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Business and Consultancy Services (Pvt) Limited

Stock Exchange Study
Private Investment Expansion Program (391-0514) of USAID

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EXECUTIVE SUMMARY

EXECUTIVE SUMMARY

The Stock Market in Pakistan depicted a sharp upward trend in 1991 and a steep decline in 1992. The general assessment was that this behavior of the market was caused by speculative transactions by some members of the Stock Exchange. The Corporate Law Authority (CLA) took note of the situation and requested United States Agency for International Development (USAID) for assistance in carrying out a Stock Exchange Study. USAID has accordingly entered into a consultancy contract with Business and Consultancy Services (Pvt) Limited (BCS) for the Study.

The Consultants have carried out an in-depth examination and analysis of the legislative frame-work, Stock Market operations, and the problems faced by the individual and institutional investors with a view to identifying weak points of the present system and constraints to the growth of the Capital Market. The Study suggests appropriate steps for better regulatory control, enhanced operational efficiency of the Stock Exchanges and restoration of the investors confidence in the functioning of the Stock Market.

The Study has been divided into 13 chapters. The first chapter draws a brief sketch of the events which led to the need for conducting the Study. The second chapter describes the methodology of the Study and chapter 3 explains in detail the Consultants' approach to self-regulation. chapter 4 deals with Articles and Memoranda of the Stock Exchanges. It covers mainly regulatory provisions pertaining to the definition of Stock Exchange, conditions and criteria for setting up an Exchange, eligibility conditions for membership and qualifications of

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the members of the Stock Exchange. Chapter 5 has been devoted to the issues pertaining to the listing rules of the Stock Exchanges. Besides the definition of a security, inter-corporate financing and qualifications of directors, accounts, audit, prospectuses and disclosure aspects of the public listed companies have been discussed in detail in this chapter. Chapter 6 covers issues of commission rates and level of 'gearing' and financial accommodation of brokers by banks. Chapter 7 deals with 'Net Capital' requirements of the members. Chapter 8, 9 and 10 high-light the problems in the areas of clearance, settlement, transfer of shares, jobbing/brokerage and insider trading. Chapter 11 speaks about major market distortions. Chapter 12 suggests futuristic studies. Chapter 13 presents a summary of the recommendations made in the Study.

The Study concludes that no structural change in the the existing regulatory set up is required. However, the Capital Issues Act needs to be merged with the Companies Ordinance and a separate comprehensive law for investment finance companies and investment advisers etc. needs to be prepared. The decisions regarding location and the number of Stock Exchanges in a city should be left to the sponsors. It is desirable to promote a secondary market in unlisted securities. In order to bring in new skills and expertise into the system, the CLA should be empowered to allow joint ventures of foreign and local securities firms and for that purpose dispense with the nationality condition for the membership of the Stock Exchanges. The Consultants feel that the CLA may also be authorized to waive the condition of two years' experience for the membership of the Exchanges.

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Changes have been suggested in the listing rules, the prospectuses and annual accounts to make them more transparent. Maintenance of separate books of accounts for business with clients have been suggested to avoid conflict of interest with the business done by the members on their own account.

Some changes in the Companies Ordinance, 1984 have been suggested in respect of investment in Associated Undertakings. It has been suggested that certification requirements of the accounts of the public listed companies should be expanded to increase the burden of responsibility of the Management and Auditors. The CLA should make more information available to the intending investors in the form of bulletin and official report on major events of the corporate sector. In order to inspire greater confidence in the members of the Stock Exchanges, the 'Net Capital' requirements have been enhanced. Suggestions have been made for a Compensation Fund and Insurance of the members to meet situations of default. The early implementation of Central Depository System and Electronic Trading have been emphasized. Measures have been suggested for regulating insider trading. In order to create secondary market for 'Debt Securities' a recommendation has been made to reduce Stamp Duty.

Further studies have been suggested to cover areas which need detailed examination and cannot be covered in this Report.

CHAPTER - 1

INTRODUCTION

Background

- 1.1. There was phenomenal growth in the business on the Stock Market in 1991. The trading showed substantial increase in the turn-over. The share Prices Index also rose sharply reflecting the mood of the boom period of 1991. There was, however, a steep decline in 1992.
- 1.2. The figures in the statement at Annexure-A would show the rise and fall in the turn-over and the Shares Prices Index.
- 1.3. The decline in 1992 is not attributable solely to a technical correction of the market but is mainly due to over-heating and speculation. It seems that some members of the Stock Exchange, trading on their own account as well as Modarabas and Investment Institutions contributed to the over-heating of the market. A couple of members defaulted and corrective action had to be taken against them by the Board of Directors of Karachi Stock Exchange. The decline has particularly hurt the small investors and has shaken their confidence in the functioning of the Stock Market.
- 1.4. The Corporate Law Authority (CLA) took note of these developments and initiated a process of review of the regulatory mechanism for the restoration of the confidence of investors in the Stock Market. There were three salient objectives of this review, namely:-
 - 1.4.1. preventing default situations in the future;
 - 1.4.2. eliminating wide swings on the Stock Market by checking 'speculation' and 'over-extension' by active members trading on

their own account; and

1.4.3. ensuring prompt and fair fulfillment of clients' orders by the members.

1.5. In fact, the stock market in Pakistan, inspite of the boom of 1991, remains thin and narrow. The shares of quite a few listed companies are not widely held, with the result that market is subjected to rather wide fluctuations from time to time.

1.6. As a result of denationalization, privatization and liberal opening of the economy, Capital Market in Pakistan is bound to develop at a faster pace. With a view to improving the operational efficiency of the Stock Exchanges and to ensure better regulatory control by the CLA, the Government of Pakistan (GOP) is planning to make suitable amendments in the current Securities and Exchange Legislation so that the Law and the Rules are in line with the changed environments.

1.7. The CLA has asked the U.S. Agency for International Development (USAID) for assistance in carrying out a Stock Exchange Study. USAID has accordingly entered into a consultancy contract with Business and Consultancy Services (BCS) for the Study (Annexure-B).

1.8. The aim of the Study is to help CLA in obtaining first-hand data and information for informed value-judgment and thereafter drafting appropriate legal amendments.

Terms of Reference (TOR)

1.9. In order to detect the operational weaknesses of the regulatory system and constraints to the growth and development of Capital Market, the Study has focused on the working of the Stock Exchanges, problems of individual investors, independent brokers and major financial institutions (mutual funds, modarabas, Development Finance Institutions (DFIs) and National Investment Trust (an open-end mutual fund sponsored by the Government). Focal point of the Study is Karachi Stock Exchange because Lahore Stock Exchange is still an extension of Karachi Stock Exchange. So will be Islamabad Stock Exchange for quite some time in the future. While carrying out the Study, the consultants have appraised and analyzed -

- 1.9.1. Articles and Memoranda of the Stock Exchanges;
- 1.9.2. Listing Rules of the Exchanges;
- 1.9.3. Practices pertaining to commission rates and clearances;
- 1.9.4. Net-worth and financial means committed by the members of the exchange in relation to business handled;
- 1.9.5. Level of "gearing" (leverage) and financial accommodation of brokers by banks and financial institutions;
- 1.9.6. Settlement and clearance procedures;
- 1.9.7. Formalities and time required for transfer of stocks and shares and debentures;
- 1.9.8. Conflict of interest in jobbing/ brokerage, etc.;
- 1.9.9. Insider trading; and
- 1.9.10. Failure to list trades.

CHAPTER - 2

METHODOLOGY

2. Methodology

- 2.1. The Consultants have approached their assignment by collecting relevant material from different sources both from within the country and from abroad. The details of material collected and perused by the Consultants may be seen at Annexure-C.
- 2.2. The material was critically examined and analyzed. In particular, the Consultants studied Interbank Report on clearing and settlement, July 1, 1992 provided by USAID. They prepared a comprehensive questionnaire (Annexure-D) for their own guidance so that structured discussion could take place with the concerned persons and agencies.
- 2.3. The material from abroad was collected to look into the latest developments in the regulatory approaches in the world and to provide a theoretical frame-work for an efficient Stock Market in Pakistan. The Interbank Report and proceedings of the three seminars held in Pakistan were found more relevant and of immediate application.
- 2.4. A series of meetings were held with the officials of CLA, members and brokers of Islamabad Stock Exchange, Lahore Stock Exchange and Karachi Stock Exchange. A number of Investment Institutions were also visited and discussions were held with their chief executives. It is worth mentioning that more intensive and lengthy discussions took place at Karachi which is the hub of the Capital Market. A list of interviewees and discussants is given in Annexure-E.

2.5. The trends of discussions are summarized as follows:

2.5.1. A number of the members of the Stock Exchange were vehemently opposed to interference by CLA and did not want additional legal powers to be given to the Authority. They were critical of detailed audit of brokers (with unnecessary publicity by CLA), which they thought was tantamount to shaking the confidence of the investors in the working of the members specially and the Stock Exchange in general.

2.5.2. Some members were vehement in their diagnosis that a lack-luster disciplining of listed companies by CLA (and some said rather strongly by the Stock Exchange Management) was responsible for the wild fluctuations on the Stock Market.

2.5.3. Similarly, the scrutiny of prospectus and 'offer for sale' was held by the members to be formal rather than substantial and critical. This criticism was against both the CLA as well as the Stock Exchange Management.

2.5.4. They (the members) were critical of the 'insider' advantage which investment institutions and industrial companies enjoy by becoming members of Stock Exchange. Yet, they did not equally oppose the Directorship of members of Stock Exchanges on the Board of listed companies.

2.5.5. They (the members) expressed the general view that the law and

the rules were drafted on the pattern of the legal provisions in the U.S.A. What is missing now is proper implementation of the law.

- 2.5.6. Most of the members of the Stock Exchanges were of the opinion that present 'Net Capital' requirements are adequate and that the Karachi Stock Exchange had successfully dealt with defaults.
- 2.5.7. It was mentioned by some members that the existing system of clearing, settlement and transfer of shares prevents smooth and speedy business on the Stock Market and that a Central Depository System should be introduced immediately.
- 2.5.8. The CLA's views are (and to a great extent shared by small investors and some investment institutions) that a greater 'external' discipline should be imposed on members of the Stock Exchanges to make for healthy growth of the investment climate and Capital Market.
- 2.5.9. A majority view very interestingly holds Modarabas and 20 - 30 active members of the Stock Exchange guilty of the practice of:
- * over-trading on the basis of money obtained for 'Badla' transactions .
 - * filling their own portfolio before filling clients' orders
 - * market manipulation.
 - * lending money by Modarabas to the active members for specu-

lative over-trading at high rates of interest i.e. 2.5 - 4 % per month.

lack of concrete and rigid house-keeping by Stock Exchange members.

2.5.10. It was suggested, during the course of discussion, that pricing of issues (including initial public offering, disinvestment offers, right issues) should be left to the sponsors and independent underwriters. It was pointed out in support of this suggestion that the evaluation of the share prices as approved by the CLA in the case of Khadim Ali Shah Bukhari and Company (KASB & Co. - a Securities Firm) and Sui Northern Gas (a gas transmission and distribution company) were not in line with the market assessment of these shares. KASB went up from Rs. 31.50 to about Rs.100 in the market and Sui Northern was under-subscribed and the under-writers became the under-takers. The latter share was quoted below the disinvestment offer price when the trading started.

2.5.11. A number of persons raised the issue of lack of transparency and insufficient disclosure about the company affairs in the balance sheets and profit and loss accounts of the listed companies and also in the prospectuses. It was emphasized by some discussants that the Auditors should demand more information from the management for full disclosure to the shareholders.

2.5.12. The Chief Executive of an Investment Bank pointed out that the

Stamp Duty was acting as a hurdle to the issuance of Marketable Debt Securities and the development of a secondary market in such Securities. It was suggested that Government may consider an amendment to the Stamp Act of 1899, to reduce the Stamp Duty to a nominal amount or eliminate it altogether. .

2.5.13. It was pointed out by some of the discussants that there are a number of laws with overlapping provisions, governing the Capital Market and that a company wanting to go public has to approach different regulatory agencies causing delays.

2.6. The above issues have inter alia been addressed at the appropriate place in subsequent chapters of the Study.

CHAPTER - 3

EXAMINATION AND ANALYSIS OF MATERIAL

3. EXAMINATION AND ANALYSIS OF MATERIAL

The Philosophy of Self-Regulation and Regulation by the Government

3.1. The Consultants have in accordance with their mandate tried to steer clear of the two extremes of 'over-regulation' and 'under-regulation' as well as 'total Self-Regulation' versus 'comprehensive external bureaucratic controls'. Over-regulation will stifle the initiative necessary for growth. Under-regulation, by removing the protective umbrella that fosters investor confidence in the market, will have the same unfortunate effect. A rational middle-of-the-road approach to regulation seems to be the right course to be followed.

3.2. The history of legislation regarding regulation of securities market shows that first attempt to discipline the securities market was made through self-regulation. The philosophy of self-regulation was adopted because: (1) the practitioners or professionals could take decisions and make policies with total awareness of what was happening on the ground in the Capital Market; and (2) the cost of management could be raised from the market activities rather than from the Government Exchequer. However, it is also a fact that self-regulation cannot be reliable and effective unless standards of self-regulation are set with abundant caution and the agency administering the regulations demonstrates unimpeachable integrity.

Self-Regulation and the Role of Government

3.3. In order to make self-regulation successful, the Capital Market and the

Self-Regulating Agency must have Government backing and support. In other words, situations demanding intervention in public interest should be regulated directly by the Government, but the area of intervention must be minimal.

3.4. In one of the seminars, it was disclosed by a participant that instead of confining its role to regulatory mechanism, the governments of some of the countries have come to the help of the investors by entering the market to prevent recession. In 1964 the Tokyo Stock Exchange started tumbling. There were forecasts of 1929 style depression for Japan. However, statutory and administrative mechanism was in place for immediate and decisive action. The Government of Japan decided to directly buy the stocks from the Stock Market before any major damage could be done. The market jumped by 20 % simply on announcement of the Government's intent, without actual purchases. By the end of the year, the market had declined by 20%. However, the Japanese Government managed to soft-land and halt the market decline. Very recently, the Japanese Government used innovative book-keeping methods to insulate part of the economy from the Stock Market slide. It has permitted business to value stocks retroactively at prices prevailing on a pre-decline date. The basic concept being that since stock values are cyclical and these will regain values, why force business to go in red because of a temporary decline.

3.5. It was also disclosed in the seminar that a few years ago investor Ivan Boesky was charged with insider trading by the Securities and Exchange Commission in the USA. The Commission arranged plea bargaining with the

culprit, liquidated his securities worth about half a billion dollar to collect the fine imposed. The entire liquidation was conducted in total secrecy and the transactions were announced after completion. Experts have commented that if the intended liquidation had not been kept secret, it would have caused the US Stock Markets to tumble.

Self-Regulation and the Role of Market Players

3.6. The role of regulatory agencies in the Capital Market is to facilitate smooth functioning of the market. The agencies have to act like a traffic policeman who directs the traffic into proper channels to avoid traffic jams.

3.7. The various actors in the capital market should be free to transact their business with awareness on honest and fair basis. They should use caution in situations of "conflict of interest" so that they don't trespass and hurt the interest of others. They should not indulge in fraud because that is not even in their self interest. The Insiders should be discouraged from using the inside information. The insiders and dealers should demonstrate fiduciary behavior. The rules of the game - the securities and exchange laws, the charters of the Stock Exchanges and the DFIs should provide for preventing unfair practices and fraudulent transactions.

Self-Regulation and Division of Functions

3.8. There are a number of studies on the division of regulatory functions

between the governmental authorities and Stock Exchanges. Their common role is to prescribe procedures for full disclosure, maintenance of appropriate accounts, proper audit and accessibility of information to all the participants in the Capital Market transactions.

3.9. The smooth functioning of any regulatory framework presupposes a close coordination and an intimate working relationship based on mutual respect for each others' sensitivities and responsibilities between the regulatory agency and the Stock Exchanges. It should be treated like a joint venture. The areas where a close liaison could be rewarding are (a) share applications - Procedure thereof (b) allotment to successful applicants and subsequent deliveries of share certificates to them (c) registration of shares and verification of transfer deeds (d) receipt of dividends by shareholders (e) the attendance by shareholders at annual general meetings and unfettered exercise of their rights to seek clarifications and information from the management and to vote on important matters such as distribution of dividends, changes in capital structure, inter-corporate financing, the election of directors and the appointment of auditors.

3.10. The Consultants feel that there is a need for more intensive dialogue between the Stock Exchanges and the CLA on the qualifications for listing, the disclosures required to be made by the companies seeking listing to intending investors, and the pricing of shares both with regard to initial public offerings and the offer of right shares by companies already listed.

The Existing Regulatory Structure

3.11. The Consultants have looked into the present pyramid of the regulatory set up of the Capital Market. At the apex, there is CLA which oversees the following laws:

3.11.1. Capital Issues (Continuance of Control) Act, 1947;

3.11.2. Capital Issues (Exemption) Order, 1967;

3.11.3. Securities and Exchange Ordinance, 1969;

3.11.4. Securities and Exchange Rules, 1971;

3.11.5. Investment Companies and Investment Advisers Rules, 1971;

3.11.6. The Monopolies and Restrictive Trade Practices (Prevention and Control) Ordinance, 1970

3.11.7. Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980; and

3.11.8. Companies Ordinance, 1984 and Rules framed thereunder.

Then there are Governing Boards of the Stock Exchanges who perform the function of self-regulation of the Stock Market.

3.12. The Consultants feel that the regulatory set-up in Pakistan is in line with the internationally prevalent systems and does not need any structural change. However, the Consultants are of the view that Regulation of the Corporate Sector by two different laws - namely, the Company Law and Capital Issues Law is creating some difficulties. Historically, the Capital Issues (Continuance of Control) Act of 1947 was conveniently used by the Government for the purpose of imposing conditions in public

interest at the time of issue of capital, including fixing remuneration of Directors, prescribing the rate of depreciation to be applied by companies, defining of "Free Reserves" and fixing the value of assets at which these could be transferred from the sponsors to the companies. This was done because the Companies Act of 1913 was inadequate and was not as comprehensive as the Companies Ordinance of 1984. The Consultants recommend that with a view to eliminating overlapping and to ensure brevity, consistency and clarity, the Capital Issues Act should be merged into the Companies Ordinance. It is also recommended that a separate comprehensive law may be promulgated to regulate Investment Finance Companies, Investment Advisers and Mutual Funds.

CHAPTER - 4

ARTICLES AND MEMORANDA OF THE STOCK EXCHANGES

4. ARTICLES AND MEMORANDA OF THE STOCK EXCHANGES

4.1. The Consultants have examined the relevant provisions of the Securities and Exchange Ordinance, the Articles and Memoranda of the Stock Exchanges and have come to the conclusion that there are several problem areas which need to be attended to. The description of the problems alongwith the recommendations are given in the succeeding paragraphs.

Definition of Stock Exchange:

4.2. One view is that the definition of 'Stock Exchange' needs to be revised. In the law it is defined as " any person who maintains or provides a market place or facilities for bringing together buyers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a Stock Exchange, as that term is generally understood, and includes such market place and facilities." The stress is on any "person" which is defined to include a Hindu undivided family, a firm, an association or body of individuals etc. The exponents of this view feel that the definition may be revised from 'any person' to 'any institution' as in the present form, the definition is very wide and liable to misunderstanding. On the other hand, it has been strongly advocated by another group that substitution of 'any person' by 'any institution' would make the definition too narrow and may cause loopholes for avoiding regulation.

4.3. The Consultants are of the view that narrowing of the definition by excluding Partnerships and Association of Persons etc., will not be in the

interest of the Capital Market because expertise in the area is presently very limited.

Criteria for Stock Exchange and number of Exchanges in a city

- 4.4. A point was raised by some participants in the seminars on the working of the Stock Exchanges that there should be criteria about the place considered eligible for setting up of a Stock Exchange such as number of companies wanting to go public, number of active share-holders and financial intermediaries etc. etc. Under the existing law, it has been argued, every town and village can ask for setting up of an Exchange and as a result the CLA is receiving demands from every province. There is the other view to the effect that determination of place where an Exchange can exist should not be regulated by law; but rather left for determination by the marketplace.
- 4.5. The Consultants agree with the view that the Stock Exchange is a business venture and it should be located where it has comparative advantage. The participants in the venture will naturally look into all the relevant factors such as proximity to business and financial community, access to technology, existence of financial intermediaries etc. before taking a decision. The Consultants are, therefore, not in favour of laying down criteria for establishment of a Stock Exchange, while at the same time advising against mushrooming, diffusion of business and difficulties of over-seeing and abnormally large number of mini-exchanges or to put it precisely retail securities shops. At the appropriate time, the existing law will permit more than one Exchange in a city if so

necessitated by the volume of business and there is demand for business in unlisted securities. There are three Exchanges in Pakistan working parallel to each other. Karachi is the most important Exchange. The other two - Lahore and Islamabad Exchanges - are imitative and only duplicate the activities of the Karachi Stock Exchange. New York has three Exchanges if one counts National Association of Securities Dealers (NASD) besides American Stock Exchange and the Big Board (the New York Stock Exchange).

- 4.6. One of the primary reasons for the recent venture capital industry boom in the United Kingdom was the introduction of unlisted securities market in November, 1980. In Pakistan there is no market for unlisted securities to encourage venture-capital investment in equity for promising companies whose shares will eventually be floated to public. Unlisted securities' secondary market should be promoted. The unlisted securities section of the Stock Exchange will need a separate regulatory frame-work. While drafting the legal provisions for regulating unlisted securities, caution should be exercised to eliminate the possibility of fraud through pressure-cooker salesmanship which happened in the bubble finance companies, cooperatives and Taj Company etc.

Prescribed conditions for a Stock Exchange

- 4.7. Under Section 4 of the Securities and Exchange Ordinance, 1969, a Stock Exchange which fulfills prescribed requirements "to ensure fair dealings and to protect investors is eligible for registration under the Ordinance." The Government has not so far prescribed any requirement for

eligibility. Although Section 34 (4) can be construed as a general basis for the CLA to direct a Stock Exchange to do any thing that the Central Government may consider expedient, yet clear and specific requirements should be spelled out in the law or rules so that the time of the Government functionaries and the general public could be saved and unnecessary litigation could be obviated. This issue came up before the Courts and the Government in the context of application for registration of a Stock Exchange in Islamabad. The issue was resolved by mutual agreement between the Government and the successful applicants who complied with the conditions imposed by the Government at the time of registration. The Consultants recommend that Section 5 of the Securities and Exchange Ordinance may be amended authorizing the Government to impose conditions, from time to time, on the successful applicants in public interest.

Citizenship of Pakistan:

- 4.8. Rule 3 of the Securities and Exchange Rules, 1971 states that no person shall be eligible to be a member of a Stock Exchange if he is not a citizen of Pakistan. The corporate membership enables foreign companies incorporated in Pakistan to become members. This is a salutary trend. The Consultants feel that a strict adherence to the condition of 'citizenship of Pakistan' precludes foreign securities firms from seeking membership of Stock Exchanges in Pakistan. This condition is not in line with the present liberalization agenda of the Government whereunder foreign investors have free access virtually to all business opportunities in Pakistan. It is recommended that the CLA may be

authorized to permit, subject to such conditions as he may deem fit, foreign nationals to become members where he considers that such membership is in public interest. This would facilitate injection of new skills, ideas and expertise of foreign groups. Again, a predetermined mix between local and foreign national as members would eliminate fear of foreign domination. Initially, the CLA may allow joint ventures between Pakistani and foreign securities firms with the former holding 51 per cent of the share capital.

Definition of Officer:

- 4.9. In Rule 2 (e) of the Ordinance, 'officer' has been defined as " Officer in relation to an issuer includes managing agents, manager, secretary or accountant of the issuer and any other person who by virtue of his office may be in possession of any material information with regard to the affairs of the issuer." Although the definition covers all persons 'privy' to company information, yet the Consultants recommend that the definition may be amended so as to include a 'Director' and 'Chief Executive' of the issuer. The specific mention of 'manager' and not mentioning 'Director' and 'Chief Executive' can create ambiguity.

Qualifications of Members

- 4.10. While examining the qualifications for membership of a Stock Exchange, the objective before the Consultants was as to what improvement can be brought about in the existing provisions of the Articles and Memoranda to ensure healthy growth of investment climate. The issues raised during

the discussion with the officials of the CLA and investors were kept in view. Stock Exchange is a very important institution of the Capital Market. The procedure for selecting the members should prescribe the conditions to put flood light on their fiduciary behavior and unblemished financial past. They should be persons of means and professional competence. It was noted that the CLA has tried to achieve this objective while granting registration to the Islamabad Stock Exchange through Article 7 of the Articles of Association (Annexure - F). The Consultants agree with the conditions of eligibility adopted by the Islamabad Stock Exchange subject to two amendments, namely, (i) about citizenship in which the CLA may be empowered to dispense with the condition about citizenship in public interest; and (ii) the power to waive the requirement of experience may be given to the CLA instead of the Stock Exchange. The transfer of this power to the CLA will help, at the time of registration of a Stock Exchange, admission of applicants who do not possess the experience but are otherwise eligible. The amended version recommended by the Consultants is as under:

(a) No person shall be eligible to become a member if:

(i) he is less than twenty one (21) years of age;

(ii) he is not citizen of Pakistan:

Provided that CLA may dispense with this condition in public interest;

(iii) he has been adjudicated an insolvent or has suspended payment or has compounded with his creditors;

(iv) he has been convicted of an offense involving fraud or

breach of trust;

(v) he has been at any time expelled by this or any other Stock Exchange;

(vi) he has been previously refused admission to membership, unless a period of one year has elapsed since the date of such rejection;

(vii) he is a lunatic or a person of unsound mind;

viii) he has not had experience in the business of securities for a period of not less than two years:

Provided that the CLA may waive the foregoing condition relating to experience in the business of securities if such person is, in respect of means, integrity and background, considered by the CLA to be otherwise qualified for membership;

(ix) he is not a graduate;

(x) he is member of another Exchange unless he possesses a minimum experience of 10 years as a Stock Broker; and

(xi) he has not paid income tax during the last three years with assessed income of Rs.100,000. Brokerage houses which are not three years old should be exempted from this requirement.

4.11. It is recommended that Rule 3 of the Securities and Exchange Rules, 1971 may be amended accordingly. It is also recommended that the members may be required to furnish a declaration certifying compliance with each condition prescribed in the Rule.

CHAPTER - 5

LISTING RULES OF THE STOCK EXCHANGES AND OTHER RELATED ISSUES

5. LISTING RULES OF THE EXCHANGES AND OTHER RELATED ISSUES

- 5.1. The Consultants consider the Listing Rules of the Stock Exchanges as the most important area of the Study and have spent more time on examination of the issues and thereafter discussions with the concerned persons and agencies.

Definition of Security

- 5.2. It has been suggested that in order to prevent re-occurrence of episodes like those of Taj Company, cooperatives, illegal finance companies and other such investment schemes, the definition of 'Security' should be revised. One of the participants in a seminar has proposed that a generic definition of Security could be "An investment contract means a contract or a transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profit solely from the efforts of the promoter or a third party." This definition was proposed in the Securities and Exchange VS. W.J. Howey and Company in the United States. The case arose in promotion of small lots of fruit trees where the offerer also offered a 'management' contract. While declaring the promotional scheme of Howey to be a security, the court pointed out that not only are formal stock certificates not required, a nominal interest in the physical assets of the enterprise, such as actually owning the fruit trees, does not preclude the determination that a security in fact exists. It is the investment package as a whole the way it is marketed that comes within the ambit of 'Security'

5.3. The Consultants have looked into the definition of 'Security' and feel that the present definition is comprehensive enough to cover variety of securities traded on the stock market. It is, however, recommended that the definition may be scrutinized further while drafting a regulatory frame-work for unlisted securities.

Inter Corporate Financing:

- 5.4. Section 208 of the Companies Ordinance, 1984 allows investment by a company in associated companies or associated undertakings under certain conditions. The resolution for this investment is required to be passed by a majority of not less than 60 % of such shareholders who are entitled to vote and are present in person or by proxy in General Meeting. Representing a view point of small investors, it has been stated that this provision has been misused by some companies.
- 5.5. The factual position on the ground is that there are three categories of shareholders in the public listed companies; (a) Sponsors; (b) DFIs and loan giving agencies; and (c) small investors. Invariably the first two categories of investors are represented on the Board of Directors, but the minority shareholders have no representation at all. The controlling interests in Pakistan generally possess more than fifty per cent of the voting power through sponsors, associated undertakings, friends and relatives. Average such ownership holding elsewhere in the world is stated to be below 15 %. Besides, an important aspect worth noting here is that, except in a few cases almost all large to medium-sized companies are managed by professionals and technocrats in the developed

countries. A number of listed companies in Pakistan can thus be termed as "closed companies" as there are only a few or no shares traded on the Stock Market. It has been alleged that the brute force of majority is used to siphon, whatever small profits are declared, to sister and group affiliated companies and controlling interests to the detriment and at the expense of the minority shareholders. This practice, it has been stated, contravenes the very spirit and purpose of the law.

- 5.6. The Consultants have examined this issue and have come to know that legal siphoning has taken place in certain cases and there is need for making it more difficult to make investment in associated undertakings. It is, therefore, recommended that instead of 60 per cent of the shareholders present in the meeting, the resolution should be passed by a majority of not less than 60 per cent of the total voting power of the shareholders.

Disclosure requirements of the listed companies

- 5.7. An important operational aspect of the business on the stock market highlighted by the members of the Stock Exchanges relates to scrutiny of prospectuses by the Stock Exchanges and the CLA. It was stated that the prospectuses are neither transparent nor do they contain meaningful data to enable an intending investor to make an informed judgment to purchase the share. A small investor, therefore, blindly follows the lead of insiders and speculators. Another point which came up during the discussions again and again was that the real profits are not shown by a large number of the listed companies. It was stated by some participants in

the seminars that the balance sheets are milked through under invoicing of sales and over-invoicing of purchases. In many cases, the transactions are recorded to have been executed in cash. The inventories are not verifiable and exist only on paper. The annual reports presented to the shareholders do not, it is alleged, represent the true state of affairs of the company. In this context, there is criticism on the role of the Auditors. The quality of audit, it is alleged, is not upto the mark and is a mere formality.

5.8. Consultants have looked into the Listing Regulations of the Karachi Stock Exchange which inter alia require a feasibility report, information about the directors and other listed companies in which they are directors (to establish their bona fides), audited accounts for the last five years and other significant data. A scrutiny of the prospectuses issued by the public listed companies indicate that they are generally in line with the prescribed requirements. There are, however, some additional areas which need disclosure such as:

- 5.8.1. projection of the operational results of the company for the next five years;
- 5.8.2. an auditor's certificate commenting on the reliability of the results projected at 5.8.1. above; and
- 5.8.3. a statement showing the turnover and profits earned by the company in the past three years if it was in existence compared with the corresponding data of other listed companies in the same industry or trade.

5.9. It is recommended that the Listing Rules may include the above information as the 'disclosure' requirement. It is further recommended that before listing, a Listing Committee and Prospectus / Public Offer Committee of the Stock Exchange should go into the track-record of the company more thoroughly. It should check the veracity of the projections and past performance.

5.10. As regards the Annual Accounts of the listed companies, the Consultants have found that detailed requirements have been prescribed about the Balance Sheet and Profit and Loss Accounts of listed companies in the Fourth Schedule to section 234 of the Companies Ordinance, 1984. The real issue, however, is that requirements regarding documentation and disclosure remain unfulfilled due to tax evasion, concealment of wealth etc.

5.11. Some members of the Accounting Profession as well as other experts have pointed out laxity in the conduct of Auditors. The following measures are recommended to improve compliance:

5.11.1. Auditors of Public Listed Companies may be appointed for a maximum period of two consecutive years with re-eligibility after a lapse of four years;

5.11.2. A Tribunal may be set up to try cases of professional misconduct of the Auditors; and

5.11.3. Certification requirements of Public Listed Companies should be

expanded to increase the burden of responsibility of the Management and the auditors. The auditors for an industrial unit of a company should be required, by law, to append the following certificate to their Audit Report.

- * The company has maintained proper record showing full particulars, including details and location of fixed assets. The assets have been physically verified by the Management during the year. To the best of our knowledge, no serious discrepancies have been noticed on verification.
- * None of the fixed asset has been revalued during the year, excepting -----
- * Stocks of finished and semi-finished goods and raw materials at the place of business and stores have been physically verified during the year by the management. In our opinion, the valuation of these stocks is fair and proper in accordance with the normally accepted accounting principles.
- * The company has not taken any loans which are prima facie prejudicial to the interest of the company.
- * In respect of loans and advances given by the company, the loan receiving parties have generally repaid the principal amounts as well as the return on such loans on the scheduled dates. In our opinion, reasonable steps have been taken to

recover the dues according to their schedule.

- * In our opinion, there are adequate internal control procedures to verify that stores, raw materials, including components, plant and machinery, equipment buildings and other assets are purchased and completed at a fair market price.

- * In our opinion, the company has an adequate internal audit system commensurate with the size and nature of its business."

This certificate would help in placing responsibility on the management and the auditors regarding the physical existence and genuineness of the assets, stocks, loans, advances and their values.

In case of an investment bank, leasing company and modaraba, the auditors should certify that these institutions have complied with the Prudential Regulations issued by the State Bank of Pakistan.

5.11.4. Six months time given for the publication of the audited balance sheet under the law is not in line with the situation on the ground. The Listed Companies now use computers for accounting data and record. In view of this development, the maximum limit of three months would be adequate.

- 5.11.5. It should be made mandatory for public listed companies to release un-audited quarterly reports as is done in many countries of the world. This measure is recommended to make investors aware of the current state of the affairs of the company.
- 5.11.6. The CLA should issue a weekly bulletin / official report giving details of decisions, pertinent information on matters which would be of interest to investors and the general public with special coverage of Public Listed Companies.
- 5.11.7. The CLA may arrange to publish an Annual Report on major events of the corporate sector which may be of interest to the investors.
- 5.11.8. One important service which is provided by the Regulatory Bodies in many countries of the world is the Records and Documents Copy Service. Documents and records are fully computerized. The lay public or interested parties, who wish to obtain updated information on public listed companies can do so without delay. Information on companies including analysis, accounting data, important correspondence, permissions, restrictions, penalties, awards, in fact every thing is available on demand. Copies are provided on nominal charges at the counter. The principle behind this is the FACT that free accessibility to the records of Public Companies is the right of the people. There is complete freedom and transparency of action and that is the reason why there is more awareness in the general public

The Corporate Regulatory bodies are less prone to abuse of their knowledge and record of companies. It is recommended that Public counters may be set up at different places for this purpose by the CLA.

Qualifications of Directors:

5.12. The current criteria for election and appointment of Directors of a Public Listed Company is restricted only to the quantum of share holding - as against their individual utility to the company. It was suggested by some discussants in the seminars that the Directors should also have some educational or professional qualifications to become eligible for election. The Consultants recommend that this issue may be examined with a view to improving the quality of decision-making in public listed companies.

CHAPTER - 6

COMMISSION RATES, LEVEL OF 'GEARING (LEVERAGE) AND
FINANCIAL ACCOMMODATION OF BROKERS BY BANKS

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6. Practices pertaining to commission rates and clearances

6.1. Clauses of the Rules and Regulations of the Karachi Stock Exchange pertaining to commission rates were examined and discussed with the members of the Exchange. The Consultants were informed that commission is charged at different rates depending upon the price of scrip and nature of order.

6.2. The allowable commission rates, under the rules of the Karachi Stock Exchange, on securities with varying market prices are as under:

Scale of Brokerage on Shares

(Ordinary, Preference, Preferred Ordinary and Deferred)

Market Price of the Stock	Allowable Commission
Upto Rupees 5	12 Paisas per Share
Above Rupees 5 to Rupees 25	25 Paisas per Share
Above Rupees 25 to Rupees 50	50 Paisas per Share
Above Rupees 50 to Rupees 75	75 Paisas per Share
Above Rupees 75 to Rupees 100	1 Rupee per Share
Above Rupees 100 to Rupees 200	1.5 Rupees per Share
Above Rupees 200 to Rupees 300	2.0 Rupees per Share
Additional 50 Paisas are charged for every Rs.100 or part thereof above Rs.300	

6.3. It is pertinent to mention here that members are obliged to charge and collect upon execution of all orders for sale or purchase or for carry over of securities on account of others, brokerage at the rates not less than the scale given in Appendix-A to the Rules of the Exchange which is reproduced in the following table:

Minimum Scale of Brokerage on Shares

(Ordinary, Preference, Preferred Ordinary and Deferred)

Market Price of Share	Institutional Commission	Other Clients
Upto Rs.19.99	9 Paisas per Share	10 Paisas per Share
Rs.20 to Rs.29.99	13 Paisas per Share	15 Paisas per Share
Rs.30 to Rs.49.99	16 Paisas per Share	25 Paisas per Share
Rs.50 to Rs.74.99	24 Paisas per Share	36 Paisas per Share
Rs.75 to Rs.99.99	40 Paisas per Share	80 Paisas per Share
Rs.100 and above	64 Paisas per Share	1.5 Rupees per Share
One percent brokerage commission is charged where the customer requests delivery against payment terms.		

6.4. The above rates are net and free from any rebate, return, discount or allowance made in any shape or manner or by any method or arrangement direct or indirect and the members /brokers charge these minimal prescribed rates because of competition among the brokers.

6.5. This is not a problem area and the Consultants have no recommendation to make on the subject.

Level of "gearing" (leverage) and financial accommodation of brokers by banks

6.6. The existing margin facilities available to members of the Karachi Stock Exchange by some banks are as under:

Bank	Financing Limit	Margin Against Market Value	Mark Up Per Day Per Rs.1000
Muslim Commercial Bank Limited	Rs.3.0 Million	40% - 50%	48-51 Paisas
United Bank Limited	Rs.2.5 Million	50%	45 Paisas
Habib Bank Limited	Rs.0.5 - 6 Million	As Under	48 Paisas

Margins required by the Habib Bank Limited are as under:

Market Value less than Par Value	20 %
Market Value less than twice Par Value	40 %
Market Value more than twice Par Value	50 %

Exposure to a single scrip is kept at a maximum of Rs.300,000

6.7. The State Bank of Pakistan has recently issued revised version of Regulation VI of the Prudential Regulation which deal with Financial

Facilities against Shares. The revised version is as under:

"Facilities against the shares of listed companies shall be subject to the following minimum margins:-

- (a) Where the market value does not exceed the preceding
12 months average market value 20 %
- (b) Where market value exceeds the preceding 12 months
average market value but does not exceed twice the
preceding 12 months average market value 40 %
- (c) Where the market value exceeds twice the preceding
12 months average market value 50 %"

6.8. The members of the Stock Exchanges have not pointed out any problem in the matter of financial accommodation by the banks. They have, however, drawn attention of the Consultants to Section 16 of the Securities and Exchange Ordinance which deals with prohibitions and restrictions regarding credit and pledging securities. The Section reads as under:

"No member or associate shall, in contravention of any rules made under this Ordinance, directly or indirectly,-

- (a) extend or maintain credit, or arrange for the extension or maintenance of credit, to or for any person for the purpose of purchasing or carrying any security; or

- (b) borrow on any security or lend or arrange for lending of any security carried for the account of a customer; or
- (c) pledge or arrange for the pledging of any security carried for the account of any customer."

6.9. It has been pointed out by some members of the Karachi Stock Exchange that the present wording of the law prohibits extension of credit to clients by a member for the purpose of purchasing or carrying any security on behalf of the client. This provision of law, it was asserted, is not practicable because quite often the customers place orders before cheques received from them in favour of the members for purchase of shares, are credited to the accounts of the members. It has been stated that extension of credit implied in purchase of securities by members, say for ICP, NIT and other clients (without advance payment) is technically in violation of the provisions of the Section. Similarly 'Badla' transactions are not in conformity with the strict interpretation of law.

6.10. It has been argued that margin trading is a very important component of investment. Individual investors should not be denied this facility. In the USA the margin is 50 % and the regulatory authorities set the margin rate and regulate it. In growing and developing Stock Markets, where new companies are continuously being listed and existing companies are raising capital, lack of liquidity can become a problem for an individual investor. Margin trading will bring in additional liquidity.

6.11. It was argued that when members are allowed to borrow from the banks at a margin, why should they be prevented from lending to the customers. When they do so, they are lending their own money and should be allowed to take the risk. It was stated that the laws of other countries do not prohibit members from lending to customers.

6.12. The Consultants recommend extension of credit by members to their clients. The law should be amended to permit such credit. The CLA and the Stock Exchange should prepare detailed rules to regulate this area.

CHAPTER - 7

NET-WORTH AND FINANCIAL MEANS COMMITTED BY THE MEMBERS
OF THE STOCK EXCHANGES IN RELATION TO BUSINESS HANDLED

7. NET-WORTH AND FINANCIAL MEANS COMMITTED BY THE MEMBERS OF THE STOCK EXCHANGES IN RELATION TO BUSINESS HANDLED

Net Capital Requirements:

- 7.1. A member is required, under Rule 3 (b) of the Securities and Exchange Rules, 1971 to maintain a 'net capital' balance in the capital account amounting to Rupees 75,000 to Rupees 250,000 under certain conditions. Under Rule 3 (e), he is required to report to the Stock Exchange weekly that he or the firm of which he is a partner had, at all the times, during the week to which the report relates, a net capital balance of an amount not less than that prescribed by law. He is further required to inform the Stock Exchange if, at any time, such balance falls short of that amount.
- 7.2. It is reported that some members of the Exchange are not maintaining even the nominal prescribed amount as a net capital balance in their capital account and that their liquidity position is not properly monitored by the Stock Exchange. It was stated in a seminar that 10 - 11 members of the Karachi Stock Exchange have serious financial problems - out of which two cases have been brought to public attention. There is a consensus amongst all the concerned persons - members of the Stock Exchanges, banks, financial institutions, investors and officials of the CLA that the prescribed amount of 'Net Capital' should be revised upwards. It was mentioned in this connection that the current price of the membership card of the Karachi Stock Exchange is more than Rs.10 million.

7.3. The consultants feel that 'Net Capital' requirement of a member should be revised in line with the increase in volume and also with reference to the volatile nature of the Stock market. It is, therefore, recommended that the minimum 'Net Capital' may be prescribed as 10 per cent of the business handled in a week subject to a minimum of Rs. 2 million. The term 'Net Capital' should be defined so as to ensure liquidity to meet immediate working capital requirements. The US regulations define 'Net Capital' as net worth (assets minus liabilities) plus qualifying subordinated loans less non-allowable assets (generally illiquid assets) and then less 'an amount', generally equal to a percentage deduction of a market value of proprietary securities, options and commodity positions. It is observed that in other countries also the principle behind the definition of 'net capital' is that it should be in cash or in securities approved for the purpose - not in plots or other forms of fixed assets. It is further recommended that in order to guard against default situations, a member's exposure to the market should not be more than Rs.40 million a week. This amount is suggested to cover a default situation in which the membership card is to be sold. The assumption is that maximum decline in the price in a week will not be more than 25 per cent. For corporate members, a higher limit may be fixed after a detailed examination of the volume of business handled by them.

7.4. It is felt that Rule 3 (e) may be implemented in letter and spirit and that the reports submitted by the members should be cross checked to safeguard the interest of other members and investors. Also penal action should be taken against 'defaulters'.

7.5. A member operating on the Stock Market has to fulfill his financial obligations arising out of his dealings with: (a) other members of the Stock Exchange; and (b) individual and institutional customers. In order to make his position financially more sound and to ensure prompt satisfaction of his obligations, it is recommended that:

7.5.1. A Compensation Fund may be created to meet default situations and to meet his obligations to other members; and

7.5.2. each member should be required to insure himself for a specified sum to meet the claims of individual and institutional customers. (The insurance can be through an Insurance Company on the approved panel of CLA or through Self-Insurance by the Stock Exchanges.)

CHAPTER - 8

CLEARANCES, SETTLEMENT, TRANSFER OF SHARES
AND FAILURE TO LIST TRADES

8. CLEARANCE, SETTLEMENT, TRANSFER OF SHARES AND FAILURE TO LIST TRADES

Clearance and Settlement Procedure

- 8.1. Only members or their authorized agents can participate in bidding on the floor of the exchange. A member or agent on receipt of a buy or sell order from his client records it in writing and then tries to match it with orders received by him from other clients. He can also buy and sell through his own account. Matching orders are kept pending for internal clearance later in the day. For unmatched orders of the clients, the members/brokers participate in bidding on the board where each share is given a few minutes for auction. Time allotted for auctioning share is not sufficient to cover all transactions and is only symbolic. Transactions made during the bidding process are recorded by the auctioneer in a printed sheet and the particulars of transactions (name of the scrip, number of shares traded and rate etc.) are communicated to the data entry clerk for feeding into the computer lying close to the ready board. The buyer and seller record transaction in their Sauda Books.
- 8.2. Transactions executed while the trading of a scrip goes on, are recorded on the same day. After the time of a scrip is over, it is traded off the ready board. Transactions carried out after the allotted time of a scrip are cleared through the clearing house. Transactions of all scrips executed during the trading period of the day are reported through FASCOM - a computer on-line data service available to the members of the Stock Exchange and others desirous against payment of fee.
- 8.3. The members/ agents after trading hours use their respective Sauda Books

to prepare tally sheets for buy order placed with a particular member or agent. A separate tally sheet alongwith contract slip is also prepared for sell order. The tally sheet in general contains information about the name, number and price of the scrip and particulars of the buyer or seller as the case may be. Late in the day, the members and agents assemble in the trading hall of the exchange where the buying members or agents are required to sign the contact slip and affix their respective seal on it to confirm the trade. A copy of the contract slip is passed on to the clearing house which serves as input for the computer. The data fed into the computer are used to generate different types of reports used by the members/agents, investors and other interested outsiders.

- 8.4. The Karachi Stock Exchange prepares and announces its clearing schedule. Transactions of specified days are cleared (payments are made to sellers and physical possession of shares certificates given to the buyers) on a specified date according to the schedule. The clearing house prepares delivery order containing the name and number of shares and the name of a buyer to whom share certificates are to be handed over. One copy of the delivery order is forwarded to the buyer for his information and three copies are sent to the seller. The seller enters number and denominations of certificates in the delivery order and gets it signed from the buyer after giving the shares certificates. One copy of the delivery order is retained each by the buyer and seller for their own record and the third copy is transmitted to clearing house. Clearing house makes payment to the selling member or agent against the duly completed signed delivery order.

- 8.5. Share certificates are accompanied with blank transfer deed signed by the share owner, in whose name the share stands, duly verified by the concerned company. In case the buyer wants to transfer title to his own name, he sends/presents the certificates with transfer deed to the registrar of the concerned company. Transfer of title takes about two months. The buyer may also retain the certificates with blank transfer deed for further trading.
- 8.6. The above procedure involves lengthy manual operation. Recording of clients' orders, matching process, entry in a Sauda Book, preparation of tally sheet and contract slip, stamp and signature of buyer on contract slip to confirm the transaction, preparation of delivery order, entry of certificates' number in the delivery orders and thereafter signature by the buyer, reconciliation of Certificate numbers recorded in the delivery order with those actually handed over to the buyer, counting of certificates, checking genuineness of certificates, verification of transfer deed by the registrar of the company etc., is time consuming and cumbersome.
- 8.7. Besides this lengthy and tedious procedure, liquidity position of the members/ agents, physical handling of scrips, fluctuation risk, lack of information and non availability of transfer stamp are some of the factors which make the clearance, settlement and transfer of scrips difficult.
- 8.8. The volume of business is increasing in the wake of privatization. Foreign individuals and institutions are keenly interested in Pakistan as a

potential market for their investment. The market is, therefore, bound to expand. Revamping of the stock market in general and the operational system of the Stock Exchanges in particular is urgently needed in order to keep pace with the changed environment.

8.9. The Consultants during their visits to Karachi Stock Exchange noted that the recommendations made in the Efficiency Enhancement Study of the Karachi Stock Exchange prepared for USAID by First International Investment Bank Limited were under active consideration of the Management of the Exchange. Some measures have already been implemented. Efforts are being made to purchase additional space adjacent to the existing premises of the Exchange. Net Capital requirements are proposed to be increased. A limit on maximum exposure of the members is being suggested. Seven trading zones were said to be created on the floor of the Exchange. A Listing Regulations Enforcement Department has been set up to ensure proper implementation of the listing rules with a view to ensuring greater transparency of the listed companies. Necessary steps are being taken for automation and computerization of the operations. The proposal of electronic trading is also under consideration.

8.10. The Consultants feel that Central Depository System (CDS) is a solution to many operational problems. Physical handling of scrips would be eliminated. The scrips will be kept in the CDS and transactions between the members/agents would be recorded simply by debit and credit to their respective accounts. This would eliminate the process of counting of certificates, verification of transfer and transportation of scrips.

- 8.11. The CDS besides being custodian of the clients scrips would also provide ancillary services such as collection of dividends, rights and interest etc. It would help ensure easy and quick access to an on-line information system. This would help expedite settlement and clearance and would ensure payment versus delivery thereby reducing the brokers' settlement risk.
- 8.12. Initiative has been taken to establish a CDS. Articles and Memorandum of the Central Depository have been drafted. The members of the Exchange are debating whether the CDS should be a profit centre or a non-profit company. The next issue to be resolved is whether CDS should keep the scrips in its own account or should serve as a custodian for keeping the scrips in the clients' account.
- 8.13. The Consultants feel that CDS will primarily support the business activities of the Stock Exchange. It should, therefore, be established as a profit-making company to ensure its financial viability and growth in line with market expansion. As regards the question whether CDS should keep the scrips in its own name or in the name of clients, the Consultants would go for the latter option. In the former case, new provisions would be required in the legislative framework which will take time.
- 8.14. It is recommended that Central Depository System should be immediately established. It is both desirable and practicable. Time is of the essence. It should be in place before the next boom occurs. There is no other way to deal with expected large turn-over. The Consultants are reminded that quite a large number of Broker Failures in 1969-70 in Lon-

don and New York Exchanges were due to 'Failure to Transfer'. It is, therefore, imperative to take advantage of the know-how and development of Soft-ware and Hard-ware in the rest of the world to put the system in place in the next half-year. The CLA should help by appointing a competent officer as a Coordinator to expedite introduction of the system. Simultaneously and not subsequently Electronic Trading should be inducted. This is the only way to eliminate delays, ensure transparency of transactions and public visibility which ensures investor confidence in the working of the Stock Exchange.

Refusal by Directors of listed companies to transfer shares:

- 8.15. It was reported in a seminar that there are occasions when a perfectly lawful request for transfer of shares, complying with all requirements necessary for the transfer, is refused by the Directors of the listed companies. This in particular, happens where the incumbent management apprehends a hostile takeover or where a group of persons attempt to acquire a sufficient number of shares to enable them to elect a director to the Board. The objection to recording transfer of shares in such cases are mostly unreasonable. The credibility of the entire share market is often put at stake on account of such refusals.
- 8.16. It has been held by our courts that the delivery of share certificates accompanied by duly verified transfer deeds in blank, constitutes a prima facie transfer of title in the shares notwithstanding the fact that such transfer might have not been recorded in the register of members of the company concerned. This principle requires to be embodied in

the legislation in unambiguous terms.

8.17. The company, in the suggested change in the law, should be required to record the transfer of shares based on transfer deeds duly filled in by a final purchaser of the shares desirous of having his own name recorded in the register of members. Such legislation would go a long way in building the confidence of the general public in the stock markets.

8.18. One does recognize that there might be situations where a transaction of sale of shares made at a stock market is required to be set aside for reasons of want of title on the part of the seller or for the reason that consent to the sale was not freely given. The law, however, must in the first instance require the recording of the transfer in the register of members and any reversal of such transfer should be made after appropriate legal or quasi judicial proceedings at the instance of the party requiring such reversal. In such an event, the onus of establishing want of title or lack of free consent should be on the person seeking reversal of the entry.

CHAPTER - 9

CONFLICT OF INTEREST IN JOBBING / BROKERAGE

9. CONFLICT OF INTEREST IN JOBBING / BROKERAGE ETC.

9.1. The issue of conflict of interest in the transactions executed by Stock Brokers and Jobbers was brought out in a number of discussions. It was pointed out that there were no qualifications prescribed for these categories inspite of the fact that they were doing a very specialized job. There were no organized training facilities nor any institutional arrangements to look into the complaints of the clients against the brokers and the jobbers. The Consultants recommend the following measures to improve the situation:

- 9.1.1. Detailed criteria should be laid down to establish eligibility for a Stock Broker and a Jobber. As recommended in paragraph 4.10 of Chapter 4, a minimum educational qualification may be prescribed. This will support one of the main objectives of regulation, namely, ensuring public confidence in the functioning of the Stock Market;
- 9.1.2. an institutional arrangement should be made for the training of the Brokers and Jobbers;
- 9.1.3. a 'Code of Ethics' may be developed for brokers; and
- 9.1.4. a Code-of-Conduct Committee should be set up by the Stock Exchanges to look into the complaints of clients against members as well as members' complaints against the clients. A register for recording complaints from the clients may be maintained by the Stock Exchanges and prompt action taken to redress genuine grievances.

Manner of Transaction of a Member's Business:

- 9.2. Under Rule 4 (4) of the Securities and Exchange Rules, 1971, a member executing an order of a customer is required, within twenty four hours of the execution of the order, to transmit to the customer a confirmation, which should include information about the date on which the order is executed, name and number of the securities, nature of transaction (spot, ready or forward and also whether bought or sold), price, commission if the member is acting as a broker and whether the order is executed for the member's own account or from the market. It was emphasized during the discussions with some investors that address of the customer is not generally stated on the confirmation memos issued by the members. In the absence of the address of the customers, it is difficult to verify from the customer the bona fide of the transaction. It is recommended that Rule 4 (4) may be amended to include the address of the customer as a part of the information.

Maintenance of Books of Account by a Member

- 9.3. The Securities and Exchange Rules provide for preparation and maintenance of Books of Accounts and other documents by a member. There are two rules which prescribe reporting and record keeping requirements. Rule 5 requires an annual balance sheet and statement of income and expenditure. Rule 8 prescribes the requirement for maintaining a journal, ledger, record of transactions with bank, contract books showing details of all contracts entered into by a member etc. For standardization of accounting of members / brokers, the Consultants recommend the following

procedure for book-keeping and disclosure of information for the members/brokers of the Exchanges:

9.3.1. Procedure:

- * Members/Stock Brokers should keep separate Books of Accounts and Bank Accounts for his business and his clients.
- * On receipt of deposit from a client, it should be deposited in the Client's Bank Account. Similarly, the receipt should be entered in the Client's Cash Book and Client's Ledger.
- * Client's Ledger should be maintained name-wise and monthly balances should be extracted and reconciled with Client's Bank Accounts.
- * When clients are charged for commission, a Journal entry should be made for transfer.

9.3.2. Verification by Auditors:

- * At the end of the year, it is the duty of the external auditor to verify Clients' Ledger Balances and reconcile the total with the Clients' Bank Balance at two different dates; at the year end and any other month during the year picked up by the auditor.
- * In case of any shortage of funds in the Client's Bank Accounts the Stock Broker should be required to transfer the funds from his own account to make the shortfall.
- * On completion of audit, the auditor should be required to

issue a special report stating the total clients' liabilities and the bank balances at two different dates.

- * The report should be submitted to Stock Exchange and CLA.

9.3.3. Advantages:

- * It will protect the investors especially in case of the liquidation of Stock Brokers as the clients funds will be separately traceable.
- * Implementation of such a procedure will improve investors' confidence in the Stock Brokers

9.3.4. Books to be maintained by Broker:

Besides the books prescribed in Rule 8, the Stock Brokers should maintain Cash Book, General Ledger and Bank Account for clients separately.

9.3.5. Disclosure Required in Financial Statements:

Audited Financial Statement of Stock Brokers should contain the following statements together with comparative figures of the last period:

- * Review of Performance
- * Statement of Financial Position
- * Income and Expenditure Statement

- * Accounting Policies
- * Nots to the Accounts
- * Sources and Application of Funds Statement
- * Cash Flow Statement

9.4. There should be audit of the members of the Stock Exchanges on annual basis apart from the appointment of auditors for special audit as and when required by the authority. The special audit should be conducted discretely without publicising the fact. Only when the audit reveals substantive (not procedural) irregularities, appropriate action taken should be made public.

9.5. The CLA should be empowered to inspect the books of accounts and the record and impose penalties for default.

CHAPTER - 10

INSIDER TRADING

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10. INSIDER TRADING

Inadequacy of legal provisions for regulating insider activities

10.1. The most complex aspect of the Securities regulation i. e. situations which give rise to opportunities - the area of 'Insider trading'- needs detailed scrutiny. The issue was discussed at length with the officials of the CLA, investors and members of the Stock Exchanges. The Consultants feel it worth quoting here the comments of the International Finance Corporation (IFC) in response to the CLA's questionnaire:

"The law is very weak in this area.... Combating insider trading is perhaps the most difficult and complex aspect of the securities regulation. Situations which give rise to opportunities for the use of critical, price-sensitive, information not available to the general public. The near impossibility to foresee, much less eliminate, or frame an appropriate regulatory response to deal with all such situations is universally recognized. Even more difficult, on occasion, is the determination whether persons that possibly had access to such information actually used that information in securities transactions".

10.2. Under Chapter III Section 12, the following persons have been identified as insiders:

10.2.1. Every Director or officer of a listed company who owns its shares; and

10.2.2. Every person who directly or indirectly owns more than 10 % of its shares.

10.3. For the purpose of Chapter III, the term 'officer' has been defined, in relation to an issuer, to include managing agents, manager, secretary, accountant or auditor of the issuer. We have already recommended in paragraph 4.9 that the definition of 'officer' may be amended to include a Director and Chief Executive of the issuer. The addition will clear an ambiguity.

10.4. The scheme of law for regulating the insider is as under:

10.4.1. he is prohibited from short selling of the security of the issuer; and

10.4.2. in case he makes any gain through purchase or sale of the securities of the issuer within a period of less than 6 months, the insider is required to report and surrender, the capital gain realized, to the issuer.

10.5. The Consultants agree with the IFC that the law is very weak in the area of insider trading. It is considered that in addition to the existing procedure of surrendering gain made within 6 months, the insider may be required to disclose all his transactions in the security of the issuer in the annual general meeting of the shareholders.

10.6. As recommended by IFC, while amending the law on inside trading, the aim should be to define what constitutes 'insider information' and who can be deemed to be an 'insider' (i.e. in possession of inside information). The new regime regarding insider trading should also cover investigation and enforcement aspects.

- 10.7. The Consultants also agree with the IFC that a three-pronged approach is called for to reduce the incidence of insider trading:
- 10.7.1. concerted measures need to be adopted to create an awareness of the offense among companies and market players;
 - 10.7.2. it is necessary to encourage corporate and market practices that facilitate detection of insider trading; and
 - 10.7.3. effective deterrents in the form of a range of punitive actions should be put in place.
- 10.8. The IFC has recommended that, insider trading regulations should stipulate that service rules of employees of listed companies and market participants (such as merchant banks, stock brokerage firms financial institutions) should make definitive provisions against insider trading. These rules, it has been suggested, should contain provisions that (a) prohibit insider trading; (b) make it obligatory for employees to report to their seniors or to CLA directly any incidence of insider trading that they become aware of; and (c) make the violation of these provisions an offense attracting the penalty of dismissal from service. Any company that fails to incorporate these provisions in its service rules should be liable to be delisted and any market participant failing to do so should be liable to lose its operating license. Also companies and market participants (as well as the concerned Directors and senior officers) failing to report any incident of insider trading upon becoming aware of its occurrence should be liable to the same penalties as if they had committed the offense themselves.

10.9. The Consultants recommend that the proposals made by the IFC should be considered for implementation in consultation with the Stock Exchanges.

10.10. The CLA should be empowered with a certain range of sanctions including, but not limited to, fines, ordering dismissal from office, prohibiting employment in positions having access to inside information and suspending or revoking the offender's license to engage in securities transactions. Market participants and companies (and wherever directly attributable, their directors/senior officers) that do not take adequate measures either to prevent insider trading or promptly to report incidents of insider trading to CLA should attract CLA sanctions. Inquiry proceedings and the imposition of penalties by CLA should not preclude criminal prosecution and civil suits to recover damages.

**Holding of the Office of Director on the Boards of Public Listed
Companies by a Stock Broker**

10.11. Under the present provisions of the law, there is no restriction on a member of the Stock Exchange to hold the office of Director on the Boards of public listed companies. By virtue of this position, they can have easy and free access to all information. The Consultants raised this issue during the course of discussion with the members of the Stock Exchanges. Some members argued that a person on the Board of Directors of a company should not be suspected of misusing the inside information because as a Director he would watch the interest of the investing public / shareholders and as a member of the Stock Exchange, he would like enhanced trading activity. Barring a good citizen from a

legitimate activity on suspicion that he might abuse his position, it was stated, does not seem fair. It was argued by a member of the Stock Exchange that placing restrictions on an insider will not resolve the the problem because an insider who does not want to act like a trustee, can always operate under a fictitious name or through a tipeg.

10.12. On the other hand, the International Finance Corporation (IFC) in their response to CLA's questionnaire has commented that members of the Stock Exchanges should not be permitted on the Board of Directors of the listed companies. Exchange member serving also on the Board of companies, it has been argued, could allow two fundamental violations to fair securities market, namely, market manipulation through insider information and conflict of interest.

10.12.1. A Board member is generally privy to confidential, non-public, material information. Although this information could be used by any Board Member to profit in the market place, the individual/firm who is also an Exchange Member has, by virtue of his position in the market, a special vantage point, making it easier to engage in damaging and manipulatory practices.

10.12.2. A Board Member is required to act only in the best interest of the company's shareholder. Despite this, the Exchange Member (e.g. broker, dealer) may feel responsibility to its shareholders or to his clients and customers. Again by virtue of his market position, it is easier for the Exchange Member to abuse his responsibilities as a Board Member.

10.13. The important point here is that, for a fair and orderly market, every one must have equal access to information. In more developed markets this is addressed in a number of ways:

10.13.1. by a prohibition against insider dealing;

10.13.2. by the strict implementation of 'Chinese Wall' to prevent the flow of information from the investment side of an institution (which a Board member might represent) to its trading side; and

10.13.3. by a prohibition against any Exchange Member trading for his own account, for the account of an associated member or for an account over which he exercises discretionary management.

10.14. The restriction at 10.13.3. would mean, for instance, that if an Exchange Member has substantial stake in a company and, by virtue of that, was on the Board, he would not be able to deal in the stock on his own account or, on behalf of his clients or give advice related to the stock in the course of his duties.

10.15. A straight-forward expedient would be to ban Directorship of Members / Brokers on the Boards of Listed Companies by virtue of their shareholding on their own account. This would, in Consultants' opinion, be invidious as it would leave the Directorships enjoyed by officers of Investment Institutions (and to some extent all Financial Institutions having a share portfolio) intact. The chances of insider trading in the latter case also cannot be precluded. The Consultants, therefore, recommend that the safeguards given in 10.13. should be strictly enforced for the time being.

CHAPTER - 11

MARKET DISTORTION

11. MARKET DISTORTIONS

Pricing of Issues

- 11.1. The Consultants, after thorough examination of the relevant material, have come to the conclusion that pricing of the shares is one of the fundamental factors that determines the degree of competition, order and fairness in the market place. The Consultants during their discussions with the members of the Stock Exchanges, solicited their comments as to whether the existing practice of pricing the securities was in line with the object of stock market development or changes were necessary to be brought about in this area. A detailed sketch of the views expressed on the issue by the members of the Stock Exchanges and other concerned institutions is given in the succeeding paragraphs.
- 11.2. In all developed markets of the world, the pricing of shares is left to the market place. Pakistan is one of the few countries that practices regulatory control over such prices. The reasons for this control have stemmed from the belief that a small investor should get the shares at a par value low incentive price and that the public must be protected from over-priced issues. This belief was historically valid when Pakistan's financial markets were in the process of being developed. The current policy reflects a lack of confidence in the market place as an arena in which buyers and sellers can interact to determine price of the scrips.
- 11.3. The principle of regulatory control stems from the belief that price of the shares in question should generally not exceed the price paid by the sponsors. In certain cases, prices are permitted by the relevant

authorities, but only if the company can present strong arguments as to why a premium should be allowed. In many cases, premiums are not permitted, and in others only a small premium is agreed to.

11.4. Share valuation is indeed an esoteric concept and many financial analysts in developed markets devote their careers exclusively to share valuation. Ultimately, it is the market place that decides values. The concept of par value as being the central determinant of price is outdated. Particularly, the return on equity in different industries varies greatly depending upon the capital intensity of the business, hence different industries will have different valuations based upon similar equity investments. Such a variation will also exist from company to company. The market's perceived value of any share will depend upon a number of factors including quality of management, type of industry, operating history (if any), reserves, etc. The concept of par value pricing does not account for all these factors. A clear example of the inadequacy of par value pricing is that there is often a huge variation with respect to the opening price of a share and the offer price. It is clear from this that the market does place a value on the share independently of its par value.

11.5. It is often the case that new companies come to the market and their shares are priced at par value. Such companies may have no operating history, may not have a well known and reputable management group and may indeed have not even begun operation. On the other hand, certain companies may have years of operating history and may have built up significant reserves and may be run by a top notch management group. In our

view it would be incorrect to prescribe equal value to the two companies. The investor is clearly getting a more valuable share for the same amount of money in that latter case. If pricing had been left to the market, then clearly a different valuation would have been ascribed to the companies.

11.6. In the case of right issues, the concept of par value pricing is also outdated. This is because the share is already freely traded in the market place and, hence, it would not be unreasonable for the 'right' shares to be priced very close to the price prevailing in the market. Shares that trade well above the par value should clearly be allowed a premium close to that suggested by the prevailing market price. It should also be mentioned that since all shares are offered on a preemptive rights basis, large premiums will not damage the value of the existing shareholders' investments. Right issues of companies that trade at significant premium to the par value often result in a significant drop in share price when a large premium is not permitted. We feel that this is unfair for these companies.

11.7. Once the market is allowed to determine prices for itself, certain restrictions should be placed upon the methods by which these prices are determined. It is, therefore, felt that the following conditions should be introduced:

11.7.1. All public issues, including 'right' issues, should be fully underwritten. This would ensure that a group of financial market participants have expressed their confidence in the pricing of

the relevant share, resulting in an outside party 'signing off' on such pricing.

- 11.7.2. There should be restriction on who should be allowed to underwrite shares. We feel that the following types of companies should be permitted to underwrite:

Commercial banks, Investment banks, Securities firms, DFIs and Insurance companies.

- 11.7.3. There should be restriction on the total underwriting commitment that any underwriting company undertake at a given time which should be based upon the total capital and reserves of such companies.

- 11.7.4. Underwriting commission should not be controlled. The commission should be negotiated between the underwriters and the management based upon the perceived risk that the underwriter is taking.

- 11.7.5. The CLA should ensure proper disclosure of information by companies. This will require injection of more relevant information into the prospectuses as recommended in paragraph 5.8. All prospectuses should be carefully checked for misleading or incorrect statements. The company should be held accountable for any misrepresentation.

11.8. The Consultants recommend that all decision relating to the pricing of issues (including initial public offerings, bonus issues and right shares etc. should be left to the sponsors, underwriters etc. There should be, however, rules in place to protect the investors by regulating underwriting activities.

**Privileged position of National Investment (Unit) Trust NIT and
Investment Corporation of Pakistan (ICP)**

11.9. An important point raised by the members of the Stock Exchanges was that certain institutions enjoy privileges which give them unfair competitive advantage. For instance under Sub-Section (3) of Section 8 of the Securities and Exchange Ordinance, no person can act as a dealer in a listed security out side the Stock Exchange. The proviso to this Sub-Section, however, exempts ICP and NIT from this prohibition. The exemption given to the ICP and NIT gives them a special privilege. In addition, NIT is given option to purchase 15 % of a new issue at the offering price.

11.10. The Consultants are of the view that these privileges need to be withdrawn. It may be mentioned that during the course of discussion with the Chief Executive of ICP, it was stated that whereas there could be no objection to withdrawal of special privilege, the prohibition placed on ICP and NIT in the Proviso to Article 13 (A) of the Articles of Association of the Karachi Stock Exchange regarding their becoming members of the Stock Exchange should also be withdrawn. This could be a reasonable demand but the membership of ICP and NIT would take away about 20 % of

the business from the hands of existing members of the Stock Exchange and would come like a shock. The Consultants, therefore, feel that the current state of the market does not permit a shock treatment. It is recommended that simultaneous action should be taken to withdraw the privileges of ICP and NIT and also to allow them to become members of the Stock Exchange after giving them an adjustment period of two years.

Development of market for debt securities

11.11. Like the capital markets of other countries, capital is mobilised in the form of equity and debt securities in Pakistan. Whereas equity upto 30 per cent is provided by the sponsors and general public, loan capital, which constitutes about 70 per cent of the total capital employed, is provided by the DFIs and the banks.

11.12. It has been brought to the notice of the Consultants that Stamp Duty is creating a hurdle to the issuance of marketable debt securities (redeemable capital - TFCs and PTCs etc.) by the corporate sector and subsequent development of a secondary market for such securities. The debt securities attract Stamp Duty at 3.5 % of the face value of the instruments unless one of the party to the transaction is a banking company or a party approved for this business under the Banking Companies Ordinance, 1962. This exemption limits the trade of such instruments to banking companies or those institutions that have been approved under the Ordinance.

11.13. One of the major barriers to the development of instruments of redeem-

able capital by the corporate sector, it has been represented, is the onerous level of Stamp Duty applicable to issuance and transfer of such instruments, levied by the provincial governments. As a result, the market has simply failed to develop, even though Pakistan is currently at a level of industrial and commercial development sufficient to sustain a large market both in terms of issuance and trading.

11.14. The consequences of this failure are significant: the corporate sector loses a major source of financing; investors lose an attractive and efficient avenue for their investment - thus the economy fails to mobilize potential savings.

11.15. The Stamp Act of 1899 is an out-dated law of the times when India was under the British Rule. In Britain, itself Stamp Duty is not levied on the issuance or trade of marketable securities but on shares, and even that is in the process of being abolished. This is more or less the case with other countries that were British colonies or protectorates, such as India, Singapore and Hong Kong, where Stamp Duty is not charged on transactions involving marketable securities. Even Stamp Duty charged on share transactions is low in these countries, not exceeding 0.5%.

11.16. In Turkey, which has an active market for commercial paper, corporate bonds, bank bills etc. with an average daily traded volume of U.S. \$ 3,009,033 and US \$ 4,257,755 equivalent in 1989 and 1990 respectively, Stamp Duty is charged only on issuance of corporate securities. The rate of this Duty is 0.4 %. The low rate is a contributing factor to the healthy market size.

11.17. The Consultants are of the view that if the rate of Stamp Duty is reduced to a nominal percentage, namely, 0.5 %, there is a possibility that a market for debt securities would be established and would grow at a very fast pace. As a result, the provincial governments would start getting much more revenue than they are getting now because there is presently no market. It is recommended that the Stamp Duty Act of 1899 may be amended so as to recognize a special category of commercial paper: corporate debt instruments issued by the public listed companies in Pakistan and the rate of Stamp Duty on transactions in these securities may be brought down to 0.5 % as against the existing rate of 3.5 %.

CHAPTER - 12

EPILOGUE

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12. EPILOGUE

12.1. A study like the present one has of necessity to be focused on narrow issues which were high lighted by the 1991 boom. Issues concerning the development of capital market need perspective and future study on the following matters is required:

12.1.1. Rules and regulations for Private Sector Unit Trusts (Open-ended Mutual funds).

12.1.2. The review of legal / administrative privileges of ICP and NTF immediately before other Private Sector Open-end and Closed-end Mutual Funds are established.

12.1.3. Conversion of Loan Instruments into equity by DFIs and the existing shareholders' Rights.

12.1.4. Listing procedure streamlining and creation of (over-the-Counter Market for new securities; market makers initial role.

12.1.5. Secondary market in loan securities.

12.1.6. Creation of a money market other than the present inter-bank transactions.

12.1.7. Stock Market access to various clients in small towns and vil-lages.

CHAPTER - 13

SUMMARY OF RECOMMENDATIONS

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13. RECOMMENDATIONS

- 13.1. The regulatory set-up in Pakistan is in line with the internationally prevalent systems and does not need any structural change. However, the Consultants are of the view that Regulation of the Corporate Sector by two different laws - namely, the Company Law and Capital Issues Law is creating some difficulties. In order to eliminate overlapping and to ensure brevity, consistency and clarity, the Capital Issues Act should be merged into the Companies Ordinance and a separate comprehensive law may be promulgated to regulate Investment Finance Companies Investment Advisers and Mutual Funds. [Paragraph 3.12.]
- 13.2. Revision of the definition of a Stock Exchange from 'any person' to 'any institution' will exclude Partnerships and Association of Persons etc. which is not in the interest of the Capital Market because of scarce expertise in the area. [Paragraph 4.3]
- 13.3. Criteria for establishment of a Stock Exchange need not be laid down. The Stock Exchange is a business venture and should be located where it has comparative advantage. The participants in the venture will naturally look into all the relevant factors such as proximity to business and financial community, access to technology, existence of financial intermediaries etc. before taking a decision. At the appropriate time, the existing law will permit more than one Exchange in a city if so necessitated by the volume of business and demand for business in unlisted securities. [Paragraph 4.5]

13.4. A secondary market in unlisted securities' should be promoted. The unlisted securities section of the Stock Exchange will need a separate regulatory framework. While drafting the legal provisions for regulating unlisted securities, caution should be exercised to eliminate the possibility of fraud through pressure-cooker salesmanship which happened in the case of bubble finance companies, cooperatives and Taj Companies etc. [Paragraph 4.6.]

13.5. The CLA may be authorized to permit, subject to such conditions as may deem fit, foreign nationals to become members where he considers that such membership is in public interest. This would facilitate introduction of new skills, ideas and expertise of foreign groups. A predetermined mix between local and foreign national as members would be necessary to eliminate fear of foreign domination. Initially, the CLA may allow joint ventures between Pakistani and foreign securities firms with the former holding 51 per cent of the share capital. [Paragraph 4.8]

13.6. Although the definition of 'Officer' covers all persons 'privy' to company information, yet it may be amended so as to include a 'Director' and 'Chief Executive' of the issuer. The specific mention of 'manager' and not mentioning 'Director' and 'Chief Executive' can create ambiguity. [Paragraph 4.9]

13.7. The procedure for selecting members of a Stock Exchange should prescribe the conditions to put flood light on their fiduciary behavior and unblemished financial past. They should be persons of means and professional competence. Rule 3 of the Securities and Exchange Rules, 1971 may

be amended in line with conditions of eligibility for membership adopted by the Islamabad Stock Exchange subject to two amendments, namely, (i) the CLA may be empowered to dispense with the condition about citizenship in public interest; and (ii) the power to waive the requirement of experience may be given to the CLA instead of the Stock Exchange. The transfer of this power to the CLA will help, at the time of registration of a Stock Exchange, admission of applicants who do not possess the experience but are otherwise eligible. [Paragraph 4.10.]

13.8. The present definition of 'Security' is comprehensive enough to cover variety of securities traded on the stock market. It may, however, be scrutinized further while drafting a regulatory framework for unlisted securities. [Paragraph 5.3.]

13.9. There is need for making it more difficult to make investment in associated undertakings to check the brute force of majority used to siphon profits to sister and group affiliated companies. Resolution for investment should, therefore, be required to be passed by a majority of not less than 60 per cent of the total voting power of the shareholders instead of 60 per cent of the shareholders present in the meeting in person or by proxy. Section 208 of the Companies Ordinance, 1984 may be amended accordingly. [Paragraph 5.6.]

13.10. The Listing Rules may require the following additional data and information to be included in prospectuses to ensure transparency:

13.10.1. projection of the operational results of the company for the

next five years;

13.10.2. an auditor's certificate commenting on the reliability of the results projected by the company; and

13.10.3. a statement showing the turnover and profits earned by the company in the past three years if it was in existence compared with the corresponding data of other listed companies in the same industry or trade.

13.11.A Listing Committee and Prospectus / Public Offer Committee of the Stock Exchange should go into the track-record of the company more thoroughly. It should check the veracity of the projections and past performance. [Paragraphs 5.8 and 5.9]

13.12.As regards the Annual Accounts of the public listed companies, detailed requirements have been prescribed in the Fourth Schedule to section 234 of the Companies Ordinance, 1984. The real issue, however, is that requirements regarding documentation remain unfulfilled due to tax evasion and concealment of wealth etc. The following measures should be adopted to improve compliance:

13.12.1. Auditors of Public Listed Companies may be appointed for a maximum period of two consecutive years with re-eligibility after a lapse of four years;

13.12.2. A Tribunal may be set up to try cases of professional misconduct of the Auditors; and

13.12.3. Certification requirements of Public Listed Companies should be expanded to increase the burden of responsibility of the

Management and the auditors. The auditors for an industrial unit of a company should be required, by law, to append a certificate about verification of assets, stocks, loans etc, to their Audit Report. In case of an investment bank, leasing company and modaraba, the auditors should certify that these institutions have complied with the Prudential Regulations issued by the State Bank of Pakistan. [Paragraph 5.11.]

13.12.4. The Listed Companies now use computers for accounting data and record. In view of this development, the maximum limit of three months instead of six months may be prescribed for the publication of the audited balance sheets under the law.

13.12.5. It should be made mandatory for public listed companies to release un-audited quarterly reports as is done in many countries of the world. This measure is recommended to make investors aware of the current state of the affairs of the company.

13.12.6. The CLA should issue a weekly bulletin / official report giving details of decisions, pertinent information on all matters which would be of interest to investors and the general public with special coverage of Public Listed Companies.

13.12.7. The CLA may arrange to publish an Annual Report on major events of the corporate sector which may be of interest to the investors.

13.12.8. The CLA should set up public counters at different places to provide record, documentation and information services at nominal charges to investors and general public. [Sub-Paragraphs 5.11.4. to 5.11.8.]

13.13. Presently share-holding is the only criterion for election and appointment of Directors of a Public Listed Company. Conditions of educational and professional qualifications may be examined with a view to improving the quality of decision-making in public listed companies. [Paragraph 5.12.]

13.14. Section 16 of the Securities and Exchange Ordinance does not allow extension of credit by the members of the Stock Exchanges to their clients. The law should be amended to permit such credit. The CLA and the Stock Exchange should prepare detailed rules to regulate this area. [Paragraph 6.12.]

13.15. 'Net Capital' requirement of a member should be revised in line with the increase in volume and also with reference to the volatile nature of the Stock Market. The minimum 'Net Capital' may be prescribed as 10 per cent of the business handled in a week subject to a minimum of Rs. 2 million. [Paragraph 7.3.]

13.16. The term 'Net Capital' should be defined so as to ensure liquidity to meet immediate working capital requirements. It should be in cash or in securities approved for the purpose - not in plots or other forms of fixed assets. [Paragraph 7.3.]

13.17. In order to safeguard against default situations, a member's exposure to the market should not be more than Rs.40 million a week. For corporate members, a higher limit may be fixed after a detailed examination of the volume of business handled by them. [Paragraph 7.3.]

13.18. 'Net Capital' balance reported by the members should be cross checked to safeguard the interest of other members and investors. Also penal action should be taken against 'defaulters'. [Paragraph 7.4.]

13.19. A Compensation Fund may be created to meet obligations of a defaulting member towards the other members of the Stock Exchange. [Sub-Paragraph 7.5.1.]

13.20. Members of the Stock Exchanges should be required to insure themselves for a specified sum to meet the claims of individual and institutional customers. [Sub-Paragraph 7.5.2.]

13.21. A Central Depository System (CDS), being a solution to many operational problems should be established immediately. [Paragraph 8.14.]

13.22. Share certificates accompanied by duly verified transfer deeds in blank, should prima facie constitute a transfer of title in the shares. The companies should be required, by law, to record in the first instance the transfer of shares based on transfer deeds duly filled in by a final purchaser of the shares desirous of having his own name recorded in the register of members. Reversal of such transfer should be made after appropriate legal or quasi judicial proceedings at the instance of

the party requiring such reversal. [Paragraphs 8.15 to 8.17]

13.23. Detailed criteria including minimum educational qualifications should be laid down to establish eligibility for a Stock Broker and a Jobber. [Sub-Paragraph 9.1.1.]

13.24. An institutional arrangement should be made for the training of the Brokers and Jobbers; [Sub-Paragraph 9.1.2.]

13.25. A 'Code of Ethics' may be developed for brokers. A Code-of-Conduct Committee should be set up by the Stock Exchanges to look into the complaints of clients against members and vice versa. A register recording complaints from the clients may be maintained by the Stock Exchanges and prompt action taken to redress genuine grievance. [Sub-Paragraphs 9.1.3. and 9.1.4.]

13.26. Rule 4 (4) may be amended to include the address of the customer as a part of the information. [Paragraph 9.2.]

13.27. For standardization of accounting, the following procedure should be adopted by the members / brokers for book-keeping and disclosure of information: [Paragraph 9.3.]

13.27.1. Members / Stock Brokers should keep separate Books of Accounts and Bank Accounts for his business and the business of his clients.

- 13.27.2. On receipt of deposit from clients, it should be deposited in the Clients' Bank Account. Similarly, the receipt should be entered in the Clients' Cash Book and Clients' Ledger.
- 13.27.3. Clients' Ledger should be maintained name-wise and monthly balances should be extracted and reconciled with Clients' Bank Accounts.
- 13.27.4. When clients are charged for commission, a Journal entry should be made for transfer.
- 13.27.5. At the end of the year, it is the duty of the external auditor to verify Clients' Ledger Balances and reconcile the total with the Clients' Bank Balance at two different dates; at the year end and any other month during the year picked up by the auditor.
- 13.27.6. In case of any shortage of funds in the Clients' Bank Account, the Stock Broker should be required to transfer the funds from his own account to make the shortfall.
- 13.27.7. On completion of audit, the auditor should be required to issue a special report stating the total clients' liabilities and the bank balances at two different dates.
- 13.27.8. The report should be submitted to Stock Exchange and CLA.
- 13.27.9. Besides the books prescribed in Rule 8, the Stock Brokers should maintain Cash Book, General Ledger and Bank Account for clients separately.
- 13.27.10. Audited Financial Statement of Stock Brokers should contain Review of Performance, Statement of Financial Position, Income and Expenditure Statement, Accounting Policies, Notes to the Accounts, Sources and Application of Funds Statement and Cash

Flow Statement together with comparative figures of the last period.

13.27.11. There should be audit of the members of the Stock Exchanges on annual basis apart from the appointment of auditors for special audit as and when required by the authority. The special audit should be conducted discretely without publicising the fact. Only when the audit reveals substantive (not procedural) irregularities, appropriate action taken should be made public. [Paragraph 9.4.]

13.27.12. The CLA should be empowered to inspect the books of accounts and the record and impose penalties for default. [Paragraph 9.5]

13.28. Besides surrendering gain made within 6 months, the insider may be required to disclose all his transactions in the security of the issuer in the annual general meeting of the shareholders. [Paragraph 10.5.]

13.29. While amending the law on insider trading, the aim should be to define what constitute 'insider information' and who can be deemed to be an 'insider'. [Paragraph 10.6.]

13.30. Concerted measures need to be adopted to create an awareness of the offense among companies and market players. [Sub-Paragraph 10.7.1.]

13.31. It is necessary to encourage corporate and market practices that facilitate detection of insider trading. [Sub-Paragraph 10.7.2.]

13.32. Effective deterrents in the form of a range of punitive actions should

be put in place. [Sub-Paragraph 10.7.3.]

13.33. The IFC proposal regarding provisions to be made in the Service rules of employees of listed companies and market participants should be considered for implementation in consultation with the Stock Exchanges. [Paragraph 10.9.]

13.34. The CLA should be empowered with a certain range of sanctions including, but not limited to, fines, ordering dismissal from office, prohibiting employment in positions having access to inside information and suspending or revoking the offender's license to engage in securities transactions. Market participants and companies that do not take adequate measures either to prevent insider trading or promptly to report incidents of insider trading to CLA should attract CLA sanctions. Inquiry proceedings and the imposition of penalties by CLA should not preclude criminal prosecution and civil suits to recover damages. [Paragraph 10.10]

13.35. A straight-forward expedient would be to ban Directorship of Members / Brokers on the Boards of Listed Companies by virtue of their shareholding on their own account. This would, in Consultants' opinion, be invidious as it would leave the Directorships enjoyed by officers of Investment Institutions (and to some extent all Financial Institutions having a share portfolio) intact. The chances of insider trading in the latter case also cannot be precluded. The Consultants, therefore, recommend that the safeguards given in 10.13. should be strictly enforced for the time being. [Paragraph 10.15.]

13.36. All decision relating to the pricing of issues (including initial public offerings, bonus issues and right shares etc. should be left to the sponsors, underwriters etc. There should, however, be rules in place to protect the investors by regulating underwriting activities. [Paragraph 11.8.]

13.37. Simultaneous action should be taken to withdraw the privileges of ICP and NIT and also to allow them to become members of the Stock Exchange after giving them adjustment period of two years. [Paragraph 11.10]

13.38. The Stamp Duty Act of 1899 may be amended so as to recognize a special category of commercial paper: corporate debt instruments issued by the public listed companies in Pakistan and the rate of Stamp Duty on transactions in these securities may be brought down to 0.5 % as against the existing rate of 3.5 %. [Paragraph 11.17.]

13.39. A study like the present one has of necessity to be focused on narrow issues which were high lighted by the 1991 boom. Issues concerning the development of capital market need perspective and future study on the following matters is required: [Paragraph 12.1]

13.39.1. Rules and regulations for Private Sector Unit Trusts (Open-ended Mutual funds).

13.39.2. The review of legal / administrative privileges of ICP and NIT immediately before other Private Sector Open-end and Closed-end Mutual Funds are established.

13.39.3. Conversion of Loan Instruments into equity by DFIs and the existing shareholders' Rights.

13.39.4. Listing procedure streamlining and creation of Over-the-Counter Market for new securities and market makers initial role.

13.39.5. Secondary market in loan securities.

13.39.6. Creation of a money market other than the present inter-bank transactions.

13.39.7. Stock Market access to various clients in small towns and villages.

ANNEXURES

KARACHI STOCK EXCHANGE SHARE PRICE INDEX

Annexure - A

Date	Share Price Index	Percentage Change
	KSE 50	
January, 1991	1,580	
February	1,551	-1.84 %
March	1,566	0.97 %
April	1,582	1.02 %
May	1,738	9.86 %
June	1,750	0.69 %
July	1,901	8.63 %
August	2,210	16.25 %
September	2,193	-0.77 %
October	2,194	0.05 %
	KSE 100	
November	1,009.96	
December	1,359.06	34.57 %
January, 1992	1,685.51	24.02 %
February	1,402.38	-16.80 %
March	1,265.79	- 9.74 %
April	1,291.42	2.02 %
May	1,472.18	14.00 %
June	1,501.97	2.02 %
July	1,502.90	0.06 %
August	1,286.27	-14.41 %
September	1,148.87	-10.68 %
October	1,250.72	8.87 %

Note: The share price index are taken at the beginning of the month.
KSE 50 Index was replaced by KSE 100 Index from November, 1991

TURN-OVER INDEX

Date	KSE 100 Index	State Bank of Pakistan
1991	Million Shares	Million Shares
January	28.76	310.16
February	26.34	317.28
March	42.79	324.57
April	62.60	369.36
May	41.78	383.67
June	27.52	387.67
July	75.93	474.32
August	58.90	486.80
September	45.59	483.78
October	46.71	499.10
November	73.74	613.43
December	86.24	718.17
January, 1992	83.51	731.74
February	54.37	672.05
March	42.55	689.98
April	48.21	742.76
May	53.33	749.86
June	49.80	762.46
July	66.13	165.95
August	64.88	156.99
September	89.75	161.00

Note: Base year of State Bank Index from July, 1992 onward 1990-91

STATEMENT OF WORK

1. Background

The Government of Pakistan is denationalizing and deregulating its economy. Capital market involvement is included in this liberalization effort. The Corporate Law Authority (CLA), which is the GOP's watchdog for capital market is planning to amend the current Securities and Exchange Act to reflect the changes and reforms that have occurred in the private sector to improve both the stock exchanges' operational efficiency and CLA's regulatory control of the exchanges. To prepare the most effective amendment to this legislation, the CLA needs information regarding the operational weaknesses and constraints to efficiency and growth facing the stock exchanges. The CLA has asked USAID for assistance in obtaining this information.

II. Objective

The objective of this purchase order is to obtain the necessary information for the CLA to draft an amendment to the current securities and exchange legislation. This new legislation will, on the one hand, result in a more efficient stock exchange; and on the other hand, will provide the CLA with the necessary regulatory and enforcement structures to protect the investors and ensure the basic financial well-being of the institutions involved.

III. Scope of Work

The contractor shall study the Karachi Stock Exchange (and to a lesser extent the exchanges in Lahore and Islamabad) and prepare a report on their operations, paying particular attention to operational weaknesses, growth constraints, and inefficiencies.

In carrying out this study, the contractor shall focus on the operation of three types of institutions which interface with the in-

dividual investor: the stock exchange itself, independent brokers, and the major financial institutions (mutual funds, modarabas, Development Finance Institutions DFIs and the Unit Trust (the GOP's open-ended mutual fund).

The contractor at a minimum shall appraise and analyze the following aspects of the Karachi, Lahore, and Islamabad stock exchanges:

1. Articles and memoranda
2. Listing Rules
3. Practices pertaining to commission rates and clearances
4. Net-worth and other financial means committed by the members of the exchange vis-a-vis business handled .
5. Level of 'gearing' (leverage) and financial accommodation of brokers by banks and financial institutions
6. Settlement and clearance process
7. Formalities and time required for transfer of stock shares and debentures
8. Conflict of interest in jobbing/brokerage, etc.
9. Insider trading
10. Failure to list trades

Using the above collected information and analysis, the contractor shall examine the functioning of the exchanges to determine the financial, institutional, and legal constraints to operational efficiency and further growth. The contractor shall make recommendations regarding the removal of these growth and efficiency constraints.

In regard to improving the stock exchange operations, the contractor shall make recommendations for (a) strengthening the internal management of the exchanges; and (b) instituting a set of minimal external regulations to ensure the solvency of brokers and prompt fulfillment of investors' buy and sell orders.

IV. Report

The contractor shall prepare a final report consisting of executive summary, methodology, analysis, findings and recommendations. The report shall be typed in double space and be atleast 40 pages in length, excluding executive summary and annexes, and other attachments. All aspects of stock exchange operational efficiency, growth, and regulation mentioned above shall be addressed in the report. The report shall be presented in draft (5 copies) to USAID within 60 days from the date of this order. USAID will distribute copies to CLA for their comments. CLA and USAID shall provide feedback, recommendations and comments within 15 days after receiving the draft report. The contractor shall present 10 copies of a final, bound report within 30 days after receiving USAID comments.

LIST OF MATERIAL COLLECTED AND EXAMINED BY THE CONSULTANTS

1. **Governing Laws and Rules**

- * The Capital Issues (Continuance of Control) Act, 1947
- * The Capital Issues (Exemption) Order, 1967
- * The Companies Ordinance, 1984
- * The Securities and Exchange Ordinance, 1969
- * The Securities and Exchange Rules, 1971
- * Investment Companies and Investment Advisers Rules, 1971
- * Prudential Regulations for Banks
- * Investment Corporation of Pakistan (ICP) Ordinance, 1966

Material Collected about:

Lahore Stock Exchange (LSE)

- * Memorandum and Articles of Association of the Lahore Stock Exchange
- * Listing Rules of the Lahore Stock Exchange

Islamabad Stock Exchange (ISE)

- * Memorandum and Articles of Association of the Islamabad Stock Exchange

Karachi Stock Exchange (KSE)

- * Memorandum and Articles of Association of the Karachi Stock Exchange
- * Rules and Regulations of the Karachi Stock Exchange
- * The Listing Rules of the Karachi Stock Exchange
- * An Introduction to Karachi Stock Exchange 100 Index of Nov., 1991
- * Annual Report of the Karachi Stock Exchange, 1990
- * Annual Report of the Karachi Stock Exchange, 1991

Papers read in the Seminar on Securities and Exchange Ordinance, 1969 and Monopolies and Restrictive Trade Practices, 1970 held at Karachi and Islamabad in August - September, 1992 by:

- * Main Mumtaz Abdullah, Chairman, Corporate Law Authority (CLA)
- * Mr. Arif Habib, President of the Karachi Stock Exchange

- * Mr. Zainulabedin, Karachi
- * Mr. Khalid Majid, Member of the Islamabad Stock Exchange
- * Mr. Tariq Iqbal Khan, Vice President, Islamabad Stock Exchange
- * Mr. Sarfraz Mahmood, FCA, Member of the Lahore Stock Exchange
- * Mr. Raja Habib, Member of the Islamabad Stock Exchange
- * Mr. Riazul Hassan Ghauri, President of the Lahore Stock Exchange
- * Dr. Parvez Hassan, Senior Partner, Hassan and Hassan Advocates.
- * Mr. Khalid Majid Hussain Shah Rahman, Chartered Accountant
- * Mr. Nasir Ali Shah Bukhari, Member of the Karachi Stock Exchange
- * Mr. Jawwad S. Khawaja, Advocate
- * Dr. Khawaja Amjad Saeed, Professor and Director, IBA, Lahore

Material of Regional Conference of Emerging Securities Market of South and South Asia held in Columbo from September 30 - October 3, 1992

- * Review of the Philippine Stock Market Performance Report by Makati Stock Exchange Inc.
- * Recent Developments in the Indian Capital Market by C.B. Bhave
- * Speech by G.B. Desai, President of the Bombay Stock Exchange
- * The Role and Development of Securities Market in Developing Economies by A. D. Lehnis
- * Role of the Regulator in Developing the Securities Market by L. Stanley
Jayawardena, Chairman, Securities and Exchange Commission, Sri Lanka
- * The Balance between Oversight Regulation by the Regulator and Self Regulation by the Stock Exchange by Tom Healy, G.M., Irish Stock Exchange
- * The Global Share Market-Foreign Investors and their Emerging Market's expectations by J. Mark Mobius, President Templeton Emerging Markets Fund
- * Automated Securities Market Systems by Bill Gorman, Consultant, Securities Trading, Settlement and Custody Systems, Los Angeles, USA.

Other Relevant Material

- * Paper on Regulatory Environment of Pakistan by Mian Mumtaz Abdullah, Chairman, Corporate Law Authority (CLA).

- * Paper on Self-Regulation of the Securities Market of the International Capital Market Group, January 30, 1992
- * Suggestions of International Finance Corporation (IFC) to CLA.
- * Court Order in the case of Islamabad Stock Exchange.
- * Seventy-Ninth Annual Report (1985-86) of the Tata Iron and Steel Company Limited, India.
- * Suggestions to Corporate Law Authority (CLA) by Mr. Yusuf H. Sherazi, Member of the Karachi Stock Exchange.
- * Suggestions to Corporate Law Authority by Mr. Khalid A. Mirza, Capital Market Manager, Central Asia, Middle East and North Africa.
- * Report submitted to National Deregulation Commission in Nov., 1986 by Mr. Ferozuddin Cassim, Member of the Karachi Stock Exchange.
- * The Development of the Jakarta Stock Exchange Inc. Country Report.
- * Equity Trading edited by Elizabeth Bishop.

QUESTIONNAIRE PREPARED BY THE CONSULTANTS FOR THEIR GUIDANCE**Growth and Operational Efficiency**

- 1.1. Do you consider that the provisions of the Securities and Exchange Ordinance, 1969 are in line with the objective conditions prevailing in the Country?
- 1.2. Is the time ripe for more self-regulations by the Stock Exchanges so as to make them fully responsive to the changes that have taken place in the context of de-regulation of the economy?
- 1.3. Do you consider the definition of the Stock Exchange inadequate? Should it be revised from 'any person' to 'an institution' to make it more restrictive?
- 1.4. Do you consider the provisions relating to Stock Exchange under Chapter II to be adequate? If not, please give suggestions.
- 1.5. The law provides for establishment of a Stock Exchange at any place desired by a person. Do you think objective conditions be laid down for eligibility of a place for establishment of Stock Exchange?
- 1.6. Do you think it would be advisable to provide in the law that only one Stock Exchange should be established in one city?
- 1.7. Do you consider any specific provision of the Ordinance and rules made thereunder unnecessary or a negative factor in the way of operational efficiency and growth of the Stock Exchanges? If so, please point out such provisions and suggest suitable changes.
- 1.8. Do you consider whether the existing organizations responsible for regulating the Capital Market are appropriate? If not, what should be the appropriate machinery to administer the law economically and effectively?

- 1.9. What other ways and means both, structural and administrative, would you suggest to bring operations of the Stock Exchanges in conformity with the objective conditions prevailing in Pakistan?

Articles and Memoranda of the Stock Exchanges

- 2.1. At present the qualifications for membership of a Stock Exchange are not specific to the work of the Stock Exchange. Do you think these should be made more specific?
- 2.2. Should the provision for citizenship of Pakistan be dispense with for membership of a Stock Exchange required under section 3 (a) (ii)?
- 2.3. Should Rule 3 (a) (vi) relating to qualifications for Stock Exchange membership be amended to admit persons who donot have experience for a period of not less than two years so tha' persons with entrepreneural skill are inducted into the system even if they have no experience in business of securities?

External Regulation - Role of Corporate Law Authority

- 3.1. Should section 5 of the Ordinance be amended to specifically authorize the CLA to impose binding conditions on the successful applicant for a Stock Exchange at the time registration or should it b left to Stock Exchanges for self-regulation?
- 3.2. Should the Authority be empowered to impose specific conditions on a registered Stock Exchange, from time to time, without prescribing them in the Rules?
- 3.3. At present members are registered with Stock Exchanges. Do you think they should also be registered with Corporate Law Authority to ensure better discipline?
- 3.4. Should the Directors be made personally responsible for admitted cases of tax evasion in respect of a company of which they are the Directors

and forced to bring back the income involved in tax evasion in the balance sheet of the company?

- 3.5. Do you consider that the provisions of section 17 relating to prohibition of fraudulent acts are adequate? If not, please give views. Do you think that the provisions relating to fraud be applicable equally to corporate fiduciaries and those who are insiders but are not corporate fiduciaries?
- 3.6. The law provides for penalty under section 22. No other power is vested in the Government with respect to findings of inquiry under section 21. Do you think powers need to be provided for specific actions as a result of the findings of inquiry?
- 3.7. Are the existing provisions for civil and criminal penalties (section 22 and 24) adequate? If not, please give views.

Internal Management - Self-Regulation

- 4.1. No qualifications are laid down for Stock Exchange Brokers, Jobbers and Underwriters. Do you think their qualifications should be spelled out in detail?
- 4.2. The law does not provide for audit of accounts of the Stock Brokers. Do you think audit be made obligatory and auditor's certificate furnished thereof to the Stock Exchanges?
- 4.3. The law provides for preparation of maintenance of books of accounts and other documents by a Stock Broker. Do you think that a review is needed so as to ensure greater accountability and transparency in record keeping?
- 4.4. Should the Stock Exchange Rules provide for taking disciplinary action against its members on complaint against them for non-performance or inadequate or delayed performance in executing their clients' orders?

- 4.5. Do you think that the Stock Exchanges should have a self insurance scheme for its members or compensation fund to protect them from claims against them?

Listing Rules

- 5.1. Do you consider the provisions of the Ordinance and the Rules to be adequate for full disclosure. Specifically, are the disclosure requirements relating balance sheet and profit and loss account as prescribed in the Second Schedule attached to the Securities and Exchange Rules in line with the modern concept of disclosure or do they lack in any detail? Please suggest amendments, if any, to make them more meaningful.
- 5.2. Do you think there should be provision in the Ordinance empowering the CLA and Stock Exchange to direct delisting of securities on the Stock Market in the event such securities are not traded above a certain percentage of its capital in a specified period?
- 5.3. Should issue price be regulated by CLA or the price be left free to be determined by the Stock market mechanism?

Transfer of Stock Shares and Debentures

- 6.1. Should there be a scheme of setting up a Central Depository System and electronic transfer of title to shares without physical possession evidenced by a certificate? What changes in the Securities and Exchange Law and Regulations do you think be brought about to support this system?
- 6.2. Do you consider whether or not provisions be introduced in the Securities and Exchange Ordinance limiting the power of the Directors in the matter of share transfer?
- 6.3. Should a provision be made to require Directors to convey any defect or any ground for refusing transfer of shares before the application for transfer is rejected?

- 6.4. Should Directors be made responsible and penalized for wrongful delay or refusal to record a transfer?

Net-Worth and other financial means committed by the members of the Exchanges vis-a-vis Business handled

- 7.1. Do you think the present 'net capital balance' requirement for a member is adequate? Should the same be raised to a more realistic level?

Insider Trading

- 8.1. At present Stock Brokers, Directors and Officers of Investment Institutions hold office on the Board of Directors of listed companies. All inside information is available to them which can be utilized to their advantage. Do you think it would be better to place restriction on their becoming Directors?
- 8.2. Should there be a provision in the Stock Exchange Rules or in the law to provide for situations of conflict of interest involved in jobbing and brokerage functions of members?
- 8.3. Do you consider the present provisions for regulating the activities of the 'insiders' to be adequate?

**THE OFFICIALS OF THE CLA, MEMBERS AND BROKERS OF THE STOCK EXCHANGES
AND DECISION MAKERS IN DFIs INTERVIEWED BY THE CONSULTANTS**

1. Corporate Law Authority (CLA)

- * Mian Mumtaz Abdullah, Chairman
- * Mr. Khalil Masud
- * Mr. Junejo M. Iqbal
- * Mr. Mustafa Javed Panni

2. Lahore Stock Exchange (LSE)

- * Mr. Riazul Hassan Ghauri, President
- * Mr. S. H. Iftikhar Ahmed, Vice President
- * Mr. Mazhar Rafique, Director
- * Mr. Akram S. Mahmood, Member
- * Mr. K. H. Basit Waheed, Member
- * Mr. K. H. Hameed Saeed, Member
- * Mr. M. Masood Akhtar, Director
- * Lt. Col. (Retd) Ch. Mohammad Iqbal, Member
- * Mr. Wasiullah Khan, Member
- * Mian Mohammad Saeed, Member
- * Mr. M. Tabassum Munir, Member
- * Mr. Shahid Mahmood, Director
- * Mr. Sh. Nasrullah, Member
- * Mian Abdul Aziz, Member
- * Mr. Atique Masood Dar, Member
- * Mr. Sh. Ishfaq Ahmed, Member's Agent
- * Mr. Sh. Abdul Majeed, Member's Agent
- * Mr. Jamil Ahmad, Secretary

3. Karachi Stock Exchange (KSE)

- * Mr. Issa Tai, Member
- * Mr. Anin Umer, Member
- * Mr. Ali Hussain, Member
- * Mr. Yaqoob Dehdi, Member
- * Syed Ejaz Ali Abbassi, Member
- * Mr. Saad Maniar, Member

- * Mr. Feroz A. Cassim, Member
- * Mr. Jehangir Siddiqui, Member
- * Mr. Yonus Essa Tai, Member
- * Mr. Bashir Jan Mohammad, Member

4. Islamabad Stock Exchange

- * Mr. Amanullah Khan, President
- * Mr. Tariq Iqbal, Vice President
- * Mr. Tariq Masud, Secretary

5. Development Finance Institutions (DFIs)

- * Mr. M. B. Abbasi, Managing Director, ICP
- * Mr. Salahuddin Qureshi, Chairman, NIT
- * Mr. Shahid Jamil, M. D. First International Investment Bank
- * Mr. Qadri, Inter Fund Modaraba, Karachi
- * Mr. Nasim, Inter Fund Modaraba, Karachi

Islamabad Stock Exchange (Guarantee) Ltd.

Articles of Association

7. Eligibility

- (1) Save as otherwise provided in Sub-Article 2, no person shall be eligible to become a member if:
- (a) he is less than twenty one (21) years of age;
 - (b) he is not citizen of Pakistan;
 - (c) he has been adjudicated an insolvent or as suspended payment or has compounded with his creditors;
 - (d) he has been convicted of an offense involving fraud or breach of trust;
 - (e) he has been at any time expelled by this or any other Stock Exchange;
 - (f) he has been previously refused admission to membership, unless a period of one year has elapsed since the date of such rejection;
 - (g) he is a lunatic or a person of unsound mind;
 - (h) he has not had experience in business of securities for a period of not less than two years provided that the Board may waive this requirement relating to experience in the business of securities if such person is, in respect of means, integrity and background, considered by the Board to be otherwise qualified for membership;
 - (i) he is not a graduate;
 - (j) he is member of another Exchange unless he possesses a minimum experience of 10 years as a Stock Broker; and
 - (k) he has not paid income tax during the last three years with assessed income of Rs.100,000. Brokerage houses which are not three years old should be exempted from this requirement.
- (2) Clause (i), (j) & (k) of Sub-Article (1) shall apply from 23rd October, 1991 being the date of amendment.

LIST OF ABBREVIATIONS USED IN THE STUDY

BCS	:	Business and Consultancy Services (Pvt) Limited.
CDS	:	Central Depository System.
CLA	:	Corporate Law Authority.
DFIs	:	Development Finance Institutions.
GOP	:	Government of Pakistan.
ICP	:	Investment Corporation of Pakistan.
IFC	:	International Finance Corporation.
ISE	:	Islamabad Stock Exchange.
KASB	:	Khadim Ali Shah Bukhari and Company.
KSE	:	Karachi Stock Exchange.
LSE	:	Lahore Stock Exchange.
NASD	:	National Association of Securities Dealers.
NIT	:	National Investment (Unit) Trust.
TOR	:	Terms Of Reference.
USAID	:	United States Agency for International Development.