

# Demutualization and Integration/Transformation of Stock Exchanges

**Report of the Expert Committee on Demutualization and Integration/Transformation**

**September 02, 2004**

## Abbreviations and Acronyms

ATS	Alternative Trading system
BSE-India	The Stock Exchange of Mumbai, India
CDC	Central Depository Company of Pakistan Limited
CDS	Central Depository System
Committee	Expert Committee on Demutualization and Integration
ECN	Electronic Communication Network
FIDE	Fully Integrated Demutualized Exchange
ISE	Islamabad Stock Exchange Guarantee Limited
IT	Information Technology
KSE	Karachi Stock Exchange Guarantee Limited
LSE	Lahore Stock Exchange Guarantee Limited
NCC	National Clearing Company of Pakistan Private Limited
NCEL	National Commodity Exchange Limited
NewSE	New Stock Exchange
NIT	National Investment Trust
NSE	National Exchange
NSE-India	National Stock Exchange of India
SECP	Securities & Exchange Commission of Pakistan
SEBI	Securities & Exchange Board of India
STP	Straight Through Processing
TFC	Term Finance Certificate
WFE	World Federation of Exchanges

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## **Executive Summary**

1. Capital market plays a vital role in channelling savings into investments leading to increased income, employment, and output. Being a developing country, Pakistan needs a securities exchange that enjoys the confidence of domestic and foreign investors and able to mobilize both domestic and foreign capital for economic growth.
2. Globally, stock exchanges have undergone transformation. Advancement in communication technology and globalization have made it possible for investors and issuers to move to more efficient capital markets, even if these are located outside geographical boundaries of their country.
3. Competition among exchanges and alternative trading systems has led to integration and demutualization in many countries. Now countries in Asia are developing their capital market through demutualization and integration. It is natural that Pakistan should also study feasibility of demutualization and integration or transformation of its three stock exchanges for the development of its capital market.
4. The Committee was constituted by the SECP to make a comprehensive plan for demutualization and give recommendations on integration or transformation of KSE, LSE and ISE.
5. In order to cover its terms of reference, the Committee conducted a consultative process in which it sought views of core stakeholders - investors, issuers and members of exchanges – through meetings and questionnaire
6. In its meetings with the representatives of the SECP, the Committee has understood that the objective of demutualization and possible integration or transformation is to address the various problems being faced by stock exchanges and to help them perform their economic role more effectively. The Committee, therefore, analyzed the problems being faced by KSE, LSE, and ISE in depth. The Committee is of the view that demutualization should be considered only if it can help in addressing problems of the market.

### **Problems Faced by the Stock Exchanges**

7. Despite economic growth in the country, companies are not seeking listing at the exchanges and little capital formation is taking place through stock exchanges. Issuers do not appear to have confidence in stock exchanges and see minimal value addition in listing. There is limited free float in the market and it is coming under increasing pressure due to a disproportionately large growth in mutual funds.
8. Investor base is small. Percentage of adult population that owns shares is less than 1%. Growth in mutual funds has not led to increase in the number of investors. The number of shareholders in listed companies has practically remained stagnant despite the bullish sentiment in the market. The only measure that is expanding investor base are offers for sale of state owned enterprises.
9. In spite of a series of reforms relating to governance, professional management has not been allowed to establish firmly in the exchanges. There is a general view that exchanges are being run by brokers in their own interest. Exchanges are unwilling or unable to supervise and discipline members and listed companies. The role of non-member nominated directors in improving

governance is rather mixed. Although they have helped in improving the standard of governance but not to the desirable extent.

10. Due to existence of three exchanges, liquidity and price discovery are fragmented and costs escalate for all stakeholders. There is virtually no competition among exchanges and KSE is the dominant exchange in all market segments.
11. Investors are vulnerable to different forms of market abuse. Market remains rife with allegations of price manipulation, front running, insider trading and blank selling. Exchanges do not have the capacity to carry out surveillance and investigation in market abuse.
12. The management of settlement risk is weak and needs improvement.
13. Exchanges are financially weak. Unlike international exchanges, they derive most of their income from listed companies rather than trading charges and other fees on services. They do not have the means to finance capital expenditure that is required for development.
14. Exchanges are also unable to attract and retain professionals. Most of the staff is non-management. Due to insufficient economic and human capital, they are unable to grow and develop like international exchanges.
15. Speculative activity dominates the trading and liquidity is highly concentrated. The equity market has been distorted by *Badla* financing. Due to excessive speculation, concentration, and *Badla* financing, the market is exceptionally volatile.
16. While the number of issuers and investors is very small, the number of intermediaries is disproportionately large. The eligibility criteria for intermediaries are weak and intermediation is generally of low quality.
17. Analysis of the problems being faced by stock exchanges shows that these are fundamental in nature and exchanges are fulfilling their economic role and discharging regulatory responsibilities to a very limited extent.
18. A mutual structure and fragmented market are at the heart of problems being faced by the stock market. A mutual structure allows control of exchange by only one stakeholder, i.e. brokers. It has also deprived the exchanges of economic and human capital that they need for further development. Fragmentation of market place has added to cost inefficiencies for all stakeholders.
19. The reforms in the past were brought within the framework of mutual structure and a fragmented market place. This is why they have not been able to make substantial impact.
20. Having analyzed the problems being faced by exchanges, the Committee considered the question as to whether demutualization and transformation or integration can address these problems and help the exchanges to perform their economic role more effectively.

### **Demutualization of Stock Exchanges**

21. Demutualization can improve governance structures at the exchanges, provide access to economic and human capital, generate commercial pressures for growth and development, allow

entry of new and better intermediaries, unlock value of membership cards for members, provide domestic and international recognition, give opportunity for making equity cemented international alliances, and help change the perception and image of an exchange.

22. International and in particular Asian experience of demutualization has demonstrated that after demutualization, the market capitalization, turnover, and products and services offered by exchanges have greatly increased to the benefit of all stakeholders. Brokers have benefited from demutualization through higher commission earned on increased trading volumes, and by capital gains on the shares, which they received on demutualization.
23. The core concern about demutualization is that it causes conflicts of interest between the regulatory and commercial role of a stock exchange. A number of measures can be taken to address this conflict including separation of some regulatory functions within or from the exchange and greater transparency into how a demutualized exchange is run.
24. The Committee is of the view that Demutualization can help solve problems of the stock exchanges. However, demutualization should be seen as a means to an end and not an end itself. It would need to be carefully structured to achieve the desired results.

#### **Transformation / Specialization of Stock Exchanges**

25. There is unrealized potential in different specialized segments such as derivatives, debt and small cap but currently KSE dominates all segments and it has no incentive to specialize in any of them. LSE and ISE have not taken any discernible steps towards specialization nor have they displayed any interest in it. Synergies achieved through integration of markets could be lost in conversion of existing exchanges into specialized exchanges
26. The international trend also favors an integrated securities exchange on which all different products are available for trading.
27. Transformation or converting an exchange into a specialized demutualized exchange is unlikely to help solve the problems of exchanges. At this moment, it is neither feasible nor desirable to convert an exchange into a specialized demutualized exchange.

#### **Integration of Stock Exchanges**

28. There are a number of factors favoring integration, such as geographically neutral custody and settlement and the ability to provide remote trading terminals.
29. There could be various scenarios in which demutualization and integration take place. The scenario in which the interest of all stakeholders is best served is the one in which all three exchanges both demutualize and fully integrate.
30. Integration of stock exchanges can bring cost efficiency for all stakeholders, improve liquidity and price discovery, increase the pool of economic and human capital, offer synergies in risk management and surveillance, reduce complexity in operations, lead to focused supervision by SECP, and provide domestic and international recognition.
31. If KSE, LSE, and ISE integrate, the CDC and NCC shall become subsidiaries of the integrated exchange. This would further enhance cost efficiencies and help in having a single business

strategy and coordinated developments. Due to integration, NCEL shall also become a subsidiary of the integrated exchange.

32. The core concern about integration is that it would eliminate possibility of inter-exchange competition. A balanced board of directors, inter-broker competition, close supervision by SECP, and encouragement of ECN, where brokers would be able to electronically match orders within the brokerage house, and possibility of licensing another stock exchange in the future, if necessary, would address concerns relating to lack of inter-exchange competition.
33. The Committee is of the view that integration can address solve the problems of stock exchanges. However, like demutualization, integration should be seen as a means to an end and not an end itself.

#### **Key Issues in Demutualization and Integration**

34. A number of key issues in demutualization and integration would have to be addressed for their successful implementation.
35. These issues include who should take decision to demutualize and integrate the stock exchanges, compensation to members, composition of the future board of directors, moratorium period on grant of new trading rights, self listing of an integrated and demutualized exchange. The Committee has discussed each of these issues in the light of responses of different stakeholders and international precedents.

#### **Recommendations**

The Committee has recommended two models, Fully Integrated Demutualized Exchange and New National Stock Exchange.

#### **Model 1: Fully Integrated Demutualized Exchange (FIDE)**

36. The Committee recommends that KSE, LSE, and ISE should form a FIDE. With the integration of the exchanges, NCC, CDC, and NCEL shall become subsidiaries of FIDE.
37. Demutualization and integration should be effected under special legislation and the two should take place simultaneously. The decision for both demutualization and integration should be taken by SECP, as the two processes have implications on the interest of investors.
38. The process of simultaneous demutualization and integration requires that as a first step, a new demutualized company be incorporated and licensed as an exchange (NewSE). Financial institutions should be given 60% shares in the NewSE against cash. Members of the exchanges should be given 40% shares against consideration other than cash for the transfer of assets of KSE, LSE, and ISE to the NewSE. KSE, LSE, and ISE should cease to exist and the NewSE becomes FIDE. Financial institutions and members should disinvest 20% of their holdings in favour of general public and FIDE should get self-listed.
39. All existing members of KSE, LSE and ISE should be given trading right in FIDE, subject to fulfilling the legal and other requirements. Those who own more than one membership card should be given a single trading right. However, their compensation should be according to the number of memberships held. Since each member shall be given a trading right in the new integrated and demutualized exchange, compensation to members is not for the trading rights but for the perceived ownership rights in the exchange.

40. A moratorium on grant of new trading rights should be placed for one year after demutualization and integration.
41. No one person should be allowed to hold, directly or indirectly, more than 5% of holding shares without prior approval of SECP. A person holding trading rights in FIDE should not be allowed to exercise voting rights, directly or indirectly, of more than 1% of total voting rights in a general meeting.
42. Employment in FIDE should generally be on a strict basis of merit. However, as between applicants for positions at FIDE who are assessed as equally capable of performing the role, preference could be given to existing staff of KSE, LSE, and ISE. FIDE should appropriately compensate the employees that might be made redundant.

**Model 2: National Exchange (NE)**

43. An alternative model is being recommended. If sufficient progress is not made towards demutualization and integration within one year, the NewSE, sponsored by financial institutions, should become National Exchange (NE) whether or not KSE or LSE or ISE merge into it.

**Critical Success Factors**

44. **The success of demutualization and integration shall depend on some critical factors. These are commitment by the SECP, commitment by the Government of Pakistan, participation and sense of ownership by financial institutions as shareholders and brokers in the new setup, fair compensation to the members of KSE, LSE, and ISE, quality of the first board of directors of FIDE or NE, and quality of the first CEO and key management personnel.**

## **1. Introduction**

Capital market plays a vital role in channelling savings of an economy into investments and lead to increased income, employment, and output for the country. In a developing country like Pakistan, the importance of capital formation through the capital market cannot be over emphasized.

Pakistan needs a securities exchange that facilitates capital formation by bringing together issuers and investors. This exchange should enjoy the confidence of all participants who should regard it as fair, efficient, and transparent. This exchange should function in line with international best practices and be internationally competitive so that it can also attract listing and capital from abroad.

Pakistan's economy is growing and the economic indicators are improving. The primary market is showing signs of recovery after many years of inactivity. The Government of Pakistan has embarked on a privatization program, which is successfully using the capital market. Economic growth offers opportunities for Pakistan's stock exchanges. These are opportunities that the country cannot afford to lose. To capitalize on these opportunities, the problems facing the exchanges have to be effectively addressed.

Globally, stock exchanges have undergone radical changes over the last twenty years. Technological developments have made it possible for a single exchange to provide geographically neutral trading, custody, and settlement services throughout a country regardless of its geographical spread. This has resulted in a string of integration and alliances of exchanges in many parts of the world.

Technological developments have also enabled successful operation of alternative trading systems like ECNs that have the potential of replacing the traditional stock exchanges.

Due to technological advancements and globalization, investors and issuers have greater freedom to move to markets that are more competitive. To be able to compete with other exchanges alternative trading systems and ECNs in terms of efficiency and fairness, stock exchanges need access to economic capital as well as an efficient decision making structure. At the same time, there have been increasing demands from regulators and the public that stock exchanges raise their standards of governance and provide equitable representation to all stakeholders in ownership and management

The mutual structure of stock exchanges, which was common among most of them for many years, became an obstacle to accessing economic capital and putting in place good governance structures that the exchanges needed. The result was that many exchanges in the world underwent demutualization.

The profound change in the exchange industry that started from the developed world has reached developing countries, including those located in South Asia. At the moment, stock exchanges are undergoing demutualization in India, while the matter is under serious consideration in Sri Lanka.

No longer is it unusual for an exchange to lose its listings and trading volumes to its competitors located in other countries. **It is important that implications of technological developments and global trends of cross border listing and trading through ATS for our stock exchanges are fully recognized by our stock exchanges.** Steps should be taken to ensure that our stock exchanges do not remain stagnant in the traditional mould while exchanges in other countries, including those in South Asia move forward by responding to the challenges. It is only natural that Pakistan, which has, for

some time, been actively trying to subscribe to international best practices in terms of market infrastructure and trading, should study the feasibility of demutualization and integration or transformation of its three stock exchanges.

It must be mentioned that while undertaking its assignment, the Committee has kept in view the fact that the process of demutualization and integration or transformation should not be considered as an end in itself but as a means to an end. **A demutualized and integrated structure should be considered only if it promises to address the problems being faced by Pakistan's stock exchanges today and help them perform their economic role more effectively.**

### ***1.1. Constitution of the Expert Committee***

The Committee was constituted by the SECP through a notification on February 17, 2004.

The Committee consists of four local members, three foreign members and a secretary, as under.

- Mr. Shamim Ahmad Khan, Former Chairman, SECP (Chairman of the Committee)
- Mr. Justice (R) Aamer Raza A. Khan, Retired. Judge, Lahore High Court
- Mr. Ebrahim Sidat, Country Managing Partner/CEO, Ford Rhodes Sidat Hyder & Co.
- Mr. Rashid Zahir, CEO, Saudi Pak Industrial and Agricultural Investment Company Private Limited
- Mr. Alan Cameron, Former Chairman, Australian Securities and Investments Commission now lawyer and company director, Deputy Chair, Sydney Futures Exchange
- Dr. Philip N. Pillai, Non-Executive Director, Monetary Authority of Singapore, Senior Partner Shook Lin & Bok
- Mr. Ashley Alder, Member and Executive Director, Securities and Futures Commission, Hong Kong
- Mr. Usman Hayat, CFA, FRM, Financial Consultant (Secretary to the Committee)

### ***1.2. Terms of Reference***

The terms of reference (TOR) of the Committee, as given by the SECP, are as follows:

#### **1.2.1. Demutualization**

To review and examine the present structure of stock exchanges in Pakistan and in that context examine the legal, regulatory and financial issues involved in demutualization of stock exchanges. Review and examination of stock exchanges would include:

- a) Form and ownership structure
- b) Management and administrative structure, including ceiling of shareholding and corporate governance norms regarding share ownership. Examination of the need to have public directors appointed on the Board or other mechanism to protect and promote public interest
- c) Regulatory framework, including SRO status, membership criteria and trading rights
- d) Effective ways to deal with issues relating to legitimate interest of all stakeholders
- e) Financial implications, such as identification of ways to deal with issues relating to rights of the employees of the existing stock exchanges, rights of the members of the existing stock exchanges particularly compensation against their seat value and their trading rights

### **1.2.2. Integration/Transformation**

To advise on the consolidation/merger and/or transformation of the stock exchanges in Pakistan and to examine the legal, regulatory and financial issues in respect thereof

- a) To examine the desirability and feasibility of consolidation/merger of stock exchanges in Pakistan keeping in view the aspects of competition/monopoly
- b) To examine the desirability and feasibility of transforming the stock exchanges in Pakistan into specialized exchanges
- c) To examine the legal and financial implications of consolidation/merger and/or transformation including identification of ways to address issues relating to rights of the employees of the existing stock exchanges, rights of the members of the existing stock exchanges particularly compensation against their seat value and their trading rights

### **1.2.3. Recommendations/Implementation**

To provide specific recommendations regarding demutualization, integration and/or transformation of the stock exchanges in Pakistan and formulate a plan of action for implementation of the same

- a) To recommend appropriate model(s) of demutualized exchange(s) and mode of consolidation/transformation after taking into account international standards and best practices in this regard and the peculiarities of the capital market in Pakistan
- b) To recommend measures to deal with possible conflicts of interest that may arise when a for-profit entity also performs regulatory functions especially if the exchange is self listed
- c) To recommend measures to ensure availability of adequate funding for regulatory function (including arrangements to manage default) in case of a for-profit making exchange
- d) To recommend a plan of action for implementation of its recommendations

### **1.2.4. Other Issues/Matters**

To consider and advise on any ancillary or incidental issues or any other matter(s) referred to it by SECP.

## ***1.3. Objective of Demutualization and Integration***

During its discussions with the representatives of SECP, the Committee has understood that the **objective of both demutualization and integration is to address many problems being faced by stock exchanges that do not allow them to effectively perform their economic role.** In this regard, the governance structure of the exchanges and **availability of financial resources necessary for technological development and human resource up gradation were identified as important issues.**

While the TOR indicates that decision for demutualization has already been taken in principle, the committee was required examine the question as to whether or not, integration of all three stock exchanges was feasible and desirable.

## ***1.4. Scope***

**The Committee has confined the scope of its study to KSE, LSE, and ISE** and has not considered PEX Limited, which was licensed as an ECN (with the status of an exchange) by SECP in 2003. The PEX was excluded from the scope because it is yet not operational and the matter of PEX Limited is subjudice.

## **1.5. Methodology Used by the Committee**

The Committee used the following methodology to cover its TOR.

### **1.5.1. Meetings with Stakeholders**

The Committee first prepared a list of important issues in the light of experience of demutualization and integration in foreign jurisdictions. This list of issues was used for consultation with the stakeholders.

The Committee met with the representatives of SECP to understand the point of view of the apex regulator particularly its rationale and objectives behind demutualization and possible integration/transformation.

Meetings with stakeholders were held in April and May 2004. The local members of the Committee met stakeholders in Karachi, Lahore, and Islamabad including members and management of KSE, LSE, and ISE. Table 1 shows the list of persons met by the Committee.

It was logistically not possible for the foreign members of the Committee to attend the meetings held with stakeholders. However, as regards deliberations of the committee, the Chairman remained in contact with the foreign members through e-mail. All the foreign members commented on the draft report and were generous in offering their views on specific issues that were referred to them. Dr. Phillip Pillai also attend two meetings of the Committee.

**Table 1: List of Persons Met by the Committee**

Serial #	Name	Date	Venue
1	Mr. Shahid Ghaffar, Commissioner SECP	March 30, 2004	SECP's Company Registration Office, Karachi
2	Mr. Arif Habib, Chairman KSE	March 31, 2004	
3	Mr. Moin Fudda, MD, KSE Mr. Yaqoob Memon GM, KSE Mr. Zafar Abdullan Deputy GM, KSE		
4	Mr. Firozuddin A Cassim, Member KSE		
5	Mr. Jahangir Siddiqui, Former Member KSE	April 1, 2004	
6	Mr. Ali Ansari, CEO AKD Securities, Member KSE		
7	Mr. Nasim Beg, CEO Arif Habib Investment		
8	Mr. Tariq Iqbal, Chairman and MD, NIT	April 6, 2004	NIT Office, Karachi
9	Mr. Samir Ahmed, MD LSE	April 12, 2004	SECP's Company Registration Office, Lahore
10	Dr. Yaser Mahmood, Member LSE	April 13, 2004	
11	Mr. Asim Zafar, CEO Zafar Securities, Member LSE		
12	Group Capitan (R) Naeem Khan, Member LSE		
13	Mr. Asif Baig Mirza, Member LSE		
14	Mr. Tabussum Munir, CEO, MTM Securities, Member LSE		
15	Mr. Habibullah Sheikh, Member LSE	May 4, 2004	SECP's Head Office, Islamabad
16	Mr. Mian Mohammad Akram, Member ISE		
17	Mr. Abdul Waheed Jan. Member ISE		
18	Mr. Omer Iqbal Pasha, Chairman and Member ISE		
19	Mr. Zahid Latif Khan, CEO Zahid Latif Khan Securities Limited, Member ISE		
20	Mr. Chaudree Iftikhar, Member ISE		
21	Mr. Asim Bhatti, CEO, Millennium Securities, Member ISE	May 17, 2004	Saudi Pak Tower, Islamabad
22	Mr. Aftab Ahmad Chaudree, MD ISE		
23	Mr. Hanif Jakhura, CEO, CDC and NCC	June 7, 2004	SECP's Head Office, Islamabad
24	Mr. Muhammad Amjad Khan, Head of IT, NCEL	June 8, 2004	

### 1.5.2. Consultation through Questionnaire

In addition to meetings, the Committee used a questionnaire for more broad based and focused consultation. The questionnaire was devised on the key issues, which were likely to surface in demutualization, transformation, and integration of stock exchanges. Final questionnaire circulated by the Committee is at Annexure A.

The questionnaire approach helped gather better thought-out written input and provided an opportunity to a large number of stakeholders to express their views, whom the Committee could not have met due to time constraints

The questionnaire was sent to each member of the three exchanges, key management personnel of the exchanges, listed companies, asset management companies, investment banks, commercial banks, non-member nominated directors of the stock exchanges, and various professional bodies. The questionnaire was also sent to the State Bank of Pakistan, NIT and ICP. The questionnaire was also placed on the websites of SECP and KSE providing an opportunity to all stakeholders to give their views to the Committee.

A total of 52 responses were received. **The Committee would like to point out that many responses received were of a high quality and reflected understanding of the rather complex issues.** The views expressed in the responses to the questionnaires have been taken into account by the Committee and are reflected in this report. Table 2 gives the list of stakeholders who responded to the questionnaire sent by the Committee.

Serial Number	Table 2: List of Stakeholders who responded to the Questionnaire
	<b>Members of KSE</b>
1.	Alfa Adhi Securities (Pvt) limited
2.	Amin Issa Tai
3.	Ample Securities (Pvt) limited
4.	Bawa Securities (Pvt) limited
5.	Jahangir Siddiqui Capital Market (Pvt) Ltd
6.	Lakhani Securities (Pvt) limited
7.	Mac Securities (Pvt) limited
8.	Moosani Securities (Pvt) limited
9.	Muhammad Munir Muhammad Ahmed Khanani
10.	Muhammad Saddiq Suleman
11.	Munaf Sattar Securities (Pvt) limited
12.	Salim Chamdia Securities (Pvt) limited
13.	Sun Securities (Pvt) limited
14.	Westminister & Eastern Financial Services Limited
	<b>Members of LSE</b>
15.	Asif Baig Mirza
	<b>Members of ISE</b>
16.	Ch. Iftikhar Ahmed

17.	Mian Muhammad Akram
18.	Omer Iqbal Pasha
19.	Black Stone Equities (Pvt) Ltd
20.	Syed Masood Shaukat
	<b>Listed Companies</b>
21.	Burma Oil Mills Limited
22.	East West Insurance Co. Ltd
23.	Fauji Fertilizer Bin Qasim Ltd
24.	ICI Pakistan
25.	Kohinoor Textile Mills limited
26.	Kohinoor Weaving Mills Limited
27.	Lease Pak Limited
28.	Maple Leaf Cement Factory Limited
29.	Millat Tractors Limited
30.	Muslim Commercial Bank of Pakistan
31.	National Bank of Pakistan
32.	Pakistan International Container Terminal Limited
33.	Pakistan PTA Limited
34.	Shell Pakistan Limited
35.	Siemens Pakistan Engineering Co. Limited
36.	Standard Chartered Modaraba
37.	Wah Nobel
38.	Orix Investment Bank
39.	Pakistan Industrial Credit and Investment Corporation
	<b>Investment Management Companies</b>
40.	ABAMCO Limited
41.	Atlas Asset Management Company Limited
42.	Investment Corporation of Pakistan
43.	National Investment Trust Limited
	<b>Professional Bodies</b>
44.	Institute of Chartered Accountants of Pakistan
45.	Investment Bank Association of Pakistan
46.	Leasing Association of Pakistan
47.	Modaraba Association of Pakistan
48.	Mutual Fund Association of Pakistan
49.	Overseas' Investors Chamber of Commerce and Industry
	<b>Regulatory Bodies</b>
50.	State Bank of Pakistan
	<b>Others</b>
51.	National Commodity Exchange Limited
52.	Nessar Ahmed, former President, Cresbank

### **1.5.3. Internal Meetings**

The Committee held 6 internal meetings as detailed in Table 3.

After the first round of consultations, an interim report was submitted to the SECP on May 14, 2004. The interim report highlighted key issues and points of view of different stakeholders met by the Committee.

Preparation of draft report was initiated in June 2004. The first draft report was submitted to all committee members on July 3, 2004. The draft report was amended in the light of the suggestions given by the members of the Committee in the meetings held on July 9, 2004 at Islamabad and August 19-20, 2004 at Karachi. The final meeting was held on September 2, 2004 in Islamabad.

Although the Committee was required to submit report by end of August, the Committee was constrained to seek extension from SECP as more time was required for careful deliberation of the issues involved.

<b>Table 3: Internal Meetings of the Committee and Record of Attendance</b>						
<b>Participants</b>	<b>Date and Place of Meeting</b>					
	<b>1 Islamabad Mar 6</b>	<b>2 Islamabad May 17</b>	<b>3 Lahore May 29</b>	<b>4 Islamabad July 9</b>	<b>5 Karachi August 19-20</b>	<b>6 Islamabad September 2</b>
Mr. Shamim Ahmad Khan (Chairman)	Attended	Attended	Attended	Attended	Attended	Attended
Justice (R) Aamer Raza	Attended	Attended	Attended	Attended	Attended	Attended
Mr. Rashid Zahir	Attended	Attended	Attended	Attended	Could not Attend	Attended
Mr. Ebrahim Sidat	Could not Attend	Attended	Could not Attend	Attended	Attended	Attended
Mr. Alan Cameron	Could not attend any meeting					
Mr. Ashley Alder	Could not attend any meeting					
Dr. Philip Pillai	Could not Attend	Could not Attend	Attended	Attended	Could not Attend	Could not Attend
Mr. Usman Hayat (Secretary)	Not Applicable	Attended	Attended	Attended	Attended	Attended

## **2. An Overview of Stock Exchanges**

There are three stock exchanges in Pakistan, KSE, LSE and ISE. KSE was formally established in 1949, LSE in 1970, and ISE in 1989. Their combined market capitalization as of May 31, 2004 was Rs 1489 billion or US \$25 billion. The companies, which have both large capitalization and high turnover, are listed on all three exchanges. The dominant market share of combined market capitalization and turnover is that of KSE, followed by that of LSE and ISE. In 2003, KSE has contributed to almost 81% of total turnover in the regular market whereas LSE and ISE have contributed to 17% and 2% at ISE.<sup>1</sup>

Practically, the three exchanges are Self Regulatory Organizations (SRO), i.e. they are front-line regulators whereas the SECP is the apex regulator.

### **2.1. Corporate Structure**

Stock exchanges are registered as companies limited by guarantee under the Companies Ordinance 1984 and licensed and regulated as stock exchanges by the SECP under the Securities and Exchange Ordinance 1969. The three exchanges are mutual bodies in which trading rights of members are embedded with ownership rights. It implies that when a person acquires membership of a stock exchange by buying a membership card, also referred to as a “seat”, he obtains perceived ownership right as well as the right to become a broker subject to the relevant laws.

All three exchanges are not for profit companies and their assets can only be distributed to members in case of winding up. Clause 50 (XXIX) of the Memorandum of Association of KSE states:

“That the income and property of the Exchange whensoever derived shall be applied solely towards the promotion of the objects of the Exchange as set forth in the Memorandum of Association and no portion thereof shall be paid or transferred directly or indirectly by way of dividend or bonus or otherwise, however by way of profit to the persons who at any time are or have been Members of the Exchange or to any of them or to any person claiming through any of them except in the case of winding up of the Exchange.”

LSE and ISE have almost identical clauses in their Memorandums of Associations.

### **2.2. Core Stakeholders**

Following is a brief overview of three core stakeholders in the stock exchange: investors, listed companies, and members/brokers.

#### **2.2.1. Investors**

The most important stakeholders in any exchange are the investors. In case of Pakistan, the number of investors remains very small, though in recent years substantial numbers of investors have been attracted to the market. The gross number of shareholders in all listed companies, directly or through

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<sup>1</sup> The market share of KSE includes the trading passed on by the brokers of ISE and LSE to the brokers of KSE.

mutual funds, is about 2 million<sup>2</sup> as of May 31, 2004. This number includes both individuals and institutions.

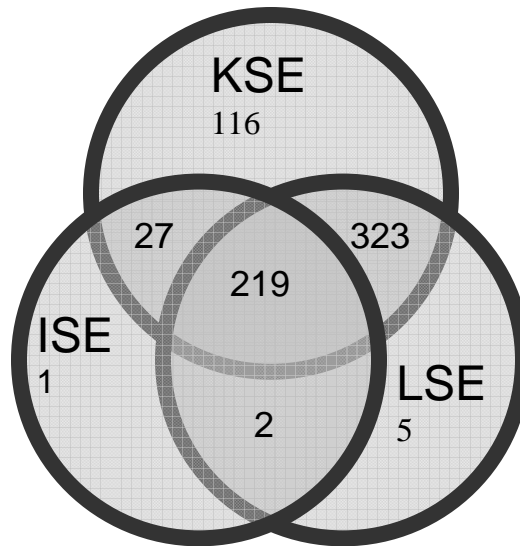
Major investors in the stock market are mutual funds. As of May 31, 2004, there are 9 asset management companies, 30 closed-end mutual funds, and 11 open-end mutual funds that invest in equities.

### **2.2.2. Issuers**

The total number of listed companies, i.e. those companies whose ordinary shares are listed on a stock exchange, is 693 as of May 31, 2004. In addition, there are 54 TFC and 4 preference shares listed on KSE and LSE.

There is substantial overlap in listed companies across the three exchanges. Figure 1 shows that the number of listed companies that are listed on all three exchanges is 219. Those only listed at KSE, LSE, and ISE are 116, 5, and 1 respectively.

Figure 1: Overlap in Listed Companies



Source: KSE, LSE, and ISE

### **2.2.3. Members and Brokers**

According to their Articles of Association, each of the three exchanges can have maximum of 200 members each. Membership cards are transferable and can be freely bought and sold. New memberships can be auctioned by the exchange. Both corporate entities and individuals can become a member of the stock exchange.

<sup>2</sup> According to KSE, gross number of shareholders in listed companies, as of May 31, 2004, is 1.9 million and according to Non Bank Finance Division of SECP, number of unit holders in those mutual funds that invest in equities, as of May 31, 2004, is 59,738

In order to trade, a member of a stock exchange has to register himself as a broker with the SECP. Currently, there are 468 members and 286 brokers. There is an overlap in both members and brokers across three exchanges. About 25 members have membership of more than one exchange. Presently while there are 200 members in KSE, meeting the maximum limit, only 151 and 117 memberships have been allowed so far by LSE and ISE respectively. The limit on the maximum number of members and policy of gradual release of membership seats creates scarcity value of memberships. There is a tendency on the part of some, to treat acquisition of membership seat as long-term investment. This has created a class of inactive members, who do not seek registration as brokers. Presently the number of inactive members in KSE, LSE and ISE is 41, 67 and 74 respectively.

### **2.3. Board of Directors**

There are ten directors on the board of each exchange.<sup>3</sup> Five are elected by members while four are non-member directors who are nominated by SECP. The Chairman of the board is elected from amongst the member directors. The Managing Director (MD) is a director by virtue of his office. The MD is appointed by the board of directors subject to the approval of SECP and removal also requires approval of SECP. Induction of independent MD was initiated in 1997. Prior to that, stock exchanges were managed exclusively by members and the elected president from among the members, functioned as CEO of the exchange.

### **2.4. Trading, Custody, and Settlement**

Trading of listed securities at all three exchanges takes place through automated continuous open auction trading in a T+3 rolling settlement cycle with a peculiar COT (badla) facility. Each exchange has its own independent trading system that is not linked to the trading system of other exchanges. All three exchanges disseminate trading data through their websites.

Custody services are being provided by a modern depository, the CDC. The shareholders in the CDC are the three stock exchanges and some financial institutions. More than 450 listed entities have their securities in book entry form. In addition to providing custodial services, CDC also acts as trustee for mutual funds.

Clearing and Settlement services are being provided by the NCC. This is a limited company owned by the three exchanges and one Development Financial Institution. It acts as a central and geographically neutral clearinghouse for all the three exchanges for book-entry securities. Both the CDC and NCC are serving all three stock exchanges. The NCC only performs the function of clearing and settlement and presently risk management is not with them. Risk management is being done at the three stock exchanges separately and there is no formal arrangement between stock exchanges and NCC regarding settlement of trades.

### **2.5. Traded Instruments**

The exchanges trade three types of instruments,

- i. Equities, ordinary and preference (Regular/cash market)
- ii. TFC (Regular/cash market)
- iii. Single Stock Futures.

Most of trading takes place in equities in the T+3 market segment. The combined average daily turnover of equities in the regular market in Jan-May 2004 was approximately 530 million shares.

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<sup>3</sup> The board of directors was last restructured by the SECP in August 2002.

Activity in stock futures is essentially confined to KSE. The average daily turnover of futures at KSE during January to May 2004 was about 30 million shares.

Virtually no trading takes place in listed TFCs at any exchange.

### ***2.6. Financing of Trading***

The market is leveraged by *Badla* financing, also known as Carry-over financing. This is a unique form of post trade financing in which funds are routed to speculators by lenders through continuous open auction trading after the close of the regular market.

The combined average *Badla* financing in January to May 2004 was Rs 21 billion. Like trading in regular and futures market, more than 80% of *Badla* financing takes place at KSE.

### ***2.7. Management of Settlement Risk***

Settlement risk is being managed by each exchange independently. The key instruments of risk management are margin deposits, clearinghouse protection fund, investor protection fund, circuit breakers or intra day price limits, capital adequacy, and market monitoring.

### ***2.8. Corporate Governance***

In order to raise the standards of corporate governance, a Code of Corporate Governance was introduced in 2002. The Code is a part of Listing Regulations of the exchanges. The Code deals with most of the key governance issues, such as disclosure, structure and role of the board of directors, and different internal and external controls.

### ***2.9. Developments in the Capital Market***

Opening of Pakistani's stock markets to foreign investors in 1991 heralded a series of reforms involving liberalization of capital market regulatory policies, improvements in quality of intermediation, and up-gradation of market infrastructure. Corporatization of brokerage proprietorships through fiscal incentives has improved brokerage services. In terms of product development, introduction of corporate bonds in the form of TFC was an extremely significant development which also entailed development of other institutions like credit rating agencies and trustee companies. Issuance of Asset Management Companies Rules in 1995 and liberalization of Investment Companies Rules opened the door for development of mutual funds in the private sector.

Repeal of Control of Capital Issue Act in 1995 was an important milestone in the process of liberalization of policies governing capital market. The repeal of the Act brought to an end forced listing of companies on reaching the prescribed threshold of paid up capital, administrative control on pricing of IPOs as well as cap on underwriting and take up commission. These changes unleashed many other developments in the market.

In 1997, automated continuous open auction trading replaced the open outcry system at KSE. During the same period, the CDC started its operations, which substantially increased efficiency of trading by providing dematerialization of securities.

During the last five years, particularly since the establishment of SECP in 1999, the reform process gained further momentum. Most of the reforms focused on risk management, governance, investor protection, and market development.

In risk management, the weekly settlement has been replaced with rolling T+3 settlement. Margin deposits have been strengthened, capital adequacy has been introduced, and circuit breakers have been redesigned. Measures have been taken to fully fund the Clearinghouse Protection Fund.

As regard governance, the size of board of directors of the stock exchanges has been reduced to 10. Four directors are nominated by the SEC while five are elected by the general body. The Managing Director is a member of the board by virtue of his office.

For investor protection, arbitration procedures have been streamlined, investor complaints are actively addressed, Investor Protection Funds are in the process of being fully funded, and a standardized account opening form has been implemented. To check front running, system of undisclosed trading has been introduced under which the identities of transacting brokers are not disclosed to other brokers. Blank selling has been banned and is replaced by regulated short selling.

In market development, settlement of trades executed at all three exchanges is now being done by the NCC. For safekeeping of their securities, investors are being provided Investor Account services directly by the CDC. Stock Futures are being traded since 2001 and *Badla* financing is being replaced by Margin Financing.

### ***2.10. Market Sentiment***

The market has shown bullish trend in recent years. In 2002, KSE-100 index rose 112%. Based on this extraordinary rise, *Business Week*, an international magazine, declared KSE as the best performing market in the world. In 2003, KSE-100 index rose by another 60%.

The turnover has also been on the rise. The average daily turnover at KSE rose from 167 million shares in 2002 to 309 million shares in 2003.

The sentiment continues to remain bullish in 2004, and the index has risen by 23% by May 31, 2004 and the average daily turnover at KSE during January-to-May has exceeded 425 million shares.

### **3. Problems of Stock Exchanges**

As stated earlier, extremely significant developments have taken place in Pakistan's capital market during the last ten years. Some reforms like the introduction of Code of Corporate Governance, implementation of automated trading and risk management measures have had profoundly positive impact on the market. However, despite these highly positive developments, Pakistan capital market continues to reflect some serious weaknesses and problems which need to be addressed to achieve materialization of the full potential of the market and to ensure that the market plays its economic role effectively.

Since the objective of demutualization and integration or transformation is to address these problems, the Committee, during its consultative process, discussed in detail the problems and weaknesses of the stock exchanges in the context of the objectives of a stock exchange, which are to:

- facilitate capital formation by channeling savings into investments
- provide liquidity and price discovery for listed securities
- manage systemic risk to safeguard market integrity
- protect investors from market abuse, such as price manipulation and insider trading
- act as a front line regulator for brokers and listed companies
- develop market by offering investors new products and services

Following is a detailed discussion of the problems and weaknesses of our stock exchanges.

#### ***3.1. Insufficient Growth in Market Capitalization***

Stock exchanges have not been able to play their due role in capital formation.

##### **3.1.1. Market Size below International Benchmark**

Market size is small even after adjusting for the size of our economy. As of May 31, 2004, the market capitalization was Rs 1488.6 billion or about US \$25 billion, which is about 35% of the Gross Domestic Product (GDP)<sup>4</sup> of Pakistan. This is below the generally accepted international benchmark of 100%.

Table 4 shows the market cap and GDP ratios for the members of the World Federation of Exchange (WFE) located in Asia Pacific in 2002. Most of the WFE members had a market cap to GDP ratio greater than that of Pakistan, which at that time was Rs 595.2 billion or only 16% of the GDP.

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<sup>4</sup> According to Economic Survey 2003-04, the GDP of Pakistan at factor cost was Rs 3705.7 billion for 2001-02, Rs 3895.2 billion for 2002-03, and Rs 4044.3 billion for 2003-04.

<b>Table 4: Comparison of Market Size in 2002</b>		
	Market Capitalization US \$ billion	% age of Market Cap to GDP
Hong Kong	463.1	287%
Kuala Lumpur	122.9	130%
Singapore	101.5	114%
Taiwan	261.3	93%
Australian	380.1	92%
Tokyo	2,069.3	50%
Korea	216.1	43%
Osaka	1,491.9	36%
Thailand	45.4	36%
New Zealand	21.7	32%
Mumbai	130.4	27%
Shanghai	306.4	25%
NSE India	112.5	24%
Philippine	18.2	24%
Jakarta	30.1	17%
Shenzhen	156.6	13%
Colombo	1.7	10%
Source: The WFE Annual Report, 2003		

### 3.1.2. Too Few Listings

Too few companies are listing on the exchanges. From January 1999 to May 2004 only 17 companies were listed at KSE whereas the number of companies which got delisted through buy back of shares during the same period was 36, i.e. for every one company listed, more than two had delisted as shown in Table 5.

<b>Table 5: Listing and Delistings at KSE</b>							
	1999	2000	2001	2002	2003	2004 Jan-May	Total
New Companies Listed through public offer (excluding funds)	0	3	3	4	4	3	17
Voluntary Delistings through share buy back	5	3	5	9	8	6	36
Source: KSE							

Different reasons are given to explain the low level of new listings and increase in delistings. These include:

- There has been slow industrial growth

- Many of the large companies suitable for listing are in the public sector.
- Tax incentives for listed companies are being gradually withdrawn, doing away with preferential tax treatment of listed companies.
- Due to lower interest rates, companies can raise expensive capital from traditional creditors - banks and development finance institutions - rather than capital market.
- A strict Code of Corporate Governance has been implemented that companies are finding cumbersome to comply with.
- A large number of companies listed in the mid nineties failed to meet investor expectations.

While the reasons cited are valid, it is difficult to explain why new listings from private sectors are not coming even though economy, particularly manufacturing sector has experienced substantial growth in the recent years.

From Jan 2002 to May 2004, 150 new public companies and 3,733 private limited companies were incorporated, as given in Table 6, whereas number of new listings on KSE during this period was only 11. While it is understandable that the newly incorporated companies would take a few years to be able to seek listing, the comparative figures do indicate a trend of companies preferring to remain unlisted as the data given is of more than two years.

<b>Table 6: Registration of New Companies</b>			
	<b>2002</b>	<b>2003</b>	<b>2004</b> Jan to May
New Un-Listed Public Limited Companies	60	52	38
New Private Limited Companies	1262	1578	893

Source: Company Law Division, SECP

There are 2,107 unlisted public limited companies and 39,558 private limited companies as of May 31, 2004. Clearly, the currently listed companies make a small part of the universe of public and private limited companies.

In 2003, KSE had one of the lowest proportion of new listings, 0.44%<sup>5</sup>, compared to members of WFE in Asia Pacific, as shown in Table 7.

<sup>5</sup> At KSE, the number of new listings through a public offer, excluding funds, was 3 while there were 689 companies listed at the end of 2003, i.e. a ratio of 0.44%.

<b>Table 7: Comparison of Listings</b>			
	<b>Number of Companies Listed in 2003 (a)</b>	<b>Total Listed Companies as of Dec 31, 2003 (b)</b>	<b>Ratio (a)/(b)</b>
Singapore	59	551	10.71%
Shanghai	67	780	8.59%
New Zealand	16	196	8.16%
Australian	107	1471	7.27%
Hong Kong	73	1037	7.04%
Taiwan	47	674	6.97%
Thailand	27	418	6.46%
Kuala Lumpur	58	902	6.43%
Tokyo	120	2206	5.44%
NSE India	35	911	3.84%
Colombo	8	244	3.28%
Osaka	26	1140	2.28%
Philippine	5	236	2.12%
Korea	13	684	1.90%
Jakarta	6	333	1.80%
Mumbai	24	5644	0.43%

*Source: WFE Annual Report 2003*

The Committee is of the view that macro-economic and fiscal factors are only a part of the reason behind lack of new listings. An equally important reason behind inability of exchanges to attract new listings seems to be that potential issuers do not generally have a positive perception of the exchanges and they see little value addition through listing.

### **3.1.3. Low Quality of Many Listed Companies**

Not only the market size is small and new listings are too few in number, many listed companies are of low quality in terms of governance and financial performance.

It is estimated that atleast a third of listed companies do not raise any capital from capital market, are absolutely illiquid or extremely tightly held. As on May 31, 2004, there were 154 companies out of 685 companies, i.e. 22% of total companies that had been placed on defaulter's counter for violating the listing regulations of KSE. Moreover, in 2002, 15 companies were delisted from KSE due to liquidation or winding up under court order.

Most of these companies were probably listed at a time when listing criteria was rather lax and companies were being forced into listing by regulation if their paid-up capital exceeded a certain

level. It is frequently argued that such listed companies do not deserve to be listed and they should either be placed on a special counter or allowed an easy exit from the market.

### **3.1.4. Limited Free Float and Supply-Demand Imbalance**

Most of the listed companies are tightly held. The number of shares available for trading, i.e. free float is limited. There are definitional issues in free float and it has not been systematically measured. However, different estimates tend to converge that shares generally available for trading are at best 15% of total outstanding shares.

Currently, at the time of listing, a company with a paid-up capital of more than Rs 200 million is required to make a public offer of 25% of its shares or Rs 100 million, whichever is higher. For companies with a large paid-up capital, the capital publicly offered usually turns out to be well below 15% of total capital.

As of May 31, 2004, there are at least 60 companies that have less than 10% of their shares in book entry form. This also shows the limited size of free float as only shares in book entry form can be settled through National Clearing and Settlement System (NCSS).

The market has seen substantial growth in mutual funds, which is increasing pressure on the limited free float. From January 2002 to May 2004, 11 open end mutual funds were launched whereas only 12 public offers of equity were made. Most of these funds are launched by asset management companies that are associated with large brokerage houses.

## **3.2. Narrow Base of Investors**

Investors are the most important stakeholders in any stock exchange. However, investor base in Pakistan is extremely narrow.

### **3.2.1. Minimal Share Ownership**

As already stated, although the number of shareholders in the country is less than 1% of population, the number of active shareholders in our capital market is even smaller. This can be gauged from the fact that the total number of securities accounts in the CDC is only about 90,000.

According to the Australian Stock Exchange (ASX), a much larger proportion of adult population owns shares in the developed countries as shown in Table 8.

<b>Table 8: Shareowners as Proportion of Adult Population</b>	
<b>Country</b>	<b>2002*</b>
Australia	50%
United States of America	50%
Canada	46%
Switzerland	25%
United Kingdom	22%
Hong Kong	20%
Germany	18%
*Includes direct and indirect ownership through funds Source: Australian Stock Exchange (ASX)	

**3.2.2. Stagnation in Number of Shareholders**

Despite the record price boom, the number of shareholders in listed companies has not increased significantly. Table 9 shows trend in number of shareholders over last four years in selected fifteen companies, which are relatively broad-based and liquid.

<b>Company</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2000</b>
Pakistan Telecommunications Company	55,868	52,460	53,387	55,462
Muslim Commercial Bank	48,811	50,032	51,001	51,335
Dewan Salman Fibre	20,301	21,064	17,077	2,126
Sui Northern Gas Pipelines Company	18,466	20,646	21,027	20,593
I.C.I Pakistan	17,431	19,548	20,531	23,052
Hub Power Company	17,260	19,456	Not Avlble.	16,999
Pak PTA	17,356	19,273	20,789	Not Listed
FFC Jordan Fertilizer	13,239	16,627	19,418	20,133
Pakistan State Oil Company	14,439	13,407	13,555	13,721
Askari Commercial Bank	12,878	13,463	11,592	11,921
Faysal Bank limited	12,020	14,326	12,125	12,553
Karachi Electric Supply Corporation	11,993	11,579	10,660	9,845
Nishat Mills	10,723	11,344	11,899	11,768
Maple Leaf Cement	9,615	10,368	11,137	10,427
Engro Chemical Pakistan	9,609	8,624	9,128	8,329

Source: Annual Reports; Data as of end June/September/December

The data shows that there is no significant growth in number of shareholders in these companies.

### **3.2.3. Small Number of Unit Holders in Mutual Funds**

In recent years, mutual funds have increased in number and size. The total assets of the open-end mutual funds that invest in equities were Rs 68 billion or about 5% of total capitalization as of May 31, 2004. Despite growth in their number and size, private sector mutual funds that invest in equities have not helped expansion of investor base.

Table 10 shows that NIT, a public sector mutual fund, has 90% of unit holders and 80% of assets. The number of unit holders in funds other than NIT is less than 2,000, i.e. even below the average number of shareholders in a small cap company.

<b>Table 10: Unit Holders in Open End Mutual Funds</b>			
	<b>Mutual Fund</b>	<b>Size of fund in Rs. Million as on May 31, 2004</b>	<b>Number of Unit Holders as on May 31, 2004</b>
1	National Investment Trust	54,216	53,549
2	Pakistan Stock Market Fund	1,007	1,518
3	Pakistan Income Fund	3,336	1,419
4	Meezan Islamic Fund	1,258	1,112
5	Unit Trust of Pakistan	3,202	731
6	UTP- Islamic Fund	669	723
7	UTP – Income Fund	1,324	289
8	MetroBank Pakistan Sovereign Fund	493	198
9	Crosby Dragon Fund	378	86
10	Atlas Income Fund	373	81
11	Faysal Balanced Growth Fund	2,027	32
	<b>Total</b>	<b>68,283</b>	<b>59,738</b>
Source: Non Bank Finance Companies Division, SECP			

### **3.2.4. Lack of the Market Awareness**

Most Pakistanis, particularly those who live outside major cities, are unaware of what capital market is and what benefits they can derive from these markets. Moreover, no significant measures have been taken by exchanges to educate investors.

### **3.2.5. Public Offers Essential to Broad Investor Base**

The only measure that is increasing awareness of the public in the market are the public offers, particularly those of large public sector companies. The policy of the Government, of privatization through public offers, is helping expand the investor base. Retail investors are now subscribing shares in public offers in large numbers. Applications in the minimum subscription lot are being given preference and often the entire issue is taken up by those applying for the minimum lot. Table 11 provides details of equity offers from January 2003 to May 2004.

<b>Table 11: Equity Public Offers</b>			
January 2003 to May 2004			
<b>Name of Company</b>	<b>Offered Capital Rs million</b>	<b>Subscription Received Rs million</b>	<b>No of Applications Received</b>
Bank Alfalah Limited	400.00	11,610.94	374,845
Sui Southern Gas Co. Ltd*	671.17	13,000.99	258,089
Oil & Gas Development Co. Ltd.*	2,150.46	28,120.78	97,570
Callmate Telips Telecom Ltd.	150.00	557.93	94,484
World Call Broad Band Ltd.	300.00	1,976.06	75,429
Pakistan Intl. Container Terminal Ltd.	160.00	1,340.68	72,946
Mac Pac Films Ltd.	100.00	473.61	52,821
Southern Network Ltd.	150.00	130.43	22,658
TRG Pakistan Limited	600.00	1,121.92	15,134
First National Bank Modaraba	100.00	121.14	3,231
National Bank of Pakistan*	131.310	1,222.302	2,279
Ittehad Chemicals	62.500	71.122	630
<b>Total</b>	<b>4,975.45</b>	<b>59,747.89</b>	<b>1,070,116</b>
*Offer for Sale by Government of Pakistan Source: Securities Market Division, SECP			

### **3.3. Lack of Balance in Governance Structures**

In its consultations with stakeholders, the Committee has found that the governance structures at the exchanges lack balance among stakeholders.

#### **3.3.1. Weak Professional Management**

It appears that professional management at the exchanges has not been encouraged by the members. It was in 1997 that Corporate Law Authority (CLA), predecessor of SECP, directed KSE to appoint an independent Managing Director (MD). Till then, a President elected from among the members acted as the CEO of the exchange. A General Manager (GM) took care of day to day operations.

It appears that members have been slow to accept an independent MD. Minutes of the board meetings show that the board of directors often discusses matters that need to be left to the management. KSE, LSE, and ISE have a number of committees comprising largely or exclusively of members of the exchanges. Many important executive matters are referred to these committee which results in diluting the powers of the management. While the number of committees has reduced over the years, they continue to play role of management in important areas of governance.

It is perceived that many a time decisions at the exchanges are taken to further the interests of the brokers at the cost of interest of other stakeholders. There are many instances that seem to support this view.

### **3.3.2. Ineffective Regulation of Members**

There appears to be unwillingness on the part of members to take disciplinary action against other members, for violation of regulations. Information received from exchanges shows that it is rare that they take disciplinary action against any member. Nor do they carry out investigations to determine whether or not any member was involved in violation of its regulations. There is a generally held view that as compared to their regulatory functions, the members accord higher priority to the commercial interest of its members.

### **3.3.3. Ineffective Regulation of Listed Companies**

Due to governance problems and poor perception of stock exchanges, listed companies are unwilling to accept stock exchanges as front line regulators.

In the recent past there have been some cases in which listed companies failed to make proper disclosure of material information to KSE. In each of these instances, confusion and panic was caused in the market. Despite the bad publicity that the exchanges received due to these incidents, there was little that they could do against the companies that had apparently violated listing regulations.

Exchanges also do not enjoy sufficient powers over listed companies. The only action that an exchange takes against a listed company is to put it on defaulters counter or de-list. It can also seek liquidation of a company through court. However this alternative is too extreme to be practicable in most cases and can hurt the interest of investors.

### **3.3.4. Unequal Access to Corporate Announcements**

All investors should have equal access to corporate announcements. Brokers, however, have maintained privileged access to corporate announcements.

Corporate announcements have a strong impact on the price of a listed security and often those who have a privileged access to information benefit at the cost of those who were not informed at the same time.

### **3.3.5. Mixed Performance of Non-Member Directors**

Non-member directors have been represented on the board of directors of stock exchanges for a number of years. After the last restructuring in 2002, SECP nominates four non-member directors out of ten directors on the board of directors of each exchange.

Appointment of nominated directors has brought an improvement in governance but less than what was expected. Stakeholders are largely of the view that the performance of nominated directors has been rather mixed. While some nominated directors have made a significant contribution to deliberations in the board meetings and thus helped the quality of governance, others have not. Record of attendance of board meetings shows that on the average, non-member directors have attended fewer meetings than member-directors in all three exchanges.

Stakeholders have cited a number of reasons behind the mixed performance of nominated directors:

- i. Since there are five member directors compared to four non-member nominated directors, the latter are in a minority at the board and cannot play an effective role.

- ii. They are not genuine stakeholders and their interest in the affairs of stock exchanges is limited.
- iii. They do not have sufficient knowledge of the affairs of the exchange to be able contribute effectively.
- iv. The term of a director - one year - is too short to develop necessary understanding of issues.
- v. Often emergency meetings are convened on a short notice making it difficult for nominated directors to attend.
- vi. They are not given adequate compensation for attending board meetings and therefore, there is insufficient incentive for them to spend time on matters of the exchange.
- vii. They are often busy in their own work and interests and cannot devote enough time to the exchange even if they were to be compensated adequately.
- viii. They are perceived to be “SECP directors” who merely follow directions of the SECP rather than take decisions on merit.
- ix. Some of them have conflict of interest, particularly the fund managers.

### ***3.4. Fragmentation of Market***

Existence of three exchanges has fragmented the market place, causing a number of problems.

#### **3.4.1. Division of Liquidity and Distortion of Price Discovery**

Since companies listed on the three exchanges overlap, existence of three exchanges has fragmented the liquidity pool to the disadvantage of all stakeholders.

Every day, investors see three different prices for the same security on three exchanges. Arbitrageurs instantly capitalize on the price differences appearing during trading hours. But differences in prices of the same securities tend to become most apparent in closing prices. When three varying closing price of the same security are published in newspapers, it leads to confusion in the minds of investors.

#### **3.4.2. Cost Inefficiency for All Stakeholders**

Stakeholders have argued that the three exchanges are duplicating resources and merely adding costs for everyone.

- i. When brokers of ISE or LSE trade through brokers of KSE, investors have to pay higher commission. The CDC charges are doubled, as securities have to move in and out of securities accounts of two participants. The commission charged by ISE and LSE brokers are also higher because of lower volume and some additional costs of routing their trades through brokers at KSE. For instance, brokers at LSE and ISE tend to maintain contact with the brokers at KSE through cell phones that remain operational through the trading hours. Eventually, it is the investor who bears this burden of increased costs of trading.

- ii. A listed company that is listed on all three exchanges has to pay three listing fees. More importantly, multiple listings add to their cost of compliance. For instance, they have to file each set of documents thrice, make each corporate announcement thrice, and devote substantially more managerial time to compliance than they would have had to, if they were listed on only one exchange.

Even though multiple listings increase cost and hassle for listed companies, LSE and ISE resist decision of companies to seek voluntary delisting, if such companies wish to remain listed only on KSE.

- iii. Each exchange is maintaining its own infrastructure thus duplicating resources. Duplication takes place in both running costs and capital expenditure. To maintain independent trading infrastructure, each exchange has to make capital expenditure independently. Often the same issues are deliberated in three exchanges independently, involving loss of managerial time.
- iv. Brokers who are trading at more than one exchange have to comply with rules and regulations of three exchanges and incur additional costs.
- v. Existence of three exchanges also adds to the cost of supervision and regulation by the SECP.

### **3.4.3. Complexity in Operations**

The regulations and operations of the three exchanges differ in important aspects. For instance, exposure slabs and margin collections are different for each exchange. These differences are a source of complexity that adds to costs and obstructs developments.

International exchanges are developing at a fast pace. Massive resources are being committed to implement Straight-Through-Processing (STP) to maximize efficiency. Settlement cycles are being reduced from T+3 to T+1. Instead of netting trades at broker level, netting in some exchanges is being done at client level. New ways of trading and settlement are being developed. Such developments would be difficult to initiate in Pakistan if multiple stock exchanges continue to exist.

### **3.4.4. Lack of Inter-exchange Competition**

A natural benefit of having more than one exchange is inter-exchange competition. There has been some competition between LSE and KSE in the past. LSE was first to automate its trading and provide the facility of remote access terminals. These IT initiatives by LSE put strong pressures on other exchanges to follow suit. LSE also took some other competitive measures such as after-hours trading and attracting TFC listings by lowering listing fee.

However, on the whole, such initiatives have been few and far between. In the recent years, there has been virtually no competition among the three exchanges.

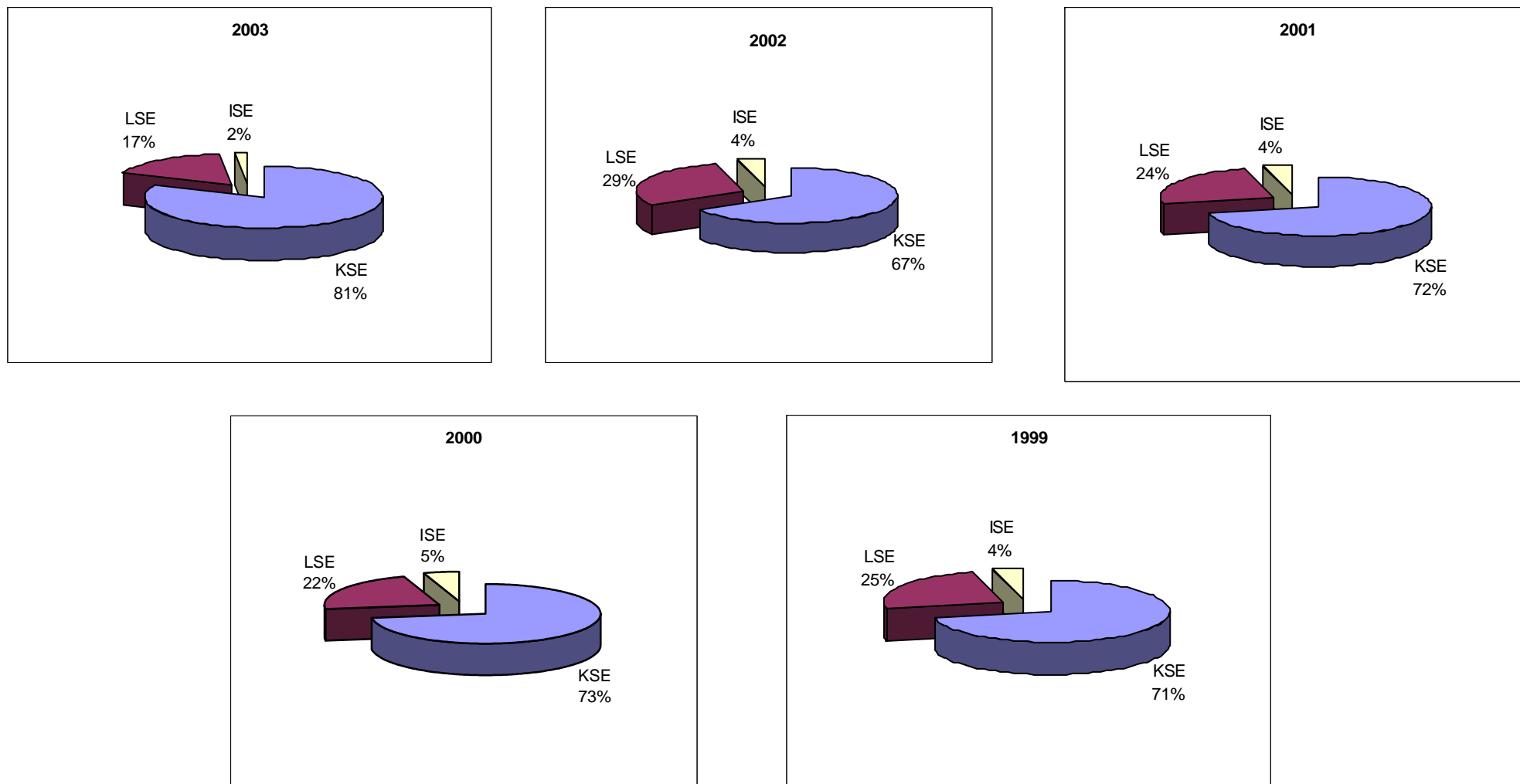
KSE is clearly the dominant and unchallenged exchange with the highest number of listed companies and largest share of turnover. This is evident from the trend in turnover over the years. In 1999, the share of KSE in the combined turnover was 71%, LSE 25%, and ISE 4%. In 2003, the share of KSE has increased to 81%, while that of LSE and ISE has decreased to 17% and 2% respectively, as shown in Figure 2.

LSE and ISE seem both unwilling and unable to compete with KSE. In most cases of development of regulations and products, LSE and ISE merely follow KSE.

Stakeholders have identified the following factors that explain the inability of LSE and ISE to compete with KSE.

- i. KSE is located in Karachi, which is the financial center of Pakistan. It has a natural advantage in attracting business particularly that from funds and financial institutions.
- ii. Brokers at ISE and LSE often trade through brokers at KSE. Their dependence does not allow ISE or LSE to compete with KSE. LSE and ISE also do not have the economic and human resources required to engage in any sustainable competition with KSE.
- iii. There could be a fear that any attempt at competition with KSE might result in KSE providing its trading terminals directly in Lahore and Islamabad. Members of KSE could also open branch offices in these cities, thus eroding the business and value of membership cards at both the exchanges.
- iv. A number of members of KSE are also members of LSE and ISE. As their primary economic interest is linked to the membership at KSE, it is natural that as members of LSE and ISE they would not endorse any move involving competition with KSE.
- v. Members of LSE and ISE have mentally accepted the permanent leadership role of KSE and do not have the motivation to compete.

Figure 2: Share of Turnover of KSE, LSE, and ISE 1999-2003



Source: Annual Reports of KSE, LSE, and ISE

### 3.5. *Inadequate Investor Protection*

Investors are not satisfied with the degree of protection received from the stock exchanges as front line regulators.

Allegations of price manipulation, insider trading, front running, blank selling and other forms of market abuse abound. There are a number of laws, rules and regulations pertaining to market abuse but there is little evidence to show significant effort to enforce these. Allegations of price manipulation are most frequent in provisional trading.

Stakeholders have stated that trading and custody lack transparency in many areas. Proprietary trading is not distinguished from that done for the clients. Almost 9% of the total listed securities are in group-accounts, where record of identity of beneficial owners is only accessible to brokers.<sup>6</sup>

<b>Table 12: Securities and Securities Accounts in the CDC</b>			
As of May 31, 2004			
	Number	Proportion of Listed Capital in Book-entry form <sup>7</sup>	Proportion of Market Cap in Book-entry form
Investor Accounts	13,210	28%	23%
Sub Accounts	70,969	28%	25%
Group Accounts	376	9%	6%
<b>Total</b>	<b>90,555</b>	<b>65%</b>	<b>55%</b>
Source: The CDC			

Reportedly, there are a large number of unregistered agents<sup>8</sup> running unauthorized branch offices, which is a great threat to naïve investors. This is supported by the fact that while there are close to 300 hundred registered brokers; the number of registered agents is less than 125.

### 3.6. *Weak Management of Systemic Risk*

Management of systemic risk at the exchanges remains weak. Despite use of a set of a variety of risk management measures, none of the three exchanges provides full novation.

The design and enforcement of risk management measures can be improved. Margins are not based on volatility and liquidity of outstanding positions. The clearinghouse protection fund and investor protection fund are not fully funded.

<sup>6</sup> In February 2003, the CDC informed market participants that it intends to discontinue the system of group-account by June 2003. It advised all brokers and their clients to start making alternative arrangements, such as opening of sub-accounts or investor-accounts in order to avoid inconvenience. The matter of abolishing group accounts is still pending, apparently due to legal technicalities.

<sup>7</sup> To calculate proportion of listed capital and market capitalization in book entry form, the CDC does not include the holdings of the Government of Pakistan. If these are included, the proportion of listed securities in book entry form would be between 25% to 30%.

<sup>8</sup> Agents are defined in Member's Agents and Traders Rules as "person appointed by a member of a Stock Exchange to act on his behalf for the purpose recognized by a stock exchange and includes a sub-broker or head of a branch office."

### **3.7. *Insufficient Economic Capital***

The stock exchanges lack economic capital.

#### **3.7.1. Limited Revenues**

The financial statements of the exchanges show that all three are in weak financial health, as summarized in Table 13-14.

KSE has been consistently incurring losses for years. It is only in 2003 that it has earned a profit due to record turnover and greater allocation of transaction charges to the income of the exchange. However, it is yet to build any reserves.

ISE is yet to earn sufficient surplus after tax to offset its accumulated losses.

LSE enjoys better health yet it is insufficient to meet its development needs.

Due to their poor financial health and not-for-profit status, exchanges do not have access to the variety of financing sources available to a financially healthy for-profit company.

ISE and LSE resort to sale of memberships to raise finances, which is not sustainable.

#### **3.7.2. Inequitable Burden Sharing**

Analysis of income of exchanges shows that exchanges are being primarily financed by listed companies as shown in Table 15-17. Despite the rapidly increasing turnover during the last few years, income of the exchange relating to listings is higher than what is earned from service charges on trading. As shown in the following tables, during the three years, 2001-03, of record-breaking turnover, the average income of KSE from listing is 39% of its total income while service charges made only 32%. For LSE, the ratios in the same period are 52% versus 19%. For ISE, these are 78% versus 9%.

Passing the financial burden to listed companies is in stark contrast to the international practice. Internationally, exchanges derive most of their income from trading related service charges and listing revenues are a relatively small part of their total income. For the members of WFE, the average income from listing is only 11% while 43% revenues are derived from trading fees.

Despite the lower contribution being made by the brokers, the exchanges have a tendency to reduce service charges when the turnover increases.

Apparently, brokers also derive some subsidies from stock exchanges. For instance, LSE is providing free back office software to its members. Members can store their back office data in servers of LSE. LSE is also providing its members with risk management software for clients, called Client Trade Risk Filter. These subsidies raise questions about the non-profit nature of the exchanges as mentioned in their Memorandums of Association.

**Financial Highlights for KSE, LSE, and ISE**

Rs in million

<b>Table 13: 3-Year Summary Income Statements for KSE, LSE, and ISE</b>									
	<b>KSE</b>			<b>LSE</b>			<b>ISE</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>
Income	309	169	143	110	68	72	31	41	15
Expenditure	207	201	179	56	67	46	20	17	13
Surplus/deficit before taxation	85	(30)	(32)	54	0.902	26	11	24	1
Surplus/deficit after taxation	57	(60)	(44)	18	0.402	15	8	21	1
Surplus/deficit brought forward	(179)	(119)	(83)	66	64	49	(10)	(31)	(32)
Accumulated surplus/deficit carried forward	(122)	(179)	(127)	85	64	64	(2)	(10)	(31)

<b>Table 14: 3-Year Summary Balance Sheets for KSE, LSE, and ISE</b>									
	<b>KSE</b>			<b>LSE</b>			<b>ISE</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>
<b><u>Assets</u></b>									
Current Assets	1,391	392	393	605	368	368	68	54	21
Non-current Assets	275	290	244	167	170	162	119	112	110
<b>Total Assets</b>	<b>1,666</b>	<b>682</b>	<b>637</b>	<b>772</b>	<b>538</b>	<b>530</b>	<b>187</b>	<b>166</b>	<b>131</b>
<b><u>Funds reserves and liabilities</u></b>									
Funds	555	402	443	97	97	97	133	126	126
Reserves and surplus	82	25	74	86	65	65	0	0	0
Current Liabilities	970	203	71	500	286	273	24	16	9

**Analysis of Income of KSE, LSE, and ISE**

Rs in million

<b>Table 15: Break-up of Absolute Income of KSE, LSE, and ISE</b>									
	<b>KSE</b>			<b>LSE</b>			<b>ISE</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>
Income from listing	98.0	86.0	51.0	64.0	29.0	40.0	24.0	37.0	10.0
Income from trading fees	149.0	37.0	39.0	20.0	13.0	14.0	3.0	2.0	2.0
Income from investment	39.0	35.0	28.0	13.0	16.0	5.0	1.0	1.0	1.0
Membership fee	0.3	0.2	0.3	0.2	0.2	0.2	1.0	1.0	2.0
Other income	23.8	10.8	24.8	12.9	9.9	12.9	2.0	-	-
<b>Total</b>	<b>310.0</b>	<b>169.0</b>	<b>143.0</b>	<b>110.0</b>	<b>68.0</b>	<b>72.0</b>	<b>31.0</b>	<b>41.0</b>	<b>15.0</b>

<b>Table 16: Relative Proportion of Income of KSE, LSE, and ISE</b>									
	<b>KSE</b>			<b>LSE</b>			<b>ISE</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>
Income from listing	31.6%	50.9%	35.7%	58.2%	42.6%	55.6%	77.4%	90.2%	66.7%
Income from trading fees	48.1%	21.9%	27.3%	18.2%	19.1%	19.4%	9.7%	4.9%	13.3%
Income from investment	12.6%	20.7%	19.6%	11.8%	23.5%	6.9%	3.2%	2.4%	6.7%
Membership fee	0.1%	0.1%	0.2%	0.1%	0.2%	0.2%	3.2%	2.4%	13.3%
Other income	7.7%	6.4%	17.3%	11.7%	14.5%	17.8%	6.5%	0.0%	0.0%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

<b>Table 17: Relative Income Comparison of KSE, LSE, ISE and Members of the WFE</b>				
	<b>KSE</b>	<b>LSE</b>	<b>ISE</b>	<b>WFE*</b>
Average income from listing	39%	52%	78%	11%
Average income from trading fees	32%	19%	9%	43%
Average income from other sources	28%	29%	13%	45%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

Source: Annual Reports of KSE, LSE, ISE.  
\*Average for 3 years

### **3.7.3. Low Level of Capital Expenditure**

Due to lack of sufficient income and reserves, exchanges are short of funds to meet their capital expenditure needs.

Some of basic capital expenditure needs remain unfulfilled. For instance, there is no disaster recovery site at any stock exchange and it is only in 2003 that KSE has established a backup system.

Internationally exchanges are seen as organizations driven by technology. Due to lack of funds, KSE, LSE, and ISE have not been able to invest in technology according to demands of the market. Access to markets is essentially confined to the three buildings of stock exchanges. It has been observed that KSE has not made necessary capital expenditure to broaden market access beyond Karachi. Most of the trading terminals are located within the buildings as shown in Table 18.

<b>Table 18: Market Access As Measured By Trading Terminals</b>			
	<b>KSE</b>	<b>LSE</b>	<b>ISE</b>
Total Trading Terminals	878	577	96
Terminals located within the building	725	376	81
Terminals located outside the building	141	201	1
Terminals located outside the city	-		14

Brokers have also been reluctant to open branch offices. Most brokers who met the Committee stated that it was primarily due to lack of control on branch offices and inadequate support infrastructure, such as remote terminals, that brokers were not opening branch offices.

In the first such initiative of its kind, LSE is currently in the process of opening a branch office in Faisalabad, in which it is providing office space to its members.

### **3.7.4. No Financial Guarantee**

A related issue to the finances of the exchanges is the term “Guarantee” used in the names of the exchanges. Investors often get confused and misled by the word “Guarantee.” It is often misinterpreted as a guarantee that all trades shall be settled or a guarantee by the members of the exchange that they shall pay all the liabilities of the exchange.

According to their Memorandum of Association, the liability of members, in case of winding up of each exchange, is limited to Rs 1000. Clause VI of the Memorandum of Association of KSE reads,

“Each member undertakes to contribute to the assets of the Exchange in the event of its being wound up while he is a member, or within one year afterwards, for payment of the debts and liabilities of the Exchange contracted before he ceases to be a member, and of the costs, charges and the expenses of winding up, and for adjustment of the rights of the contributories among themselves, such amount as may be required, not exceeding one thousand rupees.”

LSE and ISE have almost identical clauses in their Memorandums of Association.

## **3.8. *Insufficient Human Capital***

The exchanges do not have sufficient human capital.

### 3.8.1. Few Professionals

Perception of weak governance and inadequate managerial compensation are keeping good professionals away from stock exchanges. Non-management staff tends to be more than the management staff. Inadequate number of professional managers has slowed down the pace of development and innovation at the exchanges.

<b>Table 19: Human Resource at the Exchanges</b>			
As of May 31, 2004			
	<b>KSE</b>	<b>LSE</b>	<b>ISE</b>
Total No. of employees	243	109	35
Management staff	112	72*	8
Non Management staff	131	37	27
*34 out of 72 are officers Source: KSE, LSE, ISE			

Instead of hiring more professionals, exchanges continue to depend on member committees. Most of committee participants are active brokers who are pre-occupied with their own business. The size of these committees is also often too large to facilitate efficient processing.

### 3.8.2. Inability to develop New Products and Services

Possibly due to insufficient human capital, the exchanges have not been able to develop new products or provide innovative services. Market is essentially confined to equities. Debt and the derivatives segments remain nascent.

The only debt instrument listed on the exchanges is the TFC. These are in essence only technically listed and there is virtually no trading activity in listed TFC.

The only derivative traded on the exchanges is Stock-Futures. These were first introduced at KSE in 2001 and trading remained confined to KSE. In 2003, the average daily turnover in futures was 12% of the average daily turnover in the regular market. Trading of futures at LSE is negligible while ISE has discontinued it.

There are no Options, Index Futures, Warrants, and Exchange Traded Funds (ETF) etc. KSE had announced plans to initiate trading in Index Futures in 2003. However, it could not be initiated so far.

There have been few initiatives in providing new services to investors, particularly institutional investors.

## 3.9. High Degree of Speculation and Concentration

The market is highly speculative and concentrated.

### 3.9.1. Low Levels of Actual Settlement

Speculative activity dominates the market. The settlement by delivery is estimated to be less than 10%. That is, as much as 90% of the traded volume is squared up within the day or carried over and squared up later on.

In 2003, the turnover velocity for the three exchanges was 601%, making it the most heavily traded market compared to all Asia Pacific members of the WFE,<sup>9</sup> as shown in Table 20.

<b>Table 20: Comparison of Turnover Velocity for the Market</b>	
(Annualized Ratio of Traded Value and Market Cap)	
<b>Countries</b>	<b>2003</b>
Korea	193.1%
Taiwan	190.7%
Thailand	136.0%
Shenzhen	125.8%
Shanghai	118.0%
NSE India	114.6%
Tokyo	82.6%
Australia	79.9%
Singapore	74.4%
Hong Kong	51.7%
Mumbai	51.6%
New Zealand	39.4%
Jakarta	34.9%
Kuala Lumpur	34.3%
Colombo	26.1%
Philippine	12.2%
Osaka	6.6%
Source: WFE Annual Report 2003	

### 3.9.2. Concentration of Liquidity and Market Capitalization

While 693 companies are listed on the exchanges, the top 10 companies at KSE account for 49% of the market capitalization and 57% of traded value. Table 21 gives comparison of market concentration in various jurisdictions.

<b>Table 21: Comparison of Market Concentration</b>		
	Market Cap of Top 10 Companies	Traded Value of Top 10 Companies
Philippine	64.5%	80.9%
New Zealand	59.5%	74.0%
Jakarta	54.2%	58.4%
Colombo	47.0%	57.1%

<sup>9</sup> Ratio for Pakistan is calculated as follows. A daily combined traded value of KSE, LSE, and ISE divided by end of day market capitalization is taken and annualized by number of trading days. The methodology for WFE is slightly different. The WFE takes the ratio between the traded value of domestic shares and their market capitalization. The value is annualized by multiplying the monthly moving average by 12, i.e. Monthly Domestic Share Turnover x 12 / Month-end Domestic Market Capitalization

Australia	41.5%	44.8%
National Stock	40.3%	44.0%
Mumbai	36.6%	43.0%
Osaka	23.8%	42.7%
Singapore	53.3%	40.9%
Hong Kong	55.3%	38.2%
Tokyo	19.3%	22.6%
Thailand	43.3%	21.6%
Taiwan	35.1%	21.3%
Shanghai	29.2%	18.7%
Shenzhen	13.7%	16.0%
Korea	50.5%	11.3%
Kuala Lumpur	33.1%	6.9%
Source: WFE Annual Report 2003		

### 3.9.3. Dominance of *Badla* Financing

The combined average *Badla* financing in January to May 2004 was approximately Rs 21 billion. On the average 6% of book entry securities of eligible companies remained in *Badla*. Considering the limited free float, this is a significantly high volume. Like trading in regular and futures market, most of *Badla* financing takes place at KSE.

Although *Badla* financing facilitates liquidity in the market, it has three major problems. First, it is considered a source of systemic risk as it allows speculators to build large outstanding positions on short term financing. Second, it contains room for market abuse. It is frequently alleged that big *badla* financier have large quantities of financed securities placed with them and thus have the market power to manipulate stock prices. Third, *Badla* financing is obstructing the development of derivatives and margin financing. Due to lenient margin regulations applicable to *Badla* financing compared to trading in Stock Future, the former dominates the latter.

In 2002, the SECP had announced that *Badla* financing shall be phased-out and replaced with margin financing and Stock Futures. However, little progress has been made in the phase out. On the other hand, *Badla* financing is continuing to grow. In first quarter 2004, the average *Badla* financing at KSE was 23 billion compared to Rs 15 billion in first quarter 2003. A key explanation behind the persistence of *Badla* financing is that those brokers who dominate *Badla* financing have maintained a strong representation on the board of KSE.

### 3.9.4. Excess Volatility

Narrowness of market, manipulation, liquidity concentration, and *Badla* financing have added excess volatility to the market. This excess volatility causes confusion and lack of confidence in the mind of investors. It can be argued that new listings, expansion in trading access and development of derivative segment would have provided depth to the market, neutralizing excess market liquidity.

### 3.10. Large Number and Low Quality of Intermediaries

Currently, there are 468 members and 268 brokers as shown in Table 22. It is apparent that given the small size of market, the number of intermediaries is disproportionately large. This large

number is difficult to justify given that most of the brokers have their offices within the premises of building of exchanges.

<b>Table 22 : Analysis of Members, Brokers and Agents</b>				
	<b>KSE</b>	<b>LSE</b>	<b>ISE</b>	<b>Total</b>
<b>Maximum Members</b>	<b>200</b>	<b>200</b>	<b>200</b>	<b>600</b>
Corporate Members	101	50	50	201
Individual Members	99	101	67	267
<b>Total Member</b>	<b>200</b>	<b>151</b>	<b>117</b>	<b>468</b>
Corporate Brokers	86	40	19	145
Individual Brokers	73	44	24	141
<b>Total Brokers</b>	<b>159</b>	<b>84</b>	<b>43</b>	<b>268</b>
Corporate Agents	1	-	-	1
Individual Agents	52	47	19	118
<b>Total Agents</b>	<b>53</b>	<b>47</b>	<b>19</b>	<b>119</b>
Source: KSE, LSE, ISE, and Securities Market Division of SECP				

The criteria to become a member, broker, and agent only cover some of the most basic elements. The criteria have no certification requirements for brokers, agents, or traders nor does it deal with the operational capacity of brokers or agents to meet the needs of his business and comply with various securities laws.

Almost half the brokers are individuals. Many among them are using obsolete systems and practices.

### **3.10.1. Weak Criteria to become a Member**

The by laws of KSE only mention a set of negative grounds of ineligibility and no certification requirements have been prescribed nor is there any requirement of experience.

### **3.10.2. Weak Criteria to become a Broker**

Prior to 2001, there was no regulatory requirement for registration of brokers. Under Brokers and Agents Registration Rules, 2001, a set of eligibility criteria has been prescribed. However, compared to other jurisdictions, the criteria are relatively weak. There is no requirement for professional certification.

### **3.10.3. Weak Criteria to become an Agent or Trader**

Agents of brokers, like brokers themselves, are also being registered under the Brokers and Agents Registration Rules, 2001. Members, Agents and Traders (Eligibility Standards) Rules, 2001 prescribe criteria for thr traders (terminal operators) employed by a Member. However, there is no requirement of registration of traders with the Commission. Although the Rules requires certification for agents but there is no mechanism for certification in existence.

### **3.10.4. Barrier to Entry to New Intermediaries**

Stakeholders have informed the Committee that currently the value of membership card of the three exchanges varies from Rs 10 million for ISE to Rs 40 million for KSE.

Buying a membership card, therefore involves heavy investment. It acts as a barrier to enter the brokerage business for professionals and institutions who have the knowledge and skills to run brokerage business but not the required financial resources.

It is also a barrier for those individual and institutions who have the resources to buy a membership card but find that they cannot earn sufficient return on this investment to make it financially viable just by transacting for clients

The costly membership cards are keeping those potential intermediaries away from the market who could otherwise offer better services to investors. This value essentially represents scarcity value because if memberships were opened, the value of card would reduce considerably.

To increase the maximum number of memberships beyond 200, a board resolution is required in KSE. In LSE and ISE, the power to increase maximum number of members is not with the board but with the general body and it requires a change in the Articles of Association.

The high cost of membership card has negative implication on development of brokerage services as the member exhausts most of his resources in buying the card. It may also be noted that while the cost of membership card is Rs. 40 million, the net capital balance required is only Rs. 2.5 million.

### **3.10.5. Membership Card Treated as Real Estate**

About 40% members who are not registered with SECP as brokers. Most of them have bought membership cards in anticipation of capital gains on their sale. They appear to treat membership cards as investment in real estate. KSE has 21% inactive members, LSE has 44%, and ISE 66%.

The interest of inactive members and active brokers often differs. Brokers view inactive members as free riders, making minimal financial or other contribution to the exchange but benefiting from the contribution of other stakeholders. The more an exchange invests in modernization of its infrastructure, the more a membership card is likely to grow in value.

Stakeholders, particularly many active brokers, are of the view that no person should be allowed membership of a stock exchange unless he intends to become active as a broker.

### **3.10.6. Low Capitalization of Brokers**

Every member has to have a specified minimum net capital balance according to the Securities & Exchange Rules 1971. In 2001, through an amendment in the Securities & Exchange Rules, 1971, the SECP redefined and enhanced ten times the base minimum capital. The impact of the amendment is that a broker at ISE needs to have a minimum net capital balance of Rs 0.75 million; a broker at LSE needs Rs 1.5 million; and a broker at KSE needs Rs 2.5 million.

Data obtained from the exchanges shows that most brokers, particularly, proprietorships are operating with low net capital balances. Given the conceptual problems in net capital balance explained earlier, it appears that most brokers are undercapitalized.

### **3.10.7. A Single Class of Brokers**

All brokers are clearing members, regardless of their capital balance or any other requirement. This is in contrast to international markets where brokers are generally divided into two classes, trading-only members and trading-and-clearing members. Such classification improves risk management and operational efficiency.

Similarly, all brokers are allowed to provide custody services to clients. Since, criteria for becoming a broker is weak, investors often suffer at the hands of unscrupulous brokers or their employees.

### **3.11. Conclusion**

Given the problems being faced by exchanges as discussed earlier in this Section, **the Committee is of the view that they are fundamental in nature and require to be addressed through structural changes.** Earlier reforms have not been able to reach the heart of problems being faced by exchanges because they were brought within the framework of mutual exchanges and a fragmented market place. Since mutual structure and fragmentation appears to be the root causes behind the problems faced by exchanges, it is necessary to examine as to whether and to what extent demutualization and specialization or integration can address these problems.

#### 4. Demutualization – Concept, Advantages, and Concerns

Demutualization is usually defined as a process that converts a not-for-profit company, often limited by guarantee, into a for-profit company limited by shares, thus separating the trading rights from ownership rights. This, however, is only a technical definition because if shares of a demutualized exchange are only held by brokers, then for all practical purposes it would remain a mutual body.

Demutualization is better thought of as a process that brings about balance among interest of different stakeholders in the corporate and governance structure of a stock exchange. It provides the exchanges with a for-profit motive and access to economic and human capital to develop business.

In developed countries, demutualization was motivated primarily by the need to compete with other exchanges, both conventional exchanges and alternative trading systems like Electronic Communication Networks (ECN). Failure to compete meant losing both liquidity and listings to others. Competitive pressures were caused and intensified to a large extent by technological developments that were bringing geographical neutrality to the business of an exchange. In order to compete, exchanges required efficient decision making structures and large amounts of funds for investment in technological infrastructure. A mutual structure was an obstacle in both decision making and access to capital, thus causing a wave of demutualization the world over.

In some countries, such as Australia, United States of America, and Britain, demutualization was largely voluntary and the regulator and the government merely facilitated the process. In other countries, the desire to address governance problems of exchanges has been the driving factor behind demutualization. The initiative to demutualize was often that of the government or the apex regulator of the securities market. For instance, in Singapore, Hong Kong, and Malaysia, exchanges have demutualized due to pressure from the government and regulators to do so. In India, the process is being led by SEBI.

Demutualization is now a well established global trend. According to the WFE, 25 out of its 54 member exchanges were demutualized, as of December 31, 2003, as given in Table 23.

<b>Table 23: Demutualized Members of WFE</b>	
As of December 31, 2003	
American Stock Exchange	London Stock Exchange
Athens Stock Exchange	NASD
Australian Stock Exchange	National Stock Exchange of India
Bolsa de Comercio de Santiago	Osaka Securities Exchange
Bolsa Mexicana de Valores	Oslo Børs
Bourse de Montréal	Philippine Stock Exchange
Budapest Stock Exchange Ltd.	Singapore Exchange
Copenhagen Stock Exchange	Stockholmsbörsen
Deutsche Börse AG	Taiwan Stock Exchange Corp.
Euronext	Tokyo Stock Exchange
HEX Plc	TSX Group
Hong Kong Exchanges and Clearing	Wiener Börse
Italian Exchange	
Source: WFE Annual Report, 2003	

The number of WFE members that are still Associations or Mutuals is only ten, as shown in Table 24.<sup>10</sup>

<b>Table 24: Associations or Mutual Members of WFE</b>
As of December 31, 2003
Bolsa de Comercio de Buenos Aires
Bolsa de Valores de Lima
Bolsa de Valores do São Paulo
BSE The Stock Exchange, Mumbai
Colombo Stock Exchange
JSE Securities Exchange, South Africa
New Zealand Stock Exchange
Shanghai Stock Exchange
Shenzhen Stock Exchange
SWX Swiss Exchange
Source: WFE Annual Report, 2003

More members of the WFE are undergoing demutualization. Kuala Lumpur Stock Exchange (KLSE) has demutualized in January 2004, changing its name to Bursa Malaysia. It intends to get self listed by first quarter of 2005.

In USA, some exchanges have demutualized, while others have not. The largest exchange, the New York Stock Exchange, remains mutual. To many observers, the mutualized structure of the exchange has contributed to its well publicized governance problems in the recent past.

Demutualization has also reached South Asia. In India, NSE-India is operating as a demutualized for-profit company since its inception in 1993. All mutual exchanges in India, including BSE-India are undergoing mandatory corporatization<sup>11</sup> as well as demutualization under the directives of the Securities and Exchange Board of India (SEBI). A Group constituted by SEBI on Corporatization and Demutualization of exchanges submitted its report in August 2002 and its recommendations have been largely accepted by SEBI. Each stock exchange has been advised by SEBI to submit a scheme for demutualization for approval by SEBI and the general bodies of the exchanges. SEBI has also suggested to the government legal amendments in various laws to enable the process of demutualization. SEBI is awaiting approval of the proposed legal amendments. According to reports, Joint Parliamentary Committee on the Stock Market Scam and Matters Relating Thereto, has emphasized the need for early implementation of Corporatization and demutualization of stock Exchanges.

In fact, the concept of demutualization has already been introduced and accepted in Pakistan. The NCEL, incorporated in 2002, was set up as a company limited by shares in which trading rights and ownership rights are not linked. KSE, LSE, and ISE own 40%, 10%, and 10% of shares in the NCEL.

<sup>10</sup> The WFE defines them as member cooperative that generally have no share capital and access to membership is restricted.

<sup>11</sup> A number of stock exchanges in India are associations.

The structure reflects recognition of the fact that from the governance point of view, demutualized structure is preferable.

Two other companies, related to stock exchanges, the CDC and the NCC, are also companies limited by shares and KSE, LSE, and ISE own more than 50% of shares in these two companies.

Market forces also appear to be generating pressure on the stock exchanges to restructure. With the introduction of internet trading in Pakistan, some large brokerage houses are likely to turn into ECN in the near future. They would be able to take away significant trading volumes from the exchanges and put strong competitive pressures that have been a contributory cause of demutualization in developed markets.

The case of an electronic and demutualized stock exchange, i.e. PEX Limited, licensed by SECP in the year 2003 is presently subjudice and decision in favor of SEC would make it difficult for the existing stock exchanges to compete with it. As a matter of fact, members of stock exchanges showed considerable interest in demutualization after grant of license to PEX Limited.

Demutualization is also a logical progression to some of the reforms introduced in the past. For instance, the decision to induct outside directors on the board of stock exchanges was motivated by the objective of providing equitable role to all the stakeholders in the management of stock exchange, while appointment of an independent MD was aimed at improving governance

#### ***4.1. Advantages of Demutualization***

During the consultative process and its deliberations, the Committee has noted a number of strong advantages of demutualization in the context of our stock exchange.

##### **4.1.1. Better Governance Structures**

Demutualization would restructure governance at the stock exchanges on a sustainable basis. The ownership rights and trading rights would be de-linked. It would increase the role of non-member stakeholders in the affairs of the exchange.

Management would be in the hands of professional managers. The board of directors and broker-committees would not run the day to day management of the exchanges. The role of the board would be policy making, supervision of management and laying down strategic direction.

This new structure of governance should lead to independent, efficient, and transparent decision making in the interest of all stakeholders, particularly investors.

##### **4.1.2. Access to Economic Capital**

A demutualized exchange should be able to raise capital from many sources as a normal for-profit public limited company. An important source of economic capital would be the new shareholders, institutions and individuals. This access to economic capital would allow large investments required in the technological infrastructure to broaden access to the market. A demutualized exchange should also be able to borrow from conventional lenders, such as banks.

##### **4.1.3. Access to Human Capital**

With better governance structures and access to economic capital, exchanges should be able to attract highly qualified and competent management professionals. With the induction of these professionals,

the management practices and culture should change and the exchange would be able to introduce new products and services.

#### **4.1.4. Profit Motive for Growth and Development**

There would be sustained pressures on the exchange to grow, develop its business and to increase its profitability. It should serve as strong incentive for increasing liquidity in the market and introducing new products. A demutualized exchange would not remain a stock exchange but graduate into a securities exchange offering a broad range of products and services. It would also seek new and diversified ways of increasing its revenues, such as share registration and selling back office software.

#### **4.1.5. Removal of Barrier to Entry for New Brokers**

In a demutualized exchange, trading rights would be given on the basis of qualifications. There would be no ceiling on the maximum number of trading rights thus removing scarcity value of a membership card. Trading rights would be non-transferable and would be granted by the exchange.

It is expected that a number of new entrants, particularly, financial institutions would acquire trading rights. It is expected that professionalism, capital adequacy, and large networks of financial institutions would raise the standards and reach of capital market intermediation.

#### **4.1.6. Unlocking of Value of Membership Cards**

Demutualization would separate the trading rights from ownership rights. Members would be able to retain their trading rights and be free to sell shares of demutualized exchange. Currently, a member cannot sell his membership card without foregoing his trading rights. Demutualization would unlock the value of membership cards for all members without loss of trading rights. They may invest these proceeds to upgrade their business.

#### **4.1.7. Greater Ability to Attract Listings**

With an improved perception and availability of wider range of products and services, a demutualized exchange would be well placed to attract listings and facilitate capital formation.

#### **4.1.8. Domestic and International Recognition**

Demutualization should lead to domestic and international recognition. A demutualized stock exchange would be an open and transparent company. This would help improve the perception of exchanges and enhance confidence of domestic and international investors.

#### **4.1.9. Ability to Make International Alliances**

A demutualized exchange should be able to enter into alliances with other stock exchanges through equity swaps. Such alliances would provide an opportunity for investments and cross-listings from other countries like the gulf and the Middle East. There could also be possibilities of listing of international Islamic debt instruments.

### **4.2. International Experience of Demutualization**

The international experiences, available to the Committee, show that after demutualization, some markets have experienced significant growth and development.

- i. In Australia, the market capitalization, transactions, and funds mobilized have grown significantly in the years after demutualization of ASX, as shown in Table 25.

<b>Table 25: Australian Stock Exchange (ASX) – Progress After Demutualization</b>			
	1998 (Year of Demutualization)	2003	Growth
Market Cap	A\$ 489 billion	A\$ 838 billion	71%
Cumulative Annual Transactions	6.6 million	17.8 million	170%
New Funds Raised	A\$ 29 billion	A\$ 38.6 billion	33%
Operating Profit for ASX	A\$ 23 million	A\$ 82.7 million	360%
Proportion of Australian Adults who own shares	40.4%	51%	26%
Source: Annual Reports of the ASX			

In 5 years, the operating profits of ASX rose by 360% to the advantage of the shareholders, which include the former members. Most significantly, the proportion of Australian adult population that owns shares has risen by 26%.

- ii. In Singapore, in the five years after demutualization, market capitalization and number of listed companies have grown by 62% and 134% as shown in Table 26. The average daily turnover at SGX has grown by 134% to the advantage of its brokers.

<b>Table 26: Singapore Exchange (SGX) – Progress After Demutualization</b>			
	1999 (Year of Demutualization)	2003	Growth
Market Cap	S\$ 198 billion	S\$ 321 billion	62%
No of listed companies	397	521	31%
Derivatives Market volume (Number of Contracts)	25.9 million	34.9 million	35%
Average Daily turnover	155.8 million shares	364.8 million shares	134%
Source: Annual Reports of the SGX			

- iii. In Hong Kong, many important developments have taken place at a fast pace after demutualization. A new demutualized integrated exchange, Hong Kong Exchanges and Clearing Limited (HKEx), was established in March 2000 with the merger of Stock Exchange of Hong Kong Limited, Hong Kong Futures Exchange Limited and three clearing houses. It was subsequently listed on its own marketplace in June 2000. HKEx shares attracted wide interest from retail and institutional investors and its year-end closing price of HK\$17.9 was more than four times its valuation during the demutualization and merger.

After demutualization, the rate of equity listings especially cross border listings on HKEx increased. During the year 2002 sixty companies were newly listed on the main board, highest since 1997. By the end of 2003, total number of companies listed on main board was 852 (against 693 companies in 1999) including 64 china-incorporated companies and 10 foreign companies.

During 2000, the Stock Exchange of Hong Kong (SEHK) besides introducing the Pilot Program for trading US securities, also successfully launched the Third Generation Automatic Order

Matching and Execution System. Hong Kong Stock Exchange also introduced Internet Initial Public Offering service. During the year, Central Clearing & Settlement system was improved to support the clearing and settlement of securities transactions denominated in foreign currencies so as to facilitate trading of foreign stocks in Hong Kong.

- iv. NSE-India is an example of an exchange that was demutualized from its inception and has made significant contribution towards development of Indian capital market. NSE-India was sponsored by leading financial institutions and was incorporated in 1992 as a tax paying demutualized exchange unlike other stock exchanges in the country and was recognized as a stock exchange under the Securities Contract (Regulation) Act in 1993. It commenced operations in the wholesale debt market segment in June 1994. The capital market equities segment went live in November 1994 while operations in the derivatives segment commenced in June 2000.

The establishment of NSE-India opened a new era of technology and innovation in the Indian financial market. The establishment of the first clearing corporation in India, NSCCL by NSE-India in 1995 led to up-gradation in clearing and settlement procedures bringing Indian financial markets in line with international standards. In 1996 the first depository in India the National Securities Depository Limited was co-promoted by NSE-India.

NSE-India has also played a pivotal role in the development of derivatives market through successful launch of index futures, index options, options on individual securities, futures on individual securities and interest rate futures on its exchange. Other innovative products such as zero coupon yield curves and exchange-traded funds have also been launched at NSE-India.

In 2000, NSE-India became the first exchange to grant approval to its members for providing Internet based trading and services. It has also played role in the development of indices through the launch of S&P CNX Nifty, CNX Nifty Junior and NSE Government Securities Index.

The success of NSE-India can be gauged from the fact that having become operational in 1994, it became the largest stock exchange in the country by 1995. Currently NSE-India has given 5,714 trading terminals in 726 cities of India.

### ***4.3. Core Concern: Conflicts of Interest***

The benefits of demutualization are substantial. Indeed, it is due to these benefits that demutualization has become a global phenomenon. However, the process attracts new concerns. The most significant concern is the conflict of interest between regulatory and commercial responsibilities. This conflict of interest can take many forms:

- i. Adequate resources may not be provided for carrying out regulatory responsibilities because this may reduce profits.
- ii. Costs for investors, brokers, and listed companies may be unfairly increased to benefit the shareholders.
- iii. Listing standards may be relaxed to maximize new listing and listing revenue.
- iv. Powers to regulate intermediaries may be unfairly used against a broker who may wish to compete with the exchange, say by acting as an ECN.

- v. Powers to penalize may be unfairly used to maximize revenue.
- vi. Powers to enforce listing regulations can be unfairly used against futures competitors and in favor of business partners.
- vii. Risk management may be compromised because tightening it could reduce trading revenues and affect financial ratios.
- viii. Carrying out surveillance and enforcement against malpractices could strain relationship with customers and reduce revenues.
- ix. Leniency could be exercised by a self-listed demutualized exchange when applying listing regulations on itself.

It should be noted that many of these conflicts are present in the current mutual structure also. Demutualization only changes the form and degree of these conflicts. In the current mutual structure the conflicts of interest are primarily between the members and other stakeholders whereas in a demutualized structure, these are between different classes of shareholders.

#### ***4.4. Measures to Address Conflicts of Interest***

The Committee has deliberated on the issue of management of conflicts of interest in a demutualized scenario. It is of the view that in a demutualized exchange, it should be possible to address the conflicts of interest by designing appropriate measures, keeping in view the international practices as well as our own particular circumstances. Following could be some possible measures:-

- i. Board of Directors is structured in a manner that the exchange is able to strike the right balance between its obligations to shareholders and other stakeholders, particularly investors at large.
- ii. A permanent committee of directors and senior management is set up to identify conflicts of interest on an on-going basis to be submitted to the board and the regulators.
- iii. Regulatory functions, such as supervision of intermediaries, are separated from business functions, such as information services to ensure due attention to regulatory responsibilities.
- iv. Detailed budgeting is prepared and provided for performance of regulatory functions so that these functions are not under-funded.
- v. A separate annual report or a separate section in the annual report of the exchange is required to be prepared on the performance of regulatory functions so that adequate attention is paid to the role of the exchange as a regulator. Specific disclosure is required in each area of potential conflicts of interest.
- vi. A restriction is placed to ensure that revenues earned by exercise of regulatory powers, such as penalties on brokers, can only be used for financing regulatory functions
- vii. Capital and prudential requirements are mandated to ensure financial health of the exchange on an on-going basis.

- viii. Risk management is transferred to another entity, e.g. NCC, so that it is not compromised with a view to improving earnings and financial ratios.
- ix. Matters related to listing of companies are transferred to an independent Central Listing Services Agency or apex regulator.
- x. Surveillance, investigations, and enforcement relating to price manipulation and other forms of market abuse are conducted by a separate internal division.

#### **4.5. Conclusion**

The Committee is of the view that a demutualized structure would offer a more conducive environment for addressing critical problems of our market and its development on healthy lines.

A series of reforms introduced during the last ten years, though greatly beneficial to market have not had the desired full impact on the market possibly due to its mutual structure. Demutualization is a logical step forward.

The Committee would, however, like to caution that demutualization should be considered only as a mean to addressing problems of the market. It would be essential to structure demutualization to ensure maximum benefit for investors, issuers, and members.

## 5. Transformation – Concept, Advantages, and Concerns

A demutualized exchange can specialize in one or a combination of the following segments

- a. Regular/Cash Market, i.e. T+3
- b. Derivatives
- c. Debt instruments
- d. Over the Counter (OTC) Market for small cap

In its consultative process and deliberations, the Committee analyzed the desirability and feasibility of converting our three stock exchanges into specialized demutualized exchanges.

### 5.1. Advantages of Specialized Demutualized Exchanges

The Committee has noted the following advantages of having specialized demutualized exchanges in the country:-

- i. Specialization would end the fragmentation of market. At the same time, it would allow an exchange, not wishing to integrate, to maintain its identity.
- ii. Except the cash market for equities, all three segments, derivatives, fixed income, and small cap are under-developed. The potential of these segments is substantial which may be realized by a specialized exchange.
- iii. Due to strong appetite for speculation, interest in stock futures is likely to grow as *Badla* financing is phased out. There is also potential for a variety of new derivatives products, such as Index Futures, Options, and Warrants. The international experience shows that it is not unusual for turnover in equity based derivatives to exceed that of underlying assets.
- iv. There are a large number of small cap inactive companies listed on the exchanges. Continuous open auction trading is not suitable for generating liquidity in these companies. An OTC market that uses market makers in the small-cap segment can add value to these companies. The regulatory framework for the OTC market has already been developed and market makers can maintain quotes using the existing trading technology.
- v. Corporate debt market, in the form of TFC, has grown tremendously over the years, as shown in Figure 3. Since the first public offer of two TFCs in 1995, the number of TFC issues has increased to 54. New developments such as income driven mutual funds and securitization are fueling the demand and supply of TFC.

Figure 3: Trend in Publicly Offered TFC, January 1995 – May 2004

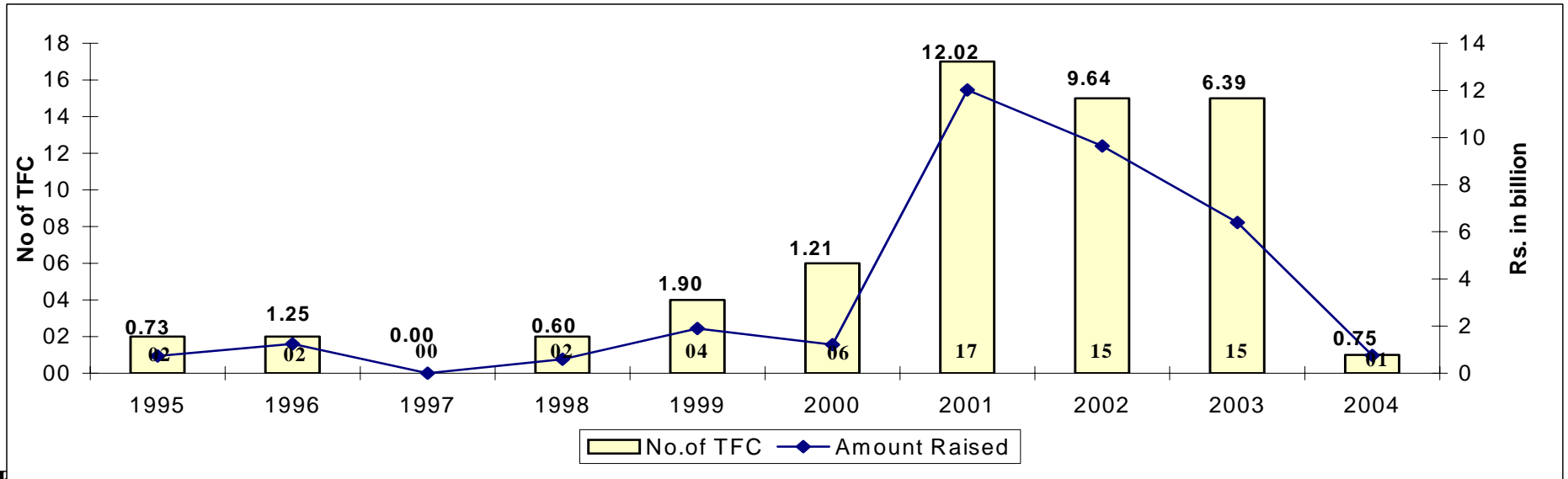
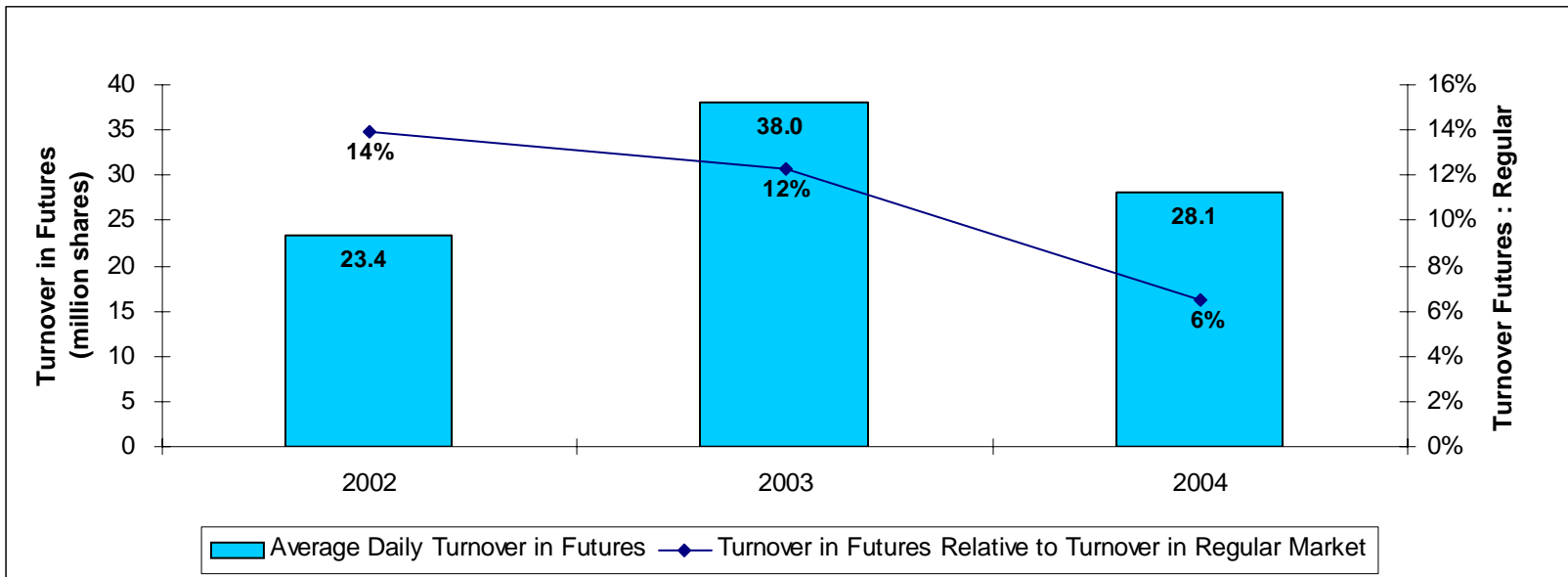


Figure 4: Trend in Stock Futures January 2002 – May 2004



## **5.2. Concerns About Specialized Demutualized Exchanges**

Stakeholders have expressed a number of concerns and pointed out difficulties about transformation of an exchange into a specialized demutualized exchange in our context:

- i. KSE is the largest exchange in equities, which is the largest segment. Trading in stock futures is also confined to KSE. It is likely that it would also dominate corporate debt and small cap segment. Since its dominance is across the board, it has no incentive to become a specialized stock exchange. On the other hand, LSE and ISE have no particular advantage in any particular segment to be able to specialize. There is virtually no trading in stock futures at LSE or ISE. LSE and ISE have taken no initiatives towards specialization. Members and management of LSE and ISE have also not shown any interest in becoming a specialized exchange.
- ii. Hedging, speculation, and arbitrage – the three purposes of derivatives – are best fulfilled when the investors can access both the cash and the derivatives market through a single trading terminal and a single broker. If there is a specialized exchange for derivatives, it would increase cost for the investors.
- iii. Derivatives are relatively complex instruments and expertise in trading in derivatives is limited. It might take some time before full range of derivatives is made available and sufficient activity is seen in these products. While average daily turnover in Stock Futures has shown some growth, as shown in Figure 4, their growth relative to the growth in the regular market has been slow.
- iv. Derivatives are successful when the underlying assets have sufficient liquidity. Usually this liquidity is found in fundamentally sound large cap companies, which have sizeable free float. There are only a few companies that would qualify for derivatives trading.
- v. Currently, stock futures can be settled by physical delivery. Due to narrowness of our markets, it is likely that this feature of settlement by delivery would remain available to reduce room for manipulation. In that case, a specialized demutualized exchange could almost directly compete with the regular market, which would defeat the purpose of specialization.
- vi. Due to financial links between the cash and the derivatives segments, integrated surveillance and risk management of the two markets is more effective and meaningful. Surveillance is one of the most neglected area in our exchanges and splitting it in two exchanges shall further weaken it. Having an integrated exchange makes it possible to provide the facility to cross-margin the outstanding positions. This is an important success factor in the development of derivatives market and it would be lost if derivatives are traded on a specialized exchange.
- vii. Corporate debt market is still in its initial stages of development. There are 54 TFCs outstanding with a par value of Rs 28 billion. After a spurt of growth in 2003 and 2003, growth in TFC segment has slowed down. These days interest rates are quite low and there is insufficient incentive for companies to raise capital through TFC.
- viii. Currently, TFCs are being traded and settled side by side with equities. It might take a long time before there is sufficient size and liquidity in the TFC segment to justify a separate counter. TFCs are largely held by institutions and the free float in TFCs is very limited. There

is unlikely to be sufficient exchange based trading in TFC till a large portion of the issue is offered to the general public through a public offer. It would take much longer before a specialized exchange can be considered for this segment.

- ix. Most of the small cap companies are listed on KSE. While regulations for the OTC segment have been approved, trading in this segment is yet to start. It is not clear why would an exchange want to specialize in a segment which has many low quality companies, accounts for a small portion of market capitalization, and commands a negligible portion of turnover.

### ***5.3. International Practices***

The general international trend is clearly towards integration so that all equities, debt and derivative instruments are traded on a single exchange. In a number of countries, such as Hong Kong and Singapore, cash and derivatives markets have merged. USA has specialized exchanges but the size of the market there is large enough to justify such exchanges.

### ***5.4. Conclusion***

The Committee is of the view that transformation of any stock exchange into a specialized demutualized exchange would not offer solution to the problems of our market. At this stage, a specialized demutualized exchange is neither desirable nor feasible.

## **6. Integration – Concept, Advantages, and Concerns**

Integration means consolidation of the three exchanges through merger. During the consultative process, the Committee has found that most of the stakeholders are of the view that existence of multiple stock exchanges in Pakistan is a core problem. The stakeholders in favor of integration of stock exchanges have put forward a number of arguments in favour of consolidation of three stock exchanges into a single exchange.

- i. Most of the listed companies, having significant capitalization and trading, are listed on all three exchanges.
- ii. A significant number of members are common among the three exchanges.
- iii. There is a single geographically neutral clearing house, NCC, for all three exchanges. If a person is a member of more than one exchange and trades on more than one exchange, the NCC nets his settlement obligation across exchanges. NCC is also providing “B2B” facility in which settlement obligations of two brokers of two different exchanges are being netted, in a limited number of liquid shares.
- iv. There is a single depository, the CDC, which is providing geographically neutral custody services to members of all three exchanges. It is possible for a CDC participant-broker of any exchange to move shares to any other participant.
- v. All three exchanges are public companies limited by guarantee. This similarity in corporate structure would facilitate integration.
- vi. Exchanges are now gradually providing remote terminals, which implies that integration of market place is only a matter of time.

### **6.1. Scenario Analysis**

The Committee considered many different scenarios of demutualization and integration to determine as to which scenario best addresses the problems facing the stock exchanges. Some of these scenarios are described below.

#### **6.1.1. If KSE, LSE, & ISE neither Demutualize nor Integrate**

If status quo is maintained, market would continue to suffer from both a mutual structure and a fragmented market. In that event, it would be essential to set up a new demutualized national exchange to serve the interests of investors.

#### **6.1.2. If KSE, LSE, & ISE Demutualize but do not Integrate**

Given their smaller size, LSE and ISE might find it difficult to undergo demutualization independently and attract new investors without a merger. If somehow the three stock exchanges demutualize independently and do not merge, there would be fierce competition among them that would aggravate the problems of market fragmentation to the disadvantage of all stakeholders. LSE and ISE may find it even more difficult to compete with the dominant KSE. It is likely that out of commercial considerations, some consolidation may take place in the long run. On the whole, this scenario does not seem desirable or feasible.

**6.1.3. If LSE & ISE Merge and Demutualize and KSE does neither**

The mutual structure prevalent at KSE would not allow it the flexibility in decision making and the access to capital required for technological up gradation in order to effectively compete with the new stock exchange. The value of memberships cards at KSE is likely to fall sharply. In the long run, KSE would have to consider both demutualization and integration for its survival.

**6.1.4. If LSE & ISE Merge and Demutualize and KSE Demutualizes**

There would be very strong inter-exchange competition in this scenario. The market may see considerable expansion in products, services, and turnover but the problems of fragmentation would be aggravated to the disadvantage of all stakeholders. The integrated LSE and ISE might have to specialize in the derivatives, debt, or small-cap OTC market because competition with KSE in the regular market could be difficult. Given the commercial benefits of integration, the two exchanges may merge in the long run. This scenario is feasible but due to implication of fragmentation of market, it is not desirable.

**6.1.5. If KSE, LSE, & ISE Integrate but do not Demutualize**

The problems of market fragmentation would be resolved but the problems of mutual structure would remain. Access to economic and human capital would be limited and the problems of governance would continue. In this situation, it would become necessary to set up another demutualized stock exchange that would be better placed to serve the investors. It is likely that there would be intense competition in the short run but in the long run, the two exchanges may merge due to commercial considerations.

**6.1.6. If KSE, LSE, & ISE Demutualize and Integrate**

The demutualized and integrated exchange shall be well placed to develop the market and serve the economy. The market would not suffer from the problems of a mutual structure or a fragmented market. However, there would not be inter-exchange competition. If the concern about absence of competition can be addressed, then this scenario shall best meet the interest of all stakeholders.

Having discussed some of the scenarios which have been envisaged, the Committee would now wish to elaborate upon full integration of KSE, LSE, and ISE. Summary of the views given by respondents to the questionnaire on the desirability of integration is given in Annexure B.

**6.2. Advantages of Full Integration**

The Committee has identified a number of strong advantages of full integration of KSE, LSE and ISE.

**6.2.1. Cost Efficiency for All Stakeholders**

An integrated exchange would save both obvious and hidden costs for all stakeholders.

All investors would be able to execute their orders without having to route their trades through another broker. This would save extra commission and hassle.

A listed company would have to pay listing fee only once. They would also have to comply with the regulations of a single exchange.

Brokers who operate at more than one exchange would only have to comply with the requirements of one exchange.

### **6.2.2. Greater Liquidity and Better Price Discovery**

An integrated exchange would provide all the market participants with greater liquidity than they can access in the current fragmented structure.

Price discovery would be aided by greater liquidity. There would be one global price for all securities at all times. The inter-exchange arbitrage business shall be eliminated.

### **6.2.3. Better Protection and Transparency for Investors**

Clients of brokers at ISE and LSE who trade through brokers at KSE would be ensured proper custody of their securities and execution of their trades.

### **6.2.4. Larger Pool of Economic Capital**

Integrated exchange shall have more revenues and assets than the current exchanges. Increased revenues and assets would enhance its ability to finance development and innovation.

### **6.2.5. Larger Pool of Human Capital**

An integrated exchange shall have access to a larger pool of professionals. Different departments in current exchanges have different strengths. These strengths would be combined in an integrated exchange. Due to greater revenues and importance in the market place, an integrated exchange would be better placed to attract more professionals.

### **6.2.6. Better Surveillance and Risk Management**

Integrated exchange would have full access to information pertaining to all market segments and intermediaries. It would be better placed to carry out integrated surveillance and risk management.

### **6.2.7. Simplicity in Operations**

Complexity and confusion caused by existence of three exchanges with different regulations and operations would be eliminated. This would reduce hidden costs and facilitate development of new products and services.

### **6.2.8. Focused Supervision by the SECP**

A single exchange would facilitate supervision and regulation by SECP. Its resources would be better focused which would improve the quality of supervision.

### **6.2.9. Domestic and International Recognition**

Integration would also bring domestic and international recognition. An integrated stock exchange would be seen as progressive and in line with international trends.

## **6.3. Integration with CDC and NCC**

The Committee is of the view that vertical integration, i.e. integration of exchanges with the CDC and NCC shall further add to the benefits of integration.

### **6.3.1. Greater Revenues and Cost Efficiencies**

Integration of CDC and NCC would further increase the revenues and cost efficiencies in an integrated exchange.

The CDC is a well governed and successful company that has added substantial value to our capital market. CDC is now a profit making organization, which has tremendous potential. KSE, LSE, and

ISE own 52.3% of shares of CDC, therefore, once the stock exchanges integrate, CDC shall become a subsidiary of integrated stock exchange. Financial highlights and shareholding pattern of CDC are given in Table 27-29.

NCC, being a new project undergoing final stages of implementation, is not profitable at the moment but it has substantial promise. After integration, NCC shall also become a subsidiary of integrated stock exchange, as the three stock exchanges own 70% of its shares. Financial highlights and shareholding pattern of NCC are given in Table 30-32.

### **6.3.2. Single Business Strategy and Coordinated Developments**

Currently, NCC and CDC are pursuing business strategies, which are not always consistent with those being pursued by the exchanges. A fully integrated exchange would be able to pursue a unified business strategy.

When trading, clearing, settlement, and custody are all provided under a single umbrella, it would greatly facilitate development of the market.

Complete vertical and horizontal integration has strong international precedents such as in Hong Kong and Singapore where the exchanges, depository, and clearing houses are owned by a single holding company.

### **Financial Highlights of the CDC**

<b>Table 27: 3-Year Summary Income Statements of CDC</b>			
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Income	292	205	159
Operating and administrative expenses	171	174	147
Operating profit	121	31	11
Profit after taxation	73	23	18
Accumulated loss/profit brought forward	(28)	(51)	(69)
Available for appropriation	45	(28)	(51)
Final paid up capital	20	0	0
Accumulated loss/profit carried forward	25	(28)	(51)

<b>Table 28: 3-Year Summary Balance Sheets of CDC</b>			
	<b>2003</b>	<b>2002</b>	<b>2001</b>
<b><u>Assets</u></b>			
Current Assets	168	66	89
Fixed Assets	133	148	105
Long term loans	2	4	13
Long term deposits and prepayment	2	2	4
<b>Total Assets</b>	<b>345</b>	<b>260</b>	<b>251</b>
<b><u>Capital and liabilities</u></b>			
Share capital	125	72	49
Long term deposits	120	170	161
Current liabilities	100	18	42
<b>Total Capital and Liabilities</b>	<b>345</b>	<b>260</b>	<b>251</b>

<b>Table 29: Shareholding Pattern of CDC</b>	
<b>As of June 30, 2004</b>	
<b>Institution</b>	<b>Share Holding</b>
The Karachi Stock Exchange (Guarantee) Ltd.	39.80%
Lahore Stock Exchange (Guarantee) Ltd.	10.00%
Citicorp Overseas Investment Corporation	10.00%
Muslim Commercial Bank Limited	10.00%
Habib Bank Limited	6.35%
National Investment Trust Limited	6.35%
Investment Corporation of Pakistan	5.00%
Pakistan Industrial Credit & Investment Corporation	5.00%
International Finance Corporation	5.00%
Islamabad Stock Exchange (Guarantee) Ltd.	2.50%
<b>Total</b>	<b>100%</b>
Source: CDC's Annual Reports	

**Financial Highlights of the NCC**

<b>Table 30: 2-Year Summary Income Statements of NCC</b>		
	<b>2003</b>	<b>2002</b>
Operating revenue	1	-
Operating and administrative expenses	18	7
Operating profit/loss	(17)	(7)
Profit/loss after taxation	(10)	23
Accumulated loss/profit brought forward	(28)	(0.209)
Accumulated loss/profit carried forward	(10)	(0.209)

<b>Table 31: 2-Year Summary Balance Sheets of NCC</b>		
	<b>2003</b>	<b>2002</b>
<b><u>Assets</u></b>		
Current Assets	42	31
Fixed Assets	13	15
Deferred Cost	7	9
Deferred Taxation	11	6
<b>Total Assets</b>	<b>73</b>	<b>61</b>
<b><u>Capital and liabilities</u></b>		
Share capital	32	35
Long term deposits	25	23
Current liabilities	16	3
<b>Total Capital and Liabilities</b>	<b>73</b>	<b>61</b>

<b>Table 32: Shareholding Pattern of NCC</b>	
As of June 30, 2004	
	<b>Proportion of Shares Held</b>
KSE	40%
LSE	20%
ISE	10%
Pak Kuwait Investment Company	15%
Source: NCC's Annual Reports and Securities Market Division of the SECP	

#### **6.4. Integration with NCEL**

The NCEL shall also become a subsidiary of the integrated exchange as KSE, LSE, and ISE own 60% shares in NCEL. A number of members of KSE, LSE, and ISE have acquired trading rights at the NCEL.

The NCEL also has tremendous potential as it is the only licensed exchange for trading in commodity futures. NCEL is likely to begin trading by opening a gold contract in 2004. This would further add to the promise of an integrated demutualized exchange.

#### **6.5. Core Concern: Lack of Inter-exchange Competition**

An apparent and major disadvantage of integration is the absence of competition. Stakeholders, who are against full integration of KSE, LSE, and ISE, have pointed out a number of negative implications of absence of inter-exchange competition.

- i. Lack of competition would make an integrated exchange inefficient. It would slow down the pace of development and innovation and allow the exchange to charge higher fees from issuers and brokers than it could have under a competitive environment.
- ii. Competition has not taken place among KSE, LSE, and ISE primarily because of their mutual structure and dominance of KSE. Once demutualized, intense competition would be seen among exchanges, to the benefit of all stakeholders.
- iii. Demutualization would allow the market forces to determine the number of stock exchanges required for the country. If smaller exchanges are unable to compete, they would wind up or merge with the larger exchange.
- iv. Monopoly could be justified once there is sufficient competition from international exchanges - not in the foreseeable future - and the fundamental needs of the market have been fulfilled.
- v. Once a monopoly takes roots, it becomes difficult to provide competition later on. SECP should not promote a monopoly structure and should keep the possibility of more licenses open even if KSE, LSE and ISE integrate after demutualization.
- vi. There should be two large exchanges in Pakistan. This can be achieved by merger of LSE and ISE, which would lead to a larger exchange better able to compete with KSE. A two-large exchange model is giving excellent results in India.
- vii. If there is only one exchange and it faces financial difficulties leading to bankruptcy, it would disrupt the entire capital market. Having more than one exchange would diversify this risk.

Other stakeholders have argued in favour of full integration of KSE, LSE, and ISE on the following grounds:

- i. An integrated exchange should be given chance to demonstrate whether or not it can meet the needs of the investors. If an integrated exchange does not effectively fulfill the needs of investors, a new stock exchange can be licensed which would compete with the integrated exchange.

- ii. At present, the size of the market in Pakistan is too small to justify multiple exchanges, even if these are specialized exchanges.
- iii. It is competition among brokers and not among exchanges that is in the interest of investors. Already, there is intense competition among brokers, which is reflected in highly competitive commission rates.
- iv. Brokerage houses should be allowed to act as ECN to compete with the integrated exchange. Necessary measures would, however, be needed to ensure that investor trading through an ECN shall be offered as favorable a price as he would have been offered if the trade was executed at the stock exchange.
- v. Stock exchanges are strictly regulated and SECP enjoys vast powers over exchanges. Therefore, abuse of powers by an integrated exchange can be addressed through effective regulatory approach and measures.
- vi. There has not been any competition among exchanges for many years. KSE accounts for 80% of the traded volume. It is highly unlikely that either LSE or ISE can compete with KSE even if LSE and ISE merge to form a larger exchange.
- vii. Experience shows that even if an exchange accounts for bare minimal volumes and its desirability and financial viability are questionable, it continues to operate. Therefore, it is not necessary that competition would necessarily result in closure or merger of exchanges that have too small a liquidity pool to justify their existence.
- viii. Technology has made it possible to have geographically neutral trading, clearing, and settlement. There is no justification left for multiple exchanges. As long as there would be more than one exchange, market shall remain fragmented causing the same problems to investors, issuers, and brokers as experienced currently.

The Committee has also considered international experiences on integration of stock exchanges. **International experience shows that usually the issue of fragmentation of market segments had been resolved prior to demutualization.** Integration, at the time of demutualization, was often of cash and derivatives market and of exchange, depositories, and clearing companies.

- In Hong Kong, four stock exchanges had unified in 1981. Later in 2000, the cash and derivatives exchange, depository, and clearing houses merged into a fully integrated and demutualized company, HKEx.
- In Singapore, there is only one demutualized and integrated exchange, SGX, for both cash and derivatives. SGX was formed on December 1, 1999 by merger of two financial institutions, Stock Exchange of Singapore that traded securities and Singapore International Monetary Exchange Limited which traded futures.
- In Australia, six stock exchanges had merged in Australia to form ASX in 1988. The ASX became a demutualized and integrated exchange for trading in equities, debt, and derivatives in 1998. Debt and index based derivatives are primarily traded on the Sydney Futures Exchange.

- In Thailand, there is one fully integrated stock exchange, TSE. The Thai depository is a subsidiary of TSE and also carries out clearing and settlement.
- In India, there are 23 exchanges. However, there are only two large exchanges, NSE-India and BSE, which compete intensely. Over the years, the NSE-India increased its market share and the desirability of existence of other exchanges is being questioned.
- In Malaysia, there is one demutualized and integrated stock exchange.
- In Sri Lanka, there is only one stock exchange, the Colombo Stock Exchange.
- In Philippines, Makati Stock Exchange and Manila Stock Exchange merged to form the Philippines Stock Exchange.
- In the USA, there have been some mergers among exchanges. However, different independent exchanges continue to operate there, some of which are specialized.

## **6.6. Conclusion**

Regional stock exchanges within a country had been established during the period when facilities of geographically neutral trading were not available. The regional stock exchanges had been established in response to the aspirations of different geographical areas for access to the market. The establishment of a CDS, automated trading and a clearing and settlement system operating at the national level has already integrated our three regional stock exchanges in many ways. Operationally, the only area in which exchanges are not integrated is the trading platform.

The automated trading system of exchanges now provides an opportunity to the members of all three stock exchanges to establish trading terminals at any geographical point, which can practically make regional stock exchanges irrelevant. It is only logical that the three regional stock exchanges be integrated, as has been done in many countries.

In India, the Report of the Group on Corporatization & Demutualization of Stock Exchanges, known as Kania Report, has strongly advocated abolition of regional stock exchanges, which in the view of the group have lost their relevance in these days of automated trading.

Most of the studies conducted on Pakistan's Capital Market Development in the past have expressed the view that demutualization and merger of the three stock exchanges were required for the future development of our market. A report titled "Pakistan's Stock Exchanges: The Way Forward" submitted to the SECP in June 2002 by international consultants, Arthur Anderson, states:

"The basis for the Way Forward will be achieved by merging the three exiting exchanges to form the Pakistan Stock Exchange, and at the same time separating ownership from the right to trade on the exchange."

Indeed, this has been the view in some other jurisdictions. In March 1999, the Government of Hong Kong stated the following in the "Policy Paper on Securities and Futures Market Reform."

"The Government believes that the reform necessary for Hong Kong is best achieved by demutualization, merger, and listing of the Exchanges and the Clearing Houses under one single holding company (NewCo). Under the new market governance structure, the stock and futures markets as well as the clearing operations will be

integrated and subsumed under this single commercial and service oriented entity. Ownership and management of NewCo would be formally separated from user interests and the inherent conflicts in traditional structure would thereby be greatly reduced. Trading rights on Exchanges would not be restricted and would be subject only to meeting the qualifications set under the relevant legislation and paying applicable fees, thus enhancing competition within the markets.”

**The Committee is of the view that the arguments and precedents supporting integration outweigh those against integration. Real and sustainable development of stock exchanges can only be achieved through demutualization and integration.** The Committee would, however, emphasize that integration should be effected with the objective of addressing problems presently arising out of fragmentation and division of liquidity pool. The committee is also of the view that the need for providing competition should be met through promotion of ECNs.

## **7. Key Issues in Demutualization and Integration**

The Committee has identified a number of key issues in demutualization and integration that must be considered while taking final decision:

### ***7.1. Decision to Demutualize***

During its discussion with SECP, the Committee has understood that the decision to demutualize has been taken in principle by the apex regulator. This is also reflected in the TOR given to the Committee. However, the Committee also looked at this issue independently and came to the conclusion that given the nature of problems of our capital market, discussed at length earlier, there is better prospect of addressing these problems in the case of demutualized structure. The, Committee, also discussed the question as to who should take decision to demutualize. There are two opposing views:

- a) The decision to demutualize or not to demutualize is a commercial decision and it should be left to members. Those who favor this view argue:
  - i. Members are the owners or the perceived owners of the exchanges and they should only sell their equity stakes in the exchanges on commercial considerations, just as any shareholder would.
  - ii. Members have developed exchanges through their own capital and resources. Others should not receive the right to decide for the members.
  - iii. World's largest stock exchange, New York Stock Exchange, has not demutualized and the Securities and Exchange Commission of USA has left the decision to demutualize to the NYSE.
- b) The opposite view is that SECP should play a proactive role towards demutualization as issues of public interest are involved, is based on the following arguments:-
  - i. Investors are the primary stakeholders in the exchanges. Since investor protection is the function of SECP, decision to demutualize should be taken by SECP.
  - ii. Since members are the only or the main beneficiaries of the mutual structure, decision to demutualize cannot be left to them.
  - iii. KSE, LSE, and ISE cannot be compared to NYSE. It may be noted that NYSE has been recently criticized for its problems of governance and many have attributed these problems to its mutual structure.
  - iv. Exchanges are not-for-profit companies limited by guarantee. Members are not owners of exchanges unlike shareholders in a for-profit company limited by shares.
  - v. Despite members being in control of the exchanges for so many years, exchanges have not been able to address many problems being faced. Our markets are underdeveloped with a strong perception problem due to imbalance in its governance structures and practices.

The Committee has examined the above arguments and also looked at international precedents.

- In Hong Kong, the decision to demutualize was driven by the Government and the Securities and Futures Commission.
- In Singapore, the decision to integrate and demutualize was primarily of the government.
- In Philippines, the decision to demutualize was that of the Securities and Exchange Commission.
- In India, which has 23 stock exchanges (other than NSE-India, which is demutualized), the decision to demutualize has been taken by SEBI.
- In Australia, six stock exchanges had voluntarily merged to form ASX as a mutual, and later voluntarily demutualized.
- In USA, the exchanges that have demutualized have done so voluntarily.

**The Committee is of the view that given the strong public interest involved in demutualization, SECP should take decision to demutualize the exchanges.**

## ***7.2. Decision to Integrate***

Like demutualization, there are two different views on who should take the decision to integrate.

- a) The decision to integrate or not to integrate is essentially of commercial nature and it should be taken by members of the exchanges alone based on commercial considerations. If any one exchange does not want to integrate, it should not be forced into integration.

Those who favor this view argue that

- i. It is only a matter of time before KSE would emerge as the national exchange. LSE and ISE account for only 20% of the combined turnover. Sustainability of LSE and ISE is questionable because KSE is capable of providing its trading terminals directly in Lahore and Islamabad.
  - ii. LSE and ISE are keen to integrate with KSE because they would be unable to compete with members of KSE. Members have already made an Inter-Exchange Joint Committee that is deliberating on the issue of integration. This committee should be given opportunity to formulate recommendations, which should be presented to members of each exchange in a general meeting. Members should decide on the issues of integration.
- b) The decision to integrate or not to integrate involves public interest and SECP should take decision on the issue. SECP should, however, consult members in devising an appropriate mechanism for fair compensation and smooth implementation of various steps that would be involved in integration.

Those who favor the second view argue that:

- i. It is unlikely that KSE would seriously affect operations of LSE and ISE by providing terminals in Lahore and Islamabad. ISE and LSE may integrate to compete with KSE. There would be at least two exchanges and the problems of market fragmentation would continue.
- ii. Members of the three exchanges may not be able to reach an agreement on valuation and compensation. There are obvious benefits of integration to members of all exchanges but their disproportionate distribution has prevented a solution.
- iii. KSE members are willing to consider integration only because they feel threatened by PEX Limited. Still, there is a clear reluctance on the part of some of the KSE members to pursue integration because the issue of PEX may take a long time to legally settle. The party that would not get a favorable decision from the High Court is likely to approach the Supreme Court and more time would be lost. The members have been given the time and opportunity to integrate the stock exchange but their response on the issue lacks sense of urgency.

The Committee has examined the above arguments and also looked at international precedents.

- In Hong Kong, Stock Exchange of Hong Kong Limited and Hong Kong Futures Exchange Limited together with the three clearing houses were demutualized and merged in 2000 following the share holders and court approvals to the scheme of arrangement and the enactment of implementing legislation. However, the decision to demutualize and integrate was practically taken by the government.
- In Singapore, the decision to integrate and demutualize was primarily of the government.
- In Philippines, unification of the Manila Stock Exchange and the Makati Stock Exchange was effected in 1994 under strong pressure from the Philippines SEC and the government. There was a total commitment by the government on unification. President Ramos in his speech on July, 1992 said on the subject:

“The SEC’s initiative to unite our two stock exchanges into one is precisely one of the most important initiatives that must be taken under this administration. While our neighboring countries have already set up global linkages, we are still arguing whether to link up Manila and Makati Stock Exchanges, a short distance of five kilometers as the crow flies. Unless we keep in step with the fast-changing times, we will always be left behind. I would like to see the day therefore when we would have one single unified exchange, wholly professionalized in the management and at par with those of our neighbors, and it better be soon.”

- In Australia, six stock exchanges had voluntarily merged to form ASX as a mutual, and later voluntarily demutualized.

- In India, which has 23 stock exchanges (other than NSE-India), the Group on Corporatization and Demutualization of Exchanges recommended that the decision to integrate is a commercial decision and it should be left to exchanges.
- In USA, different exchanges overlap in products and services and market remains fragmented.

Precedents exist to support both points of view. However, it is clear that the decision in each country was taken primarily on the basis of local needs and realities.

The Committee has discussed the recommendations of the Group on Corporatization and Demutualization of Exchanges in India at length. The Committee has observed that in India, the NSE-India is serving the needs of the investors well. The investors dissatisfied with the mutual exchanges, such as BSE-India have the option to trade at the NSE-India using its vast trading network. It could be argued that merger of exchanges in India is not critical to investor interest.

**The Committee is of the view that given the strong public interest involved in integration, SECP should lead the three exchanges to integration. This was done in the case of many other reforms, which in the longer run have proved beneficial for the market though they were initially resisted by members of stock exchanges.** SECP should, however, consult the members on all major issues including the issue of fair compensation and smooth implementation of measures required to demutualize and integrate.

### ***7.3. Licensing of More Stock Exchanges***

It has been demanded by some members of the exchanges that an integrated exchange must be a statutory monopoly through a bar on grant of future licenses. They argue that:

- i. Integration of existing exchanges shall not be meaningful if market is to be fragmented again by another stock exchange that might be licensed by the SECP in future.
- ii. Competition to integrated exchange shall be provided by ATS/ECN and international exchanges.

Those who are against putting any freeze on grant of future licenses argue that:

- i. Demands for a monopoly status presume that an integrated and demutualized exchange shall effectively fulfill needs and interest of investors. Any such presumption at this stage is premature. In case, an integrated and demutualized exchange fails to meet the needs of investors, a new stock exchange shall become necessary.
- ii. The possibility of competition from another exchange, that could be licensed in future, would force an integrated and demutualized exchange to remain efficient and fair for all stakeholders. If a freeze were placed on future licenses, it would remove all threats of competition to the integrated exchange that could make it inefficient.

- iii. Jurisdictions that have a single exchange are subject to competition from other international exchanges. No international competition to an integrated exchange in Pakistan is likely in the foreseeable future.
- iv. An integrated exchange would be front line regulator as well as competitor of the brokerage houses that would wish to act as ECN. Therefore the ability of ECN to effectively compete with its regulator exchange first needs to be tested.
- v. Countries that have only one exchange are generally those that have strong institutions exercising necessary checks. We need to be cautious about abuse of a monopoly.
- vi. A new exchange shall be licensed only if it is justified. In the past, the SECP and its predecessor, CLA, have successfully resisted persistent demands from different cities for licensing of stock exchanges. Licensing another stock exchange is not a routine matter and the legal provisions on the subject appear to be restrictive.

**The Committee is of the view that giving a monopoly status to any exchange would not be in the interest of investors. The possibility of grant of new licenses should remain, depending on the interest of investors and the needs of economy of Pakistan.**

#### ***7.4. Sequencing of Integration & Demutualization***

Demutualization and Integration could happen in three ways

- a. First Demutualization, then Integration
- b. First Integration, then Demutualization
- c. Simultaneous Demutualization and Integration

Those who favor demutualization to precede integration argue that a demutualized structure is more amenable to integration. A number of key issues in integration such as valuation would have been resolved through demutualization. In the absence of any precedent of merger of companies limited by guarantee, there may be legal complications in the process, which may hold back demutualization. It is also feared that if exchanges proceed to integrate first, the process of demutualization may be derailed.

Those who favor integration-first argue that the size and significance of ISE and LSE do not make demutualization and investment by institutions a meaningful exercise. Independent demutualization of KSE, LSE, and ISE would create confusion and unrest among members and may lead to controversies that could hurt the reform process.

Those who favor simultaneity in integration and demutualization argue that integration would bring the size and significance required for successful demutualization. Members and investors would be reluctant to accept shares of a company unless the company has reasonable size and future prospects. Both demutualization and integration would be complex exercises and separating the two would add to cost and time required to effect them.

The Committee considered the international precedents regarding sequencing.

- In Hong Kong, the equity segment had already integrated in 1981 through unification of four stock exchanges. Demutualization and integration of cash exchange and derivatives exchange took place simultaneously in 2000.
- In Singapore, there was only one stock exchange. Integration of the cash and derivatives exchange took place simultaneously with demutualization.
- In Australia, integration had taken place in 1987 while demutualization took place in 1998.
- In India, the Group on Demutualization and Corporatization recommended that integration is a commercial decision best left to exchanges, implying that demutualization should precede integration.

**The Committee is of the view that demutualization and integration are conceptually distinct but their practical implementation is linked. These links demand that the two should take place simultaneously.**

### ***7.5. Legal Mode for Demutualization and Integration***

The existing law is silent on the issue of conversion of a company limited by guarantee into a company limited by shares. This was also the case in many international jurisdictions in which demutualization took place. In most cases, special legislation was enacted to facilitate the process of demutualization and integration.

- In Hong Kong, The Exchanges and Clearing Houses Merger Ordinance was enacted in order to effect integration and demutualization.
- In Singapore, to effect demutualization and merger of SES and Simex, the Singapore Government passed the Merger Act in 1999.
- In Australia, demutualization was effected by a scheme of arrangement approved by members and then by the court, with special legislation only to deal with shareholding restrictions and some re-arrangement of regulatory roles.
- In the case of Toronto, the Ontario Legislative Assembly passed a special legislation to facilitate demutualization.
- In Malaysia, demutualization was effected under a special legislation, Demutualization (Kuala Lumpur Stock Exchange) Act, 2003.
- In India, the relevant laws are being amended to effect demutualization. The Central Government has moved Securities Laws (Amendment) Bill, 2003 to the Parliament, seeking amendment of Securities Contract (Regulations) Act, 1956 and the Depositories Act, 1996, to enable the process of corporatization and demutualization of stock exchanges. According to the statement of objects and reasons attached to the Bill, it had been prepared in pursuance of the Joint Committee on the Stock Market Scam and Matters Relating Thereto, which recommended that the process of corporatization and

demutualization of exchanges should be expedited. The main stated objectives of Bill are:-

- a. Defining Corporatization and demutualization;
- b. Limiting the organizational form of a stock exchange to a corporate entity;
- c. Specifying the procedure for corporatization and demutualization (including approval of scheme for corporatization and demutualization by Securities and Exchange Board of India);
- d. Specifying the time limit within which the shares shall be disinvested by stock brokers under the scheme of corporatization and demutualization;
- e. Restricting the voting rights of brokers as shareholders, and brokers' participation on governing board of stock exchanges so as to plug the loopholes inherent in governance of stock exchanges whose organizational form is mutual

The Committee has identified the following major legal issues involved in implementing demutualization and integration:

- a. Mode of Integration
- b. Conversion of companies limited by guarantee into companies/company limited by shares
- c. Governance structure of the demutualized set up, which shall have certain special features with regard to representation of certain classes and categories of shareholders on the Board and limiting voting powers, disproportionate to their shareholding
- d. Regulations of the new setup
- e. Regulatory role of the exchange with respect to listed companies

There are two courses of action available:

- i. As the process of demutualization and integration involves amalgamation and reconstruction of stock exchanges, approval of the court can be sought after a scheme of reconstruction and amalgamation is prepared. This process would involve valuation and determination of swap ratios. After approval of the scheme by the court, SECP can prepare the operational and regulatory framework of the demutualized set up, invoking the following statutory provisions:
  - a. Section 90 of the Companies Ordinance, 1984 which enables issuance of different classes of shares, having varying rights, disproportionate to share holding.
  - b. Section 506 of the Companies Ordinance which empowers SECP through powers delegated by the Federal Government, to make rules for the establishment and regulation of activities of any company or a class of companies. The object of stock exchanges, being specialized business, rules can be framed to regulate these in accordance with policy framed to safeguard and promote public interest.

- c. Section 5 of the securities and Exchange Ordinance requires re-registration of companies as stock exchanges subject to fulfillment of certain conditions, which may be prescribed by SECP, exercising powers of Federal Government.
  - d. Section 33 of the Securities and Exchange Ordinance empowers SECP to make rules in respect of a number of sections of the Ordinance including section sections 4 and 5, which deal with registration of stock exchanges.
- ii. The other course of action as followed by a number of other countries, is to promulgate a special legislation which should be self contained and should comprehensively cover all the issues involved in the process of demutualization and integration.

**The Committee is of the view that a special legislation would be a preferable course as all the legal requirements of demutualization and integration, can be covered by the proposed special law.**

### ***7.6. Compensation to Members and Trading Rights***

One of the most critical issues before the Committee was that of compensation. The issue of whether there are plausible grounds for compensation, and if so, who should be compensated, on what grounds, by whom, and in what form has been deliberated by the Committee at length. Any form of financial compensation would necessarily involve valuation. **The Committee is of the view that any valuation required should be done by professional valuers. The Committee would however, provide a conceptual framework within which exercise of valuation should be carried out.**

The point of view expressed by members of the exchanges on compensation can be summarized as under.

- i. Members of exchanges should be compensated for value of their membership cards, which are bought and sold in the open market at high prices. Members need be compensated because membership cards would cease to exist due to demutualization. The assets of the exchanges would be transferred to the new demutualized and integrated set-up. If it were not for demutualization and integration, members would continue to hold membership cards and the value of the cards would be preserved.
- ii. Further justification for compensation to the members of stock exchanges is that demutualized and integrated exchange would get the listed companies and liquidity at KSE, LSE, and ISE and these have been created by the efforts of members of exchanges. Moreover, the pool of knowledge and skills developed in the exchanges over the years, which though not reflected in the balance sheets at all, would also be transferred to the new demutualized and integrated exchange.
- iii. The value of membership cards differs across three exchanges and these differences should be taken into account. The value of a membership card at KSE is higher than that at LSE, which in turn is higher than that at ISE.
- iv. Members should be compensated by the demutualized and integrated exchange. Shares of demutualized exchange should be issued to members against the value of their membership cards.

- v. Even if the members retain their trading rights in a new demutualized set up, some compensation would be required because unlike the currently mutual set up, there would not be a cap on trading rights. If more brokers enter the market, it would reduce the size of the commission pool per broker.
- vi. Some members have expressed their view that members of stock exchanges are not entitled to any compensation as stock exchanges are companies limited by guarantee and members cannot derive any pecuniary benefit. Besides the members, a number of other stakeholders like the government and the listed companies have made significant contribution to the development of the exchanges.

The Committee has considered the following in analyzing the compensation issue.

- i. **Value of the membership cards has two components, value of the trading right in the exchange and the perceived value of ownership claim on the exchange.** The source of value for the trading rights is the future stream of income from the brokerage commission and it is linked to the level of turnover at the exchange. The source of value for the ownership rights is the fair value of assets and/or future income stream of the exchange as a company. The future income stream of an exchange as a company is also closely linked with its pool of liquidity. The primary source of value for each exchange as a company may differ from one exchange to other. For KSE it might be the future income earned from trading revenues as KSE accounts for 80% of the trading in the country. For ISE, it might be its assets, as ISE owns a highly valuable piece of land in Islamabad. But it must be noted that the value of each exchange as a company is distinct from the value of trading rights owned by the members of the exchanges.
- ii. Legally, since exchanges are not-for-profit companies limited by guarantee, members are not the owners or residual claimants in the exchanges as shareholders are in a for-profit company limited by shares. According to the Memorandum and Articles of Association of the exchanges, members cannot derive any direct and indirect pecuniary benefit from the exchanges. The income and property of the exchanges can only be distributed to the members in case of winding up. Demutualization of not-for profit companies is generally explicitly prohibited or not provided for in corporate law because the intention of the law is that any special privilege granted to a non-profit institution is not to be passed on to individuals. Often not-for-profit companies limited by guarantee enjoy low or no taxation and are given subsidized resources such as land by the Government on the presumption that pecuniary value of these would not be distributed to the members at any stage.
- iii. **Demutualization and integration would require that the existing members be given trading rights in the new exchange so that they can carry on their business as brokers.** However, if members retain their trading rights in the new setup, then they need not be compensated for the value of the trading rights. The Committee would like to point out that a demutualized and integrated set up in all likelihood would be much superior to the three exchanges whether in terms of size of liquidity pool, potential for growth, number of listed companies, corporate image, or any other measure. Therefore, maintenance of their trading rights in an integrated and demutualized exchange is to the great advantage of members of all three exchanges.

- iv. The ability of a broker to earn brokerage commission is internal to the member. The market shares of members differ significantly and competitiveness of a member depends primarily on his own expertise and resources rather than the size of liquidity pool at his exchange.
- v. The assets of the exchange have been developed by contribution from all stakeholders and it would not be correct to assume that these only represent the contribution of members. In fact, exchanges continue to derive most of their revenue from listed companies. The *laga* charge that exchanges collect from members is fully recovered from the investors as it is built into brokerage commission. The Government has also foregone substantial amount of tax revenue for many years due to not-for-profit status of the exchanges. Since the assets have been built by contribution from all stakeholders, it might not be fair to only compensate the members against these assets.
- vi. Members do not give a meaningful financial guarantee to meet the liabilities of the exchanges. According to the Memorandum of Association of exchanges, the liability of members, in case of winding up of exchange is limited to Rs 1000. Therefore, members cannot claim compensation against any guarantee.
- vii. Due to the mutual not-for-profit structure of exchanges, the value of membership cards of an exchange is not related to its assets. It essentially represents scarcity value, as the number of maximum membership in each exchange is restricted to 200. Had there been no ceiling on number of members and an unlimited number of memberships were available, membership cards would not have carried any value.

Value of membership cards keeps changing in response to market forces of demand and supply. If a new stock exchange was to be licensed by the SECP, it is likely that the exchange-wise market share of turnover, among other things, would change which would change the demand for membership of KSE, LSE, and ISE and the value of these memberships would be reduced considerably.

A good case in point is the licensing of the NSE-India and value of membership cards of the BSE-India. Within three years of its licensing, the NSE-India emerged as India's largest exchange. The value of membership cards of the BSE-India has plummeted with the success of the NSE-India, even though during this period Indian securities market has grown in size and sophistication.

There is no moral or legal compulsion on SECP to maintain the scarcity value of the membership cards of KSE, LSE, and ISE by not licensing another stock exchange that could be better placed to serve the investors and meet the demands of Pakistan's economy. Some members have informed the Committee that the market value of their membership cards and their ability to sell these cards was seriously affected when PEX was licensed as a stock exchange. If the court decision results in allowing PEX to act as a stock exchange, it might drastically reduce the value of membership cards of all three exchanges.

Even in the current mutual structure if some large brokerage houses start functioning as ECN, they would become competitors to the exchanges, which would reduce the value of membership cards.

The Committee also looked at some international practices with regard to compensation in the event of demutualization and integration.

- i. In Hong Kong, in the case of merger of Stock Exchange of Hong Kong Limited (SEHK) and Hong Kong Futures Exchange Limited (HKFE), members of both exchanges exchanged their shares in the respective exchanges for the shares of HKEx. Each SEHK share and HKFE share was cancelled in exchange for 800,000 and 1.4 million shares of HKEX, respectively. The authorization to trade remained unaffected as brokers of both the exchanges, who were trading members immediately prior to the merger, retained their trading rights.
- ii. In Singapore, to compensate the SES shareholders, SIMEX shareholders and SIMEX seat holders, the SGX issued shares to each. The value of the shares was based on slight discounts to the estimated market value of shares, and seats, at the time, taking into account the former shares and seat values would decline once commission was liberalized and access to exchanges opened up. The value was such that S\$6,000,000 attributed to each SES share. S\$115,000 to each SIMEX share and S\$170,000 to each SIMEX seat. The aggregate value of SGX shares issued to shareholders of SES and SIMEX and to SIMEX seat holders was approximately S\$ 308.24 million.
- iii. In Australia, as part of demutualization process the former eligible members were issued shares in ASX. Each of the 606 eligible former corporate and natural members received 166,000 shares resulting in total issued capital of 100,596,000 shares. There was no cash out offer for members and there were no additional shares offered or funds raised by ASX.
- iv. In USA, the Chicago Mercantile Exchange (CME) was the first U.S. Stock Exchange to demutualize. For the purpose of demutualization CME issued two kinds of shares Class A and Class B shares. Both classes of stock have the immediate traditional features of a common stock, however the primary purpose of the class B stock is to confer trading privileges associated with the exchange membership. A total of 25,855,200 shares of class A common stock were allocated. Class B shares at the exchange are traded much the same way as membership or “seats” on the exchanges were traditionally bought and sold. The value of class B shares as determined by the market are based on the value of trading rights and of the A share equivalents bundled with the trading rights.

**The Committee has observed that the available international case studies do not provide the rationale for offering compensation to the members.** The Committee understands that various jurisdictions have addressed this issue in the light of their respective legal framework and practices and pragmatic considerations. Most of the international exchanges were also profitable entities with significant reserves. It is likely that direct and indirect contributions from members were the primary source of revenue for these exchanges.

Having considered all the views and facts regarding the issue of compensation and seen the international precedents, **the Committee is of the view that members of KSE, LSE, and ISE should be given a trading right in the new demutualized and integrated exchange. Since the trading rights of members would be preserved in the demutualized and integrated exchange, there is no justification for paying any compensation to the members on account of their trading rights. However, in order to facilitate smooth and orderly implementation of demutualization and integration, members may be given compensation for their perceived**

**ownership rights in the form of shares of the new demutualized and integrated company to the extent of fair value of the exchanges.**

The Committee would like to point out that those assets of KSE, LSE, and ISE that may have been made available by the Government or its agencies to them on a preferential or concessional basis on the grounds that the exchanges were not-for-profit organizations may have to be excluded from valuation for purposes of demutualization.

For issuing shares to the members of KSE, LSE, and ISE the value of an exchange, as a company, should be equally divided among its members. Say, if the value of an exchange is estimated at Rs 100 million and there are 100 members in the exchange then the value per member is Rs 1 million. Each member should be issued 100,000 shares of the new demutualized and integrated exchange at a face value of Rs 10 each.

The Committee understands that the valuers appointed for valuing each exchange shall use different approaches, such as the income approach and the asset approach to value each exchange. The turnover that takes place at each exchange would be captured in the income approach while the fair value of physical assets would be captured in the asset approach. Therefore, relative advantage of each exchange, be it greater turnover or ownership of strategic assets, would be taken into account in valuation.

Those who own more than one membership should be given a single trading right in the new demutualized and integrated exchange. However, their entitlement to shares of the new exchange should be according to the number of memberships owned. That is, a person who is a member of KSE, LSE and ISE should be given a single trading right in the new demutualized and integrated exchange but he should be given compensation in the form of shares in all three exchanges.

### ***7.7. Moratorium on New Trading Rights***

Once the barrier to entry in the form of scarce membership card is withdrawn, new entrants would be able to enter brokerage business. Demutualization should attract institutions, particularly banks, and other corporate and individual brokers.

Currently, those brokers who have the human resources and technological infrastructure to run a modern day competitive business are few in number. After demutualization, due to entry of better-equipped new comers, particularly financial institutions, the brokerage industry is likely to become more competitive. This would put strong pressures on existing brokers to improve the quality of their services.

To facilitate existing brokers in preparing for inter-broker competition that is likely to follow demutualization, a moratorium on grant of new trading rights was imposed for a certain period in many jurisdictions. Clearly, longer the moratorium, longer it shall take to realize benefits of bringing in new brokers.

Internationally, different moratorium periods have been imposed taking into account the local situation. In Hong Kong and Toronto stock Exchanges, moratorium period of two years was prescribed while moratorium period of one year and fifteen months was imposed in Stockholm and Chicago Mercantile Exchange respectively.

**The Committee is of the view that moratorium should be placed on grant of new trading rights in the demutualized and integrated set up, preferably not exceeding one year, and trading rights should remain transferable during the moratorium period.** This measure is expected to provide additional comfort to the existing members.

### **7.8. Criteria for Trading Rights**

Stakeholders have strongly expressed the view that there must be meaningful licensing and certification requirements for brokers, traders, agents and the key employees. These certifications should be customized for the local situation and appropriate time should be allowed to existing brokers to upgrade themselves for examinations. However, those who cannot pass the necessary examinations must not be allowed to be in this business and there should be no exceptions.

Some stakeholders have suggested that criteria for grant of trading rights should include an assessment of operational capacity of a broker to conduct brokerage business and being compliant with relevant laws. This includes having an appropriate office infrastructure, back office system, trained employees, and compliance mechanism.

Some stakeholders have suggested that to increase operational efficiency and reduce settlement risk, brokers should be classified into trading-only brokers and trading-and-clearing brokers. The latter should be subject to higher standards than the former. In addition, only those brokers should be allowed to provide custody services to clients who can meet new and higher standards.

**The Committee is of the view that in order to improve the quality of intermediation, it would be necessary to review the current criteria for granting trading and custody rights.** Criteria should be prescribed for brokers, traders and agents as well as code of conduct for key employees.

### **7.9. Listing of a Demutualized Exchange**

International experience shows that demutualized exchanges have often self-listed. However, listing is not as widespread as demutualization. While a total of 25 member exchanges of WFE were demutualized as of December 31, 2004, the number of those that were listed was only 10, as given in Table 33.

<b>Table 33: Demutualized &amp; Listed Members of WFE</b>
As of December 31, 2003
Athens Stock Exchange
Australian Stock Exchange
Bolsa de Comercio de Santiago
Deutsche Börse AG
Euronext
Hong Kong Exchanges and Clearing
London Stock Exchange
Singapore Exchange
Stockholmsbörsen
TSX Group
Source: WFE Annual Report 2003

To address the conflicts of interest in self listing, the apex regulator assumes the role that a self listing exchange plays for other listed companies, as in the case of Hong Kong, Australia and Singapore.

Stakeholders have been largely in favor of listing. Listing would offer a number of benefits to a demutualized exchange:

- i. Under the current law, listing is a mandatory requirement for making a public offer of securities. Moreover, brokers are only allowed to trade in securities that are listed.
- ii. It would provide liquidity and price discovery to all shareholders, whether current or potential. It would also be required to attract financial institutions and strategic investors like other international stock exchanges.
- iii. It would subject demutualized exchange to higher standards of governance than an unlisted public company. The Code of Corporate Governance shall become applicable to demutualized exchange, which would automatically ensure adoption of many good governance practices.
- iv. It should force the demutualized exchange to strive to become a role model for other listed companies.

**The Committee is of the view that benefits of listing are substantial and a demutualized and integrated exchange should seek self-listing. To address the conflicts of interest in self-listing, SECP should assume the role that an exchange plays for other listed companies.**

### ***7.10. Allocation of Shares to Different Stakeholders***

The views of stakeholders differ significantly in their recommended allocation to different categories of stakeholders, general public, financial institutions, and brokers.

Some have suggested that general public be given lower allocation. They argue that for the general public, the only purpose of investment in shares is the expected return for which many other avenues are available. Usually, individual investors are not active in exercising their voting rights and a large number of inactive shareholders would increase the voting power of others. They are unlikely to understand the governance issues and their implications in the functioning of a stock exchange.

Others have argued that general public be made a sizable allocation so that there is adequate liquidity in the shares. The general public represents the investors at large and their allocation should be significant. If shareholders of a demutualized exchange are broad based and diversified, the conflict between interest of shareholders and other stake holders would be considerably diluted..

Some are of the view that financial institutions should be given highest allocation. The success of a demutualized exchange would depend a great deal on participation by financial institutions as shareholders and brokers and their commitment towards establishment and operationalization of a better governed exchange. Financial institutions would have the expertise and professionalism to actively exercise their voting rights for promoting good governance.

Others are of the view that members should be given the highest allocation. This view is held by members only. The different views are summarized in Table 34.

<b>Stakeholder Category</b>	<b>Minimum</b>	<b>Maximum</b>
General Public	10%	40%
Financial Institutions	20%	50%
Members	30%	60%

**The Committee is of the view that financial institutions should be allocated the highest percentage of total shares to ensure independence of the exchange.**

### **7.11. Ceiling on Share Ownership of a Demutualized Exchange**

If a few persons or a single category of shareholders assume control of the exchange by acquiring most of its shares, then it could lead to some problems as experienced under mutual structure. The ownership of demutualized exchange should, therefore, be broad based.

Some stakeholders have expressed fear that given the large resources commanded by some market participants, control by a few could be a possibility as it may be difficult to enforce a ceiling in our market because of lack of transparency in shareholding.

Most stakeholders have favored a ceiling of 5%. International experience shows that generally a ceiling of 5% was imposed either on the shareholding or on voting rights that could be directly or indirectly controlled or exercised by a person or a group of persons acting in concert.

- In Hong Kong, a ceiling of 5% on shareholding was prescribed. However, the Securities and Futures Commission, in consultation with the Finance Secretary, could approve a greater than 5% shareholding if it serves public interest.
- In Singapore, a ceiling of 5% on shareholding was used which could be increased with the prior approval of Monetary Authority of Singapore.
- In Australia, initially a ceiling of 5% was imposed in demutualization of ASX which was later increased to 15%, to allow strategic alliances with other exchanges or technology firms – none of which has happened. But both the ASX and the Sydney Futures Exchange, to which the same rule applies, do have non-broker shareholders with holdings at or above 5%, and below 15%.
- In India, the Group on Demutualization and Corporatization of Stock Exchanges recommended a ceiling of 5%.

It has been pointed out that a ceiling of 5% was deemed adequate in other exchanges due to limited number of members. The number of members in our markets is close to 500 and any ceiling, in our case, has to be much lower.

**The Committee is of the view that in order to ensure broad based shareholding a ceiling on either shareholding or voting rights would be required and it should take into account the local peculiarities. Meaningful mechanisms would be needed to enforce such a ceiling.**

### **7.12. Composition of Board of Directors**

Board of directors is the most important pillar of governance. How different stakeholders are represented on the boards would be an important factor in determining the quality of the board and its ability to meet new challenges.

The role of the board in a demutualized exchange would be different from what it is in the current mutual structure. In a demutualized exchange, it would be professional management that would perform the many managerial functions currently undertaken by the board itself. The role of the board in the demutualized structure would be oversight of management and laying down strategic direction.

Stakeholders have suggested different compositions. Some have argued that no broker be allowed on the board of a stock exchange while others have argued that persons associated with brokerage industry should have strong pressure on the board. Some have also suggested that independent bodies and the Government of Pakistan should directly nominate directors on the board. There appears to be a general agreement that all directors, except the CEO, should be non-executive.

- In Hong Kong the board comprises of 8 public interest directors appointed by the Financial Secretary who represent public and market interest and 6 directors are elected by the shareholders. The chief executive of HKEx is an ex officio board member.
- In Singapore, there are 11 members on the board of directors out of whom 4 represent broker interests.
- In Australia there are 9 directors on the board out of whom 4 are from brokerage background, 4 are from non-brokerage background while the CEO is also a member of the exchange.
- Toronto Stock Exchange comprises 11 members on the exchange out of whom 6 are outside directors.

**The Committee is of the view that current board structure and its present role is unsuitable for a demutualized and integrated exchange and a restructuring of the board would be required.**

### **7.13. Tenure of Directors**

The current term of a director is one year. Some stakeholders have argued that the term should remain one year so that those elected on the board can be held accountable annually.

Others are of the view that the term should be of three years as the performance of the board cannot be adequately assessed in one year. A longer term helps the board in longer-term policy making. It also helps the director to develop understanding of technical issues and brings continuity in implementation.

When a demutualized exchange shall become listed, the term of a director under the Code of Corporate Governance shall be three years.

**The Committee is of the view that term of a director should be three years in line with the Companies Ordinance, 1984 and the Code of Corporate Governance.**

#### ***7.14. Criteria and Procedure to become an Elected Director***

Currently, to become an elected member of the board, a person has to be member of exchange for at least one year. Since only a member can be elected director, a candidate for director first fulfils the criteria for membership. Experience shows that only active brokers are elected as directors and therefore, an elected director has to meet the criteria applicable to a broker.

Elections for directors are held on a one-member one-vote basis. The Memorandum of Association of the exchanges does not allow any voting by proxy. Those who receive the most votes stand elected.

Section 187 of the Companies Ordinance 1984 has declared some persons ineligible to become directors. Section 187(j) specifically prohibits a person from becoming director of a listed company if he is a member of a Stock Exchange engaged in the business of brokerage, or is a spouse of such member:

Once a demutualized exchange becomes listed, the general criteria for becoming a director of a listed company, as given in the Code of Corporate Governance, shall become applicable on a director. Clauses (iii), (iv), and (v) of the Code state the following on qualifications and eligibility for a director:

“(iii) No listed company shall have as a director a person who is serving as a director of ten other listed companies.

(iv) No person shall be elected or nominated as a director of a listed company if:

(a) his name is not borne on the register of National Tax Payers except where such person is a non-resident; and

(b) he has been convicted by a court of competent jurisdiction as a defaulter in payment of any loan to a banking company, a Development Financial Institution or a Non-Banking Financial Institution or he, being a member of a stock exchange, has been declared as a defaulter by such the stock exchange; and

(v) A listed company shall endeavor that no person is elected or nominated as a director if he or his spouse is engaged in the business of stock brokerage (unless specifically (unless specifically exempted by the Securities and Exchange Commission of Pakistan).”

**The Committee is of the view that brokers should be allowed to seek election as directors on the board of a listed stock exchange and for this purpose exemption shall be required from Section 187(j) of the Companies Ordinance 1984 and clause (v) of the Code of Corporate Governance. Once an exchange has demutualized, directors would be elected on a one-share one-vote basis in cumulative voting system under the Companies Ordinance 1984.**

#### ***7.15. Criteria and Procedure to become a Nominated Director***

SECP has issued guidelines for appointment of nominated non-member directors on the board of a stock exchange. According to these guidelines, a person should be eligible for inclusion in the panel if he:

- i. is a graduate from a recognized university or equivalent;

- ii. has a professional qualification, or a university degree or diploma in business, finance and management or a closely related discipline; and
- iii. has at least 5 years of experience in matters relating to stock exchanges, accounting, banking, investment advisory, management, economics, fund management and IT etc;

The guidelines also state that a person should not be eligible for inclusion in the panel if he:

- i. has been associated with any illegal banking business, deposit taking or financial dealings;
- ii. has been convicted of fraud or breach of trust or of an offence involving moral turpitude or removed from service for misconduct;
- iii. has been adjudged as insolvent or suspended payment of debts or has compounded with his creditors;
- iv. has betrayed lack of fiduciary behavior and a declaration to this effect has been made by the Court under section 217 of the Companies Ordinance, 1984 at any time during the preceding five years; and
- v. has been convicted by a court of competent jurisdiction as a defaulter in payment of any loan to a banking company, a Development Financial Institution or a Non-Banking Financial Institution

SECP's guidelines also lay down the procedure for nomination. A panel of sixty professionals is constituted based on recommendations of professional bodies and the Securities Market Division of the SECP. Based on the recommendation of the Securities Market Division, the Chairman SECP gives the final approval.

**The Committee is of the view that the guidelines are helpful in finding appropriate persons for nomination as directors.** However, before appointment, an assessment of prior performance of the candidate as an independent director should be made. Moreover, the candidate should undertake that he would be devoting the time required for discharge of obligations of a director.

### ***7.16. Compensation for Directors***

Stakeholders are largely of the view that directors should be compensated for attending board meetings. They argue that directors have to devote significant time and effort to prepare for board and committee meetings and it would be fair that they are compensated in financial terms.

**The Committee is of the view that all directors, whether elected or nominated, should be appropriately compensated.**

### ***7.17. Criteria and Procedure for Selection of Key Management Personnel***

Stakeholders are generally of the view that in order to ensure quality of Chief Executive and other key management personnel, there should be a specific set of fit and proper standards. However, there are some key positions, such as Head of IT Department, which may not be covered by this criteria.

Currently, there are no specific qualifications and experience required for the MD or General Manager. Clause 54(a) of the Memorandum of Association of KSE states:

“The board shall appoint a qualified and experienced person as a whole time paid Managing Director who shall function as the Chief Executive of the Exchange. The appointment of Managing Director shall be made for such period, not exceeding three years at a time, and on such terms and conditions as the Board may determine.”

Clause 54(b) states:

“A person shall not be eligible for appointment as Managing Director if he is a member of the Exchange.”

Clause 55(a) states

“The Board in consultation with the Managing Director shall appoint General Manager, Secretary, other Executives and members of staff who shall not be the members of the Exchange. “

Stakeholders have emphasized the need for the management of the stock exchanges to strike a balance between regulatory and commercial roles at the exchange. The prior work experience of management personnel should be given due weight to ensure avoidance of any unnecessary tilt in either direction.

Others have argued that given the small size of corporate sector in Pakistan, it may not be easy to find the right Chief Executive. Therefore, specific and rigid standards should not be used and the board of directors should be allowed to exercise their discretion and general criteria to select a Chief Executive.

Some have also suggested that demutualized exchange should hire a number of people from international exchanges. Since there are a large number of Pakistani professionals working in the financial sector abroad, it should be possible to hire people with the desired international experience.

**The Committee is of the view that the standards applicable on a nominated and elected director should be applicable on the Chief Executive, General Manager and/or Chief Operating Officer.**

### ***7.18. Geographic Neutrality of Trading Terminals***

Integration would be successful if an integrated exchange is able to provide trading terminals that operate on a level playing field regardless of their physical location. Any lags, that could have been avoided, between two terminals located at two different places, would cause problem.

The Committee has consulted an expert in IT who is of the view that if necessary investments are made, geographic neutrality should be attained. Technology would not be a barrier to integration and matters related to technology can be resolved within a few months.

Turnover on account of integration of existing trading terminals is likely to increase substantially. Later, the turnover may increase much more as more remote terminals would be provided. To cope with higher activity, servers of greater capacity, stronger networks, and higher bandwidth would be required to cope with additional activity.

To provide uninterrupted services, integrated exchange should use both satellite link and fiber optic link. Resources required for monitoring the network would be much greater than used at present.

To minimize possibility of unauthorized access of internet trading terminals given to clients by brokers, smart card system would be required in addition to conventional passwords. Similarly, smart card system would be required for terminals used by the traders or agents of brokers.

To reduce operational risk, an integrated exchange would need fault-tolerant machines as well as a disaster recovery site. Providing trading terminals across country would also require investment in support services such as a call center.

There would be four major heads of IT infrastructure: networks, computer hardware, human resource, and disaster recovery site. Technology is expensive and this is the only area in which running costs and capital expenditure would significantly increase after integration.

**The Committee is of the view that all necessary measures should be taken to enable a demutualized and integrated exchange to provide geographically neutral trading terminals in different parts of the country.**

### ***7.19. Tax Liabilities in Demutualization and Integration***

As all the three Exchanges are presently constituted as "not for profit", being companies limited by guarantee, the members of the said Exchanges are not legally entitled to any direct or indirect pecuniary benefit in the income or assets of the said Exchanges. In fact, on this very premise, the Exchanges currently are not liable to taxation on their income / profit.

Considering the Committee's earlier view that members of the existing Exchanges should be issued shares as consideration other than cash against the fair value of the net assets of the existing Exchanges, there would be a need to provide tax shelter to the members to prevent the value of such shares being taxed in their hands as "income / gain". It may be pertinent to note that the Income Tax Ordinance, 1979, (now repealed) provided an exemption from tax to any income of an individual member of the Exchange derived from transfer of his membership rights or share of a Stock Exchange in Pakistan to a company until 30 June 2001.

Additionally, it is to be noted that while the Exchanges are presently subject to tax on their income, in the event of demutualization and integration, it would be advisable to make suitable provisions in the tax law so as to prevent the Exchanges from being exposed to any potential adverse tax consequences arising from consideration received or deemed to be received by it on transfer / disposal of their net assets to FIDE, for which its shares are recommended to be issued to the members of the existing Exchanges.

### ***7.20. Redundancy of Employees of Exchanges***

Exchanges have a number of employees made redundant due to transfer of clearing and settlement operations to the NCC. Integration shall add to these redundancies.

The Committee is of the view that employment in a demutualized and integrated stock exchange should generally be on a strict basis of merit. However, as between applicants for positions, who are assessed as equally capable of performing the role, preference could be given to existing staff of an

exchange. **Appropriate compensation should be paid to the employees who are made redundant.**

### ***7.21. Financial Health of an Integrated Exchange***

Stakeholders have expressed concern that a demutualized and integrated exchange, being a commercial organization, may face financial difficulties leading to bankruptcy that could disrupt the capital market.

**The Committee is of the view that capital and prudential requirements shall have to be put into place to safeguard financial health of a demutualized and integrated exchange. These should be determined by the SECP.**

### ***7.22. Role of SECP in Demutualization and Integration***

Role of the SECP before, during and after demutualization and integration would be critical. International experience shows that the role of apex regulator was critical in effecting demutualization and its supervision has increased after a stock exchange becomes a for-profit entity.

It appears that the SECP enjoys necessary powers over the exchanges under the Securities and Exchange Ordinance, 1969. It can:

- Register a stock exchange and suspend or cancel its registration
- Suspend or remove the board of directors, any member, or official
- Determine the number and places of stock exchanges
- Register brokers and agents and suspend or cancel their registration
- Demand information from stock exchanges
- Direct a stock exchange to list or delist a security
- Suspend trading in any security
- Penalize insider trading and other market abuse
- Register a depository and suspend or cancel its registration

**The Committee is of the view that demutualization and integration would be complex and hence would require focused and dedicated attention by the SECP.** Measures shall also have to be taken to further strengthen SECP to enable it to cope with its additional responsibilities after demutualization.

## **8. Recommended Models**

The Committee has had intensive deliberations to develop structure of a demutualized and integrated stock exchange, which besides adhering to the highest standards of governance and effectively playing its economic role of mobilizing capital for the corporate entities should also be practically feasible. The Committee is also keen that the recommended structure should not cause any avoidable disruption in the functioning of the stock market.

The Committee considered a number of structures which may be suitable for implementation of the proposal for establishment of an integrated and demutualized stock exchange.

**It is proposing two alternative models viewed by the Committee to be in the best interest of investors and be feasible. These are:-**

- i. Fully Integrated Demutualized Exchange (FIDE); and
- ii. National Exchange.

### ***8.1. Fully Integrated Demutualized Exchange***

The three stock exchanges should merge into a single FIDE. The CDC, NCC, and NCEL shall become subsidiaries of FIDE.

#### **8.1.1. Legal Mode and Sequencing**

Demutualization and integration should be effected simultaneously under a new and specific legislation. The law should deal with the broader scheme of arrangement. Other issues should be dealt with through the existing laws, rules and regulations.

#### **8.1.2. Process of Demutualization, Integration, and Listing**

Demutualization and integration should take place simultaneously as follows:

- i. A new public company limited by shares, NewSE, is incorporated and licensed as a stock exchange by the SECP.
- ii. NewSE shall on inception raise its share capital in a manner that 60% shares of the NewSE be issued to the financial institutions at par for cash consideration while 40% to the members of KSE, LSE, and ISE, issued at par for consideration other than cash i.e. representing the respective fair value of net assets of each exchange. It is important to note that the aggregate amount of 60% shares shall be determined based on the fair value of net assets of the three exchanges for which 40% shares, as aforesaid, are to be issued to their members equally, based on their respective fair value of net assets.
- iii. The assets of KSE, LSE, and ISE are transferred at a fair valuation to NewSE. KSE, LSE, and ISE cease to exist and all membership cards stand cancelled.
- iv. Financial institutions and existing members of stock exchanges make public offer of their shareholding and the NewSE becomes a fully integrated, demutualized, listed public company.

### 8.1.3. Allocation of Shares

The distribution of share capital in FIDE should be as under:

#### Before Public Offer

Financial Institutions	=	60%
Members of KSE, LSE, and ISE	=	40%

One of the financial institutions shall play a leading role with greater equity participation. Each member and financial institution should be required to offer 20% of its shareholding to the general public.

#### After Public Offer

Financial Institutions	=	48%
Members of KSE, LSE, and ISE	=	32%
General Public	=	20%

Alternatively, the Committee recommends that instead of a divestiture to the extent of 20% in favor of general public, FIDE may consider making a fresh issue of shares at par to the general public. However, enabling law for demutualization and integration should provide for appropriate dispensation from the provisions of Section 86 of the Companies Ordinance, 1984 to overcome the right of pre-emption available to the existing shareholders of FIDE. As such additional capital would technically be a Right issue.

### 8.1.4. Ceiling on Shareholding and Voting Rights

No person should be allowed to hold, directly or indirectly, more than 5% of voting shares without prior approval of the SECP.

A person holding trading rights in FIDE should not be allowed to exercise voting rights, directly or indirectly, of more than 1% of total voting rights in a general meeting.

To facilitate enforcement of the above, following measures should be considered:

- Shares of FIDE should only be kept in dematerialized form in the CDS
- Shares of FIDE should not be kept in group-accounts but only in sub-accounts and investor-accounts in the CDS

### 8.1.5. Board of Directors

The recommended composition of the interim board of directors, from the time of incorporation of NewSE to the Annual General Meeting of FIDE, is given below:

Total number of directors	=	9
Number of Nominated Directors	=	8
Out of which...		
Nominated Directors Representing Member Interests	=	3
Nominated Directors Representing Non-Member Interest	=	5
Chief Executive	=	1

All nominations should be made by the SECP. Directors representing member interest should be appointed by the SECP in consultation with the stock exchanges. One member should be selected from each exchange. The Chief Executive should be appointed by the board of directors with the approval of the SECP. Chairman should not be associated with brokerage business

The first board of directors would be elected at the first Annual General Meeting replacing the interim board.

- i. The recommended composition of board of directors is given below:

Elected Directors	=	6
Nominated Directors	=	3
Chief Executive	=	1
- ii. The office of Chairman and MD/CEO should be separate.
- iii. All elected and nominated directors, including Chairman, and should be non-executive
- iv. Chairman should not be associated with brokerage business
- v. The tenure of directors should be three years
- vi. Nominated directors should be appointed by the SECP, as per its existing guidelines
- vii. All directors should be compensated for attending board or committee meetings. The level of compensation should be determined by FIDE in line with market norms.
- viii. To facilitate directors in making effective contribution to the deliberations in the board meetings, FIDE should take steps such as providing detailed orientation.

#### **8.1.6. Trading Rights**

Initially, members of KSE, LSE, and ISE should be given one trading right in the FIDE subject to fulfilling legal requirements. Where a person is a member of more than one exchange, he should be given a single trading right.

After the moratorium period, trading rights should be by qualification, non-transferable, and not subject to any upper ceiling.

There should be at least two classes of brokers each with its own set of criteria:

- i. Trading only Brokers
- ii. Trading and Clearing Brokers

Only corporate brokers with a large capital base should be allowed to become Trading- and-Clearing Brokers.

The criteria for awarding trading rights should include certification examinations for brokers, agents, and traders. The criteria should also take into account the operational capacity of broker to serve his

clients and comply with the relevant laws. The criteria should include a deposit to be made by brokers with FIDE. The size and form of the deposit should be determined by FIDE. The criteria should encourage consolidation in the number of intermediaries. The FIDE should determine the criteria in consultation with the SECP. The existing brokers may be made trading-only brokers or trading-and-clearing brokers as per the new criteria developed by FIDE.

To maintain their trading rights, every member of KSE, LSE, and ISE should be required to meet the new trading criteria within the time set by FIDE. There should be a phased plan for up-gradation of existing brokers to meet the new criteria.

#### **8.1.7. Moratorium Period**

There should be a moratorium period of 1 year on grant of new trading rights after demutualization and integration. Trading rights should remain transferable during the moratorium period. After the moratorium period, trading rights should be non-transferable to be granted only by the FIDE.

#### **8.1.8. Management of Settlement Risk**

Settlement risk management should be transferred to the NCC as it develops adequate capacity.

Given the importance of risk management, a specific and permanent committee of the board of directors and senior management should be set up to periodically review all matters pertaining to risk management.

Any change in regulations relating to risk management should continue to require approval by the SECP.

#### **8.1.9. Encouragement of ECN**

In order to provide competition to FIDE, SECP should develop the necessary framework to allow brokerage houses to act as ECN, i.e. provide electronic in-house order matching services. The legal framework for ECN should ensure that an investor trading through an ECN shall be offered as favorable a price as he would have been offered if the trade was executed at the stock exchange.

#### **8.1.10. Compensation to Members**

Although members of the three exchanges do not legally have beneficial or ownership rights in the assets of the Exchanges, on grounds of practical and pragmatic considerations there could be some justification whereby members be compensated for their perceived ownership rights in the net assets of the exchange. The fair value of each exchange, as a company, should be assessed by valuers. For issuing shares to the members of KSE, LSE, and ISE, the value of an exchange as may be determined through a process of valuation, should be equally divided among the members of an exchange. Say, if the value of an exchange is estimated at Rs 100 million and there are 100 members in the exchange then the value per member is Rs 1 million. Each member should be issued 100,000 shares of the new demutualized and integrated exchange at a face value of Rs 10 each.

The Committee would like to point out that those assets of KSE, LSE, and ISE that may have been made available by the Government or its agencies to them on a preferential or concessional basis on the grounds that the exchanges were not-for-profit organizations may have to be excluded from valuation for purposes of demutualization.

The Committee understands that the valuers appointed for valuing each exchange shall use different approaches, such as the income approach and the asset approach to value each exchange. The turnover that takes place at each exchange would be captured in the income approach while the fair value of physical assets would be captured in the asset approach. Therefore, relative advantage of each exchange, be it greater turnover or ownership of strategic assets, would be taken into account in valuation.

#### **8.1.11. Measures to Address Conflict of Interests**

The most effective measure to address conflicts of interest in a demutualized exchange would be a balanced board of directors and supervision by SECP. However, a number of other complementary measures would also be required.

- i. A permanent committee of board of directors and senior management personnel should be formed that would develop a system for identifying all conflicts of interest to the board.
- ii. SECP should administer the self-listing of FIDE. SECP should play the role that an exchange plays for a new company seeking listing.
- iii. Any increase in cost for issuers, brokers, or investors should be subject to approval of SECP.
- iv. A permanent committee of directors and senior management should be set up to identify conflicts of interest on an on-going basis to the board and regulators.
- v. Regulatory functions should be separated from business functions.
- vi. Detailed budgeting should be required for performance of regulatory functions.
- vii. A separate annual report or a separate section in the annual report should be required on performance of regulatory functions. Specific disclosure should be required in areas where there is a conflict of interest for the exchange between its regulatory and commercial function.
- viii. Revenues earned by exercise of regulatory powers, such as penalties on brokers, should be used only for skill and professional development of brokers, traders, agents, etc. and education of investors.
- ix. A permanent Risk Management Committee should be formed consisting of senior management and directors.
- x. Surveillance, investigations, and enforcement into price manipulation and other forms of market abuse should be conducted by a separate internal division.
- xi. After FIDE has been listed, SECP should assess the need to separate the listing function from the FIDE.

#### **8.1.12. Human Resource**

Employment in FIDE should be strictly merit based. However, as between applicants for positions at FIDE who are assessed as equally capable of performing the role, preference could be given to existing staff of an exchange. Appropriate compensation should be paid to the employees who are made redundant.

#### **8.1.13. Financial Health of FIDE**

Capital and prudential requirements should be placed on FIDE to ensure its financial health on sustained basis. These should be determined by the SECP.

#### **8.1.14. Plan to Solve Market Problems**

The board of directors of FIDE should make a set of clear and detailed short-term to long-term plans for addressing the various problems facing the capital market. The board of directors of FIDE should monitor its progress in addressing these problems.

### ***8.2. Alternative Model – National Exchange (NE)***

As an alternative to FIDE, the Committee recommends that if sufficient progress is not made towards demutualization and integration in one year, the NewSE, sponsored by financial institutions, should start its operations as a National Exchange (NE).

The NE would have the economic and human capital and the desired governance structure to emerge as a truly national securities exchange in Pakistan and address the problems of the market.

After three years, SECP should assess the desirability and feasibility of each exchange. If any exchange is found unable to effectively serve the investor interests, its registration should be cancelled.

### ***8.3. Critical Success Factors***

Success of FIDE or NE shall depend on the following critical factors.

- i. Commitment by SECP
- ii. Further strengthening of SECP to cope with additional responsibilities
- iii. Commitment by the Government of Pakistan
- iv. Participation by banks and other financial institutions in the new setup as shareholders and brokers, with a strong sense of ownership in making FIDE a success
- v. Fair compensation to members of KSE, LSE, and ISE against their perceived ownership rights in the exchanges
- vi. The quality of the first board of directors and its Chairman
- vii. The quality of the first CEO and expertise of the management team

#### **8.4. Implementation of Demutualization and Integration**

The Committee would recommend the following implementation plan for demutualization and integration, as per the first model, FIDE.

- i. SECP discusses this report with the Committee. Any issues that need clarification are explained by the Committee.
- ii. Given the financially sensitive nature of the recommendations of the Committee, the SECP puts a freeze on issuance of new memberships by KSE, LSE, and ISE before the report is made public.
- iii. SECP discusses the recommendations of the Committee with all the stakeholders, particularly the members of the stock exchanges.
- iv. Valuers, legal advisors, and merger consultants are appointed to value the exchanges, draft the required legislation, and develop a detailed scheme of demutualization and integration. The technological arrangements for integration of trading platform of the exchanges are made so that trading can go on uninterrupted.
- v. The proposed legislation is submitted to the Government and steps towards promulgation are taken.
- vi. Memorandum and Articles of Association of NewSE and its Rules and Regulations are prepared by a team of professionals and members appointed by the SECP.
- vii. Based on the valuers' reports, the total paid up capital is determined so that 60% of shares are issued to financial institutions against cash and 40% of shares are issued to members of KSE, LSE, and ISE for consideration other than cash.
- viii. SECP nominates the interim board of directors of the NewSE. The board selects a Chief Executive for one year term. The Chief Executive is approved by the SECP.
- ix. Assets of KSE, LSE, and ISE are transferred to the NewSE which becomes FIDE. All trading is now only done on FIDE. KSE, LSE, and ISE cease to exist.
- x. The board of directors of FIDE implements the detailed scheme of arrangement.
- xi. Members and Financial Institutions make a public offer of 20% of their holding through an offer for sale document. FIDE becomes self listed. SECP administers the self-listing of FIDE in the same manner as FIDE shall administer the listing of other companies.
- xii. After the end of one-year moratorium, trading rights are opened for new brokers.

## 9. Comparison of Current & Recommended Structures

	Current	FIDE	NE
<b>Number of Exchanges</b>	3	1 (subject to the need to license another stock exchange)	4 (KSE, LSE, ISE and NE) The number may reduce due to subsequent mergers, if any
<b>Corporate Structure</b>	Not-for-profit public companies limited by guarantee, without share capital	A listed for-profit public company limited by shares	A listed for-profit public company limited by shares
<b>Number of shareholders</b>	Members are implicitly owners of the exchange and membership is restricted to 200	No upper or lower ceiling on number of shareholders	No upper or lower ceiling on number of shareholders
<b>Types of Shareholders</b>	Do	Financial institutions, general public, former members of KSE, LSE, and ISE	Financial institutions, and general public.
<b>Election of Directors</b>	Through Annual General Meeting on a one-member one vote-basis	Through Annual General Meeting on a one-share one-vote basis	Through Annual General Meeting on a one-share one-vote basis
<b>Number of Trading Right Holders</b>	Limited to the number of members of stock exchanges registered with the SECP as brokers	Members of KSE, LSE, and ISE during the moratorium period. Afterwards, any number of persons that meet the criteria of FIDE and are registered with the SECP as brokers.	Any number of persons that meet criteria of NE and are registered with the SECP as brokers
<b>Types of Members of Clearinghouse</b>	All members are trading members as well as clearing members	Two types, Trading-only and Trading-&-Clearing members	Two types, Trading-only and Trading-&-Clearing members
<b>Sources of revenue</b>	Listing fee, service/laga charges on transactions etc	Transaction charges/Laga, information services, clearing and settlement fee, listing fee, custody fee, other business ventures etc	Transaction charges/Laga, information services, listing fee, other business ventures etc
<b>Access to Economic</b>	Restricted due to not-for-profit mutual	All channels, including capital market,	All channels, including capital

<b>Capital</b>	structure	available to a listed public company shall be available to FIDE	market, available to a listed public company shall be available to NE
<b>Room for making international alliances through equity stakes</b>	None	FIDE would be well placed to enter into alliances with international exchanges	NE would be well placed to enter into alliances with international exchanges
<b>Maximum number of Trading Rights</b>	Maximum number of trading rights in an exchange are limited to maximum number of members in that exchange, i.e. 200	After the moratorium period, there would be no cap or floor on number of trading rights	There would be no cap or floor on number of trading rights
<b>Transferability of Trading Rights</b>	Transferable – can be freely sold or purchased from members or exchanges, as applicable	Transferable during moratorium period. Non-transferable after moratorium period and given by FIDE based on qualification	Non-transferable – given by NE based on qualification
<b>Status of CDC</b>	A public company limited by shares that is owned by KSE, LSE, ISE and other financial institutions	A public company limited by shares that shall be a partially owned subsidiary and service provider of FIDE	CDC shall be a service provider to the NE just as it is a service provider to the existing stock exchanges
<b>Status of NCC</b>	A private company limited by shares that is owned by KSE, LSE, and ISE and other financing institutions and acts a service provider to the existing exchanges	A private company limited by shares that would be a partially owned subsidiary of FIDE and act a service provider to FIDE and other institutions, if desirable and feasible	A private company limited by shares that shall be a service provider to the NE just as it is a service provider to the existing stock exchanges
<b>Composition of the board</b>	A total of 10 directors; 5 directors are elected by members, 4 are nominated; Managing Director is a director by virtue of his office	A total of 10 directors; 6 are elected by the shareholders; 3 are nominated by SECP; Managing Director is a director by virtue of his office	A total of 10 directors; 6 are elected by the shareholders; 3 are nominated by SECP; Managing Director is a director by virtue of his office
<b>Chairman of the board</b>	Member, usually an active broker	Not associated with brokerage business	Not associated with brokerage business
<b>Tenure for a Director</b>	1 year	3 years	3 years

<b>Broker Committees</b>	A number of broker committees are used by exchanges as supplementary decision making bodies	No broker-committees would share any direct or indirect role in decision making. User forums may be established by the FIDE for on-going feedback on services	No broker-committees would share any direct or indirect role in decision making. User forums may be established by the NE for on-going feedback on services
<b>Management of systemic risk</b>	Responsibility of the exchanges	Responsibility of the NCC	Responsibility of the NE
<b>Ceiling on Shareholding</b>	Not Applicable	<p>A broker should not be allowed to exercise voting rights of more than 1% of total voting rights in a general meeting.</p> <p>Those who do not have trading rights in FIDE and are not associated with those holding trading rights should not hold more than 5% of voting shares without prior approval of the SECP.</p>	<p>A broker should not be allowed to exercise voting rights of more than 1% of total voting rights in a general meeting.</p> <p>Those who do not have trading rights in NE and are not associated with those holding trading rights should not hold more than 5% of voting shares without prior approval of the SECP.</p>

## **Annexure A: Questionnaire for the Stake Holders**

1. In your view, what would be the most significant advantages/disadvantages of Demutualization of our exchanges?  
Please state advantages/disadvantages with reasons
2. Should the Karachi Stock Exchange (KSE), Lahore Stock Exchange (LSE) or Islamabad Stock Exchange (ISE) or any combination thereof integrate/consolidate? What would be the most significant advantages/disadvantages of integration?  
Please answer in Yes/No, state advantages/disadvantage with reasons
3. Whose decision it should be to integrate or not to integrate?  
Please propose who should take the decision and state your reasons.
4. What would be the best sequence for demutualization and integration?  
Please specify your proposed sequence and state your reasons
5. Should there be only one exchange (monopoly) for all types of securities or more than one exchange (competition) after demutualization?  
Please answer in Yes/No and state your reasons.
6. Is having specialized demutualized exchanges, not in direct competition with each other, for equity, debt, derivatives, small-cap, etc or any combination thereof desirable, and feasible?  
Please answer in Yes/No and state your reasons. If your answer is yes, propose the number and types of specialized exchanges. Please state your reasons
7. What should be the criteria to determine that the holder of trading rights / broker is (i) fit and proper, and (ii) credit worthy?  
Please state your proposed criteria and reasons
8. Should a demutualized exchange seek listing? If yes, should it be allowed to self-list or only list on another exchange? What should be the time lag, if any, between demutualization and listing?  
Please answer in Yes/No, give your proposed method of listing and time lag, and state your reasons
9. How should shares of an exchange undergoing demutualization be offered to non-members? What should be the proportional allocation of shares to each stakeholder category, i.e. general public, members, financial institutions, etc?  
Please propose a method, state your allocations with reasons.
10. Are you in favor of imposing ceilings on number of voting shares to prevent a person or a group of persons from taking control of a demutualized exchange? If yes, what ceiling would you propose? What measures would be required to practically enforce such a ceiling?  
Please answer in Yes/No, propose your ceiling, if applicable, propose measures to enforce the ceiling and state your reasons.
11. What should be the fit and proper standards for the key management personnel of a demutualized exchange?  
Please state your proposed standards with reasons

12. How many directors should be on the board of a demutualized exchange? What should be the proportion of elected and nominated directors?  
Please give your proposed number and types of directors and state your reasons
13. What should be the length of the term of a director?  
Please specify your proposed length with reasons.
14. What should be the fit and proper standards for a director of a demutualized exchange?  
Please specify your proposed standards and reasons.
15. Who should nominate directors and what should be the procedure for nomination?  
Please give your proposed method of nomination, if applicable, and state your reasons.
16. What measures should be taken to ensure that nominated directors can effectively contribute in the board? Is compensation key to attracting nominated directors of desired quality? How much a director should be paid for attending a board meeting or a committee meeting?  
Please propose your measures and compensation for a director. Please state your reasons.
17. Should special conditions be imposed on the office of the Chairman of the board of a demutualized exchange, such as separation of the offices of Chief Executive and Chairman?  
If yes, what special conditions should be imposed?  
Please answer in Yes/No and propose your conditions, if applicable. Please state your reasons.
18. What would be the major conflicts of interest in a demutualized exchange? How should these conflicts be identified on an on-going basis?  
Please state the conflicts, your proposed mechanism for their on-going identification, and state your reasons
19. What steps should be taken to deal with the conflicts of interest in a demutualized exchange?  
Please state your proposed steps with reasons
20. Are there any other issues specific to demutualization and integration that you would like to express your views on?

## Annexure B: Response by Stakeholders on Integration of KSE, LSE, and ISE

<b>List of Stakeholders who are in favor of Integration of KSE, LSE, ISE</b>
<b>Members</b>
11 Members of KSE/LSE/ISE
<b>Listed Companies</b>
Fauji Fertilizer Bin Qasim Ltd
ICI Pakistan
Millat Tractors Limited
Muslim Commercial Bank of Pakistan
Orix Investment Bank
Pakistan International Container Terminal Limited
Pakistan PTA Limited
Pakistan Industrial Credit and Investment Corporation
Shell Pakistan Limited
Siemens Pakistan Engineering Co. Limited
Standard Chartered Modaraba
Wah Nobel
<b>Others</b>
ABAMCO Limited
Atlas Asset Management Company Limited
Institute of Chartered Accountants of Pakistan
Investment Corporation of Pakistan
Leasing Association of Pakistan
Modaraba Association of Pakistan
Mutual Fund Association of Pakistan
National Commodity Exchange Limited
Nissar Ahmed, former President of Cresbank
Overseas' Investors Chamber of Commerce and Industry
State Bank of Pakistan
<b>List of Stakeholders who are against Integration of KSE, LSE, and ISE</b>
<b>Members</b>
7 members of KSE/LSE/ISE
<b>Listed Companies</b>
East West Insurance Co. Ltd

<b>List of Stakeholders who did not give a definite response on Integration of KSE, LSE, and ISE</b>
<b>Members</b>
2 members of KSE/LSE/ISE
<b>Listed Companies</b>
Burma Oil Mills Limited
Kohinoor Textile Mills limited
Kohinoor Weaving Mills Limited
Lease Pak Limited
Maple Leaf Cement Factory Limited
National Bank of Pakistan
<b>Others</b>
Investment Bank Association of Pakistan
National Investment Trust Limited

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