Press Release

CDSC Admitted as the Fourth Firm to the CMA Regulatory Sandbox

Nairobi, 08 April 2020…The Capital Markets Authority (CMA) has announced the admission of the Central Depository and Settlement Corporation (CDSC) to the Regulatory Sandbox to test its proposed screen-based Securities Lending and Borrowing (SLB) platform for a period of five months from 07 April 2020.

The CMA Acting Chief Executive, Mr. Wyckliffe Shamiah, lauded CDSC for their contribution to enhancing liquidity in the capital markets through their SLB model, which has enormous potential, if successful.

Mr. Shamiah observed, ''Making the Kenyan capital markets vibrant and liquid is a key priority for the capital markets industry, which is aligned to the ambitions of the Regulatory Sandbox to facilitate this through innovative solutions''. While the Capital Markets (Securities Lending, Borrowing and Short-Selling) Regulations 2017 envisages a bilateral model of SLB, the test of the Screen-based model will ensure that any investor can perform an SLB transaction through approved Central Depository Agents. If the test is successful, the current Securities Lending and Borrowing Regulations will be amended to include the screen-based model and address other issues which have hampered the uptake of the bilateral SLB product.

Mr. Shamiah added that the CDSC initiative is aligned to the Authority's mandate of promoting the development of Kenya's capital market to be an investment destination of choice through facilitative regulation and innovation anchored in the Strategic Plan (2018-2023) and the Capital Market Master Plan (2014-2023).

CDSC is the fourth firm to be admitted to the Regulatory Sandbox. Others include Innova Limited and Pezesha Africa Limited. Innova is testing its cloud-based data analytics platform, while Pezesha is testing an internet-based crowd-funding platform through which investors can provide loan facilities for Small and Medium Enterprises.

''The Regulatory Sandbox allows live testing of innovations under a less onerous regulatory regime and is expected to attract fintech companies and existing capital markets licensees to test the application of technology to financial services'', added Mr. Shamiah.

Sandbox participants are required to comply with minimum regulatory requirements prescribed by the Regulatory Sandbox Policy Guidance Note (PGN) such as submission of test plans, which outline key test objectives, testing metrics, performance indicators, safeguards and remedial measures for test clients.

The Regulatory Sandbox was facilitated through approval of the PGN in March 2019, which indicates that the Authority can revoke or suspend an approval to participate in the Regulatory Sandbox at any time before the end of the test period and can take enforcement action against a participant in breach of the regulatory requirements.

Upon exit from the Sandbox, participants could be granted a license or approval to operate in Kenya subject to compliance with existing legal and regulatory requirements. The Authority may in the alternative grant permission to operate in Kenya subject to compliance with the terms of a letter of no objection. Mr. Shamiah observed, ''where there is need for a broader legal or regulatory reform, we may adopt new regulations, guidelines or notices pursuant to Section 12 and 12A of the Capital Markets Act, based on insights gained from the Regulatory Sandbox test.'' A denial of permission to operate in Kenya under prevailing legal and regulatory requirements may also be issued.

The Regulatory Sandbox is not an incubation center, physical or virtual space. It is not applicable for proposed products, services or business models that are already addressed under existing laws and regulations.

ENDS

SECURITIES LENDING AND BORROWING (SLB)

This is the temporary transfer of securities from one party to another, with a simultaneous formal agreement to return the securities at a pre-agreed price either on demand or at an agreed date in the future. Full legal title to the securities is transferred from the lender to the borrower so that the securities can be used entirely as the borrower desires, including selling them onward to others. SLB transactions are governed by the terms of securities lending agreements aligned to terms and conditions as agreed by the parties and in line with international best practice. Lenders and borrowers will always have unique characteristics that cause them to either remain on the borrowing side or lending side. Borrowers are market participants who identify trading opportunities that will more than make up for the lending fee costs. Most borrowers are therefore active market participants who take advantage of price movements. They include market makers, arbitragers, directional short sellers or players in the derivatives and Exchange Traded Funds markets.

Unlike borrowers, lenders are usually institutional investors, particularly pension funds and insurance companies, that are long or medium term investors in the securities. We also have high net worth individual investors whose interest is to grow the value of their portfolios over the medium to long term. They therefore lend securities in order to earn a lending fee and increase the return on their portfolio.

The loaning of securities may be for a fixed term, or at times may be left open so that securities can be recalled by the lender or returned by the borrower as and when necessary. The structure of

SLB involves three parties i.e. the lender, lending agent and the borrowers. The impetus to lend securities stems from a desire to increase the financial performance of the funds while creating minimal risk to the funds. Lending agents provide support services to lenders. They maintain a pool of assets available for lending and cut on administrative costs for the lenders.
The above set up improves liquidity by unlocking securities to facilitate trades and subsequently increasing the number of transactions.

Under normal circumstances, the securities to be returned by the borrower are not required to be the same, i.e. same registration number, and rather will be what is referred to as *wholly equivalent*. *Wholly equivalent* means the returned securities are of equivalent value/maturity or the same number and counter. An effective SLB programme needs to address the potential lender's risk if the borrower fails to return the borrowed securities. Normal practice is therefore that securities lending is always accompanied by collateral from the borrower. The collateral is thus used to mitigate the credit risk between the counterparties. The collateral may be delivered to the lender, or to a person acting as an agent for the borrower or be maintained within separate accounts by the borrower on behalf of the lender. The collateral is usually in the form of cash or liquid securities.

With regards to the economic interests of the lender, it is important to note that lenders have a medium to long term horizon which is tied to the return on his/her holdings. It is therefore in their interest to ensure that as much as the securities are loaned to the borrower and the legal title transferred to the borrower, they seek to retain the economic interests in the same such as those related to voting rights for equities. Securities loans are therefore constructed in a way to enable the lender to continue enjoying all the economic benefits of ownership of the securities, during the period of the loan. That means that even though the dividends and interest are paid to the borrower, the borrower is under obligation to pass them to the lender at an appointed time. Lenders are equally exposed to investment risks such as rise and fall in the value of those securities as well as default risk by the issuer.

BACKROUND INFORMATION ON THE CAPITAL MARKETS AUTHORITY

The Capital Markets Authority was set up in 1989 as a statutory agency under the Capital Markets Act Cap 485A. It is charged with the prime responsibility of both regulating and developing an orderly, fair and efficient capital markets in Kenya with the view to promoting market integrity and investor confidence. The regulatory functions of the Authority as provided by the Act and the regulations include; Licensing and supervising all the capital market intermediaries; Ensuring compliance with the legal and regulatory framework by all market participants; Regulating public offers of securities, such as equities and bonds & the issuance of other capital market products such as collective investment schemes; Promoting market development through research on new products and services; Reviewing the legal framework to respond to market dynamics; Promoting investor education and public awareness; and Protecting investors' interest. For more information, please contact Antony Mwangi, Head of Corporate Communications on amwangi@cma.or.ke