

## ***A Watershed Moment: Ethiopia Introduces Capital Market Proclamation***

By: Fekadu Petros, 14 June 2021

On 10 June 2021, the Ethiopian Parliament approved the much anticipated Capital Market Proclamation. The proclamation spans over numerous pages and chapters. It creates the Capital Market Authority and appellate tribunal, it defines market players, products and services, rules and procedures, systems and institutions, prohibited practices, and offences and penalties. Below we provide a cursory observation of the major parts of the new proclamation.

**Scope of the proclamation:-** The proclamation has many new concepts, institutions and products. In short, it is a law that regulates the entire market ecosystem. In terms of scope the proclamation covers the regulator and all actors in the capital market, and products offered on the market. Let us see each in a brief detail.

**Capital market regulator:-** The capital market regulator- known under the proclamation as the Capital Market Authority is established by the proclamation as an autonomous public entity accountable to the Prime Minister. It is to be overseen by a board of directors with seven members-to be appointed by the Prime Minister. The governor of the NBE, and the director of AABE (Accounting & Auditing Board of Ethiopia) serving the board as ex-officio members. The Authority licenses actors, approves products to be traded on the market, disciplines market participants, and facilitates knowledge sharing and awareness creation about capital markets, among other things. The Authority also has the mandate to coordinate and cooperate with other institutions such as the National Bank, Attorney General and even foreign similar institutions with the view to maintaining integrity of the market within and beyond the border. Its main function is protection of investors from abuse by market actors, and maintaining integrity of the market. To effectuate these objectives, the authority is given broad range of powers including issuing directives, approving products, licensing of actors, on-sight and off-sight supervision and monitoring, and surveillance of actors, etc.

**Key actors:-** a capital market cannot be realized in the absence of the necessary ecosystem. Therefore the proclamation introduces these ecosystem/actors. These include the securities exchange, the securities depository and clearing company, investment bank, brokers, analysts, fund managers, investment advisors, collective investment scheme operator, and so on.

- **The Securities exchange:-** is the first and foremost institution that comes to mind when one thinks of a capital market. Hence, the proclamation defines a securities exchange both as a platform where securities are traded, and as self regulatory body/institution, i.e., with the power to regulate members that trade on the exchange. The proclamation envisages one securities exchange to be established as PPP by the state and the private sector, unless the private sector shows no interest in the partnership, in which case the exchange is to be established as state owned enterprise. Hence, the securities exchange is to be a share company in nature, as a first preferred design.

The exchange has broad powers and responsibilities, such as facilitating trade in securities, regulating members' conduct, and performing other post trade activities.

- **Securities depository and clearing company:-** is designed as a share company that works in parallel with an exchange. The main function of a Securities depository and clearing company is to serve a depository of securities before trade, and facilitate clearing and settlement (payment of price and delivery) of securities after trade. In a way, the Securities depository and clearing company is an institution that manages the Central Securities depository (CSD), and the Clearing Counterparty (CCP) for clearing and settlement. The proclamation defines the CSD as a “system for central handling of securities where securities are dematerialized and held in custody so that dealings in respect of these securities are effected by means of entries in securities accounts without the physical delivery of certificates; or which permits or facilitates the registration, clearing and settlement of securities transactions or dealings in securities without the physical delivery of certificates.”

- **Investment bank:-** is defined under the proclamation as non-deposit taking financial institution that facilitates the creation of capital for other companies, governments, and other entities through underwriting issues of securities by others. Such a bank also, acts as an intermediary between a securities issuer and the investing public, facilitating mergers and other corporate reorganizations and acting as a broker or financial adviser for institutional clients. Since the proclamation does not prescribe nationality restriction, foreign investment banks can provide investment banking services.

- **Brokers-** persons or companies that conduct the business of purchase and sale of securities for the account of others in consideration of a commission. Brokers are vital especially for individual investors as these groups can only access the exchange through brokers' intermediation. The Authority is empowered to issue directives on brokers, and with the general law in the Commercial Code on brokers, there is fairly adequate law for securities brokers, now.
  
- **Collective Investment Scheme Operator (CIS Operators)-** these can be various types of funds such as mutual funds, hedge funds, and other collective investment arrangements. A CIS is any arrangement whereby investment funds are managed collectively by a manager for the purpose of spreading risk between participants, so as to enable sharing gains and losses among diverse groups of investors from diversified investment portfolios. CIS Operator is a legal entity that has overall responsibility for management and performance of the functions of a collective investment scheme. Compared to many neighboring countries Ethiopian law is rather underdeveloped in this area of the law. But the new capital markets may encourage the creation of these CIS in the future.
  
- **Credit rating agency-**is an entity that issues opinions regarding the credit worthiness of an entity, a security or an issuer of securities using an established and defined rating systems or rating categories. Because decisions to buy or sell a security must depend on sophisticated analysis of securities, and since every buyer and seller is not conversant with analyzing the quality of the security being offered, the services of rating agencies is crucial. Global rating institutions like the S&P, Fitch, Moody rate sovereign states and big multinationals. Hence, if the experiences of some African countries is to be followed, foreign rating agencies will be allowed or will establish subsidiaries in Ethiopia. To this effect, the proclamation does not put nationality restriction unlike other laws in the financial sector.
  
- **The capital market tribunal (CMT):-** the proclamation establishes an autonomous Capital Market Tribunal to hear and determine appeals from the decisions of the Authority, and other institutions 'exercising the functions and powers of the Authority.' The '*other institutions*' here refers to the SROs that exercise the Authority's regulatory power. Therefore the CMT will have jurisdiction to hear and determine appeals from decisions of not only the CMA, but also the exchanges, Securities Depository and Clearing Company and other SROs. The tribunal

comprises five members with a chairperson (all to be appointed by the PM) and the necessary secretariat staff. The judges may be full time or part-time, but serve a term of five years, though eligible for reappointment.

- **Other stakeholders: auditors, media and lawyers:** These are reputational intermediaries regulated outside the capital market proclamation. This however, does not diminish their importance in enhancing the integrity of the market. Lawyers guide issuers and underwriters to go by the rules, auditors serve by verifying that the value of the security represents the true net worth of the issuer. Financial media is also very important as it is the channel through which the investing public gets market information. There are references in the proclamation about these stakeholders.

**Self regulatory organizations (SRO):-** given the complexities of capital market regulation, viz. the complex nature of participants and products on the market, the proclamation introduces self regulation as a complementary to the Authority's regulation. As provided in the proclamation, the function of an SRO is to regulate its own members through the adoption and enforcement of rules of conduct for fair, ethical, and efficient practices in the capital market; with a view to promoting the protection of investors and the public interest. Therefore, while the Securities Exchange and the Securities Depository and Clearing Company are entrusted with self-regulatory power over their members by their nature, the proclamation also calls for other participants to form SROs. Such would be a possibility for instance for brokers and dealers to form associations that will regulate their members.

**Products:-** one of the source of complexities of capital markets is the diversity of products traded on the market. Under the proclamation capital market products covers the various securities, derivative contracts, units in a collective investment schemes and other products which the Authority designates as tradable on the market. The term securities in turn covers shares, bonds, debentures, whether issued by the government or private company, and all other similar instruments, asset backed securities such as MBS, etc. The term securities also covers derivative contracts such as futures, options, and swaps. Units in collective investment schemes are also defined as products traded on exchanges.

The proclamation also recognizes OTC products such as repurchase agreements (repo), securities lending, securities buy-sell back/sell-buy back transactions and related financial contracts. The place of

OTC market is not clear in the proclamation. However, the law is expected to evolve through time and be flexible for products not suited for exchanges for which OTC market needs to flourish.

**Prohibited activities:-** the proclamation also incorporates a list major market manipulative practices which are prohibited. It thus defines and prohibits improper practices such as insider trading, market manipulation, false trading, fraudulent transactions, use of manipulative means, false or misleading statements, front running, and other similar acts.

**Offences and penalties:-** In the miscellaneous section, the proclamation prescribes a long list of offences and corresponding penalties. Expectedly, the offences include the list of prohibited activities, and the penalties range from fine amounting from 100,000 Birr to 1000,000 Birr, and sentences ranging from simple imprisonment to 15 years sentence. This apparently looks severe, but capital market offences are serious crimes in many parts of the world.

**Other issues:-**Other issues regulated in the proclamation include public offering and trading of securities, disclosure of interests, takeovers and protection of minority investors, collective investment schemes, and compensation fund. With the exception of the last two, all other matters are regulated by the general company law in the commercial code. These are dealt in the CMP to introduce special rules to be applicable in the capital market only. In relation to collective investment schemes, the proclamation deals with issues of creation, management and rights and duties of members of such schemes. Compensation fund is created by the proclamation in order to compensate investor loses as a result of failure of actors in the capital market.

**Dispute resolution:-** while the proclamation creates the Capital Market Tribunal for adjudicating appeals from decisions of the Authority, it designates arbitration as a means of dispute resolution for member to member contractual disputes. The occurrence of member to member disputes from contract default is unlikely since the function of the exchange and the securities depository and clearing company will bring contract defaults to zero. But harm to investors and participants can still occur from occurrence of prohibited acts. In such a situation, the dispute between the offender and the injured investor/member will be referred to arbitration, while the disciplinary and/criminal matter will be handled by the Authority and the courts.