

Corporatization and Demutualization of Stock Exchanges

The Federal Government enacted a special purpose legislation known as Stock Exchanges (Corporatization, Demutualization and Integration) Act, 2012 (“the Act”). This Act has been commenced with effect from May 07, 2012. According to the framework provided in the Act, the Exchange was required to get demutualized after compliance with certain prerequisites. The corporatization was an integral tool for the demutualization. Through the mode of corporatization, the Exchange being a “not for profit” entity and limited by guarantee company with no share capital has been converted into a public limited company having a share capital which has been devised through the course of revaluation of assets and liabilities at a cut off date of March 31, 2012.

The whole process of the demutualization has been supervised by the Demutualization Committee and the Board of Directors of the Exchange.

Process of Demutualization

The following scheme of arrangement has been followed in Pakistan:-

1 Legal Framework

Through the mode of corporatization, the Exchange being a “not for profit” entity and limited by guarantee company with no share capital has been converted into a public limited company having a share capital which has been devised through the course of revaluation of assets and liabilities at a cut off date of March 31, 2012.

2 Revaluation of Assets and Liabilities

The Exchanges with the prior approval of SECP appointed renowned Chartered Accountants to undertake the assignment of revaluation of assets and liabilities of the Exchanges for the purpose of determining net assets of the Exchanges.

3 Share Capital

Securities and Exchange Commission of Pakistan based on the net assets value as determined by A.F. Ferguson & Co. has accorded approval to the Paid up Capitals of the Exchanges. In this regard, ISE has evolved a paid-up capital of PKR.3,671,869,991/- (US \$ 36,718,99.91) divided into 367,186,999 shares of Rs.10/- each. As per the scheme of demutualization shares of total paid-up capital have been issued amongst members of the respective Exchanges whereby every member got equal equity shares along with a certificate of Trading Right Entitlement.

4 Scheme of Shareholding of Demutualized Exchange

As per the scheme sixty percent shares have been transferred into a blocked sub-account of every initial shareholder which are being maintained by every Exchange which shall be utilized to make the shareholding of the Exchange broad based through the sale to the Strategic Investor

and financial institutions and also through the course of Initial Public Offering (IPO) thereby reducing the shareholdings of TRE certificate holders into minority. Forty percent shares of total entitlement have been transferred in the designated accounts of the initial shareholders.

5 Memorandum and Articles of Association

The Memorandum and Articles of Association of Exchanges have been developed by legal experts, reviewed by Demutualization Committees and Board of Directors and after consultation with Commission has been approved and adopted by the general body of the Exchanges in the Extraordinary General Meetings.

6 Legal Status of Exchanges

After compliance with all the requisite formalities, Exchanges have been issued certificates of re-registration on August 27, 2012 by the Registrar of Companies whereby the word “guarantee” stands omitted and the Exchange was named as “Islamabad Stock Exchange Limited”, “Lahore Stock Exchange Limited” and Karachi Stock Exchange Limited” . These certificates of re-registration also envisage that the Exchanges are corporatized and demutualized entities in terms of the Act.

7 Demutualization Committee

The Demutualization Committee is a statutory Committee constituted under section 3 of the Stock Exchanges (Corporatization, Demutualization and Integration) Act, 2012 (the Act) to supervise the entire process of demutualization. The Demutualization Committee of ISE comprises 13 members and the Managing Director. Syed Mukhtar Hussain Jaffery is the head of this Committee who has been a senior member of the Exchange now a TREC holders of the Exchange. He is also a senior fellow member of Institute of Chartered Accountants in Pakistan.

In terms of the powers under the Act, the Demutualization Committee has supervised and accomplished the tasks relating to corporatization and demutualization as prescribed under the Act. The Demutualization Committee has approved the valuations of the Exchanges carried out by a foreign bank duly appointed by the Securities and Exchange Commission of Pakistan for the purpose.

8. Powers of Demutualization Committee relating to Strategic Sale and Disinvestment of Shares

- To enter into negotiations, finalize and execute agreements for sale of upto 40% of the total issued share capital of ISE out of the shares deposited into CDC’s blocked account with strategic investor
- To accept or reject an offer from a prospective strategic investor.
- To determine the offer price for offer for sale to general public and financial institutions .

9 Board Composition

Upon corporatization and demutualization, the Board of Directors of the Exchange was replaced by the First Directors comprising eleven members out of which four were nominated by the Exchange representing TRE certificate holders interest for an interim period till election of Directors within thirty days from the date of re-registration of the Exchange whereas six independent directors were nominated by SECP. The MD is an ex-officio member of every Board of the Exchange.

The Board of First Directors decided to conduct election of Directors in respect of four seats. In the EGMs shareholders of the Exchanges elected four Directors for a period of three years. The nominees of SECP on the Board of the Exchange shall continue till the time the representatives of shareholders including general public after divestment of sixty percent shareholding are so elected or co-opted. According to the scheme of demutualization, the representatives of TRE certificate holders on the Board of the Exchange can not exceed four at any time and the Chairman of the Board shall always be a person who is neither a TRE certificate holder nor their connected person in terms of the provisions contained in the Act.

10 Shareholding Structure

According to the scheme envisaged under the Act, the entire paid-up capital of the Exchanges as worked out after the revaluation of assets and liabilities has been equally allotted to initial shareholders who were previously the members of the Exchanges. These initial shareholders can retain upto 40% shares as allotted to them whereas the 60% stake has been mandatorily retained by the Exchange. As per the provisions of the Act and Regulations framed there-under, upto 40% of these reserved shares may be allotted to a strategic investor and financial institutions whereas the remaining 20% shares shall be allocated to the general public through IPO. The proceeds to be received from such divestment are to be disbursed amongst 121 shareholders equally.

11 Valuation of the Exchange by International Investment Bank

As required under the Act, a valuation of the Exchange has been carried out by international investment banks duly approved by SECP in terms of the Act. The valuation so carried out has been submitted in a sealed envelop containing the “reserved price” of shares to SECP within the prescribed timeline as required under the provisions of the Act.

This valuation provides a basis for the negotiation and offer of shares to the Strategic Investor and the IPO. This valuation shall be furnished to the selected strategic investor through a confidential memorandum once an evaluation of such investor has been made by the Demutualization Committee.

12 Segregation of Commercial and Regulatory Functions of Exchange

In order to address the issues of conflict of interest post demutualization, a comprehensive plan has been chalked out with the approval of SECP which is intended to elaborate the regulatory arrangements that the stock exchange will have in place to ensure clear segregation of its regulatory and commercial functions. For the purpose, a Regulatory Affairs Committee (RAC)

has been constituted by the Board which functions as a 'Chinese wall' for effectively segregating the regulatory functions of the stock exchange from its commercial activities.

The RAD is overall responsible for the regulatory compliance of TREC Holders by setting minimum admission standards for TREC holders and through formulation of rules and regulations relating to proprietary and client level trading. The RAD shall also oversee the other regulatory functions such as surveillance, monitoring and risk management, enforcement and compliance, investors' complaints, arbitration and litigation and other related functions. Upon implementation and clear segregation of roles and responsibilities, the overall functioning of the Exchange have improved significantly.

In short, the demutualization is poised to bring new dimensions and characteristic changes to the securities market and the economy of Pakistan. The ISE is fully cognizant to ripe benefits from this window of opportunity and to start its journey on the path of progress and development.

13. Strategic Investment

Exchanges are now in process to divest their shares to some Strategic Investors to the tune of 40% as envisaged under the Act. In this regard, ISE is also planning to invite the Expression of Interest for the Sale of 146,874,799 ordinary shares of Rs.10/- each being 40% of the shareholding of the Exchange as reserved for the Strategic Investor at a reasonable premium. The prospective strategic partners/investors shall be entitled to take over the management control of the Exchange. The strategic investment besides the Exchange, is also subject to approval of Securities and Exchange Commission of Pakistan.

QUALIFICATION CRITERIA FOR PROSPECTIVE STRATEGIC INVESTOR

As prescribed under the Stock Exchanges (Corporatization, Demutualization and Integration) Regulations, 2012 framed under the Act, a Strategic Investor must be a stock exchange, a depository company, a derivative exchange or a clearing house meeting a certain criteria approved by SECP.