

**Country Review: Islamic Republic of Pakistan
IOSCO Objectives and Principles of Securities
Regulation
Follow-up Report on Assessment of
Implementation**



OICU-IOSCO

**THE BOARD
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

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I. INTRODUCTION AND METHODOLOGY USED FOR THE ASSESSMENT

This follow-up report on the assessment of implementation of the IOSCO Objectives and Principles of Securities Regulation was conducted by the IOSCO Assessment Committee (AC) following a request by the Securities and Exchange Commission of Pakistan (SECP), as part of its efforts to assess its capital market regulatory framework against the IOSCO Objectives and Principles, following a 2004 Financial Sector Assessment Program (FSAP) report and as a follow-up of a 2015 Country Review: Islamic Republic of Pakistan IOSCO Objectives and Principles of Securities Regulation Detailed Assessment of Implementation (see <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD495.pdf>).

As per the mandate given to the Review Team (RT), the follow-up review was limited to assessing progress made by Pakistan on the recommendations expressed in the 2015 Report in relation to the 14 Principles of the IOSCO Objectives and Principles, which as per that 2015 Report were rated as either Partly Implemented (P12, 15, 16, 17, 24, 29, 30, 31, 32) or Not Implemented (P2, 6, 19, 23, 28). The purpose of this report is hence to provide an outline of the changes made by Pakistan as a follow-up of the 2015 IOSCO recommendations, and to assess, where applicable, the potential impact on the compliance grading granted in the 2015 Report in accordance with the IOSCO Objectives and Principles of Securities Regulation.

The review was performed by a RT of 5 regulators nominated by member organizations from developed and emerging markets and a member of the IOSCO secretariat who collectively brought a broad range of current knowledge and practical expertise to the task. They were Raluca Tircoci-Craciun (IOSCO Secretariat), Selcan Olca (Turkey CMB), Majeed Abduljabbar (Saudi Arabia CMA) and Mark McGinness (Dubai FSA). The RT leader was Laurent van Burik (Luxemburg CSSF). In order to ensure consistency with the initial 2015 review, all the members of the RT for this report had previously been part of the RT that had carried out the initial IOSCO review in 2015.

The primary source document for the RT's assessment was a Consolidated Progress Report prepared by a task force set up by the SECP which was submitted to the RT at the beginning of June 2017. In performing its review, the RT has further, through SECP, been in contact with certain stakeholders in Pakistan, for a written exchange and a desk-based review of follow-up questions the RT had in relation to information received in the Consolidated Progress Report. The review has been carried out on the basis of a desk-based review of the information received through the Consolidated Progress Report, answers to follow-up questions from the RT and written information received from stakeholders in Pakistan.

The IOSCO Objectives and Principles of Securities Regulation have last been modified in May 2017. Given that this review is a follow-up review of the one conducted in 2015, this report assesses the Pakistan securities regulation framework against the version of the IOSCO Objectives and Principles of Securities Regulation dated September 2011, as the 2015 review had been performed against that version of the IOSCO Methodology.

This report has to be read in conjunction with the 2015 Report, in relation to which this report provides an overview of the follow-up changes made to the Pakistan capital markets regulation.

All findings reflect the situation as at 1 June 2017.

II. SUMMARY

As per the 2015 review, IOSCO had noticed significant improvements in Pakistan in the structure and practice of regulation since the 2004 FSAP. At the same time, the 2015 Report noticed that challenges remained in different areas, such as the powers of SECP or more generally in relation to the scope of capital markets regulations (e.g. in relation to the identification and mitigation of systemic risk, the regulation of hedge funds or other information service providers, the mitigation of risks to investors from conflicts of interest in the work of research analysts employed by brokers, or the creation of an oversight body for the accounting and auditors that is independent of that audit profession and is acting solely in the public interest).

On the basis of the 2015 Report, the Pakistani authorities have initiated various legislative and regulatory reforms, so to adapt the Pakistan capital markets regulations to international standards based on the recommendations made by IOSCO under the IOSCO Principles and Objectives.

The IOSCO AC has taken note of the important efforts made by Pakistan since 2015 to adopt legislative changes recommended by IOSCO in relation to the IOSCO Objectives and Principles as per the 2015 Report, in view of globally increasing the compliance level of Pakistan with the IOSCO Objectives and Principles. The legislative changes adopted by Pakistan on the basis of the recommendations made in the 2015 Report cover a wide range of different aspects in the field of capital markets regulations, such as an enhancement of the statutory powers of SECP, changes to the Pakistan Companies Act, an overhaul of the Securities Broker Regulations or changes designed to ensure an independent oversight of the audit profession.

Under the global lead of SECP, legislative and regulatory reforms have been implemented through either the adoption of new, or the modification of existing legislative acts such as the Securities Act, 2015, the Futures Market Act, 2016, the SECP Amendment Act, 2016, the Companies Act, 2017, the Securities Brokers Regulations, amendments in the Non-Bank Finance Companies (NBFC) Regulations, the Research Analyst and Private Fund Regulations, the regulatory framework for Securities Advisers, Securities Managers, Underwriters, Share Registrars and Balloters, structural reforms and developmental initiatives at the stock exchanges and/or Self-Regulatory Organizations (SROs) — Pakistan Stock Exchange (PSX), Central Depository Company of Pakistan (CDC), National Clearing Company of Pakistan (NCCPL), the establishment of the Audit Oversight Board of Pakistan (AOBP), general governance reforms in the SRO space, reforms for Capital Market Intermediaries and for the Issuers, reforms for Investor' Access, awareness, protection and facilitation, Investor facilitation measures and supervisory architectural reforms.

With regard to the standards under the IOSCO Objectives and Principles, it is considered that although a number of changes to the Pakistan legal and regulatory framework have been introduced, an effective implementation of most of those changes is still in process. On this basis, this report provides an overview of the legal and regulatory changes made to the Pakistan securities regulations since 2015 as at 1 June 2017. As per the IOSCO Objectives and Principles, the grading of the compliance levels not only requires that appropriate regulations are in place but more importantly requires there is an effective implementation of the regulatory framework. On this basis, the changes made since 2015 in relation to the 14 Principles under

review have led to an increased grading for 10 of the 14 Principles. In relation to the other three Principles, an increased grading of the compliance level with the IOSCO Objectives and Principles compared to the grading reflected in the 2015 Report will mandate further evidence of an effective implementation and functioning of the reforms engaged over time. One Principle has been reclassified as being Not Applicable in relation to Pakistan (i.e. Principle 28).

The RT wishes to thank the staff of the SECP for the collaborative and professional approach they brought to the review process, and the large volume of work they completed in providing the RT with the progress report information, responding to follow-up questions of the RT and coordinating follow-up questions of the RT with local stakeholders.

III. TABLE 1: SUMMARY IMPLEMENTATION OF THE IOSCO PRINCIPLES – MAIN FINDINGS

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| Principle 2. The Regulator should be operationally independent and accountable in the exercise of its functions and powers. | |
| Initial findings | <p>IOSCO Principle 2 states that the regulator should be operationally independent and accountable in the exercise of its powers and functions. The methodology by which the Principle is to be assessed requires positive answers to the questions:</p> <ol style="list-style-type: none"> 1. Does the securities regulator have the ability to operate on a day-to-day basis without <ol style="list-style-type: none"> a. external political interference? b. interference from commercial or other sectoral interests? <p>Furthermore, IOSCO has defined “interference” as a “formal or informal level and method of contact that affects day-to-day decision making and is unsusceptible to review or scrutiny.” The IOSCO methodology does not require evidence of improper conduct. Nor has it taken a view on the circumstances in which political involvement in policy formulation, fee setting, budgets etc. might improperly influence decision making by a regulator, or at least give the public the perception that this is so. This is because, by its nature, such interference is difficult to establish and more difficult to prove. In practice therefore, this Principle has been assessed on the basis that it is directed at identifying vulnerabilities inherent in structures and processes and not at the efficacy of day to day decision making.</p> <p>The RT was not exposed to any evidence that the SECP does not operate in practice as an independent agency free from political or commercial interests. However, the current structure does not provide sufficient assurance that it is adequately ring-fenced from political interests. Maintaining therefore the current structure will not ensure that the SECP is operationally independent from political interference as required by this Principle.</p> <p>SECP has advised that it, and the Federal Government (FG), are considering possible options proposed by the RT:</p> <ol style="list-style-type: none"> a. Either the chairman of the SECP or a private sector member of the Policy Board would be appointed as Chair of the Policy Board to distance, to a greater degree than that present, the decisions taken by the Policy Board. b. Implementation of a (published) code of conduct for adherence by Policy Board members specifying their role and responsibilities. <p>In the assessors’ view, these options provide clear benefits (subject to the terms of the code of conduct). Option (b) will also have an impact on Principle 5. Overall, an uprating from Not Implemented to Partly Implemented is likely to be the most that can be attained maintaining the current structure. This would be consistent with a clear majority of recent assessments carried out under the FSAP.</p> |
| Initial Assessment | Not implemented. |

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| Follow-up action | <p>Legal Framework Enhanced</p> <p>In 2016, the independence of SECP has been further strengthened through an amendment to the SECP Act. Section 3(3) of the SECP Act now explicitly states that SECP will be administratively, financially and functionally independent and the Federal Government will use its best efforts to promote, enhance and maintain independence of the SECP.</p> <p>The SECP Act, 1997 (Section 5(7)) empowers the Federal Government to appoint one of the members of the Policy Board as its chair, who can either be from the private or the public sector members appointed on the Board.</p> <p>In order to ensure that decision making at the Board level is dominated by private sector members and to effectively increase the distance between the Policy Board and the Federal Government, amendments have been made in SECP Act, 1997 (Section 12) through SECP (Amendment) Act, 2016. Now the majority of members on the Policy Board are from the private sector, increased to six (from previous four) and total Board members increased to eleven (from previous nine). On 10th January 2017, the Federal Government appointed two new members from the Private Sector on Policy Board while third appointment is in process.</p> <p>Practically the two ex-officio Board members representing SECP and State Bank of Pakistan (SBP) are from the private sector, thus effectively making the private sector members on the Board to be eight vis-à-vis three members from the public sector. Considering that the Board decisions are made through a vote, the majority of Board members from the private sector ensures that the voice of the private sector with their expertise prevails in the Board decisions.</p> <p>The three public sector Board members are from the Ministry of Finance, Ministry of Law and the Ministry of Commerce, who in practical terms play an effective role in obtaining requisite support for SECP in discharge of its functions relating to policy matters, legal framework development and regulating the insurance sector, respectively. These members remained advantageous for SECP in implementation of its reform agenda and facilitate smooth passing of various legislative reforms from both the Parliament and the Government.</p> <p>The SECP Policy Board in terms of Section 21 of SECP Act 1997 makes the SECP policies to tie them in the Government's economic policy. The Policy Board, being a policy making advisory body, has a limited role to the extent of policy and budget approval, etc. while it has no operational powers which all rest with the commission.</p> <p>The recently revised IOSCO methodology on independence of the regulator (Principle 2) explains that the assessment should consider "whether, practically speaking, the regulator is in fact operationally independent from external political interference and from commercial, or other sectoral interests, in the exercise of its functions and powers". Pakistan's 2015 review had stated on principle 2 that, "there is no clear evidence that the SECP does not operate in practice as an independent agency free from political and commercial interests."</p> <p>This review of the recommendation should therefore, take into account that the legal and regulatory framework does not have any structural features which could impact the independence of the SECP; and that there is no evidence of actual interference in the day-to-day operational decisions or other evidence pointing to a deficit in SECP's independence.</p> <p>Code of Conduct</p> <p>A Code of Conduct for Policy Board members, specifying their role and responsibilities in line with IOSCO recommendations, along with the amendments in Securities and Exchange Policy Board (Conduct of Business) Regulations 2000 was notified vide SRO 1223 (I)/2015 dated 11th December 2015 after its approval from the Board. According to the said amendment, the Members of the Board have to comply with the Code of Conduct and upon appointment of any new Member of the Board, he/she signs the declaration to abide by the requirements of the Code. Both newly appointed Board members on their joining, before attending their first Board's meeting, signed the Code and the 'Declaration of Compliance with Code of Conduct'. Since December 2015, the Declaration of conflict of interest is always solicited prior to taking up of the agenda of the Board meeting and is made part of the meeting minutes.</p> |
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| Comments | <p>SECP have taken several steps in ensuring that the requirements specified in Principle 2 are met. In this regard, the fact that the number of members on the Policy Board from the private sector has been increased to six and in practice, the two ex-officio Board members representing SECP and SBP are from the private sector, ensures now a greater distance from possible political influence. The new Code of Conduct, in place since December 2015, requires the Members of the Board to comply with its provisions and upon the appointment of any new Member of the Board, he/she signs the declaration to abide by the requirements of the Code.</p> <p>According to the findings of the initial assessment report, these measures – cumulated – confer an upgrading from Not Implemented to Partly Implemented for this Principle.</p> |
| Revised assessment | Partly Implemented. |
| <p>Principle 6. The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.</p> | |
| Initial findings | <p>Lack of a regulatory process to monitor, mitigate and manage systemic risk. At the time of the assessment, amendments are proposed for the SECP Act with regard to the powers and functions of the SECP. A new provision is proposed for the SECP to identify and address the systemic risk factors. SECP plan for systemic risk mitigation and amendments of the SECP Act should be therefore accelerated.</p> <p>IMF/IOSCO have recently made the following update to the assessment process of which the SECP should be aware as it develops its work in this area. They state: “The first assessments of Principles 6 and 7 conducted by the IMF after the introduction of the new Assessment Methodology focused on three high level issues in assessing the existence of a process to identify systemic risk or to review the perimeter of regulation, which is required pursuant to Key Question 1 of the respective Principles: (i) whether the arrangements in place allow for a holistic (across products, entities, and markets) view of risk; (ii) whether they allow for a periodic reassessment of risk; and (iii) whether they allow for proper follow-up (actions). The experience gained since has enabled an enhancement of the assessment criteria, for example, by looking at the type of data and analysis that the authorities use to identify such risks, and the degree to which the processes implemented allow for proper accountability. This is in line with the recommendations included in the recent report of the Assessment Committee of IOSCO.”</p> |
| Initial Assessment | Not implemented. |
| Follow-up action | <p>Risk Identification</p> <p>SECP has adopted/developed the following mechanism for identification of systemic risk to address systemic threats in Pakistan’s securities market that may emanate from the clearing house:</p> <p>a. Risk Register</p> <p>A risk register is maintained by the systemic risk department (SRD) of SECP that lists systemically important entities/ institutions for capital market infrastructure and potential risks faced by these entities. The risk register is presented in a heat map matrix to analyze risks based on the impact and likelihood. The risk register and heat map data are regularly reviewed and analyzed.</p> <p>b. Investor-level Risk Profiling System</p> <p>An investor level risk profiling system has been developed in collaboration with the clearing house to assigns probability of default to each investor based on given criteria. The past trading record, captured by the unique identification number of the investor, is assessed on various parameters including settlement track record, availability of information, degree of regulation, active and seasoned investor and core line of business. The clearinghouse performs daily analysis on the settlement</p> |

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| | <p>obligations of the clients of brokerage houses, in order to identify brokerage houses that pose the highest risk to the clearinghouse in terms of settlement. Accordingly, risk management decisions (i.e. calling additional margin/limiting exposures etc.) are taken. Requisite daily reports are analyzed for timely action in this regard.</p> <p>c. Stress Testing</p> <p>Stress testing is performed against extreme but plausible market conditions to assess the settlement risk and adequacy of resources available with the clearinghouse.</p> <p>d. Financial Reporting</p> <p>This system requires quarterly financial reporting by entities enabling effective monitoring of financial position such as capital adequacy, paid-up capital and net worth etc. Reports are generated to identify any deterioration in financial position of entities that can pose systemic risk.</p> <p>Analysis of Data</p> <p>Relevant information is obtained from the infrastructure entities including the exchange, clearinghouse, central depository, Mutual Funds Association of Pakistan (MUFAP) and information published in media and reports of independent research analysts. Following indicators are regularly analyzed:</p> <ul style="list-style-type: none"> • Market wide P/E comparisons • Outstanding leveraged positions across all market segments (margin financing system, margin trading system, deliverable single stock futures, etc) and bank lending against shares etc. • Foreign and local investors portfolio investment • Turnover velocity • Leverage financing rates • Exchange rate/Currency devaluation risk <p>Periodic Risk Report is circulated to the risk committee and the Commission.</p> <p>Risk Governance & Assessment of Entities, Products and the System</p> <p>A multi-layered risk governance structure has been put into place within SECP as well as at different market entities particularly the clearinghouse.</p> <p>Pursuant to Clearing House (Licensing & Operations) Regulations 2016, the clearinghouse has constituted a risk committee comprising of independent directors, CEO, CRO and industry experts. Two meetings of the risk committee have been held.</p> <p>In order to ensure that effective functioning of risk committee, the Board of Directors is required to immediately report to the Commission in case it does not agree with the recommendations of the committee. Further, the clearinghouse has an established risk department, which is headed by a Chief Risk Officer. Likewise, the regulatory framework governing NBFCs require Asset Management Companies (AMCs) to have an independent risk management function.</p> <p>The risk functions of infrastructure companies (clearinghouse, central depository, AMCs etc.) independently analyze the data/information relating to product/entity. The information is then submitted to the SRD for further analyses and holistic review. Head of SRD then takes the matter to the cross-departmental risk committee within SECP for further deliberation, if required before escalating it to the Commission for information and decision-making.</p> <p>Engagement with Market Participants to Understand Emerging Risks</p> <p>SRD interacts with the market entities, participants and supervisors (e.g. exchanges, clearinghouse, central depository, brokerage houses, MUFAP, AMCs and SBP etc.) to assess evolving risks and discuss related matters.</p> <p>SECP engages in discussions and conducts meetings with the board committees, special purpose committees and top management of the exchange, clearing house, central depository</p> |
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and other market entities to better understand the issues and emerging risks in the market. Furthermore, SECP is actively engaged with IOSCO members on issues pertaining to systemic risk. For instance, SECP recently held telephonic and video conferences with the capital market authorities and exchanges of various jurisdictions including Singapore, Malaysia, Thailand, Hong Kong and Turkey etc. on systemic risk management issues specific to clearinghouse.

Periodic Assessment

Systemic risk is a priority area of SECP. The systemic risk itself and the processes to monitor, identify and manage systemic risk are reassessed periodically. As a general policy, SECP has set six-monthly reassessment cycle for review of the measures taken to monitor, mitigate and manage risks. The six-monthly reassessment cycle is incorporated in the regulations of clearinghouse as well.

The processes to monitor, mitigate and manage systemic risk are reviewed as follows:

1. Quality of collateral is reviewed every six months
2. Stress testing methodology is reviewed quarterly
3. Procedures in crisis management for example effective functioning of default committee of clearing house and its liquidity arrangements.

Regulatory Actions

The arrangements put in place to monitor and identify systemic risk highlighted various issues. Accordingly, the clearinghouse, MUFAP and SECP took pre-emptive action to mitigate those risks.

For example:

1. The analyses of trading history in 2016 revealed that foreign investors were net sellers during the year, whereas asset management companies were the net buyers. Further analyses of trading history of funds disclosed the pattern that Funds became net sellers during slow or negative market movement. This was a point of concern especially as this behavior could have adversely effected the market and the entire system during stress periods.

SECP and MUFAP observed that the selling pressure by Funds during slow or negative market movement was due to redemptions by unit holders. This highlighted weak liquidity management by the Funds. AMC industry agreed with the observation. Accordingly, SECP, in consultation with the AMCs, issued direction to AMCs to have liquidity arrangements such that:

- Exposure in illiquid securities could not be more than 10%
- AMCs to maintain 5% of net assets of funds as cash and cash equivalents
- Mandatory bank lines of 10% of net assets of fund to meet redemptions during stress periods

2. While reviewing the quality of collateral with the clearinghouse, it was observed that some illiquid and fundamentally weak securities were being accepted as collateral. SECP in consultation with the clearinghouse conducted a holistic review of the criteria for securities accepted as collateral. In view of the market conditions, significant changes were made to the criteria such that that number of securities accepted as collateral reduced to less than half and only high quality and highly liquid securities are now accepted as collateral. Ongoing review of the criteria is now a regular feature of systemic risk management and a requirement of regulations.

3. Various other measures have been taken to manage and mitigate systemic risk such as the Value at Risk (VAR) margins and haircuts have been increased in wake of the recent volatile market conditions.

- 1) In order to enhance the capacity of clearing house in situations of extreme turmoil and ensure smooth settlement of trades, possibility of provision of a credit line to

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| | <p>support the settlement guarantee fund is under consideration. In this regard, provisions made in Companies Act 2017 to utilize “Companies Unclaimed Instruments and Dividend and Insurance Benefits and Investors Education Account” to serve as collateral/guarantee against the credit line. The NCCPL has commenced operations as a central counterparty (CCP) with effect from 2 May 2016. The reform entailed major regulatory restructuring for transfer of risk management from PSX to NCCPL, changes to default management procedures and establishment of a consolidated Settlement Guarantee Fund.</p> |
| Comments | <p>A series of measures have been implemented by SECP regarding monitoring, mitigating and managing systemic risk. In this regard, the legal mandate of SECP was broadened to encompass systemic risk and to provide a clear definition of systemic risk. SECP established a Risk Management Department to strengthen risk governance structures across all the regulated functions, monitor firms, products, and micro and macro-economic conditions, and propose pre-emptive actions for stability of capital market. Further, a cross-departmental risk committee has also been established. To address macro level systemic risk issues, a Council of Regulators has been established having SBP and SECP as its members. In October 2015, SECP also became a member of the FSB’s Regional Consultative Group for Asia.</p> <p>While there are several important improvements especially with regard to SECP mandate and the new structures, these are quite new. Effectiveness and practical ability of the new systems would require time, and it would be early to assess this at this stage of implementation. Please also refer to comments in Principle 32 dealing with the procedures in place for dealing with the failure of a market intermediary.</p> |
| Revised assessment | Partly Implemented. |
| <p>Principle 12. The regulatory system should ensure and effective and credible use of inspection, investigation, surveillance and enforcement power and implementation of an effective compliance program.</p> | |
| Initial findings | <p>At the time of assessment, the SECP does not employ a risk-based assessment and lacks an intensive or structured on-site inspection program. The majority of firms may only be inspected once every ten years. But the major impediment to effective compliance is congestion and delay in the Courts. Commentary on recommendation from 2015 Review: <i>The SECP’s “Global/Joint Inspection” system, which aims to have full coverage for brokers should be accorded priority and implemented.</i></p> <ul style="list-style-type: none"> a) Maintain momentum of joint inspection during 2016-17; and b) The program under the Joint Inspection Regulations should be made known to the entire broking community so that they can expect and be prepared for such an inspection. |
| Initial Assessment | Partly implemented. |
| Follow-up action | <p><i>Off-site Surveillance</i></p> <p>From 4 June 2015, filing of quarterly reports from brokers through SECP’s online Financial Reporting System (FRS) encompassing net capital balance, balance sheet and related annexures was implemented to assess the financial health of the broker along with its regulatory compliance level. The information was also used to calculate risk-based ratios and generate alerts regarding regulatory non-compliance. From 31 July 2015, SECP implemented fortnightly reporting of client asset segregation, as required under regulation 4.18 of Exchange Rulebook, to the Stock Exchange.</p> <p>Since 2015, SECP undertook various Thematic Reviews for supervision of compliance of brokers against various important areas. In dealing with broker default, SECP found brokers were maintaining double books. To ensure integrity of data submitted by brokers and their books of account, the SECP reviewed brokers’ back-office accounting systems to assess</p> |

shortcomings and identify the reasons of brokers default. The SECP also developed standards for software specification and for client data authentication. Vendors' selection criteria was prescribed; penetration testing/vulnerability assessment or source code review of storage and processing applications is now required at least every two years; single back office software is required to operate; remote access to database is now strictly prohibited. Compliance of these new requirements was to take effect from 1 September 2017.

On-site Inspection of Brokers

Risk-based on-site inspection plan for brokers for the year 2015-16 and 2016-17 was instituted — in addition to Joint Inspections of brokers being conducted by SROs. At the time of the review, 26 of the planned 30 inspections had been carried out. A Joint Inspection Team (JIT) commenced its operations in December 2015, and had successfully completed 98 inspections, which also includes 30 limited scope inspections. More were in progress. In addition, as a special assignment JIT conducted a detailed Thematic Review of 35 TREC Holders of Lahore and Islamabad.

The inspections conducted by JIT on a risk-based approach, are judged to be wider and more effective than the Exchange's system audit. Due to direct consultation and collaboration among the team members representing SROs and close supervision of the oversight committee, non-compliances were highlighted under all major operational and technical areas during the course of inspection resulting in disclosure of a more accurate status of compliance at the brokerage houses inspected.

Based on the findings of joint inspections, several disciplinary actions were taken by respective SROs against non-compliant TREC Holder Participants, including the imposition of fines, blocking of relevant sub-accounts, restriction or suspension of admission to the Central Depository System (CDS). Actions in respect of a few cases were under way. The JIT has advised it is committed to expanding JIT inspection to 100% coverage in coming years.

Compliance with Reporting

SECP has prescribed the following periodic reporting requirements for intermediaries:

- i. Fortnightly reporting of Client Asset Segregation;
- ii. Monthly reporting of Liquid Capital; and
- iii. Quarterly reporting of financial statement through the online Financial Reporting System

SECP advises that Intermediaries are almost 100% compliant to these reporting requirements and the overall compliance culture is generally improving within the regulated entities. The SECP also reports that recent inspections have also revealed improving compliance culture within the intermediaries and number and severity of non-compliances is generally declining.

Non-disclosure

In response to a concern that no penalties are imposed by PSX and SECP in any case of non-disclosure of trading by directors in their own scripts, the SECP advised that it maintains database of beneficial owners of listed companies, wherein, UIN of each beneficial owner is matched with Market Surveillance System. SECP generates trading report of beneficial owners of listed companies and monitors compliance as a routine matter. From July 2016 till 30 June 2017, 2,600 returns of beneficial ownership were filed with the SECP. During this period nearly 50 warnings and one Show Cause Notice was issued to the beneficial owners of listed companies. During the same period, tenderable gain (gain made on purchase and sale or sale and purchase of securities of same class of same listed company by a beneficial owner, within six months) amounting to Rs9.823 million was recovered from ten beneficial owners among listed companies

Enforcement Actions — The Outcomes of the Annual Inspection Plans

SECP detected 96 cases of violation in the matter of client asset segregation that were referred

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| | <p>to PSX for appropriate legal proceedings. PSX issued show cause notices in this regard and conducted hearings for 32 cases imposing penalty in one case, while, at the time of this review, hearings were in process for the remaining 64 cases. To accelerate the processing of the remaining cases various measures have been taken:</p> <ol style="list-style-type: none"> i. Amendments have been made in the regulatory framework for accelerating the enforcement as now Senior Managers are also empowered to conduct the hearings of brokers. ii. The Exchange is also <u>in process of developing</u> a roadmap to build capacity of the Regulatory Affairs. iii. The Exchange is in the process of developing a Software for Fortnightly Reporting of Clients Assets Segregation Statement to streamline the reporting requirements for the Brokers and the Exchange. iv. A move from manual to automated CASS reporting system is expected <u>to be completed in the next two (2) quarters</u>. v. The penalty regime for the Brokerage Houses have been substantially revamped in light of international best practices whereby the powers of CRO have been broadened. vi. Furthermore, the process of hearing and appeal have been streamlined to ensure transparency and independence. <p><i>Court Delays</i></p> <p>Some courts in Islamabad and Quetta have been designated Special Courts to hear matters concerning breaches of securities laws. However, at the time of review, no prosecution had been initiated in these Courts. In Karachi, where the majority of the prosecutions are filed, the Chief Justice agreed in May 2017 to notify the responsible one of the Banking Courts of the arrangement to give these matters some priority.</p> |
| Comments | <p>In some Principles where effectiveness is a fundamental element, the Methodology requires statistical evidence of implementation. This Principle is one of these and it is clearly just a matter of time before the effects of the legislative changes and the new program produce results. The designation of Courts to expedite and hear securities matters is a considerable achievement and should be hailed as a model for other jurisdictions that suffer delays in their Courts. The results of this enhancement — consistent and timelier hearings, judgements and resolution from the Courts in Islamabad, Quetta and Karachi — will take some time. The SECP's new program (in this case an Inspection Program) has been launched with energy and precision and the SECP deserves credit and praise for these initiatives. Consequently, in this case, it can be said that an upgrade to Broadly Implemented is probable in the medium term.</p> |
| Revised assessment | Partly Implemented. |
| <p>Principle 15. The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their power.</p> | |
| Initial findings | <p>The SECP became a signatory to the IOSCO MMoU on 10 March 2011. Central Bank approval is required to obtain bank records. The protocol in place between the SECP and the Central Bank has proved to be defective and approval pursuant to a MMoU request has not been forthcoming. Legislation (a proposed Section 42C of the SECP Act) to allow the SECP to obtain and share bank records without Central Bank approval is before Parliament.</p> |
| Initial Assessment | Partly implemented. |
| Follow-up action | <p>Section 42C of the SECP Act was passed and has proved effective — since the initial findings, there have been two examples of information and assistance (concerning bank records) being successfully provided by the SECP to a fellow signatory under the MMoU.</p> |

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| Comments | It is rare for an upgrade by two levels (from Partly to Fully) but the evidence concerning this Principle is exceptional, particularly such a fundamental issue as cooperation. Despite the small number of foreign requests being received by the SECP, the fact that, as a result of a change in the Law, all those requests recently received have been satisfactorily dealt with, is sufficient to justify a revision of the benchmark. This new collaborative start should continue. |
| Revised assessment | Fully Implemented. |
| Principle 16. There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investor’s decisions. | |
| Initial findings | <p>The downgrade arises from several factors.</p> <p>It is not consistent with the general obligation under the law that offers to the public must be accompanied by a prospectus that renounceable rights issues (i.e. rights that have value and can be sold on to the public) can be made with only a very limited content circular for documentation.</p> <p>The implementing regulations should be amended in regards to the disclosure of material information, to reflect immediate dissemination of price sensitive information to the general public. Currently, under Section 15D (1) of the Ordinance 1969 and regulation 16(1) and 16(2) of the implementing regulations the immediate publication of price sensitive information is not required.</p> <p>Currently, the implementing regulations allow management of a company making an offer to the public the use of possible mitigating factors in the risk section of the offering document. This approach works to weaken the importance of the risks section of the offering document and may actually give potential investors a level of comfort that in reality might not exist. Thus, amendments should require a clear separation between the disclosure of risks section and any possible mitigating factors section proposed by the management of the firm.</p> <p>Clause 6 of the Guidelines should be amended to make it mandatory to publish any prospectus to the public in Urdu as well as in English. It is worth noting that the SECP view is that the use of Urdu for prospectuses would be difficult due to cost concerns and lack of interest from current investors. While, this may be true in the short term, the introduction of prospectuses in Urdu would be essential to broaden the potential investor base within Pakistan that is currently limited to the English-speaking part of the population which is minuscule when compared to the size of the population.</p> <p>The assessor understands that SECP is working on amendments to the Listing Regulations to address the concerns that have been highlighted. We would recommend that these initiatives should be pursued with high priority.</p> |
| Initial Assessment | Partly implemented. |
| Follow-up action | <p><i>16.1 The implementing regulations should be amended in regards the disclosure of material information.</i> Necessary amendment has been made in Section 5.6.1 of Exchange Rulebook.</p> <p>Revised Exchange Rulebook is available at PSX website at the following link: https://www.psx.com.pk/</p> <p><i>16.2 The implementing regulations should be amended to reflect a separation between the disclosure of risks section and any proposed mitigating factors.</i> Requisite amendments (notified 4 March 2015) have been made in the “Guidelines for Preparation of Prospectus”</p> <p>The amended version can be viewed at https://www.secp.gov.pk/document/guidelines-for-preparation-of-prospectus/</p> <p><i>16.3 SECP should consider removing the exemption from the requirement to publish a</i></p> |

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| | <p><i>prospectus from renounceable rights issues (rights that can be sold on to the public).</i></p> <p>Requisite SRO prescribing the contents of “Abridged Prospectus for Right Issue” has been notified for circular to be sent to members along with the notice offering new shares under Section 86(3) of the Companies Ordinance, 1984 vide notification dated 11 March 2015.</p> <p>The notification can be viewed at https://www.secp.gov.pk/document/revision-of-prescribed-circular-accompanying-offer-right-shares-by-companies/?wpdmdl=12693</p> <p>Further, SECP on 31 December 2015 has also directed all companies to publish contents of Circular to be sent to the members along with the notice offering new shares in Urdu language in addition to English.</p> <p><i>16.4 Clause 6 of the Guidelines should be amended as to make it mandatory to publish any prospectus to the public in Urdu as well as in English.</i> The Supreme Court of Pakistan has passed a judgment dated 8 September 2015, concerning adoption of Urdu as official language. The decision can be viewed at http://www.supremecourt.gov.pk/web/user_files/File/Const.P._56_2003_E_dt_3-9-15.pdf</p> <p>In view of the said decision, SECP has, in practice adopted requirement from issuer companies to publish prospectus in Urdu language.</p> <p>Few examples of prospectuses, approved in Urdu and published in December 2015, can be viewed at the following web links: http://www.awwal.com.pk/wp-content/themes/marketer/pdf/Prospectus%20Awwal%20Modaraba%20Urdu.pdf http://e.dunya.com.pk/index.php?e_name=KCH&edate=2015-12-28&page=36 http://e.jang.com.pk/12-19-2015/karachi/page10.asp http://e.jang.com.pk/12-19-2015/karachi/page11.asp</p> <p>The requirements for the publication of prospectus in Urdu language is being implemented as a special condition under Sub-section 1 of Section 88 of the Securities Act 2015 since 2015 and the prospectus are published in Urdu language in addition to the English language.</p> <p>SECP on 31 December 2015 has also directed all companies to publish contents of Circular to be sent to the members along with the notice offering new shares in Urdu language in addition to English. Further, prospectuses published in Urdu are available: see Roshan Packages Abridged Prospectus (Urdu Translation).</p> <p>The websites of SECP and SROs are also bilingual both in Urdu and English for investor facilitation.</p> |
| Comments | <p>The SECP have done an impressive amount of work in improving their regulatory frame work, with many changes that over time will prove appropriate to guard investor rights and play a major role in enhancing and guaranteeing a high level of investor protection, which in turn may lead to a higher rating. Currently, these changes are very new and do not allow to gauge their effectiveness on the ground.</p> |
| Revised assessment | <p>Broadly Implemented.</p> |
| <p>Principle 17. Holder of securities in a company should be treated in a fair and equitable manner.</p> | |
| Initial findings | <p>Although the processes being followed in Pakistan to help assure that the holder of securities are treated in a fair and equitable manner generally seem to meet international best practice and are extensive and clearly defined, the time limits for disclosure of substantial shareholdings (and changes) results in the downgrade. Recognizing the difficulty in establishing beneficial ownership when there is a deliberate attempt to obscure this information, SECP should examine its powers to disenfranchise shares where it is unable to establish the identity of the beneficial owners to satisfy itself that these are sufficient. See also Principle 37.</p> |

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| Initial Assessment | Partly implemented. |
| Follow-up action | <p>17.1 SECP should obtain changes to the time limits for public disclosure of substantial shareholdings (and changes) to a maximum of 2 days in order for the information to be timely, useful to the public and to be consistent with international good practice. SECP should examine its powers to disenfranchise shares where it is unable to establish the identity of the beneficial owners, to satisfy itself that these are sufficient. See also Principle 37. Amendments implemented in listing regulations to introduce public disclosure of changes in interest by substantial shareholders.</p> <p>Necessary amendments have been approved and implemented for KSE, Lahore Stock Exchange (LSE) and Islamabad Stock Exchange (ISE), in June-July 2015.</p> <p>Revised Exchange Rulebook is available at PSX website at the following link: https://www.psx.com.pk/</p> <p>Section 272 of the Companies Act, 2017 empowers the SECP to freeze voting rights of shares in cases where there is reason to believe that certain facts related to ownership are not clear.</p> <p>Companies Act, 2017 can be viewed at https://www.secp.gov.pk/document/companies-act-2017/?wpdmdl=28472</p> <p>Further, under Section 100 of the Securities Act 2015, the SECP has the powers to issue directives to listed companies for the protection of members or in the public interest. These powers can be invoked, directing a company to impose restrictions on transfer, voting and the payment of dividends in respect of shares where beneficial ownership cannot be ascertained.</p> <p>Securities Act 2015, notified on 18 May 2015 can be viewed at https://www.secp.gov.pk/document/securities-act-2015/</p> |
| Comments | The SECP have done an important amount of work in improving their regulatory framework, with many changes that over time will prove appropriate to guard minority shareholders rights and play an important role in enhancing and guaranteeing a higher level of investor protection. Currently, these changes are very new and do not allow to gauge their effectiveness on the ground. |
| Revised assessment | Broadly Implemented. |
| Principle 19. Auditor should be subject to adequate levels of oversight. | |
| Initial findings | <p>Although SECP has certain sanctioning power under Section 260 of the Ordinance 84 in relation to non-compliance with provisions of the Ordinance 84 by auditors, the accreditation and oversight mechanism of the audit profession in Pakistan as such is currently under the exclusive responsibility of Institute of Chartered Accountants Pakistan (ICAP), which is a self-regulated professional body which is not acting, and cannot seem to be acting in the public interest. Principle 19 is therefore Not Implemented, although rules and procedures for the licensing and the oversight of the audit profession do as such exist (under ICAP).</p> <p>As an immediate priority, Pakistan should ensure that progress is made in relation to the implementation of an auditor licensing and oversight mechanism which is performed under oversight of a body that acts in the public interest, as the current Audit Oversight Board of Pakistan (AOBP) project seeks to achieve. It is understood that the AOBP is in the early stages of development and it is currently not possible to assess if the regime contemplated by the AOBP proposal (no draft of which could be disclosed to the assessor) will meet the requirements under Principle 19 in an adequate manner. According to information received and based on the discussion of the assessor with relevant stakeholder, there seems to be resistance from the auditing profession to hand over audit licensing and oversight power from ICAP to an independent and non-industry dominated oversight body such as contemplated by the AOBP initiative.</p> |

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| Initial Assessment | Not Implemented. |
| Follow-up action | <p>To establish a non-industry controlled audit and accounting profession oversight body as the AOBP ensuring adequate independence and oversight in the public interest, appropriate amendments have been made in SECP Act 1997 giving detailed mechanism for audit oversight under “PART IX-C, AUDIT OVERSIGHT BOARD”.</p> <p>The amendments in SECP Act promulgated on 6 August 2016, is available at the following link: https://www.secp.gov.pk/document/secp-amendment-act-1997-for-your-information-and-record/?wpdmdl=17801</p> <p>AOB notified by the FG on 23 December 2016 and has initiated work on its operationalization. First meeting of AOB was held on 20 January 2017. To address its funding requirements SECP contributed Rs.30 million as seed money.</p> <p>AOB, is making effort to further streamline its funding sources to ensure sustainability through fees from audit firms, and fees and charges from Public Interest Companies (PICs) as provided under 36P, Section IX-C of the Act.</p> <p>AOB Business Plan for five (5) years has been prepared and has been approved by the Board in its 4th meeting held on 13 April 2017. It includes training plans for AOB members and its staff for efficient and effective performance of their duties. The Board in its 4th meeting has also approved the registration form for registration of new firms as under Sub-section (1) of Section 36T of the Act.</p> <p>Keeping in line with AOB Business Plan, a detailed organogram for AOB has been approved by the Board.</p> <p>AOB Conduct of Business Regulations have been finalized. Preliminary draft of finance regulations was presented to the Board in its 4th meeting. AOB, in its fifth meeting, has approved Audit Oversight Board Conduct of Business Regulations, 2017 and Audit Oversight Board Finance and Investment Regulations, 2017.</p> <p>With regard to administrative matters being expedited to fully operationalize the organization, AOB is committed to effectively implement AOB’s mandate of maintaining oversight and control of audit profession in the country.</p> <p>Chief Executive Officer (CEO) position for AOB was advertised on Sunday, 9 April 2017. AOB selection committee conducted interviews of qualifying candidates for CEO position on 24 and 26 May 2017 and the recommendations of shortlisted candidates shall be presented to the Board for decision in its 6th meeting.</p> |
| Comments | <p>In order to reestablish public confidence into the audit process of PICs, Pakistan has, following the recommendation issued in the IOSCO 2015 Report, engaged into reforming the audit profession oversight mechanism. This effort has resulted into a modification of the SECP Act 1997, with the insertion of a new Part IXC of the Act on the Audit Oversight Board (AOBP). The AOBP AOB oversight framework primarily relies on already established quality control system of ICAP while addressing the issue of independence of quality assurance process through its functional authority under the law. AOB has an oversight authority on ICAP’s Quality Assurance Board (QAB) and can carry out direct inspection of audit firms, in case it is not satisfied with the work performed by QAB. The AOB functions and powers include inter-alia:</p> <ul style="list-style-type: none"> • register audit firms of PICs on the recommendation of QAB; • deregister audit firms, on its own motion or on the recommendation of QAB while relying on the work and inspections carried out by QAB or its own inspection; • review and examine QAB work and assess the appropriateness of QCR framework and take such necessary actions as deemed necessary; • oversee and review policies, procedures and programs of QAB for ensuring an effective oversight of audit of PICs and to specify any improvement required in QAB’s policies, procedures and systems; • direct the ICAP for changes in QCR framework as deemed necessary, |

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| | <ul style="list-style-type: none"> • conduct inspections and inquiries of QAB records of a registered audit firm or may conduct direct inspection of records of the audit firm and the PIC, if not satisfied with the work of QAB, and • Impose penalty, sanctions or revocation of registration. <p>This Principles is one where effectiveness and perception of effectiveness is a fundamental element, the Methodology requiring statistical evidence of implementation. The AOBP was technically created at the time of the Amendment of the SECP Act 1997 in August 2016, and was effectively created in December 2016 with the appointment of a chairman and members of the AOBP in December 2016. This being said, the effective implementation of Principle 19 cannot be confirmed at the time of the assessment, although Pakistan is in the process of implementing the changes required under Principle 19 and as recommended in the IOSCO 2015 Report. Possible further upgrade will be possible when legislative changes will eventually effectively be implemented and their implementation tested.</p> |
| Revised assessment | Partly Implemented. |
| Principle 23. Other entities that offer investor analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them. | |
| Initial findings | <p>Research Analysts Regulations, 2015 have been drafted by SECP staff and are awaiting approval from the SECP. It is expected that they will be adopted and published during the second quarter of 2015, after a 4-week consultation period with the industry.</p> <p>Based on the draft Research Analysts Regulations, 2015 shared with the RT, it appears that the proposed regulations will potentially address some of the key aspects applicable to this Principle, with the exception of the requirements to have an overarching provision concerning integrity and ethical behavior, and detailed requirements on disclosure of actual and potential conflicts of interest.</p> <p>On the basis of the above, Principle 23 is Not Implemented at this stage, but a subsequent assessment of the Principle might lead to the conclusion that if the Research Analysts Regulations, 2015 are effectively adopted and implemented, the rating might change to Partially or Broadly Implemented. Any rating of Fully Implemented would in addition require effective implementation and enforcement of the regime to be in place.</p> |
| Initial Assessment | Not Implemented. |
| Follow-up action | <p>Research Analyst Regulations, 2015 have been notified and implemented since July 2015. The regulations can be viewed at https://www.secp.gov.pk/document/research-analyst-regulations-2015/</p> <p>In terms of the regulations, all entities/individual brokers are required to intimate their research analysts' business to the SECP and compliance with the regulations is now part of on-site inspection conducted by SECP and the Joint Inspection by SROs.</p> <p>Thirty-eight brokers have so far notified themselves as research entities and are submitting research to the SECP online. The names of research analysts have been placed on the website of SECP, the Pakistan Stock Exchange and Jama Punji portal.</p> <p>Furthermore, PSX has been advised vide letter dated 23 June 2016 to incorporate compliance requirement for all TREC holders in respect of Research Analyst Regulations. The non-compliance can be ensured through JIT inspections. List of notified research entities is placed and regularly updated on PSX and SECP websites.</p> <p>The research reports issued by these research analysts are reviewed on a continuous basis by the SECP in order to ensure that they are in conformity with the Research Analyst Regulations. A thematic review in this regard has been completed and based on which enforcement against few research houses is being initiated.</p> <p>The research reports issued by these research analysts are reviewed on a continuous basis by the SECP in order to ensure that they are in conformity with the Research Analyst</p> |

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| | Regulations. |
| Comments | With the Research Analyst Regulations, 2015 Pakistan has implemented specific legislation in relation to sell-side securities analysts (i.e. the so-called Research Analysts), setting out minimum standards in terms of qualification, expertise and certification requirements for research analysts, including independent research analysts. The Research Analyst Regulations, among others, specifically covers and promotes integrity and ethical behavior. |
| Revised assessment | Broadly Implemented. |
| Principle 24. The regulatory system should set standards for eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme. | |
| Initial findings | The downgrade results from several deficiencies. The absence of a statutory licensing regime for those who market schemes (distributors) is significant. A high priority therefore should be imposed on licensing and supervision of distributors directly by SECP or via an SRO with the appropriate mandate and subject to SECP oversight. The implementing regulation fails to address critical issues in regard to dealing with asset management companies (AMCs), namely best execution requirements and restricting churning. There is no onsite inspection program for trustees despite the reliance the regulatory framework places on their fulfilling their responsibilities properly. SECP has initiated work to develop regulations covering some of these issues which should, in due course, lead to an assessment upgrade. |
| Initial Assessment | Partly implemented. |
| Follow-up action | <p>Process to License and Qualify Distributors</p> <p>As per the regulatory requirement, the distributor of a single AMC is required to have written agreement with the AMC clearly stating the terms and condition for avoidance of fraud and mis-selling. As per the regulator requirements AMC shall use the following mechanism for monitoring of distributor:</p> <ul style="list-style-type: none"> • AMC shall allocate unique identification number to all of its employees engaged in sales and to its distributors. The company/firm which acts as distributor for a single AMC shall also allocate unique identification number to all of its employees engaged in sales. The AMC shall maintain a register containing details of its own employees and its distributors along with their employee details and unique identification numbers which shall be send to MUFAP on monthly basis. The MUFAP shall be responsible for maintaining centralized database and shall disseminate and update this data on its website for the information of investors. • AMC shall devise the risk profiling criteria to be used by its own employees and its distributors for soliciting investment from investors. • Each AMC shall arrange an in house training for its own employees and its distributors twice a year. Moreover, each company/firm which acts as distributor for a single AMC shall also arrange an in house training for its own employees twice a year. • AMC and its distributors (in case of company/firm) shall issue a proper identification card to each individual who is engaged in distribution of mutual funds which would be displayed to the prospective investors. • Person engaged in distribution function have to get Institute of Financial Market of Pakistan Certification regarding mutual fund distribution. • AMC shall be responsible for the acts and omissions of all its employees and its distributors if they were its own acts and omissions. <p>Regulation 3 of the Securities & Future Advisers (Licensing & Operations) Regulations, 2017 is reproduced hereunder: <i>“Provided that a person performing distribution of Collective Investment Schemes (CIS)</i></p> |

and/or Voluntary Pension Fund (VPF) units of multiple AMCs by entering into contracts with such AMCs will be required to obtain licence as a securities adviser under these regulations, in order to perform functions of a distributor, and all licensing conditions applicable to a securities adviser shall be applicable to such distributor”

1. Licensing Conditions:

Further the Licensing Conditions for Securities Adviser & Future Advisers are provided in regulation 4 of the Regulations which are reproduced hereunder:

- a) *It has a place of business in Pakistan;*
- b) *In the case of a company, its memorandum and articles of association allow it to apply for grant of licence under the Act;*
- c) *The applicant, or in the case of a company, it, its sponsors, directors and senior management officers shall fulfill the fit and proper criteria specified in Annexure A;*
- d) *In the case of a company, the sponsors shall collectively hold not less than fifty one percent shares and not less than twenty five percent shares in the case of a listed company. The sponsor’s portion of share capital shall not be sold or transferred, nor any arrangement of transfer of control of the securities adviser or futures adviser shall be affected without the prior written approval of the Commission;*
- e) *The applicant, or in the case of a company, its relevant employees shall have the requisite qualification and/or experience and certification as specified in Annexure A;*
- f) *It meets the financial resource requirements as specified in these regulations, where applicable; and*
- g) *It maintains membership of an association of securities advisers and/or futures advisers, as the case may be, or any other association or self-regulatory organization, which is approved by the Commission for the purpose, and abides by the code of conduct specified by such association at all times.*

2. Financial Resource Requirement:

Further, with reference to the Financial Resource Requirements as provided in regulation 6 of the Regulations, a person applying for license under these Regulations shall maintain a minimum net worth of Rs.1 million at all times in case of a company.

3. Education, Qualification & Experience:

The education or other qualification and experience criteria is provided under clause (b) of Annexure A “Fit & Proper” which stipulates that:

- (1) *In case of a securities adviser, the securities adviser, or where applicable, its chief executive officer or the head of its advisory business shall:*
 - a) *Be a CFA Charter holder, or be a member of a recognized body of professional accountants, or possess a post-graduate degree in finance, accountancy, business management, commerce, economics, capital market, financial services or related disciplines from a university recognized by the Higher Education Commission of Pakistan, or equivalent; and*
 - b) *have a minimum experience of five years of trading, dealing or giving investment advice in financial products/securities/funds, asset or portfolio management, or related experience in the capital market or the financial sector; and*
 - c) *have relevant mandatory certifications from the Institute of Financial Markets as specified by the Commission within one year of the grant of licence under these regulations or such extended time period as may be allowed by the Commission.*

Provided that for the above person, where a person possesses seven (7) years of experience specified for any category above, the minimum qualification requirement for such category shall be waived.

4. Credit Information:

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| | <p>With reference to the financial soundness and integrity of the applicant, Credit Information Reports of the applicant, its directors and sponsors are being called from the SBP which are scrutinized for any overdue payment irrespective of the amount of the over/past due payment.</p> <p>5. Internal Exchange of Information:</p> <p>Exchange of information is also being called from other departments of the Commission for any adverse issues.</p> <p>Powers of SECP</p> <p>Under the Securities Act, 2015, mutual fund distributors fall under the category of securities adviser and by virtue of the same, they have been required to obtain license with the SECP under the Securities and Futures Advisers (Licensing and Operations) Regulations, 2017. As per the provisions of the Act and the Regulations, SECP has wide-ranging powers regarding licensing, regulation, monitoring and supervision of distributors. Such powers include:</p> <ol style="list-style-type: none"> 1. Granting, refusing or cancellation of license or renewal based on eligibility requirements and any other licensing conditions as may be imposed; 2. Powers to take disciplinary action against licensed person (distributor) including power to suspend or cancel license of a distributor, publicly reprimand it, or impose fines on such person if found guilty of misconduct or non-compliant with any provisions of the Act or Regulations including the fit and proper criteria; 3. Powers to issue directions including restriction of business; 4. Power to call for information; 5. Power to receive any document, report, information or return as and when required; 6. Right to receive financial reports, audit reports and records to be maintained by the distributor; 7. Powers for offsite monitoring and onsite inspection. <p>The advisers/distributors have been required to seek licensing with the SECP within six months of the commencement of the regulations.</p> <p>Further, SECP has taken actions against banks who being a CIS distributor were in violations of regulatory requirements.</p> <ol style="list-style-type: none"> 1. Order dated 5 May 2016 passed by SECP wherein the AMC was penalized with fine of Rs.500,000 and was advised to refund Rs.297,540 to the complainant as well. 2. Order dated 14 April 2016 passed in which a distributor of AMC was penalized and the complainant was refunded Rs.297,540. |
| Comments | <p>The SECP have done an important amount of work in improving their regulatory framework standards for eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme (CIS). Changes that over time will prove appropriate to guard investor rights and create an effective regime to allow a flourishing CIS business environment within Pakistan while playing a major role in enhancing and guaranteeing a high level of investor protection, which in turn may lead to a higher rating. That said, currently, these changes are new and do not allow the assessor to gauge their effectiveness in the protection of investors, especially unsophisticated types of investors, which is at the heart of Principle 24.</p> |
| Revised assessment | Partly Implemented. |
| <p>Principle 28. Regulation should ensure that hedge funds and/or hedge fund managers/advisors are subject to appropriate oversight.</p> | |
| Initial findings | <p>Pakistan, currently has no regulatory framework to deal with hedge fund activities. It is recommended that such regulations should be addressed in the near future. This can be done by adding regulations to allow the registration of hedge funds and appropriate penalties to deal with illegal marketing of foreign hedge funds within Pakistan. The scale of such activity</p> |

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| | <p>is currently unknown.</p> <p>SECP has published, for consultation, a draft “Private Funds Regulation”. The assessor understands that the draft regulations (unseen) cover the registration of private funds domiciled in Pakistan (including hedge funds) and fund manager, standards for internal organization and operational conduct, supervision and enforcement etc. If these regulations in due course meet the requirements of Principle 28, and there is evidence of their effective enforcement, a significant upgrade will be appropriate.</p> |
| Initial Assessment | Not implemented. |
| Follow-up action | <p>Private Fund Regulations</p> <p>Private Funds Regulations, 2015 have been notified and implemented vide SRO 1159 (I)/2015 dated 25 November 2015. The regulations can be viewed at https://www.secp.gov.pk/document/sro-1159-of-2015-private-funds-regulations-2015/?wpdmdl=12563</p> <p>So far, three private fund management companies have been registered with SECP under the Regulations. Consequently, SECP granted three licenses to undertake private equity and venture capital fund management services under the said Regulations. Subsequently, a licensed entity has launched a private fund.</p> <p>The regulations should also deal with the legal and illegal marketing of foreign hedge funds in Pakistan including matters such as registration, approval of overseas jurisdictions and penalties for breach.</p> <p>The Regulation prohibits to establish, launch or operate any private fund business unless registered with the SECP under these Regulations and prohibits invitation from public for subscription (regulation 14).</p> <p>Therefore, any marketing of foreign funds in Pakistan is illegal and penalized under Section 282J of Companies Ordinance, 1984 whereby any contravention of the regulations is punishable with fine not exceed fifty million rupees.</p> <p>SECP has also established coordination mechanism to work with the law enforcement agencies in Pakistan namely the Federal Investigation Agency to take action against illegal activity in financial services.</p> <p>To curb illegal marketing of financial services, SECP has developed and implemented a comprehensive Investor Education Program named “JamaPunji” to enhance financial literacy and financial capability of investors.</p> <p>Posters, creating awareness on illegal financial activities were printed and placed countrywide on banks ATMs, branches of national saving center, airports and petrol pumps.</p> <p>The Investor Education Web portal http://jamapunji.pk/ was launched in June 2015, an entity verification service through mobile phone SMS to “8181” was launched in November 2015 and a comprehensive media campaign is being conducted through print and social media in particular on how to avoid fraud and falling prey to illegal/unregulated activities. Investors alerts specifically on “Avoiding Social Media Fraud” are also part of the campaign.</p> <p>To create awareness for the general public and to restrict illegal marketing of financial services, Investor Education Program named ‘JamaPunji’ has also published a series of lessons for the capital market investors to safeguard their hard earned income and avoid from potential scams.</p> <p>Further, to raise awareness about legal and illegal funds being offered in Pakistan, SECP has initiated an awareness campaign on Private Fund Regulations to deter illegal activities in the area of fund management, in particular from the foreign entities. Several media advertisement were published recently, in leading newspapers with wide circulation.</p> <p>The awareness campaign will continue through further through media releases in the coming months.</p> |
| Comments | The implementation of the Private Fund Regulations by the SECP is a very positive development. That said the Private Fund Regulations primarily deal with the private equity and venture capital businesses and do not appear to specifically deal with hedge funds in the |

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| | <p>sense of Principle 28. Furthermore, it seems that the hedge fund business under international definition does not actually exist in Pakistan. The Private Fund Regulations seem to fit more appropriately in Principle 24 as they cover an alteration of CIS business. For the purpose of this review, the changes described hereabove in relation to Principle 28 have been taken into account in the assessment of Principle 24 above. This being said, the draft “Private Funds Regulation” shall be finalized and implemented as a matter of priority, having regard to the IOSCO standards.</p> |
| Revised assessment | Non Applicable. |
| <p>Principle 29. Regulation should provide for minimum entry standards for market intermediaries.</p> | |
| Initial findings | <p>Current registration (at the SECP) rules focus on brokers as natural persons and do not provide enough specific criteria (requirements for organizational structures, risk management systems, supervisory systems, written policies and procedures, internal controls etc.) regarding the brokerage companies. KSE Rules are further developed in this regard, however these rules only apply to the KSE TREC holders. CDC participation requirements and NCCPL membership requirements complement the technical requirements for brokers. However, rules regarding eligibility of brokerage companies should be further revised and developed in parallel with the new system after demutualization of the exchanges, where all the brokers are corporate entities.</p> <p>The lack of a single database in Pakistan for criminal record checks is a system vulnerability. SECP checks only the records of the SECP for the assessment of the registration requirements.</p> <p>During the registration process (initial and renewal of the licenses) at the SECP, the fit and proper criteria are applied to the CEO or any one director of the board, however not to the shareholder. (Revised KSE Rule Book (2014) requires major shareholders to comply with the fit and proper requirements mentioned in the KSE Rule Book, however this is only a requirement for having a TREC at the KSE.)</p> <p>Considering that the registration of brokers are renewed every year, the limited number of the SECP staff dealing with the applications and registrations raises concerns in terms of workload and effectiveness. In addition, SECP and the exchanges do not conduct any on-site visits to a brokerage company at the initial registration or licensing stage. This is a weakness in terms of the assessment of the application and verification of some of the information that the company has provided, such as, location of the firm, internal organisation, staff, technical infrastructure, resources etc.</p> <p>While there are eligibility criteria in the regulation for the underwriter, they are not licensed and are assessed by the SECP only when there is an IPO application. Furthermore, the regulation regarding underwriters is not very comprehensive and does not include any capital requirement.</p> <p>Regarding the deficiencies, SECP has provided that they will revamp broker’s registration rules by December 2015 and the Underwriter Rules and the Credit Rating Rules by June 2015.</p> <p>SECP notes that the Institute of Capital Markets (ICM) conducts mandatory certification for sale agents/distributor of CIS. As planned by the SECP, this requirement could be extended to investment advisor, critical staff at the brokerage company (such as analysts), and underwriters to complement the professionalism in the market.</p> |
| Initial Assessment | Partly implemented. |
| Follow-up action | <p>Revised Regulations</p> <p>Requirements for market intermediaries have been specifically laid down in the Securities Act 2015, notified on 18 May 2015. In terms of Part V of the said Act, no person shall carry on regulated securities activity unless licensed by the SECP. For the purpose of the said Act, “regulated securities activity” include: “securities broker, securities adviser, securities</p> |

manager, share registrar, credit rating company, balloter, underwriter, debt securities trustee; or any other activity as may be notified by the Federal Government. Securities Act, 2015 can be viewed at <https://www.secp.gov.pk/document/securities-act-2015/>

Furthermore, for risk management in relation to custody of assets by a broker, the “maximum custody limit” was enforced as 25 times the prevailing capital adequacy level of a broker through amendments in the Central Depository Company of Pakistan Regulations, notified on 7 November 2014. The amendments can be viewed at <https://www.cdcaccess.com.pk/download.faces?id=14257>

For the purpose of smooth implementation of the regime, SECP directed the CDC to closely monitor the assets under custody positions of all TREC holders and ensure that the TREC holders that hold custody position in excess of the allowed limit must reduce their excess positions. SECP has noted that the brokerage industry remained compliant with the said regime.

In addition, to ensure transparency and governance, all brokers are required to appoint audit firm as per panel specified by the State Bank of Pakistan, since July 2015. An auditor must be a chartered accountant firm and must have a satisfactory rating under the Quality Control Review Program of the Institute of Chartered Accountants of Pakistan to become a member of the SBP’s panel of auditors. Regulatory actions have been initiated against brokers failing to comply with the directives, including freezing of trading terminals.

Further, provision for conducting on-site visit of a brokerage house at the time of initial registration and subsequent renewal to verify the company information and assess application as well as availability of necessary infrastructure, has been included as standard practice through SECP directive dated 30 December 2015.

In order to facilitate investors, enhance their confidence and to promote growth of the capital markets, SECP has approved amendments in Brokers’ Office/Branch Office Regulations provided in Chapter 22 of the PSX Rule Book as follows:

- The Broker shall display standees about the products, it is selling and the procedure of investments therein, in Urdu language in a clear and concise manner with the logo of “JamaPunji” covering the following contents: (a) who is Stock Broker; (b) procedure for investment in stock market; and (c) procedure for opening an account with CDC.
- Moreover, Brokers shall (i) place at its office/branch office, the information for the potential investors relating to various products/services being offered through printed brochures; (ii) not employ a person who has been convicted of any non-compliance and violation by the Exchange, the Commission and/or any other competent authority; (iii) ensure proper arrangements are in place for guidance and customer support including (a) guidance in filling account opening forms and completion of documentation; (b) provision of drop box facility for collection of complaints; and (c) security arrangements including installation of CCTV Cameras for the safety of record; (iv) give notice in writing to the Exchange and all its clients before: (a) temporary suspension of trading facility; and (b) permanent closure of any of its office/branch office. The notice shall also be published in at least two newspapers one in English and one in Urdu languages; (v) intimate its clients in writing about contact details for future correspondence, in case of permanent closure of any of its office/branch office; and (vi) intimate its clients in case of re-location of office/branch office. Moreover, Exchange shall conduct periodic visit/inspection of the Brokers’ office/Branch offices and shall submit its inspection report to Commission.

Similar requirements have also been prescribed for AMCs, leasing companies and Investment banks vide SECP’s Circular 2 and 3 of 2016 dated 22 January 2016 available at <https://www.secp.gov.pk/document/circular-no-2-of-2016-%EF%BF%BD-regulatory-requirements-for-branches-of-asset-management-companies/?wpdmdl=7195>; and <https://www.secp.gov.pk/document/circular-no-3-of-2016-regulatory-requirements-for-branches-of-leasing-companies-and-investment-banks/?wpdmdl=7196>

Brokers are also required to maintain functional websites under SECP’s directive dated 1 July 2015.

In case of brokerage companies, the requirements have been revamped through implementation of the Securities Brokers Licensing and Operations Regulations, 2016, notified on 24 June 2016 and available on: <https://www.secp.gov.pk/document/securities-brokers-licensing-and-operations-regulations-2016/>

The new regulations cover enhancements in the requirements for brokers at the time of registration (Chapter 2), governance structure (code of corporate governance for brokers covered in Annexure D), internal control (Regulation 16(8) and (9)), risk management (Regulations 8(4)(d)); major shareholder (Regulation 4) and compliance (Chapter 3). Further, the brokers can only operate if established as a corporate legal entity.

The following has been incorporated in Broker regulations:

- The names of sponsors, directors and senior management officers of Brokerage firms are now mandatory to appear in the list of active tax payers issued by the Federal Board of Revenue of Pakistan.
- The Commission obtains credit information bureau (CIB) reports of directors, sponsors and the brokerage Company itself, from the SBP to evaluate the financial solvency of the firm and its management.

The Brokerage firms can obtain license under three categories of Brokerage. The financial resource requirements and regulatory requirements vary in accordance to the category under which the broker seeks license. The three categories are listed below:

- (a) **“Trading Only”** broker can only execute its proprietary trades and trades on behalf of its customers but cannot settle executed trades or keep custody of securities.
- (b) **“Trading and Self-Clearing”** broker can execute as well as settle its proprietary trades and trades executed on behalf of its customers and can keep custody of securities owned by it and its customers subject to such conditions as may be imposed by the Commission.
- (c) **“Trading and Clearing”** broker can execute as well as settle its proprietary trades and trades executed on behalf of its customers and can keep custody of securities owned by it and its customers subject to such conditions as imposed by the Commission and, in addition, such securities broker can settle trades of other securities brokers and their customers and keep custody of the securities owned by such other securities brokers and their customers.

| Category | Paid up Capital Rs.M | Net worth Rs.M | Minimum Net Capital Balance Rs.M |
|---------------------------|----------------------|----------------|----------------------------------|
| Trading Only | 15 | 15 | 2.5 |
| Trading and Self Clearing | 35 | 35 | 5 |
| Trading and Clearing | 100 | 100 | 10 |

SECP has stated that the Licensing Status of Securities Broker under the Securities Broker (Licensing and Operations) Regulations, 2016 is as follows:

| | |
|--|------------|
| Total Brokers as of 30 June 2016 | 340 |
| Licence Granted | 150 |
| Licence Refused | 36 |
| Proceedings for Refusal of Licences are in Process | 25 |
| TREC Surrender/Terminal Suspended/Defaulted | 40 |
| Application for Renewal of Licence are found Deficient | 9 |
| Application for Renewal of Licence under Scrutiny | 62 |
| Renewal of Licence not Yet Due | 18 |
| Total | 340 |

The new regulatory regime has made it mandatory for brokerage firms to specify the sponsors. Relevant clauses in respect of obligations of sponsors are provided below:

- The applicant has to identify names and details of its sponsors which shall be required to collectively hold and retain not less than fifty-one per cent of the share capital of the applicant, and in the case of a listed company, not less than twenty-five per cent of the share capital of applicant;
- The applicant and its sponsors should not have controlling interest in any other company holding license as a securities broker;
- In case of a company, its sponsors have to submit verifiable documents to demonstrate that they have financial resources not less than twice the amount of the paid-up capital requirement for the relevant category of securities broker for which application is made;
- Sponsors of the Brokerage firm have to ensure that they have and will continue to have representation of at least twenty per cent on its board of directors;
- The sponsors' portion of share capital of the applicant or any part thereof cannot be sold or transferred, nor any arrangement for transfer of control of the securities broker can be affected without prior written approval of the Commission;
- The applicant and its sponsors must not have controlling interest in any other company holding license as a securities broker.

In order to streamline the entry requirements for intermediaries, certain regulatory and procedural requirements were also introduced as follows:

Instruction No.4 of 2017

In order to effectively implement the entry standards for brokerage houses, SECP has noted that it has issued special instructions to its Company Registration Offices (CROs) regarding amendment in Regulation 4(j) of Securities Brokers (Licensing and Operations) Regulations, 2016, wherein it was intimated that:

- CROs will not accept any filing with respect to any change in sponsors' shareholding unless accompanied by requisite approval from Securities Market Division of Commission.
- Also filing for change in directors will be accepted only if accompanied by No Objection Certificate (NOC) from PSX.
- Incorporation of new Securities/Commodities Brokers will be allowed only if NOC from Securities Market Division of Commission is provided by concerned Sponsors.

The PSX was also intimated regarding appointment of Directors/CEO in accordance with fit and proper criteria as prescribed in the Securities Brokers (Licensing and Operations) Regulations, 2016. PSX is advised to issue NOC, thereby allowing CROs to accept change of Directors/CEO by the Securities Broker.

Addition of new clause in document of license

A new condition has been added in the text of Certificate of License of Securities Brokers which is reproduced as below:

- The Securities Broker shall not indulge in any activity other than the securities broker activity as defined in the Securities Act, 2015 and in case any activity other than the regulated activities defined in Section 63 of the Securities Act, 2015 is provided in Memorandum of Association, the same shall be deleted/omitted from Memorandum of Association of the Company within 60 days.

Conversion of SMCs into Public Company or Private Company

The SECP notified that any Single Member Company (SMC) already licensed as a securities broker under the Securities Brokers (Licensing and Operations) Regulations, 2016 shall convert its status to a public company or a private company, other than a single member company, within a period of sixty days, vide SRO No. 213(1)/2017. Link of the same is given below: <https://www.secp.gov.pk/document/sro-securities-brokers-regulations-2016/?wpdmdl=27138>

The Status of Securities Brokers Converted from SMC to Private Limited Company is as

follows:

| | |
|--|-----------|
| Total SMC Securities Brokers | 18 |
| SMC Securities Broker converted to Private Limited Company | 2 |
| TREC Surrender/Terminal Suspended/Defaulted | 3 |
| Licence Refused | 4 |
| Application for conversion is in Process | 9 |

SECP has noted that since demutualization, corporatization of brokers has been facilitated by requiring conversion to companies over time to ensure accountability and transparency. Post integration, all existing single member broker companies are required to convert to private/public companies considering that single member company structure poses risks to investor protection in default cases and creates problems of succession of operations and business continuity.

New intermediary regime segregates the role of apex and front line regulator as below:

Role of PSX in implementation of broker regulations:

Regarding the process SECP has explained the following: “All application of registration along-with supporting documents are initially received by the PSX. The PSX scrutinizes the application for grant of license and the documents submitted by the applicant prior to submission of the same for consideration of the Commission along-with a letter of recommendation. The exchange is also liable to perform on-site visit of securities broker’s premises, prior to allowing commencement of business to a securities broker, and the same is communicated to the SECP.”

Role of SECP

Meanwhile, to support and streamline the process of renewal of broker’s registration the SECP has developed a Broker Portal that is interlinked with the Financial Reporting System (FRS) and Corporate Registration and Compliance System (CRCS) to verify the compliance. The Broker Portal was rolled out in production on 6 February 2017.

The SECP stated that it evaluates the Securities Brokers on many grounds prior to issuance of License as a Securities Broker. In this regard, a checklist is followed for detailed analysis of eligibility of Brokerage firm in light of the Securities Brokers (Licensing and Operations) Regulations, 2016:

- Application forwarded by Securities Exchange (PSX) after scrutiny
- Recommendation by PSX after on-site visit
- Category of Brokerage
- Copy of TRE Certificate issued in name of Applicant [Regulation 4(b)]
- Copy of National Identity Card
- Form-A attached and filled up as prescribed [Regulation 5(1)]
- Fee Challan Form [Regulation 5(1) and 9(1)]
- Attested copy of Memorandum and Articles of Association [Regulation 4(a)]
- Copy of Forms 3, 27, 28 and 29 of the applicant duly certified from the CRO concerned
- List of Directors/ Sponsors [Regulation 4(c)]
- Pattern of Shareholding of directors/sponsors
- Information form/CV of individual Directors/ Sponsors/Senior management
- Certificate of educational qualification of Director/CEO/Compliance officer enclosed along with the application [Schedule I (Annexure B)]/If not, relaxation in educational qualification requested
- Experience certificate of CEO/Director/Compliance officer [Schedule I (Annexure B)]
- Additional requirements in case of Trading and Self-clearing and Trading and

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| | <p>Clearing categories [Regulation 7], such as Independent director (Required only for Trading and Clearing Category), Member of clearing house/NCCPL and Participant of CDC</p> <ul style="list-style-type: none"> • Financial information, such as Annual reports of last three years attached [Regulation 16(1)(f), annexure D], Audited statement of NCB [Regulation 6(4)], Auditor enlisted with Category A or B as devised by State Bank of Pakistan [Regulation 16(1)(f), annexure D], Net Worth Statement [Regulation 6(7)], Minimum paid up capital & CIB report [Regulation 8(2)] • Bank Details [Annexure A (4.11)] • Name of Sponsors/ Directors/Senior management is showing on ATL (active tax payer list) [Regulation 4(h)] • Exchange of information from all concerned CROs and Securities Exchange for adverse issues • Details of arbitration awards announced and implemented • Details of customer complaints received and redressal status • Compliance status of orders passed (if any) <p>The above information has been made part of online Broker Portal to provide quick access to detailed and updated information of securities brokers that will aid in quick processing of Application of renewal of licenses via the online broker registration system, on its implementation in 2018.</p> <p><u>Broker Profile System</u></p> <p>SECP has explained that the broker profile portal has been established, which is simultaneously available to CDC and PSX. The objective of establishing the Broker Portal was to form a close connection between the brokers' general information, management information, shareholding patterns, credit information, branches and agent status, enforcement actions and complaint with claims. A broker profile database has been developed to have complete broker's information at one place regarding broker's registration and renewal, adjudication, litigation and Investor's complaints and claims pending. SECP has noted that this has substantially reduced the processing time of each application/process. The salient features of the Broker Portal include:</p> <ul style="list-style-type: none"> • Broker's Profile <ul style="list-style-type: none"> • Basic information of the company • Directors of the company • Other directorship of the board of directors • Shareholders of the company • Shareholders as directors in other companies • Shareholding of the company in other companies • Shareholding Pattern (As per the latest Form A) • Auditors • Net Capital Balance • Financial Highlights • CIB Report • Licenses/ Registrations • Enforcement Actions/ Court Cases <ul style="list-style-type: none"> - Inspections/ Enquiries under process - Show cause notices under process - Orders, prohibitory order, warning, directions issued - Orders, warnings, directions issued by PSX, CDC and NCCPL - Appeals filed before Appellate Bench - Court cases filed by SECP against the broker and vice versa |
|--|--|

- Details of Complaints
- Details of Claims
- List of TREC holders of PSX
- List of registered brokers with their registration dates
- List of suspended stock brokers with registration and suspension dates
- List of defaulted stock brokers with registration and default dates and settlement position wise

For Securities Advisers, the Securities and Future Advisers (Licensing and Operations) Regulations, 2017 notified on 21 April 2017 and available at <https://www.secp.gov.pk/laws/regulations/> cover requirements for licensing (Chapter II regulation and licensing conditions); conduct (Chapter III), other requirements including restriction on keeping custody of customers' assets, general responsibility (Chapter IV) and accounting and audit (Chapter V).

For Underwriters, the requirements have been revamped through the Public Offering Regulations, 2017 notified on 2 May 2017 available at <https://www.secp.gov.pk/document/clean-copy-of-public-offering-regulations-2017-updated-january-5-2018/?wpdmdl=30546> and the Public Offering (Regulated Securities Licensing) Regulations, 2017 notified on 2 May 2017 available at <https://www.secp.gov.pk/document/public-offering-regulated-securities-licensing-regulations-2017/?wpdmdl=31006>.

The Public Offering Regulation Chapter IX covers Functions and Responsibilities of underwriters, requirements include: Regulation 17 sub-clauses 7,8, 9, 11 and 16 on reporting lines, internal controls, policies and procedures etc.; Regulation 22 describes the responsibilities of underwriter; and Schedule 9, Part III includes underwriting arrangement, commissions, brokerage and other expenses.

A person registered as an underwriter prior to coming into force of these Regulations, is deemed licensed as an underwriter under these Regulations and shall comply with all the requirements of these Regulations within a period of one year from the date of coming into force of these Regulations.

Currently, there are 41 Underwriters that are deemed licensed under these Regulations.

Share Registrar and Balloters Regulations, 2017:

The Share Registrar and Balloters Regulations, 2017 are notified vide notification no. SRO 16(1)/2017 dated 11 January 2017. The said regulations are framed under the Securities Act. To effectively enforce these regulation, SECP completed one inspection and has planned inspections of licensed share registrar for 2017-18.

The existing share registrar and balloter shall comply with the requirements of these Regulations within a period of one year from the date of coming into force of these Regulations.

Currently, there are 19 Balloters and Transfer Agents that are deemed licensed under the Act and these Regulations.

Debt Securities Trustees Regulations, 2017:

The Debt Securities Trustees Regulations, 2017 are notified vide notification no. SRO 15(1)/2017 dated 11 January 2017. The said regulations are framed under the Securities Act, 2015 and has replaced Debt Securities Trustees Regulations, 2012.

A person registered as debt securities trustee prior to coming into force of these Regulations, is deemed licensed as a debt securities trustee under the Act and these Regulations till the time its existing certificate of registration remains valid. The existing debt securities trustees are required to comply with the requirements of these Regulations within a period of one year from the date of coming into force of these Regulations.

Currently, there are 16 Debt Securities Trustees that are deemed licensed under the Act and these Regulations.

Consultant to the Issue and Banker to an Issue:

The Consultant to the Issue and Banker to an Issue are notified by the Federal Government

as regulated securities activity under Section 63 of the Securities Act, 2015. The functions and responsibilities of consultant to the issue and Banker to an issue are covered in Public Offering Regulations, 2017, while licensing of both Consultant to the issue and Banker to an Issue are covered in Public Offering (Regulated Securities Activities Licensing) Regulations, 2017.

The abovementioned intermediaries are required to meet Fit and Proper Criteria for functioning as a regulated activity.

Currently, one application for grant of license as banker to an issue and one application for grant of license as consultant to the issue is under process.

Single Database for Criminal Records

SECP has taken requisite measures to deter the entrance of criminals in the financial sector through the following:

- a) SECP's Public Disclosure and Media Strategy, requires disclosure of criminal proceedings after filing of a criminal complaint to make it public once the court has admitted the case. After court decision on the case, the SECP make a public announcement, which includes the identity of the defendant, a brief summary of the facts of the case and the decision of the court. The same is also available on SECP's website as investor alert at <https://www.secp.gov.pk/data-and-statistics/investor-alerts/>
- b) The processing for the grant of fresh license to any entity entails seeking a report from the SBP on the credit history of the directors/CEO of the company as maintained by the SBP's Credit Information Bureau and checking from the SECP's internal database maintained by SECP for any adverse issue or proceeding against the entity or the individuals.
- c) Automation of all SECP business processes including the enforcement actions and criminal records is expected to be developed by 2018.

SECP is asked to confirm to whether there is any improvement about a general database for criminal records in Pakistan. SECP has responded that currently, there is no such country wide database of criminal record. However, it has also noted that SECP as a practice has adopted to have feedback from all law enforcement entities pertaining to the financial sector including Federal Investigation Agency (FIA), National Accountability Bureau (NAB), SBP, and Financial Monitoring Unit (FMU). Recently, during divestment of a market infrastructure entity, SECP while reviewing the fit and proper criteria took feedback from these authorities.

On-site Visits to the Brokerage Houses at Time of Registration

The provision for conducting on-site visits of a brokerage house to verify the company information and assess application as well as availability of necessary infrastructure either by SECP or the exchange, at the time of initial registration and subsequent renewal has been included as standard practice through SECP directive dated 30 December 2015.

Further, SECP notes that this requirement is made part of legal framework as proviso of Regulation 8(2), of the Securities Brokers (Licensing and Operations) Regulations, 2016, notified on 24 June 2016. It requires that while deciding to grant license to a securities broker, the SECP may seek additional information from other Government agencies/regulatory bodies including obtaining credit information bureau (CIB) reports from the SBP and may also conduct a pre-licence assessment or a visit of the premises of the applicant to verify the genuineness of information submitted.

Further, as per Regulation 8(2), of the Securities Brokers (Licensing and Operations) Regulations, 2016, within three months of the grant of licence, the securities exchange, prior to allowing commencement of business to a securities broker, shall confirm through a visit of such securities broker's premises that the securities broker has put in place: i) adequate professional management; ii) necessary technology, systems and internal procedures; iii) organizational structure with clear lines of responsibility and authority; and iv) risk management, supervisory system, infrastructure.

SECP states that, prior to the promulgation of Securities Brokers (Licensing and Operations) Regulations 2016, the PSX conducted onsite visits of 63 brokerage houses for the renewal of their registration, from 1 January to 30 June 2016. Subsequently, pursuant to clause No. 8(4) and 9(3) of Securities Brokers (Licensing & Operations) Regulations, 2016, the PSX has conducted approximately 222 on-site visits of brokerage firms as part of the renewal of certificate of registration process, as per new regulatory regime since its promulgation in June 2016.

SECP Capacity Enhancing

The SECP has stated that it conducted a comprehensive exercise related to human resource management, including carrying out work load assessment to indicate deficient areas and highlight where additional resources are required. The capacity of brokers registration department has been enhanced through additional resources and refining the work flow. The staff strength has been increased to 38 officers.

To support and streamline the process of renewal of broker's registration, SECP since February 2017, has automated the broker's profile system. The system has made the registration process efficient with its access to both PSX and SECP and its linkage with the Financial Reporting System (FRS) and SECP Corporate Registration and Compliance System (CRCS) to verify the compliance.

The objective of establishment of Broker Portal was to form a close connection between the brokers general information, management information, shareholding patterns, credit information, branches and agent status, enforcement actions and complaint with claims, a broker profile database has been developed to have complete broker's information at one place regarding broker's registration and renewal, adjudication, litigation and Investor's complaints and claims pending. SECP has noted that this has substantially reduced the processing time of each application/process.

Certification Requirement for Market Professionals

SECP states that certification requirements have been made mandatory for brokerage company through directive issued in April 2015 and subsequently revised keeping in view the stakeholders feedback in December 2015.

All persons engaged in sales function of a brokerage house are required to obtain stock brokers certification (SBC). The CEOs, Chief Investment Officers, Head of Operations, Head of Compliance, and Head of Sales of a brokerage house have to obtain certifications in Pakistan Markets and Regulation Program (PMR) and Fundamentals of Capital Market (FCM) certifications offered by Institute of Financial Markets (IFM).

The PMR, FCM and SBC are mandatory for all sales supervisors including branch managers engaged by a brokerage house. The PMR covers complete regulatory framework at exchanges, depository and clearing level; and the FCM tests understanding about basic capital market concepts like time value of money, measuring investment return, ethics and code of conduct, structure of markets, asset classification, primary and secondary markets, financial intermediaries, etc.

Till date, total candidate registration is 3,682 and the certification examination passed is as follows:

- i. Pakistan's Markets Regulation (368)
- ii. Fundamental of Capital Markets (479)
- iii. Stock Brokers Certification (63)
- iv. Mutual Fund Distributor (1301)

Directives can be viewed at: <https://www.secp.gov.pk/document/circular-92015-dated-april-8-2015-issued-by-directorhod-lcid-regarding-mandatory-certification-for-professionals-of-capital-market/?wpdmdl=12615>; and <https://www.secp.gov.pk/document/circular-no-47-of-2015-mandatory-certification-for-the-professionals-of-capital-market/?wpdmdl=7198>

For analyst, qualifications, experience and certification requirement (Regulation 3) have

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| | <p>been catered for in the Research Analyst Regulations, 2015. The regulations have been notified and implemented since July 2015 and can be viewed at https://www.secp.gov.pk/document/sro-709-i2015-research-analyst-regulations-2015-amended-as-on-aug-1-2017/?wpdmdl=28978</p> <p>The IFM has launched its certification for research analysts and securities advisers.</p> <p>Further, SECP vide its Circular 11 of 2017 dated 27 April 2017 available at https://www.secp.gov.pk/document/circular-11-of-2017/?wpdmdl=27680 has made it mandatory for research analysts to obtain the Research Analysts Certification offered by the IFM within six months of the issuance of the circular.</p> <p>In the case of Securities Advisers, SECP vide its Circular 14 of 2017 dated 15 May 2017 available at https://www.secp.gov.pk/document/circular-no-14-of-2017/?wpdmdl=28051 has made it compulsory for securities/futures advisers to obtain the Financial Advisors Certification (FAC) offered by the IFM. In order to facilitate compliance with the requirement, the existing and new securities and future advisers have been given a year to obtain the certification. The certification requirement has been launched with a view to inculcate good governance practices and increased investor protection. Further distributors of CIS units of multiple AMCS shall also be required to obtain license as securities advisers with the SECP and shall be required to obtain Mutual Fund Distributors Certification offered by IFM.</p> <p>Further, IFM has developed an eight Certifications based 4-month Diploma Program in Capital Markets in collaboration with a leading business school of Pakistan — Institute of Business Administration (IBA) Karachi. The program is scheduled to be offered/opened for registration in August 2017.</p> <p>SECP notes that the certifications launched by IFM for research analysts and securities/futures advisers is expected to help develop human capital in the Pakistani capital market, specify minimum standards for intermediaries involved in giving research/investment recommendation to investors, and assist in ensuring that only professional/skilled personnel are involved in these activities. The same will also ensure that such intermediaries are aware of their responsibilities under the regulatory framework while carrying out the business of research analyst/advisers.</p> |
| <p>Comments</p> | <p>Pakistan’s regulations were outdated and needed to be updated and better organized. This was a major recommendation at the initial assessment in relation to market intermediaries. SECP has taken various steps in order to improve its regulatory framework. The new regulation is very comprehensive and addresses several issues regarding the initial recommendations such as organizational structures, risk management systems, supervisory systems, written policies and procedures regarding the operations of MIs, internal controls, criteria for major shareholders, on-site visits to brokerage companies at the initial registration, etc.</p> <p>More specifically, the new regulation requires that the market intermediaries are licensed, and there are minimum criteria that must be met before a license is granted. The criteria include financial resources and an assessment of the applicant in various areas covering business conduct, resources, past conduct, etc. Further, the market intermediaries are required to update relevant information and material changes as the licenses are renewed periodically.</p> <p>The SECP has provided information regarding the regulator and the SROs’ processes and resources to carry out review of applications. Further, it is a very positive improvement that SECP has automated the broker’s profile system which is expected to improve the speed and consistency of the registration process and provide collective data to the system. In addition, at the initial assessment the limited number of the SECP staff dealing with the applications and registrations was raising concerns in terms of workload and effectiveness. SECP has enhanced the capacity of brokers registration department through additional resources and refining the work flow, and the staff strength has been increased to 38 officers (the number was reported to be 5 at the initial assessment).</p> <p>While SECP has been putting efforts in having feedback from all law enforcement entities pertaining to the financial sector including FIA, NAB, SBP, and FMU, an important issue to note is still the lack of a general criminal record database. However, a Pakistan Criminal</p> |

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| | <p>Database exceeds the purview of the SECP.</p> <p>On the other hand, the IOSCO Methodology requires consistent application of the regulatory framework which would require more time to assess. Considering that the SECP has developed a new regulatory system for the whole brokerage industry it would not be possible to assess the consistency at this stage of implementation.</p> |
| Revised assessment | Broadly Implemented. |
| Principle 30. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake. | |
| Initial findings | <p>While there are initial and ongoing capital and other prudential requirements for brokers, the net capital of the broker is calculated based on accounting for current assets and current liabilities and does not give sufficient weight to the range of risks required to be accounted for under this Principle. The system allows for some protection against market risks, however it does not take into account other risks such as credit, liquidity and operational. On the other hand, although capital market standards are not designed to give sufficient weight to the full range of risks to which a broker is exposed, the base minimum capital and capital adequacy procedures and exposure limits provided in the Risk Management Regulations (RMR) of the stock exchanges enable a broker to absorb some losses. For investment advisors, only absolute minimum equity requirements exist rather than any risk-based capital requirements such as a percentage of annual expenditure although it appears that investment advisors which carry on the business of portfolio management deal for clients.</p> <p>In addition, with regard to reporting, the structure of Net Capital Balance (NCB) reports is not very detailed and only covers a net (capital) number which is calculated as current assets minus current liabilities. Further, its reporting frequency (bi-annual) to the SECP is not sufficiently frequent. Regarding the deficiencies, SECP is committed to upgrading the Broker Registration Rules by December 2015 and the Underwriter Rules and the Credit Rating Rules by June 2015.</p> |
| Initial Assessment | Partly Implemented. |
| Follow-up action | <p>Risk-Based Initial and Ongoing Capital Requirements</p> <p>SECP has reported that Pakistan’s securities markets remained fragmented with many weak legacies prevailing in the brokerage regulatory regime stemming from the mutualized exchange structure. SECP developed a comprehensive plan to capitalize the markets through injection of capital or consolidation, and to weed out weak players. The Plan envisages demutualization and integration of three exchanges, shifting of custody from brokers, back office standardization and introduction of the concept of professional clearing member.</p> <p>To manage the risk in relation to custody of client assets by a broker, the “maximum custody limit” was imposed to be 25 times the prevailing capital adequacy level of a broker through amendments in the Central Depository Company of Pakistan Regulations, notified on 7 November 2014. For the purpose of smooth implementation of the regime, SECP has directed the CDC to closely monitor the assets under custody positions of all TREC holders and ensure that the TREC holders that hold custody position in excess of the allowed limit must reduce their excess positions. SECP has noted that the brokerage industry is compliant with the said regime.</p> <p>The Securities Brokers (Licensing and Operations) Regulations 2016 have revised the existing capital requirements for brokerage houses reflecting the risk undertaken. The regulations distinguished brokers into three types based on activities. The enhanced capital requirements for each type have been established based on risk associated with the type of activities performed by the brokerage house (Regulation 5 – Financial Resource Requirements). (The Securities Brokers (Licensing and Operations) Regulations 2016, notified on 24 June 2016).</p> <p>The new capital requirements introduced in the said Regulations cater for credit risk,</p> |

liquidity risk, operational risk, and external risks faced by brokers.

Further, SECP has noted that the concept of liquid capital has been introduced in line with international best practices. Enhanced thresholds of paid up capital, net worth and Net Capital Balance have been prescribed for different categories of brokers based on the functions they are allowed to perform. For example, brokers with custody and settlement functions have to maintain greater thresholds of capital. Furthermore, capital requirements have been prescribed to provide for absorption of losses in case of external risks.

SECP has stated that the concept of Liquid Capital for securities brokers will ensure that securities brokers hold sufficient capital to protect their customers and creditors from losses and delays if they were to fail. The securities brokers must hold enough capital to absorb any losses on liquidating its positions or from closing customer's defaulting positions that are guaranteed to clearing houses. The Liquid Capital requirements provide a suitable tool for gauging the financial health and capital adequacy of securities brokers.

A key requirement of these Regulations which needed to be implemented was the filing of monthly Net Capital Balances and Liquid Capital to PSX by the brokers. This has been implemented and is being monitored by SECP on a regular basis. PSX enforces this requirement and furnishes a monthly summary report to SECP in the succeeding month. 277 TREC Holders have submitted their monthly NCB and LC Statements for the month of March 2017.

The SECP has notified on 27 April 2017 following threshold for liquid Capital, based on the analysis of liquid capital information reported by securities brokers for July to December 2016 and PSX has circulated these requirements vide letter dated 28 April 2017 available at <https://www.psx.com.pk/newsimage/98522-1.pdf>

Minimum Amount of Liquid Capital

| <u>Broker Category</u> | <u>Amount (Rs.M)</u> |
|-------------------------------|-----------------------------|
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| Trading & Self-Clearing | 15 |
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| Trade Only | 5 |
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In addition to the minimum liquid capital amount, following ratios correlating with Liquid Capital have also been notified.

- a) Total liabilities including ranking liabilities should not exceed 1000% (10 times) of Liquid Capital.
- b) Total Short-term liabilities should not exceed 500% (5 times) of Liquid Capital.
- c) Total trade receivables should not exceed 200% (2 times) of Liquid Capital.

SECP is asked whether market intermediaries required to maintain records such that capital levels can be readily determined at any time. SECP has responded that Regulation 33 of the Broker Regulations specifies requirements relating to maintenance of books of accounts and other records. Regulation 33(1) provides for securities broker to keep accounting and other records, which disclose with accuracy, the financial position at that time; enable the securities broker to prepare financial statements at any time; and demonstrate whether the securities broker is maintaining in its regulated securities activity adequate financial resources to meet its business commitments.

Comprehensive and Frequent Reporting

For the purpose of risk management in relation to **custody of assets** by a broker, the "maximum custody limit" was imposed to be 25 times the prevailing capital adequacy level of a broker through amendments in the Central Depository Company of Pakistan Regulations, notified on 7 November 2014. For the purpose of smooth implementation of the regime, SECP has directed the CDC to closely monitor the assets under custody positions of all TREC holders and ensure that the TREC holders that hold custody position in excess of the allowed limit must reduce their excess positions. SECP stated that the brokerage industry is compliant with the said regime.

The Regulation 6 of the Securities Brokers (Licensing and Operations) Regulations, 2016 prescribes financial resource of a broker and require securities broker to file **monthly statements of Net Capital Balance and Liquid Capital** to the SECP and inform the SECP

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| | <p>when these fall below stipulated thresholds. Comprehensive mechanism has been prescribed for computation of monthly net capital balance and liquid capital (Schedule II and III to the Regulations) notified on 24 June 2016. SECP has noted that maintaining Net Capital Balance and Liquid Capital of brokers and filing of their statements with PSX on a monthly basis in compliance with Regulation 6(4) of the Broker Regulations is regularly monitored and action is being taken for any non-compliance. Net Capital Balance and Liquid Capital reports are being submitted to PSX which disseminates the same to the SECP.</p> <p>Further, the Code of Corporate Governance for Brokers prescribed at Annexure D of the Securities Brokers (Licensing and Operations) Regulations, 2016, require all securities brokers to prepare and circulate an Annual Report to the Commission and the securities exchange. The Annual Report contain the following statements:</p> <ul style="list-style-type: none"> • Annual audited financial statements • Directors’ Report • Statement of compliance with this Code • Pattern of shareholding; and • A statement by the CEO that there are no transactions entered into by the broker during the year, which are fraudulent, illegal or in violation of any securities market laws. <p>SECP has noted that compliance of this requirement is monitored and any non-compliance trigger legal proceeding against the broker.</p> <p>Regulatory Measures</p> <p>SECP and PSX are asked about the specific regulatory measures that could be taken by them when periodic Net Capital Balance and Liquid Capital reviews of brokers indicate material deficiencies.</p> <p>According to Regulation 6(6) of the Securities Brokers (Licensing & Operations) Regulations, 2016, in case of any shortfall in the Net Capital Balance and/or Liquid Capital, either reported by the securities broker or identified by the securities exchange or the Commission, the securities exchange shall immediately restrict the trading facility of such securities broker and shall only allow it to close out the open position in a controlled environment.</p> <p>PSX has noted that SECP in exercise of its power has switched off the trading terminals of ten (10) brokerage houses since October 2016 to date.</p> <p>Further, SECP is asked to confirm whether it has specific authority to impose restrictions on an intermediary’s regulated business activities and more stringent capital monitoring and/or reporting requirements if an intermediary’s capital deteriorates so as to endanger its capacity to fulfil its obligations or when it falls below minimum requirements. SECP has responded that under Section 81 (4) of the Securities Act, 2015, the SECP has the powers to issue any directions or take disciplinary action (including suspension) against the intermediaries who are unable to meet their financial resources/capital requirements or are in contravention of any provisions of the Act and the rules/regulations made thereunder. Further, according to Article 70, SECP may grant a license subject to such conditions or restrictions as it considers necessary and SECP may, by written notice served on the holder of the license, amend or cancel any of the conditions or attach new conditions.</p> |
| Comments | <p>Major recommendations of the 2015 Report were revising capital requirement regulation in order to reflect the risks that the intermediaries undertake, and frequent and comprehensive reporting to the regulator in this regard. The new Securities Broker Regulations 2016 revises existing capital requirements. It categorizes brokerage firms in connection with the risks they are taking. SECP has developed a set of risk control mechanisms including capital and other prudential requirements. The new regulation has a wider coverage in relation to risks and requires frequent reporting to the regulator.</p> <p>While the system has been indeed improved, and SECP and PSX are of the view that it reveals the financial conditions of market intermediaries better, as the regulation is quite new it would be difficult to assess its effectiveness and sufficiency at this stage of</p> |

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| | implementation. |
| Revised assessment | Broadly Implemented. |
| <p>Principle 31. Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.</p> | |
| Initial findings | <p>Eligibility rules regarding brokerage companies address requirements of knowledge and experience, financial soundness (including capital requirements), ethical attitude, some fit and proper criteria (applied on the CEO and one director of the board) and conflicts of interest. CDC participation requirements and NCCPL membership requirements complement the technical requirements for brokers. However, as noted in Principle 29, current rules are more focused on brokers as natural persons and do not provide enough specific criteria (requirements for organizational structures, risk management systems, supervisory systems, written policies and procedures, etc.) regarding the brokerage companies. KSE Rules are further developed in this regard, however these rules only apply to the KSE TREC holder</p> <p>The regulation does not explicitly mention:</p> <ul style="list-style-type: none"> • the requirements related to appropriate management, organizational structure, and outsourced activities; • the requirement for adequate internal controls (except for the new KSE regulation, which applies only to KSE members); • that management of a market intermediary should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct; • requirements for brokers concerning segregation of key duties and functions, particularly those duties and functions which, when performed by the same individual, give rise to conflicts of interest. <p>Further, there is no requirement for brokers to be subject to an objective evaluation of its internal controls through an internal audit function. Internal audit is an ongoing controlling process, whereas the system audit generally occurs once in two years; it is also very limited in scope as are the SECP’s on-site inspections and off-site surveillance tools. In these circumstances it is important for the brokers to have a strong internal audit function.</p> <p>While there are some protection measures for the assets of the clients, with regard to the money of the clients, the account at the bank is in the name of the broker, with the client’s segregation maintained in the back office of the respective broker. This raises concerns regarding the safety of clients’ money through misuse by brokers (and has resulted in losses) or competing claims of other creditors in the event of a brokers’ insolvency). In any case, in the latter case the regulatory framework does not provide for effective segregation of client money. A partial remedy might be found in a facility NCCPL has recently started offering which enables investors to keep their cash with NCCPL instead of brokers and settle their trades directly from the security/cash accounts maintained with NCCPL. This appears to eliminate the risk of misappropriation of cash for investors who choose to use the facility. It is not mandatory for brokers to use this facility.</p> <p>The regulations do not require market intermediaries to provide an efficient and effective mechanism to address investor complaints internally.</p> <p>In order to monitor compliance by market intermediaries, SECP supervises the entities however it takes a long time to supervise all the entities. SECP does not have a specific risk-based supervision program. The regulatory capacity regarding supervision (both off-site and on-site) needs to be enhanced.</p> <p>Regarding the deficiencies, SECP has stated that it will upgrade broker’ registration rules by December 2015 and the Underwriter Rules and the Credit Rating Rules by June 2015.</p> <p>Further, SECP is planning to have a system called “Global/Joint Inspection” which will be</p> |

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| | <p>developed with a view to eliminate the duplication and inefficiency created due to separate inspections conducted by each SRO. This plan aims to have a full coverage for broker inspection, by end May 2015. The plan should provide for more effective and efficient supervision of brokers; however, its application in practice will require assessment once it has been operational for a period of time.</p> |
| Initial Assessment | Partly implemented. |
| Follow-up action | <p>Segregation of Client Assets and Funds</p> <p>From 31 July 2015, SECP has implemented fortnightly reporting of client asset segregation, as required under Regulation 4.19 of Exchange Rulebook, from the Stock Exchange. The Exchange issued the necessary circular to all TREC holders from 7 August 2015. The Exchange shares the data on client asset segregation with the SECP to carry out inspection and verification of the data. Regular fortnightly meetings are held between SECP and Stock Exchange to evaluate the position of client asset segregation by the brokers and to determine the actions needed to rectify violations. Regulatory actions have been taken against non-compliant entities to ensure compliance with this requirement. Further, back office software standardization framework through formulation of criteria for software vendor accreditation has also been initiated by the Exchanges.</p> <p>The Exchanges were advised to conduct on-site verification of segregation of assets of all registered brokers. For this purpose, PSX was made to take the lead of this exercise and initiated random on-site verification of segregation of assets of registered brokers.</p> <p>The Exchanges served notice to brokers, randomly select any date for segregation data, gather information (CDC record, back office record, bank record) and analyze the same. In case of discrepancies, a re-verification date was announced to resolve the segregation issues. The SECP, during this exercise, conducted regular meetings with exchanges to keep a check on the progress and the issues relating to segregation.</p> <p>Furthermore, under Regulation 5 of the Securities Brokers (Licensing and Operations) Regulations, 2016 custody of client assets is allowed only to clearing members having stringent requirement to maintain higher thresholds of paid up and liquid capital and frequent reporting to exchange and SECP.</p> <p>In addition, for compliance of segregation clause of the Rule Book, the Cash Management System has been modified and implemented by the PSX, whereby all brokerage houses have to segregate cash margins according to their client's deposits. The revised system has been implemented since 29 February 2016.</p> <p>PSX takes necessary enforcement action against those brokers who are found non-compliant with the requirement of client asset segregation.</p> <p>Also, for enhanced investors' protection, shifting clients' assets custody from brokers to third party custodians is being introduced.</p> <p>SECP is specifically asked about how the system works after the introduction of the new system where there are three types of brokerage houses and two of those types can keep custody of customers' securities. Further, the NCCPL and CDC can also provide custody services. SECP has referred Regulation 25(3) of the Broker Regulations. Said Regulation requires a securities broker licensed under Trading and Self-Clearing category or Trading and Clearing category shall maintain separate sub-accounts under its participant account in the CDS for each of its customers, to maintain the custody of all securities belonging to the customer. Accordingly, custody is maintained in the CDS under the Participant umbrella of those securities brokers that are licensed to keep custody of customers' securities. Such brokers maintain their own securities in respective house account, whereas client securities are kept in the separate sub-accounts in the name of each client.</p> <p>As regards winding-up/bankruptcy, Section 148 of the Securities Act, 2015 provides that a licensed person shall not file a petition for winding up unless it satisfies the Commission that it has settled all outstanding investors' claims as per default regulations and obtained prior approval of the Commission. The Commission may in interest of the public or interest of investors, impose such further conditions as it deems appropriate. The section further provides that the Court may refuse to entertain petition for winding up of a company if the</p> |

Court is satisfied that the above requirements have not been fulfilled.

SECP has further commented that, the new measures have helped in identification of customer assets for recovery in event of default. After the promulgation of new regulatory regime of securities brokers, three default cases of brokerage firms have been recorded, where PSX has invited and registered claims of investors. PSX will initiate the transfer of customers' funds and securities and the return of client assets once the default management procedure is completed.

On the other hand, National Custodial Services (NCS) and Direct Settlement Services (DSS) being provided by the NCCPL and the CDC respectively are designed to provide clearing and custody services to those investors who pre-fund their trades, trade less frequently and choose to maintain custody of assets independent from brokers. In both these services, an investor is required to execute trade through a broker while pre-funding the same at NCCPL/CDC level. After execution of trade, the broker initiates such trade to NCCPL/CDC for shifting of his clearing and settlement obligations towards clearing house. Upon affirmation by NCCPL/CDC, the executing broker is absolved from clearing and settlement obligations and the same are taken up by NCCPL/CDC being service provider. SECP has further noted that due to this pre-funded operational model, a very limited number of trades are being carried out through these services and so far only 330 DSS accounts and 112 NCS accounts have been opened and the majority of the investors choose to maintain custody of their assets with the brokers.

Regarding the clients' funds, Section 78(3) of the Central Depositories Act, 1997 requires SECP to make regulations in relation to segregation of customer money to be paid into segregated bank accounts to be established for customer money and designated as trust accounts or customer accounts. It further requires that regulations be framed with respect to opening, control and keeping of bank accounts, specifying when and how customer money is to be paid into such accounts, dealt with, and accounted for, in the prescribed manner. Accordingly, Regulation 23 of the Broker Regulations dealing with segregation of customer money caters to these areas. Regulation 23 stipulates that customer money shall not form part of the assets of the securities broker for any purpose and shall not be available in any circumstances for payment of any debt or liability of the securities broker.

PSX has further confirmed that Clients' Assets Segregation ensures that the Brokers maintain assets (Cash and Securities) belonging to House and customers separately. The Broker are required to maintain separate bank account for funds belonging to their customers. It is also required that the title of Bank Account for clients' funds include the word 'Client'. PSX ensures that the said segregation is maintained by way of reporting of Client Assets Segregation Statements (CASS) by the Brokers on fortnightly basis and CASS is also required to be audited annually by statutory auditors of the Brokerage Houses. In addition, PSX has further noted that they ensure protection of clients' funds through System Audit, Joint Inspection and On-site Inspections. The abovementioned inspections include procedures for verification of Segregation of Clients' Assets. The Exchange has conducted On-site verification of 134 Brokerage Houses and appropriate enforcement actions against non-compliant Brokers has been taken have been taken which include seeking clarification, issuance of Advice /Warning, Penalty and/or restriction(s) at times.

CDC has noted that it was introduced as reform measure whereby the settlement is now possible at client level and the system automatically picks and drop securities in case of sell and buy transactions of the sub-account holders. CDC comments that this leads to more transparency and reduced misappropriation of clients' assets. Previously such settlements were made from the main account of the Participant, manually where chances of misappropriation, error was said to be high. CDC has provided information regarding various additional protection measures such as introduction of standardized sub-account opening form, introduction of Reason Codes regime, circularization of account balance statement to clients and sub-account holders, introduction of investor account service, effective monitoring of pledge transactions, etc.

CDC further comments that in case of insolvency of Securities Broker/ Participant, there is no impact on the right of ownership of securities in sub-accounts. At present, there are various Participants restricted/suspended/terminated by CDC, however sub-account holders can have control over securities held in their respective account by requesting movement of

securities through Portfolio Transfer. CDC facilitates movement of securities by way of Portfolio Transfer upon written request of concerned sub-account holders accordingly and normally it may take between 7–15 days for transfers subject to No Objection Certificates received from the Participant/Stock Exchange.

Eligibility Rules for Market Intermediaries

The Securities Brokers (Licensing and Operations) Regulations, 2016, notified on 24 June 2016, cover enhancements in the requirements for brokers at the time of registration (Chapter 2), governance structure, internal control (Regulation 16(8) and (9)), risk management (Regulations 8(4)(d); major shareholder (Regulation 4) and compliance (Chapter 3). Further, the brokers can only operate if established as a corporate legal entity.

The Public Offering Regulations, 2017 and the Public Offering (Regulated Securities Activities Licensing) Regulations, 2017 have been notified on 2 May 2017 which provide requirements for underwriters. In terms of the Regulations, the following are eligible to be licensed as an underwriter:

- i. Scheduled bank
- ii. DFI
- iii. Housing finance company
- iv. Investment finance company
- v. Leasing company
- vi. Licensed Broker

The relevant clauses of the Public Offering Regulations, 2017 which cover requirements include Regulation 17, general responsibilities of the consultant to the issue, book runner and underwriter (Chapter IX), Clause 17 (7), (8), (9), (11) and (16).

Regulation 22 describes the responsibilities of underwriter and Schedule 9, Part III includes underwriting arrangement, commissions, brokerage and other expenses. The requirements for management and organizational structure of an underwriter have been catered for in the principal laws of eligible entities (i.e. (i) and (ii), the banking companies law, NBFC Regulations for (iii), (iv) and (v) and the Securities Act for (vi)).

In case of Securities Advisers, the Securities and Future Advisers (Licensing & Operations) Regulations, 2017 notified on 21 April 2017 available at:

<https://www.secp.gov.pk/laws/regulations/> cover requirements for securities advisers including licensing requirements for securities and future advisers (Chapter II regulation and licensing conditions); conduct of securities and futures advisers (Chapter III); other requirements including restriction on keeping custody of customers' assets (Regulation 17) and general responsibility (Regulation 18, Chapter IV); and accounting and audit (Chapter V).

On 11 January 2016, the three stock exchanges were integrated into a single unified trading platform, the PSX. Accordingly, the brokerage houses have revamped their systems in line with the single national exchange. (As covered in Principle 29).

SECP has noted that, integration of the stock exchanges has provided numerous benefits in terms of reducing fragmentation, enhancing competition in terms of best price discovery and order execution, increasing efficiency, improving governance standards, synergies, economies of scale, and has played a crucial role in attracting strategic partners and international investors. For brokers, integration enabled brokers of the former Lahore Stock Exchange (LSE) and Islamabad Stock Exchange (ISE) become TRE Certificate Holders of the surviving entity (i.e. Pakistan Stock Exchange Limited) and have direct access to a much larger pool of liquidity and benefits of not requiring a third party to execute trades on their behalf as was the case in the pre-integration scenario where LSE and ISE brokers intending to trade on a more liquid platform had to route their trades through Karachi Stock Exchange (KSE) brokers and incurred additional costs in the process. Integration of stock exchanges has thus also led to reduced costs for brokers, consolidation of the order book and improved risk management as each broker itself enters trades directly to a central platform. Brokers of the less liquid LSE and ISE have also automatically had to raise their service and compliance standards to comply with the more robust regulatory and supervisory environment of the

integrated exchange.

Improving SECP's Supervision Function

SECP has stated that supervision function has been greatly enhanced through introduction of Securities Brokers (Licensing and Operations) Regulations, 2016, and practices. The new measures include reporting of Net Capital Balance and Liquid Capital introduced through new broker's regime, implemented on 24 June 2016 (covered in detail in Principle 30)

- Risk based supervision (on-site/off-site inspections) have been introduced as discussed in Principle 12 above.
- To increase the effectiveness of the surveillance function, the staff strength has increased from 27 (Dec 2015) to 43 (May 2017).
- From 4 June 2015, filing of quarterly reports from brokers through SECP's online Financial Reporting System (FRS) has been implemented.

Further, requirements for periodic reporting have also been enhanced through fortnightly reporting of client asset segregation.

SECP further notes that Joint Inspection Regulations are in force and the system has been working effectively. (For details see Principle 12)

Internal Audit Function

Regulation 16 (9) (e) of the Securities Brokers (Licensing and Operations) Regulations, 2016, notified on 24 June 2016 requires that all brokerage houses have to have effective and operationally independent internal audit function. To ensure compliance of this requirement, SECP has planned to undertake a thematic review during 2017.

Guidelines for Addressing Conflicts of Interest

The conflict of interest by market participants has been specifically addressed in the Securities Act, 2015, notified on 18 May 2015.

Section 7: Regulations of securities exchange:

- (1) The regulations of a securities exchange, may make provision
 - (c) with respect to the risk management procedures, misalignment of incentives and conflict of interest between securities broker, its employees and its clients;

Regulation 14: Conflict of Interest, of the Securities Brokers (Licensing and Operations) Regulations 2016, notified on 24 June 2016, prescribes comprehensive provisions and procedures to be adopted by securities brokers for catering to conflict of interest.

Addressing Investor Complaints

SECP on 1 June 2017 launched a new Service Desk Management System (SDMS) for lodging complaints through its website <http://sdms.secp.gov.pk/>.

The new system available to users in both English and Urdu, offers ease of use to the public for filing queries and complaints with SECP. It ensures prompt action and regular updates on handling of complaints.

The SECP has already made available its new toll-free facility 0800-880-08 to the public where anyone can call, free of cost, for grievance redress and investor education. The SECP's toll free facility is integrated with the new and technologically superior SDMS to give the user a convenient query and complaint filing experience.

To facilitate the complainant, the system provides links to important frequently asked questions (FAQs) and SECP. System users can now easily file queries and complaints or check status of a previously lodged concern. The system provides prompt and regular notifications through SMS and email to the users each time progress takes place on their concern.

To ensure timely action and more convenience to system users, the system has auto escalation features which, ensure that the SECP's senior management gets automatic updates

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| | <p>and detailed reports regarding the performance of their issue handling officers. Detailed dashboards and sophisticated reporting also allows for SECP to better analyze complaint trends, develop better monitoring strategy and develop better guidance material based on the nature of complaints and queries being filed by the users. The new system is expected to enhance investor awareness and, in particular, investors’ complaint resolution.</p> <p>SECP as part of its investor education and awareness campaign, create awareness among investors on process of filing complaints to the exchanges and the SECP itself. Requisite information is also available on the web portal “JamaPunji” (https://jamapunji.pk/protect-yourself/complaints) and also covered under investor awareness media campaigns run by SECP in collaboration with SROs (https://jamapunji.pk/news).</p> <p>The Securities Brokers Regulations provide specific provisions in the context of complaints mechanism and require brokers to implement internal procedures to ensure proper handling of customer complaints (Regulation 27: Customer Complaints).</p> <p>Providing Statement of Account to Clients</p> <p>Necessary amendments were approved and implemented for KSE, LSE & ISE, in June-July 2015, making it mandatory for brokers to furnish quarterly statement of account to clients. The same are also accordingly applicable for PSX.</p> <p>Revised Exchange Rulebook is available at PSX website at the following link: https://www.psx.com.pk/</p> <p>Centralized KYC (Know-Your-Customer) Organization</p> <p>SECP has provided information on a new CYC Organization. Rules providing for establishment and operationalization of Centralized KYC Organization (CKO) have been promulgated and the entity will become operational in the last quarter of the calendar year 2017. The information of the nominee shall be available in the Customer Relationship Form which shall be provided to the broker at the time of account opening. In relation to beneficiaries, since brokers can no longer open omnibus or group accounts, each customer holds his securities in his own name. Hence, KYC information of each customer of a broker shall be available with the CKO. In the case of collective investment schemes, each unit holder shall also be subject to the said regime. CKO will provide a centralized system for maintaining separate and exclusive database for the KYC information of clients maintaining accounts with market intermediaries. CKO shall assist in avoiding duplication of procedures performed at the time of opening accounts with different market intermediaries, while ensuring that the KYC data used by these intermediaries is verified, well maintained and centralized.</p> <p>The designated market intermediaries will be required to register with CKO and will perform the initial KYC including the in-person verification of the clients and upload the details on the KYC information system to be developed by CKO. CKO will ensure authenticity and completeness of the information of the clients submitted by authorized intermediary and will also issue an acknowledgment letter to the correspondence address of the clients.</p> <p>In order to perform complete verification, the CKO shall obtain requisite customer information from National Database and Registration Authority (NADRA) and also enter into arrangements with mobile service providers to verify the cell phone numbers of customers. In case within the prescribed time no confirmation is received from the clients, CKO will block their registration and they will not be allowed to trade further. As a result, once the client has undergone KYC process with an authorized Intermediary, such client will need not undergo the same process again with another intermediary and will only have to provide a written authorization for registering with the subject intermediary.</p> |
| Comments | <p>With the introduction of the new regime, there has been various and comprehensive improvements. The new Securities Broker Regulations 2016 addresses most of the recommendations of the 2015 Report regarding segregation and protection of client funds, organizational and managerial requirements for brokers, internal control requirements, dealing with customer complaints internally, compliance, major shareholders, frequent reporting to customers and regulator, conflicts of interest, etc. Further, another important</p> |

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| | <p>improvement that should be mentioned is that the SECP has developed a system of controlling the client asset segregation. SECP has been putting efforts on preventive measures and ensuring the verification of the data.</p> <p>Inspection Plans and Risk Factor basis formula is introduced which is an improvement in supervision and inspection function of the SECP. Reporting of client asset segregation is a complement to off-site supervision and additional enforcement actions have been taken by the SECP as well as PSX and CDC. With regards to the Joint Inspection team, it is expected to further complement the system.</p> <p>CDC rules on protection of client assets, new centralized KYC Organization, mechanisms to address investor complaints are further positive developments.</p> <p>On the other hand, as the regulation and measures that have been taken are quite new, it would require time to assess its effectiveness at this stage.</p> |
| Revised assessment | Broadly Implemented. |
| Principle 32. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investor and contain systemic risk. | |
| Initial findings | <p>The default management regulations of all the three stock exchanges and the Pakistan Mercantile Exchange Limited (PMEX) set out procedures in case of a settlement default of the broker, including restraining conduct and dealing with the assets and liabilities of the defaulter. On the other hand, there is no specific plan or scenario analysis in order to deal with failures other than settlement default or failures of large conglomerates.</p> <p>With regard to early warnings, SECP interprets early warning signals of a possible default through System Audit Reports, investor complaints, NCB certificates, CDC inspections, delivery defaults, etc. However, enhanced off-site periodic reporting is essential in order to be preventive and to enable necessary action to be taken before a default occurs. SECP does not receive off-site periodic reports other than the NCB report. Further, the NCB reporting period and the coverage of the report does not give sufficient information regarding the financial risks that the intermediary carries. Therefore, once an audit/inspection is done in a single firm by the SECP or the Exchanges (via System Audits), it would take some time until the conduct of a new inspection. In the meantime, SECP receives semi-annual certified NCB reports which are actually a certification of the capital (as a number), but not a detailed risk-based capital report. Weekly NCB reports that the brokers submit to the exchanges are also not detailed or risk-based but include only a submission of the capital (as a number). As is noted in Principles 30 and 31, ongoing surveillance tools including periodic reporting in some critical areas need to be identified and improved capital adequacy reporting (including an obligation to report when a broker's capital declines to within a SECP defined percentage (e.g. 120%) of its minimum capital requirement imposed. These will serve as early warning signals of a potential default.</p> <p>SECP and the Exchanges have the authority to restrain conduct and take necessary steps in order to protect investors, in case of a default of the broker. Further, there are additional measures such as Insurance Schemes and Guarantee Funds to minimize the loss in case of a default.</p> |
| Initial Assessment | Partly Implemented |
| Follow-up action | <p>Plans for Failures of Brokers and Default Management Regulations of PSX and NCCPL</p> <p>PSX</p> <p>PSX has a default management regulation (Chapter 21 of PSX Rule Book). When a Broker has been declared as Defaulter by the Board, the Exchange shall at once forfeit/cancel his TRE Certificate and such Broker shall cease to be a TRE Certificate Holder of the Exchange. All the assets of such Broker under the control of the Exchange including his Base Minimum Capital shall be utilized by the Default Committee in accordance with the requirements of</p> |

Chapter 21.

To expedite the process of satisfaction of claims lodged with PSX against Defaulter Brokers and providing relief to investors, the Board of Director of PSX in its meeting held on 14 July 2016 empowered the Managing Director thereof for constitution of Committees to handle matter pertaining to verification and satisfaction of claims lodged with PSX against Defaulter Brokers.

Furthermore, the following developments have been made after the initial assessment in 2015:

- The Customer Compensation Fund (Establishment & Operation) Rules, 2017 and Centralized Customer Protection Compensation Fund Regulations, 2017 have been framed by the SECP and notified in the official Gazette on 28 April 2017.
- These legislations provide the governing framework for establishment and operation of the fund which is to be utilized for settling investor claims of securities brokers which are declared defaulter by PSX.
- PSX regulations and the trust deed relating to the customer compensation fund are being revised to bring them in line with the said legislations.
- Under the draft default management framework, assets of securities brokers available as base minimum capital would be exclusively utilized for settling investor claims. For any unsettled claims, relevant amount shall be disbursed from the customer compensation fund.
- Size of the customer compensation fund has been enhanced to approx. Rs.2.8 billion from under Rs.1 billion to provide adequate cushion to investors.
- The fund has been made completely independent from the exchange and operates in the form of a trust.

NCCPL

There have been significant improvements in the default management system, after the promulgation of the Securities Act, 2015 and the Clearing House (Licensing and Operations) Regulations, 2016, the major highlights are given by the NCCPL below:

1. The NCCPL has assumed the role of a Central Counterparty whereby it guarantees settlement of eligible trades through Novation (Clause 3.16 of Chapter 3 of the NCCPL Regulations, 2015).
2. The risk management function for securities brokers performed by PSX has been shifted to NCCPL with effect from May 2016.
3. In order to efficiently discharge its role as a Central Counterparty, NCCPL has established a Settlement Guarantee Fund after carrying out a thorough study to determine the appropriate size of the Settlement Guarantee Fund (SGF) through an independent actuary firm (Chapter 29 of the NCCPL Regulations, 2015 governing the establishment, contribution, utilization and replenishment of the SGF).
4. The concept of a default waterfall has been introduced in the default management procedures that clearly indicate the process flow and utilization of resources to manage the default. The NCCPL shall utilize the security deposits paid by the securities broker to NCCPL under applicable provisions of the NCCPL Regulations, 2015, cash margins deposited by the defaulting clearing member and settlement guarantee fund to ensure timely settlement of money obligation. The NCCPL under the default waterfall is also eligible to utilize any insurance coverage and bank financing, subject to its availability, to manage a default. NCCPL has noted that during the current year there was only one instances where the securities broker failed to settle the money obligation during the settlement date, however, due to effective default management the settlement was carried out seamlessly and full amount was recovered through the process in accordance with the provisions contained under the NCCPL Regulations, 2015 (Clause 13.2 of Chapter 13 of the NCCPL Regulations, 2015).
5. There is a requirement to prepare a detailed report on completion of default

proceedings. This report is required to be submitted to the Commission, securities exchange, central depository and the defaulter to whom the report relates (Section 39 of the Securities Act, 2015).

6. Various provisions have been included in the statutory framework to provide firm and clear resources and options to the clearing house, a brief overview of these provisions stipulated under the Securities Act, 2015 is given below:
 - a. Certain provisions of the company's law have been made inapplicable in case of market contract, market charge and default proceedings pertaining to disclaiming of property, recession of contracts, etc. (Section 41 of the Securities Act, 2015).
 - b. A property that has been provided as market collateral shall not be liable to execution or legal process for the enforcement of a judgment, etc. with the consent of the clearing house. (Section 42 of the Securities Act, 2015).
 - c. A clearing member has been made party to the contract as a principal whereby it is liable to make payment or delivery to the clearing house (Section 43 of the Securities Act, 2015).
 - d. No action, claim or demand in respect of right, title or interest held by any person against a property deposited with the clearing house as market collateral, shall be commenced or allowed against the clearing house (Section 44 of the Securities Act, 2015).

NCCPL has noted that these provisions will ensure that the default proceedings to recover the defaulted amount are carried out expeditiously without any legal hindrance.

Further, under the new Companies Act, 2017, Section 244(12) the bank account maintained for unclaimed/unpaid dividends and proceeds from sale of shares or Modaraba certificates, shall serve as collateral in order to facilitate the provision of credit facility to NCCPL upon the direction of the Minister-in-Charge. In order to address any systemic risk in the capital market, this would enhance the resources available to NCCPL which could be used against brokers' settlement defaults. The powers under this sub-section shall be exercised only in case where in opinion of the Commission the resources of the clearing house are or likely to be insufficient for timely settlement of trades executed at the securities and future exchanges.

NCCPL is also in touch with the banks to obtain credit line to support SGF:

7. Various governance related measures have also been implemented that may not be considered specifically in relation to default management, however, they add significant value towards the efficiency and transparency of the risk management process and default management mechanism:
 - a. Requirement to determine the optimal capital level for the clearing house through an independent expert on the basis of the current and projected risk associated with clearing house operations (Clause 6 of the Regulations)
 - b. Requirement to have independent directors not less than one third of total directors (Clause 9(2) of the Regulations)
 - c. Requirement to appoint Chief Regulatory Officer (Clause 11(1) of the Regulations)
 - d. Requirement to constitute Risk Committee (Clause 12 of the Regulations)
 - e. Requirement to appoint Chief Risk Officer (Clause 13 of the Regulations)

NCCPL has noted that all the above stipulated requirements have duly been complied by the NCCPL.

Plans for Failures Other than Settlement Default and Failures of Large Conglomerates

SECP states that MOU for the purposes of cooperation and information sharing regarding risk management, minimizing adverse effects of market disruptions, large exposures and investigations of violations has been signed between PSX, CDC and NCCPL on 31 December 2015.

Further, a committee of CEOs of CDC, NCCPL and PSX has also been constituted which meets regularly to enhance collaboration and improved coordination on common matters.

The Committee met five times during 2016 and schedules its meeting as and when needed. As also stated in Principle 29 and 31, the Securities Brokers (Licensing and Operations) Regulations, 2016, notified on 24 June 2016 require securities broker to file monthly statements of net capital balance and liquid capital to the SECP and inform the SECP when these fall below stipulated thresholds. SECP notes that this acts as an early warning sign to deal with failures other than settlement default or failures of large conglomerates.

Further, regarding Principle 6 on Systemic Risk issues, SECP reports that they have established a Risk Management department to strengthen risk governance structures across all the regulated functions, monitor firms, products, and micro- and macro-economic conditions, and propose pre-emptive actions for stability of the capital market. Further, a cross-departmental risk committee has also been established. In addition, SECP has noted that they have adopted/developed mechanisms for identification of systemic risk to address systemic threats in Pakistan's securities market that may emanate from the clearing house (Risk Register, Investor-Level Risk Profiling System, Stress Testing, and Financial Reporting). Relevant information is obtained from the infrastructure entities including the exchange, clearinghouse, central depository, MUFAP and information published in media and reports of independent research analysts and indicators are regularly analyzed. SECP has noted that a multi-layered risk governance structure has been put into place within SECP as well as at different market entities particularly the clearinghouse. (For further details see Principle 6)

Ongoing Surveillance Tools (Early Warning Systems)

From 4 June 2015, filing of quarterly reports from brokers through SECP's online Financial Reporting System (FRS) encompassing net capital balance, balance sheet and related annexures has been implemented to assess the financial health of the brokerage house along with its regulatory compliance level. The financial information provided in these returns is also used to calculate risk-based ratios and generate alerts regarding regulatory non-compliance.

The provision for the conduct of on-site visits of a brokerage house to verify the company information and assess the application as well as the availability of necessary infrastructure either by SECP or the exchange, at the time of initial registration and subsequent renewal has been included as standard practice through SECP directive dated 30 December 2015. (Also covered in Principle 29)

Furthermore, in relation to custody of assets of by a broker, the "maximum custody limit" has been revised to 25 times the prevailing capital adequacy level of a broker through amendments in the Central Depository Company of Pakistan Regulations, notified on 7 November 2014. For the purpose of smooth implementation of the regime, SECP has directed the CDC to closely monitor the assets under custody positions of all TREC holders and ensure that the TREC holders that hold custody position in excess of the allowed limit must reduce their excess positions. SECP notes that the brokerage industry is largely compliant with the said regime with the exception of only eight brokerage houses. The Securities Brokers (Licensing and Operations) Regulations, 2016, notified on 24 June 2016 require securities broker to file monthly statements of net capital balance and liquid capital to the SECP and inform the SECP when these fall below stipulated thresholds.

Inspection plan 2016-17 approved by the Commission covered 30 brokers. So far 16 inspections and 14 investigations have been carried out by SECP in this regard.

Customer Compensation Regulations

The Customer Compensation Fund (Establishment & Operation) Rules, 2017 and Centralized Customer Protection Compensation Fund Regulations, 2017 notified in the official Gazette on 28 April 2017 took effect from date of said notification:

- The fund has been made completely independent from the exchange and operates in the form of a trust.
- The trustees to be appointed by the securities exchange are required to be fit and proper persons approved by the Commission.

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| | <ul style="list-style-type: none"> • The legislation includes specific clauses requiring the exchange to determine minimum size of the fund on periodic basis by engaging independent expert for the same. • The scope of contributions to the fund has been expanded under which exchange is required to contribute proportion of its revenue to the fund and also deposit any penalties, fines, etc. collected therein. • Further, the trustees have been required to ensure that an investment policy is made for the fund with the approval of the exchange. • In the event of dissolution of the fund or winding up of the exchange, assets of the fund can only be transferred to another fund established for the purpose of protection of customers as per the directions of the Commission. • It has also been made mandatory for the trustees to submit annual accounts of the fund to the Commission. • Assets of the fund cannot be transferred to any person other than as explicitly permitted under the legislation. • The exchange has been required to disclose at its official website and in its annual report a summary showing opening balance, contributions made to the fund, utilization of fund and closing balance. <p>(See also Principle 31 “Segregation of Client Funds” for issues regarding client assets in the event of a firms’ failure)</p> |
| Comments | <p>There are important improvements in relation to various areas such as cooperation arrangements between PSX, CDC, NCCPL, developing early warning signals of a possible default of Market Intermediaries, developing ongoing surveillance tools, improving the application of on-site visits to brokerage houses, developing a centralized fund to compensate investors in case of broker defaults, new reporting system regarding client asset segregation.</p> <p>While, there are several improvements especially with regard to client asset protection, the regulation and the introduced system for the brokerage industry is quite new. The regulator (and self-regulators) has been dealing with three default cases in the last couple of months and the processes of investors’ compensation are still ongoing. Effectiveness and practical ability of the new systems would require time and it would be early to assess this at this stage of implementation.</p> <p>Please also refer to Principle 12 for effective surveillance and regulatory powers and Principle 6 for systemic risk issues.</p> |
| Revised assessment | Partly Implemented. |

IV. THE RESPONSE OF THE AUTHORITIES.

The SECP welcomes the opportunity of being the first jurisdiction undergoing follow up review by the IOSCO Assessment Committee and contributing to achieve the AC’s objective of standards implementation. We appreciate the 2015 AC Review of Pakistan, which provided us with an opportunity to comprehensively review our regulatory and supervisory framework and vigorously pursue an action plan to address the areas, identified for improvement in the Review. SECP being firmly committed to implement Review recommendations made significant reforms in Pakistan’s legal, regulatory and supervisory architecture, endorsing our pledge to bring Pakistan’s markets in line with international standards.

The SECP appreciates the IOSCO's view that Pakistan has made important efforts since 2015 to adopt legislative changes recommended by IOSCO. We are encouraged with the RT comments on various measures taken by SECP for implementing the recommendations on Principles 16, 17, 29, 30 and 31. SECP really appreciates the RT views on implementation of recommendations on Principle 15 stating, "*the evidence concerning this Principle is exceptional*" and on Principle 12 stating, "*The designation of Courts to expedite and hear securities matters is a considerable achievement and should be hailed as a model for other jurisdictions that suffer delays in their Courts*". SECP broadly agrees with the findings of the report.

The SECP appreciates the significant time and effort the RT dedicated to complete the follow-up assessment, as well as their thoroughness and professionalism in assessing our system against the IOSCO Principles. We believe that our graduation in 10 assessed Principles under this follow-up Review could not have been achieved without the RT's continuous support and guidance. We appreciate your commitment, time and effort dedicated to this Review since 2014. SECP while remaining committed to develop and implement reform initiatives consistent with IOSCO standards, will carefully consider the findings of this follow-up Review and give due consideration to their effective implementation. We would also like to take this opportunity to comment on some specific recommendations as set out in the ensuing paragraphs.

1. Contribute to the Process to monitor, mitigate and manage systemic risk (Principle 6)

The SECP notes the assessors' finding that the measures taken by SECP to meet the requirements of Principle 6 are relatively new, however, their effectiveness is evident from the following:

- (i) Investor level risk profiling has been completed and stress testing results are being analyzed on daily basis to evaluate systemic risk.
- (ii) Risk governance structures at the SROs and the SECP are fully installed and functional. There is a permanent CRO and fully functional risk committee of the clearinghouse convening regular meetings. Similarly, the risk governance structure at SECP is completely operative with a risk department and a high powered risk committee.

SECP considers that the risk governance structure has started yielding results as the quality of collateral was materially enhanced, and directives on liquidity management of AMCs were issued during the period under review in order to strengthen safeguards against systemic risk. The above merit consideration for a better assessment rating.

2. Use of inspection, investigation, surveillance and enforcement power and implementation of an effective compliance program (Principle 12)

We understand that designation of courts to expedite securities related matters will take some time to yield results (just to update that Federal Government has also notified special court in Karachi). However, the measures such as regular annual inspections of PSX, PMEX, NCCPL and CDC by SECP, and inspection of intermediaries/brokers under the joint inspection regime are in place since 2015 and SECP's commitment to continue this in future render appropriate upgrade in assessment rating.

3. Hedge Fund Regulation (Principle 28)

SECP agree that the hedge fund business does not actually exist in Pakistan and the assessment of Not Applicable is correct. However, any fund if offered to eligible investors to invest in financial assets including derivatives will be classified as “Alternate Fund” under the Private Fund Regulations of 2015.

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