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Volume IV of IV

Design of a Course Outline and an Annotated Syllabus for a Broker Certification Course for Karachi Stock Exchange

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The International Science and Technology Institute, Inc.
1129 Twentieth Street, NW Suite 800
Washington, DC 20036

ISTI — TEAM MEMBERS

Project Manager:

Bradford A. Warner, Jr. is Vice President of ISTI's Private Enterprise and Economics Division. Mr. Warner has over 25 years of international corporate finance experience including capital market development, public and private securities offerings, corporate direct investment, real estate and equipment lease financing and venture capital portfolio management.

Corporate Law Authority Training Program:

Robert M. Bishop, former Senior Vice President, Chief Regulatory Officer and Member of the Managing Committee of the New York Stock Exchange, was the longest-termed regulatory officer in the exchange's history. An employee from 1955, and an officer from 1963, he retired in 1986 after heading N.Y.S.E. regulation during years of major crisis, development and change. He has advised 13 foreign stock exchanges.

Anthony D. Loehnis, former Group Executive Director and Vice Chairman of S.G. Warburg in London and Executive Director of Bank of England for Overseas Affairs, has over 25 years of international corporate finance and banking experience. He is a member of the Group of Thirty, Chairman of the Centre for Economic Policy Research, Director of the U.K—Japan 2000 Group and member of the Council of Management of the Ditchley Foundation.

Debra J. Kertzman is an attorney who is currently the Regulation Specialist for the USAID/Sri Lanka Financial Markets Project which is being managed by ISTI as contractor. She has worked for the U.S. Securities and Exchange Commission, the Hong Kong Securities and Futures Commission and as a securities lawyer in New York City.

Karachi Stock Exchange Training Program and Certification Course:

John R. Buehler has over 30 years of management experience in the capital markets industry including former positions as National Marketing Director, National Training Director and National Sales Manager of three N.Y.S.E. member firms. In addition, he founded the NYSE/NASD Securities Industry Examinations required of all U.S. investment brokers and securities firm branch managers. He is a member of the Examinations Policy Review Committee of the NYSE and a past member of the NASD Qualifications Committee.

Alfred C. Morley has over 40 years' experience in the investment business, dealing primarily with securities research and management of institutional funds and with the training of global investment professionals. He was the first President of the Institute of Chartered Financial Analysts and is the ISTI Program Coordinator for establishing the CFA program in Sri Lanka under the USAID/Sri Lanka Financial Markets Project.

John L. Kinnaman has over 20 years experience in stock exchange and securities firm operations and management in the U.S. and internationally. As ISTI's Advisor to the Colombo Stock Exchange, he was responsible for the development of its Central Depository, and recently he has advised on clearance and settlement, stock exchange rules and custody arrangements in Tanzania, Venezuela, Bulgaria, India and Pakistan. He is a former Vice President of NYSE, Midwest Stock Exchange and the National Securities Clearing Corporation.

Ronald E. Copley is an Associate Professor of Finance at the University of North Carolina and a principal reviewer of examinations for the Institute of Chartered Financial Analysts. He also is engaged in investment management for professionals, retirement plans and foundations. He is an expert court witness on investments and personal and business valuation and advises the State of North Carolina on its $7 billion pension fund.

Susan S. Martin, as an ISTI consultant, designed and implemented the first Sri Lanka stockbroker licensing program for the Colombo Stock Exchange and the Securities and Exchange Commission, including formulating the syllabus, compiling and writing the training manuals, teaching the curriculum and administering the final examinations. Ms. Martin is a stockbroker by profession.

Design of a Course Outline and an Annotated Syllabus
for a Broker Certification Course for the Karachi Stock Exchange

- Program Management — Tab A
- Study Guide — Tab B
- Uniform Application for Stock Market Certification or Transfer — Tab C

PROGRAM MANAGEMENT

Introduction

A nation's securities markets must be efficient, honest and credible to attract investors within its own borders and internationally, as well; therefore, a regulatory framework must be established that is perceived to be fair and equitable.

Further, it must be recognized that the principles of fair trade and trust are integral parts of the market system and must be instilled into and subscribed to by all participants.

Moreover, the standards of training, professional development and qualifications of securities industry personnel are essential to the health of the marketplace.

Background

The securities markets of Pakistan have entered into a period where they are among the fastest growing in the world. Spearheaded by the Karachi Stock Exchange (KSE), the markets have been able to attract hundreds of millions of dollars of investment capital from international sources in a time frame of only a few years. Within Pakistan itself the markets have become a vital part of the country's financial strength and have become the vehicle of mobilizing capital from institutions, high net-worth investors, and small savings investors, as well. As such, the stock exchanges have acquired the status of public utility institutions, duty-bound to protect the interests of the investors through the continuous review and upgrading of regulations and professional standards.

Proposal

Keeping in mind the urgency and necessity for amendments/additions and improving the efficiency, management and control of its affairs, the Karachi Stock Exchange has elected to institute a certification program. The program would be a means of setting standards for the background, knowledge, and business behaviour of the securities industry personnel who deal with public investors. The program would take into consideration the certification programs of capital markets of other countries, many of which have established such requirements, but would be tailored to the specific investment environment of Pakistan. The Exchange has requested assistance in developing the program from the International Science and Technology Institute (ISTI), Inc., through the offices of U.S. Agency for International Development (USAID).

Recommendations

Within the context of the foregoing, ISTI recommends to USAID the following actions and specific details for the certification program:

1. Authorization

The entire certification program should be authorized and co-sponsored equally by the Karachi Stock Exchange, the Islamabad Stock Exchange and the Lahore Stock Exchange. The program should have the endorsement of the Corporate Law Authority (CLA) and be clearly so designated. After considerable discussions with each of the exchanges and the CLA, ISTI has had assurance from each institution that this is not only an acceptable arrangement but is anticipated with enthusiasm and a spirit of cooperation.

2. Scope of Broker Certification Program

As the Corporate Law Authority licenses and supervises stock exchanges and their operations in Pakistan it is recommended that the stock exchanges be delegated the right to certify and supervise professional brokers operating in Pakistan. The CLA would recognize the legitimacy of the certification program operating individually or jointly by all licensed stock exchanges. It is recommended that the KSE maintain a central broker information file containing the broker's:

- name
- address
- exchange membership(s)
- date of certification
- date(s) of certification suspension, as applicable
- date(s) of re-institution of certification, as applicable.

3. Existing Stock Exchange Professionals

We recommend that each stock exchange and the CLA recognize the established professional qualifications and capabilities of individuals who have been practicing in the stock market for some time. Specifically:

3A. Any stock exchange member who has more than five years of stock market experience, as of the effective date, without sanction, would be automatically certified.

3B. Any agent of a stock exchange member as of the effective date who has more than five years of continuous stock market experience without sanction, should be automatically certified.

AGENT: Any professional broker who deals with and/or advises clients/investors on investment decisions.

3C. All members and agents having less than 5 years but more than two years continuous experience in the stock market should be required to attend the same lecture series about the market as will be offered for individuals preparing for the certification examination. The lecture series, based upon the material presented herein, should be available in languages other than English, as appropriate. Each individual in this category upon completion of the lecture series would be deemed certified under the program.

3D. All individuals with less than two years of stock market experience, from the effective date must satisfactorily pass the certification examination, as defined herein, in order to become a certified securities representative.

3E. After the effective date all individuals wishing to become certified must pass the recognized certification examination.

3F. Individuals who are licensed or certified as securities professionals in foreign capital markets where such programs exist, and return to work in Pakistan should be given some consideration or recognition of the foreign license.

3G. Waiver considerations: Consideration may be given for waiver of the examination requirement for certification of certain individuals with extensive relevant experience proposed by a sponsoring member. Waiver from the examination should be granted only after consideration and approval of the board of directors of the reporting SRO. When the waiver is granted by an SRO's board of directors, the candidates should be granted full status as a certified securities representatives.

3H. Individuals, as in paragraph 3C and paragraph 3D, required to satisfy the training or examination requirements must do so within six months of the effective date of the certification program.

4. Details of the Program

The specific parts of the program shall be instituted as follows:

A. Sponsorship
B. Background Disclosure
C. Pledge
D. Training
E. Examination
F. Supervision

4A. Sponsorship

Each candidate must be sponsored by a member of one the exchanges testifying that the candidate is under the supervision and control of the member and that the candidate is of high moral character. The sponsor agrees to notify the exchange of any change in the status of employment or affiliation of the candidate, before or after certification.

4B. Background Disclosure

A registration form shall be completed by each member and applicant for certification and submitted through the sponsoring member to the appropriate exchange for consideration. The form will contain the following information:

Personal Data:

Full name, date of birth, physical description.

Residential History:

All addresses for at least the last 5 years, including dates.

Employment and Personal History:

An accounting for the past ten years including dates, positions held, and unemployed time.

Other Businesses:

An accounting of other businesses not shown above acting as proprietor, partner, principal, officer, director, trustee, agent, employee, majority investor or otherwise.

Legal:

A record of any arrest, law-suit, court action, conviction of a felony, bankruptcy, discharge from employment for cause, etc.

Education:

A complete listing of all educational institutions attended with a record of major studies, degrees or diplomas granted, and dates of attendance.

Certification Disclosure:

A statement as to whether certification has ever been granted, denied, or applied for.

Guarantee:

A sworn statement that all of the information is accurate and complete, without reservation.

Note : A stock exchange may deny consideration for certification based on inaccuracies or incompletions on the forms. It may also deny, without appeal, any applicant whose background disclosure indicates conduct, character, or personal information which would not be in the best interests of the Pakistan capital markets or the investing public.

It will be the responsibility of the sponsoring member and the certified securities representative to inform the exchange of material changes to the information submitted on the forms.

The completed forms will become the property of the exchange.

4C. Pledge

Each applicant must pledge to uphold the rules, regulations, and laws of the securities industry and to fully cooperate with the self-regulating organizations (nominally: KSE, LSE, ISE) in any dispute or investigation. (A recommended pledge form C2 is attached as Appendix II, Tab C.)

4D. Training

Training courses to prepare candidates for the certification examination will be offered by the Karachi Stock Exchange, initially, and as time goes on by the other exchanges and training organizations as well. The courses may use the study outline prepared by ISTI, included with this report, to develop lesson plans and individual instructional aids.

The courses may also be structured according to the examination specifications developed by ISTI And modified by the exchanges.

Training course attendance will not be required of certification candidates. Those who believe their background, education, and experience have prepared them well for the examination should be allowed to take it upon their sponsor's official notification to the exchange.

The training courses should be offered on a regular schedule so that sponsoring members can program their candidates' time requirements.

It is anticipated that when the certification program is first put into effect there may be an initial surge of interest in training courses and many in succession may have to be offered.

Subsequently, however, the scheduling of quarterly programs may be sufficient to satisfy the needs of sponsoring members.

4E. Examination

4E1. Purpose

The certification examination should be a qualification examination, intended to safeguard the investing public by helping to ensure that brokers are competent to perform their jobs. The exam should measure accurately and reliably whether each candidate possesses the knowledge, skills, and abilities to perform the functions required of the position. It should be aimed at the fundamental and basic understanding of the securities business which should be reasonably expected of a professional broker.

The composition of the examination questions should, in every case, meet the test of relevancy to the job of a broker in the Pakistan securities markets. Moreover, the weighting of subject areas to be tested should be carefully considered.

4E2. Structure

ISTI recommends that the topics to be covered on the examination should include seven parts:

1. Fundamentals of Securities
2. Economics, Securities Analysis, Portfolio Analysis, Market Theories
3. Trading on the Exchange Markets
4. Laws, Rules and Regulations
5. Clearance, Settlement and Securities Processing
6. Dealing with the Investing Public/Ethical conduct
7. International Markets and Investing

A detailed analysis of the topics to be covered is contained in Tab B "Examination Specifications." This will also list the recommended percentage of questions for each topic on each examination.

4E3. Review

The examination content must be continuously monitored to ensure its relevancy and accuracy as a measure of competency. It is important that a review committee, consisting of professionals from the self-regulating organizations, should study the contents of examinations to see that recent changes in the industry are accounted for and that questions are in line with current conditions. It is recommended that

the review committee be of a manageable size, with a representative from each SRO to work in consort with the independent agency composing and conducting the examination.

4E4. Composition of the Examination

It is recommended that responsibility for composing the examination be delegated to the Institute of Business Administration (IBA) whose reputation as an educational institute is unquestioned and fully supported by all the SROs. The IBA, in keeping with the examination specifications, will write appropriate questions for each topic and develop a question bank, from which it will draw examinations as needed and requested by the SROs. The IBA will administer the examinations and monitor the results, analyzing questions for degree of difficulty and integrity. The format will be purely objective, four-part multiple choice questions with concise stems, correct keys and viable destructors.

4E5. Passing Grade

In keeping with the purposes and high standards of the program it is recommended that the passing grade on the examination be no less than 70% correct answers. This is to be a pass/fail exam and those candidates attaining 70% or better will receive only the grade of "Pass" and not a numerical score. The numbers will remain with the IBA for analysis purposes.

In the case of those who fail the exam, the IBA will report a numerical grade for each section of the exam and an overall numerical grade. This procedure is designed to assist candidates in their study for a retake of the exam. Those who fail must wait a minimum of 30 days before retesting and must have the approval of the sponsoring member. All results will be reported by the IBA directly to the appropriate stock exchange.

4E6. Length and Duration

It is recommended that the examination consist of no less than 100 questions to be answered in a maximum of 2 hours.

4E7. Language

The examination will be written and administered in English. However, it is recognized that there may be candidates for whom this may present a special difficulty. To be fair to these candidates it is recommended that on request, the IBA may either extend the time allowed to take the regularly scheduled exam or administer an oral exam in the language of the candidate.

4F. Supervision

As a part of the total certification program, newly designated certified securities representatives (CSRs) will enter into a period of special hands-on training and qualification. During this time frame a new CSR will be assigned to a specific supervisor appointed by the sponsoring member, who will have direct responsibility for his/her conduct and actions. The supervisor will work closely with the new CSR to ensure that he applies the knowledge gleaned from the training and examination phases in a professional manner.

The intent is to increase the CSR's total skills through practical, on-the-job experience, coached by a supervisor on a point-by-point basis. All recommendations made by a new CSR to an investor will be concurred with by his appointed supervisor. Additionally, all orders entered by a CSR on behalf of an investor must be co-signed by the supervisor.

The supervisor thus becomes a party to all actions of the new CSR and, as such, assumes joint responsibility for the consequences.

The duration of the supervisory requirement will be 90 days from the date of certification.

The purpose of the supervision process is to provide additional protection to the interests of the investing public by assuring fully qualified, experienced and professional attention to investment needs at all times.

5. Certification Fees

It is recommended that there be a reasonable fee payable by sponsoring members to the appropriate exchange on behalf of each candidate who takes the exam, regardless of passing or failure scores. The fee would cover charges to the exchange by the IBA, plus administrative costs.

There should, as well, be honest and forthright negotiation between the SROs and the independent testing agency, the IBA, as to the ongoing role of and commitment by the IBA in the overall certification program.

6. Certificate

Each stock exchange, or all three jointly, should prepare a physical certificate for presentation to individuals successfully completing the examination and fulfilling all other requirements to become certified securities representatives in Pakistan. The certificate should clearly identify the certification purpose, the sponsoring exchange(s), the recognition of the CLA, the date of certification and be signed by a recognized authority e.g., President, KSE. The certificate should be professionally printed and be suitable for framing and display in the new CSR's office.

KARACHI STOCK EXCHANGE AND USAID
CERTIFICATION PROGRAM

SEQUENCE OF EVENTS

1. ISTI for USAID (BUEHLER, KINNAMAN, MARTIN)
   Recommends certification procedures
   Develops examination specifications
   Develops study outline
   Delivers to Karachi Stock Exchange which, upon concurrence, delivers examination specifications to IBA.

2. IBA develops question bank
   From which it will draw questions for examinations
   (KSE AND IBA negotiate costs).

3. KSE arranges for courses for those wishing to prepare for examinations.

4. IBA conducts examinations at the request of KSE
   (KSE and IBA negotiate costs).

5. IBA authenticates examination results and delivers to KSE
   (or appropriate exchange)
   IBA reports analysis of failures to KSE (or other)

6. SROs convey certificate to qualifying candidates

7. SROs reports names and affliations of certified people to
   to CLA for microfilming and record keeping

8. SROs (KSE, LSE and ISE) appoint committee to periodically
   Review examination and specifications.

A STUDY GUIDE

Introduction

The Certification Program Study Outline has been designed to meet the needs of:

1. Instructors or institutions who prepare candidates for the certification examination.

2. Candidates themselves who wish to structure their own course of study in preparation for the exam.

The study outline may also be used by those not necessarily preparing for the certification examination but who wish to increase their knowledge of the securities marketplace. In this regard, the study outline may provide an organized approach to the vital topics of concern in the securities industry.

Preparation

The study outline has been carefully researched and prepared by a group of securities industry professionals who have had many years of experience. It has been specifically tailored to the markets of Pakistan after careful consideration of the experiences of certification programs in other countries of the world including Asia, Europe and North America.

As markets, laws, government policies, and economic conditions change so must the study outline be modified. In this regard, a review committee appointed by the exchanges will regularly review the content of the study outline and the certification examination itself to ensure that they are current and relevant. Further, they will also analyze the examination specifications to maintain the integrity of the program.

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I. The Financial System

What is a Financial System?

A financial system consists of individuals, partnerships, institutions, companies, markets and government organizations that are involved in assisting the process of exchange of financial assets. A financial asset is anything which will be generally accepted by the community as representing value, and which can be exchanged for money, bonds, mortgages, shares, etc. Money is the most liquid (cash) financial asset while investment in a long-term loan to a company may be comparatively non-liquid, or more difficult to convert into cash.

A financial system fulfills a number of functions including:

- payments — the provision of an effective and convenient means where the payment for goods and services can be made.

- investment — encourages savings and ensures that the savings are borrowed and used hopefully in productive areas with as little uncertainty and risk as possible.

- government fiscal and economic growth objectives — enable the government to raise the taxes and funds it requires, and to achieve its economic growth objectives.

A financial system enables lenders to use their excess funds in a way which produces more funds through the earnings of interest. Conversely, it increases the resources available to borrowers and enables them to achieve a higher level of output, or acquire more assets than would be possible if the borrowed funds were not available. In other words, the financial system aids the mobilization of savings for businesses who plan to make productive use of them.

An effective and publicly reliable system of finance is the cornerstone of any economy and the means of growth. If there was no confidence in the financial system, businesses would not deposit their funds with financial intermediaries. If funds are not available to the public which enable them to make productive use of them the economy would stagnate.

Every modern economic system has a mechanism that ensures that people can exchange their resources, labor, goods or services for the ability to obtain other resources they want. Similarly, if a company could not exchange income earned for labor, then there would be no one with money to buy the results of the company's production.

Money and Financial Assets

The securities industry is intrinsically linked to the use of money in the Pakistan financial system. As economists will tell you the real activities of production — the exchange of real goods and services, are facilitated through money being available to permit the purchase and sale transactions to proceed. They will also inform you that the cost of money (interest rate) is not only an important factor in

determining the quantity of goods that is produced, but it also provides a benchmark for determining and assessing returns on investments.

Money in its basic concept is really a *matter of confidence*: once the confidence is destroyed money reverts to its intrinsic value. Confidence is vital as can be seen by the gradual development of paper money which has negligible intrinsic value, despite its higher face value. The growth in confidence has enabled society to use a wide variety of forms of money — each having various degrees of liquidity risk and return.

Financial Intermediaries

The financial intermediaries act as "middlemen," pooling the funds of savers and passing that money on to borrowers. The intermediaries are paid for providing the service of matching borrowing and lending requirements, and carrying risks through paying the savers at one rate of interest and lending at a higher rate — this is the margin earned by intermediaries. They also charge fees for some of their services.

How Money Flows in a Financial System — Intermediation

Within the financial system two main types of financial flows can be identified:

- direct — From a lender directly to a borrower. This method of transferring funds is only efficient where the sums involved are small for both borrowers and lenders. It would be inefficient for an industrial company wishing to borrow a large sum of money to have to borrow from thousands of individual small savers.

- indirect — Through financial intermediaries where savers' funds are pooled and packaged and are then provided to borrowers for a fee. This is the most commonly used channel when the financial intermediary lends funds to a borrower, or accepts cash for temporary periods.

By operating in volume, financial intermediaries can take advantage of certain economies and use special skills in the administration and supervision of their lending and borrowing. The success of a financial intermediary depends upon its ability to satisfy the needs of borrowers and lenders at less cost than can be achieved in direct financing. They provide safety and convenience for both lender and borrower.

Disadvantages of Financial Intermediaries

The main disadvantage is the cost of using an intermediary which is passed on to both lenders and borrowers through margins and fees. Direct financing is generally less costly because margins do not have to cover the cost structure of an intermediary, but it is less convenient.

Conclusion

The nature of intermediation in the financial system is never constant. The financial system is constantly changing, often not by choice, but as a result of the regulation to which it is subjected. International influences are also catalysts for change and will continue to influence the financial system. Intermediaries also initiate change in the financial system through innovation; comparing the range of financial services available now with previous years. In looking at the intermediaries in the financial system it is important to consider how they have responded to change to date, as this is a good indication of the future of that particular intermediary or segment of the market. It is also a good indication of how the financial markets in the developing economies of Asia, including Pakistan, are responding to change and are likely to continue to develop.

Interest Rates as Market Indicators

Interest rates are the cost of funds. Their level and the direction in which they are moving are both indicative of the level of economic activity.

Money market analysts use trends in the 24-hour rate as an indicator of the ease or tightness of official monetary policy and of money market sentiment.

The "prime rate" is the average weighted treasury bill rate which is another leading indicator of the ease or tightness of official policy and the money market in general. This is a very sensitive rate and the market reacts quickly to changes in this rate.

Exchange Rates

Movements in the value of a country's currency can directly affect the value of its listed securities in a number of ways:

- by influencing the level of anticipated company receipts from export earnings;
- by altering the expected profit position of producers in industries vulnerable to imports of competitive products;
- by altering the actual or perceived investment returns of foreign investors in the domestic market.

The fluctuation in exchange rates between the currencies of trading nations has become an increasingly important factor affecting the performance of many stock markets since financial deregulation in the OECD (Organization for Economic Corporations and Development) countries became more pronounced during the 1980s. The economic well-being, major trading and capital importing nations are vitally affected by the relative strength of their currencies. Consequently, the strength of the US dollar, the Swiss franc, the Japanese yen, the German mark and the pound sterling relative to the domestic currency of a country affect both the short- and medium-term outlook of the market as a whole, and particularly the specific sector where earnings are strongly dependent on exports in that country.

Currently, most nations operate a floating exchange rate. As was noted earlier, relative currency changes are in part the result of interest rate movements. Some countries may be affected due to a major tightening in government monetary policy expressed in the form of higher interest rates, and some have been affected by the decline in the value of the US dollar against other major currencies, underlining the interrelationship between domestic and international economic factors of the currency environment.

Balance of Payments — Terms of Trade

For exporters of primary commodities the price level of such items in both domestic currency and other trading currency is of major concern to the share market. Moreover, the overall quantity and value of such exports has a major bearing on the country's balance of payments.

The balance of payments is a record of the country's total transactions with the rest of the world and is often seen by the market as one of the most important indicators of the economic health of the nation.

The country's balance of payments is the difference between all funds that have left the country (payments for imports, overseas loans, etc.) and the funds received (receipts from exports, overseas investments, etc.) The balance of payments has a number of sections:

- current Account — this section records the difference between the local currency value of exports and imports (goods, services, etc.);

- capital Account — this section records the flow of investment funds and loans between the country and other countries;

- balancing Item — the government has to collect thousands of pieces of information from hundreds of sources to work out the final balance of payments figure. It then checks its final figure against the central bank's record of flow of funds in and out of the country. The difference in the two figures is the balancing item and shows the extent to which the information is incorrect.

A deficit in the current account means that industry as a whole is paying more money to overseas companies than those companies are paying to their domestic counterparts. Hence, capital is leaking out of the country that could be channelled into productive areas such as the share market. A deficit in the capital account means the government owes money and in fact the amount owed is measured in billions of rupees. A government funds this debt by issuing treasury bills/notes/bonds.

Underlying these considerations on the balance of payments and commodity prices are overall movements in a country's terms of trade. Generally used as a measure of a country's current trading prospects, the terms of trade measure movements in the value of a country's export relative to it's imports. An adverse movement in the terms of trade can reflect a movement in the underlying cost of imports due to changing demand, inflation or currency depreciation, or it can reflect a movement in the prices commanded by exports due to similar causes.

Government Economic Policies

A range of government economic policies influence investment patterns in all financial markets, not only those of the stock market. Some of these are related to interest rates, exchange rates and the balance of payments. Other areas relate more to specific or purely domestic matters which are nevertheless of importance in affecting the movement of stock prices.

The most significant areas are:

- monetary policy;
- fiscal policy;
- tariff policy;
- foreign investment policy;
- wages policy.

Monetary Policy

Monetary policy is concerned with measures to influence the supply of money and the level of interest rates in the economy. Monetary policy is implemented by: (a) the buying and selling of government securities by the central bank to influence interest rates; and (b) the use of central bank controls over the banking system, such as capital adequacy guidelines.

A government, through it's agent the central bank, has the ability to alter the total flow of money in the economy. In doing so, it effects changes in the level of production, prices, employment and incomes. For example, lower housing loan interest rates will encourage more people to borrow to buy a house and encourage builders to go out and build new homes, thereby increasing employment in the building industry.

As stated above, monetary policy is implemented through adjustment of interest rates, through a range of open market operations in securities, foreign exchange markets through the central bank, and the exercise of controls over a range of financial institutions.

Fiscal Policy

Fiscal policy is that part of government economic policy which seeks to influence the economy through changes in taxation, welfare payments, and government expenditure. The two most important tools of fiscal policy are levels of taxation and government expenditure. Fiscal policy is important for share market participants as it affects overall economic performance and influences the profitability of individual industries.

Traditionally, fiscal policy has been enacted through the annual budget. Adjustments to the level of public spending and the necessity for a public sector borrowing requirement to fund government

expenditure programs is also an important area of fiscal policy which has a direct impact on investment decisions and the stock market.

What Makes a Market Work

Three features are essential for a market to work effectively:

- information about the product being offered;
- opportunity to buy and sell at a price (liquidity);
- assurance that once the deal is done, payment will be made.

Participants

There are a number of different types of investors in the stock market including:

- **the passive long-term investor** who buys and holds shares with a view to securing long-term capital gains. The group of investors has little impact on the daily share price;
- **the active trader** who attempts to capitalize on the constantly moving share prices in order to make a profit;
- **the irregular trader** who trades on an infrequent basis, say monthly or quarterly. This group has an impact on share prices accentuating the rises or falls;
- **institutional investors**, e.g. the large life assurance companies, merchant banks, pension funds, etc. who are seeking high levels of capital gain. This class of investor usually exerts a significant influence over the daily trading and price of shares.

Factors Which May Influence Investment in the Share market

The decision to invest in a company listed on the share market must take into consideration a number of diverse factors including:

- share market cycles and indices;
- dividend imputation and capital gains tax;
- bulls and bears (market strength vs. market weakness);

- fashion.

Stock Market Investing

The securities industry is part of the financial system of a country. A financial system consists of individuals, companies, and government organizations that are involved in the process of producing and consuming goods and services and exchanging financial assets. The securities industry is concerned with the flow of funds and the creation, management and trade of securities in the financial system. The movement of funds between lenders and borrowers is an important part of the securities industry.

Markets Within Markets

Products traded on financial markets are often called securities. What does the term "securities" mean? The term "securities" (an abbreviation for "marketable securities") is a general term applied to all stocks, shares, debentures, notes, bills, government bonds, etc. Securities are evidence of ownership or debt.

A share certificate or a stock certificate is nothing more or less than evidence of ownership, whereas a debenture or bond is evidence of a debt. The former are equity securities, the latter are loan securities.

"Securities" is the term used to describe any piece of paper traded in financial markets. The reader may be interested to know the origins of the term "securities." It is derived from a Latin word meaning "without worry." It would appear the word has wandered somewhat from it's roots, however, investors in equity securities may be comforted!

What is a Stock Market?

The stock market is the central marketplace for the raising of equity funds by corporations and by governments. It provides a marketplace where company and government securities may be bought and sold. It brings together enterprises who wish to raise money through the issue of new securities with individuals and organizations seeking to invest their savings or surplus funds. In so doing, the stock market offers investors liquidity with the ability to convert their investments into cash at short notice, thereby encouraging the flow of savings into productive ventures.

The Karachi Stock Exchange like other exchanges around the world has developed to meet two basic and complementary needs: a business need for funds and an individual's or company's desire to invest savings efficiently, and for buyers and sellers to agree to subsequent trades.

The exchange operates for the convenience of investors and is open during fixed hours each day between 10:15 a.m. to 2:00 p.m. from Sunday to Thursday, during which business people known as *brokers,* who are members of the exchange, may make transactions on behalf of their clients. The exchange itself determines the buying and selling prices of shares. Prices are determined entirely by supply and demand, the same as any auction-house. The exchange does not act to promote fair trading, it does publish price quotations, and sets rules and standards for trading. It is a self-regulatory organization.

The Stock Market is made up of two markets:

- The *primary market* allows a company or government to raise initial capital. This is usually done by a company issuing a prospectus through an underwriting broker. For example, when a company is first "floated" on the stock exchange it may issue 10 million shares each with a par value of 10 rupees to raise Rs.100 million. The purchasers of the shares become the initial owners and they can remain shareholders of that company or sell their shares to someone else on the secondary market.

- The *secondary market* is the central marketplace provided by the stock exchange where people can buy and sell securities. It is an auction system and the price of the share is determined by supply and demand, the perceived market value of the company.

In a free enterprise system, funds are directed to those areas which investors consider the most profitable opportunity. These judgements are in turn reflected in the level of activity in the secondary market where transactions in existing securities are affected.

How Securities are Bought and Sold

The current trading system on the Karachi Stock Exchange (KSE) is an "open-outcry" system, under which lots are offered and the brokers shout as though they are at an auction.

Alternatively, the "bid-and-offer" system using market members is used where the broker is offered two prices: a buying and a selling price, and chooses whether to take one or to bargain for it. In both cases the action has taken place on the floor of the exchange or on trading screens and the **three** market essentials — *production information*, *equal opportunity* for all and the seller, and *trustworthiness* in payment have been imposed.

In many countries technology has automated the process of the marketplace. The advances in computing, coupled with the refinement of screen display of rapidly changing information has enabled dealers in financial centers to trade electronically from their offices.

Stockbrokers

The stock exchange provides the marketplace. Shares are bought and sold through stockbrokers who are members of the stock exchange. Brokers charge commission for the service of buying and selling shares.

Stockbrokers have a variety of roles including:

- acting as agents for the clients in buying and selling shares;

- offering investment advice on a wide range of investments to both private and corporate clients. Advice can cover a variety of areas, e.g., investment portfolio formulation and review, capital raising, takeovers and reconstructions;
- underwriting new issues of shares.

II. Registered Companies

Pakistan company law is based on and chiefly derived from the British company law. In England, the formation of joint stock companies began several centuries ago. In 1600, three years before the death of Queen Elizabeth I, the East India Company was formed; the Hudson Bay Company was formed in 1670 and the Bank of England in 1694. Such companies were formed by royal charter or by special act of Parliament. At that time incorporation by any other means was not available, and groups carrying on important business such as banking and insurance were considered partnerships. For the first time in 1844, incorporation into companies other than by royal charter or special act was introduced.

In the Indo-Pak sub-continent following the *English Companies Act of 1844* an act for *Registration of Joint-Stock Companies* was for the first time enacted in the year 1850. Every unincorporated company of partners was established under a deed containing a provision that the shares in the business of the company were transferable without the consent of all the partners.[1]

Although in the last mentioned act, the privilege of limited liability was not conferred on the members. Companies were allowed to sue and be sued by it's shareholders, and in the case of insolvent companies there were provisions where the directors might be held accountable for poor management and rateable contributions were to be realized from the shareholders for payments of the company's debts. Liability of past members was indicated, and finally the company would be dissolved. Thus the act of 1850 was the nucleus around which subsequent companies acts developed. The limitation of liability was available only after 1855 by the passing of the *Limited Liability Act, 1855* which allowed any joint stock company the ability to obtain a certificate of complete registration with limited liabilities.

Many amendments and acts took place over the years until the *Companies Act of 1913* came into effect laying down the company rules for disclosure, liability, voting, etc. As in India, the Government appointed a company law committee in 1950, and the new *Companies Act of 1956* came into being. In 1959 Pakistan appointed a company law commission. The commission completed it's work and submitted a detailed report in 1961. Unfortunately, the recommendations of the commission were not implemented and the *Companies Act of 1913* continued on the statute book up to the enforcement of the *Companies Ordinance of 1944.*

Major changes took place through the next few years and a *Draft Companies Ordinance* was prepared and published in December of 1980 for eliciting views of the public. The draft evoked considerable interest from all sections of the economy, and each section did his best to bring forth viewpoints before the government.

Last but not least, the company law entitled *The Companies Ordinance of 1984* was finally issued on October 8th, 1984. This piece of legislature comprises of the longest number of sections of any act in the statute book of Pakistan.

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[1] Information was taken from the "Company Law in Pakistan" book, dated 1986.

Memorandum of Association — Articles of Association

The memorandum of association is the registered company's charter and defines it's constitution and powers. It informs shareholders, creditors and all persons dealing with the company what the company's objectives are, it's permitted range of activities, and what capital it has.

The memorandum affects and controls the company's *external* activities while the articles of association affect and control it's *internal* management and activities of the company. The memorandum and articles must be registered with the Corporate Law Authority (CLA) under the *Companies Ordinance 1984* rules and regulations.

The *Companies Ordinance* states that any two people can form a private company, but it takes seven people to form a public company.

The Company as a Form of Business

A company is an entity, a legal entity, created for specific purposes and certified under the *Companies Act #17 of 1982*. That is, the company exists in the eyes of the law as a person, separate and distinct from the people who own the company. As a legal entity, a company has all the rights and all the responsibilities of a person.

Corporation

When a business has reached a certain size, the owners may form it into a company.
A company can enter into contracts; it can own or sell property; and it has a continuous life regardless who owns the stock of the company. The liabilities of the company and of the stockholders who own shares in the company are limited only to the assets of the company. The risk of the shareholders of the company is thus limited to losing the original invested capital and protects the owner and investors from risking personal assets.

Remember, the distinct advantage of a company is that the owners or shareholders are not personally liable for the debts of the company since the company is regarded as a separate entity or person.

Sole Proprietorship

This is the simplest form of organization whereby the business would not exist without the owner/operator. The liability of the sole proprietor is not limited to the original investment in the business. If the debts of the sole proprietor were to exceed the assets of the business, he or she would be personally liable for those debts. If the sole proprietor should die, then the business would also terminate. However, most businesses start with a new idea with the hopes of eventually becoming a company.

Partnerships

A partnership is formed when two or more persons join together to carry on a business activity with each person contributing money, property, labor, or skills. The rights and obligations of each of the partners in a partnership is defined under a "partnership agreement" which should be in writing and signed by all partners. The liabilities of the partnership is again *not* limited to the original investment

in the business. If the debts of the partnership were to exceed the assets of the business, the partners would all be *personally liable* for those debts. Upon the death of one of the partners, to continue it would require that the surviving partners buy out the interest of the deceased.

Corporate Capitalization

When a new company is incorporated, it's articles will indicate how many shares of stock may be *authorized*. This may have little to do with the actual number of shares actually *issued*. For example: A new company that is authorized to issue 100,000 shares may only issue 25,000 shares. The remaining 75,000 shares may be issued at a later date. The board of directors may also amend the articles to increase the number of shares.

All new companies, when they incorporate, need money if they wish to start in business. Once a new company is incorporated, the initial working capital is obtained by selling shares in the company. These shares are identified as ordinary and/or preference shares which gives the shareholder equity ownership. A company which raises Rs. 250,000 by issuing 25,000 shares at Rs. 10 sets the price of the capital stock of the company at Rs. 250,000.

The directors of the company can use the capital in any manner that will best serve the company consistent with the articles of association and accepted business practice. New capital may be used for a number of reasons, such as; the purchase land or machinery, development, or new technical innovations.

Company capital is classified as either:

1. equity shares (ownership), or
2. debt (loans).

As mentioned earlier, when a company raises working capital it will issue equity securities. These shares represent **ownership** in the company. A company also may raise capital by issuing participation certificates to institutions who loan them money. These are debts and must be paid back at a certain time or exchanged for company shares (equity). The total capitalization of a company consists of long-term (more than one year) liability plus equity.

The securities industry is intrinsically linked to the use of money in the Pakistan financial system. Economists will tell you that the cost of money (interest rate) is not only an important factor for determining the quantity of goods that are produced but it also provides a benchmark for determining and assessing returns on investments.

Companies who need money to run or expand their businesses may seek a *financial intermediary* such as a commercial bank, a merchant, or a development bank. All can assist in the raising of capital.

Company Securities - Ordinary and Preference

Ordinary Shares

Ordinary shares normally represent the bulk of a company's basic ownership money, or equity capital. Ordinary shares represent evidence of ownership in a company. When a person buys shares in a company, he or she acquires certain *rights* and *obligations* as owners.

1. Limited liability: If a company should go bankrupt, the shareholders liability will be limited to the amount of their investment.

2. Transfer of shares: Shareholders have the right to sell, trade, or transfer ownership in their shares (gift,donation or bequest) to other people. However, shares listed on the stock exchange in Pakistan may not be traded outside the floor of the exchange without prior approval from the exchange.

3. Declaration of dividends: When the board of directors of a company declares a interim dividend (usually in cash form), a shareholder has the right to that dividend. The board can also declare bonus shares (extra stock). Directors propose the final dividend amount for share-holder approval at the annual general meeting.

4. Annual reports: A shareholder has the right to receive an annual statement of accounts which includes the company's balance sheet and the profit and loss statement.

5. Residual claims at dissolution: If a company is forced into dissolution or bankruptcy, the shareholders have the right to residual assets after all secured debentures, taxes, unsecured debts, general creditors and preference shareholder claims have been satisfied.

6. Right to vote: Each shareholder has the right to vote for members of the board of directors. His or her voting power is determined by the number of shares of stock held. This right may be assigned to others.

Forms of Dividends from Ordinary Shares

1. Dividends represent a pro-rata distribution among the shareholders. Briefly, each shareholder receives a definite amount of money per share owned. This dividend comes from *profit after taxes*. A current stock exchange ruling states that listed companies should pay final dividends within 45 working days after the annual general meeting.

2. Another form of dividend is the *bonus share*, which is a share issued to existing shareholders for free. Bonus shares are issued to current shareholders by capitalizing the reserves of the company and, in effect, paying a dividend in shares instead of cash. This has the effect of increasing shares issued and a reduction in the revenue reserves (retained earnings). The bonus shares do not increase or decrease stockholders equity or net worth; however, it will theoretically reduce the current market price of the stock, and the amount of profit which could be paid on each share as cash dividends.

3. *Share rights* are a form of dividend. If an investor owns 5,000 shares of ordinary shares from a company with 50,000 shares issued and outstanding, he or she owns 10% of the control, earnings, and net worth of the company. When a company wants to raise more funds by issuing additional securities, it must give the current shareholder pre-emptive rights to the new issue. A pre-emptive right is the right of the shareholder to maintain his or her proportionate ownership in that company. Because the additional shares in a rights offering are usually offered to shareholders below the current market value, rights usually have a market value all their own and may be actively traded.

Participation Term Certificates / Term Finance Certificates

These Participation Term Certificates (PTCs) are a long-term liability for the company requiring capital. PTCs are used to raise working capital for companies instead of issuing equity shares. These are debts which are discounted and paid back at a later time, usually 5 years. In some instances if the company is doing well, they may decide to exchange the PTC (debt) for shares (equity), if the agreement was a convertible issue, where debt is exchanged for equity ownership. This is attractive for the company since they would not have to pay off the debt.

(discuss or list some of the specifics of PTC/TFC)

Statutory Voting

Each shareholder has one vote for each share held. If a person owns 100 shares, then he or she may cast up to 100 votes for each director. For example: If you own 100 shares, and five directors are to be elected, you would then have 500 votes, but may only apply 100 votes for each director. Voting does not have to be done in writing, it may be done by a show of hands at the meeting.

Proxies

When it is difficult for a shareholder to attend a shareholders meeting, he may vote by means of a proxy. This is a written authorization that delegates to another person the right to their vote at the meeting. Shareholders that fail to return their proxies make it easier for management to grasp a larger representation at the meeting. Proxies allow shareholders to vote for or against key issues that will be brought up at a meeting.

III. Company Reports and Disclosures /Securities Analysis

Under the *Companies Ordinance 1984*, there are some specific regulations that must be followed by companies and their accounting practices. *(The specific sections should be listed and discussed)*

Disclosure Requirements

Annual reports should comprise:

- a description of the company and it's activities;
- statutory reports from the directors and the auditors;
- the profit and loss statement;
- the balance sheet;
- the statement of sources and applications of funds;
- various notes to the accounts which provide further information on the statements, plus some additional facts.

Annual accounts should be distributed to shareholders and the stock exchanges within six months of the close of the accounting period. Half-yearly accounts should be submitted within two months of the closing period.

The KSE also requires annual reports and accounts no later than 21 days before a meeting of shareholders for public companies which are listed on the KSE *(to be discussed in more detail in Section VII)*.

International Accounting Standards

A minor influence on company disclosure is overseas accounting standards. Overseas countries produce their own accounting standards. There is also an international accounting body, the International Accounting Standards Committee (IASC), which sets it's own standards. Affiliated national accounting bodies agree to follow international standards as closely as possible. Thus, in theory, where a Pakistan accounting standard does not exist, reference should be made to the international standards.

Finally the professional accountant in preparing financial statements is guided by accounting practices. These are derived from the method of accounting which has developed from the "real world" and recommended methods of accounting contained in recognized accounting text books.

Some of the practices affect all financial statements and some are specific to industries. Where an accounting practice is not covered by the above legislation and accounting bodies general business practice directs the practice and disclosure used.

Who Uses Financial Statements?

A considerable divergence of opinion exists as to who are the users of annual reports. It is stated that users would include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. Readers of financial statements need to compare financial information published by one company with that of another company.

The directors must provide certain information in a management/chairman's report. Directors of a public company (which includes a company listed on a stock exchange) are required to report on the company's operations during the year up to the time of the annual general meeting. Further, directors should comment on likely developments and expected results unless the directors believe this disclosure would be detrimental to the company. If such disclosures are omitted, this must be stated in the director's report.

The directors have to assert that the profit and loss statement, the balance sheet and the notes are true and fair. They also have to comment on the company's ability to pay it's debts. Directors must comment on whether or not the accounts have been prepared in accordance with approved accounting standards and mention anything that may have an effect on the year's results but which was not included in the accounts for that year. A company's financial statements must be audited and signed by an independent chartered accountant.

The average person believes the financial statements show:

1. the financial situation of a business at a point in time,

2. the profit or loss that a business made during the year.

Financial Statements

The primary step for a licensed broker to learn about a company's performance is to interpret that company's financial statements. The three most important financial statements are:

1. balance sheet;

2. profit and loss (income statement);

3. statement of changes in financial position.

As you learn about financial statements, you will find that you will not be prepared to accept all the figures that are contained in financial statements at face value. Financial analysts earn their "bread and butter" because investors and other users of financial statements believe these statements need to be interpreted in order to determine the "real" financial situation of a company. If the financial statements showed the "real" situation of the company, the need for analysts to spend all their time recasting the figures would be removed. Due to these circumstances, it is little wonder that people, including

accountants, have difficulty in understanding financial statements. So, in this course we will look at the financial statements and attempt to explain what you see in "plain English" terms so that you can better understand financial statements.

Balance Sheet

The balance sheet represents a snapshot photo of all the assets, liabilities, and shareholder's equity at one point in time (usually the last day of the year). The balance sheet equation is:

Assets − Liabilities = Shareholder's Equity

It is the responsibility of every company to prepare the report so as to present all the information necessary for the members to understand how well or how badly their company has performed during the reporting period. Assets are everything the company owns. Liabilities include everything the company owes. Shareholder's equity is that which is remaining for the shareholder's after deducting all liabilities from the assets.

Assets

Current assets represent cash and those assets which in the normal course of business will be turned into cash within one year, such as; cash, marketable securities, accounts receivable and inventories. Fixed assets (less depreciation) represent long-term assets that a company owns for it's use. Included in fixed assets are; land, buildings, machinery and office equipment.

Depreciation (also known as amortization) is the periodic allocation of the cost of a fixed asset over it's estimated useful life. Machinery and equipment will be depreciated and is deducted from the cost of the fixed assets. The government has listed specific depreciation rates that will be used when arriving at balance sheet values.

Intangible assets are assets having no physical existence, yet having substantial value to the company. Some intangibles would be patents, copyrights trademarks, etc.

Liabilities

Current liabilities generally include all debts that fall due within the coming year. Current liabilities would be accounts payable, taxes due, dividends approved by the shareholders but not yet paid, etc. Long-term liabilities are obligations of a company that are due after one year. Some long-term liabilities are debentures, leases, etc.

Analysis of the Balance Sheet and Income Statements

Working Capital = Current Assets − Current Liabilities

The excess of current assets over current liabilities is called working capital. This is the amount a company has to work with to run it's day to day operations. A company should have a positive working capital.

$$\textit{Current Ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

This ratio measures the short-term liquidity of a company. The higher the ratio, the more liquid and the more creditworthy the company.

$$\textit{Earnings Per Share} = \frac{\text{Net Income} - \text{Preference Dividends}}{\text{\# of Ordinary Shares Issued}}$$

This ratio shows the earnings for every share of ordinary stock issued.

$$\textit{Price Earnings Ratio} = \frac{\text{Market Price of Share}}{\text{Earnings Per Share}}$$

This shows the relationship between the earning capacity of the company and it's share price in the market. This is a ratio investors look at often. Ideally, an investor should seek investment opportunities offering a low PE combined with a high potential growth rate in earnings. Conversely, an investor should avoid a high PE stock with a low potential growth rate in earnings. This isn't always easy since companies with high growth rates tend to sell at high PEs.

By studying the annual report of a company it is possible to understand it's performance during the year. A decision to invest should be preceded by a study of a company's financial statements.

Sources of Equity

There are three major classes of equity: issued capital, reserves and retained profits. Shareholders invest money in a company whereby they buy a portion of the company's profits each year in the form of a dividend.

The source of equity arising from the issuing of shares is called issued capital. Companies are authorized in their memorandum of association to raise a specific amount of authorized or nominal capital by issuing shares.

Share Capital and Reserves

Share capital is classified as *authorized, issued, and paid up*. Authorized capital is the maximum amount of capital a company can issue under it's current resolution. Issued capital is what has been issued out of authorized capital. Paid up capital is what shareholders own of issued capital. Reserves are the profits not distributed to shareholders as dividends, but retained in the company itself for future use. While revenue reserves (cash) can be used to pay dividends in cash, capital reserves (equity) may not be paid out in cash, but in kind, in the form of bonus shares.

Profit and Loss Statement

The income statement shows the company's operations. This statement reflects revenues generated which are the main function of the company, expenses incurred, net trading profits earned during the year, and dividends which are paid out of net profit after tax.

$$Profit = Income - Expense$$

Key Points

- the structure of the profit and loss statement
- how analysis uses the operating profit before abnormal items and income tax as an indicator of company performance
- the distinction between operating and non-operating income
- the distinction between income tax expense and income tax payable
- the distinction between abnormal and extraordinary items
- why abnormal items are listed separately in the notes
- why extraordinary items are listed separately on the profit and loss statement
- factors which may influence a company's dividend policy
- why contingent liabilities are not included in the balance sheet
- how to identify the performance of individual industry segments within a group

- the function of the funds statement

- some of the significant aspects of a company's operations that the reader of financial statements may derive from the funds statement

- the distinction between sources of funds and applications of funds

What it Shows

The profit and loss statement shows how much revenue a company has earned during the year from the sale of it's products or services, and how much profit is left over after paying expenses incurred during the year. The amount left over after paying income tax is called operating profit after income tax out of which dividends may be paid to the shareholders.

The balance, which is called *retained profits or retained earnings* is kept by the company and used for future operation and growth. The profit and loss statement tells us the earning power of the company. Analysts are particularly interested to know how much and how consistently a company makes profits. A business may have grown considerably but could have done so solely with the help of a bank overdraft or other finance facilities. If the business does not make profit, the burden of interest payments will become too great and the business will fail, i.e., the profits earned and the cash available will be less than the interest to be paid on it's borrowings.

What it Does Not Show

A company must profit to survive. Gross profit is the difference between sales and the cost of goods sold, while operating profit is the difference between the gross profit and operating expenses.

Under current accounting standards, companies are not required, nor do they choose, to disclose how they calculate the operating profit. They show the operating revenue received from sales and other sources on the first line of the profit and loss statement or in the notes to the accounts, followed by the operating profit, with limited disclosure in the notes on expenses incurred in making that profit. However, the gross profit is normally not disclosed. Gross profit is significant as it indicates the profit available to pay operating expenses. Companies do not like to disclose too much about their gross profit as it indicates their strengths and weaknesses and may give competitors too much information about their gross margins. A typical manufacturing business would aim for 30% to 35% gross profit margin.

Dividends

The shareholders of a company are it's owners and are entitled to receive a share of the earnings of the company. Some companies pay their shareholders once a year (final dividend), while others pay during the year (interim dividend) as well as a final dividend. A company's dividend policy will be influenced by a number of factors including legal restrictions on what profit is available for distribution, the need to sustain economic growth and the need to satisfy shareholders. The policy will be determined by the directors and approved at the annual general meeting.

Sources and Application of Funds Statement

(sources and uses of funds)

This statement reflects changes in the financial position, or changes in working capital (current assets less current liabilities) of the company. From this statement an investor should be able to determine a company's cash flow, net profit after taxes plus depreciation and any extraordinary charges to reserves which are book-keeping deductions and not paid out in cash. This statement shows the way in which funds flowed into the company and how they were applied. The sources and uses statement can be most useful for securities analysis, and investors should study it carefully.

What it Shows

The balance sheet and the profit and loss statement provide a lot of information but do not give all the answers. They do not provide information on where the earnings went, how funds were used from new shares, how working capital increased while profits substantially decreased, etc. The answers to these and many other questions are contained in the statement of sources and applications of funds (the funds statement).

In recent years there has been an increasing use of the funds statement in published financial reports to supplement the balance sheet and the profit and loss statement. The view today is that the statement is necessary for an adequate understanding of the changes which have taken place in a company between two consecutive balance sheet dates.

The funds statement summarizes the financing and investing activities of a company including the use of funds generated from operations, and it highlights the changes in the financial position of a company during the period.

The funds statement provides the financial analyst and potential investor with information on key aspects of a company such as turnover; profit before and after taxation; shareholders' equity and their rate of return; earnings per share and divided distribution; working capital ratios; and gearing rations etc.

IV. Investment Risks And Objectives

When a certified securities representative (CSR) makes recommendations for a client, the suggestions should be in line with the client's objectives and characteristics. They should consider the risks and rewards involved and should be designed to benefit the client. Therefore, the CSR should know the types and degrees of risk that the client is willing to assume as well as the investment risks attached to each recommendation. The financial investment risks are:

1. *inflationary risk* is the risk that money will lose its purchasing power as prices increase.

2. *business risk* is the uncertainty with regard to the demand for a company's services or products and management's ability to operate the company profitably.

3. *selection risk* is the risk of having many securities to choose from: all apparently suitable, but the client may select one that performs poorly.

4. *timing risk* is the risk of sustaining losses or lowering possible gains by purchasing or selling securities at a disadvantageous time in a company's business cycle.

5. *market risk* is the uncertainty of future prices due to changed investor attitudes. Investor optimism or pessimism can make large swings in securities prices, even with securities of a good sound company. With regard to market risk, the better the grade of investment, the better it will be with respect to market risk.

6. *credit risk* is a measure of the credit worthiness of the issuing company. The risk is that the issuer of a security will be unable to pay the interest or principal when due at maturity.

7. *liquidity risk* is the ability to convert a security into cash. Liquidity risk is concerned with adverse changes in the quality of securities originally bought that permits their convertibility into cash without significant penalties or loss.

8. *marketability risk* is the speed and ease with which a security may be bought or sold without a significant price change. A security that has a large amount of shares outstanding and is actively traded is highly marketable and therefore liquid.

9. *risk of legislative changes* is the risk that new legislation or changes at the governmental level may affect potential value of securities purchased.

Investment Objectives of Customers

Investments made by clients are made for many reasons. Many individuals have different reasons for investing their money. They may invest for their retirement, university education for their children, vacation or travel, etc. The source of their investment may come from savings, part of current income, or lump sum proceeds from an insurance settlement or inheritance. No matter where the client's money may come from or what their reasons are for investing, there are only two general classifications of investment objectives: income, and capital appreciation.

Since it is impossible to combine all of the above objectives, the CSR's duty is to tailor an investment portfolio as close as possible to the specific objectives of the client, keeping in mind the client's personal and financial background. The KSE strongly feel a CSR must have reasonable grounds for believing that any investment he or she recommends to a customer is suitable based upon the client's needs and objectives.

One of the most difficult tasks a CSR has is to determine the financial stability of the client. Most clients are usually unwilling to divulge their financial status to CSRs since they may consider their status as private. The CSR will have to use tact in finding out certain information by pointing out that the more information the broker has, the better he or she can advise the customer. A CSR should also avoid making recommendations with respect to insurance, estate wills, or taxes unless qualified to do so. A CSR should also be aware of the changing factors that affect a client's investment decisions. These decisions can change over the years with regards to age, marital status, dependents, employment, etc.

Portfolio Analysis and Management Policies

Clients' portfolios are analyzed and managed by CSRs according to their customers' objectives, financial status, limitations, and suitability. Thus portfolio policies and management of these portfolios are formed to suit the needs of the customer. There are three types of portfolio investment management policies:

1. aggressive;
2. defensive;
3. aggressive/defensive.

An aggressive portfolio policy is predominately invested in ordinary shares. The assumption is that the market is strong and rising and that ordinary shares are for younger clients and those who are willing to bear a fair or higher degree of risk. Also, an aggressive policy seeks to maximize returns but the customer has to take on a higher level of risk.

A defensive portfolio is concerned with the safeguarding of principal and minimizing risks. Thus, a more balanced portfolio is sought for and should be tailored with the customer's limitations in mind. A defensive portfolio should place emphasis on securities that resist declines in market prices. This strategy is also more suitable for older customers and those who are less willing to bear risk.

An aggressive/defensive portfolio is often referred to as a balanced portfolio and usually includes both shares and debt and hopes to act as a hedge against the market fluctuations.

Tax Consequences of Securities Transactions

CSRs should be familiar with some basic rules governing taxation when giving advice to their clients. Above these basic rules, clients should seek the help of competent professionals such as tax attorneys and public accountants. The following is designed for brokers to have a basic understanding of the ever changing tax laws and consequences.

(discuss specific taxes that apply in Pakistan)

Economic Factors Affecting Securities

To understand the securities business we should have a basic understanding of economics and how it affects securities as a source for investment. Economic indicators are used to measure numerically the progress or decline in various sectors of an economy during a particular period relative to a base period.

Gross Domestic Product

This measure indicates the value of goods and services produced by the economy of Pakistan during the year, at factor cost, market price, and in constant prices.

Gross National Product

The Gross National Product (GNP) represents the total value of goods and services produced in the economy during the year after adjusting for net external income. This is the most comprehensive measure of what is produced at the prevailing market prices. Components of Gross National Product are:

1. *net national product*: GNP less depreciation equals NNP;

2. *national income*: NNP less capital expenditures and business taxes. NI represents all forms of income, wages, rental income etc.;

3. *disposable personal income*: personal income less taxes;

4. *personal savings*: this is the amount left over after personal expenses.

Changes in the Economy and Business

Inflation is a process of steadily rising prices resulting in a decreasing purchasing power of the rupee. Inflation exists when there is an excess of total demand over the total flow of goods and services produced (GNP) in our economy. If the demand for goods and services by consumers, government and businesses exceeds the available supply, prices will go up. There are too many rupees chasing too few goods. In addition, inflation can occur through a cost push process in which increased costs induce increased prices.

Money Supply

Money supply is the amount which exists in our economy at a given time. The money supply consists of:

M1 — Currency (paper money and coins) and demand deposits (checking accounts).

M2 — M1 plus total time deposits (savings accounts) in commercial banks. Also included in M2 are various types of time deposits which have different lengths of maturity.

Basics of Fundamental Share Analysis

The difference between financial statement analysis and equity analysis is while the analysis of financial statements is the foundation on which good equity analysis is built, there is much more analysis than just analyzing numbers drawn from companies' accounts. An analyst must always be thinking about other things, such as:

- what type of industry is the company in?
- what are the cyclical patterns of the company's business?
- does the quality of management match the size of the company? Is management competent, or indeed honest?
- is the company dominated by one person, and if he departs how will the company be affected?
- is the company in control of its own destiny, or are its profits at the whim of other factors (international prices/government policies etc.)?
- what strategy does the company have in place for the future?
- who's on the share register? Is there the likelihood of a take-over for the company?
- what are the company's strengths and weaknesses? Basically, if the company has a reputation for being a company of excellence, what is the secret to its success? Conversely, what is the cause for poor performance?

Explanation of Fundamental Analysis

The term *fundamental analysis* is in many ways self-explanatory. It involves the analysis of the financial statements of a company combined with a consideration of other factors. Fundamental analysis aims either to place a value on the underlying assets of the company, or to estimate what earnings over the next couple of years are likely to be.

The fundamental analyst studies the background of particular industries and individual companies. They consider the costs, profit margins, management performance, production, and financial statistics. The fundamental analyst is concerned with the above in different stages of a company's life cycle. These stages are development, growth, stabilization and decline. Most analysts focus on future earnings rather than current dividends or assets in the belief that the growth of earnings determines the growth in share price.

With this theory there is tremendous room for interpretation and subjective judgment, which is why there are always many different opinions on what a share's price should be.

What are the Shares Worth?

A key objective of this subject is how to assess the value of shares in industrial companies, both on an absolute basis and also on a relative basis. For example, we may know the "market" (by which we mean the leading industrial companies) is trading on a PE of 12.0 x 1993 earnings and we have analyzed a company and assessed that it is currently trading on 12.6 x 1993 earnings (a 5% premium to the market PE). If we consider the company should trade on at least a 10% premium to the market, then we are justified in saying it is under-valued based on our estimates of future earnings.

Valuation techniques, PE method of valuation, discounted cashflows, and the cost of capital is what the analyst's job is all about. We will study the PE method and the difference between earnings and cashflow later in the module.

Basic Facets of Equity Analysis

Any analysis of a company involves a careful study of its published accounts. Many analysts (perhaps 50%) are not trained accountants, though most have done some introductory courses enroute to becoming analysts.

The essence of fundamental security analysis is that shares have a value which reflects a large number of economic conditions. A change in any of these economic conditions, referred to as fundamental factors, can cause a change in the value of the shares. Accordingly, a primary function of the security analyst is to:

a. identify factors of significance which can be combined to determine the value of a share; and

b. devise methods or techniques which combine these factors in financial terms so as to determine the security's true or real intrinsic value.

The fundamental factors which combine to determine a security's value are very large in number. In general however, it is found that analysts attempt to identify factors which influence security values at three major levels:

a. The *macro-economic level* — the effect of such factors as income taxes, exchange rates and interest rates which affect most security values.

b. The *industry level* — factors common to the industry in which the firm under analysis operates. Such factors would include things like barriers to entry, near substitutes, market acceptance and penetration, etc.

c. The *firm level* — factors peculiar to the firm under analysis, including such things as management, employees, location, productivity, marketability of the firm's products, competition, firm's image, growth prospects, etc.

Basically, most approaches to fundamental or "intrinsic" value calculations find their origins in two basic concepts:

a. the capitalization or discounting of current maintainable or expected future earnings, dividends or net cash flows; and

b. the net realizable value of a firm's assets less liabilities on a going concern or wind-up basis.

As with any model, the quality of output is essentially a reflection of the quality of input. Unfortunately, there has been a tendency to emphasize the implications of the output, as opposed to concentrating on the quality of the input (in other words, "garbage in will give garbage out").

Advantages of Fundamental Analysis

a. *Discipline*: Any attempt to arrive at an estimate of intrinsic value tends to reduce the vagueness of an investment opportunity. It forces the investor to quantify the variables, instead of merely relying on qualitative judgement. Even though forecasting the main variables can be hazardous, it can highlight particular problems which might not surface with a more subjective approach.

b. *Risk*: In determining appropriate discount rate (rates of return) for an intrinsic value calculation, it brings into clear focus the implications of risk associated with an ordinary share investment.

   The actual difference or "premium for risk" would vary depending on the quality of the stock and the likely risk of the estimated variables being wrong. Taxation differentials and different growth potentials also effect the appropriate rates of discount.

c. *Linking of current share price, fundamentals and likely market performance*: In some models the use of estimated PEs is one of the crucial steps in determining intrinsic value. The analysis applies past and current PEs to determine the appropriate multiplier. If the PE of a listed company is high compared with its past or similar listed companies, the analyst must then study certain factors (future dividends etc.) to see whether the projections made justify the current multiplier. The PE to be used is of crucial importance and the analyst must be careful not to be influenced by current market psychology in selecting the appropriate PE.

d. *General*: Experience has shown a willingness to concentrate on short-term earnings models where the forecasts are not as exposed to the vagaries of time. Many argue that the market reflects the efficiency of its components and it is hard to out-perform because of the high levels of expertise and competition that exist. Fundamentalists believe it is therefore essential to compare current price levels with short-term intrinsic value estimations.

Disadvantages of Fundamental Analysis

a. *Forecasting of crucial variables*: When forecasting future earnings streams it soon becomes obvious that this is an immensely difficult task, subject to many pitfalls. It is therefore tempting to resort to broad analytical judgements in calculating maintainable earnings. Even when given the earnings per share (EPS) figure for the first year, it is necessary to determine a payout ratio to enable dividend streams and retained profits to be calculated for the following year. One must remember

that valuation of returns, dividends and benefits may or may not be attainable due to outside factors. In summary never underestimate the inherent difficulties in forecasting which tends to accelerate over time.

b. *Changing market sentiment and market cycles*: These changes often render intrinsic value analysis somewhat sterile in the shorter term. Many share valuation models assume that there is a direct relationship between earnings and the current share price. In practice, cyclical declines and/or temporary psychological change in market ratings could have a greater effect on the actual share price than the projected or achieved growth rate in earnings. The old saying that value is "only what you can sell it for" appears to have merit in the short term.

A book called *In Search of Excellence — Lessons from America's Best Run Companies*, is an excellent anthology on successful businesses. The writers believe that if one can identify excellence in a company, one of the key tasks of being an analyst has been achieved. The authors identify eight attributes that characterize most nearly the distinction of the excellent, innovative companies. They are:

1. a bias for action;
2. close to the customer;
3. autonomy and entrepreneurship;
4. productivity through people;
5. hands-on, value driven;
6. stick to the knitting;
7. simple form, lean stuff;
8. simultaneous loose-tight properties.

The Impact of Macro — Factors on Security Analysis

Macro factors can have a dramatic effect on the security analyzed. There are several types of macro factors: some are interrelated and some are caused by overseas events. Major macro factors are:

- Economic — exchange rates, inflation, wages, taxes etc.;
- Social and Political — unemployment, welfare, tariffs, etc.;
- Disasters — fires, floods, droughts, plagues, etc.

Any of these factors can effect a company's earnings, risk profile and growth prospects. Therefore, it is imperative that security analysts understand how these could affect the pricing of a security and, in particular, how vulnerable the underlying business is to macro factors beyond its control.

Examples of how macro factors affect equity analysis are:

- a depreciation in the value of the Pakistan rupee against the US dollar can lead to increased purchase costs for importers, and decrease demand if the cost is passed onto customers.
- floods could destroy crops and the volume of produce, thereby decreasing revenues, unless a premium price is imposed on consumers who have the demand.

Sources and Evaluation of Information

The analyst attempts to identify factors which influence share value at three major levels:

- macro-economic level;
- industry level;
- firm level.

At macro-economic level:

- domestic and overseas government budgets and announcements;
- domestic and overseas central bank bulletins and announcements;
- domestic and overseas economic advisory bodies such as the OECD, IMF and some universities;
- research reports by stockbrokers and other analysts;
- financial and non-financial newspapers, journals and magazines;
- government statistics;
- data bases such as Reuters.

At industry level:

- all of the sources above which may also focus on relevant domestic or overseas industry data;
- special government enquiries and reports and specific industries;
- regular government department reports;
- industry representative bodies and journals;
- annual industry classification books;
- annual reports put out by similar businesses;
- independent experts' reports on businesses.

At firm level:

- stockbrokers' and other analysts' research reports;
- financial and non-financial press;
- trade journals;

- promotional literature put out by the firm;
- takeover documents;
- data bases such as Reuters;
- the library;
- discussions with directors and management, etc.

The analyst's evaluation and selection of the required information will be continually changing but will usually be in part a function of:

a. the independence of the source of information;

b. the objectives of the analyst versus the objectives of the information supplied from the above sources;

c. the timeliness of the information;

d. previous experience with the quality of information received.

Unfortunately, or fortunately, depending upon one's point of view, the time available can also restrict the sources of information. For this reason, the analyst needs to know his objectives and follow the right direction to save valuable time.

Some other risks industries face are:

technology — one of the biggest risks an industry can face is the risk that a technological change will make the industry virtually obsolete.

change in tastes — a sudden change in community tastes can severely damage an industry's profitability and stunt its growth. The fashion industry is vulnerable to changing tastes.

risk of demographic changes — these changes can affect the profitability of some industries. If the birthrate in a country would fall suddenly it would have an adverse effect on demand for baby carriages and all the related items.

Life Cycles of Industries

The grandfather of concepts for predicting the probable course of industry evolution is the familiar product life cycle. The hypothesis is that an industry passes through a number of phases — introduction, growth, maturity and decline.[2]

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[2] Source: Michael E. Porter, Competitive Strategy Techniques for Analyzing Industries and Competitors. (New York Free Press, 1980)

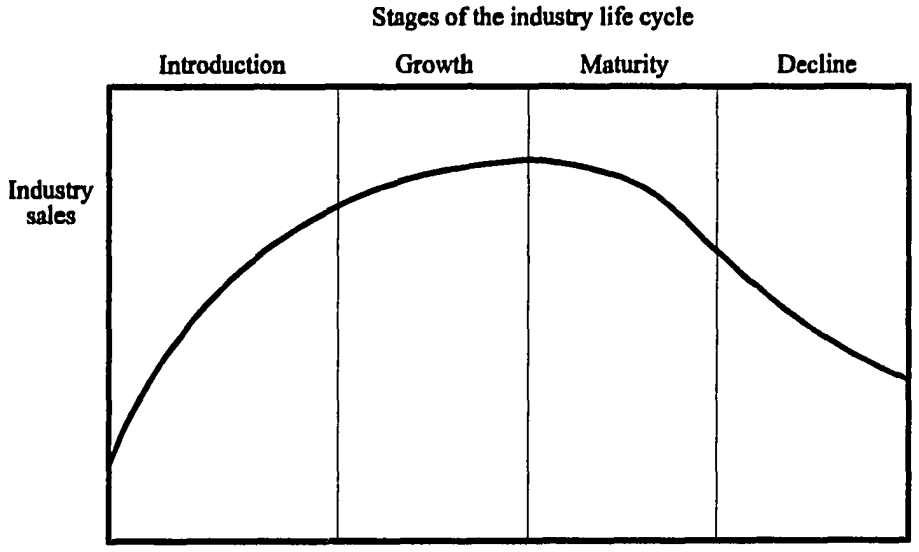
These stages are defined by points in the rate of growth of industry sales. Industry growth follows an S-shaped curve because of the innovation and diffusion of new products.

The flat introductory phase of industry growth reflects the difficulty of overcoming buyer inertia and stimulating trials of new products.

Rapid growth occurs as many buyers rush into the market once the product has proven itself successful.

Penetration of the product's potential buyers is eventually reached, causing the rapid growth to stop and level off to the underlying rate of growth.

Finally, growth will eventually taper off as new substitute products appear.



* Source: Michael E. Porter, Competitive Strategy Techniques for Analyzing Industries and Competitors. (New York Free Press, 1980)

The product life cycle has attracted some legitimate criticism. The duration of the stages varies widely from industry to industry, and it is often not clear what stage an industry is in. Industry growth doesn't always go through the S-shaped pattern. Sometimes industries may skip maturity and pass straight from growth to decline. Companies can affect the shape of their growth curve through product innovation and repositioning. If a company takes the life cycle as given, it becomes an undesirable self-fulfilling prophecy.

Since actual industry evolution takes so many different paths, the life cycle pattern does not always hold, even if it is a common pattern of evolution. Nothing in the concept allows us to predict when it will hold and when it will not. These problems diminish the usefulness of the concept as a planning tool.

Industry: The Evolutionary Process

Every industry begins with an initial structure — the entry barriers, buyers and supplier power, etc., which exist when the industry comes into existence.

Although initial structure, structural potential, and particular firms investment decisions will be industry specific, we can generalize about the important evolutionary processes. There are some predictable and interacting dynamic processes that occur in every industry in one form or another, though their speed and direction will differ from industry to industry.

The Bottom-Up Approach to Investing

This is probably the most common of all methods and looks at the fundamentals of each stock, price earnings ratio, dividend yield and net asset backing to decide whether the stock is cheap or expensive. Many analysts focus on future earnings rather than dividends or assets in the belief that the growth of earnings determines the growth in share price.

The Top-Down Approach to Investing

The first step in this approach starts with the broad international and domestic economic outlook where you make predictions for the trend of interest rates, gross national product, wages, inflation, commodity prices and other broad economic factors.

The second step is to decide which sector of the stock market should benefit most from your predicted trends. If you believed that the construction business was to decline, you would sell your shares in developers and building supplies.

The third step in the process is to look at individual stocks within your chosen sector and pick those stocks which will benefit most from future trends. At this point many top-down analysts also use the techniques from the bottom-up approach in making final stock selections.

As you can see, there is tremendous scope for interpretation and subjective judgement, which is why there are always many different opinions on what a stock's price should be. After all, for every buyer there is a seller and if everybody agreed there would be no market.

Technical Analysis

Technical analysts aim to predict stock price movement. However, they dismiss the likelihood that accurate forecasts can be made by analyzing fundamentals. Instead, they focus on the stock market itself and follow price movements closely: the assumption being that any influences on prices are already reflected in these movements. Technical analysts maintain that you do not need to gauge **why** prices move, but by following the prices only, patterns will emerge which will indicate the likely direction of where the shares are headed.

Technical analysts study and plot charts on the past and present movements of stock prices, the volume of trading, and the number of shares advancing and declining. They then look for patterns and try to predict the direction of prices for a stock or for the market as a whole.

Market Theories and Analysis

Technical analysts are concerned primarily with the activity of the stock market in general and price movements of particular company shares they are watching. By studying the stock market in general along with individual price movements, the technical analyst will attempt to predict how the shares will move. A technical analyst doesn't care if the company's earnings are going up or if the company is growing, he is only concerned with the price movement of the shares. The analyst will have theories based on charts or numbers. Some of the widely used theories are:

1. advance - decline theory: This theory measures the strength of the stock market's rise or fall. For example: if 50 issues are traded on the KSE on a particular day, and 25 issues advanced in price and 25 issues declined in price, an index can be calculated by dividing the shares that advance by the total traded which equals 50%, indicating a neutral position. Advances are considered to be bullish while declines are considered bearish.

2. volume of trading: This is the relationship between market price to total volume traded. A rise or decline in prices on high volume signifies a continuation of the price movement. A rise or decline in prices on low volume signifies a reversal of the price movement. Technical analysts like to see heavy trading (high volume) in a rising market, but discouraged in a declining market. Also, in a declining market, if the volume decreases the trader believes that the selling will cease and therefore the decline may end.

Technical Analysis of Individual Securities

A head and shoulder chart formation is one of the classic patterns agreed upon by technical analysts as being a reversal of a trend in the price of a share. If the head and shoulder pattern appears at the top of an upward trend (head and shoulders, top) it would be the reversal of an upward trend. If the head and shoulders pattern appeared at the bottom of a downward trend (head and shoulders, bottom) this would indicate a reversal of a downward trend in the price movement of a particular share. For example: if a share price moves between the Rs. 30.00 to Rs. 35.00 range, the Rs. 30.00 level represents the support level (head and shoulder, bottom formation). A bottom formation indicates that the share price has bottomed and the reversal will occur where the share should go up. The Rs. 35.00 level represents the resistance level (head and shoulders, top formation). A top formation indicates that the share price has peaked and the reversal will occur where the price will go down.

Efficient Market Theory

This approach is a relatively new approach in market theory. This theory simply states that investors believe that share prices accurately reflect the true or intrinsic value of individual shares. The efficient market theorists are not concerned with technical or fundamental analysis. They also do not believe in an over-valued or under-valued share. Whatever the current price of a stock, is the true intrinsic value.

Beta Factors

The beta coefficient represents the volatility of a share relative to the market in general. A share that fluctuates up and down the way the market does would have a beta coefficient of 1.00. A stock that fluctuates up and down twice the rate as the market would have a beta coefficient of 2.00. A share with a beta of -2.00 would move twice as fast as the general market, but in the opposite direction. The higher the beta factor, the more speculative the share.

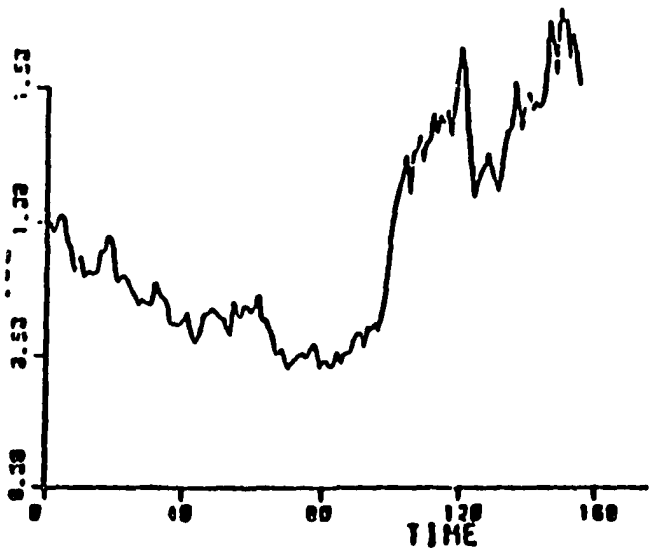
Contrarian Investing

The Contrarian theory is that to succeed in the stock market you must do something different from everybody else. Many investors believe that one who buys when others are desperately selling and to sell when others are greedily buying will reap the most rewards. Investors try to stay away from fads and industries that appear temporary. It is believed that it is impossible to produce a superior performance unless you do something different from the majority.

Charting

Charting, also called technical analysis, is another form of stock selection which some people use to buy and sell shares. The premise of a pure chartist is that the direction of a stock price can be determined from the pattern of its previous movements, and that fundamental analysis is unreliable.

Both fundamental and technical analysts seek the same objective: to predict the future price movements using historical data. The fundamental analyst looks at the economy, the industry and the company while the technical analyst considers share prices, trading volumes and other market data. Both offer clues to the future and support each other. (See charts on following page.)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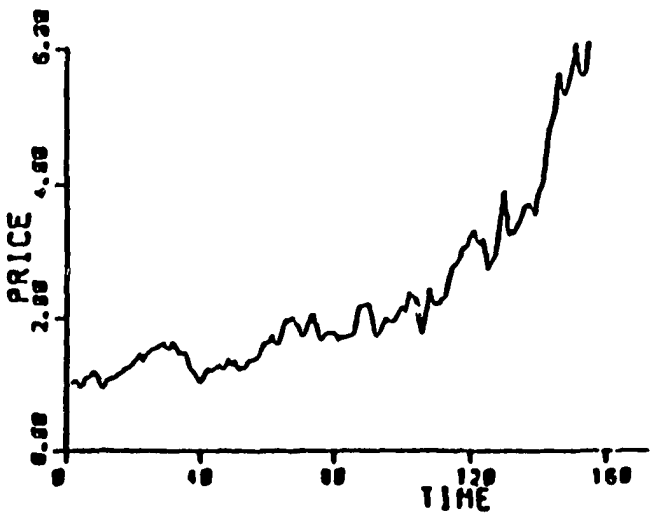
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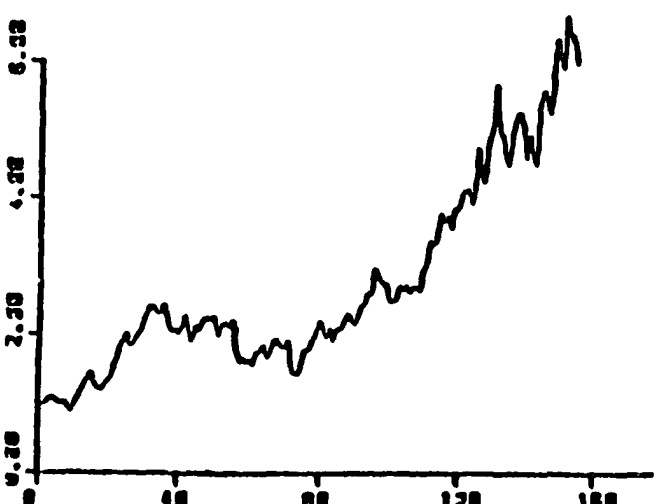
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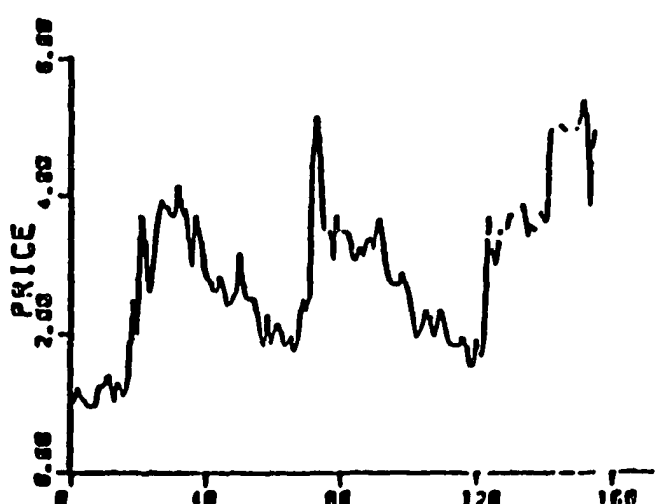
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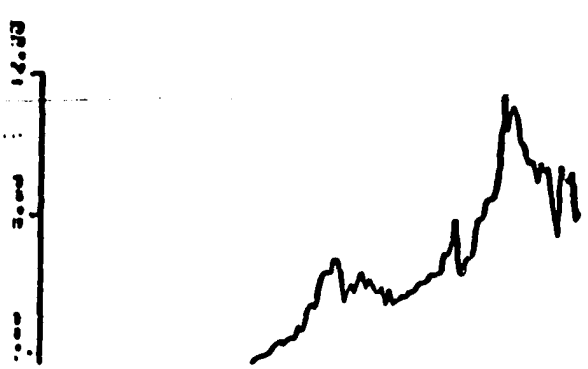

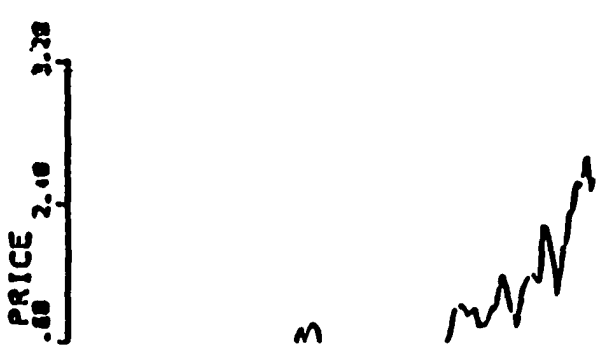
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Industry Classification

Industries are further broken down into three categories:

1. *Defensive Industry* - Defensive industries usually report steady earnings and dividends even during a recession. During good times mild improvements are reported. Medical and food industries are examples of defensive industries.

2. *Growth Industry* - Growth industries show continued growth year after year in sales and earnings. The growth industry usually pays little if any dividends because they need the earnings to reinvest back into the company. Computers and electronics are examples of growth industries.

3. *Cyclical Industry* - With the cyclical industry, sales, earnings, dividends and share prices fluctuate widely with the business cycle. These industries will be affected most with the downturn or recoveries in the economy. Autos and housing are examples of cyclical industries.

Investment Timing is Important

Investment timing is just as important a strategy as stock selection and diversification. For a short-term investor, it can mean the difference between making or losing money. For the long-term investor it is not as crucial, but nevertheless is still important. Due to the difficulty in picking the bottom or the top of a cycle, it is a good idea to buy and sell stocks at regular intervals throughout a market cycle. Note that investment timing is slightly less relevant at the top end of the market than at the speculative end.

Knowing a company's earnings potential and understanding what an increase or decrease might do to the share price is fundamental. This is where brokers' estimates and your own homework and observation of price patterns become an invaluable tool. Timing can also involve a certain degree of luck.

A number of events can significantly effect a market and these events cannot be reasonably expected to be predictable.

i. War — e.g. the Iraqi invasion of Kuwait.

ii. Political Upheaval — a potential assassination or unexpected resignation of an influential county's leader or treasury or finance minister might affect markets.

iii. Unexpected Company Risk — a company might suddenly reveal a liability (perhaps off-balance sheet) not previously known to the market. The share price would suffer accordingly.

Don't Ignore the Warning Signals

When in doubt get out. More often than not, when warning signals emerge, such as rumors of imminent failure, bad press, late payment of dividends, things can only get worse. It is surprising how many people left money in failed public companies despite the warnings. While rumors may seem unfounded, if enough people believe them, they can be self-fulfilling. Investors should monitor their

investments and try to gain a close understanding of them. Hence it is important to differentiate between potential terminal problems and, say, a press article slanted in a negative way.

Don't Put All Your Eggs in One Basket

A diversity of stocks is an essential feature to consider in managing a portfolio. There is safety in numbers, and many advisers believe a portfolio should contain at least seven stocks to prevent too much loss in the total portfolio value when one stock has a sharp decline. Of course one should also diversify assets, allocating funds between property, equity and fixed interest.

It is also prudent to diversify among types of stocks. For instance, a portfolio of twenty mining stocks will be likely to suffer as much as a single stock if the mining industry should suddenly drop. Experienced commentators suggest a portfolio for a private investor should have at least seven stocks spread amongst at least six industries. Institutional portfolios such as various unit trusts have more than a hundred stocks.

There are a number of schools of thought on whether the strategy of having a small number of stocks or a large number makes any difference to investment performance. However, there are, in Pakistan, many cases where employees and families have all their wealth in the company they are associated with, in effect a one-stock portfolio. There are also employees of companies who have built up large holdings in their company and retire better off than many investors who have had a large portfolio of stocks over the years.

Don't Get Greedy

Despite what anyone says, greed can be a bad thing, unless it is taken in moderation. It is often hard to know when to sell — always leave something for the next person. You should, as a guide, set a preferred return rate and make sure you sell out when it is reached.

Many investors can relate to this rule. How many times does an investor seek an extra few cents on a sale price only to see the price fall back and thus miss the sale? The investor will then often sell at prices much lower than originally intended. This scenario is common in the commodity market where price movements can be erratic and difficult to comprehend by the average investor.

Don't Follow the Crowd

Many times over the past decade we have seen the stock indexes rise 20% and as a result have witnessed investor interest intensify as they try to participate in the firming market. Similarly, when the market falls suddenly, pessimism abounds and investors will off-load stock for fear of prices falling to even lower levels. In these situations investors are swinging with the prevailing mood and this *stampeding* with the masses often results in unwise investment decisions. Hence the *mood* of the market outweighs fundamental parameters.

This scenario was dramatically seen after the 1987 stock market crash in major markets. Market and media commentators and high profile brokers spoke of a prolonged economic downturn, an international calamity which threatened the cornerstone of the western world. "Capitalism was in trouble"!

Many investors in these countries sold their quality industrial shares at ridiculously low prices in reaction to media scare mongering and misinformation. As one recalls, most western governments relaxed monetary policies which eased interest rates and resulted in firmer markets in early 1988. Conversely in 1987, when P/E ratios on quality stocks were 15 to 20 and the market was booming, too few investors sold at those inflated prices. In fact most individuals were net buyers during this period. Here again, going with the crowed was ill-advised.

V. Certified Securities Representatives/Responsibilities

Ethics in the Securities Industry

There is increasing concern and interest in ethics in the business world. This can be seen by the increase in the number of articles and discussions related to ethical issues in business. The media, various business and professional organizations are displaying greater concern and awareness for ethical issues.

Ethics is concerned with moral standards or principles; what is good or bad; what is right and what is wrong. Ethics are generally a matter of moral values, personal responsibility, integrity and conscience. However, ethics are very important to business transactions. In fact, it would be difficult for business to function without a "standard of conduct" as well as rules. Words like "trust," "fidelity," "integrity," are frequently used in the securities industry. "My Word is My Bond" is a motto that enables brokers to exchange shares efficiently without bureaucratic systems. Once a client loses faith or trust in a broker or brokerage firm, the confidence is shattered and sometimes takes years to repair.

Ethics concern basic notions of what actions are right or wrong. These notions vary from person to person, from society to society, and from time to time. The concepts are molded of human experience slowly and gradually taking form as assumptions, oral or written traditions of public conscience, and eventually as working codes.[3]

Today many companies have established codes of ethics as guides for their employees, requiring that company business be conducted not only in compliance with the law, but also in accordance with the highest standards of business integrity and honest dealings.[4]

The "Code of Ethics" is a business practice that has been identified and adopted by most businesses and is also appropriate to the Pakistan financial markets.

Integrity

Stock exchange members and their representatives/agents (CSRs) must observe high standards of honesty, integrity and fairness in conducting their business in the securities industry.

Skill, Care, and Diligence

CSRs must act with due skill, care and diligence in conducting their business in the securities industry.

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[3] *Business Law,* by Anderson, Fox & Twomey.

[4] Idem.

Observance of Standards

CSRs must, in undertaking their activities in the securities industry, at a minimum comply with applicable provisions of any code or set of standards that apply to the securities industry and must observe high standards of market conduct.

Information about Clients

CSRs must seek from clients any information about their circumstances and objectives which might reasonably be expected to be relevant in enabling members to fulfill their responsibilities to such clients.

Information for Clients

CSRs must take reasonable steps to give a client, in a comprehensible and timely manner, any information needed to enable such clients to make a balanced and informed decision. CSRs must similarly be ready to provide a client with a full and fair account of the fulfillment of their responsibilities to clients.

Conflicts of Interest

CSRs must be diligent to identify and avoid potential conflicts of interest, and declare them, if and when they arise. Where conflicts arise the CSR must ensure fair treatment to all clients by disclosure, internal rules of confidentiality, declining to act, or otherwise. CSRs must be guided by the principles that they must act in the best interest of the client at all times.

Client Assets

Where CSRs have control of or are otherwise responsible for assets belonging to a client, they must arrange proper protection for those assets by way of segregation or identification, and must not use the assets in any way for their advantage without prior approval from the client.

Internal Organization

Members must organize and control their affairs in a responsible manner. Where members and CSRs employ staff or are responsible for the conduct of others, they must have adequate arrangements to ensure that they are suitable, adequately trained and properly supervised. Members and CSRs must have well defined procedures and systems to facilitate compliance with any code or set of standards applicable to the securities industry.

Relations with Regulators

Members/CSRs should deal with regulatory and self-regulatory entities in the securities industry in a cooperative manner, and keep such organizations promptly informed of anything concerning their activities which might reasonably be expected to be disclosed to them.

CSRs /Brokers and Client Accounts

Although the Karachi Stock Exchange has specific rules and regulations about brokers, there are also other guidelines on ethical conduct that are expected of CSRs. The CSR is the firm's contact with the public and must be a person of good character and business repute. In addition he/she must have adequate training in the securities business.

There should be a *Good Business Conduct* rule of the KSE that states CSRs shall adhere to good practice and fair principles of trade in the conduct of business affairs. The CSR along with agreeing to abide by the rules of the KSE and the CLA, should follow certain guidelines.

All advertising, marketing letters, research reports and written notes should be approved by a responsible manager. Communications with the public, written or oral, must be truthful and in good taste. All recommendations, written or oral, must be reasonable and accompanied with current information on the security the CSR is recommending.

"Know Your Customer" is a good rule for any CSR to follow. Along with the information you gather for the new account form, a broker should know all the essential facts about a customer including his investment objectives. If there are any concerns, a CSR should record this and keep the information in the customer's file. This is done to protect the customer, the CSR and the member firm. This enables the CSR to make suitable recommendations for the customer.

A registered CSR when engaged with a customer, especially in a fiduciary capacity should definitely be the "prudent man" in his decisions. The CSR should never recommend a speculative security to anyone earning a low income or who cannot afford to assume the risk.

CSRs must take note of the essential facts regarding their customers and their activities on a new customer account form. In addition, it is the obligation of the CSR and the office manager to know all the facts about each customer (new or existing). To assure that essential facts about each customer is received, the CSR must have each customer fill out a new account report form. This should contain:

1. customer's full name;
2. customer's address;
3. customer's telephone number;
4. identification number;
5. nationality;
6. legal age of customer;
7. occupation, employer and type of business;
8. bank references;
9. whether customer is associated with the firm or the company he is buying;
10. signature of person authorized to transact business if other than the customer.

When a CSR has authority to create activity in a customer's account on its own initiative, the account must be labeled **discretionary account**. A signed trading authorization must be obtained from the customer and accepted by a responsible manager. Discretionary accounts must be reviewed frequently by the member. This is necessary to ensure that there is no excessive or frequent trading activity.

A **power of attorney** is required if a person other than the customer is given trading authority. A CSR should also obtain the name and occupation of any person with authority to buy or sell in a customer's account before accepting instructions from someone other than the customer. The power of attorney must be signed by the customer prior to trading in any security.

Joint account agreements are needed when two or more persons are listed on the same account. All persons listed on the account must sign the new account form, and must be listed as one of the following:

a. joint tenants in common: each party owns a fractional interest in the joint account. In the event of death, the estate of the deceased person inherits that fractional share,

b. joint tenants with rights of survivorship: each party owns interest in the entire account. At the death of one person, the other party automatically inherits the other's share.

Fiduciary Accounts

A fiduciary is a person who is placed in a position of trust. Another person's property or money is entrusted for the benefit of another. The types of fiduciary accounts are:

a. Administrator: An administrator is a court appointed person directed to settle the final affairs of a deceased person. This is necessary if the person does not leave a valid will. Brokers should obtain the court appointment along with the other new account papers.

b. Trustee: A trustee is a person or entity appointed under the terms of a trust agreement to perform a specific function. A copy of the trust agreement should be obtained with the proper account forms.

c. Executor: An executor is a person named in a valid will and is charged with the responsibilities of handling the final affairs of a deceased person. A broker should always obtain a copy of the will with proper identification and the new account forms.

Insiders and Insider Trading

Insider trading is one of the most difficult and complex tasks of securities regulation. It is difficult to foresee and eliminate or to frame an appropriate regulatory response to deal with all such situations. It is also difficult to determine whether persons that had access to such information actually used that information in securities transactions. It is also very hard to determine what is actually "inside information."

Investors assume that market supply, demand and price are accurate reflections of the **investing public's** valuation of each particular security. Insider trading compromises these expectations and thereby undermines investor confidence that is essential to a system of efficient capital formation.

In Pakistan, insider dealing is regulated under anti-fraud provisions and prohibitions against short swing profits by insiders under the applicable securities legislation. Legislation also requires insiders to disclose beneficial ownership interests.

Brokers should be extra careful dealing with "insiders" of companies. *The Companies Ordinance, 1984* (section 220) requires every listed company to keep a register showing the holdings of every insider holding at least 10% of the beneficial interest in the company. This could be a director, officer or employee of a company, or related company with access to unpublished price sensitive information, that when released could have a bearing on the price of the companies securities. This could also include attorneys, accountants, investment counselors, advertising agencies and members of their immediate families. Insiders are people who are in a privileged position and are privy to what is going on in a company. They have access to inside information and cannot take advantage of the knowledge they have. *The Companies Ordinance* (sections 221 and 222) requires every person mentioned to give notice to the company of any change in writing within 15 days of acquisition or change of interest.

The Companies Ordinance (section 223) prohibits any person considered an insider from directly or indirectly *short-selling* such securities.

The Companies Ordinance (section 224) prevents any insider from making any gain by the purchase or sale of any security, within any period less than six (6) months. In the event that such action occurs the person shall make a report and the profit shall be considered that of the company.

Section 20 of the *Securities and Exchange Ordinance* dealing with "anti-fraud" provisions, provides for "private right of action for damages." Persons believed to have acted in good faith and were given fraudulent information may bring action against that person. Persons found to have violated the anti-fraud provisions are subject to imprisonment up to 3 years, a maximum fine of Rs. 30,000 or both.

Unless he or she can prove that *due diligence* was exercised, every director, manager or other officer is responsible for the conduct of his or her affairs.

Short Selling

Selling short is the selling of a security that is not owned by the seller at the time of the sale. The customer is selling something he or she does not own. The short seller anticipates that a particular security will decline in price in the near future. The seller borrows the security from an owner (through a brokerage firm) willing to lend the securities and must at some point repay the owner by buying the securities in the open market, hopefully at a lower price.

Arbitrage

Market arbitrage is the simultaneous buying and selling of the same security in different marketplaces to take advantage of a price disparity between the two markets. For example, a customer buys a security at Rs. 60.00 on the NYSE and sells it at the same time on the American Exchange for Rs. 61.50.

Margin Accounts

A margin account is where a customer can buy more securities with the same amount of money, or the same amount of securities with a lower initial cash outlay by pledging the securities purchased as collateral for a loan. The customer borrows a portion of the purchase price and this way he can leverage an investment. Interest shall be charged on any balance unpaid by settlement date.

VI. Regulatory Environment in Pakistan

The Role of the Authorities in the Financial/ Capital Markets

The creation of a sound and efficient securities market, serviced by a competent financial services industry, is at the heart of economic development within the entire Asian region. The ability of enterprises to raise new funds from the public and for investors to be able to trade their securities on a reliable and fair market are critical factors in the development of national and regional economic stability.

Market abuse tends to undermine confidence in the fairness and efficiency of capital markets, and thereby frustrate economic development. Fraud and abuse in the securities industry bring into question the reliability and integrity of those responsible for caring for other peoples' money. Confidence once shaken is difficult and costly to restore. This is true from the standpoint of governments as well as the macro and micro perspectives of those directly engaged in business.

Public confidence in the soundness of the financial system is the cornerstone of any economy. The key to this confidence is a belief by lenders, that their funds will earn the agreed rate of interest and will be returned in full on the agreed date. These lenders place their confidence on the regulators to ensure that intermediaries that accept money are prudently run and that securities markets are efficient and equitable.

Regulation and supervision of financial intermediaries aim to ensure institutions are properly run, so they can absorb economic and financial ups and downs without defaulting on their debts. Regulation of securities markets aims to control the behavior of borrowers and securities traders. Borrowers are required to provide sufficient information so that investors can make well-informed decisions. Regulation of securities brokers/traders attempts to minimize misconduct and insolvency.

The nature and stringency of regulation differ between types of institutions and between institutions and markets. This means that some institutions and markets are safer than others. The added risk in some investments needs to be compensated for by the potential for higher returns.

In a financial system investors are provided with a full spectrum of risk and return. Banks are at the very low end of the risk spectrum and non-banks have higher risks. Investments in securities markets are often more risky: though safeguards exist to protect investors, it is important to realize that the ultimate responsibility lies with the investor to assess the viability and safety of an investment.

The regulatory framework is not static, as financial markets and institutions evolve and change, the regulatory framework is also required to change. The financial industry derives its powers, roles and functions from the CLA and the KSE. They both strive to:

- enforce the nations laws to achieve compliance;
- maintain, facilitate and improve the performance of companies, and of the securities markets in the interest of business efficiency;
- protect the interest of investors, and through regulation of the securities market promote the confidence of investors;

- achieve uniformity and due diligence in the performance of functions and exercise of powers, and promote the establishment of high professional standards;
- streamline procedural requirements;
- process and store documents and information;
- ensure that relevant documents and trading information are readily available to the public.

The stability of the financial system as a whole is of vital importance. The system could not operate efficiently unless investors had confidence in the strength of the financial institutions and in the stability of financial markets overall. Governments therefore, have a responsibility to ensure that there is public trust in the soundness of the financial system.

Objectives of Market Regulation

Once a government accepts that a stock market/exchange is a valuable mechanism for mobilizing investment capital, it follows that the ground rules for that exchange need to be set so as to deliver a number of key objectives consistent with the social contract previously referred to. Encouraging and maintaining the confidence of the suppliers of investment capital is the key theme of the regulatory objectives discussed below.

1. Every investor has a different degree of risk, and in order to make decisions, investors need to be fully informed of their investment options.
2. Private enterprise and market conditions of companies change continuously. Investors need to have confidence that as their investment needs change, they can change all or part of their portfolio without altering the market conditions.
3. Investors need to have confidence that their interests will be at all times protected. Since investors are not in a position to monitor the day to day activities of companies, they therefore require that the conduct of the companies be fair and equitable, regardless of the paid-in capital of the company.

Corporate Law Authority

The overall regulatory control rests with the Corporate Law Authority (CLA). This is the regulating agency for the corporate sector and the securities market. There are six major acts that regulate the listing requirements for companies, the protection for investors, take-over codes, etc.

(all the codes and a chart would be good to explain here)

Companies Ordinance

The companies ordinance sets the guidelines and rules for all individuals who want to become a company. This states the capital requirements, etc., whether a company is limited, private, or guaranteed.

(a better explanation is needed here with specific rules)

Regulation is Self-Regulation

The objective of setting the ground rules to encourage investors and maintain their confidence is a common theme of stock markets across the globe. A second theme, and one where the answers are different in each country, is the question of whether the regulations are set by the legislative and their delegated authorities, or by the market participants through their industry associations.

The design of regulatory structure involves consideration of different approaches and alternatives such as regulation by the government or self-regulation by the stock exchange, or a mix of the two alternatives. In some countries the concept of self-regulating officers (SROs) has developed and these SROs have the authority to discipline their members in all matters. In Pakistan, most of these issues are a part of legislation and are dealt through the CLA through provisions of the *Securities and Exchange Ordinance*. The concept of SRO is getting more prominent, yet there is a need to develop this through appropriate legislation so that the regulation of the market and trade can be effective and more efficiently dealt with.

Regulations Governing the Stock Exchanges

Since the stock exchanges have now become a strong vehicle for mobilizing funds, it is necessary that rules and regulations are provided for protecting the interest of investors. The stock exchanges are governed through a set of their rules and regulations so that different aspects of its day to day operations are properly, timely and efficiently conducted. There are ten different rules and regulations that apply to the trading of the stock exchange that should be discussed in length.

Securities and Exchange Ordinance, 1969

For regulating the stock market, protecting the interests of investors, and regulating trading in securities this ordinance was enacted. Some of the main functions of the CLA under this law are: registration, enforcement of restricted shareholders, maintenance of books by CSRs, etc. With this ordinance the exchange assure that investors' interests are protected and that confidence in the market is maintained.

Reforms

Due to the constant changing investing climate and the government, a member and CSR should always stay informed of reforms and changes with the CLA and all other rules and regulations. *(Any changes should be discussed here.)*

Takeovers

Takeover regulations regulate a change in control of companies whose shares are held by the public and requires that they be conducted in an orderly and fair manner. Takeovers are regulated under the *Monopolies and Restrictive Trade Practices Ordinance, 1970* administered by the CLA. The general principles of takeover regulations are; the equality of treatment and opportunity for all shareholders, availability of adequate information and advice to all shareholders, maintenance of fair and orderly

markets in the shares of the company, and no action which might frustrate the offer without shareholders being allowed to vote on the issue.

Other Pakistan Financial Institutions

Economic Development

As the economy grows and matures, a number of things tend to happen.

1) The government adopts a role in the management of the finance sector, issuing licenses to participants, establishing codes of conduct, and generally attempting to ensure that the payment system works efficiently and fairly.

2) A greater range of financial needs become apparent. On the capital surplus side, lenders/investors seek to place their funds in a vehicle more directly related to their own cash flow requirements. Borrowers and investors also seek financing products more tailored to their needs.

3) Governments frequently determine, on national policy grounds, that financial intermediaries directed at specific market segments are required, which the private sector may not see the need to fill.

This process of development therefore gives rise to a range of institutions and corporations. Countries establish central banks and, at a later stage of development, securities regulatory authorities to manage the financial system. A broader range of financial intermediaries evolves from merchant banks and finance companies to stock brokers, mutual funds and venture capital companies. The national governments establish dedicated investment companies to promote targeted sectoral investment.

Leasing

Leasing finance is a relatively new class of installment credit introduced to Pakistan, although it has a long history in other parts of the world. The history of leasing, an alternate mode of finance, can be traced back to 1877 when Bell Telephone began renting out its telephones in the US. However, the first law to regulate leasing was passed in the UK in 1284 (*Statute of Wales*). At this time little was known of the alternate mode of financing, and as the pioneering companies developed the responsibility of marketing, leases became a tremendous challenge. Today there are leasing companies, finance companies, banks and other financial institutions that are engaged in leasing.

What is Leasing?

Definition — "as a contract between the lessor and lessee for the hire of a specified asset selected from a manufacturer or a vendor of such asset by the lessee. The lessor retains ownership of the asset while the lessee has possession and usage on payment of lease rentals over a specified period."

Leasing as a form of trade was also practiced in pre-Islamic times and it is to the credit of Islam that it was recognized as an admirable tool of financing which did not work on the principal of interest. In the Islamic setting *Ijara* mode of financing appears to be somewhat similar to the western leasing mechanism. Ijars is a contract that allows all the benefits of ownership of a hired article on a specific fixed rent, for a specific period so that any vagueness may not cause any dispute among the parties

concerned. Thus due to the characteristics, the Ijara mode of financing has unanimously been approved by the prominent jurists of the recognized schools of Islamic Shariah. Islamic ideology in its report declared, in June 1980, that leasing conforms to the Islamic tenets.[5]

Leasing has spread gradually to a number of developing countries, following initiatives by International Finance Corporation (IFC). IFC participated in the formation of the National Development Leasing Corporation (NDLC) in Pakistan. There is also participation in equity and transfer of know how in Orix Leasing Pakistan Ltd., and Atlas-Bot Leasing Ltd. Asian Development Bank has provided a credit line of $5 million (US) to Pakistan Industrial and Commercial Leasing Ltd. for leasing operations.

Regulatory Environment

There was no regulation to provide for establishment of leasing companies in Pakistan till the end of 1989 when the government of Pakistan formalized some rules. The work relating to approval of leasing companies was transferred from the Finance Division of the Ministry of Finance to the Corporate Law Authority (CLA) in December 1991. The CLA framed some comprehensive rules for leasing companies in consultation with the Central Board of Revenue and the Finance Division. New rules came into effect In May 1992 and were modified in August of the same year. Some of the features of these rules are:

a. A leasing company has to have a minimum paid-up capital of Rs. 100 million. Existing companies have been given a period of five years to bring their capital to this level.

b. Exposure to a single group is not to exceed 10% of the paid-up capital and free reserves of the company.

c. The period of lease agreement is not to be less than three years.

d. A leasing company has to invest 70% of its funds in leasing business.

A total of 25 companies have so far been granted permission to de leasing business, and as of October 1992, 14 companies have gone public and stand listed on the Exchange. All the companies have been able to give returns ranging from 7.5% to 28% to their shareholders. Even in the present market conditions (bearish) companies are being quoted at considerable premiums. Recently the government of Pakistan has allowed them to raise funds by way of "Certificates of Deposit" ranging from three months to five years.

It is important to note that 28 listed "Modarabas" are also doing leasing business. Out of the total business activities of Modarabas in 1991, leasing accounted for 76%.

Foreign Exchange Markets

Foreign exchange trading involves the buying and selling of different currencies, exchanging one for the other, or for one's own currency. These are not securities in terms of the definition provided earlier.

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[5] Report from M. Javed Panni / Corporate Law Authority.

Buyers and sellers transact their business over the phone subsequently confirming details via telex. This means that participants can be located in different part of the globe. This flexibility has resulted in the establishment of a multitude of foreign exchange centers throughout the world. The strategic location of these centers in different world time zones allows the international foreign exchange market to remain open 24 hours a day.

The Central Bank closely supervises the domestic foreign exchange operations of individual banks and has established for each bank limits in respect to its net open overnight foreign exchange exposure.

Investment Companies / Mutual Funds

Collective Investment Vehicles

Investors who purchase mutual funds or into an investment trust will have their monies invested for them by professional managers. The investors will have their monies used to buy the securities (shares, leasings, PTCs) of other companies which will be spread over many industries to reduce risk. This is a collective investment vehicle that investors buy into. Each investor owns proportional interest in the portfolio held by the fund or investment trust.

The advantages of investing in a unit or investment trust is **diversification** and **professional management**. Investment decisions are made by a group of full-time professional managers who have a responsibility to meet the objectives of that unit or investment trust. Professional managers will make the decision to buy securities, when to buy, when to sell and research new companies for investment purposes. Few individual investors have the required knowledge or the time to devote to managing their own portfolio, even if they had the expertise. The investor also will buy shares of many different companies in different industries, therefore spreading his risk and not putting all his eggs in one basket. Diversification and professional management does not provide the investor with guarantees against loss or gain. This does however, reduce risk considerably.

Investment Trust

An Investment Trust is a *closed-end* investment vehicle that has a fixed capitalization. For example: a public offering by a closed-end investment trust may offer one million shares at 20 rupees a share and no more. They are not constantly issuing new shares, nor do they redeem their shares. Since closed-end investment trusts do not continue to sell or redeem their shares after the initial issue, they can be bought and sold on the trading floor of the exchange and their price will be determined by supply and demand. An investor must rely on the demand and the underlying value of the trusts assets to keep the price up. The best known is the ICP group. There are currently 22 different funds that after all the money is received it will close on the same day. ICP also manages portfolios for individual customers. The average return the past few years has been 18%.

Investment companies are closely regulated under the *Securities and Exchange Ordinance*, 1969 which sets forth the prohibitions and requirements. The main distinction between an investment company and other companies is that an investment company is **principally** engaged in the business of buying and selling securities of other companies. An analysis is required to determine whether the company meets the definition and requirements, which is a **ratio of 89%** securities to total assets in Pakistan.

Mordaraba Companies

Mordaraba companies are regulated under the *Flotation and Control Ordinance, 1980.* The registrar is responsible for registering Mordaraba management companies and ensuring that the company follows the rules and regulations prescribed by law. Also regulated by the *Religious Board* which scrutinizes all Mordaraba applications to ensure that no non-Islamic business is carried out by a company which is against the tenets of Islam. The Board periodically examines the managerial policies and also prescribes the form of lease agreements, Musharka agreement, etc. The Corporate Law Authority on its own also examines the Mordaraba in the light of the prevailing market situation and issues guidelines which are to be followed. Equities and leasing are popular investments for Mordaraba companies.

National Investment Trust

The National Investment Trust (NIT) is the only open-end mutual fund in the country. It was established in 1964 and investment is allowed for individuals and companies. Any new public (listed) offering of shares that hits the market NIT has the right to 15% of the shares available. The average return the past few years has been 14% and both the NIT and the ICP account for 25% of the trading business that is done on the Karachi Stock Exchange.

VII. The Stock Exchanges of Pakistan

Growth and Recent Development

The KSE came into being in September 1947 and was incorporated as a company limited by guarantee in March 1949. At this time the number of listed companies was only five with listed capital of Rs. 37 million.

During this period up to 1971 the Pakistan economic policy was guided by the free market economic system. It was between 1958 and 1970 that major thrust toward industrialization and growth of capital markets took place. The stock exchange grew and the number of listed companies increased to 318 with the capital increasing to Rs. 4.439 billion. The stock exchange developed not merely as an equity market, but also played a role as a major financial institution in the capital markets.

In 1971 Pakistan underwent a major political change resulting in the loss of the Eastern Wing of the country (Bangladesh). The elected government which took over sought to introduce a new social and economic order by abandoning the private sector development policies, and instead adopting the socialistic or "mixed economy" where the government has a larger role in economic activity to ensure a more equitable distribution of wealth.

From 1977 to 1984, the government changed again to a military regime. This reversed various policies of the previous government and new economic policies were introduced to restore the confidence of the private sector and to promote investment in the country.

From 1985 until 1990, there was a strong policy towards encouraging the private sector as an important vehicle for the development of national economy. New products were introduced, giving the stock market a vital role to play in the capital markets. Equity investments were encouraged through a number of fiscal and taxation concessions available in the government savings schemes.

In 1991 the real revolution in the role of the stock market began and a number of major policy changes were announced and implemented when the present government took office. Some of the policies were:

- privatization of state owned companies including commercial banks;
- removal of exchange control, where foreign and Pakistani investors could trade freely and have foreign currency accounts;
- auctioning of government bonds and creation of a secondary bonds market.

The privatization policy has given a new dimension to stock market activities, and the policy of free market economy which has applied to the entire monetary system. The fundamentals of the Pakistani economy are strong and there are plenty of opportunities to share in the development of the country for both local and foreign investors.

The Karachi Stock Exchange like other exchanges around the world has developed to meet two basic and complementary needs: a business need for funds and an individual's or company's desire to invest savings efficiently.

The exchange operates for the convenience of investors and is open during fixed hours each day between 10:15a.m. to 2:00p.m. from Sunday to Thursday, during which business people, know as *brokers*, who are members of the exchange, may make transactions on behalf of their clients. The exchange itself does not determine the buying and selling prices of shares. Prices are determined entirely by supply and demand, the same as any auction-house. The exchange does not act to promote fair trading, it does publish price quotations, and sets rules and standards for trading. It is a self-regulatory organization.

Management

There are three stock exchanges operating in Pakistan: Karachi, Lahore and Islamabad. Many companies listed on the KSE are also listed and traded on the Lahore Stock Exchange (LSE) and the Islamabad Stock Exchange (ISE). The CLA supervises the activities of all three stock exchanges. The KSE, LSE and ISE cooperate on market development matters through a joint exchange committee.

The management of the KSE vests in the president and the governing board of directors. The president is elected directly by the general body of members along with 14 other directors. Apart from this, the board has one nominee each from the NIT and ICP. The vice-president and the treasurer are also elected from the members of the board. The term of office is the calendar year. Where the person has served as president or director for two consecutive years, he must retire for one year thereafter. The board of directors exercise all powers vested in them under the *Articles of Association*.

Listing Requirements

A company wishing to raise capital and obtain a listing on the Karachi Stock Exchange must apply to the KSE, and under the listing requirements must submit a copy of the "Draft Prospectus" and other required documents prior to initiating the share offering.

The areas to be disclosed in the prospectus are laid down in the *Company Ordinance 1984*. After the KSE has reviewed the prospectus and given their approval the company must also get approval of the Corporate Law Authority. The companies ordinance and the KSE rules and regulations also define the procedure for allotment and time frame for dispatch of shares. The cost of a new issue must be stated in the prospectus, and it is estimated that the cost of a new issue is approximately 6%.

Companies desiring to issue Bonus or Rights to the shareholders are also governed by the provisions of the *Capital Issues Act 1947, the Companies Ordinance and the KSE*. The Companies Ordinance also prescribes the time period for holding annual meetings, distribution of profits, penalties, etc. that a corporate body must adhere to. The authorities seek to protect the minority shareholders as much as possible.

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Listing Regulations

1. The Exchange shall decide the granting for listing of a scrip within a maximum period of three (3) months from the date of application. In case of refusal, the exchange must state reasons within two (2) weeks of the decision.

2. Application for listing must be accompanied by many documents as well as the draft prospectus. Some required are:

   a. memorandum and *Articles of Association*;
   b. feasibility reports;
   c. names of directors;
   d. underwriting agreements;
   e. audited financial statements for the last five years (or shorter if the company has only been in operation for a short period of time).

3. No company will be accepted unless it is registered under the ordinance as a *publicly listed company* with a minimum paid-up capital of Rs. 20 million.

4. No company shall be listed unless it has made a public issue which is subscribed to by not less than 250 applicants.

5. In the case of Modaraba companies applying for listing, 30% of total paid-up capital shall be subscribed to by the sponsors, friends, relatives or associates, with the balance of 70% being offered to the general public, including NIT.

6. The company shall inform the Exchange of the subscriptions received in case of over-subscription. The company shall then make a decision within 10 days of closure of subscription as to what applicants have been accepted. Applicants not accepted shall be refunded their money within 10 days of the decision.

7. Share certificates will be dispatched within 30 days of closing of subscription, and allotment letters shall be exchanged for shares within 60 days.

8. The company must also pay the brokerage commissions within 30 days of closing the subscription list to the KSE at a minimum rate of one percent (1%) of the value of shares sold through them.

9. Any company not complying with the requirements of the KSE regulations shall pay the exchange a penalty of Rs. 500 for every day during which the default continues.

10. In the case of dividends, rights or personal share transfer, the transfer of shares must be completed within 45 days of application.

11. In case a subscription is under — subscribed, a company must find and underwriter within 15 days to take up the balance. If the underwriter won't take up the balance the offering will be canceled.

12. A company applying for listing must pay an initial fee of 0.1% of the paid — up capital, subject to a maximum of Rs. 5,000,000. Whenever a company increases its paid-up capital an extra fee must be paid.

Continuing Listing Requirements

1. The company shall give a minimum of 15 days notice prior to the close of share transfer books for any reason.

2. Three hundred copies of all financial reports must be sent to the KSE no later than 21 days before a meeting of shareholders is held.

3. The annual general meeting (AGM) with the balance sheet and profit and loss account of a listed company must be held within 6 months following the close of its financial year. The company must also supply minutes of the AGM to the KSE within 60 days of such meeting. A company may apply for extensions for a fee.

4. Annual listing fees shall be paid before the 30th of September of each year. The fees range from Rs. 2,500 to Rs. 15,000.

5. Failure to comply with any of the annual listing requirements will result in a Rs. 500 fine per day.

6. Intimation of a dividend or other entitlements shall be sent to the exchange no later than 15 days prior to the close of the books.

7. All listed companies shall dispatch the interim dividends to shareholders within 45 days of the closing of the share transfer register. All final dividends must be dispatched to the shareholders within 45 days of the AGM.

Delisting or Suspension

A listed company may be delisted or suspended for any of the following reasons:

a. if its securities are quoted below 50 percent of face value for a continuous period of three (3) years;

b. if it has failed to declare a dividend or bonus for five years from the date of the last dividend or bonus. In the case of a manufacturing company: five years from the date of commencement of production;

c. if the company fails to hold its annual general meeting for a continuous period of three (3) years;

d. if the company fails to pay the annual listing fees for a period of two years, or goes into liquidation.

The whole company shall be delisted unless the company has been given the opportunity to be heard. Trading in suspended or delisted shares shall cease until all suspension is withdrawn and the listing is restored by order of the board.

Trading Floor Rules and Regulations

The trading floor of the Exchange is governed by rules prescribed by the Karachi Stock Exchange Rules Committee, approved by the CLA. The activities of the stock market can be divided into two categories: ready listed securities (secondary), and provisionally listed securities (primary). The main function of such a market is to create liquidity.

Listed securities are grouped into 27 different industrial and commercial sectors. The first eight (8) sectors are mutual funds to textile companies which constitute more than 40% of the total listed companies, and are the most active. The other nineteen (19) are grouped together.

Ready Delivery Contracts

The *Ready Counter* is where the trading is allowed in all listed companies. Settlement takes place through a Clearing House. Clearing dates are posted monthly in advance, and generally trades from Tuesday to Monday will settle the following Monday.

Trading in a scrip above par value is suspended if the price fluctuates by 50% from the opening price. If the scrip is quoted Rs. 5 below par value trading is also suspended.

Unless specified, shares or debentures are traded in specific *board lots* in regards to share size, certificates and rupee amount.

There are specific rules regarding buying-in or selling-out a member. A member who fails to exercise his right to buy-in or sell-out in the manner provided in the rule (Ready Delivery Rule 6/a-d) shall forfeit all rights of recourse against the member in default.

Rule 7 states that shares shall not be bought-in nor sold-out while its transfer books are closed for payment of dividends, bonuses, rights, or the receipt of calls.

Provisionally Listed Companies

Provisionally listed companies are companies which have offered their shares to the public either through a prospectus or an offer for sale from an individual. Companies which have obtained approval of the KSE for listing are provisionally listed from the next day of balloting, after public floatation. Listing on the ready board occurs once the company announces the dispatch of the share certificates to the subscribers.

In order to participate in this market a member must deposit Rs. 2500 as a basic deposit for each scrip traded provisionally. This will entitle the member to do business of no more than 25,000 shares (Rs.100,000). A "hella" or special clearing occurs if there is a fluctuation of three or more rupees per share for any given scrip.

Trading in the provisionally listed sector is closely regulated by the KSE. The maximum number of shares that can, at the close of any business day, remain outstanding in any scrip in a member's account is determined by the KSE. If the member trades in excess of his deposit and does not pay the balance, his excess can be bought out/sold in on the open market by the Secretary of the KSE. In addition, if the price of a provisionally listed security fluctuates by 100% or more, trading is suspended until listed on the ready board.

Clearing is prepared similarly to those shares traded on the ready board, but the clearing takes place after the scrip is transferred to the ready board (after the company issues certificates).

When orders are entered they are either *advance orders* or *floor orders*. An advance order is one which is received by the agent or broker before the commencement of trading at 10:15 a.m. They attempt to match orders and clear internally. Orders entered after trading has stared will be sent to the floor ring.

Market Information

Once trading is over, transactions recorded throughout the day are consolidated and reported via FASCOM (an electronic market system) which is available to all members and outside parties for a monthly fee. This system has been in operation for a year and is divided into four parts: KSE Index, volume, pluses and minuses, and provisionally listed shares. The KSE also publishes a *Daily Fluctuation Report* which contains price and volume listings for all reported transactions. This information is also included in the *Ready Board Quotation Journal*, a daily publication of the KSE, subscribed by many institutions and individual investors.

Market information has been computerized and the KSE has three facilities under this system:

a. a T.V. display terminal subscribed to by the members within the building;

b. market information retrieval facility subscribed to by the members within the building and outside the building by financial institutions;

c. market information for international investors through Reuters on 225,000 terminals in 134 countries.

Spot Transactions

Spot transactions are cleared on the same trade day and therefore, are not routed through the clearinghouse.

Brokerage Commissions

There are two types of client classification for commissions; institutional and individual. Different rates are charged for each category. Brokerage commissions are prescribed in accordance with the schedule fixed by the KSE, with the average commission at 1/2% (half percent) of the market value of the shares. The present *Duty Stamp* is 1.5% of face value of the shares.

Zakat (welfare fund by government) is only applicable to resident Pakistanis who have 2 1/2% deducted off the face value of the shares. Zakat is not applicable to foreigners, non- Muslim, and non-resident Pakistanis.

Types of Orders

Market Order - A market order is an order to buy or sell a stated amount of shares at the most immediate price after the order is presented. By September 1, 1992 orders will be time stamped to assure a priority and time protection for clients.

Limit Order - A limit order is an order to buy or sell a stated amount of shares at a specific price or better. Also, limit orders stand in time priority and may not be executed until all prior orders are executed.

Unique Transactions

Badla Transactions

A large portion of financing to brokers, independent contractors and major investors is provided through a financing mechanism called "badla." A member dealing in badla typically obtains financing against "liens" with different banks, over shares. The financier himself operates as a custodian/bank, extending loans to other members/agents.

All badla arrangers depend upon the clearing system, especially for the monthly badla transaction. There are three types of badla: weekly, monthly, and transfer badla.

(explain and use examples of all three badlas here)

Badla contracts are generally not considered as free market trades, but as trades negotiated between the parties. In most cases such transactions are not recorded as traded in the fluctuations list for the day.

Loan Transactions

If the seller is not able to deliver shares on the clearing day, he contacts the buyer for deferment of the delivery of the shares. This is done by giving the buyer a check of the same amount (market price) as deposited by the buyer to the clearing house. The buyer intimates to the KSE that he has received delivery which in turn releases payment to the seller. The buyer then executes a contract for the same number of shares for the next clearing, the seller makes another contract for the next clearing and the seller receives payment from KSE.

Gola Transaction

In a gola transaction a member's agent, taking advantage of the market fluctuations, pockets the gain accruing to the member by executing an unauthorized trade, clearing the previous transaction done on behalf of a client member.

Hawala Transaction

A hawala is where a member has bought a share at a price from one member and later (same day) sells the shares, same quantity, at the same price to another member. He may request the buyer and seller to treat the transaction as one trade, which aims to avoid paying double commissions.

Floor Agents and Jobbers

Each member is allowed to have up to 8 agents on the floor to transact business on behalf of the member. As most of the members do not require eight agents, they may allow the use of their agents by jobbers (independent contractors) who account for 30% of total volume traded. Jobbers generally have a zero trading position at the end of each clearing to avoid physical clearance. They benefit from the price fluctuations which occur during the day, and generally net out their positions. Independent operators acting as sub-brokers have their own clients and work on a pre-determined commission sharing basis with their principals (members). All members and sub-brokers as defined herein will be required to become certified securities representatives (CSRs) when the certification program becomes effective.

Clearance and Settlement / Securities Processing

Any member of the exchange may become the member of the Clearinghouse by paying an initial deposit of Rs. 20,000. The deposit is refundable and may be withdrawn by giving proper notice in writing.

All transactions except "spot" are cleared through the Clearinghouse. The settlement days are specified in advance and are notified by the Clearinghouse. At the end of the accounting period, the Clearinghouse works out the net position of every member in every scrip in which the member dealt. It will then calculate how the deliveries and receipts shall be settled. The net balances are adjusted either by giving a check/pay order to the Clearinghouse or receiving a check from the Clearinghouse.

The transactions are reported to the Clearinghouse by the selling members by submitting a copy of the "contract ticket" signed and stamped by the buying member. The ticket should have details of the transaction indicating: the name of the scrip, quantity, price, date and code number of the member concerned. **Note:** The KSE Clearinghouse is not supposed to accept contracts which are not within the price fluctuations reported for the day.

The accounting period and the settlement day for transactions may be changed by the Exchange when necessary, however the usual accounting period and settlement day is:

Accounting Period	Settlement Day
Monday to Sunday	the following Sunday

All contract tickets must be submitted to the Exchange before 9:30 a.m. the following day. If the contracts are not received before the specified time, members shall be liable to a penalty which may be prescribed by the board of directors from time to time. It is important to note that the contracts are executed on the same day of the deal in order to avoid any dispute.

When the share certificates are issued by the company and after registration is complete, neither the selling or the buying member shall be responsible to any person for any subsequent disputes or claims to the title unless bad faith or fraud is alleged to have taken place.

Service charges are payable by both the selling and buying members as per the subscribed amounts. Members are also responsible for verifying the accuracy of details in all documents prepared by the Clearinghouse.

Weekly Clearing Position

There are two weekly clearing position statements. One pertains to the amounts that are payable to or receivable from members. The other pertains to the number of shares to be delivered to counterparts.

The process of registration may take anywhere up to two months, although the officially fixed time is 45 working days.

(All information has been taken from the Clearinghouse Manual of the KSE, dated 1990).

Custodian Services

Share certificates are currently held by private investors, KSE brokers, large institutional investors (such as NIT or ICP), or custodian banks.

Custodial functions include the safekeeping of actual share certificates, settlement of all deliveries and receipts, sending of positions to various registrars, collection of dividends and interest, exercise of corporate actions, and regular reporting to the beneficial owners.

Some custodian banks in Karachi are Standard Chartered and Citibank. Most of their current clients are foreigners.

Central Depository Company of Pakistan Limited

In order to eliminate certain settlement problems and settlement risks and to facilitate the growth of the Pakistan capital markets, the KSE along with International Finance Corporation (IFC), Citibank, MCB, LSE, ISE, ICP, NIT and PICIC has formed the CDC to develop and introduce a national Central Depository System (CDS).

The CDS will be a system of automated deliveries and settlements for all three stock exchanges, including immobilized stock holdings for all custodians and individual investors who actively trade in the stock market. All investors who deposit their holdings into the CDS will continue to receive all individual beneficial shareholder rights. It is anticipated that the CDS will be operational in part by the end of 1994.

VIII. International Financial Markets

The Outlook of the Securities Industry

Recent Developments

A number of factors will influence development in financial markets into the mid 1990s. These are:

1. deregulation and reregulation
2. globalization
3. international investment
4. disintermediation
5. securitization

Deregulation and Reregulation

Following a strong move toward deregulation in the 1980s some countries are now experiencing a countervailing move to firmer regulation. This is however, within a context of considerable free market activity. Part of this may be attributed to excesses arising from the 1980s.

Globalization

Globalization refers to the integration of world markets as a result of deregulation and technological innovations which facilitate the trading of securities across all markets. Globalization means that no market is isolated from developments in other markets. Globalization means that whenever a major event affecting overseas markets occurs, the impact of that event could be felt simultaneously in Pakistan.

The global share market crash in October 1987 showed how quickly markets around the world react to one another. With Pakistan having a relatively small economy, the impact of overseas events has not been felt too sharply, but this is bound to change.

The extent to which globalization affects financial markets in smaller countries cannot be overstated. As in the case of the equity or share market, a number of factors are likely to affect the daily prices.

Technological developments in communication systems have made global marketplaces possible. Technology has mechanized the process of the marketplace. Players in the foreign exchange, stock and money markets deal along wires from their offices using video screens, telephones, and fax machines.

The fastest growing stock exchange in the world is not an exchange in the traditional sense with a trading floor, it is an electronic network of dealing on screens in the US, called the NASDAQ (National Association of Securities Dealers Automated Quotations).

Some financial markets are now trading twenty four hours daily due to the differences in time zones, and in some cases the same markets trade every day of the week — depending on the country chosen. The world will operate a major triangular shaped market between the major centers of London, New York and Tokyo. London is well situated to be the leading financial center as it can trade with Tokyo in the morning and New York in the evening.

International Investment

The creation of global markets coupled with deregulation has extended the marketplace for investors. Reasons to invest overseas vary from time to time depending on the domestic, economic and political outlook. International investment has a number of advantages including:

- It enables investment in different markets and different currencies. Markets and currencies do not all move in unison and careful timing with regard to when to be in or out of a market or currency can increase returns.
- It enables risk to be spread out by being in a mix of markets and currencies.
- It counters the limitations of smaller markets: the Pakistan market, in terms of the world stock market is relatively small and is currently very much influenced by inflow and outflow of overseas funds. (It is interesting to note that the Australian share market in total is smaller than IBM!)
- It enables access to stocks and sectors not available in the local markets, and enables access to broader property markets and interest rate markets.
- Investment in markets with different cycles tends to reduce the overall volatility of a portfolio.
- It facilitates participation in economies which are growing faster than ours.

Investing overseas can reduce risk and increase return, but care must be exercised and knowledge of both overseas markets and currency movements are required.

Disintermediation

Disintermediation describes the process of companies arranging their own borrowing and placing their deposits directly in the market without going through a financial intermediary.

Large companies often make arrangements for the placement of their funds themselves, and in fact the impact of capital adequacy regulation is actively encouraging this process. Today companies have their own traders looking at the markets and using computers to work out the best opportunities for making the most of their money. This process is happening on a global scale: companies are establishing their own subsidiaries to assist in raising funds through leasing, credit operations and managing investment. This trend towards disintermediation is restricted to very large and sound businesses that can access financial markets in their own right.

Securitization

Securitization describes the process of taking a debt, evidencing that debt by a piece of paper (a security) which can be readily bought and sold in the financial markets. Asset securitization was first applied to residential mortgages in the US. The mortgaged-backed securities market is now worth over US $800 billion.

The growth in the technique has been matched by an increasing diversity of assets. Car loans, credit cards, commercial loans and equipment leases are some examples. Generally, securitization could apply

to any pool of receivables that has a steady cash-flow and can be repackaged with a reasonable diversification of risk.

The World's Stock Markets

Today more and more of the major industrial and commercial companies look at the world as their marketplace and divide it into three regions — the USA, Europe and Asia — for planning, marketing and investment purposes. Large corporations see the need to have a presence in each of the major financial centers, through separate stock exchange listings.

The list below shows the relative size of some of the world's stock markets.

	Weighting	
	31/10/88	31/10/91
World	100.0	100.0
USA	30.9	36.38
Europe		
UK	8.3	10.69
Germany	3.0	3.62
France	2.5	3.32
Switzerland	1.6	1.9
Italy	1.5	1.21
Spain	1.0	1.11
Holland	1.3	1.63
Sweden	0.9	0.91
Belgium	0.7	0.65
Denmark	0.3	0.49
Norway	0.2	
Austria	0.1	
Sub-total Europe	21.4	26.2
Japan	41.6	30.89
Hong Kong	0.8	1.06
Singapore/Malaysia	0.5	0.69
Sub-total Asia	42.9	32.64
Australia	1.6	1.72
Canada	2.5	2.75
New Zealand	0.2	0.13

World stock market capitalizations (approximate)

Source: Morgan Stanley Capital International Perspective, Geneva

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Notes on Selected Asian Securities Markets

Hong Kong

History

Trading in securities in Hong Kong can be traced as far back as 1866 but Hong Kong's first stock exchange was not established until 1891, the predecessor of what is now the Hong Kong Stock Exchange. Hong Kong's rapid economic development in the 1960s increased the awareness and need for major companies to raise capital in the stock market. To keep pace with Hong Kong's growing securities market, the Far East (1967), Kam Ngan (1971) and Kowloon Stock Exchanges (1972) were established.

Since the four exchanges operated independently, centralized administration and quotations of share prices were impossible. Realizing the difficulty in supervising the securities industry, the Hong Kong government formed a working party in 1977 to study the feasibility of unification of the four exchanges. In 1980, the new unified exchange, Stock Exchange of Hong Kong Limited (SEH), was incorporated under the jurisdiction of the *Stock Exchanges Unification Ordinance*. The SEC held its first annual general meeting in 1981 at which its first committee was elected, and started trading in 1986.

Basis of Regulation

With its law firmly rooted in the British system, it is no surprise that Hong Kong's security regulatory process closely parallels the British experience.

The securities industry is governed by (1) The Companies Ordinance; (2) The Securities Ordinance; (3) The Securities (Stock Exchange Listing) Rules 1986 (which is subsidiary legislation under the Securities Ordinance); and (4) The Protection of Investors Ordinance.

The Companies Ordinance contains provisions to ensure disclosure in documents relating to invitations by or on behalf of a company to the public to subscribe
or purchase shares or debentures of a company.

The Securities Ordinance regulates stock exchange operations and it protects investors by requiring registration of brokers. It also provides for the investigation of malpractice and for the establishment of a stock exchange compensation fund to compensate clients of defaulting stockbrokers.

Compensation is entirely within the discretion of the Securities and Commission. The maximum compensation is HK $1 million. Brokers are required to pledge HK $50,000 per seat towards the compensation fund.

The *Protection of Investors Ordinance* aims at protecting investors by prohibiting the use of fraudulent or coercive means to induce investors to buy, sell or to take part in investment arrangements and it regulates the issues of related publications.

The Securities Commission, established in 1974 under the Securities ordinance, takes steps to safeguard the interests of persons who invest or propose to invest in securities and suppresses illegal, dishonorable and improper practices in relation to dealings in securities.

India

History

The origin of the stock market in India goes back to the latter part of the eighteenth century. The earliest security dealings were transactions in loan securities of the East India Company, the dominant institution of those days. Corporate shares had come into the picture by the 1830s, and assumed significance with the enactment of the *Companies Act* in 1850. The introduction of limited liability marked the beginning of the era of modern joint stock enterprises. This was followed by the American Civil War in 1861-86 which created an acute demand for Indian cotton. The outcome was the share mania of 1860-65. However, the bubble burst with the end of the Civil War and a disastrous slump followed. It was long and severe. It also resulted in complete ostracism of the broker community. The tremendous social pressure on the brokers led to their forming an informal association which later gave birth to "the Native Share and Stock Broker's Association," (now known as the Bombay Stock Exchange) in 1887. This Stock Exchange played a major role during the phase of recovery from the seven-year depression. It continued to grow in stature and size and became the nerve center of all financial activity and the first recognized by the government of India.

The cotton textile industry which contributed a lot in the establishment of the Bombay Stock Exchange, was also the prime factor in the development of Ahmedabad as a center for dealing in stock and shares. As new cotton textile mills were floated and business grew, the "Ahmedabad Share and Stock Broker's Association" was formed in 1894, which later came to be known as the "Ahmedabad Stock Exchange."

The next stock exchange was established in Calcutta in 1908. The industries that contributed to its birth and subsequent development were jute, coal and mining. Like the Bombay Stock Exchange, it was born out of a crisis when the boom of 1904-08 broke and a need was felt for an organized body for mutual protection of brokers and safety of the trade.

With the outbreak of the First World War, all imports into India ceased and Indian manufacturers enjoyed a booming economy. The three stock exchanges flourished during this period of prosperity. However, the boom also led to the formation of many rival stock exchanges. The Second World War also resulted in a sharp boom and mushroom growth in the number of stock exchanges. However, many of them perished during the slump that followed. Most of the other stock exchanges languished until 1965 when the government came out with comprehensive legislation called the '*Securities Contract (Regulation) Act* to regulate the functioning of stock exchanges. This legislation made it mandatory on the part of the stock exchanges to secure recognition from the central government. Only the established stock exchanges in Bombay, Ahmedabad, Calcutta, Madras, Delhi, Hyderabad and Indore were recognized under the act.

Thailand

History

In July 1962, a private group set up an organized stock exchange in the form of a limited partnership which was changed into a limited company in the following year called the "Bangkok Stock Exchange."

Trading on the floor of the BSE was inactive. Turnover registered highs of 160 and 114 million baht in 1968 and 1969, respectively, after which trading fell sharply to between 46 and 28 million baht per year (except in 1972 when turnover of debentures hit 87 million baht while turnover of stocks was only 26 million baht) until it ceased operation in the early 1970s.

In 1972, the *Control of Commercial Undertakings Affecting Public Safety and Welfare Act* was amended to extend government control and regulation over the operations of finance and securities companies which up until then had operated freely. The long awaited legislation which provided for the existence of the new Securities Exchange of Thailand (SET) was enacted in May 1974. This was followed at the end of the year by the proclamation of the *Revenue Code Amendment* to stimulate the investment of savings in the organized capital market in general and through SET in particular. Trading on SET began on April 30, 1975 and in January 1991, the name was changed to the Stock Exchange of Thailand.

Basis of Regulation

As the foregoing suggests, stock market trading in Thailand is (a) at a relatively early stage of development and (b) predominantly driven by legislation rather than the industry. Existing operations are governed by the *Civil and Commercial Code* and the *Public Company Act*: a *Securities Exchange Commission Act* is in the process of being drafted and should have been implemented during the fall of 1992.

Indonesia

History

Systematic trading of securities in Indonesia started on December 14, 1912, when an association of stockbrokers named "Vereeneging voor de Effectenhandel" was established in Jakarta under the Dutch government. Two other similar associations were set up in Java, one in Surabaya on January 11, 1925, and one in Semarang on August 1, 1925. Securities traded on the exchanges were mostly stocks of Dutch companies operating in Indonesia, bonds of Dutch East Indies government municipal bonds, and a few American stocks. At this time, trading was fairly active, but the three exchanges were closed in 1942 upon the outbreak of World War II.

In 1949, after becoming independent from the Netherlands, Indonesia embarked on the immediate reconstruction of the national economy. As part of reconstruction measures, the government attempted to reopen a stock exchange. In 1951, it proclaimed *Emergency Act No. 13 — 1951* concerning the Stock Exchange (which later became *Law No. 1952* on the Stock Exchange) and the Jakarta Stock Exchange was established in 1952. With the central bank as an advisory body, the stock exchange was managed and operated by the Association of Money and Securities Traders (PPUE — Perserikatan

Perdagangan Uang dan Efek-Efek). Pioneering members were three Dutch private banks, two Dutch brokers and two Indonesian national banks. Mostly government bonds of Indonesia, the Industrial Bank of Indonesia (now Bank Pembangunan Indonesia, or the Development Bank of Indonesia), and stock of Dutch companies issued during Dutch rule were traded, but trading was not active.

Securities trading dwindled after the nationalization of Dutch businesses in Indonesia beginning in 1958 and the ban on trading of Dutch securities in 1960. The flight of Dutch capital as a result of a territorial dispute between Indonesia and the Netherlands and high inflation in 1965 further accelerated the downturn of the market and the stock exchange became a mere shell.

In order to mobilize funds into more productive sectors, the government started work on the dramatic improvement and reform of the securities market to smoothly implement economic policies, and started preparations for the resumption of the stock exchange by establishing various committees. As a result *Presidential Decree No. 56, 1976* and a series of Ministry of Finance decisions concerning the securities market were proclaimed. The main measures taken by the decrees and ordinances were the establishment of Badan Pelaksana Pasasa, or the National Investment Trust Company, and a system of tax preferences for companies listed on the stock exchange and investors investing in the stock.

As a result, the stock exchange made a fresh start on August 10, 1977, with the listing of PT. Semen Cibinong, a cement producing joint venture with an American firm.

In 1990, the Jakarta Stock Exchange (JSE) was privatized: this was consistent with a wave of deregulation in the Indonesian capital markets aimed at revitalizing those markets.

Basis of Regulation

Indonesian law is based on the European model, as opposed to the predominantly British model on which Sri Lankan law rests. Due to this and the post war history of Indonesia, capital markets are controlled through BAPEPAM, a Capital Markets Policy Council and the National Investment Trust Company.

The Global Share Market Crash — October 1987

On Monday, 19 October 1987, the New York Dow Jones share index plunged 508 points, or 23%, which far outstripped the great Wall Street crash of 1929. On Tuesday, 20 October 1987, the Australian all ordinaries share price index crashed 515 points, or 25%.

The objective of this section is to examine what actually happened in world share markets in October 1987 and why it happened. We will also consider the aftermath of the crash.

What Precipitated the Sell-Off?

Selling pressures first got out of control on Wall Street, the home of the United States share market. Many commentators argue that happenings in that country's economy provide the reasons why share ownership fell out of favor.

Certainly, releases of key US economic statistics just prior to the crash give basis to this supposition. US trade and budget deficit statistics indicated that the US was still a substantial net borrower of overseas-

sourced funds. US consumers continued to live beyond their means seemingly having an insatiable desire for imports. A lower valued US dollar following the *Louvre Agreement* pushed the price of overseas goods imported by Americans higher and higher as importers passed on increased costs. However, US import levels were only modestly checked. (Under the *Louvre Agreement* the major industrialized nations agreed to a coordination of economic policies aimed at promoting stable world economic growth).

At the same time export volumes, while registering a material recovery, were not high enough to greatly improve the situation, and the US ran a string of high monthly trade deficits. Hence the US had been spending more than it produced, and investing more than could be financed by its savings. As a result, US imports were almost double exports, and massive borrowing from abroad had converted the US from the world's largest creditor country to the world's largest debtor.

In this environment, fears increased that the US dollar would have to be lowered still further to have any worthwhile impact on these trade deficits. These fears took on increased urgency as indications grew that US economic growth, which had been sluggish, was on the rebound. Higher US economic growth could be expected to spill over into increased US demand for imported goods, putting further upward pressure on the US trade deficit.

Unfortunately, it was apparent that a further sharp fall in the US dollar could, by increasing inflation in the US and the threat of recession elsewhere, lead to a financial crisis and serious world recession.

Some economists took the pessimistic view that the US dollar depreciation would not be sufficient to produce healthier trade (and budged deficit) numbers. Their message was that the only way to set things right was to push the US into a recession — a severe way of slowing consumer spending and US imports!

Germany and Japan had budget surpluses. They relied on export-led growth and invested savings abroad that could often have been used more fruitfully at home. Fearing a resurgence of world inflation, Germany and Japan began to tighten domestic monetary policy. US Treasury Secretary James Baker warned that if other major economic powers, particularly Germany and Japan, did not stop this tightening in domestic policy the US would allow its currency to decline.

Obviously, this was a dangerous scenario. Higher world interest rates would slow international growth levels and, at the same time, push Third World debt problems back into the limelight. Both events could be expected to have a depressing effect on the equities markets.

It must be stressed, however, that despite all the doom and gloom regarding inflationary expectations, the actual numbers being released at that time indicated, at worst, only a moderate pick-up in prices growth.

On the debt market in the US, interest rate levels had certainly picked up in the weeks prior to the share crash. Rates for the thirty year US government bond, often used by the financial press as a barometer of interest rate levels, had pushed above the 10.40% mark for the first time since 1985.

Why?

Turning to the US equities market itself, the mood like that in other world financial centers was uncertain. Investors were beginning to feel that the increased returns offered in the debt market were

day-by-day becoming more attractive than those on offer in a share market that was now in its sixth consecutive year of a bull run. Price/earnings ratios of stock which show the relationship between the market price of a company's shares and the earnings per share are a useful tool for measuring the value of a company's shares. These nations around the world then experienced the highest PERs in recent history.

With bond interest rates so high, and signs emerging of a strengthening US economy with no end in sight to US trade and budget deficits, the time was ripe for a share sell-out and what a fire-sale it was! In fact, the magnitude of the fall took virtually all investors by surprise and caused grave concern and substantial losses. What was different to the four other heavy falls on Wall Street since 1945, was the tremendous speed with which this fall took place.

What Happened to Stop Equity Prices Falling Further?

Events in the US market were again the driving force behind what happened elsewhere in the world. Accordingly, when seeking an answer to this question in the Sri Lankan context one must adopt a top-down approach.

Following the rout in Wall Street on Monday, 19 October 1987, the Federal Reserve (the US central bank) acted quickly, by way of open market operations, to ensure that enough funds were pumped into the banking system to meet liquidity requirements. The substantial boost provided by these funds precluded any sharp rise in market-determined interest rates.

The Federal Reserve's move was the start of an internationally coordinated effort to ensure interest rates did not increase even higher (something that occurred in the 1992 Crash). If they had, the returns accruing to share-holdings would have been even less attractive vis-a-vis those for debt and property investments.

However, the US authorities were more worried about the impact the simultaneous occurrence of higher interest rates and lower share prices would have had on the real economy. Companies would have greatly curtailed investment plans and would have been reluctant to expand current production. The two major methods of fund-raising available to companies would be more expensive, thereby demanding greater returns to ensure viability.

Those corporations/individuals with funds to invest (including those who had sold shares) placed a substantial portion of these funds into government bonds. The reasoning behind this move was the high return then on offer plus the "flight to quality" idea in times of uncertainty. As a result of this greatly increased demand for bonds, rates in this market fell appreciably — in the case of the US thirty year bond from around 10.40% to 9.60%.

These declines acted as an encouragement to investment in the equities market over ensuing days. Share values again looked reasonable on the back of still reasonable forecasts for corporate earnings, and other economic benchmarks.

Improved political considerations also played their part in stopping the downward spiral in equity prices. Talks took place between the US and West Germany and they, together with the other G-7 countries re-affirmed their commitment to the so-called *Louvre Accord* which calls for the G-7 countries

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to cooperate in the setting of exchange rates. That is, the major governments of the Western world again opted to support their commitments to external policy stabilization.

The US promised to quickly undertake fiscal policy adjustments with the aim of lowering its Federal Budget deficit. For their part, Japan and West Germany would look to stimulate their own economies, instead of tightening credit by way of lower bank lending as was the case prior to the crash.

One final factor that halted the share price decline in Wall Street should also be highlighted. Dozens of announcements emanated from Wall Street following Black Monday's decline stating that firms were undertaking stock repurchase plans (that is, firms were buying their own shares).

Program Trading

World attention focused on computer-aided program share trading when it came to an abrupt halt in the United States on 20 October 1987, in the wake of the share market crash on the previous day.

Program trading is, in effect, computer share trading. It is a recent stock market phenomenon made possible by powerful software that can analyze stock prices instantaneously. In assessing the market conditions, the computer triggers buy and sell orders when selected stocks reach certain threshold prices. As a result, any tentative trend can be magnified many times by thousands of computers selling at once. Program traders use computers in order to trade on the small difference that open up between the cost of shares and their futures.

Computers do what they are programmed to do: sell when prices start to fall and buy when prices start to rise. There is no human discretion involved. Some commentators say program trading over-reacted to the fall on Wall Street, accelerating the crash.

International Investing

Since the lifting of many worldwide restrictions in the early 1980s on international investment, both small investors and large institutions now invest heavily through unit trusts and investment companies in overseas equity markets.

Overseas investors now perceive the world's equity markets as one equity market. Overseas equity investment can be undertaken either directly or indirectly. Investors, particularly the big institutions, can operate by buying shares directly on overseas stock exchanges through brokers of the country concerned, or they can invest indirectly through numerous professionally managed equity funds offered in the country. Several important factors have reflected the substantial increase in world stock markets. These equity cycles largely reflect the flow of overseas and domestic activity. A careful monitoring of economic indicators underlies most successful stock market investments.

Falling inflation and interest rates resulted in a shift back into financial assets and away from physical assets such as property investments and commodities. Lower economic growth in the industrialized countries, and a lower world oil price for the past few years resulted in an improvement in corporate profits in those countries. Privatization of government run businesses took place in several countries. This heightened interest in the market among small investors. (Discuss Advantages and Disadvantages of International Investing).

EXHIBIT 1

KARACHI STOCK EXCHANGE CERTIFICATION PROGRAM

Examination Specifications

ISTI Recommended Percentage of Questions Per Exam		
15%	I.	Fundamentals of Securities Include types and definitions.
25%	II.	Economics, Securities Analysis, Portfolio Analysis, Market Theories Principal factors affecting securities markets and prices.
10%	III.	Trading on the Exchange Markets Types of orders, floor procedures, etc.
20%	IV.	Laws, Rules and Regulations Exchange Rules Membership Requirements, Listing Requirements Corporate Law Authority Rules Corporations (Laws & Rules that pertain to) Initial Public Offerings Dividends Registration Requirements Taxation Laws & Policies
15%	V.	Clearance & Settlement/Securities Processing
10%	VI.	Dealing with the Investing Public, Ethical Conduct Corporate Accounts Individual Accounts Foreign Accounts
5%	VII.	International Markets and Investing (Could be part of II)

EXHIBIT 2

Model Questions

Closed Stem Format

Used when the stem (the part of the question that poses the question) is complete and, for its reason, is ended by a question mark.

Which of the following would consider annual reports of a company to be the most important factor in making investment decisions?

a. technical analyst
b. a chartist
c. a contrarian believer
d. a fundamental analyst

Which of the following industries is most cyclical?

a. natural gas
b. food
c. medical
d. home appliances

Which of the following is an example of an arbitrage?

a. buying shares on the New York exchange and selling them on the New York exchange
b. buying shares on the New York exchange and selling them on the Chicago exchange
c. buying shares on the New York exchange and buying the same shares on the Chicago exchange
d. buying shares on the Chicago exchange and selling them on the Chicago exchange

When referring to dividends, which of the following applies to the term "Cumulative"?

a. dividends of previous years in arrears are payable before payment of other dividends
b. a percentage of profits must be paid after all dividends are paid
c. before a fixed dividend is paid, all ordinary shares must receive a dividend
d. the nominal value of the issued capital which is used on the balance sheet

Incomplete Sentence Format

Used when the stem is not a complete question, but is an incompleted statement which the alternative choice, or options, will logically complete.

Liquidity is the degree of ease with which an asset can be
(A) purchased on credit
(B) converted into cash
(C) used as loan collateral
(D) subject to arbitrage

Gross National Product is:

a. the total value of goods and services produced in the economy during the year after adjusting for net external income
b. the index used to measure the change in the general price level of consumer goods
c. the value of the share market by total capitalization
d. disposable personal income

If an analyst wanted to determine a company's ability to pay those debts that would be maturing in one year, or less, he would be most interested in:

a. the debt to equity ratio
b. the inventory turnover
c. the acid-test ratio
d. the current ratio

To find the yield of an ordinary share you would need the:

a. retained earnings and current assets
b. market price and retained earnings
c. yearly dividend and net worth
d. market price of the share and the yearly dividend

"Except" Format

Used when the stem requires the candidate to recognize the one incorrect answer from among the four options presented. To avoid possible confusion with correct answer formats, "EXCEPT" is capitalized.

The CLA defines "Insider" of a company as all the following EXCEPT:

a. officers of the company
b. shareholders owning 1%
c. directors of the company
d. private consultants to the company with access to non-public information

A company's application for listing must be accompanied by all the following EXCEPT:

a. names of directors
b. history of dividends paid for the last five years
c. memorandum and articles of association
d. the draft prospectus

A shareholder has the right to do all the following EXCEPT:

a. vote for directors
b. vote for a change in the corporate charter
c. vote for a bonus issue
d. vote for a rights issue

Roman Numeral Format

Used when the stem requires the candidate to identify two or more of four possibly correct answers. Each of the answers is designated by a Roman numeral distinguishing it from the A, B, C, D designations of the options.

A growth stock would most probably be characterized as having which two of the following?

I. A high price-earning ratio
II. A mature market for its product
III. A low dividend payout ratio
IV. A low return on equity

(A) I and II
(B) I and III
(C) II and IV
(D) III and IV

A listed company may be de-listed or suspended for which of the following reasons?

I. if its securities are quoted below 50 percent of face value for a continuous period of three (3) years.

II. if it has failed to declare a dividend or bonus for five years from the date of the last dividend or bonus. In the case of a manufacturing company; five years from the date of commencement of production.

III. if the company fails to hold its annual general meeting for a continuous period of three (3) years.

IV. if the company fails to pay the annual listing fees for a period of two years, or goes into liquidation.

(A) I and IV
(B) II and III
(C) II, III and IV
(D) I, II, III and IV

Companies desiring to issue bonus shares or rights are governed by the provisions of:

I. *Capital Issues Act of 1947*
II. *Companies Ordinance Act of 1984*
III. Karachi Stock Exchange Rules

(A) I and II
(B) II only
(C) II and III
(D) I, II and III

EXHIBIT 3

Bibliography

The following reference sources are offered to assist candidates for the Series 7 Examination (Certified Securities Representative). The list is not all-inclusive. It is merely a sample of laws, regulations, rules and texts on the Pakistan financial market and financial markets in general which are generally available through stock exchange, professional and business libraries. Copies of Laws and ordinances can be purchased through government printing offices.

In no way should inclusion of any work in the following list be taken as an endorsement of it by any self-regulatory organization involved in the preparation of "A Study Guide."

LAWS AND ORDINANCES

Companies Ordinance, No. 47 of 1984
Securities & Exchange Ordinance, 1969 (and Amendments)
Securities & Exchange Rules, 1971
Investment Companies & Investment Advisers Rules, 1971

THE KARACHI STOCK EXCHANGE (GTE) LIMITED

Memorandum and Articles of Association
General Rules and Regulations
Listing Regulations
Rules for Ready Delivery Contracts
Regulations for Trading in Provisionally Listed Companies
Forward Delivery Contracts (Suspended by CLA)
Clearinghouse Procedural Manual
"Rules Governing the Operation of the Central Depository System" — Central Depository Company (GTE) Limited (when operational)

GENERAL

Handbook of Investment Products and Services
Victor L. Haper
New York Institute of Finance
New York, NY, USA

The Stock Market
Richard Tervels and Edward S. Bradley
John Wiley & Sons
New York, NY, USA

Specific Financial Market Areas/Products

The Handbook of Fixed Income Securities
F.S. Fabozzi and I.M. Pollack, ed.
Dow Jones - IRWIN
Homewood, Illinois, USA

Investment Companies and Variable Contracts
Phillip K. Jones
Pictorial Publishers, Inc.,
Indianapolis, Indiana, USA

The Interpretation of Financial Statements
B. Graham and C. McGolrick
Harper & Row
New York, NY, USA

Security Analysis
B. Graham, D. Dodd and S. Cottle
McGraw-Hill, Inc.
New York, NY, USA

A Guide for Using the Foreign Exchange Market
Townsend Walker
John Wiley & Sons
New York, NY, USA

Technical Analysis: A Personal Seminar
The New York Institute of Finance
New York, NY, USA

Stocks, Bonds, Options, Futures:
Investments and their Markets
S.R. Veale, ed
The New York Institute of Finance
New York, NY, USA

BOOKLETS AND REFERENCE GUIDES (KSE LIBRARY)

You and the Investment World
Educational Services
The New York Stock Exchange, Inc.
11 Wall Street
New York, NY, USA

The New York Stock Exchange, Inc.
1. Understanding Financial Statements
2. Getting Help When You Invest
3. We Welcome You as a Customer

4. How to Get Help When You Invest
5. Understanding Stocks and Bonds
6. 10 Questions to Ask ..... Before You Buy Stocks.

New York Institute of Finance
Publications for Investment Professionals
Catalog, 1993
NYIF
2 Broadway
New York, NY 10004, USA

Securities Training Corporation
Course Catalog, 1993
17 Battery Place
New York, NY 10004, USA

The Philadelphia Stock Exchange, Inc.,
Publications Catalog
1900 Market Street
Philadelphia, PA 1903 USA

The National Association of Securities Dealers
Understanding Your Role as an RR
1735 K Street
Washington, D.C. 20006 USA

APPENDIX I

Form C-1

Uniform Application for Stock Market Certification or Transfer

FORWARD TO:

KARACHI STOCK EXCHANGE (GTE) LIMITED
MEMBER/AGENT CERTIFICATION DEPT.
STOCK EXCHANGE BUILDING
STOCK EXCHANGE ROAD
KARACHI, 74000, PAKISTAN

PART ONE

FAMILY NAME | SURNAME | OTHER NAME(S) (Specify if none) | EMPLOYMENT NUMBER

SPONSORING STOCK EXCHANGE MEMBER NAME | EMPLOYEMNT DATE

MEMBER'S MAIN ADDRESS Street/Bldg/P.O. Box CITY PROVINCE POSTAL CODE

MEMBER'S BRANCH I.D. APPLICANT'S OFFICE ADDRESS STREET/BLDG/P.O.BOX CITY PROVINCE POSTAL CODE

WILL APPLICANT MAINTAIN CERTIFICATION WITH MORE THAN ONE STOCK EXCHANGE MEMBER? [ ] YES [ ] NO
if "yes", please list details in PART THREE
if "yes", are other stock exchange members aware of this plan? [ ] YES [ ] NO

APPLICANT TO BE CERTIFIED WITH THE FOLLOWING:
[ ] KSE [ ] ISE [ ] LSE [ ] OTHER (SPECIFY) _____

TYPE OF EXAMINATION REQUESTED (CHECK ALL APPLICABLE)
[ ] S-7 FULL REGISTRATION/CERTIFIED SECURITIES REPRESENTATIVE
[ ] RESCHEDULE EXAM SERIES _____
[ ] OTHER _____

THIS PORTION MUST BE COMPLETED FOR ALL TRANSFER OR RE-CERTIFICATION FILINGS
APPLICANT'S CURRENT ADDRESS: STREET/BLDG CITY PROVINCE POSTAL CODE

MEMBER APPLICANT IS TRANSFERING FROM: TERMINATION DATE DD/MM/YR

PART TWO - PERSONAL DATA
FAMILY NAME | SURNAME | OTHER NAME(S) (Specify if none)

DATE OF BIRTH (DD/MM/YR) | SEX | HEIGHT | WEIGHT | CITY/COUNTRY OF BIRTH

RESIDENTIAL HISTORY
GIVE ALL ADDRESS FOR THE PAST FIVE YEARS, STARTING WITH CURRENT ADDRESS

STREET/BLDG/P.O.BOX	CITY	PROVINCE	COUNTRY	POSTAL CODE	FROM MM/YR	TO MM/YR

PART THREE - EMPLOYMENT HISTORY
ACCOUNT FOR ALL TIME FOR THE PAST TEN YEARS. GIVE ALL EMPLOYMENT EXPERIENCE STARTING WITH YOUR PREVIOUS EMPLOYER AND WORKING BACK TEN YEARS. INCLUDE FULL AND PART TIME WORK, SELF-EMPLOYMENT, MILITARY SERVICE, UNEMPLOYMENT AND FULL TIME EDUCATION.

FROM MM/YR | TO MM/YR | POSITION HELD

NAME
CITY PROVINCE STATE/COUNTRY
NAME
CITY PROVINCE STATE/COUNTRY
NAME
CITY PROVINCE STATE/COUNTRY
NAME
CITY PROVINCE STATE/COUNTRY
NAME
CITY PROVINCE STATE/COUNTRY

PART THREE
ARE YOU CURRENTLY ENGAGED IN ANY BUSINESS (NOTE SHOWN ABOVE) EITHER AS PROPRIETOR, PARTNER, OFFICER, DIRECTOR, TRUSTEE, EMPLOYEE, AGENT OR OTHERWISE?
[ ] YES [ ] NO if "yes", please explain below:

The appropriate signatory area DOES NOT have to be completed UNLESS this page is being submitted as an amendment

DAY MONTH YEAR

SIGNATURE OF APPROPRIATE SIGNATORY - MEMBER

TYPE OR PRINT NAME OF APPROPRIATE SIGNATORY

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UNIFORM APPLICATION FOR STOCK MARKET CERTIFICATON OR TRANSFER

If making an amendment to this page, complete only item 21 and items you are amending

MEMBER NAME | SRO | APPLICANT'S FAMILY NAME | SURNAME | OTHER NAME(S)

IF THE ANSWER TO ANY OF THE FOLLOWING QUESTIONS IS YES AND YOU CANNOT UTILIZE THE CERTIFICATION ITEM O BELOW ATTACH COMPLETE DETAILS OF ALL EVENTS OR OR PROCEEDINGS OR DRP

PART FOUR

- Charges-Accused of a crime in a formal complaint, information, or indictment
- Investment or Investment-Related - Pertaining to securities, commodities, banking insurance, or real estate (including, but not limited to acting as or being associated with a broker dealer investment company, investment adviser, futures sponsor, bank, or savings and loan association).
- Involved - Doing an act or aiding, abetting, counseling, commanding, inducing conspiring with or failing reasonably to supervise another in doing an act
- Foreign Financial Regulatory Authority - includes (A) a foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to the regulation of investment or investment related activities, or (C) member organization, a function of which is to regulate the participation of its members in the activities listed above

A. Have you been convicted of or plead guilty or nolo contendere ("no contest") in a domestic or foreign court to:
   (1) a felony or misdemeanor involving: investments or an investment-related business, fraud, false statemnts or ommissions, wrongful taking property, or bribery forgery, counterfeiting or extortion?
   (2) gambling:
   (3) any other felony?

B. Have you, or an organization over which you exercised management or policy control, ever been charged with any felony or charged with a misdemeanor specified in question A(1) or (2) in a domestic foreign court?

C. Has any domestic or foreign court ever:
   (1) enjoined you in connection with any investment-related activity?
   (2) found that you were involved in a violation of investment-related statutes or regulations?

D. Has the Corporate Laws Authority ever:
   (1) found you to have made a false statement or omission?
   (2) found you to have been involved in a violation of investment-related regulations or statutes?
   (3) found you to have been a cause of an investment-rested business having its authorization to do business denied, suspended, revoked, or restricted?
   (4) entered an order denying, suspending or revoking your certification or disciplined you by restricting your activities?
   (5) imposed a civil money penalty on you, or ordered you to cease and desist from any activity?

E. Has any other National regulatory authority or any provincial authority or foreign financial regulatory autority ever:
   (1) found you to have made a false statement or omission or basin dishonest, unfair or unethical?
   (2) found you to have been involved in a violation of investment regulations or statutes?
   (3) found you to have been a cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted?
   (4) entered an order against you in connection with investment-related activity?
   (5) denied, suspended, or revoked your certification or license or otherwise prevented you from associating with an investment-related business, or disciplined you by restricting your activities?
   (6) revoked or suspended you license as an attorney, accountant or federal contractor?

F. Has any self-regulatory organization or foreign exchange:
   (1) found you to have made a false statement or omission?
   (2) found you to have been involved in a violation of its rules?
   (3) found you to have been the cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted?
   (4) disciplined you by expelling or suspending you from membership, barring or suspending your association with its members, or restricting your activities?

G. Has any foreign government ever entered an order against you related to investments or fraud, other than as reported in items A,B,C, or E?

H. Have you ever been the subject of an investment-related, consumer-initiated complaint or proceeding that:
   (1) alleged compensatory damages of Rs. 250,000 or more, fraud, or wrongful taking of property?
   (2) was settled or decided against you for Rs. 100,000 or more, or found fraud or the wrongful taking of property?

I. Are you now the subject of any complaint, investigation, or proceeding that could result in a "yes" answer to parts A-H of this item?

J. Has a bonding company denied, paid out on, or revoked a bond for you?

K. Do you have any unsatisfied judgments or liens against you?

L. Have you or a firm that you exercised management or policy control ever, or owned 10% or more of the securities of failed in business, made a compromise with creditors, filed a bankruptcy petition or been declared bankrupt?

M. Has a broker or dealer member firm that you exercised management or policy control ever, or owned 10% or more of the securities of, been declared bankrupt, had a trustee appointed or had a direct payment procedure initiated?

N. Have you been discharged or permitted to resign because you were accused of:
   (1) violating investment-relating statutes, regulations, rules, or industry standards of conduct?
   (2) fraud or the wrongful taking of property?
   (3) failure to supervise in connection with investment-related statutes, regulations, rules or industry standards of conduct?

DISCOLSURE CERTIFICATION (OPTIONAL)

You may only certify to the accuracy and completeness of the disclosure information in your file if it has been fully provided in DRP format. If DRP(s) are not on file, do not answer these certification boxes. Provide full details of all matters on DRP(s). All appropriate questions in part four must be answered, regardless of whether the certification is being utilized. Refer to the instructions on the inside cover of the Form C-1 for additional information on the utilization of the certification language.

O. I have reviewed a copy of my disclosure file taken from the certification system. I acknowledge that all information contained therein is fully disclosed, accurate and in DRP format. I further certify the following:

1. I have no new information to add to my disclosure file
2. I have new information to add to my disclosure file which is reported on the attached DRP(s)
3. I have updated information, reported on the attached DRP(s), which was previously reported and contained in Occurance

The applicant and appropriate signatory area DOES NOT have to be completed UNLESS this page is being submitted as an amendment.

DAY MONTH YEAR | SIGNATURE OF APPLICANT

TYPE OR PRINT
NAME OF APPLICANT: _____

DAY MONTH YEAR | SIGNATURE OF APPROPRIATE SIGNATORY

BEST AVAILABLE DOCUMENT

UNIFORM APPLICATION FOR STOCK MARKET CERTIFICATION OR TRANSFER
DISCLOSURE REPORTING PAGE (DRP)

SURNAME FIRST NAME OTHER NAME(S) (Specify if none)

MEMBER NAME

INSTRUCTIONS

This Disclosure Reporting Page (DRP) is to be used to report details of affirmative responses to PART FOUR questions.

- Use a separate DRP for each event or proceeding. Complete items 1-8 below. (Item 9 is optional)
- One event may result in more than one "yes" answer in PART FOUR, if so, use only one DRP to report this information.
- The information provided on this DRP will be entered into the certificaiton system verbatim. It is very important that clear and concise information be provided for each item on this form.
- It is not a requirement that documents be provided for each event or proceeding. Should they be provided with the DRP, they will not be accepted as disclosure in lieu of answering the questions on this form.

1. This DRP relates to the following questions in part four:

[ ] A (1)	[ ] C (1)	[ ] D (3)	[ ] E (2)	[ ] E (6)	[ ] F (4)	[ ] I	[ ] M
[ ] A (2)	[ ] C (2)	[ ] D (4)	[ ] E (3)	[ ] F (1)	[ ] G	[ ] J (1)	[ ] N (1)
[ ] A (3)	[ ] D (1)	[ ] D (5)	[ ] E (4)	[ ] F (2)	[ ] H (1)	[ ] K (2)	[ ] N (2)
[ ] B	[ ] D (2)	[ ] E (1)	[ ] E (5)	[ ] F (3)	[ ] H (2)	[ ] L	[ ] N (3)

2. Is this DRP being filed to change or update any information regarding a previously reported event or proceeding? [ ] YES [ ] NO
   Complete items 1-8, and if yes, also circle the items below which are being changed.
3. Who initiated this event or proceeding? (Enter name of firm, regulator, court, customer, etc.)
4. What type of event or proceeding was this? (i.e., customer Complaint, Termination, Civil, Administrative, Criminal, Arbitration)
5. On what date was the event or proceeding initiated:
6. Identify the docket or case number of the event or proceeding (if any).
7. What were the allegations against you? (Include amounts of actual or alleged damages or claims.)
8. a. What is the current status of the event or proceeding?
   b. On what date was this status reached:
   c. What was the result: (Include felony/misdemeanor, a description of the penalties, amount of fine, payment or settlement; terms of the disposition, length of suspension or restriction, etc.)
9. You may provide a brief summary of this event or proceeding. (Your information must fit within the space provided.)

DAY MONTH YEAR SIGNATURE OF APPLICANT

BEST AVAILABLE DOCUMENT

UNIFORM APPLICATION FOR STOCK MARKET CERTIFICATION OR TRANSFER
ATTACHMENT SHEET FOR ITEMS IN PART ONE, TWO & THREE

FAMILY NAME	SURNAME	OTHER NAME(S)
MEMBERS NAME	SRO	

Use this Attachment Sheet to report continued information from PARTS ONE, TWO & THREE of Form C-1
(For PART FOUR use the Disclosure Reporting Page (DRP)

ITEM OF FORM (IDENTITY)	ANSWER

DAY	MONTH	YEAR	SIGNATURE OF APPLICANT

ATTACHMENT SHEET

BEST AVAILABLE DOCUMENT

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UNIFORM APPLICATION FOR STOCK MARKET CERTIFICATION OR TRANSFER
THIS FORM MUST BE COMPLETED, SIGNED AND SUBMITTED WITH FORM C-1

MEMBER NAME | SRO | APPLICANT'S FAMILY NAME | SURNAME | OTHER NAME(S)

THE APPLICANT MUST READ FOLLOWING VERY CAREFULLY

1. I swear or affirm that I have read and understand the items and instructions on this form and that my answers on this form and that my answers (including attachments) are true and complete to the best of my knowledge. I understand that I am subject to administrative, civil or criminal penalties if I give false or misleading answers.
2. I apply for certification with the jurisdictions and organizations indicated in part one as may be amended from time to time and, in consideration of the jurisdictions and organizations receiving and considering my application, I submit to the authority of the jurisdictions and organizations and agree to comply with all provisions, conditions and convenants of the statutes, articles, memorandum of associations and rules and regulations of the jurisdictions and organizations as they are or may be adopted, or amended from time to time. I further agree to be subject to an comply with all requirements, rulings, orders, directives and decisions of, and penalties, prohibitions and firmation imposed by the jurisdictions and organizations, subject to right of appeal or review as provided by law.
3. I agree that neither the jurisdictions or organizations nor any person acting on their behalf shall be liable to me for action taken or omitted to be taken in official capacity or in the scope of employment, except as otherwise provided in the stautes, articles, memorandum of association, or the rules and regulations of the jurisdictions and organizations.
4. I authorize the jurisdictions and organizations to give any information they may have concerning me to any employer or prospective employer, any national authority, or any other organization and I release the jurisdictions and organizations and any person acting on their behalf from any and all liability of whatever nature by reason of information.
5. I agree to arbitrate any dispute, claim or controversy that may arise between me and my firm, or a customer, or any other person, that is required to be arbitrated under the rules, articles, memorandum of associations of the organizations indicated in part one as may be amended from time to time and that any arbitration award rendered against me may be entered as a judgement in any court of competent jurisdiction.
6. For the purpose of complying with the laws relating to the offer or sale of securities in the jurisdictions indicated in part one may be amended from time to time, I irrevocably appoint the administrator of each of those jurisdicitons, or such other person designated by law, and the sucessors in such office, my attorney upon whom may be served any notice, process or pleading in any action or proceeding against me arising out of or in connection with the offer or sale of securities or commodities, or out of the violation or alleged violation of the laws of the jurisdictions. I consent that any such action or proceeding against me may be commenced in any court of competent jurisdiction and proper venue by service or process upon the appointee as if I were a resident of, and had been lawfully served with process in, the jurisdiciton. I request that a copy of any notice, process or pleading served hereunder be mailed to my current residential address as reflected in this form or any amendment thereto.
7. I consent that notice of any investigation or proceeding by any self-regulatory organization against applicant may be given by personal service or by regular, registered or certified mail or confirmed telegram to applicant at his/her most recent business or home address as reflected in this Form C-1, or any amendment thereto, or by leaving notice of the investigation or proceeding at such address.
8. I authorize all of my employers and any other person to furnish to any jurisdiction or organization or any agent acting on its behalf, any informatoin they have, including my creditworthiness, character, ability, business activities, educational background, general reputation, history of my employment and, in the case of former employers, complete reasons for my termination. Moreover, I release each employer, former employer and each other paron from any and all liability, of whatever nature, by reason of furnishing any of the above information, including that information reported on the Uniform Termination Notice for Stock Market Certification (Form C-3). I recongnize that I may be the subject of an investigative consumer report ordered by the jurisdictions, or organizations with which this application is being filed, an waive any requirement of notification with respect to any investigative consumer report ordered by any such jurisdiction or organization. I understand that I have the right to request complete and accurate disclosure by the jurisdiction or organization of the nature and scope of the requested invistigative consumer report.
9. I understand and certify that the reporesentions in this form apply to all employers with shom I seek certification as indicated in Items 4 and 9 of this form. I agree to update this form by causing an amendment to be filed on timely basis whenever changes occur to answers previously reported. Furhter, I represent that, to the extent any information previously submitted is not amended, the information provided in this form is currently accurate and complete.
10. If I have become temporarily certified as an agent, I acknowledge that this application form certification with the jurisdications and organizations incidated in Part One is separate and distinct from any temporary certification already obtained with the jurisdictions and organizations. I further understand that my certification may be denied, suspended or revoked under the laws, regulations or rules of the jurisdicitons and organization.s.

Month | Day | Year

SIGNATURE OF APPLICANT

TYPE OR PRINTE NAME OF APPLICANT

THE FIRM MUST COMPLETE THE FOLLOWING

To the best of my knowledge and belief, the applicant is currently bonded where required, and, at the time of approval, will be familiar with the statute(s), constitution(s), rules and by-laws of the agency, jurisdicition or self-regulatory organization with which this application is being filed, and the rules governing certifiedpersons, and will be fully qualified for the position for which application is being made herein. I agree that, notwithstanding the approval of such agency, jurisdiction or organization which hereby is requested, I will not employ the applicant in the capacity stated herein without first receiving the approval of any authority which may be required by law. This firm has communicated with all the applicant's pervious employers of the past three years.

EMPLOYER	NAME OF PERSON CONTACTED	POSITION OF PERSON CONTACTED	EMPLOYED FROM	TO	HOW CONTACTED PHONE	LETTER	INTERVIEW

IN ADDITION, I HAVE TAKEN APPROPRIATE STEPS TO VERIFY THE ACCURACY AND COMPLETENESS OF THE INFORMATION CONTAINED IN AND WITH THIS APPLICATION.

THE APPROPRIATE SIGNATORY AREA MUST BE COMPELTED ON ALL INITIAL TRANSFER OR AMENDMENT FILINGS.

MONTH | DAY | YEAR

SIGNATURE OF APPROPRIATE SIGNATORY

TYPE OR PRINT NAME APPROPRIATE SIGNATORY

BEST AVAILABLE DOCUMENT

FORM C-3

UNIFORM APPLICATION FOR STOCK MARKET CERTIFICATION OR TRANSFER
THIS FORM MUST BE COMPLETED FOR ANY CSR TERMINATION
AND SUBMITTED TO REPORTING SRO WITHIN TEN BUSINESS DAYS OF TERMINATION

MEMBER NAME SRO CSR'S FAMILY NAME SURNAME OTHER NAMES(S)

MEMBER'S MAIN ADDRESS Street/Bldg/P.O. Box CITY PROVINCE POSTAL CODE

CSR'S OFFICE ADDRESS Street/Bldg/P.O. Box CITY PROVINCE POSTAL CODE

TERMINATION DATE DD/MM/YR

REASON FOR TERMINATION:

[ ] RETIREMENT [ ] RESIGNATION, REASON: _____

[ ] DEATH [ ] TERMINATION BY MEMBER, REASON: _____

IF TERMINATED BY MEMBER SUFFICIENT INFORMATION MUST BE REPORTED TO REPORTING SRO TO PERMIT SRO TO AJUDGE CONTINUITY OF CERTIFICATION OR TO CAUSE FURTHER INVESTIGATION BY RESPONSIBLE SRO.

CAUTION: REPORTING SRO MEMBER SHOULD EXERCISE DUE CAUTION IN COMPLETING THIS FORMS, AS INFORMATION PROVIDED HEREIN COULD EFFECT THE EMPLOYMENT OPPORTUNITIES OF THE CSR.

WILL THE REPORTING MEMBER CONSIDER THE CSR DESCRIBED HEREIN FOR RE-EMPLOYMENT? [ ] YES [ ] NO

DAY MONTH YEAR

SIGNATURE OF APPROPRIATE SIGNATORY - MEMBER

TYPE OR PRINT NAME OF APPROPRIATE SIGNATORY

BEST AVAILABLE DOCUMENT