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PROMOTING GROWTH IN AFRICAN CAPITAL MARKETS

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Other documents in this series:

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PREFACE

This publication follows a UNITAR-conducted regional workshop entitled '*Development and Regulation of Capital Markets*' which was held in Harare, Zimbabwe in August 2002 and which invited 29 senior government officials from East and Southern African countries. UNITAR conducts periodic regional training events with its partners (in this case, the Macroeconomic and Financial Management Institute of Eastern and Southern Africa) with the aim of sensitization and skills-building on the one hand and information exchange and cross-fertilization of experiences on the other.

As part of UNITAR's training activities in the legal aspects of debt, financial management and negotiation, UNITAR has now developed a distinct *cluster* of training and skills-building in the field of *Development and Regulation of Capital Markets*. This cluster has evolved from our firm belief that capital markets provide the financial investment support for companies to fund research and product development, business modernization and infrastructure as well as expansion of domestic and international markets. Furthermore, an efficient capital market requires careful planning and controls by both government and the private sector. If there is too much control and regulation, the market will not develop because business entrepreneurs will move elsewhere. If there is too little control and regulation, foreign and domestic investment will be discouraged. Thus a delicate balance has to be found with the ultimate aim of growth and sustainability of the capital markets and the proper involvement of domestic entrepreneurs and companies as the engine for this growth.

This publication brings to the fore two papers, dealing with issues directly treated as part of our regional training workshops. The *first paper* introduces the New Partnership for African Development (NEPAD) and argues for its immediate implementation. It then showcases a specific Small and Medium-sized Enterprises Scheme as a possible case for emulation in Africa and concludes by commenting on the restructuring of African capital markets. The *second paper* argues that the slow growth of capital markets in Sub-Saharan Africa is a result of several factors including a lack of quality parastatal privatizations, a reluctance on the part of privately owned companies to raise capital through public offerings, and restrictive company and securities laws and stock exchange requirements. It states that continuing along the same path holds little promise and new and innovative thinking and measures are needed. It then goes along to say that Small and Medium-sized Enterprises hold the promise of the future and are instruments for achieving NEPAD's goals. The paper thus proposes a potential programme for reform through the development of Micro-Cap Securities Markets in Sub-Saharan Africa.

The two papers in this publication have been contributed by UNITAR's eminent experts and speakers, *Chief Dennis O. Odife* and *Professor Stuart R. Cohn*. I want to take this opportunity and thank them for their respective contributions to this publication and document series and for their constant support to our training activities.

I hope that this document is useful as well as challenging to the readers.

Marcel A. Boisard
Assistant Secretary-General of the United Nations
Executive Director of UNITAR

IMPLEMENTING THE NEW PARTNERSHIP FOR AFRICAN DEVELOPMENT (NEPAD) BY PROMOTING THE DEVELOPMENT OF THE SME SECTOR IN THE CONTEXT OF CAPITAL MARKETS IN AFRICA

by Chief Dennis O. ODIFE

ABSTRACT

The African Union (AU), which replaces the OAU (Organization of African Unity), heralded its birth with the introduction of the New Partnership for African Development (NEPAD) comprising long and short-term strategies for achieving economic growth and development with peace and prosperity for Africans, collectively and in their individual countries. The NEPAD is a new approach of partnership with the rest of the world based on a promise by African nations to be of collective good behaviour, domestically, economically and politically, and internationally. Peer pressure will be used to ensure compliance. Based on its action plan, NEPAD identifies a funding gap of over US$ 64 billion per annum, which has to come from outside Africa and be raised under favourable conditions. The success of NEPAD is also predicated on its being owned and led by Africans. The paper argues that such ownership requires more rapid eradication of poverty in Africa and possibly drastic mobilization of Africans on the continent and in Diaspora through the SME (Small and Medium-sized Enterprises) and SSI (Small Scale Industries) sector and also through existing or new African capital markets.

Introduction

This paper discusses the New Partnership for African Development (NEPAD) and its implementation through the promotion of the Small and Medium-sized Enterprises (SME) sector in the context of capital markets in Africa.

What is NEPAD? The New Partnership for African Development, or NEPAD is... a pledge by African leaders, based on a common vision, a firm and shared conviction, that they have a pressing duty to:

- Eradicate Poverty,
- Achieve Sustainable Growth & Development,
- Individually and Collectively.

In coming to this conclusion African leaders contrasted Africa's poverty and Africa's backwardness, with:

- Africa's Resources,
- Africa's History, and
- African Genius and Ingenuity.

They came to the final conclusion that what is required to mobilize these resources, and to use them properly are bold and imaginative leadership, sustained human development effort, and Global Partnership -- based on shared responsibility, and mutual interest. NEPAD is therefore a call for a new relationship of partnership between Africa and the international community, to overcome the development chasm.

The NEPAD concept places Africa's resources in four components as follows: -

- COMPONENT I: Raw Materials and Minerals,
- COMPONENT II: Ecology and Rain Forests,
- COMPONENT III: Africa as Cradle of Mankind, and
- COMPONENT IV: African Creativity/Culture.

It then goes on to review how Africa got to its current situation of backwardness and decadence. It traces the historical impoverishment process to have arisen from Colonialism, from the Cold War, from the workings of the international economic system, and from poor domestic policies pursued over the years by the political leadership in the various African countries. **We note that, with perhaps one exception, these conditions have not ceased to exist.**

NEPAD is based on the belief that Africa's leaders now have a new political will under democracy, as demonstrated by the recent establishment of the African Union (AU). Under the AU as opposed to the defunct OAU (Organization of African Unity), which it replaces, African nations agree not only to surrender some of their sovereignty in exchange for collaboration in commonly owned institutions but also to pursue common programmes to foster economic growth and development for African people in their various countries, individually and collectively. The AU is thus determined not only to promote economic growth and development but also to deal with conflicts and to censure deviation from the norm through a process of peer review and pressure. NEPAD is therefore conceived as an Agenda for continental renewal, using national and regional Priorities and Plans, which should have been prepared through participatory processes involving the people. Unfortunately and for a start, it is argued that as their people mandated African leaders, they are entitled to articulate plans and lead implementation of the NEPAD Programme on behalf of their people, without following the recommended bottom-up visioning process.

From this perspective, NEPAD represents a new framework for interaction with the rest of the world, and it has the following strategic aspects:

- Conflict Prevention/Management/Resolution,
- Promote/Protect Democracy/Human Rights,
- Restore/Maintain Macroeconomic Stability,
- Institute Transparent Legal/Regulatory Frameworks for Financial Markets,
- Tackle HIV/AIDS,
- Promote Role of Women,
- Capacity to Maintain Law and Order, and
- Promote/Development of Infrastructure.

For its implementation to be effective, NEPAD must be owned and led by AFRICANS. The NEPAD agenda sets out the Long term Vision, comprising a set of Programmes covering what needs to be done in the short term. The objective of the programme is to develop capacity to sustain growth at required levels. There is as a result need for massive investment to bridge existing gaps for Africa to catch up. The immediate conclusion is that "…Africa needs to raise required funding under best possible conditions…" An appeal is therefore made to the development partners.

As set out in the NEPAD programme, its long-term objectives are threefold, namely:

- To eradicate poverty in Africa,
- To place African countries both individually and collectively on a path of sustainable growth and development, and
- To promote the role of women in all activities.

The Goals of NEPAD are no less ambitious. They are, to achieve:

- Average GDP growth rate of above 7% p.a. for the next 15 years,
- Achieve Agreed International Development Goals (IDG): namely,
    - Reduction of extreme poverty by half between 1990 and 2015
    - All children of school age to be in school by 2015
    - Removal of all gender inequalities up to secondary education by 2005
    - Reduction of infant mortality ratios by two thirds between 1990 and 2015
    - Reduction of maternal mortality rates by three-quarters between 1990 and 2015
    - Access to reproductive health for all by 2015
    - Reversal of loss of environmental resources by 2015 by sustainable development strategies put in place by 2005.

These agreed International Development Goals are to be achieved through the implementation of approximately six initiatives, as follows:

- Peace, Security and Political Governance Initiative,
- Economic and Corporate Governance Initiative,
- Human Resource Initiative,
- The Environment Initiative,
- Capital flows Initiative, and
- The Market Access Initiative.

A few of these initiatives are examined in more detail hereafter, starting with the Economic and Corporate Governance Initiative. Under this Initiative, in order to enhance quality of economic and public financial management as well as corporate governance, A Task Force from the Ministries of Finance and Central Banks will be commissioned to review economic and corporate governance practices and make recommendations for appropriate standards for consideration by the Head of States Implementation Committee within six months [Para 89]. The Recommendations of this body will go to African States for Implementation.

Another initiative worthy of review is that for Mobilizing Resources under The Capital Flows Initiative. This Initiative identified an Annual Resource gap of 12% of GDP amounting **to US$ 64 billion, and concludes that this must be sourced from outside Africa.**

NEPAD itself is to focus on Debt Reduction and ODA (Overseas Development Assistance) in the short run. Private capital flows are to result in the long term from the implementation of the Economic and Corporate Governance Initiative. The need to mobilize capital internally and externally was also recognized.

Regarding the low level of domestic savings in most of Africa, NEPAD notes the tragic loss of domestic savings through capital flight. It therefore recognized the need for policies to reverse capital flight, **and to make Africa and African states the preferred locations for investment by Africans and foreign investors**. To address the shortfall in funding, the NEPAD r**equests developed nations to pledge their Treasury Bills to finance the plan, and urges the rest of the world, (and probably the IMF) to establish Special Drawing Rights for Africa.**

Under the Promotion of Private Capital Flows Initiative, the NEPAD proposes a long-term approach to filling the development funding gap identified earlier. Strategies will be emplaced to deal with public and international investor perception of Africa as high risk. Public Private Sector Partnerships (PPP) will be encouraged and the AU will promote the deepening of capital markets within countries as well as cross border harmonization and integration via a Financial Market Integration Task Force.

Other NEPAD Programmes are in various sectors and include :

- Transportation and Energy
- IT, Science and Technology
- Brain Drain
- Environment and Culture
- Promoting the Private Sector, and Exports
- Manufacturing and Mining
- Agriculture, Health, Education, and
- Regional approaches.

Assessment of the NEPAD

It is rather early in the day to make a thorough assessment of the NEPAD Programme and its implementation. At this stage a few comments only will suffice. First, a question that readily comes to mind is whether NEPAD is a new wine in old skins or an old wine in new skins. Regarding the apparent imperviousness of African leaders to correction the question may be asked: can the Leopard change its spots? Have African leaders become Leopards-without-spots such that the possible changing of spots would not arise? Are they all truly born again? It is perhaps too early to tell.

Secondly, regarding the monumental changes taking place in Africa, especially the transition from the OAU to AU, a question arises, whatever happened to the Economic Commission for Africa (ECA)? Is it dead and buried or just comatose? Why the reticence regarding the role and achievements of this body earlier on conceived and heralded as the harbinger of African economic salvation?

Thirdly, NEPAD recognizes that the visioning process adopted in its preparation is Top-Down rather than Bottom-Up, as is required especially in a democracy. This is a major weakness. Fourthly, the most unfortunate aspect of the NEPAD however is its assumption of the position of a *moral minority* for the African people, whereas African leaders had earlier on rejected calls for reparations as a solution to the African problem. This posture contradicts the bold programmes of the NEPAD, which appear to be attempting to transform Africans

from a moral to an *ideological minority* in the world. As Hare, N and, Hare, J explain it in "An African Answer", [1]

> ***"…Ideological minorities come with their own beliefs, values, goals, aspirations and agendas. They know what they want and set out to get it wherever they may find it. A moral minority, by contrast, rests its case on the request for a moral atonement or restitution, a moral obligation on the part of their oppressor to right their wrong…They are inclined to wait and wait and wait in vain…"*** [2]

This posture on the part of African leaders and the NEPAD just will not do. Africans under the AU ought to take responsibility for their destiny, especially in the context of the mindset of their development partners. African leaders ought to possess and to demonstrate in their planning, a more thorough understanding of the personality profiles of the leaders of the free world at this point in time. There is little doubt that George Bush II, the leader of the free world today shares the views of his father who said in 1991[3] that:

> ***"…Destiny is not a matter of CHANCE, It is a matter of CHOICE,***
> ***It is not a thing to BE WAITED FOR, It is a thing to BE ACHIEVED…"***
> ***- Pres George W Bush, 1991***

African nations should not continue to believe and to act on the basis that the destiny of the people of this continent should be a matter of chance. The challenge of NEPAD should be to make it a matter of **choice**. **African nations having failed, refused or neglected to develop their financial markets, should not now be pleading for access on favourable terms to international capital markets!** Nor should African nations continue to plead market inadequacy as an excuse for seeking the required funds outside Africa notwithstanding Africa's resource profile and continued poor macroeconomic performance. **The integration of African capital markets should hardly take precedence over the establishment, deepening and widening of individual African national capital markets to bring on board as many Africans as possible before targeting the foreign investor.** The proposed partnership is therefore hardly a true partnership. Africans should transform themselves into more of an ideological than a moral minority to make their quest for growth and development better assured.

There are also several unanswered questions and troubling facts. What do the non-African Partners think of the plan? What do the African owners think of the plan? At their recent meeting with some African Leaders, G-8 Leaders appeared skeptical, and perhaps unconvinced. On their own, several Africans also appear skeptical or at best they are hardly enthusiastic about the NEPAD. They seem to know little of the NEPAD. Moreover, **the Top-Down visioning process has robbed them of participation in its design ab-initio, an essential condition for pride in ownership and success.** Therefore, they probably also join

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[1] Edgar J Ridley, "An African Answer: The Key to Global Productivity", Africa World Press, P O Box 1892, Trenton NJ, 08607, 1992.

[2] D. O. Odife: "Changing Trends in Stock Exchange and Capital Market Development: Lessons for Africa" published by UNITAR, 'Capital Market Development: The Road Ahead – Document No. 13', Geneva, November 2000.
Federal Government Printer, Abuja. Report of the Panel on the Review of the Nigerian Capital Market, Federal Ministry of Finance, Abuja, Nigeria, 1996.

[3] Dennis Odife, "New Perspectives on Nigerian Economic Reform" ALKESTIS BOOKS, Lagos 1994, p226.

in asking the questions: Will/Can African Leaders change their spending and investment records? Can Leopards change their spots? Can African ownership of NEPAD be achieved? At what cost/in what time frame?

The troubling facts are that:

- Africa has resources, and yet so many Africans are dying daily of hunger and disease in lands that could be very fertile,
- Africa provided and still provides substantial resources to the world,
- Africans export their resources to Europe/USA/Asia while their governments mismanage the rest,
- Africans in Diaspora have substantial resources they could invest in Africa, but are hardly doing so!
- Africans are still providing the world with cheap skilled labour that could build Africa.

Implementing the NEPAD

The NEPAD is not an institution but a programme of action. Its implementing authority is the AU with its individual membership together with permanent as well as ad hoc bodies that may be established for specific purposes. The identified annual funding gap of US$ 64 billion is a major obstacle to implementation. It is in questionable taste for NEPAD to request the development partners to pledge their treasury bills for African development. Most significantly, it reduces the entire arrangement to a master-servant affair rather than a true partnership. The situation is made worse by the fact that the so-called development partners are unlikely to oblige. The failures to obtain massive debt relief and substantial overseas development assistance make the programme a lame duck from the start. To worsen matters, the results of the Corporate Governance Initiatives are to be felt in the medium term, while as John Maynard Keynes said, "…in the long run we are all dead…" There is therefore the need for more immediate action if the programme is not to fail from the start.

As correctly identified by the NEPAD, the key to its success is ownership and leadership by the ordinary African. This, in my view, can only now, in the absence of a bottom-up Africa-wide visioning and sensitisation process, be achieved by immediate mass mobilization of Africans using internally generated revenues, no matter how limited. This would demonstrate self-reliance so critical to the African spirit, while encouraging Africans in Diaspora and foreign investors, in that order, to invest in the new African initiative to help itself. The NEPAD is a product of the government sector. African ownership of it must emphasize ownership by the ordinary African, especially those in the informal sector and the SME and SSI sectors of the African economy. One good way to get Africans to own the NEPAD and to lead its implementation would be to persuade them to buy into the NEPAD through programmes that are relevant to them and which they can proudly identify with.

The SME/SSI Sector in Africa

The SME (Small and Medium-sized Enterprises) sector is potentially the largest and fastest growing area of economic activity in Africa. It also has far greater potential for employment generation than either the government sector or the rather weak private sector in most of Africa. It is also often referred to as the informal sector and is seen as different from the organised private sector. Quite obviously, attempts to encourage the growth of the private

sector in Africa are likely to be more successful if they target the SME sector as their starting point. More importantly, attempts to achieve African ownership and leadership of NEPAD require rapid and massive mobilization of this sector.

This is however likely to be both a daunting task and a challenging one. Many countries have tried over the years to promote and to support their SME sectors with different degrees of success. The rising poverty rate in most of Africa indicates that perhaps a lot still remains to be done.

A NIGERIAN CASE STUDY

Recent Nigerian experience is a good case for study. Not only is Nigeria the largest black African country, she also has a very large informal sector, often estimated at over 70% of the economy. Nigerian Governments have historically made various attempts to stimulate the SME sector, which is also seen as the indigenous sector. In the seventies, Nigerian governments pursued policies designed to stimulate and promote equity share ownership amongst the indigenous population as well. All through the period, Nigerian banks were obliged by prevailing monetary policies to lend prescribed proportions of their credit portfolios to small-scale enterprises defined variously as 'the indigenous sector' and more recently as the SME sector. In the nineties, following Nigeria's adoption of a Structural Adjustment Programme, the Nigerian Reserve or Central Bank working jointly with the African Development Bank (ADB) established and ran a programme for export stimulation for the benefit of Nigerian raw material processing and exporting SME. The Export Stimulation Loan (ESL) Scheme provided the fixed capital component but did not address the issue of local equity and of working capital. In the event, these SMEs, as well as others, were easily crowded out of the banking sector in the allocation of scarce credit by both the government sector and by the organised private sector. Funding, or lack of it, was thus obviously a critical factor in the underperformance of that sector. Actual delivery of available funding may have been another factor but we shall look at this in more detail later.

The rising rate of urban and rural poverty in Nigeria as in many other African countries has naturally raised questions about the adequacy of past policies and programmes. The need to bridge the **'development chasm'** in the shortest possible time as NEPAD envisages, also compels a search for other alternatives. Are there any other options? Specifically, we pose the question: Is it not possible to promote the SME sector through the capital markets of Africa?[4]

In answering these questions, the bold example of the Nigerian Monetary authorities and Nigerian banks and the decision of Nigerian banks to set aside 10% of their annual profits before tax for investment in the equity of SME and SSI (Small Scale Industries) in Nigeria deserve study. Actual implementation will also be monitored for lessons.

According to press reports, within the first two years of the operation of the scheme alone, Nigerian banks accumulated over ₦11 billion in their respective SME Reserves. The bulk of these funds, it is alleged, still reside with the banks and less than 10% are invested. It is further suggested either that the banks are not willing to part with their SME Reserves or

[4] D. O. Odife: "Financing the African Economy: The role of the Capital Market" being the text of a paper presented at the Goldland International Conference on 'Conceptualising the African Approach to Management' at the University of Lagos, Akoka, July 2000.

that the SMEs themselves are not forthcoming to apply for and take the funds. Remedies being considered include sanctions against erring banks and possibly, the mandatory transfer of un-invested reserves to the CBN or some designated agency.

What is the problem? What should be done? In the first place the Nigerian authorities deserve commendation for this bold initiative. The new programme deals a fatal blow on the SME funding problem by designating a special pool of funds exclusively for SME. Secondly, the programme achieves a vital breakthrough by making it an "equity scheme" rather than a traditional "loan-type scheme". These are the strengths of the programme as it is. These mean that properly implemented Nigerian banks would become major partners in the industrial reconstruction of the country through the SME Sector. Moreover, this could rapidly become a model for emulation by other African countries. Unfortunately these strengths do not guarantee the success of the scheme. This leads again to the question: What is the problem?

The problem is that the scheme is an equity type scheme in a framework with very weak capital markets. The state of African capital markets has been documented in the bibliography to this presentation. What is now required is to attempt to promote and to support the SME sector in Africa in the context of African capital markets. This requires a radical and urgent rethink of capital markets in Africa and their restructuring to focus on the local investors as a prelude to attracting the foreign investors.

In the rest of this paper we shall examine the other difficulties being encountered by banks and SME operators in the implementation of the Nigerian Banks SME funding programme. We shall suggest how the programme may be refocused towards the capital market to ensure its success.

Initial reports on the performance of banks under the scheme suggests that banks appear to be attempting to use the funds to set up their own SMEs instead of giving the funds to outside SMEs. One can empathize with banks starting their own SMEs with their reserves, rather than giving the funds to their 'enemies' as BOFID appears to require Banks to do under the current Prudential Guidelines. One would therefore have allowed banks to set up their own SMEs as a way of jumpstarting the process. Not much harm can come from banks starting their own SMEs and gaining experience in the process! How many SMEs would the banks set up anyway? Now that banks have been stopped from starting their own SMEs, how many non-bank related SMEs have they funded in total.

As things currently stand, and if the foregoing is a true description of the state of affairs, the laudable objectives for which the scheme was set up are unlikely to be achieved. Under these circumstances, and like most Nigerian schemes, this very laudable scheme could fail, and thus not be available as an option for the implementation of the NEPAD. In the rest of this paper, I shall be addressing the shortcomings of the Nigerian Scheme in order to make it more implement able in Nigeria and thus enhance its prospects for adoption as a possible model for NEPAD and for other African countries.

Background

Sometime ago, I had the privilege to address[5] members of the Lagos Chamber of Commerce and Industry at their Year 2001 Second Lecture Luncheon held in Lagos. In my presentation, I drew attention to a number of minor contradictions contained in the Nigerian banks SME funding Programme. In my view, these shortcomings needed to be addressed to facilitate implementation of the Scheme. I have read that paper again and see no reason to alter the views I expressed at the time. The issues I raised are fundamentally, design rather than implementation issues.

I had raised some of the same issues in an earlier paper[6] titled "Promoting SME/SSI in Nigeria" when I provided a background to the formulation of economic policies for the promotion of SME/SSI in cooperation rather than competition with government to develop the economy. I shall summarize some of the issues raised here to the extent that they are of relevance to other African countries as well:

1. Government says it is committed to private sector leadership of the economy.
2. Government erroneously assumes that the private sector comprises only those who are players in it today, especially the Organised Private Sector (OPS), ignoring the informal sector.
3. This leads to the true but unfortunate comment that the private sector has not been able to generate growth.
4. An economy, in which government has been as dominant and for as long as it has been as in ours, will of necessity hardly have a private sector worth speaking about which one can expect to generate growth.
5. We may for now, ignore the equally valid argument that the private sector that exists has been battered and is not in any position to generate growth.
6. Going by the size of our population and the potential yet to be tapped, the existing private sector is a tiny fraction of the size of the private sector that can drive this economy and provide the needed leadership.
7. How will the 'private sector' be expanded to be able to have a chance to provide the much-desired economic leadership?
8. The first step is to achieve successful privatisation.
9. Second, the private sector will expand as a result of new entrants who come in to exploit the tremendous opportunity sets to be released by the freeing up of competition prior to and consequent upon privatisation.
10. Third, the private sector will expand as a result of entry by (a) our own entrepreneurs whom we must now encourage to start up their companies and (b) exploit the opportunities which we need to show them, and (c) based on funding which we have to provide through the banks and (d) from financing opportunities which we must provide for them through capital market reform.
11. Fourth the private sector will further expand when the existing businesses recover and begin to use up more capacity and even to expand.

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[5] Dennis O. Odife, "Banking, Insurance and the Capital Market in Nigeria: New Synergies for Economic Recovery", Lagos Chamber of Commerce and Industry, 13th September 2001.

[6] Dennis O. Odife, "Promoting SSI and SME in Nigeria", contained in "Financial Markets in a Democracy", Tolbrook Limited, Ikeja, Nigeria, 2000, [205 p].

12. Fifth the private sector will further expand as a result of foreign investment whether by Nigerians bringing back their money or by foreigners, including Africans in Diaspora coming to exploit new opportunities in Nigeria.

Private sector ownership and leadership of the economy is therefore of strategic importance to every African country. Hence if the Scheme were to fail it would not in my view be because implementation was faulty. Rather it would be on account of design errors, which are still present in the conception of the Scheme. For these reasons, I shall expatiate on the issues once more in the hope that they will be better understood this time. It is my hope and prayer that policy makers will use them to enhance the design of the scheme to make implementation easier and more straightforward.

In so doing I shall be repeating some of the points made in the earlier papers. I shall as much as possible be doing so only where, in my view, the issues involved can be better focused, this time with possible examples to make them better understood. I shall also introduce a number of other concepts that may have been mentioned earlier though only in passing.

a) Clearer Identification of Beneficiaries

Who are the intended beneficiaries of the SME Funding Scheme?
There is need for the beneficiaries of the scheme to be more clearly identified. Whereas the promoters of the existing SME and SSI in the country think that they are the sole beneficiaries of this fund, and even the banks may think so as well, they all do so in error. Since the fund is a growing one, its beneficiaries must include **not only existing SME/SSI but also potential ones.**

The requirement for African ownership and leadership of NEPAD adds a further dimension. Seen as a component of NEPAD all Africans will be obliged to embrace the promotion of SME and SSI wherever they live in their respective domains and countries as a way of achieving rapid growth and development therein. There lies the promise of growth. Nigerians, young men and women, old and young, and indeed all Africans, who are desirous of establishing their own businesses, will now have a chance to do so under this scheme. They must be told and they must be encouraged to reach out to the scheme and to take advantage of it to set up their own SME or SSI. Some will fail, some will succeed, and that is how it should be.

Clearer identification of beneficiaries will lead to an expansion of the **universe of persons** to which the scheme should apply. Young graduates as well as retired persons who think they are able to set up SME are thus challenged and invited to strive to participate. They are all invited to learn more about NEPAD, **to learn about this scheme**, to understand the need **for entrepreneurship training** and **to find out which SMEs are best suited to their localities.** Thereafter, they are invited **to think more of investing than of making frivolous expenditures**. They are to be encouraged to see their **destiny as a matter of choice** and to find ways to accumulate capital for enterprise promotion. This can only be good for both the banking system and for the African economy.

To help this later group participate in the SME programme may also require that we look to the **idea of incubation centres** such as they have in Israel and Malaysia, to name a few places. Promotion of SME/SSI development in Africa would probably require more extensive and aggressive enterprise incubation than in other parts of the world, in view of the scale of the problem.

b) Provision of Entrepreneurship Training for the Beneficiaries

All beneficiaries of the SME programme have something in common; they all need **entrepreneurship training** to enable them to refocus their ideas and to bring out their best. Banks, as implementation agents of the scheme, must find ways to assist SME promoters in this regard. Banks can do so by themselves running **entrepreneurship-training programmes** all over the country, **not just in Lagos and Abuja**, and by running such training programmes at affordable prices. Alternatively, they may encourage other training organisations including NGOs to provide such training. The same would apply to other countries once the programme is adopted continent wide.

Such training should also include **the identification of potential projects** especially where it is backed with research showing **the gaps in the production or demand/supply of particular items** in the country.

The identification of projects that could be done in particular areas of the country should therefore be a **major national research effort in the drive to discourage trading and to promote industrialisation**. African countries should all embrace this approach as an aspect of NEPAD.

c) SMEs need lots of Financial Advice

Even the existing SME/SSI are unlikely to automatically qualify for bank equity without some financial advice, however provided. Some banks may provide such financial advice themselves. Many of the SME in the country are already distressed and in need of reactivation and refurbishment. The books of accounts of SMEs are seldom in order and their audits may be in arrears. Not being obliged to report to anyone, most SME operators take their time in getting their records straight. Moreover, even when they do so, they probably grossly understate their incomes for tax purposes. Based on such understated incomes, they may therefore look unattractive to any potential investor. In addition, they are likely to resent the possibility of their performance and the worth of their businesses now being judged on the basis of such ‘defective’ records. They will need time to set the records right but time is hardly on their side. We need to persuade SME operators who fall into this category, (and they are probably in the majority) to come forward and we need to find ways **for the system** not to penalize them for the errors of the past.

African nations may need to review their corporate reporting frameworks to capture the essential data of SME operators without pushing them into the revolt bracket that Hernando de Soto[7] explained to be a major cause of informality.

d) **SMEs unlikely to be able to pay for Advice**
Most SMEs operate on a small scale for lack of funding. They practically live from hand to mouth and scarcely have funds with which to purchase hardware, talk less of paying for 'software' in the form of financial advice. **They may in fact not even appreciate that they need such advice** and even when they do, they may not be able to pay for such advise.

Moreover, **not many banks are competent to render the sort of advice that SMEs need.** However, banks have the means to retool quickly and to pull in the experts who will give such advice as part of their services. Banks are now doing this and setting up SME Departments as part of universal banking. The existence of the SMIEIS and the large reserves banks have accumulated is an added impetus for them to set up such desks or departments and to man them appropriately.

Banks will also have to discover innovative ways of providing such financial advice to needy SME for the mutual benefit of all. In the context of NEPAD and the regeneration of the African continent, **African nations will all have to refocus on how to educate their people for entrepreneurship and how to offer the sort of advice which SME operators need on terms which are affordable.**

e) **SMEs need Equity but prefer to take Loans.**
As was noted above, most SME tend to be undercapitalised precisely because the promoter did not have the resources to plough into the business. After operating as a one-man show, such promoter is however resentful of any attempt to share control of his business, which is what equity represents. The entrepreneur would thus rather **prefer to take a loan**, which he or she hopes to be able to repay soonest, than to receive any bank's equity investment. In addition, entrepreneurs would prefer to receive such loans at some **low concessionary rate of interest.**

Unfortunately for such promoters, the SMIEIS is an equity fund and not a loan fund, and banks are not permitted to give out any part of the SME reserve as loans. In addition, in the **current monetary policy environment of tight money**, banks are unlikely to lend other funds to the SME at affordable interest rates, until the issue of high interest rates in the economy is better resolved.

The challenge of NEPAD is that it would oblige all African nations to seek macroeconomic stability and to pursue policies that bring interest rates down to acceptable levels. Each government is thus seen as the architect of its peoples' fortunes, good or bad.

f) **Banks have equity funds to give but prefer to give loans**

[7] Hernando de Soto: "The Other Path: The Invisible Revolution in the Third World", I.B Taurus & Co, Ltd. Publishers, London, 1989.

On the side of banks, the truth is that the SMIEIS (Small and Medium Industries Equity Investment Scheme) is a fund to be invested in the capital market but very few banks understand and play in the capital market. They therefore lack the skills to handle this programme. Equity investment is more risky than lending and banks are merely being risk averse when they prefer to lend than to give equity. They usually take securities for lending and can even appoint receivers or receiver–managers to recover the loan. For their equity investment, there is absolutely nothing they can do in the event of failure, except perhaps take over such business and run it better than the promoter.

On the other hand, it may be that banks are simply disinterested, because the SME Reserve funds are already outside their balance sheets, to all intents and purposes. Banks would perhaps prefer the traditional option of lending rather than venturing into the new area of stock investing especially in unquoted securities.

From this point of view the SMIEIS represents both a challenge and an opportunity. It challenges the banks to find out the best way to deal with the problem, and it is an opportunity for them to learn about the stock market and to discover the hidden value in the SME sector of the economy and their operators.

In the context of SME funding, this aspect of getting the funds into the SME is the problem of delivery. In the context of the NEPAD, ownership is more in keeping with equity and the capital market than with the money market. **Sourcing the funds from the banking sector for investment in SME equity is ingenious but the true masterstroke will be achieved when the banks are able to deliver such funds to the needy SME in the context of African capital markets.** The current state of African capital markets need not be a deterrent. If existing markets are not suitable, it is perhaps because they were not designed with the small African investor in mind. The challenge under NEPAD is to design the sort of capital markets, which have the small African investor in mind and which will trade the sort of securities that he and perhaps not the foreign investor would like to invest in. **Such capital markets will probably be smaller, slimmer, [thanks to IT] and be community based.**

g) What is the Fair Price for the Shares of the SME and who determines it?

In all of the argument about investing in SMEs, no one appears to have taken cognisance of the fact that investment in equity means **investment in the shares of a company** and that there has to be a framework for determining the **initial fair price** to pay for such shares.

First of all, the shares must exist, which is to say that the capital of the SME must be large enough to accommodate the planned investment by banks. To achieve the appropriate capital size, appropriate stamp duties must be or must have been, paid to the relevant government office such as the Corporate Affairs Commission. This is usually a significant investment that many SME are reluctant to make at all.

Second, is that as said earlier, the SME promoter probably understated his true earnings in the past. He now has to sell his shares not on the basis of past achievement but of future potential. He must thus pay for fresh feasibility/viability studies, including projections as a way of justifying the value of the shares. An independent broker or firm of valuers or firm of chartered accountants may have to be appointed by both parties to value the shares.

Most crucial of all is the answer to the question; does the bank intend to be able to re-sell the shares at any stage to any party other than the promoter? In a private company, the bank has to offer the shares first to the promoter. If the promoter does not wish to buy the shares or does not agree with the price, he can of course block any sale. He can do so because in a private company, the right to transfer is usually restricted. It is only in a public company that shares may be freely transferred. **In venture capital parlance, we are speaking of an 'exit strategy'. No bank would wish to make an investment for which it cannot envisage an exit. The capital market framework, representing the ability to sell the shares at will, represents such exit.**

The public company is therefore the ideal vehicle for the investment of shareholder's funds by any bank. **The value of shares in a public company can be determined at any time by reference to the official list of the stock exchange.** For public but unquoted shares, the OTC (Over the Counter Market) where it exists, usually provides a reference price. Nevertheless, this would mean that the SME has to become a public company for the purpose of participating in this scheme. Is this what the scheme intends?

Even if the scheme did not intend this, I urge that we need to amend the new initiative by banks to fund SMEs to enable it to provide for this. I argue further that the scheme will only succeed to the extent that we expand our market infrastructure to include markets for trading in the shares of eligible SMEs, and so continually determining the price of their shares.

As I have argued above, even though SME promoters are looking for money they may not necessarily want bank staff on their boards, telling them what to do. It should be recalled that bank SME directors may not even be the most senior bank staff, **and that it would not even be in the best interest of our economy for senior bank staff to abandon the management of the banks to run from one board meeting to the other in the SMEs in which their banks have invested.** Moreover, for all their wisdom and skill, banks do not of necessity have competence in the running of SMEs. Their contributions, on the boards on which they serve are thus likely to be questionable and possibly unproductive and acrimonious. **Both parties would therefore need umpires to keep them on their toes and of good behaviour at all times**. Such umpires are best provided in the form of **other holders of the shares of the same SME** and an **impersonal framework like the equity market.**

In an earlier section, I drew attention to the possibility of slimmer IT-enabled community-based capital markets focused on the small African investor rather than the foreign investor. I have in mind market frameworks such as the OTC,

Over The Counter market, or **Capital Trade Points.** Such frameworks would enable any shareholder, including the investor bank or banks to sell their shares to other investors and to withdraw gracefully when necessary from the project and without killing the SME. It would also make it possible for other investors who may have appetites for SME/SSI equities to be able to participate in them without owning them exclusively. These ideas are not new. The concept of Capital Trade Points as a framework for the trading of SME equities in various zones of the country was a major proposal of the Panel on the Review of the Nigerian Capital Market in 1996[8], which it was my privilege to lead.

As a final note, I have to observe that 'public-ness' may need to be redefined in the context of SME ownership. The company laws of most nations now prescribe a minimum of fifty persons to make up a public company. It should be possible, if the laws are suitably amended for NEPAD, for less than that number to make up a public company. This has recently become the practice in some jurisdictions outside Africa.

Compulsory Education for the Banks

One other benefit of the Nigerian Banks SME Funding Scheme is that all Nigerian banks are now obliged **to study the equity markets and to understand how they are structured, how they are regulated and how they operate**. The success of the Scheme will thus depend on how seriously they undertake this assignment, what they learn from it, and how they use such knowledge. African ownership of the NEPAD will similarly require all Africans, including Africans in Diaspora to study not only the NEPAD but also hopefully the promotion of the SME sector in Africa in the context of African capital markets. The SMIEIS is an equity scheme and banks will have to account to both the reserve banks and their own shareholders for how their own funds therein perform. They will not be able to do so unless they take a deeper interest in the equity markets of this great continent.

This reorientation of all African banks in the direction of equity markets would qualify as a revolution in its own right and may well be the greatest benefit arising from the SMIEIS to Nigeria in the new democracy, and to Africa. Similarly, the reorientation of all Africans in the direction of ownership and leadership of NEPAD through the promotion of the SME sector, and in the context of African capital markets could become one of the greatest achievements of the NEPAD and the African Union.

- It will focus attention on an internal source of some of the required funds,
- It will focus the attention of Africans towards investing in Africa;
- It will focus attention on African capital markets and hopefully showcase their inadequacies for the task ahead for immediate remedial action.
- It will invite the attention of all Africans in Diaspora to the great revival in Africa.
- It will provide a sound basis for genuine partnership.

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[8] D. O. Odife: "Changing Trends in Stock Exchange and Capital Market Development: Lessons for Africa" published by UNITAR, 'Capital Market Development: The Road Ahead – Document No. 13', Geneva, November 2000.
Federal Government Printer, Abuja. Report of the Panel on the Review of the Nigerian Capital Market, Federal Ministry of Finance, Abuja, Nigeria, 1996.

I doubt if the foreign investor too will be left far behind in seizing the immense opportunities that will be unleashed by such a profound exercise.

Solving the Infrastructure Problems of SME/SSI.

During the earlier aforementioned presentation, I explained that one of the problems of our SMEs is the high cost of infrastructure, which they have to bear alone. I remarked that:

> "… I cannot end this address without looking at the problem of infrastructure which increases the cost of investment for all in Nigeria and especially the SME/SSI who are least equipped to bear the burden. In this category are power, water, transportation, communication and security. One thing such infrastructure have in common is that they are crucial and it is easier to own them jointly than for each of us to try to provide his own. The second feature is that they are large in scale and expensive to construct. It takes a very long time to recover the investment in them**. Usually, they are funded with debt rather than with equity, long-term debt of the sort that we in Africa do not have the markets, with the possible exception of South Africa**. Because of these features they are best provided by utilities, or by a central authority. …"

Such infrastructure includes the cost of land, fencing, security, factory building, power and water. On average, the 80:20 rule in which 80% of the costs of the SMEs abroad are spent on equipment and 20% on infrastructure is reversed in Nigeria such that 80% is spent on infrastructure and 20% on operating equipment. For the success of the scheme to be guaranteed, there is need to assist the SMEs to reduce the cost of infrastructure. **One way to do this is to assist them to operate in clusters or in Industrial Estates, of the type in Wales where basic infrastructure is put in place. The Nigerian Vision 2010 report fully anticipated this solution in 1997 when it proposed the establishment of 'industrial clusters' in various parts of the country. The eventual coalescence of these industrial clusters would make Nigeria one giant industrial conurbation in Africa**.

The approach, which I would suggest, is for banks, working alone or in collaboration with themselves or with state governments and other high net worth individuals, to jointly establish industrial estates. These estates will bear the cost of infrastructure and pass them on gently to SME/SSI, which take up abode in such estates. Aside from Wales, I suspect that this is something we can learn from South East Asia, and that it will be an additional contribution by us to our economy as we try to take advantage of the Nigerian Banks SME Funding Programme.

Conclusion

The paper introduces the NEPAD programme of the AU and argues successfully for its immediate implementation. The NEPAD itself is an ambitious programme for the rejuvenation of Africa through African ownership and leadership of the programme. A major weakness is that it adopts the position of a moral minority rather than an ideological one. Another weakness is that the Top-Down approach to its articulation rather than the Bottom-Up approach more applicable in a democracy robs it of broad-based African ownership and leadership so critical to its success. Furthermore, it predicates its success mainly on external

funding to bridge the perceived development gap. In the face of NEPAD's obvious funding difficulties, the paper argues alternatively for seeking potentially more rewarding African ownership and leadership of NEPAD through the promotion of the SME sector in the context of African capital markets.

It then showcases the Nigerian Banks SME Funding Programme (SMIEIS) as being worthy of emulation notwithstanding its teething problems. Properly redesigned and implemented along the lines proposed in the paper, the Nigerian Banks SME Funding Programme or the SMIEIS presents a possible model for adoption across Africa. The SMIEIS removes finance as an impediment to the establishment and growth of SMEs in Nigeria. The residual delivery problem is to be resolved through collaborative action with the regulatory authorities and the public to embrace African capital markets appropriately redesigned for the trading of SME securities.

The paper concludes that the restructuring of African capital markets which must follow, together with the mass mobilisation, and re-education of Africans and African institutions for the process, will awaken investor interest, African and non-African alike, in investing in Africa and thus hasten growth and development as NEPAD seeks to achieve with international goodwill.

THE DEVELOPMENT OF MICRO-CAP SECURITIES MARKETS IN SUB-SAHARAN AFRICA: NEW APPROACHES TO FOSTERING ENTERPRISE GROWTH

by Professor Stuart R. COHN

Introduction

The problems affecting capital market development in sub-Saharan African ("SSA") countries have and continue to be studied, analyzed, and dissected in a variety of offices, forums, and workshops. One of the more promising efforts in recent years is the region's adoption of the principles and goals of NEPAD, the New Partnership for African Development. NEPAD presents a comprehensive program to foster the region's entrepreneurial capacities.

There is much that is commendable in the NEPAD initiative. Foremost, in my judgment, is the recognition of the importance of fostering the growth of small medium-sized enterprises (SME's) at the micro-economic level. It is through the development and growth of the SME's that national economics will improve. SME's offer significant prospects for increased employment, increased utilization of the region's productive and intellectual resources, improved tax base for government revenues, and low-cost accessible investment opportunities for local populations. SME's are Africa's future. Large companies have already done what they could and cannot be expected to grow much larger or provide materially greater economic impacts into local economies. The growth potential of SME's is the principal hope for the future of improved productivity, employment, tax revenues, and infrastructure capacities.

Despite NEPAD's promising goals, Chief Dennis Odife forcefully argues in the accompanying article that the NEPAD initiative is inherently flawed by its fundamental reliance upon non-African financial sources. As he points out, such reliance will lead to continued dependence on and lender controls by non-African institutions. I believe that Chief Odife's analysis is correct, and that NEPAD's promise can only be achieved through internal financing and growth. This paper promotes an alternative approach to NEPAD's exclusive reliance on external funding, one that seeks to foster domestic investment, particularly in small and medium-sized enterprises that dot the African commercial landscape.

Sub-Saharan Africa is rich in resources and entrepreneurial spirit. A principal problem has historically been a lack of domestic capital infusion to initiate business opportunities and to support sustained business growth. This paper proposes that steps be taken to create micro-cap securities markets that will allow SME's to raise capital through local limited securities offerings not currently possible under the statutes and regulation of most sub-Saharan countries. By the term "micro-cap," I refer to those companies that are too small to meet listing requirements on most stock exchanges and that generally are not sufficiently developed to undertake the expense and effort of a registered public offering under current offering requirements.

The proposals require thinking "outside the box" of the traditional and conservative existing company and securities laws. An important starting point is the realization that traditional standards have not worked to promote small business development. That is no surprise, as the standards are by and large based on English models that are both old and limiting. If we do not want to continue to plow the same barren fields, models need to be developed that give promise of a more fruitful harvest. That is the promise that NEPAD offers through its emphasis on promoting the development of local enterprises. If innovative models can succeed where old ways have not, the need to rely on foreign capital could be significantly reduced.

The Problem of Capital Financing

Where do start-up and developing companies obtain their working capital? This is a universal dilemma not confined to sub-Saharan Africa. Throughout the world, small and growing businesses mainly rely on family, friends and small bank loans as their principal capital sources. In the United States, many young companies are funded through multiple credit card borrowing, a source not readily available in the region where credit cards are not commonly available. In some more developed countries, governments have established financial assistance programs for smaller companies, whether by way of direct grants or indirect loan guarantees. These programs are not generally found in the sub-Saharan region.

Today's business market is capital intensive. Information technology is expensive, so too is meeting regional and even global competition that the IT boom has generated. Without access to needed capital resources, businesses stay small. A small business might find a comfortable market niche, but without substantial input of additional capital it is not likely to grow. Where can growing businesses turn for additional capital? Once friends, family, and other personal resources are exhausted, where is the source of new capital? Unfortunately, those sources are very limited. They are limited by reason of access, not because they do not exist. Restrictive company and securities laws do not make it feasible to attract capital through securities offerings. Without the ability to make limited public offerings, companies are stymied in seeking new infusions of capital. In some more developed countries, venture capital firms provide a major source of funding. Unfortunately there is relatively little venture capital in the SSA region. As a result, by default and by tradition, banks are the principal capital funding sources for SME's.

Bank financing presents two significant hurdles. One is that banks are notoriously reluctant to loan a significant amount of money to smaller businesses in the absence of collateral or solid personal guarantors, neither of which are usually available. Bankers are remarkably unimpressed by pro forma financial statements showing anticipated cash flows and profit potential. As the old maxim goes, if a bank is willing to give you a loan, you probably don't need it.

The second problem with bank financing is more endemic to SSA, and that is the historically high interest rates charged on commercial loans. Rates vary among countries, but interest in the range of 25%-35% is quite common, and it is rare to see interest rates below 20%. Such interest rates are beyond the capabilities of many SME's. For many developing companies, research and development costs, marketing expenses, and capital outlays are very high in early years relative to revenues. Even if profits are attained, margins are not likely to support interest payments in excess of 20%. Even seasoned and well-established companies would have difficulty meeting such payment obligations. If loans are sought outside of the

formal banking system, payment terms are no better. The informal lending market generally charges more, not less, interest, as they are accustomed to dealing with higher risk ventures and peg their rates accordingly.

If bank financing is not available or too costly, there is little alternative for the entrepreneur but to hope that the undercapitalized business is able to generate profits on the proverbial shoestring. That hope is often long on optimism and short on reality.

The lack of adequate funding sources in SSA requires that new approaches are needed to address capital financing concerns. Otherwise, economic development will continue at its slow, inadequate pace and NEPAD's goals will not be achieved. What I propose is an overhaul of company and securities laws and regulations that will permit the development of micro-cap securities markets for SME's. Nothing is suggested that is not already working in other countries. In that regard, the suggestions take into account the important goal of investor protection, an inevitable concern when discussing easing limitations on capital raising. Measures are recommended in this paper to address that concern.

Current Impediments to SME Securities Offerings

Several reasons exist that preclude SME's from going into the public market to raise capital through the sale of securities. The principal reasons include:

1. Company Law Limitations

   Company law throughout most of SAA is similar, owing their common inheritance from English and colonial statutes. The principal division in the company laws is between private and joint stock companies. Private companies are limited to no more than 50 shareholders, the securities are non-transferable, and private companies cannot offer any shares or debentures to the public. Joint stock companies, by contrast, can issue transferable securities and have any number of shareholders.

   The dichotomy between private and joint stock companies is a long accepted construct but on close examination does not have any basic justification other than tradition. There is no reason why the structure, rights, and obligations of all companies that have equity shareholders should not be the same. That is the situation in the United States, where one corporate law applies to all companies, large or small. There is no compelling reason to support the prohibitions against selling securities and against the transfer of securities that apply to private companies. Such prohibitions preclude effective capital raising by private companies and have no inherent justification.

   As a result of current company laws, private companies are limited to trying to attract investors who will be locked into their investment for an indefinite period of time. This is an extremely difficult task and should not be necessary from either a legal or economic perspective. If a shareholder of a so-called private company desires to sell his or her shares, the transaction should be governed by the securities laws, similar to any other stock transaction. Full disclosure is the key, and that applies to all companies, large and small. One might argue that the shareholder can sell his or her shares when (and if) the private company eventually becomes a joint stock company,

but the timing of such transformation is uncertain and meanwhile investors hold an illiquid asset.

More significant as impediments to capital raising are the public offering provisions of most company and securities laws. Any offering of securities, regardless of size or number of purchasers, must comply with the full registration process set forth in a schedule to the company law statute. The registration requirements are essentially the same in those countries that have adopted securities legislation to replace or supplement the traditional company law. There are no "private" or "limited" offering exceptions. SME's desiring to raise a relatively small amount of capital must go through the same costly, time-consuming process of registration as if it were a multi-million dollar offering. SME capital requirements are often too low, too sporadic, and too immediate to warrant the required registration process. I have not examined all of such statutes, but ones that I have reviewed do not provide meaningful exceptions to the registration process. In a recent workshop in Harare, Zimbabwe, attended by representatives of 12 different African countries, not one participant was aware of any private or limited offering exception to the registration process.

2. The Problems of Listing on Stock Exchanges

Even if an SME was willing and able to undertake a full registration process for the sale of securities, there is likely to be very little investor interest because of the lack of a secondary market. A secondary market is the trading forum for buying and selling shares by shareholders. A stock exchange provides a secondary market for shareholders of companies listed on the exchange. Potential investors are not inclined to purchase securities if no secondary market exists for subsequent resale. Or, if they are willing to buy illiquid securities, they will do so only at depressed prices. For shares that have no trading market, a shareholder would have to find his own buyer, determine a price, and negotiate all elements of the transaction. This is highly inefficient and not an attractive prospect to potential investors. Thus, companies selling their shares to the public announce their intention to list the shares on the exchange so that a secondary market forum can exist. The promised existence of a secondary market makes the initial offering of securities more attractive.

Two serious problems exist in this area for SME's. The first is that many SME's, even after the sale of shares in a public offering, will be too small to meet exchange listing standards. Stock exchanges listing requirements are usually quite high with regard to company assets, number of shareholders, and market capitalization. SME's in their early years of development are unlikely to meet listing requirements. Hence, such companies cannot provide an stock exchange listing to potential investors.

Some exchanges, recognizing the problem and seeking to attract smaller companies into their fold, create listing tiers. Tier I is composed of large companies that meet the regular listing requirements. Tier II is composed of smaller companies who qualify under modified listing standards. Although this arrangement has the merit of allowing

smaller companies to be listed on the exchange, in practice the two tier system has generally not been successful. Many investors regard second tier companies with skepticism. A Tier II label is like a badge of demerit ---- a Tier II listing connotes a public company that is not "good enough" to make it to the "big board." Hence, trading in Tier II stocks tends to be sparse. This adversely affects both stock prices and liquidity (the two are linked). The potential of a Tier II listing is thus a meager inducement for SME's and potential investors.

3. Lack of An Over-The-Counter Market

The inability to meet exchange listing requirements would not be a serious impediment to a public offering by SMEs if those companies could assure potential investors that an over-the-counter ("OTC") market would be created for secondary trading. An OTC market provides a liquidity function for shareholders similar to that of an exchange. The OTC market can be as active and efficient as an exchange. Most secondary trading in the U.S. occurs in the OTC market. Indeed, some companies prefer to remain in the OTC market even if they have the size and configuration to be eligible for exchange listing. These are often companies that started small, developed an active OTC market for their shares, and now see no benefit to listing their shares on an exchange despite their qualification to do so.

Unfortunately, an OTC market does not exist in most SSA countries. Zimbabwe, Nigeria, and a number of other countries actually prohibit an OTC market, for their stock exchange rules preclude brokers from trading in any securities not listed on the exchange. Other countries that do not have such a prohibition have not established any rules on requirements for OTC trading, which effectively results in brokers avoiding trading activity because of the absence of standards.

It would be wrong to suggest that the mere act of creating the mechanism for an OTC market is a panacea for SME liquidity problems. An OTC market requires brokerage firms willing to undertake the time and cost in its development, it requires a regulatory agency willing to adopt trading and disclosure rules, and it requires a sufficient number of companies on the OTC market to make the whole endeavor worthwhile. None of this will happen overnight. But it will never happen without changes in statutes and other rules to allow SME's to more readily solicit capital from the public.

If standards are put in place for an OTC market, that will also facilitate trading of securities through the Internet. The Internet is becoming the trading vehicle of choice for many investors. Although many investors might avoid SMEs because of risk and liquidity concerns, the ability of SMEs to have their shares traded over the Internet creates an additional marketing tool for capital raising.

2.

4. Tax and Financial Disclosure Concerns

An oft-stated major impediment to attracting SME's to make public offerings is the concern that the required disclosure of audited financial statements will alert government authorities to possible prior under-reporting of taxable income. The two sets of books phenomenon is frequently noted in discussions. The tax collector sees a set of books that show little if any profit, while the owners' set of books shows the true condition of the company. If the company were to make a public offering that requires audited financial statements, prior under-reported income might be disclosed. Visions of fines and jail terms for tax evasion dance in the heads of SME owners who are being encouraged to undertake public offerings. For owners of SMEs who are at risk in such a situation, the decision to forego the offering is an easy one, even if the result is a foregoing of much needed capital for the company.

The idea of a tax amnesty has been floated from time to time as a means of encouraging companies to sell and list their shares on the exchange. Strong legal and political reasons, however, militate against the adoption of any forgiveness program. And so the problem remains. A number of countries offer a reduction in the corporate tax rate (such as from 35% to 30%) for companies listed on the national stock exchange. In light of the relatively low number of private companies that have chosen to list on stock exchanges, current tax inducements do not appear to be very effective. More thinking needs to be done to resolve this very practical problem. Several suggestions are discussed below in the Proposals portion of this article.

5. Control Concerns

Owners of SMEs are understandably reluctant to sell securities to the public if the result is a diminution or loss of management control. This is a very real personal problem, especially for SME's developed and nurtured within family units. It is a problem, however, that can be addressed through education of company owners as to alternative offering techniques, and through changes to existing statutes and regulations to permit more diversified ownership interests.

Proposals for Development of Micro-Cap Markets

In response to the problems and concerns discussed above, adoption of several new measures are necessary to foster micro-cap markets in which SME securities can be sold and traded. They include the following:

(A) Exemptions for Registration

Registration requirements, whether contained in company laws or securities laws, should be modified to allow exemptions from registration for qualifying SME's that conduct small or otherwise limited offerings of securities. Exemptions could be developed based upon one or more of the following elements:

- the amount of securities being offered,
- the knowledge and experience of the potential investors
- the relationship of potential investors to the company
- the financial abilities of the potential investors
- the degree of government regulation already applicable to the issuing company (such as regulated entities), or such other factors as policy-makers consider appropriate. In the United States, different exemptions from registration exist for offerings up to $1 million (Rule 504), offerings up to $5 million (Rule 505 and Regulation A), and for offerings of an unlimited amount directed at knowledgeable and experienced investors (Rule 506 and Section 4(2)). Based on analogous factors, registration exemptions in SSA countries could be considered, for example:
  - for offerings below a certain amount,
  - for offerings between certain minimum and maximum amounts that are accompanied by basic disclosure documents,
  - for offerings only to experienced and capable investors, such as institutional investors, investment funds, unit trusts, and persons meeting net worth tests (called "accredited investors" in the United States),
  - offerings limited to persons who have a direct relationship to the company, such as employees, creditors, suppliers, consultants, and principal customers.

Investor protection must continue to be a central element of all securities offerings. The following measures are among those that could be considered appropriate in adopting registration exemptions:

- Exempt securities offerings would continue to be subject to all liability provisions applicable to registered offerings. The exemption would apply only to registration, not to disclosure liabilities.
- All exempt offerings would be made only through a written disclosure document provided in advance to all purchasers. No offers to purchase securities could be accepted without prior delivery of the disclosure document.
- The requirement for audited financial statements could be modified or entirely eliminated for some types of offerings, but un-audited financial information should be set forth to the same extent and in the same manner as with audited statements.

- The disclosure document need only contain fundamental information that is necessary to an understanding of the company and its management. Such fundamental information could include, for example:
  - a brief history of the company
  - names and business experiences of each of the directors and officers
  - description of any transactions entered into or proposed between the company and any of its directors or officers
  - description of the products and services provided by the company, with approximate percentage of respective contributions to revenues and profits
  - proposed use of proceeds of the offering
  - information regarding the potential secondary trading market for the securities
  - a list of risk factors advising potential investors of the principal categories and risks faced by the company and shareholders.
  - The securities commission, capital markets authority, or Central Bank division charged with supervisory powers regarding securities offerings could consider adopting "merit review" standards for exempt offerings. The concept of merit review allows agencies to refuse to permit an offering to proceed if the agency concludes that the offering involves to high a risk of loss to investors. There is a wealth of merit review standards developed by the North American Securities Administration Association (NASAA) that could serve as a basis for adoption of local standards. Regulators should keep in mind, however, that SME's often experience difficult times in early years. If offerings are not allowed to go forward until certain profit levels or assets are achieved, the purpose of promoting SME offerings may be significantly undermined.
  - Directors, officers, and other insiders should be prohibited from immediately selling their shares in whatever secondary market is created by reason of the SME's public offering. Such sales would have the inevitable effect of depressing market value, leaving the newer shareholders holding shares that might have a reduced market value. Exempt offerings should include the requirement that company insiders can sell their own shares in the ensuing public market in limited quantities spaced over time. This is analogous to the Rule 144 in the United States that applies such resale limitations on all control persons.

(B) <u>Creation of An Over-The-Counter Market</u>

Just as the privatization movement required the establishment of stock exchanges in those countries lacking them, so too the loosening of strictures on SME securities offerings requires the development of an over-the-counter market. As previously noted, most SME's will not qualify for stock exchange listing, even after engaging in a public sale of securities. Tier II eligibility standards might be met for exchanges that create tiers, but the trading experiences for Tier II companies have not been generally successful. One approach to the 2-tier problem is to have only one tier of listed companies, all meeting the same listing standards. This would require a reduction in listing requirements to bring SME's into the trading market, a move that is likely to be opposed by many exchange managers.

The better course might be to develop an OTC market in which brokerage firms assume responsibility for creating and operating trading markets for SME and other unlisted companies. There is financial incentive for brokerage firms to create such a market, as they benefit from share trading both as principal (when buying or selling shares they own) and brokers (through trading commissions). Additional advantages exist, including that OTC transactions are off the exchange and therefore not subject to exchange trading hours, price or spread limitations.

Creation of an OTC market will have to overcome current restrictions in some countries on brokers trading in equity securities off the exchange. This measure, designed to promote companies to list on the exchange, has not led to a significant growth in private company exchange listings. A new approach is in order. There is nothing novel about the OTC market. More companies are traded in the OTC market in the United States than on stock exchanges. The fact that an OTC market is established will serve to encourage SMEs to consider raising capital through public or limited offerings, as potential investors in those companies will know that a secondary market for resale of the securities is in existence.

A major concern in the OTC market is the development of quotation and trading standards. Since a large part of the OTC market is somewhat invisible, taking place mostly in broker-dealer offices, there should be a clear set of regulations applicable to OTC trading. In developed countries with OTC markets there exist substantial rules and standards to assure transparency in OTC transactions and customer fairness. Many of these provisions can be readily imported into existing capital market structures. Indeed, the growing use of the internet for secondary securities trading renders the existence of an OTC market inevitable. (See, "New Flow of Trade," Financial Mail. August 23, 2002, p. 20: "Trading in companies listed on African stock exchanges has never been easier, thanks to Johannesburg start-up LiquidAfrica's Internet-based rating and financial information platform.") Rather than subject the OTC market to the perils of an uninformed market, regulators should formalize requirements and procedures. This could be best achieved by working closely with broker-dealers in developing standards and practices for an OTC market. Broker-dealers should be encouraged to form a self-regulatory organization (SRO) for both rule-making and internal disciplinary measures, analogous to the stock exchange SRO that governs exchange trading.

A major gap in the securities legislation of most SSA countries is the failure to address disclosure requirements for non-listed companies. In countries that do not ban OTC trading, an informal market might exist to handle occasional buying and selling of non-listed company shares. If the OTC is to be developed and formalized, disclosure requirements analogous to those of listed companies should be adopted. That includes periodic reports disseminated to broker-dealers, shareholders and the media, and requirements for timely announcements of material events. Shareholders and potential investors in OTC companies are entitled to the same quality of information regarding material company developments as investors in exchange-listed companies.

(C) Improved Tax and Other Financial Incentives

Those interested in capital market development can plan and put procedures in place from here to eternity, but a viable market will not develop unless privately owned companies respond affirmatively. In that regard, the disclosure problem related to the reporting of company income noted above looms large. This problem must be more forcefully addressed if SME's are to be encouraged to go to the capital markets.

There is no easy solution to the problem of past transgressions. Amnesty is not politically or socially feasible. Perhaps, however, the problem is not as severe for many companies as generally considered. The disclosure problem will depend on whether and to what extent audited financial statements will be required for offerings that fall within a limited offering registration exemption. Offerings exempt from registration do not necessarily have to require the same degree of financial reporting as registered offerings. That is the case for exemptions in the United States. Under Regulation D (17 C.F.R. 230.501-508), for offerings up to $2 million the only audited statement required is a balance sheet. The income statement need not be audited. The same is true for offerings up to $7.5 million if the issuer cannot obtain audited statements "without unreasonable effort or expense." The limited financial disclosure requirements for exempt offerings in the United States have not proven to raise investor protection problems.

In addition, tax or other financial incentives could be affirmatively developed that will alleviate the disclosure concerns. Tax incentives could be granted to SMEs that develop a public market in their securities. Currently a number of countries provide some tax reduction for exchange-listed companies. The usual range is around 5%, e.g. from a 35% to 30% tax rate. That amounts to an effective tax reduction of approximately 14.3%. In my judgment this is a small incentive for most companies. The costs of registration and ongoing disclosures compliance can equal or exceed the 5% reduction in taxes, especially when one adds to these costs the increased exposure to securities law liability for both the company and its management and the annual accounting, listing, legal, and other costs associated with becoming a publicly-traded company. Moreover, a 5% reduction is scarce recognition of the potentially significant economic benefits that a company can generate by being an active participant in the country's economic development.

I would recommend a much larger tax reduction be provided to encourage SME public offerings. A reduction closer to 33% (e.g. from 35% to 23.4%) would be much more meaningful than the current provisions. A larger tax reduction does not necessarily mean a concomitant reduction in government tax revenue, given the history and tradition of under-reporting of taxable income. Indeed, the economic growth generated by the newly raised capital, including increased employment, salaries, and trading activity may well lead to a net gain in government revenues regardless of the amount of corporate tax reduction.

Other tax or financial incentives should also be considered. Capital gains and dividend taxes might be substantially reduced or eliminated for publicly-held SME's. Licensing and import fees might also be modified. Priority consideration for bidding by government contracts might be given to publicly-traded SMEs. A government-

backed loan program, similar to the Small Business Administration program in the United States, might be considered for qualified SME's. In some countries, NGO's have been formed to give financial and administrative assistance to companies engaging in public offerings. An example is the Business Uganda Development Scheme ("BUDS") created by the Uganda Private Sector Foundations. BUDS was developed as a cost-sharing grant scheme in which firms can receive up to 50% of professional and other fees incurred in public offering or other business planning schemes. No doubt other innovative financial incentives could be considered once policy-makers and the business community put their collective thoughts together.

(D) Education Program for SME Owners and Managers

A frequently voiced concern by SME owners is the potential loss of control that could occur through one or more public offerings of securities. It is certainly true that equity offerings could dilute the initial owners' percentage of stock ownership below majority levels. However, loss of control is not a necessary or even likely result even if a majority of the shares are sold to the public. Many owners and managers of SME's do not understand that they can maintain control of the company even under materially changed circumstances, nor are they aware of the significant economic benefits (in addition to capital raising) that can result from a public market in a company's securities. An ongoing educational process is required. The educational program could be developed by the securities commission, a Central Bank, a stock exchange or an NGO. What is important is the education process.

A public offering does not necessarily mean a loss of control of the company by existing management. Depending on capital requirements, an offering might involve less than a majority of the ordinary shares. Moreover, an offering need not consist entirely of ordinary shares. An offering that combines ordinary shares, preferred shares, and debentures could raise the needed capital with relatively little dilution of initial ownership interests. If company laws permit (if not they should be amended), multiple classes of ordinary shared could be offered, with management retaining control of the class that elects the majority of the directors. The New York Times newspaper is an excellent example of a publicly-held company involving one class of shares owned by the family of the early founders and a second class of stock owned by the public. The publicly-held shares pay a higher dividend than the management-controlled class. Dividends are often more important to shareholders than the ability to elect a majority of the board. Most shareholders have too few shares to have a significant impact on director elections and would gladly trade their ephemeral power to elect directors for a higher dividend rate.

This leads to the second main point to emphasize for SME owners, namely that even if they lose control of a majority of the voting shares they will probably continue to have working control of the company. Working control is different than absolute stock ownership. It refers to the fact that management controls the operation of the company regardless of the number of shares owned, and will continue to control management until a concerted effort to replace them is successful. History suggests that management can stay in control of a company long after the controlling family or founders have lost absolute voting control. That is because of a combination of investor support and the difficulty of replacing incumbent management. Investors

purchase company’s shares because they believe in the capacity of the managers. Shareholders do not revolt against existing management without good cause. Even if some shareholders become unhappy with management, it is no easy matter to displace them. Management often controls considerable number of shares, directly or through others, and they also are able to use company resources to fight any dissident shareholder movements. Unhappy shareholders must finance on their own any election fight, and that can be a very expensive undertaking. The advantage is entirely in the hands of existing management, who are likely to retain control of the company barring significant reversals, personal derelictions, or well-funded hostile take-over efforts by other companies.

A public market for the company’s securities offers important advantages to the company and management in addition to providing the opportunity for capital formation. Advantages include:

- allowing the founding family or other initial owners to “cash in” at least a portion of their shares and thus enjoy a substantial economic benefit for their years of hard work;
- giving the initial owners an opportunity to diversify their economic risk by selling some of their shares in the market and using the proceeds for other investments;
- creating a marketable security that can be used as incentive to attract, retain, and reward company employees; and
- creating the ability to obtain personal loans from lending institutions using marketable securities as collateral.

Other tangible and intangible benefits flow to management by reason of their company becoming public. A complete exposition is not necessary here. What is important is to emphasize the role of education in fostering greater interest among SME’s in considering the public sale of securities. Capital markets are a relatively new phenomenon in many sub-Saharan countries. Even the most astute business owner often thinks only of the potential downside and does not have sufficient understanding of the financial advantages that a public offering can provide.

Conclusion

With rare exception, capital markets in sub-Saharan countries have not developed or grown as hoped. There are numerous reasons, including a lack of quality parastatal privatisations, a reluctance on the part of privately owned companies to raise capital through public offerings, and restrictive company and securities laws and stock exchange requirements. Continuing along the same path offers little promise for significant growth. Innovative thinking and the adoption of new measures is necessary. In every country in the region there are numerous SME’s that could grow and prosper through the infusion of additional capital. Attention must be directed to how to facilitate such capital funding within the regulatory system. Investor protection and business development are not mutually exclusive concepts. Indeed, both can be achieved and a viable, efficient securities market can be developed for SME’s.

SME's hold the promise of the future, they are the instruments for achieving NEPAD's laudable goals. The creation of capital-funding opportunities and micro-cap markets for SME's is well within current capacities. There must be a will to innovate. If the will exists, viable micro-cap markets can be achieved within a relatively short time frame. The proposals set forth in this paper are intended to provide food for thought and a potential programme for reform. Although innovative, the proposals are well within the boundaries of sound policy and practice. It is hoped that NEPAD's vision of enhanced capital markets will spur consideration of new approaches to the fostering of enterprise growth.

PROFILE OF THE AUTHORS

Chief Dennis O. ODIFE was educated at King's College, Lagos, The University of Lagos, and the Graduate School of Business, Columbia University in the city of New York. He is an economist by training, a banker and Stockbroker by profession. Chief Odife joined the Council of Nigerian Stock Exchange in 1976 and was on the Council till 1979. In 1979, Chief Odife founded Centre-Point Investments Limited into which he invited other prominent Nigerians. He promoted Centre-Point Securities Limited and Centre-Point Merchant Bank Plc of which he is currently the Vice Chairman and Chief Executive Officer. He has authored and published over 200 academic and professional papers on various aspects of Nigerian economy especially on Money and Capital Markets Issues. Chief Odife is highly respected in his native hometown Nkwelle-Ezukana in Oyi Local Government Area of Anamba State, where he holds the revered title of OGBUEFI EZENWEGBU IV (the ancestral title of his fore fathers) and sits on the highest decision council of his kingdom. He has been a leading figure in the development of international financial markets in Nigeria and has advised on these issues in his country and abroad.

Professor Stuart R. COHN was educated at University of Illinois, B.A., Honours School of Jurispendence, Oxford University, B.A., Yale School, LL.B. He has lectured widely at Universities in the U.S.A., Germany and Uganda and has accumulated a number of educational awards and honours. He has published three books, numerous articles and other publications. Amongst these are "Securities Counselling for New and Developing Countries" and "Capital Market Development in Uganda". He is currently Professor of Law at the College of Law, University of Florida. Professor Cohn is also Senior Special Fellow of UNITAR since November 2001.

UNITAR

UNITAR is an autonomous body within the United Nations which was established in 1965 to enhance the effectiveness of the UN through appropriate training and research. UNITAR's programmes in the legal aspects of debt, financial management and negotiation are among a wide range of training activities in the field of social and economic development and international affairs carried out, generally, at the request of governments, multilateral organizations, and development cooperation agencies. UNITAR also carries out results-oriented research, in particular research on and for training, and develops pedagogical materials including distance learning training packages.

UNITAR's **Training and Capacity Building Programmes in the Legal Aspects of Debt, Financial Management and Negotiation** are conducted for the benefit of over 35 partner countries mainly from sub-Saharan Africa and Vietnam. These programmes aim at meeting the priority training needs of senior and middle-level government officials through a wide range of seminars, workshops, and training of trainers workshops. In parallel to training activities, the programme also assists in strengthening local capacities of governmental and academic institutions through distance learning training packages, up-to-date publications as well as networking activities.

During 2002, the programme will focus on :

- Training government officials through short-duration regional seminars and workshops on various aspects of debt, financial management and negotiation ;
- Developing On-line Training Courses (in parallel with its traditional regional training) with a view to tapping a wider audience and reducing cost of training per participant ;
- Strengthening existing ties with regional training centres and offering joint courses with partners in the field ;
- Creating awareness among senior government officials of the importance of the legal aspects in the borrowing process and of putting together a multidisciplinary team for loan management and public administration;
- Providing in-depth training and skills development for accountants, economists, financial experts and lawyers coming from government ministries and departments involved in negotiation, financial management and public administration ; and
- Developing and disseminating training packages and 'best practice' materials directly related to the practicalities of legal aspects of debt and financial management, with a view to strengthening existing human resources and institutional capacities at the national level.

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