

# Investment Banking: Legal Framework, Opportunities and Regulatory system

## 1. Introduction

Ethiopia is at a critical juncture in its economic history. The launch of the Ethiopian Securities Exchange (ESX) and the full implementation of the Capital Market Proclamation No. 1248/2021 are the beginning of an organized capital market. This transformation creates a compelling need for sophisticated financial system facilitators, especially investment banks. Unlike commercial banks that primarily accept deposits and make loans, investment banks are the architects of the capital market and provide strategic advice to companies, governments and other entities to raise capital, raise funds for companies, for merging companies, acquire shares of companies subject to control by

Ethiopian Capital Market Authority (ECMA), and other complex securities transactions.

*"The role of investment banks will play significant role in building market depth, ensuring efficient capital allocation, and enhancing investor confidence."*

This article provides a comprehensive explanation of the legal and regulatory framework governing investment banking activities in the emerging Ethiopian capital market. It explores the scope of activities permitted under the current legal framework, licensing requirements, potential market opportunities, and significant regulatory landscapes that need to be addressed. As the market expands, the role of investment banks will play significant role in building market depth, ensuring efficient capital allocation, and enhancing investor confidence.

## 2. Investment Banking and Capital Market Legislations

The Capital Market Proclamation No. 1248/2021 establishes the legal framework for all capital market participants, including investment banks. This proclamation establishes the Ethiopian Capital Market Authority as the main regulator and outlines the licensing and regulatory framework for all capital market service providers.

As defined in the proclamation, an investment bank is a non-deposit-taking financial institution that engages in the sale of securities by other companies, the government or other institutions on behalf of the issuer or by connecting the issuer with the purchasing public, raising capital, assisting in the merger and restructuring of companies, and providing advisory services to its clients as a broker and on financial matters. The Capital Market Service Provider Licensing and Supervision Directive has created a separate license category of "Investment Bank". The Directive

specifically identifies several categories of licenses that, when combined, are the main activities of an investment bank. Accordingly, an investment bank is licensed firm may provide the following related categories of services without additional licenses:

- **Securities Market dealer:** - Services of buying or selling securities for itself or for other persons as an agent,
- **Securities Broker:** - Services of executing orders to buy or sell securities as an agent,
- **Investment Advisor:** Services of providing professional advice and preparing related documents to persons wishing to invest in securities.

In addition, investment banks play a role of agents for the issuers, especially in the primary market, where they may purchase securities from issuers and sell them to buyers. In the secondary market, investment banks play a significant role in stabilizing the market and finding the right price by borrowing securities from institutional investors, offering them to the

market, selling them, and repurchasing them at a lower price.

Anyone who wants to operate as a full-service investment bank must obtain a comprehensive investment banking license that covers many of these activities. Although each requires specific requirements and licenses, an investment bank license is a license that covers all four of these activities.

### **3. Main Functions of an Investment Bank**

Within the scope of the Proclamation and the directives, investment banks in Ethiopia may perform a number of important functions.

#### **3.1 Capital Raising (Primary Market Activities)**

This is the most important function of an investment bank and includes the following.

- **Initial Public Offerings (IPOs):** Advising a company on its first offering of securities (stocks, bonds or other instruments), preparing the documents for registration with the ECMA, structuring the offering, pricing it in the market

and ensuring that the company will raise the intended capital,

- **Follow-on Public Offerings:** Assisting previously listed companies in raising capital by leading the process of offering additional new securities,
- **Issuance of debt securities:** Structuring and selling corporate bond or government bond offerings.

#### **3.2. Merger and Acquisition Advice**

Investment banks act as strategic advisors in mergers and acquisitions, and corporate restructurings. These activities include the following:

- **Valuation:** Determining the fair value of a company,
- **Managing corporate finances,** including mergers, acquisitions, and other transactions that require the purchase and sale of assets,
- **Support:** Assisting in negotiations and financing arrangements,

- Providing independent opinions for decision-making: Providing independent opinions to the company's board of directors on the fairness of the transaction price.

### **3.3. Trading (Secondary Market Activities)**

Investment banks act as market makers to execute clients' buy and sell orders. The primary purpose of this is to create liquidity in the market for the securities they sell and buy. In addition to acting as agents, investment banks also create stability in the market by buying and selling securities they have agreed to, sometimes on a short sell. In addition, they act as market makers by acting as buyers and sellers and by entering bid and ask prices, thereby ensuring that the market is predictable and stable.

### **3.4. Investment Banking and Research**

Investment banks provide key services to institutional and other investors that support investment decisions by providing high-quality, independent research and analysis on investment sectors, particularly those that issue

and sell fixed-income debt instruments and equity securities.

## **4. Investment Bank Licensing and Regulatory Framework**

The process of establishing an investment bank in Ethiopia is governed by the Authority. The following are some of the prerequisites that must be met to establish an investment bank.

### **4.1. Strict Capital Requirements**

One of the main requirements for obtaining a capital market service provider license is to meet the required capital for the sector. The Licensing directive set minimum capital requirements for each type of license. Since the responsibility of an organization that provides multiple services is high, the minimum capital requirement for an investment bank is higher. In this regard, the minimum capital requirement for issuing a license to provide investment banking services is 100 million birr for regular banks and 25 million birr for other organizations.

### **4.2. Fit and Proper Requirements**

The Authority strictly assesses the qualifications, experience and integrity of an investment bank's directors, managers and key employees. This fit and proper assessment includes a detailed assessment of the reputation of the company's executives, whether they have been convicted of financial and antitrust offences, whether they have been declared bankrupt, and other detailed criteria. This assessment process is carried out every time when company applies for a license and during its operations.

## **5. The Critical Role of Investment Banks in Market Development**

The successful entry of capable investment banks into the market is not only a business opportunity but also a prerequisite for a healthy capital market. We will briefly discuss the role of investment banks in this regard.

### **5.1. Pricing and Initial Market Valuation**

A key challenge for initial public offerings in ESX is determining the right price. Investment banks play a critical role in the process of

pricing by using their valuation expertise and investor networks to conduct the necessary research to ensure that companies are not undervalued and investors do not pay above the value of the securities.

### **5.2. Building Investor Confidence**

Due Diligence conducted by a reputable investment bank serves as a quality indicator for the market. The involvement of an investment bank provides assurance that the information provided by the issuer is accurate and reliable.

### **5.3. Product Innovation**

As the market matures, investment banks are expected to take the lead in developing new financial instruments such as asset-backed securities, derivatives, and green bonds to expand the market and meet the diverse needs of investors.

### **5.4. Consulting Services for the Partial Privatization of State-Owned Enterprises into Public Companies**

Following the home grown economic reforms, the Ethiopian government's partial privatization

and liberalization policy is expected to bring great opportunities. In this regard, investment banks with experience in large-scale privatization projects are expected to play a crucial role in structuring complex transactions and valuing state-owned enterprises appropriately.

## **6. The Evolving Competitive Landscape**

**International players:** International investment banks, when working in partnership with local investment banks and companies or establishing local branches, are expected to bring in international expertise and lead to significant knowledge transfer in the local context.

**Local pioneers:** Local pioneer investment banks can provide advisory services to large corporations and focus on mergers and acquisitions of medium companies. Commercial banks should be able to leverage their existing client relationships to provide investment

banking services, which will play a significant role in the growth of the sector. This is because the depositors' money held by commercial banks needs to be protected and risk-free, and it is appropriate for commercial banks to establish a separate entity under their responsibility, after ensuring that there is no objection from the National Bank, and after meeting the requirements required by the authority and the requirements set out in the regulations, to be granted an investment banking license.

## **7. Conclusion**

The establishment of a formal capital market in Ethiopia is a development that will create a favorable environment for the growth of investment banks. According to the current Capital Market Proclamation No. 1248/2021 and the Capital Market Service Provider Licensing and Supervision Directive No. 980/2016, ECMA will grant licenses to applicants who meet the requirements for an investment bank license. Accordingly, investment banks are expected to play a

significant role in the market and the economy by performing only the activities permitted under the regulatory framework.

The success of this new financial ecosystem depends on the capacity and credibility of investment banks. They are expected to become important market players that connect Ethiopian enterprises with the capital they need to grow, and to improve the economy by advising on restructuring, mergers and acquisitions, and privatization transactions. Ultimately, they are expected to build trust in the market, which is the foundation for a prosperous market. For regulators and market participants alike, the coming years will be a time of intense learning, adaptation, and collaboration. Investment banks will play a leading role in writing the next chapter of Ethiopia's economic history.

