

Securities and Exchange Commission of Pakistan

Press Release

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2008 stock market crisis: Committee blames abrupt and ad hoc policy shifts

ISLAMABAD, August 11: The arbitrary use of force majeure powers, abrupt and ad hoc policy shifts and autocracy at the Securities and Exchange Commission of Pakistan (SECP) led to the 2008 crisis in the stock market, said the Shamim Ahmad Khan committee report.

The SECP had constituted the committee in 2012 to analyze the crisis. The committee remained inactive due to Mr Shamim Ahmad Khan's resignation. However, the SECP Chairman, Mr Zafar Hijazi reactivated the committee and approved revised terms of references (ToRs) in January 2015.

As per revised TORs, the committee was mandated to study the factors leading to the 2008 crisis, rationale for imposing of the floor by the exchanges under their risk management system (RMS) regulations and review the impact of imposition of the floor on the market. The committee was also asked to give policy recommendations based on the experience of the 2008 crisis.

The committee submitted its report to the SECP on June 5, which the Commission has presented to the Policy Board in its meeting held Monday. The report analyses the causes, events, impact and outcome of the 2008 market crisis primarily with a 'lessons learned' objective. The Board decided to deliberate on in its next meeting.

The committee criticized the SECP for not functioning as a collegiate body during the 2008 crisis and emphasized the need for the same. It also recommended development of a strategic capital market development plan by the SECP and procedure for improved coordination between the SECP and the State Bank.

The committee expressed its concern over the arbitrary use of force majeure powers and abrupt and ad hoc policy shifts, including changes to risk management by the stock exchanges. It recommended to the SECP to devise transparent policy clearly spelling out circumstances in which the regulator can intervene in the market under the emergency powers now conferred upon it under the 2015 Securities Act.

It also provides a set of recommendations, which could help prevent recurrence of such crisis. It has suggested reforms across the SECP, stock exchanges, Central Depository Company (CDC) and National Clearing Company of Pakistan (NCCPL).

Committee recommended to revamp the existing broker regime and suggested stringent criteria for CDC participants whereby only select institutions fulfilling required criteria are

allowed custody of clients' securities. The committee suggests the NCCPL to function as a statutory body and to be converted into a central counterparty (CCP) with adequately funded Settlement Guarantee Fund (SGF). Additionally, the committee observed conflict of interest on the boards' of stock exchanges, NCCPL and CDC due to presence of broker directors.

While presenting the committee's report, the Chairman SECP Zafar Hijazi briefed the policy board that since concerns raised by the committee pertain to 2008, majority of these have already been taken care of; the remaining are part of the SECP's reform agenda and in implementation stage.

He informed the board that the committee's feedback regarding the SECP's working has been addressed as SECP is functioning as a fully collegiate body and all important matters are deliberated upon at the Commission level. For improved coordination, Zafar said, the SECP entered into an MOU with SBP in March 2009 and dialogue is being maintained through coordination committee and taskforce meetings.

Moreover, with promulgation of the new act, the stock exchanges' powers in terms of force majeure have been vested with the SECP. The SECP is devising broad policy parameters in which it can intervene under the emergency powers.

To address the need for developing a long-term strategy and plan for development of stock market, the SECP has drafted a capital market development plan, which will be rolled out once the consultation process with the stakeholders is completed.

List of corrective actions taken/proposed to be taken in light of the observations/ conclusions/ recommendations of the Report of the Committee constituted to study the 2008 Stock Market Crisis

Sr.	Observations/Conclusions/Recommendations of the Committee	Corrective Action Taken/Proposed to be taken
1.	<p>The SECP may function as a collegiate body as envisaged by the SECP Act, 1997 and reiterated by the Supreme Court. The Chairman SECP who was also then Commissioner SMD unilaterally handled the entire situation without bringing it to the notice of the full bench of Commissioners. The Commission also did not take any notice of the market situation itself.</p>	<p>The Commission is now functioning as a collegiate body with the Chairman as Chief Executive. Operational authority has been largely devolved to departmental heads (Executive Directors) and each Commissioner has been assigned certain “oversight” responsibilities to assist the Chairman.</p> <p>The Securities Act, 2015 was promulgated in May 2015 post which all policy matters are deliberated and decided at the Commission level. Powers relating to all important policy matters and decisions have not been delegated by the Commission to ensure that the same are duly considered at the Commission level. Only operational/day-to-day functional level powers are delegated to executives.</p> <p>Due public consultation process is being ensured on new concepts/products and regulations and amendments therein, which was not the practice before.</p>
2.	<p>The crisis showed absence of coordination between SECP and SBP.</p>	<p>Post the 2008 stock market situation, the SECP on March 20, 2009 signed a MoU with the SBP and dialogue is also being maintained through coordination committee meetings and other special purpose committees and taskforces.</p> <p>However, avenues are being explored for further improved coordination. The SECP aiming to strengthen regulatory collaboration for monitoring and mitigation of systemic risks, has proposed to the SBP establishment of a Council of Financial Sector Regulators for closer co-operation and collaboration among the regulators having responsibilities for systemic stability. The underlying objective is to contribute to the efficiency and stability of financial regulation by providing a high-level forum for co-operation.</p>
3.	<p>There is need to develop long-term strategy and plan for the development of stock market reflecting the vision of the regulator. The plan</p>	<p>Our capital market today faces a multitude of challenges which need to be dealt with prudently in order for the market to encash on its full</p>

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	<p>should consist of long-term, medium-term and short-term goals along with timeline to be achieved. The plan should be devised after taking into confidence the relevant stakeholders.</p>	<p>potential. Hence, the PRDD-SMD has recently re-initiated work on developing a comprehensive capital market development plan which could not be finalized earlier in 2012. The draft plan includes concrete goals and targets for sustainable development and growth of the Pakistani capital market. Input is being provided by relevant stakeholders including the stock and commodity exchanges, depository company, clearing company and capital market experts forming part of “Consultative Group on Capital Market” constituted by the Commission earlier this year. Suggestions/recommendations of the Committee to be implemented in the medium-term are being taken care of in the plan.</p> <p>The plan will be rolled-out for stakeholders’ consultation adopting a structured approach.</p>
4.	<p>Force majeure appearing in the RM Regulations should be clearly defined to mean only acts of God or civil disturbance.</p>	<p>Under the Securities Act, 2015 emergency powers have been entrusted to the SECP. Accordingly, instructions for removal of the entire provision of force majeure from the regulations of the stock exchanges were issued by the SECP to the Karachi (KSE), Lahore (LSE) and Islamabad (ISE) stock exchanges on June 26, 2015.</p> <p>The entire provision has accordingly been removed from the KSE regulations on July 15, 2015 while same are being processed by LSE and ISE in line with the Securities Act, 2105.</p>
5.	<p>Under the new Securities Act, 2015, SECP has been vested with emergency powers to act promptly in emergency situations. There is need to lay down transparent policy specifying circumstances under which such powers may be used. This requires formulation of transparent policy clearly spelling out circumstances in which the regulator can intervene.</p> <p>There is need for the Commission to finalize a transparent policy, clearly laying down the parameters under which the emergency powers under the Securities Act, 2015 may be exercised.</p>	<p>The SCEP has engaged services of a legal consultant who along with a dedicated team of SMD officers is working on drafting various rules and regulations to be promulgated under the Securities Act, 2015. This includes formulation of broad policy parameters to be adopted by the SECP for intervening in the market.</p>
6.	<p>During 2008 crisis SECP did not carry out independent analysis of the market situation which is essential to formulate policies to deal with such situations.</p>	<p>The SECP has now constituted a dedicated unit within the Securities Market Division for undertaking risk assessment and carrying out independent analysis of the market.</p>

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		This accompanied with off-site and onsite inspections would enable the SECP to be better informed regarding the situation of the market and its participants and formulate policies accordingly.
7.	<p>One striking feature of all the crises is the abrupt and ad hoc changes made in the policies including changes in risk management, which undermines credibility of the regulators.</p> <p>There were frequent instances of ad hoc interventions in the market like change in circuit breakers, change in margin requirements and allowing CFS MK-II to the DFC.</p>	<p>The Securities Act, 2015 requires any regulations framed under the Act and amendments carried out therein to be duly notified for seeking public opinion along with the rationale for the regulation/amendment, for at least 7 days through placement of the same on the website of the exchanges, CDC, NCCPL and SECP, as the case may be.</p> <p>Furthermore, as mentioned above, all policy nature powers including framing and amending regulations have been vested with the Commission and hence no single Commissioner or executive can carry out policy changes singly.</p> <p>Also, deletion of the provision of force majeure from the regulations of the stock exchanges has also curbed chances of it being misused for transferring DFM positions for financing through the leveraged market products.</p>
8.	The Committee has recommended early steps to revamp the broker regime with respect to classification of brokers, capital adequacy, code of conduct and fit and proper criteria.	<p>The revised broker regime catering to these areas is being introduced as part of the regulatory framework under the Securities Act, 2015. The regime will be focusing on minimum entry standards, criteria for sponsors, directors and employees, corporate governance, risk-based capital adequacy and regular audits.</p> <p>Also, to ensure segregation and safeguarding of clients' assets, categorization of brokers into trading/clearing members will be introduced, to allow custodial functions with well-capitalized financial institutions and corporate brokerage houses only.</p> <p>It is expected that the relevant regulations to cater for this area would be notified for public comments and stakeholder consultation with approval of the Commission during August 2015.</p>
9.	Weaknesses and deficiencies in the systems and processes of CDC allowed unauthorized movement of the securities of the clients by brokers.	Various reforms have been introduced by the SECP post 2008 which include restrictions on free delivery transactions, automation of securities settlement process, restriction on blanket authorization to brokers by clients and enhanced

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		<p>audit requirements by CDC.</p> <p>The recent launch of National Custodial Services at NCCPL and Direct Settlement Service at CDC provide clearing, settlement and custodial services without the involvement of brokers.</p> <p>Further, under the Securities Act, a new regime is being introduced for market intermediaries that includes categorization of brokers into trading/clearing members which will allow custodial functions only with well-capitalized financial institutions and corporate brokerage houses with limitation on asset under custody.</p>
10.	<p>There is conflict of Interest on the board of exchanges, NCCPL and CDC due to presence of broker directors. The Committee raised its concern on the constitution of the board of exchanges CDC and NCCPL due to presence of broker directors.</p>	<p>Restructuring of the boards of the stock exchanges consequent to demutualization and limiting nomination of brokers to one each on the boards of CDC and NCCPL have reduced this conflict. Further, post 2008 a Fit & Proper Criteria for Directors on the Boards of the Stock and Commodity Exchanges, CDC and NCCPL was introduced. The said criteria provides for a comprehensive way of judging the prospective individuals for directorship including professional, academic and ethical aspects.</p> <p>Conflict of interest issues may also be further addressed through divestment of stock exchange ownership to strategic investors, financial institutions and general public for which possible avenues are actively being explored by the SECP and the stock exchanges. However, in the meantime the Boards of Directors of PMEX, LSE and ISE were recomposed in 2015 to bring diversity and to inculcate national level representation on the governing bodies of these national level institutions. Various prominent professionals possessing vast experience of the financial and capital markets and the regulatory domain were appointed on these boards. Further, efforts are also underway to improve/strengthen the role of SECP appointed directors on these institutions.</p>
11.	<p>One of the important factors responsible for the 2008 crisis was the leveraged product CFS MK-II which allowed speculative trading in the ready market. It fuelled excessive buying which</p>	<p>The CFS MK-II product has already been discontinued in 2009. The SECP in 2011 introduced the Margin Financing System and Margin Trading System under the Securities</p>

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	ultimately led to settlement problems.	<p>(Leveraged Markets and Pledging) Rules, 2011 which were approved by the Federal Government. Under these rules Margin Trading, which is being relied on as the primary leveraged market product, was designed to specifically address weaknesses of the CFS MK-II by imposing requirements regarding financee participation and a revamped default management regime in case of financee default.</p> <p>It may be noted that the Committee has not made concrete recommendations for abolishing MTS. However, given the past history and role of leverage in our market, MTS may be critically reviewed also in line with international practices for the development of our derivative market.</p>
12.	Existing criteria for becoming CDS Participant needs to be made more stringent by prescribing additional qualification and net worth. It is also proposed that keeping in line with our recommendations regarding broker regime, the role of TREC Holder Participant may be segregated through classification, such as 'Trading TREC Holders' and 'Clearing TREC Holders' where latter would be subject to fulfillment of stringent criteria for becoming CDS Participant, including appointment of compliance officer. Such practices are followed in other jurisdictions.	<p>Under the Securities Act, a new regime is being introduced for market intermediaries focusing on minimum entry standards, criteria for sponsors, directors and employees, corporate governance, risk-based capital adequacy and regular audits. Also, to ensure segregation and safeguarding of clients' assets, categorization of brokers into trading/clearing members is being introduced to allow custodial functions with well-capitalized financial institutions and corporate brokerage houses only, which will also include limitation on the clients 'assets under custody.</p> <p>The asset under custody regime has already been incorporated in the CDC Regulations and is being further improved for implementation whereas relevant regulations to cater to the broker regime areas is expected to be notified for public comments with approval of the Commission during August 2015.</p>
13.	Due to the importance of the function of clearing and settlement, NCCPL should ideally be a statutory body and its board should not have any representation of brokers.	<p>This has been taken care of through registration and regulation of NCCPL under the Securities Act, 2015.</p> <p>In addition to this, the SECP is currently conducting a detailed analysis of international models of custodians and clearing and settlement companies to ensure CDC and NCCPL structures, comply with international best standards.</p>

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14.	<p>NCCPL may be converted into a central counterparty in line with international practice. The Committee suggested that the amount of equity and SGF required for NCCPL to function as central counterparty may be calculated based on the experience of past crises.</p>	<p>NCCPL shall act as a Central Counter Party with a Settlement Guarantee Fund of appropriate size in accordance with actuarial valuations, to ensure robust and efficient default management regime in line with global best practices. Regulatory framework for the purpose is being introduced under the new Securities Act, 2015.</p>
15.	<p>The Committee is of the view that given the rampant incidence of misuse of clients' assets by brokers, it is important to carry out a comprehensive audit of the CDS participants. Since CDC itself cannot carry out audit of the participants beyond their regulatory compliance due to legal reasons, holistic audit of the CDS participants should be carried out by SECP. Part IV of the new Securities Act, 2015 provides for regulation of CDC by SECP and SECP has sufficient powers to regulate CDC. It is suggested that the audit of CDS participants being proposed should include movement of securities checked with proper money trail and authorization along with proper segregation of assets.</p>	<p>SMD is restructuring and strengthening the existing inspection regime by introducing the concept of global inspections. Adopting a risk based approach this exercise will be conducted jointly by the exchanges, CDC and NCCPL on an annual basis covering brokers of exchanges, CDC and NCCPL participants. The regulations have been drafted and post approval of the Commission the same shall go through public/stakeholder consultation process.</p>
16.	<p>It is recommended that the role of the Policy Board may be evaluated by the Government with a view to taking decision on its continuation or its revised composition. Some international experts have pointed out that a Policy Board in the present form is not consistent with autonomous status of SECP.</p> <p>Momentous developments like stock market crisis and unprecedented intervention by stock exchanges in 2008 were not noticed by the Policy Board.</p>	<p>The report of the Committee has been presented to the Policy Board for seeking guidance. The constitution of the Policy Board needs to be looked into to bring majority of private sector members. Further, a code of conduct and measures to address conflict of interest need to be introduced.</p>