in share trading and spontaneous growth. The formalization stage saw the adoption of a self-regulatory framework with efforts to increase the participation of local citizens in share trading especially in the post-independence period. This is also the period when the Government adopted a controlled policy regime and implemented tax policies that penalized share returns more than returns from other financial assets. Further, the Nairobi Securities Exchange which had served as a regional market among the East African states lost its market share with the break-up of the East African Community. Partially because of these developments, the stock market was characterized by a state of dormancy during this phase. This gave way to the revitalization stage where efforts were made to strengthen the institutional infrastructure and also to enhance the policy environment in order to facilitate growth of the stock market.

There were limited studies if any that have assessed the factors affecting the demutualization of the NSE. This study therefore sought to fill this research gap by establishing the extent to which these factors affect the demutualization strategy of the Nairobi Securities Exchange.
CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

Research methodology involved describing the procedures that were applied in conducting the study (Mugenda and Mugenda, 2003). Mugenda and Mugenda (2003) further adds that research methodology includes research design, population and sample, data collection procedures, data analysis procedures and measurement variables. Kothari (2004) defines research methodology, as the way of systematically resolving a research problem. This chapter presents the research methods that will be used to explore the factors affecting the demutualization strategy of the NSE. The chapter provides a description of the research methodology, the population, the sampling procedure, how the subjects were obtained and the rationale for their selection, the tools to be used together with the procedure to be adopted in data collection and finally how the data will be analyzed.

3.2 Research design

Research design is the ultimate blueprint for the collection, measurement and analysis of data (Kothari, 2004). This study adopted a descriptive survey approach. According to Schindler and Coopers (2003) descriptive study is concerned with finding out the what, where and how of a phenomenon. The research design and methodology entailed collecting data useful for analysis and coming up with relevant recommendations and conclusions.

3.3 Target Population

The target population of this study comprised of all the 58 key stakeholders at the NSE. This shall included: Capital Makets Authority (CMA), Central Depository Systems (CDS), Stock Brokerage firms, and mutual companies. Two questionnaires will be administered to each organization.
3.4 Sample Size

Thorpe, Smith and Jackson (2008) said that a sample refers to a subset of those entities that decisions relate to. Denscombe (1998) posed that, the sample must be carefully selected to be representative of the population and the researcher also needs to ensure that the subdivisions entailed in the analysis are accurately catered for. Following the small population, the researcher conducted a census study so that all the members of the population are included. The study targeted directors of the companies because they are well informed of the effects of demutualization strategy besides playing a key role in the demutualization process.

Table 3.1: Sample Size

<table>
<thead>
<tr>
<th>Organization Group</th>
<th>Number of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nairobi Securities Exchange</td>
<td>1</td>
</tr>
<tr>
<td>Central Depository System</td>
<td>1</td>
</tr>
<tr>
<td>Capital Markets Authority</td>
<td>1</td>
</tr>
<tr>
<td>Stock Brokerage firms</td>
<td>8</td>
</tr>
<tr>
<td>Investment Banks</td>
<td>12</td>
</tr>
<tr>
<td>Investment Advisers</td>
<td>17</td>
</tr>
<tr>
<td>Fund management companies</td>
<td>18</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>58</strong></td>
</tr>
</tbody>
</table>

Source: (CMA Website, www.cma.co.ke)

3.5 Data Collection Methods

Primary data was collected using a questionnaire. The questionnaire made use of both open and closed ended questions. A five point likert scale was used where respondents were required to fill in the level of their agreement with the various statements under each variable.
3.6 Piloting

Piloting was carried out to test the validity of the instruments. Validity indicates the degree to which the instrument measures the constructs under investigation (Mugenda and Mugenda, 1999). There are three types of validity test, content, criterion and related construct validity. This study used content validity because it measures the degree to which the sample of the items represents the content that the test is designed to measure. A pilot study was conducted by sending five questionnaires to the NSE staff. The responses provided helped the researcher in refining the data collection instrument to make easier for the respondents to provide the required information. The final questionnaire was printed and dispatched to the field for data collection with the help of research assistants.

3.7 Data Collection

Questionnaires were administered to the respondents through a drop and pick method. The questionnaires were delivered to the organizations’ registered offices. For the respondents who wanted to receive the question via email, the same was sent to them through the email they provided. The respondents were allowed a number of days to fill the questionnaire after which the researcher called to confirm collection.

3.8 Data Analysis

Before processing the responses, data preparation was done on the completed questionnaires by editing, coding, entering and cleaning the data. The data was then entered into Statistical Package for Social Sciences (SPSS) Version 17.0 for analysis.

Data collected was analyzed using descriptive statistics. The descriptive statistical tools helped in describing the data and determining the respondents’ degree of agreement with the various statements under each factor. Measures of central tendency including mean and standard deviations were used to analyze likert type of questions. Data presentation was in the form of figures and tables.
In order to determine the extent to which each factor affects the demutualization strategy of the NSE, the researcher conducted a regression analysis using the following regression model.

\[
Y = B_0 + B_1X_1 + B_2X_2 + B_3X_3 + B_4X_4 + \epsilon
\]

Where \( Y \) = Demutualization of the NSE

\( X_1 \) = Ownership Structure

\( X_2 \) = Government Policy and Regulations

\( X_3 \) = Shareholders' Involvement

\( X_4 \) = Corporate Governance

\( \epsilon \) = Error term
CHAPTER FOUR
DATA ANALYSIS, PRESENTATION AND INTERPRETATION

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

4.1.1 Response Rate
The study targeted 58 respondents who included: Nairobi Securities Exchange, Capital Markets Authority (CMA), Central Depository Systems (CDS), Stock Brokerage firms, investment banks, investment advisors, and fund management companies. From the study, 42 out of 58 target respondents filled in and returned the questionnaire giving a response rate of 72%. This commendable response rate was made a reality after the researcher made personal calls and visits to remind the respondent to fill-in and return the questionnaires. This response rate was excellent and representative and conforms to Mugenda and Mugenda (1999) stipulation that a response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent.

Table 4.2: Response Rate

<table>
<thead>
<tr>
<th>Response</th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Responses</td>
<td>42</td>
<td>72</td>
</tr>
<tr>
<td>Non-responses</td>
<td>16</td>
<td>28</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>58</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Source: Research Data, 2012

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

Figure 4.2: Gender of the Respondents

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

Figure 4.3: Level of Education

The study further sought to determine the respondents’ current designation within the organization. According to the findings, majority (38%) of the respondents were stock
analyst, 28% were Directors, 17% were branch managers whereas 10% and 7% were others and managing directors respectively as illustrated in figure 4.3 below.

![Bar Chart: Designation of the Respondents]

**Figure 4.4: Designation of the Respondents**

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

![Bar Chart: Period in the Securities Industry]

**Figure 4.5: Period in the Securities Industry**
4.3 Ownership Structure

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

<table>
<thead>
<tr>
<th>Table 4.3: Ownership Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frequency</td>
</tr>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Source: Research Data, 2012

The study further required the respondents to indicate the extent to which they agreed with aspects about organizational ownership structure and how they affect demutualization in the NSE. According to the findings, the respondents agreed that demutualization changed the ownership structure of the stock exchange as shown by a mean of 4.2802 and std. deviation of 0.684; demutualization diversified the exchanges’ shareholder base at a mean of 4.2391 and std. deviation of 0.467; demutualization separated trading and ownership rights as indicated by a mean of 4.3750 and std. deviation of 0.593; and a change in the ownership structure usually reflected a change in the assets and the strategy adopted by the firm to respond to certain changes in the business environment as shown by a mean of 4.3468 and std. deviation of 0.536. (See table 4.4 below). According to Aggarwal (2002) Demutualization is about changing the ownership structure of the stock exchange; from a mutual association with one vote per member and possibly consensus-based decision making, into a company limited by shares, ranking parri passu. In the business world, a change in the ownership structure usually reflects a change in the assets and the strategy adopted by the firm to respond to certain changes in the business environment such as, the globalization, the rise of global
competition and technological advances. Ramos (2006), states that demutualization separates trading and ownership rights, diversifying the exchanges’ shareholder base. The outcome of this structure change for the avenue itself is extremely beneficial, due to the fact that it increases trading volume and order flow. Krishnamurti et al. (2003) provide an empirical contribution for the area of stock exchange ownership forms by comparing the market quality of National Stock Exchange, a demutualized exchange, with that of the mutually owned Bombay Stock Exchange.

Table 4.4: Aspects of Ownership Structure

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

Source: Research Data, 2012

4.4 Government Policy and Regulatory Framework

On whether demutualization was affected by government policy and regulatory framework, the study found that most (94%) of the respondents agreed demutualization was affected by government policy and regulatory framework while 6% disagreed as indicated in figure 4.5 below. This is because of the key role that the government plays in safeguarding investors’ interests and ensuring that the confidence is not lost and that at no time shall one of its national economy barometers shall be put under receivership or bankruptcy. Also, the Government policy would assist the market in the next level of stock market front for example consolidation and globalization.
The study also required the respondents to indicate their level of agreement on statements about government policy and regulatory framework. According to the findings in table 4.5 below, the respondents agreed to a very great extent that the securities market regulation was critical to ensure efficiency, integrity and fairness of the markets that together lend credibility to markets and safeguard investor interest and confidence at a mean of 4.6271 and std. deviation of 0.497; It curbed the conflict of interest between owners of exchange and the business they offered as shown by a mean of 4.5463 and std. deviation of 0.574; It set the rules governing primary and secondary market trading as indicated by a mean of 4.5329 and std. deviation of 0.539; It defined the qualification of organizations to participate in demutualization at a mean of 4.5468 and std. deviation of 0.498; it guided the operative and ethical practices of market participants in particular brokers and dealers as shown by a mean of 4.5905 and std. deviation of 0.588; and it ensures investor protection, and transparency of market transactions as shown by a mean of 4.6197 and std. deviation of 0.499. Demutualization of stock exchanges leads to a legal status of the stock exchanges being changed from company limited by guarantee to a public company limited by shares. In addition, the majority ownership may be segregated from the right to trade on the stock exchange as shareholdings of the stock exchanges were before the demutualization process (Hughes and Zargar, 2006). Elliot (2002) and Karmel (2000) devoted themselves in studying the effect of regulatory issues after the
demutualization process, stock exchanges are regulating their trading markets by themselves. As a result of demutualization, there is a collision between the interests of a for-profit exchange and the fair conduct of trading. The securities market regulation is critical to ensure efficiency, integrity and fairness of the markets that together lend credibility to markets and safeguard investor interest and confidence. To achieve this, the regulators have to perform adequate oversight of exchanges in order to deal with, the conflict of interest between owners of exchange and the business they offer, rules governing primary and secondary market trading, qualification, operative and ethical practices of market participants in particular brokers and dealers, investor protection, and transparency of market transactions, among others (Pirrong, 2000).

Table 4.5: Statements about Government Policy and Regulatory Framework

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

Source: Research Data, 2012

On the extent the respondents agreed with challenges facing Kenyan Government policy and regulation framework. The study found that the respondents strongly agreed that the existing situation failed to agree with the basic requirement that regulatory provisions
should be simple and flexible as shown by a mean of 4.5945 and std. deviation of 0.567; compliance with such a diverse set of regulatory provisions might lead to increased costs of compliance because of the possibility that the requirements might be in conflict with one another at a mean of 4.4831 and std. deviation of 0.538; and issues of compliance were necessarily complicated because each of the individual regulators had specific regulatory goals as shown by a mean of 4.5871 and std. deviation of 0.553 (see table 4.6 below).

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

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

Source: Research Data, 2012

#### 4.5 Corporate Governance

On whether corporate governance affected demutualization in the NSE, the study established most of the respondents agreed that corporate governance affected demutualization in the NSE at 89% while 11% disagreed as illustrated in figure 4.6n below.
In addition, the study required the respondents to rate their level of agreement on aspects of corporate governance. From the findings, the respondents strongly agreed that demutualization, a change in the corporate governance structure of an exchange, was not an end in itself at a mean of 4.5678 and std. deviation of 0.576; Exchanges, when run as mutual associations, clubs and cooperatives of traders and brokers allowed members exclusive rights of access to trading systems and platforms as shown by a mean of 4.5426 and std. deviation of 0.549; and it was in the profit-motivated exchange's best interest to ensure fair and transparent practices and, as such, good corporate governance needed to be an integral part of the exchange once it was driven by the profit motive as shown by a mean of 4.6258 and std. deviation of 0.586. Similarly, they agreed that demutualized stock exchanges would continue to provide most of the same services; they would have different governance structures in which outside shareholders are represented by boards of directors at a mean of 4.4834 and std. deviation of 0.498; and under demutualization, there was increased acceptance to separation of ownership from membership that automatically provided trading rights as shown by a mean of 4.4839 and std. deviation of 0.498 (see table 4.7 below).
Table 4.7: Aspects of Corporate Governance

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

Source: Research Data, 2012

4.6 Regression Analysis

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

Table 4.8: Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.8998</td>
<td>0.80964</td>
<td>0.786</td>
<td>0.65323</td>
</tr>
</tbody>
</table>
Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (demutualization of NSE) that is explained by all the three independent variables (government policy and regulatory framework, ownership structure and corporate governance).

The four independent variables that were studied, explain only 81.0% of the factors affecting demutualization strategy of the Nairobi Securities Exchange as represented by the $R^2$. This means that other factors not studied in this research contribute 19.0% of the factors affecting demutualization of the Nairobi Securities Exchange and therefore, further research should be conducted to investigate the other factors (19.0%) that affect demutualization of the Nairobi Securities Exchange.

Table 4.9: Coefficient of determination

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1 (Constant)</td>
<td>2.394</td>
<td>0.300</td>
<td>5.264</td>
<td>.371</td>
</tr>
<tr>
<td>Ownership structure</td>
<td>0.565</td>
<td>0.061</td>
<td>0.390</td>
<td>3.123</td>
</tr>
<tr>
<td>Government policy and regulatory framework</td>
<td>0.549</td>
<td>0.082</td>
<td>0.346</td>
<td>2.484</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>0.536</td>
<td>0.096</td>
<td>0.005</td>
<td>2.752</td>
</tr>
</tbody>
</table>

As per the SPSS generated table above, the equation ($Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \epsilon$) becomes:

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

The regression equation above show that taking all factors into account (government policy and regulatory framework, ownership structure and corporate governance)
constant at zero, demutualization will be 2.394. The findings presented also shows that taking all other independent variables at zero, a unit increase in ownership structure will lead to a 0.565 increase in demutualization; a unit increase in government policy and regulatory framework will lead to a 0.549 increase in demutualization; and a unit increase in corporate governance will lead to a 0.536 increase in demutualization. This depicts that ownership structure contributes most to demutualization followed by government policy and regulatory framework. At 5% level of significance and 95% level of confidence, ownership structure had 0.028 level of significance; government policy and regulatory framework showed a 0.035 level of significance, and corporate governance showed a 0.047 level of significance hence the most significant factor is ownership structure.
CHAPTER FIVE
SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction
This chapter discusses the overall findings with the aim of answering the research questions. The chapter also presents conclusions and recommendations from the current study based on the objective of the study and recommends future possible studies. The general objective of this study was to determine factors affecting demutualization strategy of the Nairobi Securities Exchange. The specific objectives included: determining the effect of ownership structure on the demutualization of NSE; determining effect of stakeholder awareness of the process of demutualization on NSE demutualization; determining the effect of corporate governance on demutualization of NSE and determine the effects of government policy and regulation on the demutualization of NSE.

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

On government policy and regulatory framework, the study found that most (94%) of the respondents agreed demutualization was affected by government policy and regulatory framework. The study also found that the respondents agreed to a very great extent that the securities market regulation was critical to ensure efficiency, integrity and fairness of the markets that together lend credibility to markets and safeguard investor interest and
confidence; it curbed the conflict of interest between owners of exchange and the business they offered; it set the rules governing primary and secondary market trading; it defined the qualification of organizations to participate in demutualization; it guided the operative and ethical practices of market participants in particular brokers and dealers; and it ensures investor protection, and transparency of market transactions. The study further established that the respondents strongly agreed that the existing situation failed to agree with the basic requirement that regulatory provisions should be simple and flexible; compliance with such a diverse set of regulatory provisions might lead to increased costs of compliance because of the possibility that the requirements might be in conflict with one another; and issues of compliance were necessarily complicated because each of the individual regulators had specific regulatory goals.

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

5.3 Conclusions

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

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

5.4 Recommendations

For demutualization to materialize at NSE, the study recommends that the current owners who include the stockbrokerage firms should commit to relinquish significant ownership to the government and to the general public so that the stock exchange can be listed to trade like any other company. Unless these current owners are committed to ceding some of their ownership in favor of the Government and the Public, the demutualization strategy of the NSE would not be achieved.

The government and a regulator also need to stand its ground and pass laws favoring the demutualization process. Like other demutualized stock exchanges in the world, the Government of Kenya needs to take a majority shareholding in the demutualized security exchange. This will help create a stable securities exchange to ensure successful demutualization; the Government should work in collaboration with other all stakeholders to ensure there is no resistance to the whole process of demutualization. A demutualized exchange would have greater flexibility to accommodate the needs of institutional investors as customers, and potentially, as owners.

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

5.5 Recommendation for Further Studies

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


Cospormac, G., (2009) *Demutualization of Stock Exchanges; A case study: London Stock Exchange and Hong Kong Stock Exchange*. Master Degree Project in Economics and Finance, University of Skovde, School of technology and society


APPENDIX 1: INTRODUCTION LETTER

Kamiri Michael Gakonde
P.O. Box 898-00217
Limuru
20th October, 2012
Dear Sir/Madam,

RE: REQUEST FOR PARTICIPATION IN A RESEARCH STUDY

I am a final MBA student at Kenyatta University. My area of specialization is Finance Option. I am currently undertaking a research thesis on “FACTORS AFFECTING DEMUTUALIZATION STRATEGY OF THE NAIROBI SECURITIES EXCHANGE”.

I would be grateful if you could spare some time from your busy schedule and complete the enclosed questionnaire. All the information provided will be used purely for academic purposes and will be treated with utmost confidentiality.

Thank you for your cooperation.

Yours faithfully,

Kamiri Michael Gakonde

MBA Student, Kenyatta University
APPENDIX 2: QUESTIONNAIRE

Please tick as appropriate (✓)

Demographic Information:
1. Gender:
   Male ( ) Female ( )

3. What is your highest qualification achieved?
   Diploma ( ) Degree ( )
   Masters ( ) PhD ( )
   Others (please specify) __________________________

4. What is your current designation within the organization?
   Director ( ) Managing Director ( ) Branch Manager ( )
   Stock Analyst ( ) Others (please specify) __________________________

5. How many years have you been in the Securities market industry?
   1 – 5 years ( ) 6 – 10 years ( ) 11 – 15 years ( )
   16 – 20 years ( ) above 21 years ( )

I. OWNERSHIP STRUCTURE

1. To what extent does the ownership structure of an organization affect demutualization?
   Very Great extent ( ) Great extent ( )
   Moderate extent ( ) Less Extent ( )
   No extent ( )

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

<table>
<thead>
<tr>
<th>Description</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Demutualization is about changing the ownership structure of the stock exchange</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A change in the ownership structure usually reflects a change in the assets and the strategy adopted by the firm to respond to certain changes in the business environment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Demutualization separates trading and ownership rights</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Demutualization diversifying the exchanges’ shareholder base</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

..................................................................................................................................................................................................

..................................................................................................................................................................................................

..................................................................................................................................................................................................

GOVERNMENT POLICY AND REGULATORY FRAMEWORK

4. To what extent has government policy and regulatory framework affected the demutualization process in Kenya?

Very Great extent ( )
Moderate extent ( )
Less Extent ( )
No extent ( )

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

<table>
<thead>
<tr>
<th>Government policy and regulation</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>The securities market regulation is critical to ensure efficiency, integrity and fairness of the markets that together lend credibility to markets and safeguard investor interest and confidence.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Curbs the conflict of interest between owners of exchange and the business they offer

Sets the rules governing primary and secondary market trading

Defines the qualification of organizations to participate in Demutualization

Guides the operative and ethical practices of market participants in particular brokers and dealers,

Ensures investor protection, and transparency of market transactions

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

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

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

CORPORATE GOVERNANCE

8. To what extent does corporate governance affect the Demutualization in the NSE?
Very Great extent ( ) Great extent ( )
Moderate extent ( ) Less Extent ( )
No extent ( )

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

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

10. Explain how corporate governance affect demutualization in the NSE

........................................................................................................................................................................
........................................................................................................................................................................

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

........................................................................................................................................................................
........................................................................................................................................................................

THANK YOU.
APPENDIX 3: LIST OF FIRMS

Regulatory Authorities
1. Nairobi Securities Exchange
2. Central Depository System
3. Capital Markets Authority

Stock Brokers
4. ABC Capital Limited
5. Afrika Investment Bank Limited
6. Drummond Investment Bank Limited
7. Genghis Capital Limited
8. Kestrel Capital (E.A) Limited
9. Kingdom Securities Limited
10. NIC Capital Limited
11. Reliable Securities Limited
12. Sterling Investment Bank Limited

Investment banks
13. African Alliance Kenya Investment Bank Limited
14. Barclays Financial Services Limited
15. CFC Stanbic Financial Services Limited
16. Dyer and Blair Investment Bank Limited
17. Equity Investment Bank Limited
18. Faida Investment Bank Limited
19. NIC Capital Investment (Kenya) Limited
20. Standard Investment Bank Limited
21. Suntra Investment Bank Limited
22. Equitorial Investment Bank Limited

Investment Advisors
23. Alliance Capital Partners Limited
24. Citidell Company Limited
25. Co-operative Consultancy Services (Kenya) Limited
26. Deloite Financial Advisory Limited
27. Executive & Corporate Advisory Services Kenya Limited
28. Franklin Management Consultants Limited
29. Iroko Securities (Kenya) Limited
30. J. W. Seagon & Company Limited
31. Lifestyle Management Limited
32. Loita Asset Management limited
33. PricewaterhouseCoopers Associates Limited
34. Regnum Consultants Limited
35. Standard Charrtered Securities limited
36. The ProFin Group (Kenya) Limited
37. Tsavo Securities Limited
38. VFS International (K) Limited
39. Winton Investment Services Limited

Fund Managers

40. Amana Capital Limited
41. Apollo Asset Management Company Limited
42. Aureos Kenya Managers limited
43. British American Asset Managers limited
44. CIC Asset Management limited
45. Co-optrust Investment Services Limited
46. Genesis (K) investment management limited
47. Dry Associates Limited
48. FCB Capital Limited
49. ICEA Asset management Limited
50. InvesteQ capital Limited
51. Madison Asset management Limited
52. Old mutual Investment services (K) Limited
53. Old Mutual Asset Managers (K) Limited
54. PineBridge Investment East Africa Limited
55. Sanlam Investment management Limited
56. Standard Chartered Investment Services Limited
57. Stanbic Investment management Services (E.A) Limited
58. Zemele Asset Management Company Limited