Changing Market Structures:

The Need and Impact of Moving from Mutualized to Demutualized Structure of Stock Exchanges in Pakistan

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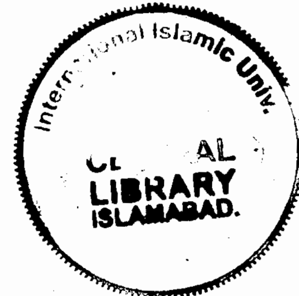

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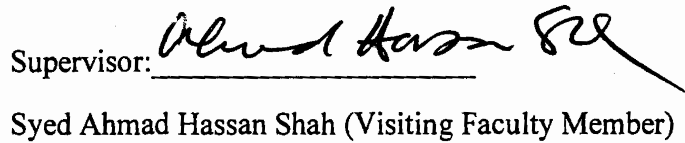
APROVAL SHEET

It is certified that I have read the thesis submitted by Ikram Ul Haque Qureshi entitled *Changing Market Structures: The Need and Impact of Moving from Mutualized to Demutualized Structure of Stock Exchanges in Pakistan* as a partial fulfillment for the award of the degree of LLM (Corporate Laws). We have evaluated the thesis and found it up to the requirement in its scope and quality for the award of the degree.



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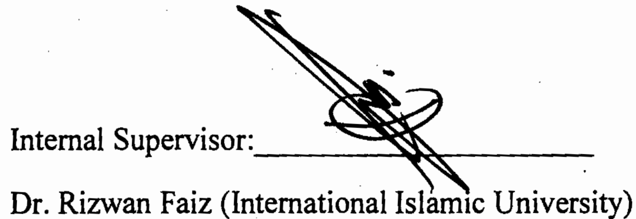

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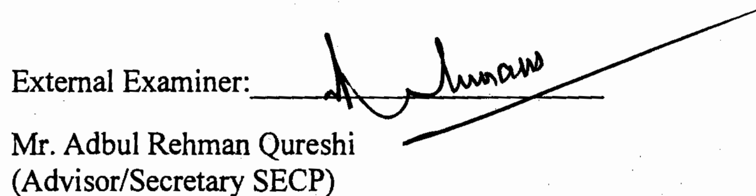

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Dedication

This thesis is dedicated to my parents and family members who always believed, encouraged and supported me during my studies.

List of Abbreviations

ASX	Australian Stock Exchange
ASIC	Australian Securities and Investment Commission
BCP	Business Continuity Plan
CDC	Central Depository Company
CFS	Continuous Funding System
CLA	Corporate Law Authority
GDP	Gross Domestic Product
DRS	Disaster Recovery Site
ETF	Exchange Traded Funds
ISE	Islamabad Stock Exchange
IPO	Initial Public Offering
KSE	Karachi Stock Exchange
LSE	Lahore Stock Exchange
NCCPL	National Clearing Company of Pakistan
NCSS	National Clearing and Settlement System
NIT	National Investment Trust
NYMEX	New York Mercantile Exchange
NYSE	New York Stock Exchange
RMR	Risk Management Regime
SRO	Self Regulatory Organizations

List of Abbreviations

STP	Straight-Through-Processing
SECP	Securities and Exchange Commission of Pakistan
TSX	*Toronto Stock Exchange*
TFC	Term Financing Certificate
WFE	World Federation of Exchanges

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Abstract

Demutualization has generally involved conversion of an exchange from a not-for-profit member owned organization to a for-profit shareholder owned corporation. Before we discuss the differences between the organizational structure of demutualized and non-demutualized stock exchanges, it is important to note that within each organizational structure there have been, and continue to be, significant variation in organization, operation, and regulation. Some of these differences relate to the role and powers of the exchange's board of directors, the chair of the board of directors, the officers, the powers of the chief executive officer, and the various committees and sub-committees. Further differences relate to the manner in which external bodies and public interest representatives have been able to influence the policies of the exchange. Also, the legal and regulatory frameworks vary considerably, as does the degree of oversight of each exchange by government or their designated regulatory authorities. As a result, the specific circumstances of demutualization, the potential issues and regulatory responses to such issues will require a careful context specific analysis. However, an examination of the demutualization process highlights a number of common themes.

In this research we will analyze different aspects of demutualization of stock exchanges which will include the evolution of exchange business from an informal forum to a formal forum, from a less regulated towards a regulated entity, from a mutualized form of business to a demutualized form. Overview of the stock exchanges in Pakistan, current issues and concerns in the Stock exchange functioning, international perspective and

trends in stock markets and finally towards the need for a demutualized exchange in Pakistan based on international practice and lessons with respect to mutualized and demutualized exchange and we will discuss several issues relating to the regulation of a demutualized exchange.

Chapter 1 gives an overall framework of the stock markets of Pakistan. Chapter 2 highlights the current problems in the stock exchanges in Pakistan. Chapter 3 covers the international perspective with respect to move from mutualization to demutualization. Chapter 4 presents on the basis of international experience and practice demutualization for the existing stock exchanges in Pakistan dicusses in length the benefits and regulatory issues post-demutualization.

Introduction

"Capital markets play a vital role in fostering sustainable capital formation by channeling the savings of an economy into investments. This facilitates the financing of various activities and helps to increase national output and economic expansion. In this process, stock exchanges play a significant role by creating an organized market where issuers and investors are brought together. In the last twenty years stock exchanges have undergone several radical transformations. One such transformation is the demutualization of stock exchanges.

Demutualization has generally involved conversion of an exchange from a not-for-profit member owned organization to a for-profit shareholder owned corporation. Before we discuss the differences between the organizational structure of demutualized and non-demutualized stock exchanges, it is important to note that within each organizational structure there have been, and continue to be, significant variation in organization, operation, and regulation. Some of these differences relate to the role and powers of the exchange's board of directors, the chair of the board of directors, the officers, the powers of the chief executive officer, and the various committees and sub-committees. Further differences relate to the manner in which external bodies and public interest representatives have been able to influence the policies of the exchange. Also, the legal and regulatory frameworks vary considerably, as does the degree of oversight of each exchange by government or their designated regulatory authorities. As a result, the specific circumstances of demutualization, the potential issues and regulatory responses

to such issues will require a careful context specific analysis. However, an examination of the demutualization process highlights a number of common themes"[1]

In this research we will analyze different aspects of demutualization of stock exchanges which will include the evolution of exchange business from an informal forum to a formal forum, from a less regulated towards a regulated entity, from a mutualized form of business to a demutualized form. Overview of the stock exchanges in Pakistan, current issues and concerns in the Stock exchange functioning, international perspective and trends in stock markets and finally towards the need for a demutualized exchange in Pakistan based on international practice and lessons with respect to mutualized and demutualized exchange and we will discuss several issues relating to the regulation of a demutualized exchange.

Historical Development of Stock Exchanges

"The history of stock exchanges can be traced to 12th century France, when the first brokers are believed to have developed trading in debt and government securities. Unofficial share markets existed across Europe through the 1600s, where brokers would meet outside or in coffee houses to make trades. The Amsterdam Stock Exchange, created in 1602, became the first official stock exchange when it began trading shares of the Dutch East India Company. These were the first company shares ever issued.

[1] See Pamela S. Hughes Partner & Ehsan Zargar "EXCHANGE DEMUTUALIZATION" available at http://www.blakes.com/english/publications/bsra/v143/Paper-Exchange_Demutualization-May2006.pdf

Usually, decisions are made democratically, on a one-member, one-vote basis and often by committees of representatives of the firm's members. As a result, the ability of members to influence the decisions of the exchange is not related to the members' level of economic interest in the exchange[3]. Also, the ownership rights in most national stock exchanges are not freely tradable or exchangeable, and are often required to be forfeited on the cessation of membership[4].

Although this has not always been the case[5], most national stock exchanges have operated on a not-for-profit basis such that any earned profits are returned to members in the form of lower trading costs or access fees. Furthermore, because most national stock exchange's constating documents expressly or impliedly adopt a non-profit objective and prohibit the distribution of surpluses, national stock exchanges are seldom able to raise capital from anyone other than their members.

In contrast, most stock exchanges that have demutualized have operated as for-profit entities, organized as corporations with share capital which are listed publicly traded (a demutualized exchange). As a result, most demutualized exchanges have been comprised of three principal and generally separate groups: owners, decision-makers, and customers. In this structure, the shareholders vest decision-making power in a board of directors who are subject to election and removal. The board of directors in turn appoints

[3] Technical Committee of the International Organization of Securities Commissions, "Issues Paper on Exchange Demutualization", June 2001, at 3

[4] Traditional stock exchanging have typically limited ownership to brokers and have appointed a number of independent or public representatives to offset the self-interest of their member.

[5] From 1802 until 1948 the London Stock Exchange was operated on a for-profit basis and paid large dividends to its members. F. Donnan, Self-regulation and the Demutualisation of the Australian Stock Exchange (1999) 10 Australian Journal of Corporate Law at page 5.

officers to manage the day-to-day operations of the corporation. Most demutualized exchanges are organized such that the voting rights of shareholders are proportionate to their economic interest in the corporation: that is, one share, one vote. Therefore, owners with greater economic interests are more capable of influencing decision making.

Also most demutualized exchanges separate ownership rights from trading privileges. As a result, demutualized exchanges, like other for-profit corporations are able to raise new capital from a variety of sources[6].

It should be noted that once demutualized, exchanges have taken many forms: some have remained private companies; some have demutualized and become public companies by listing their stock on their own exchange; some have become subsidiaries of publicly traded holding companies; some have limited the tradability of their shares post-public listing while others have permitted the immediate free exchange of their shares; and most have imposed share ownership restrictions. While the appropriateness of each of the various post-demutualized structures will be dependent on the circumstances, it should be noted that most of the benefits associated with demutualization are generally thought to be associated with the publicly listed demutualized exchange with freely tradable shares.

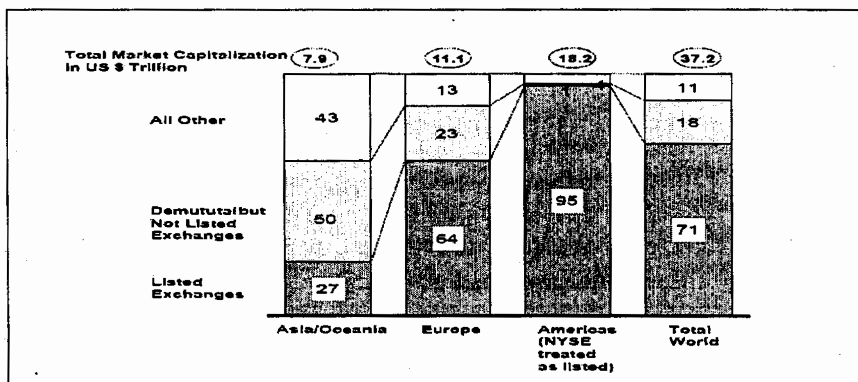
In summary, demutualization is the process of continuing an organization from its mutual ownership structure to a share ownership structure. This process often entails, first obtaining the appropriate regulatory and governmental consents, then converting membership rights into shares, which may be followed by public issuance and listing of

[6] Technical Committee of the International Organization of Securities Commissions, "Issues Paper on Exchange Demutualization", at 3, June 2001, available online at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD119.pdf

the exchange, with immediate or eventual freely tradable shares. In this manner, a quasi-governmental institution is transformed into a profit-oriented publicly traded company. The emerging exchange's governance structure rests the ultimate control of the exchange in the hands of its shareholders. This effectively separates ownership from trading privileges as stockbrokers become the exchange's customers and are no longer required to be owners.

At the end of 2004, "the total stock market capitalization of world's exchanges was $37.2 trillion of which 30 per cent was from Europe, 20 per cent was from Asia/Oceania and rest from the Americas." With the addition of the NYSE as a publicly traded company on March 8, 2006, presently over 70 per cent of the world's total stock market capitalization is comprised of publicly-listed exchanges. It should be noted that a small but significant portion of exchanges accounting for 18 per cent of world's total stock market capitalization have demutualized but not listed their shares. Not surprisingly the overwhelming majority of demutualized and listed exchanges are concentrated across Americas and Europe; this trend is illustrated in Figure 1.

Figure 1



As of March 7, 2006, 22 stock and derivative exchanges have become publicly listed corporations and almost all of the largest stock exchanges have demutualized and listed their shares in the last decade."[7]

[7] See footnote 1 above.

Chapter 1: Overview of Stock Exchanges in Pakistan

Presently there are three exchanges in Pakistan which are : (a) Karachi Stock Exchange (Guarantee) Limited ("KSE"); (b) Lahore Stock Exchange (Guarantee) Limited ("LSE"); and (c) Islamabad Stock Exchange (Guarantee) Limited ("ISE"). KSE was established in 1947, LSE in 1970, and ISE in 1989. The KSE is Pakistan's biggest and most liquid exchange in Pakistan with the average daily turnover of 525.15 million shares and market capitalization of US $ 54.28 billion.[8] All the three stock exchanges are striving to provide quality and value-added services to the capital market for efficient, transparent and orderly manner that is compatible with international standards and best practices. Their collective market capitalization as of May 31, 2004 was Rs 1489 billion. The market capitalization of KSE as of July 2007 is Rs. 4,019,41817 million as compared to Rs. 2,801,182 in 2006. The revenues of the KSE for the year ended June 30, 2007 stood at Rs. 1,192 million as compared to Rs. 1,182 million of the last year, thereby recording a marginal increase of about 0.85% over previous year[9]. This mainly comprised of trading fee, listing fee, other income comprising of share of profit from associated companies and return on surplus funds placed with the financial institutions. Operating expenses increased to Rs. 506 million as compared to Rs. 313 million, recording an increase of 62% over last year. The said increase is due to legal and professional charges to the tune of Rs. 22.5 million for demutualization of the Exchange, depreciation charges

[8] See Karachi Stock Exchange available at: http://www.advfn.com/StockExchanges/about/KSE/KarachiStockExchange.html

[9] See annual report of KSE available at http://www.kse.com.pk/aboutus/annualreports.php?id=7&sid=7.07

amounting to Rs. 42.6 million due to change in method and an increase in salaries, fuel & power. The Exchange thus recorded a pre-tax surplus of Rs. 685 million as against Rs. 869 million during the previous year, i.e. lesser by 21%.

During the financial year 2006-07, several measures were implemented to strengthen market environment and boost investors' confidence. Some of the significant measures taken by KSE with the approval of SECP include:

- Introduction of Unique Global Identification Number (UIN) effective from August 01, 2006 in order to provide a traceable link between every order entered at the trading system of the Exchange and the person on behalf of whom the said order is placed. This measure is expected to ensure greater transparency in the market and further strengthen investor protection;
- Introduction of KSE-30 Index based on free float, which was launched from September 01, 2006. The new index functions alongwith existing two indices, i.e. KSE All Share Index and KSE-100 Index. The new index gives weight to the constituent companies as per their actual liquidity in the market and is not unduly influenced by tightly held large-cap companies, thus providing better representation of market movements;
- Introduction of Continuous Funding System with revised features and elimination of off-market in-house financing by the members;
- Introduction of new Risk Management Regime (RMR) based on VAR based margining system in line with the international best practices from December 04, 2006. The new RMR cater for elimination of netting across the markets, across

the scripts, across clients and across settlement periods. It also include process of collection of margins, their acceptable forms, declaring securities eligible as collateral and valuation of such securities by applying the specified haircuts;

- Introduction of Cash Settled Futures Contract effective from April 02, 2007 and providing few relaxations subsequently to boost interest of the market participants in the product. However, this product has not so far taken off and efforts are underway to activate this product; and
- Payment of returns to members on Cash Margins in Deliverable Futures market on quarterly basis.

In April 2007, during the Prime Minister's visit to China, the KSE has signed a MOU with Shanghai Stock Exchange for mutual cooperation. The companies with greater capitalization and high proceeds are listed on all three exchanges. The dominant market share of combined market capitalization and turnover is that of KSE, followed by LSE and ISE. In 2003, KSE has contributed to almost 81% of total turnover in the regular market whereas LSE has contributed to 17% and 2% at ISE. Practically, the three exchanges are Self Regulatory Organizations ("SRO"), i.e. they are front-line regulators whereas the SECP is the apex regulator.

1.1 Legal Structure

The stock exchanges in Pakistan have been incorporated as companies limited by guarantee under the Companies Ordinance, 1984 and licensed and regulated as stock exchanges by the SECP under the Securities and Exchange Ordinance 1969. The three

exchanges are mutual bodies with trading rights of members are entrenched with ownership privileges. It entails that when a person acquires membership of a stock exchange by buying a membership card he obtains apparent ownership rights as well as the right to become a broker subject to the relevant laws.

All three exchanges are not for profit companies. Clause 50 (XXIX) of the Memorandum of Association of KSE states:

> "That the income and property of the Exchange whensoever derived shall be applied solely towards the promotion of the objects of the Exchange as set forth in the Memorandum of Association and no portion thereof shall be paid or transferred directly or indirectly by way of dividend or bonus or otherwise, however by way of profit to the persons who at any time are or have been Members of the Exchange or to any of them or to any person claiming through any of them except in the case of winding up of the Exchange[10]."

LSE and ISE have almost identical clauses in their respective Memorandums of Associations.

1.2. Stakeholders

There are three key stakeholders in the stock exchange: investors, listed companies, and members/brokers.

[10] Source Company Registration Office Karachi of Securities and Exchange Commission of Pakistan

1.2.1. Investors

The investors are considered as essential stakeholders in any exchange. In Pakistan, the number of investors remains very small, though in recent years substantial numbers of investors have been attracted to the market due to liberalization and privatization initiatives introduced by the Federal Government. The gross number of shareholders in all listed companies, directly or through mutual funds, is about 2 million as of May 31, 2004. This number includes both individuals and institutional investors.

Major investors in the stock market are mutual funds. As of May 31, 2007, there are 18 asset management companies, 43 closed-end mutual funds, and 27 open-end mutual funds that invest in equities.

1.2.2. Issuers

The total number of companies listed on a stock exchange stood at 658 as of September, 2007[11]. Additionally, there are 54 Term Financing Certificates ("TFC's") and 4 preference shares listed on KSE and LSE.

There is substantial overlap in listed companies across the three exchanges. The number of listed companies that are listed on all three exchanges is 219. Those only listed at KSE, LSE, and ISE are 116, 5, and 1 respectively.

[11] Source Karachi Stock Exchange available at www.kse.com

1.2.3. Members and Brokers

The Articles of Association limit the maximum number of members to 200 for each stock exchange members each and provide for the transferable membership cards that can be freely bought and sold. However, if the stock exchange considers that there is need for issuance of new membership the same may be done by the respective stock exchange. Moreover, corporate entities and individuals together are eligible to become members of the stock exchange.

In order to buy and sell or effect transactions, a licence to act as broker is required to be taken from SECP under the Broker Registration Rules 2001 that set out the criteria and other requirements for the same. At present, there are 468 members and 286 brokers in total. However, again there is an overlap of both members and brokers across the three exchanges. At the moment there are 25 members who have membership of more than one exchange. The number of members in KSE is 200 i.e. the maximum limit, LSE so far allowed 151 persons to become members and ISE has allowed 117 memberships[12].

However, the achievement of membership is being considered by most of the members as long-term investment thus, resulting chaos for and some of the members do not adapt to register themselves as brokers. The same can be affirmed as the number of inactive members is 41, 67 and 74 in KSE, LSE and ISE respectively.

[12] Source Karachi Stock Exchange available at www.kse.com

1.3. Board Members

There are ten directors on the board of each exchange. Out of 10 members 5 are selected by members while 4 are independent directors and designated by SECP. Out of the members one person is elected as chairman of the board. Managing Director, subject to clearance by SECP, is appointed by the board of directors of the exchange and removal also requires approval of SECP. In year 1998, in order to make sure the independence and to enhance the performance of the stock exchanges, the appointment of MD was initiated by SECP. Previously, the stock exchanges were solely dealt by the members and the chief executive was appointed amongst the members.

1.4. Trading, Custody, and Settlement

Trading of listed securities at all three exchanges takes place through automated continuous open auction trading in a T+3 rolling settlement cycle (i.e. investors must complete their security transactions within three business days) with a peculiar Continuous Funding System (the "CFS") facility. Each exchange has its own independent trading system. The exchanges disseminate trading data through their websites. However, in order to link trading and settlement system, NCCPL has signed a memorandum of understanding with CDC[13].

Custody services of the securities are being provided by CDC. The shareholders in the CDC are the three stock exchanges and some financial institutions. More than 450 listed

[13] Source National Clearing Company Limited available at www.nccpl.com.pk

entities have their securities in book entry form. In addition to providing custodial services, CDC also acts as trustee for mutual funds. However, clearing and settlement services are being provided by the NCCPL. NCCPL is a public limited company owned by the three exchanges, one Development Financial Institution and Pak-Kuwait Investment Company. It acts as a central and geographically neutral clearinghouse for all the three exchanges for book-entry securities. Both the CDC and NCCPL are serving all three stock exchanges. The NCCPL only performs the function of clearing and settlement and presently risk management is not with them. Risk management is being done at the three stock exchanges separately and there is no formal arrangement between stock exchanges and NCCPL regarding settlement of trades. NCCPL was incorporated in the year 2001 by the authentication of SECP.

1.5. Traded Instruments

The key instruments are traded in all the three stock exchanges include:

i. Equities, ordinary and preference shares;

ii. Term Finance certificate TFC; and

iii. Single Stock Futures.

Most trading takes place in equities in the T+3 market segment. The combined average daily tumover of equities in the regular market in Jan-May 2004 was approximately 530 million shares [14].

[14] Source Karachi Stock Exchange available at www.kse.com

Activity in stock futures is essentially confined to KSE. The average daily turnover of futures at KSE during January to May 2004 was about 30 million shares. Virtually no trading takes place in listed TFCs at any exchange.

1.6. Financing of Trading

The market is leveraged by Continuous Funding System (CFS). Previously the process was known as Badla financing, also known as Carry-over financing. This is a unique form of post trade financing in which funds are routed to speculators by lenders through continuous open auction trading after the close of the regular market.

The combined average Badla financing in January to May 2004 was Rs 21 billion. Like trading in regular and futures market, more than 80% of Badla financing takes place at KSE. SECP in the year 2008 has introduced CFS MK II that is more organized and regulated.

1.6.1. Management of Settlement Risk

Settlement risk is being managed by each exchange independently. The key instruments of risk management are margin deposits, clearinghouse protection fund, investor protection fund, circuit breakers or intra day price limits, capital adequacy, and market monitoring[15].

[15] In order to effectively manage the risk and market speculation each stock exchange has promulgated their own regulations with the approval of SECP these include Investors Protection Fund Regulations, The Margin Trading Regulations, Members Default and Procedure for Recovery of Losses, Regulations Governing Associate Membership of KSE Clearing House and Regulations for Short Selling under Ready Market, 2002 etc. available at www.kse.com

1.7. Corporate Governance and Enhanced Disclosures

To increase the corporate disclosures and bring transparency as to the corporate affairs, Corporate Governance code was prepared by SECP in year 2002. The Code was made enforced by including it in the listing regulations. The Code deals with most of the key governance issues, such as disclosure, structure and role of the board of directors, and different internal and external controls.

1.8. Developments in the Capital Market

Opening of Pakistani's stock markets to foreign investors in 1991 heralded a series of reforms including liberalization of capital market regulatory policies, improvements in quality of intermediation, and up-gradation of market infrastructure. In terms of product development, introduction of corporate bonds in the form of TFC was an extremely significant development which also entailed development of other institutions like credit rating agencies and trustee companies. Issuance of Asset Management Companies Rules in 1995 and liberlization of Investment Companies Rules opened the door for development of mutual funds in the private sector.

Repeal of Control of Capital Issue Act in 1995 was an important milestone in the process of liberalization of policies governing capital market. The repeal of the Act brought to an end forced listing of companies on reaching the prescribed threshold of paid up capital,

administrative control on pricing of IPOs as well as cap on underwriting and take up commission. These changes unleashed many other developments in the market.

In 1997, automated continuous open auction trading replaced the open outcry system at KSE. During the same period, the CDC started its operations, which substantially increased efficiency of trading by providing dematerialization of securities.

During the last five years, particularly since the establishment of SECP in 1999, the reform process gained further momentum. Most of the reforms focused on risk management, governance, investor protection, and market development.

In risk management, the weekly settlement has been replaced with rolling T+3 settlement. Margin deposits have been strengthened, capital adequacy has been introduced, and circuit breakers have been redesigned. Measures have been taken to fully fund the Clearinghouse Protection Fund.

As regard governance, the size of board of directors of the stock exchanges has been reduced to 10. Four directors are nominated by the SEC while five are elected by the general body. The Managing Director is deemed to be a director and member of board by virtue of his office.

For investor protection, arbitration procedures have been streamlined, investor complaints are actively addressed, Investor Protection Funds are in the process of

being fully funded, and a standardized account opening form has been implemented. To check front running system of undisclosed trading has been introduced under which the identities of transacting brokers are not disclosed to other brokers. Blank selling has been banned and is replaced by regulated short selling[16].

In market development, settlement of trades executed at all three exchanges is now being done by the NCC. For safekeeping of their securities, investors are being provided Investor Account services directly by the CDC. Stock Futures are being traded since 2001 and Badla financing is being replaced by Margin Financing[17].

1.10. Market Response

The market has shown a bullish trend in recent years. In 2002, KSE-100 index rose 112%. Based on this extraordinary rise, Business Week, an international magazine, declared KSE as the best performing market in the world. In 2003, KSE-100 index rose by another 60%.

The turnover has also been on the rise. The average daily turnover at KSE raised from 167 million shares in 2002 to 309 million shares in 2003. The sentiment continues to remain bullish in 2004, and the index has risen by 23% by May 31, 2004 and the average daily turnover at KSE during January-to-May has exceeded 425 million shares[18].

[16] Karachi Stock Exchange Regulations for Short Selling under Ready Market, 2002 available at www.kse.com.pk

[17] Karachi Stock Exchange Margin Trading Regulations available at www.kse.com.pk

[18] Please see annual report of Karachi Stock Exchange available at www.kse.com.pk

Chapter 2: Current Dilemma of Stock Exchanges in Pakistan: a deep insight analysis of Stock Exchanges

As stated earlier, capital market of Pakistan has witnessed considerable growth during last ten years. Some reforms like the introduction of Code of Corporate Governance, implementation of automated trading and risk management measures have had profoundly positive impact on the market. However, despite these highly positive developments, Pakistan capital market continues to reflect some serious weaknesses and problems that are required to be tackled to achieve materialization of full potential of the market and to ensure that the market plays its economic role effectively.

Since the objective of demutualization and integration or transformation is to address the problems and weaknesses of the stock exchanges in the context of the objectives of a stock exchange, which are to[19]:

- facilitate capital formation by channeling savings into investments
- provide liquidity and price discovery for listed securities
- manage systemic risk to safeguard market integrity
- protect investors from market abuse, such as price manipulation and insider trading

[19] Report of the Group on Corporatisation & Demutualisation of Stock Exchanges of India available at Securities and Exchange Board of India available at http://www.sebi.gov.in/circulars/2003/smdcir03.html

- act as a front line regulator for brokers and listed companies
- develop market by offering investors new products and services

Following is a detailed discussion of the problems and weaknesses of our stock exchanges.

2.1. Insufficient Growth in Market Capitalization

Stock exchanges have not been able to play their due role in capital formation.[20]

2.1.1. Market Size below International Benchmark

Market size is small even after adjusting for the size of our economy. As of May 31, 2004, the market capitalization was Rs 1488.6 billion or about US $25 billion, which is about 35% of the Gross Domestic Product (GDP) of Pakistan. This is below the generally accepted international benchmark of 100%. However, the same has increased considerably to 2907.6 billion as of May 31 2006.[21]

Table shows the market capitalization and GDP ratios for the members of the World Federation of Exchange (WFE) located in Asia Pacific in 2002. Most of the WFE members had a market cap to GDP ratio greater than that of Pakistan, which at that time was Rs 595.2 billion or only 16% of the GDP.

[20] The information and the data contained in this chapter has been obtained from the report of the committee constituted by SECP for the identification of the problems of the stock exchanges of Pakistan available at www.secp.gov.pk

[21] Please see annual report of Karachi Stock Exchange available at www.kse.com.pk

Table 1

Comparison of Market Size in 2002

	Market Capitalization US $ Billion	**Percentage of Market Capitalization to GDP**
Hong Kong	463.1	287%
Kuala Lumpur	122.9	130%
Singapore	101.5	114%
Taiwan	261.3	93%
Australian	380.1	92%
Tokyo	2,069.3	50%
Korea	216.1	43%
Mumbai	130.4	27%
Shanghai	306.4	25%
NSE India	112.5	24%
Jakarta	30.1	17%

Source: SECP committee's report

2.1.2. Too Few Listings

Too few companies are listing on the exchanges. From January 1999 to May 2004 only 17 companies were listed at KSE whereas the number of companies which got delisted through buy back of shares during the same period was 36, i.e. for every one company listed, more than two had delisted.

Different reasons are given to explain the low level of new listings and increase in delistings. These include:

- There has been slow industrial growth
- Many of the large companies suitable for listing are in the public sector.
- Tax incentives for listed companies are being gradually withdrawn, doing away with preferential tax treatment of listed companies.
- Due to lower interest rates, companies can raise inexpensive capital from traditional creditors - banks and development finance institutions - rather than capital market.
- A strict Code of Corporate Governance has been implemented that companies are finding cumbersome to comply with.
- A large number of companies listed in the mid nineties failed to meet investor expectations.

While the reasons cited are valid, it is difficult to explain why new listings from private sectors are not coming even though economy, particularly manufacturing sector has experienced substantial growth in the recent years.

From Jan 2002 to May 2004, 150 new public companies and 3,733 private limited companies were incorporated whereas number of new listings on KSE during this period was only 11 while it is understandable that the newly incorporated companies would take a few years to be able to seek listing, the comparative figures do indicate a trend of

companies preferring to remain unlisted as the data given is of more than two years. However, total number of companies incorporated in the year 2005-2006 was 6,868[22].

As of May 31, 2004, there were 2,107 unlisted public limited companies and 39,558 private limited companies as of May 31, 2004. Clearly, the companies currently listed account for a make a small part of the universe of public and private limited companies.

In 2003, KSE had one of the lowest proportion of new listings, 0.44%, compared to members of WFE in Asia Pacific, as shown in Table 7.

Table 2

Comparison of Listing

Country	Number of Companies Listed in 2003	Total Number of Companies as of 2003	Ratio (a) and (b)
Singapore	59	551	10.71%
Shanghai	67	780	8.59%
New Zealand	16	196	8.16%
Australian	107	1471	7.27%
Hong Kong	73	1037	7.04%
Taiwan	47	674	6.97%
Thailand	27	418	6.46%
Kuala Lumpur	58	902	6.43%

[22] Source annual report of SECP available at www.secp.gov.pk

Tokyo	120	2206	5.44%
NSE India	35	911	3.84%
Colombo	8	244	3.28%
Osaka	26	1140	2.28%
Philippine	5	236	2.12%
Korea	13	684	1.90%
Jakarta	6	333	1.80%
Mumbai	24	5644	0.43%

Source: SECP committee's report

2.1.3. Low Quality of Many Listed Companies

Not only the market size is small and new listings are too few in number, many listed companies are of low quality in terms of governance and financial performance.

It is estimated that at least a third of listed companies do not raise any capital from capital market, are absolutely illiquid or extremely tightly held. On May 31, 2004, there were 154 companies out of 685 companies, i.e. 22% of total companies that had been placed on defaulter's counter for violating the listing regulations of KSE. Moreover, in 2002, 15 companies were de-listed from KSE due to liquidation or winding up under court order.

Most of these companies were probably listed at a time when listing criteria was rather lax and companies were being forced into listing by regulation if their paid-up capital exceeded a certain level. It is frequently argued that such listed companies do not deserve

to be listed and they should either be placed on a special counter or allowed an easy exit from the market.

2.1.4. Limited Free Float and Supply-Demand Imbalance

Most of the listed companies are tightly held i.e. ownership structure of the companies is such that most are family owned[23]. The free float which shows the quantity of shares presented for trading in the exchange is very limited. There are definitional issues in free float and it has not been systematically measured. However, different estimates tend to converge that shares generally available for trading are at best 15% of total outstanding shares.

Currently, the company that intends to get its securities listed and its paid up share capital is above 200 million rupees it is required to make a public offer of 25% of its shares or Rs 100 million, whichever is higher. For companies with a large paid-up capital, the capital publicly offered usually turns out to be well below 15% of total capital.

As of May 31, 2004, there were at least 60 companies that have less than 10% of their shares in book entry form. This also shows the limited size of free float as only shares in book entry form can be settled through National Clearing and Settlement System (NCSS).

[23] Source annual conference on corporate governance organized by LUMS with the major funding provided by City Group available at www.lums.edu.pk

The market has seen substantial growth in mutual funds, which is increasing pressure on the limited free float. From January 2002 to May 2004, 11 open end mutual funds were launched whereas only 12 public offers of equity were made. Most of these funds are launched by asset management companies that are associated with large brokerage houses.

2.2. Narrow Base of Investors

Investors are the most important stakeholders in any stock exchange. However, investor base in Pakistan is extremely narrow.

2.2.1. Minimal Share Ownership

As already stated, although the number of shareholders are not more than one percent of the entire population, the number of active shareholders in our capital market is even smaller. This can be gauged from the fact that the total number of securities accounts in the CDC is only about 90,000.

According to the Australian Stock Exchange (ASX), a much larger proportion of adult population owns shares in the developed countries as shown in Table 8.

Table 3

Shareowners as Proportion of Adult Population

Country	**2002**
Australia	50%
United States of America	50%

Canada	46%
Switzerland	25%
United Kingdom	22%
Hong Kong	20%
Germany	18%

Includes direct and indirect ownership through funds Source: Australian Stock Exchange (ASX)

Source: SECP committee's report

2.2.2. Stagnation in Number of Shareholders

Despite the record price boom, the number of shareholders in listed companies has not increased significantly. Table 9 shows trend in number of shareholders over last four years in selected fifteen companies, which are relatively broad-based and liquid.

Table 4

Trend in Number of Shareholders

Company	2003	2002	2001	2000
Pakistan Telecommunications Company	55,868	52,460	53,387	55,462
Muslim Commercial Bank	48,811	50,032	51,001	51,335
Dewan Salman Fibre	20,301	21,064	17,077	2,126
Sui Northern Gas Pipelines Company	18,466	20,646	21,027	20,593
I.C.I Pakistan	17,431	19,548	20,531	23,052
Hub Power Company	17,260	19,456 Not Available.	16,999	

Pak PTA	17,356	19,273	20,789	
			Not Listed	
FFC Jordan Fertilizer	13,239	16,627	19,418	20,133
Pakistan State Oil Company	14,439	13,407	13,555	13,721
Askari Commercial Bank	12,878	13,463	11,592	11,921
Faysal Bank limited	12,020	14,326	12,125	12,553
Karachi Electric Supply Corporation	11,993	11,579	10,660	9,845
Nishat Mills	10,723	11,344	11,899	11,768
Maple Leaf Cement	9,615	10,368	11,137	10,427
Engro Chemical Pakistan	9,609	8,624	9,128	8,329

Source: SECP committee's report

The data shows that the number of shareholders in these companies has not increased considerably.

2.2.3. Small Number of Unit Holders in Mutual Funds

In recent years, mutual funds have increased in number and size. The total assets of the open-end mutual funds that invest in equities were Rs 68 billion or about 5% of total capitalization as of May 31, 2004. Despite growth in their number and size, private sector mutual funds that invest in equities have not helped expansion of investor base.

Table 5 shows that NIT, a public sector mutual fund, has 90% of unit holders and 80% of assets. The number of unit holders in funds other than NIT is less than 2,000, i.e. even below the average.

Table 5

Unit Holders in Open End Mutual Funds

	Mutual Fund	**Size of Fund in Rs. Million**	**Number of Unit Holders**
1	National Investment Trust	54,216	53,549
2	Pakistan Stock Market Fund	1,007	1,518
3	Pakistan Income Fund	3,336	1,419
4	Meezan Islamic Fund	1,258	1,112
5	Unit Trust of Pakistan	3,202	731
6	UTP- Islamic Fund	669	723
7	UTP - Income Fund	1,324	289
8	MetroBank Pakistan Sovereign Fund	493	198
9	Crosby Dragon Fund	378	86
10	Atlas Income Fund	373	81
11	Faysal Balanced Growth Fund	2,027	32
	Total	**68,283**	**59,738**

Source: Non Bank Finance Companies Division, SECP[24]

[24] Source: SECP committee's report

2.2.4. Lack of the Market Awareness

Most Pakistanis, particularly those who live outside major cities, are unaware of what capital market is and what benefits they can derive from these markets. Moreover, no significant measures have been taken by exchanges to educate investors.

2.2.5. Public Offers Essential to Broad Investor Base

The only measure that is increasing awareness of the public in the market are the public offers, particularly those of large public sector companies. The policy of the Government, of privatization through public offers, is helping expand the investor base. Retail investors are now subscribing shares in public offers in large numbers. Applications in the minimum subscription lot are being given preference and often the entire issue is taken up by those applying for the minimum lot. Table 11 provides details of equity offers from January 2003 to May 2004.

Table 6

Equity Public Offers

January 2003 to May 2004

Name of Company	Offered Capital in RS. Million	Subscription Received in Rs. Million	Number of Application Received
Bank Alfalah Limited	400.00	11,610.94	374,845
Sui Southern Gas Co. Ltd*	671.17	13,000.99	258,089
Oil & Gas Development Co. Ltd*	2,150.46	28,120.78	97,570

Callmate Telips Telecom Ltd.	150.00	557.93	94,484
World Call Broad Band Ltd.	300.00	1,976.06	75,429
Pakistan Intl. Container Terminal Ltd.	160.00	1,340.68	72,946
Mac Pac Films Ltd.	100.00	473.61	52,821
Southern Network Ltd.	150.00	130.43	22,658
TRG Pakistan Limited	600.00	1,121.92	15,134
First National Bank Modaraba	100.00	121.14	3,231
National Bank of Pakistan*	131.310	1,222.302	2,279
Ittehad Chemicals	62.500	71.122	630
Total	**4,975.45**	**59,747.89**	**1,070,116**

*Offer for Sale by Government of Pakistan Source: Securities Market Division, SECP

2.3. Lack of Balance in Governance Structures

In consultations with stakeholders it transpired to the SECP Committee for demutualization that the governance structures at the exchanges lack balance among stakeholders.

2.3.1. Weak Professional Management

The SECP Committee for demutualization concluded that that the members of the exchanges have not supported professional administration in the exchanges. In 1997 Corporate Law Authority (CLA), predecessor of SECP directed KSE to appoint an independent Managing Director (MD) to ensure fair and transparent disclosure practices. Till then, a President elected from among the members acted as the CEO of the exchange and General Manager (GM) was entrusted to take care of the day to day operations of KSE.

The members of the KSE initially did not welcome the appointment of an independent MD. However, gradually the same attitude changed. Minutes of the board meetings reveal that the board members often discuss matters that need to be left to the management. KSE, LSE, and ISE have a number of committees comprising largely or exclusively of members of the exchanges in order to improve the deficiencies. Many important executive matters referred to these committees which results in diluting the powers of the management. While the number of committees has reduced over the years, they continue to play role of management in important areas of governance of the exchanges.

It is apparent that numerous decisions at the exchanges are taken to maximize the interests of the brokers at the cost of interest of other stakeholders. There are many instances that seem to support this view.

2.3.2. Ineffective Regulation of Members

In most of the cases it appears that where applicable laws of the exchanges are contravened by any of the member, the other members show reluctance to take any disciplinary action against that member. Data of exchanges shows that it is rare that they take disciplinary action against any member. Nor do they carry out independent investigations to determine whether or not any member was involved in violation of its regulations. There is a generally held view that as compared to their regulatory functions, the exchanges give higher priority to the commercial interest of its members.

2.3.3. Ineffective Regulation of Listed Companies [but companies always have threat of being delisted]

Due to governance problems and poor perception of stock exchanges, listed companies are hesitant or reluctant to recognize stock exchanges as front line regulators.

In the recent past there have been some cases in which listed companies failed to make proper disclosure of material information to KSE. In each of these occasions uncertainty and panic was created in the market. Despite the bad publicity that the exchanges received due to these incidents, there was little that they could do against the companies that had apparently violated listing regulations.

Exchanges also do not enjoy sufficient powers over listed companies. The only action that an exchange can take against a listed company is to declare and place it on defaulters counter or de-list it. Moreover, it can initiate proceeding for the liquidation of a company through High Court. However this alternative is too extreme to be practicable in most cases and can inflict irreparable loss to the investors.

2.3.4. Unequal Access to Corporate Announcements

All investors should have equal access to corporate announcements. Corporate announcements play a vital role in order to attract the investments. Unfortunately Pakistan's capital market lack proper disclosure mechanism. Resultantly, most of the investors at the time of investment could not have a true and fair picture of the financial and corporate health of a company. Brokers, however, have maintained privileged access

to corporate announcements. The corporate announcements are directly associated with the price of the shares of the listed company.

2.3.5. Mixed Performance of Non-Member Directors

In order to enhance the performance of the stock exchanges, there are appointed number of directors who are not members of the exchange. After the last restructuring in 2002, SECP nominates four non-member directors out of ten directors on the broad of directors of each exchange.

Appointment of nominated directors has brought an improvement in governance but less than what was expected. Stakeholders are largely of the view that the performance of nominated directors has been rather mixed. While some nominated directors have made a significant contribution to deliberations in the board meetings and thus helped the quality of governance, others have not. Record of attendance of board meetings shows that on the average, non-member directors have attended fewer meetings than member-directors in all three exchanges. It has also been noticed that at times the nominated directors tend to go against the reform agenda of SECP and show a biased approach towards the members and overlook greater interests of stakeholders.

The following reasons result into mixed performance by the nominated directors:

i. Five member directors are from the market as compared to four non-members i.e. nominated directors. As the nominee directors are in minority hence they can not play an effective role.

ii. Nominee directors are not directly connected with linked with the rise and fall of the affairs of stock exchanges. However, at certain points they are unable to understand their fiduciary duties towards the market participents

iii. In most of the cases nominee directors lack sufficient knowledge of the affairs of the exchange to contribute effectively.

iv. The term of a director - one year - is too short to develop necessary understanding of issues.

v. Often emergency meetings are convened on a short notice making it difficult for nominated directors to attend.

vi. They are not given adequate compensation for attending board meetings and therefore, there is insufficient incentive for them to spend time on matters of the exchange.

vii. They are often busy in their own work and interests and cannot devote enough time to the exchange even if they were to be compensated adequately.

viii. They are perceived to be "SECP directors" who merely follow directions of the SECP rather than take decisions on merit.

ix. Some of them have conflict of interest, particularly the fund managers.

2.4. Fragmentation of Market

Existence of three exchanges has fragmented the market place, causing a number of problems. Most of the companies which even do not wish to list their securities on KSE have to do so as KSE occupies 80 percent of entire market percentage.

2.4.1. Division of Liquidity and Distortion of Price Discovery

Since companies listed on the three exchanges overlap, existence of three exchanges has fragmented the liquidity pool to the disadvantage of all stakeholders.

Every day, investors see three different prices for the same security on three exchanges. Arbitrageurs instantly capitalize on the price differences appearing during trading hours. But differences in prices of the same securities tend to become most apparent in closing prices. When three varying closing price of the same security are published in newspapers, it leads to confusion in the minds of investors.

2.4.2. Cost Inefficiency for All Stakeholders

Stakeholders have argued that the three exchanges are duplicating resources and merely adding costs for everyone.

i. When brokers of ISE or LSE trade through brokers of KSE, investors have to pay higher commission. The CDC charges are doubled, as securities have to move in and out of securities accounts of two participants. The commissions charged by ISE and LSE brokers are also higher because of lower volume and some additional costs of routing their trades through brokers at KSE. For instance, brokers at LSE and ISE tend to maintain contact with the brokers at KSE through cell phones that remain operational through the trading hours. Eventually, it is the investor who bears this burden of increased costs of trading

ii. A listed company that is listed on all three exchanges has to pay three listing fees. More importantly, multiple listings add to their cost of compliance. For instance, they have to file each set of documents thrice, make each corporate announcement thrice, and devote substantially more managerial time to compliance than they would have had to, if they were listed on only one exchange.

Even though multiple listings increase cost and hassle for listed companies, LSE and ISE resist decision of companies to seek voluntary delisting, if such companies wish to remain listed only on KSE.

iii. Each exchange is maintaining its own infrastructure thus duplicating resources. Duplication takes place in both running costs and capital expenditure. To maintain independent trading infrastructure, each exchange has to make capital expenditure independently. Often the same issues are deliberated in three exchanges independently, involving loss of managerial time.

iv. Brokers who are trading at more than one exchange have to comply with rules and regulations of three exchanges and incur additional costs.

v. Existence of three exchanges also adds to the cost of supervision and regulation by the SECP.

2.4.3. Complexity in Operations

The regulations and operations of the three exchanges differ in important aspects. For instance, exposure slabs and margin collections are different for each exchange. These differences are a source of complexity that adds to costs and obstructs developments.

International exchanges are developing at a fast pace. Massive resources are being committed to implement Straight-Through-Processing ("STP"), a mechanism that automates the end-to-end processing of transactions of the financial instruments[25], to maximize efficiency. Settlement cycles are being reduced from T+3 to T+1. Instead of netting trades at broker level, netting in some exchanges is being done at client level. New ways of trading and settlement are being developed. Such developments would be difficult to initiate in Pakistan if multiple stock exchanges continue to exist.

2.4.4. Lack of Inter-exchange Competition

A natural benefit of having more than one exchange is inter-exchange competition. There has been some competition between LSE and KSE in the past. LSE was first to automate its trading and provide the facility of remote access terminals. These IT initiatives by LSE put strong pressure on other exchanges to follow suit. LSE also took some other competitive measures such as after-hours trading and attracting TFC listings by lowering listing fee.

However, on the whole, such initiatives have been few and far between. In the recent years, there has been virtually no competition among the three exchanges, as even for ISE and LSE combined, KSE is too large for them to compete.

KSE is clearly enjoying the dominant and unchallenged position in the Pakistan's capital

[25] http://www.deccanherald.com/deccanherald/apr022004/b9.asp

market. This is evident from the trend in turnover over the years. In 1999, the share of KSE in the combined turnover was 71%, LSE 25%, and ISE 4%. In 2003, the share of KSE has increased to 81%, while that of LSE and ISE has decreased to 17% and 2% respectively.

LSE and ISE seem both unwilling and unable to compete with KSE. In most cases of development of regulations and products, LSE and ISE merely follow KSE.

Stakeholders have identified the following factors that explain the inability of LSE and ISE to compete with KSE.

i. KSE is located in Karachi, which is the financial center of Pakistan. It has a natural advantage in attracting business particularly that from funds and financial institutions.

ii. Brokers at ISE and LSE often trade through brokers at KSE. Their dependence does not allow ISE or LSE to compete with KSE. LSE and ISE also do not have the economic and human resources required to engage in any sustainable competition with KSE.

iii. There could be a fear that any attempt at competition with KSE might result in KSE providing its trading terminals directly in Lahore and Islamabad. Members of KSE could also open branch offices in these cities, thus eroding the business and value of membership cards at both the exchanges.

iv. A number of members of KSE are also members of LSE and ISE. As their primary economic interest is linked to the membership at KSE, it is natural that as members of LSE and ISE they would not endorse any move involving competition with KSE.

v. Members of LSE and ISE have mentally accepted the permanent leadership role of KSE and do not have the motivation to compete.

2.5. Inadequate Investor Protection

The studies in this respect suggest that investors are not satisfied with the degree of protection expected from the stock exchanges as front line regulators.

Allegations of price manipulation, insider trading, front running, blank selling and other forms of market abuse are among the major concerns of the investors. There are various regulatory tools to erdicate market abuse but there is little evidence to show significant effort to enforce these. Allegations of price manipulation are most frequent in provisional trading.

Stakeholders are of the view that trading and custody is deficient in transparency in many areas. Proprietary trading is not distinguished from that done for the clients. Almost 9% of the total listed securities were in group-accounts, where record of identity of beneficial owners was only accessible to brokers[26].

[26] In February 2003, the CDC informed market participants that it intends to discontinue the system of group-account by June 2003. It advised all brokers and their clients to start making alternative arrangements, such as opening of sub-accounts or investor-accounts in order to avoid inconvenience. The matter of abolishing group accounts is still pending, apparently due to legal technicalities.

Table 7[27]

Securities and Securities Accounts in the CDC

	Number	**Proportion of Listed Companies in Book-entry form**[28]	**Proportion of Market Capitalization in Book Entry Form**
Investor Accounts	13,210	28%	23%
Sub Accounts	70,969	28%	25%
Group Accounts	376	9%	6%
Total	**90,555**	**65%**	**55%**

Source: The CDC

Reportedly, there are a large number of unregistered agents[29] running unauthorized branch offices, which is a great threat to naïve investors. This is supported by the fact that while there are 311 hundred registered brokers among them 220 are corporate brokers while there are 91 individual brokers. The number of registered agents was less than 125 in the year 2003. However, the same has increased to 195 in the year 2005 and to 307 in the year 2006[30].

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[27] Source: SECP Committee report on demutualization.

[28] To calculate proportion of listed capital and market capitalization in book entry form, the CDC does not include the holdings of the Government of Pakistan. If these are included, the proportion of listed securities in book entry form would be between 25% to 30%.

[29] Agents are defined in Member's Agents and Traders Rules as "person appointed by a member of a Stock Exchange to act on his behalf for the purpose recognized by a stock exchange and includes a sub-broker or head of a branch office."

[30] The statistics are taken from annual report of SECP for the year 2007 available at www.secp.gov.pk

ISE is yet to earn sufficient surplus after tax to offset its accumulated losses.

LSE enjoys better health yet it is insufficient to meet its development needs[32]. Although the market share of LSE is very minute as compared to KSE, it has got greater financial health.

Due to their poor financial health and not-for-profit status, exchanges do not have access to the variety of financing sources available to a financially healthy for-profit company. ISE and LSE resort to sale of memberships to raise finances, which is not sustainable.

2.7.2. Inequitable Burden Sharing

Analysis of income of exchanges shows that exchanges are being primarily financed by listed companies as shown in Table 15-17. Despite the rapidly increasing turnover during the last few years, income of the exchange relating to listings is higher than what is earned from service charges on trading. As shown in the following tables, during the three years, 2001-03, of record-breaking turnover, the average income of KSE from listing is 39% of its total income while service charges made only 32%. For LSE, the ratios in the same period are 52% versus 19%. For ISE, these are 78% versus 9%.

Passing the financial burden to listed companies is in stark contrast to the international practice. Internationally, exchanges derive most of their income from trading related service charges and listing revenues are a relatively small part of their total income. For

[32] The analysis is based on the comparative study of financial statistics of KSE and LSE

the members of World Federation of Exchanges, the average income from listing is only 11% while 43% revenues are derived from trading fees[33].

Despite the lower contribution being made by the brokers, the exchanges have a tendency to reduce service charges when the turnover increases.

Apparently, brokers also derive some subsidies from stock exchanges. For instance, LSE is providing free back office software to its members. Members can store their back office data in servers of LSE. LSE is also providing its members with risk management software for clients, called Client Trade Risk Filter. These subsidies raise questions about the non-profit nature of the exchanges as mentioned in their Memorandums of Association.

2.7.3. Low Level of Capital Expenditure

Due to lack of sufficient income and reserves, exchanges are short of funds to meet their capital expenditure needs.

Some of basic capital expenditure needs remain unfulfilled. For instance, till 2003 when KSE implemented backup system, there is no disaster recovery site at any exchange. In the year 2007 KSE has planed to upgrade information technology infrastructure including setting up of Business Continuity Plan (BCP), Disaster Recovery Site (DRS) and Data warehouse[34].

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[33] Available at www.world-exchanges.org

[34] See http://www.thenews.com.pk/daily_detail.asp?id=76673 (1-15-08). The information has been taken from annual report of KSE for the year 2007 available at www.kse.com.pk

Internationally exchanges are seen as organizations driven by technology. Due to lack of funds, KSE, LSE, and ISE have not been able to invest in technology according to demands of the market. Access to markets is essentially confined to the three buildings of stock exchanges. It has been observed that KSE has not made necessary capital expenditure to broaden market access beyond Karachi. Most of the trading terminals are located within the buildings as shown in Table 8.

Table 8[35]

Market Access As Measured By Trading Terminals

	KSE	LSE	ISE
Total Trading Terminal	878	577	96
Terminal located within Building	725	376	81
Terminal located outside the Building	141		1
Terminal located outside city	-	201	14

Brokers have also been unwilling to setup branch offices. Most brokers are of view that it was principally due to the deficiency of effective control on branch offices and insufficient support infrastructure. Resultantly the brokers do not opt for opening branch offices.

[35] Source: Committee Report of SECP on Demutualization

2.7.4. No Financial Guarantee

An associated problem in the way of its finances is the expression "Guarantee" which is used in the names of the exchanges. Investors frequently get puzzled and take the wrong impression about by the word "Guarantee." Usually it is misinterpreted as a guarantee that all trades shall be settled or a guarantee by the members of the exchange that they shall compensate against the liabilities of the exchange.

Memorandum of Association provide that in case of windingup, the liability of members, is limited to Rs 1000. Clause VI of the Memorandum of Association of KSE reads as follows:

> "Each member undertakes to contribute to the assets of the Exchange in the event of its being wound up while he is a member, or within one year afterwards, for payment of the debts and liabilities of the Exchange contracted before he ceases to be a member, and of the costs, charges and the expenses of winding up, and for adjustment of the rights of the contributories among themselves, such amount as may be required, not exceeding one thousand rupees."

2.8. Insufficient Human Capital

The exchanges do not have sufficient human capital.

2.8.1. Few Professionals

Perception of weak governance and inadequate managerial compensation are keeping good professionals away from stock exchanges. Non-management staff tends to be more than the management staff. Inadequate number of professional managers has slowed down the pace of development and innovation at the exchanges.

Table 9[36]

Human Resource at the Exchanges

	KSE	LSE	ISE
Total No. of employees	243	109	35
Management staff	112	72*	8
Non Management staff	131	37	27

*34 out of 72 are officers Source: KSE, LSE, ISE

Instead of hiring more professionals, exchanges continue to depend on member committees. Most of committee participants are active brokers who are pre-occupied with their own business. The size of these committees is also often too large to facilitate efficient processing.

2.8.2. Inability to develop New Products and Services

Possibly due to insufficient human capital, the exchanges have not been able to develop new products or provide innovative services. Market is essentially confined to equities. Debt and the derivatives segments remain nascent.

[36] Source: Report of Committee of SECP on demutualization.

The only debt instrument listed on the exchanges is the TFC. These are in essence only technically listed and there is virtually no trading activity in listed TFC.

The only derivative traded on the exchanges is Stock-Futures. These were first introduced at KSE in 2001 and trading remained confined to KSE. In 2003, the average daily turnover in futures was 12% of the average daily turnover in the regular market. Trading of futures at LSE is negligible while ISE has discontinued it.

There are no Options, Index Futures, Warrants, and Exchange Traded Funds (ETF) etc. KSE had announced plans to initiate trading in Index Futures in 2003. However, it could not be initiated so far.
There have been few initiatives in providing new services to investors, particularly institutional investors.

2.9. High Degree of Speculation and Concentration

The market is highly speculative and concentrated.

2.9.1. Low Levels of Actual Settlement

Speculative activity dominates the market. The settlement by delivery is estimated to be less than 10%. That is, as much as 90% of the traded volume is squared up within the day or carried over and squared up later on.

In 2003, the turnover velocity for the three exchanges was 601%, making it the most heavily traded market compared to all Asia Pacific members of the WFE[37],[9] as shown in Table 10.

Table 10

Comparison of Turnover Velocity for the Market

Countries	2003
Korea	193.1%
Taiwan	190.7%
Thailand	136.0%
Shenzhen	125.8%
Shanghai	118.0%
NSE India	114.6%
Tokyo	82.6%
Australia	79.9%
Singapore	74.4%
Hong Kong	51.7%
Mumbai	51.6%
New Zealand	39.4%
Jakarta	34.9%
Kuala Lumpur	34.3%
Colombo	26.1%

[37] Ratio for Pakistan is calculated as follows. A daily combined traded value of KSE, LSE, and ISE divided by end of day market capitalization is taken and annualized by number of trading days. The methodology for WFE is slightly different. The WFE takes the ratio between the traded value of domestic shares and their market capitalization. The value is annualized by multiplying the monthly moving average by 12, i.e. Monthly Domestic Share Turnover x 12 / Month-end Domestic Market Capitalization

Philippine	12.2%
Osaka	6.6%

Source: WFE Annual Report 2003

2.10. Large Number and Low Quality of Intermediaries

When the market size is compared with intermediaries, it transpires that the number of intermediaries is excessively huge. The huge number is complex to give good reason that most of the brokers have their offices within the premises of building of exchanges.

Table 11[38]

Analysis of Members, Brokers and Agents

	KSE	LSE	ISE	Total
Maximum Members	**200**	**200**	**200**	**600**
Corporate Members	101	50	50	201
Individual Members	99	101	67	267
Total Member	**200**	**151**	**117**	**468**
Corporate Brokers	86	40	19	145
Individual Brokers	73	44	24	141
Total Brokers	**159**	**84**	**43**	**268**
Corporate Agents	1	-	-	1
Individual Agents	52	47	19	118
Total Agents	**53**	**47**	**19**	**119**

Source: KSE, LSE, ISE, and Securities Market Division of SECP

[38] Source: Report of Committee of SECP on demutualization.

The criteria to become a member, broker and/or agent only cover some of the most fundamental elements. The criterion has no requirement as to the professional qualifications for brokers, agents, or traders nor does it cover the operational capacity of brokers or agents to meet up the requirements of business and compliance with various securities laws. Almost half of the brokers are individuals. Many among them are using obsolete systems and practices.

2.10.1. Weak Criteria to become a Member

The by-laws of KSE refer to a set of conditions for the ineligibility of a person to become a member. However, they do not provide for any certification requirements.

2.10.2. Weak Criteria to become a Broker

Prior to the promulgation of Brokers and Agents Registration Rules 2001, there was no regulatory requirement for registration of brokers. Under Rules a set of eligibility criteria has been prescribed. However, a comparison of similar piece of legislation enforced in other jurisdictions reveals that the conditions are relatively weak. Moreover, these lack requirements as to the professional qualification.

2.10.3. Weak Criteria to become an Agent or Trader

The Rules as referred above also provide for the registration and regulation Agents of brokers like brokers themselves. Members, Agents and Traders (Eligibility Standards) Rules, 2001[39] prescribe criteria for the traders (terminal operators) employed by a

[39] See http://www.secp.gov.pk/annualreport/pdf/AR2001.pdf

Member. However, they are silent with respect to requirements for registration of traders with SECP. Although the Rules requires certification for agents but there is no mechanism for certification in existence.

2.10.4. Barrier to Entry to New Intermediaries

There exist barriers that are internationally considered as a major threat to foster competition among the members. The value for membership of the three exchanges ranges from Rs 10 million for ISE to Rs 40 million for KSE. Thus, membership requires extensive investment and creates a barrier for the new entrants. Moreover, it restricts professionals and institutions that have the knowledge and skills to run the brokerage business from undertaking the business. It also operates as a barrier for those individuals and institutions that have the resources to purchase the membership but find that they cannot earn sufficient return on this investment to make it financially viable by transacting for clients alone. The costly membership cards are keeping those potential intermediaries away from the market who could otherwise offer better services to investors. This value essentially represents scarcity value because if memberships were opened, the value of card would reduce considerably.

To increase the maximum number of memberships beyond 200, a board resolution is required in KSE. In LSE and ISE, the power to increase maximum number of members is not with the board but with the general body and it requires a change in the Articles of Association. Expensive membership has negative implications on the development of brokerage services as on purchase of the same, the member exhausts most of his

resources. The cost of membership card is Rs. 40 million, the net capital balance required is only Rs. 2.5 million.

2.10.5. Membership Card Treated as Real Estate

About 40% members of the stock exchanges are not registered with SECP as brokers. Most of them have bought membership cards in anticipation of capital gains on their sale. They appear to treat membership cards as if investment in real estate. KSE has 21% inactive members, LSE has 44%, and ISE 66%.

The interest of inactive members and active brokers often differs. Brokers view inactive members as free riders, making minimal financial or other contribution to the exchange but benefiting from the contribution of other stakeholders. The more an exchange invests in modernization of its infrastructure, the more a membership card is likely to grow in value. Stakeholders, particularly many active brokers, are of the view that no person should be allowed membership of a stock exchange unless he intends to become an active broker.

2.10.6. Low Capitalization of Brokers

Every member has to have a specified minimum net capital balance according to the Securities & Exchange Rules 1971. In 2001, through an amendment in the Securities & Exchange Rules, 1971, the SECP redefined and enhanced ten times the base minimum capital. The impact of the amendment is that a broker at ISE needs to have a minimum net capital balance of Rs 0.75 million; a broker at LSE needs Rs 1.5 million; and a broker at KSE needs Rs 2.5 million.

Data obtained from the exchanges shows that most brokers, particularly, proprietorships are operating with low net capital balances. Given the conceptual problems in net capital balance explained earlier, it appears that most brokers are undercapitalized.

2.10.7. A Single Class of Brokers

All brokers are clearing members, regardless of their capital balance or any other requirement. This is in contrast to international markets where brokers are generally divided into two classes, trading-only members and trading-and-clearing members. Such classification improves risk management and operational efficiency.

Similarly, all brokers are allowed to provide custody services to clients. Since, criteria for becoming a broker is weak, investors often suffer at the hands of unscrupulous brokers or their employees.

Given the problems being faced by exchanges as discussed earlier in this Section, we are of the view that they are fundamental in nature and require to be addressed through structural changes. Earlier reforms have not been able to reach the heart of problems being faced by exchanges because they were brought within the framework of mutual exchanges and a fragmented market place[40]. Since mutual structure and fragmentation appears to be the root causes behind the problems faced by exchanges, it is necessary

[40] "Demutualisation & integration of stock exchanges.", PPI - Pakistan Press International, Nov 7 2004 Issue

to examine as to whether and to what extent demutualization and specialization or integration can address these problems.

Chapter 3: From Mutuality to Demutualization: Seeking Guidance from International Practice and Evidence

3.1. Fundamentals of Demutualization

Financial exchanges developed as informal collective organizations of traders in particular financial instruments in many jurisdictions[41]. With the passage of time, the exchanges started devising their own laws for conducting their day to day business[42]. Subsequently, the states in which these informal, collective organizations were based moved to regulate financial exchanges, usually as part of a more general regulation of financial and investment activity[43]. Today, regulation of financial exchanges is based on the idea that investors will only trade financial instruments in markets which work properly, which are not rife with fraud, which have accurate information about the price of the financial instruments readily available, and in which trading, clearing, and settlement procedures are efficient[44]. Because exchanges are considered to be one of the

[41] See Technical Committee, International Organization of Securities Commissions, Discussion Paper on Stock Exchange Demutualization, 1 (Dec.2000) available at http:// www.iosco.org/download/pdf/2000-stock_exchange&uscore;demutualization.pdf (last visited August 22, 2007) ("A fair and efficient capital market is a public good. A well-run exchange is a key part of the capital market.).

[42] See Stuart Banner, The Origin of the New York Stock Exchange, 1791-1860 27 J. Leg. Stud. 113, 132 (1998) ("From its inception, the New York Stock and Exchange Board operated a miniature legal system, with its own rules governing securities trading and its own mechanism for resolving trade-related disputes.").

[43] See, e.g., Paul Mahoney, The Exchange as Regulator, 83 Va. L Rev. 1453, 1457 (1997) ("for most exchanges, comprehensive governmental regulation of rules and procedures is a twentieth-century phenomenon."). In the U.S., securities markets are regulated under the Securities Exchange Act of 1934, 15 U.S.C. §78a, et seq. (the "Exchange Act"); in the U.K., exchanges are currently regulated under §§ 36-41, 119-120 Financial Services Act 1986, 1986 Ch. 60. §§ 285-300 Financial Services and Markets Act 2000, 2000 Ch. 8, will replace the provisions of the 1986 Act when the 2000 Act

[44] See Zhao Li, Securities Regulation in the International Environment available at http://theses.gla.ac.uk/691/01/2009zhaoliphd.pdf

key source for the economic growth of the country, there must be effective system and control that depict true and fair picture of the affairs of the exchange[45]. The public interest in ensuring the ready availability of capital for productive enterprise requires that financial exchanges must be regulated, but there are issues about how that regulation should be carried out.

Many states have adopted systems for the regulation of exchange activity that rely, at least partly, on self-regulation[46]. Self-regulation allows regulators to defer to the expertise of exchange participants about what rules and procedures are necessary to make the exchanges work[47].

Ownership structures of exchanges have also reflected public and private elements: in different societies, exchanges have been privately constituted structures or organizations created by an act of the state[48]. Where exchanges originated as spontaneous collective organizations, they have taken the legal form of a mutual organization: in some

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[45] "The FSA aims to maintain efficient, orderly and clean financial markets and help retail consumers achieve a fair deal." Financial Services Authority Press Release, Consultation launched on changes to the U.K. listing regime, FSA/PN/007/2001, Jan. 17, 2001, available at http:// www.fsa.gov.uk/pubs/press/2001/007.html (last visited Feb. 15, 2001). Cf. Tech. Comm., Int'l Org. of Secs Comm'ns, Supervisory Framework for Markets (May 1999), available at http://www.iosco.org/download/pdf/1999-supervisory_for&uscore;markets.pdf, 2 (last visited Aug. 23, 2007) ("Regulators in all markets acknowledge that investors want fair, honest and orderly markets. Thus, the integrity of the markets is an important matter of public interest and regulators should take actions that promote these objectives of fair and efficient capital markets.").

[46] See International Organization of Securities Commissions, Objectives and Principles of Securities Regulation, ii, (May 1998) available at http:// www.iosco.org/download/pdf/1998objectiveseng.pdf (last visited Aug. 27, 2007) ("The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.")

[47] See SRO Consultative Committee, International Organization of Securities Commissions, Model for Effective Regulation, available at http:// www.iosco.org/download/pdf/2000-effective_self-regulation.pdf (last visited Aug. 27, 2007)

[48] Ranald Michie states that a formal stock exchange was first created in Paris in 1724, after the speculation provoked by John Law's activities. The Exchange's membership was limited to 60 by the government. Ranald C. Michie, The London Stock Exchange. A History, 3 (1999).

jurisdictions exchanges were unincorporated associations, in others they were incorporated mutual entities[49]. In the last few years, however, these exchanges have begun to demutualize, to transform their business organization from a not for profit business to a proprietary business[50]. In other jurisdictions, stock exchanges functioned historically as public institutions[51].

Financial markets are not immune to globalization[52]. Exchanges are engaged in cross border business, through listing securities of foreign issuers, and through allowing foreign persons to trade through their facilities. Members of exchanges may be multinational firms. Exchanges may themselves be multinational enterprises[53]. So, it is not surprising that bodies that are responsible for harmonizing approaches to financial regulation should have begun a process of developing agreement on the critical features of regulation of financial exchanges. Increased competition between exchanges and non-exchange securities markets, exchange mergers, and demutualizations raise issues at the international and domestic debates. This chapter first examines mutual businesses, including exchanges, and demutualization, from a domestic perspective.

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[49] For example, before its demutualization, the Chicago Mercantile Exchange ("CME") was an Illinois not-for-profit corporation. See, e.g., Chicago Mercantile Exchange, Inc., Amendment No. 5 to Form S-4 Registration Statement, available at http://www.cme.com/news/cme_s4.pdf (last visited Sep. 3 , 2007).

[50] See Treasury Select Committee, Ninth Report, Demutualisation, Volume I- Report and proceedings of the Committee, P 1 HC 605- I (July 27, 1999)(Session 1998-9), available at http://www.parliament.the-stationery-office.co.uk/pa/cm199899/cmselect/cmtreasy/605/60502.htm (last visited Sep. 3, 2007).

[51] The Cayman Islands Stock Exchange (established 1997) is "a private limited company owned by the Cayman Islands Government but operated as an independent entity." http://www.csx.com.ky/ (last visited Sep. 3, 2007).

[52] See Maurice Obstfeld, The Global Capital Market: Benefactor or Menace, 12 J. of Econ. Perspectives 9, 11 (1998).

[53] See, Euronext, The European "Hub" of the Global Network, available at http://www.boursedeparis.fr/fr/sbf6/pdf/Euronext.pdf (last visited Feb. 14, 2007).

3.2. Mutual Businesses

Mutual businesses are businesses that are designed to be run by managers for the benefit of their members[54]. They differ from traditional partnerships and companies in that the members do not have traditional ownership rights in respect of the company, nor do they typically have rights to share in revenues of the business. Members have equal rights to participate in decision-making. The business accumulates revenues, rather than distributing them. Mutuals trace their origins to medieval guilds in northern Europe, which were member associations. These guilds were originally linked to the boroughs in which they were established, so were part of a public authority, although they later separated from the boroughs and came to be seen as private[55]. In contrast to the situation in northern Europe, business activity in Italy was carried on through joint stock enterprises characterized by investment of capital, rather than associations of people. The joint stock company spread to Northern Europe by 1700, but its development was slowed in England by the Bubble Act of 1720[56]. During the 18th century a number of petitions for incorporation were rejected by the Crown, and businesses were formed as partnerships instead. By the beginning of the 19th century, there were increasing numbers of joint stock companies in England.

Some financial exchanges developed as mutual businesses before the introduction of general incorporation statutes. For example, the London Stock Exchange started in coffee houses in Change Alley, moving to a building marked as "The Stock Exchange" in 1773,

[54] See foot note 39 *ibid*

[55] See C.A. Cooke, Corporation, Trust and Company, 21-31 (1951).

[56] See Bishop Carleton Hunt, The Development of the Business Corporation in England 1800-1867, 9 (1936)

and charging an entrance fee for admission.[57] But the exchange "failed to control the London securities market as it was neither exclusive nor dominant. In 1801 the Stock Exchange became an organization. In order to have an organized business, the persons who were not members of the exchange were debarred from transacting business in the market. The London Stock Exchange adopted its first set of rules and regulations in 1812, before the first general incorporation statute in England was enacted in 1844. Before 1844 corporations were created by statute or by charter, and other businesses took the form of deed of settlement companies. In the early nineteenth century, Parliament also produced special legislation to regulate various types of mutual enterprise, including building societies, and savings banks. Building societies formed in the U.K. during the eighteenth and nineteenth centuries as mutual organizations to facilitate their members' home ownership. Maitland points out that, in 1877, a Royal Commission suggested that the London Stock Exchange (LSE) should be incorporated, but that the Stock Exchange was not interested. The LSE finally incorporated as a private limited company in 1986[58]. The first New York general incorporation statute was enacted in 1811[59], but the NYSE was not incorporated until 1971[60].

The privileges of members of mutual firms vary from jurisdiction to jurisdiction, and also depend on the provisions of the mutual's constitutive documents. Decision-making procedures vary. In the same way that owners and managers of corporations find that

[57] See foot note 39 *ibid*
See David Kynaston, The City of London, Vol. 1, A World of Its Own 1815- 1890, 16-17 (1994).
[58] See, e.g. London Stock Exchange, Information Memorandum, 9 (2000) available at http://www.londonstockexchange.com/dealing/pdfs/demutualisation.pdf (last visited Sep. 14, 2007).
[59] Act of Mar. 22, 1811, ch. LXVII, §1, 1811 N.Y. Laws 111. Other Stock Exchanges subsequently formed in the U.S. See, e.g., Joseph L. King, History of the San Francisco Stock and Exchange Board, 1 (1910) (recording the organization of the exchange in 1862).
[60] See http://www.nyse.com/pdfs/historical99.pdf (last visited Aug. 25, 2007).

their interests may conflict, disputes may arise about the respective rights and duties of management and members of mutuals[61]. The major differences between mutual firms and proprietary firms are financial rights of members, and during decision-making procedures that apply within the firms.

3.2.1. The Demutualization Movement

Exchanges are not the only type of mutual business to demutualize in the last decade. U.K. building societies have demutualized, becoming more like banks. Insurance companies in various parts of the world have also demutualized[62]. There are three main arguments for demutualization: subjecting the company to the discipline of the marketplace; facilitating the raising of capital; and allowing diversification into areas that would not be appropriate for a mutual enterprise[63]. The arguments exchange managements make for demutualization are similar to those which managements of insurance companies and other types of mutual firm (or their members) make for demutualization, but exchanges raise issues which do not arise in the context of other companies.

Sometimes a firm may adopt a partial demutualization strategy, involving the transfer of the business of the mutual to a proprietary company. The mutual company becomes a holding company that does not engage in business itself.

[61] See http://www.fsa.gov.uk/consumer/whats_new/equitable/RegUp82.pdf (last visited Aug. 23, 2007).
[62] See James A. Smallenberger, Restructuring Mutual Life Insurance Companies: a Practical Guide Through the Process, 49 Drake L. Rev. 513 (2001).
[63] See Treasury Select Committee, Ninth Report, Demutualisation, Volume I- Report and proceedings of the Committee, P 1 HC 605- I (July 27, 1999)(Session 1998-9), available at http://www.parliament.the-stationery-office.co.uk/pa/cm199899/cmselect/cmtreasy/605/60502.htm.

During the last ten years, an increased tendency towards demutualization has been witnessed[64]. The Exchanges that have opted demutualization are London, Toronto and Australian Stock Exchange. Late in 2000, NASD announced its decision to spin off the Nasdaq market, retaining only a minority interest, and it completed a private placement in January 2001[65]. The NYSE has also announced its intention to demutualize.

Exchanges demutualize for reasons similar to those identified by other types of mutual firms[66]. The Australian Stock Exchange's demutualized because the interests of large and small brokers were diverging and it was difficult for the exchange to represent both interest groups and remain competitive[67]. Richard Grasso, of the NYSE, has expressed this last concern even more forcefully, arguing that members of the exchange can only "realize economic value from their right to trade on the NYSE floor," which "skews the interests of member-owners toward the value of the floor trading privilege." In addition, the diversity of the interests of members "is a continual source of tension and conflict. At times it leads to careful deliberations and consensus judgment. All too often it can lead to cumbersome decision-making and strategic gridlock."

The Toronto Stock Exchange sold the idea of demutualization to its members by suggesting that it would give the members new rights to any surplus of the exchange and

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[64] See Technical Committee, International Organization of Securities Commissions, Discussion Paper on Stock Exchange Demutualization, 1 (Dec.2000) available at http:// www.iosco.org/download/pdf/2000-stock_exchange&uscore;demutualization.pdf (last visited August 22, 2007)

[65] See Nasdaq Press Release, Nasdaq Completes Private Offering and Expands Board, (Jan. 25, 2001) available at http://www.nasdaq.com/about/pr_private_offering_012501.stm (last visited Augustt. 25, 2007).

[66] See Toronto Stock Exchange, Demutualization of the TSE, at http:// www.tse.com/tse_inc/demutual.html (last visited August 22, 2007).

[67] See Presentation to the Securities Institute of Australia, 9 May, 2000, available at http:// www.asx.com.au/shareholder/l3/SP090500_AS3.shtm (last visited August 21, 2007).

that it would limit their risk of liability[68]. NYMEX stated that, although it would not guarantee a market in the exchange's shares, it would be able to pay dividends to stockholders[69].

Another set of reasons for demutualization involves introducing new governance structures into exchanges: moving from a world of consensus, based on one vote per member, to a world of voting according to the level of investment in the enterprise and a model of taking account of the interests of shareholders in decision-making. The move from a consensus-based system should increase the ease of decision-making[70]. In addition to changing procedures for decision-making, demutualization may be a tool for changing the culture of a firm.

There is also a public relations advantage: in a world where traditional exchanges are being challenged by a range of non-exchange service providers which compete with the services offered by exchanges[71]. Exchange managements portray demutualization as a forward-looking strategy. For example, the chairman of the NY Mercantile Exchange stated demutualization as "indicative of the progressive and innovative manner in which we will proceed as a for-profit corporation to reposition the Exchange as a 21st century

[68] See Toronto Stock Exchange, Information Circular providing members with information regarding demutualization of the Toronto Stock Exchange and the market realignment in Canada, 1 (1999), available at http://tsers.com/cgi-bin/uni_framset.cgi?content/pdf/infocirc.pdf (last visited Sept. 5, 2007)

[69] See NYMEX Holdings, Inc., Amendment No. 1 to Form S-4 Registration Statement, 1 (Apr. 14, 2000) available at http://www.nymex.com/news/s4_April.pdf (last visited August 19, 2007). These statements also appeared in the proxy statement and prospectus dated May 12, 2000 available at http:// www.freeedgar.com/.

[70] See Toronto Stock Exchange, Demutualization of the TSE, at http:// www.tse.com/tse_inc/demutual.html (last visited August 22, 2007).

[71] See Are Mutual Insurers an Endangered Species? Sigma No 4/99, 10 (1999) available at http:// www.swissre.com/e/publications/publications/sigma1/sigma499.Paras.0002.File.pdf (last visited Sept. 15, 2007).

business enterprise that will create and pursue profitable new opportunities, react rapidly and decisively in an increasingly competitive marketplace, and explore interest by outside investors.[72]"

When mutual exchanges convert to proprietary companies, they substitute the need to maximize profits to benefit shareholders with the interests of members and the centre of decision-making changes. Rather than running the business on the whims of the members, the management of a proprietary exchange will be managing the business as if it were any other type of business. A rational management will adopt business strategies that promote the interests of exchange shareholders in maximizing the returns on their investment. Managers may be even more likely to do so in case their own interests are there in the value of the exchange's shares because of share option schemes. Some argue that increased competition between financial markets is one reason why market participants no longer need mutual exchanges[73]. Competition between markets should also encourage proprietary exchanges to consider the interests of market participants as part of their profit maximizing strategies.

These advantages may be realized, but at a cost. If nothing else, there is an immediate financial cost to the enterprise, and its owners, as demutualization is not cheap. Prudential reported demutualization expenses of $113 million in the nine months leading up to the end of September 2000, before the completion of its demutualization[74]. The Sydney

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[72] See NYMEX Press Release, Exchange Demutualizes, (Nov. 20, 2000) available at http://www.nymex.com/news/pr_detail.cfm?id=319 (last visited August 28, 2007).

[73] Sydney Futures Exchange, Proposal to Demutualise Information Memorandum, 177 (June 19, 2000) available at http:// www.sfe.com.au/site/html/shareholder/demut.htm (last visited Sep. 14, 2007)

[74] See Prudential, Third Quarter 2000 Fast Facts, available at http://www.media.corporate-ir.net/media_files/PRIV/10693/reports/fast facts_december00.pdf (last visited August 15, 2007).

Futures Exchange stated that it would spend Aus$4.8 million on its plan, whether or not it demutualized. Financial regulators may incur additional costs in monitoring the conflicts of interest that may arise in proprietary exchanges.

3.3. Exchanges as Proprietary Businesses

In order to begin to think about the implications of exchanges being proprietary businesses, rather than mutual enterprises, it is helpful to think about the business of exchanges. Exchanges sell listings for financial instruments that satisfy their requirements[75]. They also provide facilities whereby people can trade in financial instruments. They put up for sale the details of the share prices of different financial instruments at which they trade. They sell regulation of their members. The exchanges provide a platform wherein investors can buy or sell the securities of the companies that are listed with them and do not sell the financial instruments themselves. Exchanges, therefore, are places where substantial information is sold in compliance with certain rules that are partly developed by themselves[76].

Within proprietary exchanges, conflicts may arise between the interests of owners and those of managers, just as they may do in any proprietary business. This means that proprietary exchanges have the same need for good corporate governance as do ordinary businesses, in addition to being subject to the constraints imposed by market mechanisms

[75] See London Stock Exchange, Information Memorandum, 9 (2000) available at http:// www.londonstockexchange.com/dealing/pdfs/demutualisation.pdf (last visited sept. 14, 2007). In the year ending March 31, 1999, 16% of the London Stock Exchange's turnover from continuing activities (excluding regulatory activities) was from company services (fees for admission to trading and annual fees).

[76] See LSE, Rules & Regulatory Guidance. Overview of Our Regulatory Role, at http:// www.londonstockexchange.com/regulation/regulation.asp (last visited Sept. 24, 2007)

and legal rules. However, there are reasons to doubt the effectiveness of corporate governance measures as protections for the interests of shareholders, even in more ordinary businesses[77]. For example, some commentators focus on executive pay that increases even at times when returns to shareholders decrease[78].

3.3.1. Proprietary Businesses as Regulators (Privatized Regulation)

In many jurisdictions, financial regulation involves a significant component of self-regulation[79]. The reason for this is partly historical. In England, Barnards Act of 1734 made time bargains illegal, so that regulation of these transactions was, necessarily, extra-legal[80].

The main justification for self-regulation in the financial context is that self-regulatory bodies have expertise that external regulators might not have access to[81]. Self-regulation may have another advantage: the regulated population may be more inclined to comply with self-regulatory rules than with rules imposed by outsiders.

Pure self-regulation would involve an unattractive prospect of financial firms "regulating" themselves in their own interest, so regulatory schemes often provide for self-regulation within a statutory framework creating a regulator. In addition to the

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[77] See William W. Bratton & Joseph A. McCahery, Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation, 73 N.C.L. Rev. 1861, 1862 (1995)

[78] See Graef Crystal, GE CEO Welch's Pay Shows Capitalism's Ugly Side (Mar. 16, 2001), available at http://www.bloomberg.com (last visited Sept. 24, 2007)

[79] See Financial Services Authority Press Release, Consultation launched on changes to the U.K. listing regime, FSA/PN/007/2001, Jan. 17, 2001, available at http:// www.fsa.gov.uk/pubs/press/2001/007.html (last visited July 15, 2007).

[80] See Ranald C. Michie, The London Stock Exchange. A History, 3 (1999).

[81] See Arthur Levitt, Dynamic Markets, Timeless Principles, 2000 Colum. Business Law Review Volume 1at page 7 (2000).

claims about the need for expertise in financial regulation, those who promote the idea of self-regulation in a statutory context often do so to achieve two potentially conflicting objectives: to make the regulatory scheme acceptable to the regulated population, and to convince outsiders that the scheme is effective. Whether the "self" or the "regulatory" part of the self-regulator's functions is emphasized may relate to the context it has been used[82].

In U.S., the regulators which oversee self-regulatory exchanges are administrative agencies, which are clearly public bodies. In other jurisdictions, the situation is more murky. The U.K.'s Financial Services Authority is a private company limited by guarantee which was originally formed (as the Securities and Investments Board) as the U.K.'s financial services regulator, and was subsequently designated as the regulator. Although the Financial Services Authority (FSA) exercises public powers, the new statute which is to form the basis of the FSA's powers will require the FSA to have regard to principles of good corporate governance in carrying out its functions[83]. This emphasis on corporate governance underscores the private aspects of the FSA's position.

A change in the nature of a self-regulatory organization from a mutual to a proprietary firm raises the question whether the need to extra care to the financial interests of shareholders, who may not be participants in the market run by the firm, adversely affect the ability of the firm to exercise its regulatory responsibilities. To the extent that the basis for delegating regulatory responsibility to the firm is its expertise, the arguments for

[82] See L.C.B. Gower, Big Bang and City Regulation, 51 Model Law Review Volume 1 at page 9 (1988).
[83] See Paul Mahoney, The Exchange as Regulator, 83 Va. L Rev. 1453, 1457 (1997)

the firm to continue as a regulator would seem to remain, although one might expect a profit-oriented firm to focus on expertise in building markets, rather than regulating them. Worse, the need to focus on profits for the benefit of shareholders might result in an under-provision of regulation in the market. Of course, the need for a mutual enterprise to focus on the interests of its members might similarly result in an under-provision of regulation in the market, and a proprietary exchange might have less need to pander to the interests of members than a mutual exchange would.

3.4. Demutualization process and Lessons from International Practices

3.4.1. History and Evolution of the Australian Stock Exchange:

The evolution of Australian Stock exchange can be traced from the existence of six independent exchanges which were situated in state capitals of the Australia. The Sydney Stock Exchange was the first exchange that was formed in year 1871. Thereafter Hobart exchange that was formed in year in 1882, Melbourne and Brisbane exchange were formed in year in 1884, Adelaide exchange that was formed in year 1887, and Perth exchange that was formed in year in 1889.

In 1903, the exchanges held their first interstate conference, which subsequently proved to be a milestone for the establishment of the Australian Associated Stock Exchanges in 1937. Through this organization the exchanges established a common set of rules and regulations.

With the development of stock exchanges and to effectively address the issues arising out due to the existence of different exchanges in the country, the members of the exchanges gathered to devise a long term mechanism. The members of the six exchanges presented various models for harmonization of the business of the stock exchanges and finally in year 1987, all the exchanges were integrated and a single exchange was established.

The reform process that finally led to a demutualized exchange started when in the year 1982 exchange was instructed by the Trade Commission to admit the corporate members for trading. The admittance of corporate members resulted into conflict of interests between the corporate and individual members. Although the individual members had 80% of the voting rights but their trading accounted only 1% of the total trade carried on the exchange[84]. This complex distribution of voting rights along with certain other elements compelled the private sector and the policy makers to undertake the reform process so that competitive market practices be introduced. The policy makers and private sector participants in order to effectively address the stock exchange issues proposed an exit mechanism for the individual members. In this regard the decision was required to be passed through a special resolution with a majority of three fourth. However, the proposal could not be approved as it could not get the approval of the three fourth majority[85]. The failure of the proposal left the policy makers and private sector participants with no option but to opt for demutualization of the stock exchange.

[84] See Richard Humphrey, Address to Association of Superannuation Funds of Australia (Dec. 9, 1998), at http://www.asx.com.au/shareholder/13/AA091298_AS3.shtm (last visited July 25, 2007).

[85] See Christopher Zinn, Australia's Share Dealers Put a Price on Themselves, GUARDIAN, Sept. 23, 1998, at page 25.

Resultantly, the Australian Stock Exchange was converted into a company limited by shares in year 1996 and the shares of the exchange were offered to the public in the year 1998 and its securities were listed on its own trading floor. The Securities Commission monitors and ensures that exchange is at all times in compliance with its own listing requirements. The exchange has shown tremendous growth since it has demutualized and is among the world's largest exchanges. The Exchange has put in place the automated trading system which enables a broker to undertake buying and selling through this system.

Today Australia has three regulated securities exchanges and two futures exchanges. They are all demutualized, for profit companies but only the ASX is listed on its own exchange. It is important to concentrate on ASX because so much of Australian Securities and Investment Commission's (ASIC) learning about conflict of interest issues derives from its regulation of ASX since trading in ASX shares began on its market on 14 October 1998.

3.4.2. The History of ASX Demutualization

As indicated above that pursuant the failure of the proposal to provide an exit mechanism to individual members, a great number of the members voted for the changes in the memorandum of association of ASX[86] and promulgation new law for demutalization. The process was completed in year 1998 and the existing members were allotted the shares of the demutualized exchange. The issue of shares occurred on the following basis:

[86] Over 96% of members supported the recommendation. Members were entitled to one vote each.

a. Each of the 606 eligible former Corporate and Natural Person Members received 166,000 shares resulting in a total issued capital of 100,596,000 shares[87].
b. There was no "cash out" offer for members, and there were no additional shares offered or funds raised by ASX.
c. There were no special restrictions placed on members concerning the sale of ASX shares.50Demutualization Events
d. There were no minimum shareholding requirements placed on members.

3.4.3. Post Demtualization Regulatory Challenges and response

The Australian legislature promulgated two laws for effective implementation of the demutualization process. The first law placed the following requirements:

a. Detail on the ASX's obligation for market supervision including an express power to require it to do specified things to ensure it complies with supervisory obligations;
b. Requirements that the ASX at least annually prepare and give to the regulator, the ASIC reports about compliance with their supervisory obligations;
c. Processes to require ASIC to act as the listing authority for ASX – i.e., the role that ASX plays in relation to all other listed entities, to ensure that the ASX as a listed company complies with its disclosure obligations; and
d. Share ownership of ASX for any single member was restricted to 5 per cent[88].

[87] While ASX had both corporate and natural person members, all members were treated equally for share distribution purposes.
[88] There was however a 5% individual ownership cap imposed by the Government and contained in the *Corporations Law;* this limit was ultimately raised to 15%.

Initially, the law imposed certain regulatory obligations towards the overall growth of the capital market of Australia[89]. In year 1998 conflict of interest secenario was developed when ASX moved a competitive bid for the takeover of SFE and rival bid was given computershare a public limited company that was listed at ASX. As there was no mechanism was in place to address the conflict issue, the matter was directly taken by the Australian regulator which instructed ASX not to proceed ahead without its previous approval. Afterwad neither ASX nor computershare could takeover SFE. In year 2000 ASX recognizing its position as a exchange regulator established an independent supervisory company which was given the mandate to act as supervisor to the activities of the ASX. The independence of the supervisory company was ensured through representation of independent directors on the board of the supervisory company. Resultantly, in year 2000 different laws were promulgated to put in place segregation of supervisory and for profit activities of ASX. The laws required that:

a. ASIC will undertake an annual assessment of ASX supervision, including by way of public reports;
b. Market operators must have in place adequate conflict management arrangements to deal with conflicts between commercial interests and ensuring the market operates fairly and transparently; and

[89] See Jeffery Lucy, "Mergers, Demutualization and Governance of Securities Exchanges", remarks to International Organization of Securities Commission, May 20, 2004, available online: http://iosco.org/library/annual_conferences/pdf/ac18-17.pdf.

The restriction on Share ownership of ASX for any single member is increased to 15 per cent[90].

3.4.4. Toronto Stock Exchange (TSX) Demutualization

3.4.4.1. Background to the TSX's Demutualization

TSX was established in year 1852. By virtue of its corporate characteristics it was not for profit company that had mutualized ownership structure. The members of the exchange were also the brokers and by virtue of their memberships they were entitled to execute transactions. Till 1997 there was no electronic or automated system of trading and all the transactions were transacted physically.

As discussed earlier that there are generally two driving factors for the move form mutualized exchange to a demutualized exchange i.e. (a) Government or policy maker initiative (b) Private sector. TSX demutualization was based upon the later form, the exchange in order to keep itself competitive undertook the analysis of TSX's potential and performance expectation surveys if it is converted from mutualized exchange to demutualized. Further, a detailed analysis conversion experience of different international jurisdictions was conducted. One of the driving factor for the demutualization of TSX was the diminishing activities of TSX in the futures market and resultantly based uon this methodology A Blue Print for Success was prepared.

[90] See Andrew Main & George Lekakis, ASX Faces Blue-chip Exodus, Australian Financial Review., Nov. 22, 2000, at page 1.

Blueprint suggested a revamped ownership structure of the members of the TSE so that the influence of the brokers may be diluted and the exchange be tuned up on internationally recognized competitive practices. The salient features of the proposed ownership structure and governance mechanism included the following:

a. for-profit instead of not-for-profit;
b. shareholder structure instead of member-seat-holder structure;
c. separation of access from ownership; and
d. initially designating at least half of the seats on the Board of Directors from outside the brokerage community.

3.4.4.2. Rationale for the Demutualization of TSX

In year 1852, when TSX was established the market player were very few and the volume of the trade was not much. However, with the passage of time the business of the exchange increased to a great extent. With the increased volume of trades and market players TSX faced different governance issues. Even, the consensus among the members was difficult to achieve and each members intended to pursue their own goals and objectives. During the early days of the exchange the number of members was limited and the decision making process was prompt. However, with the increased number of members the decision making process delayed. Resultantly, the exchange failed to take prompt decisions in the interests of the investors. Moreover, the exchange also faced national and international pressures as the mutual structure of the exchange failed to ensure required disclosures of the systems and controls of the exchange business to retain

the investor's confidence. The monopoly of the members with respect to the limited number of seats to execute the business on the floor of the exchange also proved to be a hindrance towards the growth of the exchange and same became outdated with the introduction of the electronic system for executing business. Thus, in order to address the governance and accountability issues the board members of the exchange decided that the structure of exchange be converted into demutualized form so that the proper systems and controls along with enhanced and more regulated governance mechanism be put in place.

3.5. The Demutualization Process of the TSX

3.5.1. Demutualization of TSX

As mentioned above that the decision to convert the form of TSX into demutualized structure was originated by the board of governors of TSX its self and to this end the board of governors approved the demutualization. Resultantly, TSX's corporate structure was converted from mutualized to a demutualized with the common characteristics of the companies i.e. memorandum and articles of association, shareholders, board of directors, perpetual succession etc. and enhanced regulatory framework to comply with. Each member was offered twenty shares in lieu of his seat.

After the conversion of the corporate structure of the exchange the shareholders of TSX through special resolution approved the demutualization, the Ontario Securities Commission also accorded its approval and imposed certain conditions. Subsequently, in order to provide an enabling legal framework for the post conversion process the legislature promulgated Ontario Business Corporations Act. The Act provided that

different market participants will undergo a reconstruction process duly confirmed by the court thereby determining the assets and liabilities of the each of the market participant and TSX incorporation was formed as fully demutualized exchange.

3.5.1.1. Responses to Regulatory Challenges

In order to effectively address the effect of concentrated ownership on the business and policy decisions of the exchange TSE inflicted certain restrictions on itself. The restrictions were temporary in nature and were remained in force till its listing. The restrictions included the following:

(a) any person or group of persons were prohibited to own or control more than five percent of the its out standing shares without the prior approval of the Ontario Securities Commission.

(b) The members who were allotted more than five percent of the shares were given exemption from the application of more than five percent shares. However, an additional restriction was imposed on them that they were debarred from exercising more than five percent of the voting rights.

(c) Free transfer of shares, without the previous approval of the board and the shareholders with simple majority, was restricted

After demutualization, TSE occupied a dual role i.e. (a) a regulator for the listed companies and (b) a supplier for business services. By virtue of conversion to for profit

entity, TSE also became a competitor for the other companies whose securities were traded thereat. The companies started questioning the neutrality of the exchange. In order to effectively resolve the potential concern of partiality, TSX setup an independent subsidiary "*Market Regulation Services Incorporation*" and the function of the market regulation was transferred to it from TSE. Further to ensure the impartiality of the newly setup company independent director were given due representation.

3.5.1.2. Consequence of Demutualization of TSE

Demutualization of TSE (TSX Venture Exchange) resulted into major consolidation of the securities market of the country and increased market liquidity and reduced transaction cost. The consolidation process included a MOU between TSX and the Bourse de Montréal. The MOU provided that:

a. TSX became the senior equity exchange by combining the senior equity securities businesses of the Toronto and Montreal exchanges;
b. The exchange that is now TSX Venture Exchange (which the TSX acquired in 2001) became the junior equity exchange by combining operations of the Vancouver, Alberta and Winnipeg stock exchanges, the junior listings from the Bourse de Montréal and the over-the-counter Canadian Dealing Network; and
c. The memorandum of agreement prevents the TSX from providing trading facilities and services for exchange-traded derivative products, comprising (without limitation) options and futures contracts, other than natural gas and electricity products, until March 2009.

3.5.2. Demutualization: Effect and efficiency in the business of TSX and ASX

After the completion of demutualization process the objective and operations of ASX and TSX have witnessed drastic alterations from their previous objective and operations which included the following:

a. Increased flexibility in decision-making;

b. Increased customer focus; and

c. Growth and expansion of activities.

3.5.2.1. Decision-Making

The quick decision making is considered to be a vital element of an efficient capital market. After the demutualization of both the exchanges the decision making process that was very lengthy, at some instances almost impossible, in the mutualized form of structure has now been reversed. Both the exchanges have full liberty to effectively and timely implement the day to day changing requirements of the market. Dominance of the brokers on the decision making process has been diluted to a great extent which was a bigger hindrance for the growth of the business. Although brokers have been given due representation on the board of the exchanges but their control to run the exchange according to their whims and wishes has been done away. Thus capability of the exchanges has consequently been enhanced for taking timely decisions for the interests of the stakeholders.

3.5.2.2. Change of Focal point from Brokers to Customers

Demutualization has resulted into another key difference that the attention of the exchanges from the brokers has been shifted to the market players. The enhanced regulatory framework of the demutualized exchanges require the decision making process to be approved from the shareholder which now include the listed companies, institutional and high net worth investors. Prior to demutualization the market participant were not included in the decision making process and focal point for all the key decisions were the brokers.

3.5.2.3. Growth of Activities

A key feature of the demutualization is the change in the objective of the exchange from not for profit to a for profit entity. After the demutualization both the exchanges have started devising policies for providing enhanced market services. As a consequence of the change in polices and strategies the activities of the ASX increased:

a. A joint venture arrangement involving a share registry business;
b. The acquisition of a 15 per cent stake in a company that provides trading and order management services to professional financial market participants; and
c. The acquisition of a 50 per cent stake in a company that provides an investor consultancy service.

The change in the policies was not restricted to national level rather it also focused on the international trading which include:

a. A two-way trading link with Singapore Exchange Limited, which is expected to be operational later this year; and

b. A one-way trading link into the United States market, utilizing Bloomberg's TradeBook system.

Similarly TSX after the demutualization revamped its policies for the interests of its shareholders and ultimately strengthening the economy of the state. In order to consolidate and increase its activities has taken various decisions which include:

a. The acquisition of approximately 40 per cent (now 45 per cent) equity interest in CanDeal.ca Inc., which owns and operates an electronic trading system for the institutional debt market and which is registered as an Altemate Trading System. This acquisition has diversified TSX's business in the electronic fixed-income market.
b. The creation of CNX Marketlink with Canada NewsWire Ltd., now CNW Group Ltd. ("CNW Group"). CNX Marketlink provides publicly listed issuers with enhanced investor communication tools. This furthered TSX's strategy to leverage their existing data capabilities and to deliver new services to their listed issuers. Marketlink offers webcasting and conference call services, which assists issuers to meet their corporate communication needs and to deliver time-sensitive information to their shareholders and other stakeholders.
c. The purchase of NGX. NGX operates a Canadian electronic commodity exchange which trades and clears natural gas and electricity contracts. This transaction extended and diversified TSX's position in Canada by broadening their product and service offering, while at the same time expanding their reach outside

Canada. NGX enables energy traders to trade and clear physical and derivative natural gas spot and forward contracts and derivative electricity forward contracts.

Chapter 4: Towards a Demutualized Exchange in Pakistan: Devising a Practical and Adoptable Procedure

In this chapter of the thesis we will elaborate certain concerns that arises once an exchange .coverts from mutualized to demutualized form. Looking .into what we have discussed so far, we can say that the demutulization of stock exchanges in Pakistan is both desirable and inevitable. Although one cannot generalise the experiences along the globe however the following two quotes highlight the importance of the objective to demutulize the markets in no time.

> "Surely it would now be impossible to deny that the securities community has reached an implicit consensus that demutualisation maximizes efficiency incentives and is critical to the survival of international exchanges[91]." and,

> "Mutuals as a way of operating financial markets were never going to survive corporate membership of exchanges, far less computerization in the financial sector, the information age, the Internet revolution, or globalization. They reflected the coffee shop origins of the markets, the shouted order across the crowded, noisy and frequently smoke filled room, where every trader knew every other trader, and what they were good for.

[91] Cha, Laura (Deputy Chairman and Executive Director, Securities & Futures Commission, Hong Kong). *Regulatory Framework after the Merger of the Exchanges*. (21/10/1999).

The wonder is not that they are coming to an end, but that they lasted so long[92]."

4.1. Critical Analysis of Various Demutulization Models with Respect to Pakistan

Before critically analyzing the various options that could be used for modeling Pakistan's stock exchange demutulization, certain issues of how the demutulization is driven by the current economic scenario around the globe need to be addressed at the outset.

The key element that is driving the developing countries to introduce the demutualized structure in their countries is that by the passage of each day the world is becoming global village and the access barrier that existed previously are being removed thus resulting an enhanced investment regime.

The other element that necessitates demulalization in Pakistan is the requirement to have increased corporate disclosures of the affairs of the stock exchanges. The international investors that intends to invest in Pakistan face difficulties with respect to the decision to make invest as the disclosure requirements as practiced in their countries and disclosure requirements as practiced in Pakistan are far different. The transformation of exchanges from mutualized exchanges to demutualized exchanges results into increased disclosures and reduction in overpowering role of the members of the mutualized exchanges.

[92] Cameron, Alan. *Demystifying Demutualization.* (2002).

This is the reason that in most of the developing countries there exist only one stock exchange and where there are more than one stock exchanges in the country the leading stock exchange manipulates its position by virtue of its market share. The remarkable difference between the market share of the leading stock exchange with rest of the exchanges of the country brings the stock exchange in position where it totally negate the competition issues. Similar situation exists in Pakistan where KSE is enjoying the dominant position in the market and LSE and ISE are no more in competition with KSE.

The transformation of the stock exchanges from mutualized to demutualized structure are two major factors that exist. The stock exchange's role in the overall development of economy of a country can not be negated thus, the governments of the developing countries put an emphasis on the stock exchange's governance structure. The implementation of higher the governance tools result into higher economic activities both for the domestic investors and foreign investors. The other factor is the difference between the role of the private sector of the developed and developing countries. In the developed countries market innovations are usually introduced by the private sector and the governments support the ideas floated by the private sector. However, in the developing counties this burden comes to the government i.e. development of stock exchanges on strong regulatory and market friendly environment.

In order to cater for the issues in most of the developing countries the concept of national exchanges has been introduced. The board members and chief executive of the exchange are usually appointed or nominated by the governments. In this way the strong regulatory

measures are being introduced and the direct role of the government can not be negated. Once the national exchange is subject to direct governance of the government, it may be given certain financial assistance to the exchanges[93].

Demutualization process initiated by the government is by and large advantageous as compared to market driven demutualization process. During the government initiated demutualization process the leading role is played by the government and all the policy decisions comes from the government which is capable of resolving the issues more comprehensively as compared to private sector where the likelihood of conflict of interests issues between various market players can badly impact the demutualization.

In most of the jurisdictions where the stock exchanges have undergone demutualization or the exchanges that are under the process of demutualization, it has been observed that the policy decision for the demutualization was government driven. After the decision of the government to demutualize the mechanism and operational issues were delegated to the regulatory authorities. The examples include India where the government set up a committee to evaluate the demutualization imitative in India.

Likewise, in Malaysia the government prepared a Capital Market Master Plan which evaluated different aspects of the demutualization and ultimately the demutualization process was completed.

The regulators are of the opinion that the laissez-faire[94] approach to demutualization could not be implemented in developing markets as to the existence of the probability of

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[93] One ofthe example of this National Stock Exchange of India available at www.nseindia.com

the collapse of the demtualized exchange which can adversely impact the economic situation of the country.

The demutualization efforts in Pakistan rest on the above mentioned thinking of regulators that in Pakistan the market structure is not a complete case of laissez-faire and different initiatives that have been introduced in the market were initiated by the government due to lack of well developed private sector.

The antagonist to the view that demutualization should be initiated by the government often argue that the demutualization process initiated by the government may cause the market failure as the conversion was not based on the market driven factors rather based on the views/ findings of the policy makers. Further, if at all the stock exchanges are converted to the demutualized form of structure based on the decision of the policy makers/government, the healthy performance of the market can not be ensured. As explained above the private sector in the developing countries has not developed itself when compared with the private sector of the developed countries, the role of the government while devising new initiatives increases to a great extent. Further, the government is also capable of acting neutral among different market participants.

Usually a demutualized exchange has witnessed different advantages that enable the exchange:

1) to modernize its technology;

[94] An economic doctrine that opposes governmental regulation of or interference in commerce beyond the minimum necessary for a free-enterprise system to operate according to its own economic laws.

2) to create a valuable currency to develop international strategic alliances and acquisitions by offering equity to relevant parties;

3) to obtain a governance and management structure that is more agile, flexible, and swift in its ability to respond to industry and market conditions;

4) to obtain a governance and management structure that is less susceptible to members' vested interests and conflict between classes of members, and, more bluntly, that is not subject to "cumbersome decision-making and strategic gridlock";

5) to unlock members' equity, and buy out the vested interests of traders;

6) to ensure that those market participants which provide most business to an exchange have a proportionate say in its control;

7) to avoid concentration of ownership power in a particular group of exchange participants;

8) to spread ownership risk;

9) to reward key market participants in equity, thus giving them a financial incentive to bring business to the exchange;

10) to provide appropriate incentives for, and impose market discipline on, management;

11) to create a catalyst for pursuing new business strategies;

12) to provide both a valuation benchmark and liquidity for investors;

13) to obtain an initial infusion of capital and to gain easier ongoing access to capital;

14) to be more willing to open up access to its markets; and

15) to improve financial decision-making, by ensuring that resources are allocated to business initiatives and ventures that enhance shareholder value.

Notwithstanding this almost universal agreement that the merits of demutualizing securities exchanges are self-evident, it is believed here that there may also be significant costs in such a process. Furthermore, it is thought likely that while some of the larger benefits, and specifically those obtained by members of an exchange who choose to sell their shares, are available immediately after such an event, the costs that arise from demutualizing a stock exchange will take some time to become apparent.

4.2. Demutualization Modes for Pakistan

Pursuant to the above analysis and the intricacies identified in the stock markets in chapter two there are three solutions in order to cater the current deficiencies and for establishing a healthy securities market in Pakistan:

1. Integration of the three stock exchanges; or
2. demutualization of the Stock Exchanges; or
3. Simultaneously integration and demutualization of stock exchanges; or
4. Establishment of National Stock Exchange.

Integration means consolidation of the three exchanges through merger. As discussed above that in Pakistan there are three stock exchanges and among them KSE is

dominating the total market capitalization. The circumstances that favor integration exist as most of the listed companies having considerable capitalization and trading are listed on all three exchanges, significant numbers of members are common and there is a single impartial clearing house for all three exchanges. Moreover there is a single depository which is providing impartial custody services to members of all three exchanges. All three exchanges are public companies limited by guarantee. This similarity in corporate structure would facilitate integration.

The integration of three stock exchanges will result into number of benefits as an integrated exchange would set aside both apparent and veiled expenses for all stakeholders. All the investors will be capable to affect their instructions without having to route their deals through another broker and it will save extra commission.

Integration will bring number of benefits to the companies. Pursuant to integration a listed company will only be required to give listing costs only once and it will have to comply the regulations of sole exchange. Integration will facilitate the brokers who affect transaction in more than one exchange will only be subject to obligations set by a sole exchange. An integrated exchange will offer all the market partakers with better liquidity than they can avail in the fragmented structure. The clients of brokers at ISE and LSE who trade through brokers at KSE will have guarantee of appropriate supervision of their securities and the trades carried on their behalf. Furthermore, an integrated exchange shall have added revenues and assets than the current exchanges that will result into innovations and overall market growth. An integrated exchange's role to conduct

dominating the total market capitalization. The circumstances that favor integration exist as most of the listed companies having considerable capitalization and trading are listed on all three exchanges, significant numbers of members are common and there is a single impartial clearing house for all three exchanges. Moreover there is a single depository which is providing impartial custody services to members of all three exchanges. All three exchanges are public companies limited by guarantee. This similarity in corporate structure would facilitate integration.

The integration of three stock exchanges will result into number of benefits as an integrated exchange would set aside both apparent and veiled expenses for all stakeholders. All the investors will be capable to affect their instructions without having to route their deals through another broker and it will save extra commission.

Integration will bring number of benefits to the companies. Pursuant to integration a listed company will only be required to give listing costs only once and it will have to comply the regulations of sole exchange. Integration will facilitate the brokers who affect transaction in more than one exchange will only be subject to obligations set by a sole exchange. An integrated exchange will offer all the market partakers with better liquidity than they can avail in the fragmented structure. The clients of brokers at ISE and LSE who trade through brokers at KSE will have guarantee of appropriate supervision of their securities and the trades carried on their behalf. Furthermore, an integrated exchange shall have added revenues and assets than the current exchanges that will result into innovations and overall market growth. An integrated exchange's role to conduct

surveillance and to ensure risk management will be increased as integrated exchange will have full admittance to information relevant to all market segments and intermediaries. The existing complications and perplexity rooted by continuation of three exchanges with special regulations and procedures will be reduced. A single exchange will help administration and regulation by SECP. Integration, in addition to the above, will also bring domestic and international recognition and the same will be in line with international drift.

The factors and the process of conversion from mutualized exchange to a demutualized exchange differ from country to country based upon different regulatory mechanisms that are in place in different jurisdictions. Different regulatory structures of the exchanges include the following:

1. guarantee limited company; or
2. mutual entity limited by shares; or
3. state owned entity.

The demutualization process usually requires an enabling legal framework that ensures the healthy conversion process. In certain jurisdictions it may be possible that it can be achieved by introduction of certain amendments to the existing laws while in certain jurisdictions a complete new law may be required in this regard. Nevertheless the conversion process requires a detailed analysis of all the applicable laws of the countries. Some of the common issues relate the conversion of the status, determination of assets and transfer of the assets and liabilities of the exchanges as the exchanges are already in existence under the applicable laws. The acts that have already been done by the

exchanges during the old framework are also required to be given savings and the various duties applicable at the time of the transfers of assets and liabilities also require exemption.

Most of the developing countries have preferred amendment mechanism for the completion of demutualization process. However, the other countries promulgated new laws for the process based on the examples of the developed countries and in doing so they have incorporated certain modifications having regard to their specific country related requirements. The examples of the countries that opted to promulgate an new law include Malaysia and South Afica.

As far as the progression of demutualization is concerned, based upon the international practice, if demutualization is to lead integration it may be argued that demutualized structure is more acquiescent to integration. A number of key concerns in integration such as valuation will be determined through demutualization. In the nonexistence of any example of merger of companies limited by guarantee, there may be legal impediments in the process, which may hold back demutualization. It is also an apprehension that if exchanges advance to integrate first, the progression of demutualization may be overturn. However, if integration is preferred over demutualization then the size and significance of ISE and LSE do not make demutualization and investment by institutions a significant exercise. Independent demutualization of KSE, LSE, and ISE would create uncertainty and turmoil among members and may lead to debate that could impair the reform process. But the most practical mode is simultaneous integration and

demutualization as integration will result the size and significance vital for successful demutualization as members and investors would be hesitant to accept shares of a company unless the company has sound size and future benefits. Both demutualization and integration are multifarious workouts and separating the two would add to cost and time required to affect them.

4.2.1. Statutory Framework for effecting Demutualization of Exchanges

As discussed above that the demutualization process each of the country differs with respect to the specific requirements of each country i.e. applicable regulatory laws, stock exchanges structure and different market participants differ from country to country. Thus, one mechanism fit for all can not be generalized and each case will have to be evaluated as a stand alone. However, following points are required to be addressed and taken care for effecting demutualization in Pakistan:

1. Mode of Integration;

2. Conversion of companies limited by guarantee into companies/company limited by shares;

3. Governance structure of the demutualized set up, which shall have certain special features with regard to representation of certain classes and categories of shareholders on the Board and limiting voting powers, disproportionate to their shareholding;

4. Regulations of the new setup; and

5. Regulatory role of the exchange with respect to listed companies.

In order to attain the integration and demutualization of stock exchanges in Pakistan the following two options are available:

(1) The procedure of demutualization and integration engross amalgamation and reconstruction of stock exchanges and the provisions of the Companies Ordinance, 1984 provide for an approval of the court is required. For the said purposes a scheme of reconstruction and amalgamation will have to be prepared and requires valuation and determination of swap ratios. Once the scheme is approved by the court, SECP can put in order the operational and regulatory structure of the demutualized, bring into action the following statutory provisions:

a. Section 90 of the Companies Ordinance, 1984 that permits to issue different classes of shares, having different rights, unequal to share holding.
b. Section 506 of the Companies Ordinance that empowers SECP through powers delegated by the Federal Government, to make rules and regulations for the establishment and regulation of actions of any company or a class of companies. In order to safeguard and promote the public interests, the SECP may make regulations for the said purposes.
c. Section 5 of the securities and Exchange Ordinance, 1969 requires re-registration of companies as exchanges subject to fulfillment of certain

conditions, which may be prescribed by SECP, exercising powers of Federal Government.

d. Section 33 of the Securities and Exchange Ordinance empowers SECP to make rules in respect of a number of sections of the Ordinance including section sections 4 and 5, which deal with registration of exchanges.

e. Section 43 (b) empowers the SECP to make rules for the laws being administered by it with the prior approval of the Federal Government.

(2) The further line of action as witnessed in a number of other countries, is to publicize a special legislation which should be self contained and should comprehensively cover all the issues involved in the process of demutualization and integration and same appears to be more practical as evidenced from international practice.

4.2.2. Stepwise procedure for Demutualization

1. Steps for Implementation:

As a first step a demutualization committee should be constituted to undertake various steps to frame a scheme for demutualization and submit the same to SECP for approval.

The demutualization committee should modify the values of the assets and liabilities on demutualization as per the scheme of demutualization submitted by the Exchanges and approved by SECP.

The demutualization committee may determine the assets and liabilities of the exchanges as may be modified through the scheme of demutualization with the approval of SECP

and then would be converted into assets and liabilities of the demutualized exchange subject to approval of the scheme of demutualization by SECP.

2. Amendments to Articles and Bye-Laws:

The demutualization committee should submit necessary changes in the rules, byelaws and articles to SECP for approval, effecting those changes as may be approved by SECP.

3. Conversion as a Company Limited by Shares:

The Exchanges should be demutualised with segregation of ownership, trading right and management of the Exchanges. The Exchanges should also be converted from company limited by guarantee to company limited by guarantee.

4. Conversion:

After seeking prior approval by SECP, on demutualization exchanges would be for Profit Company.

5. Ownership and Trading Rights:

Twin rights of the members which accrue as a result of membership, of the Exchange will be bifurcated by extinguishment of the membership into:

(a) Ownership by issue of shares of the demutualized exchange; and

(b) Transferable trading card.

6. Allotment of Shares to the Members:

The demutualization committee should allot to each member such number of equity shares of such value as per scheme of demutualisation approved by SECP.

7. Trading Right Deposit:

The interest free trading right deposit, if issued to the members, should be locked in for a period of 3 years or for an extended time as may be decided by the board of the exchange. The deposit with the exchange shall not entitle the holder of any interest.

8. Shareholding

The existing members of the exchanges would be allotted shares of demutualized exchange as a switch over of their current interests. Brokers of the exchange would be allotted equal number of shares on demutualization in accordance with the decision of the committee and previous approval of SECP. Further, right to vote attached to the shares held by these brokers will be prescribed by SECP keeping in view the competition concerns among different market participants.

9. Voting Rights:

No single individual or associated companies or associated undertaking would be permitted hold more than 5% of the total voting rights at any point of time so that the ownership structure can be kept diluted instead of concentrated ownership as is evidenced in the mutualized form of exchanges.

10. Dispersal of Shareholding:

Such shareholding of the brokers should be detached to 49% paid-up capital and the interests of non-trading members of the Exchange shall be enhanced to 51% of the total paid-up in three years of the allotment or within a further extended time as may be specified by the committee with previous approval of SECP.

11. Listing:

The Exchange should be given the option lists its shares on its own floor or some other international exchange.

12. Corporate Governance:

The Exchange will be subject to the applicable corporate governance requirements and will be required to have independent directors on its board, independent auditors, disclosures as related party transactions etc.

4.3 Regulation of a Demutualized Exchange

As discussed that stock exchanges are intermediaries: They bring together sellers and buyers, investors and issuers, and, through information distribution, informed and uninformed market participants. Although these are more constituencies than other financial institutions have, that fact alone would not call for special attention. What makes stock exchanges out of the ordinary is that they wear two caps at the same time i.e. (a) regulator for the companies whose securities are listed and (b) regulated as their activities are being supervised by the securities regulator. This scheme of arrangement is called hybrid system wherein stock exchange act as front line regulator for the listed companies and for its own securities.

Demutualization result into drastic transformations of management system of exchanges. Under traditional structure, the broker-dealers are the key decision makers. With demutualization, and a subsequent initial public offering, however, ownership and control separate. Outside stockholders provide nothing more than capital. Thus, the power shifts from the broker-dealers to senior management when stock exchanges go public. This makes it much easier to run a business in a highly competitive environment than under the mutual structure. Despite the benefits attached to demutualized form of structure, the key decisions and new initiative require prior approval of the stockholders that is sometimes considered as lengthy process.

Moreover, at certain point in time long term targets of exchange conflict with members of the exchange. For instance, floor brokers oppose electronic trading systems, which make their workplace obsolete, but in the long term the stock exchange may need to invest in such a system to defend its market share. And for the stock exchange to succeed in drawing investors, it may need to reduce the spreads between ask and bid prices a change that directly reduces the broker-dealers' income.

In demutualized exchanges the executives have increased decision making power as compared to mutualized form of business. This has been acknowledged by all demutualized exchanges along the globe[95].

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[95] Robert M. Greber, Chairman, Pacific Exchange, Inc., Public Statement Regarding Moving Securities Exchanges into the 21st Century (June 15, 1999).

4.3.1. Conflicts of Interest

Demutualization is far from being free of challenges. Various regulatory problems arise when stock exchanges demutualize, go public, and list their stock. If we are unable to address the challenges that come with this progress, the traditional regulatory system--most importantly the concept of self-regulation--faces an uncertain future. This is why so many observers are worried about the progress of demutualization and the changes it brings.

All regulatory concerns related to demutualization arise from one source: the stock exchanges' regulatory powers. Without its public mandate, a stock exchange could be treated as any other financial institution. But with the far-reaching regulatory powers that Federal Government and the SECP have conferred on the stock exchanges, their organizational structure needs our utmost attention, most importantly regarding conflicts of interest that might divert the stock exchanges from fulfilling their regulatory duties and the trust with which they have been invested.

The possibility of conflicts of interest in publicly traded stock exchanges is not an invention of outsiders. The stock exchanges themselves are, though to a lesser degree, aware of these problems[96].

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[96] John W. Carson, Conflicts of Interests in Self-Regulation: Can Demutualized Exchanges Successfully Manage Them? (World Bank Policy Research, Working Paper No. 3183, 2003), available at http://ssrn.com/abstract=636602 .

4.3.3. Concept of Self-Regulation

The Securities and Exchange Ordinance, 1969 establishes a two-tiered approach for the regulation of the stock markets: self-regulation, coupled with governmental oversight. The governmental oversight of such exchanges is carried out by SECP, a central administrative agency that was inaugurated in 1999 by the promulgation of SECP Act, 1997. Self-regulation means a regulatory regime under which an organization or industry sector establishes its own rules and regulates itself accordingly[97]. Under the current system, stock exchanges are, to a considerable extent, self-regulators because they set the rules for the markets they organize. The primary purpose of self-regulation is to benefit from the private sector experience. The market players are well aware of the market abuses to which government or the regulator can not identify. Moreover, the rules of conduct that are framed by the market players can cover more aspects and will be recognized amicably in contrast to the rules framed by the government or the regulator.

4.3.4. Regulation of Stock Exchanges (Governmental Powers)

Governmental oversight of stock exchanges can be divided into two parts: First, there are certain requirements for registration as a self-regulatory organization; second, the SECP continuously monitors and controls the stock exchanges' conduct. Stock exchanges have to register with the SECP before they can open their market to investors; transactions on unregistered exchanges are, unless an exemption applies, unlawful.

[97] Cf. Black's Law Dictionary 1391 (8th ed. 2004) (defining self-regulation as "[a]n organization's or industry's control, oversight, or direction of itself according to rules and standards that it establishes").

For all kinds of regulation by the stock exchanges, it is important to remember from earlier parts that the stock exchanges' regulatory powers are often only the first layer of oversight. With respect to many areas, the SECP has the power to intervene. With this regulatory system and the stock exchanges' role in mind, now we turn to the conflicts of interest that arise when stock exchanges demutualize and go public.

4.4. Regulating Stockholders

Noteworthy and worrisome conflicts of interest arise when stock exchanges regulate their stockholders[98]. The former members as the owners of the stock exchange will get the first shares when the stock exchange demutualizes and thereby keep their control over the stock exchange's management. Although the shareholding of the former members will be diluted, either by going public or in a second offering, broker-dealers will retain a significant share in the stock exchange that could allow them to influence the stock exchange's policies, theoretically to make management be lenient toward them. But this concern should not loom too large: First, with many of them in financial need and looking for capital to invest in new technologies, the share of members in the exchange will probably sink over time, as mainly non-broker-dealers will buy the offered shares. Second, and this is probably the most important reason, their position as stockholders is much weaker than as members, so demutualization reduces the threat of undue member influence rather than increasing it. And last but not least, as for all conflicts, demutualization and listing do not affect the stock exchange's obligations under the Securities Exchange Ordinance and the oversight by the SECP thereunder. It is therefore

[98] Otchere, I.. "Stock exchange self-listing and value effects", Journal of Corporate Finance.

not likely that publicly traded stock exchanges generally will under-regulate their members.

Matters change if the issue is not about the regulation of the broker-dealers in general, but about one or a few broker-dealers with a huge share. We can extend this to regulated issuers that hold large shares, such as listed financial holding companies. Let us assume that such a regulated broker-dealer or issuer holds thirty percent of the stock exchange. Now, management is in a significant personal conflict of interest, because if management displeases this major stockholder, its days are numbered. This leads to a material conflict of interest, the dimension of which is entirely different from a conflict over whether the stock exchange could be tempted to under-regulate good customers: First of all, customers are unlikely to have a share in revenues as large as stockholders have in the exchange's equity. Second, displeasing customers threatens management only indirectly, if at all. Displeasing controlling stockholders, on the other hand, creates a direct threat to management, as this shareholder might use the very next chance to oust them. In this constellation, the watchful eyes of the SECP and the market (both of which know of the large stockholder due to reporting requirements) would not be sufficient to mitigate the conflict that is to avoid the risk of under-regulation of large stockholders, as outsiders can only see what is presented to them. But whether the stockholders get special treatment such as extended deadlines or favorable surveillance is not always visible to someone who is not on-site.

One of the proposals to mitigate conflicts of that type is to set forth restrictions and limits

for ownership in stock exchanges. Such strict ownership rules would not be good policy, because they might prevent ownership structures that are desirable both from a regulatory and a competitive standpoint. Under the regime, there would not be such a conflict of interest at all, because the regulatory arm of the stock exchanges would report to the SECP and not to management. Management would have no influence over the regulation of stockholders, with the consequence that large stockholders would not have a reason to threaten and to oust them, as a new management could not do anything about it either.

4.4.1. Regulating Competitors

Significant conflicts of interest arise whenever stock exchanges regulate competitors and thereby pass judgment on a competitor's cause, the constellation. The conflicts that arise with regulating competitors also occur in cases of mutual stock exchanges (because such exchanges also want to maintain or improve their competitive position), the pressure of stockholders to deliver profits may boost the incentive to treat rivals unfairly, and the tendency of for-profit exchanges to expand their businesses may create more opportunities for discrimination than would exist in a traditional stock exchange. Stock exchanges have plenty of ways to treat competitors unfairly, such as by delaying regulatory decisions, imposing unjustified sanctions, excessive fees and fines, and, generally, by exaggerating surveillance. Especially in the case of competing issuers, halting the trading in stocks of a competitor for an unreasonable period of time or without reasons may be quite damaging. That the competitors can appeal such actions and sue the stock exchange is no adequate remedy, as it will often be very difficult to prove the stock exchange's bad motivations, especially in the many cases where stock exchanges have

broad discretion. Moreover, initiating a case against the exchange may result bad publicity that comes with the lawsuit regardless of its outcome. Last, but not least, threatening to leave the exchange will only be an option in a few cases, as there often will be no adequate, alternative marketplace. Consequently, in most cases, competitors will be almost unprotected against the stock exchange's conduct.

4.4.2. Trading Regulation

Any broker-dealer that competes for listings or transactions will bring the stock exchange that regulates the broker-dealer into significant conflicts of interest. One of the most common areas for such conflicts may be broker-dealers that engage in in-house crossing, i.e., that match orders without routing them through the national market system, or organize other markets that compete with the stock exchange. Stock exchanges have considerable incentives here for unfair regulation. Aside from stock exchange members that happen to organize a competing market, there might be conflicts with organizers that normally would not be interested in being a member of a stock exchange, but that are nonetheless driven into the stock exchange's hands as a consequence of the regulatory environment.

4.4.3. Issuer Regulation

The potential conflicts of interest caused by the regulation of competitors are even greater with respect to issuers. Whereas the number and the business scope of broker-dealers is naturally and by law limited, issuers that are listed on a stock exchange can be engaged in any type of business. This means that there can be issuers competing in all the businesses that the stock exchange itself is engaged in. To the extent that demutualized stock exchanges expand their business (e.g., into derivatives trading, clearing, settlement, index

services) the opportunities for unfair issuer regulation will increase dramatically. Under the regime we propose, such conflicts would be mitigated by separating the stock exchange's regulatory arm from its business operations, so that management has no opportunity to discriminate against competitors.

4.4.4. Regulating Oneself

Once the exchanges convert from mutualized structure to demutualized structure they get an option to get their own securities traded by listing the securities at a specific forum. However, the decision becomes more critical whether these exchanges should list their securities on their own floor or some other exchange. In order to better understand the issue we can have the instance of New York Stock Exchange: New York Stock Exchange has converted to public limited company, known as NYSE Group Inc., where should its stocks be traded? The answer seems obvious--predominantly on its own market. Just as auto producers use their own cars on their premises, airline employees their own flight connections, and computer producers their own laptops, so can stock exchanges use their own markets to list their shares.

Likewise most of the exchanges that have converted their form of structure from mutualized exchange to demutualized exchanges have got their own securities on their own floors. This phenomenon is usually referred to as self listing[99]. The exchanges that have listed their own securities include NASDAQ Stock Exchange, the Frankfurt Stock Exchange and London Stock Exchange etc.

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[99] See International Organization of Securities Commissions, Issues Paper on Exchange Demutualization (2001) [hereinafter IOSCO on Exchange Demutualization

Listing of securities on the its floor raises questions as to whether the stock exchange will be impartial enough to apply the regulatory framework to itself the same way it does to others. This question leads back to the notion expressed in the first paragraph of this Article: No one shall judge in her own cause.

The following discussion distinguishes between conflicts that arise in the context of trading regulations and issuer regulations.

4.4.5. Trading Regulations

Once a demutualized exchange lists its securities on its own floor, the question as to the conflict of interests arises i.e. how an exchange can treat its own interests and interests of other securities listed at its own floor. The conflicts are correlated to two distinct regulatory powers of stock exchanges: the power over the broker-dealers and the power over the trading as a whole, known as market surveillance. Stock exchanges might misuse their broad powers over broker-dealers in order to influence trade in their own stocks positively. Most susceptible to undue influence by the stock exchange is probably the specialist that oversees the trading in the stock exchange's stocks, because this particular broker-dealer is not only subject to the stock exchange's regulation, but can also be influenced by the stock exchange's management if the latter threatens to choose another specialist.

Among the general powers of stock exchanges over the market, one might think that the stock exchanges' authority to halt, delay, and resume the trading in stocks might be

troublesome, especially with regard to companies that have material news pending. These powers seem to give opportunities for self-preferential treatment, for example if the stock exchange's management delays a halt in the trading of their stocks so that they can sell (bad news) or buy (good news) in advance of the news release. Such conduct, however, is not limited to publicly traded stock exchanges; any member of management can commit such securities fraud (to give it a proper name) by not disclosing the information to the stock exchange, and trading to its own advantage.

More worrisome is probably the authority to decide on delistings[100], an area where the stock exchange's power can be based on both the listing rules and the trading rules. None of the conflicts discussed in this subsection arise when the stock exchanges' regulatory arm is separated and reports to the SECP, as proposed later herein.

4.4.6. Issuer Regulations

Conflicts related to the issuer regulation of self-listed stock exchanges are the core problem of self-listing, and they will not be solved just by separating the regulatory arm. As explained earlier, issuer regulation is based on listing regulations or listing agreements into which the stock exchanges enter with the issuers. Listing regulations prescribe the terms and conditions for the companies to keep their securities listed on the stock exchanges.

For several reasons, listing requirements for self-listed stock exchanges cannot be

[100] see Jonathan Macey et al., Down and Out in the Stock Market: The Law and Economics of the Delisting Process, available at http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=583401.

governed by traditional listing agreements. So far, commentators have questioned whether stock exchanges will "negotiate listing agreements with themselves and then supervise continuing compliance with such agreements[101]." Those concerns that the stock exchanges will not honor the listing agreements are probably warranted, but perhaps on slightly different grounds. Stock exchanges cannot enter into listing agreements with themselves, because no one can make a contract with oneself. It does not work. You cannot establish a claim against yourself. Of course, that is a very technical aspect, a problem that might be easy to solve. For example, stock exchanges might publicly announce that they are bound to their listing rules, so that they will be constrained by public scrutiny to follow those rules, instead of following a contractual obligation. But there remain a couple of problems that are not so easy to overcome.

To begin with, a considerable number of listing rules are subject to individual negotiation. That is why parties normally enter into individual listing agreements instead of using the same set of rules for all issuers. Who is going to "negotiate" the terms for listing? While we sometimes engage in spirited debates over transactions that might or might not be entered into at arm's length, this is a situation here where only one arm is involved, so to speak.

Even if we overcome all those procedural problems, there remains one substantive point, the core problem: Most of the normal listing rules would, literally applied to stock exchanges, not make any sense. Why should the stock exchange, as an issuer, submit

[101] See Reena Aggarwal, Demutualization and Corporate Governance of Stock Exchanges, 15 Journal of Applied Corporate Finance 105 (2002)
Amir N. Licht, Stock Exchange Mobility, Unilateral Recognition, and the Privatization of Securities Regulation, 41 Journal of International Law 583 (2001)

annual and interim reports to itself, the stock exchange as the regulator? Why should the stock exchange, as issuer, give notice about important developments to itself, as the *2606 regulator? There are dozens of such notice obligations, particularly for charter and by-laws amendments and various material changes, such as with regard to directors and officers, the auditor, or the business purpose. All these reporting requirements make sense if the issuer is not the stock exchange. But reporting to oneself is like a soliloquy, even if there is some sort of separation. Is there any sense in reporting a change of directors within the same company? Is there any benefit in delivering the annual report from one department to another?

The question here is not whether we can trust the stock exchanges to examine their own reports as thoroughly as the reports of the other issuers. Much of the benefit gained from reporting requirements is connected to the fact that material information gets from inside the company to outsiders, people who are not in any way affiliated with the company, so that an outsider puts a watchful eye on the information. All that would be lost if a stock exchange reports to itself.

Not so important are the problems that arise with respect to listing fees, which are normally part of the listing agreement. At first view, it might raise competitive concerns if the stock exchange charges its competitors higher fees than it charges itself. But at a closer look, it does not matter what fees the stock exchange itself pays because they are merely transferred from the left pocket into the right pocket. From a regulatory and a

competitive viewpoint, self-listing fees do not matter (although they might from an accounting and tax viewpoint).

Stock exchanges at all times have the power either to de-list or suspend the trading of the securities. As already mentioned, this power has two foundations: It can be based on both the listing rules and the trading rules. Stock exchanges may be tempted to allow themselves an easy way to delist that is not available for other issuers. On balance, the usual listing agreement regime does not work for self-listed stock exchanges. Since the main reason for that is the lack of outside control, any proposal to tighten the requirements placed on stock exchanges when regulating themselves misses the point. Instead, later parts of this Article put forward the idea of mandatory dual listing for stock exchanges. Implementing this would allow a competent outsider, another stock exchange, to have a closer look at the exchange. And there is no concern about bias--under the proposed regime, the regulatory arm of the other stock exchange would report to the SECP if it is itself a publicly traded stock exchange.

4.7. Amendments to the Regulatory Regime

Demutualization and subsequent listing of stock exchanges requires our greatest attention. The progress alone does not, however, require greater changes to the regulatory system, as the challenges that come with the new organizational structure of stock exchanges are manageable. We put forward a simple proposal that seems sufficient to address the emerging problems without overly hindering stock exchanges or throwing overboard the traditional regulatory system: First, the regulatory arm of the stock exchanges should be separated from the other business units. Second, the reporting line

of the should be changed from the members of the board of the exchange rather to the apex regulator e.g. SECP. Third, self-listed stock exchanges and their affiliates should be required to have a second listing at another stock exchange.

The argument commences with introductory remarks on the desirability and extent of regulation, then introduces the proposed regulatory regime, and finally discusses why this proposal is superior to other approaches.

4.7.1. Introductory Remarks

Any proposal of a regulatory framework for demutualized and publicly traded stock exchanges touches upon the general question of how much regulation of stock exchanges is desirable. The chief regulatory officer of NYSE perhaps captured best what we must be able to expect: "If self-regulation is going to work, it must show that our decisions are irrelevant to whether it helps or hurts the New York Stock Exchange as a business."

The offered proposal aims at nothing more than mitigating the conflicts of interest so that the impartiality of stock exchanges remains above doubt, without overly hindering the management of the stock exchanges. Demutualization and subsequent public listing are critical to help stock exchanges compete with other marketplaces, but overly regulating publicly traded stock exchanges, which would be the result of some institutions' and commentators' proposals, would erase the intended positive effects, cause the entire restructuring to be questioned, and cement the U.S. stock exchange's passive role in the worldwide consolidation, a result that by no means would be good policy. Therefore, when discussing the new regulatory environment for demutualized for-profit exchanges,

we should be careful with regard to the regulatory intensity that we want to employ. Of course, we should not be indifferent toward conflicts of interest only because they have always existed; but with the legislative and regulatory history in mind, we should be confident that we can handle the challenges that come with demutualization without questioning the whole system, and without trying to mitigate all possible conflicts.

4.7.2. Elements of the Proposed Regime

The proposed regulatory regime for publicly traded stock exchanges has three prongs: segregation of the regulatory arm from the business operations, reporting to the SECP, and mandatory dual listing for stock exchanges and affiliates.

4.7.3. Segregation of the Regulatory Arm

Publicly traded stock exchanges should separate their regulatory arm from the other business units. Though details differ, there seems to be a broad consensus for such segregation, and there is already some experience with such a move. The HKEx, for instance, spun off its regulatory arm with demutualization, and the NYSE had taken steps in that direction as part of its corporate governance overhaul, and again announced that it would further separate its regulatory arm as part of the merger of Archipelago and the subsequent going public. The proposed separation mitigates all incentives and conflicts that are related to the regulatory intensity in general, the regulation of stockholders, of competitors, of oneself, and of affiliates. It also precludes hidden cross-subsidization, which some commentators and organizations are concerned about.

4.7.4. Reporting to the Securities and Exchange Commission

The second point complement that there should be separation between the regulatory domain: The head of the regulatory arm should not report to senior management or to the members of board of the exchange, rather it should be towards apex regulator[102] e.g. SECP. The rationale behind this amendment is that separation itself does not change much if the head of the regulatory arm is still responsible to the general management of the stock exchange. Under such a system, the regulatory arm is only one division among others. The conflicts of interest that require the separation are hardly mitigated if the regulatory arm continues to report to senior management. The latter, for instance, could require the regulatory arm to meet the company's income targets, which would make the regulatory arm focus on fines and neglect areas that create little income, regardless of whether this is good policy from a regulatory standpoint.

The stock exchanges themselves are aware of this problem. For instance, as a consequence of its corporate governance problems[103], the NYSE changed its regulatory structure so that the chief regulatory officer will be answerable to independent directors instead of the chairman[104] concededly, a significant improvement over reporting to senior management. If one believes that independent directors are the long-sought-after panacea for various corporate governance issues, one will probably say that reporting to them is

[102] Schich, Sebastian Wehinger, Gert. "Prospects for stock exchanges.", Financial Market Trends, Oct 2003 Issue

[103] Press Release, NYSE & Archipelago, New York Stock Exchange and Archipelago Exchange Agree to Merge (Apr. 20, 2005), available at http://www.nyse.com/pdfs/joint_release.pdf

[104] Hovanesian, Mara Der. "Big Stick At the Big Board; NYSE regulators are on a mission to restore the exchange's credibility.(", Business Week, Nov 15 2004 Issue, available at http://www.nyse.com/pdfs/joint_release.pdf

sufficient to ensure a proper separation of the regulatory arm from the other business units. However, if one believes that independent directors are to some degree dependent on management and tend to fraternize with management, reporting to independent directors does not adequately lessen the conflict issues. In this regard, it is questionable that independent directors may not have the necessary regulatory knowledge and understanding of the stock exchange's daily business to qualify as contact persons for reporting abuses of regulatory power.

It seems, therefore, worth considering a requirement that the head of the regulatory arm report to the SECP. This reporting requirement would not give the Commission the power to make any decisions within the stock exchange, concerning, for instance, their hiring of additional regulatory staff. Such decisions should be left to the stock exchange, because it is not likelihood that stock exchange generally under-regulate or overregulate. The requirement of reporting to the SECP will ensure only that the regulatory staff has someone impartial to whom to report single abuses of regulatory powers, particularly overregulation of competitors and underregulation of oneself and affiliates.

4.7.5. Mandatory Dual Listing for Stock Exchanges and Affiliates

The first and the second prongs of the regulatory proposal do not entirely address the challenges that come with self-listing. The problem here is that stock exchanges cannot enter into a listing agreement with themselves, and even if we find substitutes for surveillance and enforcement, most of the listing requirements would miss their underlying purpose.

To overcome this problem, stock exchanges, along with their affiliates, should be required to choose another market for a second listing (a concept which will be referred to as mandatory dual listing hereinafter). The rule would not apply to stock exchanges and affiliates that do not want to list the stocks on their own market and therefore not rely on self-listing. So for example, if the New Demutualized Exchange goes public and also wants to list its stock on its own market, under the proposal put forward it must apply for listing at another stock exchange. In the age of globalization, dual listing at a well-organized foreign stock exchange should also fulfill the dual listing requirement, and the SECP could make a list of such eligible foreign exchanges At first blush, one could counterargue that listing at competing marketplaces is not better than self-listing. To be sure, the second stock exchange faces conflicts of interest when it regulates competitors, particularly if the second stock exchange itself is demutualized and publicly traded, as discussed in earlier parts. Such competitor-regulating stock exchanges, however, would be subject to the first two prongs of the proposed regulatory system: Their regulatory arm would be separated and would report to the SECP, procedures that the Commission could require by foreign stock exchanges if they want to qualify for dual listing.

Concededly, dual listing creates downsides for the stock exchange. First of all, stock exchange in order get itself listed on other exchange becomes subject to listing fees. Secondly, the listing on two exchanges might lead to market fragmentation and reduce liquidity. However, there are also benefits of dual listing; otherwise companies would not voluntarily dual list, as some do. Even without such benefits, the downsides of dual

listing constitute no basis for rejecting the proposal of mandatory dual listing. If the costs of dual listing are too high, the stock exchange can avoid them by forgoing self-listing and listing solely at another stock exchange.

It is probably not too late to catch up with global competition--but it will require prompt action to come into the list of preeminence in stock trading.

Conclusion

The aim and objective of this study rested on the demutulization of stock exchange markets in Pakistan. After a detailed review and analysis of the global trends and recent practices in major stock exchanges in the world, it is clear that demutulization and integration of stock exchanges are both necessary and the need of the time.

Any proposal of a regulatory framework for demutualized and publicly traded stock exchanges touches upon the general question of how much regulation of stock exchanges is desirable. We found during the analysis that any offered proposal aims at nothing more than mitigating the conflicts of interest so that stock exchanges remain as impartial as possible, without overly hindering the management of the stock exchanges.

Demutualization is critical to help stock exchanges compete with other marketplaces. The dream of this competence shatters when any overly regulated, publicly traded stock exchange, which would be the result of some institutions' and commentators' proposals, would erase the intended positive effects, cause the entire restructuring to be questioned. Therefore, when discussing the new regulatory environment for demutualized for-profit exchanges, we should be careful with regard to the regulatory intensity that we want to employ. Of course, we should not be indifferent toward conflicts of interest only because they have always existed; but with the legislative and regulatory history in mind, we should be confident that we can handle the challenges that come with demutualization

without questioning the whole system, and without trying to mitigate all possible conflicts.

In the end we will enumerate the major findings of this study;

1. There is a vital role of demutulization in the current capital market scenario, which makes it more important to be implemented.
2. All three stock exchanges of the country must be integrated and demutulized. The legislation in this regard is call of the time.

3. The current proposed act to provide enabling procedure for demutualization is a valuable addition in this regard.

As highlighted before that the conversation of an exchange from a mutualized to a demutualized form of governance structure can either originate from the private sector or by the government. In Pakistan, private sector has not yet developed to a level where the innovations can be proposed by the private sector and it does not and will intend to dilute its monopoly. The private sector participants (Brokers and key players) are enjoying their powerful role at the cost of small investors and are making the decisions for their own wellbeing.

In order to initiate and complete the demutualization process in Pakistan, the Government has show a great political will. This will can be materialized in the form of promulgation

of a special law that should provide for the adequate mechanism for the completion of the entire process.

In addition to that the law should also provide SECP the requisite powers so that the smooth transformation of the stock exchanges from mutualized to demutualized structure can be accomplished. The SECP should be given the final approving authority for the approval of each step involved in the entire process in order to avoid any deadlock.

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