

SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
NIC Building, Jinnah Avenue, Blue Area, Islamabad

BEFORE THE COMMISSIONER (SECURITIES MARKET)

M/s. Nishat Chunian Ltd. And others

...Petitioners

Vs.

Securities and Exchange Commission of Pakistan

... Respondent

Date of Hearings: 02-07-2002
19-11-2002

Present at the hearing on 02.07.2002:

- | | | |
|----|-------------------------|--|
| 1. | Mr. Imtiaz Siddiqui | Legal Counsel (APTMA) |
| 2. | Mr. S.H. Naqvi | ICC Textiles Mills Ltd. |
| 3. | Mr. Tariq Masood | Spencer and Co. Ltd. |
| 4. | Mr. Mazhar Hussain
& | Shadab Textiles Mills Ltd. & Sargodha
Spinning Mills Ltd. |
| 5. | Mr. Mohammad Arshad | Salman Akram Raja Advocates |

To assist the Commissioner (Securities Market):

- | | | |
|----|-------------------|--|
| 1. | Mr. Rashid Sadiq | Executive Director (Enforcement) |
| 2. | Ms. Nadia Rasheed | Assistant Director (Securities Market) |

Present at the hearing on 19.11.2002:

- | | | |
|----|-------------------|-------------------------------|
| 1. | Mr. Hanif Jakhura | Chief Executive Officer (CDC) |
|----|-------------------|-------------------------------|

ORDER

1. The matter before me arises from Writ Petition No. 2462 of 1999 filed by M/s. Nishat Chunian Limited before the Honourable Lahore High Court along with other connected Writ Petitions Nos. 2304/99, 3620/99, 4218/99, 5638/99, 5635/99, 1245/99, 12079/99, 12080/99, 11049/99,

11050/99, 11072/99, 1965/99 and 3185/99 against Securities and Exchange Commission of Pakistan (SEC) and others.

2. The Honourable Lahore High Court disposed of the above-mentioned petitions with the observation that SEC and not the Honourable Lahore High Court is vested with the function of regulating central depositories and stock exchanges and that the Court will exercise its power of judicial review only if the regulatory functions have not been properly performed. The Court further directed the SEC to proceed with the re-examination of the issues agitated in the petitions after hearing the concerned parties, including the petitioners.
3. It is pertinent to summarize and briefly state the issues raised in the Writ Petition No. 2462 of 1999, which are as follows:
 - a) The shares of petitioners are mostly held by long-term investors who represent the core of capital market of the country and the trading of the petitioners' shares is negligible vis their total holding as well as over all trading of listed shares.
 - b) The petitioners did not join the CDS because of absence of significant transaction of shares at any stock exchange and absence of meaningful utility of the system in relation to the fiscal charges.
 - c) The Listing Regulations were modified to de-list such companies, which do not join the CDS after its declaration as eligible security, by CDC. That in case of the petitioner, the notice of declaration of eligible securities was totally unilateral.
 - d) The CDC Regulations under Chapter 5 and Regulation 3.8 relating to CDC Fees and Charges are ultra vires the Central Depositories Act 1997. Demanding of deposits, fee and other charges from the petitioners are bad in law.
4. Pursuant to the directive of the Honourable Lahore High Court, SEC proceeded with the re-examination of the issues and hearings of petitioners and that of CDC were held on 02 July, 2002, 19 November, 2002 respectively before the Commissioner (Securities Market). In the hearing on 02 July, 2002 the attendants unanimously agreed with the fact that the Central Depository System (CDS) is beneficial for all CDS Elements / market participants such as issuers, participants and investors alike and that CDS is an essential element of a transparent and efficient capital market.
5. Some of the representatives expressed concern regarding the fee structure of CDC. It was alleged that the amount of security deposit levied on the issuers was very high and that it constituted a financial burden on the textile companies especially those with low capital base and low turnover in the stock market.

6. Mr. Imtiaz Siddiqui on behalf of All Pakistan Textile Mills Association (APTMA) expressed apprehension regarding the Security Deposit required by CDC and stated that no depository around the world takes an initial deposit from the issuer. He further alleged that the Central Depositories Act 1997 does not provide for taking any deposits by CDC. Mr. Mazhar Hussain added that majority of the textile companies are financially unstable and the security deposit would pose constrain on the cash flows in the prevalent circumstances. He further stated that high capital base of many textile companies was a result of conversion of debt into equity putting such companies into higher security deposit slab.
7. Central Depository Company of Pakistan Limited (CDC) was incorporated in 1993. It was granted Certificate of Commencement of Business in 1994. The company was granted licence to act as Central Depository in 1996 under Central Depository Establishment and Regulation Rules 1996.
8. The exponential growth in Pakistani Capital Market in the last decade forced all players to think about setting up of a depository as it became extremely difficult to manage settlements of trading volumes which had increased manifold, physical handling of paper certificates not only became laborious but also time consuming. Hence it did not remain feasible. In this background setting up of a depository was felt necessary.
9. Experts of the renowned international firm Price Waterhouse conducted a study in 1993 to develop a conceptual framework for the depository. The study was sponsored by the United States Agency for International Development (USAID) and their report laid the foundation of depository design. In November 1994, the Board of CDC awarded a turnkey contract to the IBM consortium for the implementation of the system in Pakistan. The IBM consortium presented a comprehensive Master Implementation Plan (MIP) to the CDC board after a detailed analysis of the following:
 - National requirements
 - Company and Banking laws
 - Regulations & Procedures
 - Financial and organizational aspects of the project
10. In April 1995, MIP was approved by the CDC board. Thereafter, user groups were formed, training sessions were conducted for the Participants, Pledgees and Issuers to explain the functioning of the system and the necessary infrastructure was developed. The infrastructure development included setting up of hardware, networking equipment including VSAT link for the three offices in Karachi, Lahore and Islamabad, development and testing of software, hiring and training of staff and establishment of CDC offices in the three cities. By linking three offices through VSAT made the depository geographically neutral.
11. Since the last decade, the capital markets of Pakistan have witnessed a substantial growth leading to a manifold increase in the trading volume.

The custody and safe keeping of physical certificates required maintenance of huge vaults by the individuals and institutions and the physical settlement of certificates were no longer feasible. Moreover, the manual system was also plagued by lengthy delays, risks of damage, forgeries and considerable time.

12. There were a number of problems faced by the members of the stock exchanges, investors, issuers of securities and others before the establishment of Central Depository Company (CDC) which are detailed below:

Problems for brokers/investors :

- a) Increased volume of book keeping and paper work.
- b) Problems in settlement due to increased volume.
- c) Maintenance of huge vaults for safe keeping of certificates.
- d) Payment of stamp duty on share transfers which was 1.5% of the face value.
- e) Risks of damaged, lost, forged and duplicate certificates.
- f) Lengthy and tedious procedure involved in pledging of physical securities.
- g) Long and cumbersome share transfer procedure taking up to 45 days.

Problems for Issuers:

- a) In case of new issues the issuers would take more than two months for the dispatch of certificates to the successful applicants and for the subsequent preparation and verification of transfer deeds.
- b) Capital and time investment required for issue and dispatch of share certificates, cash dividend, bonus and right issues.
- c) Issuance of duplicate certificates.
- d) Activities carried out for share transfer during book closure:
 - Signature verification
 - Checking correct value of transfer stamps
 - Verifying genuineness of certificates
 - Signature of Director for confirmation of transfer

13. The answer to all these questions was to set up an electronic book entry system in Pakistan. This led to the establishment of Central Depository Company of Pakistan Limited to manage and operate the Central Depository System.
14. The electronic settlement of securities through CDS provides many benefits to all market participants. Further, it needs to be appreciated that CDS is an important feature of the capital market which enhances the efficient handling and settlement of shares. The Listing Regulations of the exchanges provide for induction of companies in the CDS after its declaration as eligible security by CDC in the overall interest of the market

participants including issuers, which greatly benefit from the system as per details hereunder:

- a) Reduced workload due to paperless settlement.
 - b) Reduced manpower requirements.
 - c) Instantaneous transfer of ownership.
 - d) No stamp duty on transfers in CDS.
 - e) No risk of damaged, lost, forged or duplicate certificates.
 - f) No impact in case of sudden increase of settlement volumes.
 - g) Instant credit of bonus, rights and new issues.
 - h) Substantial reduction of paperwork during book closure.
 - i) Convenient pledging of securities.
 - j) Substantial reduction in time and capital investments.
15. The Central Depositories Act was enacted in 1997. The CDC Regulations were formulated by the CDC management in the same year in consultation with Issuers, Stock Exchanges and the Legal Counsel. The same were approved by the Board of Directors of CDC. SEC after reviewing these Regulations and consulting market participants approved these Regulations.
16. The Board of Directors of the Stock Exchanges also reviewed their listing regulations and proposed suitable amendments resulting from implementation of CDS keeping in view the following:
- Smooth operations of overall stock market operations.
 - Investors' protection.
 - Facilitating investors in secondary market trading in an efficient and transparent manner.
 - Benefit to the "Issuers" of "listed securities" as outlined in paragraph 14".

Stock Exchanges are frontline regulators for brokers/issuers (listed companies). The issuers are regulated by listing regulations. There is a laid down procedure for stock exchange(s) to make regulations. The Stock Exchange Board of Directors approve regulations on the recommendations of the management of the Exchanges. Before these regulations are forwarded to the Board for approval, a board committee reviews the draft regulations and while doing so also consult different stakeholders. The Board of Directors after deliberation forwards the regulations to the SEC for approval. SEC examine these regulations and approve the regulations if it is satisfied that these regulations are in public interest and that they ensure fairness and transparency in the market.

The Board of Stock Exchanges keeping all benefits that accrue to the market participants for joining CDS approved the amendments and sent them for SECP's approval. SEC was of the firm opinion that joining of CDS by the issuers of listed securities was in the overall interest of the capital market and specially in safeguarding the interest of the small investors. Further, it also saved the issuers of all inefficiencies and tedious

work relating to share transfers and accordingly keeping all aspects in view approved the regulations making it mandatory for listed companies to join CDS.

17. CDC is a Commercial Organization set up to act as a service provider to various market participants including issuers. Its shareholders include Stock Exchanges, IFC, Citibank (Overseas) Investment Corporation and local institutions including those listed on the Exchange.
18. Section 35 of the CDC Act empower the Depository to make regulations. I have reviewed the process of levy of CDC charges. The management of the CDC prepare a proposal for imposition of charges to different participants and forward it to the Board of Directors of the CDC. The Board of CDC (which also include issuers) deliberates the issue and forward the schedule of charges/deposit to the Commission for final approval. The proposal of levy of any charges/deposit and its increase is scrutinized in detail by the Commission before final approval is accorded. It may also be noted that charges/deposit of CDC can not be fixed by CDC in its discretion. In order to have a check on the CDS charges, the regulations have been framed so that prior approval of the Commission is required. After reviewing the existing procedure followed by CDC in imposing different charges, I am satisfied that CDC is following a transparent procedure for determining the charges/deposit.
19. The manner and method of formulating the regulations of the exchanges and CDC and the amendments made therein are both comprehensive and transparent. SEC while exercising its regulatory function of approving the regulations of CDC and stock exchanges ensures that such regulations further the objective of a fair, efficient and transparent stock market and protection of investor's interest.
20. It is apparent that CDC provides a service to the investors, issuers and members of stock exchanges and the benefits under the CDS clearly outweigh the fee/charges/deposit imposed under the CDC Regulations.
21. I have also looked into the arguments put forward by certain issuers that turnover in their scrip is low and as such their induction with CDS cannot be justified. I hardly see any justification between turnover of securities at the stock exchanges and their CDS eligibility. CDC under regulation 5.1.1 may declare a security as eligible security whether or not the issuer has made an application for those securities to be declared as eligible securities. The declaration of securities as eligible securities by CDC is done in consultation with the stock exchange(s) (frontline regulators for listed companies) in the best interest of capital market and for the protection of investors.
22. It has also been observed that substantial number of shares of various companies which have low turnover at the stock market have already joined the CDS. Few details are as follows:

Eligible Security in CDS	Shares available in CDS	Paid-up Share Capital (No. of shares)	Percentage of shares in CDS with reference to paid-up share capital
Gulistan Spinning Mills Limited	7,672,484	10,000,000	76.72%
Gulshan Spinning Mills Limited	10,598,874	12,650,000	83.79%
Indus Polyester Company Limited	4,152,310	12,360,200	33.59%
Island Textile Mills Limited	141,850	500,000	28.37%
Kohinoor Power Company Limited	4,714,240	12,000,000	39.29%
Olympia Spinning & Weaving Mills Limited	1,834,050	2,400,000	76.42%
Salfi Textiles Mills Limited	2,750,699	3,038,700	90.52%
Yousaf Textiles Mills Limited	5,974,915	6,360,500	93.94%
Tata Textiles Mills Limited	9,420,402	13,100,000	71.91%

23. Out of 44 petitioner companies 10 companies realising benefits of the system joined CDS during the pendency of the petitions and when they joined the system substantial number of shares were deposited by the investors in the system. The details are given below:

Eligible Security In CDS	Shares available in CDS	Paid-up Share Capital (No. of shares)	Percentage of shares in CDS with reference to paid-up share capital
Din Textile Mills Limited	14,812,674	15,441,934	95.92%

Kohinoor Textile Mills Limited	37,210,510	53,320,839	69.79%
Nishat (Chunian) Limited	27,003,665	40,320,000	66.97%
Nishat Mills Limited	74,088,649	111,344,367	66.54%
Prosperity Weaving Mills Limited	7,475,725	16,800,000	44.50%
Umer Fabrics Limited	9,514,270	24,005,200	39.63%
Ellicot Spinning Mills Limited	4,107,091	10,950,000	37.51%
Reliance Weaving Mills Limited	2,462,875	16,432,500	14.99%
Nestle Milkpak Limited	1,889,325	45,263,925	4.17%
Adil Textile Mills Limited	319,000	7,725,800	4.13%

24. CDC is an infrastructure project for capital market and its advantages/benefit for investors/issuers in ensuring safety, transparency and efficiency are enormous. The project was initiated by the Karachi Stock Exchange in collaboration with Lahore and Islamabad Stock Exchanges. The initial capital for the CDC was provided by the sponsors. The financial plan for CDC included raising of funds through paid up capital, deposit from members of the Exchange(s) and issuers and loans. In all fairness fund raising was planned from those who were the beneficiaries. It may be noted that deposit taken from issuers are subject to refund once a company decides to get out of CDS.
25. I have reviewed the latest financial position of CDC. The CDC's financials are now on strong footings. I have also noted CDC has provided relief to some users of its system in the shape of tariff reduction.
26. After hearing the petitioners and CDC I am convinced that CDS has enormous benefits for the issuers. This point has not been disputed by the petitioners as well. I strongly feel that management of companies who have not joined CDS have failed in their fiduciary duty of providing

maximum benefit to their shareholders in terms of cost efficiencies and hassle free transfer of securities which is their legitimate right. They have also exposed their shareholders to risk of fraud, forgery and loss.

27. After hearing both the petitioners and CDC, I direct as under:
- (i) CDC to reduce security deposit by 50% for issuers joining the CDS after the issue of this Order.
 - (ii) CDC to make appropriate plan to refund 50% of security deposit to such issuers who are already in the CDS.

Now since the petitioners have themselves admitted the benefits of the systems and they have been provided relief through reduction in deposit, all listed companies who have not joined the CDS so far are directed to join the CDS by 31 July, 2003.

28. That the matters agitated by the petitioners are disposed off, in the instant Order.

(Shahid Ghaffar)
Commissioner (SM)

ANNOUNCED

Islamabad,
Date: January 30, 2003