NUST INSTITUTE OF MANAGEMENT SCIENCES

THESIS

“REAL REASONS OF MARCH 2005 STOCK MARKET CRISIS, INVESTIGATION AND COVER-UP: LESSONS FOR SMALL INVESTORS”

Submitted To:
Mr. Sabir Hussain Jafri

Submitted By:
Muhammad Mumtaz Khokhar

Registration #: 2005-NUST-MBA-12

MBA 2k4

ACKNOWLEDGEMENTS

First of all, I would like to thank Allah Almighty for giving me the ability, knowledge and strength to do this thesis. I would also like to thank my parents because without their prayers and support, I would not have been able to succeed.

I would like to take this opportunity to thank my thesis advisor, Mr. Sabir Hussain Jafri, for providing me the guidance without which this thesis would not have been possible.

I would also commend the efforts of the Karachi Stock Exchange for developing and maintaining their website, www.kse.com.pk, which is an excellent source of information. The reports developed by the taskforce and the forensic report on the crash of the stock market in March 2005 were available on the website.

TABLE OF CONTENTS

Executive Summary

The KSE Index rose from 6,218 on December 31, 2004 to 10,303 on March 15, 2005. This was an increase of 65 percent in only two and a half months. Not only did the index rise during this period, but the value traded also increased from Rs.20 billion to somewhere between Rs.50-100 billion.

The most marked increases were recorded in shares of oil and gas, telecom and cement companies.

Many possible reasons can be attributed to the rise in the index like higher corporate earnings announcements, privatization of some state-owned enterprises through the stock market, and the euphoria created in the market about the possibilities of a rise in the Index through the media.

On 12th April, 2005, Dr. Tariq Hassan, Chairman of SECP, formed a taskforce so as to find out the reasons for the fluctuation in the stock market, especially between 1st January and 31st March, and suggest measures to further strengthen the regulatory framework for stock exchanges. Some of the key reasons identified by the taskforce for the sharp rise in the index were increased liquidity due to higher remittances, low interest rates, better corporate performance, higher oil prices, relatively liberal availability of badla financing, and IPOs of public sector enterprises.

SECP requested Diligence USA, LLC to perform a forensic investigation of some alleged manipulative activities regarding the stock market crisis of March 2005, as transacted on the KSE. Diligence investigated accusations related to the removal of regulated badla financing and in-house Badla, wash trades, and breaching the regulations governing Futures Contracts (exceeding the Rs.50 million reporting threshold). Diligence issued its report on November 21, 2006.

Chapter 1:
BACKGROUND

Stock Markets in Pakistan

There are three stock exchanges in Pakistan. The largest stock exchange of the country is located in Karachi. It has the highest number of companies listed on it. The second largest stock exchange of Pakistan is located in Lahore. Finally, the third stock exchange is located in Islamabad.

Karachi Stock Exchange (KSE)

KSE is not only the largest stock exchange of Pakistan, as mentioned above, but it is also the most liquid stock exchange. 654 companies were listed on it as of 31st January, 2007. On 31st January, 2007, they had a market capitalization of Rs.3, 077.401 billion and a listed capital of Rs.516.939 billion. In the year 2002, "Business Week" acclaimed KSE as the best performing stock market in the world.

KSE-100 index was introduced on 1st November, 1991. Its base was 1,000 points. The KSE-100 index increased to 1,770 points by the year 2001. However, the index rose sharply to 9,989 points by the year 2005 and touched its peak of 12,285 points in February 2007. It is a capital-weighted index. Almost 86 percent of the market capitalization of the exchange is accounted for by 100 companies. The KSE-100 approach is the most generally accepted measure of the exchange.[1]

KSE-30 index was introduced at the end of 2006. It is the first free float index of Pakistan. It consists of 30 stocks that are most floated in KSE.

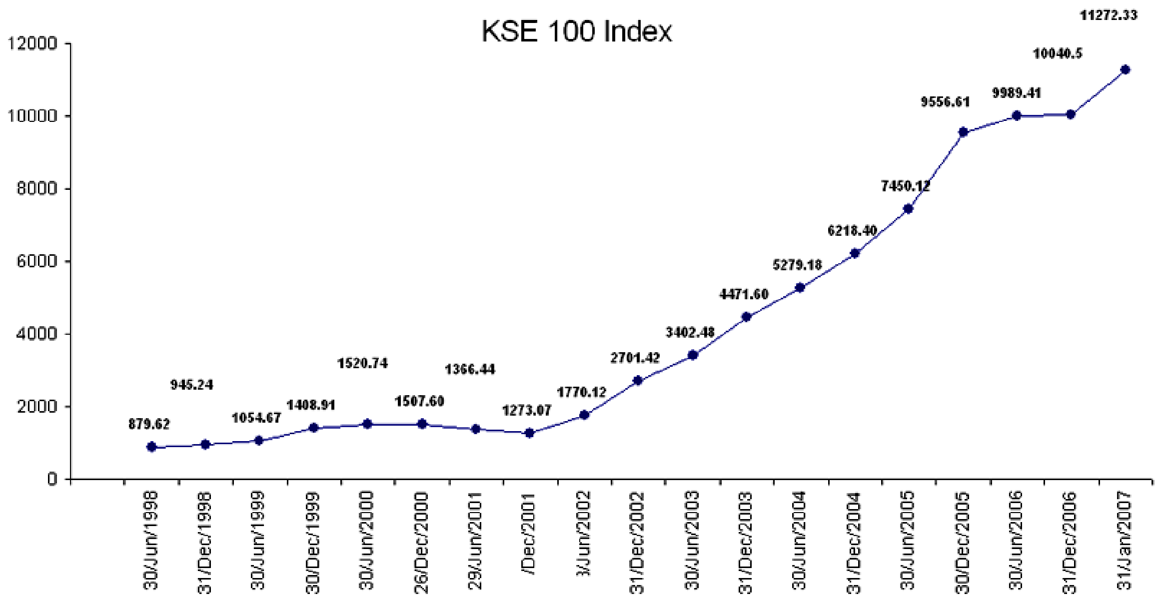
The following table shows the progress of KSE:

Year	Number of Listed Companies	Listed Capital (Rs. million)	Market Capitalization (Rs. million)
1950	15	117.3	-
1960	81	1,007.7	1871.4
1970	291	3,864.6	5658.1
1980	314	7,630.2	9767.3
1990	487	28,056.0	61750.0
2000	762	236,458.5	382,730.4

Source: www.kse.com.pk

And the following graph shows the performance of the market between June 1998 and 31st January, 2007:

[1] http://en.wikipedia.org/wiki/Karachi_Stock_Exchange



Source: www.kse.com.pk

Note that from 30th June 1998 to December 2001 the market was quite stable. But after that the market rose sharply. One of the reasons for this sharp rise could be the increase in liquidity due to the rise in remittances after September 11, 2001.

Lahore Stock Exchange (LSE)

LSE is the second largest stock exchange of Pakistan. It was established in October 1970. Over a period of 25 years, the number of members has increased from 83 to 152. LSE has started its branches in Faisalabad and Sialkot also.

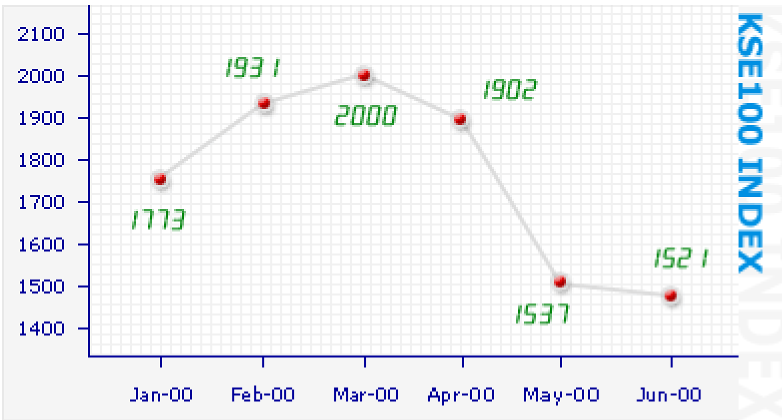
Islamabad Stock Exchange (ISE)

Although ISE was incorporated on 25th October, 1989, it became completely operational on 10th August, 1992. Out of the three stock exchanges, ISE has the minimum number of companies listed on it.

Background-March 2005 Stock Market Crisis

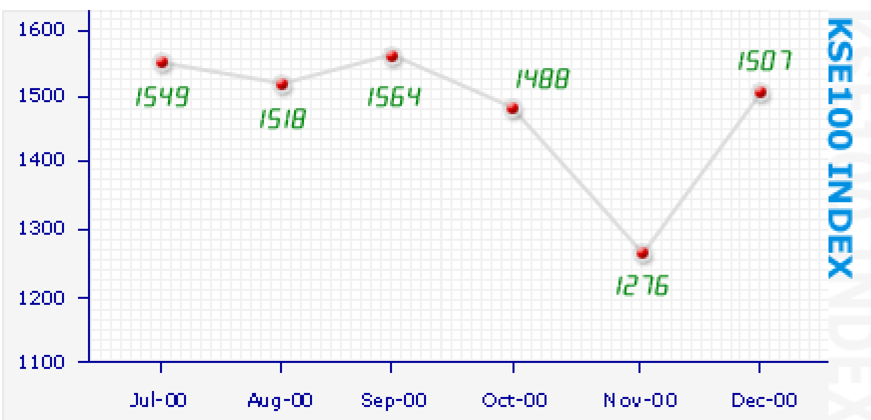
Before presenting the background regarding the stock market crisis of March 2005, consider the following graphs that show the performance of the KSE 100 index:

Index Graph of KSE-100 for the Year 2000 (Jan –Jun):



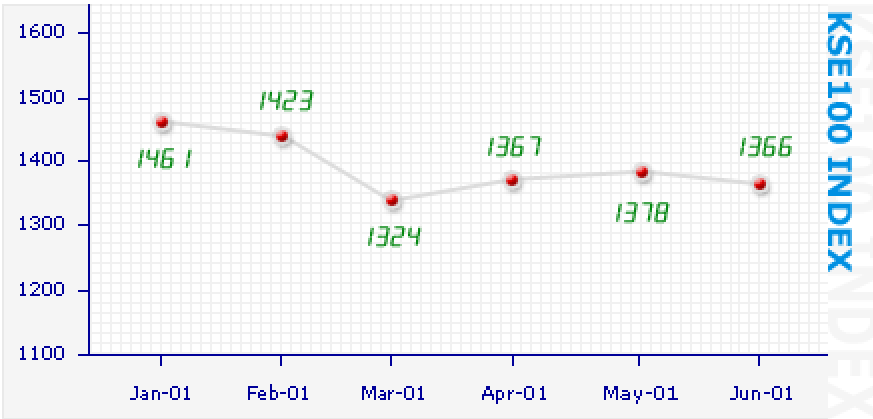
Source: www.kse.com.pk

Index Graph of KSE-100 for the Year 2000 (Jul –Dec):



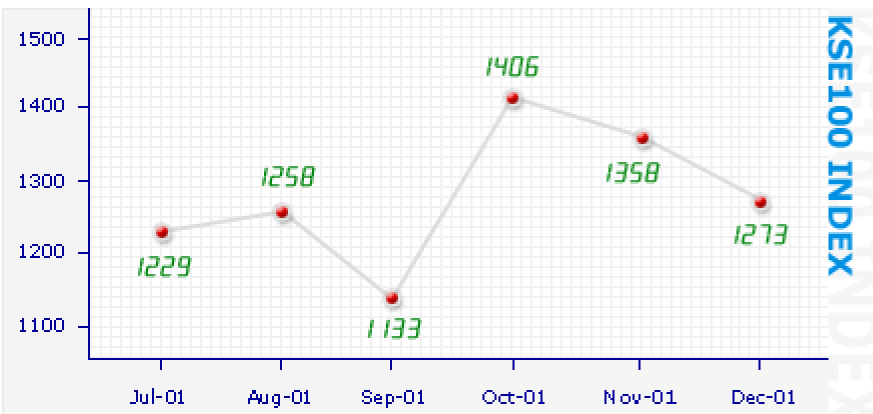
Source: www.kse.com.pk

Index Graph of KSE-100 for the year 2001 (Jan –Jun):



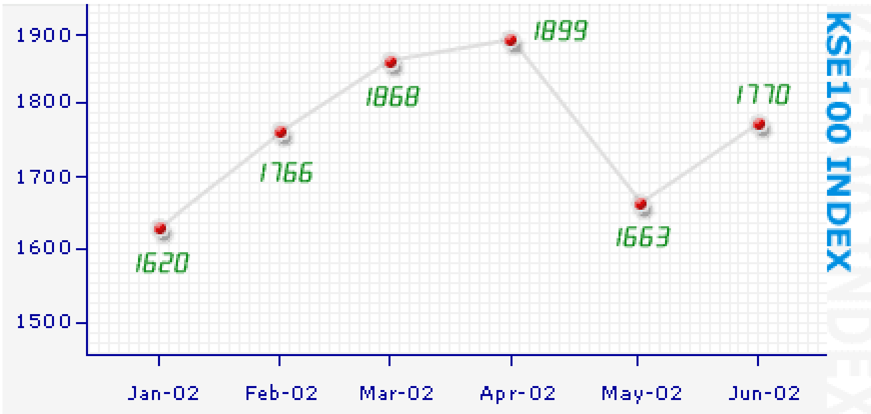
Source: www.kse.com.pk

Index Graph of KSE-100 for the year 2001 (Jul –Dec):



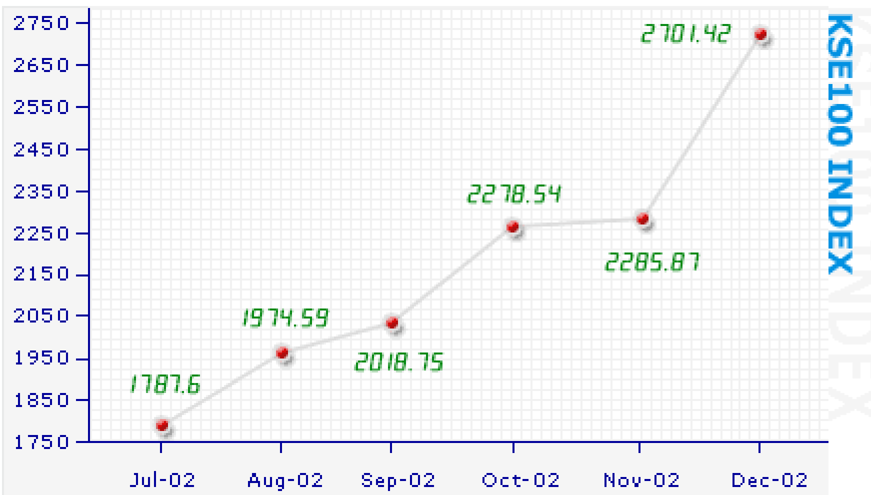
Source: www.kse.com.pk

Index Graph of KSE-100 for the year 2002 (Jan –Jun):



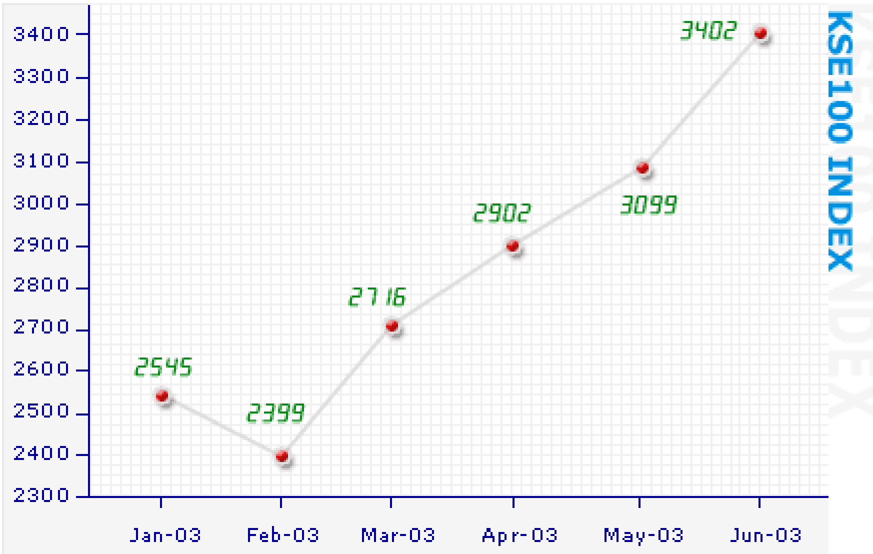
Source: www.kse.com.pk

Index Graph of KSE-100 for the year 2002 (Jul –Dec):



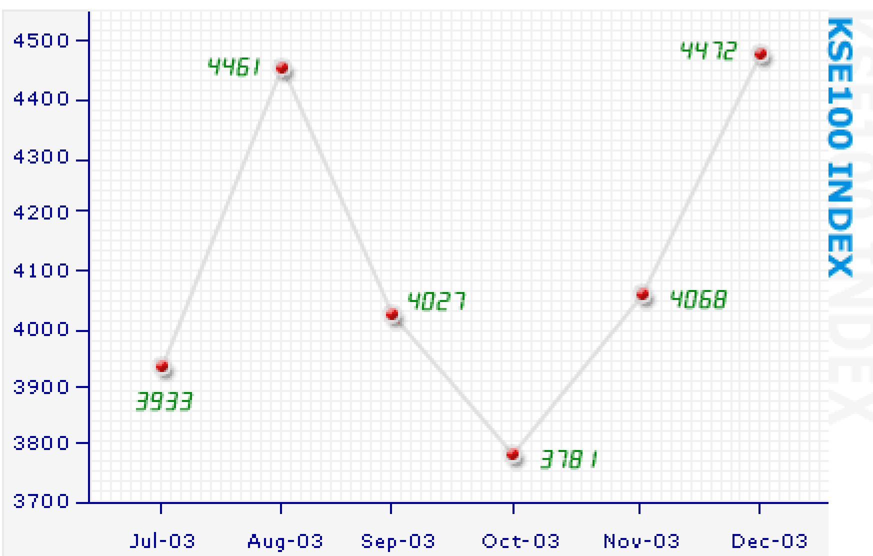
Source: www.kse.com.pk

Index Graph of KSE-100 for the year 2003 (Jan –Jun):



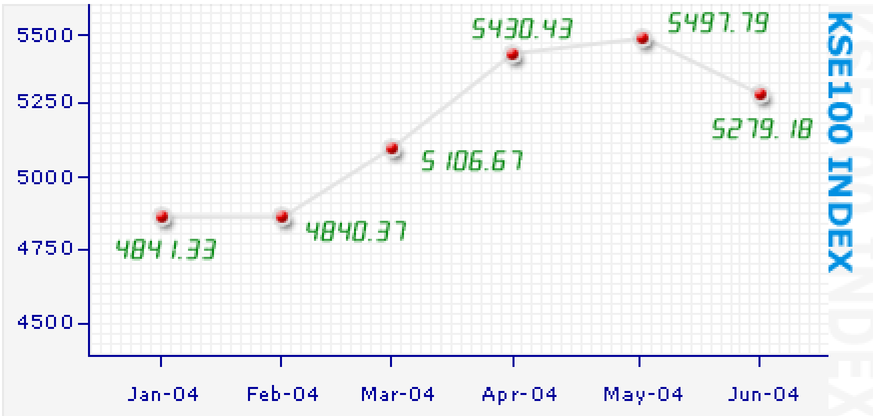
Source: www.kse.com.pk

Index Graph of KSE-100 for the year 2003 (Jul –Dec):



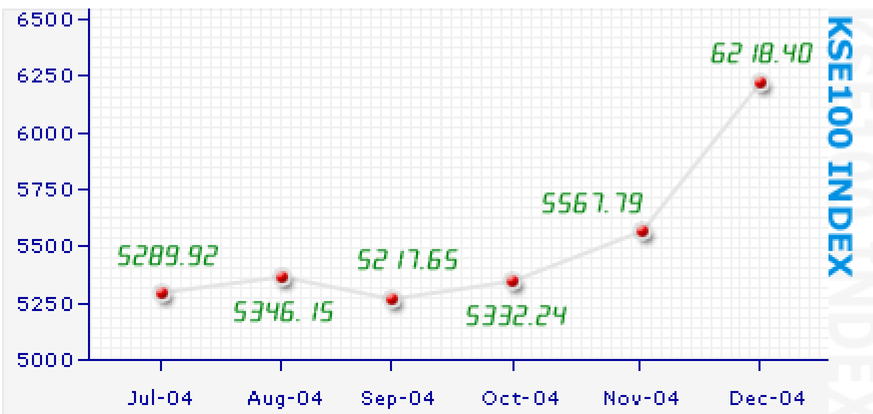
Source: www.kse.com.pk

Index Graph of KSE-100 for the year 2004 (Jan –Jun):



Source: www.kse.com.pk

Index Graph of KSE-100 for the year 2004 (Jul –Dec):



Source: www.kse.com.pk

Index Graph of KSE-100 for the Year 2005-06:

Source: www.ksestocks.com

The KSE 100 index faced a major decline abruptly in March, 2005. Although the index was rising in 2005 initially, and touched a record high of 10,303 on March 15, 2005, it fell sharply on March 17, 2005 by almost 25 percent of its value, as shown in Figure 1. This decline took place in only eight trading sessions.

Market participants incurred substantial investment losses and this created strong public reaction. Many rumors surfaced as to the possible causes behind the abrupt rise and decline of the market in March, 2005, including overambitious day traders and the manipulation of equity and financing markets by different major players in the market. This was not the first time that the stock market had faced a crisis. In fact, the previous stock market crisis took place just a few years earlier in May, 2002.

Government inquiries initiated in order to determine the reasons behind the market's fall. The objective of these inquiries was also to inspect whether any wrong-doing, including manipulation, were the reasons behind the decline of the market. On March 31, 2005, the Securities and Exchange Commission of Pakistan (SECP) formed a task force to examine the factors responsible for the fluctuation in the stock market and suggest measures to further strengthen the regulatory framework for stock exchanges.

As a matter of fact, many possible reasons can be attributed to the rise in the index. These reasons include:

- Higher corporate earnings announcements,
- Privatization of some state-owned enterprises through the stock market,
- Announcement of privatization plans of some major public sector enterprises,
- Large injection of foreign portfolio investment,
- Increased liquidity due to higher remittances,
- Low interest rates,
- Relatively liberal availability of badla financing,
- Higher oil prices,
- Speculative buying.

Additionally, euphoria was created in the market about the possibilities of a rise in the Index through the media. Government officials gave statements linking the rise in the KSE Index to good economic management. Brokers and various others gave statements in the media in order to encourage investors to take advantage of the rising market. Hype was created about the shares of a few companies (that had a high weight in the KSE index). This led to prospective investors to form unjustified expectations regarding the whole market. Finally as mentioned earlier, privatization officials appeared in the media and announced the privatization of profitable and well-known public sector corporations.

The rise in the KSE index initiated in December, 2004 as the market rose from 6,218 on December 31, 2004 to 10,303 on March 15, 2005. This was an increase of 65 percent. Not only did the index rise during this period, but the value traded also increased from Rs.20 billion to somewhere between Rs.50-100 billion. This rise in index can further be attributed to increase in the badla financing and the availability of the futures market, which was inaccessible since 2001, when it was introduced.

The most marked increases were recorded in shares of oil and gas, telecom and cement companies.

Before going ahead and analyzing the reports developed by the taskforce (formed by SECP) and by Diligence, it is important to consider an interesting observation. Consider the graph on the previous page, which is an index graph of KSE-100 for the year 2005-06. Note that since the end of August 2005, the index started to rise again after its crash earlier that year in March and then for most of the time, it had stayed above its previous peak of 10,303 (after which the stock market had crashed).

Chapter 2:
SUMMARY OF THE REPORT GENERATED BY THE TASKFORCE

Objective of the Taskforce

On March 31, 2005, the Securities and Exchange Commission of Pakistan (SECP) decided to form a task force to examine the factors responsible for the fluctuation in the stock market, especially between 1st January and 31st March, and suggest measures to further strengthen the regulatory framework for stock exchanges. This involved the taskforce to particularly search for clues of market manipulation insider and other market abuses. The taskforce was also required to study the role of different stakeholders in the stock market crisis, including the role of the different market participants, front line regulators and the SECP.

Composition of the Taskforce

On 12th April, 2005, Dr. Tariq Hassan, Chairman of SECP, formed a taskforce in order to achieve the objectives mentioned above. The taskforce comprised of:

1. Justice (Retd.) Saleem Akhtar, Chairman
2. Dr. Mohammad Zubair Khan
3. Mr. Shahid Kardar
4. Mr. Sultan Allana
5. Mr. Aadil Naeem Khan, Secretary (and also an official of SECP).

Mr. David White, an international Stock Market expert, provided the necessary assistance to the taskforce.

The Limitations of the Taskforce

The taskforce was given 30 days to conduct interviews, study the problem, collect information, analyze the data, examine some transactions, reach conclusions and finally write a report. Additionally, the taskforce had limited IT resources and lacked experienced human resources.

Moreover, the investigation of the taskforce concentrated on a few shares (primarily which were heavily weighted in the stock market), large investors, and large brokers because the stock market is highly skewed.

There are also many structural flaws that hide the identity of persons who undertook the transactions. For example, brokers do not declare whether the trade represents a transaction on their own account or on behalf of a client.[2] The potential for insider trading and the existence of Benami and Group accounts further affected the results of the taskforce's investigation adversely.

[2] Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005, pp. 8.

Reasons for the Stock Market Crisis

According to the report developed by the taskforce, the key reasons behind the sharp rise in the index were increased liquidity due to higher remittances, low interest rates, better corporate performance, higher oil prices, relatively liberal availability of badla financing, and IPOs of public sector enterprises.

Moreover, beginning in December, 2004 till mid March, 2005, hype was generated by the media about the better prospects of the Index. For example, government officials gave statements linking the rise in the KSE Index to good economic management. Additionally, brokers and various others gave statements in the media in order to encourage investors to take advantage of the rising market. Privatization officials also appeared in the media and announced the privatization of profitable and well-known public sector corporations.

The inflated expectations about the potential performance of the stock market in the future caused the prices of major stocks to increase. However, the difference between the ready and future prices could not be explained by the differences in the interest rates. This created opportunities for arbitrage. Moreover, due to the huge leverage, the futures market had no shortage of buyers.

Additionally, investors who were unable to take advantage of the arbitrage opportunities due to liquidity problems utilized badla financing that was available at high interest rates (badla rates were capped at 18% in KSE but were uncapped in LSE). On the other hand, the increased availability of badla financing from primarily brokers and institutions, further raised the expectations in the futures market and in the ready market. This also increased the stock prices. According to the report developed by the taskforce, some of the key badla providers were also selling in the futures market, thus taking advantage of the raised expectations about increase prices in the future.

The following table shows some of the major brokers on February 28th, who provided badla financing":

Badla Providers as of February 28th, 2005	Amount (Rs. Million)
Arif Habib Securities	4,622
Aqeel Karim Dhedi	4,233
Atlas Invest	2,228
DJM Sec. Ltd	1,815
Orix Bank Inv	1,731
KASB Securities	1,714
Darson Ltd.	1,534
First Capital Equities	1,468
Motiwala Securities	1,030
S.C. Securities	995
Jahangir Siddiqui	917
Akberally Cassim	849
Mohammed Hussain	759
First Equity	693

Source: Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005

And the following table shows some of the large net sellers in the March Futures:

1. Arif Habib Securities
2. Aqeel K D Securities
3. DJM Securities
4. Jehangir Siddiqui
5. Orix Bank
6. KASB
7. First Capital Equities
8. FDM Capital Sec
9. Firozuddin A. Cassim
10. S.C. Securities

According to the report developed by the taskforce, the market rose during December, January, and February because:

- Stock prices rose by more than the cost of badla, enabling investors in the ready market to make profits regardless of whether they purchased in cash or financed their trade with badla.
- Secondly, as mentioned earlier, arbitragers were making substantial profits in the ready and future markets.
- Since the index broke its own record in each of these months and reached a new peak (surpassing their future prices in many scrip), the buyers in the futures market also generated profit.

The report further mentions that the sharp increase in the index was not due to a change in any of the fundamentals.

Moreover, the report says that after analyzing the stock market data, there were signs that players had undertaken wash trades. The analysis further showed that the brokers and their clients primarily dealt amongst each other in groups and subgroups at both broker and client level.[3] Substantial volumes were traded between clients of the same brokerage house. The analysis also says that some brokers indulged in excessive day trading (disproportionate to their capital base), because KSE did not have pre-trade capital adequacy verification. Approximately 0.1% of investors were responsible for more than 98% of turnover. Many small brokers traded extremely large volumes of single scrip. This may have been one of the reasons behind the euphoria present in the market.

The March Futures Contract

On February 24, 2005, the March futures contract opened. From this date to March 4, 2005, the KSE index rose from 8,253 to 8,793. Additionally, the arbitrage margins in the futures market between these dates reached 40 percent. Active trading was being conducted by the large brokers and investors. On March 3, 2005, the amount of financing provided by the badla market was Rs.33 billion. 70% of this amount i.e. 23.1 billion, was accounted for by five scrips namely, PSO, POL, NBP, OGDC and PTCL.

However, after March 4, 2005, the badla financing providers started to reduce the amount of badla financing provided. For example, badla financing for PSO reduced overnight from Rs.6.3 billion on March, 8, 2005, to Rs.2.4 billion on March, 9, 2005, following a corporate announcement/adjustment. This is a decline of 62%. Badla financing provided for PTCL also declined by 53% from one trading day to next. It is interesting to note that although the scrip prices and the KSE index were rising, around Rs.5.7 billion, or 17% of the total badla financing, was pulled out during March 7, 2005 and March 15, 2005. It is also important to note that the brokers were pulling out the funds on behalf of their clients. Major broker/clients included:

1. Mutual Funds,
2. Insurance Companies,
3. Investment Banks, and
4. Commercial Banks.

According to the providers of badla financing, they started to withdraw badla financing because they were nervous regarding the sustainability of the rise in the market, which would threaten the ability of the badla borrowers to repay their loans. However, interestingly, this reasoning of some badla providers was contradictory to their investment decisions in the ready market as buyers. For example, some brokers had sold in the March futures contract at higher prices than in the ready market, from where they were pulling out COT financing.

The other two factors that occurred during March 7, 2005 and March 15, 2005, were: i) fearing the possibility of default in a highly leveraged market, the KSE management

[3] Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005, pp. 13.

confirmed with different brokers whether they would be able to honor their obligations in the futures contract. This sent alarming signals to market players. ii) Another issue that added to the existing uncertainty in the market was that there was a rumor that the futures contract for March would not be rolled into April and that there would be settlement of the contract with delivery (although this practice is consistent with the rules, it does not operate in reality).

The taskforce has given a hypothesis, which needs to be tested. The hypothesis is that the providers of badla financing who were reducing the provision of badla financing in particular scrips after March 8, 2005, were selling actively in the ready market and were holding sell positions in the March futures contract in the same scrips at prices higher than the ready market prices.

The reduction in badla financing reduced the liquidity in the ready market significantly and decreased the prices in the ready market. As a result, the providers of badla financing, enhanced their gains from their earlier decision to sell at higher prices. Moreover, on March 16, 2005, the decline in liquidity caused a reduction in the prices of scrips that were affected by badla financing. And interestingly, OGDC, NBP, PSO, PPL, POL and PTC (these six scrips accounted for more than 60% of the KSE index) were responsible for more than 75% of the decline in the index. It is further interesting to note that apart from PPL (since PPL is not a badla financed scrip), all the other five scrips, i.e. OGDC, NBP, PSO, POL and PTC, accounted for more than 70% of the finance provided through badla financing. With the decline in these heavily weighted scrips, the market sentiment changed and the index fell, activating locks on day trading after March 16, 2005. Furthermore, the investors in the ready market could not exit and sell because the locks became operational due to the circuit breaker. They even could not roll over their since COT financing was declining. Buyers in the futures market deposited mark to market losses on a daily basis[4]. On the other hand, daily locks at the beginning of each trading day were still occurring in the ready market. Consequently, the management of KSE worried that some buyers in the futures market may be unable to buy their shares at the agreed price and some investors in the future market may default.

According to the report developed by the taskforce, there were two types of sellers in the March futures contract:

1. Firstly, those that were holding shares that they had sold in the futures and earned the arbitrage profits, regardless of the level of the ready market at the end of month. These investors were worried that buyers of their future contracts would default. Therefore, it was in their interest to help the potential defaulters pick up these shares.[5]
2. The other sellers of the March contract violated the KSE rules and would not have held the shares that they had sold in the future, but had planned to buy these after

[4] Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005, pp. 18.

[5] Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005, pp. 18.

the market fell. These sellers could have played a role in bringing prices down in the ready market by withdrawing COT financing. [6]

The report mentions, the following as the major net sellers and net buyers in the March contract (most of who were not potential defaulters):

Largest Net Buyers	**Largest Net Sellers**
Orix Investment Bank	Arif Habib Securiites
Motiwala Securities	Aqeel Karim Dhedhi Securities
Fawad Yusuf Securities	Elixir Securities
M.R.A. Securities (Pvt.) Limited	BMA Capital Management
Muhammad Junaid Memon	Invest Capital & Sec.
First National Equities Limited	Muhammad Nadeem Abdul Ghaffar
Moosani Securities	Noman Abid & Co.
Yaqoob Habib	Taurus Securities
Zillion Capital Securities	Escorts Investment Bank Limited
Pak Meezan Securities	First Capital Equities
D.J.M. Securities	FDM Capital Sec
SAZ Capital Securities (Pvt.) Ltd.	Firozuddin A. Cassim
First Equity Modaraba	A. Jabbar H. Ali Mohammed Khanani
Iqbal Usman Kodvavi	Sherman Securities
HH Misbah Securities	Invisor Securities

Source: Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005

[6] Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005, pp. 18.

The Bail out of Potential Defaulters

KSE extended the COT session for one hour on March 25, 2005 and again on March 26, 2005. Then after a meeting with the Chairman, SECP (along with his Commissioner) on March 27, 2005, SBP removed the restriction of maximum exposure in badla financing that was enforced on banks. Later that day, an informal meeting took place whose outcome was that the banks of the Exchange should be contacted to extend Margin Financing to the members who required bridge financing, since they had extensive deposits with the Exchange against their exposures in the March Futures Contract. Moreover, it was decided in this meeting that the COT session of March 25, 2005 should also be made available on March 27, 2005, in order to provide leverage to those seeking financing through badla. However, amazingly no minutes of this meeting were recorded; neither was there any firm reasoning for taking these decisions. This arrangement was against the normal trading rules allowed some large arbitrage players to benefit. The amount of badla financing provided between March 25, 2005 and March 27, 2005 was Rs.12 billion. And OGDCL, POL, PSO, NBP, and PTCL accounted for 93.33% of this amount, i.e. Rs.11.2 billion. The largest providers of COT financing on March 25, 2005 were:

Broker	Badla Provided (Rs. Million)
Arif Habib Secu	5,474
Aqeel Karim Dhe	1,240
DJM Sec. Ltd	917
Abdul Jabbar Khanani	743
Akberally Cassim	633
Bilquis Saleem	417
First Capital Equities	381
Elixir Securities	290
A.R. Securities	270
First Equity	249
Alfalah Securities	190
Concordia Securities	177
Jahangir Siddiqui	155
AMPLE Sec.	141
Aziz Fidahusein	140

Source: Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005

The following table shows the COT financiers and the Net Receivers in the March Contract:

Name of COT Financiers	Total Increase in COT during March 24-25, 2005 (Rs. in million)	Net Sell Position Futures Market (Rs. in million)
Arif Habib	5,474.81	5,909.55
Akberally Cassim	632.56	1,608.05
Jahangir Siddiqui	154.81	1,008.74
Invest Capital	54.84	978.33
Bilquis Saleem	416.74	690.05
Aqeel Karim	1,239.32	344.60
Amin Issa Tai	139.06	344.60
Ali Hussain Raja	17.05	207.69
Asian Securities	45.72	145.90

Source: Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005

Note that the amounts in the two tables above are similar and Arif Habib Securities has received the most benefit due to the extended COT session. Hence, the providers of badla financing were not bearing any risk to save the market as they knew that the KSE Clearing House had sufficient deposits of margin. Additionally, they had already earned a higher price for their lending. Interestingly, the COT financing was to the weak holders of futures contracts was developed to give benefit to lenders and borrowers:

1. During a meeting of the KSE board, the rate at which COT financing is provided was increased from 18 percent to 24 percent, even though this issue was not in the agenda.
2. Apart from OGDC, bailout COT financing was provided in other scrips. This is because OGDC was already overvalued and now the providers of COT financing were reluctant to provide finance to the OGDC holders. Consequently, it was important to design another bailout package for the holders of OGDC with public money. Therefore a consortium of institutions that was led by NIT purchased shares of OGDC at Rs.117.50 from the sellers. The reasoning provided by NIT for its course of action was that it was worried about the impact the decline in the market would have on the level of its redemptions, the demand for which would be expected to rise. This intervention was an off-market transaction and saved some private investors by the use of public funds.

Policy, Procedural and Systemic Flaws

<u>Broker house/ client positions</u>

The broker also performs the duties of COT finance provider, mutual fund, investment bank. Brokers often perform trades between their own accounts and that of their clients. This provides opportunities for market abuse. Moreover, this creates a conflict of interest in a broker transacting business without proper disclosure of his involvement or ensuring best prices for the client.[7] As a matter of fact, due to the conflict of interest at the board, the KSE management was unable to take action against those who breached the rules.

And interestingly, Proprietary Trading rules are not given on the website of KSE and therefore, many investors may not have been aware of them.

Ability of Brokers to undertake excessive day trading and 'wash sales'

There were no limits on the level of day trading done by a broker because pre-trade verification systems and other capital adequacy measures were not present. Additionally, the use of wash trades resulted in market manipulation.

The role of Circuit Breakers

The circuit breakers were a defect in the system for major shares that were actively traded. Although they prevented the manipulation of prices of illiquid shares, they acted as an obstruction in the market when there was excess volatility.

Lack of gross margining on offset futures trades at the broker and client level

The software installed by the KSE contributed to systemic risk by permitting the netting of buy positions of one client of a broker with the sell position of another client of the same broker (the long position of one client being offset with the short position of another) resulting in inadequate risk margins being collected by the clearing house (since one person's inability to settle his commitments can lead to bankruptcy). The leverage available as a result of the offset of these positions was a major contributor to excess speculation compared with other markets that require client margining at a gross level, along with a value at risk system of adequate standard to estimate broker margins.[8]

Mutual Funds, Commercial and Investment Banks

The involvement of financial institutions in the badla market caused conflicts of interest. There appeared to be limitless availability of such financing in relation to the total funds available and there was no transparency on the involvement of investment banks and mutual funds being both arbitrageurs and providers of badla financing.

[7] Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005, pp. 25.

[8] Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005, pp. 26.

Institutional Factors

Conflicts of interest in Board of KSE

The board of KSE was not willing to allow the separation of responsibility between that of a board and the management, which strengthened the already existing conflict of interests, which are present in a jointly managed exchange. Moreover, the Board worked at cross purposes to management by continuously delaying the necessary improvements, especially pre-trade risk verification and establishment of better risk management systems. Furthermore, according to the report developed by the taskforce, there is also a ‘them’ (management) and ‘us’ (brokers) approach.

KSE Management Weaknesses

SECP was not proactive and did not insist the board to implement reforms in a timely fashion. The KSE management did not demand listed entities to elucidate media speculation nor did they require them to provide any reasons for excessive price movements. The exchange is not demutualized and therefore lacks a strong management.

Inadequate surveillance by SECP, and weak implementation of policy reforms

Although the SECP developed many firefighting initiatives and piecemeal proposals, the Exchanges did not implement them. The SECP was satisfied by issuing directives but did not ensure that whether these were being implemented or not. Although the futures market was operational since 2001, the SECP delayed the formulation of a Futures Act and review the regulations of the market. Moreover, the SECP broker inspection, surveillance, and monitoring systems developed by SECP did not function effectively before and after the stock market crisis.

OTHER FACTORS

The Privatization Process

The issuance of a small percentage of a major scrip at the retail level resulted in a sharp rise in the price, as retail investors sold out to institutional investors for whom it was incumbent to weight their funds to hold an index equivalent. Since the design of the KSE 100 index is characterized by the over dominance of a few leading scrips the process of price appreciation in the ‘bull run’ was amplified. The taskforce interviewed some market players and they raised their concerns regarding the public statements given by the government officials or the key position holders in the regulatory authorities of public sector corporations that were to be privatized regarding the price that the divestment process would get.

Lack of transparency of Arbitraging Business and COT Financing Linkages

Another reason behind the market taking extra risks when the market was already highly leveraged is the lack of knowledge of the overall position of the market and lack of transparency of the market activity by arbitrageurs.

Analyst Research

It is interesting to note that some research intended to develop a very optimistic outlook for companies and it was told that front running by the staff of the brokers and their favored clients was common. Nevertheless no action has been taken by the KSE or SECP to eradicate this practice and investors are susceptible to being harmed by such actions.

Media Comment

Interestingly, there are no guidelines or codes of conduct covering the comments of media and analysts.

Proposals and Recommendations

Policy, Procedural, and Systemic Proposals

Rewrite the Proprietary Trading Rules and Ensure Dissemination of the Rules to Market Participants

The proprietary trading rules should be clarified. The ability of brokerages to front run clients and engage in other abusive practices should be removed. Trading through accounts with other brokers should be barred. And fines for exploiting the rules should be very high.

The SECP should introduce primary regulation to cover the regulatory responsibilities of the Exchanges. The laws regarding the ability of the SECP to carry out forensic investigations and enforcement should be strengthened so that custodial sentences for serious market abuse can be imposed. This should take care of the conflict of interest that is present at the board level of the Exchanges.

Creation of a "Free Float' Index

There should be a better market capitalization index that is weighted for stock available for trading in a company. Moreover, before a company is included in an index, it must have a minimum percentage of its capital available for trading.

Elimination of Circuit Breakers and replacement with Market Halts based on a Free Float Index

The KSE and SECP should remove circuit breakers and introduce market halts for varying time periods depending upon the movement in the market index. The removal of circuit breakers will also help in moving to a Value at Risk based on the volatility of individual stocks.[9]

Design of the Futures Contract

The futures contract was in contrast to other markets. In Pakistan, the futures contract was a deferred delivery of the purchase and sale of a scrip with a T+30 settlement period decreasing daily - T+29, T+28, to eventually match the ready market's T+3 at the close of futures trading. However, in other markets the trading is of a contract which specifies certain characteristics such as the number of shares per contract (usually 1000), the acceptable scrip for delivery, what adjustments are made for corporate actions such as dividends, bonus and rights issues if declared during the currency of the contract. And in the developed markets, futures are usually traded in a series of 30, 60 and 90 day contracts where a longer timeframe is available for trading which accommodates better roll over capability.[10]

The futures contracts involved the purchase and sale of one share. It was restricted to a rolling period of 30 days. No position limits existed. Additionally, there was no reporting of client exposures above a certain level of trading. Moreover, the buy and sell positions were netted and the margining methodologies contained deficiencies.

Hence, the specification of the futures contract should be redesigned. If the current system is replaced by another system, it will have to phased in and supported by the adequate risk management instruments and mechanisms.

Furthermore, margins should be evaluated on the basis of value at risk at the level of client (gross margin) with speculative position limits based on the free float of the scrip. And, above a particular reportable level, brokers must report client open positions. This would enable regulators to monitor the risk that is emerging. For futures, the contract months should be closer to the 30 day contract which is next to expiring and the 30 days, 60 days and probably 90 day contracts.[11] The website of KSE must provide the weekly futures positions by scrip and the disclosure must be clear as to net position calculations.

---

[9] Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005, pp. 30.

[10] Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005, pp. 31.

[11] Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005, pp. 31.

Phase out of Badla/COT trading

In order to evade market stress, a ‘home’ needs to be found for the scrips in badla trading for the final phase out of badla trading. Hence, it is important to handle the phase out of badla in a manageable and timely manner in order to ensure that alternate financing mechanisms such as margin financing are readily available and freely accessible to the investors.

Capital Adequacy of Brokers

It must be ensured that brokers have adequate capital. The method of allowing the outstanding shares to be settled at T+3 is very lenient. Something needs to be done about this issue to ensure systemic risk can be controlled in the future.

Mutual Fund and Investment Bank activity in Arbitrage and COT business

Firstly, the mutual funds and insurance companies should have restricted themselves to certain percentage of investment in COT financing. Secondly, every week, the mutual funds must report to the SECP about their investment in COT and arbitrage. Subsequently, the SECP should publish aggregate positions by counter on its own website and on the website of KSE.

Privatizations

The SECP, Ministry of Finance and the Privatization commission should review the current IPO offering process to see if modifications could be made to allow a ‘book build’ process including allocations to institutions to be introduced. The level of issue should also be carefully considered and an assessment t made as to the likely impact of the issue on the overall market in an effort to avoid the development of over exuberant markets.

Institutional Recommendations

Demutualization of the Exchanges

A fast-track process must be commenced so that the independence of management of the exchanges from brokers can be ensured. In order to do this, the taskforce recommends the government should appoint and fund a small independent commission and the matter should not be left only to the exchanges. And until the demutualization occurs, the independence of the board of KSE should be improved by appointing an independent chairperson, who is a non-broker, and has an important standing in the community.

Moreover, when the board of KSE meets during meetings, it should only discuss issues that are on the board’s agenda, unless an issue is very extraordinary.

Strengthening National Clearing Company Limited (NCCL)

It is very important to strengthen the National Clearing Company Limited (NCCL) because the development of risk management through it would assist in the development of the capital market.

The NCCL should be capitalized to the extent necessary for it to embark on the development and installation of the required systems and mechanisms to implement international best practices in risk management, clearing, and settlement. This process should look at available resources, including the existing Clearing Protection Fund, and seek to ensure that the clearing system can face any period of market disruption.[12]

The pre-trade verification of KATS is necessary till an enhanced risk management system is introduced. Furthermore, limits on open day trades should be established. Additionally, client positions should be margined on a gross basis and minimum client margin requirements set in order to limit the amount of uncovered leverage in the market.[13]

Monitoring and Surveillance of Members for Market Abuse and Insider Trading

A properly functioning surveillance department must be put in place, which has modern data analysis software and a prosecution function that can charge considerable penalties. Furthermore, the rules and framework in this area should be strengthened. If the exchanges are unwilling to undertake the necessary changes, then SECP should become the frontline regulator. SECP should levy members to cover the costs of undertaking such work. Moreover, there should also be an appropriate compliance culture in place so that the rules are effective. The exchanges should be determined to enforce the rules and levy heavy sanctions when they are violated or exploited.

Development of a Market Transaction Data Warehouse

Although a data warehouse plays an important role in controlling market abuse, the KSE lacks a data warehouse for all the KATS actions. Hence, the KSE must design a broad database for all the actions of KATS. The data warehouse must also have access to the details of brokers and clients to ensure proper surveillance, controlling and regulating of all trading that occur. Additionally, this data warehouse must be based on an approved KATS retention policy.[14]

[12] Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005, pp. 33.
[13] Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005, pp. 33.
[14] Stock Market Review Taskforce: Report into Stock Market Situation March, 2005, Report June 2005, pp. 34.

Chapter 3:
SUMMARY OF REPORT GENERATED BY DILIGENCE USA, LLC

SECP requested Diligence USA, LLC to perform a forensic investigation of some alleged manipulative activities regarding the stock market crisis of March 2005, as transacted on the KSE. Diligence investigated accusations related to the removal of regulated badla financing and in-house Badla, wash trades, and breaching the regulations governing Futures Contracts (exceeding the Rs.50 million reporting threshold). Diligence issued its report on November 21, 2006.

Corporate Profile

Diligence provides investigative, anti-corruption/anti-fraud, forensic accounting, and due diligence services to Fortune 500 companies, leading financial institutions, law firms, international organizations, and various domestic and foreign government agencies. The headquarter of Diligence is in Washington, D.C. and has main offices in New York, London, Moscow, Brussels and Hong Kong, Diligence consults with clients on business intelligence matters, compliance policies/programs, litigation support, and international risk management strategies. Diligence has an operationally experienced, multi-lingual and international staff with diverse backgrounds including domestic and international law enforcement, global financial media investigation and reporting, the World Bank Department of Institutional Integrity (corruption and fraud investigations unit), the Volcker Committee investigation of the U.N. Oil-for-Food Programme in Iraq, and "Big Four" accounting and auditing firms.[15]

The Scope Limitations of the Investigation and the Report Developed by Diligence

SECP asked Diligence to carry out a forensic investigation of some alleged manipulative activities pertaining to the events that occurred in the stock market in March 2005, as carried out on KSE. The report developed by Diligence includes information obtained by Diligence as of 21st November, 2006.

Retention of Independent Forensic Investigators

On 11th July, 2006, Prime Minister Shaukat Aziz gave a statement that forensic accountants were examining the March 2005 crisis of Karachi Stock Exchange and would submit a report within a period of three months. In fact SECP had retained Diligence in July 2006 to comprehensively investigate the activities that occurred during March 2005. Diligence especially had to determine whether manipulative schemes or dishonest/illegal conduct existed and contributed to the sharp decline of the market.

The investigation of Diligence focused on:

- The allegations of restriction and withdrawal of COT (including, to the extent possible, in-house badla),
- The allegations of wash trades, and
- The allegations of breaching the regulations that govern futures contracts.

[15] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp.2.

Diligence found the trading-related records and information to be inconsistent and often incomplete. Additionally, universal client identification codes were not available and client codes within individual brokers were not properly used. Furthermore, CDC group accounts existed to complicate the analysis. Another factor that complicated the analysis was that KSE did not preserve the order book records and critical compliance documents.

WITHDRAWAL OF REGULATED COT

Diligence found that there was a substantial withdrawal of funds from the COT market in the in the period immediately prior to the market's sharp decline. However, it found no proof that suggests that the removal of the COT funding was part of a manipulative scheme.

In September 2004, SECP started the permanent phase out of COT as the market's primary leveraging mechanism in order to move to a financing alternative that has less attendant to participants

Diligence has not been able to examine the activities related to the market's in-house badla because reliable data was not maintained by the brokers. Additionally, the regulated and unregulated COT activities in LSE and ISE have not been investigated by Diligence.

Forensic Examination of Carry Over Transactions on the Karachi Stock Exchange

Importance and Trends of COT Investment

The phase out of regulated COT started in October 2004. At that time, badla financing was available on only twenty-nine of more than 670 scrips traded on the KSE. However, trading in COT-eligible scrips accounted for the large majority of the trading activity in the Ready Market. In the months just before its phase-out, the market's Total COT remained fairly stable, moving between Rs.22.7 billion and Rs.28.5 billion per day. However, since November 2004 the Total COT started rising sharply. It touched an all-time high of Rs.40.3 billion on February 18, 2005. This sudden increase fell by around Rs.11.0 billion to Rs.29.0 billion by March 15, 2005. This brought the daily Total COT levels to a level similar to its 2004 volumes.

The Significance of New COT Availability

From July to October 2004, the daily volume of New COT remained quite stable, fluctuating between Rs.16.0 billion to Rs.24.9 billion. However, the daily transaction values of New COT started rising sharply in November 2004, due to the increase in the trading volumes in the Ready Market. Consequently, the daily volatility of the New COT also increased.

Proportion of COT Across Eligible Scrips and Brokers

COT was not only available in few of the market's total listed scrips, the investment in COT was heavily concentrated in only few of the scrips that were COT-eligible. Around half of daily New COT investment was concentrated within five of the twenty-nine scrips eligible for COT between July 2004 and October 2004scrips namely, OGDC, POL, PSO, PTC and NBP. And as the phase out of COT progressed, the proportion of COT exposure held in these five scrips relative to the entire COT market rose steadily.[16] The New COT held in these scrips represented around 80% of all daily New COT by March 2005.

Almost all the brokers trading on the KSE participated in the COT market. However, daily transactions of New COT on the KSE were heavily concentrated across relatively few brokers. Six brokers from the 138 brokers that participated in the COT market on behalf of lenders contributed around half of the total value of COT purchases that happened during the period of January 3, 2005 and March 15, 2005. These six brokers were (in descending order):

1. Aqeel Karim Dhedhi Securities (Pvt.) Ltd,
2. Arif Habib Securities Limited,
3. Atlas Capital Markets (Pvt.) Limited,
4. KASB Securities Limited,
5. Orix Investment Bank Pakistan Ltd., and
6. Akberally Cassim & Sons.

However, the brokers that represented the borrowers of badla financing were not that concentrated. 142 brokers participated in COT sale transactions during January 3, 2005 and March 15, 2005. Half of them were accounted for by twelve brokers, with one broker.

The Growth and Decline of COT Prior to March 16, 2005

Many have put allegations that the fall in Total COT from February 18, 2005 (when it touched its peak) to March 15, 2005 was the primary source of the market's decline. Many have also alleged that the decline in Total COT was because of the manipulative actions of a few major COT brokers and lenders.

Mandated Phase-out of COT

Introduction

SECP decided in 2004 to develop a plan to phase out COT and replace it with a more modern margin-based financing mechanism. The plan involved phasing-out scrips on a weekly basis (one per week) in reverse order of their Total COT on August 31, 2004. The schedule was to start the phase-out in October 2004 and finish it in June 2005. Of the twenty-nine scrips, eighteen were phased-out before to the beginning of the market's fall in late March 2005. The report of Diligence refers to these scrips as "GROUP A."

[16] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 20.

Effects of Phase-out on Market Liquidity

The Period October 8, 2004 to December 31, 2004

Of the twenty-nine COT-eligible scrips, seven had been phased out. The impact on the COT market's liquidity due the phase-out of these seven scrips was negligible, since the initial scrips in the phase-out plan accounted for proportionately the smallest investments of COT.

The Period of January 1, 2005 to February 18, 2005

Seven additional scrips were phased out during January 1, 2005 and February 18, 2005. The combined effect of these seven scrips was about Rs.5 billion, and accounted for almost 13% of the market's Total COT at the start of this six-week period. But the net impact on the market's Total COT due to their phase-out proved negligible also. The Total COT for the scrips that were eligible for badla financing, continued its sharp climb and reaching its peak on February 18. The net increase in the COT values during January 1, 2005 and February 18, 2005 was attained regardless of the removal of almost Rs.5 billion from the seven phased-out scrips. This indicated that the new investment in COT for the scrips not yet affected by the phase-out considerably outpaced the COT removed due to the phase-out.

The Period of February 19, 2005 to March 18, 2005

Four scrips were phased-out between February 19 and March 18, 2005. The effect on liquidity of the removal of Total COT was that around Rs.5 billion was removed. But interestingly, this removal of liquidity was achieved through the phase-out of a fewer number of scrips in a shorter span of time. And as per the original phase-out plan of SECP, the COT investment being phased-out each week was progressively rising.

The collective impact of the scrips that were phased-out during this period had a negative effect on Total COT during that period, in the sense that the level of New COT transactions for the remaining scrips that were eligible for badla financing did not keep pace with and could not make up for the COT withdrawn by the phase-outs. Thus during the latter half of February 2005, the Total COT fell steeply in all the scrips. However, the volumes of COT transactions started to increase during the first half of March, the rate of the rise was not enough to offset the amount of COT withdrawn from the COT market by the scrips that had been phased-out.

Conclusion

The Total COT of the scrips phased-out from being eligible for COT during January, 2005 to March 18, 2005 was Rs.10 billion, or 28% of the market. Although there were some rises in New COT in the remaining COT-eligible scrips, and possible increases in inhouse Badla, the removal of a large number of scrips from COT eligibility by

March 18, 2005 clearly had an adverse impact on the total liquidity in the market and might have been a major source of instability of the market.

The most important finding, however, is that the removal of liquidity was caused by external regulatory forces. This is not related to intentional broker or COT lender action. This withdrawal was authorized by the regulations of SECP and KSE.

Temporary Suspension of COT

Introduction

Two weeks before the fall of KSE in March 2005, the two scrips that had relatively high volumes of COT activity (PSO and PTCL) each had their eligibility for New COT. They willingly suspended trading for a period of five trading days. Actually, a few weeks earlier, the boards of PSO and PTCL had announced the payment of dividends, due to the strong financial performance of the companies. As a result, both scrips moved to spot trading (T+1) in the Ready Market in order to carry out the dividend payments they had announced. Although their suspension from the New COT market was according to normal practice became one of the factors that contributed to the qualms in the capital markets during this critical period prior to the KSE crash. The report of Diligence refers to these scrips as "GROUP B."

Effects of Suspension on Market Liquidity

Historically, both PSO and PTC had been heavily traded stocks on the KSE. This trend increased in 2005 as investor interest in the shares grew with repeated reports of possible privatization, the heavily promoted sale of stakes in the companies to foreign entities, and general positive news surrounding the two companies.[17]

Pakistan State Oil (PSO)

An optimistic attitude for PSO together with privatization interests generated very heavy trading volumes of the scrip in both the Ready and COT markets during the early months of 2005. Consequently, PSO had the heaviest average daily investment in Total COT of any single scrip. The availability of badla financing in PSO was significant to the liquidity of the total market. On March 10, 2005, PSO moved to spot trading. Therefore, its participation in the New COT market for five trading days, i.e. until March 17, 2005, temporarily suspended. The effect of the temporary suspension of PSO was that the level of Total COT decreased in the market by approximately Rs 4 billion, i.e. 12%.

Pakistan Telecommunications Company Limited (PTCL)

PTCL also had heavy trading volumes in shares and these were attributed to the privatization interests. The government was intending to sell a 26% stake PTCL. Additionally, market analysts expected that PTCL would have high earnings that year.

[17] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 27

There were heavy trading volumes in PTCL in the Ready and COT markets during the initial months of 2005. PTCL ranked as the fourth heaviest according to volumes in Total COT of all COT-eligible scrips.

On March 15, 2005, PTCL moved to spot trading and therefore, its participation in the COT market temporarily suspended for five trading days. On March 22, 2005 its participation in the COT market resumed, i.e. during the middle of the crash of the market. The temporary suspension of PTCL from the New COT market resulted in a reduction in the level of Total COT in the market by about Rs.3 billion, or 10%.

Combined Impact on COT Market

The temporary suspension of COT for both PSO and PTCL during around the same time period had a large impact on the COT market, and may well have been a major factor of the market's instability. Their joint temporary suspension resulted in the reduction in the level of Total COT in the market by about Rs.7 billion, i.e. about 21%. A very interesting point to note is that this suspension of newly available COT occurred at a time when scrips with larger levels of COT were leaving the COT market each week due to the mandate of SECP.

Conclusion

The temporary suspension of New COT trading for PSO and PTC was not a result of some intentional or manipulative scheme of lenders. Actually, this COT suspension was, in both cases, a company-directed suspension for administrative reasons in the normal course of business. No actions of any broker and/or COT lender can be attributed to the temporary suspension of New COT for PSO and PTC for this period, nor could anyone have foreseen the unfortunate timing of such suspensions in terms of overall liquidity conditions existing at the time.[18]

Active COT-Eligible Scrips

Introduction

There were nine COT-eligible scrips that lie outside analytical Groups A and B. These are referred to as Group C. In 2005, these Group C scrips accounted for the majority of the market's total investment in regulated COT. In fact the Total COT in these nine scrips amounted to Rs.19.7 billion on January 3rd, 2005, which was 54% of the total market. Hence, the proportion of this group's Total COT relative to the overall market rose as COT eligibility in scrips outside of this group was phased-out, or temporarily suspended.[19]

These nine scrips were also responsible for a large portion of daily trading volumes on the Ready Market. In fact during the period of January 3, 2005 and March 15, 2005,

[18] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 30.
[19] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 30.

trading in these scrips accounted for almost half of the total value of shares traded on the KSE, and played a major role in dictating the overall daily market movements.

Examination of COT Activity and Trends

Diligence tried to find any proof of a decline in COT investment within the Group C scrips before March 15th, 2005 as that might indicate a potential voluntary withdrawal of liquidity in the regulated badla market.

Contribution to Total Investment in COT

During January 3, 2005 to March 15, 2005, the Total COT for the scrips within Group C, generally increased progressively from, i.e. increasing from Rs.19.7 billion to Rs.23.7 billion, which represents an increase of 19.8%. And interestingly, while the market's value of Total COT declined, during this period, Total COT in Group C scrips rose from Rs.22.4 billion to Rs.23.6 billion.

Daily Availability of New COT

Diligence made the following observations for the period between March 1, 2005 and March 15, 2005:

- The daily transactions of New COT for Group C, increased as a whole, moving from Rs.9.7 billion on March 1 to Rs.13.4 billion on March 15, an increase of almost Rs.4 billion.[20]
- The level of daily transactions of New COT for four of the five trading days prior to the market's decline on March 16th experienced trading volumes in excess of the average daily trading volume of New COT for the group over the preceding six week period.[21]
- Investment in New COT for each of the individual scrips within Group C generally followed the trend of the group as a whole. By March 15, the day before the market began its decline, all nine scrips were experiencing higher daily volumes (in Rupees) of New COT than at the beginning of the month. Moreover, the daily volume of New COT for eight of the nine scrips on March 15th was at or higher than the average daily level of New COT for the prior two weeks in March 2005.[22]

Therefore, Diligence found no evidence that the availability of New COT for any of these scrips was pulled-out from the market. These findings refute the accusation and

[20] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 32.

[21] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 32.

[22] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 32.

commonly-held opinion that COT was intentionally pulled-out from the market by brokers and COT lenders in the days just before crash of the market.

Variability and Cyclicality of New COT

During 2004 and initially during 2005, the daily transactional volume in New COT was very cyclical and there were large variations in fairly short span of time. A comparison of daily transactional volumes of New COT to Ready Market trades shows that any downward trends that may be present from time to time did not appear to directly or negatively influence the daily trading volumes of the same scrips.[23]

Trends in Broker-Initiated Levels of COT Investment

Diligence also investigated the activities of COT trading at the broker level to find which broker has intentionally pulled-out substantial funds from the badla market in the weeks before the market's crash. During March 1, 2005 and March 15, 2005 the daily purchases of New COT by eleven brokers (who had the largest trading volumes in the COT market) did not generally fall. Jointly these eleven brokers accounted for substantial bulk of the total purchases of New COT during this period, any of which traded daily in large volumes of COT. The data analyzed by Diligence provides no evidence that any of these major brokers pulled-out large amounts of funds were during this period.

Moreover, Diligence also investigated the client-level trading data to determine the basic source of funds for New COT. The objective of the investigation was to ensure whether badla funding was concentrated between a small number of lenders and whether or not the brokers gave a significant proportion of total funds lent. Diligence found that for the period March 1, 2005 and March 15, 2005, the financing provided for New COT through the two largest providers, namely Aqeel Karim Dhedhi Securities (Pvt.) Ltd and Arif Habib Securities Limited, were heavily concentrated among relatively few lenders. And in cases where clients are concentrated, the risk of manipulation is mitigated by the fact that the large majority of the lenders were regulated third-party banks, mutual funds or other financial institutions that are seemingly independent of the brokers and subject to separate financial and regulatory controls.[24]

It did not appear to Diligence for each broker examined that proprietary accounts or broker controlled banks or mutual funds played a significant part in providing regulated badla financing. This reduces the broker's influence in the short-term on the supply or removal of badla investment funds.[25]

---

[23] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 34.

[24] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 36.

[25] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 37.

Comment on COT Investment at Lahore Stock Exchange

Diligence also studied the New COT trends pertaining to the Group C scrips on LSE during the first couple of weeks of March, 2005. They found that the trend in the New COT was upward showing that there was no systemic and intentional withdrawal of badla financing for these active scrips.

In-House Badla

Diligence was unable to find any constructive data or information about the activities of in-house Badla prevalent in the weeks before the crash of the market's March 2005.

Other Findings

Trading patterns in Futures Markets

Trading volumes in the futures market of KSE increased quickly in the months just before March. Some people believe that the decline in the availability of badla financing in the Ready Market. The sharp and unparalleled level of open positions in the futures market combined with the high levels of leverage in the badla markets might have resulted in the instability of the market at that time.

COT Trends during Market's Decline

The data of purchase transaction by the largest brokers, during March 16, 2005 and March 24, 2005, indicates that the brokers transacting COT purchases appeared to follow the same general trends of the overall market. The data does not suggest that any one broker or group of brokers appeared to have manipulated the COT market or acted in concert contrary to the general market trend.[26]

And although the New COT decreased during March 16, 2005 and March 24, 2005, that can be attributed to the demand function since trading volumes in the Ready Market fell similarly in the same period. Diligence found no evidence that the amount of New COT relative to trading volumes in the Ready Market decreased, instead, it remained steady.

WASH TRADES

Diligence evaluated the following in order to determine whether wash trades had been conducted:

1. The KSE trading data for intra-broker wash trading activities, or wash trades by same clients within one broker.
2. The KSE trading data for inter-broker wash trading activities, or wash trades by same clients across more than one broker.

[26] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 46.

3. The client-level detailed trading data for a sample of four large-volume brokers suspected of participating in excessive wash trading, to determine if any additional illegal wash trading had occurred.

Review of Taskforce Findings

Intra-Broker Wash Trades

Diligence analyzed trading data collected from KASB and concluded that the transactions were not wash trades. Additionally, Diligence found that the KSE's trading data contains incomplete and inconsistent client codes, which makes it hard to correctly determine the investors involved in the market transactions.

Inter-Broker Wash Trades

According to Diligence it is very difficult to determine clues of inter-broker wash trades by relying just on the KSE data and hence it disagrees with the conclusions drawn by the taskforce. According to Diligence in order to conduct a successful analysis of wash trades, analysis needs to be conducted at the client level and on the individual trade level.

Wash Trade Analysis of Four Large Brokers

Identification of Potential Wash trades

Diligence was unable to examine the possibility of inter-broker wash trades due to KSE the data limitations. But Diligence did find the possibility of intra-broker wash trades by using the back-office trading data of four of the larger brokers.

Analysis of Potential Wash trades

Diligence found many instances when the same client appears to have been both the purchaser and seller on the same market trade. In order to confirm that these trades were truly wash trades Diligence tried to answer the following two questions:

1. Were the trade volumes large enough to potentially impact scrip price?[27]
2. Were the trades followed by additional non-wash trades by the same investor through which he/she could have profited from a price increase?[28]

And according to Diligence, many instances were found in which the wash trade was apparently material to total trading activity for the same scrip but in most instances the size of the wash trade represented only a very small fraction of that client's total trades for the day, and often less than one percent of the scrips' total KSE market activity.[29]and while answering the second question, Diligence found many instances in March, 2005 that may have resulted in an illegal profit.

---

[27] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 57.
[28] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 57.
[29] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 57.

Summing up, Diligence could not identify adequate proof that would suggest that there wash trades have occurred in order to pump the market and manipulate the market during March, 2005. Furthermore, Diligence has reservations about the methodologies used by the taskforce to identify instances of wash trades. However, Diligence does acknowledge that there may have been independent instances of wash trades but according to Diligence these instances were not part of a manipulative scheme.

FUTURES CONTRACTS

Background and Scope

Diligence performed the following steps in order to investigate the trading activities of brokers selling in the Futures market:

1. Identifying any instances of brokers in net sales positions in excess of the Rs.50 million threshold of Clause 3(b) in March 2005 Futures contracts, thus triggering a need for the broker to satisfy the KSE that the shares sold were indeed held or recently purchased by the broker as directed in Clause 3(b).[30]
2. For the brokers holding the largest net sales positions in March 2005 Futures contracts, comparing the broker's net sales positions to the shares reported held by the broker in its accounts at CDC. A short-fall in shares held of greater than Rs.50 million might be found to be a potential violation of Clause 3(b) and Section 17(a).[31]
3. Quantifying and examining the lending of New COT for COT-eligible scrips by the market's more influential brokers for the period March 1 to March 18, 2005, to determine whether New COT for those scrips was reduced by these brokers, which could be a potential violation of Section 17(a).[32]

Findings

Identification of Brokers with Net Sales Positions over Clause 3(B) Threshold

Diligence used KSE trading data for the futures market to find all the instances for March 2005 futures contracts in which a broker trading a certain scrip apparently surpassed the threshold of Rs.50 million. Diligence found 2,491 instances of brokers that had open net sales positions in the March 2005 Futures contracts for a certain scrip, on a particular day, surpassed the threshold of Rs.50 million. These 2,491 cases were found across 88 brokers and across 24 scrips that were eligible for futures contract. Clause 3(b) requires such brokers to deposit with the KSE the shares representing the surplus amount over the threshold, or provide KSE with the documentation that shows that the shares were recorded at CDC, at the time their positions surpassed the Rs.50 million threshold.

[30] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 61.
[31] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 61.
[32] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 61.

Examination of Net Sales Positions of Larger Volume Brokers for Violations of Clause 3(B) and Section 17(A)

Section 17(a) of the Securities and Exchange Ordinance (1969) prohibits the use of any scheme, act or practice calculated to act as a fraud upon the market and the participation in naked short sales to a significant degree may be construed as a violation of Section 17(a).[33]

Diligence gathered account information from CDC in order to investigate of the thirteen brokers' (who had the largest net sales positions across multiple scrips) net open sales positions in the March 2005 Futures contracts. The account information from CDC provided information regarding quantities of shares held by each of the brokers for each of the scrips traded. The results that Diligence obtained were in line with the conclusion of the taskforce pertaining to these activities. It was found by Diligence that every broker (out of the thirteen brokers) had for at least one trading day net futures sales balances, in one scrip, in excess of Rs.50 million. And interestingly, some of these brokers perceptible shortfall in shares at CDC was hundreds of millions of rupees and was prolific across several scrips for an extensive period of time.

New COT Activity of Larger Brokers Appearing to be over Clause 3(B) Threshold

Diligence studied the amount of New COT given to the market in the first couple of weeks of March 2005 by the thirteen brokers who had the largest net sales positions across multiple scrips. Diligence found that the New COT given by these brokers either remained fairly stable or rose till March 15, 2005.

[33] Diligence: Forensic Investigation for the SECP into the KSE Events of March 2005, pp 63.

Chapter 4:
THE MAIN DIFFERENCES BETWEEN THE TWO REPORTS

The findings and conclusions of Diligence differ very much, in many respects, with the findings and conclusions of the Taskforce. The most important difference between the two reports was that Diligence did not support the idea that a manipulative scheme had caused the stock market crisis. Diligence also does not believe that the removal of badla was apparently the reason for the decline in market prices. According to Diligence, they did not find any proof that would establish that some influential brokers systematically and manipulatively exaggerated the market prices and then deflated them, hence earning large profits by doing so.

And although Diligence did find proof of possible wrongdoing by a large number of brokers in some areas, it believes that these possibly illicit acts were not a part of a manipulative scheme.

<u>Withdrawal of Regulated COT</u>

Like the Taskforce, Diligence also found that there was a substantial withdrawal of funds from the COT market in the in the period immediately prior to the market's sharp decline. Unlike the taskforce, Diligence found no evidence that regulated badla was restricted or withdrawn from the stock market by any influential broker before the decline of the market as part of a manipulative scheme. Rather the withdrawal of regulated COT during the months of February and March of 2005 was according to Diligence due to two independent reasons:

1. SECP had already decided that would phase out badla financing for some scrips. The withdrawal of regulated COT during the months of February and March of 2005 was part of the implementation of this plan of SECP and it had begun in October 2004.
2. The withdrawal of regulated COT during the months of February and March of 2005 was due to the temporary suspension of the availability of new badla financing for two scrips that were heavily traded namely, PSO and PTCL. And the temporary suspension on these scrips was due to their move to spot trading to carry out the dividend payments they had announced. In fact in the two weeks before the market's decline, new badla financing increased and was available for some scrips until March 21st, 2005. These were those scrips for which SECP did not phase out badla financing or which undergoing a temporary suspension.

As for the scrips that did not have a regulated or self-imposed removal of COT, the findings of Diligence show that the level of New COT for the period of February and March was cyclical and did not have an unfavorable effect on the Ready Market trading.

Wash Trades

According to the taskforce, wash trades were an important part of the manipulative scheme devised by some brokers to cause the rise in the market. The taskforce had identified many instances of wash trades both for the same client and for many common clients across brokers to cause the market to rise. And according to the taskforce, the brokers dealt with their clients largely in groups or sub groups at both broker and client level. Taskforce reported that substantial volumes trade occurred between clients of the same brokers and there were many cases when the same client or house account of a broker was both the buyer and the seller.

The taskforce primarily used client codes (given in KSE trading data) in order to determine alleged intra-broker wash trades. Diligence compared the client codes to the client information (obtained from the broker's back-office trading data) and found many instances in which certain trades were inappropriately categorized as wash trades by the Taskforce. Therefore, the accuracy of the methodology employed by the Taskforce is doubtful according to Diligence.

Diligence also studied trading data and identified that the parties involved in those transactions were not identical. Hence, the transactions were not wash trades.

In their investigation, Diligence found that the KSE's trading data contain incomplete and inconsistent client codes, which makes it hard to correctly determine the investors involved in the market transactions. And if the client codes are incomplete and inconsistent then how can taskforce rely on them to categorize the trades.

According to the taskforce, there were several instances of partial trades of scrip among different clients between different brokers and concluded that this was an evidence of wash trade. However, according to Diligence investors that trading in the KSE ought to use a broker in order to conduct a transaction. Therefore, according to Diligence, if many brokers have large amounts of trading activity amongst each other, it is normal and cannot be called an evidence of wash trading.

Diligence also disagrees with the taskforce on the conclusions reached by them on the inter-broker wash trades, since the universal identification coding system for investors did not exist and Diligence believes that without them it is very difficult to recognize the same clients across different brokers.

Contrary to the taskforce, Diligence could not identify adequate proof that would suggest that there wash trades have occurred in order to pump the market and manipulate the market during March, 2005. However, Diligence did find many independent incidents of wash trades.

Futures Contracts

According to the taskforce, in the weeks before the crash of the market some brokers carried out a substantial amount of sales of March 2005 Futures contracts. This resulted in having net sale positions in excess of same scrip shares held at CDC or recently purchased in the Ready Market. Another accusation of the taskforce was that these brokers also withdrew badla financing in order to sell in Futures at extremely elevated prices due to the rise in the market, and then later to buy the shares in the Ready Market at reduced prices.

And although Diligence identified several cases, in which the brokers might have breached the securities regulations, Diligence does not believe that violations were a voluntary and a component of a manipulative scheme to raise the market and then cause it to crash, as alleged by the Taskforce. Instead Diligence believes that possible breaches are independent individual instances to make profit.

Diligence gathered account information from CDC in order to investigate of the thirteen brokers' (who had the largest net sales positions across multiple scrips) net open sales positions in the March 2005 Futures contracts. The account information from CDC provided information regarding quantities of shares held by each of the brokers for each of the scrips traded. The results that Diligence obtained were in line with the conclusion of the taskforce pertaining to these activities. Diligence established that every broker (out of the thirteen brokers) had for at least one trading day net futures sales balances, in one scrip, in excess of Rs.50 million.

Another accusation of the taskforce was that the brokers that large naked short sale positions in the Futures contracts were some of the brokers that reduced the financing in the badla market and therefore, caused the market to fall sharply. Diligence studied the amount of New COT given to the market in the first couple of weeks of March 2005 by the thirteen brokers who had the largest net sales positions across multiple scrips. Diligence found that the New COT given by these brokers either remained fairly stable or rose till March 15, 2005. Therefore, Diligence found no proof that would indicate that the allegations of the taskforce were correct.

Chapter 5:
POST-DILIGENCE POLITICAL ECHOES

As mentioned earlier, Dr Tariq Hassan assigned an independent task force on 18th April, 2005 in order to examine the accusations of market manipulation. The taskforce submitted the report to Dr Tariq Hassan, who was the SECP chairman then, on 30th June. However, according to Dr Tariq Hassan when he wanted to proceed with the recommendations given by the taskforce in their report, Mr. Salman Shah, the Prime Minister's Adviser on Finance, and Mr. Omar Ayub Khan, the Minister of State, started to impede his efforts. Moreover Dr Tariq Hassan revealed that Mr. Shaukat Aziz forced him to keep friendly ties with the people involved in the crash of stock exchange. Hence on 4th August, 2005, Dr Tariq Hassan put forward his resignation, which was rejected by Mr. Shaukat Aziz.

After five months, Dr Tariq Hassan gave orders to appoint forensic investigators in order to find some of the big brokers who were responsible for the crash of the stock market. This time he was sacked. According to Dr Tariq Hassan, when he was sacked, SECP had all the pertinent data that was related to the stock market crash.

Then in the mid of the year 2006, the National Assembly's Standing Committee on Finance and Revenue made a decision to discuss the report developed by the taskforce on the crash of the stock market. The protesting opposition members surmounted the efforts of the government of preventing Dr Tariq Hassan from appearing before the committee. On 7th July, 2006, Dr Tariq Hassan issued a 'white paper' on the stock exchange crash that took place in March 2005. According to him he almost reached to a 'few big fish' but was then shown the door. He said, "The last orders on my table, when I was removed from my post on Eid day, was the appointment of forensic investigators to probe the few big brokers held responsible by the taskforce (for the crash)." The National Assembly's Standing Committee on Finance and Revenue in its meeting (lead by Chaudhry Anwar Ali Cheema) commanded the appointment of another team of forensic investigators to investigate reports about the involvement of 11 high-profile brokers in the crash of KSE in March 2005.

According to the MNA of the ruling party, Kashmala Tariq, there was a threat to the life of Dr Tariq Hassan since had taken on some influential people.

According to the opposition committee members, including Mujeeb Pirzada, Mohammad Laseeque Khan, Qurban Ali Shah, Khalid Iqbal Memon and Sardar Ayaz Sadiq, the government was accountable for the stock market crash that took place in May 2006 since the government took no action against the powerful brokers that were involved in the stock market crash of March 2005. In fact these members wanted the prime minister to resign for his alleged intervention in the affairs of the stock market and links with few brokers.

According to Dr. Tariq Hassan, the Security agencies were set upon him so as to frighten him. He was followed everywhere and his phones were bugged.

On 8th March, 2007, SECP was asked by the National Assembly's Standing Committee on Finance and Revenue to hand over an investigation report by 10th April, 2007 regarding the brokers involved in the stock market crash in March 2005. In case SECP did not submit a report by 10th April, the committee would begin its own investigation. The chairman of the committee, Anwar Ali Cheema, said that the SECP would not have any role to play once the committee began its own investigation. According to Murtza Satti of the Pakistan People's Party-Parliamentarians (PPPP), the SECP was wasting the time of committee. Furthermore, according to Sardar Tufail of the ruling Pakistan Muslim League (PML), the committee should play its role in order to make the situation better. Moreover, according to Naveed Qamar of the PPPP, the committee should develop a strategy to nullify the rumors that the issue of the crash of the stock market would be ultimately shelved. The committee required a justification from the SECP for the forensic investigation into the crash, which did not identify the people responsible for the stock market crash and moreover cost above a million dollars. After the meeting, Cheema told the reporters that the taskforce, which was formed to examine the crash of the stock market, discovered flaws in the policies of the SECP and held it and the management of KSE responsible for the crash.

The National Assembly's Standing Committee on Finance and Revenue also required SECP to hand over a report regarding the five top brokers accused of being involved in the stock market crash of March 2005. Moreover, the committee also demanded a report regarding the reasons behind the unavailability of the record of transactions of some brokers from the 'order book data'. According to Dr Tariq Hassan he completed the process of appointing the forensic investigators only after he was told that the data pertaining to all the transactions existed with the SECP. According to one of the taskforce members, Dr Zubair, the data provided to the forensic investigators was insufficient. Furthermore, he said that the forensic investigators mentioned this in their report. Haider Abass Rizvi of the Muttahida Qaumi Movement required an explanation from the SECP officials on the reasons behind the unavailability of the complete data of transactions.

According to Dr Tariq Hassan, he was removed from his office 'illegally' during the holidays of Eid. He said that the reason behind this was that he had completed the process of initiating a forensic investigation regarding the crash of the stock market. According to him, his successor appointed Diligence after a delay of around seven months in order to cover up the involvement of high profile brokers in the scam and to discredit the report of the taskforce.

Dr Tariq Hassan and the members of the taskforce were called by the National Assembly's Standing Committee on Finance and Revenue on 24th April, 2007 to discuss crash of the KSE in March 2005. Moreover, the federal law secretary and the local representatives of Diligence, Inc. were also summoned by the committee. In an earlier meeting, Syed Naveed Qamar of the PPP-Parliamentarians put the blame on the committee chairman for favoring Raziur Rehman, the SECP chairman, during questioning and threatened a walkout. The SECP chairman was criticized by Kashmala Tariq of the ruling PML for taking back the statement that he made earlier regarding the availability of the data for March 2005 of the stock exchange. She said that Raziur

Rehman asserted that all the data was available with the SECP, but now he is saying that it is not available. Clarifications were demanded by some of the members regarding the crash of the stock market. However, the chairman deferred them till the meeting that was scheduled on 24th April, 2007. Although Raziur Rehman acknowledged that the commission was supposed to maintain the records for the last five years, however according to him, the commission could not do so due to lack of facilities and equipment. Raziur Rehman said that SECP has only data of 15th March, 2005. According to him show cause notices were issued to 88 brokers by the SECP and the matter was discussed with legal experts. According to the legal experts, the brokers had committed no violation of the rules. They also said that the show cause notices should be withdrawn.

On 3rd May, 2007, the National Assembly's Standing Committee on Finance and Revenue termed the investigation carried out by Diligence a sham investigation. It was also decided by the committee to consult the parliament regarding reinvestigating the alleged scam. By the end of May 2007, the committee would finalize its suggestions for the parliament. The suggestions may include undoing all the share transactions that occurred in the 30 days prior to the crash of the stock market. The suggestions may also include making the loop around almost a dozen people, who were involved in the incident, tighter. The suggestions may also include referring the case to NAB or the Federal Investigation Agency or ultimately to the Supreme court. Although SECP has recently cleared brokers from the charges of market manipulation based on the report developed by Diligence, the committee, as mentioned earlier, was not satisfied by the investigation carried out by Diligence, for which Diligence was paid $1 million.

Chapter 6:
OTHER ANALYSIS

Calendar of Events

Index Graph of KSE-100 for the year 2005-06:

January 01, 2005 to March 15, 2005:

A sharp increase was seen during this period, as the KSE-100 index increased by 62.1 percent to 10, 303 on 15th March, 2005. The most marked increases were recorded in shares of oil and gas, telecom and cement companies. According to the "Pakistan Economic Update (July 2004-March 2005)" by Asian Development Bank, the main factors behind the sharp rise in share prices were higher corporate earnings announcements, privatization of some state-owned enterprises through the stock market, announcement of privatization plans of some major public sector enterprises and a large injection of foreign portfolio investment (foreign investment of $82.3 million were injected into the market in the first eight months of FY2005 as compared to a divestment of $38.5 million during the same period last year). The other factors behind this sharp rise were "following the herd" buying and speculative especially in the first half of March, 2005. The index rose by 21 percent during the first half of March, 2005.

According to the "Pakistan Economic Update (July 2004-March 2005)" by Asian Development Bank, the economy improved in the first quarters of FY2005. There were double digit increases in the production and sale of cement. There were large increases in imports of iron and steel and construction machinery. Additionally, there was a 45.6 percent increase in disbursement of bank loans for housing. All these indicate that there was a high growth in construction. Moreover, there was a 76 percent increase in cellular telephone connections to 8.8 million in February 2005. Additionally, there were 160, 000 WLL given in the first eight months of the year. These indicate that the telecommunication services are expanding at a quick pace.

<u>March 17, 2005 to April 13, 2005:</u>

According to the "Pakistan Economic Update (July 2004-March 2005)" by Asian Development Bank, the share prices had increased too high to be sustained, with excessive exposures of banks and brokers. The following technical correction caused the index to decline to 7, 124 on 13^{th} April, 2005.

<u>April 14, 2005 to August 17, 2005:</u>

During this period there many small dips and rises in witnessed at the index. During this period, the management of the Karachi Stock Exchange (KSE) sent an appeal to the Securities and Exchange Commission of Pakistan (SECP), regarding the phasing-out of COT with Margin financing. However, the outcome of the meeting between KSE and SECP officials was quite discouraging and the stock market received new wave of selling pressure from the retail investors as they were hoping an extension in the COT. During this period, the share prices remained under the influence of uncertainties arising from the release of the badla rules and though negotiations on suggestions of stockbrokers to extend the period without any harsh conditions were successful they failed to cheer the mood of investors.

Additionally, the delay in privatization of Pakistan Telecommunication pre-bid meeting was creating havoc.

However, later during this period, the stock players welcomed the decision of the Securities Exchange Commission of Pakistan (SECP) of enhancing the members' exposure limit in the futures market and change in the exposures rules. On June 10, 2005, the Securities and Exchange Commission of Pakistan (SECP) accepted the plea of stock exchanges to suspend the phase-out of Carryover Transaction (COT) at the present level of Rs.12 billion.

<u>August 18, 2005 to February, 2006:</u>

During this period, the index rose steadily; although not as sharply as during the January to March period. The economy had a strong growth during this period, although not as strongly as earlier. The economy grew at 6.6 percent. However the growth was the lowest as compared to last three years. Commodity producing sectors, like manufacturing and construction, experienced a slowdown. Consider the following table:

EIC Analysis

Economic Analysis

According to the “Pakistan Economic Update (July 2004-March 2005)”, in the first three quarters of FY2005 the performance of the economy improved, and the strong performance of commodity and services sectors gave an indication that the economic growth will be more than 7 percent in the fiscal year 2005. The report also mentioned that cotton attained a record high output. Moreover, as compared to the previous year, the rice crop was also better. Furthermore, extensive winter rains had made the prospects for the winter crops better. The large-scale manufacturing sector had a double-digit growth. Additionally, there was a large increase in the private sector credit. There was also a double-digit growth in exports. The report also mentioned that the fast growth of imports (especially of machinery and raw materials) indicates that the economic growth is high. However, there was also a huge trade deficit and the there was a sharp acceleration in the inflation in the first three quarters of the fiscal year 2005.

Industry Analysis

Huge rises in the imports of iron and steel and construction machinery and the rise in the disbursement of bank loans for housing by 45.6 percent gave an indication that high growth in construction was present in the fiscal year 2005, as mentioned by the “Pakistan Economic Update (July 2004-March 2005)”. Moreover, the rise in the cellular telephone connections by 76 percent reflected that the telecommunication services were expanding at a quick pace.

Company Analysis

The company selected for analysis is OGDCL, which is heavily weighted on the KSE index.

In the fiscal year 2003-04, the “Profit after Taxation” of OGDCL was Rs.22.41 billion. In the fiscal year 2004-05, OGDCL achieved a “Profit after Taxation” of Rs.32.97 billion, which represents a 47.122% rise. In the fiscal year of 2005-06, OGDCL attained a “Profit after Taxation” of Rs.45.97, which is an increase of 39.43%.

In the fiscal year 2003-04, the Dividend Payout Ratio of OGDCL was 77%. In the fiscal year 2004-05, the Dividend Payout Ratio rose to 98%. Then in the fiscal year 2005-06, the Dividend Payout Ratio was 84%.

In the fiscal year 2003-04, the P/E ratio of OGDCL was 12.38, which increased to 13.73 in the fiscal year 2004-05. The P/E ratio became 12.79 in the fiscal year 2005-06.

The EPS of OGDCL increased from 5.21 in the fiscal year 2003-04 to 7.67 in the fiscal year 2004-05. In the fiscal year 2005-06, the EPS was 10.69.

The Net Sales of OGDCL increased from Rs.51.33 billion in the fiscal year 2003-04 to Rs.73.71 billion in the fiscal year 2004-05. This represents an increase of 43.60%. Then in the fiscal year 2005-06, the Net Sales of OGDCL increased to Rs.96.76 billion representing an increase of 31.27%. The rise in the Net Sales may be attributed to the rise in the volume of sales and the oil prices.

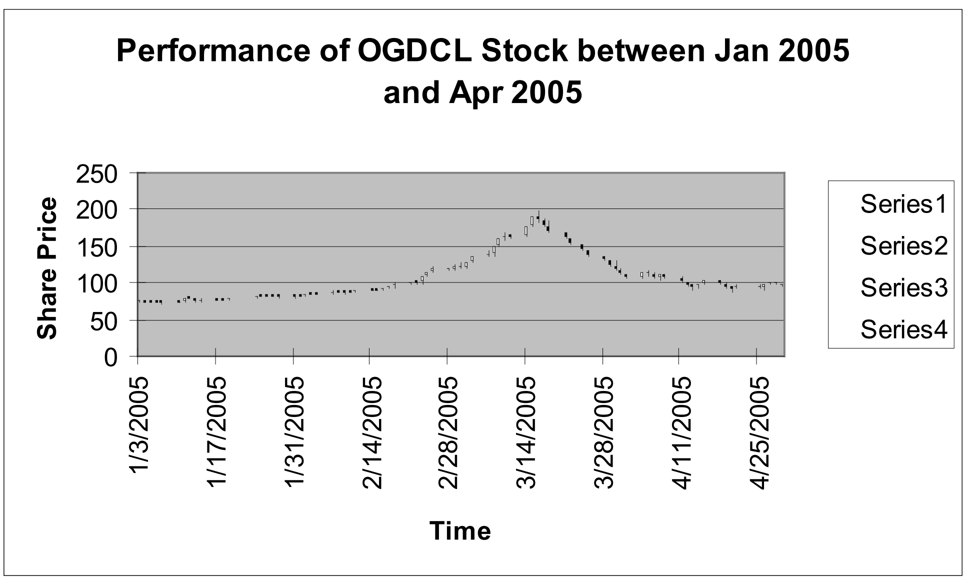
In the fiscal year of 2005-06, 16 new exploration licenses were acquired and covered an area of 28,066 sq. km. Moreover, OGDCL attained 100% drilling targets. Furthermore, five oil and gas discoveries were made.

<u>The Performances of some Stocks between January 2005 and April 2005</u>

Consider the performance of some of the stocks during the period January 2005 and April 2005.

Performance of OGDCL Stock between January 2005 and April 2005

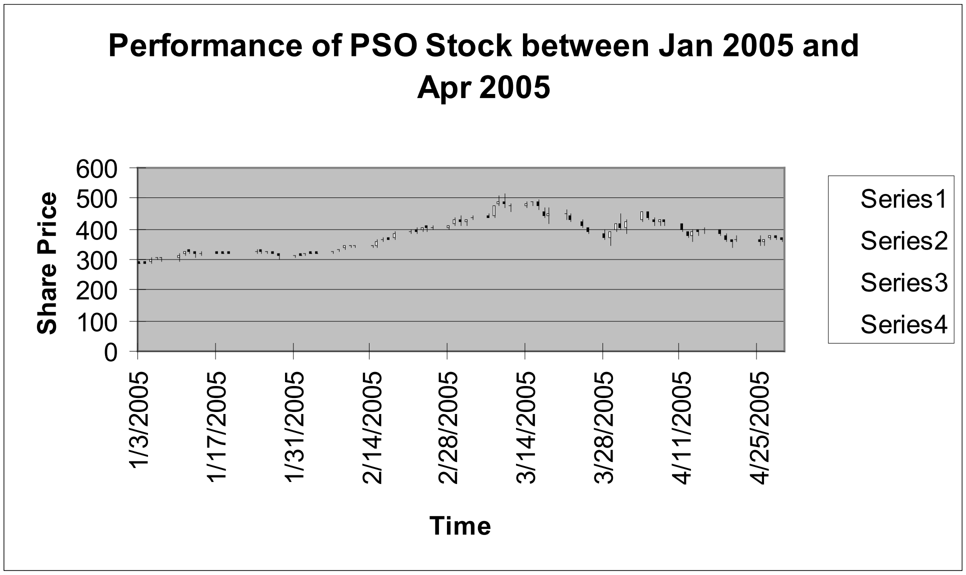
The following graph shows the performance of the stock of OGDCL between January 2005 and April 2005.



The graph shows that the price of the OGDCL stock remained fairly constant between 3rd January, 2005 and 14th February, 2005. However, after that the price rose steadily from Rs.88.70 to Rs.180.75 on 16th March, 2005. Then from 17th March, 2005, its price began to fall sharply. On 20th April, 2005 the price of the OGDCL stock was Rs.88.10. On 3rd January, 2005, the total value of COT (unreleased and open market COT) of OGDCL was Rs. 5,252,874,655. Then on 14th February, 2005, the total value of COT of OGDCL was Rs. 5,244,431,965. The total value of COT of OGDCL on 16th March, 2005, was Rs. 7,322,758,665. However, on 20th April, 2005, the total value of COT of OGDCL was Rs. 2,911,487,610.

Performance of PSO Stock between January 2005 and April 2005

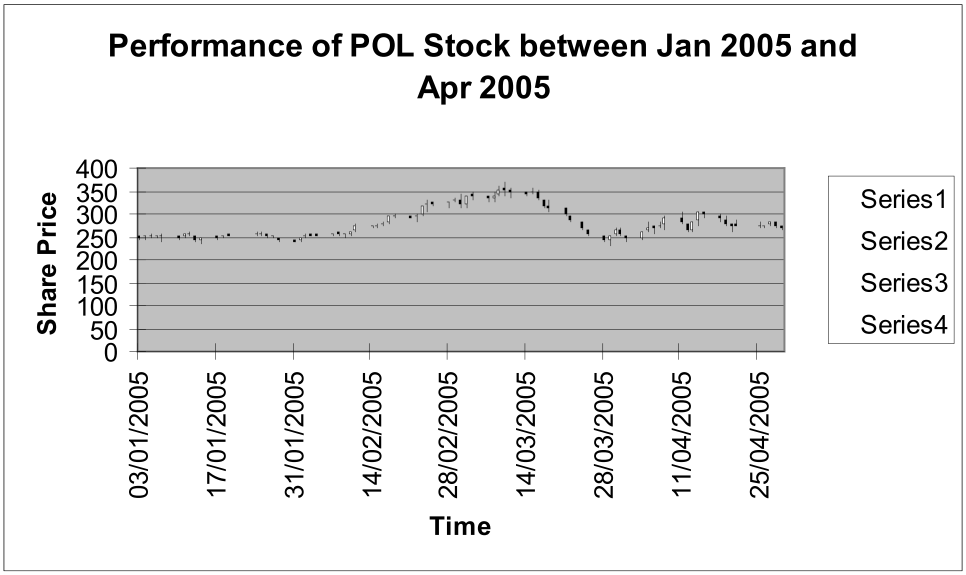
Consider the following graph, which shows the performance of the stock of PSO between January 2005 and April 2005.



The graph shows that the price of the stock of PSO rose steadily from Rs.286.95 on 3rd January, 2005 to Rs.488.90 15th March, 2005. After that, the price of the PSO stock dropped from this level. On 19th April, 2005 the price of the PSO stock was Rs.360.10. On 3rd January, 2005, the total value of COT of PSO was Rs. 4,530,219,830. Then on 15th March, 2005, the total value of COT of PSO was Rs. 2,378,455,300. However, on 19th April, 2005, the total value of COT of PSO was Rs. 4,555,901,155.

Performance of POL Stock between January 2005 and April 2005

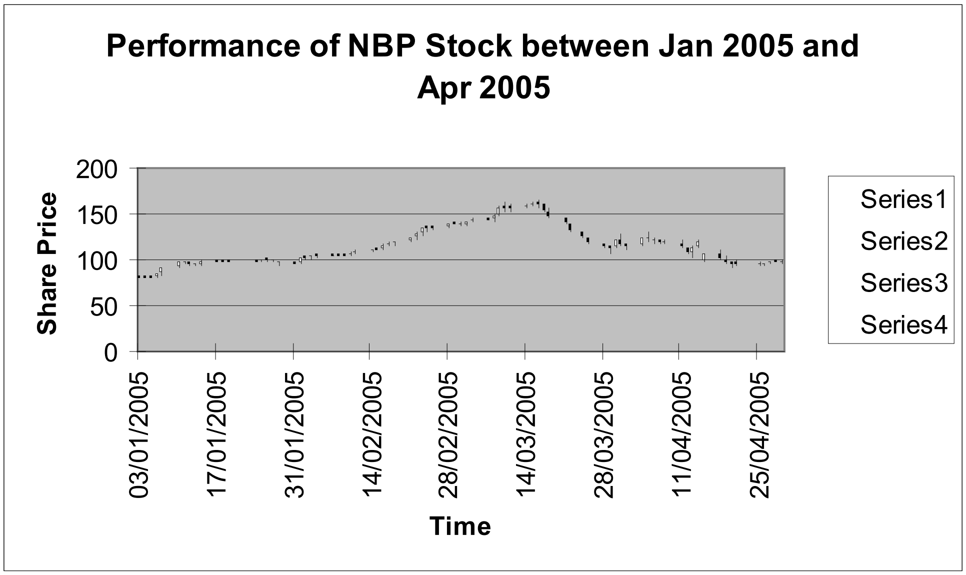
The following graph shows the performance of the stock of POL between January 2005 and April 2005.



The graph shows that the price of the POL stock remained quite stable from 3rd January, 2005 to 9th February, 2005. However, after that the price rose steadily from Rs.252 on 9th February, 2005 to Rs.346.50 on 15th March, 2005. Then the next day, the price of the POL stock fell to Rs.329.30. On 17th March, 2005 its price fell to Rs.315. This downward trend continued till 28th March when the price of the POL stock was Rs.240.75. After that the price of the stock did rise but it did not rise to the level as it had attained earlier, as depicted by the graph. On 3rd January, 2005, the total value of COT of POL was Rs. 5,262,353,300. On 9th February, 2005, the total value of COT of POL was Rs. 4,512,845,495. The total value of COT of POL on 15th March, 2005, was Rs. 5,631,047,300. However, on 28th March, 2005, the total value of COT of POL was Rs. 5,444,611,445. On 8th April, 2005, the total value of COT of POL was Rs. 4,200,193,880.

<u>Performance of NBP Stock between January 2005 and April 2005</u>

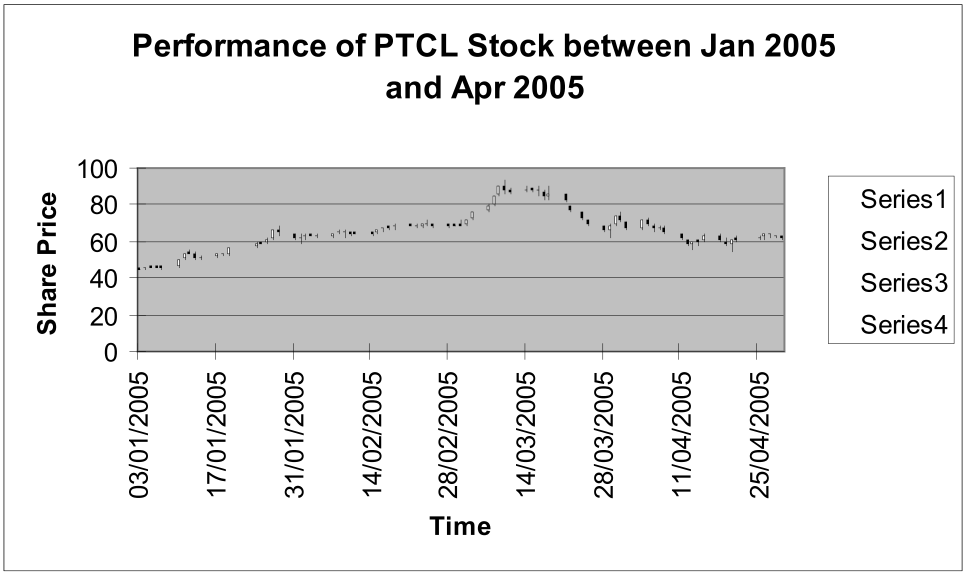
Consider the following graph, which shows the performance of the stock of NBP between January 2005 and April 2005.



The graph shows that the price of the NBP stock almost doubled between 3rd January and 15th March, 2005. The price of the stock of NBP increased from Rs.81.40 on 3rd January, 2005 to 161.75 on 15th March, 2005. However, after that the price declined steadily to Rs.112.50 on 28th March, 2005. After that the prices rose a little but then they declined again as depicted by the graph. On 25th April, 2005 the price of the NBP stock was Rs.94. On 3rd January, 2005, the total value of COT of NBP was Rs. 1,496,098,980. Then on 15th March, 2005, the total value of COT of NBP was Rs. 3,833,465,140. The total value of COT of NBP on 28th March, 2005, was Rs. 4,791,134,155. And on 25th April, 2005, the total value of COT of NBP was Rs. 1,026,901,735.

Performance of PTCL Stock between January 2005 and April 2005

The following graph shows the performance of the stock of PTCL between January 2005 and April 2005.



The graph shows that the price of the stock of PTCL increased steadily between 3rd January, 2005 and 14th March, 2005. On 3rd January, 2005, the price of the stock of PTCL was Rs.44.35 and on 14th March, 2005, it was Rs.88.15. This means that between 3rd January, 2005 and 14th March, 2005, the price of the PTCL stock doubled. However, after that the price began to fall and on 19th April, 2005 the price of the PTCL stock was Rs.57.25. On 3rd January, 2005, the total value of COT of PTCL was Rs. 2,451,125,800. Then on 14th March, 2005, the total value of COT of PTCL was Rs. 2,716,606,700. However, on 19th April, 2005, the total value of COT of PTCL was Rs. 4,560,664,825.

Chapter 7:
CONCLUSION

The rise in the KSE index initiated in December, 2004 as the market rose from 6,218 on December 31, 2004 to 10,303 on March 15, 2005. This was an increase of 65 percent. Not only did the index rise during this period, but the value traded also increased from Rs.20 billion to somewhere between Rs.50-100 billion.

The EIC Analysis shows that the stock market should rise, which it did between January 2005 and March 15, 2005. However, the EIC Analysis provides no reason for the stock market to fall. The Karachi Stock Exchange, as everybody knows, is a speculative market. It does not operate according to the fundamentals.

Moreover, the newspapers that were issued during the period prior to the stock market crash show that the media played a role in raising the stock market. Euphoria was created in the market about the possibilities of a rise in the Index through the media. Brokers and various others gave statements in the media in order to encourage investors to take advantage of the rising market. Hype was created about the shares of a few companies (that had a high weight in the KSE index). This led to prospective investors to form unjustified expectations regarding the whole market. Additionally, privatization officials appeared in the media and announced the privatization of profitable and well-known public sector corporations.

After studying the report generated by the taskforce and the report developed by Diligence, and keeping in view the EIC Analysis and the post-diligence political echoes, it seems that the stock market was manipulated.

REFERENCES

- http://www.secp.gov.pk/Reports/rpt_Taskforce_StockMarket%20.pdf
- http://www.secp.gov.pk/Reports/ForensicInvestigationForSECP.pdf
- http://www.kse.com.pk
- http://en.wikipedia.org/wiki/Karachi_Stock_Exchange
- http://www.ksestocks.com/index.php?page=Static_Charts
- http://www.dawn.com
- http://www.dailytimes.com.pk
- http://www.brecorder.com/
- http://www.adb.org/documents/economic_updates/PAK/eco-update-pak-2005.pdf