

**REGULATION OF EQUITY MARKETS IN UGANDA: THE ROLE OF
THE CAPITAL MARKET AUTHORITY IN INVESTOR
PROTECTION**

BY

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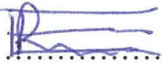
**A RESEARCH PAPER SUBMITTED TO THE FACULTY OF LAW IN
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DECLARATION

I, **RENE ACHIENG EDWIN**, hereby declare that this dissertation is original and has never been presented in any other institution. I also declare that any secondary information used has been duly acknowledged in this dissertation.

Signed this 16 day Of June 2013

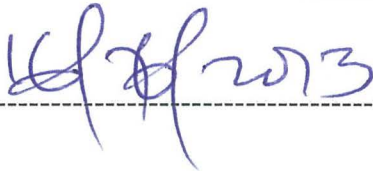


I, **MR. SSEWAYA MOHAMOUD**, have read this dissertation and approved it for examination.

Supervisor: **MR. SSEWAYA MOHAMOUD**



Signature:-----



Date:-----

DEDICATION

This dissertation is hereby dedicated first and foremost to my family: dad, mum, and my three other siblings secondly to my immediate extended family members and friends. I also dedicate it to all my friends, Caroline, Agnes, Martin, Kavuma just to mention a few who enabled me to accomplish what I have with their wonderful support. May God keep them and bless them abundantly. Thank you.

ACKNOWLEDGMENTS

I thank the Almighty God, for providing me the grace and sustaining my interests and the love for learning.

Special thanks and gratitude go to my parents for approving me with all the support towards my studies. This has opened more chances especially the fact that am now in position to make a reasonable contribution to nation building.

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The Capital Markets (Establishment of stock Exchanges) Regulations

The Capital Markets (Exempt Dealers) Regulations

The Capital Markets (Licensing) Regulations

The Capital Markets (Prospectus Requirements) Regulations

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ACRONYMS

BAT	British American Tobacco (Uganda) Limited
CMA	Capital Markets Authority
EADB	East African Development Bank
EMH	Efficient Market Hypothesis
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IPO	Initial Public Offering
MTN	Mobile Telecommunications Network
NRM	National Resistance Movement
OTC	Over the Counter Markets
RA	Regulatory Agency
UCL	Uganda Clays Limited
UIA	Uganda Investment Authority
USE	Uganda Securities Exchange

ABSTRACT

This dissertation examines the legal and commercial implications of Government intervention for investor protection in Uganda's equity market. It begins by discussing the rationale of the regulation and importance of investor protection in the development of equity markets and capital markets as a whole. The dissertation further examines the operation of the Capital Markets Authority as the regulatory agency and the distribution of regulatory responsibility among the regulatory organs. The study takes a step-by-step tour of the primary and secondary markets and examines the legislation related to the equities markets and its impact on investor protection. The study creates a link between capital market development and investor protection and looks at the conflict between the regulated and free markets. It highlights contradictions and constraints to market development and how they affect investor protection. It also sets out supporting systems and gives recommendations for the development of an efficient capital market, with emphasis on equities markets. While this research is primarily concerned with Uganda's equity markets, reference is made to other markets to fill the gaps left by the new capital markets regime.

CHAPTER ONE

GENERAL INTRODUCTION

1.1 Background:

Government regulation of markets can be traced as far back as the era of mercantilism in Europe, which ran from the demise of feudalism until the beginning of the Industrial revolution. In this period, countries regulated the market in order to create favorable balance of trade, accumulate gold and silver from other nations, and ultimately increase the wealth and power of the state. "This was the first modern alliance between big government and business"¹ The Advent of classical liberalism in the eighteenth century and the works of scholars like Adam Smith (1723-1790) brought about an economic revolution. The paradigm of Adam Smith contended that, by virtue of "the invisible hand" of capitalism, if individuals pursue their selfish interests producing, buying and selling in a free, meaning unregulated, market, then wealth is created and social welfare and prosperity grows.² This he put in his book "The Wealth of Nations" thus: "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interests. We address ourselves not to their humanity, but their self love."³ The economic system proposed by this new paradigm came to be represented by the French term "laissez-faire", translated to mean "let alone".

The liberalists advocated for the removal of government control with competition remaining as the sole controlling force in the market.⁴ The liberalist school of thought did not go without some criticism from a number of nineteenth century economists and scholars who advocated for 'dirigisme,' or "government control." These included the proponents of the teachings of Karl Marx, Friedrich Engels, and John Maynard Keynes (1883- 1946). These scholars argued that the liberalists, and the capitalism they had created from their Teachings, "had sown the seeds of their own destruction."⁵ John Keynes wrote a book entitled "The End of Laissez-Faire" warning about the evils of unregulated markets in 1926, three years before the 1929-market crash and

¹ "Adam Smith and the New Paradigm- Economics and Its Beginning" at, <http://krypton.mankato.msus.edu/~renner/eaib.htm>.

² "Neoliberalism- A Short Course"- <http://memebers.tripod.com/~PPLP/neoliberalism.html>.

³ Adam Smith: *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) Book Chapter 2.

⁴ This line of thought resurrected in the twentieth century capitalist era and neoliberalist scholars, Friedrich Hayek and Milton Freeman, even won the Nobel Prize.

⁵ "Capitalism, Marxism and Reformism- Neoliberalism- A Short Course"<http://memebers.tripod.com/~PPLP/neoliberalisni.html> 11.

“Great Depression” in the United States of America: It was believed that lack of transparency and market abuses caused that crisis. Regulatory legislation was therefore passed to redress market failures, which occur when the private marketplace fails to operate properly and in a competitive manner. There are three main types of market failure, namely natural monopoly, externalities, and asymmetrical information.⁶ Natural monopoly occurs as a result of unfair competition and price fixing by companies with a large share of the market and this may lead to exploitation.

Externalists are costs “not properly accounted for in the prices which are established in a competitive market.”⁷ Here a party outside the market may incur a cost in that market, for ice, a company that wishes to cut its costs by dumping waste in a nearby river may cause someone with no interest in that company to incur a cost from the resultant pollution. Lastly, asymmetrical information occurs when the “insiders” or promoters of share offerings withhold information that should be made public to investors if that information does not serve their interests. The insiders can use this informational advantage to exploit the investor. Unlike the Mercantilist era, this new era of regulation was mainly aimed at protecting investors. It has been said, that; “An investor has the heart of a lamb, the feet of a cheetah, and the memory of an elephant”⁸. This means that the investor usually makes decisions based on information given to him by “insiders” in the market who have an informational advantage over him or her, making him or her vulnerable and at a disadvantage in case of market failures.

Capital markets were developed with the aim of checking market failures. Investor supremacy was highest on the agenda and legislation was passed in various countries to regulate these markets... “Investors are not expected to be protected against normal market risks. But they do need to be made aware of them in what are commonly referred to as ‘health warnings in advertisements and prospectuses.”⁹ Investor protection was not a strong point in Uganda before the inception of the Capital Markets Authority (hereafter called the CMA) and many investors did not get the benefit of adequate disclosure. The CMA was therefore established to regulate

⁶ Tim S. Campbell: *Financial Institutions, Markets and Economic Activity* (1982) McGraw Hill Inc. USA. Page 367.

⁷ Lbid.

⁸ Ms. Candy Wekesa; “The Role of a Lawyer”- *Capital Markets Journal*, Volume 3, Number 2, April/ December 1999. Page 15 12.

⁹ Mbumba S. ECapumpa: “Investor Protection in the Zambian Securities Market”- *Capital Markets Journal Vol.4*. No.1 January/ March, 2000. Page 10.

and oversee the capital markets industry in Uganda with the goal of promoting transparency and protecting the investor from potential market failures that may arise from fraud. The CMA is a government agency created by Act, with “broad powers ranging from rule-making to licensing to enforcement actions.”¹⁰ The CMA is therefore the Uganda capital market’s primary regulatory body. Capital Markets in general have a number of goals. These can be divided into four groups:

National goals involve privatization of national companies, strengthening domestic companies, developing local ownership and attracting foreign investment. Entrepreneurial goals involve capital formation, diversification of ownership risks and alternative financing sources. Investor goals include efficient use of investment capital, diversification, and liquidity. Finally, regulatory goals include consumer protection, informational needs of the investor, allocative efficiency, and corporate governance.

It would therefore be justifiable to say that if a culture of transparency is adopted in our capital markets we will see increased investor confidence and a corresponding increase in investment. This will ultimately boost capital utilization and value and wealth creation, which would be a positive step in the development of our economy. The powers of the CMA are detailed in its parent Act as: “(i) The development of all the aspects of the capital markets, with particular emphasis on the removal of impediments to, and the creation of incentives for longer term investment, (ii) the creation, maintenance, and regulation, through implementation of a system in which participants are self regulatory to the maximum practicable of the market in which securities can be issued and traded in an orderly, fair and efficient manner, (iii) the protection of crests; and (iv) the operation of a compensation fund.”¹¹

The CMA is in charge of the participants in the market in what is termed, “the regulatory pyramid”, which I discussed in detail in chapter two. “The basic philosophy of regulation is to provide an environment where markets and investments are allowed to grow on a sound long-term basis. The spill over effects of this will be the capital markets contributing to the

¹⁰ Stuart R. Cohn and Fred Zake: *Capital Market Development in Uganda*, (1999) ILI- Uganda (Kampala) Page

¹¹ Capital Markets Authority Act, Cap 84 sec 2.

functioning of the economy and the creation of wealth. Maintaining the integrity of markets and investor-confidence is fundamental to the achievement of this goal...”¹²

1.2 Statement of the Problem:

A developed capital market is of great importance to the development of a country's economy. “The capital market has often been likened to the brains of an economy...and are a ‘sine qua non’ for sustainable economic development.”¹³ The level of investment and volume of funds involved in the market, however, greatly increase the possibility of an economic crisis in case one part of the system defaults. Examples of economic crises that occurred as a result of this are the American market crash and “Great Depression” of 1929, and the capital outflow, devaluation and stagflation in Mexico and East Asia in 1994 and 1997 respectively. In the conflict between regulation and liberalization it has been contended thus: “The adverse effects of capital market liberalization can easily overwhelm whatever small benefits trade deregulation may bring.”¹⁴ The statement shows that the need for regulation is greater than the capitalist need for unregulated “laissez-faire” or free trade even though the latter may bring about a semblance of economic growth. The principal aim of regulation is to promote transparency in the market and requiring full disclosure by the issuers, or promoters of shares does this. This would limit the market failure of asymmetrical information and the “insider” promoter using his informational advantage to cheat the investor.

Uganda's capital markets regime is rather new, having started in 1996. It therefore remains to be seen how it will address the market failures that may exist in Uganda's securities market.

1.3 Hypothesis:

The study hypothesises that;

- (a) Capital markets are very important to country's economy. A developed capital market would lead to better use of savings, capital formation, and value and wealth creation both for individual investors and the state, and overall economic growth.

² Ms. Candy Wekesa: Legal and Regulatory Issues in Capital Markets. Paper presented at a seminar entitled ‘Development and Regulation of Securities and Capital Markets, May 15- 26, 2000 at ILI-Uganda. Page 23 14.

³ “Why Regulate in the First Place- The Securities Commission Business Plan”
http://www.sc.com.my/html/publications/inhouse/businessplan/scbp_regulate.html.

⁴ “Negative Effects of Trade and Capital Market Liberalization- Third World Network on
.ine”:<http://www.twinside.org.sg/title/negat-cn.htm>.

- (b) Another hypothesis is that an efficient market is one in which prices of securities reflect the impact of all the information publicly available concerning the future prospects of the associated companies. This is what is referred to as the “Efficient Market Hypothesis.”¹⁵ This highlights a conflict between the investor, who needs full disclosure in order to make an informed decision, and the promoters of shares who would like to release information only if it serves their interests. The question, therefore, is: How much information is necessary? Proponents of this hypothesis contend that the market price of a commodity “impounds all public information new information only becomes available at random,” therefore, the actual value of a commodity takes a back seat to the bargaining power of the participants in a market.
- (c) The study further hypothesises that owing to the imbalance in bargaining power between the investor and promoter, there is a need for government intervention to protect the investor without, however, negatively affecting market development. There is a need to strike a balance between market regulation and the maintenance of the freedom of trade.
- (d) Finally, the study hypothesises that investor protection leads to an increase in investor confidence and a rise in levels of investment. This will ultimately lead to individual, market, and national economic growth and development.¹⁶

1.4 Objectives of the Study:

This research paper aims at examining the state of market regulation in Uganda with emphasis on investor protection. It studies, the operation of the primary and secondary markets, outlines the problems that investors face, shows the action that regulatory bodies like the CMA have taken, and finally gives recommendations for the strengthening of the new market regulation system in Uganda. This system of regulation would, in turn, boost investor confidence, increase investment, and ultimately lead to economic growth. This shows therefore that regulation is very crucial for economic development and should be discussed. The research paper shows the need for investor protection based on the principle of investor supremacy. It further shows the dangers

¹⁵ Sid Mittra and Chris Gassen: *Investment Analysis and Portfolio Management*. Harcourt Brace Jovanovich, Inc. New York (1981). Page 6 16 Ibid 16.

¹⁶ Guaranteed in article 40 of the 1995 Constitution of the Republic of Uganda.

that investors face in the securities market and problems the regulatory agencies like the CMA face in rule making, licensing, and enforcement in the securities market.

The study makes a critical assessment of the laws governing investment and market regulation in Uganda, with emphasis on investor protection. It also attempts to show the dangers that may arise from lack of clarity, as well as contradictions in the applicable law, particularly the jurisdictional conflict between the *Companies Act* and the *Capital Markets Authority Act* the research paper makes a comparative study of the pre- CMA share offer, and the post-CMA initial public offerings by Uganda Clays Limited and British American Tobacco Limited in a series of case studies. These case studies show, in the Ugandan context, the problems that would arise if there were no adequate disclosure and due diligence in share offers, and thus, the need to regulate the market. The paper finally makes recommendations for the regulation of the market, restoration of investor confidence, and consolidation of the securities market in Uganda. This would ultimately lead to a better investment climate in Uganda and a corresponding economic gain.

1.5 Scope of the Study:

The purpose of this study is to critically analyze the role of the CMA in regulating capital markets in Uganda with particular emphasis on investor protection.

1.5.1 Geographical Scope

The study places Uganda in the global market and gives a comparative analysis of market in Uganda and other more developed markets in Africa, Europe, and North America.

1.6 Significance of the Study:

- a) Many studies have been done to examine the performance of emerging capital markets in developing countries. However, many of these studies focus on the emerging capital markets of Southeast Asia, Latin America, and the Caribbean. Sub-Saharan Africa and Uganda in particular, has not received the attention that the 18 Southeast Asia and Latin American countries have received in the academic literature¹⁷ The international entrepreneurs, this study aims at placing the Sub- Saharan stock market on the map.

¹⁷ Sam Q. Zioroklui: *Capital Market Development and Growth in Sub-Saharan Africa: The Case of Tanzania*, *African Economic Policy Discussion Paper* Number 79 February 2001. Page 2 19.

Many companies see emerging markets as a good source of capital and “the lion markets of Africa are now developing in such a way that investors interested in emerging markets can no longer ignore them.”¹⁸

- b) For the investor, the study focuses on rights issues and shows regulation as a tool for promoting the economic rights of investors. The focus on investor protection highlights the need for a more public-oriented capital market regime and shows the progress made, as well as the shortcomings of the current regulatory regime.
- c) Apart from this study being an academic requirement in partial fulfillment of my degree, it aims at tracking a new economic era in Uganda and studying a capital markets regime that will shape the economic future of Uganda.

1.7 Research questions:

- a) What are the linkages between capital market development and economic development?
- b) How much protection should an investor be accorded?
- c) What is the rationale for investor protection and government intervention in Uganda's equity markets?
- d) To what extent has the existence of a regulated equity market improved the prospects of raising long-term capital and protecting investors?
- e) How is the onus and power of regulation shared among the various regulatory organs?
- f) What is the effect of legal and administrative regulation of the equities market on investor ton?

1.8 Justification for the Study:

The state of investment in Uganda before the advent of the CMA put emphasis on the positive capital market theory which stressed the “is” rather than the “ought” which was stressed by the normative capital markets theory. This investment regime had the characteristics of a “laissez-faire” market, without strict government regulation especially as far as disclosure requirements were concerned. This regime was manifested in the share offer of Greenland Group of

¹⁸ Per Kenneth Mwenda in “Securities Regulation And Emerging Markets: *Legal And Institutional Issues For Southern And Eastern Africa*” Murdoch University Electronic Journal Of Law Issn 1321-8247 Volume 20

Companies, where the investors did not have adequate information and as a result, did not make informed investment decisions.

The birth of the CMA was therefore necessary to address the lacuna in market regulation in Uganda and as a result, increase investor confidence and volume of investment in Uganda, with an aim of fostering economic growth and development. The CMA has been in force for only four years and the volume of transactions in the securities exchange is still rather low. This infant regime should therefore be studied with an element of projection into the future. The CMA is at the top of the regulatory pyramid in Uganda's capital market and it gets its power from the *Capital Markets Act*. However, the CMA conflicts with the Registrar General's Office, where registration statements are filed. The Registrar General gets his authority from the *Companies Act*, which does not have rules of regulation as strict as those of the *Capital Markets Authority Act*.

1.9 Literature review

This review seeks to examine the existing literature about the conditions affecting the development and regulation of the Ugandan security market in general, and equity market in particular. The capital market plays an important part in economic development of any country. It is therefore important to define the concept of investment.

SID MITTRA AND CHRIS GASSEN: in "Investment Analysis and Portfolio Management" defines investment as the commitment of a given sum of money at the present time in the expectation of receiving a larger sum in the future.¹⁹ A market can be defined as a situation where two or more people meet to express their choices with regard to financial assets and the market is the place or mechanism where the said assets are exchanged²⁰. Markets assume different classes based on the type of traded instrument and degree of regulation. The less regulated markets are known as the "Over the Counter" Markets (OTC), while formal stock exchanges are vigorously regulated.²¹ The market determines the value of the asset, thereby

¹⁹ Chapter 1 page 4.

²⁰ Tim S. Campbell: *Financial Institutions, Markets and Economic Activity* (1982) McGraw Hill Inc. USA. Page 54.

²¹ Leo Kibirango: *Securities Markets: A Reliable and Credible Source of Low Cost Capital: Capital Markets Journal*: Vol. 4, Jan/ Mar, 2000, Page 36.

creating wealth and income to participants in case the market value of the said asset appreciates. A financial asset is a future claim on some future income, while wealth can be defined as a right to an income stream, which an asset is expected to generate. According to the CMA, publication entitled: "General Information And Guidelines For Issue Of Securities — July, 1999", capital markets are "sophisticated markets where the products for sale include equity or debt securities issued by government or corporate bodies, and units in collective investment schemes and these securities include shares, stock, bonds, debentures, notes, rights, warrants, options of futures in respect of shares, bonds or debentures."

The two major forms of securities are equity and debt. Equity securities are investments, which "become part of the permanent capital of a company"²² and they usually take the form of stock in the company. The investor, in effect, buys a part of the company but has neither a claim to repayment of the principal, nor payment from profits. The equity holder mainly makes a profit from secondary trading on the stock market. Equities are a good source of low cost capital to the entrepreneurs, but the risk levels are high for the investors.

Debt securities occur when a lender gives money to the company "on the promise that both the principal and interest will be paid."²³ They may be in the form of treasury bills, bonds and fee notes, and are more risky to the entrepreneur and less risky to the investor than equity securities.

The capital market can be divided into two distinct sections, namely the primary and secondary markets. According to TIM S. CAMPBELL in his book "*Financial Institutions, Markets, and Economic Activity*"²⁴ the primary market is the market where new securities are issued to obtain new funds. This is done by way of an Initial Public Offering (IPO) where the public are invited to buy shares in an enterprise that is going public for the first time. The secondary market on the other hand "comprises the market for outstanding financial assets"²⁵ This, according to "General Information and Guidelines for Issue of Securities — July, 1999" is a facility where securities initially acquired from the primary market are subsequently traded.

²² Stuart R. Cohn! Fred Zake: *Capital Market Development in Uganda*: Op.Cit. Page'&.23 3.1

²³ Ibid. Page 22

²⁴ Tim S. Campbell: *Financial Institutions, Markets and Economic Activity* (1982) McGraw Hill Inc. USA. page 150

²⁵ Ibid

The main participants in a capital market include sellers or promoters of securities and other financial instruments who seek to obtain money from the sale of the shares on the one hand, and potential purchasers who are willing to invest in the offered securities. The market also has investment advisors, accountants, lawyers, underwriters, broker-dealers and broker representatives and the regulatory organs that are collectively instrumental in facilitating the transactions in a securities exchange.

According to *Capital Market Authority Act*, a broker is one who buys or sells securities as agent for a customer while a dealer is one who buys or sells securities for its own account²⁶. Brokers give their clients investment advice for which they charge commissions, while dealers try to buy shares cheaper than they sell them, thereby making a profit. While the "Ancien R gime" made a distinction between the two it became clear over time that this was impracticable and firms of "market makers"²⁷ acted as both broker and dealer.²⁸ It is more common now to have the dual-purpose broker-dealer firms. Broker representatives, commonly referred to as "stockbrokers," are employees in the broker-dealer firms and deal directly with individual customers.

ADAM SMITH, in *An Inquiry into the Nature and Causes of the Wealth of Nations*²⁹ advocated for the market to be guided only by forces of competition and self-interest, writing: "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interests. We address ourselves not to their humanity, but their self-love." However, he does consider the possibility of abuse of this market system and in the same book, writes: "Consumption is the sole end and purpose of production and the interest of the producer ought to be attended to only in as far as it may be necessary for promoting that of the consumer."³⁰ Adam Smith's work shows the development of the investment climate along with the development of capitalism in the eighteenth century. However, his work was limited as the level of trade was still very low at that time and the market was not as sophisticated as it is now. His work does not deal with the Ugandan capital markets situation and is generally used as a foundation for the study of the need for regulation.

²⁶ Stuart R. Cohn! Fred Zake: *Capital Market Development in Uganda*: Ibid. Page 3

²⁷ Also known as broker-dealer firms.

²⁸ Bernard Grey: "*Beginners' Guide to Investment*:" *Investors Chronicle; Century Business* (London, 1991) Pages 28,29 and 31 32.

²⁹ Smith: "The Wealth of Nations," Op.Cit, Book 1, Chapter 2.

³⁰ Smith: "The Wealth of Nations" Op.cit. Book 4, Chapter 8. 24

The work of DAVID RICARDO was similar to Adam Smith's and he asserted, in "*The Principles of Political Economy and Taxation* (1817) that the free market is "the best allocation of resources" and "the market is always right," advocating that the poor were to blame for market imperfections. Like Adam Smith's work, his writings provide a historical perspective in the development of capital markets, but cannot be used in an analysis of contemporary capital markets. The liberalists were opposed by proponents of "Dirigisme", or government control. Many nineteenth century scholars criticized "*Laissez-Faire*" markets and they included Karl Marx, Friedrich Engels, and John Maynard Keynes (1883- 1946) KARL MARX and FRIEDRICH ENGELS in "*The Communist Manifesto*" studied the labour relations in portraying an imbalance in bargaining power. They contended that "Wealth is created in blood, sweat and tears" but this is not always equal to value, which is a factor of haggling and bargaining. In "*Das Capital: A Critique of Political Economy Volume II*, Edited by Friedrich Engels, they contended that the free market created a two-tier community with a wealthy bourgeoisie minority and a relatively poorer proletariat majority, creating a class struggle. However, Marx concentrated mainly on labour relations and did not emphasise investment and capital markets. This could be because, like Adam Smith and other eighteenth and nineteenth century scholars, he lived in a time when the market was not as sophisticated as it is now, and therefore his work cannot give an accurate portrayal of the state of the market today.

JOHN MAYNARD KEYNES (1883- 1946) wrote about the dangers of free markets in his book "*The End of Laissez-Faire*", in 1926 and three years later in 1929, the American stock market crashed due to market failure and lack of due diligence and transparency. His twentieth-century writings draw a clearer picture of the market, and are probably more relevant to the public sector driven market in Uganda than the work of the eighteenth and nineteenth century scholars. His work was, however limited to the American economy and his writing, also has mostly historical value to the study of Uganda's equity market.

TIM S. CAMPBELL, in "*Financial Institutions, Markets and Economic Activity*," describes the ingredients of market failure as "natural monopoly, externality, and asymmetrical information"³¹ and explains the need for government regulation. This is further emphasized by RUMU

³¹ Page 367

SARKAR in "*Development Law and International Finance*"³² contends; "the state assumes the role in mitigating the harshness of capitalism plays a central role in deciding what safety nets to provide."³³ Their work has great descriptive value, but, provides a perspective outside Uganda, and does not adequately cover the emerging markets. Uganda's capital markets are governed by the CMA, which gets its authority from the *Capital Markets Authority Act Cap 84, 1996*. We also have Part III of the *Companies Act of Uganda*,³⁴ at capital market activity. Furthermore, there are a number of regulations protected under the *Capital Markets Authority Act* governing various aspects of the market. These include: The Capital Markets (Establishment of Stock Exchanges) Regulations The Capital Markets (Licensing) Regulations.

The Capital Markets (Prospectus Requirements) Regulations. The Capital Markets (Conduct of Business) Regulations The Capital Markets (Advertisement) Regulations The Capital Markets (Exempt Dealers) Regulations The Capital Markets (Accounting and Financial Requirements) Regulations The Capital Markets (Register of Interest in Securities) Regulations The legislature gives the CMA legitimacy and power to carry out its duty. This power is supplemented by the rules of the stock exchange, also called the Self Regulatory Organs (SRO), which may include the memorandum and articles of association of a company. The licensees in a market may also issue codes of conduct and procedure manuals to govern their operation and these may act to regulate the capital market. It should be noted, however, that the Capital Markets Authority Act is the main law governing capital markets operation in Uganda and these rules must not be contrary to it.

There has been a little conflict between the *Companies Act* and the *Capital Markets Authority Act* and the numerous laws and regulations may prove tedious to the simple investor, thereby diminishing their informational and regulatory value, but the detail is important to maintain the high market standards of transparency. The capital market in Uganda can be described as an emerging, rudimentary market. STUART R. COT-IN and FRED ZAKE, in "*Capital Market Development in Uganda*" explain in detail the operation of the market in Uganda, discussing its role in privatisation, regulatory role, and power. It also extensively looks at the relevant laws governing capital markets in Uganda. This book is a contemporary study, which gives insight on

³² International Economic Law Series; Kluwer Law International (1999), London.

³³ Page 39

³⁴ Cap 110, Laws of Uganda.

the market operation in Uganda and is very valuable for a study of Uganda's capital markets regime.

Material from a seminar entitled; "*Development and Regulation of Securities and Capital Markets*"³⁵ conducted by Professor Stuart Cohn, gave exhaustive material on the capital markets regime in Uganda, especially in relation to other more developed markets. A paper entitled "Legal and Regulatory Issues in Capital Markets" by Ms. Candy Wekesa presented at the above mentioned seminar explained the regulatory structure of the capital markets regime in Uganda. This material is very detailed and valuable to my study, but the capital market is very dynamic and the information may soon become outdated. Further information on capital markets in Uganda can be found in the "*Capital Markets Journals*" which are produced quarterly by the CMA and are very up to date and informative. Other informative CMA publications include "General Information and Guidelines for Issue of Securities" a simplified pamphlet. These may be supplemented with Internet research.

1.10 Methodology

1.10.1 Research design

In compiling data for this research paper and testing the hypothesis a number of methods were employed: A comparative study of legislation governing capital market regulation shows some conflict especially between the *Companies Act* and the *Capital Markets Authority Act* and the antecedent regulations. There is a need to study the legislation and make resolutions with regard to the aspects of regulation and enforcement in the laws of Uganda.

1.10.2 Data collection

Libraries were used to review published literature, information from conferences, textbooks, newspaper articles and case law. Internet research is a source of a wide range of documents that are very useful and informative.

The aforementioned methods of research were advantageous in that: Reading through records, reports, textbooks, and related publications exposed the researcher to a wide range of literature, which showed the history and jurisprudence as well as the advances in capital markets regulations. The articles of jurisprudence showed the historical basis and a greater insight into

³⁵ May 15-26, 2000 at the International Law institute-Uganda (Kampala).

investment and capital markets. The study of legislation showed the loopholes and areas in the regulatory legislation that are silent and need to be addressed. Interviews and newspaper articles give the Ugandan context and help reconcile the Ugandan situation with the global scenario. The problems outlined are accompanied by recommendations that suggest ways to improve the situation of investors in Uganda.

1.10.3 Area of study

A comparative study of pre and post- CMA investment regimes illustrate and justify regulation of the market further. A study of the contemporary legislation governing regulation of capital markets shows the advances in investor protection and shows how the law can be reformed to serve the interests of investor sovereignty better. The study will further show the inadequacies in regulation and enforcement as well as the role of different regulatory bodies. This research also shows the laws of Uganda, which are applicable to capital markets and how these laws will help in investor protection. Lastly, recommendations will be put forth in the Ugandan, and the global context, suggesting legal and extra-legal ways of promoting investor sovereignty, protection, and confidence through market regulation.

1.10.4 Qualitative analysis

The information collected was evaluated with documentary review and the research theme in a systematic way in order to describe what was on ground, establish useful conclusions and recommendations that were unbiased and were in line with the objectives of the study.

1.10.5 Limitations to the Study

While carrying out the study, the researcher encountered various constraints. The Researcher had a difficult time collecting data from the libraries and the internet for much time had to be spent so as to get enough literature. The researcher faced financial constraints doing the research for he had to spend money going to the library and pay for internet charges which were expensive. The researcher being a student faced a problem of time management for it was difficult to do the research as you attended class

CHAPTER TWO

REGULATION OF CAPITAL MARKET IN UGANDA

2.1 Introduction

The capital markets regime in Uganda is public sector driven with the Government deliberately setting up the necessary regulatory structure to create and maintain a transparent and efficient market in which the interests of the investor are paramount and can be protected. Uganda employs the “cocktail approach” of regulation, combining oversight, and self-regulation. This it does by using a “Regulatory Pyramid.”³⁶ This method is effective, in that, it apportions the onus of regulation, supervision, and enforcement fairly among the market institutions, namely, “the Regulatory Agency, the Self Regulatory Organization,³⁷

The Capital Markets Authority is the Regulatory Authority, and, being at the top of the regulatory pyramid oversees the SRO and tile licensees in both the primary and secondary markets. This regulatory body derives its existence and power from Parliament³⁸ and as a product of legislation its powers and duties are clearly stipulated in the enabling Act to avoid misunderstanding. The Regulatory Agency is empowered by both the *Companies Act*³⁹, and the *Capital Markets Authority Act*⁴⁰ and its antecedent regulations, to carry out its role of protecting the investor from any market failures and ensuring that the market is fair, efficient, and transparent. These functions and powers are discussed in section 5 of the Act and extend to licensing market operators, regulating and supervising market practices and compensating investors for losses. The first duty of the CMA is developing all aspects of the market, removing impediments and creating incentives for longer-term investment⁴¹. In furtherance of this goal, it is empowered to advise the Minister on matters relating to the development and operation of capital markets.

³⁶ Ms. Candy Wekesa: Legal and Regulatory Issues in Capital Markets. Paper presented at a seminar entitled “Development and Regulation of Securities and Capital Markets, May 15- 26, 2000 at ILI-Uganda, Page 1. Also see Appendix A on page 81.

³⁷ Herein after referred to as the SRO that is, the Stock Exchange and Member Associations, and the licensed firms themselves.”

³⁸ through the Capital Markets Authority Act, Cap 84

³⁹ Cap 110, Laws of Uganda.

⁴⁰ 2009 Capital Markets Authority Act, Cap 84.

⁴¹ Ibid. Section 25 (1)(a).

2.2 Duty of CMA

The Duty of CMA is to create, maintain and regulate the market and implement a system where the market is self-regulatory as far as possible⁴². In carrying out these functions, the Act gives the CMA jurisdiction in registering, licensing, authorizing or regulating stock exchanges, investment advisers, registrars, securities brokers or dealers and their agents. The CMA also has the duty of maintaining surveillance over securities to ensure orderly, fair and equitable dealings in securities with a view to maintaining proper standards of conduct and professionalism in the securities business⁴³.

The duty to protect the investor is perhaps the most important function of the CMA⁴⁴. In pursuing this goal, the CMA is empowered to formulate principles for the guidance of the securities industry⁴⁵ and monitor the solvency of license holders and take measures to protect the interests of customers where the solvency of any license holder is in doubt⁴⁶. The CMA is charged with performing the functions conferred on it by section 43 of the Companies Act⁴⁷, which deals with registration of the prospectus. This empowers the CMA to set the disclosure standards during an IPO. The CMA is further empowered to adopt measures to minimize and supervise any conflict of interest that may arise for brokers or dealers and protect the integrity of the securities market against any abuses arising from any unfair advantage the issuer might use to the investor's detriment. This would ultimately create the necessary environment for orderly growth and development of the capital market.

2.3 The practice of insider trading

This is one of the most common offences in the primary market. It involves the use of confidential material information by company officers, directors, employees and other insiders to buy or sell shares from or to an unsuspecting public⁴⁸. This asymmetrical information could take

⁴² Ibid. Section 25(1)(a).

⁴³ Ibid. Section 25 (2)(c).

⁴⁴ Ibid. Section 25 (1)(c).

⁴⁵ Ibid. Section 25(2)(e).

⁴⁶ Ibid. Section 25 (2)(f).

⁴⁷ Ibid. Section 25 (2)(j).

⁴⁸ Stuart R. Cohn and Fred Zake: *Capital Market Development In Uganda: A joint Publication of ILI Uganda and ILI Washington*, 1999 Page 173.

the form of material information about the company, which is withheld from the public that would lead to the appreciation or depreciation of the share price of the equities. These insiders use this unfair informational advantage to influence the price of securities to the detriment of the prospective investors. Insider trading is contrary to the requirement that the market be transparent and efficient and is therefore prohibited by law⁴⁹. The CMA is finally empowered to intervene in case the investors incur losses and this it does by establishing an investor compensation fund.

This shows the supremacy of the investor and the need to protect him or her from any loss as a result of market imperfection. From the, above, we see the extent of Government intervention in the securities markets to ensure a fair and efficient market and promote investor protection. This shows that capital market regulation and investor protection are now a priority of the government. In order to detect, deter and penalise partiality of market structures, informational equivocation, and unfair market practices, the regulator has the task of approving stock, exchange and system operators, and making listing and other rules to give the investor fair access to market facilities and information. The regulator further ensures that the information given is relevant, timely, and widespread, especially with regard to market prices in a bid to make the market efficient. This pre- and post-trade information should be available to the public to let investors know if and when they can deal. These three values are closely linked to investor protection and promote market integrity, investor confidence, and a corresponding individual, market, and national gain. In an IPO, there are a number of steps that a company must take before it can be listed.⁵⁰

The first step is the company's decision to go public. A company that wishes to get low- cost capital for expansion or divest its interest in the company may offer its shares or debentures to the public⁵¹, who seek diversified investment opportunities, fewer business risks and a chance to own part of the company. According to the Companies Act, any reference to the offering of shares or debentures to the public is seen as: "...including a reference to offering them to any section of the public, whether selected as members or debenture-holders of the company

⁴⁹ Capital Markets Authority Act, Cap 84.

⁵⁰ Ibid. Section 25 (4) The Minister has discretion in appointing members of the CMA.

⁵¹ The Companies Act, Cap 110, s. 40(3)(b).

concerned or as clients of the person issuing the prospectus...⁵²This offer may not be seen as public if it is properly construed as: "...not being calculated to result, directly or indirectly, in the shares or debentures becoming available for subscription for purchase by persons other than those receiving the offer or invitation, or otherwise as being a domestic concern of the persons making and receiving it..."⁵³

Along with the benefits of this stage of the IPO, the issuer of shares must also consider the burdens of registering the company in deciding whether the company has the financial or managerial capacity to go public. The company then executes formal resolutions to convert from a private enterprise to a public one, and lodges it in the companies' registry. The CMA, in order to ensure investor protection, regulates the public offer of shares and sets the qualifications for a public offer. Before a company can go public, it must meet certain requirements set out by the Uganda Securities Exchange. A two-tier system has been created to encourage both large and small companies to list on the stock exchange and ensure broad market participation for both the investor and issuer. In tier one, the company must have a minimum paid up capital of 500 million shillings and must offer for sale to the public, shares valued by the company's auditors at the time of application at not less than 500 million shillings for equities.

The CMA also prescribes a listing fee of 0.1 percent of the value of the securities being listed but not less than five hundred thousand shillings and not more than ten million shillings. Any additional listing will attract a fee of 0.05 percent, but not more than two hundred and fifty thousand shillings and not more than five million shillings. The USE also charges an additional annual listing fee of 0.025 percent of the market capitalization of the listed securities. The company must have audited accounts for the past five years. The second tier requires the company to have a minimum paid up capital of 250 million shillings and must issue or offer shares to the public whose value as determined by the 61 or 150 million shillings for debt securities, auditors at the time of application at 150 million shillings for equities. The initial listing fee is 0.05 percent of the issue value of the shares to be listed subject to a minimum of 250,000 shillings and a maximum of 5,000,000 shillings. An additional annual listing fee is 0.025 percent of the market capitalization of the listed securities.

⁵² *ibid* s. 57(1).

⁵³ *ibid* s. 57(2) 40.

The company must have audited accounts for the past five years. The next step is the assembling of the team who will work with the company's directors and managers. This team comprises "the sponsoring broker, the underwriter, the financial adviser or merchant bank, the legal counsel, the reporting accountants and auditors, the publicity firm and advertisers, the independent registrar or transfer agent, and special experts depending on the nature of the issuer's business"⁵⁴. These experts will be charged with making the offer as efficient and transparent as possible in order to ensure that the company's business is in order and prospective investor is given enough information before purchasing the securities, which is the principal consideration in a public offering. The third step is the performance of the due diligence process. This is a process where the company ensures that the information it intends to put in the prospectus is not misleading and the company's interests are clearly stated and the team member's 62 and 80 million shillings for debt securities. 64 both regulated by the regulatory agency 65 regulated by the Central Bank 66 regulated by the Uganda Law Society 67 regulated by the ICPAU 68 indirectly regulated by the Advertising regulations 69 regulated by the registrar guidelines, which are still being formulated in Uganda.⁵⁵ Contributions are compiled in accordance with the prospectus regulations. This process in effect gives the prospective investor constructive notice about the company and the purchase of shares is an arms length transaction. The investor should therefore have all the necessary information to limit his risk. The fourth step is the preparation of a prospectus, also regulated by the prospectus regulations.

2.4 Prospectus

According to the *Capital Markets Authority Act*, the prospectus must cater for the unsophisticated investor in a "plain English disclosure standard"⁵⁶ in the cover page, summary, and risk factor parts of the prospectus. The prospectus is the basis of the adequate disclosure standards in an IPO, which shall be discussed in detail later on in this chapter. After the preparation of the prospectus, the publicity firm must inform the public of the company's decision to go public through advertising, road shows and meetings with potential individual and institutional investors in accordance with the advertising regulations. The offer should be seen by

⁵⁴ Indirectly regulated by the prospectus regulations.

⁵⁵ Source: Ms. Candy Wekesa: *Legal and Regulatory Issues in Capital Markets*: A paper presented at a seminar entitled "Development and Regulation of Securities and Capital Markets," May 15-26, 2000 at ILI- Uganda; Page, 13.

⁵⁶ 72 Ibid.

a large number of people to qualify as a public offer. The next step is the execution of an underwriting agreement where the lead or sponsoring broker or a syndicate of brokers undertakes to minimize the issuer's risk by either buying all the shares and reselling them to the investors⁵⁷ or buying any left-over securities after the offer is closed.

In Uganda the underwriting agreements are reviewed and regulated by the CMA. At this stage the performance and value of the company can be gauged and the underwriter and company price the shares of the company. The pricing of the shares, while determining how much money the company will make, can have an effect both in the primary, and secondary market and subsequent performance of the shares must be taken into consideration. This price should be the main consideration before the purchase of shares by the prospective investors. After distribution of the prospectus to the public, the "offer period" begins. In this period prospective investors apply for shares in the company. This period runs until the company's receiving institutions stop receiving applications for shares. The opening and closing dates and times must be clearly stated in the prospectus, per the prospectus requirement regulations⁵⁸.

The allotment process follows the end of the offer period. Here, the successful applicants get share certificates and unsuccessful ones get their money back. The date of announcing the allotment policy must also be stated in the prospectus. The last stage of the IPO is the listing stage, where, after the regulatory agency approves the company's prospectus, the sponsoring broker applies to the stock exchange to have the newly issues shares listed. The main regulatory consideration in the primary market is adequate disclosure and it is the duty of the regulatory agency to set the standard of disclosure. These standards play a major role in investor protection and market regulation. It is important to note, however, that they are not aimed at ensuring that the investment is totally free of normal market risks, but that the investor is made aware of the risk before he commits his money. . Over and above the duty to prevent loss to the investor, the regulator has the duty of setting up a compensation fund to reduce the impact of any loss to the investor in the event of market failure⁵⁹.

⁵⁷ This is called the firm commitment underwriting.

⁵⁸ for example, page 1 of the Uganda Clays Limited prospectus gives the offer period as four weeks, from 12:00 PM on Monday 11 October, 1999 to 3:00 PM on Friday 5 November, 1999.

⁵⁹ This is a legal duty per Sections 5 and 82 of the Capital Markets Authority Act, Cap 84

In an equity market, the main vehicle for disclosure is the prospectus, which has been described as: "...any prospectus, notice circular, advertisement, or other invitation, offering to the public for subscription or purchase any shares or debentures of a company and includes any document which, save to the extent that it offers securities for consideration other than cash, is otherwise a prospectus."⁶⁰ The prospectus further defined as "a document that seeks "full and adequate disclosure" by giving all "material information" to assist the prospective investor make an informed decision... an illustration of the "long arm of the regulator", which fishes out or causes the fishing out of all information, positive or negative, about the Issuer in order to meet the disclosure standards prescribed under the law."⁶¹ The prospectus is the main source of information for the prospective investor and, in Uganda; this is where we first see the regulatory authority of the CMA over the issuer of securities. It is mandatory to issue a prospectus in any application for shares in or debentures of a company⁶². Considering that information is very crucial in investment and is the focus of market regulation⁶³, it is necessary to set clear disclosure standards.

A weak prospectus will mislead investors, make continuous disclosure reporting harder, and jeopardize the work of the regulatory agency, thereby discrediting the entire market. The common law principle governing the standard of disclosure in a prospectus was dealt with in *New Brunswick and Canada Rly and Land Co. Ltd v Muggeridge*,⁶⁴ where Kindersley, VC said; Those who issue prospectuses are bound to state everything with strict and scrupulous accuracy and not only abstain from stating as fact that which is not so, but to omit no one fact within their knowledge the existence of which might in any degree affect the nature, or extent, or quality of the privileges and advantages which the prospectus holds out as inducements to take

⁶⁰ Companies Act, S. 2 it should be noted that the Companies Act uses the word "prospectus" in the definition and this makes the section vague.

⁶¹ Ms. Candy Wekesa: "Prospectus: Protection or Puzzle?" *The Capital Markets Journal*, Vol. 4, No. 3, July! September, 2000, Page 26.

⁶² The Companies Act, Cap 110.

⁶³ This was the basis of the Efficient Market Hypothesis (EMH) per SID MITTRA AND CHRIS GASSEN: in "Investment Analysis and Portfolio Management" Op.Cit, Page 6-7.

⁶⁴ [1860] 30 Li Ch 242

shares.” The prospectus must therefore comply with the disclosure standards set in the les - of the *Companies Act*⁶⁵ and the Capital Markets (Prospectus Requirements) Regulations, 1996⁶⁶.

2.5 Conclusion

In conclusion, these provisions give the matters to be stated in the prospectus before company can get listed. The prospectus must have a caution note on the first page of the prospectus stating that the prospectus has been submitted to the CMA for approval and the Registrar of Companies for registration. The caution note must also state that the securities on offer have not been approved or disapproved by the authority and the prospective shareholder should carefully consider the matters set forth under the caption “risk 47. factors”.⁶⁷ This is aimed at informing the prospective investor of the business risk involved. The prospectus must have the purpose of the issue.

⁶⁵ Sections 32, 40, 41, 379, 380, 382 and parts I, 11 and III of the Third Schedule 46.

⁶⁶ See S. 4 and part I and II of the Schedule.

⁶⁷ Matters to be Stated on the First Page of the Prospectus; Part I of the schedule to the Capital Markets (Prospectus Requirements) Regulations, Cap 84

CHAPTER THREE

MODALITIES OF ISSUING SHARES TO THE PUBLIC

3.1 Introduction

The purpose of the issue of shares in Uganda Clays Limited was to implement the Government's decision to divest its holding to the public⁶⁸, enhance the image and status of the company and foster the growth of the housing sector and capital markets in Uganda.⁶⁹ The prospectus should spell out the rights of the different classes of holders of securities⁷⁰. These rights extend to "dividends, capital, pre-emptive rights to subscribe to new issues of shares, redemption (where applicable), voting rights, and the creation or issue of further shares of equal priority with the shares." This is important because it clearly sets out the extent of the shareholder's rights and may influence a prospective investor in his decision to buy shares. The prospectus must have a statement on the legal status and affairs of the issuer. This includes a brief history of the initial organisation, including the form and name under which the initial organisation took place. This statement must contain information on the history, titles, contracts, licenses, consents, litigation, and any other information pertinent to the company that might influence the investor's decision to buy shares.⁷¹

There should be information relating to executive officers, directors or nominees for the position of director, giving details of their business experience, whether they have been involved in a petition of bankruptcy or criminal proceedings that "permanently or temporarily prohibited him or her from acting as an investment adviser or a director or employee of a broker or dealer, director or employee of any financial institution or engaging in any type of business practice or activity. This information may influence prospective investors who might suffer loss in the even of fraud or mismanagement by the director or executive."⁷² The directors' interests in the

⁶⁸ UCL is listed in class 4 of the Public Enterprise Reform and Divestiture Act.

⁶⁹ "Key Information and Background:" Uganda Clays Limited Prospectus (1999). Page 7.

⁷⁰ Per paragraph 2(a) of part II of the schedule to the Prospectus Requirement Regulations and paragraph 17 of part I of the third schedule to the Companies Act, 1964 V.

⁷¹ Ibid. Paragraph 2 (c) of Part II of the Schedule 47.

⁷² In the English case of *Re Darby, ex. p Brougham* [1911] 1 KB 95, where two discharged bankrupts, previously convicted of fraud incorporated a company and did not disclose this to prospective investors; the "corporate veil" was lifted to make them liable upon the company's liquidation.

company must also be stated since they are trustees of the investors' money and conflict of interests may affect the shareholders. This information extends to the director's shareholding, any acquisition or disposal of the issuer's share capital by the director within a one-year period prior to the public distribution and any contracts or options to purchase securities of the issuing company or any holding or subsidiary company.⁷³

3.2 Guiding the financial platform

There should also be information on the lead and sponsoring brokers, financial advisers, registrars, auditors, and lawyers, receiving bankers, underwriters, public relations firms and any other professional advisors of the issue. The prospectus must contain audited financial statements for five or three years depending on whether the issue is in tier one or two. This should inform the prospective investor of the issuer's capital or debt. The prospectus must give information on the loan and debt profile of the issuing company and to this effect; there should be information on the company's bankers⁷⁴. The prospectus should also have information on the dates of and parties to all material contracts not entered into in the ordinary course of business two years before the issue of the prospectus⁷⁵.

An accountant's report must cover the financial statements and include a review of the unaudited statements where applicable. There should be information regarding the company's authorized share capital and details of land and fixed assets of the issuer. This may include and is not limited to authorized share capital, amount paid up, location, area or tenure of the factories and fixed assets, and particulars of primary plant and equipment.⁷⁶ This should be accompanied by a valuation report with respect to the value of the property. There should also be a statement regarding the intended and transient use of net proceeds of the company.⁷⁷ In line with the caution note and the performance of the due diligence process, the prospectus must have a section labelled "risk factors" dealing with risks on new ventures, construction, licensing, regulation, competition, taxation, dependence on a key personality, taxation, level of indebtedness, dilution and unexpectedness of dividends. This information acts as a warning to

⁷³ Prospectus Requirement Regulations, S.2 (d) (iii) to (vii) and paragraphs 3 and 16 of part I of the third schedule of the Companies Act.

⁷⁴ Prospectus Requirement Regulations. (b).

⁷⁵ Ibid.

⁷⁶ (i) 93 Ibid.

⁷⁷ Ibid. (k) 49.

the investors that there are business risks that they should consider when making their investment decision.

Finally pursuant to the “plain English standard” there should be a summary of the matters to be stated in the prospectus for clarity and easier use by the prospective investor. This information gives protection to both the company and the investor. While it gives the investor all the material information necessary for making an informed investment decision, it relieves the company of any liability in case of unforeseen financial loss to the investor⁷⁸. In addition to the information in the prospectus the company must furnish the investors with copies of the memorandum and articles of association, authorizing regulations, agreements with professionals, trustee agreements and a contract with the guarantor in case of debt securities

3.3 Empowering of the CMA

The prospectus Regulations⁷⁹ further empower the CMA to seek further information and documentation in a particular case or class of cases that might be to the investors’ benefit.⁸⁰ This strict disclosure standard limits market failures, promotes transparency and credibility of the market thereby making it more favorable to investors. The rationale for government regulation of the primary market can be clearly seen by looking at the effects of an IPO on the market participants. The main reason for floatation of shares by any company is the need to raise capital. Equity markets provide a cheaper, more abundant alternative to the traditional methods of raising finance through high-interest loans. In this case, the company sells a portion of its shares to the public for money, which it will need for expansion.

Businesses under state control⁸¹ can be floated in a privatization exercise, which is aimed at separating Government from business in order to increase public participation and improve the management of the privatized companies. The floatation of a company may indicate a move away from the traditional family business operation that is very common in Uganda and this may

⁷⁸ Mbumba S. Kapumpa, *Supra*, footnote 9. The principle of caveat emptor is qualified here and the investor is deemed to have constructive notice if the issuer acts in good faith.

⁷⁹ Regulation 5 (1).

⁸⁰ In the Uganda Clays Limited IPO for instance, the CMA sought a report on the company’s environmental policy to minimize the negative effects of the clay mining, as well as a geological survey on the life expectancy of the clay reserves, which are the main raw material of the company.

⁸¹ The Government of Uganda has sold its shareholding in both Uganda Clays Limited and British American Tobacco (Uganda) Limited to the public on the stock exchange.

lead to better management and growth of these companies, the primary market has many benefits for the issuer, investor, market, and economy in general.

3.4 Benefits of floatation to the company

The benefits of floatation for a company are not limited to capital realization and improvement in management. When the company gets listed its shares become liquid and can be converted to cash quicker than shares in a private company. This would help the entrepreneur diversify his investment and minimize risk. The liquidity may also lead to establishment of employee benefit programmes to encourage employee investment in the company. This would lead to better quality of work, as the employees would now own a share of the company. A company that meets the disclosure requirements for getting listed is regarded as having high standards of corporate governance and this will boost the company image. The company would further benefit from shareholder support through the shareholders identifying with and buying the company's product and even providing extra capital should the need arise. In a share offer, the investor diversifies his investment opportunities and utilizes his or her savings better. This may also lower his or her investment risk through an "eggs in more than one basket"⁸² approach.

3.5 Disadvantages

The offer of new issues to the public may, on the other hand have its disadvantages. The disclosure requirements are a big source of discord among the entrepreneurs who find that exposing all the weaknesses of the company might kill the selling element of the company and ultimately lead to losses. The entrepreneurs further fear that competitors could use the information to the company's detriment. This is common in Uganda where the standards of corporate governance leave a lot to be desired. To add to their discontent, the high cost of going public has discouraged many entrepreneurs. The team of professionals required for an IPO is seen as an added cost rather than a factor in getting capital. Many entrepreneurs fear the loss of control that might occur as a result of an IPO.

The development of the equity market will be contingent on a change from the traditional "build-own-operate" family business corporate structures and lack of corporate governance common in Uganda's commercial organization and this might not augur well with the directors of such

² Ms. Candy Wekesa: Legal and Regulatory Issues in Capital Markets: A paper presented at a seminar entitled 'Development and Regulation of Securities and Capital Markets,' May 15-26, 2000 at ILI-Uganda; 52

companies. The opportunity to own a part of a company is an incentive to savings mobilization as a result of the development of the supply side of the securities market. With more equity and debt securities being traded, the stock market will get depth and width, which lead to lower investment risks, greater competition, and better products on the market. Ultimately, the developed market through increased investment and public participation in the market will boost the national economy. Strong business units will evolve and there will be lower costs of capital as financial institutions compete with capital markets. Ultimately, higher savings and returns on investment as a result of market development will lead to wealth creation and sustainable growth and economic development.

These benefits are, however dependent on investor confidence, which determines the levels of investment and growth of the market. Protection of the investor is therefore a necessary requirement for the development of capital markets. In furtherance of their common goal of investor protection the *Capital Markets Authority Act*⁸³ and *Companies Act*⁸⁴ contain both civil and criminal penalty provisions against unlawful practices in an IPO. These provisions set out the liabilities of the issuers with regard to the IPO and are necessary to enforce the rights of the subscribers who are usually at a disadvantage compared to the issuers of securities.

The *Capital Markets Authority Act* prescribes civil and criminal sanctions in the form of fines imprisonment and compensation for contravention of the rules set out in part IX of the Act. These criminal sanctions are also provided for non-compliance with the disclosure requirements set out Section 40 and the third schedule to the *Companies Act*. This non-disclosure shall lie against a director if he fails to state that the error was not deliberate or he was unaware of it. This is based on the principle that the directors act as trustees to the shareholders and must act in good faith. In allegations of fraud or negligence against directors or promoters of a company the onus of proof lies on the subscriber. Individuals can be fined up to ten million shillings, imprisonment up to five years or both.⁸⁵

⁸³ Part IX of the CMA Act lists various market offences and section 90 lists the criminal and civil liabilities for the offences named in sections 83 to 89 of the Act.

⁸⁴ The Companies Act Cap 110, Sections 45 and 46 53.

⁸⁵ Ibid. Section 90(1)(a).

Companies, on the other hand can be fined up to twelve million shillings. Over and above the remedy of fines or imprisonment is the requirement that compensation be paid to the aggrieved party by a person convicted of an offence under part IX of the Act⁸⁶. The rationale for this is the recognition of the duty of care held by the issuers of security⁸⁷ - and fraudulent or negligent breach of this duty will require the party in the wrong to make good the losses sustained by the person claiming the compensation. An investor's rights with regard to the prospectus are absolute and cannot be waived. Section 40 of the *Companies Act* makes the issue of a prospectus mandatory and Section 40(2) makes it clear that contractual waiver cannot avoid prospectus violations. This provision operates to prevent instances where, owing to the superior bargaining power of the issuer, the investor may be induced to waive his rights to his detriment⁸⁸. Section 41 of the *Companies Act* preserves any common law remedies that the investor may seek. These remedies may include damages for misrepresentation, rescission, and actions for negligence.

The common-law remedy of damages for misrepresentation in a prospectus is based on the belief that "those who advertise a prospectus know that it will be relied on indiscriminate by investors who apply on allotment and those who buy on the market."⁸⁹ As seen in the case of *Peek v. Gurney*⁹⁰ if a false statement was made in the prospectus and it was the intention of the issuer it acted upon an investor that acts upon such misrepresentation to his detriment is entitled to damages⁹¹. This was extended to cover the subscriber's loss as a result of negligent misstatements in the prospectus.⁹² However, as was seen in *Derry V. Peek*⁹³ if the directors make the misrepresentation in the honest belief that it is true they will not be liable for misrepresentation. This *Companies Act* provides a defense for an honest mistake of fact that may make what may be strictly construed as a misrepresentation exculpatory.⁹⁴ This defense does not

⁸⁶ Ibid. Section 90 (2).

⁸⁷ This is based on the principle set out by *Kindersley, VC in New Brunswick and Canada IUy and Land Co.Ltd v Muggeridge*.

⁸⁸ the Companies Act, Cap 110. Section 90(3) 54.

⁸⁹ D. J. Bakibinga: *Company Law in Uganda. Professional Books Publishers & Consultants Ltd- Kampala* (1997). Page 101.

⁹⁰ (1873)L.R. 6 H.L.377 This remedy is restricted to the actual allottee of the shares and not the subsequent purchasers of the shares.

⁹¹ This is further illustrated in section 87 of the Capital Markets Authority Act, Cap 84

⁹² this remedy is given in Section 45 of the Companies Act, Cap 110.

⁹³ [1889] 14 App Cas 337.

⁹⁴ Section 40(4)(b) 55.

extend to mistakes of law, in the alternative, if the statement in the prospectus is untrue and misleading, but not fraudulent, the aggrieved subscriber may seek to rescind the contract and have the register of members rectified.⁹⁵ Proof that the prospectus contained a misrepresentation in respect of a material matter intended to be acted upon and the company is liable would entitle the aggrieved subscriber to repayment of the initial investment he made in the company. The common law provision for damages for misrepresentation is concretized in section 85 of the *Capital Markets Authority Act* that prohibits making false or misleading statements to induce a person to buy or sell securities. Liability with regard to these statements lies with the issuer if they are made fraudulently or recklessly to the investor's detriment.

The *Companies Act* prescribes a number of monetary fines for irregular allotment under Section 51 and reporting violations under Section 54. Section 45 entitles a subscriber who has suffered loss as a result of misrepresentation to a claim of compensation against the director or person named as director in the prospectus. This liability may extend to experts under Section 42 of the Act. The Act prohibits false trading and market rigging. This offence takes the form of creating a false or misleading appearance of active trading with respect to market or price for the securities.⁹⁶ It may also involve purchase or sale of securities with no change of beneficiary mainly leading to fluctuation of the price of the securities⁹⁷. If it is shown that the issuer willfully created a false or misleading appearance of trading in securities trading he commits an offence.

The Act further prohibits transactions that are tantamount to share price manipulation with intent "to induce other persons to sell, purchase, or subscribe for securities of the body corporate or related body corporate."⁹⁸ The CMAs mission statement to "promote and facilitate the development of an orderly, fair and efficient capital market in Uganda 116" points to the state's goal of increasing investor confidence. This increased confidence will ultimately lead to increased investment, market growth and economic development. Investor protection is perhaps the main consideration from which all the other goals stem and it is in the state's best interests to

⁹⁵ Section 118 of the Companies Act, Cap 110

⁹⁶ Capital Markets Authority, Cap 84 Section 83(1)

⁹⁷ Ibid. Section 83 (2)

⁹⁸ Ibid. Section 84 56

safeguard the investors' rights, which would otherwise be violated by unscrupulous issuers of securities.

The CMA Post-IPO: Substantive and Regulatory Aspects of the Secondary Market⁹⁹: This chapter seeks to study the regulatory role the CMA plays in the secondary market. This role is in line with the obligation given to it by the CMA Act to create, maintain and regulate the market and make it as self-regulatory as possible¹⁰⁰. This is the source of the CMA's mission statement, which is: "...To promote and facilitate the development of an orderly, fair and efficient capital market in Uganda"¹⁰¹. This CMA has the task of "removing impediments to, and the creation of incentives for longer term investment in productive enterprise"¹⁰² and it can achieve this by increasing investor confidence through "protection of investor interests."¹⁰³ The aspects of regulation involve licensing and supervising market participants, imposing sanctions on participants who violate the securities regulations, and as a last resort, compensating aggrieved investors for their loss¹⁰⁴.

⁹⁹ We see in Candy Wekesa's article entitled Legal and Regulatory Issues in Capital Markets. Op.Cit, Page 15 that the secondary market is synonymous with the Stock Exchange.

¹⁰⁰ Capital Markets Authority Act, S.25(1)(b).

¹⁰¹ Capital Markets Authority Aipual Report and Accounts, 1998/ 1999, page 2.

¹⁰² Capital Markets Authority Act, Cap 84 S.26(1)(a).

¹⁰³ Ibid, S.6(1)(c).

¹⁰⁴ Ibid, Sections 82(1) and 26(1)(d) deals with the investor compensation fund.

CHAPTER FOUR

CONSTRAINTS IN CAPITAL MARKETS IN UGANDA

4.0 Introduction

This chapter will discuss the bottlenecks that capital markets in Uganda are faced with. The chapter deals mainly in the bottleneck that touches in all the capital markets available in Uganda.

4.1 Challenges facing capital markets

There are a number of extra-legal problems the capital markets face in protecting the investor and promoting capital markets in Uganda. In Uganda the supply side still leaves a lot to be desired. This means that there are fewer companies meeting the listing requirements and there is very little competition. Investors wishing to “hedge” their risks by diversifying their investments, will not have many options and this may lead to the market failure of monopoly, which puts all their eggs in one basket. Meanwhile, the small companies that comprise the bigger part of Uganda’s corporate sector still rely on debt securities as a source of capital and the competition puts a strain on capital market development. Uganda faces a shortage of professionals like lawyers and accountants who are familiar with capital markets or would help in facilitating capital market regulation.

A shortage of skilled personnel might lead to insufficient disclosure before and subsequent to the IPO, thereby undermining investor protection by exposing the prospective investor to a higher level of risk. The investor compensation fund is established under the *Capital Markets Authority Act*¹⁰⁵ as a source of compensation for an investor who suffers financial loss due to market failures. It was meant to be an alternative to litigation, which can be expensive and burdensome to the investor. The fund gets its resources from contributions, licensees’ initial deposits,¹⁰⁶ ill-gotten wealth where the beneficiaries are unascertainable,¹⁰⁷ reimbursements and interest or profit from reinvesting the fund. However, the immaturity of Uganda’s capital market limits the operation of the investor compensation fund. Unless and until the market develops, the fund will not have enough money to compensate the investor.

¹⁰⁵ Capital Markets Authority Act, Cap 84 Sections 26(1)(d) and 82.

¹⁰⁶ Capital Markets Authority (licensing) Regulations, Cap 84 Part II 85.

¹⁰⁷ Capital Markets Authority Act, Cap 84. Section 90.

4.2 Constraints to government Regulations

The conflict between laissez-faire and dirigisme and its effect on Investor Protection: The capital markets regime in Uganda can at best be described as “infant.” This infancy is reflected in the fact that the CMA and USE have only recently been established under the *Capital Markets Authority Act*. This chapter is aimed at analyzing inadequacies in Uganda’s market regulatory structure and the conflicts that undermine the CMAs regulatory role. It further analyses contradictions between capital market regulation and the need for development of a free market and their effect on investor protection in Uganda. The CMA has the contradictory duties of developing and regulating the market. This can be seen by comparing their duty to protect the investor¹⁰⁸ with the obligation of implementing a system where the market is as self-regulatory as possible¹⁰⁹ and developing all aspects of the market and removing impediment to or creating incentives for long-term investment¹¹⁰. We see dialectical materialism being manifested in the Government employing a “cocktail approach” of oversight in the primary market and self-regulation in the secondary market trying to find a syndessertation between the laissez-faire based positive theory as the dissertation¹¹¹ and the dirigisme-based normative theory as the antidessertation.¹¹² This emphasizes the conflict between the need for regulation based on the supremacy of the investor, and the need to develop a free market fuelled by the forces of demand and supply.

4.3 Equity Market

The question that follows therefore is how much regulation should the equity market have without negatively affecting the market? As we saw in the previous chapters, the primary justification for dirigisme is the need to protect the investor from market failures¹¹³. Their investment decisions are usually based on second-hand information from better-informed insiders in the market and they risk losing their investment if they do not fully understand the modus operandi of the market. The Government¹¹⁴ therefore has the onus of preventing the

¹⁰⁸ Capital Markets Authority Act, Cap 84. Section 26(1)(e).

¹⁰⁹ Ibid, Section 26(1)(b).

¹¹⁰ Ibid, Section 26(1)(a) 77.

¹¹¹ This involves the liberal common law norms of “caveat emptor” and noninterference by the Government, which favor entrepreneurs.

¹¹² This equitable principle of fair play stresses Government intervention for investor protection.

¹¹³ Capital Markets Authority Act, Cap 84 Section 26(1)(c).

¹¹⁴ through the CMA as a Regulatory Agency.

insider from unfairly using any informational advantage he may have to the vulnerable investor's detriment. This is done through regulation of the market with emphasis on disclosure requirements and ensuring that there is no reach of the insiders' duty of care to the investor as a result of a conflict of interest.

4.4 Public ignorance

However, public ignorance or apathy, with regard to the operation of the CMA is a limitation to investor protection and general capital market development. Many entrepreneurs consider dirigisme not only unnecessary, but a restraint of trade and a violation of their economic rights.¹¹⁵ The opponents of dirigisme believe that Government intervention leads to perfect competition, which is "...a stationary situation in which all competitive activity has ceased..."¹¹⁶ They further dismiss the cocktail approach of regulation, contending that laissez faire is a substitute for dirigisme and they cannot function in the same economy. "...The belief in the superiority of the free market over centrally controlled economies and ...the need for political guidance and Government decision making makes as much sense as being half-pregnant..."¹¹⁷ Only two equities have been listed on the stock exchange¹¹⁸ and the volume of trade is still very low. This raises the issue of jurisdiction of the regulatory authority. The CMA has more control over public companies than private ones and focuses on establishing public confidence through investor protection. Despite the benefits of getting listed, many companies are reluctant to get listed and the level of compliance by the private sector is still quit low. Until the market is well developed and companies bring themselves within the CMA's jurisdiction by meeting the listing requirements, shareholders in a private company will not be afforded the protection that accrues as a result of the company getting listed.

4.5 Rudimentary management structures

Uganda's private sector is largely made up of small private enterprises with rudimentary management structures. They mainly take the form of family businesses and their directors and shareholders are usually one and the same. The owners of these companies fear the loss of

¹¹⁵ The Constitution of the Republic of Uganda, 1995, Article 40(2) confers the right to practice a profession and carry on any lawful occupation, trade or business.

¹¹⁶ Gerard Jackson "*Competition, Telecommunications and Ignorant Columnists*": The New Australian, No. 81, July 6-12, 1999. citing Milton Hayek.

¹¹⁷ Ibid. Mr Jackson tries to dismiss "*political guidance*" as being contrary to free trade.

¹¹⁸ Uganda Clays Limited in 1999 and British American Tobacco Limited in 2000.

control in the form of voting power and management that goes with listing the company.¹¹⁹ It therefore follows that the founders' mentality that a company they put time, money and effort into would be taken over by shareholders is a serious impediment to companies going public. This notion, however, becomes more illusory as the company grows and the owner will find that the capital raised from selling equities is adequate compensated for the loss of control.¹²⁰

4.6 Disclosure Requirements

The adequate disclosure requirements in an IPO present a conflict between the need for privacy for the company and its owners vis-à-vis the strict disclosure requirements set by the CMA for listed companies. The term "transparency" implies that the company will be "akin to living in a goldfish bowl"¹²¹ implying that public companies have disclosure obligations that are not shared by private companies. As a result, many entrepreneurs do not take kindly to the idea of exposing all the company and its directors' "dirty linen" in order to meet the adequate disclosure requirements. These disclosure requirements make disclosure of any material information that would affect the company before and after listing mandatory. The entrepreneurs fear that the strict initial and subsequent disclosure requirements will negatively affect the public company's share price by making public any problems that the company might have and the market failure of asymmetric information is still rife in private companies today.¹²² It should be noted however that this fear, though real, is fast becoming illusory. Private companies cannot grow in an informational vacuum.¹²³

4.7 Banks and creditors

Banks creditors and business partners continuously seek information about their histories, financial position and prospects and management structure in a bid to find out exactly whom they are dealing with. The *Companies Act*¹²⁴ also requires the company to file annual returns with financial information similar to that in a prospectus. Taking into account the lack of a good

¹¹⁹ Nafula Awori: "Demystifying the Decision to go Public: What does it Really Do for the Company?" *Capital Markets Journal* Volume 3, No. 1 January/ March, 1999, Page 7 117.

¹²⁰ S. Cohn and F. Zake: *Capital Market Development in Uganda*, Supra, Pages 93- 94.

¹²¹ S. Cohn and F. Zake: *Capital Market Development in Uganda*, Supra, Page 92

¹²² This is a global problem. According to the CNN programme "Money Line with Lou Dobbs" on June 26, 2001 companies in the USA have been accused of not reporting money paid as terminal benefits for laid off workers in a bid to make their companies financial position look more attractive to investors.

¹²³ S. Cohn and F. Zake: *Capital Market Development in Uganda*, Supra 80.

¹²⁴ Section 125.

corporate governance culture in Uganda, most entrepreneurs look at the disclosure of financial statements and tax reports with trepidation. They fear that disclosure may lead to civil and criminal liability. It is not disputed that most of the companies in Uganda's corporate sector have a poor taxpaying reputation and many entrepreneurs fear that their initial and continuous disclosures requirements in the capital market can lead to Government action against them for underpayment or even non-payment of tax.¹²⁵

The costs incurred in an IPO are an obstacle to companies' participation in the stock market. Up front costs incurred in paying the attorneys, accountants and consultant involved in the IPO in addition to subsequent costs in preparation of periodic reports are daunting to the entrepreneurs. In addition, many companies in Uganda are small and cannot meet the capital requirements necessary for the IPO. Uganda's commercial legislation namely *Companies Act*¹²⁶ and the *Capital Markets Authority Act* and its antecedent regulations, which are the major legislative instruments governing the capital market, have been criticized as being too complex and hard to understand.

4.8 Duplicity and uncertainty

The duplicity and uncertainty in the law has been seen as a major source of injustice, especially for the investor who seeks to rely on the legislation to enforce his rights¹²⁷. This uncertainty could be because the law has been adopted in a vacuum since there is no history of capital markets trading and it is based on laws governing other, more developed markets. This signifies that the regulatory mechanism in the market is still largely untested and based on western models. In establishing the CMA, the Government recognized the need to represent all the shareholder interests and encourage them to participate in the decision-making process. The *Capital Markets Authority Act*¹²⁸ prescribes a twelve-member authority representing the interests of both the private and public sector. The Minister of Finance appoints six members from the private sector to look after the interests of private companies. The composition of the board is intended to represent a wide range of people and institutions affected by capital markets in

¹²⁵ S. Cohn and F. Zake: *Capital Market Development in Uganda*, Supra, Page 92.

¹²⁶ Companies Act, Cap 110, Laws of Uganda.

¹²⁷ An example of this duplicity is the repetition of the third schedule to the Companies Act, Cap 110 in the Capital Markets (Prospectus Requirements) Regulations, Cap 84.

¹²⁸ Section Five.

Uganda and provide an avenue for the business community to voice their opinions and ensure that their interests are kept paramount by giving them a say in the development of a law that might affect their businesses.

Currently, the privates sector institutions represented in the CMA are: The Institute of Certified public Accountants, Uganda Law Society, Uganda National Chamber of Commerce, Uganda Manufacturers Association, Insurance Institute of Uganda and Uganda Bankers Association.¹²⁹

These key institutions are instrumental in promoting the interests of the private businesses, which make up a large part of the commercial sector in Uganda. However, the question that arises is whether these “core stakeholders” represent the entire business community in Uganda. The high standards required by the CMA might alienate it from the business community and this might lead to companies not appreciating the benefits of getting listed.

The prospectus, which has been described as the “long arm” of the regulator that seeks “full and adequate disclosure” of all “material information” to assist the prospective investor make an “informed decision”¹³⁰ may defeat its purpose if the prospective investor cannot comprehend the prospectus’ contents. The prospectus has a “presentation puzzle” and is “styled in English with a host of technical jargon for a population whose literacy rate is 62%.”¹³¹ The prospectus serves to give prospective investors constructive notice of the company’s affairs and if the investor does not understand the prospectus’ contents his chances of maintaining an action against an insider if he incurs a loss are limited by “caveat emptor”¹³²

The CMA therefore faces a daunting task of ensuring that companies disclose all material facts about their companies, while attaining simplicity in the prospectus. Many writers have understated the importance of disclosure requirements to the investor. The most notable critic of the disclosure requirements was George Benston¹³³ who contended that detailed reports are more useful to the trained analyst than the ordinary stockholder. “The analyst then passes on his information to his clients, or in any event, trades on the information, thereby bringing its effect to

¹²⁹ Source: *CMA Annual Report and Accounts 1998/ 1999* 82.

¹³⁰ Ms. Candy Wekesa: Prospectus: Protection or Puzzle; *Capital Markets Authority Journal*, Volume 4 Number 3 July/September, 2000. Page 26.

¹³¹ Ibid.

¹³² or “buyer beware”.

¹³³ George J. Benston: “Required Disclosure and the Stock Market: An Evaluation of the Stock Exchange Act of 1934,” *American Economic Review*, 63 (March 1973), Pp. 132-155.

the market. But does it get there by means of the financial reports required?"¹³⁴ The test is whether the disclosure leads to observable and significant changes in the prices of securities to which that information relates. A negative answer would therefore undermine disclosure requirements, which form the basis of investor protection. A broker dealer's dual role of advising the investor and dealing on the stock may present a problem with regard to the broker-dealer's interest in the transaction. When the broker-dealer takes on a greater role than that of a middleman, he acts as both agent and principal and might use any informational advantage he might get as a result of his insider role in the market to the investor's detriment.¹³⁵

4.9 Conclusion

In conclusion, market manipulation as a result of asymmetric information is still a problem in many capital markets. These problems are mainly associated with the shortcomings in criminalization of insider trading. The enforcement of the "disclose or in" rule¹³⁶ that prevents insiders from trading in securities if they have information not readily available to the public is difficult if the disclosure is made to a third party. It is hard to prove that inside information has been divulged to a third party and this makes the de facto situation very different from the de jure with regard to preventing.

³⁴ Ibid.

³⁵ In *Hughes v. Securities Exchange Commission*, United States Court of Appeals, District of Columbia Circuit, 949 F.2d 969 it was held that a broker dealer's informational advantage his position of trust with the investor gives him a duty of care to the investor.

³⁶ Set in *Hughes v. Securities Exchange Commission*, Ibid. 84.

CHAPTER FIVE

CONCLUSION AND RECCOMENDATIONS

5.1 Introduction

This chapter examines the supporting systems necessary for the development of a regulatory framework in Uganda's capital market. This is a discussion of the legal and extra-legal steps that should be taken to ensure that capital markets grow in line with the goal of investor protection.

The global rise to prominence of capital markets shows the change in the public's perceptions with regard to the role of the state in business. The state was traditionally seen as a provider, entrepreneur, regulator, and administrator of justice. It was generally responsible for providing public services, redistributing wealth, and mitigating the harshness of capitalism.¹³⁷ In many developing countries, including Uganda, the state was seen as the sole entrepreneur and even took deliberate steps to nationalize and take responsibility for industry. An example is Dr. Milton Obote's "Move to the 89. Left"¹³⁷ and particularly the "Nakivubo Pronouncements" of May 1, 1970, which placed over sixty percent ownership of all means of production in the hands of the Government.¹³⁸

The recent liberalization and divestiture of state enterprises in Uganda and other states shows that the state is moving away from the traditional role of economic production to the more appropriate regulatory role in the economy. Though the concept of capital markets is new to Uganda, having only begun in 1996 with the enactment of the *Capital Markets Authority Act* it is believed that it will bring about a revolution ushering in new era in her commercial sector.

The Government has implemented policies focusing on "promoting private sector development ... strengthening public private sector partnership and abolition of state monopolies in utilities such as electricity and telecommunications."¹³⁹ It therefore follows that with the growth of the private sector and public participation in industry the provision of appropriate measures of security for investors is necessary not only as a human rights issue, but also to encourage investment both at the local and international level.

³⁷ This policy was contained in the "Common Man's Charter" of 1969.

³⁸ Phares Mutibwa: *Uganda Since Independence: A Story of Unfulfilled Hopes*. Fountain Publishers- Kampala 1992). Page 70.

³⁹ H.E. Y.K. Museveni: "Uganda: *Making Institutions Support Private Sector Growth*." Final Report; September 5, 2000. Page v 89.

These policies are expected to result in overall economic growth and development. Public perceptions of the market are influential to the development of capital markets. A negative perception of the market not only discourages prospective investors, but could also lead to people already in the market pulling out. Without active, unremitting public support and participation, the market will wane from the lack of products and liquidity. The CMA's primary focus is on building investor confidence through regulation.

5.2 Recommendations

The author presents the following recommendations.

5.2.1 Duty of government in capital markets

The Government has a duty to provide a suitable environment for the growth of the capital market.¹⁴⁰ However, Government policies have been criticized for not giving incentives to promote private sector participation in the equities market and generally discouraging the development of the capital markets industry. In particular, many blame Uganda's tax regime and cite the fact that the expenses incurred by a company during its IPO are non-tax deductible¹⁴¹ as a major hindrance to companies' participation in the equities market. The suitable environment can be extended to include a secure setting for investment, which would encourage people to invest in long term projects.

The Government must therefore ensure that there is a good political climate by preventing internal discord and civil strife, which would serve to discourage investors from participating in Uganda's equity and capital market. In pursuing this objective, the NRM Government has, since 1986, liberalized the economy and promoted the public sector by pursuing an aggressive investment drive through the Uganda Investment Authority. Through the "big push" initiative¹⁴² and the privatization drive, particularly the divestiture of its holdings in Uganda Clays Limited and British American Tobacco (Uganda) limited, the Government has played a big role in the development of Uganda's capital market.

However, the number of equities being traded on the Uganda Securities Exchange is still very low and this might negatively affect the development of the market. The Government's decision

¹⁴⁰ Ibid. Section 26(1)(e).

¹⁴¹ Section 31 of the Income Tax Act, 1997.

¹⁴² This involves attracting foreign investment by the CMA and UJA. 86.

to look for strategic investors for the majority of the companies it is privatizing¹⁴³ further undermines the development of the capital markets industry in Uganda. From the above analysis, one can be justified in contending that while it is not disputed that dirigisme is necessary for investor protection, it only flourishes in a developed capital market and Uganda's market is far from developed. Evaluating the CMA's performance today would be premature since it is too early to say whether a large number of private companies will be listed on the stock exchange. However, the infancy of the market and low volume of trade means that until the market achieves this growth the CMA will play a limited role in investor protection in Uganda's commercial sector.

5.2.2 Increasing public awareness

Development of the market is contingent upon a number of supporting systems that directly or indirectly affect capital market regime. Without these systems no regulatory framework can exist and the regulatory institutions would be rendered inert. Public awareness is a fundamental supporting system to the development of an efficient equities market. As long as the public remains ignorant of what capital markets have to offer, the markets will lack liquidity and continually lag behind due to the lack of investment. The CMA increased public awareness through road shows and seminars during the IPOs of Uganda Clays Limited and British American tobacco (Uganda) limited. With the support of the Austrian development agency, it also published a number of informative brochures and leaflets¹⁴⁴ and set up a website,¹⁴⁵ which act as sources of information about investment and the securities market in Uganda. To supplement this, the Government should implement and finance a policy to inculcate capital markets related subjects in secondary schools and tertiary institutions' programmes of study. Apart from training the general public, there should be an effort to improve the quality of supporting professionals like lawyers and accountants who help in preparing a company for its IPO. Their professional input is essential in the implementation of the due diligence and adequate disclosure requirements prior to and after the IPO which are the main tools of investor

¹⁴³ For example, instead of privatising Uganda commercial Bank on the stock exchange, Government sought strategic investors and this has been very controversial. 87cc).

¹⁴⁴ Simon Rutegea: "Events at the Uganda Securities Exchange" *Capital Markets* (ets Journal, Vol. 4, no. 4, October/ January, 200).

¹⁴⁵ www.ugandacapitalmarkets.co.ug. The CMA shares this website with the USE and Uganda Investment Authority 90.

protection. The Government should concentrate on capacity building to facilitate the operation of the equities and capital markets. This training should be extended to the media to increase their comprehension and reporting on market issues.

5.2.3 Stronger Legal Regime

There is a need to provide compliant laws to support market development. In Uganda, the companies Act is the main legislative document for regulation of the commercial sector. This fifty year-old Act was derived from the 1948 British *Companies Act*, which was drafted largely with large public companies in mind. Since most of the companies in Uganda are small private enterprises, Uganda's Companies Act has been deemed obsolete and condemned for not meeting the market participants' needs. The Government of Uganda through the Uganda Law Reform Commission is in the process of implementing the Commercial Justice Reform Programme, which involves enacting a new, more compliant *Companies Act*. A new Companies Bill was proposed on September 28, 1998²⁶¹ based on the "core company law" approach. This approach recommends that the *Companies Act* slimmed down and simplified to cater for contemporary business needs.

A stronger legal regime would provide better legal and regulatory provisions than the current one under the 1964 *Companies Act*.

5.2.4 Promote Saving through Banking

The need to promote savings and exploit our resources more efficiently is a primary supporting system to capital market development. Savings are a major source of capital for the investor and symbolize demand for the equities. They would be more accessible if the banking and pension sectors were strengthened. Uganda's banking sector took a nosedive in 1999 when a number of banks were closed due to mismanagement. The highlight of this crisis was the closure of Greenland Bank on April 1, 1999. This eroded public confidence in the banking sector and negatively affected the supporting system of savings mobilization. It is hoped that with the development of a strong banking system the volume of investment will increase and lead to capital markets development.

5.2.5 Collective Investment Scheme

The Government should strive to achieve a wide retail investment base along with a strong institutional investment base. This will provide stability to the issuer and security for the investor. This objective could be attained through collective investment schemes, which encourage open-ended investment and broader public participation in equity transactions. The collective Investment Schemes Bill was tabled before Parliament and approved in the first quarter of 2000. The scheme will further facilitate savings mobilization and bring the market closer to individual investors who could not afford to invest earlier. The Government should focus on promoting private sector participation in the equities market and adopt economic more investor-friendly.

The CMA does not guarantee investors protection against normal market risks but ensures that they are made aware of the risks involved in what are commonly referred to as 'health warnings in advertisements and prospectuses.' This will ensure that the market is fair and encourage investment. It is believed that the investor compensation fund will act as a mitigating force, compensating the investors if they incur losses due to market imperfections. The supply side of the market must be improved if we want to achieve the desired levels of growth.

5.2.6 Increased Divestiture

In addition to providing an exit mechanism for the Government in the divestiture of its interests in Uganda Clays Limited and British American Tobacco (Uganda) limited, the CMA has its eye on other companies in which the Government has interests that it intends to divest. These include Kinyara sugar Works, Uganda Commercial Bank, Bank of Baroda, Stanbic Bank, Barclays Bank and Uganda Telecom Limited. The involvement of the CMA in the privatisation process shows the confidence the Government has in the capital markets and is intended to motivate private sector corporations and investors to utilize the equities market as a source of capital and an avenue for investment. The importance of corporate governance as a supporting system cannot be understated. Considering the predominance of family business-corporate structures in Uganda it is essential to stress professionalism and good corporate governance in the administration of these companies. Companies that do not meet the CMA's corporate governance requirements do not qualify to trade on the stock market.

5.2.7 Increase on Volume of Trade

The need for depth and an increase in the volume of trade through companies participating in the equities market therefore necessitates meeting these requirements. A viable capital market can only exist where the Government plays an active extra-legal role in assuring security and a good investment climate. Any political upheaval would be detrimental to capital market development since it would discourage long-term investment. The Government's relative improvement in national security and concentration on improving her economy through pursuing an aggressive investment promotion drive has encouraged foreign direct investment that brings depth to the market.

5.2.8 Government Support

The Government could also promote investment by facilitating the regulatory organizations. Computerizing the USE, for instance would increase efficiency in the market and boost investor confidence.

There are three main beliefs that justify the formation and development of an equity market in Uganda. The first is that there is no scarcity of resources to invest in "productive, transparent and well-managed enterprise."¹⁴⁶

The second is that the development of an equity market is a long-term affair and the capital market regime in Uganda is, indeed, a going concern. The third is that many medium sized businesses in Uganda are family owned and financed "through high cost debt" and an alternative source of capital must be sought. The capital market in Uganda is fast growing and it is justifiable to say that investor protection and market development are complimentary factors and a market cannot have one without the other. This interdependence makes capital markets and particularly equities markets complex operations dependent on many contingencies for survival.

The Government has already started implementing reform policies to strengthen the CMA and has boosted the equities market through its Public Enterprise Reform and Divestiture Programme. However, it is not sufficient for the Government to set up the institutions and pass appropriate legislation then leave the rest to the privatisation unit. It is not possible to judge the performance of the market based on divestiture of state enterprises and it still remains to be seen whether

¹⁴⁶ Mr. Simon Rutega: Events at the Uganda Securities Exchange: Capital Markets Journal, Vol. 4, No. 1, January/March, 2000 Page 4

Uganda's equities market will be successful in the private sector. One can only infer from looking at market success and prominence in other countries like the United States of America that capital markets are viable avenues for investment and a major contributor to economic development.

5.3 Conclusion

In conclusion, the development of an efficient capital market requires alliances between the state and private interests. A developed capital market is of benefit to investors, entrepreneurs and the economy as a whole. The benefits include: "(a) mobilization of long-term savings for long-tenured investments, (b) providing risk capital (equity) to entrepreneurs, (c) broadening ownership of firms, and (d) improving the efficiency of resource allocation through competitive pricing."¹⁴⁷ The investor is the lifeblood of the capital markets industry and the supremacy of his interests is the major basis for regulation of equity and capital markets. The state must ensure that it develops public confidence in the market and this will lead to better resource utilization, easier access to capital, promotion of industry, wealth creation and general economic growth and development.

¹⁴⁷ Sam Q. Ziorklui, Howard University: Capital Market Development and Growth in Sub-Saharan Africa. The case of Tanzania: African Economic Policy Discussion Paper Number 79, February 2001 97

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