

ENQUIRY REPORT

FIXING A FLOOR ON THE PRICE OF SECURITIES BY THE STOCK EXCHANGES

BACKGROUND

This Enquiry Report is prepared pursuant to the *suo moto* notice taken by the Competition Commission of Pakistan (hereinafter ‘**Commission**’) against Karachi Stock Exchange (Guarantee) Ltd (hereinafter ‘**KSE**’), Lahore Stock Exchange (Guarantee) Ltd (hereinafter ‘**LSE**’) and the Islamabad Stock Exchange (Guarantee) Ltd (hereinafter ‘**ISE**’) for placing/fixing a minimum price floor for securities on 27 August 2008.

FACTS

1. The KSE, ISE, and LSE (collectively referred to hereinafter as ‘**Undertakings**’) are companies registered with the Securities and Exchange Commission of Pakistan (hereinafter “**SECP**”) and falls under the definition of undertakings pursuant to Section 2 (p) of the Competition Ordinance, 2007 (hereinafter ‘**Ordinance**’).
2. The KSE, *vide* its notice KSE/N-501,¹ placed a floor on the trading price of all securities keeping in view the bearish trading in securities. This floor was based on the closing price of securities on 27 August 2008 and was to take effect from 28 August 2008. For securities listed after 28 August 2008, the floor was set after the second day’s trading.²
3. On 28 August 2008, both LSE³ and ISE⁴ replicated the price floor decision taken by KSE.
4. The Commission took cognizance of this matter and on 2 September 2008 sent a letter to the Managing Director of KSE (hereinafter “**MD KSE**”) requesting an explanation as to why the price floor had been set/fixe. The Commission had received a reply dated 6 September 2008, sent by the KSE through its counsel. The above-said letter did not contain the requisite information as was asked by the Commission from the KSE, therefore, the Commission sent another letter on 15 September 2008 requesting therein further clarification with regard to the rationale behind the fixing of the price floor. A reply from the MD KSE was received on 29 September 2008.
5. On 15 October 2008, the Commission wrote a letter to the SECP quoting the letter of the MD KSE dated 29 September 2008, asking for the apex regulator’s comments on the matter. No reply has been received by the Commission as of the date of this report.
6. The Commission also wrote to the LSE and the ISE, seeking their point of view for the rationale behind the imposition of the price floor on their respective trading platforms. Replies were received from them on 28 November and 1 December 2008, respectively. The submissions made by KSE,

¹ The Notice: <http://www.kse.com.pk/kse4/notices2/images/004177-1.gif> and the Press Release: <http://www.kse.com.pk/kse4/notices2/images/004178-1.gif>

² Notice issued on 1 September 2008: <http://www.kse.com.pk/kse4/notices2/images/004255-1.gif>

³ Floor Price Level of 27 August 2008: <http://www.lahorestock.com/Notices/Notice28082008.pdf>

⁴ Market Stabilization Measure: http://ise.com.pk/ise_website/circulars/Circulars/Aug-28-08.jpg

LSE, and ISE are listed below in the section submissions and addressed in the section analysis.

7. For the purpose of this enquiry, the *relevant product market* is the market for the trading of securities, both in the Ready and the Futures Market, and the *relevant geographical market* is where the trading of such securities takes place, namely, KSE, LSE, and ISE.

THE ISSUE

8. Whether by placing a floor on the trading price of securities, the Undertakings have restricted and foreclosed choice, and created barriers to entry and exit which has resulted in the prevention, restriction and reduction of competition in the relevant market;
9. And whether such an agreement/decision by the Undertakings practice violates Section 4 of the Ordinance.

SUBMISSIONS

SUBMISSIONS BY THE KSE

10. *No barrier to entry or exit.* The legal counsel stated that there had been no restriction on entry and exit, as the price floor mechanism applied to all parties equally. No competitor has been placed on a weaker footing or been discriminated against and there has been no restriction on choice [letter of 6 September 2008]. This point was reiterated by the MD KSE, who said that this action had in no way affected the relevant market, nor had it restricted entry and exit [letter of 29 September 2008].
11. *Market regulation.* The MD KSE stated that the action taken by the KSE was a form of “market regulation,” which they are entitled to do under the *Securities and Exchange Ordinance, 1969*. To support his contention, the MD KSE highlighted market regulation that has taken place in other financial markets the world over, with a view to stress the universal nature of government intervention in times of economic turmoil and uncertainty. The current market situation in Pakistan, defined as “abnormal stress and facing a crises like situation,” was compared to the crisis in Russia where the market was completely shut down and blanket prohibition on certain types of trading in the United States and the United Kingdom.
12. *Resale price maintenance.* Counsel for the KSE stated that Resale Price Maintenance (RPM) did not apply to the action taken by KSE because the “RPM concept thus applies to (a) a manufacturer or supplier, (b) who supplied (i.e. sells) goods to its retailer/ dealers, and (c) requires the onward selling (i.e. resale) of the goods by the said retailer/dealers to be subject to price restrictions set by the manufacturer/supplier.” Counsel further stated that since their clients were not the supplier of securities, this was not an instance of “resale.”

SUBMISSIONS BY THE LSE

13. The LSE, in their reply to the Commission on 28 November 2008 said that similar action had to be taken by LSE to “avoid a pricing disparity.” The LSE also provided copies of communication with the SECP in which their disapproval of the price floor mechanism was expressed. Finally, we were told that “the KSE does not consult the LSE on market issues” and that “the decisions of the KSE are unilateral.”

SUBMISSIONS BY THE ISE

14. The ISE, in their reply to the Commission on 1 December 2008, stated that “both ISE and LSE took this decision reluctantly after KSE had already implemented this measure.” The rationale given by the ISE was that since both ISE and LSE follow a unified trading platform, they had no choice but to follow the decision imposed by the KSE, otherwise a significant price disparity would have resulted between the commonly-listed securities on the Undertakings.

ISSUES AND ANALYSIS

15. **No Barrier to Entry or Exit.** The action taken by the Undertakings had the effect of “trapping” shareholders and has created a barrier to exit and entry. By setting a minimum price, shareholders are unable sell their stock(s) because there are no buyers at the artificially-maintained price levels and thus, they cannot exit the market. Likewise new investors cannot enter the market because the prices have forcibly been kept high. So while there has been no active prohibition on the entry and exit from the market, the action of the Undertakings has the effect of reduced competition in the market because it has made entry and exit almost impossible.
16. In July 2008, the KSE implemented a form of regulatory action on the directive of the SECP that placed “circuit breakers” on the prices of shares. Circuit breakers have the effect of controlling extreme movements (either upwards or downwards) in the price of a share – in this case, they limited the maximum rise and fall in any share in a day to five per cent or Rs. 1.00, whichever was higher.⁵ These circuit breakers had been put in place since 23 July 2008 and trading had continued within these limits. Initially, the market showed positive movement but numerous factors continued to drive the market down, which resulted in the KSE applying the measure of fixing the price floor of securities. The placing of a price floor on share prices cannot be compared to the circuit breakers put in place by SECP. Circuit breakers allowed shares prices to move upwards and/or downwards but more slowly, thereby providing a sufficient degree of flexibility in which the market continued to operate. However, in fixing the floor price of the securities, the KSE has had the effect of completely freezing the market because very few are willing to buy at the prices prescribed by the Undertakings.
17. **International Precedent.** The claim by the KSE that such activities regularly happen in international markets was also looked into. There is no precedent where a floor price has been placed on the trading of securities. In the market crash of 1987, referred to as Black Monday, restricted trading was enforced temporarily but that was primarily because the computer technology at that time could not handle the volume of trading. Restrictive trading was as a result of poor technology and not in an attempt to manipulate the market.⁶ The 1997 Asian Market Crash and the 1998 Russian Market Crash were both predominantly currency-related crashes. In Asia, the market crash was triggered in Thailand when the government refused to unpeg the Thai Baht from the US Dollar and devalue it, which along with numerous other factors caused markets to cascade all over the South East Asia. The 1998 Russian Market Crash was also sparked by the artificially high exchange rate

⁵ SECP Restores Old Circuit Breakers, Salman Siddiqui, The News, 12 July 2008;

http://www.thenews.com.pk/daily_detail.asp?id=123561

⁶ <http://www.federalreserve.gov/Pubs/feds/2007/200713/200713pap.pdf>

maintained by the government.⁷ In the current financial crises, Iceland, which is on the brink of bankruptcy, has shut down its stock market operations and suspended trading.⁸ A Kuwaiti court issued a writ ordering the temporary suspension of the stock market after it felt the government was not doing enough to halt the rapid fall of the stock market.⁹

18. The events mentioned in the preceding paragraph are not analogous to the price floor decision taken on 27 August 2008 by the KSE. In times of financial crises, stock markets have been shut down and trading stopped altogether but such restrictions on market trading like those placed by the Undertakings have rarely been enforced. KSE has also referred to instances where “in England and the United States blanket prohibition on certain types of trading” were imposed. It is true that restrictions on certain types of trading have been imposed but these have usually been on insider trading or a prohibition on the practice of short selling. In our research, no other instance of blanket prohibition on trading in those markets can be found.
19. Therefore, the action taken by the Undertakings is without precedent. If the KSE felt convinced that Pakistan is going through “abnormal stress and facing a crises like situation,” then proper reforms in the financial sector should have been proposed and risk management measures instigated engaging all stakeholders – as stated in their press release – prior to the floor mechanism being put in place,. There have been no indications of any reform initiative. Even if the reasons for its action on 27 August 2008 are, as claimed by KSE, a short-term measure, the price floor mechanism has been perpetuated for three months with no lifting of the price floor in sight.¹⁰
20. It is pertinent to highlight the view of the other two stock exchanges in the country, namely ISE and LSE, who have expressed their reservations on “the arbitrary and artificial price ranges and price floor” and their contention that this action has “significantly impacted and shaken the confidence of the investors.” The ISE has also said “that imposition of such a ‘floor’ greatly affects the choice, exit and entry determinants of a free market.” We also note that market participants have expressed their disagreement with the action of the Undertakings in fixing a price floor.¹¹
21. And finally, we note coverage in the international media stating that “since the curbs were imposed, Pakistan’s credit rating has been cut, giving it the world’s second-lowest grade.”¹²

⁷ http://findarticles.com/p/articles/mi_qa3674/is_200204/ai_n9026596/pg_9?tag=artBody:col1

⁸ Iceland Stock Market To Stay Shut; <http://news.bbc.co.uk/2/hi/europe/7666498.stm>

⁹ Kuwait Stock Market Opens After Suspension;

http://arabia.ndtv.com/Story.aspx?pageheader=news&sub_category=&ID=NEWEN20080072914

¹⁰ KSE Board Again Fails To Reach Decision On 'Floor.' Irfan Malik, 24 November 2008;

<http://www.nation.com.pk/pakistan-news-newspaper-daily-english-online/Business/25-Nov-2008/KSE-board-again-fails-to-reach-decision-on-floor/1>

¹¹ Stockbrokers Clamour for Removal of 'Floor;' Dawn, 2 December 2008;

<http://www.dawn.com/2008/12/02/eb7.htm>. Also “Analysts, however foresee little recovery in the market with the curbs to stay for the next 15 days. “The investors are least interested in the market which is reflected from the thin volumes, especially the foreign investors are frustrated, but finding no exit due to the placement of floor,” Faisal Shaji, an analyst at Khoja Securities pointed out.” Quoted in the Daily Times, 10 September 2008; http://www.dailytimes.com.pk/default.asp?page=2008\09\10\story_10-9-2008_pg5_11

¹² Pakistan Extends August Stock Trading Curbs Until Oct. 31;

<http://www.bloomberg.com/apps/news?pid=20601091&sid=aQXAF0qDJiuU&refer=india>

CONCLUSION

22. In view of the above, it is concluded that setting a minimum price at which shares/stocks can be traded *prima facie* constitutes a contravention of Section 4(1), in particular Section (4)(2)(a) as it constitutes the “*fixing the purchase or selling price or imposing any other restrictive trading condition with regard to the sale or distribution of any goods...*” in this case, securities.
23. This act on the part of the Undertakings has prevented reduced and restricted competition in the market by disallowing market players from selling securities at a price of their choice.

RECOMMENDATION

24. In view of the foregoing, giving effect to such an arrangement *i.e.*, setting a floor on the price of securities on the part of the Undertakings, has significantly impacted the confidence of investors. Therefore, proceedings may be initiated in public interest under **Section 30** against the Undertakings in accordance with the law.

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