



► Chairman's Review

The Securities and Exchange Commission of Pakistan (the Commission) has made tremendous efforts to ensure that it keeps pace with Government of Pakistan's economic development programme and indeed to supplement the same as we recognize that the Commission has a developmental as well as a regulatory role. Consequently, the Commission has taken great strides in its efforts to ensure that the standards and principles adopted in the Pakistani capital markets conform to international best practices. With this objective in view, a comprehensive review is being undertaken of the laws, rules and regulations in all areas within our remit with a view to ensuring that a transparent, orderly and stable market place is established. Investor protection is a key objective and SECP is moving towards a regime where onsite and offsite inspections are common place.

Market Review

The Karachi Stock Exchange 100 Shares - Index showed a healthy growth of 34 percent, closing at 9,989.41 on 30 June 2006 compared to 7,450.12 at the end of last year. Market capitalisation of Karachi Stock Exchange (KSE) crossed PKR 2.8 trillion (US\$ 46.69 billion), an increase of 35 percent over last year.

Capital Market Reforms - Ensuring Transparency and Mitigating Risk

To reduce systemic risk at the exchanges, the Commission, during the year, introduced a new risk management structure based on Value at Risk (VaR) principles, together with a new valuation methodology, again based on VaR, for valuing the collateral held by the exchanges. A pre-trade margin verification system was also implemented in all the markets. Position limits at market, member and client levels have been introduced and are in the process of being implemented. To recognise the true exposure of the market, netting regime has been overhauled and now netting across markets, across settlements or across clients is not allowed.

In order to ensure that the market is not starved for funding, the Commission has followed a policy of improving and strengthening the avenues of accessing liquidity besides introducing new leverage products to give the market a choice. The carry-over trading (badla) system of financing was replaced by a Continuous Funding System (CFS) which was introduced as an interim measure during late 2005. The Commission revamped the CFS system this year and strengthened it by introducing position limits, CFS funding can be availed against ready purchases only, banning inhouse badla, increasing the number of scrips to accommodate inhouse badla positions and enhancing the CFS limit from Rs. 25 billion to Rs. 70 billion. This had a salutary effect on cost of financing and average cost of funds has come down to 12-13 percent from earlier 18-20 percent. The Commission has introduced CFS Mk II, a new financing product, essentially akin to margin financing, which would adequately address the biases inherent in the existing CFS and also provide a level playing field to all market participants. This product is under implementation at the National Clearing Company of Pakistan Limited.

To ensure transparency in the market place, the use of client codes was made mandatory and Universal Client Identification Number (UIN) was introduced and implemented from 1 August 2006. Now UIN and client codes are checked at a pre-trade level ensuring that all trades can be tracked to the real investor.

Direct Margins by Financial Institutions

To ease the capital and working capital requirements of the brokerage community and to enable them to use their scarce resources for development of the retail sector, the Commission has promoted a regime where all local financial institutions will be required to deposit the relevant margins on their trades directly with the stock exchanges. This will enable small brokerage houses to provide specialized services to financial institutions.

Inspection - Monitoring and Surveillance

The Commission has made a policy decision that monitoring and surveillance of the market will be its top priority. Inspection and investigation capacity of the stock exchanges and the Commission is, therefore, being enhanced to enable onsite and offsite inspection to take place on a routine and regular basis, together with the capacity to undertake full blown investigations whenever the need arises. Where, either on a complaint or based on offsite reviews, special investigations are necessitated, these will be conducted immediately. A serious fraud investigation unit is in the process of being set up manned by fully qualified and trained persons to handle serious fraud.

The Commission has purchased a market surveillance and monitoring system to enable the Commission to monitor the market on a real time basis. This system together with the UIN capability would ensure that manipulation, wash sales and front running are eliminated and that the Commission has the wherewithal to react in a timely manner. Presently, the Commission continues to monitor the market through inhouse developed utilities. The Commission has also developed a new capital adequacy regime for the broking community which is currently in discussion phase prior to implementation.

Demutualisation

In order to ensure that the ownership and management of the exchanges are separated, the Commission has single mindedly pursued the process of demutualization of the stock exchanges. Amendments were piloted in the Finance Bill 2006 to enable the process to start pending enactment of a specialised Demutualisation Act. The Commission has signed a Memorandum of Understanding (MoU) with KSE which provides for an eighteen months timeline to complete the demutualisation process. We are confident that demutualisation shall take place by December 2007.

Corporate Sector Development

Several initiatives have been taken to encourage businessmen to opt for incorporating a company rather than working as a partnership or sole-proprietorship. The steps include facilitation to form a single-member company, provide templates of memorandum and articles of association, self selection of business name, providing guidance by publication of guidelines, holding of promoters conference, reduction in fees and abolition of stamp duty. These steps resulted in increased incorporations in as much 6186 companies were registered in the year, which is a 100 percent increase over the previous year. During the year renewed efforts were made to clean up the CRO data.

Holding Companies

A lot of developmental work has been done on introducing a Holding Company concept to our corporate sector. Extensive discussions have been held with all stakeholders and the Central Board of Revenue to ensure that necessary tax incentives are provided to enable companies to move towards group holding structures.

NBFI Review

The Commission is at an advanced stage of implementation of the Voluntary Pension System Rules, 2005. Four applications have been received for the grant of registration to act as Pension Fund Managers and licences have been issued.

Based on the market feedback, necessary changes in the tax treatment of the Voluntary Pension System (VPS) have been made through an amendment in the Income Tax Ordinance, 2001. Various tax anomalies have been removed and scope of the VPS has been expanded. The Commission is in the process of finalising several guidelines for proper implementation of the VPS Rules.

In pursuance of its objective to develop the market and encourage new products, the Commission is preparing to put in place the Private Equity and Venture Capital Rules developed with the recommendations received from market participants.

The Real Estate Investment Trust Rules were also finalised by the Commission during the year and are expected to be promulgated shortly. The development of Real Estate Investment Trusts would enhance the outreach of consumers, particularly middle-income, interested in acquiring a stake in real estate. Moreover, they would provide for financing of large projects at the same time providing for diversification and deepening of the mutual fund industry.

Insurance Sector

Insurance is an important segment of capital markets and the Commission's capacity in this area is being strengthened. With the introduction of Takaful, the sector has shown considerable growth and three new life insurance companies and one general insurance company have started operations or are in the process of commencing soon. The Commission has revised the paid-up capital requirements for existing and new insurance companies to ensure that the insurance sector can grow and develop and be able to play an effective and due role in our capital markets.

Participation in IOSCO

The Commission actively participated in the International Organisation of Securities Commissions (IOSCO). As Chair of Working Group 3, Pakistan was tasked with providing a Report on "Guidance to Emerging Market Regulators Regarding Capital Adequacy Requirements for Financial Intermediaries". The Commission prepared and submitted the report which has been accepted by the Emerging Markets Committee of IOSCO and is in the process of being implemented.

Capacity Building of the Commission

The biggest challenge facing the Commission is access to high quality and well trained manpower. The Commission has revised its payroll and perquisites in consultation with HR Consultants to bring the same in line with the market. Annual reviews and promotion policies and procedures have been streamlined and bell curve introduced. Systems have been put in place to ensure that the evaluation process is fair, just and properly conducted.

CHAIRMAN'S REVIEW

To enhance capacity at the Commission, we are in the process of hiring over 200 officers in various grades. Again the process and procedures have been revamped to ensure that the selection process is transparent to ensure that the best candidates are selected and *sifarish* has no role. Continuous training is an avowed goal of the Commission as we believe that training the existing staff will make a huge difference for the Commission as well as to the individuals concerned.

With a view to providing an effective service to the regulatees, a full fledged Karachi office has been established so that the Commission becomes accessible to the regulatees and our capacity to access the regulatees is increased.

E-Services

With a view to providing effective and convenient service to our corporate regulatees and to streamline and facilitate the procedures for registering a company together with selection of name, submission of various forms and fees, registration of charges etc., we are in the final stages of instituting an internet based system, which would facilitate and speed up the process and would dispense with the need to visit the Commission offices. In future, all returns, filing of all types of forms etc., would be done through the internet. Once implemented, this process will increase the Commission's efficiency, reduce turnaround time and provide great convenience to the regulatees.

We are also in the process of introducing a new Corporate Universal Identity Number for each corporate, which will replace the old style registration numbers and instead of provincial registration, registration will be on an all Pakistan basis.

The Continuing Reform Agenda

The key challenges facing the Commission today arise mainly from its expanded mandate over recent years and the inconsistency in its regulatory authority in different sectors. While in certain areas the Commission has wide, proactive regulatory powers, in others it found itself restricted and thus forced to be reactive. Over the years, several amendments have been made in the legislation to cater for the Commission's expanded mandate but these did not go beyond providing stop-gap interim measures. The regulatory framework, therefore, needs to be updated so as to effectively address modern-day market issues.

The Commission will continue implementing its reform programme based on international best practices, conforming closely to IOSCO principles. The areas of focus include market/product development; enhancing governance of exchanges and risk management; development of a well-capitalised clearing house; improving the licensing regime for market intermediaries; and strengthening the legal and regulatory framework. The purpose is to mitigate trading risks and corporate failures.

Development of Laws

The Commission has taken up the task of strengthening the laws, rules and regulations and is committed to ensuring that these are reviewed and modernized at all times and are brought in line with developments around the world. The Commission has, therefore, been involved on a number of laws, some of which are in the process of enactment, while others are on the drawing board and in process of eliciting public opinion.

Drafts of the new Securities Act, the Financial Services Commission Act and the Futures Trading Act have been developed and have or are being refined in consultation with stakeholders. The Companies Ordinance, 1984 is being redesigned and reformatted in line with the recommendations and policy guidelines provided by the Company Law Review Commission set up for the purpose.

During the year, the Commission initiated the process of amending the Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 as well as the Modaraba Companies and Modarabas (Floatation and Control) Ordinance, 1980.

Acknowledgments

The Commission is aware that notwithstanding its status as the apex regulator of the securities market, it cannot succeed in implementing reforms without taking responsibility for the front-line regulator and for the financial intermediaries. This it cannot do without the support and co-operation of the Government. I would like to take this opportunity to thank the Government, particularly Ministry of Finance, Ministry of Commerce and the Federal Board of Revenue for providing continued support to the Commission in all matters.

I would also like to thank the Policy Board members for their dedication and support.

Various committees and commissions have been constituted at various times during the year by the Commission and I would like to thank the chairmen and the members of each of these committees or commissions for their hard work and dedication for doing a splendid job. The progress made and results achieved would not have been possible without their support. I would like to publicly acknowledge the efforts of Justice (R) Ajmal Mian, for heading the CLRC, Mr. Shaukat Tarin for heading Margin Financing and CFS Mk II Committees, Mr. Shehzad Naqvi for spearheading the Debt Capital Market Committee, Mr. Iqbal Hassan for heading Direct Margins from Financial Institutions Committee, Justice (R) Saleem Akhtar for heading the March 2005 stock market crash task force, and Mr. Riaz A. Malik for heading the Task Force on transfer pricing.

The past year has been tumultuous and the Commission has taken momentous steps in many directions. I would like to take this opportunity to thank the staff and officers of the Commission for their dedication and hard work. They were essentially responsible for the Commission's achievements and I am grateful to all of them.

Razi-ur-Rahman Khan
Chairman
March, 2007