Dr. Tariq Hassan
Chairman
Securities and Exchange Commission of Pakistan
Islamabad

Subject: Report of the Taskforce to Review the Stock Market Situation

Dear Dr. Tariq Hassan,

We are pleased to enclose herewith the Report on the Review of the Stock Market Situation with reference to the Notification No.F.156/SECP(TF)/CSM/2005 of April 8, 2005.

We strongly recommend that this report be made public immediately in the interest of greater transparency in government and public accountability.

With best regards

Justice (Retd.) Saleem Akhtar	(Chairman)	______________________________
Dr. Mohammad Zubair Khan	Member	______________________________
Shahid Hafiz Kardar	Member	______________________________
Sultan Allana	Member	______________________________

Report of the Taskforce:

Review of the Stock Market situation March 2005

June 2005

TERMS OF REFERENCE

The Taskforce's Terms of Reference were to:

(i) Identify the causes for the situation arising in the Karachi, Lahore and Islamabad Stock Exchanges during 1st January to 31st March 2005 or other periods, as deemed appropriate by the Taskforce.

(ii) Analyse the role of various market participants including but not limited to the role of investors, brokers, Badla financiers, recipients of Badla finance, mutual funds, banking companies, non-banking financial institutions, investment banks, development financial institutions, in bringing about the recent stock market events.

(iii) Investigate allegations of market manipulation, insider trading and other market abuses and suggest regulatory and operational reforms for enhancing investor protection.

(iv) Examine the role of the front line regulators (i.e. the Karachi, Lahore and Islamabad Stock Exchanges), the apex regulator (i.e. SECP) and other stakeholders in the recent market situation.

(v) Review the impact of discussions by offerors of securities and their agents, market participants, including research analysts together with media in the recent events and recommend guidelines to ensure accurate reporting and information processing.

(vi) Recommend regulatory and operational reforms for market (the Stock Exchanges, NCCPL, CDC) for the efficient monitoring and accountability of the market participants.

(vii) Propose measures for strengthening and consolidating the regulatory regime particularly with a view to enabling emergency intervention, preventing systemic risk and promoting market stability.

(viii) Form sub-committees, co-opt such members and appoint such auditors or other professionals, obtain information and documents, require attendance of any persons, commission audits of the stock exchanges, brokers and financial intermediaries and generally inquire into and investigate any matter having any bearing on the recent market events.

(ix) Do all such other acts and exercise such powers as may be necessary for the fulfilment of the mandate.

TABLE OF CONTENTS

TASKFORCE REPORT JUNE 2005

INTRODUCTION

Taskforce Composition

1. Following protests outside the offices of the Karachi Stock Exchange and a spate of media based demands for an inquiry, the Chairman of the SECP, Dr Tariq Hassan, set up a Taskforce on 12th April 2005 to investigate the developments in the Stock Market during the first quarter of 2005.

   The members of the Taskforce were:

   Mr Justice (Retd.) Saleem Akhtar, Chairman
   Dr Mohammad Zubair Khan
   Mr Shahid Kardar
   Mr Sultan Allana

2. Secretary to the Taskforce was Mr Aadil Naeem Khan , an SECP Official.
3. The Taskforce was assisted from time to time by Mr David White, an international Stock Market expert who undertook analysis of Stock Market activity utilising data provided by the KES, LSE and ISE.

Taskforce comments on the Terms of Reference

4. The Taskforce noted that the need for an extraordinary group like itself, to investigate the situation that emerged in the stock market when frontline regulators, the three stock exchanges in Karachi, Lahore and Islamabad, exist together with the apex regulator, the Security and Exchange Commission of Pakistan, is symbolic of the underlying weaknesses in the performance of regulatory bodies, and the credibility deficit of public institutions. This investigation by the Taskforce does not absolve the regulators of their statutory responsibilities.

5. The Taskforce recognises the need to place a credible report before the public within a short time frame. However, considering the scale of the assignment mandated to it, the 30 day time period allocated to hold interviews across the country, assess the problem, request information, review data, follow up investigations of some transactions, fully pursue matters that have come before it, reach conclusions and then write a report, the Taskforce feels that a more detailed investigation would have required a longer time span than allotted. This became more obvious as the Task Force pored through huge volumes of data involving millions of transactions, data limitations, the anonymous nature of many transactions, the use of group accounts by brokerages, the need to conduct on site inspections in some cases, the lack of any precedent to follow for such analysis and the time required to conduct interviews, not to mention the time required by market participants to respond to data requests from the Taskforce; some brokers, did not even respond. Some, failed to comply with requests for data which hampered

the analysis the Taskforce wished to complete. And most importantly the extremely limited IT and experienced human resources made available to assist the Taskforce seriously constrained the breadth and depth of investigation required to make a thorough inquiry of every major transaction.

Scope of Activities and Conclusions

6. Undaunted by the immensity of the task, and taking full use of the limited resources and cooperation of the regulators and market participants in providing information, the Taskforce has conducted a broad investigation of the said events. The work has been brought to an early conclusion in deference to the wishes of the public at large for an early report. The factors described above dictated the Taskforce to adopt a strategy to economise on time and resources by focusing on the most prominent apparent failures and violations which contributed to the abnormal volatility and instability in the marketplace. Since the stock market in Pakistan is highly skewed in terms of size, trading patterns[1], financial power, volumes of brokers' business and weighted value of scrips in the KSE index, the inquiry has naturally focussed on a few large scrips, large investors and large brokerage houses. Consequently, the conclusions focus on the activities of the same entities, leaving the time consuming larger investigation to the normal regulatory functions and responsibilities of the KSE, LSE, ISE and SECP, who have more extensive resources at their command and should have by now conducted their own investigations.

7. The Taskforce has identified the factors and actions which contributed to the instability in the stock prices, both as the market went up and as it collapsed. Relying on macro-level information, the report has described the manner in which some participants appear to have benefited from the manipulation of market sentiment, prices and liquidity, identifies the key causes of the situation that developed in March 2005, and explains how the transactions arranged outside the rules of the market ostensibly to 'save' the market benefited some of the very people who arranged these transactions. The report also describes how managers of public institutions undertook losses arising from pre-arranged transactions using public money, in clear violation of their institutional mandates. It concludes by recommending the structural reforms required and the steps that need to be taken by the Stock Exchanges and the SECP to check the recurrence of such events because of policy, procedural, systemic and institutional capacity weaknesses.

8. The findings of the Taskforce place an unavoidable responsibility on the SECP to take a number of follow up actions to take this report to its logical conclusion, including making the report public immediately, completing the detailed forensic investigation where required and prosecuting those responsible for violating laws and regulations. The characterisation of events during the turbulent days of the market by the report

[1] Turnover velocity is 19 times that of Mumbai and Malaysia and 36 times that of Columbo

also provide the Stock Exchanges and the SECP with clear and unmistakable pointers to conduct their own investigations of many other such transactions which the Taskforce could not pursue, due to time constraints. The completion of this report is not the end of the investigation; on the contrary, in many ways it is the beginning.

9. Any investigation of the KSE is handicapped by a number of structural flaws which hide the identity of persons undertaking transactions. This has been facilitated by brokers dealing through other brokers with the clear intention of covering their tracks as symbolised by the existence of 'dhobi' brokers. In addition, brokers do not declare whether their trade represents a transaction on their own account or on behalf of a client. The other factors that have plagued this investigation were potential insider trading and the liberal existence of Benami and Group accounts. These factors make the KSE an opaque market and, consequently, a haven for man ipulators.

10. Appendix I details the meetings held by the committee as well as persons interviewed or persons who presented argument as to the market situation to the committee.

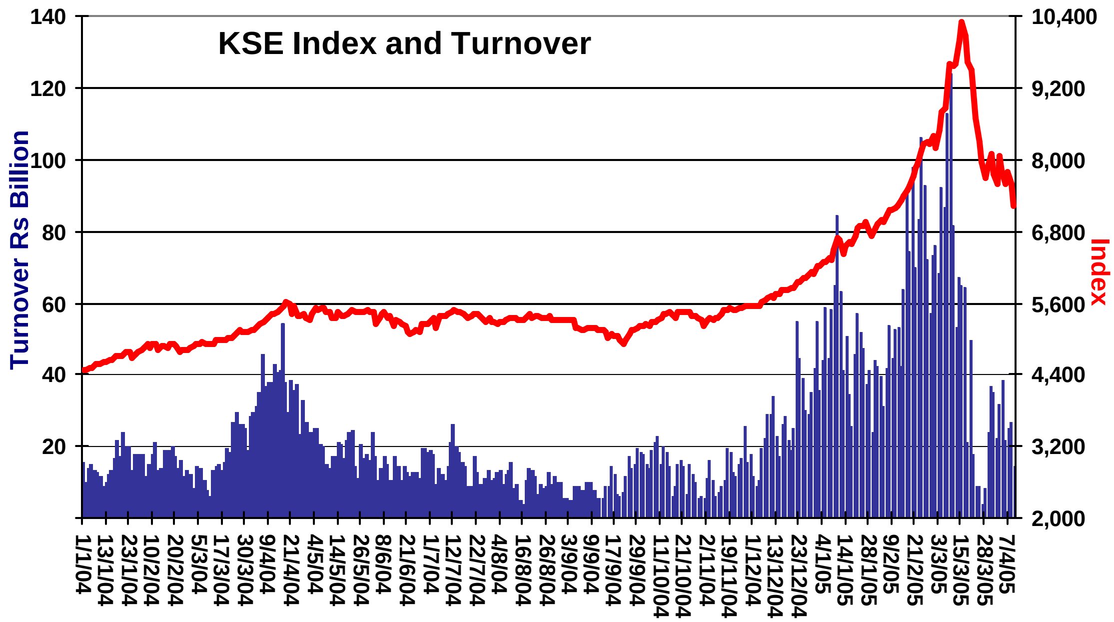
WHAT HAPPENED: THE FACTS

11. The KSE experienced a steady bull run reflected in both the KSE 100 index and trading volumes, starting just after the last stock market crisis in May 2002, until end November, 2004. This period saw increased turnover, which, however, remained under Rs. 20 billion (except for a brief period between March and June 2004). The main factors behind the 'bull run' were:
    i. Increased liquidity due to higher remittances.
    ii. A regime of low interest rates
    iii. Improved corporate performance
    iv. Higher oil prices
    v. Relatively liberal availability of COT financing
    vi. IPOs of public sector enterprises marked for divestment and floatation of more mutual funds

12. Just as some of these positive influences on the stock market were beginning to wane, such as: interest rates began to rise, remittances started to level off, COT phase out of scrips commenced, the KSE 100 shot up.

13. Starting December 2004, and culminating in mid March 2005, the KSE saw an unprecedented rise in the KSE 100 index, increasing by 65% from 6,218 on December 31, 2004 to 10,303 on March 15, 2005. This sharp climb in the index was accompanied by an increase in the value traded from around Rs.20 billion to a range of Rs.50-100 billion per day. This ascent in the index was facilitated by increased COT financing and the activation of the futures market, which had been dormant since its introduction in 2001.

14. Chart 1 Turnover (Traded Value)



What explains this?

15. During this period, especially since mid October, 2004, there was an unusual build-up in the media about the prospects of a rise in the KSE index, fuelled by statements from[2]:

   i. Government officials who linked the rise in the KSE index to good economic management.
   ii. Privatisation officials who announced the impending accelerated program for the privatization of prominent and profitable public sector corporations.
   iii. Brokers and others who appeared in the media encouraging investors to take advantage of a rising market.
   iv. Hype about a few scrips which were heavily weighted in the KSE index, heightening unjustified expectations about the entire market.

16. It will have to be ascertained by a more thorough investigation if any of these officials and others had any interest in the market and benefited in any way directly or indirectly by such announcements. These factors stimulated market sentiment, creating unwarranted confidence in the capital markets about the strength and sustainability of the escalation in the index and of the prices of listed stock.

17. The exaggerated expectations about the index in the future were reflected in the high prices of prominent stocks in the futures market, with the difference between the ready and future prices being more than what could be explained by the interest rates,

[2] See Appendix II for a list of government officials, Privatisation Commission, brokers and others

creating lucrative opportunities for arbitragers[3]. Holders of liquidity had an advantage because they could purchase in the ready market with cash and sell in the futures market at the same time at inflated prices, locking in their profits. There was apparently no shortage of buyers in the futures market because they enjoyed huge leverage (being only required to put up a 10 percent deposit initially), and the mood of the market was bullish.

18. In these circumstances, the role of Badla financing in whetting investor appetite needs to be understood. Badla financing, which grew markedly during this period, provided financing to investors who lacked liquidity to purchase in the ready market, albeit at high interest rates[4]. Investors were willing to borrow at exorbitant Badla rates (which were capped at 18% in KSE but rose in the uncapped LSE to over 100%) because the accelerated rise in stock prices made such expensive borrowing feasible. The growing availability of Badla financing from lenders, who were largely brokers and institutions, added to the buying frenzy in the ready market, raising stock prices on a daily basis and further amplifying expectations in the futures market. It may be noted that some of the major Badla providers were the same people who were selling in the futures market, and thus benefiting from the heightened expectations of price rises in the future. In other words, there was a strong nexus between lenders and brokers/investors who could influence market sentiment to their own advantage.

19. The major brokers representing financiers of Badla on February 28, 2005 and some of the largest net sellers in the March Futures were:

Badla Providers 28th February 2005	Amount (Rs. Million)
Arif Habib Securities	4,622
Aqeel Karim Dhedi[5]	4,233
Atlas Invest	2,228
DJM Sec. Ltd	1,815
Orix Bank Inv	1,731
KASB Securities	1,714
Darson Ltd.	1,534
First Capital Equities	1,468
Motiwala Securities	1,030
S.C. Securities	995
Jahangir Siddiqui	917
Akberally Cassim	849
Mohammed Hussain	759
First Equity	693

[3] See Appendix III How Arbitrage Works
[4] See Appendix IV for aggregate Badla value on daily basis for the months of February and March.
[5] Some brokers of Badla finance are lending the money of various clients

24,589

Large Net Sellers
Arif Habib Securiites
Aqeel K D Securities
DJM Securities
Jehangir Siddiqui
Orix Bank
KASB
First Capital Equities
FDM Capital Sec
Firozuddin A. Cassim
S.C. Securrities

20. The sharp rise in the index in March, peaking at 10,300 on March 15 and its precipitous fall in the latter half of the month are easier to understand in the context of the continuing rise in the market during December, January and February. During this period:

    i. Investors in the ready market were making profits whether they bought in cash or financed their trades with Badla, because stock prices rose by more than the cost of Badla. The continued and expanding availability of Badla [6]enabled speculators to roll their positions for little risk margin, albeit at high effective interest rates; while Badla financiers made huge profits at the high Badla rates.
    ii. Arbitragers in the ready and future markets, (including mutual funds and banks) made sizable profits.
    iii. Buyers in the futures market also made money because in each of these months the index reached a new peak, surpassing their future prices in most scrip[7].

21. By end of February the KSE index was rising almost vertically, reaching 8000. The market PE ratio was now over 14 compared to about 10 during the long bull-run[8]. The sharp rise[9] in the index could not be explained by any change in the fundamentals. However, Government officials, and brokers made public statements that the KSE index was destined to rise further. On February 27, Dr. Ashafaque Hassan Khan, Advisor to the Prime Minister said that it would be difficult to guess how long it would take for the KSE to hit the new high mark of 10,000.

---

[6] See Appendix V for a discussion of Badla financing

[7] This was also facilitated by the design of futures contracts, which actually provides for the deferred delivery of scrip for up to 30 days, and allows large well capitalised players to undertake arbitrage between the futures and ready market.

[8] See Appendix VI – PE Graphs

[9] Movements in prices are measured by historical volatility calculations and at this time the volatility rose over 50%. This had not occurred since the last market crisis in 2002. Appendix VII details and graphs the historical statistics of the KSE 100 Index.

22. Speculation in a handful of scrip led the market of which two examples are given below

i. OGDC: rumours spread of new oil and gas finds which would raise their stock value manifold. Speculators invested in OGDC in the ready and futures market bolstering its value from Rs.74.95 on December 31, 2004 to Rs.189.75 by March 15, 2005. It is surprising that during this long speculative spell in OGDC, the KSE management did not prevail upon the OGDC management to place full information before the market about the veracity of such news, nor did the management of OGDC provide a clarification. While it was an omission of responsibility on the part of KSE and OGDC, it is not clear whether key individuals at these institutions were aware of the correct position but chose not to inform the market and may or may not have benefited directly or indirectly by withholding this information.

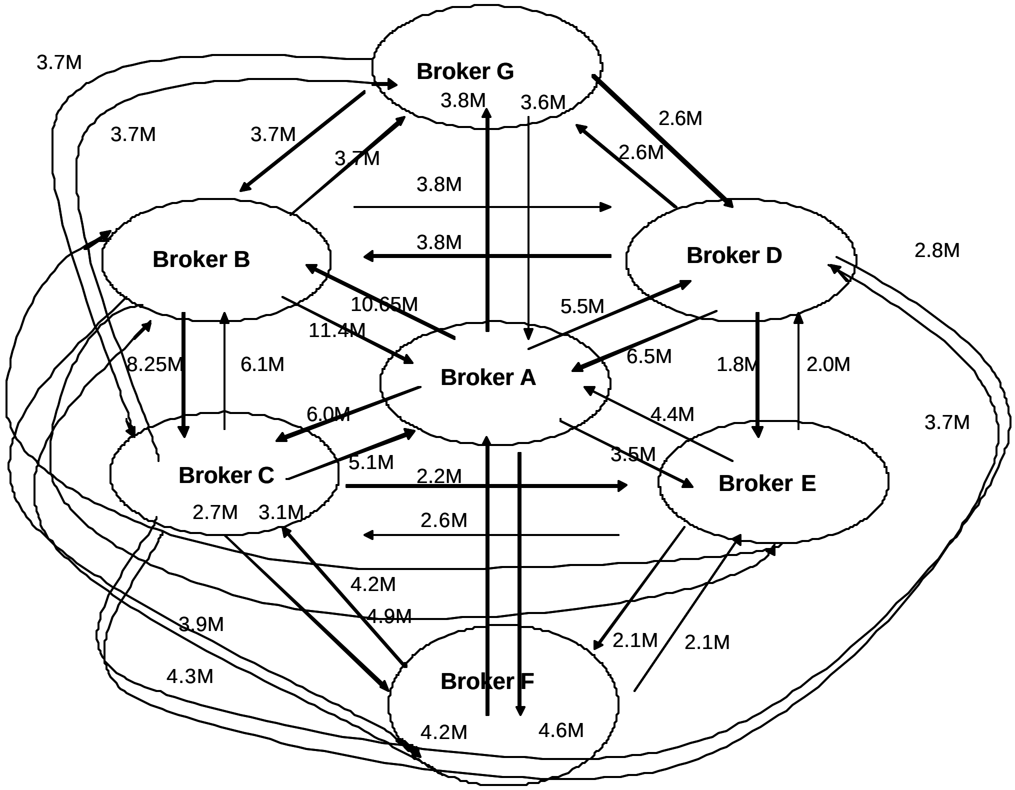
ii. PTCL: The Privatisation Commission had already announced the privatization of PTCL following routine procedures. As is normal in such situations, the market speculates on the price at which the publicly owned stock would be sold to the highest bidder. However, in this case on March 12, Chairman PTA made a public statement that "$2 (about Rs.119) a share as a reference price for the strategic investor of PTCL is quite reasonable". This naturally fuelled market expectations and the stock price of PTCL rose from Rs.86.85 to Rs.88.15 the next trading day, only to fall the next 2 days as stocks were offloaded by profit takers.

23. The analysis of stock market data helped identify a number of potential cases of market abuse where players had undertaken "wash trades"[10]; either for the same client or a series of common clients across brokers to "pump" the market. Analysis shows that the brokers and their clients largely dealt with each other in groups or sub groups at both broker and client level[11].

24. Large volumes were also traded between clients of the same brokerages and there were numerous instances of the same client or house account of a broker being both buyer and seller, in violation of rules, raising concerns about the sanctity of these transactions. The diagram below indicates this just for OGDC trading in March at a broker level. It represents the inter-trading between the top seven brokers. It is noted

[10] A wash trade is an illegal stock trading practice whereby an investor simultaneously buys and sells shares in a company through two different brokers. Such a trade enhances the activity in the stock, giving the impression of active trading without any change in beneficial ownership, a clear violation of Section 17 of the Securities and Exchange Ordinance, 1969.
[11] List of brokers and clients indulging in such trades is attached as Appendix VIII

that brokers often closed out any balance left from these trades with "off-market difference trades".



Broker A: Moosani Securities; Broker B: Akeel Karim Dhedhi Securities; Broker C: Worldwide Securities; Broker D: A.H.K.D Securities; Broker E: Mr. Munir Ahmed Khanani; Broker F: Motiwala Securities; Broker G: Mr. Muhammad Anas Kapadia

25. This matter requires thorough follow up by the SECP.

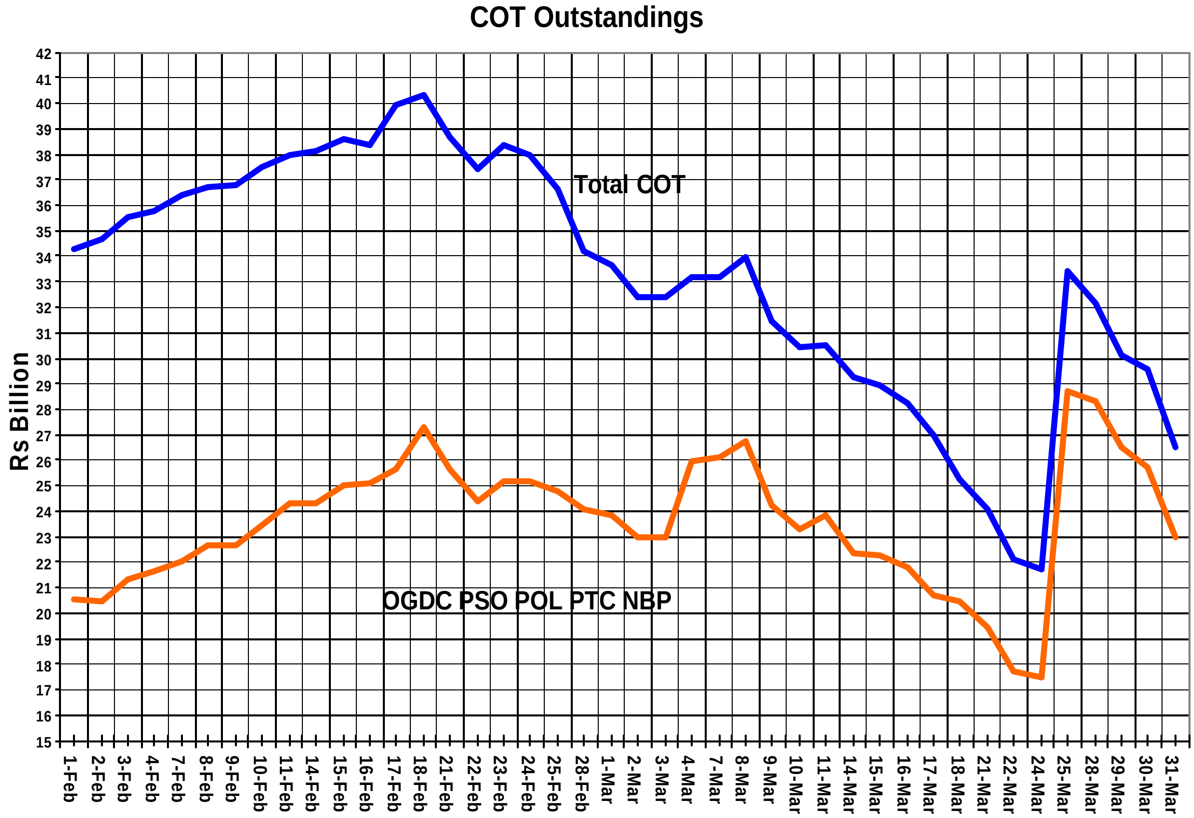
26. The data also enabled identification of excessive day trading by some brokers, which was disproportionate to their capital base. Such activity was facilitated by KSE not having pre-trade capital adequacy verification, as has been operational at the LSE since 2001. It is estimated that 0.1% of investors (the super speculative element) accounted for over 98% of turnover. A number of small brokers traded very high volumes of a single scrip, which may have contributed to the hype in the market. One broker, Worldwide Securities, mostly for a single client with an undisclosed identity, traded over Rs 115 bn worth of shares in the leading six stocks in the month of March, almost exclusively as day trades. This accounted for over 6% of the value of the leading six stocks transacted in March 2005.

The March Futures Contracts

27. In the backdrop described above, the March futures contract opened on February 24. During the first week of the March contract i.e. February 24 – March 04, the market sentiment in the ready and futures market remained unchanged, with full and continuing support from Badla providers, with the KSE index rising from 8,253 to 8,793, and the arbitrage margins in the futures market touching 40 percent. Big brokers and investors traded actively in the ready and future markets, remaining bullish on the market as reflected in their continuing financing of the Badla market, which was Rs.33 billion on March 3, 2005 (70% of which was accounted for by five scrips, PSO, POL, NBP, OGDC and PTCL).

28. After March 4 the first signs of a change appeared as Badla providers started to pull Badla out. Then, suddenly around March 8, on the occasion of a corporate announcement/adjustment in PSO, some of the Badla financiers (Badla is scrip specific financing) decided to reduce lending in PSO. A similar reduction in Badla finance for PTCL happened on March 11. Badla financing for PSO declined overnight by 62% from Rs.6.3 billion on March 08, to Rs.2.4 billion on March 09, while Badla finance for PTCL declined by 53% from Rs. 5.7 billion on March 11 to Rs. 2.7 billion on the next trading day, March 14 (although some of the decline in Badla can be attributed to the closure of PSO March A and PTCL March A contracts).

29. Between March 7 and March 15 some Rs 5.7 billion or 17% of overall financing was withdrawn in Badla finance, although scrip prices were increasing and the index was still rising. This reducing Badla level is depicted in the chart below:
Chart 2



30. It is noted that the brokers would be withdrawing funds on behalf of clients, and the major broker clients were mutual funds, insurance companies, and commercial as well as investment banks. For example, Arif Habib associated asset management firms were major clients of AKD Securities.

31. Badla providers explained that they stopped financing because they began to worry about the sustainability of the market rise and the consequent ability of Badla borrowers to repay their loans. Giving reasons for taking such an action Mr Nasim Beg of Arif Habib Asset Management, a major mutual fund, stated that the volume of leverage was beginning to worry them and that in the week beginning March 7, 2004 they decided to withdraw funds from the COT market. It is interesting that this fund had sold in the March futures contracts at prices higher than in the ready market from which it was withdrawing Badla financing. Moreover, this explanation of some Badla providers was contrary to their investment decisions in the ready market as buyers.

32. Two additional events also occurred during this period which turned the sentiment bearish and created panic in the market leading to the sudden collapse of the market.

i) The KSE management apparently worried about the possibility of default in a highly leveraged market, called up various brokers and banks to reconfirm that the brokers would be able to honor their obligations in the futures contracts, sending alarming signals to market players.

ii) A strong rumor was floated that the futures contracts for March would not be rolled over into April and that there would be settlement of the contract with delivery. Although strictly speaking such an outcome would have been consistent with the rules it was out of line with existing practice which added to market uncertainty.

33. It is possible that the Badla providers who were reducing their lending in specific scrips after March 08, had been selling actively in the ready market and were holding sell positions in the March futures contract in the same scrips at prices well above their ready market prices. This will need to be examined by a detailed forensic investigation and on-site inspection by SECP later.

34. Their decision to reduce Badla finance in the ready market was a manipulation of the liquidity in the ready market that would push prices down, thus augmenting their gains from their earlier decision to sell at higher prices. As a consequence of the Badla pull out, liquidity in the ready market declined sharply, reflected in a rapid decline in turnover from March 9 onwards.

35. With sharp contraction in liquidity and turnover, prices of scrips affected by Badla withdrawal plunged on March 16. OGDC, NBP, PSO, PPL[12], POL and PTC, which represented over 60% of the KSE Index on March 15, 2005 contributed to over 75% of the fall in the index. These stocks, excluding PPL, which was not a Badla financed stock, also represented over 70% of the finance provided via COT trading.

36. Since these scrips are heavily weighted in the KSE index (as mentioned above), the market sentiment changed with it and the index dropped, triggering locks on day trading after March 16, 2005.

37. Investors in the ready market who wanted to exit could not sell due to the locks that became operational because of the circuit-breakers[13] nor could they roll over their position as Badla financing was drying up.

[12] PPL was not included in KSE 100 calculation.

[13] The Exchanges employ circuit breakers designed to dampen the impact of a rapidly falling or rising market to assist control exposure margin deposits by brokers. In most markets, clearinghouses base risk exposure margins are calculated utilising a ‘value at risk’ (VAR) system, where the individual volatility

38. Buyers in the futures market deposited mark to market losses in accordance with regulations with the KSE on a daily basis. As the end of the March futures contract period approached on March 25, 2005, the ready market was still experiencing daily locks at the beginning of each trading day, and the KSE management feared that some buyers in the futures market may not be able to purchase their shares at the contracted price and some investors in the future market might default.

The Unusual Events in the Second Half of March and the Nature of the 'Crisis'

39. To appreciate developments in the subsequent days of March, it needs to be understood that while position holders in the ready market and weak buyers in the futures market were being hurt in the falling stock market, the sellers in the futures market who had locked in their arbitrage profits were also not certain of realizing their profits in case of default by weak holders. The Sellers in the March futures contract were of two types: (i) those that were holding shares that they had sold in the futures and locked in their arbitrage profits, irrespective of the level of the ready market by the end of month; these investors were apprehensive that buyers of their future contracts would default. It was in their interest to help the potential defaulters pick up these shares. (ii) the other sellers of the March contract, in clear violation of KSE rules (although not easily enforceable due to group accounts), may not have held the shares that they had sold in the future, but had planned to buy these after the market fell. The latter category of sellers could have played a role in bringing prices down in the ready market by pulling out Badla financing.

40. At this juncture, the only true, if any, potential crisis, existed in the futures market, although circuit breakers were not allowing weak holders to exit in the ready market. If there was a default by any investor/buyer in the futures market the broker would be liable to the clearing house for his clients' obligations (but in any case this would not be greater than the difference between the current market price of the scrip and the contracted price on which the default occurred). In case the broker also defaulted on meeting his clients' or his own obligations, the clearing house would then utilize the margins deposited by the broker as initial margin and as mark to market losses. The

of a scrip determines the margin required. In Pakistan, circuit breakers were set at 5% on the down-side and 7.5% on the up-side. For investors, particularly small investors, the operation of circuit breakers[13] became a nightmare as they could only watch a falling, 'limit down', market on a daily basis with no means of exiting their positions either in the ready or futures markets and volumes shrank dramatically. This is what is referred to as the 'Graveyard Market' where buyers refrain from entering the market in hope of lower prices being offered and sellers are hostage to a lack of buying.

clearing house would also move to settle the remaining liability by liquidating the assets of the broker, which include the market value of his membership card and his office assets. Remaining losses of the clearing house would then be met from the Clearing House Protection Fund (up to a maximum of Rs.50 million per default) and the Investor Protection Fund (up to a maximum of Rs.10 million per member), out of the funded amount of Rs.684 million and Rs.386 million respectively as on March 25, 2005. In case the combined receipts from these different sources were unable to settle the dues of the KSE Clearing House (the amount payable to the sellers), then the sellers would have been required to forgo their remaining profits on a pro-rata basis, scrip-wise. This explains the anxiety of the sellers with regard to the possibility of default in the futures market as that would have jeopardized the realization of their accrued profits.

41. The major net sellers (brokers) in the March contract and the major net buyers (brokers) in the March contract (many of whom were not potential defaulters) were the following:

Largest Net Buyers	Largest Net Sellers
Orix Investment Bank	Arif Habib Securiites
Motiwala Securities	Aqeel Karim Dhedhi Securiities
Fawad Yusuf Securities	Elixir Securities
M.R.A. Securities (Pvt.) Limited	BMA Capital Management
Muhammad Junaid Memon	Invest Capital & Sec.
First National Equities Limited	Muhammad Nadeem Abdul Ghaffar
Moosani Securities	Noman Abid & Co.
Yaqoob Habib	Taurus Securities
Zillion Capital Securities	Escorts Investment Bank Limited
Pak Meezan Securities	First Capital Equities
D.J.M. Securities	FDM Capital Sec
SAZ Capital Securities (Pvt.) Ltd.	Firozuddin A. Cassim
First Equity Modaraba	A. Jabbar H. Ali Mohammed Khanani
Iqbal Usman Kodvavi	Sherman Securities
HH Misbah Securities	Invisor Securities

42. The questions confronting the market investigation team, for which there were no ready answers, were:

i) How large was the potential default among the buyers of futures contracts?
ii) What would be the volume of losses to the clearing house, considering that the futures buyers had already deposited up to 30% of the buying price and deposited mark to market losses daily in the falling market?
iii) What was the net worth of the brokers' assets to help clear the liability of the clearing house?
iv) Would there have been a domino effect as claimed?

43. According to the KSE management, the impending defaults in the futures market could have triggered a domino effect on others but they have failed to provide any calculations or evidence in support of their assessment. This assertion is challenged by some large brokers who believe that the extent of potential default and its repercussions are exaggerated. The contention of the KSE management also runs contrary to their own claims that the existing risk management system of the market and margin deposit ratios were adequate to meet an eventual default and the financial position of the KSE Clearing House was strong on the back of adequate margins. In light of the above it appears that the fears of the KSE about a contagious default were exaggerated, and the situation did not warrant, prima facie, any intervention contrary to market rules. The mere default by some brokers and investors would not have threatened the integrity or reputation of the market, in which default is one of the normal potential outcomes anyway.

The Bail Out of Potential Defaulters

44. It is interesting that despite making claims about the robustness of the existing mechanisms and the adequacy of the risk management system, the KSE management and some large brokers, began efforts to design bail out plans for potential defaulters starting March 24, possibly aimed at protecting their own interests. Upon getting verbal representations from some of the member Directors and market participants, the Managing Director (MD), KSE, due to time constraint, obtained concurrence of other members of the Board on telephone and it was decided to extend the COT session for one hour on Friday and again on Saturday, March 26, 2005.

45. On Saturday, March 27, 2005, the Chairman, SECP along with his Commissioner (Securities Market (SM) met with the Governor, State Bank of Pakistan (SBP). As an outcome of this meeting, SBP, vide its BPD Circular No. 11 of 2005 dated March 26, 2005 withdrew the restriction of maximum exposure in COT, imposed on Banks earlier, vide BPD Circular No. 5, dated February 26, 2005.

46. Later that day, an informal meeting was held at the SECP Karachi Office at around 11:00 p.m. which, apart from Chairman SECP and Commissioner (SM), was attended by the MD, KSE, DGM Operations, major brokers, Mr. Arif Habib, Mr. Aqeel Karim, Mr. Nasir Ali Shah Bukhari, Mr. Jahangir Siddiqui, Mr. Kamal Afsar (State Life), Mr. Saqib Sherazi (Atlas Investment Bank), Naeem Farooqui (Orix Investment Bank), Mr. Nehal Cassim (Akberali Cassim), Mr. Najam Ali (ABAMCO), Mr. Munaf Ibrahim (Jahangir Siddiqui Securities) and Mr. Farrukh H. Sabzwari (KASB Securities), none of whom was a Director of KSE. Mr. Yasin Lakhani, Chairman of the Board of Directors decided to stay away from this meeting.

47. It was discussed and agreed in this meeting that considering the settlement quantum of March Futures Contract, the banks of the Exchange should be contacted to extend

Margin Financing to those members, who were in need of bridge financing, as they had substantial deposits with the Exchange against their exposures in the March Futures Contract, which would be immediately released once settlement of March Futures Contract took place. But in the event, this facility did not play a significant role in the eventual bailout.

48. More importantly, it was agreed that the COT session of Friday, March 25, 2005, should also be made available on Sunday, March 27, 2005, to allow leveraging to those seeking financing through COT. It is amazing that no minutes have been recorded of this meeting, nor has any basis been provided for taking these decisions. The COT Session of Friday, March 25, 2005 was first extended on the same day and thereafter the same session was again provided on Saturday, March 26, 2005 and Sunday, March 27, 2005. The Task Force noted that under the regulatory framework of the Exchange, COT facility is only provided in the Ready Market (T+3 Settlement System), to facilitate weak buyers of Ready Market to carry-over (leverage) their settlement obligations from current date to a subsequent settlement date. Nevertheless, the extended COT session of Friday, March 25, 2005 not only facilitated the weak buyers of Ready market but also enabled the weak buyers of March 2005 Futures Contract to manage their settlement obligations due on March 30, 2005. This was not in line with established practices of the market and not in consonance with the COT rules that regulate the use of Badla only in the ready market. In this case future positions were treated as if these were ready market transactions. Through this ingenious arrangement extended COT was designed in violation of normal trading rules, benefiting some large arbitrage players. The regulators acquiesced to this procedure that circumvented the rules to benefit some large brokers who were sellers in the futures market.

49. Badla finance provided on the Friday (including the extended Saturday and Sunday COT trading) amounted to over Rs 12 billion of which Rs 11.2 billion related to the five key stocks referred to earlier.

50. The major providers of Badla on March 25, 2005 were:

Broker	**Badla Provided (Rs. Million)**
Arif Habib Secu	5,474
Aqeel Karim Dhe	1,240
DJM Sec. Ltd	917
Abdul Jabbar Khanani	743
Akberally Cassim	633
Bilquis Saleem	417
First Capital Equities	381
Elixir Securities	290
A.R. Securities	270
First Equity	249
Alfalah Securities	190
Concordia Securities	177
Jahangir Siddiqui	155
AMPLE Sec.	141
Aziz Fidahusein	140
	11,416

51. There were several members of the Exchange, who had net receivable (net sellers) in the March Futures Contract and also provided COT in the COT extended session of Friday, March 25, 2005 till Sunday, March 27, 2005. The list of some of these members along with their respective quantum in COT and net receivable in March Futures Contract is as under:

COT Financiers and Net Receivers in March Contract

COT Financiers		Total Increase in COT during March 24-25, 2005 (Rs. in million)	Net Sell Position Futures Market (Rs. in million)
Code	Name		
50	Arif Habib	5,474.81	5,909.55
182	Akberally Cassim	632.56	1,608.05
149	Jahangir Siddiqui	154.81	1,008.74
97	Invest Capital	54.84	978.33
125	Bilquis Saleem	416.74	690.05
19	Aqeel Karim	1,239.32	344.60
114	Amin Issa Tai	139.06	344.60
200	Ali Hussain Raja	17.05	207.69
139	Asian Securities	45.72	145.90

52. It is interesting to note the similarities of amounts in the two lists above. Arif Habib Securities appears to be the main beneficiary of the extended COT session. Therefore, Badla providers, contrary to their claims that they had stepped in to save the market, were not undertaking any risk to do so since they were well aware of the adequate deposits of margins with the KSE Clearing House and had already extracted a higher price for their lending.

53. This extension of Badla finance to the weak holders of futures contracts was further designed to the advantage of both lenders and borrowers. First the Badla rate was enhanced from 18 percent to 24 percent in a meeting of the KSE Board via an out-of-agenda item. Secondly, bailout Badla financing was provided in scrip other than OGDC, which had been pumped up so extensively above its true value that now even Badla providers (who were sellers of the same scrip) were unwilling to finance holders of OGDC. As a result, it became necessary to arrange a second and complementary bailout package for OGDC holders at the expense of public money. Consequently, a consortium of institutions led by NIT and including SLIC and NIC arranged to buy shares of OGDC at Rs.117.50 from a whole range of sellers, some of whom had acquired these at the closing of the March contract. NIT was represented by the MD and Chairman Mr. Tariq Iqbal Khan, NIC by the MD and CEO Mr. M. A. Lodhi, and SLIC by its Chairman Mr. Kamal Afsar .NIT claimed that it had done so because it was concerned about the effect that the fall in the market would have on the level of its redemptions, the demand for which would be expected to rise. But in fact, the intervention, which was an off-market transaction, in effect saved some private investors using public funds. However, it is not quite clear how NIC and SLIC were influenced to become part of the consortium.

54. From the above it is obvious that some of the vested interest groups behind the KSE Board prevailed upon the KSE in informal meetings, of which no minutes or records have been maintained, to bend Badla rules to raise Badla rates, thereby protecting their interests and multiplying their returns.

Summing Up

Looking back, a pattern emerges in which different scrips were manipulated and played in different ways by the major brokers to their advantage. For instance, the price of the OGDC stock was pushed up with the help of rumors about substantial oil and gas finds which were never refuted by any one. Since OGDC had a disproportionately large weight in the index, this played on the market sentiment encouraging buying in all major stocks. PTCL and PSO, which were themselves helped by announcements pertaining to their privatization, were both sold heavily in the ready market during the first week of March by some major brokers at prices which could not be justified by the fundamentals. Subsequently, Badla financing for these two stocks was withdrawn suddenly which contributed to the fall in their price in the ready market, critically impacting on the overall index, and was instrumental in changing the direction of the market. This is a stark example of the power of the investors / lender in the stock market who can first, sell rising scrip, and then withdraw financing to pull it down. The examples of PSO and PTCL which suffered sudden reductions of 50-60 percent in Badla financing between March 08 and 14, and the subsequent impact on their prices is a clear example, especially when Badla financing was restored for the two scrips after March 25 (although full information on all Badla financiers is not available as yet, information from one of the largest brokers in the market shows that financing was withdrawn between March 8 and 9, 2005 for PSO by ABAMCO and between March 11 and 14 by Faysal Bank and PICIC, among others).

55. This environment made it possible for investors to buy these stocks cheaply compared to their prices in the first week of March. This could have enabled investors who had sold these two scrips in the future to pick up stocks at much lower prices thereby making large capital gains. The holding back of Badla by financiers who had earlier sold in the future market at a high price suggests that these brokers could have been involved in such a manipulation. The readily available information from CDC, the existence of group accounts, the holding of stock for various reasons in a common pool by a broker, does not permit a straightforward investigation of such manipulation. However, a detailed forensic investigation including onsite inquiry needs to be conducted by SECP to ascertain the facts and determine if manipulation of this type had taken place.

56. The Badla that was withdrawn from PTCL and PSO during March 8 and 14 returned for these scrips on March 25 when COT was extended to buyers in the future market, possibly by the same Badla providers. And since OGDC was still considered too risky to finance by Badla providers, the weak holders of OGDC had to be bailed out with public money through NIT, SLIC and NIC.

HOW COULD THESE EVENTS OCCUR

57. While the KSE has been proclaimed recently as the best performing emerging market, the events of the first quarter of 2005 have bared the high risk that investors face in this market. The risks are rooted mainly in the structure of the market where concentration of financial power and the unholy nexus between lender and investor gives brokers an unfair edge over other investors. The risks arise because the role of the front line regulators is compromised by the blatant and continuing conflict of interest on the Boards of the stock exchanges. Risks also lie in the opaque domain of the exchanges where those transacting can design manipulations behind the screens of group accounts, benami accounts and dhobi brokers. The repeated crises have shown that presently this is not a place where small savers can invest their life long savings on the strength of fundamentals. Investors, particularly small savers, should tread carefully in such a market ensuring that they are well informed about the strengths and weaknesses of different scrips.

58. It has been argued above that the run up of the market was aided and abetted by a combination of factors, some of which should have been addressed by the SECP and KSE prior to the market's "bull run". These are discussed in detail below.

POLICY, PROCEDURAL AND SYSTEMIC FLAWS

Broker house/ client positions

59. The Taskforce noted that apart from wearing several hats simultaneously, of broker, of Badla/COT provider, of mutual fund and investment bank, brokers and their staff frequently conduct trades between their own accounts and that of their clients, thereby creating opportunities for market abuse. Not only is there apparently no adequate control over this activity there is a clear conflict of interest in a broker transacting business without proper disclosure of his involvement or ensuring best prices for the client. Although the SECP finalised and gazetted proprietary trading rules after due consultation with the exchanges, these rules[14] provide an excuse for brokers to advise their clients that they may be disadvantaged if their orders are aggregated with 'house' orders. Thus the rules provide little protection to investors as they fail to protect a client when trades are aggregated.

60. Moreover, there is little or no policing by the KSE or SECP of these rules. The Taskforce was informed that when the surveillance department highlighted alleged serious breaches of rules, the KSE management was powerless to initiate appropriate action against rule violators mainly because of the conflict of interest at the Board.

[14] Appendix IX regulations for Proprietary Trading 2004

Proprietary Trading rules, unlike other rules, are not published on the KSE website and it is doubtful that most investors know they even exist.

Ability of Brokers to undertake excessive day trading and 'wash sales'

61. Presently there are no limits on the level of day trading by a broker, due mainly to the lack of pre-trade verification systems and other capital adequacy measures. This weakness, coupled with an almost out of control use of wash trades either directly by a broker's client or through the use of two or more brokerages in violation of the rules, facilitated market manipulation. The Taskforce strongly urges to the SECP to undertake a thorough forensic investigation and possible prosecution of suspected 'wash trades' and other manipulative practices that have been identified in this report.

The role of Circuit Breakers

62. The circuit breakers were a flaw in the system for major actively traded shares. While they may have played a role in preventing manipulation of prices in illiquid shares they served as major market impediment at the time of excess volatility.

Lack of gross margining on offset futures trades at the broker and client level

63. The software installed by the KSE contributed to systemic risk by permitting the netting of buy positions of one client of a broker with the sell position of another client of the same broker (the long position of one client being offset with the short position of another) resulting in inadequate risk margins being collected by the clearing house (since one person's inability to settle his commitments can lead to bankruptcy). The leverage available as a result of the offset of these positions was a major contributor to excess speculation compared with other markets that require client margining at a gross level, along with a value at risk system of adequate standard to estimate broker margins.

Mutual Funds, Commercial and Investment Banks

64. The Taskforce believes that the involvement of financial institutions in the COT market led to perceived and possibly real conflicts of interest. Not only did there appear to be no limits to such financing in relation to the overall funds under their management there was lack of transparency on the involvement of mutual funds and investment banks being both arbitrageurs and COT financiers.

INSTITUTIONAL FACTORS

Conflicts of interest in Board of KSE

65. The evidence before the Taskforce suggests that the KSE Board was unwilling to concede the division of responsibility between that of a Board and the independence

required for management to perform its proper role. In our opinion, this is reinforcing the inherent conflict of interests that exist in a mutually managed exchange.

66. The Taskforce found that the Board worked at cross purposes to management by continually delaying needed improvements, especially pre-trade risk verification (which was already in place at the LSE as far back as 2001) and institution of better risk management systems. In fact they generally obfuscated matters which were not in their interest.

67. There also exists a ‘them’ (management) and ‘us’ (brokers) attitude which is unhealthy in such an important institution for the development of Pakistan’s capital markets.

KSE Management Weaknesses

68. Many participants thought that the KSE management had been too lax with risk management standards and were particularly critical of netting at the client level (see below). When confronted the Exchange management maintained in its defence that it was constrained by a ‘conflicted’ board. However, the Taskforce believes the KSE management could have done more to highlight deficiencies to their Board and the SECP should have been more proactive and demanding of the Board to ensure timely implementation of reforms.

69. The KSE management should have required listed entities to clarify media speculation or to state if they were aware of any reasons for excessive price movements, something provided for in the listing regulations.

70. Complaints were made about the lack of technical competence of KSE management and their ability to keep pace with developments in the market.

71. Market players also repeatedly endorsed the need for an assertive and strong management. The Taskforce believes that this may only be achieved in a demutualized exchange and until a well functioning, independent management process is put in place, the successful implementation of significant structural reforms covered in this report is likely to remain in jeopardy.

Inadequate surveillance by SECP, and weak implementation of policy reforms

72. Whereas the SECP had considered or designed a myriad of fire fighting initiatives and piecemeal proposals, the lack of action by the Exchanges in implementing measures to address these issues did not prompt it to ensure enforcement in a timely fashion prior to the developments in the market. It seems that the SECP assumed that just the issuance of directives and the drafting of rules was enough, for instance with respect to the replacement of Badla/COT with margin financing. It took comfort from the handful of meetings it held with key players without ensuring that the alternative

system was in place by the time COT was withdrawn[15]. Further evidence of the SECP piecemeal and ad-hoc approach to reforms is provided by: a) the effort launched only recently to draft a Futures Act and review market regulations, although the futures market had become operational in 2001; and b) the permission that it had granted the LSE to introduce cash based settlement for futures contracts only to allow the KSE a few months later to install a scrip delivery system for futures contracts.

73. The Task Force believes it was incumbent on the SECP to have acted more forcibly, via directives to a recalcitrant exchange to ensure that the recommendations[16] of the previous enquiries into market crises were implemented in a more timely fashion. The Task Force believes that the SECP should have been more prescriptive, via directives, to eliminate impediments to the proper functioning and surveillance of the markets and its players.

74. In our opinion, therefore, the lack of rigorous SECP follow up enabled a number of the causes for the manipulation of the market to develop.

75. Finally, the SECP broker inspection, surveillance and monitoring systems established by SECP failed to function effectively either prior to the market crisis, or since. The SECP in its submission noted the intended installation of a more robust monitoring system.

OTHER FACTORS

The Privatisation Process

76. The Taskforce believes that the issuance of a small percentage of major a scrip at the retail level led to the conditions of rapid price appreciation as retail investors sold out to institutional investors for whom it was incumbent to weight their funds to hold an index equivalent. This was because they wanted to track the index movement. And, as discussed elsewhere, the design and construction of the KSE 100 index, characterised by the over dominance of a few leading scrips, amplified this process of price appreciation in the 'bull run'.

77. Market players interviewed by the Task Force also expressed their concerns about: a) the alleged leakage of PC deliberations or the agenda items of its meetings; and b) the public statements made by government officials or holders of key positions in the regulatory authorities of public sector corporations marked for privatisation about the price that the divestment process would fetch (as already discussed above).

[15] The onus was on SECP to ensure that the system of margin financing was securely in place, since it knew that brokers would resist the withdrawal of COT under which the entire risk is with the clearing house.

[16] Appendix X is a table outlining the major findings of the previous enquiries and the subsequent actions taken by the SECP

Lack of transparency of Arbitraging Business and COT Financing Linkages

78. The Taskforce believes that the lack of knowledge of the overall position of the market and lack of transparency of the market activity by arbitrageurs lulled the market into taking additional risks in an already highly leveraged market.

Analyst Research

79. The Taskforce noted that some research seemed to be geared to 'painting' a very rosy outlook for companies and it was told that front running by brokers' staff and their favoured clients was described as common. An example of research was referred to the Taskforce that amounted to the distribution, clearly against rules, of 'insider information". On Tuesday, 11th January 2005 the research report issued from Al-Falah Securities[17] claimed that Al-Falah Securities has sources in PTCL, and according to those sources, PTCL revenues are to increase due to non-incorporation of certain adjustments, allowed in the rules released by Ministry of Telecommunication on January 1, 2005). On the subject day the price of the shares of PTCL closed at the upper circuit breaker value. The prices increased by Rs. 3.79 or 7.45 %. However, little or no action has been taken by the KSE or SECP to eliminate this practice and investors are vulnerable to being disadvantaged by such actions.

Media Comment

80. The Taskforce was continually told of concerns about media commentary and its impact on the market. It is amazing that currently there are no guidelines or codes of conduct covering media and analyst comments, especially relating to conflicts of interest which are not disclosed in the media as is the practice in other jurisdictions.

81. Concerns were also expressed about comments on the market made by the Exchange management to the media. This is an area that needs guidelines to be issued by the SECP.

[17] See Appendix XI – Broker research paper

PROPOSALS AND RECOMMENDATIONS

POLICY, PROCEDURAL AND SYSTEMIC PROPOSALS

Rewrite the proprietary trading rules and ensure dissemination of the rules to market participants

82. The proprietary trading rules, including the level of penalties, need to clarify and unambiguously eliminate the ability of brokerages to front run clients and engage in other abusive practices. Trading via accounts with other brokers should be barred. Fines for abuse of the rules should be set at a very high level.

83. The SECP should ensure the introduction of primary regulation to cover the Exchanges' regulatory responsibilities. The laws relating to the ability of the SECP to undertake forensic investigations and enforcement should be strengthened to enable imposition of custodial sentences for serious market abuse. This is essential in view of the conflict of interest at the Board level of the Exchanges.

Creation of a "Free Float' Index

84. An improved market capitalisation index, weighted for stock available for trading in a company would provide a better foundation to measure market movements. It is also considered that a company should have to have a minimum percentage of its capital available for trading before it is included in an index. We understand that the KSE has initiated an exercise to design a new index based on market float.

Elimination of Circuit Breakers and replacement with Market Halts based on a Free Float Index

85. The KSE and SECP should work towards the elimination of circuit breakers and the introduction of market halts for varying time periods depending upon the movement in the market index. The halt regime existing in the Indian market may well be suitable for introduction in Pakistan. The elimination of circuit breakers will also assist the move to a Value at Risk system based on the volatility of individual stock prices which would be difficult if circuit breakers, which act as a governor on price movements, are not eliminated. Some form of circuit breakers could be applied to illiquid stocks in order to protect against market manipulation.

Design of the Futures Contract[18]

86. The futures contract was really a deferred delivery of the purchase and sale of a scrip with a T+30 settlement period decreasing daily - T+29, T+28, to eventually match the ready market's T+3 at the close of futures trading. This is in contrast to other markets

[18] See Appendix XII – Issues with Design of Futures Contract

where the trading is of a contract which specifies certain characteristics such as the number of shares per contract(usually 1000), the acceptable scrip for delivery, what adjustments are made for corporate actions such as dividends, bonus and rights issues if declared during the currency of the contract. In developed markets, futures are usually traded in a series of 30, 60 and 90 day contracts where a longer timeframe is available for trading which accommodates better roll over capability.

87. Current contracts were for the buy and sale of one share and restricted to a 30 day rolling period. There were no position limits and no reporting of client exposures over a certain level of trading. Also buy and sell positions were netted and there are deficiencies in margining methodologies.

88. The futures contract specification and the series of months for which it is traded should, therefore, be redesigned inline with a modern single stock futures derivative market. If the present system of final settlement of single stock futures based on physical settlement is replaced by cash settlement[19] it would have to be phased in (giving adequate adjustment time) and supported by other complementary risk management instruments and mechanisms like margin deposits on the basis of value at risk, capital adequacy of brokers and a securities borrowing and lending system.

89. Margins should be assessed on a value at risk basis at client level (gross basis) with speculative position limits based on the free float of the scrip. Brokers should have to report client open positions over a certain reportable level so regulators may monitor emerging risk. Contract months for futures should be the near month 30 day contract that is next to expire and the 30 days, 60 days and possibly 90 day contracts.

90. The KSE website should also report aggregate futures positions by scrip weekly. The disclosure should be unambiguous as to net position calculations.

Phase out of Badla/COT trading

91. Whereas the Taskforce shares the concern of the SECP that COT trading is not a viable alternative to a modern derivatives market, the final phase out will require a 'home' to be found for the scrips in COT trading to avoid market stress. Therefore, the phase out of COT should be handled in a manageable and timely manner so as to ensure that investors have alternate financing mechanisms such as margin financing, readily available and freely accessible to support their investment and trading activities. Furthermore, the futures market will also need to be further developed, along the lines as recommended earlier in this section.

[19] It is also noted that while a cash settlement system lowers settlement risk and effectively separates the future and ready markets while physical settlement leaves less room for manipulation and is also less likely to be attacked for non-compliance with Shariah.

Capital Adequacy of Brokers

92. There is a need to ensure brokers have adequate capital. The current method allowing shares outstanding to be settled at T+3, based on twenty five times net capital, defined as current assets minus current liabilities with some adjustments for associated lending and house positions, is too generous and not in line with best practice. In most jurisdictions capital is based on risk adjusted assets to be held in the form of liquid capital and this is based on a percentage of total on and off balance sheet liabilities, usually about 5% of liabilities. High 'haircuts' are applied to thinly traded stocks and illiquid assets such as property and long term investments.

93. The SECP and Exchanges have to address this issue as a matter of urgency to ensure that any further systemic risk can be contained. This is an area that has not received detailed attention by the Taskforce, in light of its tight timetable. However, in our view, a marked improvement of broker capital adequacy has become essential to check similar situations from arising again.

Mutual Fund and Investment Bank activity in Arbitrage and COT business

94. The taskforce recommends two measures to improve regulation in this area:
   i) Mutual Funds (and Insurance Companies) should have placed upon them a maximum investment in COT financing, like 15% to 20% of funds under management.
   ii) Mutual funds should report weekly to the SECP their investment in arbitrage and COT activity. The SECP should publish via the KSE website and its own website aggregate positions by counter.

Privatisations

95. The SECP, Ministry of Finance and the Privatisation commission should review the current IPO offering process to see if modifications could be made to allow a 'book-build' process including allocations to institutions to be introduced. The level of issue should also be carefully considered and an assessment made as to the likely impact of the issue on the overall market in an effort to avoid the development of over exuberant markets.

INSTITUTIONAL RECOMMENDATIONS

Demutualisation of the Exchanges

96. The Taskforce believes a fast-track process has to be initiated to ensure the independence of management of the Exchanges from brokers. For the achievement of this objective the Government may have to become directly involved to prevent the process from being blocked by existing vested interest. There will be many issues to be addressed and complex steps to be taken to arrive at appropriate structure. It is recommended the Government appoint and fund a small independent commission to

drive this matter to conclusion. Left only to the Exchanges, demutualisation is unlikely to be achieved within an acceptable time frame.

97. Until demutualization is achieved, the independence of the KSE Board should be further enhanced, by requiring the appointment of an independent, non-broker, Chairperson of significant standing in the community. The SECP should appoint the Chairperson in consultation with the Finance Minister.

98. Furthermore, the KSE Board when it meets, subject to very exceptional circumstances, should only address items scheduled on the Board meeting's agenda, and not allow board member(s) to raise ad hoc issues for decision without proper analysis or input from management.

Strengthening National Clearing Company Limited (NCCL)

99. The devolvement of risk management, via a properly instituted robust and dynamic 'value at risk' system maintained and operated by an independently managed clearing entity is essential to the development of the capital market.

100. Much that precipitated the current crisis (weak holders of futures contracts) would have been averted if a system of margin calculations and their collection was in place and in accordance with world best practices.

101. The NCCL should be capitalised to the extent necessary for it to embark on the development and installation of the required systems and mechanisms to implement international best practices in risk management, clearing, and settlement. This process should look at available resources, including the existing Clearing Protection Fund, and seek to ensure that the clearing system can face any period of market disruption like the recent one.

102. Until an improved risk management system is introduced, pre-trade verification of KATS trading is essential. Limits on open day trades should also be established.

103. Client positions should be margined on a gross basis and minimum client margin requirements set in order to limit the amount of uncovered leverage in the market.

Monitoring and Surveillance of Members for market Abuse and Insider Trading

104. It is essential that the regulators have proper surveillance and monitoring systems in place, supported by a strong compliance culture, backed by appropriate rules and penalties as well as having exchange staff fully up to date with market practices and vulnerabilities.

105. Therefore, there needs to be a concerted and determined effort within the KSE to staff both a properly functioning surveillance department with a modern array of data analysis software as well as a properly resourced and capable enforcement/prosecution function with the ability to levy meaningful and very substantial penalties (like hefty fines, suspension of trading rights for a week, etc.) with appropriate reference to the SECP for criminal prosecution of market abuse and insider trading.

106. The rules and framework in this area need considerable bolstering and if the Exchanges are not willing to undertake the necessary changes, both policy and procedurally the SECP should become more frontline in this area of regulation (supported by legislative changes wherever necessary) and levy members to cover the costs of undertaking such work.

107. Furthermore, it is essential not only to have adequate rules but to ensure there is a proper compliance culture in place for the rules to be effective. In addition the rules have to be supported by a determination within the exchange to police the rules and subject abuse to heavy sanctions including large fines and suspension or expulsion of members.

Development of a market transaction Data Warehouse

108. The Taskforce was dismayed at the lack of readily available market transaction data; the KSE does not maintain a data warehouse of all KATS actions such as the audit trail of all bids and offers. The KSE was overwriting the daily tape of these actions on a 30 day rolling basis. By the time the Taskforce requested such data most had been overwritten. It is essential that the KSE has an acceptable data retention policy and systems to support that policy.

109. It is understood the KSE Board had rejected management's requests to set up such a data warehouse. Such a warehouse is an essential element in policing market abuse.

110. The exchange should, therefore, develop a comprehensive database of all KATS actions as well as have access to broker clients detail for proper surveillance and policing of all trading to be undertaken. This data warehouse should be based on an approved KATS retention policy.

APPENDICIES

APPENDIX I - SCHEDULE OF MEETINGS OF THE TASKFORCE

APPENDIX II

A) STATEMENTS FOR OFFICIALS AND

B) OTHERS

APPENDIX III - HOW ARBITRAGE WORKS

APPENDIX IV - SCHEDULE OF BADLA FINANCING AGGREGATES

APPENDIX V - OUTLINE OF BADLA FINANCING

APPENDIX VI - PE GRAPHS

APPENDIX VII - HISTORICAL VOLATILITY

APPENDIX VIII - DETAILS OF BROKERS INVOLVED IN WASH TRADES

APPENDIX IX - PROPRIETARY TRADING RULES

APPENDIX X - SUMMARY OF RECOMMENDATIONS OF REPORTS INTO OTHER CRISES

APPENDIX XI - AL FALAH RESEARCH PAPER

APPENDIX XII - Issues with design of Futures contracts