

A CASE OF ALTERNATIVE TRADING SYSTEMS IN THE CAPITAL MARKET OF PAKISTAN

Comparative Analysis of Legal Framework of Alternative Trading Systems in International Jurisdictions and mode, manner and benefits of introduction of this concept in Pakistan

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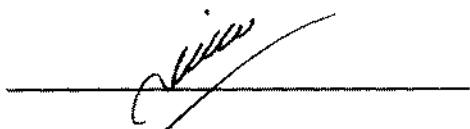


Final Approval

It is certified that we have gone through and evaluated the dissertation submitted by Mr. Ahmad Ibrahim, a student of LLM Corporate Law having University Registration No. 331-FSL/LLM/CL/F11 titled "**A Case of Alternative Trading Systems in The Capital Market of Pakistan Comparative Analysis of Legal Framework of Alternative Trading Systems in International Jurisdictions and mode, manner and benefits of introduction of this concept in Pakistan**" in partial fulfillment for award of degree of LL.M Corporate Law. We have evaluated the dissertation and found it upto the requirement in its scope and quality for award of degree.

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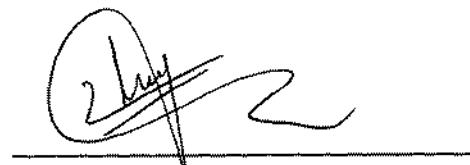


Table of Contents

DECLARATION	i
DEDICATION	ii
ACKNOWLEDGEMENTS	iii
CERTIFICATE OF USE	iv
LIST OF ABBREVIATIONS	v
ABSTRACT	vii
CHAPTER 1: INTRODUCTION OF THE TOPIC AND RESEARCH BACKGROUND.....	1
1.1 Introduction.....	1
1.2 Research Objective.....	7
CHAPTER 2: CAPITAL MARKET IN PAKISTAN.....	10
2.1 Basics of Capital Markets	10
2.1.1 Primary Market.....	10
2.1.2 Secondary Market	11
a. Auction Market	11
b. Dealer Market.....	12
2.1.3 Instruments of Capital Market	13
a. Equity Securities.....	13
b. Debt Securities.....	14
c. Derivatives.....	15
2.1.4 Participants of Capital Markets	15
a. Issuers.....	15
b. Service Providers.....	16
c. Self-Regulatory Organizations.....	17
d. Investors.....	21
2.1.5 How Stock Exchanges Work	22
CHAPTER 3: ATS, DEFINITION AND IMPLICATIONS.....	25
3.1 Definition and Characteristics	25
3.2 Trading Options Offered by ATSs.....	28

3.2.1 Auction markets	29
3.2.2 Call markets	29
3.2.3 Crossing systems or crossing networks.....	29
3.2.4 Market maker systems	29
3.3 Distinction between ATS and Traditional Exchanges.....	30
3.4 Characteristics and Benefits of ATS.....	32
CHAPTER 4: COMPARATIVE ANALYSIS OF DIFFERENT JURISDICTIONS	36
4.1 Regulation of ATSs in the United States.....	36
4.2 Regulation of ATSs in Europe	40
4.3 Regulation of ATSs in Canada.....	44
4.4 Comparative Analysis of International Jurisdiction	50
CHAPTER 5:REGULATION OF ALTERNATIVE TRADING SYSTEMS AND ROLE OF REGULATOR	56
5.1 Present Status and Practices	56
5.1.1Free delivery mechanism in CDS	57
5.1.2Broker-to-broker (B2B) in NCSS.....	58
5.2 Issues and Potential Regulatory Implications of ATS.....	59
5.2.1 Regulatory Objectives.....	59
5.2.2 The Issues	60
a. Trading at best price.....	60
b. Best execution.....	60
c. Conflict of interest.....	61
d. Fragmentation.....	61
e. Transparency.....	61
f. Monitoring and surveillance.....	62
g. Enforcement.....	62
h. Access to trading.....	63
i. Systems.....	63
5.2.3. Ancillary Risks	63
a. Performance of trades.....	63

b. Capital Adequacy Requirements	63
5.3 Regulatory Themes.....	65
5.3.1Level playing field.....	65
5.3.2Consistent approach.....	65
5.4 Proposed Options.....	65
5.4.1 OPTION I: The Introduction of a Self- Standing ATS Regime.....	66
5.4.2 OPTION II: Additional regulatory requirements for ATSs by amending the Existing legislation.....	67
5.4.3 OPTION III: Replacement of the “regulated market” regime by “a trading system regime”	68
5.4.4 Way forward	68
CHAPTER 6:RECOMMENDATIONS FOR PROPOSED ATS LEGAL REGIME FOR PAKISTAN	69
6.1 Role of SECP in Capital Market.....	69
6.2 Existing Legal Framework.....	70
6.2.1 SECP Act 1997	70
6.2.2 Securities and Exchange Ordinance, 1969	72
a. Definition of stock exchange.....	73
b. Prohibitions.....	75
c. Definition of Broker & Dealers	75
d. Regulation of Brokers	76
6.2.3 Securities Act 2015	78
6.3 Proposed Amendments.....	79
6.3.1 Amendment in the Securities and Exchange Ordinance, 1969	79
a. Definition of “Exchange”.....	79
b. Rationale for the proposed definition	81
c. Systems Not to be Included in the Definition of the Exchange	84
d. Exemption from the Definition of “Exchange” for Certain Alternative Trading Systems	86
e. Amendment in section 8 of the Securities and Exchange Ordinance, 1969	86
6.3.2 Amendments in SECP Act 1997 to enhance the jurisdiction of the SECP	86

a. Introduction of Concept of Self-Regulatory Organizations	87
b. Registration of self-regulatory organizations.	87
c. Application for registration	88
d. Required regulations.....	88
e. Maintenance and inspection of records.....	88
f. Sanctions.....	89
6.3.3 Amendment in Broker and Agents Registration Rules, 2001.....	89
6.3.4 Regulatory requirements of ATS	90
6.3.5National Market System.....	91
6.3.6 ATS Regulations/Rules.....	92
a. Scope of Regulation/Rules ATS	92
b. Requirements for Alternative Trading Systems Subject to Regulation	93
6.4 Conclusion	99
First Option	99
Second Option	100
Third Option.....	100
Recommendations.....	100
BIBLIOGRAPHY	102
Books, Articles and Laws	102
Websites.....	112
Precedents.....	114

DECLARATION

I HEREBY, declare that this thesis is original and has never been presented in any other university or institute of learning. I also declare that this thesis has never been copied and any secondary information used has been duly acknowledged in this thesis.

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(June, 2015)

DEDICATION

This thesis is dedicated to my family, who has always encouraged me to achieve everything that I am today, especially my mother and my wife for their unconditional love and support and also for their care and prayers.

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- ✓ Firstly, I would like to gratefully acknowledge Allah Almighty, who is most merciful and helpful to complete this work successfully by His countless blessing. Allah almighty always supported me throughout my life in a number of ways and now also because of His blessing I have been able to complete this dissertation.
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- ✓ It will be injustice if I don't acknowledge and thanks my best friends and colleagues who have encouraged and support me.

MIAN AHMAD IBRAHIM
(June 2015)

CERTIFICATE OF USE

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LIST OF ABBREVIATIONS

ADB	-	Asian Development Bank
AMEX	-	American Stock Exchange
ATS	-	Alternative Trading System
B2B	-	Broker to Broker
CDC	-	Central Depository Company
CDS	-	Central Depository System
CLA	-	Corporate Law Authority
CSA	-	Canadian Securities Administrators
ECN	-	Electronic Communication Network
EEA	-	European Economic Area
ETF	-	Exchange Traded Funds
FESCO	-	Forum of European Securities Commission
FSAP	-	Financial Sector Assessment Program
IAS	-	Investor Account Services
IDA	-	Investment Dealers Association
IIROC	-	Investment Industry Regulatory Organization of Canada
IOIs	-	Indication of Interests
IOSCO	-	International Organization of Securities Commissions
IPO	-	Initial Public Offering
ISE	-	Islamabad Stock Exchange Limited
KATS	-	Karachi Automated Trading System
KSE	-	Karachi Stock Exchange Limited
LSE	-	Lahore Stock Exchange Limited
MTF	-	Multilateral Trading Facilities
NASD	-	National Association of Securities Dealers
NBFIs	-	Non- Banking Finance Institutions
NCSS	-	National Clearing and Settlement System

NYSE	-	New York Stock Exchange
OTC	-	Over-the-Counter
OTCBB-		Over-The-Counter Bulletin Board
PETS	-	Proprietary Electronic Trading System
RSP	-	Regulation Services Providers
SECP	-	Securities and Exchange Commission of Pakistan
SI	-	System Internalizers
SRO	-	Self Regulatory Organization
TSX	-	Toronto Stock Exchange
TSXV	-	Toronto Stock Exchange Virtual
UMIR	-	Universal Market Integrity Rules

ABSTRACT

This research aims to introduce alternative trading system to enhance and facilitate the capital market in Pakistan. Present legal framework of the securities market in Pakistan has practically turned into a centralized market resulting in investors having lesser options and has effectively consolidated control in the hands of the members of one exchange, which has in past and potentially in future, results in market abuse. The proposed dissertation will discuss the nature of alternative trading platforms and comparative analysis of legal frameworks in United States of America and United Kingdom and proposed framework for Pakistani capital market in light of the present practices. This dissertation will suggest reforms in the legal framework of Pakistan and amendments in the existing regime regarding the introduction of the concepts of alternative trading systems ("ATS"). The proposed legal reforms will discuss, whether to have a tiered exchange approach, securities information processor approach or follow the US model, the amendments in the definitions to cover ATS, mapping out a legal framework, exclusions of certain systems from the definition of ATS, whether to have statutory rules or bye-laws governing the ATS on the same footing as that of existing securities exchanges, compulsory integration of orders on ATS into a public quotation system, settlement of dispute etc.

CHAPTER 1: INTRODUCTION OF THE TOPIC AND RESEARCH BACKGROUND

1.1 Introduction

A holistic view of the capital market of Pakistan transpires that the business of securities dealing is centralized in a single stock exchange i.e. Karachi Stock Exchange Limited (KSE), which creates hindrance in growth of capital market in Pakistan as lack of competition in the market is detrimental to the interests of the investors and results in depletion of investor base. In order to address this problem in light of global experiences, there is a need to introduce Alternative Trading Systems (ATS) through necessary amendments in the laws governing capital markets as experienced in different jurisdictions around the globe.

ATSs are "non-exchange trading venues specifically designed to match buyers and sellers to find counterparties for transactions negotiated privately between the parties"¹. ATSs have risen in importance in several financial markets around the world as an alternative to traditional exchange, or as a complement to voice broking and bilateral over-the-counter (OTC) trading.

During last two decades, the traditional trading platforms such as exchanges have been in a state of frenzy of change. Sir Howard Davies, former Chairman of the Financial Services Authority, observed that "once a sleepy preserve of national monopolies, the world of exchanges has of late started to catch the eye"².

An overview of the international jurisdictions transpire that, market participants have developed a variety of alternative trading platforms that provide services traditionally offered by exchanges. The financial markets globally "are no longer synonymous with securities and future exchanges and the range of market structures available has become much more fluid and innovative"³. Therefore, it is high time that following the global trends, the Pakistani

¹Anton Golub, John Keane and Ser-Huang Poon, *The impact of internalization on the quality of displayed liquidity*, (Foresight Report, Government Office for Science, UK, 2012) p.7.

²Dick Frase and Helen Parry, *Exchange and Alternative Trading Systems*, (London, Sweet & Maxwell, 2002), First Edition, p.ix

³Dick Frase, *The Legal Structure of Financial Markets*, (London, Sweet & Maxwell, 2002), First Edition, p.1

markets should explore ways and means for introducing ATSs with adequate legal and regulatory support.

Mr. Tariq Naseem a well-known figure of capital market, while discussing the impact of advancement of technology on the traditional structures has observed in his presentation on the capital market at ICMAP that "many of these innovative methods, were not foreseen by a regulatory framework applicable in Pakistan that was designed decades ago"⁴. Although all the stock exchanges in Pakistan are completely automated and the outcry method of trading has given way to the fully automated KATS (Karachi Automated Trading System)⁵ and ULTRA⁶ respectively and trade orders are being placed on the automated trading systems of these exchanges through brokers in an undisclosed manner which matches the orders based on time and price factors, but some peculiar problems remain. Interestingly, the Securities and Exchange Ordinance, 1969 (Ordinance) and the Securities Act 2015, the primary laws for regulations of securities market in Pakistan, still provide for "segregation of the role of brokers and jobbers"⁷, however, in practice this distinction has blurred. In practice, the brokers are also allowed to undertake propriety trading⁸. This practice gives rise to the issues of conflict of interest and front running. There also exists a thriving market of negotiated deals which do not take place on any exchanges rather "such transactions are only reported through brokers for the purposes of disclosure of trade and transfer of securities"⁹ in the Central Depository System (CDS). This practice is further supported by the free delivery mechanism provided by the Central Depository Company of Pakistan Limited (CDC) in CDS. Through incremental amendments, this process has been made restrictive; therefore in order to cater to this negotiated deals market, it is imperative that legal reforms should be introduced to pave way for introduction of alternative trading systems in Pakistan.

⁴ Naseem, Tariq, "Capital Markets and Mutual Funds", (presentation at ICMA Pakistan, Islamabad), Institute of Cost Management Accountants, Pakistan, March 26, 2015

⁵ Regulation 2 (e) of the Karachi Automated Trading System (KATS) of the Karachi Stock Exchange, 2011

⁶ Regulation 2 (g) of the Internet trading regulations of the Lahore Stock Exchange, 2012

⁷ Section 2 (1)(h) of the Securities and Exchange Ordinance, 1969

⁸ Regulation 4 of the Regulations for Propriety Trading of the Karachi Stock Exchange, 2004

⁹ Regulation 15 of the Karachi Automated Trading System (KATS) of the Karachi Stock Exchange, 2011

Although the exchanges continue to meet a range of needs, their functions occupy an increasingly less central role. "The services they provide, such as securities listing, dealing and settlement, are being unbundled, and they occupy a smaller share of their chosen markets"¹⁰. Dr. J.N Dhankar has observed with respect to benefits of ATS that "ATS face less strict rules than stock exchanges"¹¹. While discussing the nature of the traditional stock exchanges, he further observed that they have following key characteristic:

- Trading is time and location specific.
- Investors can only route their trades through a broker; which is a member of an exchange.
- Only standardized securities are admitted for trading¹².

"The objective of ATS and Stock Exchange is to provide a trading platform"¹³. The major difference between these two platforms is that the securities of issuer are listed on a stock exchange, whereas an ATS is merely a trading platform. Further, ATS is governed purely through contracts governed under the contract law of the land and the stock exchanges are regulated through a formal set of rules, which affords them flexibility when it comes to interpretation. While analyzing the legal structure of exchanges, it is admitted that exchanges are being regulated through subsidiary legislations, where an exchange is given power to make its rules by statute, "those rules normally have the status of secondary legislation and will take precedence over any contractual obligation"¹⁴. These statutory rules may have the strength of law but at times they can be more rigid and create hindrance in achieving objective of promotion of trade and free markets. It is settled principle of law that "statute cannot be interpreted in the same way as a commercial contract; the literal words of a statute have to be relied on and followed"¹⁵. Therefore, statutory rules might not be the most pragmatic solution

¹⁰ D. Frase and H. Parry, *Exchanges and Alternative Trading Systems*, (London, Sweet & Maxwell, 2002), First Edition, p.32.

¹¹ Dr. Dhankar, J.N., *Pricing of Securities*, (Bharat Publications, 1994), First Edition, p.21.

¹² *ibid*, p.45.

¹³ Forum of European Securities Commission, "Standards for Alternative Trading Systems", (European Commission Publication, June 11, 2001), p.6.

¹⁴ Dick Frase, *The Legal Structure of Financial Markets*, (London, Sweet & Maxwell, 2002), First Edition, p. 18

¹⁵ Shearson Lehman Hutton Inc v. Maclaine Watson & Co. Ltd (1988) 1 W.L.R 946 p.985-986, (1989) 1 All E.R. 1056

in the fast evolving nature of the capital markets. The introduction of ATS will be a step forward towards deregulation of the financial markets, i.e. from over regulated to lesser and balanced regulatory regime and will provide a flexible framework suited to the needs of the market.

Further as per Korean Capital Market Institute publication, "in theory ATSs reduce explicit transaction costs"¹⁶. The cost of a single trade i.e. fee or commission, executed on a stock exchange is higher than the charges paid to ATSs. Therefore, the increased competition among trading systems and the elimination of intermediaries will result in lower transaction costs in ATSs.

The extended trading hours offered by the ATS open a wide range of opportunities to the investors. These long trading hours are particularly appealing for serious and sophisticated investors who can hedge their positions and make significant profits round the clock.

As per Instinet (one of the largest cross border ATS operating in Europe) report available on its website, "with the growth of index-related and cross border products, institutional portfolios are increasingly structured on a sector basis, rather than by country as in past"¹⁷. This is relevant from the investment point of view, since the investors want ATSs to be admitted to several stock exchanges. Instinet, for example, is a member of 19 stock exchanges and offers access to 40 equity markets worldwide¹⁸. In order to trade in Europe's fifty most liquid shares, a broker would otherwise have to be a member of eight stock exchanges and be able to cope with the different regulations and different clearing and settlement systems.

From the an investor's perspective, if you need to select a trading system you have to keep in mind different criterions like manner of execution, striking for the best possible price, efficiency of exchanges and alternative trading systems. Stikeman Elliott LLP report, 2011 reveals that ATSs have an advantage over the exchange, "since their specialization gives them edge over

¹⁶ Sohyun Kang, "A Study of Reducing Market Impact Costs in the Domestic Stock Market", *Capital Market Perspective*, Korean Capital Market Institute, Volume 4, Issue No. 2, (2012), p. 33

¹⁷ <http://www.institinet.com/includes/index.jsp?thePage=/html/ab_index.txt> accessed on 12-04-2015

¹⁸ ibid.

conventional stock exchanges in order to provide investors with customized market models¹⁹. Depending on its needs an investor may opt a crossing system, a quote-driven system, a hit-and-take system or a call-auction system. In international jurisdictions, to let investors adapt the degree of transparency to the individual transaction, "ATSs offer both open and anonymous limit order books"²⁰. This enables the institutional investors to reduce the market impact of block trades. All of the foregoing has given rise to introduction of alternative trading platforms.

It is a settled principle of business philosophy that it is only the competition which makes markets and anything which makes it easier for competitors to emerge is a good thing²¹. The following chart will further illustrate the practical advantage of ATS with respect of average execution time, execution²²:

**Average execution time
(USA, August 2003)**

- Stock exchange: > 20 seconds
- ECN: 2-3 seconds

Execution fee:

- ECN: 0.19 cents per share

Trading hours:

- CboeATS: 8:00 a.m. to 10:00 p.m.
- Tradelink: 8:00 a.m. to 11:00 p.m.
- Liquidnet: 2:00 a.m. to 6:00 p.m.

As for the aspect of liquidity, a study²³ compiled by Investment Technology Group Europe (a leading liquidity aggregator) expounds the importance of the ATS in the European markets. The chart below explains the liquidity sources from primary sources such as traditional stock exchanges, registered displayed multilateral trading facilities (MTF) and the dark pools.

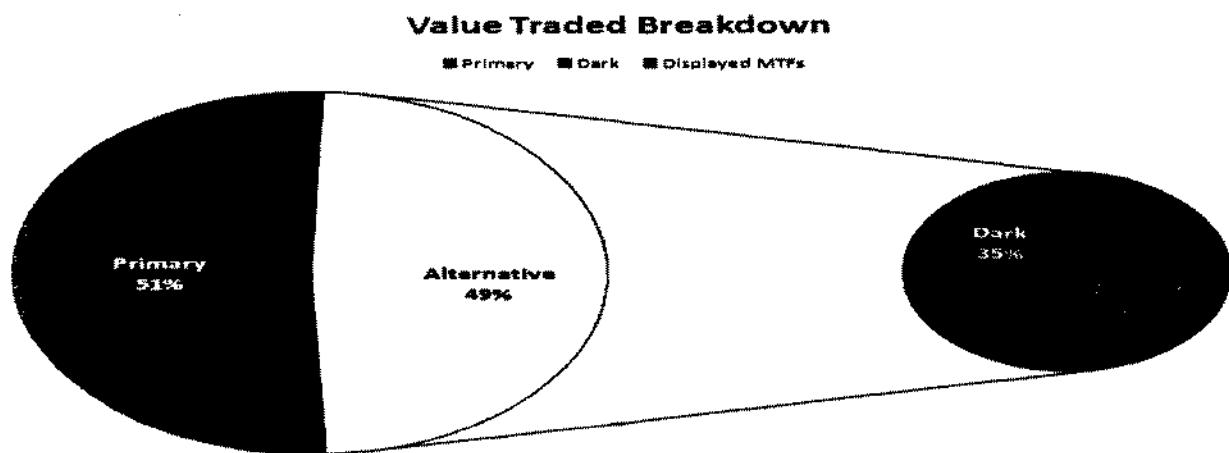
¹⁹ Simon A. Ramano & Ramandeep K. Grewal, "Alternative Trading Systems, Market Place Evolution in Canada", *Stikeman Elliot LLP publication*, (2011), p. 24-25, assessed June 18, 2015 on <www.stikeman.com/2011/en/pdf/AlternativeTradingSystems.pdf>

²⁰ Marion Mühlberger , "Alternative Trading Systems: a catalyst of change in securities trading", *Deutsche Bank Research publication*, (January 11, 2005), p.2

²¹ Mitchener, Kris James & Ohnuki, Mari, "Institutions, Competition, and Capital Market Integration in Japan", *The Journal of Economic History*, Cambridge University Press, vol. 69(01), (2009), p. 141

²² <<http://www.sec.gov/rules.shtml>> accessed on 09-08-2013

²³ Yossi Brandes & Ian Domowitz, "Alternative Trading Systems in Europe: Trading Performance by European Venues Post MiFID", *Investment Technology Group publication*, (May 2010), p.4



From a regulators angle, ATS can provide a platform for trading of large block of shares with effective price discovery. The trading of large blocks of shares on a traditional stock exchange can drive the share price and the market in a particular direction²⁴, which is potentially hazardous and such transactions usually take place off market/exchange through brokers.

A robust and thriving capital market is a need of every developing economy. The exchanges are generally connoted as the barometer of the economy. Therefore, it is essential that "the avenues of raising capital for the issuers are provided in form of vibrant and performing exchanges"²⁵. At the same time, "it is imperative to have a robust secondary market for trading of securities and to provide investment diversity to the investors"²⁶. This is where the need of introduction of alternative trading platforms in Pakistan attains significance. Not only do ATS contributes in the development of secondary market but at the same time provides the investors multiple investment opportunities to make profits, hedge their positions and diversify their portfolios.

²⁴ Donald B. Keim and Ananth Madahvan, "The upstairs market for large-block transaction: Analysis and Measurement of Price effect", *The Review of Financial Studies*, Oxford University Press, Spring, Vol. 9, (1996), p.8

²⁵ Josiah Adudu, Jacinta MweluMasila and Erick Nyakundi Onsongo, "The Determinants of Stock Market Development: The Case for the Nairobi Stock Exchange", *International Journal of Humanities and Social Science*, Center for Promoting Ideas, USA, Vol. 2, No. 9, (2012), p. 11

²⁶ Securities Industry Study, Report of the House Subcommittee on Interstate and Foreign Commerce, 92nd Cong., 1st Sess. (1972), Fed. Sec. L. Rep. (CCH) Spec. Rep. 438 (August 25, 1972), at p.155

1.2 Research Objective

The objective of this research is to introduce alternative trading system to enhance and facilitate the capital market in Pakistan. The approach adopted was to highlight the problem and issues by giving a detailed overview of how capital markets are functioning in Pakistan, this included the legal framework and also how practically a single share is traded in the capital market to the advantages the introduction of ATS can offer to the existing system.

The Chapter II gives a detailed overview of the capital markets. Present legal framework of the securities market in Pakistan as established under the Securities and Exchange Ordinance, 1969 ("Ordinance") has practically turned into a centralized market i.e. KSE. "Although the Islamabad Stock Exchange (ISE) and Lahore Stock Exchange (LSE) exist, but on account of low volumes and minimal investor base, the business conducted on these exchanges is negligible"²⁷. This defragmentation has resulted in investors having lesser options and has effectively consolidated control in the hands of the members of the KSE, which has in past and potentially in future, result in market abuse. Further, "this defragmentation has also failed to produce liquidity"²⁸. In theory, "in case of centralized markets the threat of systemic risk and market abuse is minimal"²⁹ as there is a single entity with an overall picture of the trading activity and the regulator can also focus its monitoring and enforcement that very single entity. However, in Pakistan this also has not happened and there is a history of "recurring market crashes after every 4 to 5 years, liquidity dry ups, share price volatility and market abuse"³⁰. Further the regulator has also time and again proved to be merely reactive and ineffective.

²⁷ Jamshed Y Uppal, "The Role of Satellite Stock Exchanges: A Case Study of Lahore Stock Exchange", *The Lahore Journal of Economics*, 14:2 (Winter 2009), p.2

²⁸ ibid, p.4

²⁹ Niamah Moloney, "Reform or Revolution? The Financial Crisis, EU Financial Markets Law, and The European Securities and Markets Authority", *International and Comparative Law Journal, British Institute of International Comparative Law*, April 2, (2011), p.11

³⁰ Dr. Attiya Javed and Asia Aman, "Global Financial Crisis and Market Reactions: Evidence from Karachi Stock Exchange Pakistan", *Working Paper, Pakistan Institute of Development Economics*, (2012), p.3

The Securities Act 2015 enacted on May 13, 2015 enables the Federal Government to make rules to provide for Alternative Trading Platforms³¹. Therefore, this new legislative development can pave the way for a new of era in the capital markets of Pakistan.

The Chapter III gives a brief introduction of the concept of ATS and the potential advantages for its introduction in Pakistan. It is discussed in this chapter that the nature of securities market is simply a pool of liquidity which can be achieved by means of a neutral, central market body (demutualized exchange) or a market maker, or an ATS providing a significant centralized point of access to a pool of liquidity³². Further, the forms of alternative trading platforms in international jurisdictions such as market maker (broker dealer) system, electronic communication networks (ECN), national market systems etc., and their distinction from other firms which are regarded as information vendors, that happen to offer services that look like trading systems but are in fact simply a montage of material from other trading systems, with the ability to route an order through to the underlying system³³, have been discussed.

The Chapter IV gives an overview of the comparative analysis of legal three legal regimes for ATS in the world. In this chapter the nature of alternative trading platforms and comparative analysis of legal frameworks in United States of America, Europe and Canada is being done.

The Chapter V is consolidation and analysis of all the issues and potential areas to be addressed while providing a new legal framework for ATS in Pakistan. This chapter also addresses different approaches that can be considered for introducing this concept in Pakistan.

The Chapter VI covers detailed recommendations and proposals for amendment in different laws and secondary legislation made thereunder enabling introduction of this concept in Pakistan. The proposed legal reforms will discuss, whether to have a tiered exchange approach, securities information processor approach or follow the US model, the amendments in the

³¹Section 175 of the Securities Act, 2015

³²Stavros Gkantinis, "Reshaping the Global Securities Markets: A Comparative Study of the Proposed Regulation NMS in the U.S. and the E.U. Directive 2004/39/EC on Markets in Financial Instruments", *Harvard Law Review*, (May 2005), p. 13

³³D. Frase and H. Parry, *Exchanges and Alternative Trading Systems*, (London, Sweet & Maxwell, 2002) First Edition, p.4.

definitions to cover ATS, mapping out a legal framework, exclusions of certain systems from the definition of ATS, whether to have statutory rules or bye-laws governing the ATS on the same footing as that of existing securities exchanges, compulsory integration of orders on ATS into a public quotation system, settlement of dispute etc.

CHAPTER 2: CAPITAL MARKET IN PAKISTAN

2.1 Basics of Capital Markets

"A capital market is a market for securities (debt or equity), where business enterprises (companies) and governments can raise long-term funds from general public (investors)"³⁴. D. Eugene F. Fama, Nobel laureate in the field of finance and economics explains that the primary role of the capital market is "allocation of ownership of the economy's capital stock"³⁵.

Some authors like Mr. Ray Austin, former Commissioner of Securities and Commodities Futures Trading of Hong Kong, have opined in his numerous addresses that capital market is a market "in which money is provided for periods longer than a year"³⁶.

In my estimate, the word "capital market" can have many different meanings, and can be broadly categorized into primary and secondary market as elaborated below.

2.1.1 Primary Market

The primary market is a market of first instance which is a platform for issuance of securities by the companies or offering of securities for sale by the substantial shareholders. In plain words, "it can be said that a primary market operation is the process of going to the public for raising funds"³⁷. In the present legal regime in Pakistan, the primary market is used for initial public offering of shares³⁸, where a private or public unlisted company converts itself into a public listed company to offer its shares to the public at large³⁹. Following broad activities are covered under the primary market:

i. Initial Public Offer

³⁴ Pathak Bharati V., *The Indian Financial System: Markets, Institutions and Services*, (Pearson Education India, 2011), First Edition, p.18

³⁵ Eugene F. Fama, "Efficient Capital Markets: A review of Theory and Empirical Work", *The Journal of Finance*, Volume 25, Issue 2, (May 1970), p.1

³⁶ Ray Austin, Presentation on Draft Futures Trading Act, 2005, Securities and Exchange Commission of Pakistan head office Islamabad, March 4, 2005

³⁷ Dr. Dhankar, J.N., *Pricing of Securities*, (Bharat Publications, 1994), First Edition, p.129

³⁸ Part VIII of the Securities Act, 2015

³⁹ Section 45 of the Companies Ordinance, 1984

- ii. Subsequent Public Offerings
- iii. Offer for sale of shares by substantial shareholders

In primary markets investors purchase securities directly from a primary source i.e. issuing company or substantial shareholder. Issue of shares in a primary market "requires approval and issue of prospectus and other regulatory approvals"⁴⁰.

2.1.2 Secondary Market

The secondary market in business parlance is synonymous to a stock exchange. This includes the KSE, ISE, LSE and all major exchanges around the world. The defining characteristic of the secondary market is that investor's trade among themselves. That is, in the secondary market, "investor's trade previously issued securities without the issuing companies' involvement"⁴¹. Internationally, the secondary market can be further categorized into two specialized types: auction market and dealer market.

a. Auction Market

In the auction market, "all individuals and institutions that want to trade securities congregate in one area and announce the prices at which they are willing to buy and sell"⁴². These are referred to as bid and ask prices. The idea is to bring together all parties and have them display their offers to ensure an efficient and transparent market. Thus, theoretically, "the best price of a good need not be sought out because the convergence of buyers and sellers will cause mutually-agreeable prices to emerge"⁴³. The best example of an auction market is the London Stock Exchange. All the local exchanges in Pakistan are auction market.

⁴⁰ Section 88-94 of the Securities Act, 2015

⁴¹ Steven M. Dawson, "Secondary Stock Market Performance of Initial Public Offers, Hong Kong, Singapore and Malaysia: 1978–1984", *Journal of Business Finance and Accounting*, Volume 14, Issue 1, (March 1987), p.68

⁴² Dhananjay K. Gode and Shyam Sunder, "Allocative Efficiency of Markets with Zero-Intelligence Traders: Market as a Partial Substitute for Individual Rationality", *Journal of Political Economy*, Vol. 101, Issue No. 1, (February 1993), p. 121

⁴³ Eugene F. Fama, "Efficient Capital Markets: A review of Theory and Empirical Work", *The Journal of Finance*, Volume 25, Issue 2, (May 1970), p.23

b. Dealer Market

In contrast, a dealer market "does not require parties to converge in a centralized location"⁴⁴. The, participants in the market are joined through electronic networks (from telephones or fax machines to complicated order-matching systems). The dealers hold "an inventory of the security in which they make a market and then stand ready to buy or sell with market participants and earn profits through the spread between the prices at which they buy and sell securities"⁴⁵. In a dealer market like the NASDAQ, "the dealers, who are also known as market makers, provide on continuous basis two way quotes for buy and sell of securities for which they are making the market"⁴⁶.

Although the Ordinance, provides for the concept of dealers, but in practice the dealer markets do not exist in Pakistan. Having said that a variant of dealer market referred to as an "over-the-counter"⁴⁷ (OTC) market exists in Pakistan. The term OTC originally meant "a relatively unorganized system where trading did not occur at a physical place, but rather through dealer networks"⁴⁸. The etymological origin of the term was most likely from the "off-Wall Street trading that boomed during the great bull market of the 1920s, in which shares were sold over-the-counter in stock shops"⁴⁹. In other words, the shares are unlisted and not listed on a regular stock exchange.

A historical analysis transpires that over time, the meaning of OTC began to change. In USA, "the NASDAQ was created in 1971 by the National Association of Securities Dealers (NASD)"⁵⁰ to bring liquidity to the companies that were trading through dealer networks. "As the NASDAQ

⁴⁴ Moez Bennouri, "Auction versus Dealership Markets, Scientific Series", *Centre of Interuniversity Research and Analysis Organization (CIRANO)*, Montreal Canada, (December 2003), p.4

⁴⁵ ibid, p.6

⁴⁶ Dr. S Gurusamy, *Merchant Banking and Financial Services*, (Tata-McGraw Hill, 2009), Third Edition, p.169

⁴⁷ Katrina Ellis, Roni Michaely and Maureen O'Hara, "The Making of a Dealer Market: From Entry to Equilibrium in the Trading of Nasdaq Stocks", *The Journal of Finance*, published by Wiley for American Finance Association, Vol. 57, No. 5 (Oct., 2002), p. 2291

⁴⁸ Duffie, D., Garlean, N. and Pedersen, L.H. (2005), Over-the-Counter Markets. *Econometrica*, Journal of the Econometric Society, 73:1815-1847, p 1831 . doi:10.1111/j.1468-0262.2005.00639.x

⁴⁹ Randall Dodd, "Markets: Exchange or Over the Counter, Finance and Development", *International Monetary Fund Publication*, (March 28, 2012), p.2

⁵⁰ Davies Folsom, *Encyclopedia of American Business, Facts on File Library of American History*, (published by Library of Congress, 2004), p.323

has evolved over time to become a major exchange, the meaning of over-the-counter has become fuzzier⁵¹. Today, the NASDAQ is still considered a dealer market and, technically, an OTC, but has the status of a stock exchange.

In our jurisdiction, this term implies a market of "negotiated deals"⁵² or trades which are not executed on the trading terminal of the exchange.

2.1.3 Instruments of Capital Market

Instruments traded in a capital market can be broadly categorized as under:

a. Equity Securities

Equity securities are securities "issued by a company that denotes a right of ownership in the assets of a company and right to share profits thereof"⁵³. Most equity securities have right to vote and participate in decision making process of the company.

There are two types of equity securities i.e. ordinary⁵⁴ and preferred⁵⁵. An ordinary shareholder can participate in shareholders meetings by exercising the right to vote.

In addition to ordinary shares, the Companies Ordinance, 1984 allows for issuance of preference shares. Preference shareholders are entitled to have a preferential right as compared to ordinary shareholders within the four corners of relevant law, which may include preferential right to payment of dividend.

⁵¹ Katrina Ellis, Roni Michaely and Maureen O'Hara, "The Making of a Dealer Market: From Entry to Equilibrium in the Trading of Nasdaq Stocks", *The Journal of Finance*, published by Wiley for American Finance Association, Vol. 57, No. 5 (Oct., 2002), p. 2299

⁵² Karachi Stock Exchange, Notice to all member titled "off exchange" Negotiated Deals Reporting System (NDRS) of KSE, October 18, 2010

⁵³ Regulation 2 (h) of the Karachi Automated Trading System (KATS) regulation of the Karachi Stock Exchange Limited approved by the Securities and Exchange Commission of Pakistan under section 34 of the Securities and Exchange Ordinance, 1969

⁵⁴ Section 2 (1) (35) of the Companies Ordinance, 1984

⁵⁵ Section 90 of the Companies Ordinance, 1984

Through Finance Act, 1999, section 90 of the Companies Ordinance, 1984 was amended, and companies were allowed to have different kinds of share capital and classes therein as provided in their memorandum and article of associations.

The Supreme Court of Pakistan in judgment cited PLD 2011 SC 778 while discussing the nature of preference shares has observed that "generally the preference shares means shares which generally do not carry voting rights, assures preferential dividend, preferential right of payment on winding up of the company"⁵⁶.

b. Debt Securities

Debt security is an instrument which is issued with a promise of repayment on a certain date at a specified rate of interest.

Mr. Tariq Naseem (op.cit.) has observed that "any debt instrument that can be bought or sold between two parties and has basic terms defined, such as notional amount (amount borrowed), interest rate and maturity/renewal date"⁵⁷. Debt securities are in fact securitization of a debt obligation and include government bonds, corporate bonds, municipal bonds, collateralized securities (such as CDOs, CMOs, GNMA) and Sukuk.

Most debt securities are traded over-the-counter, "with much of the trading now conducted electronically"⁵⁸. The total money value of trades conducted daily in the debt markets is much larger than that of stocks, "as debt securities are held by many large institutional investors as well as governments and non-profit organizations"⁵⁹.

⁵⁶ PLD 2011 SC 778, First Capital Securities vs. Securities and Exchange Commission of Pakistan & others, p.791-92

⁵⁷ Naseem, Tariq, "Capital Markets and Mutual Funds", (presentation at ICMA Pakistan, Islamabad), Institute of Cost Management Accountants, Pakistan, March 26, 2015.

⁵⁸ Felice B. Friedman, "Regulation of fixed Income Securities Market in United States of America", *The World Bank Publication*, (December 2003), p 26.

⁵⁹ Agnes Foy, *The Capital Markets*, (Round Hall Sweet & Maxwell, 1998), p.48.

Debt securities are safer investments than equity securities, but riskier than cash. Debt securities get their measure of safety by having a principal amount that is returned to the lender at the maturity date or upon the sale of the security.

c. Derivatives

Derivative is a security "whose pricing is based on the value of an underlying asset"⁶⁰. In its nature it is a contract *inter se* party where the value is measured from the intrinsic value of an underlying asset which may include shares, bonds, commodities, currencies, interest rates and market indexes.

The most common type of derivatives traded on international stock exchanges are futures contracts, options and swaps. Derivatives are generally used for hedging of risk and speculation. In Pakistan, commodity, financial and securities derivatives⁶¹ are traded which are required to be approved⁶² by the Securities and Exchange Commission of Pakistan.

2.1.4 Participants of Capital Markets

The participants of capital market of any jurisdiction can be categorized in the following manners:

a. Issuers

Issuers are basically user of funds. The Securities Act 2015, defines issuers in relation to securities as "any person who has issued or proposes to issue securities"⁶³. They are the companies registered under the Companies Ordinance, 1984 or their substantial shareholders. In a capital market issuers undertake following activities:

- i. Initial public offerings (IPOs)- Companies may require funds for expansion / new projects

⁶⁰ John C. Hull, *Options, Futures and other Derivatives*, (Pearson Education India, 2009) First Edition, p.39

⁶¹ Section 2 (1) (cd) of the Securities and Exchange Ordinance, 1969

⁶² Rule 23 of the Commodity and Future Contract Rules, 2005

⁶³ Section 2 (1) (xxvii) of the Securities Act 2015

- ii. Offer for sale of Shares – Sponsors of successful companies may want to encash their investments

b. Service Providers

Service Providers are the back bone of any capital market. They can be broadly categorized, apart from self-regulatory organizations (SRO) which are discussed in the following sub-section, as intermediaries and support service providers.

(i) Intermediaries

Broadly following intermediaries perform services in the capital market:

- i. Stock⁶⁴ and Commodity Brokers⁶⁵
- ii. Agents of Stock Brokers⁶⁶
- iii. Clearing and Custodian Members⁶⁷

(ii). Support services providers

Following support service providers operate in the capital markets and provide different services:

- i. Credit Rating Agencies⁶⁸ and Auditors⁶⁹
- ii. Consultants, Advisors
- iii. Lead Managers & Book Runner⁷⁰
- iv. Balloters⁷¹
- v. Transfer Agents⁷² & Underwriters⁷³

⁶⁴ Rule 5 of the Brokers and Agents Registration Rules, 2001

⁶⁵ Rule 2 (1) (b) of the Commodity Exchange Future Contract Rules, 2005

⁶⁶ Rule 14 of the Brokers and Agents Registration Rules, 2001

⁶⁷ Rule 2(1) (f) of the Clearing Houses (Registration and Regulation) Rules, 2005

⁶⁸ Rule 2 (1) (c) of the Credit Rating Companies Rules, 1995

⁶⁹ Section 252 of the Companies Ordinance, 1984

⁷⁰ Regulation 2 (1) (J)Draft Book Building Regulations, 2015

⁷¹ Rule 4 of the Balloters and Transfer Agents Rules 2015

c. Self-Regulatory Organizations

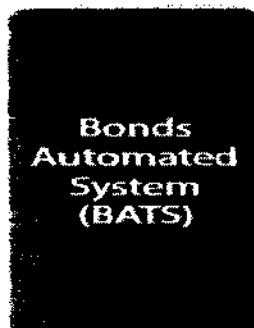
(i) Stock and Commodity Exchanges

The self-regulatory bodies that operate in a capital market are the platforms and market place for sale and trade of securities. They are generally classified as stock and commodity exchanges.

In Pakistan following exchanges are presently operating:

- i. Karachi Stock Exchange⁷⁴ or the "KSE" established in 1947
- ii. Lahore Stock Exchange⁷⁵ or the "LSE" established in 1970
- iii. Islamabad Stock Exchange⁷⁶ or the "LSE" established in 1989
- iv. Pakistan Mercantile Exchange Limited⁷⁷ established in 2002 and operations started in 2007

For the purpose of this dissertation it will limit the discussion to KSE which is the biggest market place in Pakistan for trade of securities. KSE offers following trading platforms:



⁷² Ibid

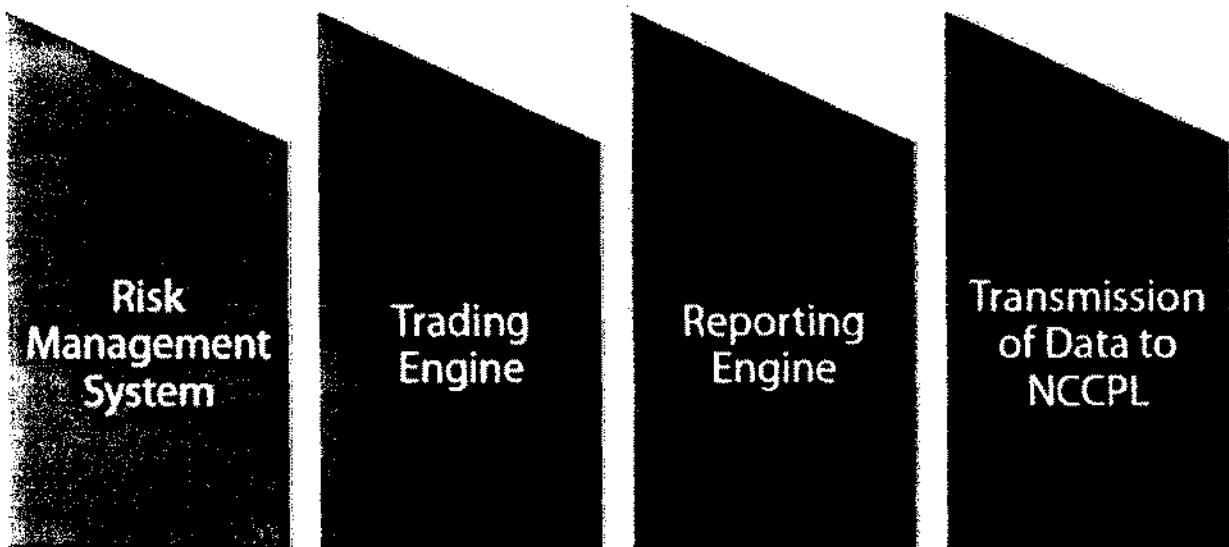
⁷³ Rule 4 of the Underwriter Rules, 2015

⁷⁴ <<http://www.kse.com>> accessed on June, 19, 2015

⁷⁵ <<http://www.lahorestock.com/#/Home.aspx>> accessed on June 19, 2015

⁷⁶ <<http://www.ise.com.pk/beta/site/index.asp>> accessed on June 19, 2015

⁷⁷ <<http://www.pmex.com.pk/about-us.php>> accessed on June 19, 2015



(ii) Central Depository Company of Pakistan Limited

The Central Depository Company of Pakistan Limited (CDC) in its Annual Report 2007 while providing introduction about its history and operation has stated that, "incorporated as a public limited (Unlisted) company in 1993, CDC is the only depository in Pakistan"⁷⁸. Its operations began in 1997 and it is the only entity handling dematerialized shares and there transfer thereof. "Through efficient functioning of CDC, approximately 99% of the market settlement is in book entry form"⁷⁹.

CDC was primarily established to operate CDS for equity, debt and other financial instruments that are traded in the Pakistani capital market. CDS is an electronic book entry system used to record and maintain securities and their transfer's registration. The system changes the ownership of securities without any physical movement or endorsement of certificates and execution of transfer instruments.

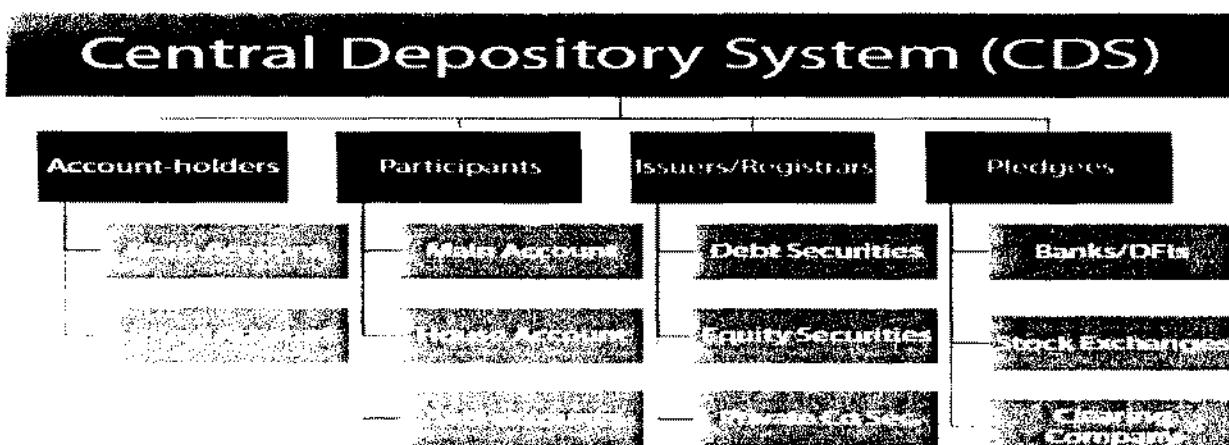
⁷⁸ Annual Report, Central Depository Company, 2007, p.4

⁷⁹ Annual Report, Central Depository Company, 2015, p.34

CDC is registered⁸⁰ and regulated⁸¹ by the Securities and Exchange Commission of Pakistan (SECP) and has branches in Karachi, Lahore and Islamabad. With the passage of time and development of Pakistan's capital market, CDC, in addition to operating CDS, also provides services that are beyond the traditional depository services such as:

- i. Investor Account Services (IAS) which "allows retail investors to open and maintain securities' accounts directly with CDC"⁸².
- ii. Trustee and Custodial Services (T&C) "which enlists Open-end and Closed end Mutual Funds and Voluntary Pension Schemes"⁸³.
- iii. Share Registrar Services (SRS) which provides "issuers facilities of registrar and transfer agent services, including registration and verification of shares and records and customer dealing on behalf of issuer companies"⁸⁴.

As per the Central Depository Regulations⁸⁵, following chart will illustrate the account structure of CDS:



⁸⁰ Rule 3 of the Central Depository Companies (Establishment and Regulation) Rules, 1996

⁸¹ Central Depository Act, 1997

⁸² Regulation 2.11.1 of the Central Depository Regulations approved by the Securities and Exchange Commission of Pakistan under section 35 (1) of the Central Depository Act, 1997

⁸³ Regulation 8E.1.2 of the Central Depository Regulations approved by the Securities and Exchange Commission of Pakistan under section 35 (1) of the Central Depository Act, 1997

⁸⁴ Section 17 of the Central Depository Act, 1997

⁸⁵ Central Depository Regulations approved by the Securities and Exchange Commission of Pakistan under section 35 (1) of the Central Depository Act, 1997

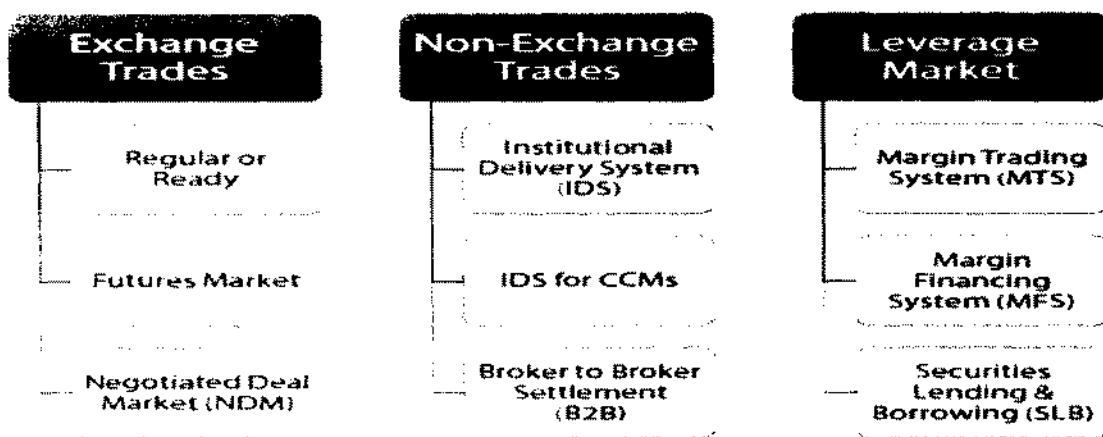
(iii) National Clearing Company of Pakistan Limited

National Clearing Company Pakistan Limited in its Annual Report 2012 while touching upon history and introduction provides that “the NCCPL was incorporated on July 3, 2001 to manage and operate NCSS in a fully automated electronic settlement system which became fully operational in the year 2003-04 by inducting and handling clearing and settlement of all book-entry securities through NCSS”⁸⁶.

As per the NCCPL Regulations⁸⁷, it has following membership types:

Clearing Members	Broker Clearing Member (BCM)	KSE Brokers
	Non-Broker Clearing Member (NBCM)	LSE Brokers
	Custodian Clearing Member (CCM)	ISE Brokers
		Banks
		Financial institutions
		Mutual funds
		City Bank
		Standard Chartered
		Douche Bank

As per NCCPL website⁸⁸, following types of transactions are handled at NCCPL:

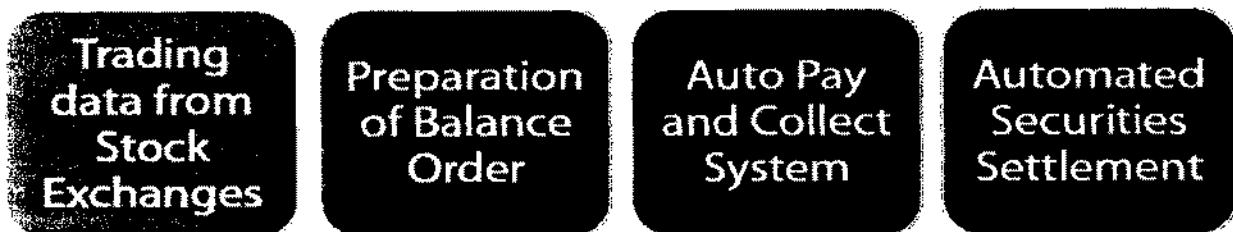


⁸⁶ National Clearing Company of Pakistan Limited, Annual Report, published in 2012, p.4.

⁸⁷ National Clearing and Settlement System Regulations in 2001 approved by the Securities and Exchange Commission of Pakistan.

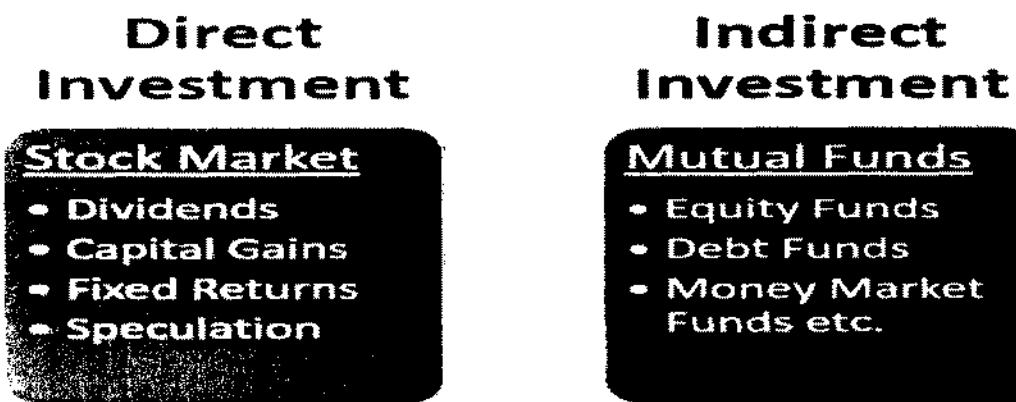
⁸⁸ < <http://www.nccpl.com.pk/services/vas.php> > accessed on June 20, 2015

As per the chapter 3 & 4 of the NCCPL Regulations⁸⁹, the following chart explains the work flow at NCCPL:



d. Investors

Investors are the provider of funds. They range from ordinary persons to sophisticated institutions. The Investor sentiment, "is a belief about future cash flows and investment risks that is not justified by the facts at hand"⁹⁰. As per SECP Investor Guide⁹¹, the investors can enter market in different ways and with different objectives:



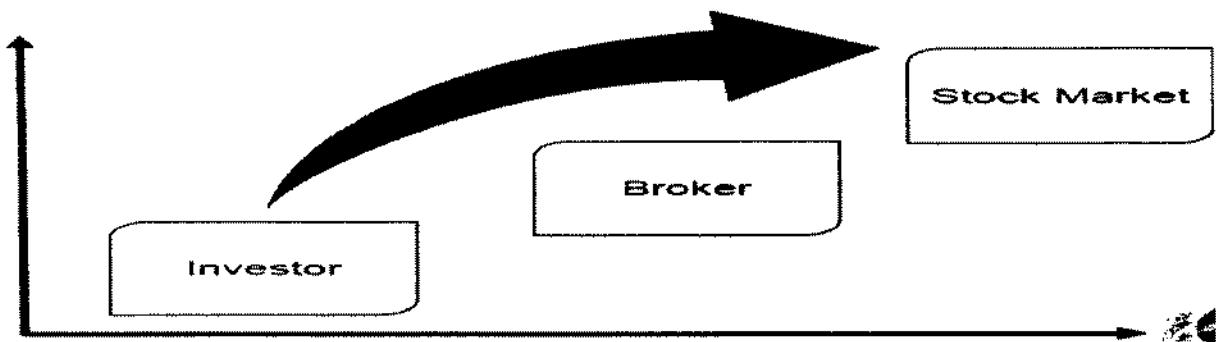
⁸⁹ Chapter 3 & 4 of the National Clearing and Settlement System Regulations in 2001 approved by the Securities and Exchange Commission of Pakistan

⁹⁰ Malcolm Baker & Jeffrey Wurgler, "Investor Sentiment, in the Stock Market", *NBER Working Paper Series, National Bureau of Economic Research*, (June 2007), p.1

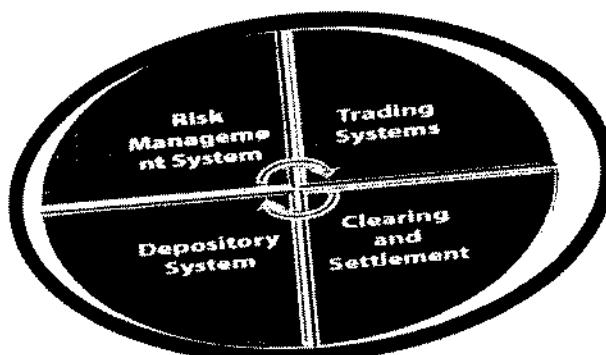
⁹¹ <<http://www.secp.gov.pk/Guides/Nov2010/InvestorGuide.pdf>> accessed on June 21, 2015

2.1.5 How Stock Exchanges Work

In Pakistan an investor cannot directly approach the stock market. It has to rout its orders "through a broker, to whom it has to pay a commission for every trade"⁹². The following chart explains the access flow:



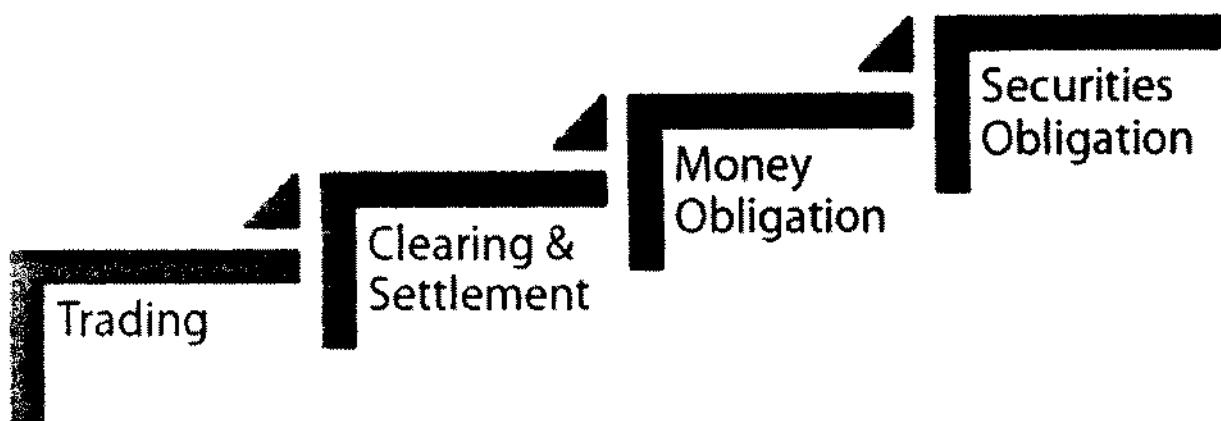
Once an investor through its broker enters the market than after its broker has complied with the risk management procedures of the exchange⁹³, the management operating flow will be as under:



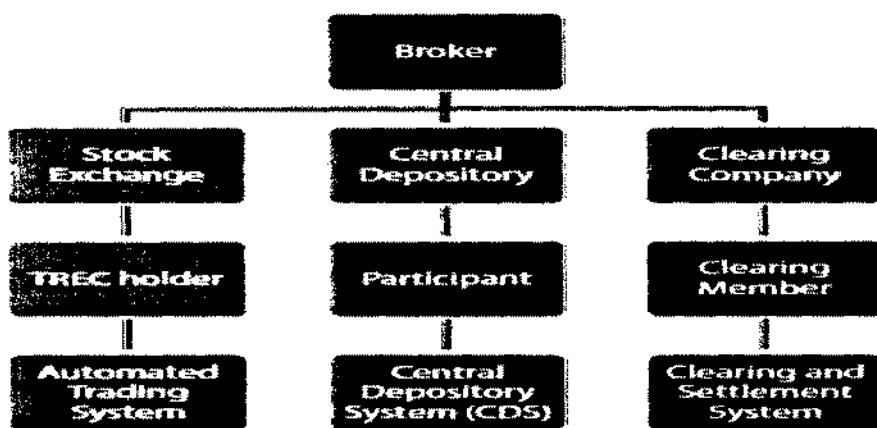
⁹² Only a broker registered under Broker and Agents Registration Rules 2001 and also registered as a clearing member under the Clearing Houses (Registration and Regulation) Rules, 2005 can have access to the exchange terminals.

⁹³ Chapter 5A.9 of the Karachi Stock Exchange Rule Book, approved by the Securities and Exchange Commission of Pakistan, under section 34 of the Securities and Exchange Ordinance, 1969.

The following figure explains the trade flow from inception to the end:

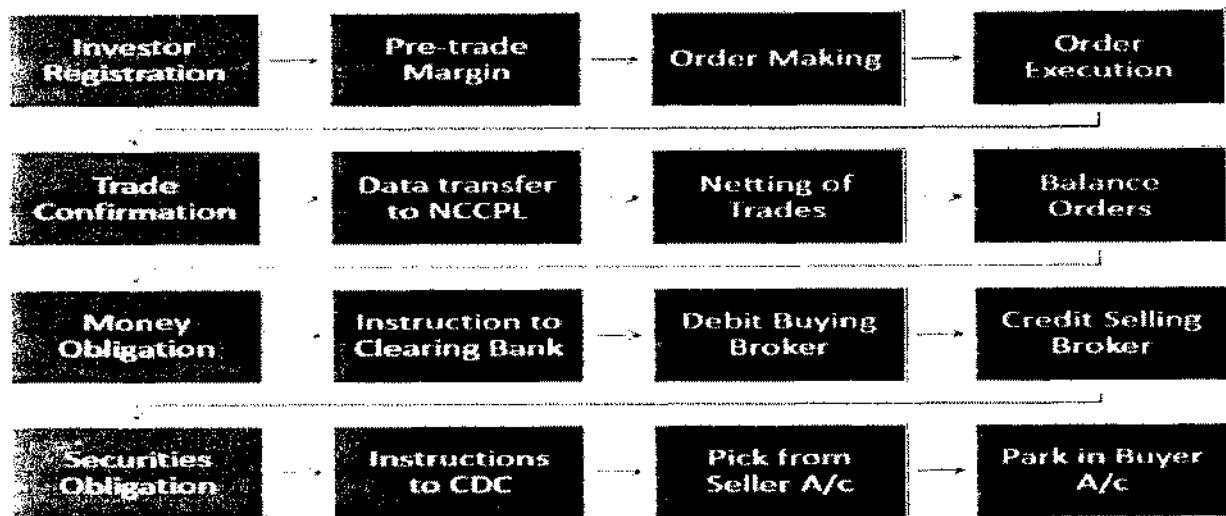


The trading will be done on exchange or off exchange (reported to the exchange). The clearing will be done at the end of NCCPL and custody function of securities is executed at the end of CDC. The money obligation is taken care of by NCCPL and the securities obligations are performed in CDS through automated system. In this entire process the broker has a pivotal role. For this very reason their admittance and function is closely monitored and regulated by the SECP under the Broker and Agents Registration Rules 2001. Primarily the brokers are required to obtain status and access to systems⁹⁴ as depicted in the following chart:

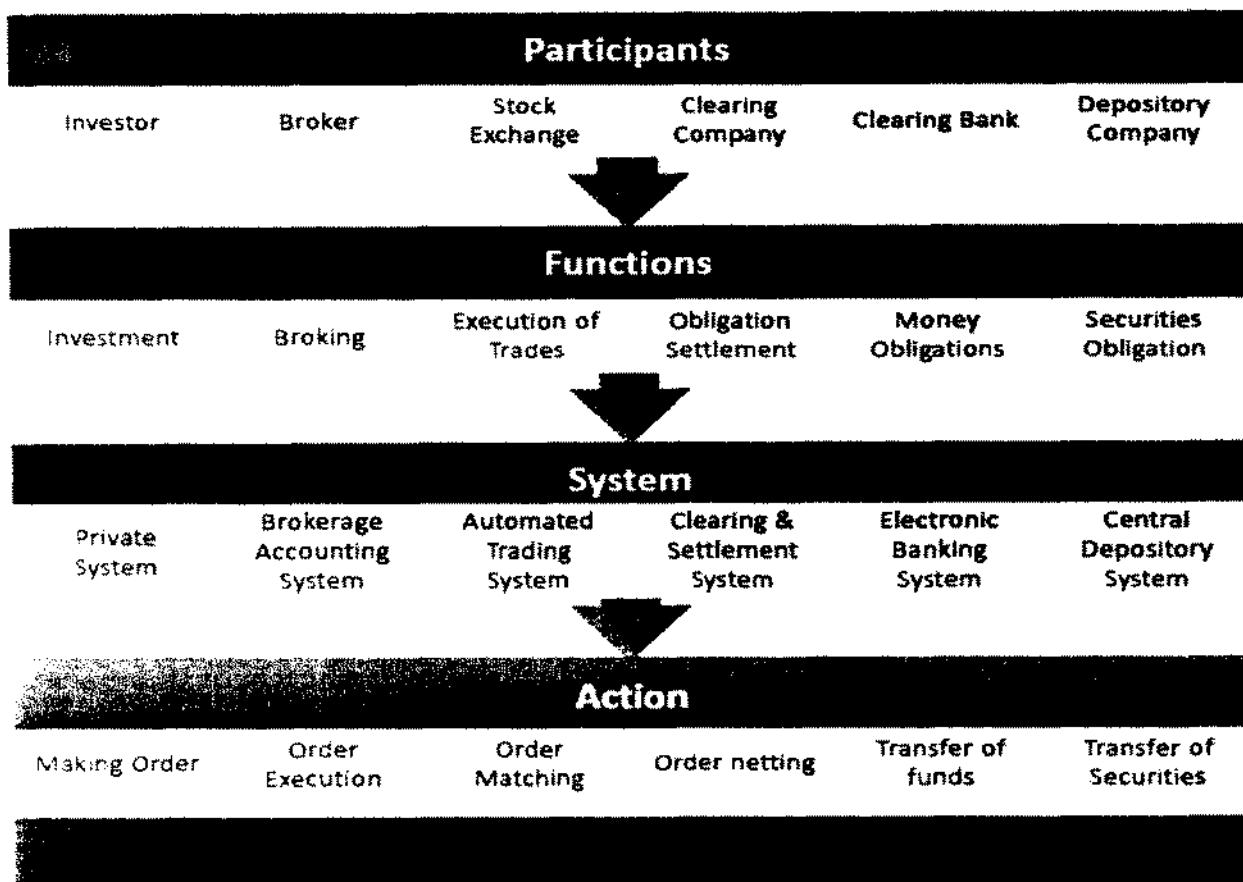


⁹⁴ The systems include the Karachi Automated Trading Systems (KATS), Central Depository System (CDS) and National Clearing Settlement System (NCSS)

The following chart will clarify sequentially how a single trade is executed on a stock exchange:



The following chart summarizes the participants in a capital market, the functions that they perform, systems that they provide or use and the actions that they undertake:



CHAPTER 3: ATS, DEFINITION AND IMPLICATIONS

The phenomenon of ATSs is a result of sea change in fundamentals of capital markets and rapid advancement in technology. The ATS invasion started in USA as far back as early 90s. As per The Forum of European Securities Commission (FESCO) report, 2003 "in Europe the emergence of a European capital market, advances in technology and the advent of electronic trading, both domestically and across national borders, are fuelling far-reaching changes in both market structures and participants' roles"⁹⁵.

In US, the ATS began as propriety trading systems. They are operated by broker-dealers and "are similar to exchanges because they allow two participants to meet directly on the system and are maintained by a third party who also serves a limited regulatory function by imposing requirements on each subscriber"⁹⁶. These ATSs can deliver a range of services, from the bringing together of buyers and sellers to complete trading platforms which offer similar functionality to that provided by exchanges, but within a different regulatory framework.

3.1 Definition and Characteristics

The definition of an ATS is quite complex. As per FESCO Report (op.cit), "different terminologies are used in different jurisdictions and the same term is often capable of bearing different interpretations"⁹⁷. This term is currently used for: bulletin boards, automated trade matching systems, electronic communication networks, proprietary trading systems (broker-run ATSs) as well as for broker-to-client automated linkages. In order to have a clear understanding of this concept, it is imperative to take stock of its characteristics.

The Ordinance appears to provide little assistance on this issue. The concept of ATS is alien to the Ordinance, there is no definition of this term and neither the law provides a distinction

⁹⁵ <www.europefesco.org.com>, accessed on 12-05-2014

⁹⁶ Jeffery W. Smith et al, "The Nasdaq Stock Market: Historical Background and Current Operation", *NASD Working Paper 98-01*, (August 24, 1998), p.36

⁹⁷ The Forum of European Securities Commission, The Regulation of Alternative Trading Systems in Europe, (European Commission publication, 2000), available at <http://www.esma.europa.eu/system/files/00_064c.pdf> accessed on 12-05-2014

between a traditional exchange and a modern alternative trading platform. However, there is no explicit bar on this.

The most acceptable definition of an ATS is as under:

"An ATS is an entity which, without being regulated as an exchange, operates an automated system that brings together buying and selling interests - in the system and according to rules set by the system's operator - in a way that forms, or results in, an irrevocable contract."⁹⁸

This is a broad definition, which captures any trading functionality regardless of whether that functionality operates bilaterally i.e. "organized around one or more dealers who make a market by maintaining bid and offer quotes to market participants"⁹⁹ or multilaterally i.e. "multilateral participation of many parties who quote their bid and offer prices"¹⁰⁰. It captures not only ATSs which contribute to the price discovery process through the matching of priced orders and the lifting of quotes, but also includes crossing mechanisms which match buying and selling interests at a price determined elsewhere, e.g. on an exchange.

The question arises should systems with bilateral functionality (for example, quote-driven systems that display a dealer's prices, and enable customers to trade at those prices against the dealer's principal book) be included in the definition of ATS?. Such systems might be viewed as automated market-making facilities, rather than as alternative trading systems as such. However, the European jurisdiction has "included bilateral systems within the definition of ATS – depending on the size and nature of their activities"¹⁰¹, because their issues are of similar kind to multilateral functionality systems. High volume bilateral systems are capable, for example, of

⁹⁸ Forum of European Securities Commission, "Standards for Alternative Trading Systems", *European Commission Publication*, (June 11, 2001), p.6

⁹⁹ Randall Dodd, "The Structure of OTC Derivative Market", *The Financier*, Volume. 9, Issue No. 1-4, (2002), p.2

¹⁰⁰ Ibid

¹⁰¹ Matthew Elderfield, *The Regulation of Market Infrastructure*, (London, Sweet & Maxwell, 2002), p. 37

contributing to market fragmentation "by internalizing significant order-flow within particular firms and thereby reducing overall order-interaction in a market"¹⁰².

While discussing the evolution of this concept in USA, the Goldman Sachs Report is one of the authentic and exhaustive document which provides that, "in USA, an ATS is an SEC-regulated trading venue which serves as an alternative to trading at a public exchange"¹⁰³. In some jurisdictions, ATSs are also referred to as "dark pools", where buyers and sellers are matched anonymously without pre-trade display of bids and offers. "The Dark Pools do not provide their best-priced orders for inclusion in the consolidated quotation data and offer trading services to institutional investors that try to trade in size while minimizing adverse price impact"¹⁰⁴.

The prime function of an ATS, is to convert the manual trading process, where traders would first try to execute trades internally before sending the order to a recognized exchange, into an electronic system. In US, ATSs are either operated by broker-dealers or affiliated with registered broker-dealers and, "accordingly, their activities are governed by the same rules and regulations that govern broker-dealer activities generally, including the provisions of the Securities Exchange Act, 1934 and SEC Regulation Short Sale (SHO)"¹⁰⁵. ATSs also constitute a market center, "making them subject to the provisions of SEC Regulation National Market System (NMS)"¹⁰⁶. In addition, ATSs are also subject to the provisions of SEC Regulation ATS, a unique set of rules designed specifically to govern the operations of ATSs. ATS are trading platforms and can be generally described as electronic trading systems that "provide automated trade matching, and process buy and sell orders using predetermined, non-discretionary trading methods"¹⁰⁷. Traditionally, trades in any given security were primarily

¹⁰² Norris Larrymore & Albert J Murphy (2006), "Internalization and Market Quality: An Empirical Investigation", *Journal of Financial Research*, 32:337-363, p.7. DOI: 10.1111/j.1475-6803.2009.01253.x

¹⁰³ <<http://www.goldmansachs.nl/ideas/public-policy/2-market-structure/sub-art/alt-trading-sys.html>>, the Goldman Sachs Report (2009), accessed on 17-04-2015

¹⁰⁴ Sabrina Buti, Barbara Rindi & Ingrid M. Werner, "Dark Pool Trading Strategies", *Charles A. Dice Center Working Paper No. 2010-6; AFA 2012 Chicago Meetings Paper*, (October 17, 2011), p. 3

¹⁰⁵ Roberta S. Karmel, *Regulation ATS and Related Market Structure Issues in United States*, (Sweet & Maxwell, 2002), First Edition , p.94

¹⁰⁶ ibid, p.96

¹⁰⁷ Helen Parry, *The Big Cheese or Positively Wall Street: Best Execution, Alternative Trading Systems and the Retail Investor in the United Stated and United Kingdom*, (London, Sweet & Maxwell,2002), Second Edition, p.149

executed on the exchange listing the security. As ATSs gain footing internationally, buyers, sellers and other market participants have a wide range of options when deciding manner and place to execute a trade. "ATSs compete with each other and with traditional exchanges by offering, among other things, different operating models, trade types and fee structures"¹⁰⁸.

His Lordship Mr. Justice Greenwood of California Circuit Court has observed and his observations are also covered in financial post of 14th April 2009 mentioning therein that, "technology, innovation, globalization, consolidation and increased investor sophistication are some of the key drivers behind the growing demand for the types of services offered by ATSs"¹⁰⁹. ATSs can differ from the exchanges in many ways and provide meaningful advantages such as competitive pricing, extended trading time, access to a broad range of markets, specialized market data, and new or unique investment strategies and trading options. While responding to demand on one hand, "ATSs have themselves increased demand for different services and fee structures, driving innovation and putting downward pressure on trading fees"¹¹⁰. Another key characteristic of ATSs is that they use innovative technologies while providing services and at the same time they attempt to control cost of the transaction. This innovative technology assists in a number of ways, "including by reducing timing while increasing access, exposure and execution opportunities across diverse marketplaces"¹¹¹.

3.2 Trading Options Offered by ATSs

Internationally, different models of ATS are in practice which provide host of divergent services which are going through a rapid evolutionary process. Historically ATS were either call or auction markets but over the years they also include matching or market making systems, crossing networks, dark pools or some combination of these, with overlapping services and distinguishing features.

¹⁰⁸ <http://www.goldmansachs.nl/ideas/public-policy/2-market-structure/sub-art/alt-trading-sys.html>, the Goldman Sachs Report (2009), accessed on 17-04-2015

¹⁰⁹ see J. Greenwood, "Alternative trading systems about to get their day in the sun", *Financial Post* (14 April 2009)

¹¹⁰ Pauline Ashall, "Regulation of Stock Exchanges and ATS in Hong Kong", *E-Commerce Asia, Asia Law & Practice*, (December 31, 1999), p. 12

¹¹¹ American Stock Exchange Report to the Securities and Exchange Commission Advisory Committee on Market Information, Re: Securities and Exchange Act release No. 34-42208; File No. S7-28-99, 2001

Some of the characteristics of ATSSs can be described as follows:

3.2.1 Auction markets

In auction markets buyers and sellers enter competitive bids simultaneously. Matching bids and offers are paired and orders are executed. "A share is generally traded at the highest bid by a buyer and the lowest offer at which a seller is willing to sell"¹¹².

3.2.2 Call markets

In call markets all orders are grouped and transactions take place together, usually at predetermined time. The clearing price is determined on the basis of number of bid and offer orders. They are also referred to as "quote driven markets and are generally fragmented"¹¹³.

3.2.3 Crossing systems or crossing networks

Crossing system or crossing networks are electronic platforms where brokers place the orders of their clients with each other before routing the same to an exchange. "Crossing networks are only order driven markets"¹¹⁴. Crossing systems are not meant for price discovery and may allow bulk orders to be entered and executed at predetermined time.

3.2.4 Market maker systems

In this type of system market maker act as liquidity providers and quote bid and offer prices. Trades are executed as soon as the orders are matched. "The market maker is the continuous source of providing liquidity and deals with the orders from their own inventory"¹¹⁵.

Using this categorization, the following framework can be set up:

¹¹² Larry Harris, *Trading and Exchanges: Market Microstructures for Practitioners*, (Oxford University Press, 2003), First Edition, p.125

¹¹³ Roy E. Bailey, *The Economics of Financial Markets*, (The Cambridge University Press, 2005), First Edition, p.40

¹¹⁴ Larry Harris, *Trading and Exchanges: Market Microstructures for Practitioners*, (Oxford University Press, 2003), First Edition, p.132

¹¹⁵ Pathak Bharati V., *The Indian Financial System: Markets, Institution and Services*, (Pearson Education India, 2009) Third Edition, p. 167

	Quote-driven systems	Order-driven systems		Price taking (crossing) systems	Active Bulletin Boards
		Continuous Matching	Auction Matching		
Basic Principle	Display of dealer quotes Automatic execution against quotes	Public limit order book Market and limit orders continuously matched in time and price priority	Limit orders and “at the opening” orders stored in a batch Algorithm calculates a single price at a set time to maximize execution	File of market orders (possibly with min/max execution limits) System crosses orders at single benchmark prices	Display of invitations to offer System declares acceptance of offers
Examples	MTS France	Instinet, Bloomberg, Island	Optimark	POSIT, E-Crossnet	Webstock, Tradecross

3.3 Distinction between ATS and Traditional Exchanges

In order to understand the concept of ATS it is imperative to draw its comparison with the traditional exchanges. The major difference appears to be their structural constitution. In Pakistan, for an exchange to get registered it has to go through the rigors of plethora of regulatory requirements. The registration process was covered under the Ordinance and now the Securities Act, 2015. An entity to be licensed as a securities exchange has to be a public company having object to operate a stock exchange¹¹⁶.

¹¹⁶ Section 4 (1) of the Securities Act, 2015

Further, it has to maintain at all times "a minimum capital (net of all losses) of rupees five hundred million or such higher amount as may be notified by the Securities and Exchange Commission of Pakistan"¹¹⁷. It also has to satisfy some independence requirement¹¹⁸ to ensure there is no conflict of interest and sanctity of demutualization process is maintained.

Furthermore, an exchange has to make regulations¹¹⁹ with the approval of the Securities and Exchange Commission of Pakistan to cover the aspects of fair and transparent trading¹²⁰, investor protection¹²¹, admission of securities for trading¹²², listing of securities¹²³, trading hours¹²⁴, risk management¹²⁵ etc. The licensed stock exchanges are subject to statutory duties¹²⁶.

On the other hand, the ATS are subject to lesser regulatory requirements, they are more flexible in their operations and can structure themselves in many ways to suit their customers basic needs and requirements. Further a major distinction is that exchange provides listing services, however, an ATS is just a trading platform.

The following chart will explain the notable difference between the ATS and a traditional exchange:

¹¹⁷ Section 4 (1) (a) of the Securities Act 2015

¹¹⁸ Section 4 (1) (b) ibid.

¹¹⁹ Section 7 ibid.

¹²⁰ Section 5 (4) (a) (i) ibid

¹²¹ Section 5 (4) (a) (iii) ibid

¹²² Section 7 (1) (o) (p) ibid

¹²³ Section 7 (1) (f) ibid

¹²⁴ Section 7 (1) (j) ibid

¹²⁵ Section 7 (1) (b) ibid

¹²⁶ Section 6 ibid

Alternative Trading Systems		
1	Only a trading platform	Provides for listing of issuers and their shares
2	Online trading with extended hours	Trading concentrated at a certain locality and within certain time span
3	Investors can directly access the system	Investor can only participate in the market through brokers
4	Flexible procedure for admission of securities for trading	Trading in standardized securities
5	Lower transaction cost	High transaction cost on account of multiple exchange charges in addition to the brokerage commission
6	The legal framework is contractual in nature	Formal set of rules having statutory backing

3.4 Characteristics and Benefits of ATS

Macey and O'Hara while discussing the key features and benefits of ATS observed that "ATSs have led to increased innovation and competition"¹²⁷. The enhanced competition among different trading platforms i.e. between ATS and traditional exchanges has led to reduction in trading costs for both institution as well as retail investors. Macey and O'Hara (op.cit.) further explain that "retail brokerages take advantage of the lower transaction fees offered by ATSs to provide low trading commission fees to their customers and investors are direct beneficiaries of market competition that ATSs introduce"¹²⁸.

As per Goldman Sachs Report (op.cit), "institutional investors can improve their trading performance by executing in an anonymous manner that diminishes their footprint in a stock's

¹²⁷ Macey R. Jonathan and O'Hara Maureen, "The Law and Economics of Best Execution", (Cornell University, Ithaca, New York University Press, 1996) 2nd Edition, p.77

¹²⁸ Ibid. p.78

trading activity¹²⁹. The institutional investors such as mutual funds and other collective investment schemes, appear to be direct beneficiaries but the real beneficiaries are in fact the small investor who have their money invested in such collective investment schemes.

Conrad, Johnson & Wahal (2001) noted that "the emergence of alternative electronic trading systems over the past decade has radically altered institutional trading practices"¹³⁰. Generally, ATS are classified into two heads i.e. crossing systems (such as ITG's POSIT) in which institutional orders are brought together and crossed at some prevailing price, and electronic communication networks (ECNs), such as Instinet, that allow counterparties to trade anonymously at negotiated prices.

Globally, these systems have experienced enormous growth and appear to provide a significant source of competition for order flow, for both exchanges and dealer markets. In USA, "the nine currently operating ECNs account for almost 40 percent of the dollar volume of trading in Nasdaq securities"¹³¹. As per Wall Street Journal, "trading volume on POSIT, the most prominent crossing network, grew at a compounded annual growth rate of over 45 percent between 1988 and 1999, and recorded a total trading volume of 6.5 billion shares in 1999"¹³².

The investors enjoy the options in trading venues as opposed to a single trading venue albeit a traditional stock exchange. The sophisticated institutional investors always seek best execution of their trades, at lesser cost in this highly competitive business environment. However, Macey and O'Hara (op.cit) note, "best execution is a multidimensional concept encompassing trade price, market impact, immediacy, timing, trade mechanism, anonymity, commissions and even

¹²⁹ <<http://www.goldmansachs.nl/ideas/public-policy/2-market-structure/sub-art/alt-trading-sys.html>>, the Goldman Sachs Report, published in 2009, accessed on 17-04-2015

¹³⁰ Jenifer Conrad, Kevin M. Johnson & Sunil Wahal, "Alternative Trading System", *The Journal of Finance*, Volume 56, Issue no. 1, (May 2001), p. 399

¹³¹ The nine ECNs are: Archipelago, Attain, Instinet, Island, Bloomberg Trade book, GFI Securities, Market XT, NexTrade, Redibook, and Strike.

¹³² See "Plan to upgrade Nasdaq trading passes the SEC," *Wall Street Journal*, 1/11/2001

quid-pro-quo arrangements"¹³³. The ATS are designed to offer variety of combinations to ensure best execution.

It is an established rule of business that competition and innovation is to be welcomed, as it is likely to lead to more efficient markets that benefit all participants, including investors. Mark Wahrenburg (2001) while dispelling the common notion that fragmentation of markets lead to reduction in liquidity and the competition is counterproductive noted that "this argument is valid only in a world with high information barriers, with functioning arbitrage links between markets the traditional fragmentation argument breaks down"¹³⁴. Although hypothetically the liquidity is fragmented across many destinations but it is accessed in a "high speed, fluid and optimized manner"¹³⁵. The regulators have to increase their capacity to put in place appropriate regulatory framework that not only fosters competition and innovation but is also capable of addressing, investor protection issues, systemic risk and risk of financial instability that might arise.

The benefits to market participants and/or investors of introduction of ATS will be as under:

- i. The introduction of ATS will ensure competition between ATS, the traditional exchanges and broker providing over the counter services. This healthy competition will drive down the trading costs and also lower commissions. In this competitive market, the exchanges and brokers will have to improve their services, including client management and advanced technologies to compete with the ATS.
- ii. In international jurisdictions, ATS offer different manners of execution of orders across a market including but not limited to continuous auction, limit order book, crossing and order preference models, as opposed to the traditional exchanges. In some jurisdictions

¹³³ Macey R. Jonathan and O'Hara Maureen, "The Law and Economics of Best Execution", (Cornell University, Ithaca, New York University Press), 1996, 2nd Edition, p.83

¹³⁴ Mark Wahrenberg, "Trading System Competition and Market Maker Competition", *Bank of International Settlement publication, BIS papers no. 7:53*, (2001), p. 53

¹³⁵ Goldman Sachs, "Market Structure Overview", September, 2009 accessed at <http://www.goldmansachs.com/our-thinking/archivemkt-structure.pdf> accessed on June 22, 2015

"ATS offer undisclosed trading i.e. where the identity of the person placing the order is not disclosed"¹³⁶. The advantage of undisclosed trading is that it reduces the impact of bulk order which have the tendency to drive the market in a certain direction. Rather than following one dimensional trading options offered by the traditional exchanges, ATS can offer services best suited to the needs of the investors.

- iii. ATSs offer diversified products and extended trading hours. In context of Pakistani capital markets, ATSs could act as nursery markets for small companies planning to grow big or entrepreneurial enterprises, shares of which are not listed on the recognized exchanges. Internationally some exchanges offer extended trading hours and in some cases "the trading hours are open round the clock i.e. 24 hour trading"¹³⁷.
- iv. ATS could become a central market place for Shariah compliant securities which are generally traded over-the-counter.

¹³⁶ Erik Banks, *Off Exchange Liquidity in the Era of High Frequency, Program and Algorithmic Trading*, (Palgrave Macmillan, 2014) Second Edition, p.37

¹³⁷ U.S. Congress, Office of Technology Assessment, *Electronic Bulls and Bears: US Securities Market and Information Technology*, OTA-CIT-469, U.S. Government Printing Office, September 1990, p. 137

CHAPTER 4: COMPARATIVE ANALYSIS OF DIFFERENT JURISDICTIONS

Like any new entrant or service provider in the capital market, the challenge for any regulator is to ensure mitigation of risks while at the same time ensuring that the benefits of competition and option of diversification flows to the investors. In relation to ATS, the regulators have to ensure that their duty to preserve an efficient and effective capital market is not compromised.

4.1 Regulation of ATSs in the United States

The Securities and Exchange Act of 1934¹³⁸ (the "1934 Act") was put in force in 1934. Till 1975, all the stock exchanges were "non-profit mutual or membership organizations with trading floors"¹³⁹. The 1934 Act required all the exchanges to register with the Securities and Exchange Commission ("US SEC")¹⁴⁰. Further the exchanges operate as a self-regulatory organization, which gives them credibility as public institutions.

In 1938, the US Congress passed the Maloney Act to establish a framework for an Over The Counter self Regulatory organization. The National Association of Securities Dealer ("NASD") is the only such self-regulatory organization that exists. All broker dealers have to be registered with NASD¹⁴¹.

The 1934 Act was amended in 1975¹⁴² and the existing regime was liberalized by giving US SEC broad powers "to design, implement and regulate trading markets"¹⁴³. This amendment paved way for the current market structure which is infested with ATS and multiple variants thereof.

In 1998, the SEC adopted Regulation ATS, which required ATSs to register with the US SEC "either as exchanges or as broker-dealers"¹⁴⁴. Under Regulation ATS, ATSs were required to

¹³⁸ 15 U.S.C. §§78a *et seq*

¹³⁹ Roberta S. Karmel, *Regulation ATS and Related Market Structure Issues in United States*, (Sweet & Maxwell, 2002) First Edition, p. 81

¹⁴⁰ Section 6 of the Securities Exchange Act, 1934

¹⁴¹ Section 5 (b) (8) *ibid*

¹⁴² Securities Act amendments of 1975, pub. L. No. 94-29, 89 Stat. 97.

¹⁴³ US SEC, Regulation of Exchanges and Alternative Trading Systems, the Securities and Exchange Act, 1934, Release No. 40760, 63 Fed. Reg. 708441-01, 70,852, December 22, 1998, p.1

¹⁴⁴ *ibid*, p.6

In USA, ATSs that opt to register as a traditional exchange has to comply with the requirements that apply to traditional stock exchanges¹⁵⁴. Likewise they have to organize themselves to undertake SRO function¹⁵⁵ and comply with SRO related requirements of the securities law.

ATSs that opt to register as broker-dealers must comply with the requirements of Regulation ATS. If the trading volume of any ATS in any particular share is less than 5% there are minimal reporting requirements. However, where the trading volume is equivalent to or exceeds 5% in any particular share, as per ATS Regulation an ATS must "link with a registered exchange or the NASD"¹⁵⁶, as appropriate, and "publicly display their best priced orders (including institutional orders)"¹⁵⁷ and "allow members of the registered exchanges and the NASD to execute against those publicly displayed orders"¹⁵⁸.

In addition to the above mentioned requirements, an ATS having more than 20% of trading volume in any single share has to comply with certain additional and more stringent requirements. These requirements include "up-gradation of the automated system"¹⁵⁹ to ensure that it has the capacity to ensure integrity of transactions. Further, such ATS cannot deny investors access to the services other than under reasonable circumstances. This requirement does not in any way impede the ability of the ATS to set minimum qualifying requirements for prospective customers/investors based in fairness and non-discrimination.

Laure Tuttle (2013) one of the staff member of Division of Economic Risk Analysis, US SEC while summarizing the overall impact of the ATS in US capital Markets observed that "trading on ATSs regularly comprises 10-15% of U.S. equity trading volume"¹⁶⁰. However, on account of lack of publicly available data on ATSs, there are some issues related to understanding of the concept

¹⁵⁴ US SEC, Regulation of Exchanges and Alternative Trading Systems, the Securities and Exchange Act, 1934, Release No. 40760, 63 Fed. Reg. 708441-01, 70,852, December 22, 1998, p.80

¹⁵⁵ ibid. p.91

¹⁵⁶ ibid. p. 69

¹⁵⁷ ibid. p. 70

¹⁵⁸ ibid. p. 70

¹⁵⁹ ibid, p.94

¹⁶⁰ <http://www.sec.gov/marketstructure/research/ats_data_paper_october_2013.pdf> accessed on 11-03-2015

and its impact on the market. However some of key statistics as per the said research are as under:

- 35 broker-dealer firms operate 44 ATSS that actively trade NMS stocks.
- ATSS execute an estimated 11.31% of NMS dollar volume, and 12.12% of NMS share volume.
- The distribution of reported trade sizes on dark ATSS is remarkably similar to that observed on traditional exchanges.
- For all market-capitalization groups of stocks, at least 10% of trading dollar volume (11.37% of share volume) is attributable to ATSS, with the largest market share occurring in medium capitalization stocks (12.30% of dollar volume and 12.86% of share volume).
- 7.39% of ETF dollar volume and 8.49% of ETF share volume is executed on ATSS as opposed to 12.83% of the dollar volume and 12.80% of the share volume in other NMS stocks.

As per the information available on US SEC website, "in the second quarter of 2012, 90 ATSS were registered with the US SEC; 21 reported no volume information and appeared to be inactive"¹⁶¹. As per information from 2012, Q2 Form ATS-R filings available on US SEC website, "of the 69 active ATSS, 45 trade in NMS stocks"¹⁶², while the majority of ATSS transact in stocks, the notional value of derivatives transacted on ATSS comprises 51.04% of ATS dollar volume¹⁶³. "Fixed income securities and credit instruments comprise 44.86% of ATS dollar volume, and NMS stocks comprise 4.05% of ATS dollar volume"¹⁶⁴.

In USA, at present there are 13 registered exchanges¹⁶⁵ that operate at national level. In addition to them there are 44 ATSS that trade in listed stocks operated by 35

¹⁶¹ <<https://www.sec.gov/foia/ats/atslist0514.pdf>> accessed on 19-06-2015

¹⁶² <http://www.sec.gov/marketstructure/research/ats_data_paper_october_2013.pdf> accessed on 11-03-2015

¹⁶³ ibid.

¹⁶⁴ ibid.

¹⁶⁵ <<http://www.sec.gov/divisions/marketreg/mrexchnge.shtml>> accessed on 19-06-2015

entities/companies some of which manage and operate than one ATS¹⁶⁶. This empirical data shows that in a small span of time a significant volume of the trades are executed on the ATS.

4.2 Regulation of ATSs in Europe

In 2004, the European Union issued the Markets in Financial Instruments Directive (the "MiFID")¹⁶⁷ with the intention of increasing competition while preserving consumer protection. Under the MiFID, the investment firms are regulated by the laws of the state in which they have their registered office, but are generally allowed to provide services to customers in any European Union state¹⁶⁸. The MiFID emphasizes transparency¹⁶⁹ and requires that investment firms seek best execution¹⁷⁰ of their customers' orders. MiFID's best execution requirement, described by the Committee of European Securities Regulators (the CESR) to be of "an overarching nature, requires investment firms to take all reasonable steps to obtain the best possible result for their clients, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to order execution"¹⁷¹. The CESR further explains that responsibility for assessing the relative importance of these best execution factors lies with the investment firm, taking into consideration characteristics of the client (including the categorization as retail or professional), the characteristics of the client order, the financial instrument that is the subject of the order and the execution venues or entities to which that order can be directed, and for retail clients, the total consideration.

¹⁶⁶ Laura Tuttle, "Alternative Trading Systems: Description of ATS Trading in National Market System Stocks", *US SEC Publication*, (October 2003), p.6

¹⁶⁷ Markets in Financial Instruments Directive, 2004/39/EC, European Commission, 2004

¹⁶⁸ ibid. para 32

¹⁶⁹ ibid. para 5

¹⁷⁰ ibid. para 33

¹⁷¹ The Committee of European Securities Regulator (CESR), "Best Execution under MiFID", *CESR Publication*, CESR/07-050b, (2007), p.3

ATSs were virtually nonexistent in Europe till 2000¹⁷², primarily since the entire Europe went through an era of modernization of the exchanges during the late 80s and 90s. This left very little room for alternative trading platforms to claw into the market.

Having said that a Study group of the Forum of European Securities Commission (FESCO) in its report dated September 2000, "identified 27 multilateral systems operating in the EEA which fit within the ATS definition"¹⁷³. The said report transpires that the operators of most ATSs were authorized in the UK and in Germany i.e. 16 and 6 respectively. Further, with one each operating out of France, Ireland, Belgium and the Netherlands.

Till 2000, the remaining eleven jurisdictions had not yet licensed or authorized the operator of any trading system falling within the definition of ATS. As per European Securities Market ("ESMA") website, "Instinet and Citicats (Germany) are the longest established systems"¹⁷⁴.

A notable feature of ATS development is the different roles they are playing indifferent markets. Where organized central markets already exist, as is predominantly the case with equities, ATSs normally attract business by offering functionality or services that the local exchange does not. After hours trading is typically one of those facilities. It is provided, for instance, by Euro TLX¹⁷⁵ in Italy. Crossing is another key functionality offered by many ATSs operating in the UK, such as E-Crossnet, POSIT and Lattice. ATSs often also offer direct access to institutional investors, which most exchanges currently do not. The tendency in organized central markets is generally, therefore, for competition from ATSs to fragment liquidity.

By contrast, in areas where there is no organized central market, "ATSs have emerged to offer greater efficiency and transparency in price formation"¹⁷⁶. This is especially true in bond markets. "MTS is a key example of this move from OTC bilateral transactions in fixed income

¹⁷² The Forum of European Securities Commission, "The Regulation of Alternative Trading Systems in Europe", *European Commission publication*, (2000), p.3, available at

<http://www.esma.europa.eu/system/files/00_064c.pdf> accessed on 12-06-2015

¹⁷³ *Ibid.* p.4

¹⁷⁴ <<http://www.esma.europa.eu/content/MTF/html>> accessed on 19-06-2015

¹⁷⁵ <<http://www.eurotlx.com/en/node/3049>> accessed on 20-06-2015

¹⁷⁶ Guido Ferrarini & Eddy Wymeersch, *Investor Protection in Europe: Corporate Law Making, The MiFID and Beyond*, (Oxford University Press, 2006), First Edition, p.66

instruments, towards a multilateral trading system operated as an ATS¹⁷⁷. MTS is currently operating as "an ATS in twenty eight jurisdictions and as a regulated market in Portugal and Italy"¹⁷⁸.

Some ATSs, such as Trade-cross in Germany, offer a trading platform for equities that have not been admitted to trading on a regulated market and for which there is no organized central market. Just as ATSs are tending to provide a centralizing force in European bond markets, "so there may be potential for equity ATSs to centralize trading inequities on a pan-European basis"¹⁷⁹.

The markets all across Europe underwent a lot of change significantly driven by "advancement in technology; change in investor preferences and by increasing competition between traditional exchanges"¹⁸⁰. Howard Davies, Chairman of the UK Financial Services Authority(now Financial Conduct Authority), has studied the impact of such systems in depth. As per his findings, "ATSs had emerged, and would develop further, where existing market providers failed to offer the type of services that market users were increasingly seeking, and at an appropriately low cost"¹⁸¹.

As opposed to US model of regulating alternative trading platforms, there is no special regulation or status of ATS within Europe. A major reason for the same is that in Europe there is hardly any difference between "a brokerage/investment firm and a registered exchange in respect to systems offered e.g., both use electronic trading platforms"¹⁸².

¹⁷⁷ The Forum of European Securities Commission, "The Regulation of Alternative Trading Systems in Europe", *European Commission publication*, (2000), p.6, available at http://www.esma.europa.eu/system/files/00_064c.pdf accessed on 26-06-2015

¹⁷⁸ <http://www.mtsmarkets.com/MTS-US> accessed on 21-06-2015

¹⁷⁹ The Forum of European Securities Commission, "The Regulation of Alternative Trading Systems in Europe", *European Commission publication*, (2000), p.21, available at

http://www.esma.europa.eu/system/files/00_064c.pdf accessed on 12-05-2014

¹⁸⁰ Matthew Elderfield, *The Regulation of Market Infrastructure*, (Sweet & Maxwell, 2002) First Edition, p. 39

¹⁸¹ Howard Davies, "ATSs need oversight, yet freedom to grow", *Trade Publication, Securities Industry News*, Vol.12 Issue 43, (November 13, 2000), p.3

¹⁸² Deloitte, "MiFID II and the new trading landscape, transforming trading and transparency in EU Capital Markets", *EMEA Centre for Regulatory Strategy Publication*, (2014), p.6

Internationally, persons desirous of operating ATS either apply for registration as an exchange or a brokerage/investment firm. The focus of regulation in case of registration as an exchange is on market integrity. Whereas, the focus of regulation in case of registration as an investment/brokerage firm is on investor protection. In Europe the preferred model is that of "investment firm regulation however, many operators such as "Coredeal" and "Jiway" have opted to be regulated as an exchange"¹⁸³.

It has been observed that in France, Greece and the Netherlands "some additional requirements are prescribed for ATS registering themselves as investment/brokerage firms"¹⁸⁴. In Italy the situation is different where the "ATS operators are not required to obtain any license or get them registered with the respective securities regulator"¹⁸⁵. However, the company or entity managing the ATS has to merely provide a copy of the system regulations to the regulator. To the contrary, in Spanish jurisdiction "government approval is required, which process is akin to registration of an exchange"¹⁸⁶. ATS has to be approved by the Government in a procedure similar to that of an exchange¹⁸⁷. In accordance with the article 14 of ISD, "the Spanish concentration rules require also that every order received by a broker has to be sent to an exchange"¹⁸⁸.

¹⁸³ The Forum of European Securities Commission, "The Regulation of Alternative Trading Systems in Europe", *European Commission publication*, (2000), p.7, available at <http://www.esma.europa.eu/system/files/00_064c.pdf> accessed on 26-06-2015

¹⁸⁴ ibid. p.8

¹⁸⁵ ibid.p.8

¹⁸⁶ Title IV, Chapter II, Act 24/1988 of the 28 July, on the Securities Market (Spanish Securities Market Act)

¹⁸⁷ "The approval by the Government is necessary since the enactment of the new Spanish Securities Market Act in November 1998. If applicable the approval is granted on the basis of a proposal by the CNMV. For its decision, amongst other aspects, the CNMV compares the ATS's bylaws, the trading and listing rules with the 'Standards for regulated markets under the ISD' of FESCO".

¹⁸⁸ According to the ISD (Article 14, Para 3) "a member state may require that transactions be carried out on a regulated market. If a member state applies paragraph 3 it shall give investors the right not to comply with this obligation and have the transactions carried out away from a regulated market".

In Portugal, the existing framework only makes a distinction on the basis of whether "an entity, business or market is regulated or not"¹⁸⁹. The Greek regime is very flexible and every fresh application is dealt with by the regulators and the government on case to case basis.

The success of these trading platforms can be mapped from the fact that as per EU website there are 153 Multilateral Trading Facilities operating in Europe at present¹⁹⁰.

4.3 Regulation of ATSs in Canada

The ATS invasion saw the light of day in Canada in 90s. Realizing the obvious advantages of increased competition and efficiency the regulators started working on this concept. In order to do away with issues pertaining to negative perception of ATS, steps were taken to develop a framework following the US model.

The capital market regulation in Canada, is done at national as well as provincial level. The provincial securities regulators prescribe their own set of rules. In addition to the same the provincial and national regulators can adopt standard policies formulated by the Canadian Securities Administrators (the CSA)¹⁹¹.

Particularly in the case of ATS, the Investment Industry Regulatory Organization of Canada (IIROC)¹⁹² also acts as a front line regulator. IIROC is currently the only self-regulatory organization (SRO)¹⁹³ overseeing all investment dealers and equity (and, in theory, debt) trading activity in Canada, primarily through its UMIR¹⁹⁴ and Dealer Member Rules¹⁹⁵.

¹⁸⁹ The Forum of European Securities Commission, "The Regulation of Alternative Trading Systems in Europe", *European Commission publication*, (2000),, available at <http://www.esma.europa.eu/system/files/00_064c.pdf> accessed on 12-05-2014

¹⁹⁰ <http://mifiddatabase.esma.europa.eu/Index.aspx?sectionlinks_id=22> accessed on 17-06-2015

¹⁹¹ <<http://www.securities-administrators.ca>> accessed on 21-06-2015

¹⁹² <<http://www.iroc.ca/about/pages/default.aspx>> accessed on 21-06-2015

¹⁹³ Notice of approval dated May 30, 2008 by Ontario Securities Commission, can be accessed on <http://www.iroc.ca/about/governance/Documents/RecognitionOrderOntario_en.pdf>

¹⁹⁴ Universal Market Integrity Rule approved by the applicable securities regulator (Federal or provincial), accessed at <http://www.iroc.ca/industry/rulebook/Documents/UMIRO101_en.pdf> on 21-06-2015

¹⁹⁵ <<http://www.iroc.ca/industry/rulebook/pages/default.aspx>> accessed on 21-06-2015

The primary instruments governing ATS in Canada are National Instrument 21-101 Marketplace Operation (NI 21-101) and National Instrument 23-101 Trading Rules (NI 23-101). These set of rules prescribe the regulatory and disclosure requirements applicable to all providers in the Capital Markets. These rules were implemented in 2001 with the objective of putting in place a comprehensive framework within which traditional and alternative trading platforms could operate.

In addition the broad requirements for governing and regulating market places, these rules also have specific requirements for regulating ATSs (the "ATS Rules"). As per NI 24-101, ATSs are also subject to "trade-matching requirements"¹⁹⁶, which requirements is similar to when trades are settled under IIROC and TSX rules.

The Stikeman Elliott Report (op.cit.) explain that, NI 21-101 was adopted in order to "create an appropriate regulatory regime for new and emerging marketplaces and to supplement the existing regime for exchanges and quotation and trade reporting systems (QTRS) in light of these new and emerging marketplaces"¹⁹⁷. At present there is no QTRS operating in Canada at present¹⁹⁸.

According to NI 21-101, a marketplace includes an exchange or a QTRS, as well as "any person or company that is neither an exchange or a QTRS that provides a market or facility for bringing together multiple buyers and sellers, brings together the orders for securities of multiple buyers and uses non discretionary methods for interaction between the parties"¹⁹⁹.

According to the CSA²⁰⁰, the last two lines of the preceding paragraph describe ATSs. From this definition it can be derived that if a person or company brings together orders for securities and if it displays, or otherwise represents to marketplace participants, trading interests entered on

¹⁹⁶ Part 3 of National Instrument NI 24-101 Marketplace Operation Rules

¹⁹⁷ National Instrument NI 21-101 Marketplace Operation Rules, s. 1.1

¹⁹⁸ See "Notice of Proposed Amendments to NI 21-101 and NI 23-101 (2011) 34 OSCB (Supp-1) dated March 18, 2011 at p.2 where the CSA confirm there are currently no QTRSs recognized in Canada."

¹⁹⁹ National Instrument NI 21-101 Marketplace Operation, s.1.1

²⁰⁰ Simon A. Ramano & Ramandeep K. Grewal, "Alternative Trading Systems, Market Place Evolution in Canada", *Stikeman Elliot LLP Publication*, (2011), p. 6. Assessed June 18, 2015 on <www.stikeman.com/2011/en/pdf/AlternativeTradingSystems.pdf>

the system, or receives orders centrally for processing and execution; regardless of the level of automation used it can be classified as an ATS, provided that it established non-discretionary methods to dictate the terms of trade between parties. However, a system that only operates as a market maker or proprietary system, or order routing system, or information processing system will fall foul of this category.

An ATS is defined in NI 21-101 as a

"marketplace that, is not a recognized QTRS or an exchange, and does not require an issuer to enter into an agreement to have its securities traded on the marketplace, provide, directly, or through one or more subscribers, a guarantee of a two-sided market for a security on a continuous or reasonably continuous basis, set requirements governing the conduct of subscribers, other than conduct in respect of the trading by those subscribers on the marketplace, and discipline subscribers other than by exclusion from participation in the marketplace."²⁰¹

It is clear from this definition that the law recognizes ATS as a trading platform other than an exchange and QTRS, which does not provide listing service. The non discretionary requirements its set is only for trading purposes and not governing the conduct of its clients.

NI 21-101 CP, S.3.1 (3) and 3.3, with respect to this definition, further clarify that an ATS that compulsorily requires its clients to comply with the requirements of a regulation services provider²⁰² as part of its contract with its client is not considered to be setting requirements governing the conduct of subscribers and therefore, will be classified as an ATS.

Similarly, an ATS is permitted to establish "trading algorithms without tripping this restriction"²⁰³. Marketplaces are also not precluded from "imposing credit conditions or requiring subscribers to submit financial information"²⁰⁴.

²⁰¹ National Instrument NI 21-101 Marketplace Operation Rules, s. 1.1.

²⁰² National Instrument NI 21-101 Marketplace Operation Rules, s. 3.1(3) and 3.3

²⁰³ National Instrument NI 21-101 Marketplace Operation Rules, s. 3.3

NI 21-101 section 6.1 and 6.3 specifies that "an ATS must register as a dealer and become a member of a self-regulatory entity"²⁰⁵ in order to carry on business in Canada and limits the types of securities that ATSs are permitted to trade i.e. "exchange-traded securities, corporate debt securities, government debt securities and foreign exchange-traded securities"²⁰⁶.

The CSA regulates the operations of ATS through regime based reporting obligations, requiring intimation where minimum trading thresholds is crossed. The threshold criterion are average daily trading dollar value, trading volume and number of trades in a given security. In case an ATS crosses that threshold, CSA reviews the operation of ATS to consider "whether it should more appropriately be regulated as an exchange"²⁰⁷.

ATSs are subject to strict systems requirements regarding their "business continuity"²⁰⁸, "disaster recovery plans"²⁰⁹ and "IT controls, and capacity and systems testing procedures"²¹⁰ as they grow in size. ATSs are also subject to record-keeping requirements relating to, among other things, "those to whom they grant trading access"²¹¹ as well the "orders and trades that they process"²¹². As a market participant for the purposes of Ontario securities laws, an ATS's records are also subject to the record-keeping and compliance review provisions of the Securities Act (Ontario).

It is pertinent to mention that National Instrument 23-101 and NI 21-101 came into force simultaneously. The objective was to create uniformity in the entire capital market regulation. This was particularly important to ensure mitigation of market manipulation and deceptive trading practices, and to clarify best execution and market conduct standards for all service providers. NI 21-101 is generic rules which impose primary administrative requirements. NI 23-101 is substantive in nature which in addition to supplementing NI 21-101 also covers subjects

²⁰⁴National Instrument NI 21-101 Marketplace Operation Rules, s. 3.4

²⁰⁵ National Instrument NI 21-101 Market Operation Rules, s. 6.1

²⁰⁶National Instrument NI 21-101 Market Operation Rules, s. 6.3

²⁰⁷National Instrument NI 21-101 Market Operation Rules, s. 6.7

²⁰⁸ National Instrument NI 21-101 Market Operation Rules, s. 12.1

²⁰⁹ National Instrument NI 21-101 Market Operation Rules, s. 12.4

²¹⁰National Instrument NI 21-101 Market Operation Rules, s. 12.2

²¹¹National Instrument NI 21-101 Market Operation Rules, s. 11.2.1

²¹²National Instrument NI 21-101 Market Operation Rules, s. 11.2.2

related to code of conduct and manner of execution of orders. These requirements are similar to requirements put in place by IIROC on its registered members.

As per NI 23-101 section 7, in order to execute trades on behalf of its clients, ATSs must execute an agreement with a regulation services provider (RSP)²¹³. The agreements between an ATS and its regulation services provider must specify that "the ATS will conduct its trading activities in compliance with NI 23-101"²¹⁴. IIROC is currently the only RSP for ATSs²¹⁵.

Briefly, IIROC came into being in 2008, by way of merger of Market Regulation Services Inc. (RS) and the Investment Dealers Association of Canada (IDA). It is recognized as an SRO by all members of the CSA and as a regulation service provider (RSP) under the ATS Rules. By virtue of being an RSP, IIROC is mandated to regulate all registered investment dealers/brokers, and person who are direct participant in the market including members of exchanges and ATS operators and account holder.

The power of IIROC to regulate ATS finds its basis through different contractual arrangements required under NI 23-101. NI 23-101 prescribes that "an RSP set requirements governing both an ATS and its subscribers, including an obligation that the ATS's subscribers conduct their trading activity in accordance with NI 23-101"²¹⁶. An ATS is accordingly required to allow the RSP to monitor and enforce, the requirements of law. RSP by virtue of contractual arrangement can also monitor the conduct of the clients of an ATS. Therefore, the jurisdiction of IIROC over the account holders of ATS is indirect and is a result of multiple and interlinked contracts. The direct jurisdiction of IIROC is limited to only registered investment dealers/brokers and service providers. Interestingly, NI 23-101 also extends the ambit of IIROC's jurisdiction those persons who are required to be IIROC members and are not registered member as such.

²¹³ Sean D. Sadler, *Annotated Ontario Securities Legislation*, (a Wolters Kluwer Business, 2006) 25th Edition, p. 505

²¹⁴ National Instrument NI 23-101 Trading Rules CP, s. 7

²¹⁵ International Monetary Fund, "Canada: Financial Sector Assessment Program: IOSCO Objectives and principles", *International Monetary Fund Publication*, (2014), p.223

²¹⁶ Ontario Securities Commission, OSC Bulletin, Volume 26, Issue 44, October 31, 203 (2003) 26 OSCB 7147

The reading of Market Integrity Notice No. 2007-002, Provisions Respecting Competitive Marketplaces dated February 26, 2007 and Market Integrity Notice No. 2006-017, Guidance – Trading Securities on Multiple Marketplaces dated September 1, 2006 transpires that “prior to the enactment of the UMIR by IIROC, each stock exchange was in charge of regulating its own trading practices”²¹⁷. However, the IIROC developed UMIR with the clear objective of streamlining and universalizing the rules under which marketplaces are regulated. As per Amendments to National Instrument 21-101 Marketplace Operation and National Instrument 23-101 Trading Rules, published on March 18, 2011 (2011), “the TSX does not directly regulate ATSs unless they are members of the exchange”²¹⁸. However, in some cases the TSX assumes indirect jurisdiction over those ATSs that are affiliates or associates of registered TSX member. The TSX Rule Book and Policies require companies/entities that are in one way or the other related to participating organizations TSX members or participants to comply with its requirements. As per TSX Rule Book and Policies, s. 1-101, 2-104, and 4-104, “a 20% or more ownership interest by the participating organization or any of its partners, directors, officers, employees or shareholders will result in a company being related”²¹⁹.

The thought process behind the Canadian regime is that the increased competition will encourage the service provider to innovate the age old practices and process and will result in the investors getting better services at lowest possible costs. The most striking point about the Canadian regime is that it is structurally very clear and the objectives of the legislation and is to create a uniform set of rules to govern all markets.

Under the existing Canadian regime, any trading platform that meets the requirements of law for registration as an ATS could either apply for registration as an exchange, or operate as a

²¹⁷ Market Integrity Notice No. 2007-002, Provisions Respecting Competitive Marketplaces dated February 26, 2007 and Market Integrity Notice No. 2006-017, Guidance–Trading Securities on Multiple Marketplaces dated September 1, 2006, p.5 and p.3 respectively

²¹⁸ National Instrument 21-101 *Marketplace Operation and National Instrument 23-101 Trading Rules*, published on March 18, 2011 (2011), 34 OSCB 11 (Supp-1). See also related IIROC Notice 11-0225, *Provisions Respecting Dark Liquidity*, dated July 29, 2011.

²¹⁹ TSX Rule Book and Policies, s. 1-101, 2-104, and 4-104

broker dealer by becoming a member of the exchange and being regulated under the rules of the exchange or get itself registered as a SRO.

However, an entity cannot be registered as an ATS if it provides listing of securities, it sets limits on order size, sets rules for conduct of market participants and has the power to penalize the participants and the clients.

On similar pattern as of US model, the regulators in Canada have the power to require any ATS attaining high volume to compulsorily register itself as an exchange.

4.4 Comparative Analysis of International Jurisdiction

In this part, I will compare the different international regimes discussed above. The US regime and the Canadian regime are almost identical, with only exception that the Canadian framework is much more clear and consolidated in two instruments. The US regime is spread over many incremental legislations and rules.

Therefore, I will compare the capital market regulatory regimes on both sides of the Atlantic. As discussed above, the MiFID came into force in EU in November 2007 and started an era of competitive securities market. Surprisingly during the same year Regulations NMS were introduced in US. The objective of NMS regulation was also to foster competition among existing securities markets.

The foremost difference between the regulations in EU and US is the unified regulatory instrument in EU i.e. MiFID and in US the market are regulated by different regulations, oversight organizations both at Federal and State Level and the self-regulatory organizations functioning under the Securities Exchange Act 1934.

In terms of regulatory oversight in EU, considering that MiFID is a directive, its implementation varies from country to country and each EU member country has its own regulator. In US there is a strong central regulator at Federal level.

MiFID provides a comprehensive unified framework for securities regulation. It regulates investment firms, Multilateral Trading Facilities (MTF), Regulated Markets (i.e. exchanges) and financial instruments. MiFID is implemented in 27 countries by equal number of regulators. There is no consolidated regulator in EU.

The securities framework in US is tiered. The first layer is the Federal laws and the Federal Regulator i.e. US SEC. The second layer is that of state laws and regulators. The state regulators only regulate and supervise those firms which are not regulated by the federal regulator or have business less than a minimum threshold. The third layer is that of self-regulatory organization which lay down framework for business practices for their members e.g. FINRA²²⁰. The self-regulatory organizations are the frontline regulators and they are overseen by the US SEC.

To further understand the MiFID directive it is imperative to understand the definition of terms investment Firm, Systematic internalizers (SI), Multilateral Trading Facility (MTF). The term investment Firm includes:

“Any legal person whose regular occupation or business is the provision of investment service to third parties and or the performance of one or more investment activities on a professional basis.”²²¹

An investment Firm can be a SI which is an organized, frequent and systematic basis deal on own account by executing client orders outside a regulated market or MTF

The MiFID describes MTF as “a multilateral system operated by an investment firm or a market operator, which brings together multiple third party buying and selling interests in financial instruments in the system and in accordance to non-discretionary rules.”²²²

²²⁰ <<http://www.finra.org/about>> accessed on June 26, 2015

²²¹ Markets in Financial Instruments Directive, 2004/39/EC, European Commission, 2004, p.3

²²² Markets in Financial Instruments Directive, 2004/39/EC, European Commission, 2004, p.5

The concept of MTF is identical to ATS concept as present in US regime, therefore for the purposes of this research ATS is interchangeably used for MTF. As per 2009, World Bank working paper, "in Europe ATS may be classified in two categories: (i) dark pools operated by broker dealers or investment banks, also called crossing networks and (ii) dark pools operated as MTFs"²²³. The former do not have to comply with MiFID pre-trade transparency requirements and with other rules imposed on regulated markets and Multilateral Trading Facility such as the non-discriminatory treatment of investors, non-discriminatory access to trading, market surveillance and to operate a non-discretionary execution system. However, the later which are operated as MTF are being regulated under MiFID.

Having said that, the European regulators are considering at present to regulate the crossing networks as MTF²²⁴. This discussing emanates from the argument put forth by the regulated exchanges and MTF that by not regulating crossing networks, they are being afforded an unfair advantage. However, the counter argument is that crossing networks merely are an automated version of the over the counter services. Research transpires that Dark pools have many variants and due to the diverse manner in which they operate, optically there hardly remains any difference between traditional exchanges and MTF. The major difference that remains is the admission of securities for trading on these systems as compared to the exchanges.

The essence of the US regulatory model for regulations of the capital market is the distinction between the broker-Dealers and the registered exchanges. The Securities Exchange Act, 1934 only provides for the registration of the broker and dealers, whereas FINRA monitors the conduct thereof. FINRA is the Self-regulatory Authority of the Brokers and Dealers²²⁵. The broker- dealer firms are the US alternate of the investment firms in Europe. However, the concept of investment firms as practiced in Europe is much broader as discussed above.

²²³ Tanja Boskovic, Caroline Cerruti, Michel Noel, "Comparing European and U.S. Securities Regulations, MiFID versus Corresponding U.S. Regulations", *World Bank Working Paper*, (2009), p.4

²²⁴ see "Europe seeks clarity on Broker Crossing Networks", Market Media, March 30, 2012 accessed at <http://www.marketmedia.com/europe-seeks-clarity-broker-crossing-networks/> on June 26, 2015

²²⁵ <http://www.finra.org/about> accessed on June 26, 2015

The ATS from their onset were registered as broker-dealer with the US Securities and Exchange Commission. As discussed above, this evolved into more elaborate set of regulations in form of Regulation ATS and Regulation NMS. At present majority of the ATS are registered as broker-dealers and most of them are below the 5% threshold or are under an exemption regime. They are not obligated to display orders on any public platform and since they are under a 5% threshold requirement as discussed above they are not covered under the Regulation NMS. Due to mushroom growth of small dark pools there is a growing concern in the US Capital market to further strengthen its regulation. The European concept of SI finds no parallel in the US regime. However, there is a similarity with regards to admission of securities for trading.

Post Global Financial Crisis, there has been an immense growth of ATS in Europe. A major reason was the liquidity spiral that hit the regulated exchanges and a volume decline.

From a broader capital market perspective, the regulators in both jurisdictions are aware of the need to improve supervision of the connected or associated institutions. In US, the Federal Reserve Bank is pushing for the consolidated supervision approach²²⁶, whereby if group or associated companies comprises of a bank and other companies regulated by US Securities and Exchange Commission has to be regulated by Federal Reserve Bank. The Europe on the other hand has moved towards establishment of Systemic Risk Council²²⁷, with a main objective of address the risk to the system and financial institutions. With respect to transparency of markets, regulators in both jurisdictions are focused on comprehensive reforms especially after the Global Financial Crisis.

In relation to the approach towards instilling discipline in the markets and taking enforcement actions, the regulators in Europe have more intrusive powers to intervene in the management of investments firms, ATS and regulated exchanges. Whereas the US regulators are more focused on setting principle based legislation and monitoring the conduct of the firms. The self-regulatory regime is working well for the US markets as compared to the regulator centered

²²⁶ Board of Governors of the Federal Reserve System, "Consolidated Supervision Framework", release no. SR 12-17, CA 12-14 dated December 17, 2012

²²⁷ Jacques de Larosiere, "The High-Level Group on Financial Supervision in the EU Report", *European Commission Publication*, (2009), p. 38

regime in EU. The EU regulators follow risk based capital requirements as opposed to the minimum capital requirement regime practiced in US.

The investor protection regime in Europe is much more structured and is segregated in two levels i.e. retail investors and sophisticate/professional investors²²⁸. To the contrary, the US regime is focused on protecting the small investors.

Another major distinction is the consolidation of all trades. In US, the regulation NMS provides for disclosure of all trades into a single system and provides for dissemination of the same to the market players. However, in Europe the trading is fragmented multiple trading platforms.

The following table will summarizes the difference in the manner the ATS and different kinds thereof are regulated in EU and US:

Concept	Definition and Example	European Regulation	US Regulation
ATS	Platform for trading that is a source of liquidity which is not displayed on order books	The ATS operated by broker-dealers such as crossing networks are not regulated. However, the ATS operated as MTF are regulated	ATS are registered as either a broker dealer or an exchange
Independently operated ATS	These platforms are operated as independent entities and include platforms such as Instinet and Posit	Majority of them are regulated as a MTF	They are subject to regulation ATS and depending open the size of the pool and volume are also regulated under Regulation NMS
Broker-Dealer operated	They are usually	Unless the management	They are subject to

²²⁸ The Committee of European Securities Regulators, "A European Regime of Investor Protection: The Harmonization of Conduct of Business Rules", *European Commission Publication*, (2002), p.3

ATS	operated and managed by a financial institution and include institutions like Credit Suisse	company/entity is registered as MTF they are not subject to "pre-trade" requirements	regulation ATS and depending open the size of the pool and volume are also regulated under Regulation NMS
MTF operated ATS/Dark pools	They include platforms which are owned, controlled and managed by MTF	They are subject to MIFID and are regulated	They are subject to regulation ATS and depending open the size of the pool and volume are also regulated under Regulation NMS
Regulated Exchange operated ATS	They include platforms operated by registered exchanges and include the ATS names "Baikal" operated by London Stock Exchange	They are subject to MIFID and are regulated	They are subject to regulation ATS and depending open the size of the pool and volume are also regulated under Regulation NMS

CHAPTER 5:REGULATION OF ALTERNATIVE TRADING SYSTEMS AND ROLE OF REGULATOR

5.1 Present Status and Practices

The Ordinance and other laws governing trade of securities have served the local markets well for last four decades. This basic regulatory structure has enabled the Pakistan to have the best performing market in the entire region. However, there is still room for growth considering the potential and consumer appetite. The markets can further instill public interest if efforts are made to make markets are free from fraud and manipulation.

From a participant and service provider point of view if "a level playing field is provided the competition among market participants can thrive"²²⁹.

Further if the regulator applies and implement laws governing securities markets in a way that encourages our securities markets to take advantage of the many benefits of technology, things can improve even further.

The result of liberalizing the market and recognizing new participants and introduction of technology will be far reaching. The investors will have a wide range of options available for executing their securities trades. The introduction and regulation of ATS could be a step in that direction.

Study of international jurisdiction transpires that ATS evolved from broker-dealer settling trades among their existing clients and netting matching orders. In Pakistan, we are going

²²⁹ Porter E. Michel, "Cluster and the New Economics of Competition", *Harvard Business Review*, Report no. 98609, (1998), p.2

through a similar stage and evolution of the "free-delivery mechanism in CDS"²³⁰ and "broker-to-broker (B2B) in NCSS"²³¹ will highlight this issue.

5.1.1Free delivery mechanism in CDS

At the time of introduction, the CDS was operationally very flexible allowing its participants to "hold, transfer and handle book entry securities of their clients without any restriction"²³². However, the major market crash of 2008²³³ and complaints of misuse of clients' securities forced the regulator to impose restrictions on free-delivery transactions in CDS. Initially, the omnibus account structure was disallowed²³⁴ and subsequently restrictions were imposed on free-delivery transactions²³⁵ and participants were allowed to move securities only where regulation governing the same permits. These restrictions created difficulties for brokers to execute and settle off-market trades between its clients. At this stage off-market transactions were started to be regulated and supervised stringently. Owing to market crises of 2008²³⁶, regulation of free-delivery transactions as well as off-market trades were gradually tightened and presently, free-delivery transactions are only allowed in some special cases, all settlements of securities is being made at client level in an automated environment and even settlement of off-market trades is automated²³⁷. Therefore, it is now very difficult for broker to privately execute and settle off-market trades. The only way is to report any such trade through negotiated deal market of KSE whereby securities obligations pertaining to such trades are settled automated automatically by picking securities from seller account and parking them

²³⁰ Chapter 9 of the CDS Regulations issued by Central Depository Company with the approval of Securities and Exchange Commission of Pakistan under section 35 of the Central Depository Act, 2015

²³¹ Chapter 9 & 11 of the National Clearing and Settlement System Regulations, 2001 with the approval of the Securities and Exchange Commission of Pakistan

²³² Regulation 9.1 substituted with the approval of the Securities and Exchange Commission of Pakistan.

²³³ Attiya Y. Javed, "Stock Market Reaction to Catastrophic Shock: Evidence from Listed Pakistani Firms", *Pakistan Institute of Developmental Economics*, Working paper no.2007:37, (2007), p.3

²³⁴ Emerging Markets Committee of the International Organization of Securities Commission, "Regulation of Nominee Account in Emerging Markets Final Report", *International Organization of Securities Commission Publication*, (October 2011), p.6

²³⁵ The Securities and Exchange Commission of Pakistan Directive No. SMD/SE/2(229)/2012 dated April 3, 2014 to the National Clearing Company Pakistan Limited titles "Restriction of Negotiated Deal Markets Transactions"

²³⁶ Dr. Attiya Javed and Asia Aman, "Global Financial Crisis and Market Reactions: Evidence from Karachi Stock Exchange Pakistan", *Working Paper, Pakistan Institute of Development Economics*, (2012), p.10

²³⁷ Regulation 9.2A of the CDS Regulations issued by Central Depository Company with the approval of Securities and Exchange Commission of Pakistan under section 35 of the Central Depository Act, 2015

into the respective buyer account. Recently imposed restriction on negotiated deal market are restricted to even report a transaction between two client or one client and proprietary account of broker that will be settled through the participant umbrella of that broker. Therefore, now as per CDS regulations coupled with restriction in negotiated deal market, it is not legally possible for a broker to provide services akin to ATS.

5.1.2 Broker-to-broker (B2B) in NCSS

As already explained that NCCPL is mandated with the responsibility of clearing and settlement of all on-exchange as well off-exchanges trades executed or reported by a broker of any of the three exchanges²³⁸. Since trading in Pakistani capital market is concentrated at KSE²³⁹, therefore brokers of other two exchanges are also routing their trade orders through KSE's broker. This has resulted in drastic reduction of trading volumes at Lahore and Islamabad Stock Exchanges as trades pertaining to these exchanges are now being routed to KSE through its brokers. This situation has led to a practice whereby KSE brokers are executing trades of their own clients as well as trades of brokers of other exchanges and their clients. Since brokers of LSE and ISE are also clearing members of NCCPL²⁴⁰ therefore they are eligible to settle their trades executed at their own exchanges as well as at KSE via its broker. The trades of brokers of LSE and ISE and their clients executed through KSE brokers are being termed as inter-exchange trades and are being settled through a mechanism called B2B²⁴¹. Under this mechanism, trade executed by a broker of KSE on behalf LSE's broker or ISE's broker and their clients, are auto initiated in favor of LSE or ISE broker for their affirmation. It means that settlement obligation of KSE's broker arising out of trades executed on behalf of brokers of other exchanges are shifted towards the respective broker of LSE or ISE²⁴². After affirmation of such transaction, KSE's broker is relieved

²³⁸ Section 2 (1) (f) of the Securities and Exchange Commission of Pakistan Act, 1997

²³⁹ Attiya Y. Javed, "Stock Market Reaction to Catastrophic Shock: Evidence from Listed Pakistani Firms", *Pakistan Institute of Developmental Economics*, Working paper no.2007:37, (2007), p.2

²⁴⁰ Rule 2 (1)(f) of the Clearing Houses (Registration and Regulation) Rules, 2005

²⁴¹ Regulation 9.14.1 of the National Clearing and Settlement System Regulations, 2001 approved by the Securities and Exchange Commission of Pakistan

²⁴² Chapter 11 of the National Clearing and Settlement System Regulations, 2001 approved by the Securities and Exchange Commission of Pakistan

from settlement of such transactions and therefore securities and money obligations of such trades are to be settled by the respective broker of LSE or ISE through its own accounts.

5.2 Issues and Potential Regulatory Implications of ATS

This section focuses on the regulatory issues after introduction of ATS in Pakistan. ATS will be new star on the horizon of the Capital Market in Pakistan. Exciting as it may seem, it poses lot of potentially implications, which are being discussed in this part. After its introduction, the SECP being the regulator of the Capital Market must focus on how to regulate these electronic alternatives to the traditional exchanges. Similarly the service providers such as brokers NCCPL and CDC must grapple "with how to fulfill their duties to clients and other regulatory obligations in the face of multiple marketplaces; and investors need to be able to understand the available options and the opportunities or pitfalls that they represent"²⁴³.

5.2.1 Regulatory Objectives

While ATS have their obvious advantage and are capable of delivering greater efficiency and avenues for investors, they also raise issues for regulation. In any given market role of regulator are to ensure:

- Investor protection²⁴⁴.
- Fair and efficient markets (market integrity)²⁴⁵.
- The reduction of systemic risk²⁴⁶.

These objectives flow from the 'Objectives and Principles of Securities Regulation', published and adopted by the International Organization of Securities Commissions (IOSCO) in September

²⁴³ see J. Greenwood, "Alternative trading systems about to get their day in the sun", *Financial Post* (14 April 2009)

²⁴⁴ Article 4.2.1 of the Objectives and Principles of Securities Regulation, International Organization of Securities Commissions (IOSCO), 2003, p.5

²⁴⁵ Article 4.2.3 of the Objectives and Principles of Securities Regulation, International Organization of Securities Commissions (IOSCO), 2003, p.6

²⁴⁶ Article 4.2.3 of the Objectives and Principles of Securities Regulation, International Organization of Securities Commissions (IOSCO), 2003, p.6

2003. They are also consistent with the preamble of the Ordinance and power function and duties of SECP under section 20 of the Securities and Exchange Commission Pakistan Act 1997.

5.2.2 The Issues

As already discussed in the earlier chapter, the ATS, in most jurisdictions, were regulated as an investment/broker-dealer firm than as a regulated market place. The modern approach however, has been different. A holistic view of the whole evolutionary history of ATS transpires that in most of the cases the ATS provides similar functions as that of an exchange which include the trading leg and in some cases settlement.

This aspect leads the discussion to another angle as to what is the most suited form of regulation of ATS, which addresses all the risks. Before, going into this discussion further, it will be in fitness of things to identify the possible threats that the ATS may pose for protection of investors.

a. Trading at best price.

Learning from different international models, ATSs can be structured and designed in a manner which may deny investors²⁴⁷ or any group thereof, access to trading at the best prices.

b. Best execution.

In a centralized market, the operations are to a greater extent transparent. The fragmentation of the market post introduction of ATS, may make best execution of

²⁴⁷ Arthur Levitt, Chairman US Securities and Exchange Commission, Testimony Concerning Strengthening and Preserving the National Market System of Securities in the United States, Before the Senate Committee on Banking, Housing and Urban Affairs, May 8, 2000

trades not only difficult but also very costly²⁴⁸. It also needs to be clear that an ATS operator owes a duty of best execution to its customers²⁴⁹.

c. **Conflict of interest.**

ATS are essentially profit making entities. Meaning thereby they can execute propriety trade for their own account and also provide trading services to their clients. This is potentially alarming, since it may impede the ATS operators responsibility to ensure achieving best execution for their clients.

d. **Fragmentation.**

The emergence of ATSs, might be beneficial from the point of view of healthy competition among different service providers but at the same time it will lead to market fragmentation and separate pools of liquidity will be created. Market fragmentation may result in transparency issues and could lead to inefficient markets. Some vocal critics of the ATS argue that if these different platforms or pools of liquidity are not coordinated together than reliable price discovery could become impossible. This will result in widening of spreads and increase in search costs and "certain groups of investors (such as retail investors) lacking the capacity to access prices across a wider range of trading platforms could be disadvantaged"²⁵⁰.

e. **Transparency.**

The nature of ATS is such that it may not be as transparent as traditional exchanges²⁵¹. There may be issues related to timely display of orders and trade reporting. This

²⁴⁸ The Board of International Organization of Securities Commissions (IOSCO), "Regulatory Issues raised by Changes in the Market Structures, Final Report", *IOSCO Publication*, (December 2013) p.13.

²⁴⁹ Scott McClesky, *Achieving Market Integration, Best Execution, Fragmentation and Free Flow of Capital*, (Butterworth-Heinemann, 2004), First Edition, p. 39

²⁵⁰ ISD Review Task Force Report, "Competition, Fragmentation and Transparency, Providing the regulatory framework for fair efficient and dynamic European securities market", *European Commission Publication*, (2003), p.51

²⁵¹ The Technical Committee of International Organization of Securities Commissions (IOSCO), "Transparency and Market Fragmentation, Report", *IOSCO Publication*, (November 2001), p. 12

seriously affects the price discovery and an asymmetric flow of information in the market always poses a regulatory issue and resultantly dampens the investor sentiment. Acceptable standards of transparency vary between different jurisdictions. The traditional exchanges have always operated with high levels of transparency. The international experience tells us that, some ATSs especially, price taking crossing networks²⁵² have attracted business because their transparency arrangements (lack of pre-trade transparency) are designed to reduce the market impact of large trades.

f. Monitoring and surveillance.

From a regulators point of view, monitoring of trades to ensure compliance of all applicable laws is essential for smooth operation of the markets. In many jurisdictions the trades are monitored on real time basis²⁵³. After the emergence of ATS, if the trading centralized on an exchange moves to multiple platforms, it will be very difficult to monitor the trades for the regulators. This problem is further surmounted in growing economies, since the regulators do not have requisite finances and capacity to undertake monitoring and surveillance activities. This may lead to market abuses.

g. Enforcement.

In a fragmented market, where the regulator lack the capacity to monitor the trades effectively, the operator of ATS will have little incentive to comply with the trading rules set by it and enforce them in letter and spirit. Therefore, the frontline regulator role to ensure orderly and fair market operations will not be performed by the ATS.

²⁵² ibid. p.17

²⁵³ The Board of International Organization of Securities Commissions (IOSCO), "Technological Challenges to Effective Market Surveillance Issues and Regulatory Tools, Consultation Report", *IOSCO publication*, (August 2012), p. 15

h. Access to trading.

In a competitive environment where multiple ATSs are operating, some service providers may set rules to allow client access to system who lack sufficient trading ability, capital adequacy or competence.

i. Systems.

There is an apprehension that ATS systems and technologies used might be unreliable and not up to the required standards. This might result in operational risks to market users

5.2.3. Ancillary Risks

In addition to the above following associated risk are also attached to introduction of ATS:

a. Performance of trades.

Unless properly regulated, an ATS may not have proper arrangements for performance of trades processed through ATS systems. There could be an increased chance of counter-party risk²⁵⁴.

b. Capital Adequacy Requirements.

In the event that the ATS assumes the role of central counter party it will be required to maintain sufficient financial resource²⁵⁵. Systemic risk may also arise in case the minimum capital requirement is not imposed.

While considering introduction of ATS in a regime and deciding about the level of regulation following points need to be understood:

²⁵⁴ Erik Banks, *Alternative Risk Transfer: Integrated Risk Management through Insurance, Reinsurance and Capital Markets*, (Wiley Finance, 2004), First Edition, p. 67

²⁵⁵ ibid, p. 102

- i. The significance of an ATS in relation to the existing market and traditional trading platforms.
- ii. The type of instruments and securities to be traded to these platforms.

Most of the issues discussed above are already covered under the existing securities law regime in Pakistan with respect to the traditional exchanges²⁵⁶. However, there are certain risks that might not be addressed by adapting existing regulatory principles and standards. These are the risks associated with market fragmentation, specifically:

- i. Impact on market efficiency when liquidity, business and volumes spread across separate, non-interactive, trading and execution platforms;
- ii. Achieving best execution; and
- iii. The ability of regulator with respect to monitoring and surveillance of the fragmented market.
- iv. Curtailing market abuse and price manipulation

Mattias Levin explains that "these risks are not necessarily unique to ATSs"²⁵⁷. In every jurisdiction in the world, there are competing exchanges. In USA, other than ATS, there are 14 exchanges competing with each other. In Europe, the discussion of creating a pan-European exchange is facing stiff resistance from the domestic exchanges of each EU member country²⁵⁸. Therefore it cannot be said for sure whether market fragmentation can become a serious issue or not.

Technology already provides the means to "re-unite fragmented markets through the aggregation of information from a wide variety of sources"²⁵⁹.

²⁵⁶ Section 8 & 9 of the Securities Act 2015

²⁵⁷ Mattias Levin, "Competition, Fragmentation and Transparency, Providing Framework for Fair, Efficient, and Dynamic European Securities Market, Assessment on ISD Task Force Report", *Centre for European Policy Studies*, (2004), p. 101

²⁵⁸ Bo Harvey, "Exchange Consolidation and Models for International Securities Regulation", *Duke Journal of Comparative and International Law*, Volume 18:151, (2007), p.18

²⁵⁹ ISD review Task Force Report, "Competition, Fragmentation and Transparency, Providing the regulatory framework for fair efficient and dynamic European securities market", (2003), p.27

In Pakistan, at least on paper there is a competition among three existing exchanges. However, the market forces has centralized the business on one exchange i.e. KSE. Even the US experience has shown that the integration to such a level can be difficult to achieve.

5.3 Regulatory Themes

It remains to be seen what would be the most suited option for the manner of introduction of ATS in Pakistan. However it goes without saying that there is a need to consider financial innovation and encourage competition in the supply of financial products and services. Considering the existing legal framework, at a purely theoretical level, two regulatory themes in particular are to be considered:

5.3.1Level playing field.

In order to ensure fair competition, the existing exchanges should be provided a level playing field with the ATSs. One way to do this would be to apply all the requirements that exchanges have to follow to all ATSs. Alternatively, a US model could be followed by lowering regulatory costs of exchanges²⁶⁰.

5.3.2Consistent approach

There is an inherent concern that since the field of capital market is completely occupied by the exchanges therefore the approach towards ATSs would not be consistent, and that this may hinder the development of a capital market in Pakistan, inhibit innovation and restrict the ability of ATSs to compete effectively. Therefore, a consistent approach has to be applied towards all trading platforms.

5.4 Proposed Options

Going forward, there are following three broad options available to SECP and the Federal Government:

²⁶⁰ John Carson, "Self-Regulation in Securities Market, Policy Research Working Paper", The World Bank, Financial and Private Sector Development, Global Capital Markets Departments, Securities Market Group, *World Bank Publication*, (January, 2011), p. 61

- (i) Development of a standalone ATS regime i.e. introducing ATS through a separate legislation.
- (ii) Development of regulation for ATSs within present legislative framework, subject only to some clarification of the relevant definitions.
- (iii) Replacement of “regulated market” regime by a “trading system regime”

5.4.1 OPTION I: The Introduction of a Self- Standing ATS Regime

This option would entail a separate legislation and creation of a separate regime. Such a regime would be in addition to the present regimes for traditional exchanges and markets.

However, considering the existing state of affairs of the capital markets and the newly promulgated Securities Act, 2015, the market participants in general will not view the development of a new legislation for introduction of ATS regulation as suited approach to developing the regulatory structure in the Pakistan. Further, having a separate regulatory regime for ATSs in Pakistan could result in unnecessary complexities and, potentially, new disparities in regulation.

This approach received criticism during the discussion phase of introduction of regulation for ATS in USA²⁶¹. Some leading market participants during the SEC consultation in 1997 on ATSs had a view that "to the extent that changes in the regulatory approach to ATSs were necessary, such changes would best be adopted under a system of enhanced broker-dealer regulation"²⁶². While a self-standing ATS categorization of firms has a superficial attraction of clarity, it raises a number of questions concerning:

- Issues while determining carve-outs, or carve-ins, by size ;
- inflexibility of the law considering that the market is at nascent stage;
- Issues related investor protection might not be covered adequately since, there are no ATS operating Pakistan and the issues posed could be incomprehensible at this stage.

²⁶¹ American Stock Exchange Report to the Securities and Exchange Commission Advisory Committee on Market Information, Re Securities and Exchange Act release No. 34-42208; File No. S7-28-99

²⁶² ibid.

Further, experience tells us that promulgation of new legislation in Pakistan take painstakingly long. Therefore, considering that Pakistan is already lagging way behind in introducing this concept in the local capital market, therefore a standalone regime through a separate legislation will further delay the introduction of ATS. Against the background, a separate ATS regime would not offer the optimum solution for introduction of ATS in Pakistan.

5.4.2 OPTION II: Additional regulatory requirements for ATSs by amending the Existing legislation

This approach appears attractive since there will be limited ATS activity in Pakistan in the beginning and ideally the legislation should evolve with the evolving market²⁶³. Further, this approach has flexibility and also is pragmatic.

Another important advantage of this regime would be that a majority of the investor protection issues associated with ATSs will already be addressed by existing framework. The area that remains to be addressed is that of market integrity. Therefore the regulation and proposed amendments should focus on the following areas:

- (i) Authorization and registration
- (ii) Information to the regulators regarding the price formation process
- (iii) approval of system rules
- (iv) information regarding manner of placement of order and execution
- (v) clearing and settlement mechanism
- (vi) induction of financial instruments to be traded on the platform
- (vii) Governance arrangement
- (viii) Pre –trade and post trade transparency requirement
- (ix) Reporting rules
- (x) Rules related to prevention of market abuse

²⁶³ Patrick J. Kelly, "Theories of Legislation and Statutory Interpretation: Natural Law and Intention of Legislature", *Washington University Jurisprudence Review*, Volume 1, Issue 1, (2009), p.11

5.4.3 OPTION III: Replacement of the “regulated market” regime by “a trading system regime”

This regime shift implies that rather than fragmenting the markets, different trading systems should be provided in a single market. This option however will be a sea change in approach. In view of the expert group of FESCO, “this option would open up the possibilities of achieving greater regulatory consistency for similar functionality, allowing more specific tailoring of regulation to specific risks and giving market service providers more flexibility in the activities for which they sought licenses”²⁶⁴. This regime will consider all exchanges, ATS and other trading platforms as trading systems within a single market.

However, considering the ground realities, such a drastic change in approach would require significant changes to the existing legal framework. It remains to be seen whether the market participants are also ready for this radical change.

5.4.4 Way forward

On the basis of the analysis in this dissertation, the appropriate short-term solution would be based on Option II.

²⁶⁴ The Forum of European Securities Commission, The Regulation of Alternative Trading Systems in Europe, (European Commission Publication), Ref. : Fesco/00-064c, 2000, p.16

CHAPTER 6:RECOMMENDATIONS FOR PROPOSED ATS LEGAL REGIME FOR PAKISTAN

6.1 Role of SECP in Capital Market

The Securities and Exchange Commission of Pakistan ("SECP") was established by the Securities and Exchange Commission of Pakistan Act, 1997 ("SECP Act 1997") as an autonomous statutory body²⁶⁵. At its inception, SECP replaced the Corporate Law Authority ("the CLA")²⁶⁶ and its mandate was limited to superintendence and control of corporate entities and regulation of the capital markets of the country. Over the years this mandate has increased many folds. At the time of establishment of SECP, three laws were administered by SECP i.e. Companies Ordinance, 1984, Securities and Exchange Ordinance, 1969 and Modaraba (Floatation and Control) Ordinance, 1980. In year 2000, the SECP was mandated to administer the Insurance Ordinance, 2000. In year 2002, the regulation of non-banking companies was given to SECP²⁶⁷. In 2003, SECP's was given the mandate to regulate the Commodity exchanges²⁶⁸ and regulation of Private Pension schemes and funds²⁶⁹.

It is fair to comments that SECP is the apex regulator of the capital market in Pakistan. It also regulates the major chunk of the financial sector. However, the SECP Act 1997, with its limited scope, was not intended for the above stated enhanced mandate of SECP and was deficient in many ways. It did not give SECP the ability to act as an integrated regulator of the sectors under its supervision and intervene in extraordinary circumstances. This issue is also highlighted in various assessment reports by international donor and law enforcing agencies including Asian

²⁶⁵ Section 3 of the Securities and Exchange Commission of Pakistan Act, 1997

²⁶⁶ Section 43 of the Securities and Exchange Commission of Pakistan Act, 1997

²⁶⁷ Part VIII A of the Companies Ordinance, 1984 was inserted through Companies (Second Amendment) Ordinance, 2002

²⁶⁸ Section 2 (1) (cc) inserted in Securities and Exchange Ordinance, 1969 through Finance Act, 2003

²⁶⁹ Section 20 (4) (w) inserted in the Securities and Exchange Commission of Pakistan Act, 1997 through Finance Act, 2008 dated June 27, 2008

Development Bank (ADB)²⁷⁰, Financial Sector Assessment Program (FSAP) carried out by World Bank²⁷¹ and US SEC.

6.2 Existing Legal Framework

Provisions of the relevant legal framework is elaborated below

6.2.1 SECP Act 1997

The SECP Act, 1997 provides for the establishment of the Securities and Exchange Commission of Pakistan. Its preamble reads as under:

“WHEREAS it is expedient to provide for the establishment of the Securities and Exchange Commission of Pakistan for the beneficial regulation of the capital markets, superintendence and control of corporate entities and for matters connected therewith and incidental thereto”

The powers and function of the Commission are enumerated in section 20 (4) of the SECP Act 1997. In relation to the Capital Markets, SECP is responsible to regulate the issue of securities²⁷², regulating the business in Stock Exchanges²⁷³, supervising and monitoring the activities of any central depository and Stock Exchange clearing house²⁷⁴, registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, underwriters, portfolio managers and investment advisers²⁷⁵. Further it is also responsible for proposing regulations for the "registration and regulating the working of collective investment schemes, including unit trust schemes"²⁷⁶.

²⁷⁰ Asian Development Bank, Rising to the Challenge in Asia, A Study of Financial Markets: Volume 09-Pakistan. Manila: Asian Development Bank, 1999

²⁷¹ World Bank, Pakistan-Financial Sector Assessment. Financial Sector Assessment Program. Washington, DC: World Bank, 2005

²⁷² Section 20 (4) (a) of the Securities and Exchange Commission of Pakistan Act, 1997

²⁷³ Section 20 (4) (b) ibid.

²⁷⁴ Section 20 (4) (c) ibid.

²⁷⁵ Section 20 (4) (d) ibid.

²⁷⁶ Section 20 (4) (e) ibid.

The SECP also has the mandate to promote and regulate "self-regulatory organizations including securities industry and related organizations such as Stock Exchanges and associations of mutual funds, leasing companies and other NBFIs"²⁷⁷.

It is the duty of the SECP to prohibit "fraudulent and unfair trade practices relating to securities markets"²⁷⁸ and to promote "investors' education and training of intermediaries of securities markets"²⁷⁹.

A subsequent amendment in the Securities and Exchange Commission of Pakistan Act, 1997, also empowers the SECP to adjudicate the investor complaints against persons "involved in brokerage business for violations of securities laws, rules, regulations, directives, codes, etc"²⁸⁰. In order to improve to quality of the service provides in the Capital Markets, the Securities and Exchange Commission of Pakistan Act, 1997 was amended to extend , the SECP's regulatory umbrella to "professionals who provide services within the financial services market"²⁸¹.

In performance of its functions and duties, it has the power to "call for information and undertaking inspections, conducting inquiries and audits of the Stock Exchanges and intermediaries and self-regulatory organizations in the securities market"²⁸².

At a policy level, it has the duty to encourage the "organized development of the capital market in Pakistan"²⁸³. On the basis of research conducted by it, it can consider and suggest reforms of the law relating to securities markets, including "changes to the constitution, rules and regulations of companies and bodies corporate, Stock Exchanges or clearing houses"²⁸⁴. In

²⁷⁷ Section 20 (4) (f) ibid.

²⁷⁸ Section 20 (4) (g) ibid.

²⁷⁹ Section 20 (4) (h) ibid.

²⁸⁰ Section 20 (4) (ha) ibid.

²⁸¹ Section 20 (4) (ja) ibid.

²⁸² Section 20 (4) (k) ibid.

²⁸³ Section 20 (4) (n) ibid.

²⁸⁴ Section 20 (4) (n) ibid.

respect of all the matter enumerated hereinabove, it can propose regulations for the "consideration and approval of the Policy Board"²⁸⁵.

Further Section 20 (6) gives very wide powers to the SECP with respect to regulating the sector. Section 20 (6) (g) is reproduced as under:

"(g) to take whatever action it can take, and is necessary, in order to enforce and give effect to the Act the Ordinance, the Law of Insurance or any other law"²⁸⁶.

The section 40 of the SECP Act 1997 extends power to the SECP to make subsidiary legislation in form of regulations. This power to make regulations is subject to consultation with the Policy Board²⁸⁷. The Policy Board of the SECP also has a power to make regulations on the recommendations of the SECP in consultation with the Federal Government²⁸⁸. The said section clearly provides that "such regulations as may be required to carry out the purposes of this Act or the functions of the Commission specified in sub-section (4) of section 20"²⁸⁹.

The power to make regulations conferred by this section is subject to the condition of previous publication and before making any regulations the draft thereof is to be published in two newspapers of wide circulation for eliciting public opinion thereon within a period of not less than thirty days from the date of publication"²⁹⁰.

6.2.2 Securities and Exchange Ordinance, 1969

The Ordinance is the primary law governing the Capital Markets in Pakistan. It provides for the protection of investors, regulation of markets and dealings in securities. This law provides the basic framework for stock exchanges and intermediaries providing services in the stock markets.

²⁸⁵ Section 20 (4) (q) ibid.

²⁸⁶ Section 20 (6) (g) ibid.

²⁸⁷ Section 40 (1)(i) ibid.

²⁸⁸ Section 40 (1)(i) ibid.

²⁸⁹ Section 40 (1) ibid.

²⁹⁰ Sub-section (2) section 40 of the Securities and Exchange Commission of Pakistan Act, 1997

a. Definition of stock exchange

Section 2 (1) (m) of the Ordinance, defines stock exchange as under:

"stock exchange means any person who maintains or provides a market place or facilities for bringing together buyers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a Stock Exchange, as that term is generally understood, and includes such market place and facilities;"

This is an archaic definition which only covers the outcry versions of the stock exchange. This definition does not cover modern electronic exchanges and trading platforms. In terms of section 3 of the Ordinance, a prohibition is placed that unless registered under the Ordinance, no entity can operate as an exchange and no person shall transact business on any platform unless it is registered²⁹¹. Further, the SECP is the sole authority to determine the number and places for the establishment of exchanges²⁹².

According to section 4 of the Ordinance, "any Exchange which fulfills such conditions or complies with such requirements as may be prescribed by the SECP to ensure fair dealings protection of investors and its sustainable economic viability shall be eligible for registration as an exchange"²⁹³.

The exchanges have to satisfy the SECP with respect to the criterion and qualification²⁹⁴ for admission of membership, procedure for disciplinary proceedings against a member, governing framework of the exchange and the manner of transaction of business²⁹⁵.

Any Exchange which fulfils the above mentioned criterion for registration²⁹⁶, may apply to the SECP for registration²⁹⁷ upon payment of the prescribed fee²⁹⁸. The SECP if it is satisfied, as to

²⁹¹ Section 3 (1) of the Securities and Exchange Ordinance, 1969

²⁹² Section Ibid.

²⁹³ Section 4 Ibid.

²⁹⁴ Section 4(2) Ibid.

²⁹⁵ Section 4 Ibid

compliance of the requirements of the law and in due consideration to the "interest of the trade and public interest" may register the Exchange, by granting a certificate of registration.

In order to govern its business, an Exchange may, subject to the previous approval of the SECP, make regulations. As per section 34 (2) of the Ordinance, an Exchange may make regulations with respect to constitution and functioning of governing body of the exchange²⁹⁹, requirement for admission and expulsion from membership of the exchange³⁰⁰, classification of member³⁰¹, capital adequacy requirements³⁰², propriety trading and conflict of interest³⁰³, manner of soliciting clients and executing their trades³⁰⁴, listing and delisting of securities³⁰⁵, procedure of registration of an issuer³⁰⁶, regulation of badla and forward transactions³⁰⁷, pledging and borrowing of clients securities³⁰⁸, brokerage charges³⁰⁹, separation of function of broker and jobber³¹⁰ and procedure for settlement of disputes³¹¹.

All regulations made under the said section are published in the official Gazette. The regulations have the force of law upon publication in the official Gazette. These regulations are essentially made by the exchanges and thereafter forwarded to SECP for approval.

The SECP has the power to direct the exchange to make, amend, and rescind regulation, by issuing a direction to this effect to the exchange. In case of failure of the exchange to comply with the direction, the SECP has the power to make or amend, with or without modifications, or

²⁹⁶ Section 4(2)(a) ibid

²⁹⁷ Section 5 ibid

²⁹⁸ Section 5(1) ibid

²⁹⁹ Section 34 (2) (i) ibid

³⁰⁰ Section 34 (2) (ii) ibid

³⁰¹ Section 34 (2) (iii) ibid

³⁰² Section 34 (2) (iv) ibid

³⁰³ Section 34 (2) (v) ibid

³⁰⁴ Section 34 (2) (vi) ibid

³⁰⁵ Section 34 (2) (viii) ibid

³⁰⁶ Section 34 (2) (ix) ibid

³⁰⁷ Section 34 (2) (xii) ibid

³⁰⁸ Section 34 (2) (xvi) ibid

³⁰⁹ Section 34 (2) (xvii) ibid

³¹⁰ Section 34 (2) (xviii) ibid

³¹¹ Section 34 (2) (xix) ibid

rescind, any regulation directed to be made, amended or rescinded. Any regulation so made shall be deemed to be made by the exchange.

b. Prohibitions

The section 8 of the Ordinance imposes restriction on dealings in securities. This section provides that "no person shall transact any business in securities on any Exchange otherwise than as may be prescribed"³¹².

Further, no business shall be transacted on "an Exchange in a security, other than a Government security, which is not listed on such Exchange"³¹³. The only exception being transaction of business in a delisted security for a period which may extend to six months in such manner as the SECP may direct.

Sub-section 3 of section 8 of the Ordinance, provides that "no person shall act as a dealer in a security listed on a Stock Exchange outside such Stock Exchange"³¹⁴ and subsection 4 ibid provides that "no person other than a member shall act as a broker or a jobber for any security not listed on a stock exchange"³¹⁵.

These restrictions are potentially restrictive and need to be amended to liberalize the market and open them to competition by introduction ATS in Pakistan.

c. Definition of Broker & Dealers

The word broker is defined in 2(c) of the Ordinance as "any person engaged in the business of effecting transactions in securities for the account of others"³¹⁶. The terminology "broker" is also defined in 2(f) of Regulations for system audit of brokers of the Islamabad stock exchange

³¹² Prescribed here means prescribed by the Federal Government through rules.

³¹³ Section 8 (2) of the Securities and Exchange Ordinance, 1969

³¹⁴ Section 8 (3) ibid.

³¹⁵ Section (4) ibid.

³¹⁶ Section 2(c) of the Securities and Exchange Ordinance, 1969

Ltd, 2004 as "broker means any person engaged in the business of effecting transactions in securities for the account of others".

The word dealer is defined in clause h of section 2 of the Ordinance as "any person engaged in the business of effecting transactions in securities for his own account, through a broker or otherwise, but does not include any person who trades in securities for his own account, either individually or in some fiduciary capacity, otherwise than as a part of a regular business"³¹⁷.

The word "dealer" and "broker" are not used synonymously in the existing legal regime as is done internationally.

d. Regulation of Brokers

As per section 5 A of the Ordinance, "no person can act as broker or agent to deal in the business of effecting transactions in securities unless he is registered with the SECP in such manner, on payment of such fees and charges and on such conditions as may be prescribed"³¹⁸.

The Federal Government in year 2001, prescribed detailed rules titled Broker and Agents Registration Rules 2001. As per rule 3 ibid, "a member desirous of acting as a broker shall make an application to the SECP, for grant of a certificate of registration through the stock exchange of which he is a member"³¹⁹. This implies that to be a broker in the existing framework, one has to be a member of a stock exchange. The sub rule (4) ibid further clarifies the situation since it provides that "the stock exchange shall forward the application to the Commission within fourteen days from the date of its receipt"³²⁰. The eligibility criterion is provided in rule 4, which essentially caters for the individual brokers and not corporate brokerage houses. As per rule 4 (1) (a), a broker has to be a member of a stock exchange.

In the existing frame work a broker has to comply with a code of conduct specified under rule 10 ibid. briefly the code of conduct provides for general responsibilities related to

³¹⁷Section 2 (h) ibid.

³¹⁸Prescribed by rules under section 33 of the Securities and Exchange Ordinance, 1969.

³¹⁹ Rule 3 (1) of the Broker and Agents Registration Rules, 2001

³²⁰ Rule 3 (4) ibid.

integrity and fairness of business³²¹ and duty to exercise due skill and care³²². Brokers are further obligated not to indulge in manipulative transactions³²³, spreading rumors or undertake any activity which could potentially distort market equilibrium³²⁴.

In relation to investors, a broker has a duty to ensure best execution of the orders³²⁵, prompt execution of orders³²⁶, issue transaction/contract notes³²⁷, avoid churning³²⁸, not to furnish false and misleading quotations³²⁹ and avoid conflict of interest³³⁰.

In relation to brokers conduct with other brokers, it is required to cooperate in transactions³³¹ and ensure settlement of transactions³³².

Many improvements have already been made in Rules and Regulations governing the registration and conduct of the brokerage house. Under the existing regime a brokerage house has obtained a certificate of registration from SECP to act as a Broker and such certificate is being renewed every year. Similarly the registration of Agents is regularized as per Rule 14 &16³³³ so that work of an agent of the brokerage house can also be observed and recorded for improving the trust of investors that Stock Market is working in a fair way. The dealings of an agent³³⁴ are very clear and diversified than the member or broker by issuing cash memos, receipts, delivery notes or any other document in his own name so that the misconduct by any individual (member, broker or agent) must easily be compensated in favor of victim loss.

³²¹ A(1) Third Schedule, Code of Conduct made under rule 12 of the Brokers and Agents Registration Rules, 2001

³²² A (2) ibid.

³²³ A (3) ibid.

³²⁴ A (3) ibid.

³²⁵ B (1) ibid.

³²⁶ B (1) ibid.

³²⁷ B (2) ibid.

³²⁸ B (4) (1) ibid.

³²⁹ B (4)(2) ibid.

³³⁰ B (6) ibid.

³³¹ C (2) ibid.

³³² C (3) ibid.

³³³ Broker and Agents Registration Rules, 2001.

³³⁴ Rule 17 (1) of Broker and Agents Registration Rules, 2001.

Having said that it appears that rules have narrowed the concept of brokerage in the existing framework as the business of brokerage has been made subservient to being member of an exchange. Further, the rules do not cater for the post demutualization scenario.

6.2.3 Securities Act 2015

During the course of my research, the Securities Bill was passed by the Parliament³³⁵ and became the Securities Act, 2015. The said Act is a game changer with respect to the introduction of the concept of ATS in Pakistan.

The Securities Act, 2015 is elaborate and detailed law, which has partially repealed the Securities and Exchange Ordinance, 1969. It introduces variety of concepts, which could potentially result in altering the traditional landscape of our Capital Market.

A term "Regulated Market" has been introduced which includes "a securities exchange, over-the-counter market or platform that is licensed by the Commission"³³⁶. Under the new regime the parallel to stock exchange is called a securities exchange, which is a very wide term and a positive change. It is defined as any "public company licensed by the Commission as a securities exchange"³³⁷.

Another term "securities market" has been introduced which is defined as under:

"Securities Market means any market or place at which or any service or facility (whether electronic or otherwise) by means of which, offers or invitations to sell, purchase or exchange securities are regularly made on a centralized basis, being offers or invitations that are intended or may be reasonably expected, to result,

³³⁵ May 13, 2015

³³⁶ Section 2 (xlvi) of the Securities Act, 2015

³³⁷ Section 2 (iv) ibid.

directly or indirectly, in the acceptance or making, respectfully, of offers to sell, purchase or exchange securities"³³⁸

This is an exhaustive definition which covers all trading platforms, including traditional stock exchanges and alternative trading platform, whether electronic or otherwise in the ambit of the securities market. However, the issue arises upon reading of section 3 of the Securities Act, 2015, which provides that that "no person can operate a securities market unless being licensed by the Commission as a securities market"³³⁹. This provision excludes the international variant of broker-dealer operated ATS from our jurisdiction.

The most encouraging aspect is the section 175 (2) (f) of the Securities Act, 2015, which specifically introduces the concept of Alternative Trading Systems in our legal regime and provides that the Federal Government shall make rules for establishing its framework and regulations thereof.

6.3 Proposed Amendments

Technological developments continue to change market structure. Therefore it is imperative that there should be a regulatory framework in place that makes sense both for current and future securities markets. This regulatory framework should encourage market innovation without compromising basic investor protections.

6.3.1 Amendment in the Securities and Exchange Ordinance, 1969

a. Definition of "Exchange"

Section 2 (1) (da) of the Ordinance defines exchange as under:

"Exchange means a Stock Exchange or a Commodity Exchange;"

The term stock exchange has been defined in section 2 (1) (m) is defined as under:

³³⁸ Section 2 (Ivii) ibid.

³³⁹ Section 3 of the Securities Act, 2015

"stock exchange means any person who maintains or provides a market place or facilities for bringing together buyers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a Stock Exchange, as that term is generally understood, and includes such market place and facilities".

The word exchange has to be redefined. This new definition would include any organization, association, person, group of persons, or system that consolidates orders of multiple parties; and sets non-discretionary conditions (whether by providing a trading facility or by setting rules) under which subscribers entering such orders agree to the terms of a trade.

Those systems that only route orders to a registered exchange, or any broker-dealer should be specifically excluded from this definition.

It is proposed that the term exchange may be defined as under:

"any organization, association, or group of persons that: (i) consolidates orders of multiple parties; and (ii) sets non-discretionary conditions (whether by providing a trading facility or by setting rules) under which parties entering such orders agree to the terms of a trade."

This amendment will be a first step towards introduction of ATS in Pakistan. Over the years the traditional stock exchanges have taken benefit from the technological advancements, and the distinction in terms of systems operated by the ATS and traditional stock exchanges has eroded. Similarly many alternative trading platforms provide services which are similar to functions of an exchange such as matching counterparties' orders, executing trades, and facilitating active price discovery. Internationally, with the growth of the Alternative Trading platforms, to be regulated as an exchange suited there economic functions. Therefore, the term exchange has to be interpreted in widest import to include markets that engage in activities functionally equivalent to markets currently registered as exchanges.

The definition of the Securities Exchange in the Securities Act, 2015 is also not very elaborate and does not shed light on what the securities exchange really is or the functions it performs.

b. Rationale for the proposed definition

i. Consolidates the Orders of Multiple Parties

To qualify as an exchange, a system must satisfy the first part of the proposed definition i.e. consolidate orders of multiple parties.

A system can be classified as consolidating orders, if it displays the orders to other system users. The example of this kind of system is the facilities provided by Nasdaq³⁴⁰. A system would also be consolidating orders if the orders of the subscribers' received are centrally consolidated for processing and execution in future i.e. limit order matching systems. The objective of this kind of system is to allow the clients post orders of buy and sell and to obtain execution against matching bids. As per US SEC Release No. 34-39884, "this type of consolidation is currently performed by systems that consolidate orders internally for crossing³⁴¹ or matching³⁴², as well as floor based markets that impose trading rules. In addition, in USA, interdealer brokers³⁴³ are considered to consolidate orders, regardless of their level of automation"³⁴⁴. The systems and platforms that are mere information providers will not classify as consolidating order. They can at best be classified as information vendors or research analysts. In essence it would mean that every order punched in the automated system for sale and purchase of any particular share, will have the opportunity to be matched with other orders entered in the platform/system for the same share.

³⁴⁰An electronic bulletin board on which subscribing broker-dealers may post indications of interest in securities they wish to trade, and advertise trades they have recently conducted, would be considered to consolidate orders..

³⁴¹A crossing system is, typically, one that allows participants to enter un-priced orders to buy and sell securities. Orders are crossed at specified times at a price derived from another market.

³⁴² Matching systems allow participants to enter limit orders and match those orders with other orders in the system. Participants are able to view unmatched limit orders in the system's book. The sponsor of a matching system typically acts as riskless principal with respect to matched orders, or contracts with another broker-dealer to perform this function.

³⁴³ Interdealer brokers (also called blind brokers and brokers' brokers) display, on an anonymous basis, the offers to buy and sell securities that are placed with them by subscribers.

³⁴⁴ Securities and Exchange Commission, 17 CFR PARTS 200, 201, 230, 240, 242, 249, and 270 [Release No. 34-51808, 2004

Furthermore, in order to fall under this definition the system should accommodate multiple parties i.e. orders of sale and purchase by multiple buyers and sellers. A system which only operates as a single counterparty for the purposes of execution of all orders such as a dealer or market maker would not meet the requirement of this definition.

Having said that mere intervention of a designated central counterparty for the purpose of settlement of trades after the orders of buyers and sellers have been matched would not, imply that the system does not accommodate multiple parties. To the contrary, a system that has many sellers, but only one seller per scrip, and multiple buyers for that particular scrip would to meet the this requirement³⁴⁵.

Important aspect is the understanding of word "order". The most acceptable definition of the term order is that "it would include any firm indication of willingness to buy or sell a security, whether made on a principal or agency basis"³⁴⁶.

ii. Non-discretionary Conditions

In order to classify as an "exchange", in addition to being a consolidator of all orders, under the proposed definition, it would have to set non-discretionary conditions under which parties entering orders in the system agree to the terms of the trade. This objective can be achieved by either providing and automated and secure trading facility or by setting rules and regulations (as done by the traditional exchanges).

The "non-discretionary conditions" will include any term and condition which will govern the trading among the system participant or clients. This will include procedures and priorities to regulate open trades and positions. Similarly, a system that permits the price of a trade to be determined at some specified future date on the basis of pre-determined and agreed criterion would be setting non-discretionary conditions.

³⁴⁵Bruce Rule, PSA Panels Embrace Internet for Institutional Trading; and Regulators Love the Audit Trail, Investment Dealers' Digest, Nov. 18, 1996.

³⁴⁶ Guido Ferrarini & Eddy Wymeersch, *Investor Protection in Europe: Corporate Law Making, The MiFID and Beyond*, (Oxford University Press, 2006) First Edition, p.103

Those systems which do not determine the manner of execution or only cover the kind and specification of means of communication i.e. hardware or software requirements, for accessing the system would not be covered under this definition. Another important aspect is communication of these conditions to the clients, system entrants and subscriber. It is settled principle of law determined over the years that unless a set of rules is communicated to people who are governed by it, they will not have any notice of the same³⁴⁷ and will not be liable to abide by them. The communication of these rules also has to be done in a reasonable manner so as to mitigate any risk of deception or disadvantage to any section of investing public.

ii.i. Non-discretionary Conditions Established by a Trading Facility

A trading facility or system that puts in place non-discretionary conditions will include a traditional exchange floor having experts and dealer to undertake and execute orders. It would also include a computer system through which orders may be matched, or any other trading facility that provides a means or location for the execution of trades. In the American jurisdiction, the US SEC as per its press release, "considers the use of an algorithm by an electronic trading system that sets trading procedures and priorities to be a trading facility that sets non-discretionary conditions"³⁴⁸.

All the activities i.e. trading and settlement would be attributed to a trading facility irrespective of the fact that the facility is offered by the system directly or indirectly. In USA, a bulletin board operator which enters into a contractual arrangement with a third party to provide execution and settlement facility is deemed to set non-discretionary condition and classified as an exchange.

ii.ii. Non-discretionary Conditions Established by Setting Rules

In order to qualify as an exchange, the service provider has to set rules for conduct of its operation. The parties 'entering into trade through the platform of such an exchange will agree to these rules. These rules in certain jurisdictions have force by virtue of a contractual

³⁴⁷ PLD 2005 Lahore 261

³⁴⁸ <https://www.sec.gov/rules/final/34-40760.txt>, accessed on 30-04-2015

arrangement i.e. as terms and condition of account opening form at the time of induction in the exchange system through a broker. In some jurisdiction these rules are statutory in nature as they draw their strength from the law itself. In Pakistan, all exchanges are empowered to make their regulation for governing their operations under the section 34 of the Securities and Exchange Ordinance, 1969. Similarly, before establishment of FINRA³⁴⁹, the National Association of Securities Dealers³⁵⁰ imposed basic rules by which securities were traded on Nasdaq³⁵¹.

c. Systems Not to be Included in the Definition of the Exchange

Following systems will be specifically excluded and not covered in the proposed definition:

i. Order Routing Systems

An order routing system merely offers post office service as it forwards all order received to a exchange for trading and execution. They do not consolidate offers for sale and purchase for the purpose of matching them for execution. Further, these systems do not set conditions and rules for the purpose of governing trades.

ii. Brokers Quotation Systems

These are systems established by market makers to disseminate their own offers and bids to the general investing public. The objective of these quotes is to invite its clients to give offers, or to allow its customers to direct orders for execution solely against its inventory. The services offered are more akin to market making and brokering. Although these systems provide a efficient means of communicating the trading preferences of different customers to one broker, but they cannot be considered as exchanges.

³⁴⁹ In 2007, the NASD merged with the New York Stock Exchange's regulation committee to form the Financial Industry Regulatory Authority, or FINRA

³⁵⁰ The NASD was a self-regulatory organization of the securities industry responsible for the operation and regulation of the Nasdaq stock market and over-the-counter markets.

³⁵¹ As per NASDAQ website, "in 1972, NASDAQ stood for National Association of Securities Dealers Automated Quotations. NASDAQ was founded in 1971 by the National Association of Securities dealers (NASD), which divested itself of NASDAQ in a series of sales in 2000 and 2001.

iii. Brokers Internal Order Management and Execution Systems

Many broker have established an automated system internally to manage the orders of their clients. These systems enables the broker to internally manage its clients' orders, including crossing or matching such orders with each other. These systems would be excluded from the definition of the exchange if the orders were only for the consumption of the traders of the broker and no other person and the clients were informed of this procedure of in-house cross trades.

Many large brokerage houses, in order to provide better services to their clients automate their internal order to book to allow their staff and traders to search and match orders with clients orders of other traders within the same brokerage house, or with orders other traders.

These systems were developed in an effort to disseminate information to all traders within a brokerage house and to assist them in crossing the order internally on discretionary basis.

Although these systems are automated but they still are subject to the discretion of the brokerage house i.e. whether to cross the trades internally or place the order on an exchange. In some cases the brokerage houses disclose to their clients as to whether the trade was executed on exchange or internally crossed, but the discretion still lies with the brokerage firm.

Since it is not pre decided, the client has a general understanding that broker will execute the order on exchange in accordance with its obligations. However, in reality the orders are executed using the internal system.

Furthermore, these internal order management and execution system are not used to consolidate orders, rather they merely automate the traditional order book. Therefore, they cannot be classified as an exchange.

d. Exemption from the Definition of “Exchange” for Certain Alternative Trading Systems

A new provision should be inserted in the Ordinance and the Securities Act, 2015, giving a broad power to the SECP to exempt any person, security, or transaction from provisions of the Ordinance, Securities Act, 2015 and the rules and regulations made thereunder.

Such an exemption may be subject to conditions. Using this authority, the SECP could exempt any alternative trading system that complies with Regulations for ATS made under section 40 of the SECP Act 1997 or rule 175 of the Securities Act, 2015 from the definition of “exchange”.

This proposed exemption will operate to the advantage of the public. Since it will instill and promote efficiency and competition. This will also enable the ATS to either register as an exchange or a broker dealer. Allowing alternative trading systems to make a business decision about how to register with the SECP would encourage the development of new and innovative trading facilities.

e. Amendment in section 8 of the Securities and Exchange Ordinance, 1969

The following proviso may be added after the proviso to sub-section 4 of section 8:

“Provided that nothing in this section shall apply to a person registered as an Alternative Trading System, facility or platform by the SECP”.

6.3.2 Amendments in SECP Act 1997 to enhance the jurisdiction of the SECP

The section 20 (4) (a) of the SECP Act 1997 provides that SECP shall be responsible for performance of:

“regulating the business in Stock Exchanges, Commodity Exchange and any other securities markets;” (emphasis added)

Although this provision can be interpreted to mean that law envisages securities markets other than the recognized exchanges. Therefore, SECP can develop a framework for introduction of ATS in Pakistan by stipulating detailed regulation.

Having said that for sake of clarity, after the words "securities market" following words may be inserted i.e. including but not limited to Alternative Trading Systems as defined through regulations.

a. Introduction of Concept of Self-Regulatory Organizations

Section 20 (4) of the SECP Act 1997 which broadly covers the powers and functions of the SECP, should also be amended to streamline the concept of Self-Regulatory Organizations (SRO). As discussed above the section 20 (4) (f) of the SECP Act 1997³⁵², provides for the concept of self-regulatory organizations, but the concept is limited to stock exchanges and association of mutual funds. For sake of clarity following the words "association of regulated persons" should be inserted after words "association of mutual funds".

Till date SECP has not legislated further on this issue, therefore it is proposed that a detailed set of regulations needs to be provided, covering following broad heads:

b. Registration of self-regulatory organizations.

A person who wishes to carry on activities as an association of regulated persons may apply to the Commission for registration. Regulated person should be defined as under:

"Regulated person" means a person who carries on or engages in business in a Regulated Activity."

The term "Regulated Activity" can be defined as under:

"Regulated activity means any activity which is required to be registered or licensed by the SECP under any law administered by it."

An application for registration should be made in the form specified by the Commission.

³⁵² Section 20 (4)(f), promoting and regulating self-regulatory organizations including securities industry and related organizations such as Stock Exchanges and associations of mutual funds, leasing companies and other NBFCs;

c. Application for registration

Upon receipt of an application made the SECP may register a self- regulatory organization if the SECP is satisfied that the applicant,—

- (a) proposes to carry on activities as an association of regulated persons;
- (b) is a body corporate;
- (c) is incorporated in Pakistan;
- (d) has a body of regulations for the governance of its members, which comply with the requirements of this Part and are approved by the SECP.

d. Required regulations

The regulations of an applicant for registration as a self-regulatory organization should be approved by the SECP and may contain provisions:

- (a) for investor protection
- (b) conduct monitoring and enforcement of member and employees of the SRO including the power to censure, impose fine, suspension, expulsion, limitation of activities, functions or operations, suspension of or exclusion from employment.
- (c) Setting out the procedure and manner of disciplinary proceedings;
- (d) Preventing unlawful and undesirable activities and conducts including deceptive market practices, manipulation and unfair trade practices.
- (e) Do away with unfair discrimination among persons who use its facilities.

e. Maintenance and inspection of records

A self-regulatory organization shall make and maintain such records in such form and for such period as may be prescribed. Self-Regulatory Organization shall also be obligated to file with the SECP any report as it requires.

The SECP should have the power to authorise an employee in writing to, inspect the records of a self-regulatory organization and to examine the financial affairs of that organization or any of its members; and prepare such financial or other reports as the SECP requires.

A self-regulatory organization shall be obligated to, produce and provide a person authorised by the SECP with a copy of any record that he requests; and answer any question he asks concerning those records.

f. Sanctions

Where a self-regulatory organization contravenes its regulations or a directive or order of the SECP, or a provision of any law administered by SECP, the SECP may make an order:

- (a) censuring the organisation;
- (b) limiting its activities, functions or operations;
- (c) suspending or cancelling its registration; or
- (d) appointing temporary management of the self-regulatory organisation; or
- (e) imposing a fine to be paid by the management in their personal capacity.

6.3.3 Amendment in Broker and Agents Registration Rules, 2001

As discussed above, Rule 3 of the Brokers and Agents Registration Rules, 2001 provides that in order to be eligible to be registered as a broker, applicant has to be a member of an exchange. This rule needs to be amended as under:

- “(a) is a member of the stock exchange or an SRO registered as association of brokers;
- (b) a body corporate or a company registered under the Companies Ordinance, 1984
- (c) directors, key managerial personnel, agents and traders possess such educational requirements as may be specified by the Commission;

(d) directors, key managerial personnel, agents and traders have not been convicted of an offence involving fraud or breach of trust;

(e) directors, key managerial personnel, agents and traders have not been adjudicated as insolvent or has suspended payment or has compounded with his creditors; .

(f) directors, key managerial personnel, agents and traders have such experience as may be specified by SECP;

(g) directors, key managerial personnel, agents and traders have not worked or being involved with a brokerage firm/company which has been convicted of an offence concerning brokerage or defaulted in payment of dues at a clearing house or defaulted in compliance with the provisions of the Ordinance, the Act and the rules and regulations made thereunder or is not in default on settlement of an investor complaint where such complaint has been adjudicated by a stock exchange or a committee of a stock exchange or the SECP or has not complied with the directives of the Commission in respect of business conduct, dealings with clients and financial prudence.”

A separate code of conduct for the broker providing service as an Alternative Trading System needs to be provided in place of the existing code of conduct specified under rule 12 of the Brokers and Agents Registration Rules, 2001.

6.3.4 Regulatory requirements of ATS

For alternative trading systems that choose to register as broker, a new set of regulations is proposed which could be issued under section 40 of the SECP Act, 1997 or as rule under section 175 of the Securities Act, 2015. These regulations/rules will specify additional requirement for the ATS to comply and will also provide a framework for registration of ATS.

Considering that this concept is new to our jurisdiction and in order to facilitate the evolution of this concept in our capital markets, it is proposed that only those systems which have a certain

volume should be required to file with the SECP a notice of commencement of operation, quarterly disclosure; and maintain records, including an audit trail of transactions.

However, an alternative trading platform with significant trading volume if opts to be registered as a broker instead of being registered as an exchange, should be required to integrate its activities into a centralized system to be established. These centralized systems in international jurisdiction have been called as the National Market System (NMS).

Alternatively, these ATS with significant volume, who trade predominantly in listed securities, should be required to link with a registered stock exchange, so that the orders (especially best price order) displayed in the system of an ATS should come in public order stream of a registered stock exchange. Once linked with a registered stock exchange, the ATS will be required to comply with the same market conduct rules as that of an exchange.

Furthermore, any alternative trading systems which exceed a set mark of volume in a any given scrip, would be required to:

- (1) grant or deny access to clients based on pre-determined standards established by the trading system; and
- (2) set up process and procedure to ensure system adequacy, address capacity and integrity related issues.

6.3.5 National Market System

In international jurisdictions, with the advent of technologies and new trading venues, the securities markets have become interdependent. While this diversification creates opportunities and benefit for many investors, they also have a potential of misallocations of capital, inefficiency and trading fragmentation, if markets are not coordinated. Further, lack of interconnectivity and coordination among these different service providers could potentially increase systemic risk.

In view of the US experience and considering once the ATS regulation/rules are in place in Pakistan, it will be imperative to establish a National Market System. The essential objective would be to integrate the existing exchanges and the alternative trading systems. The SECP should have the mandate to regulate the NMS. The SECP should ensure that there is stable and orderly capital market in Pakistan, where all the buying and selling interest are centralized to ensure best possible execution of order of investors, irrespective of the fact whether the order is placed in ISE, LSE, KSE or any ATS.

The key features to be addressed in formulating the regulation for NMS is to:

- (i) prevent the publication and dissemination of deceptive trade and orders
- (ii) ensure accurate, and reliable dissemination of order and transaction information
- (iii) eliminate asymmetric flow of information in the capital market to minimize the information advantage.

6.3.6 ATS Regulations/Rules

a. Scope of Regulation/Rules ATS

The SECP should make regulation under the SECP Act, 1997 of the Federal Government should make rules under section 175 of the Securities Act, 2015 as discussed above to regulate ATS, which would define the term “alternative trading system” as any system that:

- “(i) an entity which brings together buying and selling interests-in the system and according to rules set by the system's operator, in a way which forms, or results in, an irrevocable contract
- “(ii) would not regulate its members or conduct surveillance of its own market.”

As per this proposed definition, those market places or trading systems which regulate the conduct of market participants and conduct surveillance of markets are ousted from this

definition. All self-regulatory authorities, as explained above will be required to be registered with the SECP.

It is proposed that any person desirous of operating an ATS would have to register as a broker first to be eligible to qualify as an ATS. Thereafter, it has to comply with certain additional requirements as set out in the proposed regulation, depending upon the volume of trades. Any alternative trading system that is registered as an exchange would be excluded from the scope of the proposed regulation.

b. Requirements for Alternative Trading Systems Subject to Regulation

i. Membership in an SRO

Since the ATS would not have self-regulation responsibilities as evident from the definition, they will be required to have membership of an SRO. After the proposed amendments related to SRO are in place, and SRO for ATS will be formed, wherein all the ATS operators will be members.

ii. Notice of Operation as an Alternative Trading System and notification of subsequent changes

It is proposed that under the new regulations, any broker desirous of providing service of an ATS would be required to submit to SECP a notice of operation on a specified form. This notice should be submitted at least 45 days prior to commencement of operation.

The said form will contain base minimum information regarding the alternative trading system. It will state the manner of its operation, the targeted client base, and the shares it intends to be traded on its system. Annexed with a form will be a narrative description of the step taken by the ATS to put in place system and procedures for reviewing “systems capacity, security, and contingency planning”³⁵³.

³⁵³ US SEC requirements

It needs to be understood that form as mentioned above is not to be equated to an application and the SECP would not approve an alternative trading system before beginning of its operations. This will be a major deviation from the existing form of regulation being done by SECP. At present SECP is a market entry and product approval regulator. The form will be just a notice to the SECP. The reason for this is because ATS will also be registered as broker under the applicable legal regime; therefore, there appears no need for duplication of process.

In addition to the said, an ATS should be required to intimate the SECP of any material changes in its system and manner of operation. This will be done by amendment to the form and should be filed at least 20 business days before the implementation of the change. A material change would include but not limited to any additions, modification or improvement to the systems, change in nature and kind of securities traded on the system, admission criterion of clients etc. On cessation of business, winding up of ATS operator, and suspension and cancellation of license/ registration as a broker, it has to forthwith file a notice with SECP.

iii. Market Transparency Requirements

The Canadian model of market transparency and clarity of objective should be bench mark for introduction of such requirements in Pakistan. Therefore, to do away with grey markets, hidden markets and to prohibit market segments to privately publish quotation, steps should be taken to ensure transparency.

The regulation will make it mandatory for any system or person offering services akin to market making to make all offers and bids publically available. They should also be required to make public any superior price they offer through the system to a select group of investors.

As already discussed above, a step in the direction of market transparency would be to link the market to a centralized system or establishment of NMS.

iv. Fair Admission processes

The exchanges are public forum designed to attract the public at large to their markets. At present every exchange has a clear cut procedure for admission to trading or access to its trading systems. There is a duty imposed by law on SECP to ensure fair market access. Further it is part of the SECP mandate to ensure that the investors are treated in the market in a fair manner without any discrimination.

Therefore, the ATS should spell out a non-discriminatory admission procedure. Further, the regulations should empower SECP to have a power to address issues related to unfair refusal or denial of access by ATS.

This fair treatment of investors will further gain importance as the ATS market evolves and one of the ATS captures a large percentage of trading volume in a security.

The proposed regulation should provide a prohibition stating that the alternative trading system should be barred from denying access to its services to any person and in case of such an event, due notice and opportunity of hearing should be provided to the said person in accordance with the principles of natural justice. The regulation should also provide a right of appeal to the SECP upon being refused admission to an ATS system.

v. Capacity, Integrity, and Security Standards

The regulation should provide enabling power with respect to capacity of ATS, integrity of system and security protocol. The SROs should be mandated to establish, a comprehensive assessment programs to determine systems' integrity, capacity, strengths, weaknesses and vulnerability. Following the Canadian model, the SROs should:

- (1) Undertake current and future capacity assessments;
- (2) Conduct capacity assessments; and
- (3) require systems to submit their own statement of compliance.

In order to provide an overarching system, the regulation should provide that SECP should conduct oversight reviews of the SROs' systems, procedures and operations. As per US SEC release, in USA, "the SROs should establish this automation review program because of the impact that systems failures have on public investors, broker-dealer risk exposure, and market efficiency"³⁵⁴. Similar approach should be followed in Pakistan.

These requirements should not be fixed but rather relative to quantum of the volume traded on the ATS. This would mean that smaller ATS would face less stringent requirements as compared to ATS which trade large volumes.

The threshold, for equity securities, should be on a security-by-security basis. If scrip traded on an ATS accounts for more than 10 percent of the share volume in that scrip, the ATS should be required to meet the proposed requirements. The regulation/rule should provide that an ATS that meets these volume thresholds would be required to have the assessment reports from the SRO with respect to its present and future capacity, system assessment reports with respect to system's ability to process transactions in an accurate, timely, and efficient manner, report with respect to systems put in place mitigate vulnerability of its systems and disaster recovery and contingency plans.

The ATS should also be required to intimate the SRO and the SECP of material systems outages, systems changes, up-gradations and breakdowns.

The regulation/rule should also provide that an ATS that meets the volume levels discussed above to have an annual independent review of the systems conducted. This review should cover, review of order handling, execution and routing and reporting of transactions. This review should be performed by a Chartered Accountant complying with the established independence requirements.

³⁵⁴ US Securities Exchange Act Release No. 27445 (Nov. 16, 1989), 54 FR 48704 ("ARP I") and Securities Exchange Act Release No. 29185 (May 9, 1991), 56 FR 22489

vi. Examination, Inspection, and Investigations of Subscribers

The proposed regulation will place a duty on the ATS to comply with the directions of the SECP and the SRO of which it is a member. They will be subject to the powers of the SECP to inspect their record and investigation. Presently, the SECP has the authority to inspect and examine any member of any stock exchange. This is because in the existing framework a broker has to be a member of a stock exchange in order to be eligible to be registered as a broker. Having said that ATS will also have certain other subscribers, such as banks, to which the SECP's inspection authority does not extend³⁵⁵. Because alternative trading systems could be used by subscribers to manipulate the market in a security, it is imperative that ATS should be under an obligation to submit to inspections and investigations.

vii. Recordkeeping

The proposed Regulation should require alternative trading systems to comply with the record keeping requirements of the SECP. They should be required to maintain daily summaries of trading and information regarding orders received, including the date and time the order was received, the date, time, and price at which the order was executed, and the identity of the parties to the transaction.

Furthermore, the ATS should also be required to maintain and preserve records of all notices provided to clients and instructions pertaining to access to the alternative trading system. These records would allow the SECP to examine whether ATS is in compliance with the regulatory requirement.

The proposed framework will provide that the records should be kept for at least three years, the first two years in an easily accessible place in physical as well as electronic form.

³⁵⁵ As per MOU between SECP and SBP dated March 3, 2008, for investigation, inspection and call for information SECP has to route the request through SBP

The brokers and exchanges are already subject to the record keeping and reporting obligations therefore it needs to be ensured that new framework is not in conflict or merely duplicating the already existing requirements.

viii. Disclosure

The ATS should be required to disclose to SECP quarterly on a specified form total volume in terms of number of securities traded and value of the securities.

The regulation will also provide that ATS should file after-hours trading information in listed securities. This information would permit the SECP to monitor the trading on ATS.

ix. Procedures to Ensure Confidential Treatment of Trading Information

The ATS will be required under the proposed regime to ensure confidentiality of the trading information. They will be required to establish firewalls between alternative trading system functions and other brokerage functions, including proprietary and client trading.

As per US SEC release 17 CFR parts 201, "in USA, in inspections of some ECNs, the US SEC staff found that some of the broker-dealers operating ECNs used the same personnel to operate the ECN as they did for more traditional broker-dealer activities, such as handling customer orders that were received by telephone. This situation creates the potential for misuse of the confidential trading information in the ECN, such as customers' orders receiving preferential treatment, or customers receiving material confidential information about orders in the ECN."³⁵⁶ Therefore the proposed framework should be focused on minimizing this abuse.

The ATS will also be required to keep information related to the identity of the clients and their order. Only those employees who are operating the ATS should be privy to confidential information. Further the ATS management should put in place procedures to ensure that all its employees are unable to use any confidential information for proprietary or client trading, unless the client agrees.

³⁵⁶ US Securities and Exchange Commission 17 CFR Parts 201, 240, 242 and 249, Release No. 34-39884; File No. S7-12-98, RIN 3235-AH41, published 2004, p.43.

x. Name of Alternative Trading Systems

An ATS registered as a broker should be prohibited from using the term “exchange” in its name since it would be deceptive and potentially mislead the investors.

As discussed above the proposed regime provides ATS with the flexibility to operate as either exchanges or broker. Therefore, it is important that the investors and public at large are not confused about the market role such systems have chosen to assume.

6.4 Conclusion

International experience has made it clear that the growth of ATS over the past several years has significant implications for market regulation. In this backdrop, it is imperative to establish a regulatory framework that caters for traditional market structures and alternative trading platforms. Therefore the proposed regulatory approach would be the most effective way to facilitate these goals of advancement of the markets.

It is important to note that presently neither the regulatory framework nor the operational set up allows introduction of ATS in Pakistan. However, taking into account the provision for establishing a framework for ATS in the Securities Act, 2015, it is abundantly clear that the legislature and regulator do realize importance of ATS for expansion of outreach of Pakistani capital market and intends to introduce ATS in Pakistan. However, at the same time, it needs to be realized that mere inclusion of an enabling clause in the new law to make regulations for ATS, is not sufficient. It also requires not only consequential amendments in the respective laws, as elaborated in the previous sections, but also to provide for a conducive operational environment for implementation of the suitable ATS model in Pakistan.

First Option

The first option could be introduction of a separate legislation and creation of a separate regime for introduction of ATS in the country. However, from the above discussion it appears that this option may not be considered appropriate by the regulator and legislature. Further, the market also may not accept and digest this type of structure at present. Since having a

separate regulatory regime for ATSs in Pakistan could result in unnecessary complexities and, potentially new disparities in regulation.

Second Option

The second option could be to provide additional regulatory requirements for ATSs and amending the relevant legislations and removing certain restriction imposed such as free-delivery transactions in CDS, negotiated deals reporting requirements, settlement of cross trades etc. This appears to be suitable approach where comprehensive rules can be developed under the Securities Act, 2015 thereby enabling recognition of ATS as a legal mechanism for executing transactions in capital market and providing required regulatory support for operations of ATS in the country. Another important advantage of this regime would be that majority of the investor protection issues associated with ATSs will be addressed under the existing framework. The area to address is that of market integrity.

Third Option

The third option to replace the “regulated market” regime by “a trading system regime” is not consider appropriate for the Pakistani capital market considering the ground realities. A drastic change in approach would require significant changes to the existing regulatory framework. It also remains to be seen whether the market participants are also ready for this radical change.

Recommendations

Hence, it may be concluded that the option to provide regulatory framework for parallel operations of ATS in Pakistan is most suitable option whereby not only outreach and access to Pakistani capital market can be further expanded but at the same time participants of this segment of capital market will be able to manage their business and operations according to their preferences and needs. The existing brokerage set up can be used, particularly that of KSE to entertain trade orders placed by the brokers of LSE and ISE. This will address the long outstanding issues such as liquidity, risks attached to inter-exchange trades, non-availability of

market makers for equity segments and higher cost of transactions for the investors operating through brokers of LSE and ISE.

Therefore, it is recommended that after making necessary amendments in the Ordinance as discussed above, a comprehensive set of regulations may be introduced by the SECP under the SECP Act 1997 or rules may be framed by the Federal Government under the Securities Act, 2015. The regulatory framework of stock exchanges, NCCPL and CDC may be accordingly aligned with those rules/regulations enabling "introduction of ATS in Pakistan".

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