CHAPTER 17

SECOND-TIER SECURITIES MARKET (SSM) AND SECOND-TIER FOREIGN EXCHANGE MARKET (SFEM)

Objectives

At the end of this chapter, the student should be able to explain the Second-tier Securities Market (SSM); lists its advantages and disadvantages and state its operating regulations. The student should also be able to explain Second-tier Foreign Exchange Market (SFEM); state the differences between SFEM and SSM; list reasons for introducing SFEM and enumerate the operating guidelines.

17.1 Meaning of Second-Tier Securities Market

The need to make many companies have their securities traded in the capital market, and the desire to encourage the public to invest in them gave rise to another level of securities market in Nigeria. The market is called the Second-tier Securities Market, known, for short, as SSM, while the Stock Exchange (NSE) is the First-tier Securities Market.

The SSM is a market for the sale and purchase of the securities (shares) of small-to-medium-sized companies. This market is less restricted than the first-tier market, the stock exchange. As a result, an investor can directly instruct stock-brokers or banks to carry out a transaction in the same way as for listed companies. However, activities in the SSM are properly regulated and the market operates in the same way as the stock exchange market as trading is subject to the normal dealing rules and regulations.

17.2 Advantages of the Second-Tier Securities Market

Companies and the investing public particularly in the Second-tier Securities Market (SSM) have some advantages or benefits accruing to them as shown below.

(i) **Enhanced Ability to Buy and Sell Shares:** Shareholders will find ready market for the shares of their companies. Buying of shares by new investors will no longer be by private arrangement and negotiation as they have direct access to buy shares and other investors can buy and sell shares as and when they wish.

(ii) **Greater Scope for Raising Capital:** New sources of raising capital are enjoyed by companies as private and institutional investors begin to operate in the market. The 10% equity offer to the public will enable the company to gradually realize capital as its ownership base expands. Quoted shares become marketable and so shareholders can borrow on the security of their shares or have ready market for their shareholdings.

(iii) **Growth Through Acquisition:** Companies quoted in the SSM are usually small or medium-sized with prospect for growth. Their interests in other companies can be paid for by issuing them their own shares, that is, they make the other companies acquire shares in them. This will make them grow and have steady cash flow as their business expands.

(iv) **Value Added:** Public quoted companies have some esteem attached to them as they are regarded as have come of age by the public. Consequently, quoted companies are seen as being serious, stable and disciplined which can be relied upon by suppliers, creditors, etc.

(v) **Survival and Continuity:** Going public by companies quoted on the SSM places ownership in the hands of shareholders which ensures perpetual succession and continuity. That is, the company will survive or continue to exist after the founders have died. Quotation on the SSM can also help to attract the best available company executives to run the company.

(vi) **Employee Share Scheme:** Each quoted company has employee share participation scheme which allows employees to share in its ownership. Thus, the staff are motivated as they are involved in the business and the well being of the company and so will work with undivided loyalty.

(vii) **Savings in Cost:** Companies quoted on SSM pay less annually to enjoy facilities similar to those enjoyed by companies quoted on the first-tier market, the Nigerian Stock Exchange (NSE).

There is also savings in cost during floatation as companies are allowed to use abridged particulars instead of the elaborately produced prospectus and advertisement.

17.3 Operating Regulations

There are regulations guiding admission and methods of admission into the Second/tier Securities Market (SSM) as discussed below.

A. Requirements For Admission into The SSM or Listing Requirements

(i) Any company seeking admission into the SSM must be a Registered Public Limited Company with a minimum of seven persons.

(ii) It must have a minimum of 100 shareholders for it to be admitted into the SSM.

(iii) It must sign General Undertaking with the Nigerian Stock Exchange which compels the company to make available all information that will enable the shareholders and the investing public to appraise the position of the company.

(iv) It must file its financial statement for the past three years with the Nigerian Stock Exchange (NSE) followed by half-yearly and annual submission of audited statement of accounts. The last audited statement of account should not be more than nine months before the application to the NSE for admission.

(v) Any company seeking admission into the SSM must by regulations make 10% of its equity available to the public for subscription or acquisition. This condition is not applicable in the case of offer by introduction.

(vi) The number of shares an individual can hold directly or indirectly in a company seeking admission to the SSM is limited to 75%.

(vii) Each company quoted on the SSM must have employee participation scheme which allows the employees of the company to share in its ownership.

B. Methods of Admission into the Second-tier Securities Market (SSM)

The method of admission into the SSM is called an â€œofferâ€. There are four types of offer for admission into the SSM. These are: offer by introduction, offer for sale, offer for subscription and placement offer.

(i) **Offer by Introduction:** This method of admission is used where at least 10% of the companyâ€™s equity shares are already held by the public. In this case, the company is just introduced into the market by the Nigerian Stock Exchange (NSE) and permitted to deal on the SSM without issuing fresh shares to the public.

(ii) **Offer for Sale:** This takes place when a company in the SSM decides to sell part of the shares of the existing shareholders to new investors.

(iii) **Offer for Subscription:** This occurs where a company in the SSM offers its new shares direct to investors to buy.

(iv) **Offer by Placement:** Under this method, a company seeking admission into the SSM is sponsored by a stock broker who undertakes to find buyers for the shares of the company. To ensure that the wider public has access to buy the shares, at least 25% of the placed shares must be made available to stockbrokers.

17.4 The Second-Tier Foreign Exchange Market (SFEM)

SFEM is a procedure for obtaining foreign exchange (foreign currencies), but by purchases in the government periodical foreign exchange market where, the Central Bank makes available some amount of foreign currencies for auction. The traditional government official rate of exchange is known as the first-tier market rate (or rate in the first window(while the rate obtainable at the periodical exchange market is known as the second-tier (or rate in the second window).

The first-tier market rate is said to be too high in favour of the naira and, therefore, the naira is over-valued, i.e. too much unit of foreign currencies is being exchanged for one unit of naira. On the other hand, the rate obtainable in the second-tier foreign exchange market is much lower than the first-tier rate and therefore, more realistic. In addition, the former is usually pegged, while the latter is varied by the forces of demand and supply.

17.5 Reasons for the Introduction of SFEM

The economic background against which the â€˜SFEMâ€™ was introduced are as follows:

(i) The governmentâ€™s bizarre foreign exchange earning from its mono-product economy fell drastically due to persistent fall in the price of petroleum. Consequently, the foreign currencies (foreign exchange) available to government dwindled.

(ii) At the same time, demand for foreign exchange was unlimited. Nigerians have an insatiable taste for foreign goods; while at the same time, most home industries depended on imported raw materials.
To worsen the situation, most of the traditional export products - cocoa, palm produce, rubber, groundnuts, etc. - are already too decadent to bring in with, any reasonable amount of foreign exchange. For Nigeria, foreign exchange became acutely in short supply. Demand, therefore, is greater than supply.

(iii) Government resorted to rationing of the available foreign exchange, as a means of allocating scarce resources.

(iv) The economy became over-regulated, some economists refer to the situation as one of a *siege economy* which is suitable to war-time only, but this is peace time.

(v) Rationing gave birth to corruption and graft as the system became very bureaucratic. Winners of import licences made unprecedented windfall gains through illegitimate sales of their won import licences.

(vi) There was gross misallocation of scarce resources as winners diverted their allocations to unauthorised channels.

(vii) Industries began to fold up for lack of imported raw materials; and unemployment swelled.

(viii) Black market in foreign exchange was thriving. Much foreign exchange was lost through unofficial market.

(ix) The cumulative effect was a widening gas in the trade and the payment relationship between Nigeria and her trading partners as Nigeria was unable to honour her debt obligations to her creditors and so the nation became credit unworthy inspite of the â€˜siege economyâ€™, there were no position sign of recovery in sight.

(x) There was â€˜capital flightâ€™ from Nigeria.

The SFEM was looked upon as the panacea for our economic ills. It was popularly known as part of Structural Adjustment Programme (SAP), which included measures to correct the continued overvaluation of the naira and provide a mechanism for the rational allocation of scarce foreign exchange.

17.6 Benefits Expected from the Successful Operation of SFEM

(i) There will be deregulation and decontrol of exchange rates. The operating rate would be determined by the inter play of demand and supply mechanism which will be realistic price for the naira.

(ii) It is expected that there will be access to foreign exchange without any administrative restrictions, that is freedom of transaction in foreign exchange.

(iii) There will be a much healthier and better competition for foreign exchange and, therefore, a more equitable allocation among Users of foreign exchange.

(iv) It is hoped that the operation of SFEM would result in more rational and efficient resource allocation through elimination, of fraudulent and wasteful practices.

(v) Increase in imported raw materials will lead to reduction in unemployment through utilization of available industrial capacity.

(vi) In addition, the use of home-made goods would be encouraged and this would also increase employment opportunities.

(vii) Agriculture in particular, and other non-oil sectors in general will be stimulated, while promoting export goods as well.

(viii) There will be liberalisation of trade and exchange control which would lead to the removal of distortions and abuses associated with the import of controls.

(ix) Free inflow of capital into the country will be encouraged, especially from funds held by Nigerians abroad. That is, capital flight will be reversed and the illegal trafficking in currency and smuggling of goods across Nigeriaâ€™s borders would be reduced substantially, if not eliminated.

(x) There will be reduction in import dependence by Nigeria. This will reduce excessive demand for foreign exchange and put an end to the regular drain on external reserves.

(xi) It will enable Nigeria to settle her import bills promptly, and thereby enhance international confidence in her economy as there will be no trade arrears.

17.7 Guidelines Governing the Operations of SFEM

(i) In SFEM, buying and selling of foreign currency is only done through the banks and authorised firms licensed as dealers.

(ii) SFEM, as a market, operates in all parts of the country where anybody can buy or sell foreign exchange in any bank nearest to him irrespective of whether or not he is the bankâ€™s customer.

(iii) Under SFEM, Hotels are authorised to buy but not sell foreign exchange in Nigeria.

(iv) Under SFEM too, selling of foreign currency is by way of auction, whereby bidding sessions are held at the Central Bank of Nigeria weekly.

(v) The official rate at which naira will be exchanged emerges after each bidding. The banks on the other hand are expected to buy at this rate irrespective of their bids and will recall with a small profit margin to buyers or customers.

(vi) In SFEM inter-bank transactions are allowed, in other words, banks are allowed to resell to other banks.

(vii) Where Dutch Auction is used at SFEM, banks are expected to pay for the foreign currency according to their bids irrespective of what the official rate is.

(viii) Both the Second-tier Foreign Exchange Market (SFEM) rate in July 1987 and the First-tier Foreign Exchange Market (FFEM) rate merged to form Foreign Exchange Market (FEM) with one ruling exchange applicable to both the operating regulation of FEM is the same as that of SFEM and the first bidding under FEM took place on 16th July, 1987.

17.8 Sources of Money to be Sold in SFEM

(i) Foreign currency domiciliary account maintained with authorised banks in Nigeria in accordance with the Foreign Currency Domiciliary Account Decree, 1985.

(ii) Foreign currency held or imported by Nigerian citizens, returning home from abroad.

(iii) Foreign currency held or imported by foreign national resident in Nigeria.

(iv) Foreign currency brought into Nigeria by tourist visiting the country.

(v) Foreign income from agency commission, professional fees and other forms of invisible earnings.

(vi) Also, non-oil proceeds earned by exporters from Nigeriaâ€™s commodities.

(vii) Unspent balance of foreign currency held by Nigerians resident in Nigeria.

(viii) Foreign currency imported by foreigners to purchase goods in Nigeria.

(ix) Foreign currency held or imported by foreign embassies and international organizations from external sources.

(x) Foreign currency provided by the Central Bank of Nigeria.

(xi) Foreign exchange imported for direct investment.

(xii) Foreign currency from such other sources as the minister of finance, from time to time, may by order be published in the gazette specified, and funds held in external accounts by individuals, corporate bodies, insurance companies and similar bodies.

The Decree adds further that, transactions in market can be conducted in foreign coins, travellersâ€™ cheque, bank drafts, mails or telegraphic order, such other money market instrument as the Central Bank may introduce, from time to time with the approval of the minister.

SFEM - Highlights of the Operation

It kicked off on Monday, 29 September, 1986. The preliminary bargaining took place on Friday, 26th September, 1986. On the first Friday, 26th September, 1986, the initial rates agreed on or negotiated and agreed on were as follows:

₦4.60= $1 (1 USA dollar)
₦6.63= Â£1 (1 pound sterling)
₦1.00= 0.69 (French France.)

A loan worth 452 million U.S.A. Dollars from the World Bank was accepted by the Nigerian Federal Government to start SFEM. The loan is for twenty years with five years *moratorium* and an annual interest rate of 8.5%. Central Bank of Nigeria is ready to intervene, should the bids for determining the rate of naira become irresponsible. This, the CBN did when, in one of the weekly bids in December 1986, she found that the naira appreciated unduly against other foreign currencies.

Merging of First and Second Market Rates

By July 1987, the first and second tier markets rates were unified; meaning that as from that time on, only one foreign exchange rate would apply in respect of foreign exchange conversion to the naira.
The Failures of both â€˜FEMâ€™ and â€˜STEMâ€™

Looking back today (in the year 2004) the operations of FEM and STEM failed to keep foreign exchange rates stable and moderate. The value of the Naira has gone down drastically. For example, one pound sterling, Â£1 to Naira is between ₦240 - ₦250 while one U.S.A. dollar $1 is between ₦135 - ₦1 38.

Summary

The Second-tier Securities Market (SSM) is a market for securities of small and medium size companies. As a stock market, it is less restricted than the first-tier securities market which is the Nigerian Stock Exchange (NSE).

Conditions for registration into the SSM include the following:

(a) Registration as a public company.
(b) Establishing a formal relationship with NSE.
(c) Should have no fewer than 100 shareholders.
(d) At least 10% of the equity must be available to the public to buy.
(e) Submission of financial statements for the past three years and thereafter half yearly and annually.
(f) No more than 75% of the issued share capital should be held by a single shareholder.

(g) There must be employee participation scheme which allows employers to own shares in the company.

SFEM is the mechanism by which the exchange rate of the naira against other foreign currencies is determined by interplay of supply and demand. The practice arose from the overregulation of the allocation of foreign currencies to all the economic sectors by the government agencies and the inherent defects in that practice.

Deregulation was also expected to lead to a more equitable use of foreign exchange, in addition to enabling the naira to find its realistic rate from its previously overvalued level.

There are guidelines for the operation of SFEM and therefore penalties including longterm jail sentences were designed for violating such guidelines. By implications, imported goods became more expensive while exports became cheaper and this helped to improve Nigeriaâ€™s balance of payments position. SFEM is part of â€˜SAPâ€™ - Structural Adjustment Programme.

However, one of the main impacts on Nigerian economy was that it led to a high rate of inflation.

By July 1987, the first and second tier market rates had been merged ; and instead of SFEM we have had FEM. This simply means only one exchange rate apply to the naira, and that is the rate obtained in the biweekly exchange rate.

However, the operations of â€˜FEMâ€™ and â€˜STEMâ€™ failed to keep the exchange rate stable. The value of the Naira has been dwindling over the years.

Revision Questions

A. Essay Questions

1. What do you understand by:
   (a) Second tier Foreign Exchange Market (SFEM)?
   (b) State the reasons for the introduction of the Second tier Foreign Exchange Market.

2. What is â€˜FEMâ€™? Explain its operation, showing the distinction between â€˜FEMâ€™ and â€˜SFEMâ€™.

3. State the sources for the finance of â€˜SFEMâ€™ and â€˜FEMâ€™.

4. (a) Explain what you understand by the Second-tier Security Market.

   (b) Justify the existence of the Second tier Security Market to the participating companies. *SSCE (1992)*

5. (a) Briefly describe what is known as Second-tier Foreign Exchange Market (SFEM).

   (b) Mention six of the rules and guidelines that govern the operation of (SFEM). *SSCE (1995)*

Objective Questions

1. Government raises funds usually through the sale of
   A. Bill of exchange.
   B. Debentures.
   C. Premium Certificates.
   D. Treasury Bills.

WASSCE (2000)

2. One of the main objectives of the Second-tier Securities Market in Nigeria is to
   A. Attract investment flow.
   B. Assist companies to raise capital.
   C. Achieve a realistic exchange rate for the naira.
   D. Eliminate currency dealings in the black market.

JAMB (2001)

3. The main factors that determine the value of a stock on the stock exchange are dividend and
   A. Capital gains.
   B. The psychology of the market.
   C. Warrant payment.
   D. Capital appreciation. *JAMB (2001)*

Use the information numbers A - E below to answer questions 4 - 8 below.

A. STOCK EXCHANGE
B. SECOND-TIER SECURITIES MARKET (SSM)
C. SECOND-TIER FOREIGN EXCHANGE MARKET (SFEM)
D. A STOCK BROKER
E. AN ISSUING HOUSE

4. The firm or a person who buys and sells securities on behalf of investors - clients for a commission is called

5. A market where investors buy and sell securities (shares, stocks, debentures and bonds).

6. A firm that helps to prepare prospectuses and sell securities offered to the public by companies and government.

7. A market established by law, for buying and selling foreign currencies (foreign exchange) at market determined rates, i.e. the rates at which naira is exchanged for other currencies.

8. That market which is for buying and selling of securities of small to medium sized companies.

9. The following are the benefits to firms operating in the SSM except

A. Cost of admission to SSM is minimal.
B. Going public in the survival and continuity of the enterprise.
C. Greater scope for raising capital.
D. Attraction of corporation tax concession.
E. Enhanced ability and flexibility to buy and sell shares.

10. Bothâ€˜FEMâ€™ and â€˜STEMâ€™ failed because
A. The naira has been stable.
B. The value of the naira has fallen over the years.
C. Foreign exchange reserve has fallen.
D. Capital outlaw is on the increase.
E. Capital inflow has risen greatly.

Project

Mention 10 commercial banks that are qualified to operate in the Second-tier Foreign Exchange Market at its commencement.

Which are the three largest commercial banks in Nigeria?

What is the significance of their large size on the exchange market?