

Pakistan:

Capital Markets Development Plan and Road Map 2020 -2027



April 2020

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LIST OF ACRONYMS

AD	Authorized Dealer
ADB	Asian Development Bank
ALM	Asset and Liability Management
AML	Anti-Money Laundering
AUM	Assets Under Management
BATS	Bond Automatic Trading System
BCBS	Basel Committee for Banking Supervision
BCG	Basel Consultative Group
BCP	Business Continuity Plan
BIS	Bank for International Settlements
bn	Billion
BTB	Broker to Broker
C&S	Clearing & Settlement
CAA	Certified Actuarial Analyst
CAR	Capital Adequacy Ratio
CCP	Central Counterparty
CDC	Central Depository Company
CDS	Central Depository System
CFS	Continuous Financing System
CHPF	Clearing House Protection Fund
CISI	Chartered Institute for Securities and Investment
CM	Clearing Member
CMDP	Capital Market Development Plan
CMDS	Capital Market Development Strategy
CMI	Capital Markets Infrastructure
CP	Commercial paper
CPE	Continuing Professional Education
CPSS	Committee on Payment and Settlement Systems
CRA	Credit Rating Agency
CTF	Counter-Terrorist Funding
DFI	Development Finance Institution
DMO	Debt Management Office
DVP	Delivery Versus Payment
EBRD	European Bank for Reconstruction and Development
EDI	Electronic Data Interchange
EM	Emerging Market (EME Emerging Market Economy)
ESMA	European Securities Market Authority
ETD	Exchange Traded Derivative
EU	European Union
EUR	Euro
FATF	Financial Action Task Force
FCA	Financial Conduct Authority (UK)
FI	Financial Institution
FINSIA	Financial Services Institute of Australia
FMAP	Financial Markets Association of Pakistan
FMDP	Financial Markets Development Program
FMI	Financial Markets Infrastructures
FRN	Floating Rate Note

FSA	Financial Services Authority (UK)
FSAP	Financial Sector Assessment Programme
FSC	Financial Stability Committee
FX	Foreign Exchange
FY	Fiscal Year
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GMRA	Global Master Repurchase Agreement
GOP	Government of Pakistan
IAIS	International Association of Insurance Supervisors
ICPs	Insurance Core Principles
IDS	Institutional Delivery System
IFI	International Financial Institution
IFoA	Institute and Faculty of Actuaries
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
IOPS	International Organisation of Pension Supervisors
IOSCO	International Organisation of Securities Commissions
IPOs	Initial Public Offerings
ISE	Islamabad Stock Exchange
ISIN	International Securities Identification Number
IT/ICT	Information Technology / Information Communication Technology
JSC	Joint Stock Company
KATS	Karachi Automated Trading System
KPI	Key Performance Indicator
KSE	Karachi Stock Exchange
KYC	Know Your Client
LLC	Limited Liability Company
LSE	Lahore Stock Exchange
MF	Margin Financing
MMOU	Multilateral Memorandum of Understanding (MMoU)
mn	Million
MOF	Ministry of Finance (also MoF)
MOJ	Ministry of Justice
MOU	Memorandum of Understanding
MRA	Master Repo Agreement
MRTB	Market-related Treasury Bill
MTB	Market Treasury Bill
MTFP	Medium Term Financial Plan
MtM	Marked to Market
MTS	Margin Trading System
NALC	Net Adjusted liquid capital
NBFC	Non-Banking Finance Company
NBFI	Non-Bank Financial Institution
NBP	National Bank of Pakistan
NCC	National Clearing Company of Pakistan Limited
NCSS	National Clearing and Settlement System
NPAs	Non-performing Assets

NPLs	Non-performing Loans
NPS	National Payment System
NSS	National Saving Scheme
OMO	Open Market Operation
OTC	Over the Counter
PD	Primary Dealer
PI	Public Issue
PIB	Pakistan Investment Bond
PKR	Pakistani Rupee
PP	Private Placement
PPP	Public--Private Partnership
PRISM	Pakistan Real Time Interbank Settlement Mechanism
QIS	Quantitative Impact Studies
RBC	Risk-Based Capital
RBCA	Risk-Based Capital Adequacy
RTGS	Real Time Gross Settlement
SBP	State Bank of Pakistan
SBP Act	State Bank of Pakistan Act, 1956
SCM	Securities Commission of Malaysia
SEC	Securities and Exchange Commission
SECP	Securities & Exchange Commission of Pakistan
SLR	Statutory Liquid Reserve requirement
SoA	Society of Actuaries
SOB	State Owned Bank
SOE	State Owned Enterprise
SPO	Secondary Public Offering
SPV	Special Purpose Vehicle
SRO	Self-regulatory Organization
SSS	Securities Settlement System
SWF	Sovereign Wealth Fund
TA	Technical Assistance
TFC	Term Finance Certificate
TOR	Terms of Reference
UCITS	Undertakings for Collective Investment in Transferable Securities
UIN	Unique Identification Number
UNCTAD	United Nations Conference on Trade and Development
USD	United States Dollar
VaR	Value at Risk
WB	World Bank
WFE	World Federation of Exchanges
XBRL	Extensible Business Reporting Language

PART 1: BUSINESS ENVIRONMENT

Pakistan economy has come under stress due to continued inflationary pressures, reduction in fiscal reserves, external and domestic debt servicing and lack of taxation revenues.

Table 1 Economic Statistics

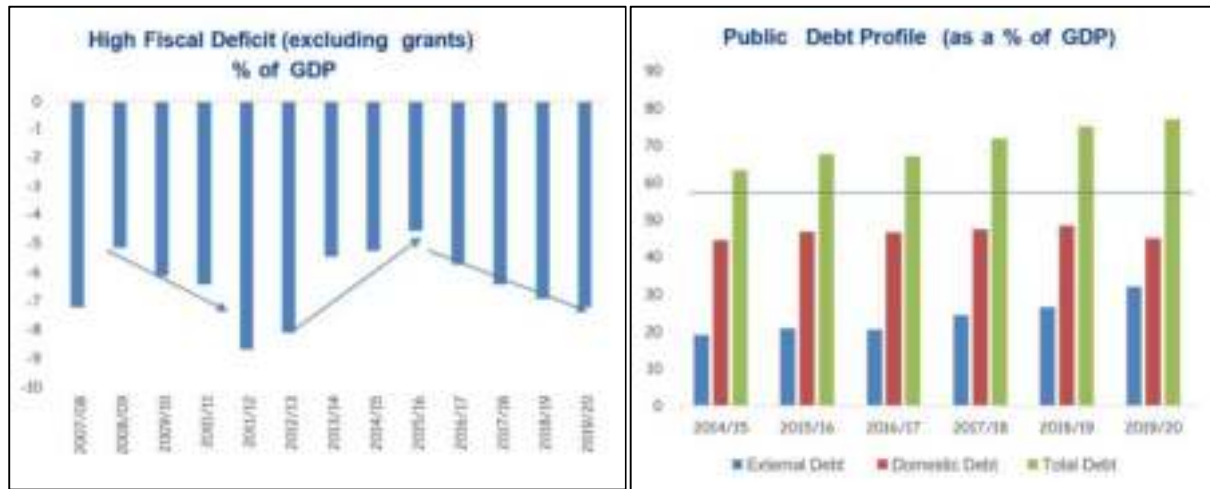
Pakistan: Selected Economic Indicators, 2014/15–2019/20

Population: 207.8 million (2016/17; provisional) Per capita GDP: US\$1,463 (2016/17)

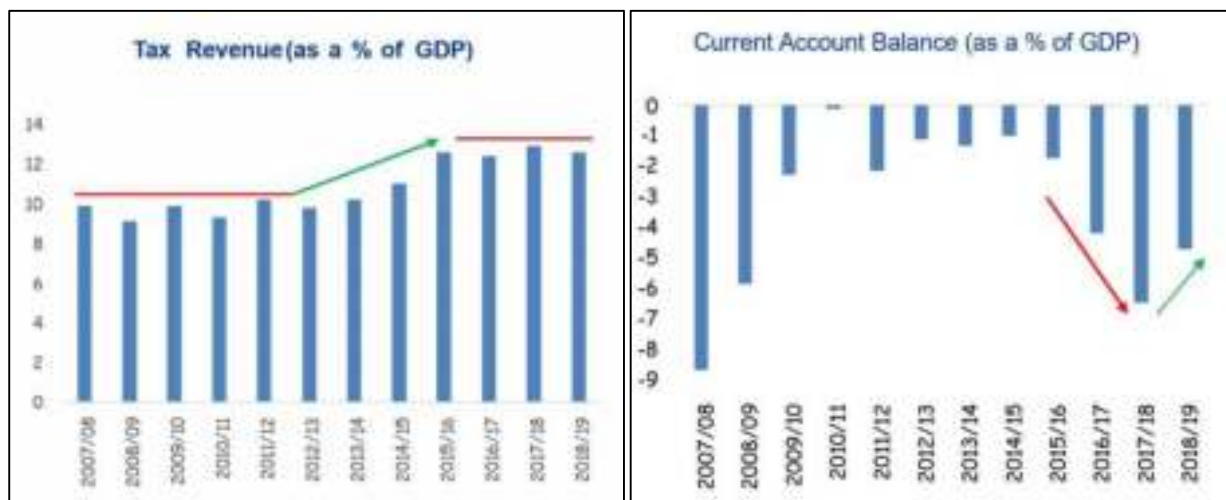
	2014/15	2015/16	2016/17		2017/2018/19		2019/20	
			Est.	Est.	Proj.	Proj.		
Output and prices								
Real GDP at factor cost	4.1	4.6	5.2	5.5	3.3	2.4		
GDP deflator at factor cost	4.3	0.4	4.0	2.4	7.5	11.8		
Consumer prices (period average)	4.5	2.9	4.1	3.9	7.3	13.0		
Consumer prices (end of period)	3.2	3.2	3.9	5.2	8.4	11.8		
Pakistani rupees per U.S. dollar (period average)	-1.5	2.9	0.4	5.0	...	...
Pakistani rupees per U.S. dollar (end of period)	3.3	2.8	0.2	13.9	...	...
(In percent of GDP)								
Gross saving	14.7	13.9	12.0	10.4	10.8	12.1		
Government	-1.6	-0.7	-0.8	-2.2	-3.6	-3.8		
Nongovernment (including public sector enterprises)	16.3	14.6	12.8	12.6	14.5	15.9		
Gross capital formation	15.7	15.7	16.2	16.7	15.4	14.7		
Government	3.7	3.7	4.9	4.2	3.1	3.3		
Nongovernment (including public sector enterprises)	12.0	11.9	11.2	12.5	12.3	11.4		
Public finances								
Revenue and grants	14.5	15.5	15.5	15.2	15.0	16.3		
Expenditure (including statistical discrepancy)	19.1	19.2	21.1	21.7	21.7	23.4		
Budget balance (including grants)	-5.3	-4.4	-5.8	-6.4	-6.8	-7.1		
Budget balance (excluding grants)	-5.4	-4.6	-5.8	-6.5	-7.0	-7.3		
Primary balance (excluding grants)	-0.7	-0.3	-1.6	-2.2	-1.8	-0.6		
General government debt incl. IMF obligations	63.3	67.6	67.0	71.7	74.9	76.9		
External general government debt	18.9	20.8	20.5	24.3	26.5	32.0		
Domestic general government debt	44.4	46.8	46.5	47.4	48.4	44.9		
(Annual changes in percent of initial stock of broad money, unless otherwise indicated)								
Monetary sector								
Net foreign assets	2.2	1.7	-3.2	-5.6	-6.3	8.9		
Net domestic assets	11.0	11.9	16.9	15.3	17.1	3.2		
Broad money (percent change)	13.2	13.7	13.7	9.7	10.8	12.1		
Reserve money (percent change)	9.9	26.5	22.5	12.7	15.7	13.5		
Private credit (percent change)	5.9	11.1	16.6	14.9	17.1	13.3		
Six-month treasury bill rate (period average, in percent)	8.8	6.3	5.9	6.0	...	...
External sector								
Merchandise exports, U.S. dollars (percentage change)	-3.9	-8.8	0.1	12.6	0.2	8.2		
Merchandise imports, U.S. dollars (percentage change)	-1.0	0.0	17.9	16.2	-4.2	-4.7		
Current account balance (in percent of GDP)	-1.0	-1.7	-4.1	-6.3	-4.6	-2.6		
Financial account (billions of U.S. dollars)	5.0	6.8	10.2	14.3	10.7	8.7		
External public and publicly guaranteed debt	159.8	193.3	209.4	218.3	225.2	234		
Debt service	20.7	22.2	30.1	26.3	37.9	45.7		
Gross reserves (in millions of U.S. dollars)	13,534	18,143	16,141	9,789	6,824	11,187		
In months of next year's imports of goods and services	3.2	3.7	2.9	1.9	1.4	2.2		
Memorandum items:								
Underlying fiscal balance (excl. grants; percent of GDP)	...	...	-6.3	-6.5	-7.3	-7.3		
General government and government guaranteed debt (incl	65.7	70.1	70	75.3	79.1	80.5		
Net general government debt (incl. IMF; % GDP)	58.2	61.3	61.5	66.8	70.7	73.5		
Real effective exchange rate (end of period percentage char	6.5	2.1	3.4	-11.2	...	...
Terms of trade (percentage change)	6.8	11.1	0.1	-3.2	-1.3	-0.1		
Real per capita GDP (percentage change)	2	2.6	3.2	3.6	1.4	0.5		
GDP at market prices (in billions of Pakistani rupees)	27,443	29,076	31,922	34,619	38,559	44,446		

Sources: Pakistani authorities; World Bank; and IMF staff estimates and projections.

2. The economy has been marked by high fiscal deficits and high debt to GDP levels:



3. Tax revenue collection has plateaued and the current account balance as a percentage of GDP has remained negative:



4. Fiscal reserves are being depleted and inflation remains very high:



Figure 1 (8 charts Key Economic Variables)

5. The trend in GDP growth is negative and inflation continues to hamper the economy with an inflation forecast by ADB to be 12% and IMF 13% in 2020:

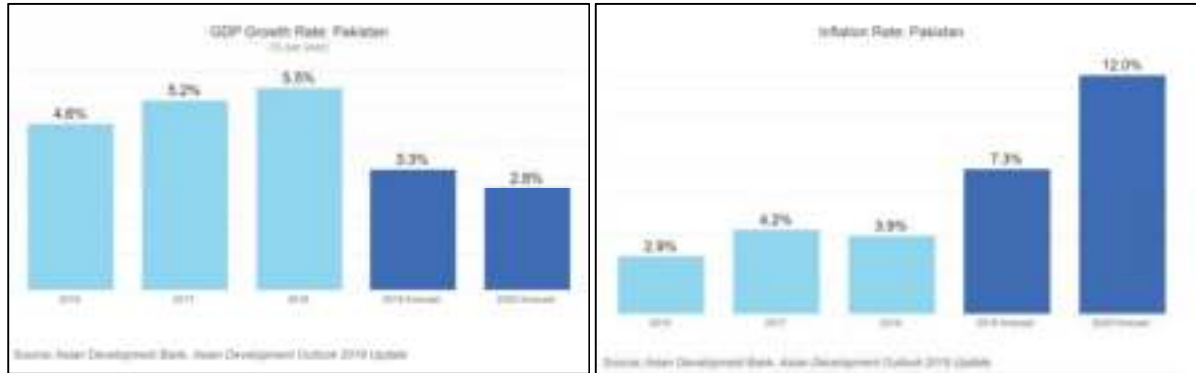


Figure 2 (2 charts GDP growth Rate and Annual Inflation Rate)

6. High inflation means continued pressure on interest rates and the currency leading to high servicing costs for both domestic and external debt. Debt sustainability is a major concern for the Pakistani economy.
7. In addition to funded PIBs there other liabilities such as National Savings Certificates, Sukuks, TBills and MRTBs

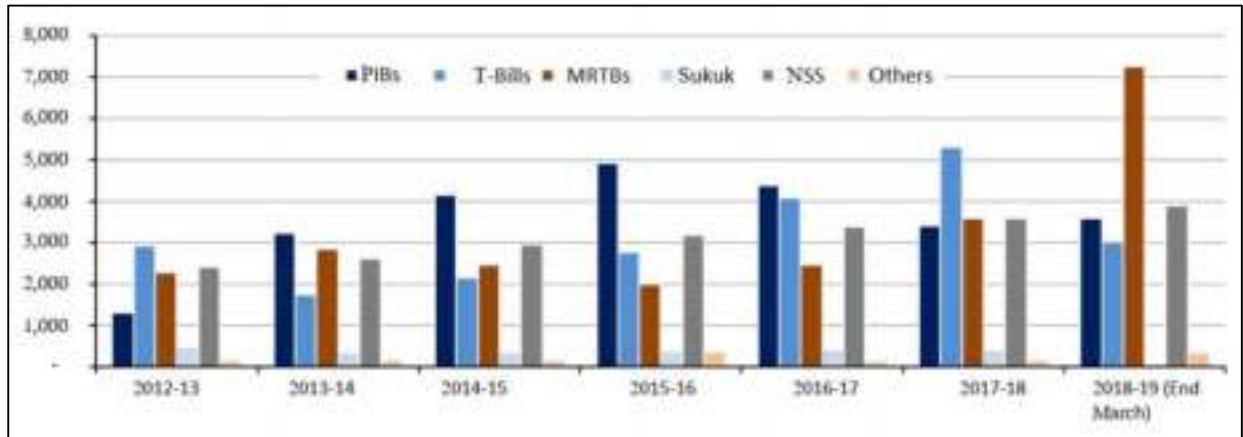


Figure 3 Instrument Components Domestic Debt

8. NSS is unfunded and at June 2019 was PKR 3.09 Trillion and had returns better than commercial money market funds.

Banking sector

9. The banking sector is made up of 33 banks (public sector (5), local private banks (20), foreign bank operating in Pakistan (5) and specialized banks(3)).with the top five have 54% of the deposit base. Three of these five are majority owned by family-based corporations.
10. Overall quality of banking statistics is:

Table 2 Quality of Banks

	<u>Dec 2015</u>	<u>Dec 2016</u>	<u>Dec 2017</u>	<u>Dec 2018</u>	<u>Sept 2019</u>
<u>Capital Adequacy</u>					
Regulatory capital to risk-weighted assets	17.3	16.2	15.8	16.2	17.1
Tier I capital to risk-weighted assets	14.4	13	12.9	13.2	14.2
Capital to total assets	8.4	7.8	7.1	7.1	7.0
<u>Asset Quality</u>					

Nonperforming loans (NPLs) to gross loans	11.4	10.1	8.4	8	8.8
Provisions to NPLs	84.9	85	87.2	83.8	80.5
NPLs net of provisions to capital	7.7	7.3	5.8	7.8	9.8
<u>Profitability Measures</u>					
Return on assets (after tax)	1.5	1.3	0.9	0.8	0.8
Return on equity (after tax)	15.6	14.4	11.5	10.7	10.8
Net interest income to gross income	70.4	71.2	72.7	75.4	79.4
Noninterest expenses to gross income	47.8	53.1	57.1	60.2	57.4
<u>Liquidity Measures</u>					
Liquid assets to total assets	53.8	53.7	54	48.7	50.8
Liquid assets to total deposits	73.3	72.1	76.1	67.2	73.5
Loans/Deposits	46.4	46.6	50.1	55.8	53.6

11. The above table indicates a reducing return on assets and in return on equity in large part due to a reducing interest rate spread.
12. The statistics for the domestic banking sector balance sheet are:

Table 3 Balance Sheet of Domestic Private Banks

Domestic Private Banks			
(Million Rupees)			
Item	30-06-2019	31-12-2018	30-06-2018
Liabilities			
Capital (Paid up)	363,284.5	362,215.3	359,539.3
Reserves	718,548.6	667,598.4	631,931.3
Demand Deposits from:	8,986,944.4	8,667,185.1	8,316,628.8
(a) Scheduled Banks	36,382.1	26,152.9	32,511.5
(b) Others	8,950,562.3	8,386,745.3	8,223,149.6
Time Deposits from:	2,247,278.3	3,841,306.5	3,806,045.4
(a) Scheduled Banks	6,985.0	4,347.0	8,280.7
(b) Others	2,240,293.3	2,091,246.4	1,858,732.4
Borrowings from State Bank of Pakistan	1,012,326.6	1,133,913.0	1,619,915.0
Borrowings from Banks Abroad	51,031.7	36,766.3	35,006.3
Borrowings from Other Scheduled Banks	487,260.0	651,479.6	364,908.5
Head Office and Inter-bank Adjustments	79,805.1	559,201.3	160,650.7
Other Liabilities	2,434,899.7	4,479,593.7	2,533,080.9
Total Liabilities/Assets	14,373,388.7	18,399,351.1	15,827,706.2
Assets			
Cash:	1,559,448.4	1,154,362.7	1,092,964.0
(a) Notes, Silver and Coins	321,094.4	207,701.6	221,381.8
(b) Balances with State Bank of Pakistan	894,812.3	634,328.8	566,923.5
(c) Balances with Other Scheduled Banks	343,933.7	312,342.2	304,658.7
			0.0
Balances Held Abroad	182,147.2	57,985.2	144,157.5
Bills Purchased and Discounted	215,152.8	196,651.3	194,815.1
Advances to:	6,118,498.5	6,142,417.4	5,608,939.1
(a) Scheduled Banks	79,179.4	146,596.5	63,784.6
(b) Others	6,039,319.1	5,995,820.9	5,545,154.5
Investments in Securities and Shares	5,999,363.0	5,906,707.9	6,245,192.7
Bank Premises	315,919.6	288,898.7	286,494.5
Head Office and inter-bank Adjustments	186,035.7	158,727.8	98,765.2
Other Assets	1,876,831.4	4,493,609.1	2,156,378.1
Contingent Assets/Liabilities:	7,279,257.5	6,611,626.5	6,868,488.8
(a) Bank Guarantees	1,271,732.5	1,153,855.8	1,138,503.0
(b) Letters of Credit	1,538,164.1	1,486,548.4	1,456,597.1
(c) Forward Exchange Transactions	2,615,083.9	2,218,628.2	1,757,587.7
(d) Other Contingent Assets	1,856,377.0	1,752,692.2	2,515,721.0

13. Investments in securities (mainly PIBs) is equal to advances and banks are major owners of PIBs due to returns which crowds out lending to the real economy.

Insurance sector

14. The insurance sector is largely undeveloped in Pakistan and market penetration for general insurance is very low:

Table 4 Insurance Market Penetration compared to Peer countries

	GDP (USD billion)	GDP per capita (USD)	GDP growth forecasted	Insurance Penetration*
Pakistan	313	1,555	3.2%	0.9%
Bangladesh	250	1,517	8.0%	0.5%
Sri Lanka	87	3,842	3.0%	1.3%
Vietnam	224	1,835	6.9%	1.6%
India	2,601	1,964	7.2%	3.6%

Casualty Insurance

15. The general insurance industry is stratified between large, medium, and small players as follows:

Table 5 Casualty Insurance Gross Premium Written 2017 and 2018

Gross Premium Written (GPW)						
Type	No. of Companies	Dec '18			Dec '17	
		PKR (mln)	Market Share	No. of Companies*	PKR (mln)	Market Share
Large	5	62,216	68%	5	56,070	67%
Medium	8	22,084	24%	8	19,346	23%
Small	15	7,783	8%	15	7,856	9%
Total	28	92,083	100%	28	83,348	100%

Source: PACRA (40 companies are licensed by SECP however, 12 are either inactive or restricted from taking premiums or considered specialist insurance companies)

16. The top five companies have nearly 70% market share:

Table 6 Casualty Insurance Largest 5 companies Gross Premium Written 2017 and 2018

Gross Premium Written (GPW)						
Companies	Rating Agency	Rating	Dec '18		Dec '17	
			PKR (mln)	Market Share	PKR (mln)	Market Share
1. Adaniye General Insurance	PACRA	AA+	21,405	23%	19,265	23%
2. IFU General Insurance	Dual	AA+	20,813	22%	20,404	24%
3. Jubilee General Insurance	Dual	AA+	10,068	11%	8,536	10%
4. United Insurance	Dual	AA	5,239	6%	5,126	6%
5. IGI General Insurance	Dual	AA	4,608	5%	2,939	4%
Total			62,216	68%	56,070	67%

Source: PACRA

Life Companies

17. The State Life Insurance Company is dominant and as a SOE is under the purview of the Ministry of Commerce. SLIC's gross premium received is more than 100% of private insurance sector's gross premiums as follows:

Table 7 Key Market Share Statistics Life Companies 2016 to 2018

Company	IFS Rating	CY18			CY17			CY16			
		Gross Premium (PKR mn)	Growth (%)	Market share(%)	Gross Premium (PKR mn)	Growth (%)	Market share(%)	Gross Premium (PKR mn)	Growth (%)	Market share(%)	
Conventional											
1	Jubilee Life	AA+	51,888	11%	25%	46,816	23%	22%	38,004	27%	21%
2	EFU Life	AA+	30,790	-2%	15%	31,421	27%	15%	24,667	-21%	14%
3	Adanjee Life	A+	13,323	-3%	6%	13,781	22%	7%	11,302	24%	6%
4	KGI Life	A+	4,794	-15%	2%	5,618	-26%	3%	7,584	91%	4%
5	TPL Life	A-	435	61%	0%	270	132%	0%	116	-75%	0%
6	Asahi Life	N/a	44	129%	0%	19	-23%	0%	25	-44%	0%
Takaful											
7	Pak Qatar Family	A+	7,817	-5%	4%	8,263	10%	4%	7,494	12%	4%
8	Dawood Family	A-	1,471	12%	1%	1,313	11%	1%	1,178	13%	1%
Premium Private Sector			110,562	3%	49%	107,501	19%	52%	90,370	9%	50%
9	SLIC	AAA	115,238	14%	51%	101,045	12%	48%	90,074	13%	50%
Total Premium			225,800	8%	100%	208,546	16%	100%	180,444	11%	100%

Source: PACRA

18. Life Insurance companies hold securities to match their liabilities and as at December 2018 their investment holdings were:

Table 8 Investments held by Life Companies December 2018

Life Investments as on Dec 31, 2018	Rs. in millions
Equity Securities	186,676
Government Securities	761,436
Debt Securities	24,444
Term Deposits	66,760
Mutual Funds	15,059
Total	1,054,375

Securities market

19. There are 544 listed companies on PSX of which 420 traded in 2019 and about 100 are regularly active, overall, there is a market capitalization of USD 41.6 billion at June 2019, the free float component (by market value) is 25% or USD 10.6 billion. Foreign ownership is 9.77%.

In calendar year to December 2019, 40 companies accounted for approximately 80% of market turnover and 95 companies were responsible for about 90% of the turnover. The free float of PSX 100 index is 13.35% and for the PSX 30, 10.61% at June 2019. During the period from 1st January 2014 to 30th June 2019 the PSX 100 index has traded between 25,479 and 52,876. The PSX 100 index, and its 20-day rolling volatility, was as follows:

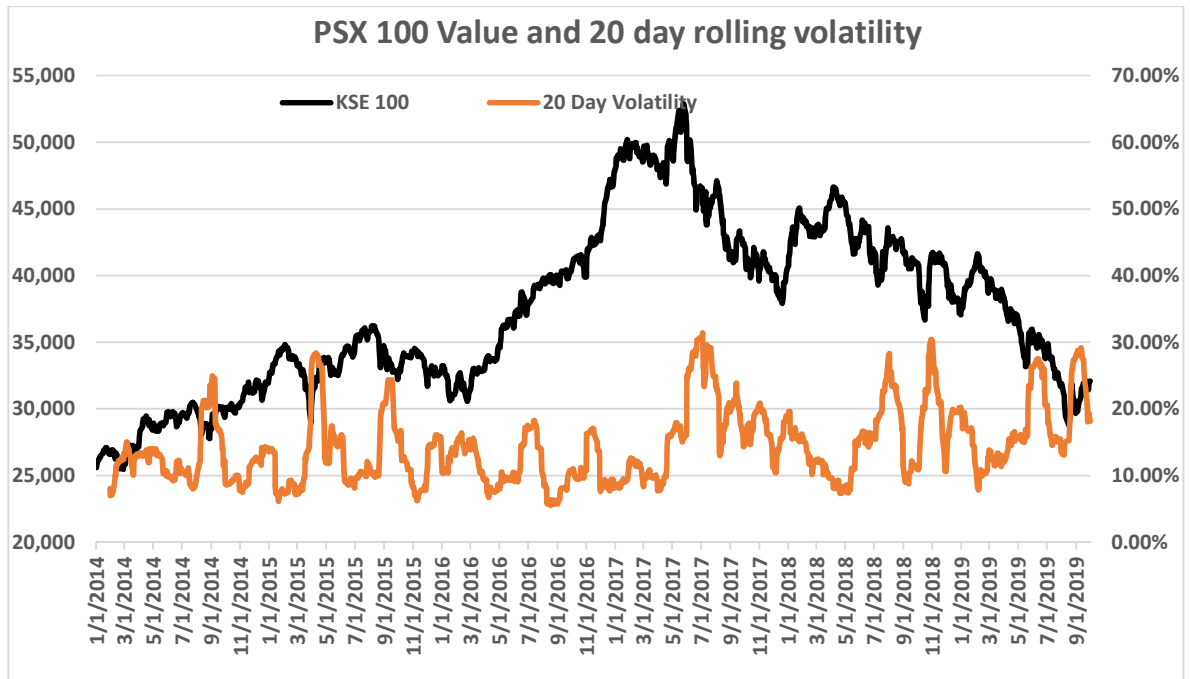


Figure 4 Performance and Volatility of PSX 100 Jan 2014 to September 2019

20. At June 2019 there were 211 brokers and the clearing company had registered 185 Institutional accounts.

21. Accounts opened at 30th June 2019 was:

Table 9 Number of Broker Investor Accounts June 2019

Category	Number of Accounts as at June 2019
Individual	235,406
Corporate	8,490
TOTAL	243,896

Source PSX, CDC, NCCPL

22. The account opening history has been:

Table 10 Number of Investor Accounts 2007 to October 2019

Account Opened during Calendar Year	Numbers of Investors (UINs)
2007	25,795
2008	22,098
2009	19,530
2010	15,898
2011	9,003
2012	13,250
2013	18,107
2014	28,752
2015	26,946
2016	17,408
2017	19,607
2018	12,074
till October 2019	6,567

Source PSX, CDC, NCCPL

23. Since 2007, 235,000 accounts have been opened, against the June 2019 situation of 243,000 accounts

24. Four thousand more accounts were closed than opened in the twelve months to June 2019 as follows:

Table 11 Investor Accounts opened and closed 12 months to June 2019

Month	Opened	Closed
Jul-18	1,579	1,556
Aug-18	1,687	1,007
Sep-18	1,320	1,678
Oct-18	2,013	2,834
Nov-18	1,800	2,459
Dec-18	1,333	2,453
Jan-19	1,593	2,124
Feb-19	1,682	1,892
Mar-19	1,703	2,615
Apr-19	1,563	1,679
May-19	1,275	1,955
Jun-19	1,759	1,389
Total	19,307	23,641

Source PSX, CDC, NCCPL

Capital market infrastructure

25. A general schema for the equity and futures market is as follows:

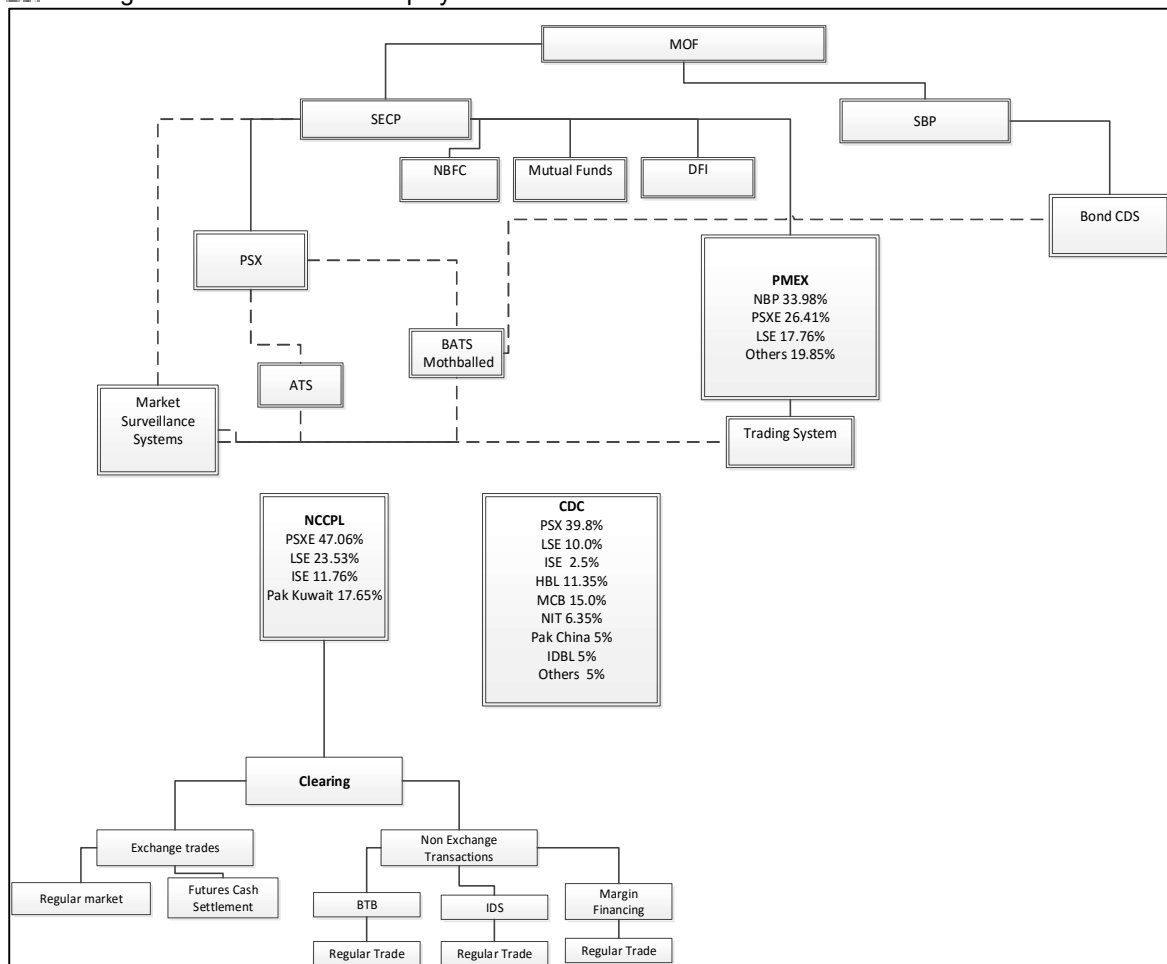


Figure 5 Schema of Market Entities

26. Currently following demutualisation there are four main entities involved:

1. Pakistan Stock Exchange (PSX)
2. Pakistan Mercantile Exchange (PMEX)
3. National Clearing Company of Pakistan Limited (NCCPL)
4. Central Depository Company Limited (CDC)

27. In 2016 the previous three exchanges (KSE,LSE and ISE) were merged and demutualised with a consortium of Chinese investors taking a strategic holding (30%) and two local institutions (10%)
28. This demutualisation left an untidy situation with other infrastructure vehicles with a number of investors in each of PMEX, NCCPL and CDC.

PART 2: DEVELOP THE DEMAND

Increase the local retail investor base

Diagnostic:

- 29. Pakistan ranks poorly on financial inclusion rankings. According to data from the SECP, only 210,000 retail investors have a trading account. The number of active investors is around 100,000. This accounts for less than 0.1% of the population. There are similar levels of low penetration across other assets; the Mutual funds industry only has 300,000 customers, and insurance sector has less than 1% penetration. Even in the banking sector, less than 25% of the population has access to a bank account.
- 30. In comparison regional markets such as Bangladesh has 2.7m investors, Malaysia has 2.5m and Thailand has 1.46m. India has a much larger retail investor base of 32m. Even Sri Lanka which only has a population of 21m has 630,000 retail investors.
- 31. One of the reasons for this low investor participation is the boom-bust cycle in the market. Our analysis shows that retail investors follow the market returns.



Figure 6 Market performance drives new investors to the stock market
Source: NCCPL and PSX

- 32. Some of the other reasons which are often cited for low retail participation are i) Lack of access of investors to stock brokers due to low penetration ii) lack of financial literacy and investor awareness to alternative sources of savings and iii) lack of trust of retail investors due to frequent cases of broker default iv) alternative informal markets and asset classes such as real estate, National Saving Schemes (NSS) and gold which have less onerous tax and KYC requirements.

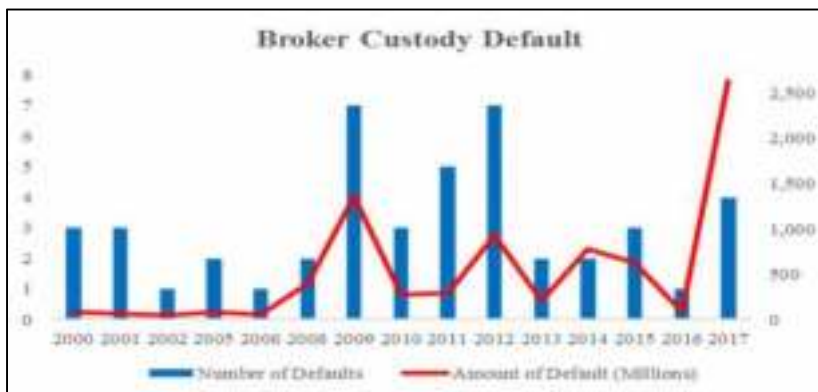


Figure 7 Broker Custody Default
Source: SECP

33. According to the SECP, since 2000, custody defaults by the brokers have resulted in claims up to PKR 8 billion with at least one broker defaulting every year since 2008 and average of 3 per annum. In addition to these custody defaults there is a general lack of quality brokerage houses; most are conflicted on account of proprietary trading, participation as a party in leverage product (MTS/Badla) and misalignment of interest leading to approach of generating trading volume.
34. Broker agents or representatives are not required to be registered either with the exchange or SECP; we have been told this global best practice has been discontinued since 2018 exposing potential and existing investors to mis-selling and other frauds. Securities Act 2015 provide for registration of authorized representatives of brokers with SECP and also specification of professional requirements for such individuals.
35. In Pakistan a whole class of intermediaries which can provide independent advice to investors is missing from the market. Investors get advice from product originators be it mutual funds, pension funds, insurance or brokerage whose interest is tied with the product. Globally, independent advisors both as individuals and in corporate structure operate in the financial markets playing a major role in expanding market outreach and building investor awareness.
36. Similarly, mutual fund, pension funds and insurance sale force is tied with the product originating entities, this give investors limited and conflicted view of the market. There are no independent third-party distributors for these products which can explain product features, associated risk and recommend product after factoring risk profile of the investor.
37. Quality of human resource particularly those which interact with the customers play an important role in market development and investor confidence. Like practised globally, SECP has setup Institute of Financial Markets (IFM) with a mandate to offer various certification for professionals operating in the capital market and insurance sector. Market participants have raised questions about quality of certifications being offered by IFM and about cost given the size of market. Review of mandatory and grandfathering provisions points to lack of firm approach on part of SECP for implementing, this could be due to absence of enabling provision the law.
38. Another big factor discouraging investors from investing in equities is crowding out by National Savings Schemes.

Crowding out by National Savings Schemes

39. While retail participation in stocks and mutual funds is a dismal 250,000, National Savings – the government's retail savings organization has 7 million clients. This mean that almost 35% of the population who have access to formal banking is also saving money with National Savings. The dominance of National Savings is quite intuitive for the following reasons:
40. Firstly, historically, it has offered superior returns to the savers. The savings products are risk free and some categories offered by them carry a free put option as they can be redeemed anytime with a minimal penalty. Over the past few years under various financial reform projects, the returns of National Saving products have been forced to become aligned with similar products offered by Mutual funds, however, we think that there is there still some more work required on this.
41. The yields on the government bonds which are linked with National Savings have been higher than the return performance of KSE100 for 5 out of the past ten years. A PkR100 invested in National Savings ten years ago will be equal to PkR294 today, versus PkR278 if it was invested in KSE-100 Index. Investors are choosing the asset class which has offered higher risk adjusted return. Even more interesting is the analysis which shows that National Savings net accruals turn negative when their interest rates go below 10%. This could reflect the "equity risk premium". This indicates that lack of investor education or trust in broker are not the primary factors which are keeping retail participation low. The returns in equities cannot match the low risk high return profile offered by NSS.

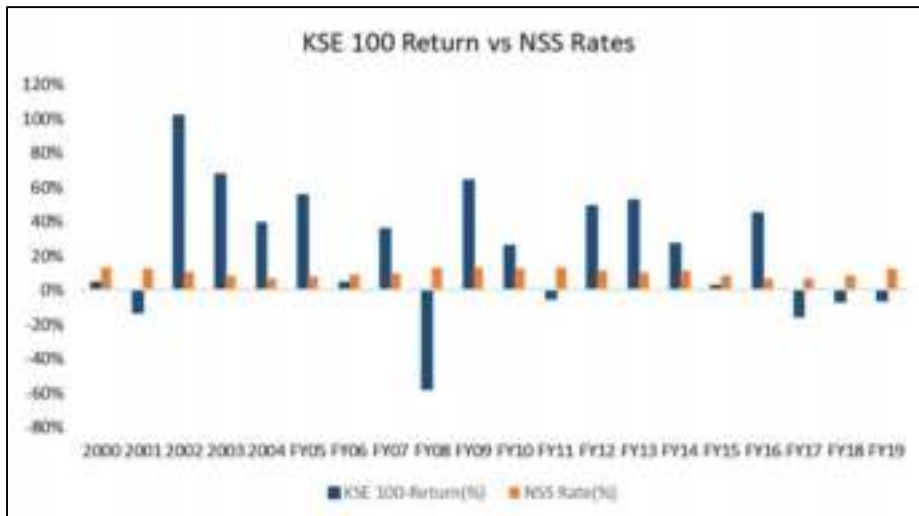


Figure 8 National Savings has offered higher return for five out of last ten years
Source: Pakistan Stock Exchange

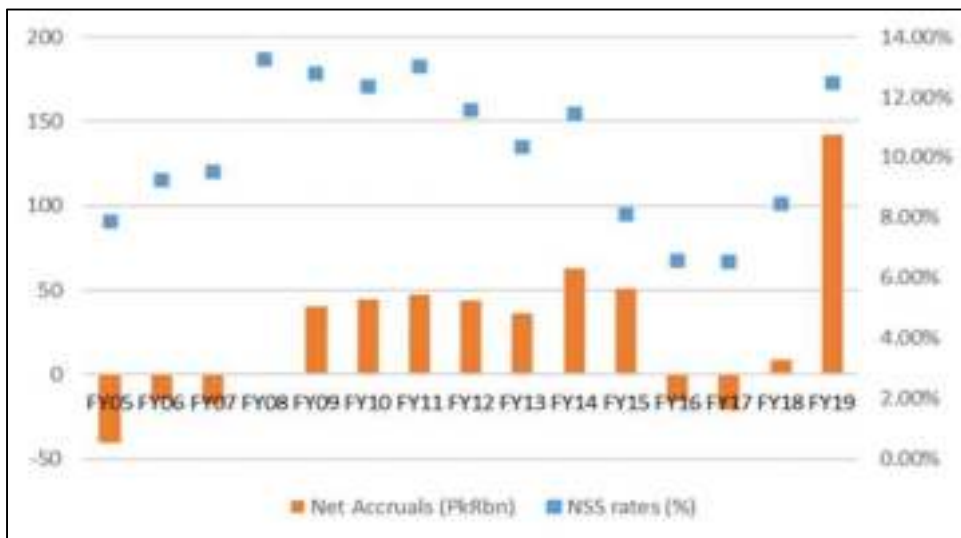


Figure 9 Investors move out of NSS when rate differential with equity markets declines
Source: State Bank of Pakistan

42. Secondly, National Savings has a wide distribution network and is very simple to onboard. The fact that National Savings is not regulated by the SECP or the SBP is a major source of benefit to it. It has to deal with fewer bureaucratic approvals and does not have to bear any compliance cost. National Savings has 376 branches of its own. In comparison, the total number of branches of all the stockbrokers combined is 210. The stock-broker with the highest number of retail clients has 11 branches. Similarly, on the mutual funds side, the two largest asset managers, NAFA (National Funds) and NIT have 21 and 27 branches respectively. Besides the direct branches, National Savings products are also sold by Post Offices and other banks.

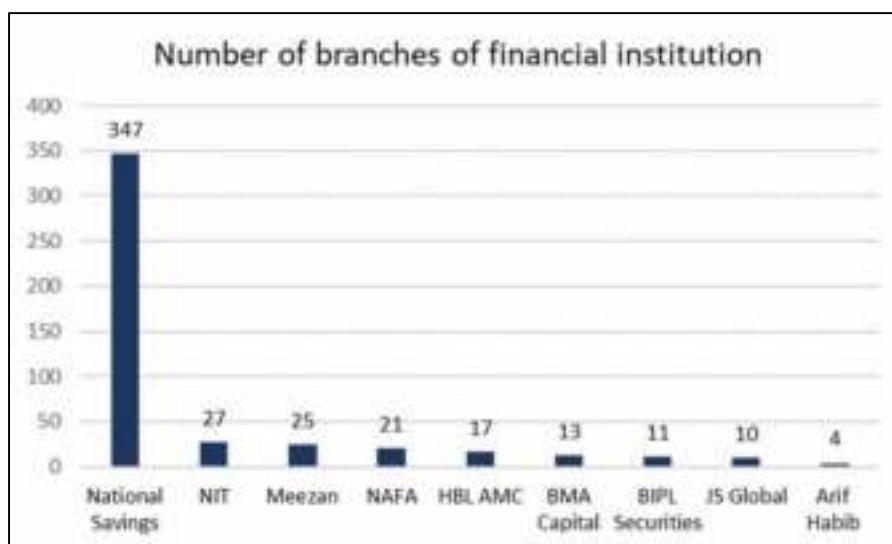


Figure 10 National Savings has a much wider sales network

Source: Pakistan Stock Exchange

43. Account opening on National Saving is easy. According to their website (click here), a client needs to fill in a form and needs to have a copy of his CNIC (National Identity Card) or NICOP (Non Resident Card) in the case of overseas Pakistani.
44. In contrast, the process for opening a stock account, a retail investor is still cumbersome. The retail investor needs to 1) Fill account opening form (for the broker and CDC) 2) Sign various declarations, policies including FACTA 3) Capture his biometric and 4) Given proof of the sources of his income
45. Although the PSX and other stakeholders such as NCCPL and CDC have made some efforts in developing an online onboarding method, currently there is a hurdle in it due to NADRA. NADRA has been unwilling to allow its biometric information to be shared on unverified devices. This means that the broker can only do biometric verification on a device which is authorized by the NCCPL and which meets specification set by the NCCPL. Consequently, digital onboarding still requires the physical interaction with the broker.

Recommendations

46. Streamline digital onboarding of retail investors by simplifying KYC/AML checks. We recommend that the government implement method for seamless digital onboarding of retail customers on their mobile devices. Due to FATF compliance requirement there has been a standstill on the efforts to promote the fintech industry. As brokers have very few branches, it is imperative that customers should be able to use digital onboarding channels. The bottleneck seems to be lack of coordination and cooperation between NADRA, SBP and the capital market institutions (PSX, SECP, CDC, NCCPL). One approach could be that MoF coordinate with the relevant stakeholder i.e. SECP, SBP, PTA, MOI, NADRA, etc to prepare a concept paper for establishment of centralized KYC for the entire financial and corporate sector to enable investors/customers to undergo KYC only once.
47. In the onboarding process the other bottleneck is in capturing the biometric. There is a double capture of the information. A retail investor who funds his account from payment through a bank account already has provided KYC/AML tests by the banks and has captured his biometric and verified it through NADRA database by the bank. Consequently, brokers should be allowed to use the KYC process which has already been done by the banks. This approach is being used in European markets such as the UK where banks are increasingly providing the services of KYC and customer identification and authentication to third party fintech companies based on a commercial arrangement. This recommendation is subject to solving any restriction under BCO 1962 in Banks sharing customer information.
48. Reforms of the National Savings. We recommend that institutional investors should be barred from investing in National Savings products. Furthermore, the pricing for NSS should be based on the returns

generate by investing in government bonds. The efforts to digitize the records need to be accelerated and KYC controls should be introduced.

49. Broker reforms: In our view the broker reforms focused on four areas; HR quality (applicable on mutual funds and insurance), custody of client assets, capital base and back office software are required.
50. Firstly, on HR, we think that the SECP should enforce the requirement for certification for people working in regulated (client facing) roles in the market. There has been no enforcement on the requirement for authorization, certification and licensing of people working in the capital market. Unfortunately, SECP has decided not to introduce the category of authorised representative hence will not be issuing any such license, we urge that SECP reconsider this decision as it is contrary to international best practice. This is a standard practice in most global markets. For example, in the UK, anyone working in a regulated role where he/she is providing financial advice to clients is required to register and pass a minimum qualification certification. Typically, these certification cover business ethics/regulations as well as professional competence in the functional business area. We think the Institute of Financial Management (IFMP) needs to be strengthened and should become the central body for certification and training for the capital markets.
51. Secondly, on custody of client assets, we recommend custody of assets should be with third party custodians (non-broker) or the banks. Only brokers with large capital and strong operational practices be allowed to keep client asset custody, for others a seamless trading mechanism should be put in place where custody should be with an independent third party – like banks, depository or independent custodian. This would reduce the risk of custody defaults.
52. Thirdly, on capital, we think the capital requirement should be linked with the overall trading volumes handled by the brokers i.e. liquid capital something already part of the regulatory framework however, implementation has been repeatedly deferred. Enforcing harsh minimum paid up capital requirements could lead to high barriers to entry and damage the level of competition in the sector.
53. Lastly, globally exchanges provide complete brokerage house software both for trading and book keeping; in Pakistan this is not the case and brokers use variety of software with no control or quality check. Standardization of brokerage house software should be mandated for investor protection and confidence. Additionally, to increase broker capacity it should be required that all financial institutions including foreign custodian to use IDS system to settle the trade once it is affirmed.

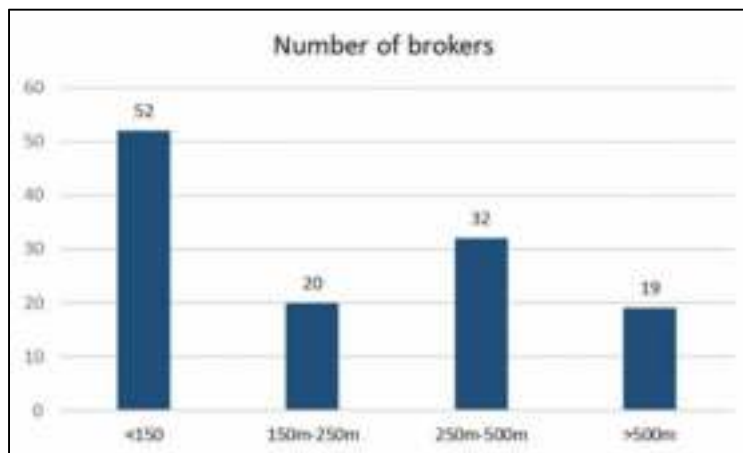


Figure 11 Only 19 brokers have more than PkR500m of paid up capital
Source: SECP

54. In a demutualized environment, a robust broker business model needs to be introduced which apart from addressing custody default should be based on the financial, operational and governance strength of a broker. Accordingly, these should determine ability to operate in different segments of the markets and offer different products. In light of the above factors, brokers should be allowed to charge advisory fees, manage discretionary portfolio, distribute mutual fund – for this exchange has to put in place mutual fund platform -, offer VPS and special savings and investment accounts, provide margin financing to their clients, etc.

55. Currently owners, officers, and directors of a brokerage house, in terms of section 153(k) of Companies Act 2017, are not allowed to be on the board of a listed company. This restricts suitable people to join the board of brokerage houses, we think this restriction should be removed as changes in definition of "insider" has made this provision redundant and regressive. However, suitable amendment should be made in the law to ensure that spirit of demutualization is maintained and no broker should come on to the board of securities and future exchanges.
56. Concept of Authorized Representative as provided in the Securities Act 2015 should be implemented for investor protection, improved HR quality and expansion of brokerage outreach.
57. As mandated in the law and practiced around the globe framework for individual securities advisors with minimum capital requirement should be reintroduced; this would expand outreach of our capital market and bring third party mutual fund distributors.
58. Globally, fund management business has seen division of labour due to which all auxiliary activities like fund accounting, trusteeship, research, and distribution has been outsourced, In fact in some cases it has become a standalone activity. Our market lacks wider participation due to narrow distribution channels; there are hardly any third-party distributors which in some cases globally are bigger than the fund managers.

Introduction of easy margin trading via derivatives.

59. Retail investors in most markets demand margin financing and leverage. Leverage products have not been able to develop properly ever since "badla" was phased out post 2008. This is a major reason why daily trading volumes on the Pakistan Stock Exchange have declined by over 90% over the past ten year. It is recommended that the PSX should gradually replace inefficient leverage products by effective single stock, cash settled derivative products. Third party custody models might also encourage banks to offer margin financing.



Figure 12 Liquidity has shrunk by more than 90%
Source: Bloomberg, PSX

New listings and privatizations.

60. Privatization of state-owned companies at attractive prices has proven to be the most effective way of increasing retail participation in the past. More than 60,000 new investors opened stock accounts during the privatization of OGDC and PPL. We recommend the government to list the state-owned companies as well as other large infrastructure assets on the stock market. Other new products such as ETFs, REITs, Shariah compliant products and new asset classes such as listing of growth technology companies could also attract more people to the stock market.

Develop a fund for investor education, and financial literacy.

61. We encourage the government to allocate further funds to the SECP for expanding its JumaPunji program for investor education. This should not be just limited to awareness of risk of investments but also for promotion of the equity markets. The media regulator PEMRA mandates Pakistani TV channels

to allocate 20% of their time for running content for public interest and welfare. Most of the time they show national anthems to meet this requirement. These media slots should be used to promote financial literacy. In the UK, FSA runs educational program in schools. Banks also run awareness programs to teach children on how to save and invest. These should be encouraged. Section 244/245 of Companies Act 2017 regarding Investor Education and Awareness Fund should be amended and made part of SECP Act 1997 for proper implementation and made available for HR training.

62. Role of Pakistan Institute of Corporate Governance should be expanded to act as a watchdog for minority shareholders by creating awareness about corporate affairs. This should educate and encourage minority shareholders activism. Given closely held nature of listed companies in Pakistan it is important and small shareholders are aware of their rights and mechanisms (understanding meeting notices, e-voting, etc.) available for participation and protection.
63. To strengthen institutional investors in the capital market following is recommended:
- a. The government should undertake study to explore possibility of offering all civil servants portable and contributory pension. Such a step apart from attracting talent would help in building saving pool for long term investments;
 - b. Currently due to regulatory issues VPSs can only be opened with an Asset Management Company his has created a monopoly like situation and should be reviewed and appropriately amended for inclusion of insurance companies and if found suitable even brokers without proprietary trading should be included;
 - c. To expand insurance penetration 3rd party motor vehicle and group life insurance should be properly implemented and possibility of making occupational health insurance compulsory under the labour law should be explored; and
 - d. Taxation issues of capital market intermediaries in general and insurance companies in particular both at federal and provincial levels should be addressed.
64. Commercial banks presence in capital market is limited to being an investor whereas globally they have major role in the development and outreach of the markets. In Pakistan banks have the largest liquidity and this limited presence affect market liquidity therefore, it is suggested that SECP along with SBP should under a study to analyse regulatory and commercial impediments hindering enhanced role of commercial banks.
65. All banks have a participant status in CDC therefore, can open sub account for their depositors. Currently CDC charges custody fee from all its account holders; CDC could consider not to charge custody fee for sub account opened with a bank and at the same time banks could be encouraged to open CDC account whenever they open Rupee account. It will expand outreach of the market and if they chose to invest their custody would be protected. Lastly, this would encourage/facilitate public to subscribe to IPOs through e-IPO system.

Strict enforcement on and action against illegal offshore FX brokers operating in Pakistan

66. According to data from SimilarWeb, the top visited websites in Pakistan include offshore FX brokers such as IQOption, Binomo, and Forex Factory. According to some estimates more than 40,000 opened accounts for bitcoin trading on platforms such as Coinbase. These apps and websites allow easy onboarding and provide investors access to seemingly a much wider asset class. However, according to ESMA research more than 90% of investors lose money on such platforms. We recommend that the SECP and SBP jointly should approach FIA Cyberwing and the IT Ministry to block such websites and apps and to take action against illegal forex brokers operating in the market.

Top Finance/Investment Websites in Pakistan			
Rank	Category	Rank	Category
	Finance		Investments
1	FBR	1	BINOMO
2	BINOMO	2	IQOption
3	IQOption	3	ZBG
4	ZBG	4	Investopedia
5	PSX	5	ForexFactory

Source: Similarweb

Figure 13 Top Finance and Investment Websites in Pakistan

Conditions to attract foreign investors

Diagnostic:

67. According to data from NCCPL, there are 750 overseas institutional investors who are set up to trade in Pakistan Stock Exchange. We think out of this around 70 have holdings and less than 30 are actively trading. Pakistan has 0.03% allocation in the MSCI Emerging Market Index. Around \$10trillion of assets are tracked by the MSCI Emerging Markets Index. However, Pakistan's share in the Index has been steadily declining and there is a risk that the market will be removed from this Index due to its low liquidity and trading value.
68. Pakistan market opened to overseas investors in 1992. The first wave of privatization and the rise in interest in Asian emerging markets, pre the East Asian Crisis, brought in the early investors. During the mid 90's global broker dealers such as Merrill Lynch, Bears Sterns, ABN Amro, CLSA, Indosuez W1 Carr, and UBS established partnerships with local brokers. However, post East Asian crisis most of these pulled out. The biggest damage was done by the nuclear tests in 1998 and the consequent freezing of the movement of capital outside the country. Most investors and global inter broker pulled out of Pakistan at that time, except for Merrill Lynch.
69. In the early 2000s there was a return of global investor interest in Pakistan, in line with the overall rally in emerging markets, especially in the Middle East region. However, this too ended with the 2008 crisis. Pakistan's policy mistake of closing the stock market for 45 days severely damaged investor confidence and Pakistan was removed from MSCI Emerging Markets Index and demoted to frontier market. It was upgraded again in 2017.
70. Currently, a few regional and emerging markets specialist inter broker deals such as EFG Hermes, CLSA, Auerbach Grayson, Macquarie, Exotics and Rencap are active in covering Pakistan. It is expected that the new privatization drive will attract the larger European and US banks as well.
71. The biggest hurdle for global investors is the lack of liquidity in the market. We have discussed in the section on supply that there are only 14 companies in Pakistan which have daily traded value of close to \$1m. For many asset managers this is considered to be the minimum threshold for invisibility.
72. Although domestically Pakistan market is over-brokered, there is scant active coverage of Pakistani equities by global brokers. Less than 20% of the companies listed on the PSX have active research coverage and only four companies are a part of the MSCI Pakistan Index.
73. Emerging Markets investors have been more engaged with and interested in larger markets and companies which have been added to the MSCI EM Index over the past few quarters, such as China and Saudi Arabia. Even smaller markets such as Vietnam and Bangladesh are attracting more inflows than Pakistan.



Figure 14 Global institutional investors have been net sellers since 2008
Source: Bloomberg, PS

74. Some of the active institutional investors in Pakistan are Franklin Templeton, Lazard, Blackrock, Aberdeen Standard Investments, Schrodgers, and Kingsway Capital.
75. Pakistani companies are not active in doing investor roadshows. They usually attend one or two annual conferences in the US, London and Singapore. A typical European company on the other hand will do investor roadshows after every quarterly result.
76. Another reason for the low participation of global investors is the lack of sufficient ESG compliant stocks. Globally, there is increasing shift in investible assets towards companies which comply with high environmental, social and governance standards. Pakistan market is dominated by financials and oil and gas sector. Globally investors have shifted away from oil and gas sector and replaced it with new growth sectors such as technology. Pakistan stock exchange does not have many innovative growth companies and the sector contribution of technology is less than 3%.

Recommendations

77. In order to avoid a downgrade from Emerging Markets to a Frontier Market status, Pakistan needs to improve the liquidity in the market. Besides earnings growth and improving the free float, other initiatives such as introducing leverage products and encouraging greater retail investor participation will also help improve liquidity. We recommend that the listed companies should be encouraged to put their updated investor relations presentation on the website and also to encourage brokers to initiate research coverage on them.
78. Listed companies should be encouraged to have active investor relations function. This includes holding regular analyst calls and providing sufficient disclosure to both sell side and buy-side analysts. In the UK, London Stock Exchange hired a research firm to provide research coverage on small and mid-cap companies which are typically ignored by larger banks. PSX should mandate holding of analyst briefings at its premises and the Exchange should provide services for webcast/conference call for analysts and investors.
79. The visa regime for business travellers, especially investors should be relaxed. Although Pakistan has introduced business visa on arrival, the documentation required to avail this is very difficult. The inviting company needs to be registered with the Chambers of Commerce. Travel restriction is usually the biggest factor which drives away investors exploring a market. Pakistan does not have easy and direct travel connections with international finance centers which further discourages investors from visiting the country to meet the companies. Many global fund managers are from India and Israel. These nationalities are not easily allowed to enter Pakistan. We recommend that Pakistan ease the visa restrictions for prospective investor. The PSX should provide the service of issuing Visa invitation letter through the Chambers of Commerce to visiting investors.
80. In order to encourage the global diaspora of overseas Pakistanis, we suggest the State Bank of Pakistan should encourage Pakistani banks to facilitate Special Convertible Rupee Accounts (SCRA).

Only two or three smaller banks such as JS Bank actively promote this product. Banks which have overseas presence such as UBL, National Bank, and Habib Bank should be particularly encouraged to facilitate this without the need for expensive and laborious documentation such as the need for separate attestation of documents. Attestation services should be offered by the bank itself. We recommend that the PSX and SECP should connect with Pakistan Consulates abroad to leverage them to offer account opening services for SCRA accounts at their premises.

Outcomes

	Action	Outcome	Timing	Responsible
1	Section 244/245 of Companies Act 2017 regarding Investor Education and Awareness Fund for proper implementation for listed companies.	Adequate funding would enable to reach out to all segments of the society like schools, colleges, universities, professional bodies, housewives, etc. through a well-designed national investor education and awareness program.	Medium Term	SECP, PSX
2	Accreditation through well-functioning professional body or Institute like Institute of Financial Markets for professionals working in the regulated sector particularly those interacting with investors should be mandated and implemented. Further, accreditation criteria may be designed in consultation with SBP. Financial Markets Association, which is registered with SECP, has designed Accreditation criteria for money market and FX brokers, after consultation with SBP SBP has requested to participate in implementation process.	Globally anybody dealing with saving and investment products has to go through certain minimum professional accreditation covering legal, ethical and technical areas. This should build quality HR and ensure ethical conduct standards are followed thereby strengthening investor confidence	Medium Term	SECP, IFM, SBP
3	Holistically review and explore possibility of expanding role of Pakistan Institute of Corporate Governance to act as a watchdog for minority shareholders by creating awareness about corporate affairs.	This should educate and encourage minority shareholders activism. Given close held nature of listed companies in Pakistan it is important and small shareholders are aware of their rights and mechanisms (understanding meeting notices, e-voting, etc.) available for participation and protection.	Medium Term	PICG, SECP
4	Framework for Securities Advisors as provided in the Securities Act 2015 should be reimplemented.	As mandated in the law and practiced around the globe this framework should be reimplemented for individual securities advisors with minimum capital requirement; this would expand outreach of our capital market and reduce conflict of interest through alignment of interest.	Short Term	SECP
5	Framework for third party mutual fund distributors should be put in place along with exchange-based platform for issuance and redemption.	Globally, mutual funds are distributed through third parties; this should bring transparency, alignment of interest, broader outreach and awareness about mutual funds and practices of asset management companies.	Short to Medium Term	SECP, PSX, MUFAP

6	Third party custody mechanism needs to be put in place for investor protection and confidence and expand market outreach.	It should protect client assets, reduce compliance cost of brokers, and expand market outreach. Additionally, it should bring banks into capital market as custodian and provide margin financing to investors.	Short to Medium Term	SECP, PSX, CDC, SBP
7	Allow brokers to conduct and charge for discretionary portfolio management Margin financing by brokers Special saving and investment account after tax basis VPS account management by brokers Delete section 153k of Companies Act 2017	Expand brokerage product suite and improve governance through quality board of directors. This should improve viability of brokerage houses and investor confidence in their governance structure.	Medium Term	MOF, SECP, FBR
8	MoF should form committee of SECP, SBP, PSX, CDC, NADRA and NCCPL to develop a seamless, straight through digital onboarding and KYC/AML process for retail investors.	This should be critical for increasing retail investor participation and driving financial inclusion.	Short term	MoF in collaboration with SECP, SBP, PSX, NADRA, CDC and NCCPL
9	Subject to banks being able to share any customer information in light of BCO 1962, allow brokers to use the KYC/AML done by Banks.	This should lower the friction in client onboarding for retail investors and help drive financial penetration.	Short term	PSX in collaboration with SBP.
10	Resolve the pricing anomalies on investment products offered by National Savings and accelerate the digitalization of CDNS in order to prevent the misuse of incentives given to select group for social protection.	This should promote the growth of the overall financial system in Pakistan by leading to greater inflow of capital into the capital markets.	Short term	MoF in collaboration with CDNS
11	Enforce a crackdown on illegal offshore FX and CFD brokers by blocking the websites/apps.	This should help crack down on illegal money laundering and outflow of capital as well as protect vulnerable retail investors from fraudulent and unregulated operators who are operating illegally.	Short term	SECP in consultation with SBP and in collaboration with FIA and Ministry of IT.
12	Make it easier for Capital Market investors to visit Pakistan by issuing investor visa on arrival sponsored by SECP or PSX.	This should improve Pakistan's perception for global institutional investors and improve the conditions to attract them to visit and meet companies for investments.	Short term	SECP and PSX in collaboration with Ministries of Interior, Foreign Affairs and FIA.
13	Promote financial literacy by using electronic media and the banks for financial literacy programs.	Enhance financial inclusion and literacy. Provide students with a better understanding of efficient ways of saving and investing.	Medium term	SECP and SBP in collaboration with PEMRA (for media campaign) and Ministry of Education/HE C.

PART 3: FOSTER THE SUPPLY

Government bonds and National Savings

Diagnostic

81. Total Public debt has been growing rapidly following the 2008/9 global financial crisis. Public debt at December 2019 was PKR 33.7 trillion. The growth from PKR 5 trillion in 2007 is clearly shown in the following:

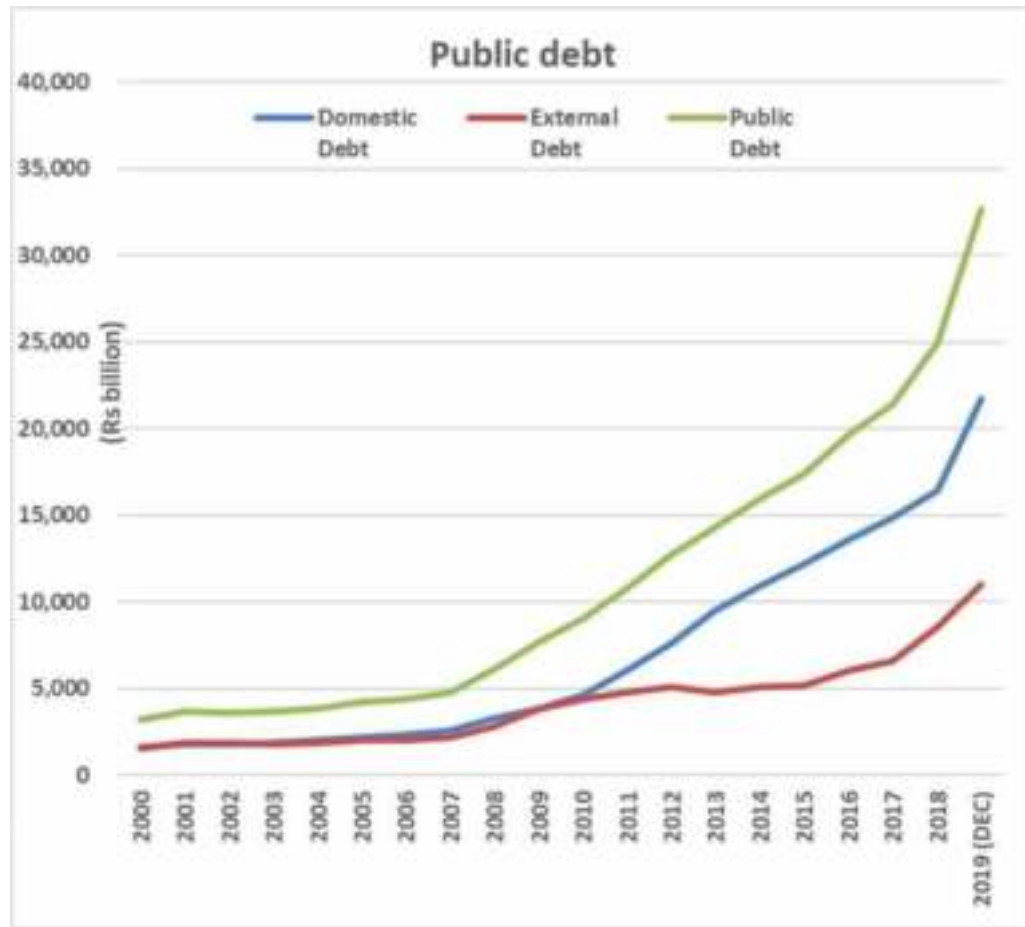


Figure 15 Growth of Public Debt (exIMF) 2000 - 2019

82. Total debt and other liabilities at December 2019 were:

**Table 12 total Debt of Government December 2019
(Rs in billion)**

	Dec-19
I. Government Domestic Debt	21,676
II. Government External Debt	10,993
III. Debt from IMF	1,042
IV. External Liabilities	1,539
V. Private Sector External Debt	2,393
VI. PSEs External Debt	638
VII. PSEs Domestic Debt	1,392
VIII. Commodity Operations ²	728
IX. Intercompany External Debt from Direct Investor abroad	593
A. Total Debt and Liabilities (sum I to IX)	40,994
C. Total Public Debt (sum I to III)	33,711
D. Total Debt of the Government	29,969

83. Domestic Debt at December 2019 was:

Table 13 Components Domestic Debt December 2019

	December 2019
Permanent Debt	13,168.7
Pakistan Investment Bonds (PIB)	12,173.0
Prize Bonds	736.1
Bai-Muajjal of Sukuk	177.8
GOP Ijara Sukuk	71.0
Special U.S. Dollar Bonds	6.4
Other	4.4
Floating Debt	5,099.2
MTBs for Replenishment	285.1
Market Treasury Bills	4,814.1
Unfunded Debt	3,408.5
Babbood Savings Certificates	978.1
Defense Saving Certificates	483.0
Pensioners' Benefit Account	338.2
Regular Income Certificates	559.5
Special Savings Accounts	448.8
Special Savings Certificates (Registered)	403.3
GP Fund	99.0
Postal Life Insurance Schemes	47.7
Savings Accounts	38.1
Other	12.8
Total Domestic Debt	21,676.4

84. The maturity profile of PIBs was mainly of a short duration term and the following shows the maturity profile and cumulative redemption profile:

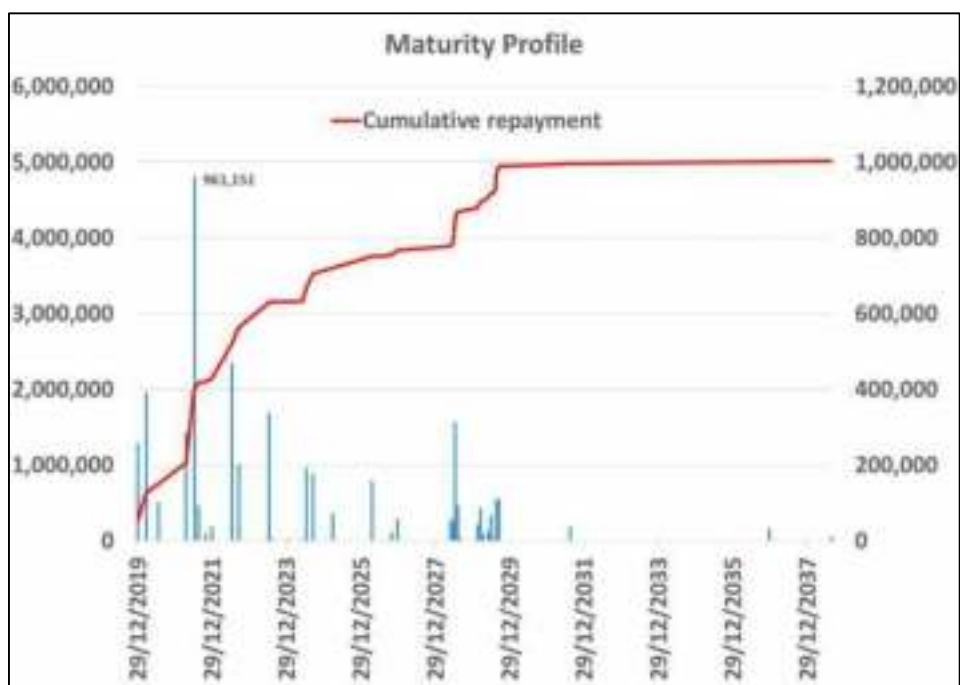


Figure 16 Maturity Profile PIBs as at 1st December 2019

85. The current profile of the PIBs means with short duration to maturity and increasing interest rates there is a large reinvestment risk and debt servicing cost. The recent re-profiling of SBP borrowing helped the government in reducing the refinancing risk of its domestic debt portfolio at end June 2019 as domestic debt maturing in one year reduced to 36 percent compared with 66 percent at end of last fiscal year. Accordingly, average time to maturity of domestic debt portfolio significantly increased to 4.2 years at end June 2019 compared with 1.6 years at end June 2018, which is very close to long-term target set by the government for its domestic debt portfolio. External debt's average time to maturity is already 7 years and government intends to maintain or slightly improve it over medium to long term

86. State Bank of Pakistan (SBP) has some monitoring parameters for the refinancing, interest rate risk, and currency rate risk for the debt composition and maturity profile as follows:

Table 14 SBP Monitoring Parameters for Risks in Government Debt

Risk Indicators	Monitoring	Indicative Ranges (MTDS 2015/16 - 2018/19)	End June 2019 Public Debt
Refinancing Risk	Average Time to Maturity (ATM) - Years	1.5 (minimum) and 2.5 - DD 3.0 (minimum) and 4.5 – PD	5.2
	Debt Maturing in 1 Year (% of total)	50% and 65% (maximum) - DD 35% and 50% (maximum) - PD	29.9
Interest Rate Risk	Average Time to Re- Fixing (ATR) - Years	1.5 (minimum) and 2.5 - DD 3.0 (minimum) and 4.5 – PD	3.2
	Debt Re-Fixing in 1 year (% of total)	50% and 65% (maximum) - DD 40% and 55% (maximum) - PD	54.9
	Fixed Rate Debt (% of total)	NA	70.6
Foreign Currency Risk (FX)	Foreign Currency Debt (% of total debt)	20% (minimum) and 35%	34.8
	Short Term FX Debt (% of reserves)	NA	158.7

87. In recent years secondary trading has been improving although primary dealers could have better quotation and spread obligations

Table 15 Secondary Debt Trading 2016 to 2019

Government Security	2016-17	2017-18	2018-19 (July-March)
Treasury Bill - 3 Months	4,954	20,114	17,093
Treasury Bill - 6 Months	3,069	3,141	34
Treasury Bill - 12 Months	2,361	258	33
Sub Total	10,384	23,513	17,160
Pakistan Investment Bonds - 3 Years	1,480	1,057	1,105
Pakistan Investment Bonds - 5 Years	1,193	1,029	626
Pakistan Investment Bonds - 10 Years	853	900	763
Pakistan Investment Bonds - 15 Years	4	10	1
Pakistan Investment Bonds - 20 Years	19	11	1
Sub Total	3,549	3,006	2,495
Government Ijara Sukuk	846	1,022	1,690
Grand Total	14,779	27,541	21,345
Daily Average volume	60	110	113
End Period Stock	8,991	9,175	6,771
Turnover ratio	1.6	3.0	3.2

88. Unfunded debt (NSS) as at December 2019 was made up as follows:

Table 16 CDNS – NSS Unfunded Debt December 2019

Unfunded Debt	3,408.5
Babhood Savings Certificates	978.1 10 year paper
Defense Saving Certificates	483.0 10 year paper
Pensioners' Benefit Account	338.2 10 year paper
Regular Income Certificates	559.5 5 year paper
Special Savings Accounts	448.8 3 year paper
Special Savings Certificates (Registered)	403.3 3 year paper
GP Fund	99.0
Postal Life Insurance Schemes	47.7
Savings Accounts	38.1
Other	12.8

89. Key National Savings Certificates had the following attributes:

Table 17 Key Parameters of NSS Certificates June 2019

Features	Defense Saving Certificates	Babhood Saving Certificates	Regular Income Certificates	Special Saving Certificates	*Pensioners Benefit Account
*Launched In	1966	2003	1993	1990	2003
Tenure	10 years	10 Years	05 Years	03 Years	10
Who can Invest	Individual and employees' funds**	A senior citizen, A single widow, physically challenged person.	Individual and employees' funds**	Individual and employees' funds**	Pensioners
Early Encashment Penalty	yes	Yes	Yes	No	Yes
Coupon payment	Zero	Monthly	Monthly	Bi-Annually	Monthly
Zakat deduction	Yes	Exempted	exempted	Yes	Exempted
Withholding Tax	Yes	Exempted	Yes	Yes	Exempted
Min & Max Limits (PKR)	100 & No Limit	1,000 & 5 million	50,000 & No Limit	100 & No Limit	10,000 & 5 Million

90. NSS returns are currently benchmarked against returns for PIBs and these are higher than equivalent money market funds:

Table 18 market returns on Money Market Funds 2016 to 2019

Funds		FY19	FY18	FY17	FY16
Atlas Money Market Fund	AAML	9.39%	5.49%	6.14%	6.02%
Atlas Sovereign Liquity Fund	AAML	8.25%	5.00%	9.38%	5.79%
ABL Cash Fund	ABL AMC	9.56%	5.41%	8.66%	5.17%
Alfalah GHP Cash Fund	AGIML	9.00%	4.70%	6.86%	5.17%
Alfalah GHP Money Market Fund	AGIML	9.10%	5.47%	5.65%	5.37%
AKD Cash Fund	AKDML	7.89%	4.69%	8.48%	5.45%
PIML Daily reserve fund	AWTIL		4.61%	6.34%	6.00%
BMA Empress Cash Fund	BMA Funds	8.84%	4.45%	4.58%	4.60%
Faysal Money Market Fund	FAML	8.87%	5.23%	7.14%	5.67%
First Habib Cash Fund	HAML	8.62%	5.42%	6.56%	5.34%
HBL Money Market Fund	HBLAML	8.47%	5.32%	6.45%	5.13%
HBL Cash Fund	HBLAML	8.89%	5.50%	7.15%	NA
JS Cash Fund	JSIL	9.47%	5.27%	5.73%	5.72%
Lakson Money Market Fund	LI	8.69%	5.47%	6.80%	5.60%
MCB Cash Management Optimizer	MCBAH	8.88%	5.41%	7.09%	5.77%
Pakistan Cash Management Fund	MCBAH	7.48%	4.67%	8.34%	5.88%
NAFA Government Security Liquid Fund	NBP Funds	8.50%	5.29%	7.64%	5.75%
NAFA Money Market Fund	NBP Funds	9.00%	5.62%	6.56%	6.34%
NIT Government Treasury Fund	NITL		5.18%	4.95%	0.00%
Askari Sovereign Cash Fund	PAOMCL		5.23%	8.48%	5.56%
UBL Liquidity Plus Fund	UBLFML	9.92%	5.51%	6.22%	5.53%
UBL Money Market Fund	UBLFML	9.84%	5.12%	5.41%	5.15%
Average Money Market Fund Return		8.88%	5.18%	6.85%	5.29%
NSS Return	RIC	9.64%	7.09%	6.36%	7.54%

91. Interest rate servicing is very high and with the continued expected inflation rate it will continue to be so.

Table 19 Interest Servicing Costs 2013 to 2019

(US\$ in million)	2013	2014	2015	2016	2017	2018-19	
						2018 (July-March)	
Multilateral	217	204	219	239	295	357	333
Bilateral	357	386	385	380	441	444	419
Bonds	111	111	300	364	366	423	284
Commercial	0	4	9	33	66	260	276
IMF	100	52	39	61	86	128	108
Short Term Government De	11	16	22	69	58	72	50
Others	4	3	1	0	0	0	0
Total Interest Payments	800	775	975	1,127	1,313	1,604	1,470

92. As at June 2019 the position on debt was as follows and now gross debt less government deposits is over 75% GDP. At September 2019 provisional total debt was 41.5 trillion 65% higher than June 2017.

Table 20 Summary of Pakistan's Debt and Liabilities 2017 to 2019

Table 5.1: Summary of Pakistan's Debt and Liabilities trillion Rupees							
	Stock			Percent of GDP		Absolute change	
	FY17	FY18	FY19	FY18	FY19	FY18	FY19
A. Total Debt and Liabilities (sum I to IX)	25.1	29.9	40.2	86.3	104.3	4.8	10.3
B. Gross Public Debt (sum I to III)	21.4	25.0	32.7	72.1	84.8	3.5	7.8
Total Debt of the Government (I+II+III-X)	19.8	23.0	29.5	66.5	76.6	3.4	6.5
I. Government Domestic Debt	14.8	16.4	20.7	47.4	55.8	1.6	4.3
II. Government External Debt	5.9	7.8	11.1	22.5	28.7	1.9	3.3
of which exchange rate impact						1.3	2.8
III. Debt from IMF	0.6	0.7	0.9	2.1	2.4	0.1	0.2
IV. External Liabilities	0.4	0.6	1.7	1.8	4.4	0.2	1.1
V. Private Sector External Debt	1.2	1.7	2.5	4.8	6.4	0.5	0.8
VI. PSEs External Debt	0.3	0.3	0.7	0.9	1.7	0.0	0.3
VII. PSEs Domestic Debt	0.8	1.1	1.4	3.1	3.6	0.2	0.3
VIII. Commodity Operations	0.7	0.8	0.8	2.4	2.0	0.1	(0.1)
IX. Intercompany External Debt	0.4	0.4	0.5	1.3	1.4	0.1	0.1
X. Deposits with banking system	1.8	1.9	3.2	5.6	8.3	0.1	1.3

Data source: State Bank of Pakistan

93. Gross government debt less government deposit to GDP grew above 75% by June 2019:



Figure 17 Debt to GDP Percentage 2011 to 2019

94.

Measures to improve domestic debt operations (PIBs & NSS)

Developing a professional fully function DMO with responsibility for all debt strategy

95. The mandate of the DMO is not that clearly defined and currently it has limited capacity to undertake all the necessary functions of a fully professional and well-functioning DMO.

96. Most DMOs have the objective to develop the market as a more liquid market that will reduce the cost of government issuance and give the market long-term sustainability as a clearly stated objective in their laws or charters. Some examples are given below:

Mission – Thailand DMO:

- Manage public debt efficiently and effectively under the relevant legal framework and IT system to achieve fiscal sustainability and economic development.

UK DMO – main aims:

- a. to carry out the government's debt management policy of minimizing its financing cost over the long-term taking account of risk;
- b. to minimize the cost of offsetting the government's net cash flows over time (while operating within a risk appetite approved by ministers);
- c. to provide loans to local authorities for capital purposes; and
- d. to manage the funds of selected public sector bodies.

97. Both the DMOs quoted would see market development as a key part of their role, so that even in circumstances of fiscal surplus they will continue to issue debt to maintain and sustain the debt market and provide benchmark rates. Both Thailand and the UK are bound by a debt ceiling of 30% of GDP. In practice this may be a more substantive restriction that it at first appears since the 30% includes external debt (which is not large) but more importantly SOE debt and central government guarantees of SOE debts. Pakistan is currently over 76% of GDP.

Improve the capacity of the DMO

98. The DMO as currently envisioned is a new function to be set up for a market under stress. Its functions encompass all government indebtedness. The focus here is on the capacity requirements of the government securities market. The demands of the government securities market are complex and technical and with the stress being experienced they will become more so as time passes. Among the areas where they will require expertise are:

- a. Establishing a professional DMO with front, middle and back office skills;
- b. Producing a borrowing plan and debt management strategy from the Government's overall Financial Strategy;
- c. Developing systems for cash flow analysis from budgetary processes;
- d. Undertaking buybacks, swaps and reopening of issues to consolidate benchmark bond issues over the yield curve;
- e. Analysis and introduction of alternative issues such as infrastructure bonds, sukuks and inflation indexed bonds;
- f. Overseeing reforms to hybrid and accrual accounting for PIBs and NSS;
- g. Producing and managing an auction calendar from the borrowing plan;
- h. Decisions on optimal maturity profile for government debt including that of NSS;
- i. Evaluating and publishing auction results;
- j. Development and operation of IT systems for managing government debt. and
- k. At a later date assessing and evaluating the performance of PDs;

99. The DMO will require extensive capacity-building assistance over a long period as the market reforms. This may involve technical assistance with the development of appropriate tools and technology.

Develop DMO capacity and resources

100. Most of the recommendations here require action from the DMO supported by MoF and SBP who currently is responsible for issuance as agent for the Government. This will require a substantial

upscaling of resources, both in number and skill level, if the necessary reforms are to be implemented.

Recommendation: Plan for a substantial capacity increase at the DMO establishing a professional DMO which is a key requirement to driving the government bond market forward.

Broaden the investor base

101. The current investor base for government securities in Pakistan is almost exclusively commercial banks. This is undesirable for several reasons.
- a. Commercial banks should devote their main energies to lending to corporate and individual clients. This is their area of expertise and where they make the major contribution to economic development. They may be required for prudential reasons to hold some government bonds, but it should not be a major part of their business or their portfolio;
 - b. Banks have other business lines and when these offer better returns than government bonds, they will not bid in the auctions.
 - c. Currently government bonds in Pakistan are relatively short-term. If the average maturity of issuance increases, the ability and desirability of banks buying government bonds will decline. Prudential requirements will restrict banks' investment in long-term bonds (though this may be easier if the secondary market was more liquid).
102. Long-term savings institutions are the natural investors in longer-term bonds – life insurance companies, funded-pension schemes and mutual funds. Indeed, such investors are very keen buyers of longer bonds as they need to match their long-term liabilities. Foreign investors may also be interested though currency considerations will weigh heavily in their investment decisions. None of these investors are substantial in Pakistan currently. There should be plans to develop these investors because life insurance, pension funds and mutual funds are developments which improve the welfare of the population, but the plans will be longer-term. It may be possible to expedite the process by permitting foreign firms to enter the market for these products.

Broaden instruments

103. There could be investor appetite for alternative debt issues:
- a. **Infrastructure bonds** The choice of infrastructure bonds then becomes a trade-off between lower liquidity and higher security from the SPV structure.
 - b. **Sukuk/Islamic bonds** claims of Sukuk investors. As noted, regulations for ensuring Sharia compliance and for SPVs do not yet exist in.
 - c. **Inflation-linked bonds** pay a yield equivalent to a real-rate of interest plus the rate of inflation. The yield is reset annually based upon an established inflation measure. Such bonds can be quite expensive in countries where inflation is rising so governments typically issue inflation-linked bonds when inflation is being brought under control. They tend to be a somewhat specialized sector of the bond market as they are complicated to price and so hard to trade.
 - d. **Floating Rate Notes (FRNs)** have a yield which varies in line with a benchmark yield. Like inflation-linked bonds they are difficult to price and therefore not easy to trade. From an issuer point of view, it also means that if the benchmark rate rises then the yield (and hence cost to issuer) on previously issued FRNs also rises whereas with conventional fixed-rate bonds only the yield on new bonds rises.
 - e. **Local government, municipal or regional government bonds**

104. **Recommendation:** The DMO should consult with the market including investors and potential investors on the market's appetite for different types of issues (but always being mindful of the cost of too much fragmentation).

Institute a Treasury Single Account (TSA)

105. **Recommendation:** Institute a Treasury Single Account (TSA) across the 56,000 Depts, Agencies and SOEs which hold surplus funds with banks involving – An end of Day Sweep process – a question will be How to share interest savings to be determined? The implementation should be coordinated with work by other donors who have established TA projects in this area.

Reforms to the auction issuance

106. **Recommendation:** Institute the follow:
- a. Implement the volume driven auctions of PIBs through adherence to target volumes to facilitate determination of market-based yields. Establish guidelines as to the auctions level of acceptance amount within a maximum variance like 25%. An example might be:
 - i. min acceptance 50%
 - ii. range 75% to 125%
 - b. Introduce a methodology so that PDs basically underwrite the auction in a manner like India and Sri Lanka where PDs commit to a slightly higher level of bids to their proportion of the offering
 - c. Implement a plan to facilitate more institutional volume as a result of the auction by increasing the percentage of auction that can be taken up as a non-competitive bid (some markets allow up to 10% to 20% of offer with increasing gradually maximum individual bids to 0.5% to 1% of auction amount)
 - d. Expansion of PDs beyond banks, DMO/SBP to consider changes to rules to enable suitably qualified brokers, investment banks and institutions to apply to be Primary Dealers
 - e. Develop appropriate electronic platforms for both the auction process and quotations and trading purposes
 - f. Reduce and consolidate the existing number of PIB issues, creating benchmark issues and develop a longer dated yield curve with additional benchmark issues. PIBs on issue can be managed via appropriate buyback, reopening and bond swap operations.
 - g. Review PD contracts to ensure a fair balance of rights and obligations including required secondary trading quotations at minimum levels and spreads which can be monitored for compliance
 - h. Implement via an appropriate entity (such as National Institutional Facilitation Technologies Pte Limited) the bond price agency rules (2017) and a Establish Bond Reporting Agency for Pakistan
 - i. DMO/SBP to engage on a regular, monthly or bi-monthly basis, with PDs to formally discuss market conditions and the DMO's forward issuance program as well as to share and receive market intelligence considering changing market conditions. DMO/SBP to issue minutes of these deliberations to achieve appropriate outcomes in line with DMOs objectives.

Introduce accrual accounting for PIBs

107. **Recommendation:** Institute accrual accounting for PIB outstanding issues and properly account for discounted issues and accrued interest positions. (A modified Hybrid approach may be needed)

Expected outcomes

No	Tasks	Outcomes	Deadline/Implementation period	Responsible Entities
1	Establishment of a professional DMO with front, middle, and back office capabilities	A strong, fully functional, debt management office, with capacity to provide the government with first class professional advice and undertake the required analysis to structure debt issuance across the yield curve manage debt servicing cost and reinvestment risk in the most efficient manner	Commencing in 2020 with aim to have proper functioning process by 2023 and best of class in 2025 IMF & WB has recently completed a TA mission on debt management and there will be a need for coordination between the IFIs on the proposed policy recommendations.	MOF DMO and SBP
2	Implement a single debt management strategy including NSS issuance and redemption program	A single coordinated debt management strategy with the benefit of reduced servicing cost and efficiencies by ensuring a single coordinated forward yield curve	Commencing in 2020 and fully implemented by 2022	MOF DMO CDNS
3	Develop and implement closer budgetary cash flow forecasting regime to ensure accuracy of underlying numbers for decision making and aid debt strategy coordination	DMO which has appropriate information flows, aided by TSA process, appropriate technology and modelling tools to ensure proper decision making and strategy selection	Commencing in 2020 and fully implemented by 2022	MOF DMO CDNS
4	Institute a Treasury Single Account (TSA) across the 56,000 Depts, Agencies and SOEs which hold surplus funds with banks – End of Day Sweep process How to share interest savings to be determined	Reduced expense and better control over government cash resources. Efficient cash management Some downside to entities who may have reduced earnings from overnight position centralisation.	Logistically this will need a phased approach and will take some years to implement. Commencing in 2020 with 805 of large balances across larger government entities completed by 2021 and balance by 2025 Early decisions will be needed to be made in relation to pension and Trust Funds as to whether they are centralised. It is noted that the processes and timelines of this activity will need to be set consistent with the requirements as set by other IFIs	MOF DMO SBP and appropriate SOE and ministries

			who have TAs related to this matter.	
5	Implement the volume driven auctions of PIBs through adherence to target volumes to facilitate determination of market-based yields. Establish guidelines as to the auctions level of acceptance amount within a maximum variance like 25%. An example might be: min acceptance 50% range 75% to 125%	Better auction outcomes at Tighter bid spreads	2020-2021	MOF DMO SBP
6	Introduce a methodology so that PDs basically underwrite the auction in a manner like India and Sri Lanka where PDs commit to a slightly higher level of bids to their proportion of the offering	More certainty as to auction fulfilment	2021	MOF DMO SBP
7	Whilst Non-bank financial institutions (e.g. brokers, investment bank, DFIs) are already eligible to apply PDS it is recommended that DMO/SBP to consider further changes to rules to enable suitably qualified brokers, investment banks and institutions to apply to be Primary Dealers	More diverse set of entities acting as primary dealers which should encourage more secondary trading	2020-2021	DMO SBP SECP
8	Reduce and consolidate the existing number of PIB issues, creating benchmark issues and develop a longer dated yield curve with additional benchmark issues. PIBs on issue can be managed via appropriate buyback, reopening and bond swap operations.	More efficient and liquid building process, reduced reinvestment risk and more volume outstanding at key benchmark yield dates	2020-2021	DMO
9	Review PD contracts to ensure a fair balance of rights and obligations including required secondary trading	Help develop secondary trading and balance their preferred treatment in auction process	2020	DMO SBP

	quotations at minimum levels and spreads which can be monitored for compliance			
10	Implement via an appropriate entity (such as National Institutional Facilitation Technologies Pte Limited) the bond price agency rules (2017) and a Establish Bond Reporting Agency for Pakistan that will cover corporate bonds. The reporting agency could also provide links of Government bond reported to SBP to provide a comprehensive database of traded prices on its porta;/website	This will aid to improve price transparency of all trading both OTC and exchange and provide a foundation to develop yield curves based on market trading. Also, prices collected on all transactions will help develop pricing for non-government debt as well.	2020-2022	SECP SBP
11	DMO to engage on a quarterly basis, with PDs in coordination with SBP to formally discuss market conditions and the DMO's forward issuance program as well as to share and receive market intelligence considering changing market conditions. SBP to record minutes of these deliberations to achieve appropriate outcomes in line with DMOs objectives.	Better engagement with PDs and flow of market condition feedback. Provides PD's an opportunity to let DMO challenges and likely auction uptakes and make PDs part of financing efforts of the government borrowings	2020	DMO SBP
12	Institute accrual accounting for PIB outstanding issues and properly account for discounted issues and accrued interest positions (A modified Hybrid approach may be needed)	Proper reflection of outstanding issues and accrued interest on governments accounting records	2020 -2021	DMO MOF

Reform of CDNS and NSS

Corporatize CDNS and establish a regulator

108. There are many issues to be addressed they can be stratified into the following areas:

- a. Giving CDNS a clearer more transparent corporate structure with a regulator to provide oversight of its operations and as a corporate entity create an on balance sheet approach to its assets and liabilities and provide returns to investors in line with it operating as a collective investment operation; and
- b. Improve NSS's operational efficiency and remove existing anomalies such as double dipping, institutional application acceptance and the "so called" free put.

Giving CDNS a clearer more transparent corporate structure

109. **Recommendation:** Corporatize the NSS/CDNS in preparation to making it a more accountable funded entity and provide a basis for protection of investors via regulated products. Further it is necessary to determine who should be its regulator to oversee assets and liabilities, risk management and investor protection including KYC. Logically SBP would seem the appropriate regulator. However, current laws may need adjustment to enable SBP to be the regulator.

110. **Recommendation:** Institute accrual accounting for NSS in order to fully account for all liabilities

Improve NSS's operational efficiency

111. **Recommendation:** Increase rate of branch digitisation in order to be prepared to implement accrual accounting and to be prepared to dematerialise certificates

112. **Recommendation:** Do not accept new institutional holders in the NSS

113. **Recommendation:** Dematerialise and digitise saving certificates this can be achieved by utilizing the existing securities depository, CDC.

114. **Recommendation:** With digitisation establish an effective compliance program to eliminate double dipping by certificate holders

115. **Recommendation:** Create a project to rationalise the distribution network for NSS and make the process much more streamlined and efficient.

116. **Recommendation:** Improve integrity of account opening for NSS (AML/CTF standards) by following through on recent announcements to address this issue

117. **Recommendation:** Create new and innovative mobile applications and bank account linkages to improve distribution and servicing of certificate holders including streamlining KYC processes once implemented the front office functions of opening and maintaining cash and securities account should be performed by Banks and CDC respectively (it is noted that there has been ongoing involvement of CDC and CDNS in achieving such a process)

Outcomes

No	Tasks	Outcomes	Deadline/Implementation period	Responsible Entities
1	Corporatize the NSS/CDNS in preparation to making it a more accountable funded entity and provide a basis for protection of investors via regulated products. Further it is necessary to determine who should be its regulator to oversee assets and liabilities, risk management and investor protection including KYC. - To determine the appropriate regulator, a detailed analysis should be carried out, preferably by a working group of all stakeholders.	Currently the CDNS is a Government department and corporatisation will help to implement many of the proposed reforms envisaged. It will also provide a better footing for its overall governance structure and executive management as it is modernised.	2020-2021	CDNS SBP SECP

2	Eliminate new applications by institutional holders in the NSS	This will regularise a long outstanding issue of preference treatment compared to alternative products and better reflect on the government social reasons for NSS	2020 - 2022	DMO CDNS
3	Institute accrual accounting for NSS in order to fully account for all liabilities	This will bring NSS into line with best international practice and provide a solid base for the calculation of true liabilities of NSS	2020-2022	CDNS
4	Increase rate of branch digitisation in order to be prepared to implement accrual accounting and to be prepared to dematerialise certificates	In order to facilitate the various reforms full digitisation of branch will be necessary. This process is essential and is an enabler to accrual accounting and dematerialisation.	2020-2021	CDNS
5	Dematerialise and digitise saving certificates this can be achieved by utilizing the existing securities depository, CDC.	It is noted that there have been discussions with CDC and that implementation will require digitization. It should not be rushed, and due operational checks incorporated to cover cyber security and investor protection particularly for technology challenged elderly customers	New issues commencing from 2021 phased implementation to 2025	CDNS CDC
6	With digitisation establish an effective compliance program to eliminate double dipping by certificate holders	Reduced servicing cost and better alignment and compliance with government social goals	2020- 2021	CDNS
7	Create a project to rationalise the distribution network for NSS and make the process much more streamlined and efficient.	Greater efficiency and reduced costs. It is noted that CDNS plan introduction of ATM/Debit Card in 2020	2020 -2021	CDNS
8	Improve integrity of account opening for NSS (AML/CTF standards) by following through on recent announcements including appointing a commercial bank agent to address this issue	Appropriate AML regime in place and neutrality of decision improved by eliminating uncontrolled account opening	2020	CDNS / Banks
9	Create new and innovative mobile applications and bank account linkages to improve distribution and servicing of certificate holders including streamlining KYC processes	Assist with transition to dematerialised environment and improve efficiency at lower cost CDNS advised it is progressing with a donor to develop a mobile app for this purpose	2020-2025	CDNS / Banks

Equity Securities

Summary

118. The supply of new securities on the Pakistan Stock Exchange has substantially dried up over the past ten years. Although there are around 544 listed companies a fewer than 15 have enough liquidity to qualify as investible for most global funds.
119. Pakistan Stock Exchange seems to have lost its role as an avenue for raising capital to fund growth capital. Instead of going public, entrepreneurs are preferring to tap domestic private equity, venture funds, growing angel investor circles and even overseas private equity. This deprives domestic investor base from getting exposure to high quality growth companies.
120. The government has relaunched its privatization program and published a list of 45 state owned entities which will be privatized. In the past, privatization and listing of state-owned entities in the banking and oil and gas sector was highly instrumental in enhancing the retail base of investors.
121. The other policy measure which has worked in the past in attracting companies to go public is tax incentives. In the 80s and 90's many companies, especially from the textile industry went public in order to avail corporate tax incentives. Given the high sensitivity of Pakistani corporates to such incentives, it might be a good model for enhancing the supply of new equity on the stock market.
122. Pakistan has high interest rates and faces a crowding out of private sector lending due to excessive government borrowing. Consequently, developing the stock exchange as a venue for raising capital will not only improve economic efficiency by enhancing the access to credit but also lower the financial risk of corporate sector.
123. The lack of availability of liquid securities to invest in is a major hurdle for foreign institutional investors. Pakistan also faces a risk of demotion from MSCI Emerging Markets Index to a Frontier Market status due to low levels of trading liquidity. Many companies have less than 5% of effective free float. Our recommendation is for the exchange to force delisting of companies which are in breach of their listing standards.
124. Our recommendation is for the government to privatize through divestment on the Pakistan Stock Exchange rather than through trade sale. Privatization of state-owned entities has proven to be the most effective tool for increasing retail investor participation. We also suggest the government to list the infrastructure projects which are a part of CPEC. This will not only provide investors with assets which have recurring cash flow but also enhance transparency of those projects.
125. It is also recommended reviewing the stock exchange board structure and listing rules to reduce the cost of raising capital. We endorse the setting up of the new proposed Growth Enterprise Market (GEM) which will replace the SME Board. We recommend tax incentives for companies who list on the Growth Enterprise Market. In most global markets, the technology sector now accounts for 15-20%+ weight in the overall market. In Pakistan, this is less than 3% with only 5 listed companies. This can be solved by encouraging the growth and development of the GEM.
126. There is a large pipeline of large infrastructure projects and businesses which have been funded by private equity and development finance institutions such as Karandaaz. We encourage the Stock Exchange to establish linkages with technology incubators, VC funds and Private Equity in order to attract the companies to prepare for listing on the Exchange. The outreach model of Euronext, where they have ambassadors who do regular presentation at tech incubators is a good example to follow.

Diagnostic

Primary / New listings

127. During the nine-year period of 2000-2008 85 companies went public on the Pakistan Stock Exchange. In comparison over the last ten years only 46 companies have listed on PSX.



Figure 18 Number of new listings on Pakistan Stock Exchange

Source: Pakistan Stock Exchange

128. Instead of using the formal capital markets, entrepreneurs are going to alternative venues for raising capital. According to a recent report on Pakistan Startup Eco-system published by i2i Ventures in collaboration with the World Bank (click here), over the past five years, there were a total of 101 deals in Pakistan-based companies, where more than \$165m was raised by 82 companies. This of course far exceeds the number of deals and the capital raised on the Pakistan Stock Exchange.
129. Just in the first week of November 2019, additional capital raising of around \$20m have been announced. i2i's report also does not include M&A transactions of Daraz by Alibaba, Careem by Uber and the 47% stake in Telenor's Easypaisa by Ant Financial.
130. The rules of listing on the exchange currently do not allow capital raising by early stage companies which are not profitable.

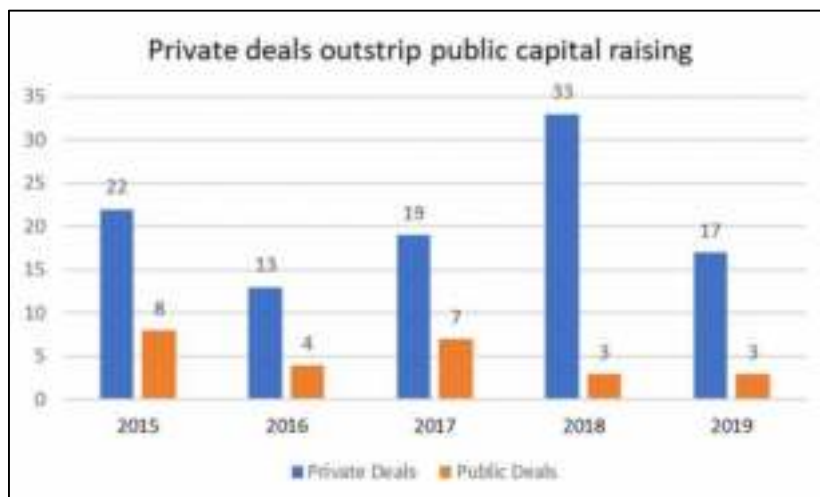


Figure 19 The number of capital-raising deals in the private and public space

Source: Pakistan Stock Exchange, i2i Venture Pakistan Start Eco-System Report 2019

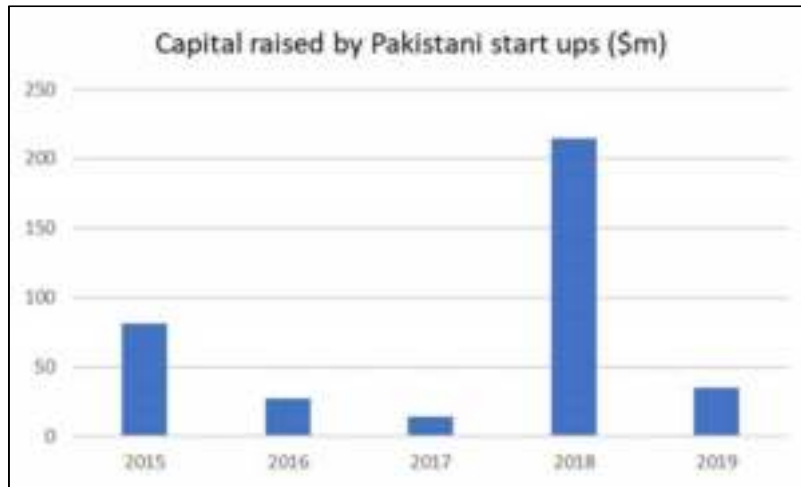


Figure 20 Start Ups Raisings - More than \$400m raised in private deals over the past 4 years

Source: i2i Venture Pakistan Start Eco-System Report 2019

131. One of the reasons for this lack of interest by companies to list is the tough rules. The rules essentially exclude early stage companies and discourage growth companies who do not pay a regular, steady dividend. The cost of compliance with the listing requirements such as the code of corporate governance is also high and restrictive. Listing on Pakistan Stock Exchange is more difficult than most global stock exchanges.

Table 21 Survey of listing requirements of Stock Exchanges

Survey of listing requirements of global stock exchanges

	Pakistan Stock Exchange		UK: London Stock Exchange		Frankfurt Stock Exchange		Euronext		
	Main Board	SME	Main	AIM	Main	Scale	Euronext	Growth	Access/Access+
Company needs to be profitable	Yes	Yes	No	No	No	No* (if it meets other requirements)	Yes	No	No
Company needs to have financial history	Yes	Yes	3 years	No	3 years	2 years	3 years	2 years	No
Approved Prospectus	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	No
Minimum freefloat requirement	Yes	Yes	25%	No	25%	10%	€5m	€2.5m	No

Source: PSX, Euronext, Deutsche Borse, London Stock Exchange

132. Besides muted interest of new business in going public, there is also very low liquidity in the companies which are listed. Only 14 companies have average daily traded value close to or over \$1m.

Table 22 Stocks with \$1m or more daily trading value

Most Liquid Stocks on the PSX	
Company	ADTV (USD MN)
Bank Al Habib	2.92
Meezan Bank	2.72
Lucky Cement	2.33
OGDC	2.09
UBL	1.43
KAPCO	1.34
DG Khan Cement	1.28
PPL	1.22
Engro Corp	1.17
Searle	1.12
SNGP	1.03
Pakistan State Oil	0.99
Maple Leaf Cement	0.99
Habib Bank	0.98
Source: PSX	

133. According to our analysis based on the data shared by NCCPL, 20% companies listed on PSX (85) account for 94% of the total trading value. The top 7% (41 companies) account for 80% of the trading volume.
134. Typically, privatization drives are the most effective ways of increasing retail participation. The state can choose to price the listing at an attractive price to ensure that the investors generate a positive return from them. This was indeed the case in Pakistan in the early 2000.
135. Management of CDC and NCCPL stated that there used to be rush for new account opening during the time of the listing of OGDC and PPL. Other countries have seen similar results. In India for example, retail investors have to be offered 35% of the total capital raised.
136. It is not uncommon for companies to “leave some money on the table” during IPOs in order to reward the shareholders for participating in the IPO and to be make the IPO successful. In Pakistan, according to a research note by KASB Securities, the average returns generated by the past 34 public listing was 12% higher than the KSE-100 benchmark.

Recommendations

Primary / New listings

137. Privatization of state-owned entities through listing on the exchange. We think the most effective way to improve the supply of equities is for the government to divest its stake in state owned entities through the exchange. The Privatization Commission has a published a list of 49 companies which will be privatized. The plan is to divest stake in OGDC and PPL on the market. The government should be pushed to also divest some of the SOE partially on the stock market. This should also improve the sale process and get a trading price for the sale of management control to a strategic buyer and also ensure that there is some public ownership of state-owned assets.
138. In the banking sector the government made it mandatory for all the banks to be publicly listed. The banking sector now accounts for around 30% sector weight in the market and besides oil and gas

is the most actively traded sector. The government could consider a similar policy for state owned entities and for companies in other licensed activities such as telecom, media, and power sector.

139. Pakistan has a growing, large and profitable telecom industry. The four large telecom operators; Telenor, Veon, PTCL and Zhong are owned by international companies. These companies should be encouraged to partially list domestically. We think this should also enhance financial transparency in this sector and could help avoid potential for an India like situation, where there were a lot of scandals associated with the auction for telecom licenses. Any sector which has a substantial dealing with the state, or the public it is suggested should have some shared ownership with the public, or at least in the first stage, be asked to make the financial statements available to the public.
140. Listing of Infrastructure assets. Large scale infrastructure projects such as railways, roads, power projects which have been financed under CPEC are ideal candidates to be listed on the exchange. Some of them might even qualify as Shariah compliant given the Sukuk which already have been structured on the underlying assets. For example, Kartarpoor project which has been developed and is managed by the FWO could be an attractive asset to be listed on the exchange. The government is developing special tourist resorts and areas, especially in the Northern Areas. These projects can be listed on the exchange.
141. This should also help address the concerns around financial transparency associated with projects related to CPEC.
142. The listing of companies with stable and recurring cash flow should also be beneficial on the demand side to pension funds and insurance companies, who at present lack sufficient suitable stocks to invest in.
143. Support the set up and development of the Growth Enterprise Market. The rules of listing on the Main Board of Pakistan Stock Exchange do not allow listing of early stage growth companies; though amendments have been made recently but impact is yet to be seen. Furthermore, strict corporate governance rules discourage first time entrepreneur who do not have an established career history. Consequently, technology sector only accounts for a less than 3% weight in the Pakistan market compared to more than 20% in most global markets. We support the set up of the proposed Growth Enterprise Market by the SECP as a replacement to the SME Board. The SME Board failed to get a single new listing.
144. The proposed rules for the Growth Enterprise Market allow for companies to raise capital for early stage companies from institutional and accredited investors. GEM does not impose the requirement for 5-year financial history and does not require strict adherence to the code of corporate governance. The proposed rules are still more restrictive than those in other international exchanges which have been set up to encourage early stage companies such as the AIM in the UK and Growth and Access markets of Euronext. These Exchanges do not restrict the sale of equity in the junior markets to only accredited investors.
145. In the UK, the AIM mandates nominated advisors and corporates brokers of the publicly listed companies to publish investment research on their corporate clients. In Pakistan, investment research coverage on listed companies is limited to the top 40 companies (less than 10% of the listed companies). All listed companies should be encouraged to keep an updated investor relations presentation and an investment research report on the Investor Relations section on their website.
146. Encouraging funds such as NIC/Ignite/Karandaaz to participate in the GEM market. The government has helped set up and fund various private equity and venture capital funds to invest in early stage companies. The most active is Ignite Fund, which is funded through a R&D contribution from the telecom companies. The Ignite has backed the establishment of National Incubation Centers in various cities. Other State backed funds include Plan 9, Plan X. Some development finance institutions such as Bill and Melinda Gates Foundation and DFID have also set up private equity funds such as Karandaaz and Boltoro. Pakistan Stock Exchange should develop linkages with these incubators, so that the entrepreneurs could be trained at an early stage on how to prepare their companies for eventual listing on the exchange. The funds should

also be provided incentives to participate in further capital rounds for their companies through the exchange.

147. Tax incentives for growth companies to list on GEM. Historic precedence shows that the corporate sector responds very strongly to tax incentives. In the 80s and 90s a lot of textile companies went public to exploit a corporate tax incentive. We think that in the technology sector, Pakistan faces a risk that global capital will acquire local companies at an early stage or the local companies with chose to list in international markets. This is already the case with existing technology companies listed in Pakistan; TRG Pakistan, Systems and Netsol, the main three technology companies have global holding companies which are domiciled in the US. In order to avoid the risk of losing the growing technology sector to global competition we think the government should consider providing with explicit tax incentives.
148. IPO process should be made disclosure based instead of approval based with only listing approval by the securities exchange. IPO process has improved a lot in recent times but remains approval based that take times. This should reduce time to listing and cost thereby encouraging companies to seek listing. With a demutualized exchange and licensed consultant to the issue role of SECP in approval should eliminated.
149. PSX should put in place hand-holding mechanism to facilitate newly listed companies so that these can cope with regulatory requirements. There is a marked difference between regulatory and disclosure requirements for an unlisted and listed companies; any delayed or misreporting undermines investor confidence. Globally securities exchanges provide these services to attract new listing and ensure quality of listing board.

Secondary Market

150. Implementation of free float requirement for new and existing companies and take measures to increase free float through stock split and tax incentive. Higher free float is prerequisite for generating liquidity and also critical for an orderly market. Tax incentive linked with free float for new companies would encourage higher offering at IPO. For existing companies' awareness about stock split (absolute free float) should be created, CDC cost should be eliminated, and lastly onetime tax incentive should be worked out.
151. Mandate all listed companies to have their updated Investment Relations presentation on the website. Encourage all listed companies to have active research coverage. Less than 10% of the listed companies have active research coverage. Lack of information make them difficult to invest in and prone to more speculative trading. Research coverage should improve financial transparency and encourage better corporate governance.

No	Action	Outcome	Timing	Responsible
1	IPO process should be made disclosure based instead of approval based with only listing approval by the securities exchange.	IPO process has improved a lot in recent times but remains approval based that take times. This should reduce time to listing and cost thereby encouraging companies to seek listing. With a demutualized exchange and licensed consultant to the issue role of SECP in approval should eliminated.	Medium Term	SECP, PSX
2	PSX should put in place hand-holding mechanism to facilitate newly listed companies so that these can cope with regulatory requirements.	There is a marked difference between regulatory and disclosure requirements for an unlisted and listed companies; any delayed or misreporting undermines investor confidence. Globally securities exchanges provide these services to attract new	Short Term	PSX

		listing and ensure quality of listing board.		
3	Implementation of free float requirement for new and existing companies and take measures to increase free float through stock split, tax incentive and mandating dematerialization of shares of listed companies under sections 72 of companies Act 2017.	Higher free float is prerequisite for generating liquidity and also critical for an orderly market. Tax incentive linked with free float for new companies would encourage higher offering at IPO. For existing companies' awareness about stock split (absolute free float) should be created, CDC cost should be eliminated, onetime tax incentive should be worked out, lastly powers under section 72 of companies Act 2017 be invoked for listed companies	Short Term	PSX, CDC, FBR, SECP
4	Mandate the Privatization Commission to give preference to floating state owned companies on Pakistan Stock Exchange rather than through trade sale. Increase the free float of NBP, PSO, OGDC, PPL and MARI by divesting additional stake in the market over the next 12 months. List National Investment Trust (NIT) on the stock exchange. However, while offloading the Government holdings in SOEs through the stock exchange issues like retention of controlling interest may be given due consideration.	This should improve the liquidity of tradeable equities on PSX and makes these companies more investible, especially for global institutional investors. Increase in free float of OGDC and PPL should also help in Pakistan's case to defend its position in MSCI Emerging Markets Index. Privatizations have historically proven to be a highly effective policy tool to increase retail participation in the stock exchange.	Short term (over the next 12 months). Privatization has been on the government agenda since early 90's but is consistently delayed. Therefore, time bounding this action is necessary.	MOF in collaboration with Privatization Commission, SECP and PSX.
5	Mandate all listed companies to have their updated Investment Relations presentation on the website.	This will enhance financial transparency for investors and make the companies more investible.	Short term	SECP and PSX
6	Encourage all listed companies to have active research coverage.	Less than 10% of the listed companies have active research coverage. Lack of information make them difficult to invest in and prone to more speculative trading. Research coverage should improve financial transparency and encourage better corporate governance.	Short term	PSX

7	Promote Growth Enterprise Market (GEM) to Private Equity and Venture Capital investors by arranging outreach events at Incubators/tech conferences etc.	This should introduce a new cohort of investors in the capital market. Private Equity companies can be a good source of future listing deal flow for GEM.	Short term	PSX
8	Open the GEM market to all investors by removing the restriction on retail investors.	This should allow GEM to be marketed more actively to the general public.	Short term	SECP and PSX
9	Mandate the government to devise a plan for listing of infrastructure projects in areas such power, transportation and tourism.	This should improve the supply of assets which can produce recurring, long term cash flows, and attract greater investments by global infrastructure funds and insurance companies in the stock market.	Medium term.	MoF in collaboration with SECP and PSX
10	Provide tax incentives for companies to list on GEM.	Tax incentives have proven to be highly effective in encouraging companies to go public. This should enhance the supply of equities on the exchange.	Medium term	MoF, SECP and FBR.

Private Equity

Diagnostics

152. Pakistan's private equity industry is still struggling to develop. The rules are restrictive which encourages asset managers to use offshore structures.
153. There are only three private equity companies who are licensed locally; Ijarah Capital, Lakson Private Equity and PNO Capital. Most other private equity funds such as JS Private Equity, Abraaj Pakistan Fund, Boltoro Capital use offshore structures, or like Karandaaz and Cyan, use a corporate investment structure. During our discussions, even Lakson Private Equity, which is using an onshore structure stated that local regulations will force them to use an offshore vehicle.
154. The primary source of capital backing Pakistan's private equity industry has been development funds such as the US government backed Private Public Infrastructure Fund (later called OPIC Fund), DFID, IFC and USAID. Development finance focused funds such as CDC and IFC have also done direct investments.
155. The Government of Pakistan first introduced regulations on the sector in 1995 and later after the creation of SECPN these were issued under the NBFC framework. The regulations have been revised three times. The last revision was the Private Funds Regulations in 2015 (PE Regulations) under section 282B (2) of the Companies Ordinance, 1984 to make detailed provisions for matters related to private equity, venture capital and alternative funds.
156. Most industry participants consider the rules on private equity to be too restrictive. Also they feel that the restrictions on the repatriation of capital by the State Bank of Pakistan prevent the industry from accessing foreign capital into domestic fund structures.
157. Some of the issues raised by the industry are:
- a. Restrictions on investment in private equity for banks/DFI: Under the Prudential Regulations, banks/DFIs can make investments in PE funds up to (a) 5% of their equity, or (b) 10% of the units of a PE fund, whichever is lower. Any investment beyond these limits requires special approval of SBP, which evaluates any such request in the light of nature of relationship of the investing bank/DFI and the investee company, and financial standing, aggregate investment portfolio, experience in managing such type of investment and efficacy of internal controls of the investing bank/DFI. The regulators have taken a cautious approach based on previous cases of banks misusing NBFCs such as modarabas to park non-performing loans. Also the aggregate investments in equity products, including PE funds, of the banks/DFIs that mobilize funds through deposits should not exceed 30% of their equity; and, for DFIs and Islamic banks that do not mobilize funds through deposits, the said cap is 35% of the equity of such banks/DFIs;
 - b. Prohibition for investment in private equity for retail investors, insurance companies and pension funds. Under the current rules private equity funds can only be marketed to accredited investors. A fund cannot have more than 30 investors. Pension funds and Insurance companies which are generally patient capital with long term investment horizons are not allowed to invest in private equity. Private Equity funds can also not be listed on the exchange;
 - c. Pakistan's forex regime under the Foreign Exchange Manual of State Bank of Pakistan is a significant bottleneck which prevents overseas investors to invest in domestic fund structure. A foreign investor into private equity cannot invest in a company at a purchase price that may be lower than the break-up value of the securities or their listed price where such securities are listed on stock exchange. Similarly, at the point of exit, the sale value cannot be in excess of book value or the listed price in case the company is publicly traded. On the debt side, the SBP's Forex Manual does not explicitly give general permission to issue, transfer and export of such instruments to a foreign investor at a mutually agreed price, and to settle the price abroad with another foreign investor or through inward remittance of the price where the buyer is resident in Pakistan;

- d. Length of the license. SECP only issues the license for 3 years and it needs to be renewed after that. This is not suitable for PE asset class as most funds have a life of 5-7 years for their holdings. Many funds complain that this clause prevents them to clear the due diligence process from overseas limited partners who invest in private equity. Hence, they are forced to use offshore vehicles.

Recommendations:

158. Issuance of longer term or perpetual license for private equity.
159. Ability to mobilize capital from pension funds and insurance companies. Insurance companies complain that they do not have access to suitable investment products. Private equity might be a suitable asset class which could match their investment duration.
160. On the foreign exchange side, we recommend that the SBP should grant:
- a. general permission for acquiring (by way of subscription or purchase from a resident of Pakistan) all forms of equity, regardless of whether they are in the nature of ordinary shares, preference shares, share warrants, or the like (Equity Instruments) for a price that is mutually acceptable to the Foreign Fund and the seller/issuer and against inward remittance of foreign exchange;
 - b. general permission for investment in Rupee-denominated term finance certificates convertible into Equity Instruments (Convertible Debt Instruments);
 - c. general permission for purchase of Equity Instruments or Convertible Debt Instruments (as the case may be) from another non-resident of Pakistan for a price that is mutually acceptable to the Foreign Fund and the non-resident seller so long as payment is made and received outside Pakistan;
 - d. general permission for remittance of dividends (subject to applicable withholding taxes) where investment has been made in accordance with the general permissions in (a) and/or (b) above;
 - e. general permission for sale of Equity Instruments or Convertible Debt Instruments (as the case may be) to another non-resident of Pakistan for a price that is mutually acceptable to the Foreign Fund and the non-resident purchaser so long as payment is made and received outside Pakistan;
 - f. general permission for repatriation in foreign exchange resulting from the sale of Equity Instruments or Convertible Debt Instruments (as the case may be) by the Foreign Fund to a resident Pakistani purchaser at a price that is mutually agreed between the resident purchaser and the Foreign Fund; and
 - g. general permission for investment into and repatriation from licensed private equity and venture capital funds by non-residents.
 - h.
161. With a view to ensure that the suggested general permissions are not misused, the same may be made subject to the following conditions:
- a. The general permissions would only be available to private equity and venture capital funds and private equity and venture capital fund managers properly licensed in advanced financial centres such as the United Kingdom, the United States, Singapore, Hong Kong, and the Dubai International Financial Centre; and
 - b. The investments in Equity Instruments by the Foreign Fund would need to be held for a minimum of [two years] (Holding Period), provided that in the case of an Equity Instrument having been listed on a stock exchange, the general permission would be

available from the date of listing without any requirement for a Holding Period; or in the case an investment in the form of Convertible Debt Instrument has been converted to an Equity Instrument, the Holding Period for the Equity Instrument would commence from the date that the investment in the Convertible Debt Instrument has been made (and not the date of the conversion); and the Foreign Fund would be required to conduct Know Your Customer checks and file details of the beneficial ownership of investors with the SBP.

No	Action	Outcome	Timing	Responsible
1	Extend the license duration for Private Equity funds for at least 7 years from current duration of 3 years.	This should help match the duration of the license with the length of the investment holdings. This should allow the funds to raise capital from overseas LPs in domestic structures.	Short term	SECP
2	Allow pension funds and insurance companies to invest in private equity	This should help develop the sector but allowing investors who are long term focused to get exposure to long term investment opportunities.	Short term	SECP
3	Clarify and issue guidelines to allow regulated and licensed overseas private equity companies to acquire and sell equities and convertible debt from local issuer at a price which is mutually agreed (rather than at break-up value) and allow non-resident to purchase and redeem units of locally established PE&VC funds under Private Funds Regulations 2015 without any pricing restriction For repatriation of disinvestment proceeds of unlisted companies up to breakup value, SBP has granted general permission to Authorized Dealers. However, for repatriation of amount over and above breakup value of shares of unlisted companies, specific permission of SBP is required. SBP considers such requests of companies, received through Authorized Dealers, on case to case basis.	Clearer instructions shall be issued for repatriation of disinvestment proceeds of unlisted securities above break-up value Accordingly, Venture Capital and Private Equity Industry in Pakistan shall have the visibility with respect to regulatory requirements for remittance of disinvestment proceeds of unlisted securities. This will help in the development of both venture capital and private equity industry in Pakistan and attract capital which is currently held offshore to Pakistan.	Short term	SBP and SECP

PART 4: BUILD CAPACITY ON THE LOCAL MARKET

- 162. There are numerous recommendations spread throughout this report relating to the funding for and the provision of capacity building for the local market
- 163. Specific recommendations relate to the development of a professional Debt Management Office
- 164. Capacity requirements for the SECP to properly function as a regulator
- 165. Capacity requirements needed at all levels for the development of derivatives and risk management tools
- 166. The education of investors across a myriad of areas and activities
- 167. The need to reach out to and build a retail securities market
- 168. Development of corporate governance understanding and application
- 169. All these measures are not separately detailed here as this would take them out of the context of the diagnostic where they were proposed

PART 5: DEVELOP RISK MANAGEMENT TOOLS

Summary

170. Over three decades, Pakistan's stock market has regularly had recurring crises stemming from collapsing asset "bubbles". Crisis events have occurred in 1998, 2000, 2002, 2005, and 2008 (lucky escape 2017) and there have been regularly-occurring broker failures/defaults that have continued even between the crisis events which has resulted in a loss of public confidence in the integrity of Pakistan's financial markets with a stagnating number of retail investors.
171. The current products:
- a. Fuels speculation in the ready market;
 - b. Involve credit by individuals who are not licensed to extend credit and therefore the product can be considered to be involving informal and parallel banking;
 - c. The process does not allow for proper credit assessment of the borrower;
 - d. Brokers can themselves act both as financier and financee; and
 - e. The products have inhibited the growth of proper approved derivative products.
172. Unless the development of the derivatives market is planned and executed properly there may not be another chance to develop these much-needed risk management tools.
173. Vigilance will be required to ensure the reform agenda does not get derailed by vested interests.
174. Pakistan has long struggled to implement leverage products and there has been a number of crises which have had their cause linked to leveraged products (Badla, Continuous Financing, MTS and 30-day futures markets). Despite these issues Pakistan has not taken definitive action to introduce proper derivative products. India which had similar issues closed all existing leveraged products and introduced exchange trade derivatives based on international standards in 2000 by banning the badla system for a more transparent trading of securities which was a major milestone for their market development. (see later for the milestones in the India derivatives story)
175. Derivative instruments have assisted transferring and managing risks for a long period, commencing with forward contracts over commodities which have existed for over a millennium, and derivatives activity over the last two decades is considered to have yielded substantial benefits to a number of emerging market economies as derivatives can reduce the likelihood of financial distress due to volatile prices and interest rates.
176. Derivatives contribute to the development of a country's financial sector by linking cash markets, hedgers and speculators. Derivatives can provide liquidity and price discovery mechanisms, transfer underlying risks among economic agents with varying and complementary preferences – transferring risks from those who wish to dispose of them, to those who are willing and able to incur them.
177. Derivatives markets can broadly be categorized into three types:
- Exchange Traded Derivatives (ETDs) which involve the trading of highly standardized contracts through a central venue, typically clearing and settling ("booking") transactions through a central clearinghouse that serves as a Central Counterparty (CCP);
 - Over the Counter (OTC) derivatives, which involve the bilateral trading of customized transactions privately negotiated and settled between the contracting parties; and
 - Centrally cleared OTC derivatives, which may be viewed as "hybrids" between ETDs and OTC derivatives and that involve the trading of standardized transactions that are privately negotiated but cleared through a CCP.

178. Derivative instruments fall into two broad categories:
- *Forward-based instruments* which have symmetrical rights and obligations between the parties and have the effect of locking in a price or rate of a transaction (or exchange of value) that will take place on an agreed future date (futures contracts are standardized forwards that are traded on an exchange); and
 - *Option contracts* that have price behaviour which is nonlinear due to the asymmetrical nature of the rights and duties conveyed to the buyer (i.e. “holder”) and the seller (i.e. “writer”) of the contract.
179. Participants in derivative markets usually undertake activity for different primary objectives:
- Hedging;
 - Speculating; or
 - Dealing.
180. Best practice is for derivatives trading to be cleared through a clearinghouse that serves in the capacity of a CCP. A CCP performs three crucial functions.
- A CCP acts as buyer to every seller and seller to every buyer for derivatives transactions submitted for clearing by its members;
 - A CCP acts as “guarantor” by assuming the credit risk of all cleared transactions; and
 - A CCP provides multilateral “netting” of transactions.

Background

181. Derivatives are financial instruments that transfer risks from one party to another. They are called derivatives because they derive their value from the value of something else – an underlying right or interest. Underlying rights or interests can include bonds which involve interest rate, credit, and currency risks, and commodities and equities which involve price risks. Underlying rights or interests can also be groups of assets, such as equity, credit or commodity indices, or relationships between prices such as the spread between two benchmark government securities.
182. The growth in derivatives activity over the last two decades is considered to have yielded substantial benefits to a number of emerging market economies. Derivative trading can facilitate access of businesses to international capital, while lowering their cost of funds and diversifying their funding sources. It can improve the competitive position of manufacturer exporters in an increasingly competitive global economy by reducing their exposure to foreign exchange risk and to the volatility input costs.
183. By providing firms with new and more effective tools for managing their exposure to various risks (e.g. adverse fluctuations in interest rates, foreign exchange rates, and commodity prices), derivatives can reduce the likelihood of financial distress due to volatile prices and interest rates.
184. With such incidental risk exposures under control, management is better able to focus on its core business – improving the quality and reducing the cost of its products. Similarly, by providing investors and issuers with a wide array of tools for managing risks and raising capital, derivatives can improve the allocation of capital and the sharing of risk in the economy, reducing the cost of capital formation, stabilizing employment, and stimulating economic growth.
185. Given the right conditions, derivatives can potentially contribute to the development of a country’s financial sector by linking cash markets, hedgers and speculators. Derivatives can provide liquidity and price discovery mechanisms and transfer underlying risks among economic agents with varying and complementary preferences – transferring risks from those who wish to dispose of them, to those who are willing and able to incur them.

Market Structure

186. Derivatives markets can broadly be categorized into three types. ETDs involve the trading of highly standardized contracts through a central venue, typically clearing and settling (“booking”) transactions through a central clearinghouse that serves as a CCP. The contract specifications for listed derivatives are typically standardized to a relatively high degree, which facilitates trading and enhances liquidity. Execution through an exchange facilitates price discovery and transparency and affords anonymity of trade counterparties. The clearinghouse becomes the counterparty to all trades by a legal replacement of bilateral trades between anonymous counterparties with those between the clearing participants and the clearinghouse through a legal process known as “novation” (or its functional equivalent). As a result, risk is “socialized” among clearinghouse participants.
187. A second category is OTC derivatives, which involve the bilateral trading of customized transactions privately negotiated and settled between the contracting parties. OTC derivatives differ from listed derivatives in several ways. First, although OTC transactions involve some standardization of terms, the presumption is that contracting parties are free to negotiate terms that fit their individual risk preferences. Second, instead of executing trades through an exchange, contracting parties execute transactions with dealers, who in turn trade with each other. Third, booking of transactions between contracting parties means that OTC derivatives involve direct exposures between the parties. These exposures lead to counterparty credit risk, which must be managed by the parties.
188. A third category, which has been increasing in importance since the global financial crisis, is cleared OTC derivatives, which are something of “hybrids” between ETDs and OTC derivatives and that involve the trading of standardized transactions that are privately negotiated but cleared through a CCP. Clearing transactions through a CCP means that dealers do not have direct counterparty credit exposure to each other but to the clearinghouse. Standardization need not be as extensive as in the listed derivatives markets, but a relatively high degree of standardization is necessary to facilitate clearing and risk management by the CCP.
189. The Table below shows some of the features and characteristics of exchange traded and over-the-counter markets.

Table 23 Derivative Markets (ETD and OTC) characteristics

Feature/Characteristic	ETD Markets	OTC Markets
Contracts/Instruments	Highly standardized	Largely customized to client requirements
Trades	High volume/frequency Lower value per trade	Low volume/high value
Liquidity	High	Low
Counterparty Risk	Mitigated through institutional risk management systems Born by CCP	Concentrated and sometimes long-term Born by parties to trades (except for CCP-cleared trades)
Transparency	High – pricing reported by exchange and widely disseminated	Low – pricing typically only reported to regulator, if at all
Price Discovery	Effective – due to high levels of liquidity and pre- and post-trade transparency	Ineffective – due to low levels of liquidity and transparency
Regulation of Participants	Intermediaries and participants highly regulated and supervised through authorization and certification including capital adequacy, fit and proper tests and suitability requirements	Varies widely – dealers may be authorized and regulated

Typical instruments

190. Derivative instruments fall into two broad categories, namely, forward-based instruments and options. Forward-based instruments have symmetrical rights and obligations between the parties and have the effect of locking in a price or rate of a transaction (or exchange of value) that will take place on an agreed future date.

Forward-Based Instruments

191. Forward (traded OTC) and futures (traded on-exchange) contracts allow parties to agree to the terms of a transaction (or exchange of value) that will take place at a future date. An example is a currency forward in which parties might agree today to exchange USD 1 mn for PKR 80 mn 60 days from today. Simply stated, futures contracts are standardized forwards that are traded on an exchange.
192. Swaps are OTC agreements to exchange cash flows at regular intervals over an agreed period according to terms agreed today. In effect, a swap is a sequence of forwards. A bank and its client might agree, for example, that over the next five years, the client will pay the bank a fixed rate of 5% on a “notional” PKR 100 bn loan, while the bank will pay the client the three-month KIBOR rate on the same amount. The client thus “swaps” a variable rate payment for a fixed rate one, which may better suit its purposes.

Options

193. Options are derivatives contracts that have price behaviour that is nonlinear due to the asymmetrical nature of the rights and duties conveyed to the buyer (i.e. “holder”) and the seller (i.e. “writer”) of the contract. The pricing (i.e. “premiums”) of options is somewhat complex because of the number of variables involved, which include the time remaining to expiration, interest rates, volatility, and, of course, the current price of the underlying instrument, right or interest.

Typical motivations of derivatives traders

194. Derivatives transactions are often classified according to the motivations and objectives of the transacting parties.

Hedging as a primary objective

195. One objective is hedging, which involves the transfer of an unwanted risk to another party in return for a “premium”. For example, a garment manufacturer/exporter might want to lock-in an exchange rate (i.e. the cost or US Dollars) for an anticipated export/sale transaction, or the cost of its raw materials (e.g. cotton) for an anticipated purchase transaction rather than face the risk of changes in these prices (e.g. the exchange rate, or the price of a bale of cotton fabric in the example above). A perfect hedge means that the hedger will be compensated through price movements in the hedge instrument (i.e. derivative contract) in the exact but opposite amounts for which the price of the object of the hedge fluctuates. This gain or loss is designed to “neutralize” fluctuations in the price of the object of the hedge (i.e. the foreign exchange rate or the price of cotton fabric in the referenced case). Thus, hedgers trade away price risk (i.e. lock-in a price), in exchange for the cost of the hedge (i.e. the premium).

Speculating as a Primary Objective

196. A second objective is speculation, which involves taking on risk from another party in order to profit from price changes. In the example above of the “cotton hedge”, the party taking on the opposite side of the transaction might be a speculator hoping to profit if the price of cotton increases. By acting as a source of *liquidity* to potential hedgers, speculators are a *vital and necessary* part of a derivatives market.

Dealing as a Primary Objective

197. A third objective is dealing, or market making, in which the dealer/market maker serves as an intermediary to facilitate the transfer of risk between hedgers and speculators, earning a spread

between the two. Dealers may be considered hedgers because, upon taking on a risk from one customer, a dealer will generally hedge the risk with another customer or in the underlying markets. While market makers generally maintain hedged portfolios of transactions (i.e. “books”), they may also engage in speculation in order to *provide liquidity* to the market. For example, if a client wishes to establish a hedge position with a dealer but the dealer cannot immediately find an offsetting transaction, the dealer might enter into the transaction, in effect establishing a speculative (open) position on the unhedged portion of the trade.

198. The Table below outlines some of the strategies employed by “users” of derivatives to achieve their primary objectives.

Table 24 Derivative Strategy Types

Strategy	Description
Hedgers	<p>Purpose: To hedge a natural underlying risk</p> <p>Examples:</p> <ul style="list-style-type: none"> • Firms impacted by fluctuations of interest rates, such as mortgage holders, to hedge their prepayment or extension risks • Natural gas users for price changes due to geopolitical or international risks – typically by buying puts and selling calls • Interest rate swap users to protect swaptions, rate locks or other corporate deals • Commodity traders, including farmers or the Exploration & Production (E&P) producers for weather and agricultural risks
Investors	<p>Purpose: To manage market risks of a portfolio</p> <p>Examples:</p> <ul style="list-style-type: none"> • Long only firms managing duration risks of fixed income portfolios while still keeping credit or spread risks • Eurodollar bank traders wanting to trade the option and underlying future for capital efficiency reasons • International hedge fund managers looking to add or reduce a specific part of market risk to their portfolio
Directional	<p>Purpose: To profit from a specific view of the market</p> <p>Examples:</p> <ul style="list-style-type: none"> • Hedge fund portfolio managers making a call on a sector, but wanting to limit downside risks • Options traders wanting to expose a view on vega and/or gamma
Arbitrageurs	<p>Purpose: To profit from price discrepancies</p> <p>Examples:</p> <ul style="list-style-type: none"> • Trading companies that specialize in automated market-making and risk taking • Prop trading firms entering into transactions in two or more markets

Market infrastructure – the Central Counterparty – a vital component

199. Current best practice, crystalized in the wake of the global financial crisis, is for derivatives trading to be cleared through a clearinghouse that serves in the capacity of a CCP. A CCP performs three functions.

- First, by means of “novation” or an equivalent legal process (described above) at the clearing participant level, the CCP acts as buyer to every seller and seller to every buyer for derivatives transactions submitted for clearing by its members;
- Second, a CCP acts as “guarantor” by assuming the credit risk of all cleared transactions; and
- Third, a CCP provides multilateral “netting” of transactions.

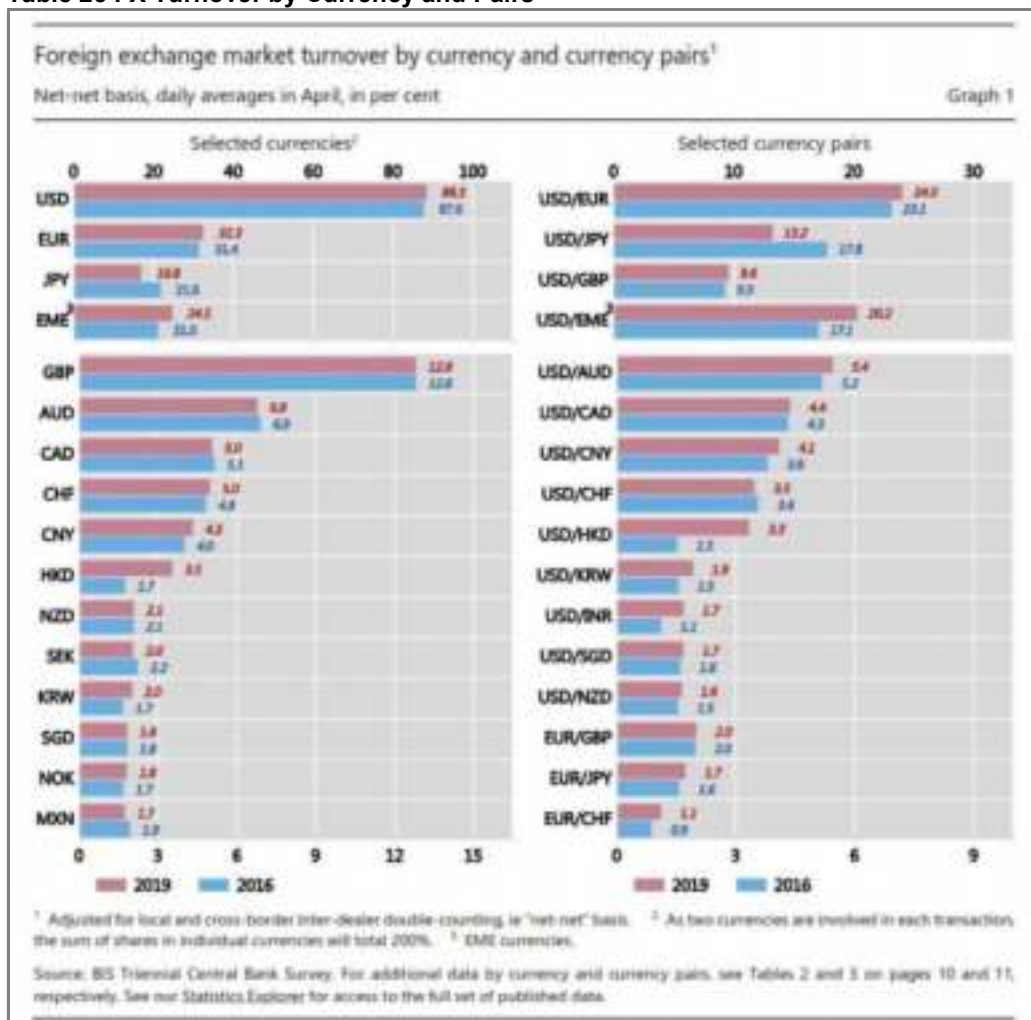
200. Only CCP “clearing member/participants” (member firms) book (i.e. clear) trades directly through the CCP. Non-member firms (or non-clearing participants) must access the clearinghouse through the intermediation of a clearing member/participant.

- 201. By their nature, CCPs (in the absence of the failure of a clearing member/participant) take on no market risk. This is to say that for every transaction with a positive value, there must be an equal and offsetting transaction with a negative value. CCPs around the globe clear many types of financial transactions, including equities (stocks), fixed-income securities, and derivatives – both exchange-traded ones and those traded Over the Counter (OTC).
-
- 202. Pakistan's NCCPL has established a CCP for the cash market and PMEX for its derivative contracts. NCCPL has undertaken benchmarking of its CCP against BIS/IOSCO's Principles of Financial Markets Infrastructure (PFMIs) as well it has had an actuary consider the adequacy of cover of its Securities Guarantee Fund (SGF).

Benchmarking – Emergence of exchange-traded derivative markets

- 203. Emerging market derivatives activity has been most prominent in *foreign exchange* forwards and swaps, followed by *interest rate* forwards and swaps and then *commodity* hedging. Structured products (securitizations) and equity-linked derivatives play a small role in emerging market hedging at present. (EME = Emerging Market Economies). The Tables below give value and volume of derivatives.
- 204. The next Table gives the notional value of OTC derivatives transactions by type.

Table 25 FX Turnover by Currency and Pairs



Data April 2019

Table 19(a): Foreign exchange market turnover by currency and currency pairs

Table 26 Global OTC Derivatives 2017 - 2018

Global OTC derivatives market		Table D5							
In billions of US dollars		Notional amounts outstanding				Gross market value			
		H1 2017	H2 2017	H1 2018	H2 2018	H1 2017	H2 2017	H1 2018	H2 2018
All contracts		942,439	931,911	994,883	944,590	12,681	10,958	18,328	9,662
Foreign exchange contracts		88,429	87,117	95,798	90,662	2,626	2,393	2,620	2,267
By instrument									
Dedicated forwards and fx swaps		51,754	50,847	56,416	53,909	1,259	1,111	1,249	1,074
Currency swaps		28,512	25,535	26,052	24,858	1,550	989	1,535	990
Options		12,088	10,679	13,307	11,817	208	192	216	193
Other products		55	36	94	38	-	-	-	-
By counterparty									
Reporting dealers		36,521	36,128	40,689	37,708	1,112	896	1,346	960
Other financial institutions		40,258	39,084	41,308	41,548	1,036	918	1,042	891
Central counterparties		2,119	2,306	2,967	2,789	64	65	71	59
Non-financial customers		11,334	11,899	13,617	11,347	479	439	431	400
By maturity									
Up to one year		69,461	68,083	76,343	71,408	-	-	-	-
Between one and five years		15,546	13,434	13,879	13,754	-	-	-	-
Over five years		5,546	5,594	5,706	5,441	-	-	-	-
By currency									
USD		77,043	74,756	84,448	80,189	2,299	1,974	2,106	1,981
EUR		27,826	28,281	31,368	28,300	829	782	825	627
JPY		14,094	14,838	15,629	15,249	405	390	363	391
GBP		11,070	12,257	11,719	11,092	346	305	307	307
CHF		4,120	4,257	4,396	3,860	113	91	94	72
CAD		4,068	4,088	4,484	4,250	340	307	317	345
SEK		2,038	2,268	2,331	2,082	95	47	59	36
Other currencies		35,788	33,491	37,621	36,381	964	878	1,089	851
Interest rate contracts		435,201	426,648	461,081	436,837	9,045	7,579	8,644	6,401
By instrument									
IRAs		75,434	68,134	84,131	67,636	129	112	107	134
Swaps		321,612	318,870	349,781	336,690	8,121	6,747	5,914	5,680
Options		37,641	39,312	46,829	42,154	796	719	629	581
Other products		338	332	361	357	-	-	-	-
By counterparty									
Reporting dealers		42,687	40,721	48,116	39,021	2,122	1,963	1,794	1,629
Other financial institutions		179,504	171,868	176,366	183,765	6,290	5,882	4,326	4,232
Central counterparties		129,716	120,128	104,685	112,083	4,388	3,217	2,732	2,713
Non-financial customers		12,881	13,729	14,441	13,094	633	614	614	546
By maturity									
Up to one year		180,179	181,443	211,284	200,635	-	-	-	-
Between one and five years		141,852	140,035	155,344	147,362	-	-	-	-
Over five years		93,815	94,836	94,957	88,844	-	-	-	-
By currency									
USD		199,034	196,596	202,510	189,382	1,850	1,424	1,328	1,181
EUR		128,553	121,891	129,817	114,092	4,135	3,581	3,140	3,134
JPY		40,971	38,772	37,215	36,306	630	491	443	464
GBP		36,084	37,571	44,522	38,453	1,480	1,292	1,067	934
CHF		4,799	4,107	4,298	3,467	84	62	52	50
CAD		9,849	10,944	12,494	14,225	128	135	134	95
SEK		6,158	5,985	6,052	5,931	87	45	60	52
Other currencies		51,625	50,814	54,478	54,430	622	539	452	499
Equity-linked contracts		6,964	6,599	7,071	6,617	524	575	608	571
By instrument									
Forwards and swaps		2,969	3,210	3,299	2,938	184	197	228	248
Options		4,061	3,360	3,772	3,680	340	378	380	323
By counterparty									
Reporting dealers		2,297	3,389	1,770	1,601	349	383	153	132
Other financial institutions		3,991	4,161	6,498	4,621	287	321	337	329
Central counterparties		70	13	20	13	3	0	0	1
Non-financial customers		676	729	803	793	77	91	117	111
By maturity									
Up to one year		4,353	4,887	4,435	4,605	-	-	-	-
Between one and five years		2,086	2,121	2,296	2,114	-	-	-	-
Over five years		525	591	340	298	-	-	-	-
By market									
US equities		2,767	2,823	3,027	2,990	217	239	260	222
European equities		2,668	2,227	2,317	2,050	149	159	170	164
Japanese equities		655	309	309	270	28	33	36	36
Other Asian equities		297	333	366	289	19	20	22	19
Latin American equities		189	184	284	281	11	12	14	19
Other equities		527	638	558	648	99	112	106	112

Table 19(b): OTC Derivative activity in FX and Equity Triennium Survey 2019

Global OTC derivatives market								
In billions of US dollars								
	Notional amounts outstanding				Gross market value			
	2017		2018		2017		2018	
	H1	H2	H1	H2	H1	H2	H1	H2
Commodity contracts	1,762	1,862	2,133	1,898	171	189	207	220
By commodity								
Gold	535	520	568	513	23	21	23	21
Other precious metal	75	53	70	65	4	3	4	4
Other commodities	1,152	1,288	1,495	1,320	144	164	180	195
By instrument and commodity								
Forwards and swaps	1,352	1,414	1,627	1,450				
Gold	395	381	419	376				
Other precious metal	58	40	54	48				
Other commodities	900	993	1,153	1,026				
Total options	410	447	506	449				
Gold	141	139	149	137				
Other precious metal	17	14	15	17				
Other commodities	253	294	342	294				
Options sold (gross basis)	254	275	313	287				
Gold	83	85	87	81				
Other precious metal	11	8	9	10				
Other commodities	160	182	218	197				
Options bought (gross basis)	248	272	305	261				
Gold	89	85	95	86				
Other precious metal	10	9	10	12				
Other commodities	149	178	200	163				

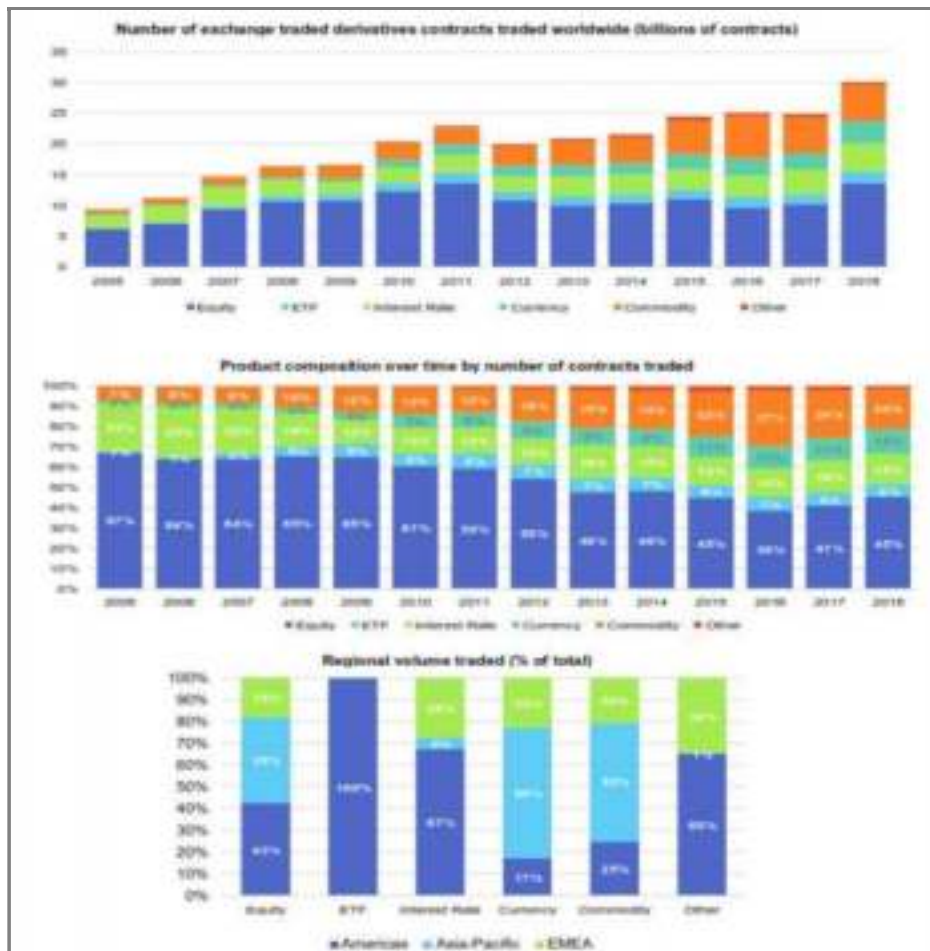


Figure 21 Exchange Traded Derivatives Traded 2005 -2018

Capacity building in derivatives

205. Derivatives and risk mitigation tools although not new subjects for regulators and market participants will still require them to come to grips with, both as to the theory of derivatives and the practical application of the risk tools which are necessary to manage these complex products.

Current approaches to managing risk

206. There are a number of financial risks that that may lend themselves well to being managed through the use of derivatives. These are discussed further below.

Interest rate risk

207. To address their exposure to interest rate risk (a risk especially well-suited to being addressed by derivatives), commercial banks and other financial institutions in Pakistan hedge this exposure by adjusting the “duration” of their assets and liabilities. This “balance sheet hedging” is accomplished by various initiatives to lengthen the tenor of deposits and shorten the maturity of the lending portfolio. In addition, commercial banks in Pakistan usually reserve the right to “renegotiate” interest rates on loans on an annual basis, effectively limiting exposure to interest rate risk on that segment of the balance sheet to a one-year horizon. Fixed rate loans for extended tenors appear to be rare in Pakistan.

208. The constraints of the above described “interest rate risk management” strategy stem from the fact that it tends to limit the range of products and services available to bank customers. Commercial, industrial and retail borrowers generally do not have access to long term lending instruments that could better address their credit requirements, match their “risk profile” and contribute to their long-term stability and growth. Retail consumers generally do not have access to long term credit products better suited for the purchase of residential properties, and so only those (high-income) households who are able to save sufficient down-payments and make high recurring payments for short term loans can afford to purchase homes. This inherent inefficiency has implications for economic growth, both in terms of its rate and in terms of its equity i.e. the broad and balanced distribution of its effects across the entire economy/society.

209. Interest rate risk management is one of the areas that are best suited to being addressed by interest rate derivatives, as may be evident from the size of this segment of the global derivatives market. The above inefficiencies, and others, can be addressed through interest rate derivatives that provide banks with the tools that would enable them to manage the risks inherent in longer term lending so they can meet the latent demand for longer term lending products while controlling their own level of exposure to interest rate risk.

Foreign exchange risk

210. Managing the risk of exposure to fluctuations in foreign exchange rates is another area in which there are ample opportunities for derivatives to play a central role.
211. While the degree of openness of the capital account is a key determinant of the success of foreign exchange derivatives (and Pakistan’s capital account is largely “closed”), it would appear that one of the key prerequisite requirements (i.e. the existence of a large and sustained demand for the instrument) is most likely to be met.

Considerations for introducing derivatives

Market structure

212. The primary policy choices with respect to market structure are whether to support the development of centralized or decentralized markets for derivatives. Policy makers will need to decide whether to support a market for Exchange Traded Derivatives (ETDs) or to encourage the development of derivatives through Over the Counter (OTC) markets.

Products/Instruments – Range and sequencing

213. After the decision on market structure (i.e. whether to introduce ETDs or to support the development of OTC markets), a central issue needing to be addressed will be the range of instruments that should be authorized and the sequencing of their introduction.
214. An important principle in the development of derivatives markets, is to offer a limited number of simple instruments in the early stages of market development so as to facilitate the attraction of demand, and to avoid fragmentation of liquidity. While this would need to be confirmed through a demand study, there is likely to be sufficient latent demand for at least three types of derivative instruments – those addressing interest rate, exchange rate and stock market risks.
215. The introduction of derivatives in India is instructive. Key steps were as follows:

Table 27 Timeline India's derivative Development 2000 - 2008

<u>Timing</u>	<u>Action</u>
December 1995	NSE asked SEBI for permission to trade index futures.
November 1996	SEBI setup L. C. Gupta Committee to draft a policy framework for index futures.
May 1998	L. C. Gupta Committee submitted report.
July 1999	RBI gave permission for OTC forward rate agreements (FRAs) and interest rate swaps
May 2000	SIMEX chose Nifty for trading futures and options
May 2000	SEBI gave permission to NSE and BSE to do index futures trading.
June 2000	Trading of BSE Sensex futures commenced at BSE.
June 2000	Trading of Nifty futures commenced at NSE.
August 2000	Trading of futures and options on Nifty to commence at SIMEX.
June 2001	Trading of Equity Index Options at NSE
July 2001	Trading of Stock Options at NSE
November, 2002	Trading of Single Stock futures at BSE
June 2003	Trading of Interest Rate Futures at NSE
September, 2004	Weekly Options at BSE
January, 2008	Trading of Chhota (Mini) Sensex at BSE
January, 2008	Trading of Mini Index Futures & Options at NSE
August, 2008	Trading of Currency Futures at NSE
October, 2008	Trading of Currency Futures at BSE

216. The growth in the derivative trading (buy volume number of contracts) over the years from 2003-2009 has been captured in the following table:

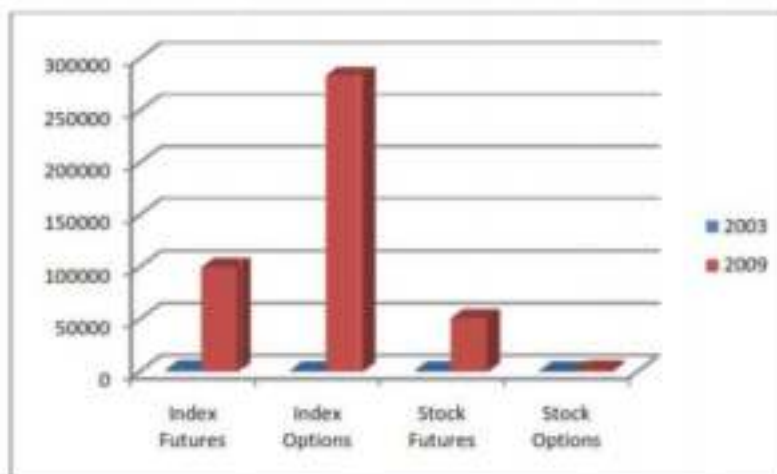


Figure 22 growth in India's Derivative contracts 2003 to 2009

Attributes of successful derivative markets

217. There are some established norms for successful derivative markets:
- a. Infrastructure vehicles with separate boards and managements to ensure independent governance and this applies to both the derivatives exchange and the clearing and settlement entity with appropriate capital structures
 - b. Development of appropriate default guarantee entities
 - c. Clear Legal status:
 - i. Unambiguous legal status for derivative product transfer and the clearing and settlement entity acting as a central counterparty (CCP) via novation of the contracts to the CCP
 - ii. Clear bankruptcy law provisions to ensure the protection of the CCP in case of the sale and transfer of collateral posted to the CCP
 - iii. Appropriate regulations covering CCP arrangements
 - d. Contract Specifications, Quality Standards and Warehousing provisions:
 - i. Clear contract specifications meeting international standards and expectations
 - ii. Where products are deliverable acceptable quality standards and control together with appropriate warehousing and delivery standards
 - iii. Independent certification of deliverable product
 - e. Proper control over members of the derivative market
 - i. Ability to license participants independent of existing members particularly well capitalized banks and international investment banks
 - ii. Fit and properness standards
 - iii. Capital Adequacy
 - iv. Conduct of business regulations tailored to derivative operations
 - v. Knowledgeable Staff
 - vi. Adequate systems
 - f. Proper market infrastructure
 - i. Trading System
 - ii. Surveillance Mechanisms
 - iii. Clearing and Settlement mechanism preferably with a sound CCP with adequate capital a guarantee fund with modern risk management assessment utilizing a system like SPAN
 - g. Adequate regulations to support the market mechanisms

- i. Segregation of client money and securities rules
 - ii. Short selling rules
 - iii. Stock Borrowing and lending rules
 - iv. Circuit Breakers based on index movements (10%, 15%, 25%)
 - v. Facilitation of market makers and appropriate tax rules to enable market making, short selling and stock borrowing and lending to work efficiently
 - vi. Regulations for approval of contract specifications, contract position limits and risk margining level approvals
- h. Key group of enthusiastic members willing to support the markets development and establishment by committing effort to development of the market including providing research and education to clients
- i. Establishment of advisor accreditation programs and investor education efforts both by the new exchange and exchange participants

Pricing benchmarks

218. The pricing of forwards, futures and currency swaps as well as for interest rate derivatives requires spot/cash markets that are able to produce a reliable reference rate based on a deep and liquid market for short-term lending and a reliable benchmark medium-term rate (e.g. 5-year T-bond) based on a deep and liquid secondary market for government securities, both of which are nascent at the present time.

Equity based instruments

219. Institutional investors need the ability to hedge a portfolio of stocks that track fluctuations in the general market. As individual stocks rise and fall with the market, depending upon their correlation with the general market (beta for futures contracts or delta in options terminology), an instrument based on the general market will not always be a perfect hedge for individual stocks. However, the introduction of options on individual stocks should await the development of liquidity in the indexed instrument although that decision can be made as the market develops. PSX has indicated it would like to introduce futures and options as a package.

Financial market infrastructure

220. The market infrastructure requirements will largely stem from the policy decision concerning market structure. An exchange-based market will require a derivatives exchange and central clearinghouse. The policy decisions will centre around the following principal issues:

- Adequate levels of capitalization;
- Governance and management structures;
- Legal status;
- Proper control of entry;
- Appropriate systems;
- Risk management systems; and
- Appropriate mechanisms for protection against default that could include a Settlement Guarantee Fund and/or Investor Protection Fund including the size required for the SGF to be viable in case of a very large default..

Demand study

221. The selection of products should be supported by a demand study that would carefully examine and seek to quantify the potential demand for the types of instruments discussed here in.

222. Recommendations:

- a. Subject to careful study of the required transition for existing DFCs, enforce the discontinuance of the legacy leverage instruments (MTS and the currently designed 30 days futures product);
- b. Develop an effective market for cash- settled single stock futures and options; and
- c. Provide technical assistance to the relevant stakeholders which will assist in eliminating the considerable systemic risk and instability associated with variants of Badla
- d. Ensure a risk management schema on a holistic basis as follows:

Risk Management Framework



Figure 23 Risk management Framework for Derivatives

- ADB provide a TA to SECP to undertake a comprehensive derivatives implementation plan and capacity building exercise. A typical road map would be as follows:

PART 6: CAPITAL MARKET INFRASTRUCTURE

Summary

223. There are a number of recommendations which are aimed at four areas:

- a. Creating a more efficient market design;
- b. Improving risk management, regulatory cooperation and oversight; and
- c. Addressing concerns related to transparency and disclosure

Market design

- a. **Recommendation:** Undertake study through an appropriate international corporate finance house or investment bank as to best structure for creation of an exchanges listed holding group company with suggested combined ownership for PSX, NCCPL, CDC, and PMEX. This will likely require a scheme of arrangement involving the creation of a new HOLDCO with a distribution in specie to minority holders in HOLDCO subsidiaries satisfied by shares in the new HOLDCO with consideration of dilution in PSX for the Chinese strategic investors. There will then likely be a compliance listing on PSX for the new HOLDCO
- b. **Recommendation:** Implement the report into Exchanges Group creation
- c. **Recommendation:** Develop a shared Technology Services company for market infrastructure vehicles to achieve synergies, straight through processing and efficiencies including developing eventually Co-Location services for HFT as derivatives are developed
- d. **Recommendation:** Separation of core and non-core business of CDC and NCCPL, particularly transfer of CGT functions to a subsidiary of NCCPL. Currently FBR has a representative on NCCPL board and segregation is seen as best practice for non-core services.
- e. **Recommendation:** Review of all existing margin finance/futures and leverage products to be replaced with the development of an appropriate modern derivatives market for equities, debt and commodities

Improving risk management, regulatory cooperation and oversight

- a. **Recommendation:** Develop a market wide approach to development of the required CCPs (one or by market segment), including approach to Securities Guarantee Funds, Investor Protection Funds. This study should look at the appropriate establishment funding, on-going market levies, risk management and governance arrangements. Benchmarked to and complying with best international standards
- b. **Recommendation:** Standardization of brokerage house back office software to improve operational efficiencies and improve oversight and risk management
- c. **Recommendation:** Consolidation of supervision function of PSX/NCCPL/CDC/PMEX
- d. **Recommendation:** SECP to enter formal MOUs with exchanges and infrastructure vehicles, Issues to be covered are:
 - o corporate finance (issuance M&A and listing obligations);
 - o intermediary supervision and
 - o market surveillance.

- e. **Recommendation:** SRO status for various associations of regulated persons
- f. **Recommendation:** Implement concepts of Independent Clearing Member (Custodian) Concept
- g. **Recommendation:** Implement Capital Adequacy outlined under Broker licensing regulations (2016) and look to remove asset under custody caps
- h. **Recommendation:** Strengthening of surveillance capacity of PSX and PMEX through acquisition of appropriate surveillance software with appropriate cross market surveillance routines

Addressing concerns related to transparency and disclosure

- a. **Recommendation:** PSX to publish on their website the current Board Delegations for market information and transparency
- b. **Recommendation:** Infrastructure vehicles to publish and provide results and outcomes of market consultations within a defined timeframe and utilise websites to publish and provide interface to intermediaries and public to participate.

Expected outcomes

No	Tasks	Outcomes	Deadline/Implementation period	Responsible Entities
1	Undertake study through an appropriate international corporate finance house or investment bank as to best structure for creation of an exchanges listed holding group company with suggested combined ownership for: PSX, NCCPL, CDC, and PMEX Probably will require a scheme of arrangement and compliance listing approach	A vertical exchanges group that has scale and operating efficiencies with the potential to release great value (high PE multiple) and enable the holding company to build required capital to undertake the requirements of a modern exchanges group	2020-2021	PSX CDC NCCPL PMEX SECP MOF
2	Implement report into Exchanges Group creation subject to stakeholders concurrence	Fulfilling the promise to release value a benefit could be rationalisation and realization of real estate assets to develop purpose built collocated management, operations and technology.	2021- 2025	PSX CDC NCCPL PMEX SECP

3	Develop a market wide approach to development of the required CCPs (one or by market segment), including approach to Securities Guarantee Funds, Investor Protection Funds. This study should look at the appropriate establishment funding, on-going market levies, risk management and governance arrangements. Benchmarked to and complying with best international standards	Creation of appropriate risk management mechanisms and establishment of internationally recognised CCPs and protection mechanisms	2020 - 2022	PSX CDC NCCPL PMEX SECP
4	Develop a shared Technology Services company for market infrastructure vehicles subject to stakeholder agreement and possibly considered in conjunction with development of exchanges group.	A pooled approach to technology innovation and development	2020	PSX CDC NCCPL PMEX SECP
5	Consolidation of supervision function of PSX/NCCPL/CDC	An improved, well-resourced inspection and enforcement function benefiting from economy of scale and shared intelligence and surveillance mechanisms	2020-2022	PSX/NCCPL/CD C/SECP
6	SECP to enter formal MOUs with exchanges and infrastructure vehicles Issues to be covered are corporate finance (issuance M&A and listing obligations), intermediary supervision and market surveillance.	Clear expression of demarcation of responsibilities and reporting	2020-2021	SECP PSX PMEX CDC NCCPL
7	Implement concepts of Independent Clearing Member (Custodian) Concept	This approach will assist to address many of the concerns related to the new broker regime and will provide much need investor protection mechanism	2020	PSX SECP
8	Implement Capital Adequacy as outlined under Broker licensing regulations (2016) and look to remove asset under custody caps	Implementation of long outstanding supervisory tool that has been delayed due to concerns on the new broker regime	2020	SECP
9	Strengthening of surveillance capacity of PSX and PMEX through acquisition of appropriate surveillance software with appropriate cross market surveillance routines	A solution to a long outstanding concern about the quality of market supervision and will provide a boost to investor confidence	2020-2021	PSX PMEX SECP
10	Standardization of brokerage house back office software.	Deployment of BBO system to ensure timely financial, capital adequacy and operational reporting by brokers	2021-2022	PSX, PMEX, CDC, NCCPL

11	PSX to publish on their website the current Board Delegations for market information and transparency	Assist the market know who is authorised to undertake various policy and operational decisions	2020	PSX
12	SRO status for various associations of regulated persons	This will enable SECP to better monitor associations of regulator persons and place more responsibility on them for the conduct of their members	2020	SECP
13	Separation of core and non-core business of CDC and NCCPL, particularly transfer of CGT functions to a subsidiary of NCCPL. This may be undertaken in conjunction with study into development of exchanges group.	Segregation of a non-core government support service which requires specialised attention	2020	NCCPL CDC SECP
14	Review of all existing margin finance/futures and leverage products to be replaced with the development of an appropriate modern derivatives market for equities, debt and commodities	This will address a long outstanding revamp of the markets approach to leveraged products which have been at the heart of market crises going back to 1990s	2021-2025 New regulations should be made in consultation with SBP	PSX NCCPL SECP SBP
15	Infrastructure vehicles to publish and provide results and outcomes of market consultations within a defined timeframe and utilise websites to publish and provide interface to intermediaries and public to participate.	Clearer transparency of decision-making process with improved market confidence in the consultation process.	2020	SECP PSX PMEX CDC NCCPL

PART 7: AMENDMENTS TO THE LEGAL AND REGULATORY FRAMEWORKS

Summary

The SECP – Regulatory Architecture and Oversight

Summary of the Key Issues in relation to the Legal and Regulatory Framework

224. The current capital markets legal and regulatory framework are contained in several pieces of legislation and notwithstanding the ongoing efforts of the Securities and Exchange Commission of Pakistan (the SECP) to ensure that these are updated and keep pace with international best practices the net effect of numerous amendments particularly to the SECP Act 2016 has created an unnecessarily cumbersome regulatory regime which does not align well in certain key areas with IOSCO Principles¹. This regime particularly impacts on the powers of the SECP with regard to its independence and its decision making capacity.
225. The SECP has an ever expanding regulatory remit which includes the systemically important market infrastructure institutions, all non-bank financial institutions including leasing, non-banking microfinancing services; pension fund scheme business; private equity and venture capital fund management services and real estate investment trust (REIT) management services. In addition to these wide ranging responsibilities the SECP is also responsible for the regulation of the insurance industry and acts as “Company Registrar” for all corporate entities in the country. This is an onerous regulatory burden and a role for which the SECP is currently not best prepared or equipped to address in terms of the human resources, IT capabilities, budget and “sectoral industry expertise” within the organization.
226. In terms of governance the term of office of the Commissioners and Chairman of the SECP is three years, with the possibility of re-appointment for another three years. Since 2009 there have been regular changes in leadership at the Chairman and Commissioner level before even the three year term is completed, which creates lack of continuity in terms of regulatory approach, policy direction and long term strategic planning as well as uncertainty for the officers of the SECP as a whole. Furthermore, the current governance arrangements significantly fetter the powers of the Commissioners in that the Policy Board which was created with the laudable intention of providing oversight over a regulatory body with far reaching inquisitorial powers is now widely perceived as micromanaging all aspects of the organization. Whilst oversight is desirable the present remit of the Policy Board has led to it de facto operating as a decision making body which sits above the Commissioners. In addition, the role of the Chairman and CEO are combined. This is unusual in international markets.
227. At present no qualifications are required by law or regulation for those working in the securities markets industry which reflect and demonstrate their level of expertise and higher education. This is unusual in today’s international markets where the regulatory authority places significant emphasis on the capability of a licensed market participant and its employees to demonstrate that they are “fit and proper” to undertake their particular role within the company measured against a demonstrable track record in which appropriate qualifications are an integral part. In other words, each individual must be appropriate qualified to undertake their particular job. The SECP wishes to follow the international standards of requiring qualifications for all employees of market participants by creating an institute(s) that will offer a wide range high quality and affordable financial markets training courses that will lead to a “certification” of expertise.
228. The current draft legislation for collective investment schemes does not cater for the variety of legal vehicles that can be used to create investment funds (in their broadest sense) but rather concentrates on the use of the “trust vehicle” as the means of fund structure. Whilst the introduction of publicly offered investment funds appears premature at this stage of market development as they require a degree of liquidity to fulfill the redemption criteria there is scope for developing a “light”

¹ IOSCO Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation (Revised 2011)

regime for private equity (PE) which fosters the development of these funds firstly to institutional and high net worth investors.

229. The underlying regulatory architecture in terms of the regulations promulgated by the SECP appears unduly restrictive given the limited market size. For markets to develop there must be some latitude which allows commercial market forces to dictate development within the parameters of transparency and disclosure and which facilitates innovation. The SECP is mindful of their regulatory responsibilities and has perhaps been unduly focused on ensuring that their regulations keep pace with the standards of developed markets whereas a more “liberal” regime may be more conducive for market development.
230. The SECP has the power to license self-regulatory bodies yet at present no such organizations have been recognized under the legislation. IOSCO has endorsed the use of SROs within statutory oversight frameworks for financial markets, as part of its broader set of thirty principles and recommends appropriate use of SROs with direct responsibilities in their areas of competency, to the extent appropriate to the size and complexity of the markets, to assist regulators in meeting their regulatory objectives of investor protection: fair, efficient and transparent markets and reduction of systemic risk.
231. Firms operating without a license targeting potential investors in Pakistan either from abroad or within the country present a systemic risk to all regulatory authorities. Whilst fraud can never be eradicated particularly via the internet the SECP does not appear to have established arrangements that include a review of the risks that these firms pose to it and to the integrity and reputation of the market.

Regulatory Architecture and Oversight:

Diagnostic

Recommendations as to the legal and regulatory framework

232. The current interconnecting legislation which impacts on the capital markets includes but is not limited to the following:
- a. The SECP Act 1997 (as amended);
 - b. The Securities Act 2015;
 - c. The Futures Markets Act 2016;
 - d. Financial Institutions (Secured Transactions) Act 2016;
 - e. The Companies Act 2017;
 - f. The Limited Liability Partnership Act 2017; and
 - g. The Corporate Rehabilitation Act 2018
233. Additionally, there is proposed legislation in draft form namely:
- a. the Non-Banking Finance Companies and Collective Investment Vehicles Act 2019 which expands the definition of regulated activities to include agriculture finance services; asset management services; collateral management services; discounting services; housing finance services; investment advisory services; investment finance services; leasing; non-banking microfinancing services; pension fund scheme business; private equity and venture capital fund management services; real estate investment trust (REIT) management services; and any other regulated form of business as may be notified by the Federal Government; and
 - b. the Netting of Financial Contract Bills which provides for finality and irrevocability of settlement and precludes the liquidator in any insolvency proceedings being able to exercise any rights against amounts allocated for netting arrangements .
234. Although there is a significant amount of relatively contemporary legislation it would be prudent to ensure that there are no overlaps, underlaps or inconsistency in coverage between all of these interacting statutes.

235. A summary of the immediate and short term recommended legislative changes to the SECP Act is found in the schedule of proposed amendments to the SECP Act which accompanies this report and the areas to be enhanced can be broadly summarised as follows:

- a. The creation of a new and separate insurance regulatory body;
- b. The transfer of the SECP's existing role as "Registrar of Companies" to a separate regulatory body;
- c. The restoration of the powers of the Policy Board to the original intention of an oversight body;
- d. Establishing continuity of governance, leadership and transparency of appointments arrangements (including removal from office and a Code of Conduct for appointees) and certainty of processes for the SECP Chairman, Commissioners and the Policy Board; and
- e. In the long term it would be desirable to separate the role of the Chairman and CEO.

The SECP Regulations

236. From a longer term perspective, the underlying regulations promulgated by the SECP should be simplified (less is more²) and rationalized in the light of industry comments that there are a "jungle of regulations" and then only incrementally amended consistent with market development. This rationalization should encompass all SECP and PSX to ensure that these are appropriate to facilitate market development namely:

- a. Ensuring capital requirements for brokers requirement to be broadly in line with international best practices
- b. Undertaking a recategorization of the roles of market participants and facilitate the introduction of the "investment advisor/intermediary" function; and
- c. Hard code in legislation that a fund management licence cannot be granted in connection with any other category of licence.

Recommendations as to Collective Investment Schemes and Private Equity (PE) funds

237. European requirements for investment funds are detailed and prescriptive and focus on both liquidity and diversification in addition European funds (UCITS) must invest in only eligible assets which include:

- a. Transferable securities admitted to or dealt in on a regulated market;
- b. Money market instruments;
- c. Deposits with credit institutions; and
- d. Financial derivative instruments of which the underlying consists of eligible assets or interest rates, foreign exchange rates or currencies and financial indices.

238. A further significant limitation of the UCITS fund structure is that no more than 10% of net assets of the fund (the so called "trash ratio") may be invested, in transferable securities and money market instruments that are not listed on an exchange or dealt in another regulated market.

239. And finally, UCITS are restricted from borrowing with the exception of on a temporary basis with a limit of up to 10% of the net asset value of the fund and short selling of securities is prohibited.

² UK Better regulation initiative

240. It is suggested that development of funds in Pakistan does not look to the complex UCITS model for funds which is inherently unsuitable for emerging and illiquid markets but rather seeks to enable the widest range of fund structures and types that are possible so that all the options are available to foster growth. Whilst investment funds are strictly regulated internationally the demands of such regulation are best suited to developed as opposed to emerging markets where liquidity and choice of investment products may be limited.
241. It is recommended that the new draft law on collective investment vehicles merits consideration of inclusion of the following legal structures for funds (and is not just concentrated on the Trust model) and includes all of the following incorporated forms:
- a. a new company;
 - b. a trust company;
 - c. contractual arrangements; and/or
 - d. a general partnership (GP) / limited partnership (LP) arrangement.
242. The above four legal structures will afford scope for development of the funds market. In particular the GP/LP form is particularly suited to PE funds. The limited partnership (LP) has, for the past thirty years, been the vehicle of choice for fund managers across private equity and venture capital to aggregate and put to work the capital of their investors. These limited partnership structures may be used across diverse categories of asset classes including real estate funds and are attractive to foreign investors.
243. LP funds must have at least one GP and any number of LP's (investors). The funds are closed ended and not intended to be transferred or traded. However, they can be transferred to another investor with the consent of the GP although this is an infrequent occurrence. GP/LP funds typically have a ten-year term normally by two years.
244. The GP³ is responsible for managing and running the partnership and contribute a nominal amount of capital, GPs themselves are normally constituted as a limited liability partnership or a company whereas the LP's are liable to the extent of their contribution to the fund. GPs have full power and authority to act on behalf of the LP and to bind the LP without prior consultation. The LP's are the investors in the fund and contribute capital to be pooled and invested. These are typically institutional investors, which can include pension funds, sovereign wealth funds, insurance companies, and high net worth individuals.
245. These legal structures then have the flexibility to select one of the following types of fund structure:
- a. Open ended with an obligation to continuously redeem;
 - b. Closed ended with no obligation to continuously redeem; and/or
 - c. Interval with an obligation to redeem at fixed periods⁴.
246. It may be prudent to consider only licensing funds which are made available by way of public offers and that the SECP simply "register" a list of private placements offered to institutional or high net worth investors⁵ who are normally considered to be capable of assessing the risk of any such schemes. Private placements are internationally usually subject to a "light" regulatory regime which involves the managers of such private funds⁶ being subject to the following requirements:
- a. notifications when significant stakes are taken or disposed of in unlisted companies;

³ To ensure that the new Companies law enables GP's to be constituted as corporate bodies

⁴ These types of funds are considered an advantage in emerging markets where liquidity is an issue

⁵ Defined by different parameters in different jurisdiction but all definitions essentially cater for the informed investor who is capable of making their own decisions or seeking their own investment advice

⁶ Alternative Investment Funds (AIF) which are regulated in Europe by the Alternative Investment Fund Directive and private equity fund managers managing AIF's must be licensed to carry on the "regulated activity" of management.

- b. disclosure of acquisition of control of unlisted companies;
- c. time-limited safeguards against the erosion of capital (asset stripping); and
- d. details of the due diligence undertaken during the investment process.

247. Again, in order to facilitate market development of investment funds it may be prudent to consider lower minimum capital requirements for fund managers given there will be custodian and segregation arrangements in place to protect investors.
248. While investment and borrowing powers for publicly offered funds will require the fund manager to operate on a risk-based approach to the investment portfolio with a general overriding requirement as to the liquidity of assets it may be advisable to consider a more relaxed approach for private placements with no restrictions on fund managers as to investment and borrowing but simply setting in place a regime which monitors and supervises fund managers but imposes upon them an overriding duty of transparency and disclosure.
249. With regard to valuation of fund assets regulations should incorporate the flexibility to cater for domestic market illiquidity and potential lack of availability of current and reliable asset prices.
250. Finally, investment funds are generally internationally exempt from taxation at the fund level, with the exception of some registration duties or other small or nominal taxes due in the country of domicile. Withholding taxes on income will depend on the country of domicile and the fund's or investors' ability to benefit from double tax treaties however most investors are reticent to invest in funds where they are obliged to seek a tax rebate from the operation of a tax treaty.

Recommendations as to Public Offers and Listing:

251. At present the SECP has the power to require compulsory listing⁷ and it is recommended that this power be removed. Listing is either a matter for government in respect of privatisation of SOE's or a purely commercial decision. It is not a decision for the regulatory authority. Any decision to "go public" as a means of raising capital should be one for the board of directors of the company following consultation with the shareholders.
252. Companies forced into listing by way of privatisation (or other means) do not necessarily have the appetite to adhere to the requirements as to disclosure and transparency and good corporate governance in many cases use flagrant non-compliance as a means of seeking to persuade the regulatory authority to "delist" them.

Simplification of Public Offering Regulations 2017 and listing requirements: A more flexible approach?

253. It is recommended that "approval" by the SECP of any prospectus is replaced with the words "prospectus filed with the SECP" to ensure that there is no misperception that the SECP has or is under any obligation to undertake any due diligence with regard to the content of the prospectus.
254. Following an extensive review⁸ a new approach to listing and prospectuses is being rolled out across the EU. There are salutary lessons to be learned from the background to these changes as the diversity of prospectus requirements across the member states and the costs of issuance were the most influential factors in the recommendations for simplification.
255. The review concluded that:
- a. The high cost of compliance with the current Prospectus Directive was prohibitive;
 - b. Ineffective investor protection was provided by the old Prospectus Directive;

⁷ The Securities Act 2015

⁸ Commission Staff Working Document Impact Assessment 2015

- c. The framework was inflexible particularly for SME's;
- d. There was a significant lack of "harmonisation" of the Prospectus Directive requirements between Member States; and
- e. The Prospectus Directive was simply out of date.

256. The new EU Prospectus Regulation broadly provides for the following changes:

- a. The smallest capital raisings and crowdfunding projects up to €1 million will not need to issue a prospectus at all;
- b. A prospectus will only be mandatory from in excess € 8 million in capital raised. For offerings below that threshold, issuers can raise capital according to local market rules issued by growth markets. The purpose of this requirement is to support the growth of local or regional exchanges;
- c. There will be a new "growth prospectus" that will be available for SMEs, mid-caps admitted to an SME Growth market or small issuances by non-listed companies;
- d. An alleviated corporate bond prospectus will be available for admission to wholesale debt markets. Hitherto the alleviated debt prospectus was only available for debt issued in denominations of at least €100 000, a denomination size which made it difficult for many investors to invest in corporate debt. The new corporate debt prospectus aims to introduce more liquidity into secondary markets for corporate bonds;
- e. A shorter prospectus for secondary issuances will allow issuers already admitted to stock markets and SME growth markets to benefit from a lighter prospectus for any "follow-up" issuances;
- f. Prospectus summaries will become shorter and the language used will be easier to understand for investors; and
- g. No more paper prospectuses will be required, except if a potential investor explicitly requests one.

257. It is recommended that the current listing arrangements are reviewed in the light of the EU experience with emphasis on the ease of listing and the development of alternative or 2nd Tier Boards (in line with GEM in Hong Kong or AIM in the UK) to promote ease of raising capital in the markets.

Governance: Regulatory, Enforcement and Decision Making:

Diagnostic

258. In respect of the exercise of any of its powers the SECP should adopt a consistent, transparent and proportionate approach which is underpinned by the following:

- a. a standardised format for all regulations, decisions and notices issued by it;
- b. an annual report which specifically address the regulatory challenges facing both the SECP and market participants including its policy for market development for the forthcoming years which sets its focus in line with its long term (5 year) plan; and
- c. publish a policy of adhering to principles of "good regulation"⁹ which encompasses regulatory expectations of market participants behaviour, and good corporate governance for the regulatory authority in terms of proportionality, openness and disclosure.

⁹ See the UK FCA principles of good regulation:

259. In respect of its own internal governance arrangements the SECP should:

- a. Develop new divisional reporting arrangements so that there is an executive director (“ED”) responsible for each line division who in turn reports to the Chairman and the Commissioner’s;
- b. Establish function-based divisions to maintain consistency of processes and regulatory policy with respect to each of the regulated sectors under the statutory remit of the SECP;
- c. Establish monthly round up meetings between all ED’s to ensure a lateral flow of information between SECP line divisions and that concerns that cross divisional lines are flagged up for action;
- d. Ensure that there are clear interdivisional protocols and procedures for referral and hand over of unresolved or persistent concerns arising out of supervision of licensed companies or individuals to enforcement for investigation and appropriate sanctions;
- e. Ensure that the Enforcement has the exclusive remit over any matter which is sufficiently grave to merit the use of the SECP’s formal investigative powers in order that the investigation and evidence gathering can be conducted in accordance with the requirements of the civil or criminal codes as appropriate;
- f. Ensure there is a division that is seized of the responsibility for regulation of the Perimeter;
- g. Ensure there is a standard set of precedents for all investigations, and proposed enforcement actions to achieve consistency of treatment and approach;
- h. Establish clear lead regulatory arrangements to ensure that only one regulatory authority is seized of the responsibility where several regulatory authorities are involved to avoid duplication of effort, potential over regulation and consequent costs and eradicate any possibility of misunderstandings between authorities;
- i. Establish arrangements for regular “round up/ market development” meetings between regulatory authorities (for example once a month) to facilitate exchange of information and share current regulatory concerns;
- j. Ensure all staff handbooks and manuals are concise but informative and up to date; and
- k. Establish a dedicated “Press Office” that enables all press enquires and SECP response to come through a single point of entry to address misinformation/ false news in the financial and other press.

260. The SECP is fettered in exercising its statutory powers of inspection, investigation and enforcement by the pervasive powers of the National Accountability Bureau. Eradication of corrupt practices is

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1. Efficiency and economy: Use of resources in the most efficient and economical way.
 2. Proportionality: Ensure that any burden or restriction imposed on a person, firm or activity is proportionate to the benefits expected taking account the costs to firms and consumers.
 3. Sustainable growth: Ensure there is a desire for sustainable growth in the economy in the medium or long term.
 4. Consumer responsibility: Consumers should take responsibility for their decisions.
 5. Senior management responsibility: A firm’s senior management is responsible for its activities and for ensuring that its business complies with regulatory requirements. Senior management are responsible for the risk management and controls within firms.
 6. Where appropriate exercising regulatory functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons subject to requirements imposed by or under law.
 7. Openness and disclosure: Publication of relevant market information about regulated persons to reinforces market discipline and improves consumers’ knowledge about their financial matters.
 8. Transparency: Exercise of regulatory functions as transparently as possible by providing appropriate information on regulatory decisions and behaving in a way that is open and accessible to the regulated community and the general public.

essential within government and regulatory organizations of all descriptions however, the way in which legislative powers have been drafted effectively means that Officers of NAB can investigate the “investigators of the SECP” when they are simply properly performing their statutory functions. There is a clear statutory immunity from suit in the SECP Act for officers and employees which is in line with the requirements of the IOSCO Principles and yet which is which is the subject of concern as there is the perception that this immunity is not heeded by Officers of NAB. There is also the perception that actions taken by NAB are neither transparent nor accompanied by appropriate accountability safeguards.

Recommendations as to the interface of the role of NAB with the SECP in the exercise of its Enforcement functions

261. It is recommended that the SECP Act be amended to clearly preclude NAB from interfering with the functions of a statutory body with its own investigative powers from lawfully discharging these in the proper performance of its regulatory obligations. At the same time, the National Accountability Ordinance 1999, which establishes NAB, must be clarified to ensure that it does not override provisions of the SECP Act which provide an immunity for officers of the SECP from legal action absent the establishment of bad faith.
262. The SECP has wide ranging powers to undertake supervision and inspection of market infrastructures and participants on a regular and ad hoc and without notice basis. Serious transgressions which cannot be remedied by a process of agreed rectification should then cause the SECP to consider the use of the more draconian enforcement sanctions at its disposal which include:
- a. the imposition of financial penalties;
 - b. withdrawal of a licence;
 - c. prohibition individuals from carrying on regulated activities;
 - d. suspension of companies and individuals from undertaking regulated activities;
 - e. making a public announcement when of disciplinary action and publishing details of warning, decision and final notices;
 - f. applying to the courts for injunctions, restitution orders, winding-up and other insolvency orders;
 - g. referring matters to the prosecuting authority to address financial crime, such as insider dealing, unauthorised business and false claims to be licensed; and
 - h. issuing warnings and alerts about unregulated companies and individuals and requesting that web hosts deactivate associated websites.

Recommendation as to Enforcement Powers

263. The SECP should publish its enforcement policy to demonstrate its impartiality, consistency of approach and proportionate response to transgressions and its intention through the use of its enforcement powers to identify and drive out behaviour that fails to meet regulatory standards or is dishonest or unlawful¹⁰.
264. Financial penalties are currently fixed by legislation. The fines to be imposed by a regulatory authority need to be a sum that is both meaningful one and provide a credible deterrent. Fines enshrined in primary legislation all too often become outdated with the passage of time and thus may foster an attitude of “easier to pay the fine than rectify the misconduct” . Where the regulatory authority has no control over setting the levels of fines then these should be used sparingly and as a first step in the process of a gradual and proportional response to rectification of misconduct which involves

¹⁰ See the FCA Mission Statement “Our Approach to Enforcement” 24th April 2019

consideration of all the available enforcement sanctions (a set out above) that the SECP has in its regulatory tool kit.

Recommendations as to Prosecutions

265. Under the current legislative arrangements the SECP is effectively a prosecuting authority and is able to prepare and prosecute criminal offences under the securities markets legislation. Concerns have been raised as to the SECP's capacity to prosecute and their lack of experience with the underlying requirements of the Criminal Codes as to evidential standards and their expertise of appearing and presenting such case before the criminal courts.
266. To address these concerns it is recommended that:
- a. The SECP only countenance prosecutions in the most egregious of cases (such as market manipulation or abuse and or insider trading) and ones where they confident that their investigations have been conducted in such a way as not to fall foul of the requisite criminal evidential requirements to meet the all the constituent elements of the offence including any mental element;
 - b. The SECP as a matter of course always consider in the first instance exercise of the "administrative and disciplinary" powers at their disposal as an alternative to securing their regulatory objectives as removal or suspension of a licence or limiting the business of a license is an immediate and effective punishment;
 - c. In those cases where the SECP considers that prosecution is a merited and proportionate response they have ensured that their enforcement staff have received the appropriate training and have the skills and expertise required to undertake the prosecution; and
 - d. The SECP consider adding to their enforcement staff individuals with the qualifications, skills and experience of prosecuting criminal matters and provide them with training on the criminal offences created by the securities markets legislation framework.

Recommendations for regulating the perimeter

267. It is recommended that the SECP has in place processes to:
- a. identify and assess whether its regulatory requirements and framework adequately addresses risks posed by products, markets, market participants and activities;
 - b. review, where it is presented with evidence of changing circumstances, its past regulatory policy decisions on products, markets, entities, market participants or activities; and
 - c. review unregulated products, markets, market participants and activities, including the potential for regulatory arbitrage, in order to promote investor protection and fair, efficient and transparent markets and reduce systemic risks¹¹.
268. The question of what a capital markets regulatory authority does and should regulate and where to draw the line is inevitably a complex challenge. This boundary (the so called "perimeter") can be difficult for consumers to understand. Some companies and individuals will try to act on the edge of the perimeter, to deliberately avoid regulation. Markets also change and adapt, so that new products and services are launched that do not easily fit within legislative categories. The regulatory response to these challenges can be met as follows:
- a. to clarify, educate and improve consumers' understanding of the protections that are in place;
 - b. to monitor activity that is at the edge of the perimeter, taking enforcement action where this is possible; and

¹¹ Methodology for assessment of compliance with IOSCO Principle 6.

- c. to work with government and the industry to ensure healthy innovation can occur while maintaining safeguards.

269. Whilst the decision whether to regulate a specific product, market, market participant or activity is ultimately a policy judgment made by the regulatory authorities in each jurisdiction a regular review of the perimeter of regulation is desirable to test the effectiveness of existing regulations and the need to modify them or adopt new regulations in light of new market developments.

270. In the UK the FCA has successfully lobbied for legislative change to give it the clear powers to issue warnings on financial products that may cause consumer detriment particularly where an activity is beyond the perimeter of regulation¹².

Recommendations for addressing consumer and industry complaints¹³

271. It is recommended that in line with international best practices that the SECP should establish arrangements to create a scheme for the investigation of retail consumer complaints arising in connection with regulated activities conducted by market participants and for complaints made by market participants against each other and against the regulatory authority itself. Such a scheme must be designed so that, as far as reasonably practicable, complaints referred to it are investigated and adjudication upon quickly.

272. There are many different approaches to arrangements for establishing such schemes, but they are usually focused on some form of dispute resolution mechanism (for example arbitration, an ombudsman, an independent complaints committee that operates outside the mainstream structure of the Courts. There are precedents for dispute resolution arrangements which operate without erosion of a citizen's constitutional rights, and it is recommended that these be closely examined to see if they would be "portable" to the capital markets sector.

Recommendations as to Budget and Funding

273. No regulatory authority ever has sufficient budget to meet its regulatory or organizational needs. Under the present arrangements the Policy Board effectively controls the budget allocation for the SECP and has the ability to endorse, reject or approve the recommendations of the SECP Commissioners. It is recommended that this power be removed from the Policy Board and in line with other international regulatory authorities the Commissioners themselves will make the recommendation to Government having identified their projected needs having undertaken an internal and external regulatory risk assessment to take account of unexpected calls on that budget in consequence of internal organizational expenditure (for example staffing needs and or staff training, premises or IT) or to meet external regulatory expenditure in consequence of market development initiatives for the forthcoming financial year.

274. It is also recommended that to finance the SECP's proposed education training and consumer education initiative that instead of surrendering any revenues from income received by way of regulatory fines that these funds are retained by the SECP.

275. Whilst in the IOSCO principles consider it desirable that that a regulatory authority should be independent in terms of its budget it is clear that the SECP cannot at this nascent stage of the market be funded by the market itself. That should be a long term objective to fully meet the IOCSO principles. However, in the interregnum restoring the autonomy to the SECP to mater of its own budget planning is a desirable objective.

¹² The work of the Financial Conduct Authority: the perimeter of regulation - Report to the Select Committee of the House of Commons August 2019

¹³ To be distinguished from the proposed Tribunal arrangements which are focused on the exercise by the SECP of its regulatory decision-making powers

Recommendations as to the Independence of the SECP and the role of the Policy Board

276. A wide range of amendments are proposed to the current SECP¹⁴ Act designed to restore the appropriate autonomy of independent decision making in line with the IOSCO Principles and reduce the remit of the Policy Board to its intended oversight function and to establish simplified governance arrangements by creating a transparent selection process for Commissioners and members of the Policy Board and ensuring that there is continuity of leadership by extending the duration of the term of office and preventing these senior office holders from being removed from their posts without cause.

SECP Senior Appointments - transparency of process, Continuity of Tenure of Office , Removal for cause

277. At present each Commissioner is responsible for a sector of the overall remit of the Commission as a whole and the organization operates in a linear structure. It is suggested that this linear structure changes to become a collegiate and horizontal decision making process with no one Commissioner having day to day responsibility for a divisional sector. This will enable the SECP to focus on taking proportionate and targeted enforcement action as and where appropriate.

Consider the long term desirability of the Separation of the roles of the Chairman and CEO

278. At present the Chairman of the Commission is also its CEO. All regulatory authorities have a dual role in that in addition to being the market regulatory they also function as a corporate body and have the responsibility of the management of the organization as a whole. This latter function should be undertaken in accordance with best practices in corporate governance (leading by example). International best practices reflect the increasing move away from the dual role of the Chairman and CEO being vested in one individual. Splitting this role reinforces the independence of the Chairman and the Commissioners in their role of the ultimate decision making body and enables them to almost exclusively devote their attention to the regulatory function whilst the CEO's remit is to focus on the day to day management responsibilities of the organization reporting to the Chairman and the Commissioners.

A separate "Company Registrar" Regulatory Authority:

Diagnostic

279. The SECP has "inherited" the role and functions of a Company Registrar. Whilst some jurisdictions have successfully combined this with that of the securities markets regulator the more common approach is to limit the remit and focus of the regulatory authority to its true purpose, that of capital markets regulation, and restrict this to companies which are listed on the Exchange, as higher standards with regards to transparency, disclosure, accounting and corporate governance are required from these enterprises as opposed to the wide variety of companies whose business will be wholly unrelated to any capital markets activities and in respect of whom lesser standards of transparency, disclosure, accounting and corporate governance will be required.
280. This additional role of inspection, supervision and potential enforcement action against companies for breaches of the Companies Act 2017 places a further burden and unnecessary set of responsibilities on the SECP not only in terms of human resources, but also budget and IT systems, while also restricting the growth of the corporate sector.
281. It recommended that this function be removed from the SECP and a dedicated corporate registry be established for all corporate bodies including listed companies, but the SECP continues to be responsible for regulating the business of companies licensed with it.

¹⁴ The detailed wording for these recommendation are set out in the schedule of proposed amendments to the SECP Act

A separate “Insurance” Regulatory Authority:

Diagnostic

282. The SECP currently has the regulatory responsibility for the insurance sector. It is recommended that there should be the creation of an independent regulatory body dedicated to this sector. This recommendation will necessitate a separate law clearly establishing the regulatory authority and its role, powers and duties all of which should be benchmarked IAIS core principles¹⁵.

Introduction of a Capital Markets Tribunal:

Diagnostic

283. IOSCO Principle 2 sets out the key criteria for the regulatory authority to be accountable in the exercise of its powers. In terms of accountability IOSCO expects that there will be a *“means for natural or legal persons adversely affected by a regulator’s decisions or exercise of administrative authority ultimately to seek review in a court”*. This process of review currently exists in the SECP Act¹⁶ but it is structured in such a way that the SECP effectively is making a judgement on a decision made by itself despite the safeguard that no Commissioner who participated in the original decision may form part of the Appellate Bench of the Commissioners. This structure is fundamentally flawed, notwithstanding the integrity of the Commissioners, since it inherently creates the perception of bias and undermines market confidence in the impartiality of the Appellate body to overturn a decision of their peers. It also runs contrary to the general principle that there should be a clear distinction between role of the investigator and prosecutor and the judge.
284. To challenge a decision made by a regulatory body in the Courts can be both time consuming and expensive and the Judiciary may not be familiar with the way in which capital markets operate or the powers and regulatory objectives of the SECP and their role in investor protection as there is no dedicated Commercial Bench as yet in Pakistan.
285. It is considered international best practice to create an appellate structure (usually a Tribunal or Panel) that is clearly defined by statute as sitting outside the regulatory authority. This Tribunal is comprised of a panel of experts who have the appropriate gravitas, expertise, independence and integrity to foster market confidence in their ability to adjudicate on decisions made by the regulatory authority with independence and impartiality. The Tribunal is structured in such a way that appeals are heard and determined within a fast track time frame (usually six months from start to finish) and enables parties aggrieved by decisions to choose to an inexpensive way of challenging decisions as opposed incurring the potential legal costs by litigation before the Courts. Tribunals have no power to award any legal costs against either party to any appeal. The Tribunal structure also acts as a filtering mechanism in that no appeal lies to the higher Courts from the Tribunal unless that Tribunal made an error of law or came to a decision that was manifestly unreasonable in accordance with the general principles of judicial review.

Recommendation as to the Establishment of an Independent Tribunal

286. It is recommended that the SECP Act be amended¹⁷ to facilitate the establishment of an independent Capital Markets Tribunal.

Summary of Expected Outcomes

287. The outcomes of these extensive legislative and regulatory recommendations will be to provide the SECP with a legislative framework which is better aligned to international best practices and benchmarked to the IOSCO principles.

¹⁵ International Association of Insurance Supervisors Core Principles 2017

¹⁶ Section 33 of the SECP Act

¹⁷ The detailed wording for the constitution of the Tribunal and its powers and duties is set out in the schedule of proposed amendments to the SECP Act

288. The SECP will have all the powers at its disposal to move in tandem with both domestic and international changes and be able to exercise flexibility in its approach to the issuance of regulations, codes and guidance to assist the market to grow incrementally without being fettering by an over ambitious and restrictive legislative framework which may impede market growth and development.
289. In terms of governance the SECP will have the appropriate autonomy in line with the IOSCO principles for regulators in respect of its internal organisational, decision making and budget arrangements and will be able to lead by example in standard setting for transparency and disclosure in the field of corporate governance.
290. The SECP will additionally have enhanced market confidence by facilitating the creation of a truly independent and fast track appellate mechanism for challenges to its decisions by regulated market participants.

Summary of Proposed Amendments

Summary of Key Proposed Amendments	Rationale
<ul style="list-style-type: none"> Reduce the statutory regulatory remit of the SECP 	Create separate regulatory bodies for the Insurance sector and for a Companies Registrar
Governance of the SECP: <ul style="list-style-type: none"> Change the appointments system of the Chairman, Commissioners and Policy Board; Removal for cause; Change tenure of office of Chairman, Commissioners and Policy Board Introduce Code of Conduct for Chairman, Commissioners and the Policy Board Introduce immediate disclosure for conflicts of interest 	<ul style="list-style-type: none"> Create an Appointments Committee which will identify and propose potential candidates in a transparent manner; Enable removal of key offices for cause to ensure continuity of tenure of office; Two five years terms for Commissioners with two year cooling off period between terms One five-year appointment for the Chairman who may not then serve as a Commissioner; One five-year appointment for Policy Board members Introduction of penalty for failure to disclose conflicts
Education and Training	<ul style="list-style-type: none"> Introduction of qualifications for all employees of licensed firms Establish a training institution to provide dedicated, high quality education and qualifications for the industry
Introduce modernised legislative framework for Collective Investment funds	To enable investment funds to be: <ol style="list-style-type: none"> a new company; a trust company; contractual arrangements; and/or a general partnership (GP) / limited partnership (LP) arrangement
Simplify SECP Regulations	Simplify the listing regulations in line with international developments
Encourage the Formation of SRO's	This will provide additional regulatory safeguards for market professionals such as accountants
Establish an independent tribunal to review SECP decisions	Remove the current arrangements where the SECP forms an appellate body to review its own decisions and create a fast track (6 months) review body which is entirely independent in line with international best practice
Establish arrangements to "police the Perimeter"	In line with international best practice and IOSCO the SECP should identify the risks which unregulated individuals and

	companies pose to its regulatory objectives and have in place a policy to address these challenges
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Expected outcomes

No	Recommendation/Action	Outcome	Timing	Responsible
1	Review statutory regulatory remit of the SECP	Statutory mandate of SECP has expanded over time and currently is beyond that of a typical securities regulator enshrined under IOSCO. A comprehensive review should be undertaken for separation of insurance oversight, companies registry, and secured transaction registry	Long Term	MOF
2	<p>Amend SECP Act to improve governance, operational and financial autonomy of SECP covering following area;</p> <ul style="list-style-type: none"> • Appointment process and tenure for Chairman, Commissioners and Policy Board • Direct appointment and tenure protection to the post of Chairman • Introduce Code of Conduct for Chairman, Commissioners and the Policy Board • Strengthen provisions related to conflicts of interest • Commission should function as a collegiate body • Bring clarity in role of policy board so as to remove any operational overlap with the commission • Regulations making process should be transparent and robust • Enhance disclosure through annual report of the commission • Deletion of provision pertaining to surrender of surplus • Exemption from applicability of income tax • Strengthen provisions pertaining to registration of SROs, professional accreditation, and investor education • Formation of Financial Market Tribunals • Streamlining and strengthening role of Audit oversight Board • Protection to SECP against undue interference by LEAs 	<p>Proposed amendments would bring transparency in the appointment process and help attract quality candidates both at the commission and policy board level.</p> <p>Governance would be strengthened through clarity in role of policy board viz-a-viz commission, chairman viz-a-viz commissioners and will enable SECP to work as a collegiate body with longer protected tenure providing continuity of policies.</p> <p>Enhanced conflict of interest provisions, improved disclosure requirements, transparent regulations making along with formation of independent financial market tribunals will make functioning of SECP transparent giving market and investors confidence.</p> <p>Enhanced role of SROs would bring efficiency in implementing professional standards and efficient enforcement</p> <p>Post formation audit oversight board has faced various issues that are being addressed through amendments to streamline and strengthen its role for having a robust accounting profession for investor protection</p>	Short Term	MOF/SECP

3	Introduce modern legislative framework for Collective Investment funds enabling investment funds to be a) a new company; b) a trust company; c) contractual arrangements; and/or a general partnership (GP) / limited partnership (LP) arrangement	Present framework for collection investment funds is restrictive and limits undertaking of these activities through formation of a non-bank finance company thereby inhibiting growth of sectors like investment advisory, private pension and private equity. A new modern law would not only address these issues but would attract investment and expertise.	Long Term	MOF/SECP
4	Simplify SECP Regulations	For development of primary market and deepening to capital market it is important that listing regulations be simplified in line with international developments	Medium Term	SECP/PSX
5	Encourage the Formation of SRO's	Absence of robust SORs in the capital market has undermined development of professional standards and also SECP has to assume responsibility of all trivial matters. A well functioning SROs in the brokerage and fund management sphere would lead to improved professional standards and provide framework for efficient enforcement enabling SECP to focus at broader and important issues.	Medium Term	SECP
6	Establish an independent tribunal to review SECP decisions	Remove the current arrangements where the SECP forms an appellate body to review its own decisions and create a fast track (6 months) review body which is entirely independent in line with international best practice	Medium Term	MOF/SECP
7	Review and strengthen governance structure at Capital Market Infrastructure institutions	Post securities act governance structure at CMII has been modified but still require improvement particularly with respect to size of board at the PSX; higher number of independent directors at board of CDC and NCCPL; nomination process, minimum experience, track record of independent directors; cooling off period, code of conduct and disclosure requirements for directors; and role, composition, and disclosure of proceedings of board committees	Short Term	SECP

PART 8: LEVEL THE TAX PLAYING FIELD

General principles

292. The aim of measures is to level the tax playing field and align this with international best practices, with the following overarching principles in mind:
- a. There should be no double taxation of residents and non-residents;
 - b. There should be tax consistency for all collective investment schemes irrespective of their structure including mutual funds, alternative funds and private equity funds, so that these have pass through status and only final investors are taxed as opposed to the structures itself;
 - c. The playing field should be levelled by making sure that investment revenues that are similar in nature but different in form (for instance interests on deposits, commercial paper, certificate of deposits, bills or bonds) are subject to a similar tax treatment;
 - d. The tax regime should encourage riskier and longer-term investments rather than safer and shorter-term investments;
 - e. There should be additional but targeted tax incentives for innovative and fast-growing businesses that present a higher risk profile and for the investors (private equity funds) that risk their money to finance these businesses;
 - f. The Code should clearly define or make clear references to the capital market law with regards to the different categories of capital market players (investors, intermediaries, nominee holders, investment or mutual funds, etc.), transactions (outright securities transactions, securities financing, forward transactions, etc.) and instruments (securities, structured products, derivatives, etc.); and
 - g. Investment funds should be exempted from taxation at the fund level and taxation should be on the basis of a clear “see through” to the ultimate investor wherever domiciled.

Proposal for Documenting real-estate sector through REITs

Diagnostic:

293. A vibrant REITs can result in formalizing the real estate sector and significantly help in improving documentation and transparency in real estate and the overall economy, with disclosure of actual transaction values at the time of transfer of property to a REIT Scheme. This would also address a major FATF concern regarding the real estate sector being used for money laundering. REITs model is a suitable avenue for greater investor protection with a trustee ensuring that funds for a particular REIT scheme are used only for particular scheme and not funnelled into other projects, thereby enhancing confidence of local and foreign investors in our real estate sector. Since the introduction of the REIT scheme only 01 Company was registered with the SECP. Following taxation factors have the impact on the growth of this sector:
- a. The current exemption from capital gains tax is available for a very limited period i.e. till June 2020 Developmental REIT Scheme and June 2021 for Rental REIT Scheme. Exemption for such limited time results in creating uncertainty for the industry and is a major impediment for growth of the REIT sector;
 - b. the provided exemption also does not cover developmental REITs other than those exclusively for residential purposes. This excludes commercial and mixed-use projects which form a key strategy for developmental REIT Schemes;
 - c. Sale of real estate to a REIT scheme at market value is required to transfer title of real estate in the name of trustee, hence capital gains arising on such transfers is not a gain on

actual sale. Since, no other form of real estate business requires such transfer, therefore any taxation on these paper gains renders the transaction uneconomical ab-initio and discourages launch of REITs.

294. Through Finance Act 2019, rate of tax on dividend from REITs Schemes was enhanced from 15% to 25%. In contrast, dividend from mutual funds (which also have such pass-through status) is being taxed at 15% whereas dividend from stock funds is taxed at 12.5%. This has caused significant disparity as a REIT Scheme is also a type of closed-end fund. In addition to adversely affecting the REIT sector, this additional tax is extremely discouraging for new entrants in the REIT industry and therefore inhibiting the immense potential that REITs offer for development of real estate sector and the overall economy. Moreover, this is particularly discouraging companies and banks from making investment in REIT Schemes due to double taxation; firstly, the company pays tax on dividend as unit holder of a REIT scheme and secondly individuals pay tax on dividend as shareholders of the company owning units in the REIT scheme.
295. Imposition of advance taxes on sale and purchase of immovable property is another issue for REITs as distribution of 90% of income as dividend, exempt the REIT Scheme from income tax. Therefore, as such there is no option to adjust the advance tax against any applicable corporate tax payments. Also, because the seller of the immovable property is exempt from capital gain tax, therefore, advance tax from the seller should not be levied.

Supporting Insurance Industry

Diagnostic:

296. Pakistan has one of the lowest insurance penetrations in the region and therefore efforts are being made to promote insurance industry to address financial fragility of masses. In particular, non-life insurers in Pakistan have resorted to cater for the needs of the corporate sector and have by-large not focused on personal lines of non-life insurance business. Further, to serve the poor and most vulnerable segment of society, personal lines of business and especially sale of low-ticket insurance products are being encouraged. We believe that micro-insurance products can play an instrumental role in development of the insurance market in Pakistan.
297. Presently, capital gains and dividend income of insurance companies is also being taxed on the corporate rate of tax of 29%. Additionally, levy of sales tax on reinsurance services by the provincial revenue authorities has added significant tax burden on the insurance sector.
298. In view of the same, following taxation issues should be attended for appropriate amendments:
- a. Federal Insurance Fee (FIF) was levied by the Federal Government for the purposes of spending on insurance awareness and education. However, the purpose for which the FIF was levied has not been fulfilled and the insurance sector has been bearing this additional cost of 1% for last 20 years now without accruing any benefit to the insurance industry in Pakistan.
 - b. Personal lines of insurance business including accident insurance, travel insurance and household insurance is subject to imposition of Federal Excise Duty (FED) which is discouraging non-life insurers to venture more into personal lines of business and especially into sale of low ticket insurance products for masses. We believe exempting these from FED would result availability of these products to the masses at lower premium.

Development of regulated commodity market

Diagnostic:

299. Majority of commodity producers/ traders work in undocumented manner; therefore, they hesitate to trade on PMEX because they would get documented as well as suffer withholding tax. Exempting them from withholding tax will not only promote trading at regulated platform but will also help to document trading activity of participants and resultant tax obligations on income. Following are some other arguments to support the proposal:
- a. There is no withholding tax on physical settlement of futures contracts in India;
 - b. Development of regulated and organised commodity markets will greatly benefit the documented agriculture sector; and
 - c. Once the traders, currently operating in the undocumented market, start to use the regulated & documented PMEX.
300. Further, the Government of Pakistan has rolled out a major initiative for development of agriculture sector to bring financial inclusion to the farmers at gross root level. The initiative is aimed at facilitating access to finance and reducing post-harvest losses in leading crop value chains. Under the direction of the Advisor of Prime Minister on Finance and Revenue, SECP, SBP and other stakeholders are working on implementing regulatory and operational reforms to introduce electronic warehouse receipts (EWR) and facilitate trading of agricultural commodities at regulated platforms.
301. To achieve this, Collateral Management Companies (CMC) Regulations were issued by SECP on July 31, 2019 and the Prudential Regulations were amended by SBP on October 18, 2019 to allow EWRs to be used as collateral by banks.
302. SECP is in process of issuance of registration to couple of CMCs which will accredit warehouses after inspection of their facilities, processes, and risk mitigation as prescribed by the CMC regulations. Testing and storing of eligible commodities into accredited warehouse and issuance of EWRs will help securing bank financing against EWRs as collateral.
303. Further, Pakistan Mercantile Exchange (PMEX) will also provide regulated platform for sale of EWRs while facilitating repayment of loan and settlement of warehousing charges electronically

Proposal for rectification of anomaly in CGT regime

Diagnostic:

304. Reforms introduced in CGT on listed securities has greatly facilitated investors in discharging tax obligations under section 37A of the Income Tax Ordinance, 2001. This system has not only enhanced efficiency and transparency but also resulted in timely collection of substantial amounts of tax for the government.
305. The acceptability and success of the aforementioned CGT system enabled its further extension to include foreign investors, futures contracts executed at PMEX and mutual funds industry, in its scope. However, there is an anomaly in the existing CGT regime that have primarily been caused by a court judgment. The definition of the term "security" provided in section 37A (3) is being misinterpreted due to absence of clarity in the said section and an Order passed by the Honourable Sindh High Court (CP.No. D1591 of 2015). This has caused omission of treatment provided in Income Tax Rules to determine date and cost of acquisition of newly listed securities.
306. In the presence of this judgment once a company gets listed, its shares get split into two parts for rest of the life of the company i.e. shares acquired after announcement of listing are called "Securities" while shares acquired in IPO and in hand of the "issuer" continue to be "Share". Further distortion in the definition of the term "Security" has put new listing on a halt.
307. In view of the same, FBR has been requested to rectify the anomaly by providing a clarity in the definition of security under the said Section 37A(3) that share of public company listed at the time of disposal shall be construed as security at the time of its acquisition notwithstanding the fact that such share was listed at the time of acquisition.

Potential of Private Fund

Diagnostic:

308. Pakistan currently has four licensed Private Funds, however, majority investors (including foreign investors) route their private equity and venture capital investments through unregulated/alternate avenues. For example, foreigners prefer such investments through offshore holding companies, which resultantly limits actual investment within the real economy, impedes accurate documentation of foreign capital inflows/outflows and hampers access to finance for our local businesses. For the immense macro-level advantages that private funds can offer, the SECP has also submitted key recommendations to the State Bank of Pakistan for removal of impediments in the growth of this sector.
309. An ideal taxation and regulatory framework for Private Funds should aim for Pakistan-focused funds pooled or domiciled in Pakistan and fund managers, who manage these funds to operate locally. This model of localizing funds and their management is followed by developed economies resulting in a thriving Private Funds industry. The following taxation issues should be addressed for the way forward for this industry:
- a. Profits and gains of PE&VC category of Private Funds are not tax at fund level up to June 2024. This time limited and partial pass through status is considered one of main reasons restraining investors as they feel uncertain regarding the future tax treatment of these funds and hence unwilling to commit any long-term financing to this industry.
 - b. Private Funds Regulations 2015 has been revamped to broaden the scope and provide greater flexibility to the industry by introducing new categories in addition to PE&VC category.
 - c. However, presently pass-through status is only provided for PE&VC category and other categories including alternate funds are not eligible for pass-through status. Hence, investors of such alternate funds are being taxed twice, once at fund level and then at the investor level. These new categories are resultantly seriously restricted due to an inherent tax disadvantage as compared to other Private Funds and direct investment in underlying assets.
310. Alternate fund category of Private Funds can act as pooled vehicle to invest in listed securities. However, redemption of units of alternate funds will attract treatment of unlisted security under CGT regime, which is significantly higher for corporate investors. Therefore, this is disadvantageous for investors to opt of alternate fund rout for investment in listed securities unless CGT on units of alternate fund investing 70% or more in listed securities, is applied in the similar way as applicable on individuals directly investing in listed securities.

Listing Encouragement

Diagnostic:

311. The businesses should be encouraged for listing in the stock exchanges presently under section 65 C of the Income tax Ordinance, 2001 Where a taxpayer being a company opts for enlistment in any registered stock exchange in Pakistan, a tax credit equal to 3[twenty] percent of the tax payable shall be allowed for the tax year in which the said company is enlisted and in the following year and for 3rd and 4th year that tax credit shall be ten percent of the tax payable

Expected outcomes

No	Recommendation/Action	Outcome	Timing	Responsible
1	Proposal for Documenting real-estate sector through REITs:	This change should have a positive impact due to the following reasons:	2020-2021	FBR SECP PSX

	<p>Following taxation issues are being submitted for appropriate amendments in the Income Tax Ordinance, 2001:-</p> <p>The first and second proviso of Section 99A of Second schedule should be deleted, and Section 99A should be reworded as follows:</p> <p>“Profit and gains accruing to a person on sale of immovable property to a REIT Scheme.”</p> <p>Paragraph B of Part I-Division III of the First Schedule ITO, 2001 be reworded as follows:</p> <p>15% in mutual funds, REIT Schemes and cases other than those mentioned in clauses (a) and (c)</p> <p>A new clause may be added in Part III of Third Schedule to the ITO 2001, as follow: “the provision of section 236C shall not apply to transfer of any immovable property to and from a REIT scheme.”</p> <p>A new clause may be added in Part III of Third Schedule to the ITO 2001, as follow: “the provision of section 236K shall not apply to a REIT scheme”</p>	<p>A vibrant REITs can result in formalizing the real estate sector and significantly help in improving documentation and transparency in real estate and the overall economy, with disclosure of actual transaction values at the time of transfer of property to a REIT Scheme. This would also address a major FATF concern regarding the real estate sector being used for money laundering.</p> <p>Increase in the number of developmental REITs will result in increased Government revenue through collection of higher sales tax, provincial taxes and other taxes from all allied construction related industries for e.g. cement, steel and service etc.</p> <p>REITs model ensures greater investor protection with a trustee ensuring that funds for a particular REIT scheme are used only for particular scheme and not funnelled into other projects, thereby enhancing confidence of local and foreign investors in our real estate sector.</p> <p>The proposed amendment has no economic or business implication for the owner of the property. Capital gains accruing to the seller through this transfer (sale) are only paper gains. As the owner is mostly issued REIT Units in lieu of real estate.</p> <p>Under a Rental REIT, the owner would generally be able to raise liquidity to the extent of 25% of the property value only. Whereas, Capital Gains tax has to be paid as if the entire 100% sale value is realized. Therefore, it results in disproportionately higher tax incidence.</p> <p>The current limited exemption cripples REITs' potential as many opportunities entail commercial developments such as malls, offices, warehouses, etc., which are ideal avenues for REIT involvement.</p> <p>In light of above, revenue collection increases as more properties will be documented and higher tax will be collected on account of unit holders. Exemption from this gain tax, which was available till limited time period, is the most critical starting point to promote REITs in the country.</p>		
2	Supporting Insurance Industry	The following are the positive outcome of the proposed changes:	2020-21	FBR and SECP

	<p>Article 8 of the Finance Act, 1989 regarding FIF read with Finance Act, 1991 should be abolished.</p> <p>The exemptions provided in Table II of Third Schedule of the Federal Excise Act 2005 in relation to insurance business Should also include:</p> <p>7A. Personal accident Insurance</p> <p>7B. Travel Insurance</p> <p>7C. Home property/ household Insurance</p>	<p>As per industry sources the amount of FIF paid to the national exchequer on a year on year basis now amounts to Rs. 1 Billion. Retention of Rs. 1 billion within the industry would result in providing additional capital resources to the sector for expansion of business by lowering rates of insurance premium providing due benefit to the policyholders of the non-life insurance sector.</p> <p>Granting exemption from FED to non-life segments will have no significant financial impact on the national exchequer but Such exemption is expected to result in increasing the gross premium of the industry. The increase in revenue of the insurance industry will significantly contribute in underwriting income of insurance industry and the increased profits would be translated into increase in tax revenue for the FBR.</p>		
3	<p>Development of regulated commodity market</p> <p>A new clause should be inserted in Part IV of the Second Schedule to the ITO, 2001, as follows:</p> <p>"The provisions of section 153 shall not apply on commodity futures contracts listed on a Futures Exchange licensed under Futures Market Act, 2016."</p>	<p>The impact of this proposal on tax revenue is expected to be neutral to positive due to adjustability of withholding tax while documentation leading towards more income tax from traders and related parties.</p> <p>PMEX request is for exemption from withholding tax only. This exemption, if granted, will have no impact on quarterly advance tax liability or final tax liability as per annual income tax return.</p> <p>The proposal will also encourage trading at PMEX leading to increased income for both PMEX and its brokers, thereby increasing tax revenues for the Government. From revenue perspective, there should not be any loss to the Government as withholding tax is adjustable against the advance/final tax.</p> <p>Similar exemption has already been provided from GST under SRO 445(I)/2004 dated 12 June 14, 2004.</p>	2020-21	FBR SECP PMEX
4	<p>Proposal for rectification of anomaly in CGT regime</p> <p>An explanation to section 37A to Income Tax Ordinance, 2001 may be introduced as below: "Shares of a company disposed of, in the tax year for which the company has the status of a Public Company, shall be deemed to be securities with effect from the date of acquisition, irrespective of the status of the Company at the time of acquisition of the said shares."</p>	<p>The amendment would increase collection of FBR through automated system of NCCPL.</p> <p>Corporate Sector shall get revived. New Listing shall start taking place. Shares of a listed company shall receive one treatment under the tax law.</p>	2020-21	FBR SECP NCCPL

5	<p>Potential of Private Fund Following amendments are recommended:</p> <p>Inclusion of following definition:</p> <p>(45A) Private Funds means a fund as defined under Private Funds Regulations 2015.</p> <p>Clause 101 of the Second Schedule Part I should be reworded:</p> <p>THE SECOND SCHEDULE EXEMPTIONS AND TAX CONCESSIONS PART I EXEMPTIONS FROM TOTAL INCOME</p> <p>(101) Any income derived by a Private Fund, if not less than ninety per cent of its accounting income of that year, as reduced by unrealized capital gains, is distributed amongst the unit or certificate holders or shareholders as the case may be. Provided that for the purpose of determining distribution of at least 90% of accounting income, the income distributed through bonus shares, units or certificates as the case may be, shall not be taken into account. Inclusion of all categories of Private Funds in PARTIV is proposed:</p> <p>PART IV EXEMPTION FROM SPECIFIC PROVISIONS</p> <p>Income, or classes of income, or persons or classes of persons, enumerated below, shall be exempt from the operation of such provisions of this Ordinance, subject [(11A) The provisions of section 113, regarding minimum tax, shall not apply to,- (xii) a venture capital company, venture capital fund and Private Equity and Venture Capital Fund and Private Fund which is exempt under clause (101) of Part-I of this Schedule;</p> <p>Inclusion of Equity Fund is proposed in PART IV</p> <p>PART IV EXEMPTION FROM SPECIFIC PROVISIONS Income, or classes of income, or persons or classes of persons, enumerated below, shall be</p>	<p>Nil impact due to the following. Currently there are four(4) private equity and Venture capital Funds registered with the Commission and as per clause 101 (next clause), PE & VC Funds have tax exemption status till 2024. Taxation at this point of time is on investor not on Fund level. However, economic activity will take place as the capital will be injected in unlisted companies by sophisticated investors.</p> <p>The extension will encourage greater participation in the private funds market and increase the size and depth of our capital markets and increase overall investment in the economy.</p> <p>This will also act as soft image enhancement for the country and attract other forms of investment as we can show a greater level of market sophistication and depth in comparison to our emerging market peers.</p> <p>In addition, these sophisticated market participants will eventually act as a source of sizable tax revenue for the state once the market has reached a level of maturity.</p> <p>As of today, this amendment has of neutral to positive impact as there are not Private funds which are investing in listed equity securities. However, in the future, this change should have a positive impact due to the factor that number of private funds investing in listed equity securities will increase will result in increased Government revenue Capital gain tax.</p>	2020-21	FBR SECP
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	<p>exempt from the operation of such provisions of this Ordinance, subject</p> <p>[(47B) The provisions of sections 150, 150A, 151 4[] 233 5[and Part I, Division VII of the First Schedule] shall not apply to any person making payment to National Investment Unit Trust or a collective investment scheme or a modaraba or Approved Pension Fund or an Approved Income Payment Plan or a REIT Scheme or a Private Equity and Venture Capital Fund or a Private Fund or a recognized provident fund or an approved superannuation fund or an approved gratuity fund.]</p> <p>Following amendment in the First Schedule is proposed:</p> <p>Division VIIProvided further that a mutual fund or a collective investment scheme or a REIT scheme shall deduct Capital Gains Tax at the rates as specified below, on redemption of securities as prescribed, namely:—</p> <p>Category Rate Individual and association of persons 10% for stock funds 10% for other funds Company 10% for stock funds 25% for other funds</p> <p>Provided further that in case of a stock fund if dividend receipts of the fund are less than capital gains, the rate of tax deduction shall be 12.5%:</p> <p>Provided further that units of private fund where investable funds are invested in listed equity securities and/or in debt securities to the extent of more than seventy per cent of the investment. the rate of tax deduction shall be 15%:</p> <p>Provided further that no capital gains tax shall be deducted, if the holding period of the security is more than four years.”</p> <p>Explanation.- For removal of doubt, it is clarified that, the provisions of this proviso shall be applicable only in case of a mutual fund or collective investment scheme or a REIT scheme.]</p>			
6	<p>Listing Encouragement</p> <p>Enlisting of Companies should be encouraged on permanent basis by introducing the following measures:</p>	<p>The benefits of listing are many fold so it will have a positive impact due to the factor that equity securities will increase will result in increased Government revenue Capital gain tax.</p>	2020-21	FBR SECP PSX

	<ul style="list-style-type: none"> • There should be one percent to two percent tax rate difference between listed and unlisted company; Once the company is registered than there will be no new tax notice for the activities of last five years prior to listing. 		
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Provincial Taxation Matters

Diagnostic:

312. Under Constitution of Pakistan, sales tax on services can be charged only by provincial governments, whereas, federal government is to collect sales tax on goods. Presently, there is one federal tax collection agency i.e. Federal Board of Revenue and four Provincial Authorities. Following issues effecting the exchanges/Institutions (PMEX, CDC, NPCCL, PSX, RIETs, Mutual Funds, Insurance sector etc):

- a. Issues of location of taxability i.e. one province demands tax based on point of delivery of services, whereas another province also demands tax on the same services based on location of head office;
- b. The tax rate of the provinces is not uniform i.e. presently the rate of tax in Sind is 13% while in others the rate of 16% is applicable;
- c. In the absence of single return mechanism, the registered person has to file different returns as per requirement of each individual province. Further, there is ambiguity over adjustment of taxes paid in different provinces and federal level by a single entity dealing in goods and services in all the four provinces and Islamabad Capital Territory;
- d. In the absence of any clearly defined taxable activities the provincial tax authorities are sending the notices of prior years' i.e. 2014-15 and 2015-16 which is unnecessarily resulting in legal process for already settled issues as well as unreasonable demands of taxation. Similar notices are expected for subsequent three years i.e. 2016-17, 2017-18 and 2018-19;
- e. Provincial taxes will enhance the ultimate cost of doing the transaction from 13% to 16%;
- f. Beside services tax the stamp duty rate on transfer of shares from 0.1% to 0.75% on transfer of shares needs to be reviewed and must be uniform in all provinces;
- g. Beside services tax RIETs are subject to stamp duty, Capital Value Tax and transfer fee at Provincial Level. The transfer of property in REIT is only a paper transaction with relatively small cash involved so any taxation/charges/fee make the REIT uneconomical and the process of documentation of economy also suffered; and
- h. Beside Services Tax the insurance sector will also attract the duty fee.

313. Recommendation: SECP and market associations mount a concerted educational and awareness campaign to ensure all levels of Government are cognisant of the damage to the capital markets of the approach of provincial bodies.

PART 9: STRENGTHEN MARKET GOVERNANCE

Market Infrastructure Boards

Diagnostic

315. A comparative study of a number of exchanges (based on latest available annual reports) around the globe, shows that these exchanges have a very diverse shareholding pattern – in some cases it is concentrated with government entities and foreign investors while in other it is dispersed. It is obvious that there is no correlation between ownership and the Board composition, in fact it is clearly dictated by regulatory framework.
316. The Table below provides a summary of Board composition:

Table 28 Board of Directors - Attributes of Selection World Wide Exchanges

Exchange	BO D size	Public Interest/ Independent Directors	Shareholder /Trading member Directors	CEO	meeting s
PSX	15	7	7	1	15
Bursa Malaysia	10	9	-	1	7
HK Exchange	13	12	-	1	9
Bombay SE	9	6	2	1	7
National SE	10	5	4	1	9
Dhaka SE	13	7	5	1	35
Nairobi SE	11*	4	2	1	7
Nigerian SE**	13*	5	6	1	10

*Nairobi stock exchange has two non-executive director and two directors representing listed companies while Nigerian stock exchange has on ex-officio director.

**Mutualized exchange

317. **Recommendation for PSX (CDC/NCCPL):** Size of the board is suggested to be reduced to 10 plus one CEO; this is in line of the average size ex PSX in the above table.
318. Quality of the board member for both shareholder and independent directors is determined through fit and proper criteria given in the licensing regulations; this should be strengthened with respect to experience, track record and excellence in the field.
319. The Chairman should be of an eminent person of standing and bring gravitas to the Board, preferably with minimal conflict of interests.
320. Experience for directors should be increased from current 7 year at senior level position to at least 15 years with mandatory requirement to have served on a Board of either a larger listed company or a Government body or an institution of equivalent stature.
321. There should be cooling off period of at least 5-7 years from a brokerage house for both shareholder and independent director before they become eligible for election or appointment as a director of PSX.
322. Currently a three-year cooling off period is provided in case of senior management of PSX but not for directors.

323. Track record for directors should be included to judge performance, excellence and likely contribution to progression of PSX
324. Currently directors are required to submit shareholding interest along with that of immediate family members to the exchange and SECP; it is suggested that it should be made public in the annual report along with trading done during the year.
325. Code of conduct for the directors should be made public on the PSX website and through annual report and the annual report should include a separate report from independent directors on the affairs of the company.
326. Nomination process for independent directors is currently opaque and should be made more transparent through calling for nominations or by maintaining pool of possible candidates the PSX should disclose its framework to provide public oversight and transparency.
327. Composition of the Board is also critical for a public interest entity, particularly one having a monopoly position both from geography and gender standpoint.
328. Geographic aspect was explicitly covered in the integration order and was evident for the first Board of PSX, this was not taken into account in case of current Board. Similarly, as the peak listing authority there should be at least one third female directors.
329. A board charter outlining the governance framework and process of the Board and approach towards governance should be developed and made public on the website and cross referenced in the annual report. Currently, role and responsibilities of the Board, various committees and management needs to be clearly defined and powers delegated to committees and management which has been suggested is made public. It is obvious from the role of directors at the Board and various committees that they have transactional role also evident from the number of meetings held and it may be reflective of poor governance and weak management.
330. Any committee should be made public with composition, mandate and work done during the year. No shareholder director should be on the committees pertaining to governance of these entities while market participants (non-directors) may be made part of other business-related committees and this should be done by nomination committee through a disclosed and transparent criterion. This would bring in wider stakeholders into decision making process.
331. Overall quality of presentation of governance arrangements and disclosure in the annual report of PSX is far below that compared to other exchanges. Both Bursa Malaysia and HK Exchange annual reports in particular the governance reports stand out, PSX needs to improve on disclosure in particular about governance.
332. SECP should take PSX to task if any senior position is unfilled beyond three months good governance practice require succession planning and minimum time to hire. Post divestment, it took more than six (6) months to fill position of CEO, even now it is vacant for over three (3) months. Similarly, CRO position is vacant for more than two (2) years this is not good leadership from an organisation that should be leading the market in the area of governance and market discipline.
333. These market infrastructure entities are very much IT companies, therefore should have very lean cost structure. However, all three entities have heavy cost base reflective to legacy practices; of all the exchanges mentioned in the table above only PSX is making an operating loss. A well-defined organogram with clear responsibilities should be developed and made public.
334. The market would benefit from a pan Pakistan market participants association with due weight for activity generated so that market participants having stake should have a clear say in the affairs of association, industry and overall market. The old local Karachi brokers association needs to be encompassed within a new market activity led association. SECP should make this a priority.
335. In case of CDC and NCCPL ratio of independent directors should be increased to at least 50% from the current level and consideration should be given to the pending integration of infrastructure vehicles into the new proposed HOLDCO.

PART 11: ROADMAP TO EXECUTE STRATEGY

336. This section provides the roadmap to execute the strategy. All key tasks are identified, the expected outcome, its timeline and responsible stakeholders. Recommendations and suggestions contained in other parts of this report and which are not included in the roadmap below are recommendatory in nature and to be consulted by SECP while considering the related matters.

No	Action	Timing	Responsible	2020	2021	2022	2023	2024	2025	2026	2027
1	Section 244/245 of Companies Act 2017 regarding Investor Education and Awareness Fund for proper implementation for listed companies.	2020-2023	SECP, PSX								
2	Accreditation through well-functioning professional body or Institute like Institute of Financial Markets for professionals working in the regulated sector particularly those interacting with investors should be mandated and implemented. SBP has requested to participate in implementation process	2020-2023	SECP, IFM, SBP								
3	Holistically review and explore possibility of expanding role of Pakistan Institute of Corporate Governance to act as a watchdog for minority shareholders by creating awareness about corporate affairs.	2020-2023	PICG, SECP								
4	Framework for Securities Advisors as provided in the Securities Act 2015 should be reimplemented.	2020-2022	SECP								
5	Framework for third party mutual fund distributors should be put in place along with exchange-based platform for issuance and redemption.	2020-2023	SECP, PSX, MUFAP								
6	Third party custody mechanism needs to be put in place for investor protection and confidence and expand market outreach.	2020-2023	SECP, PSX, CDC, SBP								
7	Allow brokers to conduct and charge for discretionary portfolio management Margin financing by brokers Special saving and investment account after tax basis VPS account management by brokers Delete section 153k of Companies Act 2017	2020-2022	MOF, SECP, FBR								
8	SBP, PSX, CDC, NADRA and NCCPL to develop a seamless, straight through digital onboarding and KYC/AML process for retail investors.	2020-2023	PSX in collaboration with SBP, NADRA, CDC and NCCPL								
9	Subject to banks being able to share any customer information in light of BCO 1962, Allow brokers to use the KYC/AML done by Banks.	2020	PSX in collaboration with SBP.								
10	Resolve the pricing anomalies on investment products offered by National Savings and accelerate the digitalization of CDNS in order to prevent the misuse of incentives given to select group for social protection.	2020	MoF in collaboration with CDNS								
11	Enforce a crackdown on illegal offshore FX and CFD brokers by blocking the websites/apps.	2020	SECP in consultation with SBP and in collaboration with								

			FIA and Ministry of IT.										
12	Make it easier for Capital Market investors to visit Pakistan by issuing investor visa on arrival sponsored by SECP or PSX.	2020	Ministries of Interior, Foreign Affairs and FIA in collaboration with SECP and PSX.										
13	Promote financial literacy by using electronic media and the banks for financial literacy programs.	2020-2023	SECP and SBP PMERA and Ministry of Education/HEC.										
14	Establishment of a professional DMO with front, middle, and back office capabilities being mindful of other donor TAs addressing DMO capacity.	202-2025	MOF DMO and SBP										
15	Implement a single debt management strategy including NSS issuance and redemption program	2020-2022	MOF DMO CDNS										
16	Develop and implement closer budgetary cash flow forecasting regime to ensure accuracy of underlying numbers for decision making and aid debt strategy coordination	2020-2022	MOF DMO CDNS										
17	Institute a Treasury Single Account (TSA) across the 56,000 Depts, Agencies and SOEs which hold surplus funds with banks being mindful of other IFI TAs in this area.	2020 -2025	MOF DMO SBP and appropriate SOE and ministries										
18	Clearer Auction cut off rules and transparency by review of Auction rules/process and a review and publishing of PD rules	2020	MOF DMO SBP										
19	Introduce a methodology so that PDs basically underwrite the auction in a manner like India and Sri Lanka where PDs commit to a slightly higher level of bids to their proportion of the offering	2021	MOF DMO SBP										
20	Implement a plan to facilitate more institutional volume as a result of the auction by increasing the percentage of auction that can be taken up as a non-competitive bid (some markets allow up to 10% to 20% of offer with increasing gradually maximum individual bids to 0.5% to 1% of auction amount)	2020-2021	MOF DMO SBP										
21	Whilst Non-bank financial institutions (e.g. brokers, investment bank, DFIs) are already eligible to apply PDS it is recommended that Expansion of PDs beyond banks, DMO/SBP to consider further changes to rules to enable suitably qualified brokers, investment banks and institutions to apply to be Primary Dealers	2020-2021	DMO SBP SECP										
22	Reduce and consolidate the existing number of PIB issues, creating benchmark issues and develop a longer dated yield curve with additional benchmark issues. PIBs on issue can be managed via appropriate buyback, reopening and bond swap operations.	2020-2021	DMO										
23	Review PD contracts to ensure a fair balance of rights and obligations including required secondary trading quotations at minimum levels and spreads which can be monitored for compliance	2020	DMO SBP										
24	Facilitate via an appropriate entity (such as National Institutional Facilitation Technologies Pte Limited) the bond price agency rules (2017) and a Establish Bond Reporting Agency for Pakistan this	2020-2022	SECP SBP										

	initially can cover corporate bonds. The reporting agency could also utilise existing Government bond reporting to SBP to provide a comprehensive database of traded prices																		
25	DMO to engage on a quarterly basis, with PDs in coordination with SBP to formally discuss market conditions and the DMO's forward issuance program as well as to share and receive market intelligence considering changing market conditions. DMO/SBP to issue minutes of these deliberations to achieve appropriate outcomes in line with DMOs objectives.	2020	DMO SBP																
26	Institute accrual accounting for PIB outstanding issues and properly account for discounted issues and accrued interest positions (A modified Hybrid approach may be needed)	2020 -2021	DMO MOF																
27	Corporatize the NSS/CDNS in preparation to making it a more accountable funded entity and provide a basis for protection of investors via regulated products. Further it is necessary to determine who should be its regulator to oversee assets and liabilities, risk management and investor protection including KYC. Form working group of stakeholders to determine regulator.	2020-2021	CDNS SBP SECP																
28	Eliminate new applications by institutional holders in the NSS by forced redemption or offering to replace with similar duration PIBs	2020 - 2022	DMO CDNS																
29	Institute accrual accounting for NSS in order to fully account for all liabilities	2020-2022	CDNS																
30	Increase rate of branch digitisation in order to be prepared to implement accrual accounting and to be prepared to dematerialise certificates	2020-2021	CDNS																
31	Dematerialise and digitise saving certificates this can be achieved by utilizing the existing securities depository, CDC.	New issues commencing from 2021 phased implementation to 2025	CDNS CDC																
32	With digitisation establish an effective compliance program to eliminate double dipping by certificate holders	2020- 2021	CDNS																
33	Create a project to rationalise the distribution network for NSS and make the process much more streamlined and efficient.	2020 -2021	CDNS																
34	Improve integrity of account opening for NSS (AML/CTF standards) by following through on recent announcements to address this issue	2020	CDNS / Banks																
35	Create new and innovative mobile applications and bank account linkages to improve distribution and servicing of certificate holders including streamlining KYC processes	2020-2025	CDNS / Banks																
36	IPO process should be made disclosure based instead of approval based with only listing approval by the securities exchange.	2020-2023	SECP, PSX																

37	PSX should put in place hand-holding mechanism to facilitate newly listed companies so that these can cope with regulatory requirements.	2020	PSX															
38	Implementation of free float requirement for new and existing companies and take measures to increase free float through stock split and tax incentive.	2020	PSX, CDC, FBR															
39	Mandate the Privatization Commission to give preference to floating state owned companies on Pakistan Stock Exchange rather than through trade sale. Increase the free float of NBP, PSO, OGDC, PPL and MARI by divesting additional stake in the market over the next 12 months. . List National Investment Trust (NIT) on the stock exchange.	2020	MOF in collaboration with Privatization Commission, SECP and PSX.															
40	Mandate all listed companies to have their updated Investment Relations presentation on the website.	2020	SECP and PSX															
41	Encourage all listed companies to have active research coverage.	2020	PSX															
42	Promote Growth Enterprise Market (GEM) to Private Equity and Venture Capital investors by arranging outreach events at Incubators/tech conferences etc.	2020	PSX															
43	Open the proposed GEM market to all investors by removing the restriction on retail investors.	2020-2022	SECP and PSX															
44	Mandate the government to devise a plan for listing of infrastructure projects in areas such power, transportation and tourism.	2020-2023.	MoF in collaboration with SECP and PSX															
45	Provide tax incentives for companies to list on GEM.	2020-2023	MoF, SECP and FBR.															
46	Extend the license duration for Private Equity funds for at least 7 years from current duration of 3 years.	2020	SECP															
47	Allow pension funds and insurance companies to invest in private equity	2020	SECP															
48	Clarify and issue guidelines to allow regulated and licensed overseas private equity companies to acquire and sell equities and convertible debt from local issuer at a price which is mutually agreed (rather than at break-up value) and allow non-resident to purchase and redeem units of locally established PE&VC funds under Private Funds Regulations 2015 without any pricing restriction For repatriation of disinvestment proceeds of unlisted companies up to breakup value, SBP has granted general permission to Authorized Dealers. However, for repatriation of amount over and above breakup value of shares of unlisted companies, specific permission of SBP is required. SBP considers such requests of companies, received through Authorized Dealers, on case to case basis.	2020	SBP and SECP															
49	Undertake study through an appropriate international corporate finance house or investment bank as to best structure for creation of an exchanges listed holding group company with suggested combined ownership for: PSX, NCCPL, CDC, and PMEX Probably will require a scheme of arrangement and compliance listing approach	2020-2021	PSX CDC NCCPL PMEX SECP MOF															

50	Implement report into Exchanges Group creation subject to stakeholders concurrence	2021- 2025	PSX CDC NCCPL PMEX SECP																
51	Develop a market wide approach to development of the required CCPs (one or by market segment), including approach to Securities Guarantee Funds, Investor Protection Funds. This study should look at the appropriate establishment funding, on-going market levies, risk management and governance arrangements. Benchmarked to and complying with best international standards	2020 - 2022	PSX CDC NCCPL PMEX SECP																
52	Develop a shared Technology Services company for market infrastructure vehicles subject to stakeholder agreement and possibly considered in conjunction with development of exchanges group.	2020	PSX CDC NCCPL PMEX SECP																
53	Consolidation of supervision function of PSX/NCCPL/CDC	2020-2022	PSX/NCCPL/CDC/ SECP																
54	SECP to enter formal MOUs with exchanges and infrastructure vehicles Issues to be covered are corporate finance (issuance M&A and listing obligations), intermediary supervision and market surveillance.	2020-2021	SECP PSX PMEX CDC NCCPL																
55	Implement concepts of Independent Clearing Member (Custodian) Concept	2021	PSX SECP																
56	Implement Capital Adequacy as outlined under Broker licensing regulations (2016) and look to remove asset under custody caps	2020-2022	SECP																
57	Strengthening of surveillance capacity of PSX and PMEX through acquisition of appropriate surveillance software with appropriate cross market surveillance routines	2020-2021	PSX PMEX SECP																
58	Standardization of brokerage house back office software.	2021-2022	PSX PMEX																
59	PSX to publish on their website the current Board Delegations for market information and transparency	2020	PSX																
60	SRO status for various associations of regulated persons	2020	SECP																
61	Separation of core and non-core business of CDC and NCCPL, particularly transfer of CGT functions to a subsidiary of NCCPL. This may be undertaken in conjunction with study into development of exchanges group.	2020	NCCPL CDC SECP																
62	Review of all existing margin finance/futures and leverage products to be replaced with the development of an appropriate modern derivatives market for equities, debt and commodities New regulations should be consistent with derivatives regulations issued to banks covering OTC Markets	2021-2025	PSX NCCPL SECP SBP																
63	Infrastructure vehicles to publish and provide results and outcomes of market consultations within a defined timeframe and utilise websites to publish and provide interface to intermediaries and public to participate.	2020	SECP PSX PMEX CDC NCCPL																
64	Proposal for Documenting real-estate sector through REITs:	2020-2021	FBR SECP PSX																
65	Supporting Insurance Industry	2020-21	FBR and SECP																
66	Development of regulated commodity market	2020-21	FBR SECP PMEX																

67	Proposal for rectification of anomaly in CGT regime	2020-21	FBR SECP NCCPL								
68	Potential of Private Fund	2020-21	FBR SECP								
69	Listing Encouragement	2020-21	FBR SECP PSX								
70	Review statutory regulatory remit of the SECP	2020-2025	MOF								
71	<p>Amend SECP Act to improve governance, operational and financial autonomy of SECP covering following area;</p> <ul style="list-style-type: none"> • Appointment process and tenure for Chairman, Commissioners and Policy Board • Direct appointment and tenure protection to the post of Chairman • Introduce Code of Conduct for Chairman, Commissioners and the Policy Board • Strengthen provisions related to conflicts of interest • Commission should function as a collegiate body • Bring clarity in role of policy board so as to remove any operational overlap with the commission • Regulations making process should be transparent and robust • Enhance disclosure through annual report of the commission • Deletion of provision pertaining to surrender of surplus • Exemption from applicability of income tax • Strengthen provisions pertaining to registration of SROs, professional accreditation, and investor education • Formation of Financial Market Tribunals • Streamlining and strengthening role of Audit oversight Board • Protection to SECP against undue interference by LEAs 	2020-2021	MOF/SECP								
72	Introduce modern legislative framework for Collective Investment funds enabling investment funds to be a) a new company; b) a trust company; c) contractual arrangements; and/or a general partnership (GP) / limited partnership (LP) arrangement	2020-2025	MOF/SECP								
73	Simplify SECP Regulations	2020-2022	SECP/PSX								

74	Encourage the Formation of SRO's	2020-2023	SECP/PSX/ MUFAP										
75	Establish an independent tribunal to review SECP decisions	2020-2023	MOF/SECP										
76	Review and strengthen governance structure at Capital Market Infrastructure institutions	2020-2021	SECP										