

APPENDIX X

Previous Stock Market Crises

There was stock market crisis in May 2000 .The crisis occurred mainly due to over trading triggered by COT financing, attempt to manipulate and lack of effective risk management system. As a result one member of KSE was declared defaulter and the KSE remained closed for one day. On the other hand at least four members of LSE were either suspended or declared defaulter and LSE remained closed for at least two days.

In order to identify the reasons for crisis two Committees were formed. One Committee headed by Mr. Etrat Rizvi was set up in June 2001 while the other Committee consisting of Mr. Habib-ur-Rehman and Rashid Sadiq was set up in August 2001.

Abnormal situation also arose at Karachi Stock Exchange during 20-22 May 2002. The market went down sharply due to growing border tension between India and Pakistan and rumors of non availability /withdrawal of funds by COT financiers. During the period 20-22 May 2002 KSE-100 index dropped by 14%. As a result market remained closed for one day i.e. 23 May 2002. The then Finance Minister advised SEC to submit an analytical report on the events during 20-22 May 2002 along with its recommendations.

Attached:

1. Recommendations of Etrat Committee (Annexure I).
2. Recommendations of M/s Habib-ur-Rehman and Rashid Saadiq Committee (Annexure II).
3. Recommendations of SECP Report (Annexure III).

Implementation Status of Etrat Committee

Recommendations of the Committee

A. Price Manipulation & Unfair Trade Practices

(1) Based on the investigations carried out by the Committee, the data made available and the circumstantial evidences, the Committee is of the opinion that the trading practices of Mr. Iftikhar Shafi can be categorized as being price manipulative and also as unfair trade practices in the shares of Adamjee Insurance and Bank of Punjab. The Committee recommends that he should be restrained from trading in the stock market for an appropriate period under the provisions of the Securities and Exchange Ordinance, 1969.

2) Lahore Stock Exchange has suspended four of its members on account of their failure to meet the Clearing House obligations. In accordance with the regulations of LSE, these suspended members be declared defaulters. These four members, as well as all the members who had defaulted since the establishment of the Exchange, be debarred for life from operating in the stock market.

3) It has been found that the following stock brokers of Mr. Iftikhar Shafi, were the front runners, when he was likely to sell his shares of Adamjee Insurance in mid-April, 2000.

- “i) Mohammad Hanif Moosa (defaulted member)
- “ii) Moosa, Noor Muhammad, Shahzada & Co. (Pvt) Ltd.
- “iii) First Capital ABN Amro Equities (Pakistan) Ltd.
- “iv) Republic Securities (Pvt.) Ltd.

“(4) In the case of Bank of Punjab it has been noted that Mr. Iftikhar Shafi’s broker Mr. Hanif Moosa of KSE and Mr. Tanveer Malik of LSE were the major sellers after April 13, 2000 and had sold large quantities of BoP shares in the week 13th to 21st April, 2000 and had reaped the benefit of high prices (on 13th April the highest price was Rs. 52.25). These two appear to have done front running and have indulged in unfair trade practices. It is recommended that suitable action may be initiated against them to recover the undue gains

B. Securities & Exchange Commission

“(1) The crisis at KSE and LSE was aggravated by the laxity of the management for non-implementation of the exposure/loss regulations. The Exchanges may be asked to take appropriate action against the persons who failed to discharge their responsibilities.

“(2)The Committee has observed that LSE has been operating Carry Over market parallel to the regular market on the last day of the trading period. The objective appears to be to facilitate its members to flout the exposure requirements. The practice needs to be stopped and LSE should allow COT for a specific time period after closure of the regular market.

“(3) The role of Stock Exchanges Co-ordination Committee need to be improved so that there is uniformity in regulations, procedures and timely coordinated actions in the stock market.

“(4) A qualifying code of conduct should be evolved for those members of the exchange who wish to be on the Board of Directors of an Exchange.
(5) The Management of the Stock Exchanges must be given operational independence. Hiring and removal of the Chief Executive of the Exchange should be with the approval of SEC.
(6) The Management of the Exchange be required to submit to SEC a compliance report on quarterly basis on the implementation of decisions taken by the respective Board and the directives issued by the Commission.
(7) The role of outside directors need to made meaningful. They should be required to submit a quarterly report to SEC.
“(8) The present system of selecting directors from amongst the nominees of professional bodies by the Stock Exchanges needs to be reviewed. The selection of outside directors be made by SEC.
(9) The SEC should carry out risk management and system audit of sample stock brokers of the Exchanges annually.
“(10) The net capital balance requirement of stock brokers should be raised substantially and a cap be placed on their capacity to trade in relation to their net capital.
“(11) A surveillance department with online data transmission facilities with all the three stock exchanges needs to be established at SEC.
“(12) The identity disclosure facility of buyer/seller stock brokers, presently being available at KATS and LOTS, may be withdrawn to curb the herd mentality and speculative trading

“(13) Officers of Karachi and Lahore Stock Exchanges on whom responsibilities for lapses in discharging their duties has been fixed, should be proceeded against.

“C. Board of Directors, Management & Infrastructure

(1) Chairman and Vice-Chairman of the Board should not assume the executive functions. Instead of direct elections, they should be elected by the Board.

“(2) Chairman of KSE Board should not be the Chairman of the CDC Board.

“(3) The KSE and LSE should expedite the up gradation of software and hardware to meet the challenges of the upcoming internet trading.

“(4) KSE and LSE should upgrade Clearing House computer system for automatic monitoring of exposures limits and loss. The system should provide for early warning signals to be sent to the dealers and automatic shut-off of their computers in the case exposures limit is reached.

“(5) A professionally staffed Surveillance department is needed at the Exchanges. It should monitor scrip-wise price movement, turnover, deliveries and COT on each clearing and report abnormal variation to the Managing Director.

D. Trading, Settlements & Carry Over Transactions

(1) For better risk management and containment of undue speculation fixed trading cycle needs to be discontinued and a revolving settlement cycle on T+3 basis be introduced initially through 10 volume leading scrips.

?(2) The audit department of the Stock Exchanges should be vested with the responsibility to carry out periodical checks to ensure proper compliance of the regulations relating to risk management.

?(3) All changes in the exposure regulations should be formally audited by the internal audit department for ensuring accuracy. Report should be submitted to the Managing Director

?(4) A system audit function capable of auditing the computer-based systems needs to be established at the exchanges. The exchanges should co-ordinate and establish contact with the international exchanges for benefiting from the international practices.

“(2) Short selling be permissible only on up tick price and that to with a disclosure. Delivery should be made compulsory by borrowing of stocks.

“(3) The Exchanges should bind their stock brokers to obtain margin from their clients and to monitor compliance, audit department should carry out random checks periodically.

“(4) Upward movement beyond 5% of the day’s opening price of a scrip be linked to trading in the scrip. Raising of price beyond 5% without any trading be prohibited.

“(5) To facilitate the monitoring of trades, particularly in case of disputes, the input of customer code be made mandatory with each order.

“(6) COT business should be broad-based so as to improve investors confidence in it. The prominent financial institutions willing to undertake COT business should be made members of the Clearing House.

“(7) COT rates should be the average of clearing period or closing rate on last day of trading, whichever is lower.

“(8) The weekly band limits for spot declaration needs to be changed to a daily band basis in the following manner:

Share Value

Share having market value of upto Rs.10.00

Daily band

Up to 25% of Rs. 4, whichever is Higher, from the opening rate of the day.

Share having market value of more than Rs. 10.00 and up to Rs.20.00

upto 15% or Rs.5 whichever is higher, from the opening rate of the day.

Share having market value of more than Rs.20.00

upto 10% of or Rs.6, whichever is higher, from the opening rate of the day.

Recommendations for KSE

Recommendations
1) Management of Exposure Limits: KSE must strengthen the Clearing and Settlement Department and take necessary steps including implementation of the recommendation of Review Committee.
2) The powers of the Board of Directors to prescribe changes in Exposure/Loss limit and slab rates for deposit payable there against. It is recommended that the decision of the Board should be made after obtaining comments of all stakeholders and subject to confirmation of SEC.
3) Delegation of authority to the Managing Director: The delegation of authority to the Managing Director to delete any company from the list of approved securities or enhance its margin may be discontinued.
4) Location of Clearing and Settlement Department. The Clearing and Settlement Department of K.S.E. is located in the old building away from the limelight. The correct location of this very sensitive department should be in the main building under the watchful eyes of the top management, ensuring the inaccessibility or no contact of the market players.

Recommendations for LSE

1. Conflict of interest provisions of the Companies Ordinance, 1984.

1.1 SEC should ensure that the Board of Directors strictly complies with the requirements of the Companies Ordinance, 1984 pertaining to conflict of interest issue. The Directors of LSE are in a fiduciary duty to safeguard the interest of LSE, its members and the investors and not their personal interest.

1.2 SEC may strictly watch the affairs of LSE and take action against the directors who violate the mandatory provisions of the Companies Ordinance, 1984, Articles of Association and directives of SEC.

1.3 The Articles 8.1 strictly prohibit directors from having business dealing with the Exchange. SEC may look into if any of the current activities of the directors could fall under the definition of business dealings.

1.4 Enquiry Committee has also observed that a sizeable number of members of KSE also hold membership of LSE. These members are not active at LSE and visit only to cast their vote at the time of election of Directors of LSE. They vote collectively for the group of directors of their own choice. SEC may also look into this aspect so that LSE may be freed from the influence of KSE.

2. Management of exposure limits. LSE must have tailored software to promptly identify the positions of those accounts, which crossed their limits of exposure and losses and identify and block their trading rights automatically. Audit department should also give priority to the compliance of exposure regulations. Before implementing any change in exposure rules, the software must be developed and tested.

3. Power to make changes in exposure and loss limits and deposit payable thereon. It is recommended that the decision of the Board should be made after obtaining comments from all stakeholders and subject to confirmation of SEC.

4. Members' Default and Procedure for Recovery of Losses Regulations. Mr. Iftikhar Shafi has recently been declared defaulter. LSE must now strictly follow its regulations and determine scrip wise loss with a statement of transactions made with other members in those scripts. The members must pay the losses to Clearing House of LSE as required by the Default Regulations of LSE.

5. Internal Audit. There is no in house audit department. This has resulted in indiscipline and other irregularities. The Enquiry Committee strongly recommends that SEC may direct LSE to immediately put in place an internal audit system, which could take the system audit of Clearing House periodically.

6. Code of conduct for directors. The members of the Board of Directors are required to follow

and be seen as conforming to the ethical standards and norms. SEC may, therefore, prepare and implement a code of conduct for the directors of and make the directors accountable for their misdeeds. Non-compliance with the Regulations Governing Members' Exposures and Members, Default and Procedure for Recovery of Losses regulations have resulted in losses to the Clearing House/members.

7. Clearing House Staff. There is great need to strengthen the professional management at the Clearing House of LSE. Every officer must know his/her job description. Orientation of the staff is also imperative along with their regular training for enhancing their capacity.

8. Recording of minutes of Board meetings. The minutes of the Board of Directors amply demonstrate lack of information, lack of discussion and deliberation and application of mind. It is recommended that the LSE may recruit a professional and experienced Secretary to the Board.

9. Trust for Member Contribution Fund and Investor Protection Funds It is recommended that trust may be established for the administration of the Member Contribution Funds.

10. Non-compliance of mandatory provisions. In a Board of eighteen (18) members, it has been noted that in several cases the attendance was less than 50% of the total number of directors. SEC may impress upon the Board of Directors to follow the provisions of the Companies Ordinance, 1984 and the Articles of Association of LSE

Recommendations of the Stock Market Report during 20-22May 2002

Recommendations

1) There was neither any settlement problem nor any risk with regard to market integrity. However, the crisis in September 2001 as well as the latest happenings in the market, certainly highlights the fact that governance and risk management issues require serious consideration. It was further observed that time and again that the member directors, particularly the Chairman and Vice Chairman continuously interfere in the day today affairs of the Exchange and try to influence the management's day to day decisions by exerting group pressure and thus forcing the management / Board to deviate from rules and regulations. This trend is dangerous and needs resolution on priority basis. The following steps need to be taken to avoid this:

1. The Chairman and Vice Chairman should not have offices in the administrative block of the Exchange.
2. The Chairman and Vice Chairman should not be elected by the members directly, rather they should be elected by the Board.
3. The existing composition of member directors needs to be reduced from 10 to 5.
4. The management of the Exchange should be strengthened

2. The problems of the market are caused by the financiers and financees (weak holders). The long-term solution for the market is easy availability for financing against shares, including margin financing which is, at present, non-existent. Till such time we are able to have proper institutional arrangements for share financing or margin financing, there is a need to improve the existing regulations for COT.

3) The SEC has directed the stock exchanges to incorporate important changes in the COT regulations with certain checks and balances as under: -

- ◆ COT should be for a **minimum period of 10 days** and the financee will have the option to release it after one day. However, the financier is obliged to rollover for 10 days, if so desired by the financee.
- ◆ COT should only be allowed in the shares of the top 15/20 companies, which are liquid.
- ◆ The margin for COT should be 25% higher than for normal market trades.
- ◆ COT shares to be kept with CDC or with the Clearing House of the Exchange to eliminate any

chances of its misuse by financiers.

4) The other risk management steps should include:

- ◆ The existing definition of net capital balance needs to be reviewed and made more effective. The possibility of keeping about 50% of the net capital balance with the management of the Exchange should be considered.
- ◆ A system of pre-trade verification should be introduced at the KSE at the earliest.

5) The Commission is holding a meeting of the SEC –Stock Exchanges Coordination Committee on 11.06.2002 and of the Capital Markets Consultative Group on 12.06.2002 to discuss inter alia the proposed amendments in the COT regulations and other proposed risk management measures.