CBN ECONOMIC & FINANCIAL REVIEW, VOL. 39 NO. 1 1-19

THE PERFORMANCE OF THE NIGERIAN CAPITAL MARKET SINCE DEREGULATION IN 1986

BY

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ABSTRACT

The capital market in Nigeria had been influenced by various factors which are associated with the level of development of the Nigerian economy. The paper discusses the development of the capital market with emphasis on the period since deregulation in 1986. The institutions that are crucial for the delivery of financial services in the market were analysed with focus on their evolution, performance and prospects. The market in Nigeria was compared with other emerging markets with the conclusion that the market, remains shallow and without the expected variety that characterised markets in countries at similar level of development. The prospects of the market appear to be bright considering the current posture of the government in the areas of privatization and commercialisation of government enterprises. Also, with appropriate regulatory framework that would guide the operators more effectively, the market could assume the expected role of providing long-term financing for the development of the economy.

1. INTRODUCTION

The role of capital in the production process and economic performance of a nation has long been recognised. Capital provides the impetus for the effective and efficient combination of factors of production to ensure sustainable economic growth. Moreover, the effective utilization of productive resources accumulated over time would determine the pace of growth of an economy. Growth in productive activities and its distribution determines the social well being of the population. Capital formation, however, can only be achieved through conscious efforts at savings

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mobilization and accumulation of resources by both the public and private sectors of an economy. The unique position of the capital market could, therefore, be appreciated from this perspective. Financial markets generally provide avenue for savings of various tenors that are made available for utilization by various economic agents. The capital market, which is a major segment of financial markets, provides a setting through which medium to long-term resources are provided for productive utilization.

The objective of the paper is to appraise the Nigerian Capital Market since 1986 when the liberalisation policy was introduced. The introduction of the Structural Adjustment Programme (SAP) in 1986 put pressure on the Nigerian capital market. This was in response to the high interest rates in the money market, which led enterprises in the private sector to partronise the capital market for equity capital. As a result, greater opportunities for private investors who wanted to borrow from the capital market were created.

The response of the Nigerian capital market to these developments is therefore the thrust of this paper.

Accordingly, the rest of the paper is structured into five parts. The theoretical and conceptual issues are treated in part 2, performance appraisal of the market using some of the market indicators is done in part 3, and problems and prospects are discussed in part 4. The last part contains the summary, conclusion and recommendations

2.0 THEORETICAL AND CONCEPTUAL ISSUES: THE ROLE OF THE CAPITAL MARKET IN ECONOMIC DEVELOPMENT

Financing the savings - investment gap, especially, in the less developed economies where savings mobilization could not keep pace with the level of investment, has necessitated the need to encourage foreign capital inflows in order to bridge the gap and thus promote economic growth. This is in line with the general belief that in the absence of domestic saving which is the source of needed capital, the encouragement of foreign capital inflows is more likely to have a positive influence on the development process. This involves the convertion of domestic and foreign resources into tangible and intangible productive assets that would improve the overall output of the economy. These resources would also need to be structured into acceptable tenors (Short, Medium and Long) so as to promote development. Therefore, the cardinal roles expected of the money and capital markets are to provide such investible funds. The capital market in particular contributes to economic development through the provision of the required resources which are within the medium to the long term spectrum. The capital market also provides veritable avenue for private enterprises to raise investible funds for expansion and other long-term purposes.

Portfolio theory considers the efficiency of the capital market based on its ability to respond to market information. A market could either be strong, semi - strong or weak in form. The efficient market hypothesis describes an efficient market as one where security prices fully and speedily reflect available information. Strong market, reflects totally the information on the performance of the listed company which then impacts on the pricing of such company's shares while semi strong and weak markets have some degree of imperfections in the ability of the price to respond to the information on such shares. The relevance of the efficient market hypothesis with respect to quoted companies is that the hypothesis holds true when the company's 'real' financial position is reflected in its share price.

Many development economists consider investment as the most important factor in the growth process. Rostow (1961) in his work defined the 'take off' of an economy into a sustained level in terms of a critical ratio of investment to national output. Arthur Lewis (1955) described the process of development as one of transforming a country from being a low saver and investor to a high saver and investor. It is conventional for economic planners to calculate fairly accurate ratios of investment to national income that will be required either to achieve a particular rate of growth or to prevent capital per head or income per head from falling.

The computation involves assumptions about the normal relationship between capital and output, a relationship usually expressed in the concept of capital output ratio. H. G. Johnson (1969) considers capital accumulation in its widest sense as the distinguishing characteristic of development and the structural transformation of economies as a process of capital accumulation.

The conditions for development consist, in the main, sustainable capital accumulation over time and creation of social and economic environment that guarantees effective utilization of capital resources. Also of relevance for policy analysis is the incremental capital output ratio (ICOR), which is critical for estimating the level of investment that would sustain, given level of output? The use of ICOR for estimating investment outlay for a given level of output was inspired by Harrod (1939) and Domar (1947). Although, their work was originally designed to establish the condition for equilibrium growth, their equations have been manipulated for various alternative uses.

The Harrod-Domar equation predicts an inverse relationship between growth and ICOR, but since ICOR is assumed constant in the long run, it is ICOR that influences growth and not the other way round. Reddway (1962) had a divergent view on the relevance of ICOR in predicting growth. He suggested that before calculating the additional capital requirement for a target growth rate, it would be prudent for a developing economy to assess the level of output that might be expected from increased utilization of existing factors and better methods applied to existing stock of capital.

The roles of financial institutions are critical in economic development as they engage in facilitating reliable payments system, mobilising savings, allocating credit and diversifying risks (Haley and Schel, 1973). Capital market institutions in particular are in position to encourage investment, as investors are able to borrow funds and invest more than they would have done without such institutions. The institutions are thus able to pool savings and direct them into viable investment outlets (Copeland and Weston, 1980).

The issue of creating a reliable capital market for development revolves around the emergence of enabling environment which allows competition to flourish. As Lowy et al (1996) noted, creation of an acceptable climate for investment is critical for development. Such climate has certain prerequisites which include a freely convertible currency; effective legal and institutional framework, reliable accounting standards and a system of regulation that protects consumers but does not otherwise inhibit competition.

The reforms in the Nigerian capital market attempt to address some of the issues enumerated by Lowy et al (1996). The recent report on the market recognised the need for an enabling environment while competition is being addressed through the establishment of additional stock exchanges and capital trading points.

3.0 PERFORMANCE OF THE NIGERIAN CAPITAL MARKET SINCE 1986:

An evaluation of the performance of the Nigerian Capital Market from 1986 - 1999 is done in this section, using some of the generally accepted criteria, which include:

(i) Number of listed companies;

(ii) Number of listed securities;

(iii) Size of the market or market capitalization; and

(iv) All-share price index, which is a measure of the performance of the market.

The analysis of the major indicators of activity in the capital market showed that the market has experienced remarkable progress since 1986. Transactions in equities in the market based on its current level of development could be considered to be weakly formed as the level of information dissemination and processing to influence market behaviour remained weak. However, with the computerization of trading and increased transparency in delivery of corporate information, the market has become more efficient. Transactions in the market recorded increases in the number of listed securities, companies, market capitalization and price index during the period under review. The improved performance of all four key indicators was traceable largely to the establishment of the second-tier securities market (SSM) in 1985 and the deregulation of interest rates in 1987, coupled with the privatization of some government owned companies in 1991. Eighteen (18) government parastatals (16 Federal and 2 state government-owned), contributed to the increased tempo in the number of companies and new securities issued and listed in the market. Furthermore, the deregulation of interest rates made many private enterprises/ investors to patronise equity market to source funds as bank lending became relatively more expensive. The number of companies listed on the exchange (equities) grew by 95.0 per cent from 100 at the beginning of 1988 to 195 at end-December, 1999. The number of total securities listed and traded also increased from 244 in 1987 to a peak of 276 in 1996 before declining to 268 in 1999. Some of the major securities traded on the market during the period were government development stocks, corporate bonds/debentures and equities. As at end-December 1999, securities listed and traded on the market were made up of 15 government bonds, 58 corporate bonds/debentures and 195 equities.

The growth of listed companies coupled with greater awareness on the part of investors resulted in increase in the number of securities issued and traded in the market. This also contributed to the increase in market capitalisation, which grew from 8.3 billion or 7.6 percent of GDP in 1987 to 294.1 billion or 8.7 percent of GDP at the end of 1999.

The number of listed companies on the Nigerian Stock Exchange is comparable with those of many emerging markets. Though capital listing was higher than in most stock markets in Africa, it fell below some other emerging markets of Asia and Latin America. For example, out of the 17 stock markets in Africa, Nigeria had the third largest number of equity listings of 183 in 1998, surpassed only by Egypt (650) and South Africa (642). Nigeria also had a higher number than Poland (143), Jordan (139), Argentina (136) and Venezuela (91). It, however, recorded fewer listings compared to India (5843), Brazil (536); Malaysia (780); Indonesia (282) and Turkey (257). Further insight into the performance of the market showed that share-price indices rose during the period under review. The observed upward trend of share prices in the stock market was an indication of relative prosperity in the economy. The all-share price index grew by 22 per cent in 1988, 38 per cent in 1990, 33.9 per cent in 1995 but dropped in 1998 and 1999.

Activities in the new issues market improved during the review period. The entry of some corporate entities into the Nigerian capital market after the deregulation of the market contributed to the upsurge witnessed in the market. Between 1988 and 1998, new issues grew remarkably from 400 million to 15,018.1 million in 1998, but fell to 12,038.5 million in 1999. On the aggregate, 355 new issues of 28,527.9 million shares valued at 56994.0 million were offered for subscription between 1990 and 1999.

Transactions in the secondary market also showed remarkable growth. A total of 1,528.4 million shares valued at 37,488.8 million in 5,855.7 deals were traded between 1988 and 1998. Transactions on the Nigerian Stock Exchange (NSE) grew from 21.5 million shares valued at 249.5 million in 1988 to 33.4 million shares worth 553.2 million at the end of 1990. By 1995, the total volume of shares traded on the market had risen to 396.91 million shares valued at 838.8 million. Between 1996 and 1997, the average volume of shares traded was 1,062.7 million, valued at 8,564.1 million. Between 1998 and 1999 securities traded averaged 3,025.7 million shares, valued at 13,826.6 million, while transactions in equities dominated the market during the period of analysis.

4.0 PROBLEMS OF THE NIGERIAN CAPITAL MARKET:

The Nigerian capital market, like the national economy, has been faced with many problems. These problems are both endogenous and exogenous. The exogenous problems are those outside the direct control of the market but which are regulation-induced. The endogenous problems are those that are internal to the market but which are amenable to changes with improved operational procedures including the adoption of information technology. Some of these problems are discussed below:

(i) Small Size of the Market:

Among the major problems facing the Nigerian capital market is the size of the market. At about 200 quoted companies and a market capitalization of 294.1 billion at the end-December, 1999 the size of the market can be considered to be small when compared with stock market in other emerging markets. For example, the South African stock market has about 650 listed companies while South Korea has about 700 listed companies. The small size of the Nigerian Stock market has been traced to apathy of Nigerian entrepreneurs to go public due to the fear of losing control of their businesses. Another factor is the weak private sector which is a serious constraint militating against healthy growth of the stock market.

(ii) Problem of Illiquidity of the Market:

The liquidity of a stock market relates to the degree of access, which investors have in buying, and selling of stocks in such a market. The more liquid a stock market is, the more investors will be interested in trading in the market. The lack of adequate number of investors in the Nigerian stock market is a reflection of problem of illiquidity in the market. At an average ratio of 2 per cent per year, the turn-over ratio, a measure of the value of shares traded relative to local market capitalization is very low in Nigeria, compared with 10.0 per cent, 9.0 per cent and 4.6 per cent in Botswana, Zimbabwe and Mauritius, respectively. The low trading activities are also a result of the ownership structure. Until 1995, when the Nigerian Investment Promotion Commission Decree 16 and the Foreign Exchange (Monitoring and Miscellaneous) provisions Decree 17 were promulgated to replace the Nigerian Enterprises Promotion Decree of 1989 and Exchange Control Act of 1962, the Nigerian stock market was restricted largely to local investors apart from the original investors in foreign companies who were already in the market before the indigenisation Decree of 1972.

New foreign capital had little or no access to the market. The good performance of Botswana, Zimbabwe and Mauritius has been traced to the open door investment policy of these countries. In addition," the buy and hold" attitude of Nigerian investors contributed to the problem of illiquidity. The holdings of original investors and the public sector are normally not traded except for terminal divestment. This often leaves only the proportion of shares held by few individuals and institutional investors for trading on the market, thus, limiting the liquidity of the market.

(iii) Slow growth of Securities Market:

Lack of cooperation between the Securities and Exchange Commission (SEC) and the Nigerian Stock Exchange (NSE) has been responsible for slow growth of the securities market. For example, one of the major criticisms of SEC was that it did not allow the issuing houses and stockbrokers to undertake the pricing of equities. With the transfer in 1993 of pricing and allotment of initial public offer to market operators, positive movement was observed in share prices. The issue of cost of raising funds in the market is also important. The cost of transaction could be said to be a measure of efficiency in the market. Transaction cost in the Nigerian capital market is enormous. The costs which an average investor would have to meet in the course of raising funds include; brokerage fees; stamp duties, and other charges that may be imposed by the SEC, apart from other fees payable to stockbrokers. Therefore, the cost of going public, raising additional equity or obtaining loan facility from the capital market is high. It has been estimated that the cost of raising US$1 million equity capital in Nigeria is about 4 per cent of the value, whereas, the cost of raising the same amount in Kenya, Zimbabwe and Ghana is 2.35 and 2.3 per cent, respectively.

(iv) Delay in Delivery of Share Certificates:

Prior to April, 1997 when the Central Securities Clearing System (CSCS) started operation, the delay in delivery of share certificates to investors and intra-firm settlements used was a problem in the market. Many of the unclaimed certificates and dividend warrants that are being published regularly are as a result of the delay in delivery of certificates. With the introduction of CSCS, shareholders are now able to take advantage of capital appreciation while transaction period has been reduced to T+5. The objective of the CSCS system is to achieve real-time transaction reporting, through automated order routing and executing system, which allows post-trade comparison and analysis, and ensures audit trail of all the market transactions.

(v) Problem of Manual Call-over

The manual call-over whereby all stockbrokers have to be physically present on the floor of the Exchange for trading in securities had also contributed to the slow growth of the market. With the recent introduction of Automated Trading System (ATS), it is expected that stockbrokers will be able to do business more efficiently and thus contribute to the growth of the market.

(vi) Double Taxation

The Nigerian stock market is faced with the problem of double taxation. In a capital market, the operating tax policies have implications for the supply and demand for financial assets. Depending on its nature and structure, taxation could either enhance or retard capital market growth. Tax can be a source of hindrance to development when it is high or levied at multiple stages. Currently in Nigeria, there is income tax, capital gain tax, withholding tax and company income tax. All these taxes together have the tendency of retarding investment because of their burden on investors. Most often, countries that have experienced growth in their stock market have come to realise the role which taxation plays in the promotion of investment in the stock market. For instance, countries like Botswana, Ghana, Kenya, Mauritius, Namibia and Swaziland have recognised the important role which taxation can play in the development of the market. Taxation of equities at both the corporate tax and dividend withholding levels is an important area that needs to be examined. The practice in the U. K. may offer a useful example for Nigeria. In the UK, through the Advance Corporate Tax (ACT) System, individuals are given tax relief at the corporate level for distributed earnings. The ACT was introduced in Britain to correct the distortions which double taxation had on corporate investment. A number of developing countries like Columbia, Jamaica, Indonesia and Mexico have one form of tax integration or the other.

Presently, Nigeria has not taken any step to reduce the burden of double taxation as incentive for investment in the capital market. Apart from its use as a means of generating revenue, some countries have used tax policies as incentives for developing capital market. They have been used not only for the supply and demand for securities, but also as penalties for companies that were reluctant to go public. For example, Brazil used dividend tax exemption or reductions, stock acquisition tax incentives and provision of tax fund shares as incentives for developing the capital market.

(vii) Lack of Effective Underwriting

Lack of effective under-writing is one of the problems confronting the Nigerian capital market. Underwriting could be in the form of firm contract, or stand-by arrangement and when an issue is large, there would be need for an underwriting syndicate. An observed deficiency of the Nigerian securities market is the non-existence of effective underwriting. Though the issuing houses claim to undertake underwriting as part of their functions, and a consortium of underwriters often exist when shares are being offered, underwriting business has hardly taken place in the real sense of it. Underwriting entails effective placing of entire issues, and establishing or maintaining a stable trading market for the under-written securities for which there would always be a lead or managing underwriter. Only a few of the existing issuing houses can undertake such functions that guarantee the underwriting of the shares not absorbed by the investors up to a certain percentage. The underwriters are in fact the 'market makers' who purchase the securities concerned on their own account to maintain a price when the market price of the offered security falls under the issue price. When such problem arises, the lead or managing underwriter would be expected to buy all such securities and distribute them to the other members of the underwriting syndicate or consortium according to predetermined ratio.

(viii) Problem of MacroEconomic Instability

Lastly, the problem of macroeconomic instability in the country has continued to be a hindrance in the development of the Nigerian capital market. Macroeconomic policies that would ensure long-term stability are essential in attracting a sustainable long term investments. Such policies should be conducive to both savings and investment to ensure confidence in the economy. Policies must ensure an attractive long-term yields for equities in comparison with other domestic and foreign investment alternatives. Frequent fluctuations in exchange rates and negative real rates of return on investments often force investors to move to other investment outlets or out of the economy entirely.

4.0 PROSPECTS FOR IMPROVED PERFORMANCE OF THE MARKET

Developments in the Nigerian capital market represent positive indication of the prospects and promise the market has for the future. Resolving the outstanding problems of the market is a major task that must be accomplished for the future development of the market. To this effect, a number of reform measures have already been undertaken to refocus the market so as to meet future challenges.

For instance, in pursuance of its deregulation policy which began with the introduction of SAP in 1986, several efforts have been made by the government to ensure that the Nigerian capital market operates like its counterparts in other economies. The deregulation of interest rates has had positive effect on the number of private enterprises sourcing funds from the market and it has also affected the volume and market capitalization. In 1991, the government deregulated the pricing of securities in the market by disengaging the SEC from securities pricing. In effect, the pricing of new stocks on the market was left in the hands of stock brokers and issuing houses. Further steps have also been taken to improve the settlement process and brokerage services. Before the introduction of the Central Securities Clearing System (CSCS) in April, 1997, the process of transacting shares used to be unnecessarily long and worrisome to investors. With the CSCS, which is a computerised depository, clearing and settlement system that acts as the clearing house for all shares traded on the Exchange the NSE has evolved a gradual dematerisation of share certificates, thus de-emphasising the use of share certificate as evidence of share ownership. An assessment of the CSCS indicates that the settlement and delivery systems of transactions in the market have been reduced from 3-6 months to 6 days.

In order to encourage continuous stock trading throughout working hours and allow dynamic pricing system, the Nigerian Stock Exchange replaced the old manual call-over method of trading with the Automated Trading System (ATS). The ATS is a computerised electronic system in which dealers from their work stations are linked to a central server at data control room of the NSE. It is expected that the electronic based trading system would enhance the efficiency of trading, transparency in the market, realistic pricing of securities and generate new trading opportunities for dealing members. Apart from that, it will also establish a trading link with all regional markets in Africa and other parts of the world. The ATS project was designed to bring the Nigerian securities market at par with international standards and enhance settlement and delivery of transactions in the market.

The removal of legal restrictions on foreign investors is also a positive development. The promulgation of the Nigerian Investment Promotion Commission (NIPC) Decree No. 16 and the Foreign Exchange (Monitoring and Miscellaneous) provisions Decree No. 17 of 1995 were made to replace the Nigerian Enterprises Promotion Decree of 1989 and the Exchange Control Act, of 1962. The enabling environment created by these legislations opened up the economy to foreign investors and also removed barriers restricting foreign investors' access to the capital market. The new Decree repealed the previous indigenisation Act which:

- limited foreign participation in the capital market,
- allowed unrestricted foreign interest in Nigerian quoted companies,
- allowed free repatriation of capital, dividends, capital gains, and other interests from investments in securities,
- allowed unhindered transactions in the foreign exchange market and provided for foreign investors to buy shares of Nigerian companies in any convertible currency.

Other efforts made at repositioning the Nigerian capital market was the constitution of the Dennis Odife panel in 1996 to review the structure and evaluate the performance of the capital market. The Panel's recommendations resulted in the promulgation of the all-embracing Investment Services Decree of 1999 to amend, modify and codify the provisions of the principal laws and regulations within the capital market as well as the re-establishment of SEC as the apex regulatory agency in the market. The panel recommended the establishment of the Abuja Stock Exchange, which has commenced operation, in addition to twelve capital trading points in other parts of the country. It is expected that the new Exchange will enhance competition and make the market fully functional and effective. The recent decision to repeal and refocus the Trustee Investment Act of 1962, the Insurance Decree of 1991 and the adoption of the strategy of sourcing funds for financing capital projects from the market by the 3 tiers of government would go a long way in enhancing the deepening of the market.

5.0 SUMMARY AND RECOMMENDATIONS.

5.1 Summary

The paper examined the performance of the Nigerian capital market since 1986. It was observed that prior to 1986, activities in the market were very low due largely to availability of other financial instruments for investment at a relatively cheaper rate. Before 1987, the interest rates were low and access to cheap funds in the money market was easy. Also, the level of activity in the market depended on government policy, such as government borrowing through Development Stocks and indigenisation policy of 1972 and 1977.

From 1986, however, the market responded positively to the liberalization policies of the government. The market witnessed increased modernization of its facilities while the operators became more active in the market. In addition, the deregulation of interest-rates in 1987 stimulated keen competition in the financial system, thereby, resulting in many enterprises in the private sector approaching the capital market for funds. From 1988 onwards, the market witnessed remarkable growth in the number of listed securities, resulting its intense market competition.

In spite of the improved performance in the market, the Nigerian capital market continued to be faced with many problems. Some of these problems are endogenous while others are exogenous. Among the major problems facing the Stock Exchange is the small size of the market, with only about 200 quoted companies and a market capitalization of 256.9 billion in 1998. The size of the market is considered very small when compared with stock markets in other emerging markets. Other problems highlighted in the paper included illiquidity, lack of cooperation between SEC and NSE, the high cost of raising funds on the market, double taxation, delay in the transfer and delivery of share certificates to investors, lack of effective underwriters and problem of macroeconomic instability.

With the recent efforts of the government at deregulating the economy and reforming the market, the prospects of improved activities in the market are very bright. The pricing of new stocks has been transferred to the issuing houses while a new stock exchange, the Abuja Stock Exchange is in place and 12 trading points are to be established in Abuja and other parts of the country. A Central Securities Clearing System (CSCS) has been introduced to reduce the time it takes to transact and deliver shares to investors while an Automated Trading System(ATS) has been introduced to enhance efficiency and transparency in the market .

The problem of macroeconomic instability is being addressed through appropriate policy measures and the strengthening of the institutional regulatory framework. The removal of legal restrictions on foreign investors to the extent which they can invest in the market represents a positive development. Also the promulgation of an all-embracing Investment Services Decree in 1999 to amend, modify and codify the provisions of the principal laws and regulations within the capital market as well as the re-establishment of SEC as the apex regulatory agency in the market are in the right direction. These in addition to the liberalization and internationalization of the market would go a long way in repositioning the market.

5.2 Recommendations

(i) Review of cost of borrowing from the market.

There is need to encourage more enterprises to come into the market so as to expand and deepen the market. This can be achieved through the review of costs of borrowing from the market. The high costs of raising funds on the market has been recognised as one of the factors militating against the growth of the Nigerian Capital Market.

(ii) Appropriate Savings / investment inducing measures

There is need to pursue economic and financial policy reforms that encourage investment in the capital market. In this respect, monetary policies should be designed in such a way that savings are encouraged for investment.

(iii) Tax incentives and listing requirements

Furthermore, small scale enterprises need to be encouraged through various tax incentives and listing requirements to come to the market. Such policy has been used in Brazil and some south east Asian countries. Though government has repealed all laws restricting free flow of foreign investment into the country, there is further need to ensure that all infrastructure in the country are revamped so as to provide the necessary basic support for the new enterprises.

(iv) Enlightenment on need to patronise the capital market.

The problem of illiquidity needs to be addressed through public enlightenment of the general public on the need to patronise the capital market and also to discourage Nigerian investors from the buy and hold attitude.

(v) Increased internationalisation of the capital market

Given the low depth of the market, there is need for some vigorous policies to internationalise the capital market to allow for the listing of foreign currency denominated securities on the stock exchanges in Nigeria.

(vi) Formation of under-writing syndicate.

Lack of effective under-writing has remained one of the problems of the Nigerian stock market. There is need to re-examine this problem and form an under writing syndicate.

(vii) Cooperation between SEC and the stock exchanges

The issue of cooperation and understanding between SEC and the exchanges should also be looked into.

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