



**A BLUEPRINT FOR REGULATION AND
DEVELOPMENT OF CORPORATE AND
FINANCIAL (NON-BANKING) SECTORS**

S E C

A Blueprint for Regulation and Development of Corporate and Financial (non-banking) Sectors¹

Regulation is a means to an end and not an end in itself. The objective of regulation is the progressive development of business, commerce, trade and industry.

Dr. Tariq Hassan

1.1 Introduction

The power to regulate business and trade and enact business and trade laws is provided in the Constitution of the Islamic Republic of Pakistan, 1973 (the Constitution). The Constitution, under Article 18, grants every citizen the right to enter into any lawful profession or occupation and to conduct any lawful trade or business. This fundamental right is conditional on such qualifications, if any, as may be prescribed by law for the purpose. Various trade and business laws, falling within the Federal Legislative List of the Constitution, have been enacted to lay down qualifications for the conduct of banking, insurance, and securities businesses. Furthermore, an enactment on companies, including non-banking finance companies (NBFCs), serves as the underlying legislation for all such business and trade activities.

The fundamental right to conduct any trade or business is also subject to the stipulation that any trade or profession may be regulated by a licensing system and that trade, commerce or industry may be regulated in the interest of free competition as well. Based on these stipulations, the Securities and Exchange Commission of Pakistan (the Commission) was established in 1997 for the beneficial regulation of capital market and superintendence and control of corporate entities. Over time, its supervisory and regulatory mandate has been extended to insurance companies, NBFCs, private pensions as well as various professional services.

The rule and regulation making powers of the Commission are derived from the Securities and Exchange Commission of Pakistan Act, 1997 (the SECP Act). Section 43(b) of the SECP Act provides that rules under the Companies Ordinance, 1984 (the Companies Ordinance) or under any law being administered by the Commission shall be made by the Commission with the approval of the Federal Government. Similarly, the power to make regulations have been conferred by Section 40 of the SECP Act on the Securities and Exchange Policy Board (Policy Board) on the recommendation of the Commission and in consultation with the Federal Government and also on the Commission in consultation with the Policy Board.

In addition to its regulatory function, the Commission has been assigned the task of encouraging the organized development of the corporate sector and the capital and insurance markets in Pakistan. In performing its functions and exercising its powers, the Commission is required to maintain facilities and improve the performance of companies and securities markets in the interest of commercial certainty, reducing business costs, and boosting efficiency and development of the economy. It is also required to promote the establishment and development of professional and educational organizations connected with insurance business with a view to improving the quality of insurance services in the country.

Mindful of its expanded role as an integrated regulator of corporate and financial (non-banking) sectors in Pakistan, the Commission is in the process of developing a medium-term strategy for improving the existing regulatory framework and facilitating the development of corporate and financial sectors.

As a step towards the formulation of the medium-term strategy, this chapter provides an overview of the current legal and regulatory framework of sectors falling within the purview of the Commission and identifies issues impeding development of these sectors. It suggests measures to address the challenges that lie ahead and provides a blueprint for the effective regulation and development of corporate and financial (non-banking) sectors in the country. Based on this blueprint, the Commission intends to develop a more comprehensive regulatory framework for development over the course of the year.

¹ Financial (non-banking) sector, for the purpose of this report, includes capital market, insurance sector, NBFC sector, modaraba sector, private pensions as well as professional service providers in these sectors.

1.2 Overview of Legal and Regulatory Framework

Over the past few years, the Commission has introduced a plethora of reforms in the legal and regulatory framework with a view to improve and update the same. This section outlines those significant developments in the legal and regulatory framework, which have considerable bearing on the future development of the corporate and financial (non-banking) sectors.

1.2.1 Corporate Sector

The Commission, upon succeeding the erstwhile Corporate Law Authority (CLA), was charged with the responsibility of regulating the affairs of companies through administering and enforcing the Companies Ordinance. The Companies Ordinance, which repealed the Companies Act, 1913, was promulgated to, *inter alia*, consolidate and amend the law relating to companies and certain other associations for the purpose of healthy growth of corporate enterprises, protection of investors and creditors, promotion of investment and development of economy. These objectives are met by detailed provisions in the Companies Ordinance pertaining to formation and registration of companies, their management and administration, duties and liabilities of directors and chief executive officers (CEOs), allotment, issue and transfer of shares, and regulation of deposits. There are also provisions for foreign companies to establish their places of business in Pakistan. Additionally, investors and creditors are protected through provisions enabling investigation, prevention of mismanagement, and winding up and liquidation of companies, with detailed sections on legal proceedings and offences.

Since the commencement of its operations in 1999, the Commission has been involved in the process of revamping the existing corporate laws and suggesting new ones to keep up with the changing needs and circumstances in Pakistan and the emerging trends internationally. Two significant developments in the regulatory framework for the corporate sector were the introduction of the concept of a single member company (SMC) and the Code of Corporate Governance.

Following the European Union model, which allows registration of a private limited company as a SMC, the Commission introduced this concept in the Companies Ordinance through the Companies (Amendment) Ordinance, 2002. Subsequently, the Single Member Companies Rules were framed in 2003 to address the practical requirements of this new concept. The introduction of SMCs will facilitate sole proprietorships to obtain corporate status and give them the privilege of limited liability as well as encourage documentation of the economy.

In order to promote good governance practices in the corporate sector, the Commission issued the Code of Corporate Governance in March 2002, which was subsequently included in the listing regulations of stock exchanges. It is presently applicable to all public listed companies while efforts are underway to extend the initiative to public sector entities and not-for-profit associations. The Code emphasizes openness and transparency in corporate affairs and decision-making process of companies and requires directors to discharge their fiduciary responsibilities in the larger interest of all stakeholders in a transparent, informed, diligent and timely manner. It seeks to strengthen corporate working, internal control system and external audit requirements of companies. Moreover, corporate and financial reporting framework has been re-defined to foster better disclosure.

1.2.2 Capital Market

The Commission regulates all aspects of the capital market including licensing and coordination, regulation of secondary market and market intermediaries, and public offerings; in addition, the Commission undertakes regular monitoring and surveillance of the market. The Securities and Exchange Ordinance, 1969 is the primary legislation providing for the protection of investors, regulation of markets and dealings in securities. These objectives are met through requirements stipulating that stock exchanges must be registered with and hence regulated by the Commission. There are further stipulations in the Securities and Exchange Ordinance, 1969 prohibiting

insider trading, fraudulent acts, false statements and making fictitious and multiple applications for new shares. The Securities and Exchange Rules, 1971, framed thereunder, provide for the basic qualification for membership of stock exchanges, the parameters for transactions of members' business and the maintenance of accounts.

Major reforms have been introduced in the regulation and working of the capital market to bring it in line with international standards. The Central Depositories Act, which was promulgated in 1997 and provides for the establishment and operation of book entry systems for transfer of securities by central depository companies, and the Central Depository Companies (Establishment and Regulations) Rules, 1996 have been instrumental in achieving the desired results. They have helped replace the manual system of physical handling and settlement of shares with a modern and efficient electronic system.

The Listed Companies (Substantial Acquisition of Voting Shares and Takeovers) Ordinance, 2002 has been promulgated to provide for fair and equal treatment of all investors as well as a transparent and efficient system for substantial acquisition of voting shares and takeovers of listed companies. These objectives are met by the requirement that persons acquiring more than 10 percent of the voting shares in a listed company must disclose this information to the said company and to the concerned stock exchange. Similarly, a person who intends to acquire more than 25 percent voting shares has to make a public announcement of his offer and send an offer letter to all the shareholders of the company.

In order to bring trading practices in stock exchanges in line with international best practices, the Commission has framed the Margin Trading Rules, 2004. These Rules aim to replace Carry-over Transactions (COT) or 'Badla' with margin financing so as to reduce systemic risk and speculative trading associated with COT/Badla. For the purpose, only such brokers, who are registered with the Commission and who meet the minimum net capital and capital adequacy requirements, will be allowed to engage in margin trading and margin financing. Margin trading will be allowed in scrips fixed by the Commission, in consultation with stock exchanges. Furthermore, the Commission, in consultation with stock exchanges, will fix the limit of margin financing facility available to any single client of the broker.

1.2.3 Insurance Sector

The insurance sector was previously under the regulatory purview of the Ministry of Commerce. In the year 2000, regulatory authority was passed on to the Commission upon promulgation of the Insurance Ordinance, 2000 (Insurance Ordinance), which repealed the Insurance Act, 1938.

The Insurance Ordinance provides for improved capitalization and administration of the insurance sector and introduces market conduct policies and procedures for sound and prudent management of insurers and protection of rights of policyholders. These objectives have been met by provisions in the Insurance Ordinance stipulating that only public companies registered with the Commission will be allowed to carry on the business of insurance. The administration of the insurance sector has been further improved by dividing it into life insurance and non-life insurance businesses. Life insurance business has been divided into four classes whilst non-life business has been divided into ten different classes. Moreover, in order to strengthen capital base of insurers, minimum paid-up capital requirements for life insurance and non-life insurance companies have been increased to Rs. 150 million and Rs. 80 million, respectively, while life insurance companies are also required to maintain statutory funds.

The Commission framed the Securities and Exchange Commission (Insurance) Rules, 2002 to give effect to the various provisions of the Insurance Ordinance. The said Rules cover significant matters relating to accounting and reporting, reinsurance arrangements and solvency and capital requirements for insurers, eligibility criteria for insurance agents/intermediaries, and conduct of surveyors.

1.2.4 NBFC and Modaraba Sectors

In order to provide for holistic and consolidated regulation of the sector, regulatory authority over various non-banking financial institutions (NBFIs) was transferred from the State Bank of Pakistan (SBP) to the Commission over a period of time. During 2002, the NBFC regime was introduced through suitable amendments in the Companies Ordinance, as a result of which regulatory authority of the Commission and SBP over financial sector has been clearly segregated. Accordingly, NBFCs have been allowed to function as companies, duly licensed by the Commission and having multi-tiered capital requirements, to carry out any one or more of the following forms of business, namely:

- i. asset management services;
- ii. discounting services;
- iii. housing finance services;
- iv. investment advisory services;
- v. investment finance services;
- vi. leasing; and
- vii. venture capital investment.

The main objective behind implementation of the NBFC concept was to consolidate the non-banking financial sector by allowing multiple business activities under one umbrella, so that a whole variety and range of financial products tailored to the needs of customers could be offered through a one-window operation. Mergers and consolidation in the sector are expected to contribute towards stronger and financially viable institutions.

In order to provide a comprehensive framework for regulation and monitoring of NBFCs, the Non-Banking Finance Companies (Establishment and Regulation) Rules (NBFC Rules) were notified in 2003. The NBFC Rules lay down the minimum equity requirements for each business activity covered under the NBFC regime ranging from Rs. 5 million for venture capital companies to Rs. 300 million for investment finance companies. Detailed conditions and comprehensive legal requirements for undertaking each of the business activities have also been laid down in the NBFC Rules.

The registration of modaraba companies and the floatation, management and regulation of modarabas is done through the application of the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 (Modaraba Ordinance) and the Modaraba Companies and Modaraba Rules, 1981 (Modaraba Rules). The Modaraba Ordinance and Modaraba Rules lay down the minimum paid-up capital requirements for floating a modaraba, which may be either multi-purpose or specific-purpose.

1.2.5 Private Pensions

In 2003, while the Ministry of Finance assigned its actuarial office to develop a contributory pension scheme for all new employees of the Government, development of the private pension scheme was entrusted to the Commission. The Commission has designed a scheme for Voluntary Pension System (VPS), which has been approved, in principle, by the Ministry of Finance. Necessary rules in this regard would be formulated to provide a comprehensive legal framework for private pensions in the country, to be administered by the Commission.

1.2.6 Professional Services

In case of professional service providers, the extent of the Commission's supervisory/regulatory authority varies largely.

i. Accountants

The accountancy profession in Pakistan is mainly regulated by two self-regulatory organizations (SROs), namely, the Institute of Chartered Accountants of Pakistan (ICAP) and the Institute of Cost and Management Accountants of Pakistan.

The Commission maintains oversight of the accountancy profession through powers given under the Companies Ordinance in relation to auditors and development of relevant financial reporting framework for companies. Furthermore, the Code of Corporate Governance contains a number of provisions for bringing about greater transparency and independence in the activities of auditors and accounting firms. The Commission is also represented by its Chairman on the ICAP Council, which facilitates participation in efforts to better develop and regulate the profession.

ii. Company Secretaries

Company secretaries play an important role in improving the governance of corporate entities. At present, there are no effective regulatory provisions or institutions for regulation and supervision of these service providers. The profession is fast growing though, particularly due to the legal requirements for appointment of company secretaries by listed companies and SMCs. In this regard, the Commission has prescribed the qualifications of company secretaries to be appointed by listed companies and SMCs, through the Companies (General Provisions and Forms) Rules, 1985 and the Single Member Companies Rules, 2003, respectively.

iii. Administrators, Receivers and Liquidators

Administrators, receivers and liquidators play an important role in not only corporate insolvency but also in prevention of mismanagement of companies. This role is reflected in various sections of the Companies Ordinance including Section 295 whereby the Commission may order appointment of an administrator from a panel maintained by it to manage the affairs of a company that is not being run properly. Similarly, in winding up of companies by the court, an official liquidator is appointed from a panel maintained by the court, on the recommendations of the Commission. Presently, there is no regulatory framework in place for these professional service providers.

iv. Stock Brokers and Agents

The integrity of members of stock exchanges and their brokers and agents is essential to instill confidence of investors in the capital market. In terms of the Securities and Exchange Ordinance, 1969, the Commission has the authority to monitor intermediaries associated with the securities market.

The Commission regulates the affairs of brokers and agents through the Brokers and Agents Registration Rules, 2001. In case of any unscrupulous or unethical activity or contravention of legal provisions, the Commission is empowered to cancel or suspend the registration of brokers and agents and impose fines. The Members' Agents and Traders (Eligibility Standards) Rules, 2001 lay down necessary criteria for registration of agents and traders of members of stock exchanges.

v. Financial Analysts

Financial and investment analysts play a crucial role in the securities market. However, there is presently no direct legal requirement for regulation or supervision of these service providers.

vi. Insurance Surveyors and Intermediaries

Section 20(4)(t) of the SECP Act provides for regulation of professional organizations connected with insurance business. Moreover, Section 20(4)(s) thereof provides that the Commission has to ensure and monitor compliance of insurance surveyors and intermediaries with laws, rules and regulations pertaining to insurance.

The insurance law has put in place strict controls for insurance agents and insurance brokers. Licensing, qualification and power for inspection in relation to insurance agents and insurance brokers are stated in Part XIII of the Insurance Ordinance while licensing and registration of insurance surveyors is to be monitored and maintained by the Commission as provided in Sections 112 to 114 of the Insurance Ordinance.

vii. Actuaries

The Commission may give assent to or reject, on reasonable grounds, the appointment of an actuary by any insurance company under Section 26 of the Insurance Ordinance. The responsibilities of actuaries and their dismissal are provided in Section 27 of the Insurance Ordinance. Moreover, Section 22(4)(da) of the SECP Act requires the Commission, while exercising its powers, to have regard to the professional competence and capability of persons engaged in the provision of services in the insurance industry.

While the said provisions do provide the Commission with authority in respect of appointment of actuaries, there is no specific provision empowering the Commission to prescribe a code of conduct for actuaries or impose penalties in case of deviation from responsibilities laid down in the Insurance Ordinance.

viii. Credit Rating Companies

In terms of Section 32-B of the Securities and Exchange Ordinance, 1969, the Commission is vested with powers to regulate credit rating companies. The Credit Rating Companies Rules, 1995 provide the necessary legal framework for registration and certain operational matters of credit rating companies. Under the said Rules, the Commission has powers relating to registration, renewal and cancellation of licenses of these companies. Moreover, the Commission can also give them necessary directions; accordingly, it has been made mandatory on credit rating companies operating in the country to submit their annual rating reports to the Commission.

1.3 Market Overview

Market development forms an integral part of the Commission's role. Since its establishment, the Commission has implemented reforms in the context of broader macroeconomic stabilization and structural agenda, thereby providing impetus to the growth and development of sectors under its purview.

As a result of the developmental efforts of the Commission, the corporate sector has witnessed rapid growth in its size with a larger number of companies registering with the Commission over the past few years. As of 30 June 2004, there were a total of 43,728 companies in the country. Of these, 42,681 companies were limited by shares including 39,769 private companies, 2,768 public companies and 144 SMCs. Foreign companies in Pakistan totaled 555; of these, 39 percent belonged to European countries, 18 percent to Asian countries and 17 percent to the United States of America (USA). New companies registered during the course of the year totaled 2,207.

Effective market development and regulation has contributed towards the positive growth of Pakistan's capital market. The Karachi Stock Exchange (KSE) has been pronounced as one of the best performing markets in the world; aggregate market capitalization of KSE was recorded at Rs. 1,421 billion against last year's figure of Rs. 755.8 billion. The Karachi Stock Exchange 100 Shares Index (KSE-100 Index) reached an all time high of 5,620.7 during the year.

The insurance sector has also exhibited progress during the year. There was increase in gross direct premium in both life and non-life insurance sectors. Gross direct non-life insurance premium showed an increase of 0.05 percent whereas for life insurance companies, the increase was 26.43 percent during the year.

Most activities within the NBFC and modaraba sectors depicted improved performance. The leasing and investment finance sectors showed impressive growth – total assets of leasing companies increased by 19 percent during the year while those of investment banks and modarabas increased by 24.7 percent and 11 percent, respectively. Performance of the capital market paved the way for growth of mutual funds, which nearly doubled their asset holdings during the year. However, growth in the housing finance sector remained stagnant. Moreover, discount houses and venture capital companies, which are still in their infancy, checked the marked growth of the NBFC sector.

1.4 Regulatory Issues and Developmental Challenges

1.4.1 Regulatory Issues

i. Regulatory Policy Vacuum

Formulation of appropriate regulatory policies remains a major challenge for the Organization. The policy making function of the Commission is required to be performed by the Policy Board, appointed by the Federal Government. The Commission is authorized to identify matters requiring policy decisions by the Policy Board; it can also make recommendations for consideration of the Policy Board. The Policy Board is empowered to make policy decisions *suo motu* or adopt policies recommended by the Commission. It can express its opinion in writing on any policy matter referred to it by the Federal Government or the Commission. Moreover, all policy decisions, including any change in a previously established policy, are required to be made only by the Policy Board. The policy-making powers extend to any and all matters within the jurisdiction of the Commission.

Hitherto, no formal mechanism of support was available to the Policy Board for formulation of policies. In order to assist the Policy Board in this regard, the Commission has recently set up the Professional Services and Policy Division. The Division will identify matters requiring policy decisions and make policy recommendations to the Policy Board through the Commission.

A holistic approach to policy formulation for the financial sector requires coordination and cooperation at a number of levels. While the Commission is entrusted with the regulation of capital market, insurance companies, modarabas and NBFCs, SBP has the regulatory authority over commercial banks and Development Finance Institutions (DFIs). Moreover, the Ministry of Finance is the relevant Governmental arm for dealing with financial matters affecting the country as a whole. The Commission recently entered into a Memorandum of Understanding (MoU) with SBP that institutionalizes mutual cooperation between the two regulators. Currently, efforts are underway to establish a structured coordination mechanism between Ministry of Finance, SBP and the Commission. This mechanism is likely to provide the desired framework for regulatory policy coordination for the financial sector.

ii. Regulatory Imbalance

The Commission exercises varied functions, ranging from supervisory to regulatory, in the sectors under its purview. In case of the securities market, corporate sector and NBFC sector, the Commission is the apex regulator. However, a regulatory imbalance exists in the case of insurance sector where the Insurance Ordinance needs to be fully implemented, particularly with regard to the setting up of the Insurance Tribunal and appointment of an Insurance Ombudsman. Due to these limitations, remedial actions cannot be taken in a timely and effective manner. This regulatory imbalance has been one of the main reasons for the relative under-development of the sector as it creates a major handicap in effectively regulating the insurance industry and protecting the interests of policyholders.

With respect to the professional service providers operating in the country, a regulatory gap seems to exist. While the Commission has been entrusted with the regulation of certain service providers within the financial (non-banking) sector, many are functioning without any proper regulatory framework in place. In the absence of necessary legal framework to govern their operations, it would be difficult to improve and monitor the conduct of professionals providing a range of services to the corporate and financial sectors in the country.

iii. Regulatory Arbitrage

In Pakistan, commercial banks are increasingly undertaking universal banking. Furthermore, the growing trend of mergers between banks and NBFCs is making it difficult to draw clear boundaries across the various types of financial service providers.

These vague boundaries open up opportunities for financial institutions to by-pass certain regulations and create an overall ambiguity about the regulatory framework in place. Furthermore, regulatory institutions and legal framework in Pakistan are traditionally compartmentalized according to institutions rather than by functions. There is, therefore, an inherent risk under the present set up that certain activities of financial institutions engaged in universal banking may remain unsupervised.

iv. Regulatory Costs

Regulation is seen as an instrument to facilitate development of the economy but this can only be achieved if the regulatory framework is effective and does not impose costs on businesses higher than the imperfections that it seeks to prevent. The objectives of regulatory framework must, therefore, be defined in view of the changing needs of a flexible and dynamic business environment. Moreover, a careful and thought-out choice must be made between which burdens to enforce and which to ease.

The legal framework is comprised of a combination of laws, rules, regulations and directions issued over a period of time. Despite significant progress in harmonization, this framework can still be complicated and expensive for market participants who must comply with it. The challenge is to maintain effective investor protection while making the legal framework more harmonized, less complex and, at the same time, cost-effective.

v. Regulatory Efficiency

While a great deal has been accomplished in updating regulatory standards, competing priorities can often result in significant time passing between the identification of a problem and the adoption of a regulatory solution. The challenge is to respond quickly and effectively to regulatory and market issues without burdening the market participants with a plethora of legal requirements that may stifle market development and innovation.

Regulatory efficiency is hampered by any delays in the law-making process. The Commission has been entrusted with the power to frame rules under the laws it administers, albeit, approval of the Ministry of Finance is required along with vetting by the Ministry of Law and Justice before the Commission can notify rules. Often times, the Ministerial reviews and approvals are time consuming and lead to unnecessary delays. In this regard, it is essential to provide for a clearly defined scheme of making laws, rules and regulations whereby the authority to make these is clearly delineated.

vi. Regulatory Compliance

A culture of non-compliance is found to be prevalent in the country. Despite best efforts, laws are perceived to be hindrances in efficiently conducting business. The problem can perhaps be best related to the socio-cultural elements where defiance to laws stemmed during the colonial rule. Despite the transformation into an independent society, the fear that laws and regulations impose requirements that may not be in the best interest of those who are to follow it appears to linger on. The situation has also been aggravated, to some extent, by rapid changes in governments since Pakistan's independence that have resulted in inconsistent economic policies and hasty law-making over a period of time.

A concerted effort appears to be necessary to improve understanding of market participants on why regulation is desirable for healthy and competitive business as well as to promote the role of stakeholders in protecting their rights. As such, regulatory compliance can be best achieved through education and awareness to address the misperceptions that exist in our economy.

vii. Regulatory Enforcement

Regulatory enforcement and adjudication is the process by which the Commission ensures that the corporate and financial sectors comply with prescribed rules and regulations. The Commission has the power to investigate the actions and records of companies and the power to impose sanctions and penalties for contravention of legal provisions. However, most of the adjudication pertaining to areas affecting investor interest is done by courts with the Commission assisting the courts in enforcement. Effective enforcement is impeded, at times, because of delays in the judicial process due to the sheer volume of litigation in the country.

Enforcement powers of the Commission have a direct impact on development of the sectors under its purview. Effective enforcement caters for the protection of investors and stakeholders, thereby building confidence in our markets.

viii. Regulatory Capacity

Being the apex regulator of the corporate and financial (non-banking) sectors, it is desirable for the Commission to have adequate capacity to formulate relevant laws, rules and regulations, vigilantly monitor their compliance and take necessary actions for contraventions. Given the diversified regulatory challenges that the Commission is faced with in the various sectors under its purview, it is essential that there is a continuous matching of skills with job requirements. While the Commission has initiated necessary steps in this regard to review the remuneration of its employees and assess their skill requirements, there is also a need to formulate and implement a human resource development strategy to ensure that the Commission's employees are adaptable to the changing financial sector landscape.

Realizing the new vistas that advancements in information technology (IT) and communications have opened for organizations, the Commission needs to be well-equipped in terms of IT skills and resources. Over the years, the Commission has laid emphasis on in-house development of software systems that would assist in its functioning as well as efficient regulation and monitoring of entities under its purview.

The underlying philosophy of automation should be to bring about a change in the overall business processes, aimed at improving organizational productivity and responsiveness, reducing costs and improving interaction with stakeholders. The Commission needs to be cognizant of these objectives in pursuing its automation program.

ix. Regulatory Assessment

An effective and efficient regulatory framework requires a regulator to remain abreast with changing dynamics. Due to increasing integration of the global financial markets, cooperation and coordination at the international level has become essential.

The Commission, in recognition of challenges posed by integrated financial systems, maintains regular liaison with counterpart regulatory bodies and is also an active member of a number of international organizations. Notably, the Commission recently underwent an assessment by the joint Mission of the World Bank and the International Monetary Fund (IMF) under the Financial Sector Assessment Program (FSAP). The Mission assessed the Commission against international benchmarks in the areas of securities, NBFC and insurance regulation and made pertinent observations to achieve full compliance with international standards.

The assessment of regulatory procedures and processes should be undertaken on a regular basis. While a start has been made with the FSAP, it is expedient that the Commission continues to monitor its adherence to international best practices.

1.4.2 Developmental Challenges

i. Corporatization

Corporatization entails separation of management from ownership while transforming an association of persons into a legal entity with limited liability having perpetual succession. It allows a number of significant benefits to the entity as well as to the economy as a whole. Primarily, it extends the rights, duties and privileges of a natural person to a legal entity. These rights include, among others, the right to borrow money and invest funds, own property, sue and be sued and enter into contracts.

In consideration of the multiple benefits arising from corporatization, the Government has encouraged a policy of corporatization and privatization of public sector entities, which is expected to have a profound impact on accountability therein. The Commission has also been proactive in encouraging corporatization, particularly among Small and Medium Enterprises (SMEs). While these efforts have led to an increase in incorporation of companies, a large chunk of SMEs and microfinance institutions remain in the informal sector. A major challenge is to attract such entities to come to the corporate fold through fiscal incentives and regulatory ease. Moreover, the progressive development of corporates in terms of their size and growth needs to be ensured.

ii. Self-regulation and Market Abuse

The growth and buoyancy of Pakistan's securities market will depend highly on the level of good governance and transparency exhibited by market participants. Poor governance, information asymmetry and conflicts of interest result in lack of investor confidence. While the Commission has introduced far-reaching reforms to improve and strengthen these areas in recent years, governance and transparency remain major challenges for Pakistan's capital market.

The basic challenge in this regard is the demutualization of stock exchanges in Pakistan that continue to be owned solely by brokers. The mutualized structure of exchanges carries with it the inherent risk/potential for market abuse. Demutualization is aimed at broad-basing ownership and separating ownership from management in order to, *inter alia*, put in place a non-conflicted self-regulatory system.

iii. Product Diversification and Outreach to Consumers

The level of penetration of insurance sector is quite low compared to other jurisdictions in the region. Although there are over fifty insurance companies in the country, their services are still limited to the main cities. The low consumer base has also resulted from limited product portfolio of insurance companies. Despite being an agrarian economy, the insurance companies in Pakistan have not offered suitable products to the agriculture sector.

iv. Market Integration

Over recent years, there have been significant developments in Pakistan's financial sector. The universal banking trend is evident, which is supported by the international trend to remove prohibitions between banking and non-banking financial and insurance services. This trend was enforced when, after more than six decades, the Glass-Steagall Act in the USA was repealed in 1999 and the Gramm-Leach-Bliley Act, adhering to the principles of functional regulation, was introduced. This new Act permitted additional activities to be conducted by subsidiaries of USA banks. The integration of financial markets within European Union provides another international precedent. While the financial sector in Pakistan is fast developing on similar lines, market integration poses a number of challenges to financial institutions in terms of achieving operational capacity, creating market niche and meeting regulatory requirements.

v. Level Playing Field

The emergence of universal banking poses increasing competition for NBFCs and modarabas from the banking sector. The mobilization base and branch networks of banks are vast as compared to NBFCs. Certain distortions at the policy level remain, which have worked to the advantage of some institutions while discriminating against others.

In such a scenario, it is important to provide a level playing field to all institutions undertaking non-banking financial activities to ensure proper development of the NBFC sector.

vi. Professional Independence and Conduct

There is no uniform framework for professional service providers in Pakistan. As such, the level of their independence and integrity needs to be improved in order for them to provide efficient and reliable services and to engender consumer confidence. It is essential that the professional service providers maintain and comply with Codes of Ethics to ensure quality and integrity of their services.

vii. International Trend towards Financial Sector Liberalization

Recent economic reforms around the world, characterized by liberalized financial sectors, have started the process of globalization. The pace of globalization is accelerating as a result of the establishment of an international trade regime under the auspices of the World Trade Organization (WTO). The General Agreement on Trade in Services (GATS) is among the WTO's most important agreements. The accord, which came into force in January 1995, is the first and only set of multilateral rules covering international trade in services.

Among other things, GATS deals with financial services and lays down the right of parties to take prudential measures, *inter alia*, for the protection of investors, deposit holders and policy holders – and to ensure the integrity and stability of the financial system. With respect to market access, the understanding contains more detailed obligations on, among other things, monopoly rights, cross-border trade, right to establish or expand a commercial presence and temporary entry of personnel. The aim is to provide a framework of obligations and a forum for future negotiations aimed at greater market access and liberalization of the financial sector.

While liberalization is most likely to stimulate capital flows, it can also aggravate the problems of financial institutions in a period of confidence loss, as capital flowing in can just as easily flow out. Financial sector liberalization achieved through increased market access does not leave room for the Government to afford any slack in the macroeconomic policy.

Another major challenge posed by financial sector liberalization is the need to mitigate the risk of market abuse due to cross-border transactions. Securities markets, particularly those in emerging countries, are susceptible to the effects of cross-border activities, specially to higher short-term volatilities after economic shocks or during periods of great uncertainty. It is, therefore, necessary that financial sector regulators are in a position to assess the nature of cross-border conduct in order to ensure the existence of fair, efficient and transparent markets.

1.5 Blueprint for Effective Regulation and Development

The Commission perceives its role to be that of a facilitator as well as a regulator. It is committed to encouraging growth and development of the corporate and financial (non-banking) sectors while ensuring necessary compliance with applicable laws. In recognition of this role, the blueprint sets out notable actions that need to be undertaken for a cohesive regulatory framework that propels economic development.

1.5.1 Coordination Among Domestic Authorities

In order to fill in the regulatory policy vacuum for the financial sector, a coordination committee of Ministry of Finance, SBP and the Commission should be set up. This would provide a platform for achieving uniformity in regulatory approach and undertaking policy dialogue in line with the present macroeconomic structure of the economy.

Cooperation with various agencies is also required to achieve the objective of corporatization. In this regard, the Commission is setting up a task force with the Central Board of Revenue (CBR) to study and rationalize the tax structure for corporates. Moreover, it would also collaborate with CBR and other concerned agencies to remove impediments to corporatization of SMEs.

1.5.2 Holistic Regulation

Given the compartmentalized regulatory structures where regulatory ambit is defined by institutions, it is extremely important for the regulatory bodies to develop cohesive policies to ensure smooth and efficient running of the financial sector. To achieve this objective, the Commission and SBP have set up a joint Coordination Committee, which meets every quarter to discuss areas of mutual concern emanating in the banking and financial (non-banking) sectors. However, to address the regulatory arbitrage posed by commencement of universal banking in the country, it appears necessary to undertake regulation by function rather than by institution. For this purpose, the Commission and SBP need to devise appropriate regulatory interventions through which banks undertaking non-banking functions are either supervised jointly by the two authorities or are required to set up subsidiaries to undertake such activities. This would also serve to provide a level playing field to all institutions providing non-banking financial services.

1.5.3 Integrated and Uniform Regulatory System

Given the broad mandate of the Commission to regulate the entire financial sector – with the exception of commercial banks and DFIs – it is crucial that its regulatory authority be consistently and uniformly defined. This may require enabling provisions in the relevant laws to allow the Commission to exercise strong vigilance and take necessary actions against all financial institutions under its purview, including insurance companies, market intermediaries and other professional institutions. In this regard, it is essential that a Corporate Laws Review Commission be set up to undertake an exhaustive review of corporate, NBFCs, securities and insurance laws for the purpose of achieving integrated and uniform legal and regulatory system across all sectors.

1.5.4 Re-regulation

In order to reduce procedural requirements, it is necessary for the Commission to go through a continuous process of re-regulation. The Government may consider delegating the issuance of rules and regulations to the Commission fully to expedite the process. Ensuring the effective administration of laws with minimum procedural requirements is a statutory mandate assigned to the Commission in terms of Section (20)(6)(d) of the SECP Act.

1.5.5 Regulatory Impact Assessment

It is important to understand the impact of regulation and also to improve the design and implementation of regulatory strategies. Virtually every regulatory policy and strategy has some economic impact. Regulatory impact assessment (RIA) is an analysis of the estimated cost and the perceived benefits of a proposed regulation. The purpose of preparing RIA is to help determine the risks, costs and benefits of a regulatory proposal and to identify who will be affected by the proposed regulation. RIA is particularly important whenever regulations are proposed that impose costs on businesses.

RIA is intended to ensure that any proposed regulation is:

- i. necessary;
- ii. aimed at the right target; and
- iii. in proportion to the problem or issue being addressed.

The concept of RIA is relatively new for Pakistan. However, it underpins any attempt to introduce cost-effective regulations. The Commission should, therefore, develop this mechanism to evaluate the impact of its laws, rules and regulations and strengthen the design and implementation of regulatory strategies.

1.5.6 Stakeholder Participation

Effective and early consultation with stakeholders helps to build commitment to the regulatory framework. It also ensures that regulations are as widely accepted as possible. In the absence of a consultative process, regulatory non-compliance is bound to increase.

While the Commission consults market participants and other stakeholders in drafting new laws or amending existing ones, there is a lack of awareness among various stakeholder groups about the dynamics of issues affecting them. In this regard, the Commission should launch an awareness program to inform investors and stakeholders about their rights and responsibilities as market participants. The awareness program will instill a spirit of openness between the Commission and stakeholders, which will go a long way in addressing the issue of information asymmetry. This, in turn, will engender trust and help to avoid an adversarial relationship, which gives rise to a culture of non-compliance.

An effective legal and regulatory framework also requires proactive participation of market representatives through recognized forums. Institutional representation helps to give a collective voice to the concerns and needs of market participants and provides a forum for effective dialogue with the Government and the regulator, as necessary. Moreover, such collective forums can be used to propel development of respective sectors. Product diversification and outreach to consumers are likely to be achieved at a rapid pace if addressed at institutional levels rather than by companies individually.

Within the corporate sector, the Federation of Pakistan Chambers of Commerce and Industry and local chambers provide representation to companies to some extent. However, since these bodies also include individuals engaged in trade and industry, they do not provide an exclusive forum for dealing with issues specific to companies. In such a situation, it is imperative that the corporate sector establishes institutional representation for voicing their collective as well as individual requirements and observations – either by establishing a separate association of corporate entities or as a sub-group of chambers of commerce and industry.

In case of the capital market, the stock exchanges in Pakistan act as the SROs for regulating the affairs of their member brokers. With the onset of demutualization of stock exchanges, it appears necessary for brokers to establish an association that represents their institutional interest.

The Insurance Association of Pakistan is the representative body of non-life insurance sector in Pakistan. It was established in 1948 to deal with the collective issues of non-life insurers. However, much improvement is desired in its functioning besides creating an institutional body of life insurers in the country.

The Modaraba Association of Pakistan (MAP) is the representative body of modarabas while the NBFC sector is represented by Leasing Association of Pakistan, Mutual Funds Association of Pakistan, and Investment Banks Association of Pakistan. These associations have been actively working to promote the business interests of relevant sections that they represent. However, given the introduction of NBFC as a consolidated entity to undertake different financial activities, it would be expedient for these associations to also consider forming one representative body for the NBFC sector as a whole.

1.5.7 Corporate Rehabilitation

In order to provide a mechanism that allows for the rehabilitation of viable businesses and thereby encourage economic growth, appropriate laws for corporate rehabilitation and insolvency need to be framed. These laws will require a greater role for administrators, receivers and liquidators with enhanced powers and duties and should also introduce Alternative Dispute Resolution (ADR) methods including mediation. Similarly, the possibility of establishing an office of a Corporate Ombudsman to resolve conflicts and investigate reported complaints also needs to be explored.

In terms of Section 295 of the Companies Ordinance, the Commission may make rules for administrators. However, no such provision exists for receivers and liquidators. In addition to a regulatory framework, these service providers also require adequate training and organization and necessary efforts should be undertaken in this regard. Like various other professional services in the financial sector, these occupations need to be recognized in Pakistan. A representative body/association would be a step in this direction as it would provide a forum for development of these professions.

1.5.8 Enhanced Compliance

In order to encourage companies to comply with the requirements of law, the Commission is seeking to develop a corporate scorecard to assess their level of compliance. Companies would be assessed on various aspects of their compliance with statutory provisions, codes of conduct as well as their corporate governance and corporate social responsibility outlook.

These efforts would be complemented by the establishment of an Institute of Corporate Governance in Pakistan, which would seek to create awareness about corporate governance and strengthen corporate bodies' compliance and conformance to laws, rules and regulations.

1.5.9 Enhanced Enforcement

The objective of market development cannot be achieved without effective and efficient enforcement. Enhancement of enforcement powers of the Commission would lead to better-governed sectors and protection of stakeholders' interests.

In addition to effectively exercising its enforcement powers, the Commission can also play a meaningful role in assisting the courts as an enforcement arm of the judiciary. In this regard, no special treatment of the Commission is advocated but a reduction in corporate litigation is sought through specific mechanisms. This may be done by instituting specialized benches in the High Courts headed by judges specializing in corporate matters. The Commission can provide assistance to judges on specific corporate and financial issues and by instituting strict actions for enforcing their decisions.

Moreover, the Commission should provide ADR methods such as arbitration, conciliation and even mediation to the corporate and financial (non-banking) sectors. ADR can also be provided by the Commission in partnership with external service providers and trade and industry bodies.

1.5.10 Regulatory Audit of SROs

In terms of Section 20(f) of the SECP Act, the Commission is charged with the responsibility of promoting and regulating SROs as well as related securities industry and NBFI associations. Moreover, in terms of Section 20(k) of the SECP Act, the Commission may call for information from and undertake inspections, conduct inquiries and audits of SROs while Section 21(a)(iii) enables the Commission to provide for standards as well as codes of conduct for these associations.

In exercise of these powers, the Commission should undertake regulatory audits of SROs and formulate necessary standards and codes to seek assurance that the self-regulatory role is being exercised in an independent, fair and transparent manner. This would help to augment the capacity of SROs operating in the country in properly exercising their regulatory and enforcement functions. This is particularly desirable in the case of professional services, where lack of effective oversight has been a major reason for lack of confidence in the integrity and independence of their services.

1.5.11 Good Governance

The Commission should further strengthen its reform processes for risk mitigation and improving governance and transparency in the corporate and financial (non-banking) sectors. In this regard, establishment and regulation of SROs, improving the skill base of market intermediaries and participants, and effective monitoring and supervision by the Commission are essential steps to boost good governance. Furthermore, the Code of Corporate Governance should be extended to all entities raising funds from the public to improve their conduct and bring in higher transparency. Good governance in all sectors would ultimately result in protecting the rights and interests of all stakeholders and maximizing returns to shareholders.

1.5.12 International Cooperation

Due to increasing integration of the global financial markets, economies have become more open and responsive to worldwide developments. In this context, it is important for the Commission to develop linkages with counterpart regulatory agencies through bilateral and multilateral agreements. Moreover, it should actively participate in the activities of international bodies to contribute towards the standard setting process, which underlies the development of international benchmarks for the financial sector.

Cooperation at international level is also essential for cross-border regulation. With the offing of WTO regime in 2005 and the consequent liberalization of financial markets, the Commission should institutionalize appropriate coordination mechanisms to ensure that liberalization of financial markets does not result in market abuse across borders. In addition to consultation and cooperation at the international level, this would also involve a thorough and extensive consultative process with industry stakeholders in Pakistan. Signing of the multilateral MoU of the International Organization of Securities Commissions (IOSCO) by the Commission would constitute a significant step in this direction.

1.5.13 Market Development

Development of the various sectors under the Commission's purview remains an ongoing activity; the Commission is continuously making efforts to bring our corporate and financial (non-banking) sectors at par with developed countries around the world.

In line with the Government's endeavors to document the economy, the Commission is promoting corporatization of entities. Efforts are being particularly undertaken to create an enabling environment for corporatization of SMEs. Appropriate steps would be identified to remove impediments to corporatization of SMEs and implemented in consultation with concerned agencies.

In order to reduce conflict of interest situations in the securities market and reduce the risk to investors, two major efforts underway at the Commission are the demutualization of stock exchanges as well as the phase-out of COT/Badla and its replacement with margin financing/futures contracts. Risk mitigation resulting through these measures would channel more investment and add depth to our market.

The Commission is also encouraging integration and mergers in the NBFC sector so as to build sound, viable and competitive institutions. While similar efforts are also underway in the insurance sector, particular attention is being awarded to the improvement of service providers in the industry – this would also involve more formalized regulatory structures for these entities.

In line with its recently expanded mandate to develop and regulate private pensions, the Commission would be launching the VPS through promulgation of necessary rules. These rules are expected to be finalized soon and would lay the foundation for development of private pensions in Pakistan.

Developmental efforts in all these sectors would be coupled with investor education and training of market participants, particularly intermediaries. The Institute of Corporate Governance would play a key role in such efforts and would provide a platform, in conjunction with other institutes/associations, to cater for the training needs of the corporate and financial (non-banking) sectors. The existing training institutions, like the Pakistan Insurance Institute, would also be supported in the execution of their training programs to improve the quality of service providers.

1.5.14 Institutional Capacity

In order for the Commission to effectively regulate the various sectors under its purview, it is imperative that it has the institutional capacity to perform its regulatory, supervisory, monitoring and enforcement functions. An adequate capacity in this regard involves dynamic systems and procedures; the desired functionality can be best achieved through state-of-the-art technology based systems, which would bring about a change in the entire business processes.

At the core of the institutional capacity is the human resource base of the Commission. The Commission's employees need to be able to adapt to the new products and services being introduced in the corporate and financial sectors and possess hands-on knowledge of their regulatory requirements. This would require regular and sustainable training and development of the employees, particularly with respect to international trends and regulatory best practices.

1.6 Conclusion

In creating the enabling environment that is needed for the development of corporate and financial (non-banking) sectors, the Commission should focus on the legal and regulatory framework and its effects on development of these sectors. An appropriate legal framework can serve as a catalyst for development. In today's modern markets, legal and regulatory reforms should have the flexibility to respond to and encourage business innovation. This flexibility must, however, be supported by an adequate risk management framework.

While providing for a level playing field to all financial market players through an efficient regulatory framework, policy makers must ensure that markets provide an attractive forum for foreign investment. In addition to enforcement of appropriate measures to check market abuse, this requires effective enforcement and redressal systems to be in place. This becomes particularly important given the international trend towards integration and financial sector liberalization.

In this scenario, it is pertinent to note that the Commission is poised to address the regulatory issues and developmental challenges within the sectors it regulates. The blueprint set out above would enable the Commission to achieve this end in an effective, economic, efficient and holistic manner.