



# **The Form and Scope of Self-Regulation under the Draft Capitals Markets Proclamation of Ethiopia**

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**A Thesis submitted to the School of Law of Addis Ababa University in partial fulfillment of  
the requirements for the LLM Degree in Business Law**

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**December 2020  
Addis Ababa, Ethiopia**

**DECLARATION**

I hereby declare that this thesis entitled *“The Form and Scope of Self-Regulation under the Draft Capitals Markets Proclamation of Ethiopia”* has been carried out by me under the guidance and supervision of Fekadu Petros (Asst. Professor).

The thesis is original and has not been submitted for the award of any degree or diploma to any university or institutions.

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**CONFORMATION**

This thesis has been submitted for examination with my approval as a university supervisor.

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## **Acknowledgment**

First, I thank the Almighty God for giving me the courage and grace to pursue the LLM program. My heartfelt gratitude goes to my advisor Mr. Fekadu Petros (Asst. Professor) his expert guidance, valuable suggestions and encouragement made to me in all stages during the work of this Thesis.

I would like to express my sincere appreciation to my family and my friends for their love, encouragement and support that have given me strength and courage.

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## **Acronyms**

AACCSA-Addis Ababa Chamber of Commerce and Sectoral Associations.

AMF-Autorité des marchés financiers

ANBIMA-Associação Brasileira dos Mercados Financeiroe de Capitais

ASIC-Australian Securities and Commission

CME-Chicago Mercantile Exchange

CSD-Central Securities Depositories

FINRA-Financial Industry Regulatory Authority

FSA- Financial Services Authority

ICMA- International Capital Markets Association

ISMA- International Security Market Association

IIROC-Investment Industry Regulatory Organization of Canada

IMF- International Monetary Fund

IOSCO-International Organization of Securities Commissions

ISDA- International Swaps and Derivatives Association

JSDA-Japan Securities Dealers Association

KOFIA-Korea Financial Investment Association

NBE-National Bank of Ethiopia

NYSE- New York Stock Exchange

OECD- Organization for Economic Co-operation and Development

OMX-Offset Market Exchange

OTC- over the counter

SDCC-Securities Depository and Clearing Company

SRO-Self-regulatory Organ

TSE-Tirana Stock Exchange

UK- United Kingdom

US-United States of America

## Abstract

*Recently, the Ethiopian government is poised to set-up the country's first stock market by 2020 and as a result, a draft Capital Markets Establishment Proclamation has been approved by the Council of Ministers.<sup>1</sup>One of the vital building blocks of strong capital markets is effective regulation of participants. This research is a doctrinal and ex-ante research that tries to assess the scope and form of self-regulation under the draft proclamation. To achieve this objective, the analysis primarily depends on primary sources and uses secondary resources as a supplement. The assessment identified that the self-regulation under the draft proclamation takes the form of a mandatory co-regulation model whereby exchanges and SDCCs are recognized as SRO and other actors may be recognized and act as an SRO under government-supervision. Meanwhile, the scope of self-regulation is very much dependent on the delegation of power to be made by the Capital Markets Authority. Accordingly, the assessment found that self-regulation is relevant in the Ethiopian context and the identified form and scope of self-regulation under the draft proclamation has merits as it provides for the recognition of SROs. Further, it was found that the draft proclamation provides for various modalities to address the inherent risks pertaining to SROs. SROs' lack the appropriate regulatory (including monitoring and enforcement) mandate under the draft proclamation to flexibly act and respond to market changes are notable limitations. Particularly, the subjective standard applied in delegation is open to arbitrary decision making on the part of the Authority and, in some instances, may expose the capital market to a potential of conflict of interest among the regulator (the Authority) and the regulated (when the government acts as a private actor).*

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<sup>1</sup>Ethiopian Reporter, December 23, 2020. <https://www.ethiopianreporter.com/article/20808>

# 1. Chapter One: Introduction

## 1.1. Background

In the modern age, the stock exchange of a country is intricately tied to its economy that a slump or a crush of the stock market sends shockwaves across the economy.<sup>2</sup> Capital markets have the potential to be a powerful tool for sustainable development in developing countries such as Ethiopia.<sup>3</sup> Capital market participation allows companies to use financial instruments as a means of accessing capital, managing risk, and creating wealth.<sup>4</sup> In general, capital market *inter alia* promotes the private sector development, increases liquidity which is linked to economic growth, helps mobilize local savings and makes resources available for local decision-making, enhances competition among banks by reducing financing cost and diversifying financial service providers, and rewards sound economic policies and creates tools to conduct monetary policy.<sup>5</sup>

Despite its broad merits, countries endeavor to form regulations and keep a constant keen eye on their capital markets to ensure they are sound and stable because a tiny fluctuation of their

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<sup>2</sup> Shem Oganga, "Evolution of the Capital Market," Quest Journals Journal of Research in Humanities and Social Science, vol.7 issue 7 (2019), p.60. Retrieved from: <http://www.questjournals.org/jrhss/papers/vol7-issue7/Ser-1/L0707015572.pdf>

<sup>3</sup> Jetu Edosa Chewaka, "Legal Aspects of Stock Market Development in Ethiopia: Comments on Challenges and Prospects," Mizan Law Review, vol.8, no.2 (2014), p.439. Retrieved from: <https://www.ajol.info/index.php/mlr/article/download/117549/107108>

<sup>4</sup> Alan N. Rechtschaffen, Capital Markets, Derivatives and the Law: Evolution After Crisis, (2<sup>nd</sup> Ed, 2014), p.46. Retrieved from: <https://ua6crfewgv.pdcn3.top/dl2.php?id=186490571&h=93fd931fd88d0e71b7420face5766826&u=cache&ext=pdf&n=Capital%20markets%20derivatives%20and%20the%20law%20evolution%20after%20crisis> Rechtschaffen

<sup>5</sup> Ruedige Ruecker, Market Potential Assessment and Road Map Development for the Establishment of Capital Market in Ethiopia, (Addis Ababa Chamber of Commerce, 2011), p.10-12. Retrieved from: <http://ethiopianchamber.com/Data/Sites/1/psd-hub-publications/market-potential-assessment-and-road-map-development-for-the-establishment-of-capital-market-in-ethiopia.pdf>

indices could lead to unforeseen financial consequences.<sup>6</sup> The main purpose of such regulations is to promote an efficient and fair capital market.<sup>7</sup>

Several jurisdictions appear to be relying more and more on a self-regulatory approach as their markets reach a critical size. Developed markets are prime candidates for using Self-Regulatory Organs (SRO) for the oversight of markets experiencing growth in the volume and complexity of securities trading because such oversight is helped by those within an SROs who have specialized expertise that may otherwise be lacking.<sup>8</sup> In such cases, the SRO is a critical component not only in regulatory oversight but also in providing the investor trust needed to fuel the growth of innovation.<sup>9</sup> The use of SROs may lead to more efficient capital markets, thus enabling businesses to tap public equity and debt markets for capital at a reasonable cost, which supports business expansion and economic development.<sup>10</sup>

The first form of active self-regulation appeared at the precursor to the London Stock Exchange (in the 1800s) with specific rules intended to prevent “disorderly action” and thereby improve the reputation of its members.<sup>11</sup> The exchange, which issued its first rulebook in 1812, had the ability to impose fines on members that were not in compliance with its rules and bar from its premises anyone who was not a member.<sup>12</sup> Shortly afterward the New York Stock and Exchange Board – the precursor to the New York Stock Exchange – was established with a set of rules that governed trading, the admission of new members, and the resolution of disputes between members.<sup>13</sup> By 1820, the New York Stock and Exchange Board had adopted a detailed set of by-

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<sup>6</sup>Oganga, supra note 2, p.64.

<sup>7</sup> Erick Rading Outa, Nelson Maina Waweru, Peterson Kitakogelu Ozili "Security market regulation: antecedents for capital market confidence in frontier markets", *Accounting Research Journal*, vol. 31 issue 2, (2018), p.157.

Retrieved from: <https://doi.org/10.1108/ARJ-10-2015-0130>

<sup>8</sup> CFA Institute, “Self-Regulation in Today’s Securities Markets: Outdated System or Work in Progress,” (2007), p.11.

<sup>9</sup> Ibid.

<sup>10</sup>John Carson, “Self-Regulation in Securities Markets,” *World Bank Policy Research Working Paper* 5542, (2011).

Retrieved from:

<https://openknowledge.worldbank.org/bitstream/handle/10986/3313/WPS5542.pdf?sequence=1&isAllowed=y> p.2

<sup>11</sup>ICSA, supra note 19, p.5.

<sup>12</sup> Ibid.

<sup>13</sup>Ibid.

laws along with a range of rules governing its members and listed companies, including member financial responsibility rules, listed company registration, and financial reporting rules.<sup>14</sup>

In the Ethiopian Context, the historical development of the stock market traces its roots back to the Imperial period.<sup>15</sup> During the Imperial Regime (1950s and 1960s), a short-lived stock market in Ethiopia existed out under the regulatory auspices of the National Bank of Ethiopia (NBE), department of Share Exchange.<sup>16</sup> The NBE also allowed other financial institutions and few private share dealers to participate in shares trading, particularly related to the facilitation of transaction of shares and other services in the share markets.<sup>17</sup> For instance, the Addis Ababa Share Dealing Group was one of the private share dealing groups that served as the connecting link for buyers and sellers in an auction process.<sup>18</sup> Moreover, financial institutions such as Addis Ababa Bank, the Commercial Bank of Ethiopia, and the Ethiopian Investment Corporation played an intermediary role in transferring and delivery of traded shares in the form of over-the-counter share dealing services.<sup>19</sup>

However, after the demise of the Imperial regime, the stock market was abolished due to the introduction of the command economy.<sup>20</sup> The Derg regime declared the nationalization of private industries and the dissolution of share dealing groups.<sup>21</sup> Since the Derge Regime, except Commodities Exchange for agricultural products under the current regime, no stock market has been legally designed to trade stocks except for the fragmented and unregulated stock trading in

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<sup>14</sup>Ibid.

<sup>15</sup>Mulunesh Gizachew, "Prospects and Challenges of Establishing Stock Market in Ethiopia," A Thesis Submitted in Partial Fulfillment for the Award of Master's in Accounting and Finance, (February, 2019), p.25. Retrieved from: <http://etd.aau.edu.et/bitstream/handle/123456789/16657/Mulunesh%20Gizachew.pdf?sequence=1&isAllowed=y>

<sup>16</sup>Amare Walle, "Establishment of Capital Markets in Least Developed Countries (LDCs): The Case of Ethiopia," A Master's Thesis in Business Administration from the School of Management Blekinge Institute of Technology, (June, 2008), p.2. Retrieved from: <https://www.diva-portal.org/smash/get/diva2:829649/FULLTEXT01.pdf>

<sup>17</sup>Jetu, supra note 3, p.443.

<sup>18</sup> Ibid.

<sup>19</sup> Ibid.

<sup>20</sup>Id, p.440.

<sup>21</sup>Id, p.444.

a dealer market.<sup>22</sup>To this end, share trading has been carried out through various means like part-time brokers or through the invested companies or sellers must find buyers by themselves, exposing them to unfair prices and delays.<sup>23</sup> This is not because of the lack of buyers and sellers in the market; rather, it is because of the lack of proper institutions that could facilitate the trade.<sup>24</sup>

With the intention of setting-up a capital market, a draft proclamation entitled, “Capital Markets Establishment Proclamation No.--/2020” is approved by the Council of Ministers.<sup>25</sup>This research tries to assess the scope and form of self-regulation under the draft proclamation.

## **1.2. Statement of the Problem**

The adoption of self-regulation mechanisms as a regulation of capital markets is one of the most controversial issues relating to capital markets. It is mostly noted that self-regulation contributes to the effectiveness and viability of a capital market. On the other hand, it has been criticized for its ineffectiveness in some jurisdictions and has been identified as one of the factors contributing to the global financial crisis (for instance, the 2008 US Stock Market Crash). Further, the role of the government in self-regulation is a highly controversial issue that requires immediate attention in the formulation of a capital market regulation. In noting these controversies, most scholars agree that a well-designed and enforced self-regulation system can positively impact capital markets. In the Ethiopian context, part III of the draft Capital Markets Proclamation deals with the recognition of SRO. This thesis tries to identify the scope and form of self-regulation under the draft capital markets proclamation and assess its relevance and effectiveness in the Ethiopian context.

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<sup>22</sup>Ibid. Indeed, the National Bank of Ethiopia in collaboration with AACCSA, also prepared a draft securities and exchange proclamation in 2001. However the proclamation was left at draft stage.. Mulunesh, supra note 15, p.26.

<sup>23</sup>Kiflework Bekele Belgu, “Should Ethiopia Consider Establishing Stock Market?” A Thesis Submitted to Addis Ababa University Department of Accounting and Finance in Partial Fulfillment of master’s in accounting and Finance, (January, 2018), p.18. Retrieved from:

<http://etd.aau.edu.et/bitstream/handle/123456789/13752/Kiflework%20Bekele.pdf?sequence=1&isAllowed=y>

<sup>24</sup> Ibid.

<sup>25</sup>Ethiopian Reporter, December 23, 2020. <https://www.ethiopianreporter.com/article/20808>

### **1.3. Research Questions**

The research attempts to address the following questions:

1. How does the draft capital markets proclamation allocate self-regulatory power to market institutions?
2. What is the nexus (synergies and tradeoffs) between the mandate of the Capital Market Authority and SRO under the draft capital markets proclamation?
3. Would the manner of self-regulation as provided in the draft capital markets proclamation be relevant and appropriate in the Ethiopian context?

### **1.4. Research Objective**

The general objective of the research is to assess the scope and form of self-regulation under the draft proclamation. The specific objectives of the research are:

- To assess the forms and scope of self-regulation under the draft capital markets proclamation;
- To assess the tradeoffs and synergies between the government authority and SRO under the draft proclamation; and
- To assess the relevance and appropriateness of the self-regulation mechanism(s) adopted in the draft proclamation.

### **1.5. Significance of the Research**

As the proposed research aims to assess the scope and forms of self-regulation under the capital markets draft proclamation, it is believed to give a detailed assessment of the subject matter. As such, it will serve as a supplement to policy and lawmakers. It is also believed to have an academic significance since, to this end, there is no research conducted on the subject matter in the Ethiopian context. Particularly, it will fill the literature gap on the subject matter. Thus, it may be used as a benchmark for further related studies. Further, it will inform practitioners, investors, and any other interested person about the various forms of self-regulation in light of the adopted self-regulation mechanism under the draft proclamation, as well as its effectiveness.

## **1.6. Methodology**

This study is a doctrinal and ex-ante research as it attempts to assess the scope and form of self-regulation under the draft proclamation. A doctrinal legal research is a research that analyses the prevailing state of legal doctrine, legal rule, or principle i.e., a systematic analysis of statutory provisions and of legal principles, and logical and rational ordering of the legal propositions and principles.<sup>26</sup> As such, this thesis is a doctrinal legal research as it attempts to evaluate the provisions on SROs under the draft Capital Markets Proclamation.

Ex-ante research is a research that analyses protentional new legislations by studying the possible effects and side-effects of alternatives, including the alternative of not regulating at all.<sup>27</sup> Thus, this thesis is further an ex-ante research in the sense that it is based on assumption and prediction, and on how the provisions of the draft proclamation pertaining to SROs appear beforehand, rather than in hindsight.

The research uses both primary and secondary sources. The primary sources are the draft Capital Markets Establishment Proclamation (as approved by the Council of Ministers) and other relevant domestic laws, as well as the laws of other countries. The secondary sources are books, journals, articles, and other materials on the subject matter.

## **1.7. Scope and Limitation of the Study**

### **Scope**

The research is limited to the scope and forms of self-regulation under the capital markets draft proclamation. It will focus on identifying the scope of self-regulation with respect to the mandates given to the government regulatory body and the forms of self-regulation. It will further assess the effectiveness of the self-regulation mechanism under the draft proclamation.

### **Limitation**

The limitations encountered are lack of studies on the subject matter in the Ethiopian context.

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<sup>26</sup> Kharel, Amrit. (2018). Doctrinal Legal Research. SSRN Electronic Journal. 10.2139/ssrn.3130525.

<sup>27</sup> Jonathan Verschuuren (ed.), *The Impact of Legislation. A Critical Analysis of Ex Ante Evaluation*, Martinus Nijhoff Publishers, Leiden-Boston 2009, ISBN 978-90-04-17020-9

## **1.8. Organization**

This paper is organized into four chapters. The first part is an introductory chapter. The second chapter reviews the literature on the subject matter and identifies the theoretical and conceptual framework. The third chapter identifies the scope and form of self-regulation under the draft Capital Markets Establishment Proclamation. The fourth and final chapter concludes the study and presents recommendations based on the assessment.

## 2. Chapter Two: Literature Review

### 2.1. Historical Development

Self-regulation has a long and varied history in financial markets.<sup>28</sup> The first form of active self-regulation appeared at the precursor to the London Stock Exchange (in the 1800s) with specific rules intended to prevent “disorderly action” and thereby improve the reputation of its members.<sup>29</sup> Shortly afterward the New York Stock and Exchange Board –was established with a set of rules that governed trading, the admission of new members, and the resolution of disputes between members.<sup>30</sup> By 1820, the New York Stock and Exchange Board had adopted a detailed set of by-laws along with a range of rules governing its members and listed companies, including member financial responsibility rules, listed company registration, and financial reporting rules.<sup>31</sup>

The development of the US securities market was undertaken in the almost total absence of government intervention before 1930’s.<sup>32</sup> Some European countries had adopted this feature of the Anglo-Saxon countries. For instance, Amsterdam Stock Exchange was a self-regulating organization.<sup>33</sup> Further, the German Stock Exchanges had been essentially self-regulating though with a degree of public intervention, usually at local level.<sup>34</sup> Before 1914 the global securities market was conducted largely through numerous self-regulated stock exchanges subject to light regulation by the state or none; Germany and Austria were the main exceptions to this.<sup>35</sup>

In the mid-twentieth century stock exchanges were still at the heart of the global securities market but were now either heavily regulated by the state or imposed onerous rules upon their

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<sup>28</sup>ICSA, supra note 11, p.5.

<sup>29</sup> ICSA, p.5.

<sup>30</sup>ICSA, supra note 11, 5.

<sup>31</sup>Ibid.

<sup>32</sup>Ranald C. Michie, The Global Securities Market: A History, (2006),

p.104.[http://dl.lux.bookfi.net/genesis/588000/451d8f9b3fb40f0114158a8bc1fad4e/as/%5BRanald\\_Michie%5D\\_The\\_Global\\_Securities\\_Market\\_A\\_Hi\(BookFi\).pdf](http://dl.lux.bookfi.net/genesis/588000/451d8f9b3fb40f0114158a8bc1fad4e/as/%5BRanald_Michie%5D_The_Global_Securities_Market_A_Hi(BookFi).pdf)

<sup>33</sup>Id, p.139.

<sup>34</sup>Id, p.137.

<sup>35</sup>Id, p.308.

membership.<sup>36</sup> In the 1920's the London Stock Exchange was subjected to an informal government control to cope with the international weakness of the £ sterling and the domestic need to refinance short-term borrowings.<sup>37</sup> Only in the United States was intervention not attempted, with the Capital Issues Committee, only formed after the United States entered the WWI in 1917, being discontinued in August 1919.<sup>38</sup> There was no need for government intervention to police the market, because the stock exchanges themselves possessed the power to do so.<sup>39</sup> Exchanges regulated transactions in equity, bond, and future markets, ensuring that who bought and sold in those venues fulfilled the terms of their contracts.<sup>40</sup> Hence, the US securities market was driven by the restrictive practices employed by the existing stock exchanges.<sup>41</sup>

However, this self-regulation also gave members the power to introduce both rules and charges that suited and benefited themselves.<sup>42</sup> Following the wide-range of abuses that investors had been exposed to and Wall Street Crash in 1929, the government had no alternative but to become involved.<sup>43</sup> The outcome was the Securities Act of 1933 and the Securities Exchange Act of 1934, followed by the establishment of the Securities and Exchange Commission (SEC) in 1934.<sup>44</sup> These were designed to prevent market manipulation and to limit speculation by forcing

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<sup>36</sup>Ibid.

<sup>37</sup>Id, p.166.

<sup>38</sup>Ibid.

<sup>39</sup>Id, p.104.

<sup>40</sup>Alejandro Komai and Gary Richardson, "A Brief History of Regulations regarding Financial Markets in the United States: 1789 to 2009," National Bureau of Economic Research Working Paper 17443, 2011, p.7.

[https://www.researchgate.net/profile/Gary\\_Richardson10/publication/228291890\\_A\\_Brief\\_History\\_of\\_Regulations\\_Regarding\\_Financial\\_Markets\\_in\\_the\\_United\\_States\\_1789\\_to\\_2009/links/583e447408ae2d217554ca30/A-Brief-History-of-Regulations-Regarding-Financial-Markets-in-the-United-States-1789-to-2009.pdf?origin=publication\\_detail](https://www.researchgate.net/profile/Gary_Richardson10/publication/228291890_A_Brief_History_of_Regulations_Regarding_Financial_Markets_in_the_United_States_1789_to_2009/links/583e447408ae2d217554ca30/A-Brief-History-of-Regulations-Regarding-Financial-Markets-in-the-United-States-1789-to-2009.pdf?origin=publication_detail)

<sup>41</sup>Michie, supra note 32, p.105.

<sup>42</sup>Id, p.104.

<sup>43</sup>Id, p.192.

<sup>44</sup>Stephen J. Choi and Andrew T. Guzman, "National Laws, International Money: Regulation in a Global Capital Market," Fordham Law Review Vol.65 Issue 5, (1997),

p.1856.<http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=3361&context=flr>

all exchanges to register and to abide by a strict set of rules.<sup>45</sup> Especially, it was the 1934 Act that brought all the country's stock exchanges under government supervision.<sup>46</sup> It gave the SEC a dominion over all self-regulatory organizations,<sup>47</sup> to regulate the issuance, purchase, and sale of securities, particularly equities and debt instruments.<sup>48</sup> In considering this legislation, Congress found exchange self-regulation wanting in important respects.<sup>49</sup>

In justifying the measures introduced by the government, William Douglas, Chairman of the SEC, commented in 1937; "operating as private membership associations, exchanges have always administered their affairs in much the same manner as private clubs. For a business so vested with public interest, this traditional method has become archaic."<sup>50</sup> In another development in 1938, a new Securities Exchange Act was enacted in which the US congress specifically rejected self-regulation as inadequate protection for investors and insisted instead on public scrutiny of every stock exchange's rules and regulations, and the overarching regulation of a government appointed body.<sup>51</sup> This made the self-regulated securities markets of the Anglo-American world to converge with those of continental Europe where self-regulation had long been important, which resulted in increase in government involvement.<sup>52</sup>

The US developments appeared to be the triumph of government regulation over self-regulation as the market not only continued to function but also appeared more stable and less exposed to manipulation.<sup>53</sup> Consequently, for many countries the United States appeared to provide a model to follow, offering a compromise between market capitalism and state control.<sup>54</sup> There were a

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<sup>45</sup>Michie, supra note 32, p.192.

<sup>46</sup>Id, p.193.

<sup>47</sup>William A. Rini, *Fundamentals of the Securities Industry*, (2003), p.167.

[http://dl.lux.bookfi.net/genesis/493000/bea7225609aec562983a6d90ec8775c5/\\_as/%5BWilliam\\_Rini%5D\\_Fundamentals\\_of\\_the\\_Securities\\_Indu\(BookFi\).pdf](http://dl.lux.bookfi.net/genesis/493000/bea7225609aec562983a6d90ec8775c5/_as/%5BWilliam_Rini%5D_Fundamentals_of_the_Securities_Indu(BookFi).pdf)

<sup>48</sup> Komai and Richardson, supra note 40, p.17.

<sup>49</sup>Sam Scott Miller, "Self-Regulation of the Securities Markets: A Critical Examination," *Washington and Lee Law Review*, Vol.42 Issue 3 (1985), p.869.

<sup>50</sup>As cited in Michie, supra note 32, p.193.

<sup>51</sup>Ibid.

<sup>52</sup>Ibid.

<sup>53</sup>Ibid, p.226.

<sup>54</sup>Ibid.

number of countries such as the Soviet Union and Eastern Europe generally which went to the other extreme and chose to operate without a securities market at all.<sup>55</sup> In China the communist takeover in 1949 led to the closure of the stock exchanges, with all trading being ended in 1951.<sup>56</sup> Elsewhere the securities markets also decayed when the state took control of corporate assets and financed itself through taxation.<sup>57</sup> In Egypt the securities market had prospered both during the WWII and into the 1950s, but then experienced a severe decline in the 1960s due to a nationalization program.<sup>58</sup> Similarly, in Indonesia the securities market revived after 1945 but nationalization in 1958 and then the departure of many of the Dutch expatriates who had generated much of the activity left only a small and informal market in the 1960s.<sup>59</sup> In a similar manner, other countries also opted for government regulation since a formal self-regulation was absent.<sup>60</sup> The absence was stifled by government antagonism towards corporate enterprise, excessive bureaucratic control over the market place, and resistance to change within the organization itself, as a result the growth of stock markets was slow and the amount of business was low (E.g. Peru, as well as the case across Africa).<sup>61</sup> As such, successful securities markets emerge as a result of the governments' willingness to relax the prohibitions and restrictions of the past.<sup>62</sup>

The above historical development shows that the beginning of the 21<sup>st</sup> C manifested on the one hand the relevance of self-regulation and, on the other hand, the difficulty to balance government involvement and the scope of self-regulation. As mentioned earlier, in 1930's the US Congress had asserted the relevance of self-regulation. Self-regulation is also evident in transatlantic securities-market organizations such as the Eurobond.<sup>63</sup> In addition, in 1992 the major participants in the global bond market had formed the International Securities Market

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<sup>55</sup>Ibid.

<sup>56</sup>Ibid.

<sup>57</sup>Ibid.

<sup>58</sup>Ibid.

<sup>59</sup>Ibid.

<sup>60</sup>Id, p.285.

<sup>61</sup>Ibid.

<sup>62</sup>Ibid.

<sup>63</sup>Those entities involved in the market had established the Association of International Bond Dealers in 1969. This self-regulatory body for the Eurobond market largely consisted of banks from around the world. Id, p.273.

Association (ISMA), which was both a trade association and self-regulatory body.<sup>64</sup> Hence, by 2000, in the absence of any international financial authority with sufficient power to command adherence to a common set of rules and regulations, self-regulation had again become of major importance, though subject to the oversight of national statutory agencies.<sup>65</sup> Self-regulation continues to play a role in ensuring an orderly market even though the state now possessed ultimate authority in ensuring both a competitive and efficient market, and one free from abuses and manipulation.<sup>66</sup>

However, the historical development also shows the difficulty to balance government control and the scope of self-regulation. In the US, the congress adopted the Securities Acts Amendments of 1975 that imposed a much more comprehensive SEC oversight role, as the congress found fault both with the SROs and the SEC in its oversight function.<sup>67</sup>

## **2.2. The Concept of Capital Markets and Self-Regulation**

### **2.2.1. Capital Markets**

The black's law dictionary defines the term capital market as a "securities market in which stocks and bonds with long-term maturities are traded."<sup>68</sup> Capital markets "facilitate securities' transactions in debt and equity and thereby supply financial resources in the financial markets."<sup>69</sup> It is a sector of the financial market where long-term financial instruments issued by corporations and governments are traded.<sup>70</sup> In this sense, "long-term" refers to a

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<sup>64</sup>Id, p.312.

<sup>65</sup>Id, p.309.

<sup>66</sup>Id, p.327.

<sup>67</sup>Miller, supra note 49, p.870.

<sup>68</sup> See, Black's Law Dictionary's (9<sup>th</sup> ed.) definition of the term, 'capital market'.

<sup>69</sup>Ali A. Ibrahim, "Developing Governance and Regulation for Emerging Capital and Securities Markets," 2006, p.7.[https://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1001&context=gps\\_papers](https://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1001&context=gps_papers)

<sup>70</sup> Frank J. Fabozzi and Pamela Peterson Drake, Finance: Capital Markets, Financial Management, and Investment Management, (2009), p.124. Retrieved from:  
<https://a8achjx7fp.pdcdn4.top/dl2.php?id=33414495&h=5d85dc55db6512fc8c4ace4fa5d11b19&u=cache&ext=pdf&n=Capital%20markets%20financial%20management%20and%20investment%20management>

financial instrument with an original maturity greater than one year and perpetual securities (those with no maturity).<sup>71</sup> Here a distinction has to be made between the money market and capital market. The money market is the “financial market for dealing in short-term negotiable instruments.”<sup>72</sup> Typically, money market instruments are debt instruments and include Treasury bills (with a maturity date of less than one year), commercial paper, negotiable certificates of deposit, repurchase agreements, and bankers’ acceptances.<sup>73</sup>

Financial assets/instruments are “intangible assets where typically the future benefits come in the form of a claim to future cash.”<sup>74</sup> A financial instrument can be classified by the type of claims that the investor has on the issuer.<sup>75</sup> Accordingly, there are three types of financial instruments applied in the capital market: equity-based instruments, debt instruments, and derivatives. An equity security, in the form of stock or shares, is a right to participate in the income from property and the distribution of property.<sup>76</sup> Conversely, debt instrument (e.g. bonds, loans or a note) is a financial instrument under which the issuer agrees to pay the investor interest plus repay the amount borrowed.<sup>77</sup>

In addition to straightforward equity or debt agreements, entities can use another form of financial instrument called a derivative to advance corporate goals in the capital markets.<sup>78</sup> Derivatives are so-called because they derive their value from another asset index or other investment.<sup>79</sup> Derivatives are contractual agreements that obligate parties to exchange assets or cash flows.<sup>80</sup> There are four categories of derivatives: forwards, futures, options, and swaps.<sup>81</sup>

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<sup>71</sup>Ibid, p.125.

<sup>72</sup> Black’s Law Dictionary’s (9<sup>th</sup> Ed.) definition of the term, ‘money market’.

<sup>73</sup>Fabozzi and Drake, supra note 70, p.123.

<sup>74</sup>Id, p.112.

<sup>75</sup>Fabozzi and Drake, supra note 70, p.112

<sup>76</sup>Patrick S. Collins, Regulation of Securities, Markets and Transactions: A Guide to the New Environment, (2011), p.4.

[http://dl.lux.bookfi.net/genesis/841000/ac87a19056d7a6bdadd9b3740de135d3/\\_as/%5BPatrick\\_S.\\_Collins%5D\\_Regulation\\_of\\_Securities\\_Mar\(BookFi\).pdf](http://dl.lux.bookfi.net/genesis/841000/ac87a19056d7a6bdadd9b3740de135d3/_as/%5BPatrick_S._Collins%5D_Regulation_of_Securities_Mar(BookFi).pdf)

<sup>77</sup>Fabozzi and Drake, supra note 70, p.112.

<sup>78</sup>Rechtschaffen, supra note 4, p.51.

<sup>79</sup>Ibid.

<sup>80</sup>Ibid.

Several actors are involved in the capital markets. The first are issuers who are investment companies or entities that issue equity/debt securities.<sup>82</sup> The second are investors who support the secondary market liquidity by participating in the buying of securities.<sup>83</sup> Third, there are intermediaries that intermediates between the customer and the market.<sup>84</sup> Intermediaries provide support to issuers to access the market and support secondary market liquidity.<sup>85</sup>

The fourth are market operators that provide infrastructure within which the market functions.<sup>86</sup> A typical form of market operator is the exchanges which establish the platform for securities transactions. There is also a Central Securities Depository (CSD) that is a “utility that holds securities.”<sup>87</sup> In many cases, the CSD holds these securities in trust for another, usually a member which is a bank or broker (which in turn holds in trust for its client).<sup>88</sup> Additionally, there are settlement-facilities or clearing agencies which may create securities accounts for its members, become an agent or a principal in the settlement of transactions, and/or provide after-settlement service.<sup>89</sup> Here a distinction has to be made between an execution and settlement of transaction. A transaction is said to be executed when a buyer and seller agree on a price the buyer will pay to acquire ownership of a security, as whole or in partial.<sup>90</sup> On the other hand, settlement occurs when the agreed amount of a security is delivered from seller to buyer and the agreed amount of money is paid from buyer to seller.<sup>91</sup> In this sense, transactions are settled

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<sup>81</sup>Id, p.162-63.

<sup>82</sup>Collins, supra note 76, p.54.

<sup>83</sup> World Bank, “Practical Guide on the Potential of Capital Markets Development in Small Economies,” (2019), p.27.<https://openknowledge.worldbank.org/bitstream/handle/10986/32067/Practical-Guide-on-the-Potential-of-Capital-Markets-Development-in-Small-Economies.pdf?sequence=1&isAllowed=y>

<sup>84</sup>George W. Arnett, Global Securities Markets: Navigating the World’s Exchange and OTC Markets, (2011), p.7. [http://dl.lux.bookfi.net/genesis/818000/d9cf36b606934e6bbd6affce056ee184/as/%5BGeorge\\_W.\\_Arnett%5D\\_Global\\_Securities\\_Markets\\_Navi\(BookFi\).pdf](http://dl.lux.bookfi.net/genesis/818000/d9cf36b606934e6bbd6affce056ee184/as/%5BGeorge_W._Arnett%5D_Global_Securities_Markets_Navi(BookFi).pdf)

<sup>85</sup>World Bank, supra note 83, p.27

<sup>86</sup>Ibid.

<sup>87</sup>George W. Arnett, supra note 84, p.37, 39.

<sup>88</sup>Id, p.39.

<sup>89</sup> Collins, supra note 76, p.57.

<sup>90</sup>Ibid.

<sup>91</sup>Ibid.

directly between buyers and sellers, and indirectly through settlement-facilities.<sup>92</sup>It has further to be noted that a settlement facilities may or may not be securities depositories.<sup>93</sup>

The fifth is the regulatory body that has a role of supervision and enforcement for the capital market development.<sup>94</sup> The mandate of the regulatory authority is most commonly defined in terms of investor protection, maintaining fair, orderly and stable markets, and financial stability.<sup>95</sup>

Based on the type of organization of the capital market, capital markets are either organized or unorganized. The organized capital market has an authority which regulates market players and has a laid down framework that controls the ongoing in the capital market.<sup>96</sup> The unorganized capital market consists of traditional actors especially in rural areas who finance funds for the long term at an agreed interest rate.<sup>97</sup>

Within the context of the capital markets, there are two subsidiary component markets the primary market and the secondary market).<sup>98</sup>

The primary capital market is where financial instruments are issued for the first time.<sup>99</sup> New issues, in the form of stocks, debentures and/or bonds, are sold to the investing public, with the proceeds of the sale flowing through to the issuing corporations.<sup>100</sup> Thus, the primary market is the market “in which new issues are sold and new capital is raised”/increased.<sup>101</sup> The basic parties in a primary market are: (1) the issuer and (2) a purchaser.<sup>102</sup> There are two major ways of issuing financial instruments in the primary market. The first is an ‘initial public offer’ which

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<sup>92</sup>Ibid.

<sup>93</sup>Id, p.58.

<sup>94</sup>World Bank (2019), supra note 83, p.27.

<sup>95</sup>Id, p. 30.

<sup>96</sup>Onanga, supra note 2, p.56.

<sup>97</sup>Ibid.

<sup>98</sup>Rechtschaffen, supra note 4, p.47.

<sup>99</sup>Onanga, supra note 2, p.57.

<sup>100</sup>Rini, supra note 47, p.155.

<sup>101</sup>Fabozzi and Drake, supra note 70, p.127.

<sup>102</sup>Onanga, supra note 2, p.57.

is the traditional method of corporations raising finance since the 19<sup>th</sup> and early 20<sup>th</sup> C.<sup>103</sup> In issuing a public offer, the issuer will advert the prospectus that provides critical information for the prospective investor<sup>104</sup> and the applicant by completing an application form will make an offer that will be accepted by the company upon the allotment of the financial instrument.<sup>105</sup> The other way of issuing financial instruments in the primary market is by making a ‘restricted offer’ in which the issuer will be offering an opportunity to buy its financial instruments to a restricted number of individuals with the aim of ensuring efficiency and swiftness.<sup>106</sup>

Secondary market, commonly known as stock exchanges, is a platform where investors sell the securities they already own to prospective buyers at a price determined by demand and supply forces.<sup>107</sup> The Secondary market is the market place in which financial instruments are resold to other parties.<sup>108</sup> No new financial instrument is issued and the issuer of the security doesn’t benefit directly from the sale.<sup>109</sup> Trading takes place among investors.<sup>110</sup> The Secondary market provides liquidity because it allows holders to resell their financial instruments.<sup>111</sup>

Secondary markets are classified into organized stock exchanges and over-the-counter (OTC) markets.<sup>112</sup> Organized stock exchanges are central trading locations, in which enlisted securities of corporations are traded.<sup>113</sup> In secondary market transactions, a security’s ownership is transferred from a seller (other than the issuing corporation) to a buyer.<sup>114</sup> Secondary market

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<sup>103</sup> Paul Nelson, *Capital Markets Law and Compliance: The Implications of MiFID*, (2008), p.24. Retrieved from: <https://w016u4rhtx.pdcn3.top/dl2.php?id=175992055&h=f13ccab43c806fba82e2266b41f0d308&u=cache&ext=pdf&n=Capital%20markets%20law%20and%20compliance%20the%20implications%20of%20mifid>

<sup>104</sup> Onanga, supra note 2, p.57.

<sup>105</sup> Nelson, supra note 103, p.24.

<sup>106</sup> Onanga, supra note 2, p.57.

<sup>107</sup> Id, p.58.

<sup>108</sup> Rechtschaffen, supra note 4, p.48.

<sup>109</sup> Fabozzi and Drake, supra note 70, p.128.

<sup>110</sup> Ibid.

<sup>111</sup> Rechtschaffen, supra note 4, p.48.

<sup>112</sup> Valdonė Darškuvienė, *Financial Markets*, (2010), p.83. Retrieved from: [https://www.bcci.bg/projects/latvia/pdf/7\\_Financial\\_markets.pdf](https://www.bcci.bg/projects/latvia/pdf/7_Financial_markets.pdf).

<sup>113</sup> Id, p.84.

<sup>114</sup> Rini, supra note 47, p.167.

transactions can occur either on an organized exchange (a listed market place) or over-the-counter.<sup>115</sup> By listed, it is meant the financial instrument must satisfy requirements set forth by the exchange.<sup>116</sup> On the other hand, the OTC market is the marketplace for trading financial instruments, which are generally unlisted financial instruments.<sup>117</sup> OTC markets are networks of dealers, who make markets in individual securities. Common equity shares that are traded on it can be listed and unlisted shares.<sup>118</sup>

### **2.2.2. Self-regulation in Capital Market**

The term ‘self-regulation’ does not have a single definition as self-regulation in capital markets takes a wide variety of forms around the world.<sup>119</sup> The term *self-regulation* may be used to refer to formal self-SROs, to standards set by financial industry associations, and to the internal supervision and compliance functions within financial firms.<sup>120</sup> Likewise, self-regulation may be defined as, “a process by which an identifiable group of people....govern or direct their own activities by rules; specifying an organization’s or industry’s control, oversight, or direction of itself according to rules and standards that it establishes.”<sup>121</sup> Self-regulation may be considered as a commitment by practitioners to maintain high standards, whether as a matter of integrity and principle without any external influence or comply with mandatory requirements/criteria, in a particular sector.<sup>122</sup> Self-regulation typically focuses on oversight of the market itself, qualification standards for market intermediation and oversight of the business conduct of intermediaries including their relationship with their client market-users.<sup>123</sup>

In conceptualizing self-regulation of capital markets, two important distinctions ought to be made. First, a distinction must be made between economic self-regulation and social self-

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<sup>115</sup>Ibid.

<sup>116</sup>Fabozzi and Drake, supra note 70, p.128.

<sup>117</sup>Darškuvienė, supra note 112, p.86.

<sup>118</sup>Ibid.

<sup>119</sup>Carson, supra note 10, p.6.

<sup>120</sup> Ibid

<sup>121</sup> Black’s Law Dictionary’s (9<sup>th</sup> Ed.) definition of the term, ‘self-regulation’.

<sup>122</sup>Nelson, supra note 103, p.18.

<sup>123</sup>International Organization of Securities Commissions (IOSCO) SRO Consultative Committee, “Model for Effective Regulation,” (May, 2000), p.3.<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD110.pdf>

regulation. While the former is concerned with the control of markets or other facets of economic life, the latter ``aims to protect people or the environment from the damaging consequences of industrialization".<sup>124</sup> Thus social self-regulation is usually taken to include mechanisms whereby firms or their associations, in their undertaking of business activities, ensure that unacceptable consequences to the environment, the workforce, or consumers and clients, are avoided.<sup>125</sup> In this regard, self-regulation of the capital markets is concerned with economic regulation and supervision.<sup>126</sup>

Second, it is necessary to distinguish between individual self-regulation (where an entity regulates itself, independent of others) and self-regulation by groups.<sup>127</sup> Defined in these terms, self-regulation may be regarded as ``the normative orders of private governments (such as corporations, schools, hospitals), and the normative orders of professional communities and business networks".<sup>128</sup> With respect to capital markets, the latter aspect of self-regulation is the one in consideration whereby parties in the capital markets are required to cooperate with each other to regulate the market.<sup>129</sup> In the general context, self-regulation concerns "groups of firms in a particular industry or entire industry sectors that agree to act in prescribed ways, according to a set of rules or principles."<sup>130</sup>

In this context, formal self-regulation in capital markets is carried out through an SRO, "which may be generally defined as a private institution that establishes, monitors compliance with, and enforces rules applicable to securities markets and the conduct of market participants."<sup>131</sup> SROs include "organizations whose authority is recognized in law or by the statutory regulator in a

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<sup>124</sup>Neil Gunningham and Joseph Rees, "Industry Self-regulation: An Institutional Perspective," *Law and Policy*, Vol.19, No 4, (1997), p.365. [https://ec.europa.eu/digital-single-market/sites/digital-agenda/files/dae-library/industry\\_self\\_regulation\\_an\\_institutional\\_perspective.pdf](https://ec.europa.eu/digital-single-market/sites/digital-agenda/files/dae-library/industry_self_regulation_an_institutional_perspective.pdf)

<sup>125</sup>Ibid.

<sup>126</sup>Collins, supra note 76, p.24 and 26.

<sup>127</sup>Gunningham and Rees, supra note 124, p.364.

<sup>128</sup>Ibid.

<sup>129</sup>Id, p.365.

<sup>130</sup>OECD, "Industry Self-Regulation: Role and Use in Supporting Consumer Interests," *OECD Digital Economy Papers*, No. 247, (2015), p.11. <https://www.oecd-ilibrary.org/docserver/5js4k1fjqkwh-en.pdf?expires=1603629812&id=id&accname=guest&checksum=63E50B5CFC0773BC9A2614A98006E562>

<sup>131</sup>Carson, supra note 10, p.5.

jurisdiction; membership-based organizations” that act as de facto legal authorities by self-policing and creating rules and policies for their members; informal or independent membership associations that often serve as advisory and educational roles for their members (some trade associations fall into this group) and, in some cases, other market participants; and *quasi-governmental entities* that perform selected self-regulatory functions.<sup>132</sup> SROs can be wholly responsible for developing the self-regulatory instruments, monitoring compliance and ensuring enforcement, or they can work with government entities and other stakeholders in these areas, in a co-regulatory capacity.<sup>133</sup> These areas of responsibility may be performed by a single SRO or they may be divided or shared among SROs within a given country or market sector.<sup>134</sup>

There are two categories of SROs. The first is registered SROs which are private-sector entities registered with the regulator as a broker-dealer association, or an exchange, or a settlement facility.<sup>135</sup> Registered SROs are entities created by the authority of company or corporations law for purposes stated in their constitutional documents.<sup>136</sup> Registered SROs may be non-profit entities owned by and operated for the benefit of their members, or commercial entities owned by and operated for the benefit of their equity-security owners.<sup>137</sup>

The second is special-purpose SROs which are private-sector entities authorized by the securities law.<sup>138</sup> Special-purpose SROs include any private-sector which is established for non-profit and authorized to regulate and supervise:

- a. Public accountants that audit the financial statements of publicly owned companies;
- b. Transactions in certain government-issued securities; or
- c. Administration of the securities-account insurance law.<sup>139</sup>

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<sup>132</sup> CFA Institute, “Self-Regulation in the Securities Markets: Transitions and New Possibilities,” (2013), p.7.

<sup>133</sup> Co-regulation can be seen as being part of the continuum between self-regulation and government regulation. OECD, *supra* note 130, p.11.

<sup>134</sup>IOSCO, *supra* note 123, p.3.

<sup>135</sup>Collins, *supra* note 76, p.40.

<sup>136</sup>*Id.*, p.41.

<sup>137</sup>*Ibid.*

<sup>138</sup>Collins, *supra* note 76, p.40.

<sup>139</sup>*Id.*, p.44.

The securities-law authority for a special-purpose SRO is specific to an entity. The authority, functions, and structure of a special-purpose SRO are defined and described in the law.<sup>140</sup> The law may also determine the relationship between securities-regulations agency and special-purpose SROs.<sup>141</sup> Special-purpose SRO entities are created by the authority of company or corporation by-laws for purposes stated in their constitutional documents.<sup>142</sup>

### **2.3. Justification for and against Self-regulation of Capital Markets**

There exist different views about the need for securities market regulation. Early research on the topic argued that securities markets should be left unregulated, with the market mandating optimal disclosure and monitoring compliance to facilitate trading and auditors and underwriters certifying the quality of securities being offered.<sup>143</sup> More recent research argues that regulation is needed to standardize the private contracting framework and prevent investors from being duped, with laws mandating the disclosure of information for issuances and specifying the liability standards facing issuers and financial intermediaries in case investors seek payment for damages when information is inaccurate or material information is withheld.<sup>144</sup> It is now widely acknowledged that securities laws are critically important for the development of securities markets.<sup>145</sup>

In several jurisdictions around the world, effective self-regulation existed before statutory regulation.<sup>146</sup> As markets developed, market participants recognized that self-regulation was necessary to protect the integrity of the market. Industry participants recognized that those who were most familiar with the customs and practices of a particular trade were best suited to create rules related to that trade, to enforce those rules and to resolve any disputes. Moreover, the familiarity with the concepts involved ensured that such disputes were quickly resolved and that

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<sup>140</sup>Ibid.

<sup>141</sup>Ibid.

<sup>142</sup>Ibid.

<sup>143</sup>Luc Laeven, “The Development of Local Capital Markets: Rationale and Challenges,” *IMF Working Paper* no.234, 2014, p.11. [https://www.imf.org/~media/Websites/IMF/imported-full-text-pdf/external/pubs/ft/wp/2014/\\_wp14234.ashx](https://www.imf.org/~media/Websites/IMF/imported-full-text-pdf/external/pubs/ft/wp/2014/_wp14234.ashx)

<sup>144</sup>Ibid.

<sup>145</sup>Ibid.

<sup>146</sup>IOSCO, *supra* note 123, p.3.

the rules for commerce continually and quickly adapted to the evolutions in the way trade was conducted.<sup>147</sup>

According to proponents, the benefits of industry self-regulation are apparent: speed, flexibility, sensitivity to market circumstances and lower costs.<sup>148</sup> On the other hand, according to the critics, self-regulatory standards are usually weak, enforcement is ineffective, and punishment is secret and mild. Moreover, self-regulation commonly lacks many of the virtues of conventional state regulation "in terms of visibility, credibility, accountability, compulsory application to all . . . greater likelihood of rigorous standards being developed, cost spreading, . . . and availability of a range of sanctions".<sup>149</sup> This being said, this section will discuss the justifications for and against self-regulation.

### **2.3.1. Justification for Self-regulation of Capital Markets**

The proponents of self-regulation contend that self-regulation by its very nature possess a greater flexibility to adapt regulatory requirements as a response to a changing business environment.<sup>150</sup> Oftentimes industry response to new issues through self-regulatory schemes can be adjusted more swiftly and easily than government regulations, which can be a time consuming, cumbersome process and may entail significant procedural hurdles.<sup>151</sup> The rapid change that businesses and investors encounter in markets may require existing regulations to be changed or updated frequently.<sup>152</sup> However, the process for governments changing regulations may be a lengthy one.<sup>153</sup> Processes overseen by industry may be more responsive and quicker,<sup>154</sup> as SROs are close to their markets and market users and can tailor their rules and surveillance techniques to the specific characteristics of their markets.<sup>155</sup> They can also modify them quickly to respond to market changes.<sup>156</sup>

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<sup>147</sup>Id, p.3.

<sup>148</sup>Gunningham and Rees, supra note 124, p.366.

<sup>149</sup>Id, p.370.

<sup>150</sup>IOSCO, supra note 123, p.3.

<sup>151</sup>OECD, supra note 130, p.18.

<sup>152</sup>Ibid.

<sup>153</sup>Ibid.

<sup>154</sup>Ibid.

<sup>155</sup>IOSCO, supra note 123, p.12.

The other main premise behind self-regulation is that “the industry has a strong incentive to police itself in order to maintain its quality.”<sup>157</sup> Proponents expound on the benefits of a system that places the responsibility for crafting and enforcing regulations in the very hands of those to be regulated.<sup>158</sup> They believe that such a system is philosophically in keeping with the principles of free-market enterprise.<sup>159</sup> They contend that because self-regulation contemplates ethical standards of conduct which extend beyond the letter of the law, it may significantly raise standards of behavior.<sup>160</sup> The close industry participation in self-regulation generates compliance benefits because the industry may be more likely to comply with internally generated rules than externally imposed ones.<sup>161</sup> At the least, industry participation in the rulemaking process likely increases the perceived legitimacy of any rule imposed by a regulator.<sup>162</sup> Industry participation theoretically also expedites the rulemaking process by generally improving the flow of information from the regulated to the regulator.<sup>163</sup> As such, self-regulation has the potential for utilizing peer pressure and for successfully internalizing responsibility for compliance.<sup>164</sup>

On the contrary, regulations which are imposed by governments might not command the full support of affected businesses, which can translate into weak compliance.<sup>165</sup> Compliance with self-regulatory mechanisms, can, in some cases, be stronger due to the benefits of buy-in by industry members who may have helped design them and who may thus have a vested interest in their success.<sup>166</sup> The degree of commitment engendered by industry control may also be beneficial for consumers/investors, as it may in some cases encourage business to “raise the bar”

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<sup>156</sup>Ibid.

<sup>157</sup> Benjamin P. Edwards, “The Dark Side of Self-Regulation,” *University of Cincinnati Law Review*, vol.85, (2017), p.599. Retrieved from: <https://scholars.law.unlv.edu/cgi/viewcontent.cgi?article=2141&context=facpub>

<sup>158</sup> CFA Institute (2007), supra note 8, p.2.

<sup>159</sup>Ibid.

<sup>160</sup>Gunningham and Rees, supra note 124, p.366.

<sup>161</sup>Edwards, supra note 157, p.602.

<sup>162</sup>Ibid.

<sup>163</sup>Ibid.

<sup>164</sup>Gunningham and Rees, supra note 124, p.366.

<sup>165</sup>OECD, supra note 130, p.19.

<sup>166</sup>Ibid.

and reach higher standards.<sup>167</sup> Hence, since self-regulation embraces industry input and representation, it contributes to a strong and effective compliance culture.<sup>168</sup>

Proponents of self-regulation further argue the use of self-regulation in markets with increasingly complex products and strategies is justified as SROs can use their expertise to increase the understanding of current market practices, meaningful rulemaking, and effective surveillance of the sector.<sup>169</sup> In self-regulation, the rules are drafted by market participants with an intimate knowledge of the market who know how to maximize the regulatory benefits (e.g., orderly markets, customer protection, reduction of systemic risk) while minimizing the business costs.<sup>170</sup> This intimate knowledge of the market is essential for creating a self-regulatory framework, which is perceived as appropriate and reasonable by the regulated individuals and entities.<sup>171</sup> This perception will in turn result in a tighter degree of compliance by the market participants operating within the self-regulatory framework.<sup>172</sup> Thus, by providing an intimate knowledge of the markets and products, SROs have the experience, resources and commitment to play a constructive role in assisting statutory regulators to examine issues and to arrive at creative and effective solutions which enhance the health of the financial markets and the protection of customers.<sup>173</sup>

Self-regulation has also been promoted on the ground that it provides significant cost savings. In theory, its greater expertise should allow it to function more cost-effective because it would enjoy lower information-acquisition and analysis costs as well as the support of the industry.<sup>174</sup> Self-regulatory organizations may also be able to act more efficiently because they do not face the same constraints as state actors.<sup>175</sup> Studies on self-regulation indicate that it can often be less costly and less burdensome for businesses than comparable government regulation, regardless of

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<sup>167</sup>Ibid.

<sup>168</sup>IOSCO, *supra* note 123, p.12.

<sup>169</sup> CFA Institute (2013), *supra* note 132, p.12.

<sup>170</sup> Ibid

<sup>171</sup> IOSCO, *supra* note 123,p.3.

<sup>172</sup>Ibid.

<sup>173</sup>Id, p.13.

<sup>174</sup>Edwards, *supra* note 157, p.603.

<sup>175</sup>Ibid.

the level of government involvement.<sup>176</sup> From the government perspective, industry self-regulation is more cost effective since most of the regulatory costs would be borne by businesses; enforcement and inspection costs could thereby be saved.<sup>177</sup>

### **2.3.2. Justification against Self-regulation of Capital Markets**

As discussed earlier, several literatures have indicated the benefits offered by self-regulation. Yet, in practice, say critics, self-regulation often fails to fulfill its theoretical promise, more commonly serving the industry rather than the public interest.<sup>178</sup> As John Braithwaite has put it:

Self-regulation is frequently an attempt to deceive the public into believing in the responsibility of a[n] irresponsible industry. Sometimes it is a strategy to give the government an excuse for not doing its job.<sup>179</sup>

Further, Self-regulation took much of the blame for the financial crisis that hit bottom in late 2008.<sup>180</sup> To some observers, self-regulatory organizations look more like industry conspiracies or cartels to curb competition than like benefactors of the public interest.<sup>181</sup> They exist, it is argued, to increase industry profits by restraining competition, and not by increasing the value of the product to consumers.<sup>182</sup> This group believes the conflicts inherent in having the regulated regulate themselves doom this system as ultimately impractical at best and grossly self-serving at worst.<sup>183</sup> It is reported that particular groups within self-regulatory organizations use their regulatory power in anticompetitive ways by crafting regulations that disproportionately burden their competitors; in particular, regulations imposing fixed costs that do not scale with firm size may have more significant effects on small firms.<sup>184</sup> As such, it is argued that self-regulation leads to regulatory capture which is a mechanism through which the industry may influence

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<sup>176</sup>OECD, supra note 130, p.18.

<sup>177</sup>Id, p.19.

<sup>178</sup>Gunningham and Rees, supra note 124, p.366.

<sup>179</sup>Id, p.370.

<sup>180</sup>CFA Institute (2013), supra note 132, p.3.

<sup>181</sup> Franklin R. Edwards, "Future Markets in Transition: The Uneasy Balance Between Government and Self-regulation," *The Journal of Future Markets*, vol.3 no.2 (1993), p. 192.

<sup>182</sup>Ibid.

<sup>183</sup> CFA Institute (2007), supra note 16, p.3.

<sup>184</sup>Edwards, supra note 157, p.605.

regulatory activity. It generally “denotes the misalignment of incentives of government actors who pursue narrow private interests that may conflict with the public interest they purport to serve.”<sup>185</sup> As a result, SROs may fail to protect the public’s interest by failing to address known problems.<sup>186</sup> Given these conflicts of interest, most observers accept that self-regulatory organizations often fail to effectively protect the public’s interests.<sup>187</sup>

Another version of the above criticism contends that SROs might not be sufficiently dedicated to their regulatory tasks.<sup>188</sup> If self-regulation does tend to insulate an industry group from regulation, it affects the general public.<sup>189</sup> Even if one sets aside the public, an SRO exercising governmental power in several ways may affect the interests of particular persons (especially, retail investors).<sup>190</sup> The SRO may impose disciplinary sanctions, deny membership and prohibit members from doing business with particular non-members or in certain securities.<sup>191</sup> Moreover, some industry participants may be able to dominate an SRO and then create competitive disadvantages for smaller members or those firms attempting to enter a market.<sup>192</sup> Hence, SROs have been criticized for lax oversight of their members’ activities, allowing unethical and even illegal conduct to continue.<sup>193</sup> SROs have also been criticized for their exposure to engage in illusory activity-actions designed to give the appearance of effort without substance.<sup>194</sup>

The above criticisms arise from the ‘public interest’ theory of regulation that is based on two assumptions. First, unhindered markets often fail because of the problems of monopoly or externalities.<sup>195</sup> Second, governments are benign and capable of correcting these market failures

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<sup>185</sup>Id, p.506.

<sup>186</sup>Id, p.608.

<sup>187</sup>Id, p.604.

<sup>188</sup>Miller, supra note 49, p.861.

<sup>189</sup>Ibid.

<sup>190</sup>Id, p.865.

<sup>191</sup>Id, p.866.

<sup>192</sup>Id

<sup>193</sup>Edwards, supra note 157, p.609.

<sup>194</sup>Id, p.610.

<sup>195</sup>Andrei Sheleifer, “Understanding Regulation,” *European Financial Management* Vol. 11, No.4, (2005), p.440.[https://scholar.harvard.edu/files/shleifer/files/02\\_eufm00121.pdf](https://scholar.harvard.edu/files/shleifer/files/02_eufm00121.pdf)

through regulation.<sup>196</sup> This theory of regulation has been used both as a prescription of what governments should do, and as a description of what they do, at least in democratic countries.<sup>197</sup>

## **2.4. Forms of Self-regulation**

In the broad sense, the form of self-regulation depends on the following major factors: the type of SRO, source of authority and the structure of the self-regulation.

### **2.4.1. Type of SROs**

The form of self-regulation depends on the status and nature of SROs. Among others, the following institutions may act as SROs: Exchanges, Member or independent SRO, Industry or Dealer's Association and Central securities depositories, and clearing agencies.<sup>198</sup>

#### **2.4.1.1. Exchange SROs**

An exchange provides transaction-execution services to its members and, in some jurisdictions, performs the functions of an SRO as required by law and regulation.<sup>199</sup> Exchanges is not a broker or dealer in transactions and does not provide transaction-settlement services, rather it provides the platform for the exchange of securities.<sup>200</sup>

Exchanges have traditionally provided two basic services to firms seeking to list securities. First, they provide a marketplace where securities can be bought and sold after the securities are initially offered to the public.<sup>201</sup> They do so by offering firms the opportunity to list their shares on trading floors or on an electronic trading system operated by the exchange.<sup>202</sup> This listing service provides access to all investors and financial intermediaries operating on the trading floor or connected to the exchange's network.<sup>203</sup> Investors can purchase initial public offerings by issuers through investment, and after the IPO they can subsequently buy and sell the firm's

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<sup>196</sup>Ibid.

<sup>197</sup>Ibid.

<sup>198</sup>Carson, *supra* note 10, p.8.

<sup>199</sup>Collins, *supra* note 76, p.42.

<sup>200</sup>Ibid

<sup>201</sup>Chris Brummer, "Stock Exchanges and the New Markets for Securities Laws," The University of Chicago Law Review, Vol 75 (2008), p.1451.

<sup>202</sup>Ibid.

<sup>203</sup>Ibid.

securities on the secondary market operated by the exchange.<sup>204</sup> In return for these services, exchanges charge commissions for listing and trading securities, as well as for access to the trading floor or system.<sup>205</sup> In providing these services, exchanges offer liquidity, that is, convertibility of a security into cash (and vice versa).<sup>206</sup>

Second, exchanges have been usually empowered to regulate and supervise a public secondary market for the execution of transactions by and between their respective members.<sup>207</sup> The nature and extent of oversight will differ depending on the laws of the country in which an exchange is located.<sup>208</sup> In the early development of securities markets, exchanges were self-regulators of various activities at the same time.<sup>209</sup>

Although, exchanges are the most common form of formal SRO in the securities markets arena, the role of exchanges as regulators is being diminished around the world.<sup>210</sup> This is because this form of self-regulation resulted in conflict of interest as the exchange SROs used their regulatory authority only to limit competition instead of additionally prevent or stop illegal practices by members.<sup>211</sup> Furthermore, exchanges that are listed companies are, strictly speaking, neither self-regulatory bodies nor membership organizations, even though most retain jurisdiction over at least some of their participants' market and business conduct.<sup>212</sup> In this regard, it is contended that exchanges should compete as markets, not as regulators.<sup>213</sup>

#### **2.4.1.2. Membership based or Independent SRO**

These are SROs based on membership of securities dealers or brokers that are independent of market operators.<sup>214</sup> In some cases, the organization may also function as an industry association

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<sup>204</sup>Ibid.

<sup>205</sup>Ibid.

<sup>206</sup>Id, p.1452.

<sup>207</sup>Collins, supra note 76, p.51.

<sup>208</sup>Brummer, supra note 201, p.1452.

<sup>209</sup>Collins, supra note 76, p.42.

<sup>210</sup>Carson, supra note 10, p.8.

<sup>211</sup>Collins, supra note 76, p.43.

<sup>212</sup>Carson, supra note 10, p.8.

<sup>213</sup>Collins, supra note 76, p.43.

<sup>214</sup>Carson, supra note 10, p.7.

for its members or play a role in organizing an OTC market, such as a bond market.<sup>215</sup> Member or “Independent SROs” that are not market operators are important in some countries, notably the United States, Canada, Japan, and the Republic of Korea.<sup>216</sup> Those SROs are structured as membership organizations of securities dealers, although, in most cases today, their corporate governance is designed to limit member control of the SRO and the associated conflicts of interest.<sup>217</sup> Such SROs have full-fledged SRO powers, including rule-making, supervision, and enforcement functions.<sup>218</sup> Independent SROs do not own or operate an exchange or marketplace, although they often regulate markets as well as their member intermediaries. Some independent SROs also have a dual role as regulators and industry associations representing their members’ interests. Others play a role in administering OTC markets, particularly for debt securities – for example, the JSDA in Japan and Brazil’s ANBIMA.<sup>219</sup>

#### **2.4.1.3. Industry or Dealers’ Associations**

Industry or dealers’ associations are representatives of brokers or dealers that intermediate between the customer and the market.<sup>220</sup> In some jurisdictions, these broker-dealer associations are vested with the power to provide services to its members, and, at the same time, perform the functions of an SRO as required by the law and regulations.<sup>221</sup> In this context, the association does not carry out the activities of a broker or dealer, particularly execution of transactions, nor is it an agent or a principal in the settlement of transactions.<sup>222</sup> Rather, it coordinates the activities of its members (such as, a securities-information processor) and duly represents them in policy or legislation development.<sup>223</sup> Additionally, where such associations are vested with a

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<sup>215</sup>Ibid.

<sup>216</sup>Id, p.8.

<sup>217</sup>Ibid.

<sup>218</sup>Ibid.

<sup>219</sup>Ibid.

<sup>220</sup>Arnett, supra note 84, p.7.

<sup>221</sup> Collins supra note 76, p.41-43.

<sup>222</sup>Id, p.42.

<sup>223</sup>Id, p.42 and 46.

regulatory power, they regulate and supervise the primary-market and secondary-market activities of its members.<sup>224</sup>

Some industry associations have limited self-regulatory functions that include setting rules or obligatory standards, besides their primary function to represent members' interests. Others are not formal SROs, but provide guidance, best practices, or set other standards for members.<sup>225</sup>

Industry association SROs may set rules that apply to certain securities market activities or may promulgate binding codes of conduct.<sup>226</sup> Those SROs generally have corporate governance systems dominated by their members.<sup>227</sup> This type of SRO may not have full-fledged rulemaking, supervision, and enforcement programs; nevertheless, they can play an important role in setting standards of conduct in securities markets.<sup>228</sup> For example, such associations are important in Brazil and Egypt, as well as in international OTC markets – namely the International Capital Markets Association (ICMA) in debt markets.<sup>229</sup> The International Swaps and Derivatives Association (ISDA) also plays a role in setting standards in derivatives markets, although it does not consider itself to be an SRO.<sup>230</sup>

#### **2.4.1.4. Central Securities Depositories (CSDs) and Clearing Agencies**

In the ordinary course of things, clearing agencies (settlement-facilities) provides transaction-settlement services to its members.<sup>231</sup> However, in some jurisdictions, they may have an additional authority to function as SRO.<sup>232</sup> CSDs and central counterparties often have limited self-regulatory functions. Both for-profit and non-profit (mutual) types of CSDs are prominent in global markets.<sup>233</sup>

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<sup>224</sup>Id, p.46.

<sup>225</sup>Carson, supra note 10, p.8.

<sup>226</sup>Ibid.

<sup>227</sup>Ibid.

<sup>228</sup>Ibid.

<sup>229</sup>Ibid.

<sup>230</sup>Ibid.

<sup>231</sup>Collins, supra note 76, p.43.

<sup>232</sup>Ibid.

<sup>233</sup>Carson, supra note 10, p.8.

## 2.4.2. Voluntary-vs-Mandatory

Another factor is the source of authority, i.e. voluntary or mandatory. An SRO's powers and jurisdiction over its members may be based on contract or established in law.<sup>234</sup> In this regard, self-regulation may be classified into two. One is voluntary self-regulation, which pictures rule making and enforcement both carried out privately by the firm or industry itself, independent of direct government involvement.<sup>235</sup> The second is mandated full self-regulation, where both rule making and enforcement are privatized through a statute.<sup>236</sup> In most jurisdictions, a member must enter into a membership agreement with the SRO that requires the firm to comply with the SRO's rules, and the SRO's powers and authority have statutory backing in securities laws.<sup>237</sup> In some jurisdictions, such as the US, the membership contract gives an SRO greater power over its members than the statutory regulator would have under the law.<sup>238</sup>

## 2.4.3. Type of Models of Self-Regulation

Four basic regulatory structures, or models, are observed globally. The models are points on a continuum, ranging from minimal reliance on SROs to significant reliance on SROs to regulate securities business. The four basic models are as follows:

1. **Government (Statutory) Model:** A public authority is responsible for securities regulation. Exchanges are usually responsible for very limited supervision of their markets but are not considered to be SROs. *Examples:* France (AMF), UK (FSA), and most European Union countries.<sup>239</sup>
2. **Limited Exchange SRO Model:** A public authority is the primary regulator. It relies on exchanges to perform certain regulatory functions tied to the operation of the market (for example, market surveillance and listing). *Examples:* Hong Kong SAR, China (Hong

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<sup>234</sup>Id, p.10.

<sup>235</sup>Gunningham and Rees, supra note 124, p.365.

<sup>236</sup>Ibid.

<sup>237</sup>Carson, supra note 10, p.10.

<sup>238</sup>Ibid.

<sup>239</sup>Id, p.17.

Kong Exchanges), Singapore (Singapore Exchanges) Sweden (Nasdaq OMX Stockholm), US (NYSE).<sup>240</sup>

3. **Strong Exchange SRO Model:** A public authority is the primary regulator. It relies on exchanges to perform extensive regulatory functions that extend beyond their market operations, including regulating members' business conduct.<sup>241</sup> *Examples:* Japan (TSE, and Osaka Securities Exchange); Malaysia (Bursa Malaysia); and US (CME).<sup>242</sup>
4. **Independent Member SRO Model:** A public authority is the primary regulator. It relies extensively on an independent SRO (a member organization that is not a market operator) to perform extensive regulatory functions. *Examples:* Canada (IIROC and the Mutual Fund Dealers Association), Japan (JSDA), South Korea (KOFIA), US (FINRA and the National Futures Association), and Colombia (AMV).<sup>243</sup>

## 2.5. Factors determining the Scope of Self-regulation

There are various factors determining the scope of self-regulation of the securities market. These factors also serve as a basis to ensure the effectiveness of self-regulation. These factors include; the scope of regulatory mandate, scope of monitoring power, and scope of enforcement, and role of government.

### 2.5.1. Scope of Regulatory Mandate

The mandate or objectives of self-regulation are widely accepted to be protecting investors and maintaining market integrity. SROs are expected to act in the public interest over the specific interests of their members or, more typically today, their shareholders.<sup>244</sup> In this sense, in evaluating the nature of an SRO, it is important to first review whether the rule-making mandate is supplemented by statute or otherwise, and then, the extent of authority (whether it assumes the role of front-line regulator or mere advocacy role).<sup>245</sup>

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<sup>240</sup>Ibid.

<sup>241</sup>Ibid.

<sup>242</sup>Ibid.

<sup>243</sup>Ibid.

<sup>244</sup>Carson, *supra* note 10, p.10.

<sup>245</sup> CFA Institute (2013), *supra* note 132, p.8.

First, there should be a legal basis for rulemaking. Self-regulation that is designed to implement laws can provide a strong basis for attracting membership and can contribute to broad stakeholder support.<sup>246</sup> In this respect, self-regulation can help with businesses to comply with existing laws.<sup>247</sup> Conveying that the intent is to facilitate implementation of legal obligations should therefore be made clear to businesses.<sup>248</sup>

Second, it is important to give a regulatory mandate to the SRO to some extent. The effectiveness of self-regulation scheme is determined by the regulatory mandate given to it.<sup>249</sup> In its most complete form, self-regulation encompasses the authority to create, amend, implement, and enforce rules of conduct with respect to the entities subject to the SRO's jurisdiction and to resolve disputes through arbitration or other means.<sup>250</sup> The IOSCO indicates that in determining the regulatory mandate of SROs, most legislators:

- a. Ensure the optimal utilization of industry specialized knowledge;<sup>251</sup>
- b. Enable the SRO to enter and execute contractual relationships;<sup>252</sup>
- c. Create a conducive environment where the SRO can flexibility operate;<sup>253</sup>
- d. Entrust the SRO with enforcing rules and regulations through investigations and disciplinary action;<sup>254</sup>
- e. Conducting financial/operations and sales practice examinations;<sup>255</sup>
- f. Conducting fitness screening for access to marketplace;<sup>256</sup>
- g. Handling customer complaints;<sup>257</sup>
- h. Having surveillance programs to detect violative conduct;<sup>258</sup>

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<sup>246</sup>OECD, supra note 130, p.24.

<sup>247</sup>Ibid.

<sup>248</sup>Ibid.

<sup>249</sup>Id, p.23.

<sup>250</sup>IOSCO, supra note 123, p.3.

<sup>251</sup>Id, p.4.

<sup>252</sup>Id, p.6.

<sup>253</sup>Ibid.

<sup>254</sup>Ibid.

<sup>255</sup>Id, p.7.

<sup>256</sup>Ibid.

<sup>257</sup>Ibid.

- i. Sharing information and cooperating with other SROs;<sup>259</sup> and
- j. Providing a dispute resolution forum.<sup>260</sup>

In this regard, clear and strong objectives should be set that should be considered in determining the regulatory mandate of the SRO and exercising of the mandate.<sup>261</sup> Clarity in the goals of a self-regulatory scheme would help to enhance their acceptability to potential participants, and, in longer term, would help to facilitate assessments of their impact.<sup>262</sup>

Government issued laws constituting the regulation of securities may have the following generally accepted objectives:

- a. Investor protection: This “means the protection of investors against financial losses as a result of fraud and other illegal activities.”<sup>263</sup>
- b. Fair and orderly markets: This may involve standards to ensure the transparency of issuers and regulatory organs. Self-regulatory organizations may also establish and enforce rules to ensure the orderly execution of transaction at fair prices.<sup>264</sup>
- c. Control of systemic risk: Systemic risk is the risk that one settlement failure will cause other failures.<sup>265</sup> It is the risk “that one entity’s failure to deliver a security or to pay money on the contractual settlement date will cause that entity’s counterparties to fail in the settlement of their obligations to another set of counterparties on the same day, and so on to a third or fourth set of counterparties.”<sup>266</sup>
- d. Competition: This objective is concerned with the enhancement of cost-efficiency and effectiveness of capital formation. To this effect the law may strive to support the equal regulation of entities that issue securities, supports the equal regulation of entities that provide securities-related services, require the securities regulatory organs to consider the

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<sup>258</sup>Ibid.

<sup>259</sup>Ibid.

<sup>260</sup>Ibid.

<sup>261</sup>OECD, supra note 130, p.23.

<sup>262</sup>Ibid.

<sup>263</sup>Collins, supra note 76, p.19.

<sup>264</sup>Ibid.

<sup>265</sup>Id, p.20

<sup>266</sup>Ibid.

competitive consequences of their respective regulatory decisions, and prohibit self-regulatory organizations from fixing commissions and other fees that members charge their customers.<sup>267</sup>

### **2.5.2. Scope of supervisory power**

Regular monitoring of the operation and effectiveness of schemes can help to demonstrate whether objectives are being achieved and members of the scheme are complying.<sup>268</sup> This would as a result ensure transparency and public accountability that can significantly help build trust and confidence in self-regulatory schemes, helping to enhance its value to all participants and possibly encouraging new firms to join.<sup>269</sup>

In light of the inherent conflicts of interest posed by the self-regulatory system, SROs must, if they are to be credible, have policies and procedures (governance and otherwise) to manage them.<sup>270</sup> SROs should be accountable to their members or shareholders.<sup>271</sup> Invariably, SROs are also accountable to their supervising (government) regulators by law or regulation, and through the regulator to the government.<sup>272</sup> Supervising regulators – usually a securities commission or similar government financial regulator – are responsible for oversight of the operation and governance of SROs.<sup>273</sup> SROs also have a broader responsibility to all stakeholders in the capital markets, especially investors.<sup>274</sup> To this effect, a self-regulation system should have a mechanism to manage the inherent conflicts of interest, ensure transparency (by prescribing clear and transparent procedures, among other things, for electing governing boards and creating rules), determine legal liability of the SRO, and identify due process.<sup>275</sup>

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<sup>267</sup>Ibid.

<sup>268</sup>OECD, supra note 130, p.24.

<sup>269</sup>Ibid.

<sup>270</sup> CFA Institute (2013), supra note 132, p.9.

<sup>271</sup>Carson, supra note 10, p.6.

<sup>272</sup>Ibid.

<sup>273</sup>Ibid.

<sup>274</sup>Id, p.7.

<sup>275</sup>CFA Institute (2013), supra note 132, p.9.

The monitoring mandate of an SRO can occur in two ways. One is to oblige the SRO to produce information to the regulator and/or the public.<sup>276</sup> While much remains to be learned, there are good grounds for thinking that the effectiveness of self-regulation depends enormously on the system's ability to produce and promulgate two kinds of information: (1) about the normative standards the industry has set for itself; and (2) about the performance of member companies in terms of those standards. Simple as it may sound, achieving transparency has proved to be a very difficult task.<sup>277</sup> In this regard, the monitoring mandate may extend to identifying and penalizing false or misleading statement or material fact, or omission of a fact.<sup>278</sup>

Another step towards achieving transparency is the development of an information system for collecting data on the progress of member companies in implementing the industry rules.<sup>279</sup> The process usually divides into two parts: reporting and data collection (member companies communicate their progress in implementing the industry codes); and the industry collects and analyzes the data.<sup>280</sup>

### **2.5.3. Scope of Enforcement power**

An entity's enforcement authority is integral to whether it is seen as a front-line regulator or similar to a trade association.<sup>281</sup> In most cases, SROs have a mixture of enforcement authorities that permits them to enforce their own rules with regard to the licensing and fining of firms and individuals in violation of those rules.<sup>282</sup> At the same time, such entities rarely have the means or the authority to try cases that would impose criminal penalties on either firms or individuals.<sup>283</sup> Both its authority and its manner of enforcement are relevant to the role the entity assumes in the hierarchy of degrees of self-regulation.<sup>284</sup> SROs should be able to ensure compliance with the

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<sup>276</sup>IOSCO, *supra* note 123, p.6.

<sup>277</sup>Gunningham and Rees, *supra* note 124, p.383.

<sup>278</sup>Collins, *supra* note 77, p.22.

<sup>279</sup>Gunningham and Rees, *supra* note 124, p.383.

<sup>280</sup>*Ibid.*

<sup>281</sup>CFA Institute (2013), *supra* note 132, p.9.

<sup>282</sup>*Ibid.*

<sup>283</sup>*Ibid.*

<sup>284</sup>*Ibid.*

rules by investigating potential violations and disciplining individuals and firms that violate them.<sup>285</sup>

#### **2.5.4. Scope of Government Involvement**

Central to any self-regulatory structure is the degree to which governmental authorities cede primary responsibility to the self-regulating entity.<sup>286</sup> Where self-regulations' role is significant, it almost invariably derives from a long track record of responsible behavior, under the oversight of statutory regulators.<sup>287</sup> That relationship has permitted SROs to contribute to the quality of regulation and to the content of policy in the public interest.<sup>288</sup> Hence, effective self-regulation must be defined within the context of government oversight. Government oversight is an essential element in the self-regulatory structure.<sup>289</sup>

The government interference in the regulation of capital markets is relevant for various reasons. First, the government should intervene for the safeguard of public interest.<sup>290</sup> Government oversight of SRO activities ensures that, among other things, all interests are given the proper consideration and voice in all regulatory activities.<sup>291</sup> Second, it may control and prevent conflicts of interest.<sup>292</sup> Government involvement would mitigate the risk of regulatory capture and favoritism that could occur when a self-regulatory body is overly "close" to the businesses that it is supposed to regulate/monitor/sanction and thus fails to exercise its functions effectively.<sup>293</sup> Third, the government, by involving itself, may govern and monitor "unregulated" participants in the capital market, such as those who are not members of the SRO.<sup>294</sup> Fourth, the

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<sup>285</sup>Carson, *supra* note 10, p.6.

<sup>286</sup> CFA Institute (2007), *supra* note 8, p.3.

<sup>287</sup>IOSCO, *supra* note 123, p.2.

<sup>288</sup>*Ibid.*

<sup>289</sup>*Id.*, p.8.

<sup>290</sup>Collins, *supra* note 76, p.3.

<sup>291</sup>IOSCO, *supra* note 123, p.8.

<sup>292</sup>Edwards, *supra* note 157, p.194.

<sup>293</sup>OECD, *supra* note 130, p.21.

<sup>294</sup> The case of "regulatory lag," may occur where the industry does not quickly perceive that the unregulated segment of the industry is of growing importance. Political and economic differences within the industry may prevent it from expanding the scope of self-regulation, perhaps due to the additional costs involved; or the gap may

government has a role to play in assuring that the rules and regulations established by self-regulatory bodies do not unnecessarily restrict competition. In particular, the rules and regulations of such bodies should not restrict competition beyond what is necessary to accomplish their purpose.<sup>295</sup>

Hence, generally government oversight provides a system of checks and balances. The governing statute should clearly delineate the respective roles of the statutory regulators and the SROs.<sup>296</sup> Also, because SROs are easy to regulate, that does not mean that they should be subject to more regulation and more oversight.<sup>297</sup> It is recommended that government regulators recognize that SROs have the same primary objectives as statutory regulators (i.e., protect investors, ensure fair and efficient markets and reduce systemic risk) and rely on the SROs to execute their responsibilities accurately, completely, effectively and efficiently in accordance with their governing documents or delegation orders.<sup>298</sup> Further, the regulatory framework should ensure that there is little to no duplication of the regulatory work performed by SROs and the statutory regulators.<sup>299</sup>

The scope of government involvement may include:

- i)* Setting out the legal framework;<sup>300</sup>
- ii)* encouraging self-regulatory action;<sup>301</sup>
- iii)* providing advice;<sup>302</sup>
- iv)* supporting compliance;<sup>303</sup>

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simply reflect a difference of opinion as to the importance of the unregulated individuals and institutions. Edwards, supra note 157, p.194.

<sup>295</sup>Ibid.

<sup>296</sup>IOSCO, supra note 123, p.8.

<sup>297</sup>Id, p.9.

<sup>298</sup>Ibid.

<sup>299</sup>Ibid.

<sup>300</sup>Laeven, supra note 143, p.9. This presumption mainly arises from the “law matters thesis,” that mainly emphasizes strong protections for the minority shareholders, and strong contract enforcement. Ibrahim, supra note 89, p.7.

<sup>301</sup>OECD, supra note 130, p.12.

<sup>302</sup>Id, p.13.

<sup>303</sup>Id, p.14.

- v) monitoring the effectiveness and impact of rules and decisions made by the SRO;<sup>304</sup> and
- vi) supporting enforcement of rules;<sup>305</sup>

Government deferment can take various forms:

- An initial “hands-off, wait and see” approach while the government assesses the success of the entity’s ability to regulate itself;
- A pre-emptor to direct government intervention by voluntary establishment of self-regulation (possibly with the threat of government intervention if the industry does not establish adequate regulatory standards); or
- Assumption of the role of ultimate guardian of the rights of citizens through an oversight authority where the SRO is the “frontline” regulator, and the government reviews its actions on a periodic basis.<sup>306</sup>

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<sup>304</sup>Ibid.

<sup>305</sup>Ibid.

<sup>306</sup> CFA Institute (2007), supra note 8, p.3.

## Chapter Three: The Form and Scope of Self-regulation under the Draft Capital Markets Proclamation of Ethiopia

Even though recently there were formation of different share companies in Ethiopia, capital market becomes an irony that never has been discovered.<sup>307</sup> During the imperial period, Ethiopia managed to develop the institutions of the stock market, such as the “Addis Ababa Share Dealing Group”.<sup>308</sup> However, after the fall of the Imperial regime, the stock market was abolished due to the introduction of a command economy.<sup>309</sup> Since then, except Commodities Market Exchange for agricultural products under the current regime, no stock market has been legally designed to trade stocks except for the fragmented and unregulated stock trading in a dealer market.<sup>310</sup>

Recently, the Council of Ministers approved a draft proclamation to build a capital-markets system following the economic reforms initiated during the last few years. According to the preamble of the draft proclamation, the need for establishing capital markets arises from the need to support the “development of the national economy through mobilizing capital, promoting financial innovation, and sharing investment risks.” The draft proclamation, seeks to lay the legal framework for regulation and supervision of capital markets, as well as set uniform requirements for issuers who desire to raise capital from public investors.<sup>311</sup>

This chapter has four parts. The first part highlights the basic features of the draft proclamation. The second and third part will identify the form and scope of self-regulation under the draft proclamation, respectively. The fourth part reflects on the identified form and scope of self-regulation.

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<sup>307</sup>Dasalegn Mosissa Jalata, “Capital Market Development in Ethiopia: Nobody Said It Would Be Easy,” Journal of Economics and Sustainable Developments, vol.5 no.27, (2014). p.257. Retrieved from: <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.664.3264&rep=rep1&type=pdf>, p.256

<sup>308</sup>Note that there was an initiative to establish a similar organization by the Addis Ababa Chamber of Commerce and Sectoral Association. This initiative included an attempt to develop rules and regulations as well as bylaws of a share dealing group. The model rules and regulations manual, *inter alia*, consists of: rules regarding membership requirements; Listing Rules; Requirements for Insurers; Listing of shares; Listing of Bonds; Trading Rules and Rules for clearing and Settlement of Stock Exchange Transactions. Jetu, *supra* note 3, p.440.

<sup>309</sup>Id, p.440.

<sup>310</sup>Ibid.

<sup>311</sup>Preamble of the Draft Capital Markets Proclamation.

### 3.1. The Capital Markets Draft Proclamation: A Brief Overview

The draft proclamation defines the term capital markets as a “market where financial securities such as shares or equities, bonds, derivatives, or other related securities are bought and sold.”<sup>312</sup> In this context, the term securities have a broader definition under the draft proclamation. It means “any instrument-in any legal form-that evidences ownership of a share in a financial transaction that is negotiable pursuant to a license from the Authority” such as shares; debt-instruments (issued by the private and public sector); loans, bonds, and other instruments that can be converted to shares in the capital of a company; any right, option or derivative relating to securities, units in a collective investment scheme; and any other instrument deemed as security by the Authority.<sup>313</sup> This broad definition of the term securities entails that the capital markets system under the draft proclamation consists of *inter alia* securities market, bond market, and derivatives market.

The draft proclamation requires the regulation of certain types of capital market activities and services including the buying, selling & dealing in securities, investment advice, underwriting, fund management, corporate finance advice, custodial services, collective investment schemes, and credit rating services.<sup>314</sup> These activities ought to be undertaken by certain entities that hold a capital markets services license for that activity.<sup>315</sup>

The draft proclamation governs both primary and secondary markets. As mentioned earlier, the primary market is a capital market where new securities are issued. In this regard, the draft proclamation identifies two forms of issuing new securities. The first is an initial public offering that means an offer to the public of any securities or a company, if: no securities of that company have previously been the subject of an offer to the public, or all of the securities of that company

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<sup>312</sup>Article 2(6) of the Draft Capital Markets Proclamation.

<sup>313</sup> Some documents are ousted from this definition of securities: commercial papers such as cheques, promissory notes, bills of lading, letters of credit, cash transfers and instruments negotiated by banks exclusively between each other, insurance policies and rights arising from retirement funds established for the benefit of the beneficiaries there from. Article 2(60) Draft Capital Markets Proclamation.

<sup>314</sup>Article 57 (1) of the Draft Capital Markets Proclamation.

<sup>315</sup> These entities include securities broker or its representative, Investment Adviser or its representative, Investment Portfolio Manager, Collective Investment Scheme Manager, Investment Bank, Broker-Dealer, Custodian, Market Maker, and Credit Rating Agency. Article 57 (3) of the Draft Capital Markets Proclamation.

that had previously been the subject of an offer to the public have subsequently been re-acquired by the company.<sup>316</sup>The second way of issuing new securities is through “private placement” which is a sale of securities to pre-selected investors and institutions rather than on the open market.<sup>317</sup> The draft proclamation asserts that privately issued securities cannot be publicly traded.<sup>318</sup>

On the other hand, it defines the term “secondary market” as a “market or markets where investors buy previously issued securities from other investors as opposed to the primary market, where investors buy new securities directly from the issuer or an intermediary.”<sup>319</sup> The draft proclamation recognizes both securities exchange/stock exchange and over-the-counter markets. The securities exchange means “in relation to premises of a licensed securities exchange, the one place in those premises which constitutes, maintains or provides a market or a facility by means of which: (a) offers to sell, purchase or exchange securities are regularly made or accepted; (b) offers or invitations are regularly made, being offers or invitations that are intended, or may reasonably be expected to result, whether directly or indirectly, in the making or acceptance of offers to sell, purchase or exchange securities; or (c) information is regularly provided concerning the prices at which or the consideration for which, particular persons or particular classes of persons, propose, or may reasonably be expected, to sell, purchase or exchange securities; or (d) clearing service for securities traded in the exchange takes place.”<sup>320</sup> As opposed to securities exchange, over-the-counter market is “a market in which securities and/or derivatives are traded by parties directly (face-to-face or using communication devices such as telephones and networked computers) with each other rather than through a recognized exchange.”<sup>321</sup>

The major parties involved in the securities exchange market are exchanges and securities depository and clearing company (SDCC). The draft proclamation establishes the Ethiopian

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<sup>316</sup>Article 2(32) of the Draft Capital Markets Proclamation.

<sup>317</sup>Article 2(50) of the Draft Capital Markets Proclamation.

<sup>318</sup> Article 77(5) of the Draft Capital Markets Proclamation

<sup>319</sup>Article 2(59) of the Draft Capital Markets Proclamation.

<sup>320</sup>article 2(62) of the Draft Capital Markets Proclamation.

<sup>321</sup> Article 2(47) of the Draft Capital Markets Proclamation

Securities Exchange having the status of share-company.<sup>322</sup> There may also be other securities as long as a license has been granted by the Authority.<sup>323</sup> Note that any person shall not establish or launch a business as a securities exchange or a derivative exchange or over-the-counter trading activity without obtaining the relevant license from the Authority.<sup>324</sup>SDCC means any legal entity that offers securities depository, clearing and settlement, and other related services.<sup>325</sup>

The draft proclamation also set out the regulatory framework for the regulation and supervision of the capital markets. The draft proclamation establishes the Capital Markets Authority as an autonomous federal government organ having the regulatory authority over capital markets.<sup>326</sup>The draft proclamation also adopts a self-regulation approach under the overall supervision of the Authority.<sup>327</sup>The draft proclamation defines the term “Self-regulatory organization” as an “an entity that is recognized under [the] Proclamation to regulate its own members through the adoption and enforcement of rules of conduct for fair, ethical, and efficient practices in the capital market; with a view to promoting the protection of investors and the public interest.”<sup>328</sup>The draft proclamation recognizes both formal and specific-purpose SROs. The specific-purpose SROs are committees established for specific purposes for which the Authority has made a delegation.<sup>329</sup> On the other hand, recognized SROs are exchanges and SDCC, and other organizations that intend to operate as SRO and have obtained an approval from the Authority for the same.<sup>330</sup>Hence, the regulation of capital markets under the draft proclamation is primarily vested with the Capital Markets Authority and SROs. The form and scope of self-regulation under the draft proclamation is discussed below.

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<sup>322</sup>Article 32(1) of the Draft Capital Markets Proclamation.

<sup>323</sup>Article 33(1) of the Draft Capital Markets Proclamation.

<sup>324</sup>Article 31(1) of the Draft Capital Markets Proclamation.

<sup>325</sup> Article 2(61) of the Draft Capital Markets Proclamation

<sup>326</sup> Article 3(1) of the Draft Capital Markets Proclamation

<sup>327</sup> Part III of the Draft Capital Markets Proclamation deals with the recognition of SROs.

<sup>328</sup>Article 2(64) of the Draft Capital Markets Proclamation.

<sup>329</sup>Article 17(1a) of the Draft Capital Markets Proclamation.

<sup>330</sup> Article 17(1b) and Article 23(1,2) of the Draft Capital Markets Proclamation.

### 3.2. The Forms of Self-Regulation under the Draft Proclamation

As discussed earlier in chapter two, the form of self-regulation is determined based on three factors: the status and nature of SRO, voluntary vs mandatory SRO, and regulatory structure.

There are four major types of SROs: Exchanges, Independent SROs, Dealers'/Industry Association, and Central Securities Depositories and Clearing Agencies. From these SROs, the draft proclamation explicitly recognizes exchanges and SDCC as SROs. Exchanges and SDCC are not required to apply for recognition as an SRO instead they are only required to obtain their operational license.<sup>331</sup> In addition to these, any organization under the jurisdiction of the Authority may apply to the Authority to be recognized as SRO.<sup>332</sup> As such, an industry association may also apply to the Authority for recognition of SRO. Therefore, under the draft Capital Markets Proclamation all of the aforementioned SROs, except independent SROs, may act as an SRO. The draft Capital Markets Proclamation does not recognize independent SROs as these SROs are independent of market operators and government.

The voluntary vs. mandatory self-regulation system classification is based on the source of authority in the initiation and operation of self-regulation. This means whether a certain organization may voluntarily operate as an SRO or there is a mandatory provision requiring all SROs to register with the relevant authority. In this regard, as mentioned above, the draft proclamation adopts a mandatory provision that, requires any SRO to apply to the Authority for recognition and, obliges exchanges and SDCCs to be an SRO, making it illegal to operate as SRO without such approval.<sup>333</sup>

Another major factor determining the form of self-regulation is the type of regulatory structure. There are four basic regulatory structures: Government (Statutory) Model,<sup>334</sup> Limited Exchange SRO Model,<sup>335</sup> Strong Exchange SRO model,<sup>336</sup> and Independent Member SRO Model.<sup>337</sup> To

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<sup>331</sup>Article 23(2) of the Draft Capital Markets Proclamation.

<sup>332</sup>Article 23(1) of the Draft Capital Markets Proclamation.

<sup>333</sup>Article 23(1 and 2) of the Draft Capital Markets Proclamation.

<sup>334</sup>Carson, *supra* note 10, p.17.

<sup>335</sup> *Ibid.*

<sup>336</sup> *Ibid.*

<sup>337</sup> *Ibid.*

this end, the draft proclamation seems to adopt a regulatory model having some of the features of the Government Model, Limited Exchange SRO model, and Strong Exchange model. On the one hand, the draft proclamation establishes the self-regulatory structure and identifies the Authority as a public authority responsible for securities regulation which corresponds to the Government (Statutory) model.<sup>338</sup> This is evident among others in article 6 of the draft proclamation which grants a wide range of powers and functions to the Authority.<sup>339</sup> On the other hand, the draft proclamation allows for the delegation of these powers and functions to SROs. Article 17(1) of the draft proclamation states that the Authority may delegate any of its functions under the draft proclamation to a committee established for a specific purpose, recognized SRO, or an authorized person.<sup>340</sup> This implies that depending on the power to be delegated, an SRO may be a Limited SRO or Strong SRO. Hence, it can be concluded that the draft proclamation adopts a co-regulation whereby the Authority is the primary front-line regulator and SROs have either limited or extensive powers depending on the delegation to be made by the Authority.

### **3.3. Scope of Self-Regulation under the Draft Proclamation**

As identified in Chapter Two, the scope of self-regulation under the draft-proclamation can be identified based on three criteria: the regulatory mandate, monitoring, and enforcement mandate, and scope of government involvement.

#### **3.3.1. Scope of Regulatory Mandate**

The draft proclamation, in its definition of the term SRO, identifies that an SRO has a regulatory mandate to adopt the rules of conduct to regulate its own members.<sup>341</sup> This has the implication that the draft proclamation recognizes that SROs have the mandate to make rules to the extent of regulating their own members, subject to the approval of the Authority.<sup>342</sup> Similarly, the draft proclamation grants security exchange to make rules or procedures of the exchange as it considers necessary or desirable for the proper and efficient regulation, operation, management,

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<sup>338</sup> See, e.g. Articles 6(1), 6(2), 6(3), 6(15) and 6(16) of the Draft Capital Markets Proclamation.

<sup>339</sup> Article 5 of the Draft Capital Markets Proclamation.

<sup>340</sup> Article 17(1) of the Draft Capital Markets Proclamation.

<sup>341</sup> Article 2(64) of the Draft Capital Markets Proclamation.

<sup>342</sup> Article 36 and 42 of the Draft Capital Markets Proclamation.

and control of the exchange and the securities market operated by the exchange.<sup>343</sup>The draft proclamation further grants SDCC to prepare rules and regulations related to the operations of clearing, settlement, and registration of securities and other activities that relate to the company's business, or to amend the same within a certain period.<sup>344</sup> In addition to this statute-based mandate (as the case may be), an SRO has a regulatory mandate based on the delegation to be made by the Authority.<sup>345</sup> However, the mandate to be specified in the rule or its amendments is not automatically applied in the sense that the SRO is required to submit the proposed rule to the Authority for approval.<sup>346</sup>

The scope of the regulatory mandate of SROs depends on the delegation to be made by the Authority to an SRO.<sup>347</sup> Under the Draft Proclamation, the Authority has a regulatory mandate over a wide range of matters which include:

- a. Grant license to any person to operate as a securities exchange, derivatives exchange, securities depository and clearing company, capital market services provider, over-the-counter trading facility or any other activity;<sup>348</sup>
- b. Supervise listing and delisting of securities on a securities exchange;<sup>349</sup>
- c. Regulate and oversee the issue and subsequent trading, both in primary and secondary markets, of capital market instruments;<sup>350</sup> and
- d. Regulate the use of electronic trading platforms for dealing in securities or services ordinarily carried out by a licensed person.<sup>351</sup>

Under the draft proclamation, the Authority can delegate any of its powers other than those relating to directive.<sup>352</sup> A delegation to be made by the Authority on any of the above-stated

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<sup>343</sup>Article 36 of the Draft Capital Markets Proclamation.

<sup>344</sup>Article 42(1) of the Draft Capital Markets Proclamation.

<sup>345</sup>Article 17 and 25(1) of the Draft Capital Markets Proclamation.

<sup>346</sup>Article 36 and 42 of the Draft Capital Markets Proclamation.

<sup>347</sup>Article 17(1) of the Draft Capital Markets Proclamation.

<sup>348</sup>Article 6(1) of the Draft Capital Markets Proclamation.

<sup>349</sup>Article 6(18) of the Draft Capital Markets Proclamation.

<sup>350</sup>Article 6(17) of the Draft Capital Markets Proclamation.

<sup>351</sup>Article 6(15) of the Draft Capital Markets Proclamation.

<sup>352</sup> Article 17(3) of the Draft Capital Markets Proclamation

powers or other powers vested on it by the draft proclamation should specify the function or power delegated to the SRO.<sup>353</sup> It should further state the terms and conditions upon which the delegation may be granted and exercised, as well as the persons authorized to exercise the delegation on behalf of the SRO.<sup>354</sup>

### **3.3.2. Scope of Monitoring and Enforcement Mandate**

Similar to the rule-making mandate, the scope of monitoring mandate of SROs depends on the delegation to be made by the Authority to the SRO.<sup>355</sup> Hence, a delegation to be made by the Authority should specify the monitoring mandate as well.<sup>356</sup> In this regard, under the proclamation, the Authority can conduct off-site surveillance activities and onsite inspections.<sup>357</sup> Further, the Authority has a power to inquire and investigate any person for which a license has been issued and any public company the securities of which are publicly offered or traded on an approved securities exchange or an over-the-counter market.<sup>358</sup> Thus, the Authority may grant any of its monitoring mandates to the SRO. For instance, according to article 18(1) of the draft proclamation, a duly authorized person on behalf of the Authority may, by notice in writing, require any person engaged in activities under the Authorities' jurisdiction to furnish all such returns or information as specified in such notice.

Similarly, the draft proclamation entitles the SRO to take disciplinary action against any of its members in accordance with its rules, if the member contravenes any provisions of the rules.<sup>359</sup> However, the scope of enforcement mandate depends on the delegation to be made by the Authority to the SRO.<sup>360</sup> To this effect, a delegation made should specify the extent of disciplinary powers delegated and the scope of sanctions that may be imposed.<sup>361</sup> The authority has a general power to impose sanctions for breach of the provisions of the draft proclamation or

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<sup>353</sup>Article 24(1) of the Draft Capital Markets Proclamation.

<sup>354</sup>Article 24(3&4) of the Draft Capital Markets Proclamation.

<sup>355</sup>Article 17(1) of the Draft Capital Markets Proclamation.

<sup>356</sup>Article 24(1) of the Draft Capital Markets Proclamation.

<sup>357</sup>Article 6(6) of the Draft Capital Markets Proclamation

<sup>358</sup>Article 6(8) of the Draft Capital Markets Proclamation.

<sup>359</sup>Article 2(64) and 27(1) of the Draft Capital Markets Proclamation.

<sup>360</sup>Article 17(1) of the Draft Capital Markets Proclamation.

<sup>361</sup>Article 24(2) of the Draft Capital Markets Proclamation.

the regulations made thereunder, or for non-compliance with the Authority’s requirements or directions.<sup>362</sup> Such sanctions include levying of financial penalties, remedy or mitigation (restitution or pay compensation), publishing findings of malfeasance by any person; suspending or canceling the license and authorization of the capital market participant, and listing of any securities for the protection of investors.<sup>363</sup> Hence, upon securing a delegation, the SRO may exercise disciplinary powers and impose sanctions as specified in the delegation.

In exercising the delegated disciplinary action, the SRO is required to inform the Authority within two days of the name of the member, the reason and the action taken, the amount of any fine, and the period of suspension if any.<sup>364</sup>

### **3.3.3. Scope of Government Involvement**

Under the draft proclamation, the Authority has a general oversight power over the activities of self-regulatory organizations.<sup>365</sup> The authority has the power to reject any proposed rule and its amendments thereof.<sup>366</sup> It can also suspend the rules of an SRO or require the SRO to amend or enforce its rules.<sup>367</sup> It may object to a change of senior personnel of the SRO.<sup>368</sup> It can remove the officer of an SRO whom it believes is not a fit and proper person or whose appointment or continuing in office is likely to be detrimental to the SRO or interest of investors/consumers/members.<sup>369</sup>

## **3.4. Evaluation of the Relevance and Appropriateness of SROs’ mandates under the Draft Proclamation**

The draft proclamation adopts a co-regulation model constituting regulation by the Authority and SROs. In this regard, it is very important to address the relevance of SRO in the Ethiopian

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<sup>362</sup>Article 6(5) of the Draft Capital Markets Proclamation.

<sup>363</sup>Article 6(5) of the Draft Capital Markets Proclamation.

<sup>364</sup>Article 27(3) of the Draft Capital Markets Proclamation.

<sup>365</sup>Article 6(13) of the Draft Capital Markets Proclamation.

<sup>366</sup>Article 25(1&3) of the Draft Capital Markets Proclamation.

<sup>367</sup>Article 27(7) of the Draft Capital Markets Proclamation.

<sup>368</sup>Article 28(1) of the Draft Capital Markets Proclamation.

<sup>369</sup>Article 29(1) of the Draft Capital Markets Proclamation.

context meaning in an economy that does not have a formal institutional, legal, and policy framework for capital market activities.<sup>370</sup>

The concept of self-regulation is embedded in the notion of decentering. The term ‘decentering’ is a term used to “express the observation that governments do not, and the proposition that they shouldn’t have a monopoly on regulation.”<sup>371</sup> It contends that governments are constrained in their actions and that they are as much acted upon as they are actors.<sup>372</sup> In this regard, some form of self-regulation is seen as a ‘quintessentially decentering regulatory strategy,’ in it lies the solutions to the problems of ‘centered’ regulation.<sup>373</sup> The assumption is that the government cannot know as much about the industry as the industry does about itself.<sup>374</sup> By this, it is not alleged that one actor has all the information necessary to solve complex problems like those that might be encountered in capital markets.<sup>375</sup>

However, in the Ethiopian context, it is difficult to determine who has specialized knowledge on the subject matter. Clearly, the non-existence of the capital market has not created the opportunity for the development of specialized knowledge for both the public and private sectors. Here it is important to understand the dynamic of relationship embraced in the new understanding of regulation which is the interdependencies and interactions that exist between the government and social/private actors.<sup>376</sup> It is not the case that society has needs (problems) and the government has capacities (solutions); rather, each should be seen as having both problems (needs) and solutions (capacities) and as being mutually dependent on each other for their resolution and use.<sup>377</sup>

The above conception of ‘decentralizing’ is of paramount significance to the Ethiopian context. The issues of specialized knowledge, lack of expertise, and lack of resources are the problem of

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<sup>370</sup>Ruecker, *supra* note 5, p.27.

<sup>371</sup>Julia Black, “Decentering Regulation: Understanding the Role of Regulation and Self-regulation in a Post Regulatory World,” in *Current Legal Problems* (2001), p.103.

<sup>372</sup>*Id.*, p.104.

<sup>373</sup>*Ibid.*

<sup>374</sup>*Id.*, p.107.

<sup>375</sup>*Ibid.*

<sup>376</sup>*Id.*, p.110.

<sup>377</sup>*Ibid.*

both sectors which ought to be solved through cooperative undertakings. Hence, self-regulation is important to Ethiopia as it creates the platform for the cooperation and mobilization of resources for a tenable regulation of capital markets. Self-regulation permits the government to influence behavior without becoming intimately involved in an industry.<sup>378</sup> It allows for regulation that would not otherwise be possible in practical terms due to restraints on resources, whether financial, personnel, or expertise.<sup>379</sup>

Another most interesting aspect of ‘decentering’ resides in the claim that the public/private distinction is in the collapse.<sup>380</sup> The collapse of the public/private distinction as a useful tool for analyzing governance and regulation is manifested in the identification of ‘hybrid’ systems that combine governmental and non-governmental actors in a variety of ways.<sup>381</sup> This is visible under the draft proclamation setting aside other economic situations. Under the draft proclamation, the government acts as a private actor in two major ways. First, the draft entitles the government to hold a share amount not exceeding 25% in the Ethiopian Securities Exchange.<sup>382</sup> Note worthily, this share allocation may extend to “whatever amount” if there is insufficient interest from the private sector.<sup>383</sup> In addition to this, the government will act as either an issuer of securities or a buyer of new/existing issues, including bond exchanges. At the same time, the government exercises its regulatory power through the capital markets authority.

The government stance as a private and public actor under the draft proclamation has a wider implication. For instance, the capital markets regulation in other countries (such as the US and UK) was initially governed by the market itself, and eventually, the government involvement increased to curb some of the pitfalls of the self-regulation (especially, conflict of interest and violation of investor rights). On the contrary, the development of the capital markets differs in the Ethiopian context. The market was not given the chance to develop by itself and regulate itself. Rather, it is being developed by the government which desires to act as a private actor on

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<sup>378</sup>Margot Priest, “The Privatization of Regulation: Five Modes of Self-Regulation,” Ottawa Law Review, Vol. 29, No. 2 (1997), p.268.

<sup>379</sup>Ibid.

<sup>380</sup>Black, supra note 371, p.110.

<sup>381</sup>Ibid.

<sup>382</sup>Article 32(2) of the Draft Capital Market Proclamation.

<sup>383</sup>Article 32(3 and 4) of the Draft Capital Market Proclamation.

the one hand and a public actor on the other hand. So, if there is an argument that self-regulation should be ousted and the government should be the sole regulator, the capital markets would be exposed to failure, possibly due to the conflict of interest and the lack of commitment to execute and enforce any matter contrary to the interest of the government. Therefore, when viewed through the decentered regulation lens, the legislator should not think in terms of using just one regulatory instrument to address, but of using a range of instruments in a combination,<sup>384</sup> especially noting the Ethiopian context.

In general, self-regulation (in its co-regulation form) offers several opportunities for the establishment of a well-developed capital markets in Ethiopia. SROs would ensure more compliance of the proclamation and other laws by regulating their respective members under the auspices of the Authority.

The major features of the draft proclamation with respect to the self-regulatory scheme will be discussed below.

One of the features of the draft proclamation is that it adopts a mandatory system whereby every SRO's authority emanates from the statute (exchanges and SDCC) and regulator (SROs recognized upon application). The draft proclamation has a positive implication in the adoption of a mandatory SRO system. As opposed to this system, one set of definitions assumes that pure 'self-regulation' is some form of collective exercise on the part of non-state actors that is voluntarily initiated.<sup>385</sup> This has been counter-argued as "there is nothing voluntary about self-regulation" rather voluntary self-regulation is construed as setting "voluntary codes" similar to non-legal rules.<sup>386</sup> However, in the case of capital markets, it is advised to adopt a mandatory system that determines the status and nature of the SROs. This is evident in the historical development of self-regulation where pure self-regulation resulted in conflict of interest, and gross violation of investors, and overall financial crises.

Another issue for discussion here is whether the regulatory mandate/function of SROs should emanate from statute (i.e., the legislator) or the regulator (i.e., executive). A common feature of

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<sup>384</sup>Black, supra note 371, p.113.

<sup>385</sup>Ibid, p.116.

<sup>386</sup>Ibid.

securities regulatory systems is the widespread use of SROs to carry out regulatory functions<sup>387</sup> that may arise out of a statute or regulator. In statutory self-regulation, the government delegates its power through legislation.<sup>388</sup>In such a model, the SRO is established by statute, which delegates a range of power to the SRO (at the very extreme this may include rulemaking, monitoring, enforcement, and sanctions).<sup>389</sup>On the other hand, in a supervised self-regulation, the delegation is made by the oversight body either at its discretion or according to the public interest criteria.<sup>390</sup>

The main difference between the two is that, unlike the supervised self-regulation, the statutory self-regulation model is not subject to the continuous oversight of a government agency.<sup>391</sup> Government control is primarily found in the structuring of the statute that delegates power to the SROs and is often found in the power to approve regulations or bylaws established by the SRO.<sup>392</sup> The hallmark of statutory self-regulation is the relatively large degree of autonomy delegated to the SRO to regulate its individual members.<sup>393</sup> Unlike statutory self-regulation, however, in the supervised self-regulation model, there is continuous oversight by a specialized government body.<sup>394</sup> There are a number of points at which the supervisory body can exert control, including approvals of certain decisions, investigations, appeals, reports, and imposition of legally binding rules.<sup>395</sup> The supervised-self-regulation model has a potential duplication of regulatory efforts by SRO and supervising agency.<sup>396</sup>

In this regard, the regulatory mandate (including enforcement and monitoring mandate) of SROs, under the draft proclamation, is mainly contingent upon a delegation to be made by the

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<sup>387</sup>Ana Carvajal and Jenifer Elliot, “Strengths and Weaknesses in Securities Market Regulation: A Global Analysis,” IMF Working Paper No. 259, (2017), p.18.

<sup>388</sup>Priest, *supra* note 378, p.242.

<sup>389</sup>*Id.*, p.251.

<sup>390</sup>*Id.*, p.242.

<sup>391</sup>*Id.*, p.252.

<sup>392</sup>*Ibid.*

<sup>393</sup>*Ibid.*

<sup>394</sup>*Id.*, p.260.

<sup>395</sup>*Ibid.*

<sup>396</sup>*Id.*, p.276.

regulator.<sup>397</sup> Indeed, the draft proclamation implies some regulatory mandate (rulemaking on certain matters) to be given to the SRO.<sup>398</sup> But, the main source of regulatory, monitoring, and enforcement mandate is the delegation made by the Authority.<sup>399</sup>

Delegation of regulatory powers to SROs in the capital market is a common trend especially in common law countries, though it takes various forms. The India Securities Act grants the Securities and Exchange Board (a government regulatory body) the right to delegate to any of the Board members or any other person subject to such conditions any of its regulatory power (excluding those relating to the matters of the Board).<sup>400</sup> The Australian Securities and Commission (ASIC) Act grants the ASIC, which is a commonwealth entity, to delegate to a “person all or any of its functions and powers”.<sup>401</sup> Similarly, the US Exchange Act of 1934 grants the Commission to delegate any of its functions to a “division of the Commission, an individual Commissioner, an administrative law judge, or an employee or employee board, including functions with respect to hearing, determining, ordering, certifying, reporting, or otherwise acting as to any work, business, or matter.”<sup>402</sup>

Although the delegation of powers is a common trend in the regulation of capital markets, some concerns can be raised regarding the draft proclamation. First, the draft proclamation seems to entitle the Authority to delegate its powers to each SRO.<sup>403</sup> In other word, an SRO is given a special delegation to exercise regulatory functions. The concern here is that the Authority may

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<sup>397</sup>Article 17 of the Draft Capital Markets Proclamation.

<sup>398</sup> These matters include management structures and shareholding rights of the self-regulatory organization taking into consideration the interests, rights and liabilities of its members, consumers, investors, and users of their services; rules of membership and conditions for approval and admission of members; and the rules and procedures of self-regulatory organization with respect to reporting and accountability to any primary regulator other than the Authority. Article 25(2) of the Draft Capital Markets Proclamation.

<sup>399</sup>Cumulative reading of Article 17 and 24 of the Draft Capital Markets Proclamation.

<sup>400</sup>Section 19 of the Securities and Exchange Board of India Act, No.15 1992.

<sup>401</sup> Note that the ASIC may be required to obtain an approval from a certain authority to delegate its powers to certain type of persons. For instance, it is required to obtain an approval of the Minister before delegating its power to a member or staff member. Section 102 of the Australian Securities and Investments Commission Act No.51, 2001 (As compiled on 23 June 2020).

<sup>402</sup>Section 4A. [78d-1)(a) of the Securities Exchange Act of 1934

<sup>403</sup>Cumulative reading of Article 17 and Article 24 of the Draft Capital Markets Proclamation.

arbitrarily delegate its powers. For example, it may potentially delegate a broader power to the Ethiopian Securities Exchange (as the government is a shareholder) and may give a lesser power to other exchanges or even deny delegation. The draft proclamation may address this concern by setting objective standards and by giving the Authority an option to enact an objective general order that applies to certain persons/entities. For instance, the India Securities Act grants the Securities and Exchange Board to make the delegation either through general or special order. Accordingly, the Board has enacted the Delegation of Powers General Order (no.01, 2019).<sup>404</sup> Similarly, the US Securities and Exchanges Commission may either delegate its power through order or rule.<sup>405</sup>

Second, the fact that the Authority may revoke a delegation at any time has an adverse impact on the operation of SROs.<sup>406</sup> This does not mean that the Authority should not entirely revoke a delegation; instead, the argument is that the reasons/causes (such as violations of the draft proclamation) leading to or the principles necessitating (as specified in article 5 of the draft) the revocation should be specified by statute. Otherwise, the SRO is being regulated on subjective standards and undermined as a tool of co-regulation and co-operation.

In general, the delegation provided under the draft proclamation does not align with the broad discretionary power exercised by the Authority. Under the draft proclamation, the Authority has a general oversight power over the activities of self-regulatory organizations.<sup>407</sup> The authority has the power to reject any proposed rule and its amendments thereof.<sup>408</sup> It can also suspend the rules of an SRO or require the SRO to amend or enforce its rules.<sup>409</sup> It may object to a change of and can remove senior personnel of the SRO.<sup>410</sup> Setting aside these powers, the Authority determines the regulatory, monitoring, and enforcement mandate of the SRO without much statute direction on the manner of delegation. The draft proclamation seems to adhere to the

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<sup>404</sup>Section 19 of the Securities and Exchange Board of India Act, No.15 1992.

<sup>405</sup>Section 4A. [78d-1)(a) of the US Securities Exchange Act of 1934 (as amended in 2018)

<sup>406</sup>Article 17(4) of the Draft Capital Markets Proclamation.

<sup>407</sup>Article 6(13) of the Draft Capital Markets Proclamation.

<sup>408</sup>Article 25(3 and 4) of the Draft Capital Markets Proclamation.

<sup>409</sup>Article 25(2) of the Draft Capital Markets Proclamation.

<sup>410</sup>Article 28 and 29 of the Draft Capital Markets Proclamation.

classic command and control regulation in which the government has a high level of involvement or sole involvement in rulemaking, inspections, enforcement, and adjudication.<sup>411</sup>

As it stands the draft proclamation has the potential of affecting some of the inherent benefits of self-regulation. One of the arguments in favor of self-regulation is that it should be flexible in the sense that decisions are made quickly and easily adjusted to meet changing circumstances, in contrast to the relatively slow and ponderous bureaucratic process of government.<sup>412</sup> However, under the draft proclamation, SROs are not flexible to quickly respond to market changes as their rule should be approved by the Authority which can take a longer duration.

Scholars have considered public involvement to be crucial for the development of financial markets and, therefore, the public sector has a key role to play: designing the rules that may be enforced.<sup>413</sup> However, as the IOSCO principles require, the legal and regulatory framework of SRO should ensure an appropriate use of them as well as adequate oversight.<sup>414</sup> Capital markets cannot flourish without an appropriate legal framework that reduces subjective decision making and encourages transparent and objective enforcement of laws and related regulatory framework.<sup>415</sup> However, the draft proclamation creates an environment where the Authority may make decisions, subjectively.

Another issue that ought to be discussed is the scope of government involvement in SRO activities under the draft proclamation. The scope of government involvement can be assessed based on three major notions. First, government involvement should be to ensure public interest.<sup>416</sup> In this regard, the draft proclamation notably recognizes the major principles of government regulation, which are protecting investors, ensuring fair and orderly capital markets system, reduce systematic risk and creating an enabling environment for long term investment.<sup>417</sup> Similarly, SROs are expected to adopt and enforce fair, ethical and efficient practices with a

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<sup>411</sup>Priest, supra note 378, p.237-238, and Article 6, 7 and 23 of the Draft Capital Markets Proclamation.

<sup>412</sup> Priest p.269

<sup>413</sup>Ibrahim, supra note 69 p.14

<sup>414</sup>Carvajal and Elliot, supra note 387, p.37.

<sup>415</sup>Kiflework, supra note 23, p.46.

<sup>416</sup>Priest, supra note 378, p.271.

<sup>417</sup>Article 5 of the Draft Capital Markets Proclamation.

view of promoting the protection of investors and the public interest.<sup>418</sup> So, if SROs fail to regulate in such a manner, the Authority should rectify the failure. To this effect, under the draft proclamation, the Authority is mandated *inter alia* to develop plans for dealing with SRO's failures,<sup>419</sup> ensure the financial and administrative resources of the SRO,<sup>420</sup> take administrative measures against SROs,<sup>421</sup> review decisions of an SRO upon an application by an aggrieved person,<sup>422</sup> and direct the SRO and take disciplinary actions against the members of the SRO.<sup>423</sup>

Second, the Government should address "under-regulation" that may arise from the self-regulation because of a lack of enthusiasm on the part of industry members or due to conflicts of interest.<sup>424</sup> In this regard, the regulator has an exclusive power over the issuance of directives.<sup>425</sup> The granting of this power addresses the risk of "under-regulation" posited by self-regulation and avoids the duplication/overlap of regulatory mandate. The draft proclamation also tries to address the risk of "under-regulation". It obliges SROs to develop a rule on various subject matters including management structure and shareholding rights, anti-competitive practices, procedures to address potential conflicts, and standard of behavior for its members.<sup>426</sup> Further, article 26 of the draft proclamation, prohibits an SRO from making a decision which adversely affect the rights of a person unless the SRO has given the concerned person an opportunity to be heard and considers that a delay will prejudice a class of consumers.<sup>427</sup>

Third, government involvement should ensure accountability.<sup>428</sup> The draft proclamation puts various mechanisms for monitoring SROs. Significantly, the draft proclamation requires SROs to submit a report to the Authority.<sup>429</sup> The annual report, which should include a report on corporate

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<sup>418</sup>Article 2(64) of the Draft Capital Markets Proclamation.

<sup>419</sup>Article 6(4) of the Draft Capital Markets Proclamation.

<sup>420</sup>Article 23(4) of the Draft Capital Markets Proclamation.

<sup>421</sup>Article 6(5) of the Draft Capital Markets Proclamation.

<sup>422</sup>Article 27(4) of the Draft Capital Markets Proclamation.

<sup>423</sup>Article 27(5) of the Draft Capital Markets Proclamation.

<sup>424</sup>Priest, *supra* note 376, p.272.

<sup>425</sup>Article 17(3) of the Draft Capital Markets Proclamation.

<sup>426</sup>Article 25 of the Draft Capital Markets Proclamation.

<sup>427</sup>Article 26 of the Draft Capital Markets Proclamation.

<sup>428</sup>Priest, *supra* note 376, p.273.

<sup>429</sup>Article 30(1) of the Capital Markets Proclamation.

governance (policy and practice) and financial statements, is to be audited by an external auditor.<sup>430</sup> Further, an SRO is required to inform the Authority of any disciplinary action against a member.<sup>431</sup> The draft proclamation also allows the Authority to undertake on-sight and off-site monitoring to the extent of using police officers, prosecutors, and auditors.<sup>432</sup> It may also conduct administrative investigation and obtain data (including testimonies) from any person whether regulated or unregulated (including SROs).<sup>433</sup> Similarly, the Authority can request any person engaged in the capital markets to furnish information.<sup>434</sup>

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<sup>430</sup>Article 30(2) of the Draft Capital Markets Proclamation.

<sup>431</sup>Article 27(3) of the Draft Capital Markets Proclamation.

<sup>432</sup>Article 6(6&7) of the Draft Capital Markets Proclamation.

<sup>433</sup>Article 6(19) of the Draft Capital Markets Proclamation.

<sup>434</sup>Article 18 of the Draft Capital Markets Proclamation.

## **4. Chapter Four: Conclusion and Recommendations**

### **4.1. Conclusion**

Recently, the Ethiopian government is in the process of setting-up the country's first stock market by 2020. To this effect, a draft proclamation entitled, "Capital Markets Establishment Proclamation No.--/2020" has been approved by the Council of Ministers. The draft proclamation offers a wide range of benefits to the Ethiopian economy as it establishes capital markets.

The most interesting feature of this draft proclamation is that it provides for co-regulation constituting government-regulation and self-regulation. Particularly, the form of self-regulation under the draft proclamation is a co-regulation and mandatory model whereby exchanges/SDCC are recognized as SRO and other actors may be recognized as such upon authorization from the Authority. Therefore, under the draft Capital Markets Proclamation all type of SROs, except independent SROs, may act as an SRO. The draft Capital Markets Proclamation does not recognize independent SROs as these SROs are independent of market operators and government. It can be concluded that the draft proclamation adopts a co-regulation whereby the Authority is the primary front-line regulator and SROs have either limited or extensive powers depending on the delegation to be made by the Authority.

Meanwhile, the scope of self-regulation (i.e. regulatory, monitoring and enforcement mandate) is significantly dependent upon a delegation made by the Authority, though the draft gives a regulatory and enforcement mandate on certain matters. Although the delegation of powers is a common trend in the regulation of capital markets, some concerns can be raised regarding the draft proclamation. First, the draft proclamation seems to entitle the Authority to delegate its powers to each SRO. The concern here is that the Authority may arbitrarily delegate its powers. Second, the fact that the Authority may revoke a delegation at any time has an adverse impact on the operation of SROs. The concern here is that the SRO is being regulated on subjective standards and undermined as a tool of co-regulation and co-operation. The draft proclamation seems to adhere to the classic command and control regulation in which the government has a high level of involvement or sole involvement in rulemaking, inspections, enforcement, and adjudication.

The assessment made on the form and scope of self-regulation under the draft proclamation shows that the draft proclamation has merits in providing for the recognition of SROs instead of solely depending on government regulation. Self-regulation is relevant in the Ethiopian context as it provides a tool for cooperative regulation of capital markets that foster compliance, accountability, and efficiency. Further, the draft proclamation adopts various modalities to ensure the proper operation of organizations having a self-regulatory power. However, some of the provisions of the draft proclamation undermine the benefits offered by self-regulation. The subjective standards applied in some of the mandates given to the Authority over SROs would affect the flexibility and undermine the specialized knowledge offered by the private sector. In conclusion, the government should adopt a more flexible self-regulation under a supervised-government regulation.

## 4.2. Recommendations

To this end, the researcher hereby makes the following recommendations relating to the draft proclamation:

1. Grant the option of making a general delegation under article 17 and/or 24 and the conditions that should be met to benefit from the general delegation to allow the Capital Markets Authority to delegate its power for specific entities (for instance, the general delegation may be availed to exchanges which satisfy certain capital and resource requirements). Alternatively, the legislator may oblige the Capital Markets Authority to develop a directive/guideline to the same effect.
2. Specify the conditions and circumstances for which a delegation may be revoked by the Capital Markets Authority instead of vesting a broad and discretionary power. In plain words, adopt an objective standard for the revocation of delegation made to an SRO. (Article 17(4)).
3. Add provisions that specify the monitoring mandate of SROs (such as, internal surveillance and internal inspections) to give it a statute-based-mandate rather than making it contingent upon the regulator.
4. Specify the objectives sought in imposing directions under Article 27(7&8) as this would ensure an objective implementation of the provision.
5. Adopt a mechanism whereby the Authority and SROs collaborate on their respective activities (through a directive or action plan) in order to establish a co-operation platform to ensure compliance.
6. Ensure that the Authority has full capacity and resources to curb the inherent risks of self-regulation (including, conflict of interest and “under-regulation”).

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