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SECP's Proactive Role in Pakistan's Capital Market Development

(Karachi, March 5, 2015): Pakistan's capital market is at a crucial juncture. Post demutualization of the stock exchanges in August 2012 these has been a structural change in the workings of capital market institutions with separation of the regulatory and commercial functions of each of the three stock exchanges, i.e. Islamabad, Karachi and Lahore. The Securities and Exchange Commission of Pakistan has taken a strong lead, not only in strengthening the regulatory framework that protects investors interest but also in launching initiatives to broaden the reach of capital market investment products to savers across the nation.

In this regard, while expediting regulatory approvals for listing of new companies, launching of new products such as REITS (Real Estate Investment Trusts) and Government Debt Securities secondary market trading, the SECP has taken a lead in pushing forward with the launch of Small & Medium Enterprise (SME) segments. They approved SME regulations for the Islamabad Stock Exchange in 2014 and have recently approved SME regulations for the Karachi Stock Exchange. A draft regulatory frame work for Private Equity has also been put out for public comment. Once implemented, these initiatives can lead to a quantum increase in opportunity for small and medium businesses business, which account for 90% employment generation in the country, to obtain funding for growth. Concurrently, the SECP, in February 2015 has set up an Investor Awareness Generation Committee to create Capital Market Hubs in small cities such as Abbotabad and Sialkot to start with. All the three stock exchanges, Central Depository Company of Pakistan (CDC), National Clearing Company of Pakistan (NCCPL) and major asset management companies are actively involved in this project the chairman of which is the CEO of central depository company.

In the above context, it is surprising to note that some constituencies of the capital market have recently expressed concern regarding lack of support for the smaller stock exchanges that comprise less than 10% of trading activity and value in the overall capital market equation in Pakistan. One lament has been lack of liquidity in Islamabad and Lahore stock exchanges with suggestions that there should a single order book (trading platform) nationally and a single investor protection fund for all investors.



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While laudable objectives, these have to be viewed in a holistic context with a realistic assessment of intuitional capacity, financial soundness, risk management capability and commercial viability. Taking a closer look at the low liquidity issue in Islamabad and Lahore, the starting point in any analysis has to be financial and institutional capability of respective exchanges and brokerage houses. If financial, marketing and operational capability have the needed economic scale, then liquidity can be generated with product innovation & targeted marketing.

As far as narrow investor base is concerned, the problem is not limited to smaller exchanges. It is a national capital market issue. And the issue is one of policy. At present, there is an uneven playing field which is a major impediment to the growth and development of the capital market in Pakistan. This relates to the national savings schemes (NSS) where not only guaranteed returns are higher than government bonds but there is a relatively lower level of formalities to open an account versus the stringent KYC regime capital market participants/institutions operate under. Further, allowing institutions to invest in NSS diverts savings away from the capital market and is a drag on its capacity to serve the long term funding needs of industry and commerce. It is here that our focus ought to be rather than simply lamenting about distribution of liquidity within the capital market eco-system.

Despite the above, the SECP has taken a serious initiative to address the liquidity issue in the smaller exchanges. Several months ago the SECP formed a high level task force to explore ways in which greater liquidity could be generated at the smaller exchanges without compromising on risk management and broadening investor interest.

This task force, named 'Inter Exchange Trading Committee' has in it the managing directors and chief executives of all the three exchanges, CDC, NCCPL and representatives of the SECP. After multiple meetings and lengthy deliberations, the final report and recommendations are being completed. Several innovative suggestions by the Lahore Stock Exchange have been discussed in great depth, including adoption of a new order routing protocol with "internalization of execution" first in Lahore Stock Exchange before routing to designated liquidity providers (i.e. Karachi based brokers), related pre-trade margin regime and role of the NCCPL in Broker-to-Broker Trade Auto-Affirmation so that clearing and settlement is efficiently handled within a national risk management regime. The concept of primary brokers and sub-brokers was also explored and potentially useful ideas generated in this regard.

In view of the above, it is incorrect to say that smaller exchanges are being ignored. The SECP is actually putting the larger exchange (KSE) under far greater and more stringent scrutiny simply because of larger transaction values generated there. This is to be expected and is appropriate in terms of looking after public interest.



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Another concern expressed has been regarding investor protection and setting up of a national investor protection trust. It is worth noting that fraudulent behavior by a small percentage of miscreants in the securities industry damages the industry reputation and hits investor confidence across the board. All the exchanges have taken proactive stance supported by the SECP in this regard since the 2008 crisis with enhancement of system audit of brokers and heightened monitoring of their activities including segregation of client and propriety assets. SECP is closely scrutinizing exchanges' performance in this regard while significantly increasing its own direct audits of the brokerage and asset management industry. The frontline regulators (i.e. the exchanges) should be welcoming this development as it increases the credibility of the capital market as whole. In fact, the SECP has gone one step further in terms of investors protection. Both the Central Depository Company (CDC) and the National Clearing Company (NCCPL) have been actively encouraged by the SECP to develop a Direct Settlement System whereby both securities and cash of investors can be kept with CDC and/or NCCPL rather than in brokers' custody. NCCPL has already developed and soft launched this facility successfully and CDC is expected to follow soon. This will provide investors the option to have national capital market institutions look after their assets if they so wish and this should go a long way to avoid the kind of crisis faced in 2009/10. The SECP has also had initial meetings with stock exchanges regarding the concept of a national investor protection fund. KSE has, during these deliberations, supported this idea in principle, provided that the initial size of the fund is at least Rs 5.0-10.0 billion with the Government pitching in initial seed capital via long-term development finance from the Asian Development Bank / World Bank and the exchanges contributing through a sustainable funding mechanism for the longer term.

Ultimately, the issue is not fixing one or two parts of the system but rather, making the overall capital market of Pakistan vibrant and deep whereby its *raison d'être* – proving a platform for long term finance generation for the country's businesses and simultaneously, providing diverse asset classes where savers can put their hard-earned savings to work with confidence and clear understanding of risks and returns. Thus, in the final analysis, amalgamation of the three stock exchanges is a vision that needs to be actualized and the owners and managements of the exchanges have to consider the commercial and strategic business viability of such a move which is likely to be welcomed by the Apex Regulator. The sequencing of such a development, i.e. before or after strategic stake sale or IPO of the exchanges, the transaction structure, valuation, etc. are the issues that exchanges should be focusing upon keeping in view the larger national interest and long term growth and viability of Pakistan's capital market.

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