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Islamabad  
June 9, 2015

ED-PR-00-SND

Ali  
17/6/15

Subject: Study On The 2008 Stock Market Crisis

Dear Hijazi Sahib,

The Committee constituted by SECP to study the 2008 stock market crisis submitted the Report to you on Friday, June 5, 2015.

As I mentioned in the meeting, I would like to place on record my gratitude to my colleagues, Mr. Habib ur Rehman and Mr. Rashid Sadiq for their assistance and support for preparation of the Report.

I may also thank SECP in general and Securities Market Division in particular for their support extended to the Committee during its work.

I would also like to place on record our deep appreciation of the hard work put in by Mr. Sajjad Ali, Deputy Director, Securities Market Division who assisted the Committee as its Secretary. Mr. Sajjad Ali's contribution towards preparation of the report has been most valuable.

In the end, I would like to thank you for the confidence reposed in the Committee and hope that its recommendations made in the best interest of SECP, would be given due consideration.

Yours Sincerely,

*S. Ahmad Khan*  
(Shamim Ahmad Khan)

Chairman of the Committee

Copy to Mr. Akif Saeed, Commissioner SECP

Case No. 17/6/15  
17/6/15

# **Report of the Committee:**

## **A Study of the Pakistan Stock Market Crisis of 2008**

**June 05, 2015**

## Table of Contents

Chapter 1: Introduction .....	1
1.1 Terms of Reference and Scope .....	1
1.2 Methodology .....	4
Chapter 2: Background of 2008 Crisis.....	6
2.1 Review of Earlier Crises .....	6
2.2 Global Financial Crisis and its Impact.....	8
2.3 Macro-economic Scenario .....	14
Chapter 3: Build up to the Crisis.....	18
Chapter 4: Imposition of Floor on Prices of Securities.....	29
Chapter 5: Period of the Floor and Issues Arising Therefrom.....	43
5.1 Negative perception of foreign investors .....	44
5.2 Distortion of price discovery and restrictions on free entry and exit in the market.....	45
5.3 Hectic search for alternate sources of liquidity.....	45
5.4 Management of CFS MK-II.....	47
5.5 Relaxation of risk management regime .....	47
5.6 Difficulties of mutual fund industry .....	49
5.7 Off-market Trading.....	51
5.8 Misuse of Clients' Securities by Brokers.....	54
Chapter 6: Debate on Removal of the Floor .....	57
Chapter 7: Post Floor Scenario .....	63
7.1 Macro-Economic Situation .....	64
7.2 Liquidity through NIT Funds.....	65
7.3 Square-up Scheme .....	65
Chapter 8: Major Issues Relevant to the Market Crisis .....	67
8.1 Market Intervention .....	67
8.2 Provision of <i>Force Majeure</i> in the Stock Exchange Regulations.....	70
8.3 Leveraged Products.....	71
8.3.1 Badla as a Factor in 2008 Crisis .....	74
8.4 Broker Regime .....	76
Chapter 9: Role of Regulators and Capital Market Institutions.....	80

9.1	Role of SECP .....	80
9.2	Role of Stock Exchanges .....	84
9.2.1	Role of the KSE .....	84
9.2.2	Role of LSE.....	85
9.2.3	Role of ISE.....	87
9.3	Role of CDC .....	88
9.4	Role of NCCPL.....	92
Chapter 10: Evaluation of the Reform Measures Introduced by SECP after the Crisis .....		96
Chapter 11: Conclusions .....		99
Chapter 12: Recommendations .....		104
12.1	SECP .....	105
12.2	Stock Exchanges .....	109
12.3	CDC and NCCPL.....	113

**Abbreviations and Acronyms**

Asset Management Companies	AMCs
Capital Gains Tax	CGT
Capital Value Tax	CVT
Carry-over trade	COT
Cash Reserve Requirement	CRR
Cash Settled Futures	CSF
Central Depository Company of Pakistan Limited	CDC
Central Depository System	CDS
Chief Executive Officer	CEO
Competition Commission of Pakistan	CCP
Consultative Group on Capital Market	the Group
Consumer Price Index	CPI
Continuous Funding System	CFS
Continuous Funding System MK-II	CFS MK-II
Deliverable Futures Contracts	DFC
Deliverable Futures Market	DFM
Diligence Inc. USA	Diligence Inc.
Equity Market Opportunity Fund	EMOF
Federal Board of Revenue	FBR
Gross Domestic Product	GDP
International Monetary Fund	IMF
International Organization of Securities Commission	IOSCO
Islamabad Stock Exchange Limited	ISE
Karachi Stock Exchange Limited	KSE
Lahore Stock Exchange Limited	LSE
Managing Director	MD
Margin Financing	MF
Margin Trading System	MT
Mark to Market	MtM
Mutual Funds Association of Pakistan	MUFAP
National Clearing Company of Pakistan Limited	NCCPL
National Investment Trust	NIT
Net Asset Value	NAV
Net Capital Balance	NCB
Oil and Gas Development Company Limited	OGDCL
Over-the-Counter	OTC
Pakistan Muslim League (N)	PML(N)
Pakistan Rupee	PKR

Pakistan Telecommunication Company Limited	PTCL
Regulations governing Default Management of the stock exchanges	Default Regulations
Regulations governing Risk Management of the stock exchanges	RM Regulations
Securities and Exchange Commission of Pakistan	SECP
Securities and Exchange Commission of Pakistan Act, 1997	SECP Act, 1997
Securities Lending and Borrowing	SLB
Settlement Guarantee Fund	SGF
Short Message Service	SMS
Small and Medium Enterprises	SMEs
Special Trading Session	STS
State Bank of Pakistan	SBP
State Enterprise Fund	SEF
Statutory Liquidity Requirement	SLR
Term Deposit Receipt	TDR
Term Finance Certificates	TFCs
Terms of Reference	TOR
Trading Right Entitlement Certificate	TREC
Unique Identification Number	UIN
United States	US
United States Dollar	USD
World Trade Organization	WTO
Year-on-Year	YOY

## Chapter 1: Introduction

The Securities and Exchange Commission of Pakistan (SECP) constituted a Committee to conduct a study of the stock market crisis of 2008. The Committee comprises the following:

- (i) Mr. Shamim Ahmad Khan – Chairman
- (ii) Mr. Habib-ur-Rehman – Member
- (iii) Mr. Rashid Sadiq – Member

Mr. Sajjad Ali, Deputy Director, SECP was appointed as Secretary to the Committee, who was assisted by Mr. Awais Ali, Assistant Director, SECP.

### 1.1 Terms of Reference and Scope

The Terms of Reference (TOR) of the Committee are as under:

1. To study the nature of the stock market crisis of 2008 in Pakistan and the factors leading to it.
2. To evaluate the rationale for placing floor on the share prices of listed securities w.e.f. August 27, 2008 in terms of the *Force Majeure* clause of the Regulations Governing Risk Management of the three stock exchanges in Pakistan;
3. To analyse the role of the three stock exchanges and the Securities and Exchange Commission of Pakistan in the decision to impose the floor;
4. To review the impact of imposition of the floor on the market;
5. To examine the events which took place during the imposition of the floor;
6. To examine the process of lifting of the floor;
7. To review the measures taken and the reforms introduced during and immediately after lifting of the floor;

8. To examine the role of the Central Depository Company of Pakistan Limited and the National Clearing Company of Pakistan Limited during and immediately after the crisis;
9. To give policy recommendations based on the experience of the 2008 crisis.

It was clarified by SECP that the study, unlike enquiry and investigation reports on the earlier crises, should focus on constructive analysis of the factors which led to the crisis. The Committee is also required to recommend measures which could help prevent recurrence of such crisis. Keeping in view the TORs, the Committee has taken a broader perspective of the issues which caused the crisis and, based on the experience of 2008 crisis would submit a set of recommendations.

Unfortunately, the crisis in Pakistan's stock market in 2008 continues to cast an ominous shadow on the market. Five years after this episode, a press report commenting on the delisting of a major multinational from Karachi Stock Exchange Limited (KSE), observed that "Investors are still nursing the wounds of an unwise decision by regulators in 2008 to close the exit door by putting a 'floor' under a stock's fall. That had quite the effect of sending the shares reeling down, so as to plunge the benchmark KSE-100 index to its all-time low."<sup>1</sup> An article published in the Dawn dated January 09, 2012 quoted Mr. Simon Cox of Hong Kong based Emerging Markets Stock Invest Fund as "I have gone through the record of stock exchanges and never since the oldest stock exchange in the world at Amsterdam was established in 1602, I could locate one

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<sup>1</sup> Mr. Dilawar Hussain in Daily Dawn, Economic and Business Review, March 25, 2013.



example where a stock exchange had ever blocked the exit in violation of basic principles of free market mechanism”<sup>2</sup>.

As a fall-out, foreign portfolio investment dried out and Pakistan was removed from the MSCI Emerging Markets Index by MSCI<sup>3</sup> on the basis of “deterioration of investability conditions in the Pakistani equity market since the imposition of the floor rule at the end of August 2008 which has resulted in the practical shutdown of the Pakistani equity market.”<sup>4</sup> The press note issued by MSCI on December 10, 2008 also observed that “by preventing securities from trading on the exchange below the closing prices of August 27, 2008, the floor rule has led to the near total paralysis of market activity in Pakistani equities and caused significant distortions to investors’ portfolio valuations by maintaining price at artificial levels.”<sup>5</sup>

In March 2009 the MSCI considered the proposal for inclusion of the Pakistan MSCI Index in the MSCI Frontier Markets Index. MSCI at that time observed that “a majority of market participants stressed the need for the Pakistani equity market to function without any trading disruptions for some time as a condition to any potential consideration of the MSCI Pakistan Index for re-inclusion in the Emerging Markets Index.”<sup>5</sup> It was accordingly decided to assign Pakistan to the Frontier Markets Index. It amounted to downgrading of the market since prior to

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<sup>2</sup> ‘In paper Magazine’ Daily Dawn, January 09, 2012.

<sup>3</sup> MSCI is a leading provider of investment decision support tools to investment institutions worldwide. The company’s products include indices and portfolio risk and performance analytics for use in managing equity, fixed income and multi-asset class portfolio. (MSCI website)

<sup>4</sup> MSCI Barra Press Release “MSCI Barra to Remove the MSCI Pakistan Index from the MSCI Emerging Markets Index”, December 10, 2008

<sup>5</sup> MSCI Barra Press Release “MSCI to Reclassify the MSCI Pakistan Index as MSCI Frontier Markets Index”, March 23, 2009

December 2008, Pakistan enjoyed the status of Emerging Markets. This decision had grave implications for portfolio investment in Pakistan.

## **1.2 Methodology**

The study is based on the information obtained from the SECP and the three stock exchanges as well as CDC and NCCPL. Minutes of KSE board were particularly helpful in providing information about the course of events in 2008 and 2009. The Committee met and held extensive interviews with a number of market participants and management of the three stock exchanges, CDC and NCCPL. The Committee also interviewed senior officials of Securities Market Division in SECP some of whom dealt with the stock market crisis of 2008. (A list of persons met by the Committee is at Annexure I)

The Committee has been informed that the Supreme Court of Pakistan had taken note of the stock market crisis of 2008 in view of petitions filed by some investors whose securities had been moved without their authorization by the members of the KSE from their CDC sub-accounts for pledging with the banks and meeting margin requirements<sup>6</sup>. The Committee has studied the correspondence between the Human Rights Wing of the Supreme Court and the SECP relating to these petitions. The Committee has obtained relevant information from National Investment Trust (NIT) regarding the market stabilization funds and held discussions with their senior officials. The Committee has looked at the reports appearing in the press and the comments of the analysts prior to and during the crisis. Data regarding economic situation

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<sup>6</sup> Source: SECP

prevailing in 2008 was obtained from the reports of the State Bank of Pakistan (SBP) as well as the Economic Survey of Pakistan.

The Committee has studied the policies adopted and followed by regulators in other jurisdictions for managing market crisis in 2008 in their respective jurisdictions.

The Committee has also benefited from the two comprehensive rulings of the Competition Commission of Pakistan (CCP) – by single bench comprising Dr. Joseph Wilson dated March 18, 2009 and by Appellate Bench comprising Mr. Khalid A. Mirza as Chairman CCP and Ms. Rahat Kaunain Hassan member CCP dated November 26, 2009. CCP while taking notice of the decision to impose floor on the prices as violation of Section 4 of the Competition Ordinance, 2007 (which later became the Competition Act, 2010), also provide insight into the process of imposition of the floor.

Before proceeding further, the Committee would like to make a few preliminary observations:

1. Study of the crisis of 2008 was initiated after more than five years of the occurrence of the crisis. A study immediately after the crisis would have been more useful to the regulators.
2. The Committee has found that a number of recommendations which had been made by the enquiry reports into the earlier crisis have not been given due attention. Some of these related to governance of stock exchanges and leverage products. Implementation of these recommendations would have definitely helped the regulator.

## **Chapter 2: Background of 2008 Crisis**

### **2.1 Review of Earlier Crises**

Pakistan's stock market has experienced recurrent crises with regularity. Some major crises occurred in 2000 and 2005 which were probed into by SECP. Since there are a number of common underlying factors of the various crises, it may be useful to analyze the earlier crises.

The report of SECP's Taskforce constituted to enquire into the 2005 crisis mentions the earlier crises in some detail. Therefore, the Committee has decided to discuss only the crisis of 2005.

In the early part of 2005, the market showed a highly bullish trend reflecting rise in the index from 6,220 points on January 03, 2005 to 10,303 points on March 15, 2005. This was accompanied by exceptionally high trading volumes. The Taskforce attributed the phenomenal rise of the market to increased COT financing, arbitrage between ready and futures market, statements made by senior functionaries of the Government, brokers and market analysts expressing highly optimistic view about the market index levels. The badla system which had driven up the market caused the subsequent downward trend when badla financiers started pulling out the facility after March 04, 2005. This period saw speculative trading in some companies like OGDCL and PTCL, excessive day trading and incidence of market abuses like wash trades. Apprehending possible systemic risk of the crisis, KSE management initiated bailout package including intervention by State Life Insurance Corporation, National Insurance Corporation and NIT to stabilize the market. The Taskforce questioned the need and the objectives of the bailout as in its view, the bailout saved some private investors using public funds.

As advised by the Taskforce, an independent firm for forensic investigations, Diligence Inc. USA (“Diligence Inc.”) was engaged in 2006 “to examine in greater detail the activities surrounding the March 2005 events and especially to determine if manipulative schemes or illicit conduct were prevalent and played a key role in the market’s precipitous decline”<sup>7</sup>. Diligence Inc. looked into the question of possible complicity of financiers, who withdrew COT facility and that of influential brokers in manipulative practices like wash trades.

Diligence Inc. while examining the transactions and the available data experienced difficulties since necessary information on a unique client identification code basis was not available. It did not have sufficient evidence to conclude that brokers had “collectively designed a scheme to obtain illicit gains”<sup>8</sup>. However, Diligence Inc. was able to find instances of individual acts of brokers aimed at exploiting the bullish sentiment.

### **2.1.1 Commonalities among Past Crises**

A common underlying factor of all the crises since 2000 is badla financing<sup>9</sup> and its variants. In 2005, one of the reasons for the crisis was the phasing out of COT financing and introduction of margin financing. In earlier crisis of 2000, rules regarding COT (badla) were unjustifiably and abruptly changed as pointed out by the Enquiry Report. It has been noticed that badla and its variants caused settlement difficulties in practically all the crises experienced by the stock market.

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<sup>7</sup> Report by Diligence Inc. on the Forensic Investigation for the SECP into the events of March 2005

<sup>8</sup> Ibid.

<sup>9</sup> Badla system has been explained in detail on pages 79 and 80

Another common feature underlying various crises was ad hoc decisions and abrupt changes in policies by the frontline and the apex regulators. In 2000 abrupt changes were made in the COT rules. In 2005 the KSE decided to offer COT financing to buyers in the Deliverable Futures Market (DFM) deviating from the product model.

The enquiry reports in respect of previous crises have also highlighted the presence of conflict of interest in the boards of the stock exchanges. It has been pointed out that decisions taken by the conflicted members were not in the interest of the market and the other stakeholders, particularly the investor public.

There is yet another commonality i.e. the stock exchanges did not adhere to their respective regulations in order to avoid default of their members. In the year 2000, stock exchanges did not follow their own regulations regarding Members Default and Procedure for Recovery of Losses Regulations. In 2008, *force majeure* provision of Regulations governing Risk Management of the stock exchanges (the “RM Regulations”) and the Regulations governing Default Management of the stock exchanges (the “Default Regulations”) were not followed.

## **2.2 Global Financial Crisis and its Impact**

Pakistan experienced crisis in the stock market in 2008 when US and most of the developed countries were undergoing financial crisis of a much larger dimension. It is appropriate to discuss the global financial crisis of 2008 which had disastrous results for the world economy. It also needs to be seen if there is any linkage of Pakistan’s domestic market crisis with the global crisis.

Although gravity of the crisis became visible in early 2008, it originated in 2007 with potential defaults by sub-prime holders. Low interest rates regime in the US accompanied by sub-prime mortgages and mortgage securitization exposed the US financial system to serious risks. Leading investment banks like Bear Sterns collapsed in March 2008 followed by Lehman Brothers in September 2008.

The financial crisis swiftly hit the real economy in the US and across the world. The OECD has estimated contraction of world economy by 2.1% in 2009<sup>10</sup> and WTO estimated fall in volume of world trade by 12% the same year<sup>11</sup>.

It may be relevant to briefly discuss the response of the regulators and the governments of respective countries to the financial crisis which led to economic turbulence of horrendous magnitude, some comparing it to the Great Depression of 1929. The intervention by the regulators was mainly in the banking sector as it had potential to cause serious systemic risk. The regulators took a number of measures to restore confidence while some governments decided to assume huge financial obligations for protecting the banking sector.

The British Government responded to the crisis in the banking sector by providing guarantee to the deposits and a rescue package for banks amounting to £500 billion. The British Treasury also allocated £37 billion to recapitalize some defaulting banks. The US Government bailed out the

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<sup>10</sup> OECD Insights – From Crisis to Recovery, The Causes, Course and Consequences of the Great Recession by Brian Keeley and Patrick Love

<sup>11</sup> [https://www.wto.org/english/news\\_e/pres10\\_e/pr598\\_e.htm](https://www.wto.org/english/news_e/pres10_e/pr598_e.htm)

two major mortgage lenders, Freddie Mac and Fannie Mae assuming liability of \$5 trillion. The US Congress decided to allow the highest ever bail-out package of \$700 billion. In view of the crisis, Morgan Stanley and Goldman Sachs lost the status of investment banks and became traditional commercial banks.

In view of the recession in the economy caused by the financial crisis, central banks of most of the developed countries lowered the discount rates. In October 2008, US Federal Reserve cut the interest rate to half a percent.

Even though most of the developing countries were not integrated with the world economy, these were hit by the fallout from the slowdown of the world economy. The negative impact was on account of reduction in exports, decline in foreign investment, fall in portfolio investment, drop in remittances and difficulties in accessing financing from the developed countries. The worst hit countries by the crisis were those which were already suffering from fiscal deficit and balance of payment difficulties. In India, the main effect was on the equities market as there was reversal of foreign portfolio investment. A report in 2008 discusses the negative impact of the crisis on Indian economy till that date. It states that “as the global financial crisis began unfolding in the first nine months of 2008, foreign institutional investors pulled out close to USD 10 billion from India, dragging the capital market down with it.”<sup>12</sup> It has also pointed out the impact of liquidity crisis and the credit squeeze on the manufacturing sector. As in the case of Pakistan, the global crisis of 2008 took place at a time when the Indian economy was experiencing slow down and credit squeeze as well as increased interest rates.

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<sup>12</sup> Article dated October 28, 2008 appearing in the Bloomberg Businessweek “World Financial Crisis: India’s Hurting, Too”



### 2.2.1 Impact of Global Crisis on Pakistan

As Pakistan's financial market was relatively insulated from the international markets, it escaped direct negative impact of the global crisis. However, Pakistan's economy which was already under severe stress due to various domestic factors was hit by indirect fall-out of the crisis. The increase in the world oil prices affected Pakistan's economy in many ways. Burdening the current account, it widened the fiscal deficit since the government took a politically motivated decision to subsidize the consumers instead of passing on the full burden of increased import prices of oil. This further fuelled the inflationary pressures. It has been estimated that subsidies constituted 47% of the fiscal deficit<sup>13</sup>. Due to the global recession, Pakistan's exports also declined and cost of international borrowing increased. Mr. Muhammad Mansoor Ali while analyzing impact of the 2008 crisis on Pakistan, has pointed out "that the operating environment of the financial sector experienced significant deterioration in 2007 and 2008 due to a confluence of factors emanating from both the domestic and international economic financial developments"<sup>14</sup>. He has also pointed out that the policy response of the central bank and the government to the mounting inflationary pressures and weak macroeconomic situation was two-fold. Initially, SBP increased the policy rate which was 7.5% in April 2005 to 15% by November 2008 and that Cash Reserve Requirement (CRR) and Statutory Liquidity Requirement (SLR) were also increased. Subsequently, SBP took measures to respond to the liquidity crunch which was partly triggered by withdrawal of deposits caused by rumors about the viability of local

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<sup>13</sup> Mohammed Mansoor Ali, Director, Economic Analysis Department, State Bank of Pakistan: Global Financial Crisis: Impact on Pakistan and Policy Response, July 2009.

<sup>14</sup> Ibid.

banks<sup>15</sup>. SBP extended liquidity support to banks and facilitated access to concessional financing schemes. It may be pointed out that while central banks of many countries lowered discount rate in the crisis environment, the SBP could not follow the trend due to high rate of inflation.

### **2.2.2 Global Stock Markets**

The global financial crisis had a negative impact on the stock markets in both the developed and the developing countries. Significant decline in the indices of 16 countries is mentioned in the following table:

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<sup>15</sup> <http://www.thenews.com.pk/TodaysPrintDetail.aspx?ID=140101&Cat=3&dt=10/9/2008>

Table 1: Regional and Global Stock Indices during Jan 2008 to Dec 2008

Index	Country	Index open Level as on Jan 02, 08	Index Level as on Dec 22, 08	% Index Change - YTD
<b>Regional</b>				
KSE 100	Pakistan*	14,075.83	6924.15	-51%
SENSEX 30	India	20,393.1	9686.75	-52%
SET Thailand	Thailand	858.74	440.4	-49%
FTSE ST All Share	Singapore	969.7	414.06	-57%
Kuala Lumpur Comp	Malaysia	1,445.03	871.16	-40%
Nikkei 225	Japan	15,307.78	8723.73	-43%
Hang Seng	Hong Kong	27,632.19	14220.79	-49%
<b>Global</b>				
NASDAQ	USA	2,653.24	1521.54	-43%
DAX	Germany	8,045.97	4629.38	-42%
S&P 500	USA	1,467.97	863.16	-41%
Dow Jones Avg	USA	13,261.82	8419.49	-37%
FTSE 100	United Kingdom	6,456.9	4255.98	-34%
*Opening of KSE dated Jan 01, 2008.				

Source: SECP

It is important to study the response of regulators in different countries which experienced sharp fall in the market indices in their jurisdiction. The International Organization of Securities Commission (IOSCO) carried out a survey on the effectiveness of the market interventions in emerging markets during the global crisis of 2008<sup>16</sup>. The survey of 29 jurisdictions carried out by the Emerging Markets Committee of IOSCO shows that only three regulators closed their respective markets during the peak of the global financial crisis, however, the duration of the closure of the market was very short. Indonesia closed its market for three days after sharp fall of the Index in October 2008. In Romania, market was closed twice in October 2008 due to increased market volatility. However, the maximum duration of the closure was 1 day. The

<sup>16</sup> "Effectiveness of Market Interventions in Emerging Markets", Emerging Markets Committee of the International Organization of Securities Commissions (IOSCO), October 2010.

duration of the three closures of the markets in Peru during this period was only 30 minutes twice and one and a half hour respectively. The survey report also mentions the decision of Karachi Stock Exchange to set a floor for share prices to limit losses due to drastic fall in the index for four months. It is significant to note that the regulators in about 25 emerging markets did not intervene in the market in any manner despite sharp decline in the index. The survey report does not mention any intervention by regulators in India where the index fell by 52% in 2008 or in Malaysia where the market fell by 40% during this period. While Hang Seng Index of Hong Kong fell by 49%, the regulators did not take any extraordinary measure. It appears that all these markets allowed their normal risk management systems to operate in order to address the sharp decline and volatility in the markets. These markets relied on self-correcting measures of the market to bring the indices to normal levels and to diffuse the volatility<sup>17</sup>.

### **2.3 Macro-economic Scenario**

Later part of 2007 and the year 2008 was marked by slower GDP growth of Pakistan, rise in inflation, widening of current account deficit and dwindling international reserves.<sup>18</sup> Partly, this situation was the result of global crisis 2008 which caused enormous increase in our import bill of biofuels.

Headline CPI inflation rose sharply from 8.8% YOY in December 2007 to 17.2% in April 2008<sup>19</sup>. The Government budget was burdened by rising prices of fuel and huge subsidies. The Government continued to borrow heavily from SBP. During May-June 2008, external account

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<sup>17</sup> Ibid.

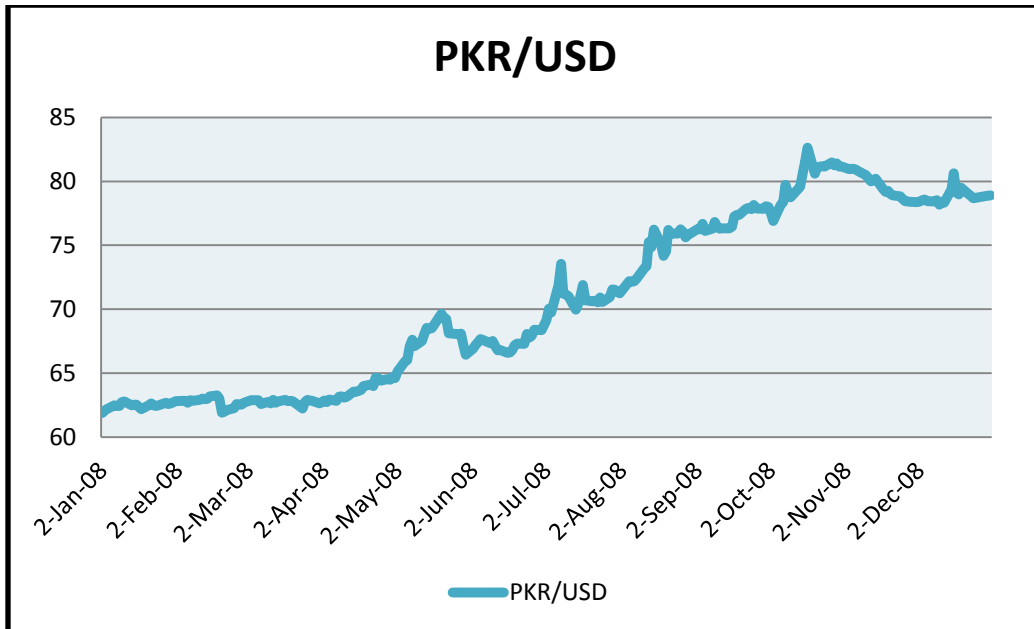
<sup>18</sup> Letter of Intent, Memorandum of Economic and Financial Policies (MEFP), and Technical Memorandum of Understanding, International Monetary Fund (IMF) November 20, 2008

<sup>19</sup> Pakistan Economic Survey 2007-08

deficit widened considerably leading to depreciation of Pakistan Rupee (PKR). Rising fiscal deficit and spiraling inflationary pressures forced the SBP to raise discount rate. Between July 2007 and July 2008 SBP increased discount rate in several steps by 350 basis points, to 13%<sup>20</sup>. In November 2008 the discount rate was raised to 15%.

Depreciation of Pakistan Rupee also led to capital flight. From April 2008, foreign portfolio investment in our stock market kept falling, coinciding with the fall of the KSE Index. The sharp fall in the value of Pak Rupee against US dollar in 2008 is indicated in Figure 1. Rapid devaluation of Pakistan Rupee while reflecting worsening macro-economic situation further exacerbated it in many ways. It increased debt servicing burden of the country as well as increased exchange rate risk for the foreign investors.

**Figure 1: Parity of PKR to USD during the period January 01 to December 31, 2008**



Data Source: University of British Columbia

<sup>20</sup> Memorandum of Economic and Financial Policies, 2008

The macro economic situation of Pakistan in 2008 has been summarized by Moody's spokesman while downgrading Pakistan's government rating from B1 to B2 on May 21, 2008. He highlighted Pakistan's fast erosion of the fiscal position, increasing current account deficit touching 7% of GDP, intensifying inflationary pressures and political turmoil<sup>21</sup>. Subsequently, Pakistan's B2 rating outlook was changed to negative on September 23, 2008 and was further downgraded to B3 on October 28, 2008. "The failure to obtain timely assistance from Saudi Arabia, China, the US and other friends, and delays in disbursements from the World Bank have eroded investor confidence and resulted in a substantial drawdown of Pakistan's foreign currency reserves...Ongoing negotiations for an IMF assistance program represent a last resort, but even this may not fully assure Pakistan of the ability to remain current over time on its external obligations, including payment on its global bond due in February 2009"<sup>22</sup>.

The deteriorating macro-economic situation in Pakistan caused negative sentiments in the stock market. The sharp rise in the discount rate adversely impacted the capital markets in many ways. It squeezed liquidity and diverted capital from stock market to risk free investment avenues like National Saving Schemes. Consequently investment in National Saving Schemes increased by 28% from 2007-08 and 3 times during the 2008-09<sup>23</sup>. It also increased the cost of business which led to lower corporate profitability.

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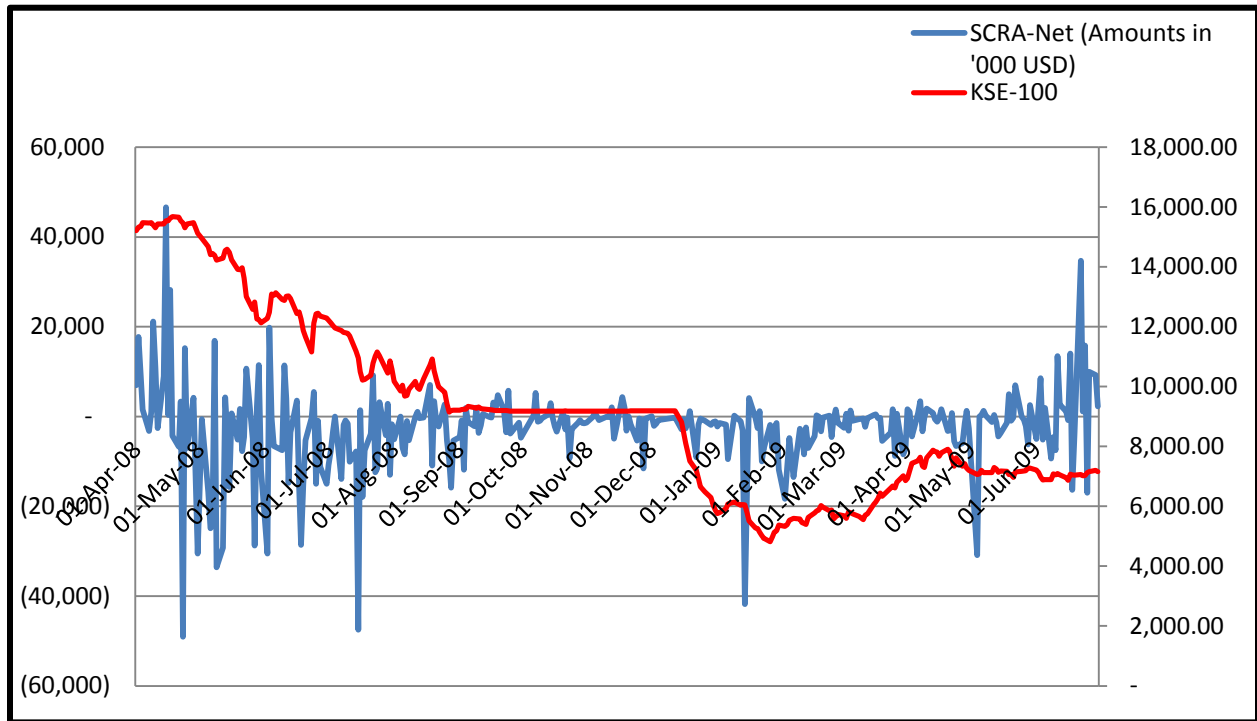
<sup>21</sup> Rating Action: "Moody's lowers Pakistan's government ratings to B2", May 21, 2008, Moody's

<sup>22</sup> Rating Action: "Moody's lowers Pakistan's ratings to B3 and keeps it on review for downgrade", October 28, 2008, Moody's

<sup>23</sup> Savings Mobilized by National Savings Schemes, State Bank of Pakistan.

As indicated in the graph given below, there was marked withdrawal of foreign portfolio investment mainly due to depreciation of PKR, political situation and the global financial crisis. This situation forced distressed foreign financial institutions to withdraw investments from emerging markets. During the financial year 2008-2009, there was net foreign portfolio investment outflow of USD 177.7 million from Pakistan's market<sup>24</sup>. Besides external factors, the massive outflow was caused by imposition of floor on securities prices by the stock exchanges in August 2008. The trend of pull-out of funds by the foreign investors correlates with the fall in the KSE-100 Index. While the market started falling from April 19, foreign investors started making sharp and consistent withdrawals from June 2008 onwards.

**Figure 2: KSE-100 index vs. inflow/outflow of funds by foreign investors during January 01, 2008 to June 30, 2009**



Source: SBP website, KSE website and SECP

<sup>24</sup> Economic Survey of Pakistan 2008-09

### Chapter 3: Build up to the Crisis

The euphoria generated by the national elections held on February 18, 2008 marked by transformation to democratic set-up and the post-election display of warmth among hither to opposing political leaders generated investor confidence. In fact, this confidence had started building up even before the elections as the market registered rise of 469 points during last four trading sessions before the elections. About the same time there was a sharp increase in the foreign portfolio investment as on February 20, 2008, there was a net inflow of about USD 56.5 million (PKR 3.5 billion)<sup>25</sup>. The market responded positively to these developments and remained buoyant till mid of April. The resulting investor confidence drove up both the index level and trading volumes. The month of March witnessed positive political developments. On March 09, the two major political parties signed the Murree declaration<sup>26</sup>.

Unfortunately, market buoyancy ended in April. The market realized that due to the stringent economic conditions, the government may impose capital gains tax in order to raise Tax to GDP ratio. On 24<sup>th</sup> April, an IMF announcement expressed concern over gradual slowing down of Pakistan's economy from 7% to 6%. It also pointed out that subsidies on fuel and electricity had reached two and a half percent of GDP<sup>27</sup>. These developments triggered negative sentiment in the market. The market started sliding from 21<sup>st</sup> April and by end of the month, the index had

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<sup>25</sup> NCCPL figures for Foreign Investors' Portfolio Investment during 2008

<sup>26</sup> <https://humaimtiaz.wordpress.com/timeline-pakistan-2008/>

<sup>27</sup> <https://www.imf.org/external/np/tr/2008/tr080424.htm>



shed 554 points i.e. 3.5%. Market capitalization eroded by PKR 156.21 billion and volumes also decreased.<sup>28</sup>

May, 2008 witnessed both political and economic uncertainty. On May 13, 2008 ministers of PML(N) resigned from the Cabinet.<sup>29</sup> On the economic front, reserves kept falling to the level of \$11.512 billion<sup>30</sup> and the value of Rupee depreciated and hovered around PKR 66-67 against dollar in the Interbank Market. On May 21, Moody's downgraded Pakistani government's rating to B2 from B1. On May 23, SBP increased policy rate by 150 basis points from 10.5% to 12%. On May 26, a member of KSE failed to meet margin requirements of PKR 98.4 million and defaulted. The continuous fall of the market in May, 2008 started causing concerns. These events sent a signal of an impending crisis in the market. On May 31, 2008 Pakistan foreign exchange reserves stood at \$11.178 billion<sup>31</sup>. On May 29, the board of directors of KSE in its meeting allowed CFS and CFS MK-II facilities to all DFM net purchase positions for May contracts invoking *force majeure* provision contained in the RM Regulations. This step was taken despite the claim of the Managing Director of KSE in the board meeting that the risk management mechanism at the exchange level did not have much problem except for one brokerage house which also came out of the difficulties<sup>32</sup>. The decision to postpone the settlement of DFM contracts and to allow financing through CFS and CFS MK-II had serious implications for the market. The decision not only deviated from the declared policy of allowing CFS and CFS MK-II only to the ready market investors, it altered the product model of Deliverable Future Contracts' (DFC) which were to be settled within 30 days. Such an abrupt and ad hoc decision

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<sup>28</sup> Data obtained from SECP

<sup>29</sup> <https://humaimtiaz.wordpress.com/timeline-pakistan-2008/>

<sup>30</sup> <http://www.aaj.tv/2008/06/the-rupee-sharp-recovery-versus-dollar/>

<sup>31</sup> <http://www.opfblog.com/2634/pak-economy-foreign-currency-reserves-depleting-fast/>

<sup>32</sup> Minutes of KSE board Meeting held on May 29, 2008

undermined the credibility of KSE. This measure was one of the series of quick fixes and midstream changes in policy in response to the market situation. It may be mentioned that trading activity in DFM during this period was quite substantial. This measure rescued weak holders and speculators. In view of the prevailing stock market conditions, a KSE delegation held meetings with political leadership and Finance Minister to discuss the declining trend in the market<sup>33</sup>. The delegation urged for postponement of imposition of the Capital Gains Tax (CGT). During May, the KSE-100 Index went down by 2,992 points i.e. 19.8% and around PKR 888.57 billion was wiped out from the market.

The assurances received by KSE from the Finance Minister in the meeting held on May 29 for extension in the exemption period of the CGT as well as roll over of the DFM contract had an immediate positive impact on the market. During the first three trading sessions in June, the market went up by 959 points. However, the volatility in the market continued during the month. Formal announcement of exemption in CGT was made on June 07 by FBR. June 13, the day thousands of people converged in Islamabad for the long march for the restoration of Judiciary, triggered the slide in the market and the negative trend continued till June 23. During this period the market fell by 1,863 points.

In order to take stock of excessive volatility and declining trend in the market, an important meeting was held on June 23, 2008 under the chairmanship of Chairman, SECP which was attended by board of directors and management of KSE. It was decided in the meeting to take a

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<sup>33</sup> Meeting held on May 29, 2008

number of measures to arrest the declining trend and to ensure stability of the market. These measures announced through a press note<sup>34</sup> were as under:

- a. As a *force majeure* for a period of 30 days, the applicable security wise circuit breaker in ready, deliverable future contract and cash settled future contracts markets were revised from -5% to +5% to -1% to +10%. This was to be reviewed on July 15.
- b. Short selling was completely prohibited in deliverable future contract market and short sale in ready market with preexisting interest against purchase on another exchange was also prohibited. These prohibitions were for a period of one month effective June 24, 2008 and were to be reviewed again 1 week prior to the start of August Deliverable Future Contracts.
- c. Bank Guarantees from “A” and above rated banks to be allowed as margin eligible security for margin deposit in the ready, future and CFS market; and tender of mark-to-market losses in future market to remain in cash.
- d. Methodology of calculating the receivables for the purposes of Members’ Capital Adequacy was agreed to be revised subject to regulatory approval.
- e. KSE would be submitting a proposal for establishment of Market Stabilization Fund of PKR 30 Billion in line with international practice. The Fund was to be structured in such a manner that it would be automatically triggered if and when volatile circumstances are witnessed in the market.

While decisions regarding eligibility of bank guarantees from high rated banks are understandable, prohibition of short-selling in the ready market and futures market, revision of

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<sup>34</sup> Press Release: Measures for Market Stabilization dated June 23, 2008 available on KSE and SECP website

circuit breakers and announcement of a possible market stabilization fund of PKR 30 billion had significant implications.

The Committee has analyzed the above-mentioned decisions which were intended to force upward movement of the market and discourage exit of investors. It is debatable as to whether a regulator should take such ad hoc measures with the intention of influencing the movement of the market. The internationally accepted role of the regulator is to ensure that the market operates in a fair, efficient and transparent manner and he should not be concerned with fluctuations in the index.

As for specific decisions, the Committee is of the view that the decision to prohibit short selling in the ready market appears to be favouring those holding long positions in the market to the detriment of the short-sellers. As regards restrictions imposed on short selling in the futures market, it led to only one sided activity in the market. With restrictions on sellers, the futures market quickly became inactive. This inactivity accompanied with rapidly declining ready market, resulted in a disproportionately widening gap in the prices of ready and futures market.

The change in circuit breakers was ad hoc in nature and involved abrupt change of rules of the game. This measure was intended to force upward movement of the market and discourage exit of investors. During a single day, 136 scrips touched the newly applicable upper circuit breaker limit of 10% while only 70 scrips touched the revised lower circuit breaker of 1%<sup>35</sup>.

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<sup>35</sup> Circuit breaker report, KSE website

A market analyst observed that “Investors started realising that a market could not artificially be given a direction and if trades had to occur, a 1% lower breaker would only delay the fall in prices. All too often, the circuit breaker was hit and trading stopped because buyers and sellers refused to transact at the price permitted on the screen. Circuit breakers converted price risk into liquidity risk. Average daily volumes fell to 10-year lows to around 20 million shares a day, from last year's daily average of 240 million shares. Brokers started feeling the consequences of the SECP decision as their volume driven income depleted.”<sup>36</sup>

Two keen observers of stock market discussing the decisions taken on June 23 commented that “While each of these measures taken is objectionable, the one that is simply absurd is reducing the lower price limits from 5 percent to just 1 percent and doubling the upper limit to 10 percent, perhaps a record in its own right. What this means is that the price of a stock may rise by 10 percent but will be allowed to fall only by 1 percent compared to its price the day before. This is just a step short of the regulators deciding the share prices, rather than the market forces.”<sup>37</sup> They have also raised an important policy issue that “by resorting to this extreme action, the KSE and the SECP have accepted that they have not been able to ensure sound management of settlement risk, which is their fundamental regulatory responsibility.”<sup>38</sup>

As regards the proposal for establishment of a market stabilization fund of PKR 30 billion, it appears to be premature as it was not backed by any firm commitment for subscription nor any organizational arrangements had been finalized. In the absence of such a commitment, the

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<sup>36</sup> Junaid Khalid, Karachi’s experiments with circuit breakers, December 29, 2008

<sup>37</sup> Dr. Adeel Malik and Usman Hayat, A record we can’t be proud of, The News, July 02, 2008

<sup>38</sup> Ibid.

announcement of the fund could have misled the investors. It may be noted that NIT managed Equity Market Opportunity Fund (EMOF) was launched on ad-hoc basis on July 25, 2008. During the three days following the announcement of the launch of EMOF, the KSE-100 index gained 1,290 points. It has also been noticed that on the very next day of the announcement off-market volumes rose sharply<sup>39</sup>. However, after the rise for three days, KSE-100 Index started its gradual declining trend.

The fall in KSE index was rather gradual till July 11, 2008 since the revised circuit breakers artificially restricted decline in the prices to only 1%. From July 1 to July 11, KSE 100 index fell by 593 points. However, the market fell sharply soon after the revised circuit breakers were restored on July 14 to June 23 level and circuit breaker mechanism reverted back to 5% lower and upper limits. The removal of the revised circuit breakers enabled release of the selling pressure which had accumulated during the period of revised circuit breaker limits. This also provided an opportunity to the mutual funds to encash their securities in order to meet their redemption obligations. During four days after the restoration of the circuit breakers to 23<sup>rd</sup> June level, KSE-100 index fell by 1,483 points. The restoration of short sales from July 14 may also have led short-sellers to further drive down the market. Selling pressure was also triggered by grave concerns about security situation. During the month, there was build-up of NATO troops around the Pak-Afghan borders and occurrence of many incidents of violence. However, the news in the market about establishment of the EMOF led to rise in the KSE index from July 18, 2008. The fund was actually launched on July 25, 2008. The rise of the index by 922 points from July 21 to July 24, 2008 could be attributed to the news of the launch of EMOF as well as visits

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<sup>39</sup> Average trading volume from June 24 to 27 in ready and off-market was 188 and 38 million shares, respectively.

of the Governor of the State Bank of Pakistan and the Finance Minister to KSE on July 21 and 22 respectively. During the visit of the Finance Minister, members of KSE urged the Government to intervene in the market.

During the next three trading sessions from the date of launch of the fund, the index again fell by 708 points. Therefore it can be assumed that the news of the fund had already been absorbed by the market prior to its launch. A view has been expressed by some market participants that the bull-run during the days leading up to the launch of the fund was due to securities being accumulated at the depressed prices to be sold later to the fund at comparatively higher prices. The market had an abnormal rise on July 30, 2008 and the index went up by 405 points.

It was noticed in July, 2008 that there was a significant gap in prices prevailing in the Ready and Deliverable Future Market of the same scrip which had led to abnormal spread between the two markets. The abnormal spreads in the same scrips noticed in July 2008 reflected lack of buyer's interest. Sellers found it hard to reduce their open interest. It was observed that, as a consequence, the required mark to market margins were not being collected.<sup>40</sup> It was therefore apprehended that members may get huge cash call on the final settlement to be based on closing price in the ready market. In view of this situation, KSE decided to adjust the prices of scrips in the DFM and collect the mark to market losses in five (5) equal installments<sup>41</sup>. On July 30, 2008 KSE index rose possibly due to buying activity of institutional traders particularly EMOF.

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<sup>40</sup> Minutes of meeting of KSE board held on July 16, 2008

<sup>41</sup> Ibid.

It appears that the slide of the Futures Market was not as rapid as that of the Ready Market. Normally, the gap between the prices of the two markets should have provided an arbitrage opportunity to bring prices between two markets at an equilibrium level. However, this was not possible due to abnormally high prices in the DFM<sup>42</sup>.

The decline of the Index by 1,376 points in August, 2008 caused widespread consternation among the market participants. The market broke the psychological benchmark of 10,000 points on August 04, 2008 when it touched 9,853 points. KSE Board met on August 01 and twice on August 5 to review the deteriorating situation of the market. In the meeting held on August 01, it was decided to hold Special Trading Session (STS) on Saturday, August 02 to provide an exit to investors and to ease the selling pressure on the market. The STS was to be held as a voluntary exercise for allowing buyers and sellers to execute trades at the closing price of Friday, August 01, 2008. The amount wise bids received during the trading session were mostly over and above the sale offers.<sup>43</sup> The result of the special trading session interestingly shows a larger presence of buyers as compared to those willing to sell and exit the market in such depressed market conditions. This indicates that investors were buoyant on expectations of an announcement of a bail-out package by the Government, which would allow them to obtain better prices.

An emergent meeting of the Board held on August 05 in the morning reviewed the situation. It was pointed out that while KSE's clearing house was not at risk, significant stress signs were being witnessed. It was noted that there had been instances of delay in the collection of margins from some 5-6 weak brokers, the aggregate exposure to whom was approximately PKR 1

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<sup>42</sup> Ibid.

<sup>43</sup> Minutes of meeting of KSE board held on August 05, 2008



billion<sup>44</sup>. Delay in margin/losses payments from two brokers also came to light and these brokers had exposure of around PKR 400 million. Some members were also facing pressure from the banks for non-payment of margins. One of the members attributed the difficulties of brokers to meet their obligations to the lack of liquidity in the market.

During the meeting, the Chairman of KSE board identified following three options before the board;-

- (i) temporary closure of the market;
- (ii) delayed opening of the market; and
- (iii) freezing the market on a specified floor level.

It may be pointed out that the Chairman made an important suggestion that the board may consider a contingency plan in the event that the expected rescue funds were not made available by the Government. Unfortunately, no such plan was prepared, although such a plan was needed in view of the difficult fiscal situation being faced by the Government at that point of time. It appears that expectation or reliance on the direct support of the Government in the circumstances was not realistic. Mr. Ali Ansari, an SECP nominated director, emphasized that while taking decision about remedial actions, it must be ensured that the market should be allowed to continue functioning.

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<sup>44</sup> Ibid.

The Committee has noted with concern that the notice issued by the KSE following the emergent meeting<sup>45</sup> is silent about the three options which had been placed before the board, particularly the option of freezing the market which was subsequently implemented after 15 trading days. Lack of dissemination of this critical information to the public violates the basic principles of good governance. The Committee feels that the asymmetry in the information available with the member directors and the general investors is a serious matter since it provided opportunity to the member directors to take full advantage and adjust their individual positions in the market accordingly.

In the board meeting held in the evening of August 05, 2008, KSE board deliberated reduction of VaR margins to provide relief to members and investors. Both the Chairman and Mr. Ali Ansari strongly opposed the proposal as they thought that any relaxation of the risk management regime was not appropriate at that point of time. Mr. Ansari recalled that there had been allegations of introducing abrupt changes in the rules of the game at the exchange in the past and approval of the proposal would fortify such perceptions.

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<sup>45</sup> KSE Notice KSE/N-4606 dated August 05, 2008 available on KSE website

## Chapter 4: Imposition of Floor on Prices of Securities

The emergent meeting of the KSE board on August 27, 2008 was held against the backdrop of a grim situation. KSE Index had lost 1,774 points during the last 6 trading sessions and stood at 9,145 points on August 27, 2008. NIT managed Equity Market Opportunity Fund which had been launched on July 25, 2008 had invested only PKR 4.27 billion by August 27. Within a year from July 2007 to July 2008 discount rate had been raised by 350 basis points by the State Bank of Pakistan in gradual steps. On July 29, 2008 Governor, SBP had justified increase in the discount rates on the grounds of “risks relating to rising external current account and fiscal deficits and worsening inflationary outlook”. The depreciation of rupee against the US dollar which accelerated from April 2008 continued in the later months. Between April and August 2008 the rupee had depreciated by around 17.97%<sup>46</sup>. The environment in the country was dampened by a number of sporadic incidents of violence.

The emergent meeting held on August 27, 2008 took stock of the decline of the market since April, which according to a member of the board was due to economic recession, free fall of rupee, sharp hike in discount rate and political turmoil. The board was informed that various meetings had been held on the previous day to deliberate upon the situation. Members of the board had consultations with various stakeholders following which two separate meetings of members were held, which were attended by 35 members and 103 members respectively.

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<sup>46</sup> Month end foreign exchange rate (Pak Rupee per US \$), State Bank of Pakistan

The members expressed difficulty in meeting the margin requirements of the exchange, the lending banks and financial institutions; and expressed disappointment at the failure of public institutions to support the EMOF. 100 out of 103 members urged upon the board to impose floor based on the closing price of securities as on August 27, 2008. According to the minutes of the board, senior members of KSE who were especially invited to advise did not propose any viable solution to stem the slide of the market and went along with the majority members for imposition of the floor.

As recorded in the minutes of the meeting of KSE board on August 27, the Chairman KSE while summing up the discussions identified three viable options for consideration of the Board:

- i. To let the market continue and let it settle down on its own merits.
- ii. To temporarily close the market in terms of the powers vested with the Board as per Articles of Association of the Exchange.
- iii. To place a floor based on closing prices of securities as on August 27, 2008, whereby the individual security prices will remain free to trade within the normal circuit breaker limits, but not below the floor price level as mentioned above.”

The board after voting decided in favor of imposition of floor, by a majority<sup>47</sup>. It was argued that “the market would remain open enabling it to perform to some extent. It will discourage the short sellers as well as stimulate covering of the short sales positions. It will also allow off-market

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<sup>47</sup> Minutes of meeting of KSE board held on August 27, 2008

transactions to be executed and reporting of the same to the Exchange.”<sup>48</sup> During the discussions, the board was cognizant of the reaction to the decision as the minutes record that “such action may invite allegation of abrupt change of rules to protect vested interest and thus the credibility of the Exchange may be affected.”<sup>49</sup>

The main stated objective of the decision to impose the floor was to release the pressure of margin calls and to avoid multiple defaults. It is interesting to note that in the subsequent meetings of the KSE Board held on September 03, 2008 and September 09, 2008 a number of other factors were quoted as objectives of the decision like facilitation of buy-back of shares by listed companies and reforming the CFS Margining System.

In the meeting held on October 25, 2008 Mr. Muhammad Sohail Dayala stated that the board while deciding the imposition of the floor had envisaged duration of the floor to be only 5 days, expecting some positive actions from the Government. This statement suggests that the motivation of the decision was to galvanize support of the government.

In view of the divergent views of the members of the board on the possible remedial measure to be taken, the matter was put to vote. The result was as follows:

- The Chairman as well as Mr. Ali Ansari and Mr. Adnan Afridi voted for Option-I i.e. to let the market continue.

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<sup>48</sup> Ibid.

<sup>49</sup> Ibid.

- Mr. Ali Ansari and Mr. Adnan Afridi voted for Option-II, in case Option-I was not adopted i.e. to temporarily close down the market.
- The remaining five broker directors voted for Option-III i.e. to place a floor on prices of securities.

It may be noted that while all the five broker directors supported imposition of floor, the three non-member directors (two of whom were nominated by SECP and one was an ex-officio director) opposed the proposal for imposition of floor. It may be pointed out that one position of SECP nominated director happened to be vacant and one of the SECP nominated directors had been granted leave of absence for the meeting. It is presumed that if all the non-member directors nominated by SECP would have been present in the meeting, the Chairman of the meeting could have exercised his casting vote against imposition of floor. In such a situation the subsequent course of events of the market could possibly have been quite different. It would have spared our stock market the dubious distinction of being the first stock market to impose floor on prices.

The record consulted by the Committee refers to the following sequence of events:

- The KSE Board convened an emergent meeting at 3 p.m. on August 27, 2008 and decided in favour of option of placing floor on closing prices of securities as on August 27, 2008.
- Managing Director KSE wrote a letter the same day to Chairman SECP conveying decision of the board and seeking approval of SECP for imposition of floor effective August 28, 2008.

- Director, SECP sent an email to LSE and ISE on August 27, 2008 at 7:21 p.m. informing LSE and ISE about the three options which KSE had considered<sup>50</sup> to deal with the continuous declining trend of the stock markets namely:
  - “1. Freezing/flooring of market at 9,144.93 (KSE 100 Index Level);
  - 2. Market closure for a definite/indefinite time period and/or
  - 3. Market continuation”
- Mr. Shakeel Aslam, Managing Director LSE responded to SECP the same night at 9:10 p.m. i.e. in less than two hours, stating that:
  - (i) He had discussed the matter with board directors/members and the general view was that interfering with market mechanism could have negative repercussions for the market and confidence of investors, especially foreign investors.
  - (ii) LSE is of the view that certain other measures should be taken to address the current volatile situation such as stabilization fund, abolishing/reducing CVT, mandating listed companies to distribute minimum of 40% of its profits as dividend. He also stated that clearing house of LSE was fully under control through the adoption of required risk management system and margins were intact.
  - (iii) However, if KSE decides to freeze or close the market, LSE would follow the same in order to avoid technical/procedural problems and avoid any distortion of the market and hence maintain uniformity.
  - (iv) Out of the options, LSE would prefer freezing the market and if so done, it should not be for a day or two but more of a sustained period of time.

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<sup>50</sup> Copy of email provided to the Committee by SECP

- ISE responded to SECP at 9:28 p.m. stating that though ISE was not in favour of any “contrived interventions in the market”, it would go along with the proposal for freezing the market in view of the prevalent situation. It also emphasized that artificial interventions in the market did not prove sustainable.
- In another letter dated August 27, MD KSE informed SECP that KSE Board had decided to place floor based on closing prices of securities of August 27, 2008 which mechanism will be introduced effective August 28, 2008 and shall continue till further notice.
- On August 28, 2008 the three stock exchanges issued notices to the members informing them of the decision to place a floor on the closing prices of August 27, 2008 both in the ready and futures market, whereby the individual prices would remain free to trade within the normal circuit breaker limits but not below the floor price level of August 27, 2008.
- The minutes indicate that during the meeting, KSE board had multiple conference calls with Chairman SECP and received feedback from one of the leading fund managers.<sup>51</sup>
- CEO’s of NCCPL and CDC were also consulted who agreed to the KSE proposal of placing the floor.<sup>52</sup> However, according to the order of appellate bench of CCP, letters of CDC and NCCPL produced before it mention that CDC and NCCPL were only informed rather than consulted.<sup>53</sup>

It is important to discuss the process of imposition of floor prices. The above sequence highlights the following facts:

1. The decision for imposition of the floor was taken in haste.

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<sup>51</sup> Para 1.7 of Minutes of the KSE board Meeting held on August 27, 2008

<sup>52</sup> Ibid.

<sup>53</sup> Page 40 of the order dated November 26, 2009 passed by the Appellate Bench of the CCP.



2. Consultation with LSE and ISE cannot be treated as meaningful since they appeared to be under pressure to deliberate and respond within a couple of hours.
3. MD KSE wrote two letters to SECP on August 27, 2008. In the first letter he sought approval on the recommendations of the KSE board for imposition of the floor and in the second he conveyed decision of the board to impose the floor. It is not clear as to what transpired in the time gap between the two letters.
4. Although LSE and ISE responded to SECP about the proposal/decision of KSE, record of SECP does not show that these responses were formally conveyed to KSE.
5. Although LSE and ISE conveyed their concurrence to imposition of the floor, both the stock exchanges emphatically pointed out that intervention of any kind in the market could not be sustainable and as such was not desirable.
6. The *force majeure* provision in the RM Regulations does not appear to have been followed by the three stock exchanges either in letter or in spirit. In this regard, the Appellate Bench of the CCP in its order dated November 26, 2009 has made some pertinent points. Firstly, while determining a *force majeure* event KSE did not follow the established principles of law which required it to prove that *force majeure* circumstances existed notwithstanding its own efforts. The justification of loss of liquidity for imposition of the floor became questionable in the light of the report submitted by KSE to the Appellate Bench.

The Committee is also of the view that while exercising powers under *force majeure* of the RM Regulations, KSE board should have applied its mind to determine that an emergency or exceptional market condition existed in the market and after making reasonable determination should have consulted NCCPL and CDC. It appears and as argued by KSE in the CCP case, the KSE board imposed floor under clause (e) which empowered KSE to take

or omit to take all such other actions as KSE Board deems to be reasonably appropriate in the circumstances having regard to the positions of the Exchange, Clearing Company, the Members and other customers.” The Committee is of the considered view that clause (e) does not give a blanket approval to the KSE to impose floor on prices and the said clause must be interpreted in line with the other clauses and reasonability of the decision must be ensured. The minutes do not indicate discussion on each of the steps stipulated under the RM Regulations and further various options available to the Board under clause (e).

7. LSE and ISE also did not follow the procedure required to be followed for exercising powers of *force majeure* under the RM Regulations.
8. The decision to impose the floor was taken by KSE in its board meeting through split vote. The final decision was taken on the basis of the vote of five broker directors of KSE. It raises questions of serious conflict of interest as the broker directors who were to personally benefit from decision for imposition of the floor did not disclose their interest nor abstain from voting as mandated by section 214 and 216 of the Companies Ordinance, 1984.
9. As stated by the Appellate Bench of the CCP, the primary reason for imposition of the floor by KSE was to protect its members and it may not be correct to say that it was in public interest.
10. One of the requirements of actions under *force majeure* clause of RM Regulations is that it should take into account the interest of customers/investors. While the interest of members was given importance there is nothing on record that KSE board considered the interest of investing public (other investors). It may also be pointed out that the meeting of the KSE board refers to consultation with a leading fund manager. It is interesting that the KSE board decided to consult an individual fund manager instead of The Mutual Funds Association of

Pakistan (MUFAP) which is the representative body of all Asset Management Companies (AMCs).

The process of decision making and the decision itself raise some fundamental questions and issues. Firstly, the situation which led to the imposition of the floor had not arisen abruptly. As a matter of fact since April 2008, the market was going through bearish trend with consequential pressures on leveraged financees. Therefore, both SECP and the stock exchanges had ample time to analyse the situation in detail and consider various options for dealing with the situation. The fact that no in-depth analysis was available at the time of taking this decision shows serious weakness of the institutions. The Committee is of the view that the regulators should have organised systems for continuous monitoring and evaluation of risks in the market so that preemptive measures could be taken in time.

Secondly, the question of imposition of the floor had been coming under discussion before its final implementation. In the KSE board meeting held on August 05, imposition of floor had been discussed as one of the options. It is surprising that the implications of implementing such a decision were not considered either by SECP or by the KSE and not shared with the LSE and ISE.

Thirdly, the provision of *force majeure* in the RM Regulations approved in February 2008 by SECP was used by the stock exchanges to make ad hoc and midstream changes in policies. This provision was used in May 2008 for allowing roll-over of DFM positions to CFS MK-II and on June 23, 2008 for changing circuit breakers and prohibiting short sale. There is visible tendency

to use this provision indiscriminately, ever since its incorporation in the regulations. In December 2008 LSE members again demanded use of *force majeure* for dealing with the CFS MK-II situation. This provision gives blanket powers and can be resorted to easily for interfering in the market. Given the indiscriminate use of this provision, SECP may decide as to whether it needs to be substituted by more specific provisions in the regulations.

The issue of imposition of the floor has been widely discussed both within the country and abroad. Three main issues which have been debated are (i) who was responsible for the decision to impose the floor; (ii) was imposition of the floor the best available option to deal with the prevalent situation; and (iii) why the floor was allowed to continue for four months.

The record available with the Committee shows that the decision to impose the floor was that of KSE which had been considering it as one of the options since August 05, 2008. Once this idea was mooted, the members jumped at it and mobilized support in its favour. 103 members of KSE gathered on August 27 to discuss the market situation and 100 out of them voiced their agreement with option of imposition of the floor. It can be presumed that these members put pressure on the board to take this decision. SECP did not convey its views or decision to KSE and thus allowed it to implement the decision. The Committee is of the view that given its responsibilities under the Securities and Exchange Commission of Pakistan Act, 1997 (the “SECP Act, 1997”) for dealing with capital market and its powers under sections 20 of the said Act, its silence tantamount to tacit approval. This view is fortified by the fact that it issued a directive to stock exchanges to lift the floor price levels with effect from December 15, 2008 exercising its powers under section 30 of the SECP Act, 1997.

As regards the second issue KSE considered three options i.e. allowing the market to continue, closing the market for a brief period and imposition of floor on prices. As has already been discussed in 2.2, Global Financial Crisis and its Impact, a survey of the impact of 2008 crisis on the emerging markets carried out by IOSCO indicates that most of the markets which had dipped during the global crisis of 2008 allowed their markets to continue functioning. Only three stock exchanges resorted to closure of the market for brief periods, the maximum period being three days. The Committee is of the view that keeping in view the experience of other jurisdictions, it would have been in the long-term interest of the market to allow continued functioning of the market under normal parameters. As has been mentioned elsewhere in the report, the decision to impose the floor did not address the underlying problems of the market. In the KSE Board meeting held on October 25, 2008, one of the directors stated that “if the floor had never been imposed, a limited number of casualties in the form of members’ default would have occurred. However, with the passage of time the financial position of a large number of brokers has gone worse and they are on the verge of default leading to collapse of the entire system.”<sup>54</sup>

As regards the third issue KSE’s announcement on August 28 mentioned imposition of the floor till further notice. However, some directors mentioned in KSE’s board meetings that the floor was intended for a limited period of time possibly 5-6 days to provide cooling period to the market as well as to galvanize support of the Government. The then Chairman SECP was quoted by an international newspaper stating that curbs to prevent shares from falling below closing

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<sup>54</sup> Minutes of meeting of the KSE board held on October 25, 2008

prices will remain for 7 to 10 days until the situation improves<sup>55</sup>. Possibly the floor continued as the government support funds did not get operationalized in time. The Committee is of the view that our economy was undergoing an extremely difficult period in 2008 as has been explained earlier and therefore expectations of a government bail-out package were not realistic. Since there was growing awareness about the negative perception and implications of the floor, the KSE decided to lift the floor with effect from October 27, 2008. A press note issued by KSE on October 14, 2008 made such an announcement. However, KSE did not implement the decision and the floor was allowed to continue. It has been noted that after October, the government which was negotiating stand-by agreement with IMF started apprehending that removal of the floor could lead to increased outflow of foreign exchange. It is felt that once the floor was not removed on October 27 as notified, implementation of decision became increasingly difficult with each passing day. The Committee is of the view that firstly KSE should not have resorted to imposition of the floor but if a floor had been imposed, it should have been lifted as early as possible. Both the apex and the frontline regulators were free to remove the floor up to October 27, 2008 after which there were external pressures for its continuation.

The Committee has evaluated the decision of imposition of floor or freezing of the market as an unusual intervention measure to be adopted by a regulatory body. As already mentioned, certain markets affected by the global crisis of 2008 had closed for short periods but none of these decided to freeze the prices. As would be explained subsequently, prolongation of the freeze for almost four months exacerbated the market situation. This experience leads the Committee to

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<sup>55</sup> The New York Times dated August 28, 2008

believe that the decision of imposition of the floor violated three fundamental principles of a stock exchange:-

- (i) Smooth functioning of a market;
- (ii) Efficient price discovery mechanism;
- (iii) Easy entry and exit.

It appears that the stock exchanges which took the decision for imposition of the floor and SECP which was consulted prior to taking this decision did not assess and evaluate full implications of the decision. It is common knowledge that ad hoc intervention in the market cannot possibly address its underlying ailments. It has been observed that the situation of the market did not improve on the removal of the floor, rather it further deteriorated as reflected by the sharp decline in the market and the number of default casualties following lifting of the floor.

The decision to impose the floor on prices of securities announced by the three stock exchanges separately on August 28, 2008 was noticed by the CCP for inquiry under section 37 of the Competition Ordinance 2007 which later became Competition Act of 2010. After detailed examination of the issue and hearing of the three stock exchanges, CCP held the separate decisions of KSE, LSE and ISE to impose a floor or fix the minimum sale price of securities to be anti-competitive and collusive action as these fell within the purview of section 4(1) of the CCP Ordinance. The order was passed on the grounds that it had the effect of preventing, restricting and reducing competition in the market. The orders also pointed out that by imposing artificial minimum price, it created a barrier to entry and by allowing the off-market, it created a private market which disadvantaged the buyers and sellers as they could not procure competitive

prices. The orders also observed that the decision virtually entrapped investors and prevented them to sell securities at a price lower than the price fixed by floor.

International experience of capital market shows that the stock exchanges strictly adhere to the principle that the markets should be functioning continuously. In this regard, a report cautions against intervention in the shape of closure of a market by regulators and states that “research has shown that markets that close indiscriminately have negative consequences when they reopen, and may even lead to further downtrends. There may also be possible reputational damage and a measure of uncertainty in trading environment.”<sup>56</sup>

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<sup>56</sup> Effectiveness of Market Interventions in Emerging Markets”, Emerging Markets Committee of the International Organization of Securities Commissions (IOSCO), October 2010.



## Chapter 5: Period of the Floor and Issues Arising Therefrom

During the period of floor, the market functioned within the upper circuit breaker limit but not below the price of each security as on August 27. From August 27 to December 15, 2008 when the floor placed on the prices of securities was finally lifted, the stock exchanges continued to struggle with managing liquidity problems and ironically, dealing with issues arising out of the floor itself. With the prolongation of the period of floor, the crisis kept deepening and unanticipated issues kept surfacing.

As recorded in the minutes of the KSE board, a member pointed out that management of KSE had envisaged floor prices only for a period of five days<sup>57</sup>. However, it remained in force for almost four months and no serious efforts appear to have been made to restore normal functioning of the market early. The KSE issued a notice on October 14, 2008 announcing lifting of the floor with effect from October 27, 2008. However, it could not implement the decision and kept dilly dallying in unrealistic expectation of bailout.

The Committee has observed that after taking an unusual measure on August 27, 2008 which later proved to be very unwise, the KSE management should have immediately taken stock of the market situation and should have initiated preparation of a roadmap outlining the schedule for removal of the floor. The KSE board and its management owed it to the investors to apprise them about the future steps and the timeline. Although negative implications of the floor became evident soon after August 27, the board and the management kept postponing removal of the floor.

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<sup>57</sup> Minutes of meeting of the KSE board held on October 25, 2008

A number of new issues confronted the market due to the imposition of the floor. These issues relate to increasingly negative perception of the foreign investors, distortion of price discovery and restrictions on free entry and exit in the market, hectic search of alternate sources of liquidity, management of the leveraged products and adjustment of risk management regime. Two other offshoots of the floor were the difficulties of the mutual fund industry in determining Net Asset Value (NAV) and the unfortunate incidence of misuse of clients' assets by the brokers.

### **5.1 Negative perception of foreign investors**

To the foreign portfolio investors, imposition of floor on the prices as on a specific date was an unusual and unprecedented mode of intervention in the market. The decision created negative perception of our stock market. Normal interventions by the front line regulators in the market are circuit breakers, trading halts and market closures which are used in times of emergent situations.

According to the press reports during this period, some market participants pointed out that “foreign investors are particularly furious over the decision”. Since the decision restricted their exit, the foreign investors felt that it infringed the fundamental market mechanism.<sup>58</sup>

MD KSE who held discussions with foreign portfolio investors to explain the circumstances under which the decision had been taken, reported that they would have preferred if the floor

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<sup>58</sup>Dilawar Hussain, “Stocks: views differ on ‘floor’”, DAWN, August 31, 2008.

would not have been imposed.<sup>59</sup> The decision undermined credibility of the market. The decision also raised grimmer possibility of more extreme measures to the disadvantage of the foreign investors could be taken by the management of the market in the future, invoking wide powers under *force majeure* provisions of the RM Regulations.

## **5.2 Distortion of price discovery and restrictions on free entry and exit in the market**

Imposition of floor on securities prices distorted price discovery mechanism which is a fundamental feature of the market. Because of the floor, prices of individual securities could only move upward within the range of prescribed circuit breakers but could not move below the prices prevalent on August 27, 2008. As a result of the floor, prices of the securities were neither truly representative of fair market value nor did these factor in the market environment. Since there were restrictions on the price levels, trades could not be executed against the orders placed below the floor price. The absence of price discovery mechanism had serious impact on the market in terms of liquidity and informational efficiency. It also restricted both exit and entry of investors in the market: the sellers could not possibly sell at a price lower than the floor price and the buyers could not take positions below the floor price level. It inevitably dried up investor's interest and the market practically became a graveyard market.

## **5.3 Hectic search for alternate sources of liquidity**

The market continued to suffer from liquidity crunch during this period. State Bank's discount rates climbed from 10% at the start of the year to 15% in November, 2008. Banks remained reluctant to extend financial assistance to the stock market. The authorized financiers of CFS

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<sup>59</sup> Minutes of the Meeting of the KSE board on September 03, 2008.

MK-II did not honor their minimum financing commitments while there was increasing quantum of CFS MK-II release transactions which had to be settled by financees.

The floor mechanism which had been imposed in the hope of generating liquidity in the market, itself became an impediment in accessing liquidity mainly due to the distortion of price discovery mechanism. According to the policy of the EMOF, funds could only be invested in a declining market, which obviously was not the case when the closing prices had been frozen. As such, injection of additional funds in EMOF became impossible. Volumes in the market dried up during the period and the average daily trading volume declined to 6.68 million shares<sup>60</sup>.

The prolongation of the floor period delayed the activation of the SEF aimed at stabilizing the market as it stipulated purchase of securities at discounted prices. It was observed that due to the continuation of off-market trading where transactions were being executed at prices lower than the one agreed to by NIT, market players could take undue advantage. The Committee has been informed that some brokers purchased securities in the off-market and odd-lot market at depressed prices with a view to selling these at a higher price to the SEF.

In view of the stringent liquidity position, a number of proposals were mooted for its improvement. These included voluntary squeezing of quantum of CFS, creation of members' own fund and streamlining procedure for buyback of shares by companies. It was proposed that NIT should write government backed European put options which should also be available to all

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<sup>60</sup> Source: SECP

foreign investors holding positions in seven selected scrips of public sector enterprises as on August 27, 2008.

#### **5.4 Management of CFS MK-II**

CFS MK II was introduced at KSE and LSE in July 2008 while it was introduced at ISE in August, 2008. The new product replaced CFS MK I, which had been in place since August 22, 2005. The new product was adopted to eliminate some elements of risks. CFS MK II enabled financial institutions as well as members of exchanges to extend direct financing to the market. An important feature of the new product was that NCCPL which had developed the product also became responsible for its risk management.

During the period of the floor, the imminent forced release of the CFS MK-II contracts and unwillingness of the financiers to meet their minimum financing commitments compounded the problem. In the absence of any fresh take-up of the forced released positions resulted in the fear that the same would have to be settled if the market was opened. However, market participants did not have the capacity to honor such settlement obligations. On the other hand, perceptions regarding further decline in prices on lifting of the floor which would result in immediate mark-to-market loss collection demands, also complicated the situation.

#### **5.5 Relaxation of risk management regime**

The imposition of the floor relieved the brokers from the pressure of margin calls and mark-to-market losses that were being faced in a constantly declining market. However, NCCPL was

concerned about increasing risk in the market due to its continuous fall. This concern was expressed in the meeting of NCCPL board on November 27, 2008.

The floor restricted downward movement in prices of securities below the level as on August 27, 2008. Calculation of closing price of securities below the floor price level was therefore precluded. Resultantly, the price differential between the trade price and the closing price based on which mark-to-market losses were to be collected from the members, was also restricted. Moreover, while upper circuit breaker limits remained unchanged, imposition of the floor price levels made applicability of the lower range circuit breakers inconsequential. In cases where prices touched the floor price levels, the floor price superseded the lower circuit breaker limit.

As a consequence of the floor, VaR margins had to be frozen on September 02, 2008 as actual volatility and liquidity of a security could not be accounted for in the VaR figures. VaR is the backbone of the risk management regime of the stock exchanges as it has a very significant role in calculation of margins and valuation of securities to be deposited with the exchange as collateral against exposure requirements. However, imposition of the floor rendered VaR calculations ineffective as once prices were frozen at the floor level, the VaR calculations could not capture the actual volatility of the securities. This correspondingly impacted the categorization methodology of securities based on the VaR regime, collection of lower margins based on the VaR of securities and allowed for an artificially higher valuation of the collaterals deposited in the form of securities with the stock exchanges. As a result, the risk management regime itself was compromised. Policies which tempered with fundamentals of risk management regime in the market signaled negative perception to local as well as foreign investor.

As a result of the floor, the default management procedures of KSE and NCCPL were also rendered ineffective. In a market which was ‘technically suspended’, the NCCPL in case of failure of brokers to deposit margins and MtM losses or arrange final settlement of positions, could not initiate the closing out process against such brokers. This was mainly due to the circumstance that forced sale of securities of the defaulting brokers, which is normally executed at lower than prevailing market prices, could not be made at levels below the floor prices. In the absence of a platform for executing the first recourse available to NCCPL in case of broker default, the entire default management regime became infructuous.

## **5.6 Difficulties of mutual fund industry**

The imposition of floor on the equity prices at the stock exchanges inevitably affected the functioning of mutual funds, since this decision adversely affected trading volumes and hindered discovery of fair valuation of equity securities.

MUFAP was concerned that the situation could lead to unfair treatment of the unit holders of the mutual funds who wished to continue holding their units, relative to those who wanted to redeem during the period of imposition of the floor. On the recommendations of MUFAP, SECP issued a circular on October 07, 2008 directing AMCs managing open-end schemes to immediately suspend pricing, issuance and redemption of the units of open-end schemes with direct exposure to equity securities and continue suspending till third day after removal of the floor. It also directed that issuance or redemption of units during the intervening period should be on the basis

of closing price of units on third day after removal of the floor. The AMC could resume dealing in units on third day after removal of the floor.

SECP issued another circular on November 5, 2008 directing AMCs that all debt securities including TFCs and Sukuk held by open-end mutual funds should be marked down by applying a prescribed formula of discounts for calculating NAV. The rationale of this circular was to ensure fair treatment of all the unit holders irrespective of the time when they seek redemption. Such an intervention by SECP was a natural corollary of the imposition of the floor.

During the period from May 08 to October 08, 2008 net redemption of income funds aggregated approximately PKR 67 billion representing more than one-third of the industry assets. The period of redemption went much beyond the prescribed six days. The redemption pressure on income funds also increased because of the news reports that mutual funds were in arrears on redemption. During this period mutual funds faced serious problems of liquidity. Financial institutions were not inclined to lend to mutual funds against TFCs portfolio since there was no secondary market for it. Financial institutions and a few banks also did not honour redemption requests of TDRs of mutual funds even on maturity. The commercial banks, on account of general liquidity crunch, did not honour even approved credit lines to the mutual funds.

The floor was removed on December 15, 2008 and as per commitment of SECP suspension of pricing, issuance and redemption was to be removed three days later. However, after removal of the floor, prices kept falling and trading at the stock exchanges was not normalized as there were no active buyers at the prevailing prices. If an AMC had resumed redemption, it would not have



been able to encash equity securities to pay for the units redeemed. The AMCs therefore continued the suspension even after the third day under the provisions of trust deed till first week of January 2009 when suspension on pricing, issuance and redemption was removed.

## 5.7 Off-market Trading

KSE while considering various options in its meeting held on August 27, 2008 had decided in favour of imposing floor on the prices. While advocating the imposition of the floor as against the option of closure of the market, it was explained that the market would partly remain open through off-market. However, risks involved in off-market were not discussed.

Market observers have questioned the decision of allowing off-market trading when the regular trading platforms were practically suspended<sup>61</sup>. Trading in the off-market at a heavy discount to the ready market had serious implications.

Trading through off-market is prone to serious risks since it is not subject to the discipline of regulated trades in terms of price, order priority and risk management. A press report highlighted three major implications of the off-market trading: distorted prices, distress sales involving sales at huge discounts and exit of foreign investors<sup>62</sup>. It was stated that “with no bar and no floor on the price level in the off-market, stocks sold at an average discount of 31 per cent to the 'floor' price. That represented a widening of lower-than-floor-price by an average of two per cent from 29 per cent since the previous week. And the average daily volume in the 'grey' (though absolutely legal) market rose by a significant 106 per cent to a huge 8.0 million shares of the

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<sup>61</sup> Dilawar Hussain, Off-market transactions: to be or not to be?, The Dawn, November 23, 2008

<sup>62</sup> Ibid.

value of \$4.7 million. Average volume the week before was also significantly large at 3.9 million shares.

“Distress sale” of MCB at discount of 55 per cent and PSO at 60 per cent the previous week by two foreign hedge funds that were into liquidation, had created a great deal of anxiety in the minds of investors.”<sup>63</sup>

The report quoted a leading broker that “huge discount of 30 to 40 per cent seen in the 'off-market' spoils the already dismal investor sentiments. The discount in the grey market gives a distorted view of stock prices and raises the level of panic,”.... “Small investors, who already seem to have lost eight out of 10 rupees from investment in equities, are likely to dump their remaining portfolio to salvage whatever they can”.<sup>64</sup> The report also quoted some brokers as saying that off-market had remained alive since SECP had not raised any objection to it. The report sums up the situation as “With the Karachi stock market 'floored' for nearly 90 days -- the longest 'peacetime' closure of a stock market in the world --, the space for maneuvering in the ready/cash market remains much too small. But the 'off-market' is a place that provides the lemon, which some say the men of means utilise to make a lemonade.”<sup>65</sup>

One of the stated objectives of continuation of the floor was the apprehension of outflow of foreign exchange from the country. However, the fact that the off-market trading continued after the imposition of the floor allowed exit of foreign portfolio investment.

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<sup>63</sup> Ibid.

<sup>64</sup> Ibid.

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The CCP which had also taken notice of the imposition of the ‘floor’ as a possibly anti-competitive measure has also discussed the negative role of off-market. It has been pointed out that “it (off-market) moved buyers and sellers away from a direct contact available in an exchange setting and forced them to trade privately thereby increased the risks necessarily incident to a private market. The decision thus created asymmetric information for buyers and sellers.”<sup>66</sup>

Unfortunately some of the brokers used the off-market trading as a gateway to unauthorized movement of client securities in CDS. In view of reports about such malpractices, SECP intervened and issued a directive dated September 09, 2008 restricting movement of listed securities in CDS in the absence of any market transactions or reporting requirements. However, some of the brokers used the directive as a cover to make unauthorized movement of clients’ securities stating these to be based on off-market transactions.

The Committee is of the view that if the off-market had not been allowed while imposing floor on the ready and futures market, possibility of misuse of clients’ securities by broker participants of CDS would have been much less.

Some market observers have even suspected a sinister motive in allowing the off-market to continue during the period of the floor. If the market had remained totally closed there would have been no possibility of misuse of clients’ shares. Even if CDC would have remained open it

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<sup>66</sup> Para 56(vi), page 32 of the Order of the Competition Commission of Pakistan dated March 18, 2009

could not have allowed transfer of shares due to lack of any underlying transaction and unauthorized movement of client shares would have been immediately detected.

### **5.8 Misuse of Clients' Securities by Brokers**

The misuse of the securities of clients maintained by brokers in the CDC sub-account for purposes of pledging these with the banks in order to obtain financing for meeting settlement obligations was a heinous act.

During and after the period of the floor, investors already struggling with the clamp-down on their exit from the market became aware of the misuse of their assets by their brokers. The KSE and SECP were swamped with investor complaints pertaining to alleged non-transfer of shares and non-payment of funds. Some affected investors even approached the Human Rights Wing of the Supreme Court for relief.

Around this time, SECP initiated enquiries into the conduct of five brokers who had allegedly misused clients' shares by pledging the shares of their clients with the banks without authorization as well as depositing client shares for the purposes of meeting margin calls. The following statement would indicate the number and value of claims filed against these brokers:

<b>Sr.</b>	<b>Name of Broker</b>	<b>Number of claims</b>	<b>Value of claims (PKR In million)</b>
1.	Eastern Capital Limited	1,638	394.77

2.	Cliktrade Limited	1,373	190.51
3.	Capital One Equities Limited	439	443.24
4.	M.K.A. Securities (Private) Limited	197	97.25
5.	Prudential Securities Limited (claims remain unverified due to proceedings stayed by Court)	393	200.33

Source: SECP

The enquiry reports held the five brokers guilty of failure to abide by code of conduct, failure to collect margins from the clients, non-segregation of client's funds and shares, criminal misappropriation of property and criminal breach of trust. Based on the findings of the enquiry reports, SECP filed criminal complaints against these brokers during 2010 and 2011. It may be mentioned that KSE and SECP received a large number of complaints alleging misuse of clients shares in addition to the five brokers already mentioned, and according to SECP, most of these complaints were resolved at their level.

It may be pointed out that the Central Depositories Act, 1997 and Central Depository Company of Pakistan Limited Regulations give CDS participants (brokers) full operational control over the shares held in the sub accounts and it became possible for a broker to transfer the shares of the clients to his own CDS account without knowledge and consent of the client. The CDS participants were not using any standardized account opening form for opening the CDS accounts of their investors and some of them used to obtain a blanket authority from their clients for handling of the securities held in their sub accounts.

Concerned by the conduct of some brokers, SECP issued a directive on May 26, 2009 disallowing seven CDS participants (including five already mentioned) from opening of new sub

accounts. The directive was issued in the backdrop of complaints received against these CDS Participants regarding non-transfer of shares to their individual CDS Accounts and non-payment of funds attributable to unauthorized pledge/ transfer of clients' securities as margin against their outstanding exposures and for obtaining finances from financial institutions.

On June 02, 2009 another directive was issued to NCCPL for barring these seven brokers/ clearing members from registering new Unique Identification Numbers (UINs) as well as mapping of existing UINs against their client codes.

The incidence of misuse of shares of clients by brokers highlights some serious weaknesses in the system of custody. According to the existing system all members of the stock exchanges can automatically assume the role of providing custodial services without evaluation of their track record, financial worth and internal systems of control. In other jurisdictions, there are a very select and limited number of institutions which are vested with custodial functions and this too after stringent scrutiny of their financial position and track record. This issue is being discussed in the later part of the report.

## Chapter 6: Debate on Removal of the Floor

Soon after the imposition of the floor, the management and some directors of KSE started getting concerned about the serious implications of the decision. Till December 11, 2008 when KSE received directive from the SECP for removal of floor, KSE Board remained engaged not only with the issues which triggered the decision to place the floor but also with the issues which had arisen due to the floor itself. The Board kept exploring innovative means for accessing additional liquidity and was actively engaged in dialogue with the SECP, the banks and the Ministry of Finance for this purpose.

In the KSE board meeting held on September 09, 2008 the MD apprised the board about the anxiety of the foreign portfolio investors who foresaw widespread repercussions if the floor remained in place indefinitely. He suggested that given the concerns of the foreigners, the exchange should announce a roadmap in this regard at the earliest as there was possibility of the stock market being downgraded by MSCI from its Emerging Markets Index. MD also informed the board about the deliberations held in the general body meeting on September 08, 2008 in which the following four objectives of imposition of the floor had been articulated:

- i. Providing cooling period to the market participants
- ii. Achievement/activation of Equity Market Opportunity Fund (EMOF)
- iii. Facilitating buy-back of shares by listed companies
- iv. Reforming of CFS Margining System

The general body also decided that decision of lifting the floor be linked with the progress on the above-stated objectives. The general body proposed revision of circuit breaker limit from 5% to

2.5% for a few days after lifting the floor, which if implemented would have been another ad hoc change in risk management measures. It is interesting to note that the general body in its meeting also “acknowledged that as a result of placing floor, they got relief by getting reduced margin calls”.<sup>67</sup>

Two board members referred to their conversation with the Chairman, SECP and conveyed his apprehension that prolongation of the floor could damage credibility of the exchange and lead to its down gradation by MSCI. The board was also informed that the Finance Minister had also desired to “remove the floor as soon as possible but with a well-thought plan to avoid any panic situation”.<sup>68</sup>

In the same meeting, Mr. Ali Ansari an independent director nominated by SECP urged the board to take a more realistic view of the situation. He pointed out that the decision had “restricted price discovery and choice of investors to move out of the market, which has impacted badly on the reputation/credibility of the Exchange”<sup>69</sup>. He thought that sufficient cooling period had become available to the market without any positive outcome and its continuation may further compound the problems<sup>70</sup>. Four directors also suggested lifting of the floor after fifteen working days simultaneously with reduction of circuit breaker limit to 2.5%<sup>71</sup>.

From September 25 to December 15, 2008 when the floor was finally removed, KSE board held 12 meetings some of which were also attended by the Chairman SECP. In these meetings, the

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<sup>67</sup> Minutes of the meeting of the KSE board on September 09, 2008

<sup>68</sup> Ibid.

<sup>69</sup> Ibid.

<sup>70</sup> Ibid.

<sup>71</sup> Ibid.



board reviewed progress of implementation of measures like NIT managed market stabilization funds, developing a put-option mechanism and streamlining the procedure for buy-back of shares. Other issues discussed were changes to the margining regime, mobilizing financiers to fulfill their financing commitments, freezing of outstanding CFS funding positions at the current levels and members own fund. The primary focus of these meetings was on two important issues (i) liquidity problems which were becoming increasingly acute; and (ii) plan for removal of the floor.

During this period the overall economic situation in the country and the lack of liquidity in the financial sector impacted the market. Minutes of the meetings held by the KSE board during this time reflect desperate attempts by market participants to seek liquidity. In the meeting held on October 11, it was noted that CFS releases on October 10, 13 and 14 were not taken up by financiers causing considerable stress to the financees and the system. The same meeting refers to meetings of the management and members of KSE with financial institutions, mutual funds and broker financiers on October 13, 2008 to invite them for providing liquidity to the CFS market. Unfortunately, despite commitments, the actual response was not very positive. As regards the stabilization funds, there was general disappointment as these did not provide sufficient support to the market. Another issue discussed in the board meetings was that due to placement of floor, buyers were unable to take up securities at their fair value. The issue of liquidity was again discussed in the KSE board meeting on October 20, 2008 mainly from the perspective of support from the banking sector. Certain proposals discussed with the SBP were deliberated in detail and issues of additional collateral requirement of the banks in the form of immovable property and membership card were discussed. In the meeting held on October 29,

KSE board was informed that Chairman NIT had shown his willingness to buy shares of seven government entities at a discount of 12.5% to the floor price in a special trading session for injecting approximately PKR 7.5 to 8.5 billion to the market's liquidity. However, the same could not materialize. Referring to the problems of liquidity a member director observed in the meeting in October 25, 2008 that "if the floor had never been imposed, a limited number of casualties in the form of members' default would have occurred. However, with the passage of time the financial position of a large number of brokers has gone worse and they are on the verge of default leading to collapse of the entire system".<sup>72</sup>

The minutes of the meetings of KSE board during this period suggest increasing realization that the decision to impose floor had not been welcomed. Therefore, in a meeting held on September 09, 2008 there was discussion on removal of the floor subject to certain support measures. One of the nominee directors of SECP who had opposed imposition of the floor, continued to vehemently advocate its removal at the earliest, since the floor was adding to the difficulties of the market. In its meeting on September 25, 2008 the board considered options of either removing the floor immediately or to decide a tentative date which may not be announced. Although the board appeared to have an open mind on removal of the floor, the decision was deferred after consulting the then Advisor to the Prime Minister on Finance (the 'Advisor'). The board hoping for a stabilization package after the forthcoming Eid decided to announce removal of the floor in October. In the meeting of KSE board on October 11, Chairman KSE informed that in a meeting attended by himself and MD KSE with the Advisor on October 05, 2008, it was decided that the floor would be removed on October 27, 2008. In the KSE board meeting held on

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<sup>72</sup> Minutes of meeting of the KSE board held on October 25, 2008

October 14, 2008 the progress of stabilization measures was reviewed and it was noted that there had been progress on announcement of buy-back of shares and reduction of CRR while the recommendations for equity fund, put-option and change in CFS margining regime were under process. The board decided to remove the floor with effect from October 27, 2008 as it expected all the stabilization measures to be implemented by that date. However, despite announcement made to the public through a press note, the floor could not be removed on October 27, 2008. The meetings from onwards suggest a continuous dialogue with the Advisor and SECP regarding removal of the floor. It has also been mentioned that the Ministry of Finance had concerns of outflow of foreign exchange in case the floor was lifted. The Government was in the process of negotiation of a stand-by agreement with IMF in November 2008 and removal of floor also became a subject of these negotiations. In the KSE board meeting held on December 03, 2008, Chairman KSE informed that the Chairman SECP had convened a meeting of all the three stock exchanges on December 03, 2008 and informed them that IMF had rejected the Government's proposal to provide any fund to support the market. The stock exchanges were also informed that IMF while approving a USD 7.6 billion stand-by loan had imposed a condition that the Government would not provide any funds to the stock market and that removal of the floor would require their approval. When the KSE board was informed in November 2008 that the floor could not be removed due to apprehension of outflow of foreign exchange which could jeopardize negotiations with the IMF, an important issue was raised as to whether KSE board should be concerned with macroeconomic situation in the country or it should carry out its fiduciary responsibilities to the market and investors. While some directors thought that the interest of national economy was paramount, others drew attention towards board's fiduciary responsibilities of safeguarding the integrity of the institution. The board was advised to

“rationalize between the national interest and the fiduciary responsibility of directors for protection of KSE’s interest.”<sup>73</sup> It was observed that responsibility of monitoring macroeconomic factors should be that of the Government and SBP. There were also questions about the magnitude of the outstanding foreign portfolio which in the opinion of a director, had been reduced significantly due to reduction of share prices in off-market. He expressed the view that the lower prices of securities could possibly attract foreign fund managers to enter the market. He advocated removal of the floor as he found no logic in further delaying its removal. On this Chairman KSE responded “that the KSE Board is responsible to safeguard all the national, institutional and the stakeholders’ interest, out of which, in his opinion, the national interest is the foremost”<sup>74</sup>. In the same meeting a member director suggested that either the market be closed or a roadmap announced forthwith.

SECP finally took decision to remove the floor through a directive issued to the stock exchanges on December 11, 2008 whereby the exchanges were directed to remove the floor effective from December 15, 2008. The directive also restricted the stock exchanges and their respective Boards of Directors from taking any action which would interfere with the normal functioning of the stock exchanges and trading of securities, including but not limited to the closure of the market or placing any restriction on the trade prices of securities, without consultation with and prior written approval of the SECP.

Outstanding positions in the CFS MK-II market were also a major factor in the members of the stock exchanges being hesitant to remove the floor early. They feared that the likely decline in

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<sup>73</sup> Minutes of meeting of the KSE board held on November 24, 2008

<sup>74</sup> Ibid.

the market following removal of the floor, shall entail heavy margining requirements and difficulties in settlement.

The decision of imposing floor on the prices appears to have been taken in haste and panic, with no clear cut objective except to arrest the rapid decline in the market and to save a few brokers from defaulting on account of failure to meet settlement obligations. While KSE Board appears to have been inclined to remove the floor by September/ October, 2008, the Government stalled this decision in view of apprehension that such decision would cause outflow of foreign exchange. Therefore, the decision of removing the floor slipped from the KSE Board to the Government in September, 2008. As the period of floor prolonged, it became evident that the objectives of imposing the floor, both declared and undeclared could not be achieved. It has been noticed that with each passing day, it became difficult for KSE to take independent decision for removal of the floor. After October 27, 2008 the Government which was facing serious macro-economic challenges indicated its preference for deferment of the decision. Subsequently, IMF which had been approached by the Government for support under a stand-by agreement also became a party to this decision. IMF advocated continuation of the floor till injection of funds. The Committee is of the view that the KSE had an opportunity of taking decision to remove the floor on September 09, 2008 when it was apprised of the negative implications of the floor and the threat of demotion of our market by MSCI. At that time, both the Chairman SECP and the Finance Minister had endorsed the decision for removal of the floor.

## **Chapter 7: Post Floor Scenario**

Removal of floor on the price level of securities in the stock market inevitably lead to drastic fall in the prices. The normal functioning of the market provided opportunity to the investors to transact freely in the market. The uncertainty created by the decision to impose the floor continued to depress the market till January, 2009. Opening at the level of 9,187 on December 15, 2008, it fell to 5,751 on the close of January 1, 2009. The index rose over the next few days but continued its downward slide till January 26, 2008 when it reached 4,815 before beginning to rise again. Thus, the index fell by about 48% in 28 trading sessions between December 15, 2008 and January 26, 2009. The daily turnover, however, showed rather erratic behavior. With occasional rises on certain dates, it remained low till March. From March 09, 2009 the turnover started gradual rise till it reached the figure of 300 million shares on March 24, 2009. It appears that it took more than three months for the market to gain momentum after the removal of the floor. It is interesting to note that once the floor was lifted and the market started recovering from May 2009 onwards, foreign investors started returning to the market from June 2009.

After removal of the floor a number of issues arose, which could be attributed to the floor itself.

## **7.1 Macro-Economic Situation**

The State Bank of Pakistan in its Financial Stability Review released on December 30, 2008 underscored the negative impact of the imposition of floor on stock market prices and on investor sentiment. It pointed out that “the imposition of floor of 9144 points on KSE-100 index on August 2008 has adversely affected investors’ sentiments by effectively blocking the exit mechanism generally taken for granted in a market based system”. It also pointed out that there were no known precedents of placing the floor on the market index. The decision to impose the

floor on prices had been taken when Pakistan was facing serious macro-economic situation. On 20<sup>th</sup> November, the Government of Pakistan approached IMF for support and three days later IMF approved \$7.6 billion stand-by agreement. This situation led to downgrading of Pakistan's rating. On 15<sup>th</sup> December 2008, Moody's while confirming B3 rating of Pakistani Bank deposits changed the outlook to negative.

## **7.2 Liquidity through NIT Funds**

The negative reputation of the market created by the unprecedented decision of imposing floor on the price level of securities discouraged investment in the market. The banks were reluctant to extend financing.

NIT EMOF which had been established to support the declining market could not invest after the imposition of the floor since its mandate permitted investment in only declining market. The total investment of the fund from 25<sup>th</sup> July, 2008 to 27<sup>th</sup> August, 2008 was PKR 4.27 billion.

State Enterprises Fund (SEF) which was launched on 13<sup>th</sup> January, 2009 for investment in eight (8) State owned enterprises made total investment of PKR 10.67 billion till June 30, 2009 since inception. While the impact of the EMOF on the performance of the market is not clearly discernible, SEF appears to have contributed to the rise of the market. KSE Index which stood at 6,059 on January 13, 2009 rose to 7,162 at the end of June, 2009.

## **7.3 Square-up Scheme**

On December 25, 2008 NCCPL announced a voluntary program for squaring up of CFS MK-II positions. The program was designed for squaring up the outstanding positions in the CFS MK-II market along with the shares deposited as margins against these CFS MK-II positions, to minimize the losses of the financiers on their CFS Financed positions and to protect the financees from possible default proceedings.

The square-up scheme which was facilitated by NCCPL was a voluntary program and positions of participants not entering the scheme were to be squared up through a tender program. The square-up scheme intended to completely deleverage the stock market system. Main features of the scheme were:

1. The financier will accept up to 30%, as determined by NCCPL of the principal amount of finance by purchasing the financed securities. The purchase consideration would be 12.5% discount to the closing price as of December 24, 2008.
2. Government owned institutions will purchase an equivalent amount of shares, subject to availability of requisite funds.
3. Remaining amount will be paid in cash.



## Chapter 8: Major Issues Relevant to the Market Crisis

While analyzing the causes, the development of the crisis and its management by the regulators, the Committee has identified some policy issues which are relevant to our market.

### 8.1 Market Intervention

While the primary objective of a market is to facilitate smooth and continuous trading, the regulator has to occasionally resort to intervention in the market, particularly when the market experiences extreme volatility or is under stress. For this purpose, a variety of tools are available which, during periods of extraordinary behavior of the market, either trigger automatically or have to be applied by the regulator.<sup>75</sup>

The experience of market intervention by various jurisdictions in emerging markets during the global crisis of 2008 has been studied by the IOSCO Emerging Markets Committee Working Group on the Regulation of Secondary Market<sup>76</sup>. The report prepared in 2010 is based on a survey of 29 emerging market jurisdictions. The report has discussed types of market interventions in emerging markets, the imposition of market intervention tools during 2008 and the effectiveness of such measures. It also discusses regulatory issues relating to market interventions. In view of its relevance to our study, it would be worthwhile to reproduce the main observations and the conclusions of this report<sup>77</sup>.

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<sup>75</sup> "Effectiveness of Market Interventions in Emerging Markets", Emerging Markets Committee of the International Organization of Securities Commissions (IOSCO), October 2010.

<sup>76</sup> Ibid.

<sup>77</sup> Ibid.

- 1) The survey conducted by the Group shows that the majority of emerging markets have in place a combination of market intervention measures.
- 2) All jurisdictions have trading halts. While Twenty eight (28) have market closures, twenty four (24) have price limits and only nine (9) have circuit breakers in place. As such circuit breakers appear to be least widely used in the emerging markets. Trading halts have emerged as most common form of market interventions. Trading halts are most commonly used to allow for dissemination of material information to the market. These are also applied if there is suspected, manipulated or fraudulent activity or the issuer fails to meet listing standards or if there is excessive volatility. The duration of the halts may range from a minimum of 10 minutes to 1 day from the time the material announcement is made. However, in cases of suspected manipulation or fraud, the duration of the halt is decided by the regulator on case to case basis. Some jurisdictions have prescribed limits on the number of days such halts can be applied.
- 3) All emerging markets have provisions to close their markets under extraordinary events. The circumstances under which emerging markets have been closed vary ranging from natural disasters, social unrests and trading glitches. In most cases, the regulator has the power to close the market while in other cases government's approval is required for a market to be closed, particularly if the closure is for a period longer than one day. Some emerging markets have prescribed out the maximum period that a market can be closed. The maximum number of days ranges from 30 to 120 days. While market closures are generally rare, there have been some instances where markets were closed during global financial crisis of 2008. Indonesia closed its market for three days following drastic fall in Index in October 2008 and in Romania, two market closures were imposed in October 2008 due to increased market

volatility and the index falling by 12 %. Some countries which do not fall under the category of emerging markets also closed markets in 2008. Kuwait closed its market for 2 days in November 2008 and Russia closed its market for four consecutive days in September 2008. Research has shown that markets that close indiscriminately have negative consequences when they reopen and may even lead to further downtrends. There may also be possible reputational damage and a measure of uncertainty in trading environment. During 2008 global crisis, jurisdictions that impose market closures have only a brief period of stabilization of prices immediately following the closure but in the longer term market continued decline.

- 4) Majority of emerging markets have provisions for price limits and the price limit bands vary between  $\pm 7\%$  to  $\pm 50\%$  of the last closing price.
- 5) Only one third of the emerging market countries have market wide circuit breakers to deal with significant fluctuation.
- 6) Market interventions measures should have clear rules and parameters to ensure that these are transparent and that these are not applied indiscriminately under political or stake holder pressure.

The Committee has looked into the legal provisions and the practices of market interventions in Pakistan. Section 9(7) of the Securities and Exchange Ordinance, 1969 empowers the stock exchanges or the SECP to suspend trading of a particular listed security for a maximum period of sixty days which is extendable. This provision gives wide powers while specific grounds for suspension have not been mentioned. It may also be mentioned that unlike other jurisdictions where circuit breakers are linked to market indices, circuit breakers in Pakistan are applied to

individual securities. The recently promulgated Securities Act, 2015 provides for emergency powers.

## **8.2 Provision of *Force Majeure* in the Stock Exchange Regulations**

An important issue which the Committee would like to highlight is the unlimited powers available to the stock exchanges through incorporation of concept of *force majeure* in the RM Regulations of the stock exchanges. The Committee is of the view that empowering the stock exchanges with wide powers under *force majeure* provisions does not appear to be in the interest of the market. *Force majeure* normally connotes natural disasters or civil disorder and cannot become basis for decision to intervene in the market irrespective of the degree of its volatility at a given point in time.

The Committee has studied the policies of other jurisdictions particularly those in Asia with regard to decision making process in the event of existing or potential disorder in the market or suspected market manipulative activities. It has been found that instead of vesting the stock exchanges with powers to invoke *force majeure*, stock exchanges and the regulators have been given powers to deal with situations of emergency. In India, both the National Stock Exchange of India (NSE) and the Bombay Stock Exchange (BSE) can take steps to ensure stabilization of the market, if in their opinion, conditions have developed which make free trading in securities extremely difficult. In the case of BSE, the governing board can take such action as it deem fit for stabilizing the market. In the case of Malaysia, authority for closing stock market in case of an emergent situation or natural disaster vests in the Minister. However, the market can be closed for five business days and the Minister is required to specify the grounds for the closure of the

market. In the case of Singapore, emergency powers can only be invoked by Monetary Authority of Singapore, the apex regulator.

The *force majeure* provisions in the RM Regulations by giving almost open ended powers to the management of our stock exchanges, sends a negative signal to the foreign investors. The use of such powers in August 2008 has deepened the fears of the investors that the management of our stock exchanges could possibly decide to close the market for indefinite period and even revoke contracts by invoking *force majeure* powers. After KSE invoked *force majeure* in an effort to arrest the fall in the market and to avoid defaults, both LSE and ISE started discussing the possibility of using these powers to deal with other situations. In meetings of NCCPL the question of revoking CFS contracts was discussed by using *force majeure* powers. Fortunately, after detailed legal examination, such a course of action was not considered to be feasible.

### **8.3 Leveraged Products**

Inquiry reports into all previous crises which struck Pakistan's stock market from time to time have held Badla financing (and its variants like COT, CFS and CF MK-II which are leverage products), as the root cause of all crises in our stock market. While discussing the stock market situation in 2008, some directors of KSE also held Badla financing as a major cause of the crisis. In October 2008, ninety five (95) members of KSE addressed a letter to the then Advisor to the Prime Minister on Finance stating that they had "come to the conclusion that CFS financing has historically been the root cause of settlement crisis in the stock market and it is a kind of Parallel Banking which is exploitative and a tool of manipulation". They demanded that CFS MK-II as well as Deliverable Futures should be done away with, as these contributed to the settlement and

liquidity crisis. A Committee constituted by SECP to review CFS MK-II in 2009 under the chairmanship of Mr. Shahzad Naqvi and consisting of twelve capital market experts concluded that “easy access to CFS Financing has - in our view – led to over-leveraging in the market place, leading to price bubbles which are detrimental to long-term investors”.

In view of relevance of badla and its variants in the crisis, it may be useful to discuss this product in some detail. Ever since the establishment of stock market in Pakistan, Badla has been used as a source of informal financing. Essentially, it involved a repurchase agreement under which a weak holder in the ready market defers payment of his purchase, to a future date. A Badla contract entails post-trade financing in which the financier makes payment and takes delivery on behalf of the financee’s purchase in the first leg and the financee takes delivery on repayment of his obligation i.e. purchase price of shares plus interest, to the financier in the second leg.

The popularity of this leverage product is due to the convenience and benefit of both the financier of Badla and its recipient. The financier extends finance on the strength of the value of security offered and not on the strength of the capability of borrower to repay. While the financier charges much higher rate of interest on his credit than the bank rate, the financee can avail of the credit promptly without any rigorous credit assessment process. It would not be wrong to say that the system is unauthorized parallel banking yielding high returns.

Since 2001 a number of changes were introduced in the Badla product in view of changed settlement policies. With the introduction of T+3 rolling settlement in September 2001, Badla became a Carry-over Transaction (COT) with restrictions on the number of days for which

financing could be availed. Later restrictions were also placed on the number of scrips in which financing through Badla could take place. Margin Trading Rules were announced in 2004 and it was decided to phase out COT from October 2004. The idea was to enable commercial banks to provide financing to the market through margin trading. However, Margin Trading Rules could not be implemented due to several reasons like the product being more cumbersome than COT and reluctance of the banks. The whole process of streamlining of the financing mechanism was overtaken by the crisis of 2005.

After the crisis, regulations for introduction of Continuous Financing System (CFS) were promulgated. Under these regulations, limit was placed on the total financing and on the number of scrips eligible for financing. However, efforts to refine the product continued in the light of the experience of the 2005 crisis, to which COT contributed significantly. However, all the efforts to reform badla financing revolved around valuation of security and ensuring financiers' commitment and not on assessment of borrower, placing limits on per party borrowing and capability to repay.

The regulators were keen to modify the financing system by ensuring participation of financial institutions who had the potential to provide financing on sustained basis. In April 2008 CFS MK-II was introduced which provided for participation of financial institutions to directly provide financing in the equity market as of authorised financiers<sup>78</sup>. In view of participation of non-broker financial institutions in the financing arrangement, administration of CFS MK-II was placed with NCCPL.

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<sup>78</sup> <http://www.dawn.com/news/289403/cfs-mk-ii-to-go-live-on-april-7>

### **8.3.1 Badla as a Factor in 2008 Crisis**

As in the case of earlier crises, leveraged products became an important factor in the 2008 crisis. Firstly, the financial institutions which as authorised financiers were mandatorily required to fulfill minimum financing commitments, failed to do so. Secondly, the rate of financing in the CFS MK-II Market soon started escalating as liquidity hungry buyers sought financing in a market with shrinking liquidity. Thirdly, the decision of SECP to allow roll-over of CFS MK-II contracts in October and November 2008 created uncertainty and discouraged financiers. Fourthly, the decision of the KSE to allow roll-over of DFM positions to the CFS MK-II Market changed the nature of the product since it is meant for ready market. Fifthly, the square-up scheme was seen as detrimental to the interest of the financiers as they could not recover their financing amount and were instead assigned the securities they had financed, which could not be easily disposed-off in the market. In addition to the factors mentioned above, it is important to mention that a number of authorized financiers were mutual funds (income funds) which were facing liquidity crunch due to redemption pressure and non-payment of TDR by banks and financial institutions.

In view of the adverse implications of CFS MK-II on the market, SECP constituted a committee to review CFS MK-II, to analyze its role during the 2008 stock market situation; to propose measures for further strengthening the risk management of the product; and to recommend alternate leverage products in line with the best international practices. The 13 member committee chaired by Mr. Shahzad Naqvi and comprising capital market experts and participants recommended that CFS MK-II and Deliverable Futures should be discontinued as “easy access



to CFS has - in our view – led to over-leveraging in the market place, leading to price bubbles which are detrimental to long-term investors whom the KSE wishes to attract.”<sup>79</sup>

The report explained as to how CFS transactions had caused systemic risk in the market. As an alternate measure, the Committee recommended Cash Settled Futures (CSF) as the primary financing product. The product involves 90 days cash settled futures contract with single stock or stock index as its underlying security. As a result of the recommendations made in the report, both these products, CFS MK-II and Deliverable Futures were discontinued. However, CSF could still not gain momentum and DFM ultimately had to be re-launched.

In 2011, the Federal Government promulgated Securities (Leveraged Markets and Pledging) Rules, 2011 which provided for Margin Trading, Margin Financing and Securities Lending and Borrowing. For a long time only Margin Trading (MT) attracted the market participants. However, there have recently been indications of market participants availing of Margin Financing (MF) in a modest manner.

MF is counterparty based financing product with proper risk assessment of the financee. MT system on the other hand has features similar to the CFS MK-II in that it is a system-based product with no counter party risk assessment.

According to reports of various inquiry committees constituted to investigate successive crises in the market, Badla has certain inherent risks such as:

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<sup>79</sup> Report of the SECP Review Committee on CFS MK-II – Discontinuation of CFS and Deliverable Futures, March 30, 2009

- (i) It fuels speculation in the ready market;
- (ii) It involves credit by individuals who are not licensed to extend credit and therefore the product can be considered to be involving informal and parallel banking;
- (iii) It does not allow for proper credit assessment of the borrower;
- (iv) Brokers can themselves act both as financier and financee;
- (v) It has inhibited the growth of derivatives products.

Most of the investors prefer to seek options such as Badla and its successor products rather than credit from banking institutions because of its ease and almost negligible risk assessment. The attraction for the Badla financiers is that it offers exceptionally high rate of return. This is why efforts to eliminate badla and its successors have not succeeded.

While the product has been regulated since 2001 when it assumed the form of COT, informal and unregulated practice of in-house badla has been widespread. In-house badla is a mode of financing to investors by brokers for purchase of shares. In this case, the custody of shares remains with the broker. Since it is not formalized and not reported in the system, it is risky for the market and has all the risks of unregulated market. The product has often led to misuse of the clients assets by the brokers in a distress situation.

## **8.4 Broker Regime**

The role of brokers in the performance of the market is critical as they are the interface between the stock market and the investors. Our stock market can achieve desirable level of depth only if the brokerage services inspire confidence of the investors. For this purpose the brokers have to

possess high degree of integrity, necessary professional skills, adequate financial resources and a sense of commitment and obligation to the investors. It is also necessary that a sound regulatory framework for brokers as well as mechanism for its effective compliance is in place.

As a result of demutualization of the three stock exchanges effective August 27, 2012 the members under the corporatised and demutualized set up have become shareholders and have acquired trading rights. Presently, approximately 345 trading right entitlement certificate (TREC) holders have, as required by the Stock Exchanges (Corporatisation, Demutualization and Integration) Act, 2012 been incorporated and are eligible to trade as brokers.<sup>80</sup> They are traditional brokers who have not gone through stringent fit and proper criteria and are not subjected to capital adequacy standards necessary for institutions handling public funds. Given the relatively small size of our market the number of brokers operating in our markets is too large. Capital adequacy requirements are not risk-based and do not differentiate between large scale and small scale brokerage houses. Similarly, all brokers can operate in all the ready, derivatives and leveraged trading segments of the stock exchanges by maintaining the minimum Net Capital Balance (NCB) requirements, although each segment poses its own unique risk.

The legal provisions regarding NCB mentioned in the Securities and Exchange Rules, 1971 which forms the basis of capital adequacy and its computation methodology is outdated and the existing reporting mechanism is prone to its misrepresentation. By maintaining the minimum

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<sup>80</sup> [http://www.secp.gov.pk/SMD/smd\\_brkr\\_agnt.asp](http://www.secp.gov.pk/SMD/smd_brkr_agnt.asp) - Total number of brokers as on April 30, 2015: KSE 175, LSE 102, ISE 68 (figures for each stock exchange include brokers with multiple stock exchange licenses).

NCB, brokers are also entitled to hold custody of their clients' portfolios well beyond their own net worth.

Misuse of client assets lying in sub-accounts of the CDC by some brokers as CDS Participants, during the 2008 crisis, shattered the confidence of the investors, some of whom approached the Supreme Court. Since 2008, a number of brokers defaulted some of whom moved for winding up while others were expelled for failure to settle investor claims and were declared defaulter by the NCCPL and KSE.

It is only since 2011 that regular inspections of brokers are being conducted by SECP. The main weakness which the inspections have brought into focus is calculation of NCB.

Recognizing the need to revamp the brokerage regime, SECP gave the task to a Consultative Group on Capital Market (the "Group"). The Group reviewed the existing regulatory framework of brokers and developed a comprehensive regime conforming to international best practices and standards in its report submitted in 2009. The report made recommendations in three important areas: (i) minimum entry standards; (ii) capital adequacy; and (iii) code of conduct.

The Committee appreciates the work done by the Group and the recommendations which are based on best international practices. It recommended comprehensive fit and proper criteria for

brokers and suggested entry requirements which clearly segregate eligibility of brokers at all levels with reference to technical, financial and business requirements. The Group proposed clear differentiation “between a member trading for its own account, for its clients, for trading in different market segments and for having clearing and depository memberships”<sup>81</sup>. The Group also proposed strengthening of the capital adequacy regime by proposing concepts of net worth and liquid capital discounted by haircuts for the brokers. The Group recommended a new code of conduct for brokers which requires the brokers to act fairly and with integrity; conduct its business activities with due skill, care and diligence and in a timely manner; functioning with adequate resources and procedures; obtaining of necessary information from clients and conveying relevant material information to clients; avoiding and managing conflicts of interest; complying with all legal and regulatory requirements; and safeguarding of clients’ assets.

SECP reviewed the recommendations of the Group and has decided to implement most of these in a holistic manner. SECP now proposes to develop revamped broker regime under the new Securities Act, 2015.

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<sup>81</sup> Report of the Consultative Group on Capital Markets dated December 24, 2009.

## **Chapter 9: Role of Regulators and Capital Market Institutions**

It is important to analyze the role of the regulators and capital market institutions like NCCPL and CDC during the 2008 crisis. The minutes of the board of directors of three stock exchanges and those of NCCPL have helped the Committee to study their roles during this period.

### **9.1 Role of SECP**

As required by the TOR, the Committee has analyzed the role of SECP as the apex regulator before, during and after the crisis of 2008. No doubt in a situation of turmoil in a stock market the role of the apex regulator is central. In order to determine the role of SECP during the crisis, the Committee has consulted the minutes of the meetings of the Commission as well as minutes of the Policy Board from April 2008 up to February 2009. The Committee also met the then Chairman SECP and the senior officers of SECP some of whom dealt with the issue. Information regarding the role of the SECP was also gathered from the minutes of the meetings of the Board of directors of the three stock exchanges held during 2008.

Observations of the Committee in this regard are as under:

- (i) Ever since the market started showing stress signs in May 2008, a number of meetings were held by Chairman SECP with officials of the stock exchanges mainly with a view to arresting declining trend in the market. A number of important decisions were taken in the meetings like revision of circuit breakers, restriction on short-selling and announcement of market stabilization fund. These measures had long-term impact on the market. However, these decisions were mainly taken by the then Chairman SECP who also had the additional responsibility of Commissioner (Securities Market Division). The Committee has gone

through the agenda items of the Commission meetings held between April 2008 to December 2008 and found that these important issues were not placed before the full Commission. The Commission was made aware of the issues emanating from the market situation only in the meeting held on October 14, 2008 when proposal for approval of the issue of directions in respect of CFS MK-II and for collection of additional margins at the rate of 10% from financees was discussed. The next time the issue was discussed by the Commission, was on December 11, 2008 when an emergent meeting of the Commission was convened to consider the approval of a directive to be issued for lifting of the floor.

- (ii) It may be mentioned that according to section 20(4)(b) of the Securities and Exchange Commission of Pakistan Act, 1997 the Commission functions collectively for regulation of the stock exchanges. It was therefore necessary that the Commission should have approved these decisions before implementation.
- (iii) According to the record available with the Committee, SECP does not appear to have displayed long-term vision in holistically addressing the issues arising out of sharp decline in the market. It appears that decisions were taken only when SECP was forced into doing so due to gravity of the situation. It has been noted that Mr. Adnan Afridi then Managing Director of KSE wrote a letter to Chairman SECP on August 27, 2008 on behalf of the Board of KSE, informing him about the KSE board's deliberations with members regarding the difficult situation of the market. It was pointed out that such a situation could pose a threat of default of a number of members causing possible systemic risk to the market as a whole. Mr. Afridi also pointed out three possible options that the Board deliberated which were:
  - (a) Allowing the market to continue in the hope of it settling down on its own merit;

- (b) Temporary closure of the market; and
- (c) To place a floor based on closing prices of securities as on August 27, 2008.

There is no record of any response from the SECP to this letter. In the absence of any advice or even a directive from the SECP, KSE went on to impose floor on the prices as on August 27, 2008 which was unprecedented in the history of stock exchanges and had disastrous effects.

- (iv) The Committee inquired from SECP as to whether SECP carried out an analysis of the situation in the market from July 2008 onwards and the various options which were being discussed by the KSE Board. According to an inter-office memo dated February 26, 2015 received from SECP “the chain of events reflects that SECP did not grant approval to the KSE proposal and therefore KSE Board itself took the decision to impose the floor under the KSE Regulations. No additional record of any analysis of KSE proposal is present.”<sup>82</sup> The Committee feels that the market situation as being portrayed by KSE should have been analyzed independently by SECP in order to determine the facts, particularly with regard to threat of default by brokers. An independent analysis would have helped the SECP to appraise the situation and to consider measures warranted by the situation. It may be pointed out that the Appellate Bench of the CCP chaired by Mr. Khalid Aziz Mirza and Ms. Rahat Kaunain Hassan obtained a report from KSE regarding loss of liquidity in the market. The report, which was prepared and submitted during the course of hearing by KSE, indicated that “although we agree that liquidity declined, the report in no way establishes that there was an excessive loss of liquidity as envisaged by the regulations.

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<sup>82</sup> SECP IOM dated February 26, 2015



Minutes of the KSE Board's meeting dated 27.08.2008 (wherein decision to impose the price floor was taken) also do not refer to loss of liquidity, excessive or otherwise.”<sup>83</sup>

- (v) It has been reported in various documents that difficulties of the market had been exacerbated by tightening of the monetary policy by SBP for which there could be valid reasons and the IMF conditionalities. There is no record available to show that SECP took up these issues formally with the SBP or the Ministry of Finance. The Committee is of the view that SECP should have given perspective of the market and that of the investors in the country to SBP and the Ministry of Finance. The Committee is also of the view that as is the practice in other jurisdictions, a crisis of the magnitude of 2008 should have been discussed jointly by the Ministry of Finance, SBP and SECP and coordinated roadmap should have been chalked. Lack of such coordination led to continuation of problems in the market. It has been noticed that the KSE was having consultations directly with the Ministry of Finance, SECP, SBP and other stakeholders to develop a set of measures for achieving market stability. The Committee is of the view that such an initiative should in fact have been led by SECP.
- (vi) It has been noted that the SECP did not place facts of 2008 market turmoil before the Policy Board. It is interesting that a presentation made by the Securities Market Division of SECP to the Policy Board in its meeting held on January 13, 2009 did not mention the imposition of the floor and its consequences to the Board. In fact the presentation made to the Policy Board was very comprehensive detailing the reform measures which SECP had taken as well as reasons for downturn in Pakistani market like tightening of monetary policy, rising world oil prices, uncertainty vis a vis capital gains tax, negative country

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<sup>83</sup> Paragraph 55, page 38 of the Order of the Appellate Bench of the Competition Commission of Pakistan dated November 26, 2009

outlook, depreciation of local currency and outflow of foreign capital. Strangely, issues relating to settlement problems and the unprecedented measure of imposition of floor and its removal and the CFS MK-II square-up arrangements were not mentioned in the presentation.

- (vii) One of the functions of the Policy Board laid down in the SECP Act, 1997<sup>84</sup> is to oversee the performance of the SECP. It is surprising that during the discussion on the presentation on the performance of the Securities Market Division in its meeting held on January 13, 2009, no member of the Policy Board inquired about the crisis of 2008.

The Committee is of the view that the full Commission which has the mandate of regulating securities market should have carried out independent analysis of the market situation and developed a long-term plan with clearly defined milestones. The Committee is also of the view that an event of such critical nature warranted convening of meetings of the Commission as well as of the Policy Board. It may be noted that the Policy Board has representation of the Ministry of Finance and the SBP and their input on the market could have been helpful.

## **9.2 Role of Stock Exchanges**

### **9.2.1 Role of the KSE**

The discussions held during the meetings of the board of directors of the KSE during the year 2008 suggest that the stock exchanges were primarily occupied with protection of interest of the brokers rather than the interest of other stakeholders, particularly that of investors. The KSE adopted a short term approach to deal with problems of liquidity and declining market. For this

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<sup>84</sup> Section 21(1)(e) of the Securities and Exchange Commission of Pakistan Act, 1997

purpose, abrupt changes were made in a number of policies which were in the nature of firefighting rather than implementing strategic plans to deal with fundamental issues of the market. These changes included revision of circuit breakers, converting deliverable futures into CFS MK-II and holding of special sessions with the objective of reducing the CFS MK-II positions. It appears that while taking such measures in a piecemeal manner, KSE did not take a holistic view of the fundamental issues in the market.

The decision making process of Karachi Stock Exchange indicates lack of meaningful consultation with its peers although Lahore and Islamabad Stock Exchanges were equally affected by these decisions. It is surprising that even while taking momentous decisions like imposition of floor on the prices, LSE and ISE were consulted through email only by SECP.

It appears that the decisions taken were not preceded by in-depth analysis which could have indicated their long term ramifications on the market. For instance, KSE could not anticipate the strong negative fall out of the decision to impose the floor and strong negative reaction of foreign portfolio investors although some nominee directors warned the Board.

The proceedings of the Board meetings of KSE indicate serious conflict of interest which has already been discussed in the report.

### **9.2.2 Role of LSE**

While going through the minutes of the board of directors of LSE during the year 2008, the Committee has noted that the board did not consider it important to discuss the turbulence in the market which had intensified in August 2008. In the Board meeting held on August 05, 2008 the market situation was not discussed and no board meeting was held immediately before or immediately after August 27 when floor was imposed on the prices of securities by KSE in

consultation with LSE. It was only in the meeting of the board on September 30, 2008 that the board was taken into confidence when a proposal was moved for ratification of the decision to impose the floor. It is interesting that even in this meeting the proposal for such ratification figures at item number 14 out of 16 items on the agenda. It is surprising that an event which jolted our stock market in August 2008 and aftershocks of which continue to be felt, was not considered important enough to be discussed by LSE board in a meeting earlier than September 30, 2008.

While discussing this issue, MD LSE briefed the board about his communication on KSE's proposed floor placement and the verbal consultation with the members of the LSE board before conveying the response within two hours of receiving request for endorsement. He informed that while conveying consent of LSE to KSE he had pointed out that "while non-interference with the market mechanism was LSE's preferred option, LSE would have no choice but to follow suit if KSE decided to close the market or to place a price floor, for reasons of technical/procedural difficulties, avoidance of the market and price distortions, preservation of overall capital markets in financial systems and maintenance of uniformity among markets as per the SECP's policies." It may be pointed out that in his email addressed to SECP on August 27 evening, MD LSE had conveyed the view of LSE that if the market had to be frozen it should not be for a limited period but for "more of a sustained period of time".

In the subsequent meetings the liquidity crunch faced by members was discussed a number of times. Members complained of depletion of the CFS pool and suggested that entire CFS MK-II should be frozen as had been done in the case of ready and futures market. The board was informed that the members in their meeting held on October 10, 2008 requested LSE to provide

funds of around PKR 250 million to all of its members for settlement of their outstanding CFS positions out of the free reserves of the exchange.

In a meeting of the Board held on October 12, 2008, the question of removal of the floor unilaterally by LSE was discussed. The question raised was as to whether it would be feasible or beneficial for LSE to restore normal trading even though KSE continued to retain the floor on the prices of securities. Some members felt that if LSE took the initiative it would enhance its reputation and marketability. However, after lengthy discussions, the Board concluded that “members of LSE were not in a position to sustain the pressure of trading volumes landing at LSE; which also likely to create procedural, settlement and other related issues”. In the meetings of the LSE Board held in early December 2008 possibility of invoking *force majeure* clauses of LSE’s RM Regulations to mitigate systemic risk through negotiations between financiers and financees was also discussed. After a long discussion however, the board decided not to jeopardize relationship between financiers and financees. These discussions indicate that if the powers of *force majeure* continue to remain with the stock exchanges through their RM Regulations, these powers could be used indiscriminately.

### **9.2.3 Role of ISE**

In the case of ISE also, the board does not appear to have discussed the market situation in 2008 and the factors which led to the imposition of the floor. In fact no meeting of the board was held immediately prior to and after August 27, 2008 when decision was taken to impose floor by KSE. In its response before the CCP ISE took the stance that both ISE and LSE had decided to impose price floor reluctantly after KSE had already implemented this decision. It also explained that both ISE and LSE being a unified trading platform (UTS) decided to follow KSE.

The role of LSE and ISE before and during the crisis of 2008 establishes the fact that the two stock exchanges are not able to function independently of KSE. This may rebut the argument that their existence generates competition among the three stock exchanges. This experience may justify integration of the three stock exchanges. Alternatively, the Lahore and Islamabad Stock Exchange should consider creating exclusive niches for themselves like platforms for trading of Small and Medium Enterprises (SMEs) and debt securities.

### **9.3 Role of CDC**

The role of CDC came into focus during and after 2008 crisis due to misuse by some brokers of clients' securities maintained in the sub-accounts. As a number of investors suffered huge losses on account of malfeasance of brokers, some investors had to resort to the Human Rights Wing of the Supreme Court for relief. On receipt of complaints SECP had already started investigation. Up to June 2009 five enquiries against major delinquents had been ordered. The Committee has been informed that in addition to the enquiries into the conduct of five brokers accused of misuse of clients' securities, SECP took notice of a number of instances of misuse of client securities. Enquiries were also ordered by SECP. Recently, CEO of Ace Securities is reported to have fled the country after allegedly misusing clients' assets to the tune of more than PKR 500 million.

The enquiries conducted by SECP have brought to light a number of weaknesses in the regulatory framework and procedures of CDC. The enquiry report into complaints against Eastern Capital Limited observed that some brokers unable to meet margin calls in continuously declining market misused client's assets to obtain finances from financial institutions for meeting

their own obligations. The enquiries conducted against the participant brokers who misused clients assets show absence of any transparent reporting system, unclear regulatory framework, ambiguity in the authority letters obtained from the clients and no effective inspection regime with respect to the CDS transactions. Some brokers used the client's securities for pledging with the banks to obtain finances and with the stock exchanges to meet margin requirements. In some cases shares purchased by clients were not passed on to their sub-accounts and were transferred from the main account to the house account or any other CDS sub-account used by the broker for this purpose. According to the original structure of CDC, operational control of the sub-accounts rested exclusively with the participants till 2008 and they could freely transfer or pledge the securities. Although, the legal framework required the participant to obtain authority of the sub account holder for moving their assets, some brokers were able to circumvent this legal provision by obtaining blanket approval through the account opening forms which were not standardized. Enquiries into this unhappy episode point out that CDC had no effective monitoring and inspection regime in 2008 to check the illegal transfers of client's shares by the brokers. It is only after September 09, 2008 that SECP imposed restrictions on free delivery.

The CDC was established as an end-user driven system where a participant (brokers, financial institutions etc.) could open sub-accounts for their clients. As the participant alone has the power to move the securities, the law assumes that a participant would act in a prudent manner, fulfilling fiduciary responsibilities. The fact that some brokers committed breach of trust raises questions about the inadequacy and weaknesses about the existing system. CDC has expressed the view that it did not have any regulatory powers to check unauthorized movement of

securities and that the powers of inspections of brokers lie with the stock exchanges and the SECP.

Following the 2008 crises, CDC took a number of initiatives to address some of the weaknesses which were highlighted in 2008. A number of these initiatives were introduced to ensure that movements of listed securities in CDS would be possible only if those are supported by market transactions. Some specific measures in this regards are mentioned below:

1. Movement in sub-accounts:

- a) From September 2008, transactions on account of sale and purchase of shares were only allowed if carried out at exchanges or reported to the exchanges.
- b) Transfer of shares from sub-account to house account without any underlying trade for pledging purpose was disallowed.
- c) Gift transactions from non-family members were required to be reported to the exchanges.
- d) Recently in April, 2015 CDC has introduced Direct Settlement Service, whereby CDC is offering direct settlement service, where custody of securities and cash will not be under brokers' control.
- e) From March 29, 2012, portfolio transfer between two accounts/ sub-accounts were henceforth allowed only if the UIN of all the account holders in both the sub-accounts were the same.
- f) In order to prevent any mishandling of shares by brokers, shares are now transferred directly to client's sub-account by NCCPL, pursuant to a transaction executed on stock



exchange. Previously, brokers used to transfer shares from main account to client's sub-account manually, which often resulted in unauthorized transfer of client's securities by the Participant.

2. On February 10, 2012, necessary amendments were introduced in reason codes mechanism, whereby majority reason codes were deactivated by CDC and participants were required to submit written request to CDC for activation.
3. Standardized format authorizing participants to handle shares in the CDS on behalf of the clients was introduced. The standard format signed by the client gives authority to the broker only for specific purposes such as market based transactions, Off-market transactions, recovery of dues, lending and borrowing, gift transactions and pledging.
4. Under the client level margining system, broker would not be able to pledge securities of a client against margin requirements of other clients or its proprietary trades. Henceforth, pledge of securities from a client's sub-account will only be acceptable to the extent of margins applicable on trading exposure of a particular client.
5. From 2009, CDC Access was launched to enable the client's to monitor their status of their securities held in CDS. SMS and web services are also provided to assist the clients.
6. From October 2012, the scope of inspection of participants was expanded with a view to effectively safeguard the interest of the client.
7. In order to provide for segregation of client's cash assets and to ensure that client's assets are not misused, brokers were required to maintain a separate bank account for his client's cash assets and ensure that margin deposited in form of securities is maintained in a separate sub-account or investor account.

The Committee is of the view that frequent instances of misuse of clients' securities by brokers have shaken the confidence of investors. Therefore, some concrete measures have to be taken by the CDC, the stock exchanges and the SECP to deal with this malpractice. Although changes in the policies introduced by CDC particularly with regard to free delivery of securities have been helpful to some extent, the potential for malpractice has not been completely eliminated. The Committee has been informed that the securities of the clients' have been misappropriated in the following manner:

- Unauthorized trade (sale)
- Unauthorized pledge
- Non-segregation of assets
- Buying/ selling of client securities through Unauthorized omnibus accounts

The Committee is of the view that it could be helpful if a system of periodic audit of client accounts is introduced. Recommendation in this respect is being made separately.

#### **9.4 Role of NCCPL**

NCCPL had to face a number of difficult issues due to the imposition of the floor. The CFS MK-II financees were not able to sell or dispose of the securities in order to settle the contract. The financees came under greater stress because the financiers did not meet their minimum financing commitments.

SECP issued a directive on October 14, 2008 whereby maturities of CFS MK-II contracts were extended from 22 business days to 44 business days. The SECP through a later directive issued on November 07, 2008 also further extended the maturity of the contracts till not earlier than five business days after the removal of the floor.

Two financees approached the Sindh High Court requesting for freeze of the outstanding positions of CFS MK-II, which was allowed by the Court. The financiers also filed constitutional petitions with the Courts against SECP directive altering terms of their contracts with NCCPL making SECP, NCCPL and three exchanges as co-defendants. The Sindh High Court on December 19, 2008 modified its earlier order dated December 13, 2008 and allowed NCCPL to square-up CFS MK-II transactions by liquidating the securities furnished by the plaintiffs and directed to furnish bank guarantee of PKR 7 billion by December 22, 2008. The order further clarified that CFS MK-II system will operate in accordance with NCCPL Regulations.

In the board meeting of December 5, 2015, the directors deliberated on facilitating arrangements with the financiers to close CFS Mk-II contracts on mutually agreed terms. After discussions a CFS MK-II Square-up scheme was agreed and circulated by NCCPL. This was a voluntary scheme and participants not entering the scheme were to be squared up through a tender program. NCCPL clarified that it was acting as only a facilitating agent to facilitate implementation of the scheme without any liability. This scheme was designed for orderly squaring up of the CFS MK-II market and the underlying CFS shares and associated shares in margins, so as to minimize losses to the financiers on their financed CFS financial positions and

minimize the final demand notice for financees. This program aimed at preventing mass scale brokers' defaults.

The Square-up Scheme intended to completely deleverage stock market system. To the extent CFS Mk-II leveraging was concerned, this was true; however, in-house financing (that is not recognized) was not the part of square up settlement. To deal with the situation and to absorb the sale of foreign portfolio investors, infusion of fund from Government or Government owned institutions was necessary.

The High Court of Sindh, on Dec 19, 2008, modified its earlier order dated December 13, 2008 and allowed NCCPL to square up CFS Mk-II transactions, liquidate the securities furnished by the plaintiffs and directed the plaintiffs to furnish bank guarantees of PKR 7 billion to the Court by December 22, 2008. The Order further clarified that CFS Mk-II system will operate in accordance with NCCPL Regulations.

Finally on December 26, 2008 NCCPL dispatched a proposal among Authorized Financiers and Financees and sought their approval within three days. The terms of CFS Mk-II Square Up Scheme, as circulated by NCCPL were as under:

1. The financier will accept up to 30%, as determined by NCCPL of the principal amount of finance by purchasing the financed securities. The purchase consideration would be 12.5% discount to the closing price as of December 24, 2008.
2. Government owned institutions will purchase an equivalent amount of shares, subject to availability of requisite funds.

3. Remaining amount will be paid in cash.

Consequent to the amicable settlement of CFS MK-II between the financiers and the financees, the legal suits were withdrawn.

Although the primary role of NCCPL during the crisis of 2008 was clearing and settlement, it had the additional role of management of CFS MK-II. The difficulties it had to face were mainly on account of change in circuit breakers and subsequent imposition of floor in the market, as a result of which the financees could not settle their CFS MK-II positions. The Committee has observed that a number of decisions being taken by the regulators like change in circuit breakers, placement of floor on prices of securities and conversion of DFM into CFS MK-II had direct impact on the risk management profile of NCCPL. The NCCPL acquiesced to the decisions of the regulator and stock exchanges regarding policy changes impacting risk management. This made NCCPL's clearing system vulnerable to defaults by financees. The Committee is also of the view that NCCPL should have acted independently and expressed its reservations to SECP.

The Committee has also observed that during the period of the crisis, there was visible conflict of interest on the board of NCCPL due to the presence of brokers. The SECP recognizing this conflict, later restricted the representation of brokers on the board of NCCPL. Presently, the NCCPL board comprises one broker from KSE and one from LSE.

## **Chapter 10: Evaluation of the Reform Measures Introduced by SECP after the Crisis**

In view of the leverage product and deliverable futures being a major factor in the 2008 crisis, SECP responded by constituting a committee for review of the product in February 2009. Details of the committee and its recommendations have been discussed in chapter 8. The committee made some major recommendations to help mitigate risks in the market. Following are some of the important recommendations made by the Committee:

1. Discontinue CFS and Deliverable Futures.
2. Accept only cash for margins and collateral for all leverage products.
3. Widen scrip level circuit breakers and introduction of market wide trading halts
4. Introduction of cash settled single stock futures and stock index futures contract with KSE-30 as an underlying.
5. Introduction of spread discounts.
6. Introduce central counterparty clearing and settlement guarantee.
7. SECP to ensure Securities Lending and Borrowing (SLB) is available to the market by June 30, 2009.
8. Distinguish between creditworthiness (net worth) and solvency (NCB).
9. SECP to impose mandatory disclosure requirement for NCB of a broker to general public through KSE website.
10. Move to client-level margining and segregation of client funds.
11. Current special margins on leverage products be replaced with concentration margin which shall also be applicable on ready market segment.

The main recommendations which were implemented by SECP were discontinuation of CFS MK-II and DFM, introduction of client-level margining regime and introduction of concentration margins. Some of the recommendations such as introduction of SLB were implemented much later.

The Committee is of the view that full implementation of the reforms suggested by the committee could have led to structural changes in the stock market. Although some recommendations were implemented, a number of important recommendations like introduction of concept of central counterparty, widening of circuit breakers and introduction of market halts, mandatory disclosure of NCB to the general public through the KSE website were not implemented.

Since a number of cases of misuse of clients' assets by brokers took place during the 2008 crisis, SECP took a number of steps to minimize chances of recurrence of such events. For this purpose some important changes in CDC's policies and framework for client asset segregation were made. Some of the measures introduced in the CDC were as follows:

1. Brokers were required to maintain a separate bank account for clients' cash assets to ensure segregation of clients' cash assets.
2. SECP directed CDC to restrict those movements of listed securities in CDS which were not supported by market transactions, to curtail free movement of securities

3. Brokers were asked to handle the clients' securities only under authorization of the clients. For this purpose, a standardized sub-account opening form was prescribed.
4. Automation of securities settlement which facilitated automatic transfer of the shares as a result of transaction executed on the stock exchange, directly to/from the sub-account of the client. This replaced the previous manual system.
5. Client-level margining regime was introduced to ensure that securities from the sub-account of the client are only pledged against margins applicable on trading exposure of the client.

Despite the reforms mentioned above, possibility of misuse of clients' assets could not be totally eliminated. As a matter of fact a number of cases of misuse of clients' assets came to notice of SECP after the implementation of these reforms.

Even in April 2015, a broker of KSE fled the country after misusing clients' funds, reportedly to the tune of PKR 500 million. In addition to the five brokers who were held guilty of misusing clients' assets in year 2008-09, a number of other instances of misuse of clients' assets by brokers came to surface. These include cases of AAG Securities (Pvt.) Ltd., Mars Securities (Pvt.) Ltd., Ismail Abdul Shakoor (Pvt.) Ltd., Highlink Capital (Pvt.) Ltd., Stock Master Securities (Pvt.) Ltd., Y.S. Securities (Pvt.) Ltd. and Ace Securities (Pvt.) Ltd. to name a few.



## Chapter 11: Conclusions

Based on the observations made above, the Committee would like to submit the following conclusions:

1. The market difficulties in 2008 were caused by steep decline in index and consequent inability of members to deposit the requisite margins with the exchange/NCCPL.
2. Financees were unable to liquidate their positions due to absence of buyers in the market or avail further financing for their positions in CFS MK-II market as financiers did not provide funding even up to their minimum financing commitments.
3. In a rapidly declining market with eroding values of collateral, the banks were hesitant to extend funding to the market participants, which also dried up liquidity.
4. According to the KSE board meetings, the unusual measure of imposing floor on the prices in the market was taken by KSE, essentially to protect its members from default.
5. The decision of imposition of floor on the prices as on August 27, 2008 was fraught with serious implications which the decision makers did not foresee.
6. The entire course of the episode shows inaction by SECP as the apex regulator. Although SECP had received a letter from KSE seeking approval for imposition of the floor, SECP did not respond to it and merely sent it to LSE and ISE for comments, thus enabling KSE to take the decision. This gave rise to the perception that the decision had tacit approval of SECP.
7. By imposing the floor, the stock market was expecting a bail-out package from the Government as had been the case in the previous crises. However, in 2008, KSE failed to appreciate the enormity of economic problems being faced by the Government, which were being discussed in the media regularly. Expectation of a Government bail-out package was

unrealistic at a time when the Government itself was struggling with broader economic issues.

8. Decision for imposition was taken by KSE invoking provisions of *force majeure* under the RM Regulations but the requirements for determination of *force majeure* event were not followed. LSE and ISE while following KSE also did not observe the requirements of the law.
9. The process of consultation between KSE and both the NCCPL and CDC required by the RM Regulations for exercising powers under *force majeure* clause was not meaningful.
10. Serious weaknesses and deficiencies in the systems and processes of CDC allowed unauthorized movement of the securities of the clients by brokers.
11. Although by and large the NCCPL played its due role, it failed to exercise independence in decision making like facilitating conversion of DFM into CFS MK-II and imposition of the floor.
12. The experience of management of the crisis raises serious concerns about the governance structure of the stock exchanges as serious conflict of interest was visible in the decision making process. The members of the stock exchanges who were affected by various decisions taken since June 23, 2008 were themselves part of the decision making process. There have been frequent instances of broker directors being privy to information well before the general public/investors. For instance the imposition of floor on the prices was discussed as one of the options in the meeting of the KSE board held on August 05, 2008 but this option was not disseminated to the public, although the decision was actually implemented two weeks later. The decision to impose floor was practically taken by five brokers who had vested interest in the decision. One of the broker directors on the board who also happened to

be Chairman of Defaulters' Committee, was most vociferous in advocating imposition of floor and fled the country after misappropriating clients' assets. Although the chairman and the MD opposed the option of imposition of floor, views of conflicted broker directors prevailed. It was only an SECP nominee director who emphatically and consistently cautioned the board against taking ad hoc decisions and imposition of floor. But his counsel was ignored.

13. The composition of the boards' of CDC and NCCPL also shows conflict of interest as the affectees and beneficiaries of the decision are themselves the decision makers.
14. One of the important factors responsible for the 2008 crisis was the leveraged product CFS MK-II which allowed speculative trading in the ready market. It fuelled excessive buying which ultimately led to settlement problems.
15. There were frequent instances of ad hoc interventions in the market like change in circuit breakers, change in margin requirements and allowing CFS MK-II to the DFC.
16. Need for streamlining and strengthening the broker regime came to surface as the market has excessively large number of under-capitalized brokers who besides trading can undertake settlement and custody functions. Capital requirements are not risk based.

Perusal of the minutes of the KSE and other documents clearly establishes that the decision of imposition of the floor was that of the brokers who lobbied for it and practically forced the board to take this decision. 103 brokers met to discuss the situation on August 27 and 100 out of these brokers urged for imposition of floor. The influence of brokers on the decision making raises questions about the independent functioning of the board. Although seeking advice from brokers as important stakeholders is understandable but interest of other stakeholders like investors, listed companies and unit holders was completely ignored.

17. Good corporate practice required that the management should have analysed the situation in the market and placed before the board, pros and cons of the three options considered by the board.
18. In case all the possible options had been carefully analysed to deal with the difficulties in the market and if international practices and experience would have been followed, a much better option would have been to let the market continue as was done by a large number of emerging markets in similar situation in 2008 or alternatively close the market for a very short period.
19. The crisis exposes serious weaknesses of apex regulator in dealing with a crisis situation. No professional analysis of the situation from April to August, 2008 done by the regulator is available. SECP would have been in a much better position to deal with the crisis if it had in place mechanism of monitoring risks in the market and its analysis. There is no evidence that the critical market situation and the imposition of floor was discussed by the full Commission. In case SECP had functioned as a collegiate body, it would have been possible for it to draw upon collective wisdom and experience of all the Commissioners.
20. The crisis also exposed the independence of LSE and ISE. Although they expressed reservations about imposition of floor, they were unable to take independent stance. LSE board did discuss removal of floor unilaterally after the imposition but could not take decision.
21. The crisis has highlighted the issue of custody of shares of investors maintained in the sub-accounts by the brokers. Misuse of client's assets by brokers is perhaps the most serious aspect of the crisis as it led to erosion of investor confidence in the stock market. This not only raises questions about CDS but more importantly, about the custodial functions of

brokers, vested in them irrespective of their financial strength and fulfillment of any fit and proper criteria.

22. The crisis showed absence of coordination between SECP and SBP. In fact, never has close coordination between the two regulators of financial sector needed as much as during the crisis, as SBP could have helped in generating liquidity in the market. Although KSE chairman and MD and some brokers interacted with SBP, there is no evidence of discussion between the heads of the two institutions. Coordination between SECP and CCP also appeared to be absent.
23. With imposition of floor, trading was diverted to off-market where shares were traded at a heavy discount. The off-market provided opportunity for exit of foreign investors.
24. Risk management being administered by NCCPL was impacted adversely by measures like change of circuit breakers and imposition of floor. NCCPL acquiesced to these decisions and did not show independence.

## Chapter 12: Recommendations

The experience of 2008 stock market crisis has highlighted the need for fundamental reforms in our capital market. It is a matter of concern that our market goes through crisis at practically regular intervals, jolting investor confidence. A number of policy changes had been recommended by experts who conducted enquiries into earlier crises but, as noted by the Committee, no concerted effort was made to fully implement these. Similarly, a number of reports have been prepared by experts of international repute on various aspects of our capital market which are available with SECP. IOSCO, a specialized international body comprising capital market regulators is continuously working towards development of capital markets on sound basis and its recommendations are also available with SECP. The Committee is of the view that if key recommendations made by the enquiry reports into earlier crises as well as those of professional experts would have been implemented, our market would have been in much better position to avoid or manage the crisis of 2008. The Committee has noted that immediately after the 2008 crisis, SECP introduced a number of reform measures which have been discussed in the previous chapter.

As the report of the Committee was nearing its completion, an important development took place which needs to be mentioned. The promulgation of Securities Act, 2015 is an important development which should help SECP to play its role in the capital market more effectively. The new law also poses a challenge since SECP is now required to formulate rules and regulations under the law, efficacy of which can only be assessed upon implementation.

Our stock exchanges were demutualized in August 2012. However, the expected benefits of an absolutely independent management overseeing the regulatory functions and a board comprising nominees of strategic investors have not yet materialized in practice. It is hoped that after induction of strategic investors, there should be qualitative improvement in the governance and functioning of the stock exchanges.

Based on the study of 2008 crisis and identification of some of the weaknesses which became apparent during the study, the Committee would like to submit following recommendations in the context of 2008 crisis:

## **12.1 SECP**

1. There is need to develop long-term strategy and plan for the development of stock market reflecting the vision of the regulator. The plan should consist of long-term, medium-term and short-term goals along with timeline to be achieved. The plan should have components covering all aspects of capital market including analysis of its current and desired position, highlighting key focus areas, acceptable risk levels and overall development targets including market size and outreach, reform measures envisaged to be introduced by the regulators; new products to be launched and improvement in policies and procedures. The plan should be devised after taking into confidence the relevant stakeholders. Chairman SECP has already constituted a Consultative Group on Capital Markets which can serve as a platform for eliciting views of all stakeholders. Once finalized, the plan should be made public and implementation by the apex and frontline regulators should be monitored and evaluated bi-

annually. As the next step, similar plans may be prepared for other sectors being regulated by SECP. Such master plans have been prepared by a number of countries like Malaysia.

2. One striking feature of all the crises is the abrupt and ad hoc changes made in the policies including changes in risk management, which undermines credibility of the regulators. Consistency of policies is critical to ensuring confidence of the investors. Midstream changes create uncertainty and can lead to asymmetrical treatment of the different set of stakeholders. It is recommended that any necessary changes, particularly adjustment of risk management regime, should be made only in emergency situations and by exercising emergency powers which are now available with SECP under the Securities Act, 2015.
3. During all the previous crises, it has been noticed that the SECP was not well-equipped in terms of systems and organizational arrangements for independently monitoring risks in the market and was therefore unable to take proactive action in time. During 2008 crisis SECP did not carry out independent analysis of the market situation, which is essential for formulating policies to deal with such crisis. It is therefore recommended that SECP should have in place a department dedicated to monitoring and evaluating risk in the market.
4. Under the new Securities Act, 2015, SECP has been vested with emergency powers to act promptly in emergency situations. There is need to lay down transparent policy specifying circumstances under which such powers may be used. It is presumed that such powers would be used very rarely. These powers can be used, as is the case in other jurisdictions, to intervene in the market in times of serious crisis. However, this requires formulation of transparent policy clearly spelling out circumstances in which the regulator can intervene.
5. SECP Act, 1997 envisaged functioning of SECP as a collegiate body with the Commissioners having joint responsibility for policy making on issues spelt out in the law.



This has been reiterated by the Supreme Court of Pakistan in a judgment. However, the concept has been diluted by delegation of policy making powers to Commissioners.

According to the proposed arrangement, the executive director/heads of departments should be responsible for all the routine work and present policy papers to the full Commission for consideration. Such a system which is prevalent in other countries, allows the Commissioners and the Chairman to focus attention on key strategic and policy issues rather than on routine matters. Among other advantages of such a structure, it would provide consistency of policies since executive directors/heads of departments would be in the permanent service of SECP, unlike Commissioners who have tenure of three years. The Committee has noted that during the last ten years there have been nine Commissioners dealing with securities market, which is not conducive to consistency of policies. It is the considered view of the Committee that if SECP had functioned as a collegiate body in 2008, it would have played a far more effective role in guiding the stock exchanges and managing the crisis. It is therefore proposed that the SECP may function as a collegiate body as envisaged by the SECP Act, 1997 and reiterated by the Supreme Court<sup>85</sup>.

6. The concept of Policy Board was introduced in the SECP Act, 1997 with the objective of establishing an institution providing a bridge between the SECP and the Government as well as the private sector, which was necessary when the regulatory functions of capital market were being transferred from the Government to an autonomous body. The Policy Board was envisaged to be dominated by private sector with a chairman also from the private sector. However, a number of changes have been made in the composition of the Policy Board through law over the years. One of the important roles of the Policy Board was to “oversee

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<sup>85</sup> The detailed order by the Honourable Supreme Court, CP No. 59 and CMA No. 326 and 633 of 2012 and Crl. O.P. 94 of 2012 in Const. P. 59.2011

the performance of the Commission to the extent that the purposes of this Act are achieved”<sup>86</sup>.

The Committee had an opportunity of seeing the minutes of the Policy Board during 2008 and 2009 to evaluate its role in overseeing the role of SECP during the crisis. As explained in chapter 9 of the report, momentous developments like stock market crisis and unprecedented intervention by stock exchanges in 2008 were not noticed by the Policy Board. As already mentioned, the first meeting held after imposition of the floor in January 2009, the Policy Board did not raise any issue about 2008 crisis, though there was a presentation of Securities Market Division before it. It is recommended that the role of the Policy Board may be evaluated by the Government with a view to taking decision on its continuation or its revised composition. Some international experts have pointed out that a Policy Board in the present form is not consistent with autonomous status of SECP.

7. The course of 2008 crisis showed absence of close coordination between the two regulators of financial sector namely, SBP and SECP. In most of the jurisdictions, crisis of the nature of 2008 would have been managed through joint efforts of the central bank and the capital market regulator. Presently, certain steps have been taken for better coordination between SECP and SBP and a few joint committees are in existence. However, the recent decision to impose moratorium on KASB Bank which was both a clearing and settling bank and a listed security, as well as KASB Bank’s amalgamation with Bank Islami, without consulting the SECP have raised questions about the degree of coordination between the two institutions. It is necessary that an institutional arrangement should be put into place which should enable

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<sup>86</sup> Section 21(1)(e) of the SECP Act, 1997

SECP and SBP to coordinate closely as both are responsible for safeguarding integrity of the financial sector.

8. There is need to clearly demarcate jurisdiction and areas of responsibility of apex and frontline regulator. Presently, SECP is taking a number of regulatory actions which should be taken by the frontline regulators. The Committee is of the view that the frontline regulator should take the lead for surveillance of the market and oversight of brokers through inspections and enforcement actions.

## **12.2 Stock Exchanges**

1. The quality of stock exchanges plays a pivotal role in the capital market of a country. It has to ensure integrity and transparency of operations, investor protection and market efficiency. This requires the stock exchanges to function as a financial institution, free from any conflict of interest. The crisis of 2008 brought into focus serious conflict of interest existing in the then composition of the stock exchange boards. As has already been mentioned in the report, during the 2008 crisis, critical decisions were being taken by five broker directors of KSE who were conflicted. Some of the broker directors who advocated imposition of the floor had personal interest in the decision. According to sections 214 and 216 of the Companies Ordinance, 1984 a director has to disclose his interest in any matter which is placed before the board. Section 216 also stipulates that such interested director shall not participate or vote on any matter in which he is interested. The provisions of Companies Ordinance, 1984 are applicable to the stock exchanges which in 2008 were companies limited by guarantee. In the case of the meeting held on August 27, 2008 it would have been appropriate if the broker directors who were to be affected by the decision should have abstained from voting.

Similarly, in the case of board meetings held earlier, in which decisions were taken which affected the broker directors personally, the directors should have abstained. SECP needs to ensure compliance with the provisions of sections 214 and 216 of the Companies Ordinance, 1984 in the interest of better governance of the boards. In view of conflict of interest of brokers being on the board, a number of exchanges in other jurisdictions do not include any broker on their board and these are functioning successfully. It may be pointed out that Bombay Stock Exchange after demutualization does not have a broker on its board.

2. During 2008, stock exchanges invoking powers under *force majeure* took a number of ad hoc decisions. The decisions related to change of circuit breakers, roll-over of DFM positions to CFS MK-II and imposition of the floor. While there are questions as to whether the stock exchanges followed the prescribed conditions required for determining *force majeure* event, it needs to be decided as to whether it is appropriate to vest the stock exchanges with such discretionary powers. Universally, *force majeure* refers to events involving natural calamity or civil disorder in a country which is beyond human control. However, the provision of *force majeure* as mentioned in the RM Regulations is given to misinterpretation and has been used rather indiscriminately. Such powers vested in stock exchanges are fraught with risk. The imposition of floor through use of *force majeure* powers in 2008 sent a dangerous signal to the foreign investors who felt that their interest could be jeopardized by the stock exchanges taking even more extreme measures invoking *force majeure* powers at any point of time in the future. It is therefore proposed that *force majeure* appearing in the RM Regulations should be clearly defined to mean only acts of God or civil disturbance. At the same time both the apex and frontline regulators need to be vested with emergency powers as is the case in other jurisdictions like Malaysia, Singapore and India. These powers are

specified and can be used in the case of emergency and natural disaster or in the case of economic and financial crisis or in situations which threaten the integrity or liquidity of the stock market. There needs to be a transparent policy with well-defined parameters as is the case with other jurisdictions. It may be mentioned that different jurisdictions have laid down the level at which emergency powers can be exercised. For instance in the case of Malaysia, power to close the stock exchange lies only with the Minister while in the case of Singapore, the apex regulator uses such powers. SECP has informed the Committee that under the Securities Act of 2015, SECP has been vested with emergency powers which could be used in emergent situations. SECP has further informed that with the emergency powers now available to SECP, stock exchanges would not be able to exercise indiscriminate powers under *force majeure*.

It is recommended that SECP should formulate a transparent policy under the emergency powers which should clearly spell out the circumstances in which such powers could be exercised.

3. As has been explained in the report, there are an excessive number of brokers in Pakistan's market relative to its size. Presently, there are about 345 brokers and all of them can perform all functions – trading, clearing and settlement. The Committee is of the view that keeping in view the incidence of misuse of clients' assets by the brokers, it is important that the function of clearing and settlement should be available with only a few brokers who have the financial strength and who fulfill the necessary fit and proper criteria. Preferably, only those brokers should be entrusted with custody of securities of the clients in their sub-accounts, who are backed by strong financial institutions. Rest of the brokers would continue to perform trading activities and would not handle clients' cash or securities.

Another important issue relating to broker regime is that the minimum required capital is not risk-based. It is important that as in the case of banks, the capital to be maintained by the brokers should be risk-based and related to the nature of activities being performed and the market segments with which the broker is engaged.

As regards the Net Capital Balance, there have been serious problems in its calculation and a consultant had recommended a capital adequacy template in the year 2006. The template was also used by the Consultative Group on Capital Markets in 2009 for recommending a net adjusted liquid capital formula. However, although the same was again endorsed by the consultant in 2010, the formula is yet to be introduced.

The Committee recommends early steps to revamp the broker regime with respect to classification of brokers, capital adequacy, code of conduct and fit and proper criteria.

The stock exchanges exercise regulatory powers as frontline regulators. For this purpose, stock exchanges need to strengthen capacity to be able to perform their regulatory role effectively. As envisaged by the scheme of demutualization, effectiveness of the regulatory functions being performed by the stock exchanges need to be continuously evaluated, both by the stock exchanges themselves and by the apex regulator.

### 12.3 CDC and NCCPL

1. Existing criteria for becoming CDS Participant needs to be made more stringent by prescribing additional qualification and net worth. It is also proposed that keeping in line with our recommendations regarding broker regime, the role of TREC Holder Participant may be segregated through classification, such as ‘Trading TREC Holders’ and ‘Clearing TREC Holders’ where latter would be subject to fulfillment of stringent criteria for becoming CDS Participant, including appointment of compliance officer. Such practices are followed in other jurisdictions.
2. Internationally clearing companies act as central counterparty either for an exchange or in OTC markets. In view of its role, it needs to be properly managed and capitalized in order to ensure its survival in the event of a significant adverse event.

The Committee proposes that NCCPL may be converted into a central counterparty in line with international practice. It will then be possible to give sanctity to the trades at the stock exchange. NCCPL’s present equity base is PKR 625 million (Capital - PKR 225 million and Reserves and unappropriated profit – PKR 400 million). NCCPL has a Settlement Guarantee Fund (SGF) of PKR 1.55 billion. It may be mentioned that NCCPL had got actuarial valuation to determine the requirement of SGF and they came up with a figure of PKR 2.2 billion. It is recommended that capitalization as well as the size of the SGF may be increased. The Committee suggests that the amount of equity and SGF required for NCCPL to function as central counterparty may be calculated based on the experience of past crises.

3. The Committee has been informed that the audit of the participants being carried out by CDC is limited in scope as it only covers contravention of CDC Regulations and does not cover financial relationship between brokers and their clients. The Committee understands the

constraints of CDC with regard to the scope of the audit as it is not a regulatory body. The Committee is of the view that given the rampant incidence of misuse of clients' assets by brokers, it is important to carry out a comprehensive audit of the CDS participants. Since CDC itself cannot carry out audit of the participants beyond their regulatory compliance due to legal reasons, holistic audit of the CDS participants should be carried out by SECP. Part IV of the new Securities Act, 2015 provides for regulation of CDC by SECP and SECP has sufficient powers to regulate it. It is suggested that the audit of CDS participants being proposed should include movement of securities checked with proper money trail and authorization along with proper segregation of assets.

4. Due to the importance of the function of clearing and settlement, NCCPL should ideally be a statutory body and its board should not have any representation of brokers.



**ANNEXURE I**

**LIST OF PERSONS MET BY THE COMMITTEE**

S. No.	Name	Designation	Organization
1.	Mr. Khalid A. Mirza	Former Chairman	Securities and Exchange Commission of Pakistan and Competition Commission of Pakistan
2.	Mr. Razi-ur-Rahman Khan	Former Chairman	Securities and Exchange Commission of Pakistan
3.	Mr. Imtiaz Haider	Former Commissioner	Securities and Exchange Commission of Pakistan
4.	Mr. Zafar Abdullah	Commissioner	Securities and Exchange Commission of Pakistan
5.	Mr. Akif Saeed	Commissioner	Securities and Exchange Commission of Pakistan
6.	Ms. Bushra Aslam	Secretary to the Commission	Securities and Exchange Commission of Pakistan
7.	Ms. Musarat Jabeen	Executive Director	Securities and Exchange Commission of Pakistan
8.	Mr. M. Javed Panni	Former Executive Director	Securities and Exchange Commission of Pakistan
9.	Mr. Imran Inayat Butt	Director	Securities and Exchange Commission of Pakistan
10.	Mr. Hasnat Ahmed	Director	Securities and Exchange Commission of Pakistan
11.	Mr. Muhammad Afzal	Director	Securities and Exchange Commission of Pakistan
12.	Mr. Mohammad Rashid Safdar Piracha	Director	Securities and Exchange Commission of Pakistan
13.	Mr. Muhammad Tanveer Alam	Joint Director	Securities and Exchange Commission of Pakistan
14.	Mr. Mateenullah Khan	Joint Director	Securities and Exchange Commission of Pakistan
15.	Mr. Asif Iqbal	Joint Director	Securities and Exchange Commission of Pakistan
16.	Mr. Tariq Naseem	Deputy Director	Securities and Exchange Commission of Pakistan
17.	Mr. Nadeem Naqvi	Managing Director/CEO	Karachi Stock Exchange Limited

**Report of the Committee: Study of the Pakistan Stock Market Crisis of 2008**  
**June 05, 2015**

18.	Mr. Aftab Ahmad Ch.	Managing Director/CEO	Lahore Stock Exchange Limited
19.	Mian Ayaz Afzal	Managing Director/CEO	Islamabad Stock Exchange Limited
20.	Ms. Mashmooma Zehra Majeed	Chief Executive Officer	Mutual Funds Association of Pakistan
21.	Mr. Tariq Iqbal	Former Managing Director	National Investment Trust Limited
22.	Mr. Shahid Ghaffar	Managing Director	National Investment Trust Limited
23.	Mr. Manzoor Ahmed	Chief Operating Officer	National Investment Trust Limited
24.	Mr. Adnan Afridi	Former Managing Director / Advisor	Karachi Stock Exchange Ltd./ Silkbank Limited
25.	Mr. Ali Ansari	Former SECP Nominee Director	Karachi Stock Exchange Limited/ Chairman NCCPL
26.	Mr. Ali H. Shirazi	Director	NCCPL
27.	Mr. Shafqat Ali	Chief Regulatory Officer	Karachi Stock Exchange Limited
28.	Mr. Ahmed A. Mitha	Chief Financial Officer	Karachi Stock Exchange Limited
29.	Mr. Abbas Mirza	General Manager Operations, Customer Services and Investors Relations	Karachi Stock Exchange Limited
30.	Mr. Ahmed Noman	Secretary & General Manager (Operations)	Islamabad Stock Exchange Limited
31.	Mr. Mohammad Hanif Jakhura	Chief Executive Officer	Central Depository Company of Pakistan Limited
32.	Mr. Aftab Diwan	Chief Operating Officer	Central Depository Company of Pakistan Limited
33.	Mr. Rasool Hooda	Senior Manager Legal & Compliance	Central Depository Company of Pakistan Limited
34.	Mr. Muhammad Lukman	CEO	National Clearing Company of Pakistan Limited
35.	Mr. Badiuddin Akbar	Former Chief Operating Officer	National Clearing Company of Pakistan Limited
36.	Mr. Imran Ahmed Khan	Chief Financial Officer & Company Secretary	National Clearing Company of Pakistan Limited
37.	Mr. Kashif Alam Khan	Chief Internal Auditor	National Clearing Company of Pakistan Limited
38.	Mr. Arif Habib	Chairman	Arif Habib Group
39.	Mr. Aqeel Karim Dhedhi	Chairman	AKD Group

40.	Mr. Jahangir Siddiqui	Chairman	JS Group
41.	Mr. Amin Tai	Chief Executive	Amin Tai Securities
42.	Mr. Nasim Beg	Vice Chairman	MCB-Arif Habib Investments
43.	Mr. M. Sohail Dayala	Former Broker Director/ Chief Executive Officer	Karachi Stock Exchange Limited/ Invest & Finance Securities Limited
44.	Mr. Shahzad Chamdia	Former Broker Director/ Chief Executive Officer	Karachi Stock Exchange Limited/ Shehzad Chamdia Securities (Private) Limited
45.	Mr. Muhammad Munir Khanani	Chief Executive Officer	Muhammad Munir Muhammad Ahmed Khanani Securities (Pvt.) Ltd
46.	Dr Yasir Mehmood	Chief Executive	Yasir Mehmood Securities (Pvt.) Ltd.
47.	Mr. Asim Zafar	Chief Executive	Zafar Securities (Pvt.) Ltd.
48.	Mr. Asif Baig Mirza	Broker Director / Chief Executive Officer	Lahore Stock Exchange ABM Securities (Pvt.) Limited
49.	Syed Mukhtar Hussain Jaffery	Chairman Demutualization Committee/CEO	Islamabad Stock Exchange Limited/ Unex Securities (Pvt.) Ltd.
50.	Mr. Zahid Latif Khan	Broker Director/ Chief Executive	Islamabad Stock Exchange Limited Zahid Latif Khan Securities (Pvt.) Limited
51.	Mian Humayun Parvez	Chief Executive Officer	Mian Parvez Aslam Securities (Pvt.) Limited
52.	Mr. Omer Iqbal Pasha	Chief Executive Officer	Pasha Securities Private limited