

**COLLECTIVE INVESTMENT SCHEMES IN EMERGING MARKETS: AN
ASSESSMENT OF THE REGULATORY FRAMEWORK FOR INVESTOR
PROTECTION IN UGANDA**

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in partial fulfillment of the requirements for the award of the degree of
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DECLARATION

I, **GRACE FLAVIA LAMUNO**, declare that this dissertation is my own work, and that it has never been presented to any other institution of learning in fulfillment of any academic requirement or any other award and all works cited herein are expressly acknowledged.

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Date:.....

This dissertation has been submitted for examination with my consent as University supervisor.

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(SUPERVISOR)

Date:.....

DEDICATION

This dissertation is dedicated to my dad, Mr. Constantine Opiyo and my late mum, Mrs. Mary Opiyo. Thank you for giving me the gift of education and always being there for me.

This dissertation is also dedicated to my husband Billy and our children, Benita and Graham.

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LIST OF ACRONYMS

AA	African Alliance
ACD	Authorized Corporate Director
ACID	Alliance of Christians in Development
BOU	Bank of Uganda
CEO	Chief Executive Officer
CIS	Collective Investment Schemes
CMA	Capital Markets Authority
COWE	Care for Orphans, Widows and Elderly
DFCU	Development Finance Company Uganda
GDP	Gross Domestic Product
ICEA	Insurance Company of East Africa
ICVC	Investment Companies with Variable Capital
IPO	Initial Public Offering
IPR	Investor Protection Regulation
ISU	Investment Services Uganda Limited
KCB	Kenya Commercial Bank
KSHS	Kenya Shillings
MBA	Master of Business Administration
MTN	Mobile Telephone Network
NASDAQ	National Association of Securities Dealers Automated Quotations
NAV	Net Asset Value
NGN	Nigerian Naira
NGOS	Non-Governmental Organisations
NHCC	National Housing and Construction Corporation Company Limited
NSSF	National Social Security Fund
NWSC	National Water and Sewerage Corporation
OECD	Organization for Economic Co-operation and Development
OEIC	Open Ended Investment Company
SEC	Securities and Exchange Commission
SEHK	Stock Exchange of Hong Kong
SOX	Sarbanese Oxley Act
UCL	Uganda Clays Limited

UCDA	Uganda Coffee Development Authority
USA	United States of America
US\$	United States Dollars
USE	Uganda Securities Exchange
UGX	Uganda Shillings
UK	United Kingdom

LIST OF STATUTES

Capital Markets Authority Act, Cap 84, 1996.

Capital Markets (Licensing) Regulations, S.I. 84-1, 1996.

Capital Markets (Licensing) (Amendments) Regulations 2003.

Capital Markets (Conduct of Business) Regulations, S.I. 84-4, 1996.

Capital Markets (Accounting and Finance Requirements) Regulations, S.I. 84-4, 1996.

Capital Markets (Exempt Dealers) Regulations, S.I. 84-8, 1996.

Capital Markets (Registers of interests in Securities) Regulations, S.I. 84-6, 1996.

Capital Markets (Establishment of Stock Exchange) Regulations, S.I. 84-3, 1996.

Capital Markets (Fund Managers) Regulations, 2004.

Capital Markets (Prospectus Requirements) Regulations, S.I. 84-2, 1996.

Capital Markets (Advertisements) Regulations, S.I. 84-7, 1996.

Capital Markets (Prospectus Requirements) (Amendment) Regulations, 1999.

Capital Markets (Prospectus Requirements) (Amendment) (No. 2) Regulations, 2001.

Collective Investment Schemes Act No.2 of 2003.

Collective Investment Schemes (Open-Ended Investment Companies) Regulations, S.I. No.100, 2003.

The Collective Investment Schemes (Unit Trusts) Regulations, S.I. No.100, 2003

The Collective Investment Schemes (Conduct of Business) Regulations, S.I. No.43, 2007.

The Collective Investment Schemes (Licensing) Regulations, S.I. No.99, 2003.

The Collective Investment Schemes (Financial and Accounting) Regulations, S.I. No. 98, 2003.

ABSTRACT

Collective Investment Schemes (CIS) exist in several markets, both emerging and developed such as the UK and most of continental Europe, the USA, Australia, China, Japan, Turkey, Greece and several other countries. The Capital Markets Authority (CMA) began licensing Collective Investment Schemes after Parliament passed the CIS Act in 2003. In Uganda, the CIS legal framework allows for both Open Ended Investment Companies (OEICs) and Unit Trusts Schemes. However, the unit trusts are the only form of schemes that are currently operational.

The CIS sector is characterized by a lot of risk to the investors which include *inter alia* conflict of interest, weak regulators, theft, misappropriation of assets, and deliberate abuse of the law by market players. Many investors have suffered significant financial loss while they trusted their advisors to look after their investments. The victims are ordinary investors from all walks of life who believe that in our society there are rules and regulations that offer protection for the consumer or investor. However, despite the existence of the laws and regulations that have been put in place to ensure that investors participating in CIS are adequately protected it is not clear to what extent the regulator and the legal and regulatory framework afford protection to the investors.

The aim of this research paper therefore was to evaluate the effectiveness of the regulatory framework for Collective Investment Schemes in protecting investors in Uganda. Specifically, the study sought to study the legal and governance structures of the different types of CIS in Uganda, establish whether the regulatory framework for CIS adequately protects investors, and establish whether CMA adequately ensures compliance and enforcement of the regulatory framework by CIS operators and to make recommendations on the way forward in view of the findings of the study

The first chapter presented the risks that the investors participating in CIS may encounter. The chapter also spelt out the methodology employed in the research which was mainly qualitative and the data was collected through the use of interview guides. Chapter two contained the theoretical framework and literature review through an examination of relevant archival resources.

The key findings of this research are contained in chapters three and four. They revealed that the laws and regulations governing CIS afford a reasonable degree of protection to investors through various provisions regarding separation of assets from management, oversight function, professional management of the funds, diversification of investments and full disclosure. However, it was also revealed that there still exist some legal and extra challenges that hinder adequate protection to the investors and these include *inter alia* illiquid markets, conflict of interest, investment restrictions, pricing and valuation, populace's lack of knowledge and operation of the capital markets industry, lack of confidence by the public in the capital markets, lack of experience by some of the operators of the CIS, deliberate abuse of the regulations, inadequate supervisory capacity by CMA.

Recommendations to address the legal and extra-legal factors inhibiting the efficiency of the law governing CIS have been given in chapter five.

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CHAPTER ONE

COLLECTIVE INVESTMENT SCHEMES

1.0 Introduction

Collective Investment Schemes (CIS) have been one of the most significant developments in the capital markets during the past few decades.¹ CIS are private financial arrangements that pool resources of many small savers, generating a large pool of resources which they then invest in a variety of assets like shares, bonds, futures and property with the sole purpose of generating high returns. Consequently, CIS have been instrumental in raising the financial sophistication of the population.²

The investments are chosen and managed by professionals usually fund managers appointed by the CIS, according to the stated objectives of the CIS. Investors are therefore not involved in the day to day decisions concerning how their money is invested.³

When promoters of investment schemes are allowed to solicit funds from the broad investing public for collective investment without a well-defined legal and regulatory framework, the risks are high of breach of the operators' obligations toward investors. The risk is particularly high since CIS typically manage assets on behalf of dispersed groups of investors who must depend on the governance system for critical aspects of monitoring of the CIS. Some of the investors may be high net worth individuals or institutions. However, CIS also attract the savings of smaller savers many of whom lack the time, financial sophistication and resources to analyze data in great depth or to take action against promoters.⁴

The CIS sector is characterized by complex agency relationships and asymmetry of information and market power. This is because the management of large amounts of assets

¹ J. Thompson, (July 2004) "Governance of Collective Investment Schemes (CIS)"(Discussion Draft For Comment, Directorate For Financial and Enterprise Affairs, *available at www.oecd.org/dataoecd/13/31/33621901.pdf* accessed on 14th September 2007 p.2.

² *ibid.*

³ M. Kamanyere, (2003) "The Rationale for Collective Investment Schemes in Uganda Capital Markets", *The Journal for the Capital Markets Industry* Vol. 2 No.1 1st quarter p.31.

⁴ J. Thompson, (2004) "Governance Of Collective Investment Schemes (CIS)"(Discussion Draft For Comment, Directorate For Financial And Enterprise Affairs July *available at www.oecd.org/dataoecd/13/31/33621901.pdf* accessed on 14th September 2007 p.4.

which are owned by a dispersed group of investors who have incomplete information and which assets are under the control of institutions with considerable power to control flows of information is detrimental to the investors. These asymmetries require transparent and disciplined procedures to ensure equitable treatment of investors.⁵

Governance failures in CIS can span a wide range of problems. There have been chronicled abuses of CIS which have included simple theft or misappropriation of assets, sales or redemptions at inappropriate valuations, deceptive promotion techniques, unclear title to assets, negligent or self-interested investment selection or management, failure to specify essential details about the undertaking, unreasonable fees, unenforceability of the obligations of the promoters and lack of an accountable party from whom redress can be sought. Some schemes have become insolvent, leading to very large losses for some investors. Some schemes may avoid the outright abuses categorized above but they may still operate primarily to the benefit of the promoters and, other insiders rather than investors.⁶

The laws of virtually all countries stipulate that CIS are exclusively to be operated in the interests of final investors.⁷ CIS operators are normally expected to compete by offering better performance and services as well as competitive costs. However, experience has shown that CIS are highly susceptible to conflicts of interest. The operators of CIS control large amounts of assets and have significant capability to control the information that is provided to investors. Many investors are individuals who have limited capability to monitor the performance of the CIS in detail. Therefore, the risk is present that some participants in the collective investment process will abuse agency relationships.⁸

In the simplest case, without some safeguards, operators of a CIS could misrepresent the assets in the portfolio or the value of the portfolio or make false or misleading representations concerning the investment strategy that will be followed or the risks involved.⁹ Operators

⁵ J. Thompson, (2004) "Governance of Collective Investment Schemes (CIS)"(Discussion Draft for Comment, Directorate for Financial and Enterprise Affairs *July available at www.oecd.org/dataoecd/13/31/33621909.pdf* accessed on 14th September 2007, p.4.

⁶ *ibid* at p.4.

⁷ *ibid* at p.17.

⁸ *ibid* at p.18.

⁹ J. Thompson, (2004) "Governance of Collective Investment Schemes (CIS)"(Discussion Draft for Comment, Directorate for Financial and Enterprise Affairs *July available at www.oecd.org/dataoecd/13/31/33621909.pdf* accessed on 14th September 2007 p.18.

may also promise exceptionally high rewards in order to attract new investors into the scheme.¹⁰

In addition to outright fraud, CIS can be used to provide benefits for those in an insider relationship with the CIS, such as an operator, investment manager, or distributor, at the expense of investors in the CIS. Insider trading is said to undermine investor confidence in the integrity of the securities market. It is known to be a major problem in many emerging markets.¹¹

There are numerous possibilities of conflict of interest in CIS for example, the operator might seek to attract many investors into the fund, even if this should result in the fund becoming too large for efficient asset management. In executing the investment strategy, the investment manager might take excessive risk or may be excessively risk averse. In addition, the CIS could appoint directors, custodians or depositaries, who lack the requisite independence.¹²

Many investors have suffered significant financial loss while they trusted their advisors to look after their investments.¹³ The victims are ordinary investors from all walks of life who believe that in our society there are rules and regulations that offer protection for the consumer/investor.¹⁴ The recent Madoff scandal is a clear example which shows how investors have lost large sums of money in the hands of professional advisers.¹⁵

While the legal framework and regulatory regime are intended for the protection of investors, it is important to make it absolutely clear to investors that the objective of the legal and regulatory system is not to prevent or minimize losses to investors where such losses occur through developments in capital markets. CIS are market-based investment vehicles and they are not subject to the same prudential controls and safeguards as banks and insurance

¹⁰ *ibid.*

¹¹ N. Biekpe, "African Capital Markets: Legal and Governance Framework." A Training Manual for Africa" Centre for Investment Analysis University of Stellenbosch, South Africa available at www.uneca.org/acmdp/training_materials.htm accessed 9th May 2007 p.5.

¹² *ibid.*

¹³ <http://sipa.ca/library/articles.htm> accessed 3rd September 2007.

¹⁴ *ibid.*

¹⁵ Interview with Robert Baldwin, CEO, Crested Stocks and Securities, on 27th January 2009

companies, for example.¹⁶ The principle that the investors must bear all inherent risks in their investment decisions, which characterizes all capital markets investments, is valid in the CIS sector as well.¹⁷ The objectives of the investor protection regime are to protect investors against fraud, negligence and conflict of interest, to ensure that each CIS observes the rules of fair and transparent operation and that investors are adequately informed of the risks involved in their investment. The CIS executes investment strategies on behalf of investors while the investor selects the desired degree of risk.¹⁸

However, despite the existence of the laws and regulations that have been put in place to ensure that investors participating in CIS are adequately protected it is not clear to what extent the regulator and the legal and regulatory framework afford protection to the investors.

1.1 Background

CIS exist in several markets, both emerging and developed such as the UK and most of continental Europe, the USA, Australia, China, Japan, Turkey, Greece and several other countries. Their establishment varies, depending on the legal system of the country in which they are established. CIS are commonly referred to as Unit Trusts, save for the USA where they are known as mutual funds. In the USA, total net assets of mutual funds amounted to US\$ 10,413,617 million at end of 2006.¹⁹ At the end of the 2006, worldwide assets held under CIS were US\$ 21,764,912 million.²⁰ In Africa, the largest and most developed CIS industry is in South Africa. In South Africa assets held in CIS investments amounted to US\$ 78,026 million.²¹

Unit trusts in Kenya are still not yet fully developed and the knowledge and operations of mutual funds are still at their infancy stages.²² In Nigeria the concept of mutual funds is still relatively new to many potential investors in the country, though it has been around for over

¹⁶ J. Thompson, (2004) "Governance Of Collective Investment Schemes (CIS)"(Discussion Draft For Comment, Directorate For Financial And Enterprise Affairs July available at www.oecd.org/dataoecd/13/31/33621909.pdf accessed on 14th September 2007 p.5.

¹⁷ *ibid.*

¹⁸ *ibid* pg 5.

¹⁹ 2007 Investment Company Institute, Fact Book pg 140 available at www.ici.org/.

²⁰ 2007 Investment Company Institute, Fact Book pg 140 at www.ici.org/.

²¹ 2007 Investment Company Institute, Fact Book p.140 available at www.ici.org/. accessed on 15th January 2009.

²² <http://www.cma.or.ke/> accessed 9th November 2007.

20 years. But analysts believe that the awareness is gradually building up following the emergence of more mutual funds and unit trusts.²³ However, analysts hold that investments in mutual funds in Nigeria are so far on a small scale with a value of a few billions of Naira compared with the situation in the United States of America where there are thousands of mutual funds that meet their investment objectives. Investments there run into trillions of dollars as they provide safe options for wealth creation.²⁴

In Uganda, the CIS legal framework allows for both OEICs and Unit Trusts Schemes. However, the unit trusts are the only type of schemes that are currently operational. African Alliance Uganda is the only licensed operator managing three unit trusts funds which include the Money Fund, Balanced Fund and High Yield Fund.²⁵

It is generally acknowledged that CIS are one of the most effective ways of mobilizing savings and investments particularly from small investors. Experience in South Africa, Swaziland, Botswana and Kenya supports this view.²⁶ Therefore, ordinary people i.e. individuals with normal jobs and average incomes-who may be well-educated, but nonetheless are not “sophisticated investors” in the legal sense are the main participants in these schemes and they must have confidence that their money is protected from fraud, theft and other risks or abuses. If these occur, investors must have confidence that there are reliable means for redress for those affected. In the absence of this confidence, individuals simply will not invest in funds in any volume. Thus owing to their critical role as an investment vehicle for small savers it is important to have legal and regulatory mechanisms that adequately protect the interests of small investors.

Putting such legal regimes in place is a demanding agenda and one that has taken developed countries many decades to achieve. In Uganda a regulatory framework was put in place before there was a market for CIS.²⁷ In the USA and Europe, CIS regulation did not really begin to take shape until the 1930s or even later, when funds had been in operation for 70 years or more and it was only developed after major scandals following the Wall Street Crash

²³ C. Oriyole, “Growing Investment Outlets” *The News Magazine* available at <http://www.thenewsng.com/modules/news/article.php?storyid=3594> accessed 9th November 2007.

²⁴ *ibid.*

²⁵ (2006) Investment Options through Collective Investment Schemes (CIS) in Uganda: *Uganda Securities Exchange Quarterly Bulletin* Volume 7 Issue No. 3 p. 6.

²⁶ J. Kato, (2004) Commentary from CMA: *Capital Markets Journal* Vol. 7 No.1 P.2.

²⁷ Interview with Eric Kenneth Lokolong, Senior Compliance Officer (Legal), CMA, on 14th January 2009.

of 1929.²⁸ Even today, amendments continue to be made to aspects of tax law and fund supervision and regulation in most jurisdictions, often associated with preventing reoccurrence of a scandal.²⁹

The need for regulation of unit trust investments has often been caused by the suspect activities of promoters of investment schemes which operate on the fringe of the corporate investment market. The history of the unit trust industry has been attended by a series of notable failures of large trusts and a lack of certainty about the rights of unit holders and the relationship between the two controlling entities; a trustee and a manager. In Australia in the 1980s a number of property trusts failed. This prompted a review of the legislation and a tightening of the obligations placed on the managing entities.³⁰

In Uganda, the law on CIS is fairly new and currently there is only one fund manager—African Alliance.³¹ Unit trusts hold tremendous opportunity for small savers to pool their resources and invest in a number of investments so as to diversify risk. However, there is a challenge of attracting small investors to participate in these schemes because of the risks associated with CIS which include conflicts of interest, insider trading and fraud among others. Therefore there is need to have measures in place that protect the interests of these investors especially the small investors who may not have the capacity to ensure that their savings are not mismanaged by the fund operator. If people do not have confidence in the system they will be reluctant to invest. Therefore, investor protection is of paramount importance if the investors are going to participate in CIS.

1.2 Statement of the Problem

CIS are a new savings product having only been recently introduced in Uganda in 2003. CIS enable investors to participate in the capital markets. The CMA is the regulatory authority that is charged with making regulations for the operation of the CIS and overseeing the capital markets and ensuring that investors participating in the capital markets are protected.

²⁸ M. St Giles, E. Alexeeva, and S. Buxton,, “Managing Collective Investment Funds” 2nd Edition John Wiley & Sons (2003) Ltd p.7.

²⁹ *ibid.*

³⁰ R. A. Hughes, (1999) “Public Unit Trusts: Some Regulative Models”, *Journal of South Pacific Law Working papers*, Working paper 2 of Vol.3 1999.

³¹ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

The CMA also ensures that CIS operators adequately comply and enforce the regulatory framework governing CIS. Although the CMA as regulator of CIS has a legal mandate to protect investors, and ensure compliance and enforcement by the CIS operators, it is not clear to what extent the regulator and the regulatory framework for CIS afford investors protection.

1.3 Objectives of the Study

1.3.1 General Objective

The general objective of the study was to evaluate the effectiveness of the regulatory framework for collective investment schemes (CIS) in protecting investors in Uganda and to propose recommendations for ensuring investor protection in CIS.

1.3.2 Specific Objectives

- a) To study the legal and governance structures of the different types of CIS in Uganda.
- b) To establish whether the regulatory framework for CIS adequately protects investors.
- c) To establish whether CMA adequately ensures compliance and enforcement of the regulatory framework by CIS operators.
- d) To make recommendations on the way forward in view of the findings of the study.

1.4 Research Questions

The research addressed the following questions in a quest to establish whether the regulatory framework for CIS in Uganda adequately ensures investor protection:

- a) What are the types of CIS permitted to operate in Uganda and what are their legal and governance structures?
- b) How does the regulatory framework for CIS ensure that investors are protected?
- c) How does CMA ensure compliance and enforcement of the regulatory framework by CIS operators?
- d) What can be done to ensure that investors participating in CIS are protected?

1.5 Scope of the Study

The study sought to evaluate the effectiveness of the law in protecting investors in Uganda. The study was conducted in Kampala district. The study covered a period from 2003 when the law on CIS came into force to October 2009.

1.6 Significance of the Study

The study made the following contributions:

- a) The research contributes to the existing knowledge in the area of collective investment schemes for future use by researchers and students to investigate further the risks associated with CIS and capital markets generally.
- b) It provides a platform for policy makers and stakeholders to find ways of improving the performance of collective investment schemes.
- c) There is a very large information gap for investors on collective investment schemes. The study reduces the information gap by adding more knowledge to the already available knowledge.
- d) The study will hopefully attract more researches in the area of collective investment schemes in Uganda.

1.7 Methodology

This methodology describes the research methods which were used to carry out the study. It covers research design, survey population, sample size, sampling procedures, sources of data, methods of data collection, data analysis, and limitations of the study.

Prior to contacting respondents for the study I obtained an introduction letter from the Faculty of Law, Makerere University authorizing me to conduct the interviews and also requesting the respondents to allow me have access to information regarding collective investment schemes.

1.7.1 Research Design

The research was qualitative owing to the fact that the study aimed at answering the above questions regarding the effectiveness of the regulatory framework in protecting investors who participate in collective investment schemes. The qualitative research method that was employed was intensive interviewing of respondents, particularly investment advisers, fund managers and Capital Markets Authority employees and desk research.

1.7.2 Study Area and Population

The study focused on Uganda because the regulator, Capital Markets Authority, oversees capital markets in the whole country and the relevant laws are applicable throughout the country.

The study population consisted of African Alliance which is the only operational unit trust manager, licensed investment advisers, licensed fund managers and employees from Capital Markets Authority who are the regulators of capital markets in Uganda and who are knowledgeable in the field of collective investment schemes.

1.7.3 Sampling

Sampling is the process of selecting a number of individuals for a study in such a way that they represent the larger group from which they are selected. The purpose of sampling is to gain information about the population by using the sample. Not only is it generally not feasible to study the whole population, it is also not necessary.³²

The sampling of the respondents was purposive or judgmental³³ because the researcher targeted particular respondents on the basis of their perceived knowledge and experience in relation to the problem of the study particularly focusing on respondents with specialized knowledge and these were selected on the basis of their knowledge of the capital markets.

³² D.A. Katebire, (2007) "Social Research Methodology: An Introduction", (Kampala: Makerere University Printery, Kampala, p.41.

³³ *ibid.*

1.7.4 Data Sources

The research was carried out using both primary and secondary data. Primary data was used to achieve the objectives of the study and was collected from the respondents using one method which is qualitative. Secondary data was collected from existing relevant literature from the libraries in the form of text books, journals, articles, reports, dissertations and the Internet.

1.7.5 Data Collection Methods and Instruments

The qualitative data was collected through interviews with key informants in order to get a detailed assessment of the effectiveness of the regulatory framework in the protection of investors in collective investment schemes.

The researcher drew up an interview guide which is essentially qualitative³⁴ with a list of topics with general questions which covered the issues to be answered during the interview. The questions were categorized and designed to suit the respondents and this also enabled the researcher to generalize the data collected from the field.

The use of interviews was because of the nature of the data required which was based on special knowledge of the regulatory framework governing collective investment schemes. Information can be extracted from the respondents by honest and personal interaction between the respondent and the interviewer and that unlike questionnaire; the interviewer can get more information by using probing questions.³⁵

The method of collecting data during the interview was by way of note taking. Note taking, it is said, can interfere with the communication between the respondent and the interviewer. This was overcome by the researcher who traveled with a research assistant who took down all the answers while the researcher gathered the information. The researcher was also able to recollect and correct any mistakes that may have been committed by the research assistant.

³⁴ *ibid* p.122.

³⁵ Muganda and Mugenda p.80.

1.7.6 Data Quality Control

The interview guide was pre-tested to ensure that it could serve the purpose of the research. A pilot study to test the nature of the responses was done to ensure that the resulting responses correctly answered the objectives of the study. Where the questions or words used were found to be vague or redundant, they were rephrased or even deleted altogether.

1.7.7 Data Analysis and Presentation

Upon collecting the data from the field through the interviews, the researcher manually summarized the findings into inter-related themes on the basis of the objectives of the study, then edited and analyzed it.

1.7.9 Limitations to the Study

The researcher encountered the following constraints:

- a) Getting information from the Capital Markets Authority (CMA) was not an easy task. Due to the fact that the staff at CMA are few in number and very busy, it was not easy to access respondents from there. Therefore the response rate was very slow.
- b) Getting information from African Alliance (operator of CIS), DFCU (the trustee) was also not an easy task. There was a lot of bureaucracy and despite the fact that the researcher had a letter from the Faculty of Law requesting access to information there was still a lot of suspicion and unwillingness by the respondents to furnish the information.
- c) Besides that, African Alliance, the operator of Collective Investment Schemes refused to violate the right of privacy of the CIS investors and therefore the researcher could not access the investors so as to interview them. As such, the researcher heavily relied on the knowledge of the professionals in this field to obtain answers to the questions regarding the study.
- d) In addition, the other knowledgeable respondents were not as easily accessible as the researcher had hoped. A lot of appointments were made and had to be rescheduled over and over again and others were completely cancelled due to the busy schedule of the respondents.

- e) Further, the researcher found difficulty in getting information on Collective Investment Schemes in Uganda. Hardly any legal research has been carried out in this area in Uganda. Therefore the researcher had to rely on other legal and non legal works on the subject from foreign literature which was also hard to obtain.
- f) The capital market is still generally undeveloped. The study was limited by the availability of the material and information which was scarce. The secondary data was scanty and had to be extracted from several sources and this was a tedious exercise.
- g) The research was also limited by finances for secretarial services, stationery and photocopying the relevant materials.

1.7.10 Overcoming the Challenges

- a) The Researcher spent a lot of time trying to fix appointments and as a result too much time went by before the interviews could finally be conducted.
- b) In addition, the researcher was only able to conduct interviews with half of the targeted population as the rest totally failed or were unable to keep the appointments and yet the researcher had a deadline to meet.
- c) More to the above, three quarters of the secondary data the researcher obtained was conducted in developed capital markets and was not addressing the risks associated with investing in CIS in emerging markets.
- d) Besides that the researcher pledged confidentiality to all the Respondents who requested for anonymity as is reflected in chapters three and four of this research.
- e) Lastly, the researcher was able to use the meager resources available to her and with the help of her family and friends was able to meet all her financial needs with respect to secretarial services, stationery and photocopying while conducting this research.

1.7.11 Ethical Issues

Before embarking on the field research, the researcher obtained an introductory letter from the Faculty of Law authorizing her to conduct the research in the chosen field of study. In

addition, the necessary connections were made with the interviewees to ensure that they are made aware of the researcher's study and need for responses.

The researcher on all occasions promised confidentiality since some respondents did mind being personally reflected in the research while others did not mind.

CHAPTER TWO

LITERATURE REVIEW AND THEORETICAL FRAMEWORK

2.1 Literature Review

This part contains a review and critique of existing literature on the effectiveness of the regulatory framework governing collective investment schemes and investor protection in Uganda. There has been little study on collective investment schemes in developing countries and as such it is difficult to find sufficient literature on the subject. The literature to be reviewed in the study will be cited mainly from studies carried out in developed countries.

2.1.1 Risks and Investor Protection

Buti³⁶ states that when an investor decides to participate in a mutual fund, he delegates to the fund manager two different tasks: the management of the investment and the choice of the asset to invest in. Investment delegation implies an asymmetry of information between the investor and the manager, since the fund manager is in contact with the market and has superior knowledge of the market state, while the investor has only the manager's report to evaluate the investment performance. This asymmetry is reinforced when the asset choice task is delegated too, since the investor loses any control on his money and the manager chooses the type of investment that maximizes his own rents. Investment delegation creates an asymmetric information problem that is more severe if the asset choice inside the portfolio is also delegated to the fund manager.

She discusses the risk that an investor places himself in when he decides to participate in mutual funds. The risk is that of information asymmetry which is a situation where one party (mutual fund manager) knows things and the other (investor) does not. This is important because it reveals one of the risks that an investor may be faced with when the investor participates in mutual funds. Studies examining this issue of information asymmetry outside of the USA are scarce and they primarily focus on one country or a number of similar

³⁶ S. Buti, "Asset Choice Regulation in Mutual Funds" EFA Maastricht Meetings Paper No 3516 available at <http://papers.ssrn.com/sol3/results> last accessed on 27th september 2007 p.3.

countries. My research adds to the current research by examining this issue of information asymmetry specifically in the Ugandan context and how it affects investor protection.

Cross and Prentice³⁷ analyze the fact that any investor, especially an equity investor, takes an obvious risk when turning his or her money over to another for management. All commercial transactions run some risk of nonperformance or fraud. They further argue that investment contracts are particularly risky in their nature, because the investor turns over his funds (often in a very large amount) to another party to manage over the long term. The manager might defalcate with the funds or simply be incompetent, causing the investor large losses. They state that to protect themselves against abuses by their agents, investors can try to monitor the agents. Thorough monitoring, however, is not realistic. It would require observing every action taken by agents through some monitoring system. Such a system would obviously entail enormous transaction costs, with the added costs making investment a far less promising use of the investor's funds. Mutual funds provide insufficient protection for shareholder interests and no safe haven from opportunistic behaviour.

Their research discusses the risky nature of investment contracts which include abuses by the investment agents and incompetence in the USA. It further shows that for the investor to protect themselves from such risks, they should monitor the agents. However, the authors state that monitoring is not realistic because it would be costly and they conclude that mutual funds do not provide adequate protection to the investors. This research adds to the current literature by examining the different risks associated with CIS and also establishes whether CIS in the Ugandan market which is still relatively new and small affords protection to the investors compared to the mutual fund market in the USA which is a comparatively more mature market.

Frankel and Cunningham³⁸ argue that no matter what laws and regulations are written and no matter how elaborate a set of internal organizational controls are developed, the leakage risk that some favoured investors will benefit at the expense of other investors remains. When a significant number of advisers allow favoured investors to benefit at the expense of other

³⁷ F. B. Cross and R. A. Prentice, (2006) "Economies, Capital Markets, and Securities Law", *The University of Texas School of Law and Economics Research Paper No 73*, available at <http://papers.ssrn.com/sol3/results> last accessed on 27th September 2007 p.17.

³⁸ T. Frankel and L. A. Cunningham, "The Mysterious ways of Mutual Funds: Market Timing" Boston School of Law Working Paper Series, Law & Economics working paper No 06-39 available at <http://papers.ssrn.com/sol3/results>, last accessed on 27th September 2007 p.238.

investors, there comes a breaking point where neither the law nor market competition provides effective constraints. At that stage the leakage created by the favouritism may become an acceptable practice. Investors and advisers will benefit at the expense of weaker or less vigilant investors. An unequal practice of this sort can undermine investor trust. After all, even those who reward advisers for special benefits must recognize that they might be competing with other investors who might pay more to receive these and other benefits at other investors' expense. Such a system threatens the efficiency of mutual funds.

This study was conducted in the USA which has a more mature mutual fund market with mechanisms that have been established to ensure protection of investors and which mechanisms have been tested and have been found wanting. This research contributes to the available literature by looking at the Ugandan market with specific emphasis on the efficiency of the laws to establish whether they have ensured investor protection and the efficiency of the CIS industry.

Higgins³⁹ argues that online trading has grown rapidly as a segment of the securities industry but despite the many benefits it affords to investors such as low commission and free research, online investors have experienced problems unique to the online environment. He further states that online broker/dealers rarely monitor system delays and outages, they do not disclose that such disruptions could occur and their records of such disruptions. The websites of many online broker/dealers lack key pieces of information for investor protection in the areas of margin requirements, privacy considerations, risk disclosures and best trade executions.

Higgin's research discusses the problems associated with online trading which in turn affect the protection of investors and it was carried out in a country with a mature capital market that has undergone a lot of testing. This research adds to the available literature by looking at problems associated with emerging capital markets and what can be done to ensure protection of investors in such a markets.

³⁹ H. N. Higgins, "Auditing disclosure risks of on line broker – dealers" *Journal of Information and Computer Security*, available at <http://www.emeraldinsight.com/researchregister> accessed 4th september 2007, p.76.

Karim⁴⁰ in his study of the role of auditors in protecting investors states that the audit profession is also very opaque. He states that the stock market crash in 1929 led the U.S. Congress to enact The Securities Acts of 1932 and 1933 meant to protect investors from fraud. In the aftermath of the stock market crash in 2000, the United States Congress again enacted the Sarbanes-Oxley Act (SOX) which required more mandatory audit requirements (including the costly and onerous Section 404 internal control reports from auditors), more costly licensing requirements (further reducing competition in the public accounting industry), and a greater focus on enforcement by the Securities and Exchange Commission (SEC) all meant to protect investors.

Karim further states that since the Securities Acts of 1932 and 1933, government regulators have relied on mandatory audit as a key tool for preventing and detecting fraud. The focus on governance reform has intensified under SOX. Unfortunately, financial statement auditing, as currently practised, is rather ineffective at detecting fraud. After the Enron and WorldCom fiasco⁴¹, the SEC concluded that consulting was the cause of audit failure and SOX banned a range of consulting services⁴². Karim states that something has to be done to protect investors from fraud, and something has to be done to stiffen the independence of auditors even under conditions of extreme duress when all other forms of market discipline have collapsed.

Karim further states that while auditors encourage corporate managers to promote transparency, they seem incapable of having any transparency for themselves. This is another instance where the audit profession has been short sighted. The opacity of audit firms makes them vulnerable to attack. The worst example of this was the concerted campaign in the 1990s by the Securities and Exchange Commission (SEC) to attack the consulting services provided by audit firms.

Karim's work thus discusses the role that auditors specifically play in protecting investors and he goes on to state that while they promote transparency, they do not have any transparency themselves and so they may not be able to protect investors from fraud. This research contributes to the current literature by looking beyond the role of the auditors generally in ensuring investor protection and looks at the roles of other capital market players

⁴⁰ J. Karim, (July 5, 2006) "Mandatory Audit of Financial Reporting: A Failed Strategy for Dealing with Fraud" also available at SSRN: <http://ssrn.com/abstract=914156> last accessed on 4th September 2007 p.9.

⁴¹ *ibid.*

⁴² *ibid.*

like the trustee, regulator and examine how they ensure protection of investors in collective investment schemes.

Newman, Patterson and Smith⁴³ argue that auditors play an important role in the U.S. in ensuring investor protection. This role extends to most, if not all, capital markets. They focus on the role of the auditor in enforcing and protecting outside investors' rights. They argue that the critical role of auditing is to detect expropriations by insiders and, by doing so, to deter such behaviour. Without detection of expropriation by insiders, the degree of investor protection provided in other forms is significantly weakened. Neither strictness of laws nor stringent enforcement matter if such laws or enforcement are not triggered. Thus, when raising external capital, insiders have incentives to retain auditors to provide outside investors with assurance that expropriations are limited. They focus on the relationship between auditors' incentives, specifically penalties due to audit failures, and the degree of outside participation in public offerings.

The authors' work is specifically geared towards the role that auditors play in ensuring investor protection in the USA. They argue that auditors play an important role in ensuring investor protection because they detect and prevent expropriations which cannot be possible with the strictness of the laws nor its enforceability. This research adds to the current literature by looking at other factors, legal and regulatory, that contribute to investor protection in emerging markets and specifically in Uganda.

Chan, Menkveld and Yang⁴⁴ state that in auditing, there is a need to give up the myth that the auditor can protect investors from management fraud. They further state that when it becomes clear that the auditor did not stop fraud, the tendency is for the regulator to get angry and go for extreme penalties such as indicting the audit firm. They provide a solution which is that public companies should purchase fraud insurance, and then the insurance companies hire the auditors or alternatively they should deregulate auditing completely and let auditors produce reports that are useful to investors.

⁴³ P. Newman, E. Patterson, and R. Smith, (July 2003) "The Role of Auditing in Investor Protection" Available at SSRN: <http://ssrn.com/abstract=421660> last accessed on 4th September 2007 p.2.

⁴⁴ K. Chan, A. J. Menkveld and Z. Yang, (2008) "Information Assymetry and Asset Prices: Evidence from the China Foreign Share Discount" Journal of Finance Vol 63 No 1 p.159.

The authors' work was conducted in China and is specifically about the auditor's role in protecting investors from fraud. They assert that auditors cannot protect investors from fraud. My research adds to the current literature by looking generally beyond the role of auditors in protecting investors from fraud. It focuses on Uganda whose capital market is still young.

Meschke⁴⁵ looks at how fund board independence affects investor protection and he states that despite detailed disclosure requirements, a sizeable fraction of fund investors seem to be ill-equipped to vigilantly monitor fees, performance, and internal policies and to rationally act on available information. Many investors do not seem to understand the amount and impact of mutual fund fees, and especially expenses that are deducted directly from fund assets such as portfolio transaction costs, management fees, and distribution fees. In the presence of informational and institutional frictions, board oversight of mutual funds may potentially serve an important economic purpose.

Meschke states that it remains therefore an empirical question whether variation in fund governance characteristics is systematically related to fund fees, performance, and compliance. He concludes that fund investors do not necessarily benefit from greater board independence if boards negotiate low fees without closely evaluating fund performance. In contrast, higher director ownership and relatively low compensation seem to align incentives between fund boards and investors.⁴⁶

Meschke's research is conducted in the USA and he states that the role that the independence of fund boards play in protecting investors does not in any way protect investors against risks because the investors are ill equipped to understand how mutual funds are managed. This research adds to the available literature by looking at how the governance structure of the CIS industry in Uganda which is different from the mutual fund structure in the USA, allows for protection of investors.

⁴⁵ F. Meschke, (March 15, 2007) "An Empirical Examination of Mutual Fund Boards" available at SSRN:<http://ssrn.com/abstract> last accessed on 4th September 2007 pp 8, 9 and 20.

⁴⁶ *ibid.*

2.1.2 Investor Protection and the Regulatory Framework for CIS

In order for the capital markets to flourish in a country, there must be a good legal and regulatory framework which oversees the markets and which also ensures that investors are protected.

Tarinyeba⁴⁷ argues that CIS are heavily regulated because the legal regime ensures that CIS are constantly monitored to ensure compliance with regulations. She further states that monitoring compliance is carried out at three levels. At the first level, all licensed persons are required to put in place compliance procedures and to ensure that their employees comply with the procedures. At the second level is the oversight function of the trustee/depositary, which includes monitoring compliance with the regulations, trust deed/memorandum and articles, scheme particulars/prospectus. The third and most critical level of monitoring compliance is done by the regulator through review of compliance reports and inspections.

However, her work focuses on the compliance aspect as one of the tools which the regulatory body uses to oversee CIS to ensure that investors in Uganda are protected. This research adds to the available literature by looking generally beyond the compliance function but to all other functions of the regulatory body in Uganda that help in creating investor protection such as licensing and approval of funds, fund management companies and other service providers, supervision of conduct of business and investigations of fund management companies.

Smith⁴⁸ in his research about the broad range of reform initiatives that have been undertaken in response to a series of mutual fund scandals that have become apparent in the USA in 2003, says that there has been much discussion about the failure of independent fund directors to detect and prevent the fund trading violations. He further states that civil actions brought against independent directors for failing to detect or put an end to abusive market timing have been unsuccessful to date as the courts have reaffirmed the independent directors' role as one of oversight not micromanagement. He further states that to strengthen the hands of the independent directors and widen the purview of their general oversight

⁴⁷ W. Tarinyeba, (2005) "Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda" *Capital Markets Journal* Vol 9 no 4, 33-38 p.9.

⁴⁸ T. R. Smith, (2006) "Mutual funds under fire: Reform Initiatives", *Journal Of Investment Compliance J* Vol. 7 No. 2,4 p.27.

responsibilities, the SEC has adopted a number of governance reforms as well as adopted new rules designed to strengthen the compliance programs of funds and their advisers and to provide for greater oversight of compliance activities of other service providers to funds. He further states that certain of the governance rules and hedge fund reforms have been successfully challenged in the courts.

Smith's work focuses specifically on the oversight role of fund directors and how the SEC has put in place new governance reforms and adopted new rules to strengthen their oversight role and prevent scandals in mutual funds in the USA. This research contributes to the available literature by looking generally at the efficiency of the legal and regulatory framework for the protection of investors in CIS in Uganda.

Gates, Lowe and Reckers⁴⁹ in their research about restoring public confidence in capital markets through auditor rotation, sought to determine the effect of audit firm rotation and/or audit partner rotation on individuals' confidence in the quality of audited financial statements. Their methodology consisted of two separate behavioural studies conducted with participants from the business and legal community (MBA and law students). In each study, one-way analysis of variance was conducted using a between-subjects approach. The independent measure was auditor rotation; the dependent measure was participants' responses to questions regarding company earnings. Their results revealed that even in an environment of strong controls for corporate governance, audit firm rotation incrementally influenced individuals' confidence in financial statements. However, audit partner rotation did not have a similar effect. Thus rotating the audit firm will better advance the goal to enhance auditor independence and audit quality and to restore investor confidence in the capital markets.

The authors' research is specific in that it examines the effect of both audit firm rotation and audit partner rotation in restoring public confidence in capital markets in the USA which is a mature capital market. This study differs from the above in that it not only focuses specifically on auditors but also generally examines the roles of other capital market players and show how each contributes to create confidence in the capital markets in Uganda which is an emerging capital market.

⁴⁹ S. K. Gates, D. J. Lowe, P. M.J. Reckers, (2007) "Restoring Public Confidence in Capital Markets through Auditor rotation" *Managerial Auditing Journal* Volume 22 No1 5-17 p.10.

Modigliani and Perotti⁵⁰ in their research on security markets versus bank finance assert that the relative attractiveness of security as against intermediated finance is very sensitive to the quality of legal enforcement. The idea is that market-traded securities are highly standardized. The income rights they promise to non controlling investors are based on legal content not a relationship thus their value depends largely on the value of security laws and their proper enforcement. They further argue that an inadequate legal framework allows expropriation of small shareholders and bondholders; it thus reduces their value and impairs the development of security markets.

The authors' research examines the effect of legal enforcement for the relative attractiveness of securities market (shares and bonds) financing as against intermediated (bank) finance and they conclude that poor investor protection hinders the development of capital markets. My research adds to the current literature by generally looking at the adequacy of the legal framework governing the capital markets and how the legal framework fosters investor protection. In addition it adds to the current literature by looking at the necessity of having a regulatory framework that adequately protects investors. The authors' research was also conducted in 2000 using data between the years 1986 and 1993 from a few selected developed and developing countries, this research contributes to the current literature by looking at the current situation and specifically focuses on Uganda which is a developing country with an emerging capital market.

Nkeri,⁵¹ asserts that most of the practitioners in the Kenyan capital markets including investors do not have very solid background information on capital markets. This is the case because there is no specific proficiency curriculum. As a result, retail investors rely on the limited knowledge of the practitioners and hearsay to allocate their meager savings in listed securities. He further states that, there is need to ensure that investors are given the relevant information and are not taken advantage of by fund managers. Investor education is also important in enhancing the level of disclosure and transparency in the market. This in turn will help the authority in its effort of continued development of disclosure based regulations. It is crucial that the investor knows what kind of information to look for, where to look for it and how to understand it.

⁵⁰ F. Modigliani, and E. Perotti, (2000) "Securities Markets Versus Bank Finance: Legal Enforcement and Investors' Protection" *International Review of Finance*, 1:2, p.83.

⁵¹ S.P. Nkeri, (2004) "Investor Education, Awareness and Sensitization Programmes in Kenya", *Capital Markets Journal* Vol.7 No 1, 1st quarter 22-24, p.14.

Nkeri's work is about the need for the provision of information and education to investors in Kenya to ensure that they are protected. This research adds to the current literature by looking generally beyond the need for the provision of information to all other measures legal and regulatory which contribute to the protection of the investors in Uganda.

Wärneryd⁵² states that because of the very nature of the corporation, the most legal protection can ensure is that the firm's internal activities are transparent to the outside investor, and that managers can be sued for violation of their fiduciary duty—the vaguely defined obligation of management to act in the interests of the owners. He further states that in no way means that enforcement of the interests of the investor becomes costless with such legal provisions in place. If the investor suspects mismanagement or outright management diversion of funds, yet does nothing, he will certainly be left with nothing. The investor must at the very least initiate litigation against management⁵³. Once the case goes to court, the investor must expend further resources. Since the court is not omniscient and does no investigation on its own, its decision depends on the evidence presented by the respective parties. He further states that a party who presents no evidence is unlikely to prevail. And evidence, of course, is costly to produce. In developing countries, where legal institutions may be informal, unreliable, and susceptible to corruption, production of evidence may even be costlier than in industrialized nations.

Wärneryd analyses the protection of investors which is offered by the law and he concludes that the protection offered by the law is only good to the extent that it ensures transparency and nothing more and that in case an investor suspects fraud, he has to spend money in litigation which is costly. This research contributes to the current literature by looking generally at other ways in which the legal framework can be of help in ensuring investor protection other than transparency.

Wekesa,⁵⁴ in analyzing the adequacy of the prospectus in ensuring investor protection observed that the prospectus is indeed a very popular document being the central tool of demonstration and a means by which capital markets and securities are made “tangible.” She further states that the prospectus as an illustration of investor protection is a document that

⁵² K. Wärneryd, (June 29, 2007) “Information and Incomplete Investor Protection” available at SSRN:<http://ssrn.com/abstract=893442> last accessed on 4th September 2007,p.3.

⁵³ *ibid* p.6.

⁵⁴ C. Wekesa, C, (2003) “Prospectus: Protection or Puzzle?” *Capital Markets Journal Vol 4 No 3*, p.26.

seeks “full and adequate disclosure” by giving all “material information” to assist the prospective investor make an “informed decision.” She asserts that the prospectus is very vital in protecting investors because it encourages disclosure which is beneficial to the investor.

The author’s work is specific in that she is looking only at the role of the prospectus in protecting investors. She states that the prospectus ensures protection of investors since it is a document that requires total disclosure. The information given in the Prospectus will help the investor to make an informed decision. This research contributes to the current literature by looking generally beyond the efficiency of the prospectus in ensuring investor protection but also examines other ways of ensuring investor protection in Uganda.

La Porta, Lopez, Silanes, Shleifer and Vishny⁵⁵ assert that when outside investors finance firms, they face a risk, and sometimes near certainty, that the returns on their investments will never materialize because the controlling shareholders or managers expropriate them. They state that expropriation can take a variety of forms. In some instances, the insiders simply steal the profits. In other instances, the insiders sell the output, the assets, or the additional securities in the firm they control to another firm they own at below market prices. Such transfer pricing, asset stripping, and investor dilution, though often legal, have largely the same effect as theft. In still other instances, expropriation takes the form of diversion of corporate opportunities from the firm, installing possibly unqualified family members in managerial positions, or overpaying executives. They conclude that expropriation means that the insiders use the profits of the firm to benefit themselves rather than return the money to the outside investors. They also argue that the key mechanism is the protection of outside investors, whether shareholders or creditors, through the legal system, meaning both laws and their enforcement.

This research contributes to the current literature by not only specifically looking at the role of the law in investor protection but looks also generally at other ways that lead to protection of investors.

⁵⁵ R. L. Porta, F. L. Silanes, A. Shleifera and R. Vishny, (2000) “Investor Protection and Corporate Governance” *Journal of Financial Economics* Vol 58 Issues 1-2 pp3-27 p.3.

Francis, Kharuna and Pereira⁵⁶ argue that timely and transparent accounting information can resolve agency problems based on information asymmetry between the firm and outside investors. Therefore, greater public disclosure of accrual-based accounting is part of the corporate governance system in countries with strong investor protection laws to meet the need for timely and transparent accounting information. They further state that when accounting is more timely and transparent, auditing is more critical as an enforcement mechanism because accounting itself is more important to outsiders, and also because accrual-based accounting introduces the possibility of managerial opportunism and they conclude that there is more demand for timely and transparent accounting in corporate governance of common law countries because financial markets are more developed in these countries, and timely and transparent accounting resolves information asymmetries between the firm (including inside owners) and outside investors.

This research adds to the current literature by looking generally beyond the importance of timely and transparent accounting information in protecting investors to other legal and regulatory factors which help in the protection of investors specifically in Uganda.

It is important to appreciate that without a reliable regulatory system that ensures investor protection especially for the small investor; there will be a lack of confidence to invest in these funds. Therefore it is only with a well established regulatory framework in place that the investors, and especially the small investor, can be guaranteed protection and this is vital for the growth and development of a vibrant capital markets industry in Uganda and in particular the Collective Investment Schemes.

2.1.3 Investor Protection

An investor is anyone who commits money to investment products with the expectation of financial return. Generally, the primary concern of an investor is to minimize risk while maximizing return.⁵⁷ Unlike in the past, many of these investors are not large companies, financial firms, or extremely wealthy individuals. A good number are “typical” retail investors i.e. individuals with normal jobs and average incomes who save for retirement and

⁵⁶ J. R. Francis, I. K. Kharuna and R. Pereira, (October 2001) “Investor Protection Laws, Accounting and Auditing Around the World” available at SSRN: <http://ssrn.com/abstract=287652> last accessed on 14th September 2007 p.26

⁵⁷ <http://www.investorwords.com/2630/investor.html> accessed on 22nd October 2008.

their children's education, and who may be well-educated, but nonetheless are not "sophisticated investors" in the legal sense.⁵⁸ It is therefore vital to ensure that the interests of the investors are protected.

Brockman and Chung⁵⁹ investigate the relation between the quality of investor protection and firm (micro level) liquidity. Their approach, in contrast to previous studies, allows them to focus on the link between investor protection and asymmetric information. They expect that relatively strong investor protection acts to minimize the costs of asymmetric information, including the costs of liquidity. Their empirical implication is that firms operating in countries with strong investor protection, *ceteris paribus*, will exhibit lower bid-ask spreads and thicker depths than firms operating in poor protection environments. In their study, they analyze spreads and depths using 16 months of high-frequency data from the Stock Exchange of Hong Kong (SEHK). The SEHK provides an appropriate setting for testing the liquidity hypothesis because it lists companies from very different investor protection environments.

The authors' study contributes to the financial literature by providing additional empirical evidence on the economic importance of investor protection using data from the Stock Exchange of Hong Kong (SEHK). This research adds to the current literature by specifically focusing on the Uganda Securities Exchange (USE) and the need for investor protection in Uganda.

Defond and Hung⁶⁰ in their study on whether there is an association between investor protection and good corporate governance they found out that there is indeed an association because investor protection fosters good corporate governance that in turn instills investor confidence. They further state that an essential role of good corporate governance is to identify and terminate poorly performing CEOs, and so one of the implications of their research is that firms in countries with strong investor protection are more likely to institute governance systems that successfully terminate poorly performing CEOs. Therefore they hypothesize that CEO turnover is more likely to be associated with poor firm performance in

⁵⁸ E.Tafara, (2007) "A Blueprint for Cross-Border Access to USA Investors: A New International Framework," *Harvard International Law Journal* 48(1), p.31.

⁵⁹ P. Brockman and D. Y.Chung, (2003) "Investor Protection and Firm Liquidity" *The Journal Of Finance* Vol. LVIII, No. 2 921-937, p.922

⁶⁰ M..L.Defond and F. M. Hung, (2004) "Investor Protection and Corporate Governance with evidence from worldwide CEO turnover," *Journal of Accounting Research* Vol 42 No 2 269-312.

countries with strong investor protection, measured as extensive investor protection laws and strong law enforcement institutions.

The authors' research is about the relationship between investor protection and corporate governance using data from *worldscope*, a database that contains financial information on publicly traded companies worldwide with a high market capitalization carried out in the period between 1997 and 2001. This research contributes to the current literature by looking specifically at the need for protection of investors in Ugandan.

La Porta, Lopez, Silanes, Shleifer, and Vishny,⁶¹ describe the legal protection of investors as a potentially useful way of thinking about corporate governance. They further find out that strong investor protection is associated with effective corporate governance, as reflected in valuable and broad financial markets, dispersed ownership of shares, and efficient allocation of capital across firms. The authors' research deals with the relationship between investor protection and corporate governance in mature capital markets. This research adds to the current literature by generally looking beyond the aspect of corporate governance to the whole governance structure of CIS and how that helps in protecting investors in an emerging market.

Kamanyere⁶² observed that CIS are important because they contribute to capital market development. She states that by making more resources available for investment, CIS raise the absorptive capacity of the market in securities issues. For CIS to invest in the domestic market, however, there must be a suitable supply of products. The supply of products is expected to come from the private sector listings, government bond issues and the privatization of state owned enterprises. Kamanyere's work specifically looks at the importance of CIS and she states that CIS are important because they contribute to capital market development. This research adds to the current literature by generally looking at the importance of protecting investors who participate in CIS.

⁶¹ L. La Porta, R. Florencio, L. Silanes, A. Shleifer, and R. Vishny, (2000) "Investor Protection and Corporate Governance", *Journal of Financial Economics* 58(1-2), 3-27.

⁶² M. Kamanyere, (2003) "Rationale for Collective Investment Schemes in Uganda" *Capital Markets Journal*, Vol 2 no 1 1st quarter 31-34.

2.2 Theoretical Framework

Before delving into a discussion on the effectiveness of the regulatory framework in protecting investors who participate in collective investment schemes it is important to highlight and discuss some theoretical issues relevant to the study. This is done to establish the theoretical framework for the research. The theoretical framework was developed out of a review of the existing literature on collective investment schemes.

Cross and Prentice⁶³ put forward the theory that people are far more likely to participate in a relatively fair and efficient system, so that if securities legislation indeed enhances fairness and efficiency, that effect will show up in larger, better functioning securities markets. While fairness arguably provides an independent, non-economic justification for the securities laws, that fairness may also produce an economic benefit by shaping the behaviour of investors. They further state that the securities laws' attempt to protect investors from unfairness and fraud is part of a larger goal — to instill faith in the capital markets so that ultimately they will be healthier and more efficient. They further assert that success in achieving that larger goal can be empirically tested, and this sort of test can indirectly capture the fairness benefit.

Tafara and Peterson⁶⁴ state that an efficient capital market requires transparency and liquidity. Transparency is afforded by thorough disclosure requirements, top-notch accounting standards, and independent audits conducted under the highest-quality audit standards. Liquidity is offered by investors who have confidence in the market and the standards under which market participants operate, and who have faith in the legal system and the quality and thoroughness of the enforcement of securities laws and regulations.

Boyle and Meade⁶⁵ put forward the theory that all major stock markets are subject to some form of mandated investor protection regulation (IPR). The underlying idea is that IPR encourages investors to participate in capital markets and thus facilitating the development of these markets.

⁶³ F.B. Cross and R A. Prentice, (2006) "Economies, Capital Markets, and Securities Law", *The University of Texas School of Law and Economics Research Paper* No 73, p.31.

⁶⁴ E.Tafara and R. J. Peterson, "A blueprint for Cross-Border Access to USA Investors: A New International Framework", *Harvard International Law Journal* Vol. 48 p.50.

⁶⁵ G. Boyle and R. Meade, (2005) "One Size Fits All? Investor Protection Regulation of Centralised Trading Platforms" *Working Paper Series* available at <http://papers.ssrn.com/sol3/results> last accessed on 14th September 2007.

This research was also guided by the theory put forward by La Porta, Florencio, Silanes, Shleifer and Vishny,⁶⁶ which is to the effect that countries with poorer investor protection, measured both in terms of the nature of the legal rules in company laws as well as the quality of enforcement, have smaller and narrower capital markets. Specifically, they found that civil law countries like France have both the weakest investor protection and the least developed capital markets, whereas common law countries have the most developed capital markets.

Wang, Liao, and Deng⁶⁷ put forward the theory that investor protection includes the level and quality of disclosure, involvement in major decisions, and protection from self-dealing by managers and large shareholders.

Moodie and Ramsay⁶⁸ advance the theory that compliance risk “is the most significant risk that a regulatory regime for collective investment schemes must deal with.” They further state that compliance risk will be contained if scheme operators establish and give effect to compliance measures that are reasonably likely to detect in advance and prevent a potential breach of the law or the scheme’s constitution. They further state that the continuing growth and diversity of the managed investments industry will continue to test both the ability of the law to regulate the industry and the ability of the industry to regulate itself.

Therefore, it is important to have a sound legal and regulatory framework for the operation of the CIS. This will encourage investors to participate in them. It is also imperative to have a regulator who oversees the capital markets and ensures investors who participate in the markets are protected. The regulatory authority also plays a critical role in ensuring that the market players comply with the laws and regulations governing CIS. In Uganda, the CMA is the regulatory body charged with overseeing the capital markets and its main objective is investor protection. With a good legal and regulatory framework in place and a good

⁶⁶ L. Porta, R. Florencio L. Silanes, A. Shleifer and R. W. Vishny, (1997) “Legal determinants of external finance,” *Journal of Finance*, Vol. LII, 1131-1150 p.1132.

⁶⁷ Y. Wang, L. Liao, and X. Deng, (2003) “The Effect of Investor Protection on Information Asymmetry in a Stock Market” *Working Paper Series* available at <http://papers.ssrn.com/sol3/results> last accessed on 14th September 2007 p.17.

⁶⁸ G. Moodie and I. M. Ramsay, (2004) “Compliance committees under the Managed Investments Act 1998” *Australian Business Law Review*, Vol. 33, No. 3, 2005 p.188 available at <http://papers.ssrn.com/sol3/results> last accessed on 14th September 2007.

regulator who regulates capital markets and ensures that CIS operators comply with the laws and regulations, this will ensure investor protection.

2.3 Conclusion

A lot of literature as shown above was mainly about the relationship between investor protection and corporate governance, firm liquidity, auditor rotation and valuation. However, hardly any literature examined the adequacy of the regulatory framework in protecting the investors in emerging markets and specifically in Uganda or the compliance and enforcement of the regulatory framework by CIS operators and how that protects the investors. This occasioned the need for this study.

This study makes several contributions to the existing literature on the assessment of the regulatory framework for the protection of investors in CIS in emerging markets. Firstly, whilst studies on the relationship between investor protection and the regulatory framework looked at mainly developed capital markets especially on OECD countries and USA, this study departs from earlier studies by looking at emerging capital markets specifically Uganda. Secondly, this study provides fresh evidence in the relationship between the regulatory framework, its compliance by the CIS operators and how that leads to the protection of investors.

Thus, the above literary and scholarly works are relevant to the present study and guide the present research. The analyses supporting the said studies are of material relevance herein so far as the discussion hereafter is concerned.

CHAPTER THREE

THE LEGAL AND OPERATIONAL STRUCTURES OF COLLECTIVE INVESTMENT SCHEMES

3.0 Introduction

A Collective Investment Scheme means any arrangement with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangement, whether by becoming owners of the property or any part of it or otherwise, to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.⁶⁹ The concept underlying CIS is simple; they are a form of institutional investment through which individuals pool their funds and hire professionals to manage their investments, with each investor being entitled to a proportional share of the net benefits of ownership of the underlying assets⁷⁰. The establishment of CIS varies, depending on the legal system of the country in which they are formed.⁷¹

However, the underlying objective of the schemes, which is mobilization of savings for investment, is cross cutting.⁷² This Chapter lays down the different legal forms of CIS generally and specifically in Uganda and their governance and management structures clearly highlighting the similarities and differences between them as well as the advantages and disadvantages of investing in CIS.

3.1 Fund Legal Structures and their Implications

The three main legal structures in which funds are created are corporate, trust or contractual.⁷³

⁶⁹ S.3 (1) of the Collective Investment Schemes Act.

⁷⁰ J. Thompson “Governance Of Collective Investment Schemes (CIS)” (Discussion Draft For Comment, Directorate For Financial And Enterprise Affairs July 2004 available at www.oecd.org/dataoecd/13/31/33621909.pdf accessed on 14th September 2007 p.3.

⁷¹ *ibid.*

⁷² W. Tarinyeba, (2005) “Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda” *Capital Markets Journal Vol 9 no 4*, 33-38 p.33.

⁷³ M. St Giles, E. Alexeeva, and S.Buxton, (2003) “Managing Collective Investment Funds” John Wiley & Sons Ltd 2nd Edition p.28.

Corporate funds are where the CIS is a separate corporate entity in which the assets are owned by the investment company and the investors are shareholders of the investment company.⁷⁴ Funds formed as companies generally operate on the basis of company law in the country in which they are created, though they are also subject to specific additional regulatory and fiscal provisions or exemptions relating to funds that distinguish them from ordinary companies. This is because corporate funds are not ordinary companies, which usually seek to make profits from producing goods or services. Instead corporate funds aim to give their shareholders good returns from making investments⁷⁵.

A corporate fund has a board of directors that is responsible to shareholders for the performance of the company in which they have invested. Such directors have a fiduciary duty to their shareholders, which essentially places a responsibility on them to treat shareholders' money as carefully as they would their own. The board is legally responsible for contracting the services of a fund management company, a custodian and any other provider of services to the fund, such as the auditor, and monitoring their performance of their obligations. It can also terminate the contracts of such organizations, including the management company and appoint replacements.⁷⁶

The shares issued by corporate funds are securities, as are those issued by other companies. The rights of investors in corporate funds are the same as investors in other companies – they buy shares in the fund and are referred to as shareholders - though fund law may give them additional rights and require them to vote on additional issues to those required under company law. Such issues would usually include a change in investment objectives of a fund and an increase in fees charged to the fund.⁷⁷ Corporate form funds can be operated under most legal systems so this form of fund is found throughout the world, though taxation treatment and inability to operate variable capital companies can restrict their performance.⁷⁸

⁷⁴ J. K. Thompson and S. M. Choi (April 2001) "Governance Systems for Collective Investment Schemes in OECD Countries" Financial Affairs Division Occasional Paper No 1 p.14.

⁷⁵ M. St Giles, E. Alexeeva, and S. Buxton, (2003) "Managing Collective Investment Funds" John Wiley & Sons Ltd 2nd Edition p.29.

⁷⁶ M. St Giles, E. Alexeeva, and S. Buxton, (2003) "Managing Collective Investment Funds" John Wiley & Sons Ltd 2nd Edition p.29.

⁷⁷ *ibid* pg 30.

⁷⁸ *ibid* pg 28.

Trust funds are where the CIS is organized as a “trust,” in which an identified group of assets is constituted and managed by a trustee for the benefit of another party the beneficiary.⁷⁹ As such, a trust is a legal person and may therefore be taxable.⁸⁰ Funds formed as trusts are generally referred to as unit trusts and holdings in them are known as units.⁸¹ They are created by a trust deed to which the signatories are the management company and the trustee.⁸² The investor becomes a beneficiary of the trust upon subscription of money to the fund, in return for which he receives a holding of units.⁸³ The beneficiary has rights to the returns earned by the fund in proportion to his contribution to the total value of the fund. Voting rights of unit holders in unit trusts are more limited than those of shareholders in corporate funds. In contrast to corporate funds, unit trusts do not have annual general meetings though they are required to call extraordinary general meetings to vote on specified issues such as increase in fees or a change in the investment objective. This is because such changes have the effect of altering the basis on which the original contract was entered into and were unknown to the investor at that time.⁸⁴

Trust form funds are only found in countries that have a common law system or which have been influenced by such countries, the main example being the English common law system which has influenced the legal system of former British colonies including America.⁸⁵

Contractual funds are where the CIS is a contract under which the investment manager invests funds on behalf of the final investor. The investor enters into a contract with an investment management company, which agrees to purchase a portfolio of securities and manage those securities on behalf of the final investor. The investor owns a proportional share of the portfolio.⁸⁶ This type of fund has no legal persona.⁸⁷ The management company is required to have a contract with a depositary to provide custody and supervisory services in

⁷⁹ J. K. Thompson and S. M. Choi (April 2001) “Governance Systems for Collective Investment Schemes in OECD Countries” Financial Affairs Division Occasional Paper No 1 p.14.

⁸⁰ *ibid* pg 33.

⁸¹ M. St Giles, E. Alexeeva, and S. Buxton, (2003) “Managing Collective Investment Funds” John Wiley & Sons Ltd 2nd Edition p.33.

⁸² *ibid*

⁸³ M. St Giles, E. Alexeeva, and S. Buxton, (2003) “Managing Collective Investment Funds” John Wiley & Sons Ltd 2nd Edition p.33.

⁸⁴ *ibid*.

⁸⁵ *ibid* p.28.

⁸⁶ J. K. Thompson and S. M. Choi, (April 2001) “Governance Systems for Collective Investment Schemes in OECD Countries” Financial Affairs Division Occasional Paper No.1 p.14.

⁸⁷ M. St Giles, E. Alexeeva, and S. Buxton, (2003) “Managing Collective Investment Funds” John Wiley & Sons Ltd 2nd Edition p.34.

order for the fund to be approved by the regulator. Investors buy “units” or “participations” or “certificates” in the fund and they are known as “unit holders” or “participants” or “certificate holders.”⁸⁸ The returns made by the fund are proportionate to the investors’ contribution to the total value of the fund.

The rights of the investors in such funds are defined by the contract with the management company, investment fund laws and regulations which establish these rights and often specify requirements for the mandatory content of such contracts. The voting rights of investors in contractual funds are often weaker than those of shareholders in corporate type funds or beneficiaries of trust type funds. Unlike them, contractual fund investors will have no vote on changes to the fund which substantially affect their interests e.g. an increase in charges unless fund law and regulation specifically mandates such rights. Without the right to vote, investors can only express their disagreement with any proposed change by “voting with their feet” and asking for their units to be redeemed.⁸⁹ Contractual form funds are found in countries which have a legal system based on a civil code and are common in continental European countries and their former colonies.⁹⁰

Whatever its legal form, a CIS generally consists of a pooling of resources to gain a sufficient size for portfolio diversification and cost-efficient operation and professional portfolio management to execute an investment strategy.⁹¹

3.2 Fund Operational Structures and their Implications

Funds whether of company, trust or contractual type generally operate either in “open ended” or in “closed ended” form.

3.2.1 Open Ended Funds

An open ended fund is a fund which has the absolute obligation under fund law and regulations to redeem its shares or units on a regular, stated basis. As a general rule, most

⁸⁸ *ibid.*

⁸⁹ *ibid.*

⁹⁰ *ibid* p.28.

⁹¹ J, Thompson, (July 2004) “Governance Of Collective Investment Schemes (CIS)” (Discussion Draft For Comment, Directorate For Financial And Enterprise Affairs Available at www.oecd.org/dataoecd/13/31/33621909.pdf accessed o 14th September 2007 p.3.

open ended funds both issue and redeem daily, the minimum requirement is always set by regulation and may be less frequent – for instance, a common provision is that an open ended fund must redeem at least once every two weeks on a clearly disclosed day and time.⁹² This constant issue and redemption means that the capital of the fund changes from day to day as new investors arrive and other investors leave the fund.

Open ended funds have to be able to create and cancel shares or units in the fund everyday to meet demand to sell units or buy them back. Another key factor is that since an open ended fund has to take in new money everyday and pay out existing investors everyday in cash, it must be able to buy and sell assets for the fund quickly and reliably.⁹³ This is why open ended funds are required by law to hold mostly liquid assets. Open ended funds constitute the largest proportion of funds internationally, they are more popular than closed ended funds largely because investors can buy or sell shares or units quickly and easily at their full net asset value or NAV.⁹⁴

However, they cannot operate efficiently or effectively in illiquid markets since they cannot easily buy or sell assets to meet purchase and redemption orders nor can they easily find prices to create accurate valuations.⁹⁵ CIS offered in Uganda are open ended in nature because when investors want their money back, it is immediately available. The unit trust manager or insurance company does not decide when to repay the investor and at what charge.⁹⁶ The regulations clearly provide for redemptions to be made whenever an investor wishes to leave the fund.

3.2.2 Closed Ended Funds

A closed ended fund is one that, like a company, has a fixed amount of capital in issue. The funds have an initial offer period to raise capital and then at the end of that offer they close to further subscriptions: usually no further issues may be made unless existing holders agree to

⁹² M. St Giles, E. Alexeeva, and S.Buxton, (2003) “Managing Collective Investment Funds” John Wiley & Sons Ltd 2nd Edition p.38.

⁹³ *ibid*

⁹⁴ *ibid*

⁹⁵ *ibid* p.39

⁹⁶ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

an increase in capital.⁹⁷ There is no duty on closed ended funds to redeem i.e. to buy back shares or units from investors so there are no demands on them to sell assets for cash. This also makes these funds more able to borrow or gear or leverage since their asset base is more stable. This structure is therefore suited to investing in illiquid as well as liquid assets, being commonly used to invest in emerging markets and in unlisted and untraded companies.⁹⁸

3.3 Legal Forms of CIS in Uganda

The law governing Collective Investment Schemes is the CIS Act of 2003 and the regulations made thereunder. These include CIS (Unit Trusts) Regulations, CIS (OEIC) Regulations, and CIS (Conduct of Business) Regulations among others. The laws provide for the different legal forms of CIS. The types of schemes legally recognized are the Unit Trusts and Open Ended Investment Companies (OEICs).

3.3.1 Unit Trusts

A “Unit Trust Scheme” is defined as a CIS under which property is held in trust for the participants.⁹⁹ The Capital Markets Authority Act,¹⁰⁰ has a much broader definition and it defines a unit trust scheme as “any arrangement made for the purpose, or having the effect, or providing facilities for the participation by persons as beneficiaries under a trust, in profits or income arising from the acquisition, holding, management or disposal of securities or any other property.”

In Uganda, the requirements for the formation and establishment of Unit Trust Schemes are contained in the CIS Act, the CIS (Unit Trusts) Regulations, CIS (Licensing) Regulations and CIS (Conduct of Business) Regulations, among others.

The key formation requirements for the formation of a unit trust are; the Unit Trust Manager/Operator and the trustee. The Unit Trust manager/operator is responsible for managing the fund in accordance with the trust deed. He is also responsible for providing

⁹⁷ M. St Giles, E. Alexeeva, and S.Buxton,, (2003) “Managing Collective Investment Funds” John Wiley & Sons Ltd 2nd Edition p.38.

⁹⁸ *ibid* p.39.

⁹⁹ S.1 of the Collective Investment Schemes Act No. 2 of 2003.

¹⁰⁰ S.2 of the Capital Markets Authority Act.

liquidity at all times and for marketing the funds.¹⁰¹ The operator must be a company incorporated under the Companies Act and must have a minimum net capital of UGX 200 million (about US\$ 85,475).¹⁰² The Trustee holds all the assets of the fund and is also responsible for supervision of the compliance of the management company's conduct of business.¹⁰³ It is important to note that the trustee and the operator must not be related entities.¹⁰⁴ The separation of the trustee and the operator ensures that the money invested in a unit trust cannot be used by the fund manager for any purpose other than that which is stipulated in the trust deed.¹⁰⁵ The trustee must be either a Bank or an Insurance Company licensed as such under the Financial Institutions Act or Insurance Act and approved to act as trustee by the Capital Markets Authority.¹⁰⁶

Unit trusts are created by a trust deed to which the signatories are the management company and the trustee. A unit trust scheme does not qualify to be licensed unless the scheme is constituted by a trust deed.¹⁰⁷ The trust deed is the key formation document for Unit Trust Schemes¹⁰⁸ and it must comply with Part III of Schedule I of the Act.¹⁰⁹ The unit trust is governed by an approved trust deed which is a legal document drawn up by the fund manager and registered with the securities commission and it is designed to govern the operations of the trust fund and protect the unit trust holders' interests.¹¹⁰ The trust deed must be approved and accepted by the trustee, custodian and fund manager of the unit trust. It defines the relationship between the trustee and the unit trust manager and also sets out their duties and powers. The trust deed also spells out the name of the scheme, investment objectives, governing law, declaration of trust, investment powers in eligible markets, rights of unit holders, the manager's charges and remuneration of the trustee as well as any limits on fund

¹⁰¹ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

¹⁰² W. Tarinyeba, (2005) "Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda" *Capital Markets Journal Vol 9 no 4*, 33-38 p.34.

¹⁰³ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

¹⁰⁴ W. Tarinyeba, (2005) "Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda" *Capital Markets Journal Vol 9 no 4*, 33-38 p.34.

¹⁰⁵ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

¹⁰⁶ *ibid* p.34, and S.9 (1) of the Collective Investment Schemes Act No. 2 of 2003.

¹⁰⁷ Part II, regulation 4 (1) of the CIS (Unit Trusts) Regulations.

¹⁰⁸ W. Tarinyeba, (2005) "Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda" *Capital Markets Journal Vol. 9 No. 4*, 33-38 p.34.

¹⁰⁹ *ibid* p.34, and S.9 (1) of the Collective Investment Schemes Act No. 2 of 2003.

¹¹⁰ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

activity.¹¹¹ The trust deed is a public document, which must be printed in the English language and made available for members of the public to inspect.¹¹²

The Unit Trust Manager/operator must produce scheme particulars that comply with Part IV of Schedule 1 of the Act.¹¹³ This document contains basic information that an investor would require such as particulars of the manager, trustee, investment adviser and auditor of the scheme, the constitution and objectives of the scheme, charges, and rights of unit holders, issue and redemption of units among others.¹¹⁴

The investor in a unit trust becomes a beneficiary of the trust upon subscription of money to the fund in return for which he receives a holding of units which may either be income units or accumulation units.¹¹⁵ Income unit holders receive income periodically, while accumulation unit holders have their income periodically credited to capital.¹¹⁶ The beneficiary has rights to the returns earned by the fund in proportion to his contribution to the total value of the fund.¹¹⁷

A licensed unit trust scheme must belong to only one of the following categories of funds: a securities fund, a money market fund, or an umbrella fund.¹¹⁸ A securities fund is a scheme principally consisting of transferable securities.¹¹⁹ A money market fund is a scheme which comprises deposits, instruments creating or evidencing indebtedness which are not transferable securities; and transferable securities other than equities.¹²⁰ An umbrella fund has constituent parts which consist of any of the categories provided for the securities fund and money market fund.¹²¹ A scheme may not change from one category to another, nor may its

¹¹¹ *ibid.*

¹¹² Part II r.5 of the CIS (Unit Trusts) Regulations and W. Tarinyeba, (2005) "Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda" *Capital Markets Journal* Vol. 9 no 4, 33-38 p.34.

¹¹³ *ibid*

¹¹⁴ Part III of the CIS (Unit Trusts) Regulations and W. Tarinyeba, (2005) "Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda" *Capital Markets Journal* Vol. 9 no 4, 33-38 p.34.

¹¹⁵ Regulation 7 (1), (a) and (b) of the CIS (Unit Trusts) Regulations and W. Tarinyeba, (2005) "Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda" (2005) *Capital Markets Journal* Vol. 9 no 4, 33-38 p.34.

¹¹⁶ Regulation 7 (2) of the CIS (Unit Trusts) Regulations.

¹¹⁷ M. St Giles, E. Alexeeva, and S. Buxton, (2003) "Managing Collective Investment Funds" John Wiley & Sons Ltd 2nd Edition p.33.

¹¹⁸ Regulation 8 (1) (a) (b) and (c) of the CIS (Unit Trusts) Regulations.

¹¹⁹ Regulation 8 (2) of the CIS (Unit Trust) Regulations.

¹²⁰ Regulation 8 (3) of the CIS (Unit Trust) Regulations.

¹²¹ Regulation 8 (2), (3), (4) of the CIS (Unit Trusts) Regulations.

objectives be changed so as to achieve that effect.¹²² This is because such changes have the effect of altering the basis on which the original contract was entered into and were unknown to the investor at that time.¹²³ Such changes also expose the investors to different risks which were not anticipated by them. This may jeopardize the interests of the investors and thus this provision is aimed at ensuring protection of the investors.

3.3.2 Open Ended Investment Companies (OEICs)

An “open-ended investment company” is defined as a collective investment scheme under which the property in question belongs beneficially to and is managed by or on behalf of, a body corporate having as its purpose the investment of its funds with the aim of spreading risk and giving its members the benefit of the results of the management of those funds by or on behalf of that body.¹²⁴ OEICs are sometimes referred to as Investment Companies with Variable Capital (ICVC).¹²⁵

In Uganda, the requirements for the formation, establishment and governance of Open ended investment companies are contained in the CIS Act, the CIS (Open Ended Investment Companies) Regulations 2003, CIS (Conduct of Business) Regulations and CIS (Licensing) Regulations, 2003.

An OEIC scheme is formed by registering the company with the Registrar of companies under the Companies Act.¹²⁶ It is required to submit a copy of the instrument of incorporation, particulars of the Authorized Corporate Director (ACD),¹²⁷ whose duties and responsibilities are similar to those of a unit trust manager, particulars of the Depositary, who performs the same functions as the trustee of a unit trust scheme and must be either a bank or insurance company¹²⁸. A prospectus, which is an information document similar to the scheme

¹²² Regulation 8 (5) of the CIS (Unit Trust) Regulations.

¹²³ M. St Giles, E. Alexeeva, and S. Buxton, (2003) “Managing Collective Investment Funds” John Wiley & Sons Ltd 2nd Edition p.3.

¹²⁴ Section 1 of the Collective Investment Schemes Act No. 2 of 2003.

¹²⁵ W. Tarinyeba, (2003) “Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda” *Capital Markets Journal* Vol. 9 no 4, 33-38 p.33.

¹²⁶ Part II of the CIS (OEIC) Regulations and W. Tarinyeba, (2005) “Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda” *Capital Markets Journal* Vol. 9 no 4, 33-38 p.35.

¹²⁷ Part II of the CIS (OEIC) Regulations.

¹²⁸ Section 9 (1) of the Collective Investment Schemes Act No. 2 of 2003, Part II of the CIS (OEIC) Regulations, W. Tarinyeba, (2005) ‘Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda’ *Capital Markets Journal* Vol. 9 no 4, 33-38 p.35.

particulars of a unit trust scheme, is also required. The ACD must be incorporated under the Companies Act and have a minimum net capital of UGX 200 million (about US\$ 85,475).¹²⁹

An OEIC does not qualify to be licensed unless it has an instrument of incorporation.¹³⁰ The instrument of incorporation must state what type of shares the company may issue. It also states that the designated person shall be the ACD of the company; it also states that the company by resolution passed by a simple majority may remove a director before the expiry of his term of office. The instrument of incorporation must not include any provision which is unfairly prejudicial to the interests of the shareholders generally. The ACD and the depositary shall make available a copy of the instrument of incorporation for inspection by any member of the public at all times during ordinary office hours and it must be printed in the English language.¹³¹

The ACD must produce a prospectus that complies with Part II of Schedule I of the Act.¹³² This document contains basic information that an investor would require such as particulars of the company, ACD, investment objectives and policy, property in which the company may invest, distribution policy, issue and redemption of shares and valuation.¹³³

The investor in an OEIC, upon subscription of money to the company in return receives a holding of shares which may either be income shares or accumulation shares.¹³⁴ Income shareholders receive income periodically, while accumulation shareholders have their income periodically credited to capital.¹³⁵

An OEIC company must belong to only one of the following categories of companies: a securities company, a money market company, or an umbrella company.¹³⁶ A securities company is a company whose objective is to invest in transferable securities.¹³⁷ A money

¹²⁹ Part II of the CIS (OEIC) Regulations, W. Tarinyeba, (2005) "Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda" *Capital Markets Journal* Vol. 9 no 4, 33-38 p.35.

¹³⁰ Part II of the CIS (OEIC) Regulations.

¹³¹ Part II, Regulation 4 of the CIS (OEIC) Regulations.

¹³² Part III of the CIS (OEIC) Regulations and W. Tarinyeba, (2005) "Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda" *Capital Markets Journal* Vol. 9 no 4, 33-38 p.35.

¹³³ Part III of the CIS (OEIC) Regulations and W. Tarinyeba, (2005) "Collective Investment Schemes: An Overview of the Regulatory Framework in Uganda" *Capital Markets Journal* Vol. 9 no 4, 33-38 p.35.

¹³⁴ Regulation 6 (1), (a), (b) of the CIS (OEIC) Regulations.

¹³⁵ Part II of the CIS (OEIC) Regulations.

¹³⁶ Regulation 5 (1), (a), (b), (c) of the CIS (OEIC) Regulations.

¹³⁷ Part II of the CIS (OEIC) Regulations.

market company is a company whose objective is to invest in deposits, instruments creating or evidencing indebtedness which are not transferable securities; and transferable securities other than equities.¹³⁸ An umbrella company is a single company with at least two sub funds, providing the opportunity for shareholders to switch all or part of their investment from one sub fund to another.¹³⁹ Part XI of these Regulations¹⁴⁰ enables the umbrella company to be treated as a single company and/or as a collection of separate sub funds as appropriate.

3.4 Types of Unit Trusts Offered by African Alliance (AA) Uganda

Although the legal regime for CIS allows for both unit trusts and OEIC's to operate in Uganda, only unit trusts are currently offered by African Alliance Uganda.¹⁴¹ African Alliance International forms the parent company of African Alliance Uganda and also has operations in Botswana, Swaziland, Kenya, Tanzania and Angola.¹⁴² African Alliance Uganda provides utilized and segregated investment management services and they invest funds domestically and globally in addition to cash/treasury management services.¹⁴³

Unit trusts are broadly categorized into general funds or specialized funds. Specialized funds include property funds, specialized debt funds and specialized equity funds. Property funds provide for investment in real estate, leases and mortgage baskets, specialized debt funds allow investment in emerging market and high yielding debt markets and specialized equity funds allow investment in certain sectors of the economy.¹⁴⁴

General funds are of three types which include balanced funds, fixed income funds and money funds. Balanced funds allow for investment in a variety of asset classes. Fixed income funds allow for investment in bonds, commercial paper and bank deposits and money funds

¹³⁸ Regulation 5 (2), (3) of the CIS (OEIC) Regulations.

¹³⁹ Part V, Division D of the CIS (OEIC) Regulations.

¹⁴⁰ CIS (OEIC) Regulations.

¹⁴¹ See Chapter 1.2.

¹⁴² Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

¹⁴³ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

¹⁴⁴ *ibid.*

allow for investment in treasury bills, bonds, commercial paper and bank deposits.¹⁴⁵ The unit trusts in Uganda fall under the category of general funds.¹⁴⁶

AA Uganda operates three unit trust funds depending on an investor's risk appetite namely: the AA Uganda Money Fund, the AA Uganda Balanced Investment and the AA Uganda High Yield Fund as discussed below.¹⁴⁷

3.4.1 African Alliance Uganda Money Fund

The Money Fund started operating on 1st January 2005. The minimum investment required is UGX 250,000 (about US\$ 107) paid in lump sum or UGX 50,000 (about US\$ 22) paid monthly.¹⁴⁸ The investment aim of this fund is to provide an attractive level of current income while preserving capital.¹⁴⁹ The fund invests in high quality short term financing instruments and deposits providing investors with access to the wholesale money market usually the preserve of the banking sector. The fund may also invest in money market instruments with a maturity of less than 13 months and the weighted average term of the portfolio may not exceed 90 days.¹⁵⁰ This fund is usually liquid, cost effective and safe.¹⁵¹ The fund is suitable for clients with high liquidity needs who might need income on a regular basis like people approaching retirement. This is the lowest risk profile fund because it is perceived that the government is most likely not going to default on its debt to the public. Jed Musinguzi, an investment analyst with AA Uganda stated that because of lower risk, the profile also has the lowest annual rate of return. Its annual rate of return as at August 2008 was 9.82%.¹⁵²

¹⁴⁵ *ibid.*

¹⁴⁶ *ibid.*

¹⁴⁷ *ibid.*

¹⁴⁸ G. Watson, "Commentary from African Alliance Manager" (February 2007) African Alliance Newsletter p.1.

¹⁴⁹ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

¹⁵⁰ G. Watson, "Commentary from African Alliance Manager" (February 2007) African Alliance Newsletter p.1.

¹⁵¹ *ibid*

¹⁵² G. Muhwezi-Bonge "Pooling money for investment" an interview with J. Musinguzi, an Investment Analyst with AA Uganda Daily Monitor Thursday November 20th 2008 p.26.

3.4.2 African Alliance Uganda High Yield Fund

The High Yield Fund started operating on 31st October 2004. The minimum investment required is UGX 50,000 (about US\$ 22) paid in lump sum or UGX 20,000 (about US\$ 9) paid monthly.¹⁵³ There is an initial fee of 2.5% on every additional investment into the fund.¹⁵⁴ The investment aim of this fund is to provide maximum income and relative capital stability from a portfolio of Uganda's interest bearing investments. The manager has powers to adjust the portfolio in line with changing fundamental factors that affect the direction of movements in interest rates.¹⁵⁵ This fund is usually liquid, cost effective and safe.¹⁵⁶

The fund invests in Uganda Government treasury bonds and local corporate bonds. The fund also ensures that there must be cash holding to facilitate ease of exit.¹⁵⁷ However, the Uganda Securities Exchange (USE) has only three corporate bonds i.e. East African Development Bank bonds, Standard Chartered and Uganda Telecom bonds which makes diversification a challenge.

Jed Musinguzi, an investment analyst with AA Uganda stated that the fund has a higher risk profile compared to the money fund because investors are lending the Government or companies' money through bonds for longer periods and hence should attract higher interest to compensate them.¹⁵⁸ This fund is suitable for young to middle aged working class people that still have many years ahead of them in work and can afford to take the risks. It is good when one is saving for higher education, wedding or housing project.¹⁵⁹ The fund's annual rate of return was 11.53% as at June 2008.¹⁶⁰

¹⁵³ G. Watson, "Commentary from African Alliance Manager" (December 2006) African Alliance Newsletter p.1.

¹⁵⁴ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

¹⁵⁵ *ibid.*

¹⁵⁶ *ibid.*

¹⁵⁷ *ibid.*

¹⁵⁸ G. Muhwezi-Bonge "Pooling money for investment" an interview with J. Musinguzi, an Investment Analyst with AA Uganda, Daily Monitor, Thursday, November 20th 2008 p.26.

¹⁵⁹ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

¹⁶⁰ G. Muhwezi-Bonge "Pooling money for investment" an interview with J. Musinguzi, an Investment Analyst with AA Uganda, Daily Monitor, Thursday, November 20th 2008 p.26.

3.4.3 African Alliance Uganda Balanced Fund

The Balanced Investment Fund started operating on 31st October 2004. The minimum investment required is UGX 50,000 (about US\$ 22) paid in lump sum or UGX 20,000 (about US\$ 9) paid monthly.¹⁶¹ There is an initial fee of 5% on every additional investment into the fund.¹⁶² The investment aim of this fund is to seek long term capital growth, consistent with moderate investment risk and a reasonable level of current income.¹⁶³ This fund is usually liquid, cost effective and safe.¹⁶⁴

The fund invests in securities listed on the Uganda Securities Exchange as well as Uganda Government Treasury Bonds and local Corporate Bonds. A cash holding will be held at all times in order to facilitate ease of exit. Property may be added as permitted by the regulations and the Fund has the ability to access global markets.¹⁶⁵ Jed Musinguzi stated that this fund offers a wide diversification in investments and the risk level is perceived to be highest in this fund. Therefore because the investor has taken these high risks and invested in all these portfolios and on a long term, they should be compensated with a higher interest.¹⁶⁶ According to Jed Musinguzi, the fund is suitable for young to middle aged working class looking to save for the long term. This fund is the most risky because it invests in a number of high risk financial instruments but also gives the highest return on investment.¹⁶⁷ The fund's annual rate of return as of June 2008 was 44.6%.¹⁶⁸

3.5 Unit Trust Investor Profile in Uganda

The investor profile of the unit trust operated by African Alliance Uganda shows dominance of individual investors who totalled 800 as at November 2008. This is followed by institutional/corporate investors who are only six and they include Mobile

¹⁶¹ G. Watson, (December 2006) "Commentary from African Alliance Manager" African Alliance Newsletter p.1.

¹⁶² Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

¹⁶³ *ibid.*

¹⁶⁴ *ibid.*

¹⁶⁵ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

¹⁶⁶ G. Muhwezi-Bonge "Pooling money for investment" an interview with J. Musinguzi, an Investment Analyst with AA Uganda, Daily Monitor, Thursday, November 20th 2008 p.26.

¹⁶⁷ *ibid.*

¹⁶⁸ *ibid.*

Telecommunications Network (MTN), Bank of Uganda (BOU), National Housing and Construction Company (NHCC)¹⁶⁹ among others. The total amount of funds managed by African Alliance by January 2009 was about UGX 3 billion.¹⁷⁰

The CMA began licensing Collective Investment Schemes after Parliament passed the CIS Act in 2003. African Alliance was granted the first unit trust license in Uganda by the CMA in February 2004 and to date it is still the only licensed operator of unit trusts.¹⁷¹ On the other hand, the Kenyan market is fairly more developed with close to ten companies operating Collective Investment Schemes. These include Old Mutual, British American Asset Managers, Commercial Bank of Africa, Stanbic Asset Management, Suntra Investment Bank, ICEA Asset Management, Dyer and Blair, Zimele and Standard Investment, among others.¹⁷²

However in Uganda, other fund managers such as Stanbic Investments and Insurance Company of East Africa (ICEA) investment services have expressed interest in operating the schemes.¹⁷³ This shows that the Collective Investment Scheme market in Uganda is still nascent but with immense potential for growth.

Insurance Company of East Africa (ICEA) Uganda announced the launch of a Money Market Fund, Growth Fund, and Equity Fund targeting individual investors as a way of cushioning them against the risks of being directly involved in the stock market.¹⁷⁴ They have embarked on an awareness campaign of the CIS product and they have approached a number of companies which include Coffee Development Authority (CDA), Uganda Clays Limited (UCL) and National Water and Sewerage Corporation (NWSC).¹⁷⁵

Gary Corbit, the Managing Director of ICEA Uganda states that they also are targeting individuals who have money but lack where to invest and they shall put it in high yielding projects.¹⁷⁶ Gary Corbit further stated that Investment Services Uganda Limited (ISU), a

¹⁶⁹ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

¹⁷⁰ *ibid.*

¹⁷¹ *ibid.*

¹⁷² Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda on 14th January 2009.

¹⁷³ *ibid.*

¹⁷⁴ Interview with Hamis Mugendawala, Fund Manager with ICEA Uganda on the 7th of January 2009.

¹⁷⁵ *ibid.*

¹⁷⁶ T. Magumba an interview with G. Corbit, Managing Director of ICEA Uganda and P. Sigsworth, Managing Director of ICEA Kenya ,Daily Monitor September 30th 2008.

subsidiary of ICEA, which was launched, had been licensed by the Capital Markets Authority and would operate as a fund management company.¹⁷⁷

Paul Sigsworth, the Managing Director of the Nairobi-based ICEA Asset Management Company said the Ugandan subsidiary would also handle funds for other companies that wish to invest with them. He said the past five years had seen an increase in the number of foreign, local banks and insurance firms. This and the discovery of oil means that the Ugandan market portends a lot yet there were still few service providers. He said the Kenyan company controls about Kshs 30 billion (about US\$ 357,148,000) and wanted Ugandans to also benefit from this.¹⁷⁸

However, Mugendawala, ICEA's Fund Manager said the absence of a trustee bank may temporarily halt their progress but added that the company is negotiating with KCB Bank, the trustee of ICEA funds in Nairobi, to extrapolate its role to the Ugandan funds. KCB has already applied for a license from CMA. "After getting a trustee we shall then determine the minimum figure individuals can contribute to the pool," he said.¹⁷⁹

3.6 Advantages of Investing in Unit Trusts

Investing in Unit Trusts brings with it a number of benefits to the investors and these benefits include *inter alia* diversification, professional management, benefits or rewards among others as discussed below.

3.6.1 Reduction of Risk/Diversification

Many individual investors select stocks, bonds or mutual funds solely to create a diversified portfolio.¹⁸⁰ Diversification is the end result of applying asset allocation strategies, which derive from modern portfolio theory, an offshoot of economics from the early 1950s. Asset allocation holds that investors should combine various asset classes that do not correlate

¹⁷⁷ *ibid.*

¹⁷⁸ *ibid.*

¹⁷⁹ Interview with Hamis Mugendawala Fund manager with ICEA Uganda on the 7th of January 2009

¹⁸⁰ J. Rogers, Diversification is a scam, <http://freundinvesting.com/2009/04/22> accessed on 20th January 2009.

perfectly to achieve a diversity that protects some asset classes when others are adversely affected.¹⁸¹

Diversification thus involves the process of spreading risk over a broad portfolio of bonds and stocks in different sectors, companies, countries or regions, hence returns are derived at minimized risk.¹⁸² An ordinary investor may only be able to afford to invest between US\$ 1,000 and US\$ 10,000. If the investor were buying securities directly, it would be difficult to buy a holding in several companies for such a sum, even though this money might be the only amount available for investment. Thus investors putting a small sum directly into securities are unlikely to be able to diversify their risk, and if the one company they choose to invest in goes bankrupt, they can lose all their money. Investing in unit trusts reduces risk because the funds are invested in 20 or more different investments.¹⁸³

Paul Sigsworth also noted that if an investor had UGX 100,000 (about US\$ 43), it would almost be worthless to invest in the stock market directly. If, however, he or she put it into a unit trust then the pool of money that accumulates can be invested in company shares by investment managers much more effectively.¹⁸⁴ He however said the risks associated with unit trusts still exist but the exposure is significantly reduced since funds are ploughed into a wide range of investment options, spreading the possible adverse reactions.¹⁸⁵

Thus, once investors understand clearly that diversification pays in that it lowers risk in relation to return they will value this diversification and seek it out. This is almost certainly the major factor in the recent success of funds in developed markets. It is even more relevant to emerging markets where the risks involved in individual securities are usually higher so that the advantages of diversification are greater.¹⁸⁶

However, since the onset of the credit crunch, nearly all asset classes have suffered, with marked falls even in the value of those assets that many regarded as safe havens. Investments

¹⁸¹ *ibid.*

¹⁸² Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

¹⁸³ M. St Giles, E. Alexeeva, and S.Buxton., (2003) "Managing Collective Investment Funds" John Wiley & Sons Ltd 2nd Edition p.4.

¹⁸⁴ *ibid.*

¹⁸⁵ *ibid.*

¹⁸⁶ *ibid* pg 5

that were supposed to provide protection via diversification failed to perform as expected, heading in the same downward direction as mainstream assets.¹⁸⁷ Financial markets have experienced unprecedented levels of turmoil, with the value of equities and other assets plummeting to lows not seen in over a generation.¹⁸⁸ This has caused many professionals to look more closely at the assets under their management and ask which can be trusted in a financial environment now littered with the debris of fallen institutions and polluted with toxic assets such as those from Enron¹⁸⁹ and more recently it was the mortgages where millions of investors lost billions as a result of holding those worthless assets.¹⁹⁰

Consequently, some advisors and fund managers have expressed concerns that there is a lack of financial instruments at their disposal that can be relied upon to retain their value and offer true diversification. More specifically, they have been forced to question whether their investment strategies offer a reliable means of balancing return potential and risk reduction.¹⁹¹ It can be argued that fund managers and investment strategists must acknowledge that, if this is to happen, they must show more rigour in their approach to diversification and greater commitment to more balanced asset allocation strategies. In practice, they must consider a broader range of instruments and assets.¹⁹²

It has also been argued that diversification is good for limiting risk to an extent but it is awful for maximizing return. Diversification will deliver only average performance at best. Rogers asserted that “if one possesses the skills and is prepared to put in the necessary time and hard work to become a top 20% performer, then why accept being mediocre? If there are insufficient quality investments available, then be patient and wait for the right opportunity.”¹⁹³

Rogers also stated that "diversification is something that stock brokers came up with to protect themselves, so they would not get sued for making bad investment choices for clients. He goes ahead to say that Henry Ford never diversified, Bill Gates did not diversify, and the only way to get rich is to put your eggs in one basket, but watch that basket very carefully

¹⁸⁷ Toxic money Versus Toxic assets.

¹⁸⁸ *ibid.*

¹⁸⁹ See chapter 2.1.1 at page19.

¹⁹⁰ *ibid.*

¹⁹¹ *ibid.*

¹⁹² *ibid.*

¹⁹³ J. Rogers, “Diversification is a scam”, available at <http://freundinvesting.com/> accessed on 22nd April 2009.

and make sure you have the right basket.¹⁹⁴ “I don’t want to say diversification is a myth, but it is overdone.”¹⁹⁵

In Uganda, the laws and regulations for CIS provide for restrictions regarding investment of the CIS funds.¹⁹⁶ This is meant to ensure that the fund managers diversity their investments with the aim that risk will be minimized for the benefit of the investors. However, some market players have argued that these restrictions are not reasonable because the product supply is still quite low.¹⁹⁷ The Ugandan capital market is so small with only 6 indigenous companies listed on the stock exchange. In addition, there is low supply of treasury bills where funds can be invested. In regard to corporate bonds, Uganda has only 3 which are Uganda Telecom, East African Development Bank and Standard Chartered Bank while in Nairobi there are hundreds of corporate bonds.¹⁹⁸ Thus ensuring diversification in a market like Uganda’s is a challenge that can only be overcome with the availability of more products on the market.

3.6.2 Reduction of Cost

Investing in unit trusts is cheap. The charges are self regulating and the public are offered the same level of fund management that the biggest investors are offered¹⁹⁹. The costs of investing in a unit trust vary from one market to another but the average small investor will usually incur higher costs in buying and selling a portfolio of individual securities for himself than a fund would. The reason is that transaction costs in most markets have historically been related to the size of the transaction. The individual investors’ transaction costs on small purchases or sales are typically much higher as a percentage of the value of each transaction than those for institutional investors dealing in large quantities such as funds.²⁰⁰

If an investor is going to invest in unit trusts with African Alliance Uganda, the fees charged will be 2.5% for the High Yield fund and 5% for the Balanced fund. These fees, compared to

¹⁹⁴ *ibid.*

¹⁹⁵ P. Vaillancourt senior vice president of Franklin Templeton Investments told Canada.com.

¹⁹⁶ Part V, CIS (Unit Trust) Regulations and Part V, CIS (Unit Trust).

¹⁹⁷ Interview with Mugendawala Hamis, Fund Management, ICEA U on 14th January 2009.

¹⁹⁸ *ibid.*

¹⁹⁹ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

²⁰⁰ M. St Giles, E. Alexeeva, and S.Buxton, (2003) “Managing Collective Investment Funds” John Wiley & Sons Ltd 2nd Edition p.4.

the fees charged by investment advisers which is 10% is on the lower side.²⁰¹ Therefore investing in CIS is much cheaper compared to investing on the open market. In addition, investors in CIS are able to invest in a variety of assets at a minimal fee since the fund manager has a duty to diversify the investments of the fund.²⁰²

3.6.3 Professional Management

Professional management is where the assets of the unit trust are managed and invested by professional fund managers with the expertise, experience and resources to do so efficiently. Investors in CIS thus rely on the competence of fund managers to make investment decisions on their behalf. Investment decisions are backed by the extensive research, market analysis and vigilant monitoring of the economic and market environment.²⁰³ The volume and complexity of the information available mean that the scope for the amateur investor has become more limited which leads to information asymmetry.

As developed markets show, there is a minority of people often retired who devote a good deal of time and energy to managing their own investments. But the majority of people lack the time, inclination or professional skills to do this. They therefore prefer to delegate the task of selecting and managing investments to professional investment fund managers.²⁰⁴ CIS provide such full time professional management in direct and simple form. This is valuable even in developed markets where information is widely available and financial markets are well developed. It is even more valuable in countries where this is not the case.²⁰⁵

On the other hand, this fiduciary duty owed by the professionals to investors has often been abused to the detriment of the investors. For example in Uganda, Crane Financial Services a reputable company operated by professionals defrauded the National Social Security Fund of millions of shillings when it under-declared proceeds from transactions it handled on behalf of the provident fund to the detriment of the investors.²⁰⁶

²⁰¹ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

²⁰² *ibid.*

²⁰³ *ibid* p.6.

²⁰⁴ *ibid.*

²⁰⁵ *ibid* p.6.

²⁰⁶ Interview with Hamis Mugendawala, Fund Manager, ICEA Uganda on 14th January 2009.

In Kenya, a number of brokerage companies operated by professionals have been defrauding the public for many years. Suntra Investment Bank, Reliable Securities Limited, Ngeye Karuiki and Company have all been implicated in fraudulent management of clients' funds, while another broker, Francis Thuo and Partners, collapsed sinking with clients' funds.²⁰⁷ In addition, Mr Jos Konzolo, a former Managing Trustee of the Kenya National Social Security Fund (NSSF) as well as a seasoned stockbroker and a one-time Vice Chairman of the Nairobi Stock Exchange and also the Managing Director of Reliable Securities Limited, a Stock Brokerage firm was arraigned in a Nairobi court to answer to charges of fraud.²⁰⁸ Jos Konzolo was charged with conspiring to defraud Barclays Bank of Kenya of more than Kshs 100 million (about US\$ 1,190,490) and also accused of stealing Kshs 49.7 million (about US\$ 591,675) from the Bank. His tenure at the chair of the association was more recently on the spot in the wake of the Safaricom Initial Public Offering (IPO).²⁰⁹

In Nigeria, Agbodobiri, the CEO of Ascending Wealth Company, a famous stockbroker was accused of fraud when he misappropriated clients' money meant for investment.²¹⁰ Christopher Okafor Sunday, who is the Managing Director of Sony Kris Company, alleged that Agbodobiri diverted and misappropriated NGN8,069,365 (about US\$ 53,054) meant for the purchase of stocks.²¹¹ Okehezeofor John accused Agbodobiri of diversion of NGN18 million (about US\$ 118,346). Agbodobiri was also accused of misappropriating NGN193,250 (about US\$ 1,270) meant for buying stocks by two spare parts dealers, Ogbu Charles Sunday and Iheonu Francis Nnamdi. Messrs. Onyeugwor Fidelis Chukwudi and four others were alleged to have been swindled to the tune of NGN186,255 (about US\$ 118,346), while Messrs. Jimoh Sheriff Lekan Alabi also claimed to have lost NGN160,000 (about US\$ 1,052) in his effort to buy shares through Ascending Wealth Company, while another client, Aghedo Blessing Anthony, lost NGN1 million (about US\$ 6,575) to the company.²¹² Miss Ngozi Favour Umeadim alleged in her petition that a total of NGN2 million (about US\$ 13,150) was paid to Ascending Wealth Investment Company to buy shares of Access Bank, but the transaction turned out to be fraudulent. Two other clients, Emeka Igwe and Nnomah Abraham Emeka, allegedly lost NGN17.9 million (about US\$ 117,688) to the company. In total, about NGN60 million (about US\$ 394,485) was alleged to have been collected from

²⁰⁷ D. Mugabe, "Fraud: How safe are the Capital markets?" New Vision, Thursday May 14th 2009.

²⁰⁸ "Stockbrokers Association Boss Resigns": Daily Nation, 28th July 2009.

²⁰⁹ *ibid.*

²¹⁰ "Stockbroker battles EFCC over fraud allegation": <http://thepmnews.com> accessed 27th July 2009.

²¹¹ *ibid.*

²¹² *ibid.*

clients by Ascending Wealth for the purpose of buying shares, but the stocks were never delivered.²¹³

Thus, while it may be true that there are some professional advisors who take their clients' interests and protection as a priority, there are many other professional advisors who disregard their clients' interests and are out there just to defraud them, especially the ordinary investors.

3.6.4 Investor Protection

Collective Investment Schemes (CIS) are governed by laws which offer investors a degree of protection. A unit trust offers the investor unprecedented protection through the separate legal capacity of the unit trust. This is backed up by the separation of functions and oversight duties of the service providers, in particular the trustee, custodian and the auditor.²¹⁴

In addition, CIS must be transparent. That is the terms on which the investment in a fund is made must be absolutely clear. Investors should be able to find out at all times what their investment is worth and be able to enter and exit the investment without undisclosed charges or penalties being levied. This contrasts with many life insurance and pension funds which historically can be characterized as opaque.²¹⁵

However, much as there is a legal framework in place, this has not prevented the investors from being taken advantage of by different companies that have fleeced Ugandans. For example, a company called Hurry Finch was registered and started operating as a unit trust, claiming that it had been registered with the Registrar of Companies and had been licensed by the Capital Markets Authority²¹⁶. The company promised huge interests on money deposited with them and many people invested their money with the company. The company was unfortunately not licensed by CMA and as a result investors lost their money and to date they have not been able to recover it since the owners of the company fled the country and

²¹³ *ibid.*

²¹⁴ Interview with Mona Batabara Muguma the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

²¹⁵ M. St Giles, E. Alexeeva, and S.Buxton,, (2003) "Managing Collective Investment Funds" John Wiley & Sons Ltd 2nd Edition p.4.

²¹⁶ Interview conducted on the basis of anonymity on 6th January 2009.

have not been apprehended²¹⁷. This proves that despite the existence of laws to regulate capital markets, this has not led to the desired protection of investors.

3.6.5 Benefits/Returns

Investing in unit trusts offers a number of rewards to the investors which include, among others, capital gains. Unit trusts provide an opportunity to achieve capital growth, particularly through equity investments and fixed income instruments like bonds.²¹⁸ Unit trusts also provide investors an opportunity to save for medium to long term periods depending on the investor's needs. They also provide for liquidity since there is instant access to one's investment whenever one wishes to exit the fund. This is an obligation under the law.²¹⁹

However, it does not always follow that the investments will bring in great rewards and more often than not, the rewards are minimal and they are never guaranteed. An instance occurred in Nigeria over the private placement of Starcomms Plc last year. At the centre of the uproar were two issuing houses for the shares of Starcomms Plc, Chapel Hill Denham and Stanbic-IBTC²²⁰. Mr. Adebayo, one of the investors that bought the private placement of Starcomms Plc observed in a fit of frustration that it is very evident that "Starcomms Plc Private Placement" has become the epitome of "fraud." "The Placement of 4.95 billion shares, which opened and closed on 3rd June 2008 at a price of NGN13.00 (about US\$ 0.085) appeared so attractive to investors at that time as it was over-subscribed," Adebayo recalled. Apparently angered at the down-turn of the investment, Adebayo explained that:

"The projection in the placement memorandum says that the company will declare a loss of NGN197 million (about US\$ 1,295,230) at the end of 2008 financial year end. Unfortunately, the company declared a loss after tax of NGN1.014 billion (about US\$ 6,666,800) in the second quarter and NGN2.149 billion (about US\$ 14,129,100) in the just released third quarter result."

Starcomms Plc was listed at NGN13.56 (about US\$ 0.089) on Monday, 14th July, 2008, between then and now, the price of the share had slid to a low of NGN3.86 (about US\$

²¹⁷ *ibid.*

²¹⁸ Interview with Mona Batabara Muguma, the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

²¹⁹ *ibid.*

²²⁰ "Investors Accuse Stanbic IBTC and Chapel Hill of Fraud in Starcomms Private Placement": Posted on February 1st 2009 by Fortune & Class accessed on 27th July 2009.

0.025). “In fact, the price dropped consistently to NGN7.46 (about US\$ 0.049) less than two months after listing,” stated Adebayo.²²¹

Another investor frontally accused the two issuing houses for Starcomms placement, Stanbic IBTC and Chapel Hill Denham, a Capital Market operator that was recently selected as one of the market makers for the Nigerian Stock Exchange. Stanbic IBTC Bank PLC through its wholly owned stock broking and asset management subsidiary, IBTC Asset Management Limited has several excellent mutual funds including the IBTC Nigerian Equity Fund, which is Nigeria’s largest mutual fund with a net asset value in excess of NGN25 billion (US\$ 164,369,000) (as at December 2007).²²² Chapel Hill Denham is a privately held business established as a full service investment banking firm. The firm is focused on providing unbiased advisory and investment services to entities and individuals involved in investing in and developing Africa’s productive infrastructure. Chapel Hill Denham emerged from the combination of the already successful businesses of Chapel Hill Advisory Partners Limited and Denham Management Limited in February 2008. It is the only bank that has a direct subsidiary that is a pension fund administrator; through the market leading IBTC Pension Managers Limited (IPML).²²³

Concerned investors argued that the two issuing houses lent their brand names to be exploited by Starcomms to defraud them.²²⁴ “The placement was actually successful because Starcomms Plc leveraged on the good name and credibility of Stanbic IBTC Bank Plc and Chapel Hill Advisory Partners. But looking at the whole situation closely, it seems there is more to what we can see. It’s so obvious that Starcomms’ goal from the word go was to defraud the public,” an investor submitted.²²⁵

“It is amazing what our corporate gurus are doing to stay on top of the ladder, gone were the days when our industrialists gave to charity, now our so called industrialists have board meetings and make strategies on how to use their companies to defraud the masses. We are all talking about Madoff²²⁶ but oblivious to the presence of individuals perpetrating worse atrocities right here in Nigeria. We all know that hedge funds are not regulated, and that probably explains why they are able to get away with all they do. How do we justify or indeed explain the flagrant act of fraud against the

²²¹ *ibid.*

²²² <http://www.ibtc.com/portal/site/nigeria/menuitem.2792be962d90f70440ff36313367804c/?vgnextoid=c12736720fee8110VgnVCM100000337608c4RCRD> accessed on 27th July 2009

²²³ <http://www.chapelhilldenham.com/our-firm/who-we-are/> accessed on 27th July 2009

²²⁴ *ibid.*

²²⁵ *ibid.*

²²⁶ Bernard Madoff, former chairman of the Nasdaq see Chapter 1.1 p.3.

public in a regulated market? Starcomms came into the market to raise capital, many unsuspecting investors rushed at it, expecting high returns on their investments; it is a pity that it is now a different story entirely. It is obvious that being a politician is not the only way to “rush” up the ladder of wealth; the capital market is an untapped goldmine to fraudulently enrich people who are influential in the business and financial sectors, another investor angrily submitted.²²⁷

3.7 Disadvantages of Investing in CIS

3.7.1 No Guaranteed Returns

Like any other form of investment, returns on Collective Investment Schemes are not guaranteed. Like any other investments, the value of a unit can go up or down thus the expectations of the investors in terms of returns may not be met and this can discourage the investors from participating in CIS.

The success of the Stanbic Bank Uganda Limited Initial Public Offer (IPO) attracted the participation of many Ugandans in the capital market. As the IPO price hit through the roof on the first day of trading finally settling at UGX 140 (about US\$ 0.060), double the price of UGX 70 (about US\$ 0.030), a number of Ugandans reaped big from the resulting windfall.²²⁸ The stock market thus turned into a safe haven where Ugandans put their investment with the hope of reaping in future.

However, it is not always a guarantee that when one invests in the capital markets they will get returns. This was clearly proved by the recent Kenya Safaricom IPO. The price of each share at the IPO was Kshs 5 (about US\$ 0.060).²²⁹ Following the successful returns investors got from the Stanbic IPO, many investors decided to invest in Safaricom hoping to reap great returns. The IPO was oversubscribed and when the shares were put on the secondary market, the price of the share shot up to about Kshs 7 (about US\$ 0.083) just for a few days and since then the price of the Safaricom share has been dropping and currently it is at about Kshs 3.5 (about US\$ 0.042).²³⁰ Investors are extremely disappointed with the Safaricom IPO because

²²⁷ *ibid.*

²²⁸ G. Muhwezi-Bonge, “Pooling money for Investment”, Daily Monitor, Thursday, November 20th 2008.

²²⁹ Interview with Ndirangu George, Managing Partner, Bullion Capital on 6th January 2009.

²³⁰ *ibid.*

they have not been able to get the returns they expected as such this has led to loss of investor confidence.²³¹

In addition, with the current global financial crisis, fuelled by the loss of investor confidence, the capital markets have been experiencing a downturn and this has exposed individual investors to the risks associated with the stock markets.²³² This just goes to show that investing in the capital market does not always guarantee returns.

3.7.2 Duration of Investment

Collective investments are not suitable for short term investors. For an investor to reap the maximum benefit of the investment, the investor has to be a medium or long term investor. This may not be motivation to the investors who may not be willing to invest their money for such long periods of time considering that the returns may also be negligible.

Long term investment cannot take place in a situation of political uncertainty and since capital markets are mainly concerned with long term investment, any indicators of uncertainty influence people's decisions to invest. In addition, market players would take advantage of the political uncertainty to price higher premiums at the expense of ordinary investors. Political certainty is therefore critical in encouraging participation of investors in capital markets²³³.

3.7.3 Lack of Influence by the Small Investor

The investment decisions of the CIS are in the hands of professional managers who must act according to the trust deed although they have authority to change the investment decisions according to the circumstances affecting the economy. The individual choice of where to invest is therefore compromised in the sense that the investor has to accept the investment decisions of the manager which may not be what the investor wants. Therefore because of their size, the small investors are considered insignificant compared to institutional investors.

²³¹ *ibid.*

²³² Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009.

²³³ W. Tarinyeba, (2004) "The challenges faced by Capital markets in emerging economies: A case study of Uganda" *Capital Markets Journal* Vol. 7 No.1, p.19.

Thus they have no influence and they can be taken advantage of when they participate in capital markets.

3.7.4 Lack of knowledge

Investors do not have solid background information on capital markets and this is because there is no specific proficiency curriculum regarding them.²³⁴ As a result, retail or small investors rely on the limited knowledge of the practitioners and hearsay to make investment decisions.²³⁵ Thus because the investors are not informed about the way the unit trusts are operated, they need to be sensitized about the operations of a unit trust so that they are not taken advantage of.

3.7.5 Illiteracy and ignorance

A big proportion of the countries in emerging markets and especially in Africa are not only characterized by high illiteracy levels. Individuals and companies especially the small and medium size enterprises are not aware of the alternative means of raising long term finance and generally about the opportunities capital markets have to offer in terms of opportunities for raising finance, particularly long term finance.²³⁶ The functioning of capital markets still eludes a large number of potential market participants.²³⁷ A report on private sector opinions on listings indicates that while a sizeable number of people are aware of the existence of the Capital Markets Authority, they were not fully informed about the functioning of capital markets.²³⁸

As a result of the small investors' illiteracy and vulnerability, they may not be in a position to comprehend the operations of the capital markets and they may not be able to fully understand whether the operators are complying with the law or not. In addition when it comes to disclosing information to the investors, the investors may not be able to

²³⁴ Interview with Ndirangu George, Managing Partner, Bullion Capital on 6th January 2009.

²³⁵ *ibid.*

²³⁶ W. Tarinyeba, (2004) 'The Challenges Faced by Capital Markets In Emerging Economies: A Case Study of Uganda' *Capital Markets Journal* Vol. 7 No.1, P.18.

²³⁷ Interview with Eric Kenneth Lokolong, Senior Compliance Officer (Legal), CMA, on 14th January 2009.

²³⁸ Interview with Robert Baldwin, CEO, Crested Stocks and Securities, on 27th January 2009 and Andrea Bohnstedt, Alfred Hanning, Ralph P. Odendall; Capital Market Development In Uganda-Private Sector Opinions on Listing FSD Series No. 2.

comprehend the contents therein thus they can be easily taken advantage of by the operators.²³⁹

There have been many instances where people were defrauded due to ignorance through companies that were promising huge interest on money invested. Some of these companies were registered as Non Governmental Organisations (NGOs) and they included Care for Orphans Widows and Elderly (COWE Uganda), Alliance of Christians in Development (ACID), Dutch International Company Limited and TEAM.²⁴⁰ The companies gained notoriety for defrauding Ugandans of millions of shillings by promising huge interests on money deposited.²⁴¹ People are very vulnerable and they need to be sensitized so that they do not just invest in any company which is promising great returns.²⁴²

Fortunately three employees of Dutch International Company Ltd, a company holding out as an investment scheme operating in different districts, were charged and jailed over fraud involving UGX 30 billion (about US\$ 12,821,100).²⁴³ The accused were arrested following complaints from some 200 victims who allegedly lost their money in the scam. Mr. Nixon Balikowa, Mr. Joshua Kasagga and Mr. Emmanuel Tenywa were charged with 100 counts of obtaining money by false pretence under section 305²⁴⁴ and appeared before Buganda Road Court. Prosecution said between November 2006 and November 2008, the company operated a financial business collecting and depositing public funds without an operating license.²⁴⁵ The Court heard that the accused persons with intent to defraud obtained UGX 30 billion (about US\$ 12,821,100) from various people on the pretext that the company was authorized to transact financial business and would pay it back with an interest of 24%.²⁴⁶

There is therefore a need for continuous investor and general public awareness campaigns so as to create more awareness about investment opportunities in the capital markets industry, to dispel some of the fears that potential participants may have, especially companies that would

²³⁹ Interview with Hamis Mugendawala, Fund Manager, ICEA Uganda on 14th January 2009.

²⁴⁰ Interview with Ndirangu George, Managing Partner, Bullion Capital on 6th January 2009.

²⁴¹ *Ibid.*

²⁴² Interview with Eric Kenneth Lokolong, Senior Compliance Officer (Legal), CMA, on 14th January 2009.

²⁴³ E.Gyezaho & L.Mukisa, "Government Cracks Whip on Fake Money Lenders" Daily Monitor, Thursday, November 20th 2008.

²⁴⁴ Penal Code Act, cap 120, Laws of Uganda.

²⁴⁵ *ibid.*

²⁴⁶ *ibid.*

wish to list but are afraid of opening up and the implications of full disclosure and accountability.²⁴⁷

3.8 Conclusion

As discussed above, there are different forms of CIS that are offered in different parts of the world. In Uganda, the law provides for two types of CIS which are the Unit Trusts and OEICs. African Alliance Uganda is currently the only company licensed by CMA that is offering CIS. The type of CIS offered by African Alliance Uganda are the Unit Trust Schemes. Investing in CIS brings with it a number of benefits as seen above, although there are also some disadvantages that come with that.

In addition, despite the fact that there is a legal and regulatory framework in place meant to ensure protection of investors in these schemes, there are a number of challenges with regard to enforcement and compliance with these laws and regulations that have eluded investor protection as are going to be discussed in the next chapter.

²⁴⁷ W. Tarinyeba, (2004) “The Challenges Faced by Capital Markets in Emerging Economies: A Case Study of Uganda” *Capital Markets Journal* Vol. 7 No. 1, pg 18.

CHAPTER FOUR

CHALLENGES OF THE LEGAL AND REGULATORY FRAMEWORK FOR INVESTOR PROTECTION

4.0 Introduction

To allow any person or company to have unlimited access to the scale of the money that can flow through funds is asking for trouble. There is potentially too great a temptation to use fund assets to the benefit of those other than fund investors.²⁴⁸ Laws and regulations must therefore put in place measures to provide for the protection of the investors participating in the funds.

At its most basic, regulation seeks to create and maintain confidence in the case of collective investment funds by ensuring that those who are permitted to attract money from the public and profit from servicing this business - funds, fund management companies and other service providers - are reputable, that they conduct their business in such a way that confidence is maintained or enhanced and that redress is available to those who suffer damage from any failure in this respect.²⁴⁹ It is vital to appreciate that without a reliable regulatory system, the public will lack the confidence in funds that is crucial to the long term development of a profitable collective investment fund sector.

In Uganda, the law governing CIS is the CIS Act and the regulations made thereunder by the CMA. This Chapter examines the challenges of the legal and regulatory framework for the governance of CIS and how they affect the protection of investors who participate in these schemes.

²⁴⁸ St Giles, M., Alexeeva, E. and Buxton, S: (2003) 'Managing Collective Investment Funds' 2nd Edition John Wiley & Sons Ltd p.15.

²⁴⁹ *ibid* p.47.

4.1 Challenges of the Legal and Regulatory Framework for the Governance of CIS

There are a number of challenges with regard to the legal and framework for the governance of Collective Investment Schemes that hinder the protection of investors who participate in these schemes and these challenges are discussed below.

4.1.1 Supervisory and Regulatory Authority

A single regulatory authority should have paramount responsibility for funds within its jurisdiction. Funds should be registered with or authorized by the regulator before the operator begins marketing activity.²⁵⁰ The regulator must have the power to promulgate and apply regulations and inspect and investigate fund management companies. It should also have adequate powers to protect the interests of investors, including revocation of licenses, suspension of dealing, freezing of fund or fund management companies' assets, levying fines, withdrawing fund authorization, commencing civil proceedings and recommending criminal prosecutions.

Under the CIS Act, the CMA, which is the capital markets regulator, has been given a lot of powers of supervision and intervention in CIS through monitoring them, carrying out inspection visits, investigations and enforcement of the laws and regulations governing these schemes.²⁵¹ This therefore should create investor protection because the CMA is always supervising the activities of the schemes to ensure there is compliance with the laws and regulations. In order to carry out its functions, the regulatory authority requires sufficient staff with adequate training and remuneration. The regulatory authority also requires adequate legal power and independence to accomplish its investigatory and enforcement missions.²⁵²

The question however, is whether CMA has the required capacity and technocrats to regulate capital markets ethically and professionally? Many industry players have argued that CMA

²⁵⁰ St Giles, M., Alexeeva, E. and Buxton, S: (2003) "Managing Collective Investment Funds" 2nd Edition John Wiley & Sons Ltd p.55.

²⁵¹ Part VIII, IX, XIII of the Collective Investment Schemes Act No. 2 of 2003.

²⁵² J, Thompson "Governance Of Collective Investment Schemes (CIS)" (Discussion Draft for Comment, Directorate for Financial and Enterprise Affairs July 2004) available at www.oecd.org/dataoecd/13/31/33621909.pdf accessed on 14th September 2007 p.6.

has no capacity to adequately regulate the capital markets.²⁵³ Some industry players have argued that CMA does not have sufficient staff to carry out inspections and one such instance is in regard to Hurry Finch Investments Ltd which was a company holding itself out as a unit trust and promising investors great returns but it was not licensed by CMA.²⁵⁴ Many investors joined it and lost their money. Employees at CMA were informed about the impending fraud but they failed to investigate and prevent the public from being defrauded. Investors may never recover their money and this raises doubts about the capacity of CMA to adequately protect investors who participate in capital markets.²⁵⁵

In addition, CMA is facing a severe crisis of credibility after its failure to take firm action against an errant fund management firm that is alleged to have defrauded the NSSF of millions of shillings by under-declaring proceeds from transactions it handled on behalf of the provident fund.²⁵⁶ In a number of transactions across two counters between February and March 2008, Crane Financial Services under-declared earnings from trading it conducted on behalf of the NSSF to the tune of UGX 726 million (about US\$ 310,270).²⁵⁷ The trades took place on the DFCU and Bank of Baroda counters.²⁵⁸ The suspect firm was suspended from trading but has since refused to surrender the money it made in the contested transactions creating a standoff between it and the USE which insists it can only be allowed back on the exchange after paying penalties and surrendering the undeclared earnings to the NSSF.²⁵⁹ Further, some industry players say lack of firm action by CMA could undermine its credibility and its ability to stop this cancer from growing out of control in future.²⁶⁰

The regulatory body in the USA also came under attack recently after the famous Madoff scandal. Bernard Madoff, the former chairman of the Nasdaq stock market, was arrested and charged with fraud in what could become the biggest-ever case of its kind. He ran a hedge fund which allegedly racked up US\$ 50 billion of fraudulent losses.²⁶¹ "The fact that the

²⁵³ Interview conducted on the basis of anonymity held on 14th January 2009.

²⁵⁴ Interview conducted on the basis of anonymity held on 6th January 2009.

²⁵⁵ *ibid.*

²⁵⁶ M. Wakabi, "CMA Credibility on the Line as Broker Defies it over Fraud Cash" The East African June 23rd – 29th 2008.

²⁵⁷ *ibid* and Interview with Mugendawala Hamis, Fund Manager, ICEA U on 14th January 2009.

²⁵⁸ Interview with Mugendawala Hamis, Fund Manager, ICEA U on 14th January 2009.

²⁵⁹ Interview conducted on the basis of anonymity held on 14th January 2009.

²⁶⁰ *ibid.*

²⁶¹ J. Quinn, 'SEC attacked over Madoff' also available on <http://www.telegraph.co.uk/finance/financetopics/bernard-madoff/4363236/SEC-attacked-over-Madoff> accessed on 7th Jan 2009.

regulators were put on notice through direct tips, press articles and industry chatter raises serious questions about the state of our regulatory system," said Republican committee member Senator Richard Shelby.²⁶² Senator Chris Dodd, the Committee's Chairman, said that the fraud was a regulatory failure of historic proportions, but was more disturbed that it went undetected for so long bearing in mind that the regulator, which was tipped off about the financier's alleged actions as early as 1999 only found out about it in 2008.²⁶³ Investors of the Madoff scandal are stuck in a kind of limbo. They do not know where their money ended up and if they can get any of it back.²⁶⁴

As can be seen from the above, regulatory inefficiencies do not only affect emerging markets. They also affect developed markets like the USA. Thus despite the fact that capital markets must have regulators, many markets are still facing challenges in this regard to the detriment of the investors. In Uganda, the regulator has been criticized for being lax and not having enough human resource capacity to effectively oversee the activities of the market players in the industry. This has resulted to the investors being defrauded.

4.1.2 Legal Framework and its Compliance by Operators

All collective investment schemes (CIS) that are promoted to the investing public should be required to operate through a recognized legal and regulatory framework. A sound legal and regulatory framework is one that encourages the development of an environment conducive to informed risk-taking.²⁶⁵ There is, however, no universally accepted best legal form for CIS.²⁶⁶

Most countries, including all countries with well developed financial markets, have enacted a body of legislation specifying the terms under which CIS may be offered. Such a framework is part of the broader system of capital market organization and oversight. Basic laws specify

²⁶² *ibid.*

²⁶³ *ibid.*

²⁶⁴ *ibid.*

²⁶⁵ J, Thompson 'Governance of Collective Investment Schemes (CIS)' (Discussion Draft for Comment, Directorate for Financial and Enterprise Affairs July 2004) available at www.oecd.org/dataoecd/13/31/33621909.pdf accessed on 14th September 2007 p.6.

²⁶⁶ *ibid.*

the legal forms in which CIS may be offered to the public and also specify that an internal governance system must be established for each CIS.²⁶⁷

In Uganda, the CIS are governed through a legal framework which includes the CIS Act, the principal legislation and the regulations made thereunder by CMA which include CIS (UT) Regulations, CIS (OEIC) Regulations, and CIS (Conduct of Business) Regulations, among others.²⁶⁸ The legal regime is meant to ensure that capital market players are constantly monitored to ensure compliance with regulations.²⁶⁹ This constant monitoring is therefore meant to ensure that investors are protected.

A functioning legal system that all parties have faith in is therefore a critical component of investor protection. Without a viable legal infrastructure in place, it is very difficult to create investor confidence.²⁷⁰ Market confidence is an important factor in creating a vibrant market. If people do not have confidence in the system, they will be reluctant to invest.²⁷¹

There is a legal requirement that the schemes are required by law to have a compliance function in place.²⁷² This means that managers, ACDs, depositaries, trustees and other service providers should have in place internal procedures and systems that are needed to demonstrate if they are in compliance or not and to enable their management to demonstrate to the regulator that their business and the funds which they manage are operated in compliance with the law and regulations.²⁷³ In Uganda, monitoring of compliance is done by the regulator through review of compliance reports and inspections as well as by the trustee or depositary which includes monitoring compliance with the regulations, trust deed or memorandum and articles and scheme particulars or prospectus.²⁷⁴ The responsibility of this function is to ensure that the company concerned is operating in compliance with the law and

²⁶⁷ *ibid* p.4.

²⁶⁸ See chapter 3.3 at p.37.

²⁶⁹ St Giles, M., Alexeeva, E. and Buxton, S: (2003) "Managing Collective Investment Funds" 2nd Edition John Wiley & Sons Ltd p.55.

²⁷⁰ Sen, P., Bahel, N., Ranjan, S., "Developing the Indian Capital Markets: Smaller Investor Perspectives" Working Paper Series.

²⁷¹ W. Tarinyeba, "The challenges faced by Capital Markets in Emerging Economies: A Case Study of Uganda" (2004) *Capital Markets Journal* Vol. 7 No.1, p.18.

²⁷² Regulation 5 of CIS (Conduct of Business).

²⁷³ Regulations 82 and 84. of CIS (Conduct of Business).

²⁷⁴ Part VII Division B and CIS (OEIC) Regulations, part VI Division B of CIS (Unit Trust) Regulations.

that its systems and procedures are designed in such a way that it remains in compliance on a continuing basis.²⁷⁵

Some market participants have argued that the rules and regulations put in place to govern capital markets are adequate to ensure investor protection but the question is whether the laws are adequately complied with by the market players and strictly enforced by the CMA.²⁷⁶ Other industry players have argued that much as there is a good legal framework in place, some market players are simply not complying with them.²⁷⁷ One such instance where compliance with the law has been challenged is in regard to the recent breach of the law by Crane Financial Services. Some industry players have viewed this as failure by the regulator to act resolutely with regard to the firm but also as likely to undermine confidence in Uganda's financial markets, a confidence that has only just recovered from the bank failures of the past decade.²⁷⁸ This poses a challenge since it shows that CMA has not done much to ensure compliance with the law.²⁷⁹

Another instance where CMA's capacity to ensure compliance with the laws and regulations has been challenged is in regard to the Safaricom IPO. Dyer and Blair which was the lead broker of Safaricom IPO mishandled the IPO and to date some investors have never received their refunds.²⁸⁰ Investors are still disgruntled but CMA has not punished the responsible brokers in accordance with the law.²⁸¹ CMA issued warnings to the brokers who were in default of the law and has not done anything else even when the warnings have failed to serve the purpose. This is a clear indication that CMA does not have the capacity to adequately ensure market players comply with the law which will ensure investor protection.²⁸² Thus, the law governing unit trusts raises a challenge with regard to the way it is complied with by the market players and how CMA adequately ensures enforceability of it. This goes back to the issue of capacity of CMA which some market players have said is questionable.²⁸³ CMA

²⁷⁵ St Giles, M., Alexeeva, E. and Buxton, S: (2003) 'Managing Collective Investment Funds' 2nd Edition John Wiley & Sons Ltd p.65.

²⁷⁶ Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009 also see chapter 4.1.1 at p.64.

²⁷⁷ Interview conducted on the basis of anonymity held on 14th January 2009.

²⁷⁸ Interview conducted on the basis of anonymity held on 6th January 2009.

²⁷⁹ Interview conducted on the basis of anonymity held on 14th January 2009.

²⁸⁰ *ibid.*

²⁸¹ *ibid.*

²⁸² *ibid.*

²⁸³ Interview conducted on the basis of anonymity on 6th January 2009.

is quite sluggish in applying the law and ensuring its compliance by the market players and this has led to loss of confidence in the law on the part of the investors.²⁸⁴

Thus, much as the law is in existence and there is a regulator to ensure compliance with it so as to build investor confidence, this has not been done effectively by CMA. Besides, there are other factors that contribute to investor confidence. Investor confidence is made or broken on the basis of investors' experience in the market. If investors have bought shares and sold for a profit they will have more confidence. If investors have bought shares and made losses, they may not come back for some time.²⁸⁵ If investors have never participated in the capital markets it is not because of a lack of confidence but usually something else. A lack of understanding is the most frequent reason.²⁸⁶ There is no confidence from the public because they do not have knowledge about the capital markets.

CMA has tried to educate the public about the importance of capital markets by organizing secondary and university challenges.²⁸⁷ These are competitions carried out among various schools where students are asked questions and are also taught about the capital markets and the school that wins gets a prize.²⁸⁸ However it has been said that CMA should take it a little further down to the primary level so that people can acquire knowledge at an early stage.²⁸⁹ Investor education and raising public awareness is still a daunting challenge for policy makers, market participants and regulators.²⁹⁰

There is thus need for more investor education although the only education people have is experience.²⁹¹ It is only after understanding what the CIS product is that the public will have confidence.²⁹² Helping investors have a general understanding of CIS and how it can work in Uganda is the first step with many miles in between before it becomes a question of confidence.²⁹³

²⁸⁴ *ibid.*

²⁸⁵ Interview with Robert Baldwin, CEO, Crested Stocks and Securities, on 27th January 2009.

²⁸⁶ *ibid.*

²⁸⁷ Interview with Eric Kenneth Lokolong, Senior Compliance Officer (Legal), CMA, held on 14th January 2009.

²⁸⁸ *ibid.*

²⁸⁹ Interview with Ndirangu George, Managing Partner, Bullion Capital on 6th January 2009.

²⁹⁰ W. Tarinyeba, "The Challenges Faced by Capital Markets in Emerging Economies: A Case Study of Uganda" (2004) *Capital Markets Journal* Vol. 7 No.1, p.18.

²⁹¹ *ibid.*

²⁹² Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda on 14th January 2009.

²⁹³ Interview with Robert Baldwin, CEO, Crested Stocks and Securities, on 27th January 2009.

4.1.3 Eligibility Requirements for CIS and other Service Providers

The fund management company must be licensed independently of the licensing of the fund itself.²⁹⁴ The purpose of licensing is to ensure that those who obtain licenses are honest, competent and solvent. The regulatory system therefore imposes standards of conduct and minimum eligibility for fund management companies to ensure they are of good repute before they issue out a license. These include capital adequacy and financial resources, the integrity of directors, competence and the ability to meet minimum standards of systems and procedures.²⁹⁵ These standards are to ensure that in case of failure to manage the funds, the investors will be compensated by the managers of the fund. Thus the regulatory framework ensures that before it issues out a license, the fund management company has fulfilled all the requirements and this is a good measure to ensure that investors are protected.

Because depositaries and trustees usually carry the responsibility for the protection of investors too, they are required to be licensed. However, some legal regimes do not require fund depositaries and trustees to be specifically licensed as such relying on the fact that they are usually banks which are subject to Central Bank supervision. In Uganda, the trustee must be either a bank or an insurance company licensed as such under the Financial Institutions Act or Insurance Act and approved to act as trustee by Capital Markets Authority.²⁹⁶ It is important to note that the trustee and the operator must not be related entities.²⁹⁷ This is to ensure that they do not take advantage of the investors but ensure that the trustee and depositary oversee the actions of the management company and that the investors are protected. Therefore by ensuring that only eligible companies participate in the capital markets, this enhances the protection of investors in collective investment schemes.

Some industry players have stated that the eligibility requirements in the law are adequate in that investor protection is emphasized.²⁹⁸ However, some argue that the eligibility criteria required for the grant of a CIS and the conditions to be fulfilled before registration are somewhat lacking in that they are vague and others need clarification.²⁹⁹ For example the Act

²⁹⁴ Part ii s.4 (1) (A) of the Collective Investment Schemes Act No. 2 of 2003.

²⁹⁵ St. Giles, M. Alexeeva, E. and Buxton, S: (2003) 'Managing Collective Investment Funds' 2nd Edition John Wiley & Sons Ltd p.55 and S.(8) (3) (a), (b) and (c) of the CIS Act S.15 (2) (a), (b), (c) and (d) CIS Act.

²⁹⁶ Part II, r 6 (1) of the CIS (Licensing) Regulations.

²⁹⁷ S. 17(1)(a) of the Collective Investment Schemes Act No. 2 of 2003.

²⁹⁸ Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009.

²⁹⁹ Interview with Mutimba Patrick, Investment Manager, AIG, on 4th November 2008.

provides that the operator should have a sound track record. The phrase “sound track record” needs to be explained to give it a level of certainty so that the operator knows exactly what the law requires from it. The Act also states that to obtain a license, the corporate name and registered or principal office of the trustee/depositary of the scheme must be indicated.³⁰⁰ This is lacking in the sense that there are no particular requirements regarding the company itself e.g. should the company have been in existence for some time and should it have a track record of profit making for at least the preceding five years of its existence evidenced by financial statements?³⁰¹ The regulations also provide for the fitness and propriety of the persons proposed to act as directors. This is lacking in that it does not take into account the qualifications of the other employees who will be involved in the business.³⁰² CIS business is a serious business and should be treated as such with the interest of the investors taken seriously. Thus all employees who are going to be involved in the CIS business should be highly experienced with the relevant qualifications needed to manage a CIS in the interest of the investors.³⁰³

It has also been argued that the regulations regarding the eligibility requirements are stringent.³⁰⁴ Apart from the obvious factors that affect all firms like erratic infrastructure services, high interest rates and difficulties in accessing commercial justice, there is a more insidious problem that hurts small firms much more than large firms – that of high regulatory costs – the amount of business, time and money tied up in regulatory activities that could otherwise be spent on productive business activities.³⁰⁵

Time and money used by business people dealing with unnecessary and or complicated rules and regulations is time and money lost to businesses. Small firms are hurt more because they usually pay higher per unit costs than large firms to comply with the same rule.³⁰⁶ Small firms also have less management time to devote to regulatory activities than large businesses. A recent study on how regulations, specifically entry costs, affect business start - ups in 75 countries confirms that rich countries – the top 25% have relatively low entry costs at an

³⁰⁰ Part II r. 4 of the CIS (Licensing) Regulations.

³⁰¹ Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009.

³⁰² *ibid.*

³⁰³ *ibid.*

³⁰⁴ Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda on 14th January 2009.

³⁰⁵ F. MacCullah & Keith Muhakanizi ‘Regulatory costs: The price we pay!’ (2002) *Capital Markets Journal* Vol.5 No. 1, October-March p.23.

³⁰⁶ *ibid.*

average of 10% of GDP per capita. Poor countries represented in the bottom 25% have staggering entry costs, an average of 65% of GDP per capita.³⁰⁷ Thus, the regulations are a challenge for companies that may wish to participate in capital markets since the barrier to entry is high.³⁰⁸

The link between high regulatory costs and corruption when rules are too costly, inaccessible or unclear affords an opportunity for those on both sides of the regulatory fence to look for a shortcut.³⁰⁹ Whereas it has often been argued that bribery can have a positive effect by allowing firms to get things done faster in an economy plagued with bureaucratic delays, Ugandan data reveals that corruption constitutes a heavy burden on firms since firms will have to spend a lot of money in the course of getting things done which money would have been better spent in making profit for the firm.³¹⁰ For the economy, regulations that provide opportunities for bribery take matters from bad to worse. First they leave serious investors feeling more at risk when making an investment decision. At worst, an investor may decide not to invest at all; at best the investor will be conservative in the amount to invest.³¹¹

When new investors are deterred, the ultimate result is a dilution of competitive intensity within an economy or sector.³¹² It has thus been argued that the regulations create a monopoly by default since the requirements are onerous, and hinder competition.³¹³ Reduced competition breeds complacency – companies are not compelled to innovate, take risks and improve efficiency and quality to the extent they otherwise would be in a more dynamic and competitive environment.³¹⁴ It is no wonder that only one trustee is involved in the operation of CIS yet there are so many banks and insurance companies operating in Uganda. This is simply because the registration exercise is too costly, time consuming and cumbersome.³¹⁵ In

³⁰⁷ Pof S. H. Hanke for Forbes Global Magazine April 30, 2001 on the Regulation of Entry, Working Paper 7892 NBER, Massachusetts.

³⁰⁸ Interview with Ndirangu George, Managing Partner, Bullion Capital on 6th January 2009.

³⁰⁹ F. MacCullah & Keith Muhakanizi "Regulatory costs: The price we pay!" (2002) *Capital Markets Journal* Vol.5 No.1, October-March p.23.

³¹⁰ R. Reinikka & J. Svenson (1999) "Confronting Competition: Investment Responses and Constraints in Uganda", New York: World Bank.

³¹¹ *ibid.*

³¹² F. MacCullah & Keith Muhakanizi "Regulatory costs: The price we pay!" (2002) *Capital Markets Journal* Vol.5 No. 1, October-March p.23.

³¹³ Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009.

³¹⁴ F. MacCullah & Keith Muhakanizi 'Regulatory costs: The price we pay!' (2002) *Capital Markets Journal* Vol.5 No.1, October-March p.23.

³¹⁵ Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda on 14th January 2009.

addition, many a times companies fulfill all the registration requirements yet CMA may take a year without issuing them licenses which is so frustrating and discouraging.³¹⁶

In view of the nature of the vast majority of companies, these requirements are onerous.³¹⁷ This raises the dilemma of promotion *vis-a-vis* protection. The question is whether the requirements should be lowered so as to make capital markets more accessible or should they be stringent to ensure maximum protection to investors and therefore build confidence in the market.³¹⁸ One can not be traded for the other and the ideal here is to attempt to strike a balance.³¹⁹ However, it has been argued that the balance between regulation, investor protection and market development is always a challenge, even in more mature markets.³²⁰ As seen in the USA, the recent Madoff scandal proves that even the most sophisticated market regulations can be broken by dishonest people as earlier discussed.³²¹

The key for investors is to understand that eventually, the rule breakers get caught because the transactions conducted take place in the formal sector that includes banks, company registries, the stock exchange that leave footprints which are easy for an auditor to follow so the law breakers eventually get caught³²². However, even if they are caught, it may be too late for the investors to recover their money and so this may not be of any help to the investor. This can be seen from the investors who invested their money in Hurry Finch Company Ltd as well as Dutch International Company Limited, companies that were holding out as a unit trust licensed by CMA and as an investment company authorized to engage in financial services respectively as discussed in the previous chapter. The investors were defrauded by those companies when they invested their money with the companies and never received any returns from their investments as had been promised by the companies.

³¹⁶ *ibid.*

³¹⁷ W. Tarinyeba, "The challenges faced by Capital Markets in Emerging Economies: A Case Study of Uganda" (2004) *Capital Markets Journal* Vol. 7 No. 1, p.18.

³¹⁸ *ibid.*

³¹⁹ *ibid.*

³²⁰ Interview with Robert Baldwin, CEO, Crested Stocks and Securities, on 27th January 2009.

³²¹ See 1.1 at p.3 and *ibid.*

³²² *ibid.*

4.1.4 Capital Adequacy

Industry players have also argued that another controversial eligibility requirement is that of capital adequacy. The regulations require that the operator of the scheme should have evidence of minimum net capital of UGX 200 million (about US\$ 85,475).³²³ While this requirement may have both positive and negative consequences, questions have been raised on the adequacy of the net worth and whether the net worth of the operator should have some relationship with the assets under its management.³²⁴ It follows from the argument that while it might be adequate for the operator to have a net worth of UGX 200 million (about US\$ 85,475) to begin with, it should be required to increase the net worth as the assets under its management grow.³²⁵

The net worth of African Alliance is approximately UGX 3 billion (about US\$ 1,282,110).³²⁶ Thus the capital requirement should be revised upwards as and when the funds of the operator increase so that investors can have confidence that they will recover their money in case the operator collapses. However, others argue that the amount of UGX 200 million (about US\$ 85,475) is on the lower side on the ground that if one is going to invest in the CIS business which involves funds from investors, they need to be able to avail a high amount of capital which will also act as security to the investors in case of failure on the part of the operator.³²⁷ Thus the figure should be increased from UGX 200 million (about US\$ 85,475) because it is on the lower side compared to the current net worth of African Alliance which is approximately UGX 3 billion (about US\$ 1,282,110) and this is a hindrance to investor protection.³²⁸

It should also be noted that the capital requirement of the operator was originally envisaged to serve as an entry barrier as well as to enable the operator to provide for its own infrastructure such as office space, personnel and systems.³²⁹ It is also a positive aspect because it acts as a protection to the investors who are guaranteed that the operator has

³²³ Part II, r 5 (c) (vi) of the CIS (Licensing) Regulations.

³²⁴ Interview with Ndirangu George, Managing Partner, Bullion Capital on 6th January 2009.

³²⁵ *ibid.*

³²⁶ Interview with Mona Batabara Muguma, the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

³²⁷ Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda on 14th January 2009.

³²⁸ Interview with Robert Baldwin, CEO, Crested Stocks and Securities, on 27th January 2009.

³²⁹ Interview with Eric Kenneth Lokolong, Senior Compliance Officer (Legal), CMA, 14th January 2009.

sufficient capital.³³⁰ However, the capital adequacy may not be sufficient to protect investors currently especially when that amount is compared to the funds being managed. Investors may not be able to recover their money in the event that African Alliance collapses. How will CMA ensure that AA pays the investors when the capital adequacy requirement of UGX 200 million (about US\$ 85,475) cannot match the value of assets under AA's management which is worth about UGX 3 billion (US\$ 1,282,110).³³¹ There is a very huge exposure to the investors which needs to be addressed.

On the other hand, the capital adequacy requirement may be good in that it serves as an entry barrier to operators who may not be able to manage such a business. However, some market players have argued that this requirement is too high for the local people to start such a business yet they may be able to meet all the other eligibility requirements.³³² This amount is therefore considered by some market players as a deterrent to local investors.³³³

Thus this capital requirement should be weighed against the need to nurture the CIS skills and encourage professionals to set up and develop fund management companies in the country. A very high initial capital requirement will act as a deterrent for development of fund management skills which are still nascent in Uganda.

4.1.5 Separation of Assets from Management

CIS are one of the types of investments that are designed to afford some reasonable degree of protection to investors and therefore in order to achieve this, CIS are structured in such a way that the assets of a scheme are held and controlled by an entity that is separate and independent from the trustee/depositary.³³⁴ This is to prevent fund management companies or directors from stealing fund assets and this also aims at ensuring that investors' property is protected. In Uganda, the Regulations provide that the assets must be held and controlled by the trustee and depositary.³³⁵

³³⁰ *ibid.*

³³¹ Interview with Ndirangu George, Managing Partner, Bullion Capital on 6th January 2009.

³³² Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009.

³³³ *ibid.*

³³⁴ Part VII Division B and CIS (OEIC) Regulations, part VI Division B of the CIS (Unit Trust) Regulations.

³³⁵ *ibid.*

DFCU is the trustee of African Alliance and they ensure that the assets of the unit trust are well kept. They do this by complying with the stringent lines of banking like safe custody practices.³³⁶ They have officers responsible for these assets which are kept under lock and key at all times.³³⁷ The Manager/ACD is required to remit to the trustee/depositary funds received from investors within four days. The fund bank accounts must also be opened in the names of the trustee/depositary and controlled by the trustee/depositary.³³⁸ The trustee is the only party with signing authority on the unit trusts' bank accounts.³³⁹ This ensures that the fund manager cannot use the funds for any purpose other than investing the money in terms of the trust deed.³⁴⁰ The trustee and the fund manager may only have a business relationship. There may be no cross shareholdings, directorships or joint venture interests.³⁴¹ The separation ensures that the money invested in a unit trust cannot be used by the fund manager, for any purpose other than that which is stipulated in the trust deed.³⁴²

Market players have argued that in as much as the law ensures that assets are held by an entity that is separate from the operator, the law poses a challenge in that it does not restrict the operator of unit trusts from providing other services in the capital markets and this situation leads to conflict of interest.³⁴³ African Alliance Uganda is a fund operator but it is also licensed as an investment adviser and a stock broker. This is not accepted in the developed markets like in the USA and other markets since it leads to conflict of interest.³⁴⁴ A client should have independent services from different service providers so as to ensure that no conflict of interest arises. For example Old Mutual fund is a South African company whose subsidiary Old Mutual in Kenya is licensed as a unit trust operator.³⁴⁵ It was denied a license to operate as a stockbroker in Kenya because they were already licensed as a unit trust operator since this would have led to issues of conflict of interest which may be detrimental

³³⁶ Interview with Agnes Tibayeita, Company Secretary, DFCU Bank on 23rd January 2009.

³³⁷ *ibid.*

³³⁸ Part IV Division A of the CIS Unit Trust Regulations.

³³⁹ Interview with Mona Batabara Muguma, the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

³⁴⁰ *ibid.*

³⁴¹ *ibid.*

³⁴² *ibid.*

³⁴³ Interview with Cephas Birungi, Legal Consultant, Birungi Barata & Co Advocates on 4th November 2008.

³⁴⁴ Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009.

³⁴⁵ Interview with Ndirangu George, Managing Partner, Bullion Capital on 6th January 2009.

to the investors.³⁴⁶ Besides, being a stock broker and fund manager at the same time leads to short selling to the detriment of the investor.³⁴⁷

4.1.6 Governance of CIS

CIS are a unique product in the capital market in that they are organized and operated by people whose primary loyalty and pecuniary interest lies outside the enterprise. Thus the need for effective governance of CIS cannot be overemphasized, especially when the CIS are repositories of trust and of investors' hard earned money; but the task of providing such protection is a difficult one.

The governance structure of CIS has potential for conflict of interest and other kinds of abuses. The CIS legal and regulatory framework has tried to address these issues but a lot is still needed in this area in order to achieve protection of the investors. It has been noted that "increasingly everything in the fund industry is favouring the manager at the expense of the shareholder. Mutual funds provide insufficient protection for shareholder interests and no safe haven from opportunistic behavior."³⁴⁸

Warren Buffet, writing in the *New York Times* on "Who Really Cooks the Books"³⁴⁹ stated that "to clean up their act, CEOs don't need independent directors, oversight committees or auditors absolutely free of conflict of interest but simply need to do what is right!" And that is the crux of the issue: "to do what is right." But what is right may not always be self evident. In fact, most ethical dilemmas are because of two competing ethical concerns and the judgment required to sacrificing one for the other³⁵⁰.

Jackson J points out in his book *Introduction to Business Ethics*³⁵¹ that there are actually two difficulties in ethical business behaviours i.e. difficulties in identification of what is one's duty in a particular situation and difficulties with compliance with doing one's duty once one knows what it is. Thus even when they have undergone the analysis and requirements to

³⁴⁶ *ibid.*

³⁴⁷ *ibid.*

³⁴⁸ Jack Bogle, founder of the Vanguard Group, p.17.

³⁴⁹ Published on Wednesday, July 24, 2002 in the *New York Times*
<http://www.commondreams.org/views02/0725-05.htm> Japheth Kato's article on business and ethics

³⁵⁰ Japheth Kato's article on Business and Ethics.

³⁵¹ *ibid.*

make an ethical decision they still must face the challenges of putting that decision into practice.”³⁵²

Blair Singer in his book *Building a Team that Wins* opines that in the case of most corporate scandals, it is not an issue of having a code or rules. It is whether the rules were followed or whether breaches of those codes were ever called. One of the starkest examples of the disconnect between the written word and executive behaviour is Enron, which had a well written code of ethics, a code that was evidently of little meaning to the executives who led the company into bankruptcy.³⁵³ In Uganda, unethical conduct and poor corporate governance contributed to bank failures in the late 90s and early 2000s.³⁵⁴

This goes to show that if the investors participating in CIS are going to be adequately protected, the governance of the CIS has to be undertaken by professionals who are going to comply with the laws in place and ensure the interests of the investors are paramount and well taken care of. However, as discussed above this has not been the case as the professionals entrusted with the management of the funds have always abused the trust placed in them and found ways to manipulate the laws to the detriment of the investors. Thus the law may not be able to ensure that the professionals practice principles of good corporate governance and this will expose the investors to all kinds of risks seeing that they are not knowledgeable and are simply relying on the professionals.

4.1.7 Oversight Role

The trustee and depositary are also required to oversee the activities of the Management Company and OEIC.³⁵⁵ They ensure that the manager and ACD keep proper records, exercise due care and diligence with respect to the scheme property, carry out pricing and valuations in accordance with the regulations, appoint a scheme auditor and periodically review the scheme particulars/prospectus to ensure that they are in compliance with the law and that the investors are protected.³⁵⁶

³⁵² *ibid.*

³⁵³ *ibid.*

³⁵⁴ *ibid* also see chapter 4.1.2 at p.67.

³⁵⁵ Part VII Division B and CIS (OEIC) Regulations, part VI Division B of the CIS (Unit Trust) Regulations.

³⁵⁶ Part VII Division B S.92 of the CIS Unit Trust regulations.

The trustee and depositary have powers to decline to execute a transaction where they are of the view that it has not been properly carried out or it might prejudice the investors. They can also request the management company to comply with any regulations that it may have breached such as failure to perform reconciliations and report to the regulator any persistent breaches. The regulations also require that the annual accounts of the manager/ACD should contain a report of the trustee/depositary.³⁵⁷ A custodian, depositary or trustee should be independent of the fund management company³⁵⁸, and it should be liable without limit to investors for any loss incurred by investors resulting from its failure to perform its obligations.

DFCU is the trustee of AA Uganda. One of the qualifications specified for trustees in the regulations is that the trustee should be persons with experience in financial services. This imposes a limitation in the choice of trustees because eminent persons from other disciplines such as law and management are precluded from being appointed as trustees.³⁵⁹ Such a limitation does not have merit in itself.³⁶⁰ Essentially trustees have a major role in the governance of the mutual fund and as such the trustees should comprise persons of eminence and standing who would be able to fulfill the fiduciary responsibility cast on them. It is necessary to give maximum flexibility to the trustees so that they could choose from among eminent persons in various fields of expertise and knowledge who would be in a position to discharge the responsibilities cast on them. For example the trustees may be persons of repute and high standing and who have experience in the fields of law, management, accountancy, and any other, however they should not be guilty of moral turpitude or be convicted of any economic offence or violation of any securities laws.³⁶¹

DFCU is a new entrant in this field without any experience whatsoever. It is purely learning on the job although the designated team handling the trustee function within the bank is set to undergo training.³⁶² The proposal is for placement in an established fund management company plus other generic training in this regard.³⁶³ However, the trustee stated that they have a dedicated team of senior management which ensures oversight and regular meetings

³⁵⁷ S. 121 of the CIS (Unit Trusts) Regulations and R. 105 of the CIS (OEIC) Regulations.

³⁵⁸ S. 17(1)(a) Collective Investment Schemes Act No. 2 of 2003.

³⁵⁹ Interview with Cephass Birungi, Legal Consultant, Birungi Barata & Co Advocates on 4th November 2008.

³⁶⁰ *ibid.*

³⁶¹ *ibid.*

³⁶² Interview with Agnes Tibayeita, Company Secretary, DFCU on 23rd January 2009.

³⁶³ *ibid.*

with AA Uganda.³⁶⁴ There is regular contact with the Fund manager to ensure compliance with the law.³⁶⁵ They seek the regulator's intervention especially for purposes of interpretation of roles where there is uncertainty.³⁶⁶ DFCU is struggling to perform their role and at one time actually decided to exit due to its high technical nature and yet the area was not one of their preferred areas of development.³⁶⁷ However, they are still performing the role but they state that the need for adequate financial and management resources is certainly necessary to enhance investor protection especially this being a fairly new area where expertise would go a long way in inspiring confidence.³⁶⁸

4.1.8 Independent Auditor

There is a regulatory requirement for a fund to be audited by a professionally qualified auditor who is independent of the management company of the fund to ensure investor protection. Auditing is defined as “obtaining and evaluating evidence regarding assertions about economic actions and events to a certain extent to which they correspond with established criteria and communicating the results to the interested users, thus it encompasses the investigation process, attestation process and the reporting process pertaining to economic action and events.”³⁶⁹

The auditor's task is to check that the financial statements made about any one fund accurately reflect its real financial position and to undertake random tests to validate this.³⁷⁰ Regulations may also place on a fund auditor the responsibility of reporting any discrepancies found during the audit to the regulator. As an additional element of supervision, it may also require the auditor to undertake a fixed number of random spot checks on funds during the audit year and report on any problems discovered. Regulations or accounting professional ethics generally require that auditors must be independent of the funds and the management companies they audit.³⁷¹ The use of independent auditors ensures a degree of protection to the

³⁶⁴ *ibid.*

³⁶⁵ Interview with Mona Batabara Muguma, the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

³⁶⁶ *ibid.*

³⁶⁷ Interview with Agnes Tibayeita, Company Secretary, DFCU on 23rd January 2009.

³⁶⁸ *ibid.*

³⁶⁹ Capital Markets Journal: A newsletter of the Capital markets authority, Kenya Issue 1 Vol.2 Dec 2003.

³⁷⁰ Part VII Division A S. 88 (3) of the CIS Unit Trust Regulations.

³⁷¹ St Giles, M. Alexeeva, E. and Buxton, S: (2003) 'Managing Collective Investment Funds' 2nd Edition John Wiley & Sons Ltd p.24.

investors since they are required to audit the funds and carry out spot checks to ensure the manager/ACD are in compliance with the regulations.

International Auditing Standards (IAS) maintains that an auditor's mandate may require him to take cognizance of and report matters that come to his knowledge in performing auditing duties which relate to compliance with legislative or regulatory requirements, adequacy of accounting and control systems, viability of economic activities, programs and projects.³⁷²

However, there have been numerous fraudulent practices that have been perpetrated by auditors in the course of fulfilling their duties. One of the biggest stock scams of all time is Enron, a Houston based energy trading company which was the 7th largest company in the USA.³⁷³ Through some fairly complicated accounting practices that involved the use of shell companies, Enron was able to keep hundreds of millions worth of debt off its books. Doing so fooled investors and analysts into thinking this company was more fundamentally stable than it actually was. Additionally the shell companies run by Enron executives recorded fictitious revenues, essentially recording one dollar of revenue multiple times, thus creating the appearance of incredible earnings figures. Eventually, the complex web of deceit unraveled and the share price dove from over US\$ 90 to less than US\$ 0.70. As Enron fell, it took down with it Arthur Andersen, the leading fifth accounting firm in the world at the time. Andersen, Enron's auditor basically imploded after David Duncan, Enron's chief auditor ordered the shredding of thousands of documents.³⁷⁴

Not long after the collapse of Enron, the equities market was rocked by another billion dollar accounting scandal. Telecommunications giant Worldcom came under intense scrutiny after yet another instance of some serious "book cooking."³⁷⁵ Worldcom recorded operating expenses as investments. Apparently, the company felt that office pens, pencils and paper were an investment in the future of the company and this therefore expensed (or capitalised) the cost of these items over a number of years. In total US\$ 3.8 billion worth of normal operating expenses which should all be recorded as expenses for the fiscal year in which they were incurred – were treated as investments and were recorded over a number of years. This little accounting trick grossly exaggerated profits which were reported at around US\$ 1.3

³⁷² Capital Markets Journal: A Newsletter of the Capital Markets Authority, Kenya Issue 1 Vol 2 Dec 2003.

³⁷³ Capital Markets Journal: 'The Biggest Stock Scams of all Time' pp33-35.

³⁷⁴ *ibid.*

³⁷⁵ *ibid.*

billion. In fact its business was becoming increasingly unprofitable. The investors felt betrayed as they watched the gut wrenching downfall of Worldcom's stock price as it plummeted from more than US\$ 60 to less than US\$ 0.20.³⁷⁶

Auditors have a real role to play in the prevention of financial reporting malpractices that corporations may perpetrate when the corporations are under pressure by the shareholders to show good performance by the corporations. However, if their independence is impaired by extremely close personal relations with their clients' key staff,³⁷⁷ the provision of significant non audit services to their audit clients, disproportionately high fee levels, significant firm income contributed by a single client, audit complacency and negligence, then playing this role will definitely be an uphill task. Auditors must form independent, meaningful and unbiased opinions, irrespective of client management's requirement or pressure. External auditors must also remember that their real client is not a corporation's management but its shareholders instead. Maintaining independence will be one of the most challenging tasks for auditors. If this is not ensured, recurrences of the recent corporate failures can be expected.³⁷⁸

4.1.9 Disclosure

The regulatory framework should ensure that timely and accurate information is made available to investors so that they can make their investment decisions in a fraud free environment. All investors whether large institutions or private individuals, should have access to certain basic facts about an investment prior to investing and so long as they hold it.³⁷⁹ To ensure that investors are empowered through provision of information, the fund management companies must disclose meaningful financial and other information to the public. Disclosure is therefore a key investor protection tool. Adequate disclosure enhances the capability of investors to undertake independent scrutiny.

The regulations require full disclosure of information relating to the schemes, the underlying funds, investment objectives, fees, commission, expenses, risks, accounting reports and performance of the funds. The Trust Deed and Instrument of Incorporation are the key

³⁷⁶ *ibid.*

³⁷⁷ D.C Jamwa, "Corporate Failures - What is Going Wrong?" (2002) *Capital Markets Journal* Vol.5 No. 4, p.15.

³⁷⁸ *ibid.*

³⁷⁹ The Investor's Advocate: "How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation" available on <http://www.sec.gov/about/whatwedo.shtml> accessed 9th November 2007.

formation document for Unit Trust Schemes and Open Ended Investment Companies (OEICs). The scheme particulars and prospectus are the key documents relating to schemes. They are public documents, which must be made available for members of the public to view.³⁸⁰ The manager of a licensed unit trust scheme as well as the OEIC's ACD are responsible for the accuracy of scheme particulars and the prospectus and must ensure that the documents do not contain any untrue or misleading statement or omit any matter required by these Regulations to be included.³⁸¹

These documents seek full and adequate disclosure by giving all material information to assist an investor make an informed decision. All prospective investors are at least offered - or in some cases must be given - a copy of the founding document of the fund.³⁸² This must usually be done either before the purchase is made or at the time the purchase is made. They are also required to report periodically to the regulator about the performance of the funds, compliance with capital adequacy requirements, investment restrictions and other requirements.³⁸³

Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions. It is easy for people to lose confidence in fund management firms or funds if information they receive is incomplete, unreliable or late. Equally, unsophisticated investors can be lulled into a false sense of security by fund management companies making misleading claims or being economical with the truth - and there is a potential incentive for them to do this if it will attract more money under management from which more fees will be earned.³⁸⁴

The manager and ACD are required to write regular reports to the investors of a fund or to other institutional clients, in which they will have to disclose and explain what they have done in the period under review, why they have done it and why the portfolio is invested the way it is at the reporting date.³⁸⁵ This latter requirement is very tough and ought to instill

³⁸⁰ Part III r.10, r.11 and CIS (OEIC) Regulations, part III r.10, r.11 of the CIS (Unit Trusts) Regulations.

³⁸¹ Part III r. 12 and CIS (OEIC) Regulations, part III r.12 of the CIS (Unit Trusts) Regulations.

³⁸² Part II Regulation 5 (1) of the CIS Unit Trust Regulations.

³⁸³ Part XI Regulation 117 (1) of the CIS Unit Trust Regulations.

³⁸⁴ St Giles, M. Alexeeva, E. and Buxton, S: (2003) 'Managing Collective Investment Funds' 2nd Edition John Wiley & Sons Ltd p.227.

³⁸⁵ Part IX of the CIS (OEIC) Regulations, part X and CIS (OEIC) Regulations.

good discipline upon investment managers and directors, and it is meant to ensure that they comply with the trust deed and instrument of incorporation thus protecting the investors.

Disclosure rules are part of the fundamental legal foundation of the capital markets. The purpose of disclosure law is to make issuers of securities criminally liable for committing fraud by withholding material facts that are essential to the price of securities³⁸⁶. In the absence of credible penalties for failing to disclose material facts, investors will be wary of issuing firms and will shun securities. Securities markets cannot possibly work well unless public arms length investors have substantial information about issuers of securities.³⁸⁷ Without this basic foundation, investors will risk only a small portion of their savings hoping to win the lottery or invest in situations where they have private knowledge of the parties involved, which gives them confidence to part with their capital.³⁸⁸

Some market players have argued that in as much as disclosure is necessary and important, the question is how is it done and what is the language used in disclosure? Is it understood by the ordinary/small investor?³⁸⁹ The information being disclosed should be in simple and not technical language.³⁹⁰ Besides, some argue that there is no reading culture among Ugandans and even if disclosure is done, it still does not benefit the investors.³⁹¹

Other players have argued that compliance with the disclosure law is not adequate.³⁹² Investors have the right to information at any time but investors are not aware of their rights. Enforcement mechanisms for disclosure are not adequate and in addition investors are not putting fund managers on their toes. When the investor does not know his portfolio performance, that is the beginning of decay.³⁹³ Investors are not demanding for disclosure and CMA is not doing much to ensure compliance with the disclosure law.³⁹⁴ They argue that some market players give enticing information to attract investors yet they are bound by the disclosure rules. For example, they should tell the investor that they may win or lose not just

³⁸⁶ David O. Beim & Charles W. Calomiris: 'Emerging Financial Markets' McGraw Hill International Series 2001p.20.

³⁸⁷ *ibid.*

³⁸⁸ *ibid.*

³⁸⁹ Interview with Ndirangu George, Managing Partner, Bullion Capital on 6th January 2009.

³⁹⁰ *ibid.*

³⁹¹ Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009.

³⁹² Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda on 14th January 2009.

³⁹³ *ibid.*

³⁹⁴ *ibid.*

how they will win.³⁹⁵ In addition, companies delay in submitting information to CMA and CMA does not take any action. This goes back to the capacity of CMA which is questionable since they are not supervising the players adequately.³⁹⁶

In Nigeria, market operators at the Nigerian Stock Exchange (NSE) reacted sharply to the NGN13 billion (about US\$ 85,471,800) financial scandals rocking one of the quoted companies - Cadbury Nigeria Plc.³⁹⁷ In June 2006, the Security and Exchange Commission (SEC) expressed concern on issues arising from Cadbury's annual reports and accounts for 2005, particularly in the areas of inadequate disclosure, non compliance with the corporate governance codes and obtaining loans for the payments of dividends to shareholders, contrary to SEC regulations.³⁹⁸ "The commission constituted an in-house committee which carried out a thorough investigation on the matter and confirmed the report of mis-statements in the account, to the tune of NGN3 billion (about US\$ 19,724,300)" SEC said in a statement. The statement announced a series of sanctions on key actors in the scam and the company. Reacting to the penalties, many of the stockbrokers said it was in tune with the rules and regulations governing the conduct of business on the capital market. They said such measures are necessary; pointing out that it was remarkable that the sanctions were not only for the officials but also the company. Cadbury was made to pay a fine of NGN100,000 (about US\$ 65.75) in the first instance and a penalty of NGN5,000 (about US\$ 32.87) per day from 30th June 2002 to 14th December 2006 within 21 days failing which trading on its shares will be suspended on the stock market³⁹⁹.

The financial scandal has led to the banning of top officials of the company from holding directorship positions among other penalties for mal practices. Describing the actions taken as appropriate, a stock-broker, Andy Saku stated that "the regulatory body acted well as this goes to confirm that as a public quoted company, there is no hiding place for fraudulent practices. Accountability and transparency are what give credibility to the market and the sanctions will restore investors' confidence."⁴⁰⁰

³⁹⁵ *ibid.*

³⁹⁶ See chapter 4.1.1 p.64.

³⁹⁷ Nigeria's hard punishment for Cadbury directors in fraud case: <http://www.panapress.en.afrik.com> accessed on 27th July 2009.

³⁹⁸ *ibid.*

³⁹⁹ *ibid.*

⁴⁰⁰ *ibid.*

4.1.10 Limits on Investment and Borrowing

The system should place limits on the investment and borrowing capabilities of a fund. Rules should require portfolio diversification, provision of liquidity to meet redemptions and containment of risk within defined parameters and lay down requirements for dealing with any breaches of such limits⁴⁰¹. Thus, unit trusts and OEICs cannot invest or borrow money in any way they wish. Under the regulations, the securities fund of both the Unit trusts and OEICs are allowed to invest 10% in transferable but not approved securities including pre-listed securities, in government or public securities, 5% in collective investment scheme units, investment trusts, 80% in approved securities, cash and near cash, and they can underwrite.⁴⁰² They are not permitted to invest in immovables and derivative instruments. Stock lending and short selling are prohibited under the regulations.⁴⁰³ The money market fund of both the unit trust and OEIC's are allowed to invest 80% in government or public securities, 80% in approved securities and cash (and near cash). They are also allowed to underwrite. They are not permitted to invest in immovables, collective investment scheme units, transferable but not approved securities including pre-listed securities and derivative instruments. Stock lending and short selling is prohibited.⁴⁰⁴

Investments by CIS are subject to investment restrictions as laid down in the regulations. These restrictions are essentially prudential investment norms, most of which are universally followed by mutual funds to ensure portfolio risk diversification.⁴⁰⁵ However, these restrictions pose a number of challenges - first challenge is industry wide exposure: industry wide exposure limit of 10% was stipulated to ensure that the savings of investors were not concentrated in a few industries and also were meant to bring about risk diversification in the portfolio investments of mutual funds.⁴⁰⁶ This restriction however has to a certain extent constrained genuine fund management strategy of mutual funds in investing in potentially good industries.⁴⁰⁷ Further, there is no standard codification and classification of industries

⁴⁰¹ St Giles, M., Alexeeva, E. and Buxton, S: (2003) 'Managing Collective Investment Funds' 2nd Edition John Wiley & Sons Ltd p.55.

⁴⁰² Part V of the CIS (Unit Trusts) Regulations, and part V of the CIS (OEIC) Regulations.

⁴⁰³ *ibid.*

⁴⁰⁴ Part V of the CIS (Unit Trusts) Regulations, and part V of the CIS (OEIC) Regulations.

⁴⁰⁵ Interview with Mona Batabara Muguma, the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

⁴⁰⁶ *ibid.*

⁴⁰⁷ Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda on 14th January 2009.

available and this makes it difficult to enforce this regulation.⁴⁰⁸ The second challenge is company wide exposure: the company wide exposure limits are to the effect that no individual scheme of a unit trust can invest more than 10% of its corpus in any one company's shares and under all its schemes put together own more than 5% of the voting rights of a company.⁴⁰⁹

However, it has been argued that the investment restrictions are not reasonable in a country like Uganda where the product supply is not adequate.⁴¹⁰ The Ugandan market is so small and this can be seen from the fact that there are only 6 indigenous companies listed on the exchange while in Nairobi they are 53. In addition, there is a low supply of treasury bills where funds can be invested. In regard to corporate bonds, Uganda has only 3 which are Uganda Telecom, East African Development Bank and Standard Chartered Bank while in Nairobi there are hundreds of corporate bonds.⁴¹¹ DFCU, the trustee which must ensure diversification, has stated that enforcing this provision is a challenge but they endeavour to ensure it is done within the limited range of products.⁴¹²

Ensuring that diversification is achieved is difficult and there is need to encourage more companies to list so that there are more products available on the market. Shell, Total, Barclays, Standard Chartered are multinational companies that are listed elsewhere, and should also be encouraged to list in Uganda.⁴¹³ However, a look at the listing requirements and the high transaction costs to have a company listed may keep many out of the capital markets industry. In Uganda, the USE listing requirements provide that for a company to list on the USE, it should have a minimum net capital of UGX 2 billion (about US\$ 854,737) and net assets of UGX 1 billion (about US\$ 427,369) in addition to having declared positive profits in at least three years of the previous five years. These requirements are onerous and discourage companies from listing.⁴¹⁴

⁴⁰⁸ *ibid.*

⁴⁰⁹ Interview with Mona Batabara Muguma, the Assistant Investment Manager with African Alliance Uganda on the 5th of January 2009.

⁴¹⁰ Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda on 14th January 2009.

⁴¹¹ *ibid.*

⁴¹² Interview with Agnes Tibayeita, Company Secretary, DFCU Bank on 23rd January 2009.

⁴¹³ Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda on 14th January 2009.

⁴¹⁴ W Tarinyeba, "The Challenges Faced by Capital Markets in Emerging Economies: A Case Study of Uganda" (2004) Capital Markets Journal Vol.7 No.1 p.19.

Under the regulations, it is not permissible to invest in offshore securities and funds.⁴¹⁵ Generally, the regulations allow CIS to invest only in securities such as shares and debt. Regulation should be made more flexible to allow investing in real estate (property fund) where the investors will get regular income and the property is appreciating in value.⁴¹⁶ It should also be expanded to include trading in derivatives like Kenya which recently started trading in derivatives.⁴¹⁷

Other market players argue that diversification is overrated. They prefer the advice of USA investment adviser Warren Buffet who said “there is nothing wrong with keeping your eggs in one basket, just watch that basket.”⁴¹⁸

It must be noted that the risk diversification strategies are extremely complex and therefore it may be appropriate that this strategy be left to the professional fund managers and trustees of CIS. In addition the incompetence of CMA especially in light of the recent scandal caused by Crane Financial Services over defrauding NSSF of billions of shillings has led some companies that were considering listing on the exchange to put off the listing plans until the regulator demonstrates that it can assure a fair environment for all stakeholders.⁴¹⁹

4.1.11 Asset Valuation and Pricing

Valuation of fund assets and pricing of fund shares or units are central to the operation of funds. If investors are to entrust their money to a common pool, they must have confidence that the way in which the investments owned by that pool are valued and priced is fair and does not disadvantage them.⁴²⁰ The price of a unit in a scheme is arrived at by valuing the scheme property (Net Asset Value) and dividing it by the number of units in issue. In an OEIC, the price of a share of any class is calculated by valuing the scheme property attributable to shares of that class and dividing that value by the number of shares of the class in issue.⁴²¹

⁴¹⁵ Part V of the CIS (Unit Trusts) Regulations, and part V of the CIS (OEIC) Regulations.

⁴¹⁶ Interview with Ndirangu George, Managing Partner, Bullion Capital on 6th January 2009.

⁴¹⁷ Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda on 14th January 2009.

⁴¹⁸ *ibid.*

⁴¹⁹ M. Wakabi, CMA Credibility on the Line as Broker Defies it over Fraud Cash: The East African June 23rd–29th 2008.

⁴²⁰ St Giles, M., Alexeeva, E. and Buxton, S: (2003) “Managing Collective Investment Funds” 2nd Edition John Wiley & Sons Ltd pg 134.

⁴²¹ CIS (Unit Trusts) Regulations, Part IV and part IV of the CIS (OEIC) Regulations.

CIS operators should take great care in constructing and regulating valuation and pricing systems, to ensure that among other things, the pricing and valuation are correctly done and that investors are not misled. Thus, a manager and ACD are required to value the underlying assets of a scheme periodically. The valuation period must be stated in the scheme particulars and prospectus. However, the valuation points shall not be less frequent than specified in the scheme particulars and prospectus and in any event not less than once in two weeks.⁴²² In case of false valuations, investors can easily be disadvantaged either to the benefit of other investors or more seriously to the benefit of the fund management company which may be able to gain in a number of different ways. In addition since the net asset value of the fund is the sole means by which investors can judge the performance of the fund manager, any error in valuation or manipulation of fund asset prices on which valuations are based may cause existing or potential investors to take investment decisions based on misleading or even fraudulent information.⁴²³

4.1.12 Compensation fund

Another investor protection tool, when all other preventive measures and remedies have failed, is the compensation fund. Compensation is the issue of recompense to investors for any failure, fraud or mismanagement on the part of the fund management companies or custodians, depositaries or trustees or even sales agents or advisers as a result of which investors have suffered losses.⁴²⁴ For regulators, compensation is an important component in establishing public confidence in the regulatory system.

Section 81 (1) of the CMA Act establishes an investor compensation fund for purposes of granting compensation to investors who suffer pecuniary loss resulting from failure of a licensed broker or dealer to meet his contractual obligations. The fund is under the control of the CMA which is the regulatory body of capital markets in Uganda.⁴²⁵ This is a notable attempt at investor protection. The aim of the laws governing the funds is to enhance investor confidence in the newly created markets. The laws governing the funds do not preclude

⁴²² Part IV r.40 of the CIS (Unit Trusts) Regulations, and part IV r.33 of the CIS (OEIC) Regulations.

⁴²³ St Giles, M. Alexeeva, E. and Buxton, S: (2003) 'Managing Collective Investment Funds' 2nd Edition John Wiley & Sons Ltd p.134.

⁴²⁴ *ibid* p.66.

⁴²⁵ Interview with Eric Kenneth Lokolong, Senior Compliance Officer (Legal), CMA, 14th January 2009.

investors from bringing litigation for civil relief based on statutory and common law violations.⁴²⁶ The fund however is not intended to provide relief for investors who have been defrauded by a company or company insiders.⁴²⁷ In addition, the investor cannot expect to be compensated for loss suffered due to a normal fall in share value. The value of shares can go up or down and in the face of a broker's honesty, the investor is not entitled to compensation.

However, it has been argued that the compensation offered by this fund is too little compared to what the investors have contributed to the fund and this cannot be compared to the compensation fund in developed countries which offer unlimited protection to the investors.⁴²⁸ Australia has unlimited protection and the deposits are guaranteed by a bank.⁴²⁹ It has been argued that the compensation should be a percentage of the funds under the management of the operator. As the funds grow the compensation fund may not be a big fallback position so the investor may lose much of their money.⁴³⁰ Fund managers do not guarantee performance but they do a lot to attract investors. They should therefore be in a position to ensure adequate compensation to the investors. Thus fund managers should be put to task to make good the losses investors incur.⁴³¹

In addition, much as the law provides for this compensation fund, in practice it is not yet in existence and this poses a challenge in that the investors may not be able to receive compensation in case of loss.⁴³²

4.2 Conclusion

With the growing number of people investing in the capital markets, many of whom are unsophisticated individuals with limited capacity to monitor the performance of CIS in detail, it is imperative to offer a degree of confidence to the investors that they will receive fair treatment through well-regulated capital markets and that they will have somewhere to turn if things go wrong. People must have confidence that their money is protected and that there are reliable means of redress in case any breaches occur. In the absence of this confidence,

⁴²⁶ Part XV S.75 of the Collective Investment Schemes Act No. 2 of 2003.

⁴²⁷ Capital Markets Authority: General Info and Guidelines for Issue of Securities July 1999 p.10.

⁴²⁸ Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009.

⁴²⁹ *ibid.*

⁴³⁰ Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda on 14th January 2009.

⁴³¹ *ibid.*

⁴³² Interview with Eric Kenneth Lokolong, Senior Compliance Officer (Legal), CMA, 14th January 2009.

individuals simply will not invest in funds in any volume. The laws and regulations governing CIS afford a reasonable degree of protection to investors through provisions regarding separation of assets from management, the oversight function, ensuring professional management of the funds, diversification of investments and full disclosure. However; there still exist some challenges with regard to the law that hinder adequate protection to the investors. These include illiquid markets, conflict of interest, investment restrictions, pricing and valuation, among others.

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

5.0 Conclusions

The development of capital markets all over the world has led to the situation in which regulations concerning particular securities and relating to these securities only are no longer sufficient to protect an investor.

Analyses from the responses obtained from interviews with various respondents and discussed in the previous chapters indicate that there are various legal and extra legal problems that face Uganda's capital market industry generally and CIS specifically. These include the populace's lack of knowledge and operation of the capital markets industry, lack of experience by some of the operators of the CIS, deliberate abuse of the regulations as highlighted in the NSSF scandal by Crane Financial Services, conflict of interest, inadequate supervisory capacity by CMA as again highlighted by the NSSF and Hurry Finch scams.⁴³³

Other weaknesses in the regulatory framework include inadequate provisions as to redress in case of collapse of AA, lack of operationalisation of the compensation fund, low capital requirements compared to the assets held by the operator, stringent investment restrictions yet there is an insufficient supply of products on the capital markets, lack of provisions regarding insurance of the investments, some of the licensing requirements are onerous and discouraging while others need more clarity, and lack of confidence by the public in the capital markets.

With the above regulatory weaknesses plaguing the capital markets in the country, there is need to find ways and means of improving on the legal and regulatory framework governing CIS to ensure that the risks generally associated with the capital markets industry are overcome. In addition, there is need to have measures in place that protect the interests of these investors especially the small investors who may not have the capacity to ensure that their savings are not mismanaged by the fund operator. If people do not have confidence in the system they will be reluctant to invest. Therefore, investor protection is of paramount importance if the investors are going to participate in CIS.

⁴³³ See Chapters 3.6, 3.7 and 4.1.

5.1 Recommendations

There are various legal and extra legal problems that face Uganda's capital market industry generally and CIS specifically. As such, the recommendations put forward are also divided into the legal and extra legal categories as discussed below.

5.2 Legal Recommendations

5.2.1 Separation of Roles by Different Industry Players to Avoid Conflict of Interest

In order to alleviate the problem of conflict of interest, it is imperative that the different players in the capital markets offer only one type of service to the investors. For example, no single company should act as stock broker, unit trust operator, and investment adviser at the same time as this may be disadvantageous to the investor while benefiting the service provider.⁴³⁴ The law should therefore ensure that different services in the capital markets are offered by different service providers so that the investor gets independent services from different service providers.⁴³⁵

5.2.2 Promoting Investor's Education

Related to the above, the CMA should carry out investor education by lobbying universities, colleges, secondary and primary schools and other education institutions to incorporate information on investment and capital markets on the curricula to improve on the capital market operations awareness for the new and young generation so that they can embrace the opportunities available from the capital markets.⁴³⁶

For this to be effective, CMA should work with the Ministry of Education to have the secondary and primary school's curricula contain the courses on capital market and investment principles as compulsory courses so that the whole public is informed from an early age about the risks and benefits of investing in the capital markets.⁴³⁷

⁴³⁴ See Chapter 4.1.5.

⁴³⁵ Interview with Ndirangu George, Managing Partner, Bullion Capital, on 6th January 2009.

⁴³⁶ See Chapter 4.1.2.

⁴³⁷ Interview with Ndirangu George, Managing Partner, Bullion Capital, on 6th January 2009.

In addition, issues of ethics and leadership should be taught at all levels of learning from the primary level to the university level to instill principles of honesty and integrity. This is so as to ensure that professionals handling investors' money are well trained and upright so as not to take advantage of the investors.⁴³⁸

5.2.3 Increase of Product Supply

The Ugandan market is so small and this can be seen from the fact that there are only 6 indigenous companies listed on the exchange while in Nairobi they are about 53. In addition, there is a low supply of treasury bills where funds can be invested. In regard to corporate bonds, Uganda has only 3 which are Uganda Telecom, East African Development Bank and Standard Chartered Bank while in Nairobi there are hundreds of corporate bonds.⁴³⁹ The number of new stock listings has not grown significantly in recent years. The principal growth in listings has come from cross-listings of shares among exchanges like Kenya Airways and KCB. While this practice has increased investment opportunities for domestic investors there still remains a challenge in ensuring compliance with the investment restrictions provided for in the regulations.⁴⁴⁰ Product supply can be increased in the following ways: relaxation of the listing requirements, relaxation of the registration exercise and relaxation of the investment restrictions as discussed below.

5.2.3.1 Relaxation of the Listing Requirements

Stringent/onerous listing requirements have a way of stifling innovation leaving the field open to competition from less regulated or unregulated alternatives. Product supply can thus be increased by reducing on the listing requirements of the Uganda Stock Exchange (USE). The current listing requirements on the USE are onerous.⁴⁴¹ The USE listing requirements provide that for a company to list on the USE, it should have a minimum net capital of UGX 2 billion (about US\$ 854,737) and net assets of UGX 1 billion (about US\$ 427,369) in addition to having declared positive profits in at least three years of the previous five years. Therefore by relaxing the listing rules of the USE, this may attract the remaining few state enterprises under the Government's privatization program to list in the Uganda Stock

⁴³⁸ Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda, on 14th January 2009.

⁴³⁹ See Chapter 3.4.2 at p.43 and Chapter 4.1.10.

⁴⁴⁰ Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda, on 14th January 2009.

⁴⁴¹ See Chapter 4.1.10.

Exchange (USE). This can also induce small and medium-sized enterprises (SMEs) to list in the USE. The multinational companies like Standard Chartered Bank, Shell, Total that are listed on other stock exchanges may also be encouraged to list on the USE. The challenge thus is to increase product supply by making the existing tough listing requirements more flexible.

5.2.3.2 Relaxation of the Registration Exercise

Product supply can also be increased by relaxing the registration exercise without compromising the quality of companies that are registered so as to encourage many companies to register so as to increase the amount of competition which will lead to better services to the investor. The current registration provisions are too costly, too time consuming and contain too many technicalities to attract smaller companies.⁴⁴² For a company to obtain a license to offer the CIS service, first of all it has to be registered with the Registrar of Companies, then it has to prepare a prospectus, trust deed and scheme particulars. It must also have a trustee/depositary. Then on completion of all that it has to apply to CMA for a license to operate. By relaxation of those requirements many more companies will be encouraged to register and participate in the capital markets industry.⁴⁴³

5.2.3.3 Relaxation of the Investment Restrictions

Under the regulations, it is not permissible to invest in offshore securities and funds.⁴⁴⁴ Generally, the regulations allow CIS to invest only in securities such as shares and debt.⁴⁴⁵ Regulations should be made more flexible to allow investing in real estate (property fund) where the investors will get regular income while the property is appreciating in value. The investment restrictions should also be widened to include trading in derivatives like in Kenya which recently started trading in derivatives.⁴⁴⁶

⁴⁴² See Chapter 4.1.3.

⁴⁴³ Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda, on 14th January 2009.

⁴⁴⁴ Part V of the CIS (Unit Trusts) Regulations, and part V of the CIS (OEIC) Regulations.

⁴⁴⁵ See Chapter 4.1.10.

⁴⁴⁶ Interview with Ndirangu George, Managing Partner, Bullion Capital, on 6th January 2009.

5.2.4 The Introduction of Electronic Systems

The introduction of the electronic trading systems will considerably reduce pricing errors and other risks associated with manual operations. The risks associated with paper transactions such as fraud and late execution of instructions will also be greatly reduced.⁴⁴⁷

Capital markets in Uganda have over the years traded using manual platforms and this has become outdated considering the growth in the volumes and levels of activities on the USE. Parliament has passed the Securities Central Depositories Bill 2008 which mandates USE to introduce the quicker method of electronic trading as opposed to the old manual trading method. The Bill also aims at protecting investors by setting minimum standards of operation by securities central depositories as well as providing for offences and prescribing penalties for those who contravene its provisions with the aim that investors will be protected.

Despite the fact that USE has been given a green light to trade electronically, little has been done to make this a reality and market players are still operating manually. There is therefore need to expedite the process so that electronic trading becomes operational and the risks associated with manual transactions are done away with.

5.2.5 Co-ordination Between all the Regulatory Authorities

There should be co-ordination between all bodies that play a role in the capital markets. These include the Registrar of companies where companies are first of all registered and subsequently disclosure is made on a continuous basis about the companies activities.⁴⁴⁸ CMA which oversees the entire process of regulating and promoting the development of the capital markets industry in Uganda and the USE which regulates the trading in securities. This is so as to ensure that only credible companies are registered and that companies registered with the aim of stealing money from the unsuspecting members of the public with promises of high returns in a short time are eliminated.⁴⁴⁹

⁴⁴⁷ Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda, on 14th January 2009.

⁴⁴⁸ Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009.

⁴⁴⁹ *ibid.*

5.2.6 Stock Market Integration

The Uganda capital market should be integrated with other markets in the region that are more developed.⁴⁵⁰ This will minimize country specific risks and achieve risk diversification as a result of cross border listing. This will also ensure that country level limitations are overcome and there will be long-term survival as well as the overall development of the capital markets in the region.⁴⁵¹

5.2.7 Legal and Regulatory Harmonization

Laws and regulations pertaining to regional capital markets should be harmonized so as to ensure a certain level of uniformity in the operation of capital markets generally.⁴⁵² This should include harmonizing policies on cross border listings, foreign portfolio investors, and auditing and financial reporting among others, which will in turn ensure the same level of investor protection regionally.

5.2.8 Increasing Capital Adequacy

The law governing CIS provides that for any company to start the business of a CIS, it must have a minimum net capital of UGX 200 million (about US\$ 85,475). However, from a number of responses received during the interviews conducted, it has been suggested that this amount needs to be increased so that it is commensurate with or above the total number of funds being managed by the fund manager.⁴⁵³ This is to ensure that the operator will have sufficient funds for refund or compensation to the investors in case it collapses or winds up.

Alternatively, it is recommended that investors should be given a time period of about three years to gather the whole of the capital and not present it in lump sum since capital alone does not make an institution run.⁴⁵⁴ The capital requirements should be reduced because skills are available locally to run a CIS and the local investors should not be hampered by failure to

⁴⁵⁰ Interview with Rober Baldwin, CEO, Crested Stocks and Securities, on 27th January 2009.

⁴⁵¹ *ibid.*

⁴⁵² *ibid.*

⁴⁵³ See Chapter 4.1.4 and also interview with Ndirangu George, Managing Partner, Bullion Capital, on 6th January 2009.

⁴⁵⁴ Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009.

meet the capital requirements.⁴⁵⁵ The investors should then be given a conditional license subject to the fulfillment of the capital requirement. When the investors fail to meet this requirement then the license may be cancelled.⁴⁵⁶

5.3 Extra legal Recommendations

5.3.1 Capacity Building in CMA

There is need for CMA to build capacity and competence so as to be able to effectively oversee the capital market industry in the country.⁴⁵⁷ They need to build human resource capacity by recruiting more employees who are knowledgeable in capital market operations so as to ensure effectiveness in monitoring, supervision and compliance.⁴⁵⁸ There is also need for CMA to build its competence by ensuring regular education and training of their staff to ensure they are up to date with the developments in the capital markets. This will also enable it to regulate the capital market industry more effectively, which will in turn build investor confidence.⁴⁵⁹

5.3.2 Capacity Building of Market Players

CIS are managed by professionals who invest funds on behalf of investors some of whom lack expertise in the area of capital markets.⁴⁶⁰ The CIS product is a fairly new one thus there is need to ensure that whoever is offering it must be a professional i.e. well educated and knowledgeable in that area.⁴⁶¹ In the interview conducted with the trustee it was indicated that it is not quite knowledgeable in the area of CIS and they were simply learning on the job.⁴⁶² Thus it is imperative that the operators undertake regular education and training to keep abreast about the operations and developments taking place in the capital markets industry.⁴⁶³

⁴⁵⁵ *ibid.*

⁴⁵⁶ *ibid.*

⁴⁵⁷ See Chapter 4.1.1.

⁴⁵⁸ Interview conducted on the basis of anonymity on 14th January 2009.

⁴⁵⁹ *ibid.*

⁴⁶⁰ See Chapter 3.6.3.

⁴⁶¹ Interview with Ndirangu George, Managing Partner, Bullion Capital, on 6th January 2009.

⁴⁶² See Chapter 4.1.7.

⁴⁶³ Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009.

5.3.3 Increasing Awareness

One of the challenges faced by operating CIS is lack of awareness of the public about these schemes.⁴⁶⁴ The functioning of capital markets still eludes a large number of potential market participants.⁴⁶⁵ Most of the responses obtained in the course of the interviews conducted revealed that there is lack of public awareness about the operations of the capital markets and that the savings and investment culture is still very poor and that trading on the stock exchange is viewed with a lot of skepticism and suspicion. This can be proved by the fact that there are only about 800 individual investors and only 6 institutional investors in the CIS out of a population of about 25 million Ugandans.⁴⁶⁶ CMA thus has to ensure that they invest time and energy in increasing awareness of both the individual and institutional investors so that everyone can have a general understanding of the capital markets industry as well as participate in and partake of the benefits of the capital markets industry.

5.3.4 Increase Savings

A fundamental constraint to increasing demand for securities is the low level of savings.⁴⁶⁷ In addition, the low levels of income mean that people are not able to save and invest in activities where the return on investment can only be realized after a long period of time. There is therefore a need to educate the public on the importance of saving and the different avenues through which their savings can grow to meet their demands specifically by investing their savings in the capital markets industry as opposed to depositing it in the banks for minimal returns.⁴⁶⁸

5.3.5 Increase Confidence in the Capital Markets Generally

Market confidence is an important factor in creating a vibrant market.⁴⁶⁹ Loss of confidence and trust among investors can be potentially devastating to the development of the capital markets. It is therefore imperative that the confidence of the public in respect to the operation

⁴⁶⁴ See Chapters 3.7.4 and 3.7.5.

⁴⁶⁵ Interview with Eric Kenneth Lokolong, Senior Compliance Officer (Legal), CMA on 14th January 2009.

⁴⁶⁶ See Chapter 3.5.

⁴⁶⁷ Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009.

⁴⁶⁸ Interview with Mugendawala Hamis, Fund Manager, ICEA Uganda, on 14th January 2009.

⁴⁶⁹ See Chapter 1.1.

of the capital market industry is boosted.⁴⁷⁰ This can be done by ensuring adequate supervision of the operators, constant monitoring and enforcement of the regulations and punishments in case of breach of any of the regulations. Once this is done the public will be encouraged to invest in the capital markets since they are assured of protection of their investments and redress in case of breach.

5.3.6 Government Assistance

Government should develop strategies for poverty reduction on national and local levels. Government should also offer financial assistance to the population.⁴⁷¹ This will ensure that more people are empowered to invest in the capital markets.

⁴⁷⁰ Interview with Rober Baldwin, CEO, Crested Stocks and Securities, on 27th January 2009.

⁴⁷¹ Interview with Mutimba Patrick, Investment Manager, AIG, on 6th January 2009.

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APPENDICES

I. INTERVIEW GUIDE: CAPITAL MARKETS AUTHORITY

Respondent Identification Particulars:

Name:

Designation/Position held:

1. The Capital Markets Authority (CMA) is the regulatory body responsible for the development of the capital markets industry in Uganda, and one of its objectives is investor protection. In 2003, a new product – Collective Investment Schemes (CIS) were introduced in the capital markets. Laws and regulations to govern CIS were also made. Do you think the regulations are adequate to protect the investor?
2. In your opinion do you think the public has confidence in CIS? What can be done to improve their confidence?
3. Do you think the requirements for the approval of funds, fund management companies, trustees and other service providers are adequate to ensure that investors are protected?
4. What measures have you put in place to monitor and supervise ongoing compliance of the law by the CIS market players?
5. What measures have you put in place to ensure that the conduct of business of CIS operators and other service providers is carried on in the interest of and for the protection of investors? Do you think those measures are adequate to protect the investors?
6. What measures have you put in place to investigate any malpractice by the CIS market players?
7. Do you think those measures in number 6 above are adequate to protect the investors?

8. What measures does the CMA employ to ensure adequate investor protection?
9. What measures are there for an aggrieved CIS investor to seek redress? How easy is it for such an investor to seek the available remedies?
10. What disciplinary measures have you put in place in case of non compliance or misconduct by the fund operators or trustee or other service providers in order to ensure investors are protected?
11. According to the functions and powers given to you by the laws what have been your achievements in the area of CIS?
12. What challenges do you think need to be addressed in the area of CIS, particularly with regard to investor protection?
13. How do you think the above challenges can be addressed to ensure investor protection?

II. INTERVIEW GUIDE: AFRICAN ALLIANCE

Respondent Identification Particulars:

Name:

Designation/Position held:

1. (a) What CIS funds do you manage?
(b) What are the differences between the different funds?
(c) Is there any fund that offers more protection to investors than another?
2. What is the total size of the funds you manage?
3. What are the investors' views of the CIS products you offer?
4. Do you think the regulations as they are now are adequate to protect the investor?
5. In your opinion do you think the public are confident that the CIS regulatory framework can ensure their protection? What can be done to improve their confidence?
6. One of your functions is investment management (defining investment objectives and styles, research, investment analysis, portfolio selection and management) which is a complex process. What measures have you put in place to ensure that the investments of the investors in the CIS are protected?
7. Do you think the licensing requirements set by the CMA are onerous or are they sufficient to ensure investor protection?
8. Investment restrictions contained in the regulations are intended to ensure that you as fund managers diversify the investments of your clients so as to limit exposure to a single investment. How easy is it to enforce this provision where product supply is not adequate to ensure diversification and minimizing of risk to the investors?

OR Is there an existing range of products adequate in terms of the needs of existing customers and regulation? In other words are there suitable assets in which to invest given the investment powers that help diversify to protect investors?

9. One of the features of CIS is that it allows free entry and exit of investors at any time and this is one of the mechanisms of investor protection. This implies that you should be able to sell some of the fund assets and pay off investors who wish to exit. However, how easy is it to sell assets in markets that are not so active as Uganda?
10. The regulations require that as CIS managers you have sufficient internal control mechanisms to ensure that the pricing and valuation is correctly done. What measures have you put in place to ensure that valuation is done correctly and consistently and that investors are not misled?
11. Under the regulations, disclosure is an important element and it is a key investor protection tool. What measures have you put in place to ensure that there is adequate and timely flow of information to investors?
12. Do you think the capital adequacy requirement of UGX 200 million is sufficient to ensure protection of investors in the CIS?
13. How easy is it for you to detect malpractices by employees/affiliates e.g. fraud, misrepresentations, valuation errors?
14. What legal and operational measures have you put in place to ensure that you act in the interests of the investors?
15. The legal regime requires that you are constantly monitored to ensure compliance with regulations. What internal compliance controls, procedures and systems have you put in place to ensure that the funds are managed in compliance with the regulations?

16. Given the kind of business you are operating there is likely to arise Conflict of interest between your employees who may want to benefit at the expenses/cost of fund investors. What measures have you put in place to ensure that this does not arise? In case it arises, what measures do you have in place for redress?
17. Do you think CMA takes its role of ensuring investor protection in CIS seriously?
18. Do you think the competence, powers and capacity of the CMA are sufficient to ensure supervision and regulation of CIS operators and to enhance the confidence of investors?
19. What are the challenges you have experienced in the management of CIS with regard to investor protection? How do you hope to overcome those challenges?
20. What have you achieved from the time you started operating CIS to date?
21. Do you think that the investors especially the retail investors are adequately protected by the regulatory measures that have been put in place by CMA?
22. How do you rate your skills in marketing, investment, administration and customer care? Are they adequate enough to ensure that investors are protected?
- 23.** Don't you think your roles as the fund management company (i.e. Investment management, administration and Marketing) are too many and this could lead to inefficiency at the cost of the investor as well as conflict of interest?

III. INTERVIEW GUIDE: AUDITOR

Respondent Identification Particulars:

Name:

Designation/Position held:

1. What legal and operational measures have you put in place to ensure that you act in the interests of the investors?
2. What internal controls and systems have you put in place to ensure that the audits of fund accounts are accurate and not misleading to the detriment of the investors?
Do you think they are adequate to protect the investors?
3. How easy is it for you to detect malpractices by the fund management company e.g. fraud, misrepresentations and discrepancies in the fund accounts?
4. What measures have you put in place to investigate any malpractice by the fund operator that is done against the investors?
5. The regulations require that the same auditors should not be retained for a period of more than four years. Do you think this is a good measure to ensure audit quality and investor confidence in the CIS?
6. Despite the fact that the auditor is independent of the fund management company don't you think your supervisory role over the management company can cause a conflict of interest given that you are chosen and contracted by it? In other words don't you think there is a likelihood to put the fund management interests above the interests of investors which is your primary responsibility?
7. Do you think that the investors especially the retail (small) investors participating in CIS are adequately protected by the regulatory measures that have been put in place by CMA?

8. According to the functions and powers given to you by the laws and regulations what have been your achievements in the area of CIS?
9. Do you think the use of the international accounting standards in developed markets is adequate and suitable for funds given that Uganda is still a developing market?
10. What challenges do you as auditor face in carrying out your role of auditing the fund and carrying out random spot checks on the fund?
11. What challenges do you think need to be addressed in the area of CIS, particularly with regard to investor protection?
12. How do you think the above challenges can be addressed to ensure investor protection?

IV. INTERVIEW GUIDE: TRUSTEE

Respondent Identification Particulars:

Name:

Designation/Position held:

1. Do you think that the investors especially the retail (small) investors are adequately protected by the regulatory measures that have been put in place by CMA?
2. Being a bank, do you think this gives investors more confidence that their investments are safe?
3. As a trustee, it is imperative that you have financial and management resources adequate to meet your duties – safekeeping of assets, oversight. Do you think that this requirement enhances investor protection or is it burdensome?
4. Don't you think as a trustee entrusted with safekeeping of the assets of the funds there is a possibility that you may interfere with them at the expense of the investors?
5. What measures have you put in place to monitor and oversee (supervise) the fund management company to ensure that investors are protected?
6. Despite the fact that the trustee is independent of the fund management company don't you think your oversight or supervisory role over the management company can cause a conflict of interest given that you are chosen and contracted by it? In other words don't you think there is a likelihood to put the fund management interests above the interests of investors which is your primary responsibility?
7. Investment restrictions contained in the regulations are intended to ensure that you as trustee supervise the fund manager's powers as regards diversifying the investments of CIS clients so as to limit exposure to a single investment. How

easy is it to enforce this provision where product supply is not adequate to ensure diversification and minimizing of risk to the investors?

8. What measures have you put in place to investigate any malpractice by the fund operator that is done against the investors?
9. What legal and operational measures have you put in place to ensure that you act in the interests of the investors?
10. According to the functions and powers given to you by the laws and regulations what have been your achievements in the area of CIS?
11. What challenges do you think need to be addressed in the area of CIS, particularly with regard to investor protection?
12. How do you think the above challenges can be addressed to ensure investor protection?

V. INTERVIEW GUIDE: INVESTMENT ADVISORS

The Researcher is a student of Makerere University, School of Post Graduate Studies. She is carrying out a research on: “COLLECTIVE INVESTMENT SCHEMES IN EMERGING MARKETS: AN ASSESSMENT OF THE REGULATORY FRAMEWORK FOR INVESTOR PROTECTION IN UGANDA”, in partial fulfillment of the requirements for the award of the degree of Master of Laws (LLM).

Please help by answering the following questions as honestly as possible. The questions require a detailed expression of opinion.

Respondent Identification Particulars:

Name:

Designation/Position held:

1. The Capital Markets Authority (CMA) is the regulatory body responsible for the development of the capital markets industry in Uganda, and one of its objectives is investor protection. In 2003, a new product, CIS was introduced in the capital markets. Laws and regulations to govern CIS were also made. Do you think the regulations are adequate to protect the investor?
2. Do you think the competence, powers and capacity of the CMA are sufficient to ensure supervision and regulation of CIS operators and to enhance the confidence of investors?
3. In your opinion do you think the public has confidence in CIS? What can be done to improve their confidence?
4. Do you think the requirements for the approval of funds, fund management companies, trustees and other service providers are adequate to ensure that investors are protected?

5. Do you think the licensing requirements set by the CMA are onerous or are they sufficient to ensure investor protection and don't they hinder competition, thus creating a monopoly which may not be in the interest of the investors?
6. Do you think the capital requirement of 200 million is on a higher side and won't it deter new market entrants?
7. The regulations require that the fund operator should keep a certain sum of cash all the time isn't this a drag on their performance seeing that they can't invest the funds?
8. Investment restrictions contained in the regulations are intended to ensure that you as fund managers diversify the investments of your clients so as to limit exposure to a single investment. How easy is it to enforce this provision where product supply is not adequate to ensure diversification and minimizing of risk to the investors?
9. One of the features of CIS is that it allows free entry and exit of investors at any time and this is one of the mechanisms of investor protection. This implies that you should be able to sell some of the fund assets and pay off investors who wish to exit. However, how easy is it to sell assets in markets that are not so active as Uganda (illiquid).
10. Under the regulations, disclosure is an important element and it is a key investor protection tool. Do you think the disclosure requirements are adequate to ensure that accurate and timely flow of information to investors which can be understood by the investors especially the "small" investor?
11. Do you think the trustee function should only be performed by a bank or insurance company or should other professional people like lawyers be included?
12. Do you think the measures in the law are adequate for an aggrieved CIS investor to seek redress? How easy is it for such an investor to seek the available remedies?

13. Don't you think one entity operating in different capacities can lead to a conflict of interest? Like African Alliance is licensed as a stock broker, unit trust operator and investment adviser do you think this is okay or only the business of fund management should be carried out to minimize conflicts of interest and ensure money for the different businesses is kept separate?
14. The regulations provide that the operator may be a unit holder don't you think that this can lead to a conflict of interest?
15. Do you think there is any guarantee that in case a Collective Investment Scheme collapsed, the investors would be able to recover their investments? Like for a bank once it collapses, there is a guarantee that all the clients will get up to three million.
16. What challenges do you think need to be addressed in the area of CIS, particularly with regard to investor protection?
17. How do you think the above challenges can be addressed to ensure investor protection?
18. Do you have any suggestions regarding what could be done to improve the legal and regulatory framework so as to enhance investor protection and generally lead to the growth of CIS in Uganda?

Thank you so much for being part of this research