

**BEFORE THE SECURITIES AND EXCHANGE COMMISSION OF
PAKISTAN**

**IN THE MATTER OF THE ABOLISHMENT OF SERVICE CHARGES BY THE
LAHORE STOCK EXCHANGE (GUARANTEE) LIMITED**

Date of hearing: July 08,2002

Present at the hearing:

1. Mr. Samir Ahmed, Managing Director (LSE)
2. Mr.Javed Masud, Director (LSE)
3. Mr.Mazhar Rafiq, Director (LSE)
4. Mr.Rashid Ahmed, Director (LSE)
5. Mr.Amir Shirazi, Director (LSE)
6. Ms. Roohi Rais Khan, Director (LSE)
7. Mr.Azhar Hussein,counsel for Syed Asim Zafar,Ammar-Ul-Haq,Gul Abdullah
Dhami,Khawaja Imtiaz Ahmed, Syed M Ismail Abbasi and Mr.Rana Munir Ahmed
(Directors' LSE)
8. Mr. Syed Ali Zafar, counsel for and on behalf of the Board
9. Mr. Asadullah Javied, counsel for Mr.Naeem A. Khan (Chairman LSE), Mr. Gulfam
Ahmed Khan Sherwani (Director LSE) and Mr. Wasiullah Khan (Director LSE)

ORDER

The matter before us arises out of the decision of the Governing Board of Directors (the "Board") of the Lahore Stock Exchange (Guarantee) Limited (the "LSE") as per its resolution passed in its Fourth Meeting held on 2 February 2002, whereby Service Charges levied on trades at LSE were abolished (the "Decision").

2. On 1 July 2002, this Commission through Commissioner (SM) called upon the Board and its individual members to explain its/their position in the matter of the Decision, so that the Commission may determine as to what action, if any, should be taken under Section 7 of the Securities and Exchange Ordinance, 1969 (the “ Ordinance”) read with Section 20 of the Securities and Exchange Commission Act, 1997 (the “Act”) in respect thereof. Accordingly, the hearing took place at the Companies Registration Office of the Commission, at Lahore. Mr. Ali Zafar appeared for and on behalf of the Board whereas Mr. Asadullah Javed appeared on behalf of Mr. Naeem A. Khan (the Chairman LSE), Mr. Gulfam Ahmed Khan Sherwani and Mr. Wasiullah Khan. Besides, Mr. Azhar Hussain Sheikh appeared on behalf of six directors i.e Mr. S. Asim Zafar, Mr. Anwar-ul-Haq, Mr. Abdullah Dhami, Mr. Imtiaz Ahmed, Mr. M. Ismail Abassi and Mr. Rana Munir Ahmed.
3. Brief facts of the case are as follows: prior to the Decision, the members of LSE were required to pay Service Charges on trades at the rate of Rs. 3.75/- per Rs. 100,000/-. The Service Charges so collected were applied towards running the day-to-day operations of LSE. As per the latest Annual Accounts of LSE, Rupees 14.2 million were collected on account of Service Charges, which constitute approximately 25 percent of the total revenue of LSE. It has been noted that the members of LSE were also required to pay Rs. 5/- per Rs. 100,000/- as contribution to the Member Contribution Fund (MCF), 15% of which was being credited to the Investor Protection Fund (the “IPF”). The IPF and the MCF had balances of Rs. 16.65 million and Rs. 111.129 million, respectively, as of June 30, 2001. However, following the Decision, LSE abolished the Services Charges completely and also reduced contributions to MCF by the members from Rs. 5/- to Rs. 3.75/-.
4. It is evident from the record that the Decision was carried through, as a result of all member directors (except one) voting in favour of the said decision. Here, it may be pointed out that the dissenting non-member directors on the Board lodged a protest against the Decision with the Chairman of LSE vide their letter dated February 07, 2002 which was endorsed to the Commission. The Commission is on record to

have expressed its concern against the abolishment of the Service Charges in a meeting with the Board on April 19,2002. Subsequently, in the Board meeting held on April 27,2002, the Managing Director of LSE requested the Board, to once again deliberate this matter and proposed that a special meeting of the Board be convened for this purpose, in the next few weeks. Since the Board remained adamant in its position with respect to the Decision the Commission deemed it appropriate to call upon the Board for an explanation in order to understand the basis and rationale for the Decision.

5. At the outset of the proceedings Mr. Ali Zafar, representing the Board, informed the Commission regarding his authorization by the Board, in its resolution passed in the meeting held on July 06,2002, which precisely stated that the legal counsel would seek adjournment of the proceedings before the Commission and would protect the interests of LSE. A request for adjournment was made; however, the learned counsel could not come up with any reasonable justification as to why an adjournment should be allowed when the Commission has assembled in Lahore, all the way from Islamabad, in order to avoid any inconvenience to the members of the Board and as to why rather than waiting for the date of hearing, no such request for adjournment was made earlier. The counsel himself rendered an apology on behalf of the Board and on the instructions of the Commission proceeded to argue the matter on the legal as well as commercial issues.
6. The first submission made by Mr. Ali Zafar was that LSE was a separate entity, governed by the Board of Directors including ten elected directors, seven nominated directors and one Managing Director. The decisions of the Board were required to be passed by a majority and each individual member was entitled to vote as per his/her own viewpoint. Therefore it did not matter whether the decision was by a large majority or whether it was marginal-once a decision was taken it was the decision of the Board. Secondly, it was argued that a notice had been served on the Board in respect of the Decision, which was primarily a commercial decision, and there was an implication in the notice that the basis for such decision was owing to the vested

interests of the member directors. Thirdly a commercial decision, such as in the present case, could not be called into question until and unless there was a violation of any provisions under the Ordinance and/or any rule, regulation or direction made or given thereunder. The decision to impose any Service Charge was made by the Board itself; and, therefore, it was the Board, which was empowered to remove it; the Commission, therefore, could not impose its decision on the Board as no provision had been pointed out which amounted to a violation under the Ordinance. As for the commercial considerations, he briefly offered the following justifications: -

- (i) The volume of the business at LSE would increase as a result of the Decision and this would compensate more than for the reduction in Service Charges; and
- (ii) That compared to those of KSE, LSE charges were higher and that KSE had also abolished these charges.

7. The counsel concluded his argument on the note that the Commission is entitled to make regulations and issue directions under the Ordinance as long as they were equitable and not discriminatory. As long as LSE is treated equitably, after adjusting for material operational differences, with the other Exchanges, LSE would recognize the powers of the Commission in that respect. He stated that the grievance of the Board was more so with the methodology adopted by the Commission in this regard.
8. The other counsel, Mr. Asadullah Javed, contended that the proceedings should be quashed and the notice should be withdrawn in light of the fact that no contravention was made and pointed out in the notice and the notice was vague in its content. It was also argued that under section 20(4)(f) of the Act it was clearly laid down that one of the objects of the Commission was to promote and regulate self regulatory organizations such as stock exchanges and, therefore, by issuing the said notice the Commission had infringed upon the autonomy of the Exchange and had violated the aforesaid provisions.

Reference was also made to the preamble of the Ordinance, which provided for the protection of investors, regulation of markets and dealing in securities and for matters ancillary thereto. It was argued that the decision to reduce the charges was absolutely in line with the spirit of the afore- mentioned preamble and that the allegations neglecting investors' interest were baseless and frivolous.

9. The third counsel, Mr. Azhar Hussein, stated that although all points had already been addressed he would like to reiterate that the beneficiaries of the Decision were not the members but the investors and ,therefore, there should be no misconception on this issue. Subsequently, the member/nominee directors present in person made their submissions before the Commission. Mr.Mazhar Rafiq, an elected director of the LSE, stated that the Decision was taken with a view to giving LSE a jump-start and to provide LSE with a level playing field. It was also contended that with this Decision the business of LSE had increased. However, he admitted that the Exchange did not stand to gain any benefit as the Service Charges had not been reduced but had been completely eliminated and for this reason he had opposed the Decision. Mr. Rashid Ahmed (nominee director) stated that the elected directors were adamant and in a hurry to push the Decision through, despite the fact that it was vehemently opposed by the Managing Director whose view was also supported by the nominee directors. It was important that the compilation of the proper projections and the consequences of such abolishment should have been taken into account. It was also emphasized that this Decision was not reached with consensus and was, in fact, the first instance where a unanimous decision had not been carried through and a split vote had taken place. Mr.Amir Shirazee submitted that the concerns of the dissenting members were adequately reflected in the minutes and he expressed his desire that the issue be resolved amicably. Mr.Javed Masud expressed his discomfort on receiving a notice where the nominee members were not a party to the Decision. Lastly, Ms.Roohi Rais Khan stated that all that the dissenting directors had asked for was a deferment till the financial implications of the Decision had been considered and even this was not taken into consideration.

10. Having heard the parties, we must express our disappointment regarding the manner in which the Board dealt with this matter. The absence of most of the members of the Board at the hearing, and sending of the counsel with a request for an adjournment, without prior intimation, is indicative of the attitude of the Board towards this important issue. The Board should rise above conflicts of interest and behave in a responsible manner in the interests of the Exchange. However, we do appreciate the Board members who made an effort to appear in person before the Commission. Before going into the merits, we would like to note that securities markets worldwide assume a distinct role within a very specific and unique regulatory framework. The primary reason for distinguishing the securities market from other segments of the corporate sector is the existence of the vast stake of the general public. It is with this most crucial of factors in mind that jurisdictions across the globe have established comprehensive regimes empowering regulators to take preventive measures for safeguarding investor interests. Therefore, the role of a stock exchange must also be appreciated in this context.
11. As for the first objection raised by Mr. Ali Zafar regarding the Decision being that of the Board and the Commission having no powers to impose its will on the Board, which is also closely similar to the objection raised by Mr. Asadullah Javed relating to interference in exchange autonomy, it needs to be emphasized that unlike ordinary companies, a stock exchange assumes greater responsibility in discharging its functions, as it seeks, and must protect, interests of stakeholders beyond its members. On one hand, the autonomy of stock exchanges is recognized as a pre-requisite for performing duties as a front-line regulator, while on the other, it is crucial that such autonomy harmonizes and maintains critical balance with the essential need to put in place a credible, transparent and effective mechanism for investor protection. Occasionally a situation may arise where balancing of the two factors, namely, exchange autonomy and the protection of investor interest becomes imperative. While the Commission appreciates that the need for exchange autonomy is crucial, the same cannot be allowed to undermine or threaten investor interests. Similarly, protection of investor interests must not be blown out of proportion to stifle progressive initiatives undertaken by the exchange. In such situations, it is

regulators task to strike due balance between the two, and in doing so, a regulator must primarily be driven by public interest rather than satisfying a select few.

12. As for powers of the Commission to monitor and supervise LSE in such matters it is abundantly clear from the Act, in particular section 20, that being the apex regulator it is our duty to supervise and monitor the activities of the stock exchanges. It is beyond comprehension as to how the Commission is expected to regulate the stock exchanges and to maintain the confidence of investors in the securities market by ensuring adequate protection for such investors without being vested with the power to give directions. While exercising its powers under the Act, the Commission is required to give regard to the financial viability of the Exchange, the quality and capability of the management of the stock exchange and the interests of public investors. Keeping this in view, the Commission is empowered to take whatever action it can take in order to enforce and give effect to the Act, the Ordinance or any other law being administered by it. The basic principle is that the provisions of the Act and the Ordinance have to be given a meaning so as to advance the object sought to be achieved by the aforesaid enactments. We have to, therefore, consider and interpret the powers of the Commission under the relevant provisions so as to see that the objects sought to be achieved are fully served rather than being defeated on the basis of any technicality. The powers and functions have been entrusted to the Commission to take whatever action is necessary to ensure fair dealings, fair administration and for the protection of the investors' interests. It is essential that while interpreting these provisions the same should not be read in isolation; rather the true letter, intent and spirit must be taken into account and given effect to.

13. Having heard the arguments and explanation of the Board, the Commission is of the view that the Board has not come up with any plausible defense or justification in support of the Decision. The argument that the Decision is warranted by competitive practices at KSE is misconceived. It is an admitted position that LSE's earlier reduction in charges (in June 2000) has not borne any elasticity of turnover. Even after the abolishment of Service Charges and reduction in MCF the turnover of LSE has shown hardly any improvement. Furthermore, trading volumes at LSE for the past few years preclude

expectation that there would be any windfall, which would compensate for the substantial sum of money - approximating 25% of its total income – which is collected on account of Service Charges on trades. The abolishment of the Service Charge under the garb of introducing competitive practices is most likely to adversely affect the financial position of LSE and will, resultantly, jeopardize smooth and efficient functioning of the day-to-day affairs of LSE.

14. It is of concern to us that after the abolishment of the Service Charges and the reduction in the contribution towards the MCF, LSE's dependence on listing fee would drastically increase. Listing fee at the time of the Decision constituted approximately 51% of LSE total revenues, and in the absence of Service Charges, has become the main revenue source. Since, the Board has not proposed any alternative revenue collection mechanism; such a situation is likely to result in an entrapment for LSE, where LSE would be encouraged to incentivize listing of companies for purely revenue collection objectives. Furthermore, the Decision does not take into account the possibility of de-listing of companies. It is noted that the principal source of revenue for stock exchanges worldwide is service charges and not listing fee. In fact, contemporary trends support establishment of listing authorities separate from the exchanges so that misconceived revenue generation schemes and perceived conflicts can be avoided to ensure sustenance of a transparent and efficient working environment for the capital markets. Under the circumstances and keeping in view the Government's commitment to re-energize the capital markets in line with commercial exigencies, the Commission cannot condone regressive measures, which constitute the foundation of the Decision. As for the argument that compared to the KSE the LSE charges were higher and that the KSE had abolished these charges we find the same misconceived. Though the charges imposed by KSE are lower, however, the same have never been abolished, and the KSE, in fact, is contemplating an increase in these charges. While making the comparison, the volume of trading conducted at both Exchanges should also be borne in mind.

15. As per the minutes the members of the Board favouring the Decision maintained that the Decision was principally motivated by the concern that lower service and other charges at

KSE were encouraging shifting of business to KSE brokers, and depriving LSE brokers of a level playing field. It is also maintained that the previous regime resulted in a higher exposure to income tax, and that abolition of Service Charges and the reduction in contribution to the MCF would eventually benefit the investor. On the other hand, the dissenting view is premised on considerations such as (a) LSE has an un-funded exposure of approximately Rs. 120 million against a cash reserve of Rs. 20 million only; (b) previous experience of reducing charges in June 2000 has not resulted in increase in turn-over; (c) under the prevailing circumstances, when LSE is recovering from the May 2000 crisis and estimated exposure far exceeds available resources, it is not prudent to reduce revenue at this time; (d) KSE is in deficit itself and is contemplating increase in charges; and (e) proper analysis of the impact of the subject abolition/reduction of charges on the fiscal condition and budget already approved by the Board has not been carried out. It is pertinent to note that the dissenting view of the Managing Director of LSE suggests that given the present financial crunch, reduction in revenues would cause problems rather than solving any, and therefore, any reduction/abolition of charges should have been put off till the next financial year.

16. The Board seems to have also overlooked the fact that to be eligible to operate and function as a stock exchange, LSE is required to ensure fair dealings; protect investor interests and facilitate sustainable economic viability. Under the Memorandum and Articles of Association of LSE, the Board is bound *to maintain high standards of commercial honour and integrity and to promote and inculcate honourable practices and just and equitable principles of trade and business to discourage and to suppress malpractices*'. It is quite evident that the Decision is to the contrary as it does not take into account interests of all stakeholders, and is motivated by interests common to the members alone. We also take note of the fact that the reduction of the contribution to the MCF directly impacts upon allocations to the IPF. This reduction is going to further increase the gap between LSE's un-funded liabilities and available cash reserves in due course. Furthermore, such reduction does not appear to be in line with the theme underlying Regulation 3 of LSE Investors Protection Fund Regulations, which obliges LSE to achieve the prescribed threshold of Rs. 100 million in the IPF. More importantly,

such reduction is in derogation to the Commission's Directive Numbered 2(44) SE/97 and 2(23) SE/99 dated 26 February 2002 whereby the stock exchanges were directed as under:

“...To start with the exchanges are required to ensure that for the year ending June 30, 2002, the exchange(s) shall fund at least 50% of the actual contribution for the year towards IPF and CHPF. This percentage should be increased to 75% in 2003 and 100% to 2004 onwards. Further the exchanges shall also ensure that IPF and CHPF are fully funded by June 30, 2007.”

17. With respect to the argument that abolition of Service Charges, in fact, goes to the benefit of the investor is also not valid. The minimum share price movement on the stock exchange is 5 paise while the service charges calculated on a share worth Rs 20 work out to be 1/13th of one paise. This miniscule amount is therefore of no consequence to any investor. It must be borne in mind that an investor while trading in securities is motivated primarily: by the price of the securities, the profit he can make, the service rendered by the Exchange and the security offered for his investments. It is keeping in mind such considerations that regulators emphasize the need for exchanges to maintain sufficient resources in such funds. As for brokers trading on their own account, with huge volumes and doing so frequently it is clear that in absolute terms the amount of Service Charges would not be negligible. Thus, it is obvious that it is these brokers, who are the eventual beneficiaries of the Decision and not the investors. Furthermore, while comparing Service Charges to the brokerage commission what cannot be overlooked is the fact that brokerage commission is far greater e.g. for trading worth Rs 100,000 the brokerage commission would roughly work out to be Rs 500 as compared to Rs 3.75 for Service charges. This reinforces the view that the amount of Service Charge would be inconsequential to any investor.

18. A perusal of the record reveals that the Decision was carried out by a majority vote of such directors who benefited from the Decision. Given the sensitivity attached to the issue and keeping in view the express objections of non-member directors, we fully agree with the views expressed by Mr. Rashid Ahmed that the Board should have attempted to foster consensus on this issue instead of going by a simple majority vote. The divide in the voting pattern makes it manifest that parochial interests have overridden concerns of non-interested members. Also, the Board has offered no satisfactory explanation for brushing aside the objections raised by the Managing Director of LSE viz. the impact of the Decision on the financial viability of the exchange, during the meeting as well as in subsequent board meetings held after the Decision was taken, which *inter alia* included the following critical areas of concern such as: a large potential tax liability, un-funded liability towards MCF and IPF and contingent liabilities owing to litigation against the LSE as a result of the May 2000 crisis. Furthermore, several questions raised during the meeting, including those relating to the financial condition of LSE and the effect of the Decision on the budget already approved by the Board, were also not addressed. It may be pertinent to mention that the financial position of the Exchange is particularly under strain after the May 2000 crisis when the LSE utilized Rs. 194 million from its resources to ensure the settlement of clearing house operations. This amount has not been received from the defaulting members and the auditors of the LSE have qualified their report by stating that *‘Recovery of Rs 194.485 Million due from the defaulted members is pending adjudication (note 25); we therefore could not ensure its recoverability’*

Further, the auditors of the LSE have also drawn attention to the contents of note 26.4(c) of the Accounts which states that the Exchange should not have withdrawn amounts aggregating Rs. 18.699 million from the MCF as the MCF regulations did not allow such payments from the Fund.

In addition, LSE’s liabilities on account of MCF amount to Rs 111.129 million, whereas towards Investor Protection Fund and Security Deposits these liabilities amount to Rs 16.565 million and Rs 44.937 million respectively. Furthermore tax authorities have raised a total tax demand of Rs 86.261 million for the assessment years 1994-95 and 1998-99 to 2000-01

against which a provision of Rs 13.784 million has been made. Thus if the appeal is decided against the LSE there is a potential liability of Rs 72.477 million. In addition provisions against wealth tax assessments for the assessment years 1992-93,94-95 and 95-96 amounting to Rs 14.8 million have not been made. An amount of Rs 4.9 million has also not been provided for against Wealth tax assessment for the years 1997-98 to 2000-01. Thus it is clear that the financial position of the LSE is bleak. In view of the afore-going facts, we are convinced that the Decision is reflective of a pre-determined and prejudiced mindset, is tantamount to a highly irresponsible conduct, is in conflict with good governance; threatens the liquidity of LSE; is directed against investor interests and is detrimental to the over all interest of the capital markets.

19.As briefly discussed above, the exchanges provide a vital service for the economy and in so doing bear great responsibilities to all those who take part in the securities market. It is with these responsibilities in mind that the Board must concern itself. In other words, the betterment of all stakeholders' interests without undue favour being given to any one class of stakeholders must be paramount, and within the active contemplation of the Board before taking any action. Clearly, the unique feature of securities markets places a greater burden on stock exchanges as opposed to other corporate sectors in the economy. In light of the foregoing, and the deliberations noted in the previous paragraphs, LSE clearly appears to have acted in a most irresponsible manner and in haste with complete disregard to the interests of investors and publicly listed companies upon whose shoulders the continued existence of LSE rests. By having abolished Service Charges and lowering MCF contribution, not only LSE placed its own Clearing House and the investing public at risk but has also exposed itself to the risk of collapse. Unfortunately, this act of the Board is indicative of a much greater malaise that has been established in the current year. A review of decisions taken by the Board shows that members' interests have achieved priority over much-needed operational independence. The Commission appreciates that the Managing Director and nominated directors have played a positive role by taking into consideration the interest of all stakeholders and have asserted to defend the right cause. The abolishment

of Service Charges is an irresponsible and prejudicial decision, which, if allowed to continue would become an undesirable precedent. In fact, it is so serious that, in and of itself, it constitutes sufficient grounds to invoke the provisions of section 7 of the Ordinance. The Commission would therefore like to caution that any irresponsible conduct of this nature in future would indeed oblige the Commission to invoke the aforesaid provisions. It is hoped that in future the Board would heed this warning and fulfill its responsibilities and perform its functions as a frontline regulator with due diligence and care.

20. In view of the foregoing, we hereby direct the Board to:

- (1) withdraw the Decision and ensure that collection of Service Charges is resumed at the rate of Rs. 3.75/- per Rs. 100,000/-;
- (2) ensure that members making contributions towards the MCF at the rate of Rs. 5/- per Rs. 100,000/-;
- (3) not change the rates of Service Charges and other charges on all trades without prior written approval of the Commission; and
- (4) comply with and give effect to this order immediately and report its compliance to the Commission not later than Friday July 12,2002.

Shahid Ghaffar
(Commissioner)

Zafar-Ul-Haq Hijazi
(Commissioner)

Abdul Rehman Qureshi
(Commissioner)

Khalid A. Mirza
(Chairman)

Dated: July 08,2002