Moral Neutralization In Pakistan's Capital Markets: A Study Of Market Abuse

Syed Irtaza Ali
University of Pennsylvania

Follow this and additional works at: http://repository.upenn.edu/wharton_research_scholars

Part of the Business Commons

http://repository.upenn.edu/wharton_research_scholars/154

This paper is posted at ScholarlyCommons. http://repository.upenn.edu/wharton_research_scholars/154
For more information, please contact repository@pobox.upenn.edu.
Moral Neutralization In Pakistan's Capital Markets: A Study Of Market Abuse

Abstract
This paper attempts to answer the question: why do brokers in Pakistan's capital markets engage in corrupt behavior? It makes use of theories of moral neutralization and ethical decision making to understand what rationalizations or justifications individuals come up with to justify or explain away their corruption. From analyzing what might motivate corruption on an individual level, this paper then looks at whether deeply embedded norms of corruption exist within brokerage organizations and across the brokerage industry. These theories are tested against insights gained from interviews with active market participants in Pakistan. The paper's findings are: 1) evidence of partial degree of institutionalized corruption in broker organizations 2) brokers neutralize ethical concerns over their corruption by i) not seeing their actions as illegal and by ii) questioning the credibility and competence of the Securities and Exchange Commission of Pakistan as their rightful regulator, and 3) a relationship based culture amongst brokers motivates corrupt behavior within the industry.

Keywords
Neutralization, rationalization, corruption, Pakistan, brokers

Disciplines
Business

This thesis or dissertation is available at ScholarlyCommons: http://repository.upenn.edu/wharton_research_scholars/154
MORAL NEUTRALIZATION IN PAKISTAN’S CAPITAL MARKETS: A STUDY OF MARKET ABUSE

By

Syed Irtaza Ali

An Undergraduate Thesis submitted in partial fulfillment of the requirements for the

WHARTON RESEARCH SCHOLARS

Faculty Advisor:

Philip Nichols

Joseph Kolodny Professor of Social Responsibility in Business

Legal Studies and Business Ethics Department

THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

MAY 2017

I would like to express my immense gratitude to Professor Philip Nichols for his guidance, mentorship, and tremendous generosity during the year it took to write this thesis. He taught me how to become a better researcher and instilled in me an essential sense of clarity that I will take forward into my future research. I would also like to thank Dr. Utsav Schurmans for teaching me the tools to engage in scholarly research through the Wharton Research Scholars seminar, as well as his constant support and words of encouragement throughout the writing process. Finally, I would like to thank the interview participants who helped in bringing this paper to life and the Securities and Exchange Commission of Pakistan for giving me access to critically important data.
ABSTRACT

This paper attempts to answer the question: why do brokers in Pakistan’s capital markets engage in corrupt behavior? It makes use of theories of moral neutralization and ethical decision making to understand what rationalizations or justifications individuals come up with to justify or explain away their corruption. From analyzing what might motivate corruption on an individual level, this paper then looks at whether deeply embedded norms of corruption exist within brokerage organizations and across the brokerage industry in Pakistan. These theories are tested against insights gained from interviews with active market participants in Pakistan. The paper’s findings are: 1) evidence of partial degree of institutionalized corruption in broker organizations 2) brokers neutralize ethical concerns over their corruption by i) not seeing their actions as illegal and by ii) questioning the credibility and competence of the Securities and Exchange Commission of Pakistan as their rightful regulator, and 3) a relationship based culture amongst brokers motivates corrupt behavior within the industry.

KEYWORDS: Neutralization, rationalization, corruption, Pakistan, brokers
**ABBREVIATIONS**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pakistan Stock Exchange</td>
<td>PSX</td>
</tr>
<tr>
<td>Securities and Exchange Commission of Pakistan</td>
<td>SECP</td>
</tr>
<tr>
<td>Karachi Stock Exchange</td>
<td>KSE</td>
</tr>
<tr>
<td>Pakistani Rupee</td>
<td>PKR</td>
</tr>
<tr>
<td>United States Dollar</td>
<td>USD</td>
</tr>
<tr>
<td>Islamabad Stock Exchange</td>
<td>ISE</td>
</tr>
<tr>
<td>Lahore Stock Exchange</td>
<td>LSE</td>
</tr>
<tr>
<td>Corporatization, Demutualization, and Integration Act, 2012</td>
<td>Demutualization Act</td>
</tr>
<tr>
<td>Corporate Law Authority</td>
<td>CLA</td>
</tr>
<tr>
<td>Asian Development Bank</td>
<td>ADB</td>
</tr>
<tr>
<td>International Monetary Fund</td>
<td>IMF</td>
</tr>
<tr>
<td>Non-Banking Finance Companies</td>
<td>NBFCs</td>
</tr>
<tr>
<td>Central Depository Company</td>
<td>CDC</td>
</tr>
<tr>
<td>National Clearing Company of Pakistan Limited</td>
<td>NCCPL</td>
</tr>
<tr>
<td>Carry over transactions</td>
<td>COT</td>
</tr>
<tr>
<td>Initial Public Offering</td>
<td>IPO</td>
</tr>
<tr>
<td>Oil and Gas Development Corporation</td>
<td>OGDC</td>
</tr>
<tr>
<td>National Investment Trust</td>
<td>NIT</td>
</tr>
<tr>
<td>Competition Commission of Pakistan</td>
<td>CCP</td>
</tr>
<tr>
<td>Morgan Stanley Capital International Index</td>
<td>MSCI</td>
</tr>
</tbody>
</table>
1. INTRODUCTION

The Pakistan Stock Exchange (‘PSX’) forms an essential component of the Pakistani capital markets. As of the end of March 2016, there were a total of 560 companies listed on the PSX with a book value of PKR 1,288.78 billion (USD 12.31 billion), a market capitalization of PKR 6,915.69 billion (USD 66.03 billion), and a market capitalization to Gross Domestic Product (‘GDP’) ratio of thirty percent. This market has experienced three major crises in the last two decades. Theses crises have been marked by allegations of market abuse, broker and investor default, and serious mismanagement on the part of the capital market regulator, the Securities and Exchange Commission of Pakistan (‘SECP’). Market abuses have included various price manipulation tactics and misuse of trade financing products by broker dealers who serve as intermediaries to investors. Given that these abuses have taken place frequently, and few, if any market participants have been held accountable for allegations of misconduct, an important question arises: why do broker dealers engage in these illegal market activities? This paper, therefore, tries to understand what possible reasons there might be for brokers engaging in corrupt behavior. It is important that this question be answered because persistent corrupt behavior inhibits the growth of a country’s capital market by eroding trust in its institutions, and in the process, discourages investment. This prevents or inhibits private sector companies from being able to access much needed capital for their business objectives and households from allocating their savings to the stock market.

This paper will make use of theories of moral neutralization and ethical decision making, to understand why brokers would engage in corrupt behavior. Techniques of moral neutralization are essentially cognitive measures taken by individuals to explain away or justify their corrupt behavior. In this paper, these techniques of moral neutralization have been situated in a larger theory about the normalization of corruption in business organizations as purported by Blake E. Ashforth and Vikas Anand. These scholars argue that there is a multi-faceted and interactive process through which corruption becomes deeply embedded in organizations. The pillars of normalization are institutionalization, rationalization (a subset of neutralization), and socialization. This paper will focus on the former two, to see what, if any, evidence of institutionalization and rationalization exists in Pakistan, and how this explains the prevalence of market abuse. The other theory of ethical decision making at the individual level being used is posited by Xiao-Xiao Liu, George I. Christopoulos, and Ying-yi Hong. They argue that when an individual decides to give a bribe, the individual considers three interactive decision frames: ethical, economic, and relational. This paper extends this model to other forms of broker corruption, and attempts to explain how these decision frames are employed by brokers to justify corrupt acts.

These theories will be tested against insights gained from interviews conducted with active market participants in Pakistan. These interviews provide a fascinating portrayal of Pakistan’s capital markets and the respective positions of the PSX and SECP within it. The interview findings

---

Note: The dollar amounts were calculated using historical US/PKR FX rate from March 31, 2016 of $1=104.7299 rupees
are a unique contribution to the field of research on this industry. The findings of these interviews resulted in six key tropes about the markets:

1. The SECP’s main functions are to regulate and develop but it can be heavy handed in its policing of the market without giving due attention to the developmental aspect of its mandate
2. Market participants maintain that the SECP has serious human resource constraints which handicap its enforcement capabilities
3. A perception exists that the SECP is not entirely independent since it is susceptible to undue political influence and broker exploitation which could potentially result in the poor enforcement of rules and regulation
4. The legal system provides inadequate support to the SECP in the fulfillment of its enforcement responsibilities and the SECP itself does not make full use of its judicial powers to investigate and prosecute white collar crimes
5. The 2008 crisis was created by global shocks but worsened by poor enforcement by the SECP which allowed exploitative brokers with vested interests in the market to force a price floor in their favor
6. SECP regulation is copied from Western countries and does not fit Pakistan’s unique context

These tropes are used throughout the paper to evaluate the theories of neutralization and ethical decision making employed. While there is no conclusive evidence of deeply embedded norms of corruption, this paper finds that a partial degree of institutionalized corruption does exist amongst broker organizations. With respect to techniques of neutralization, this paper finds that market participants are able to neutralize the questionable nature of their activities by 1) not seeing their actions as illegal and by 2) questioning the credibility and competence of the SECP as their rightful regulator. Finally, this paper finds that a brokerage community exists that transacts on a relational basis, allowing them to engage in corrupt behavior with each other’s help.

2. A BRIEF OVERVIEW OF PAKISTAN’S CAPITAL MARKETS

2.1 Capital market structure in Pakistan

Pakistan’s capital markets came into existence shortly after the partition of India in 1947. The Karachi Stock Exchange (‘KSE’) was incorporated in 1949, starting out with 54 members and 13 listed companies with a paid-up capital of PKR (‘Pakistani Rupee’) 110 million.4 The Lahore Stock Exchange (‘LSE’) was set up in 1970 to “broaden the base of investment and develop the capital market in the central and northern zones of the country.”5 6 Later in 1989, the Islamabad

---

5 Ibid.
Stock Exchange (‘ISE’) was created. In 2012, the National Assembly and Senate of Pakistan passed the Corporatization, Demutualization, and Integration Act, 2012 (‘Demutualization Act’). This began the process whereby which the KSE, LSE, and ISE were demutualized and then integrated to form the Pakistan Stock Exchange by January 2016. Demutualization is the process by which the right to trade on the exchange is separated from the ownership right. The goal, enshrined in the Demutualization Act itself, was to attract a strategic investor that would help “increase efficiency and improve governance standards,” by divesting ownership from the broker dealers who previously owned, operated, and traded on the exchange. In December 2016, after a competitive bidding process, a 40% equity stake was awarded to a consortium of Chinese buyers, which included the Shanghai Stock Exchange. In this paper, the vast majority of the discussion will revolve around the KSE and the PSX, since the KSE has historically experienced the greatest turnover in Pakistan’s stock markets and is generally regarded as the primary exchange. This market is served by 342 brokers who act as intermediaries for investors but also trade on their own behalf. The Pakistan Stock Exchange has evolved into a major emerging market exchange, and the Pakistani capital market is a large, growing, and important sector of the economy.

The primary regulator for this market is the Securities and Exchange Commission of Pakistan which was founded on January 1, 1999, as a result of the SECP Act (December 1997). The SECP is the spiritual successor of the Corporate Law Authority (‘CLA’), which was a department of the Federal Government’s Ministry of Finance. The CLA had “been administering Corporate Laws in the country since 1981,” but “lacked autonomy and was a bureaucratic structure that made it difficult to effectively pursue transparency, disclosure and authenticity of operations

---

Note: This number is as of June 30, 2016.
in the financial sector.”

15 In the 1990s Pakistan faced rising external debt and diminishing debt servicing capacity, which got “international donor agencies, (such as the Asian Development Bank (‘ADB’) and the International Monetary Fund (‘IMF’)) in the fiscal and monetary policy making of the country.”

16 The rapid growth of the market during the early 1990s “highlighted the need for establishment of an independent regulatory body with full operational and administrative autonomy.”

17 The transition from CLA to SECP occurred through the efforts of the Asian Development Bank under a Capital Market Development Program created in conjunction with the government of Pakistan to “strengthen…securities market governance, institutions, regulation, and supervision” by giving “operational and financial autonomy to SECP in regulating the securities markets, nonbanking finance companies (‘NBFCs’) and corporate affairs.”

18 The SECP is today the “independent statutory regulatory authority for the superintendence and control of corporate entities, administration of the corporate laws and the beneficial regulation of the capital market.”

19 In its role as securities market regulator, the SECP supervises the primary securities market as well as the secondary market, and therefore the Pakistan Stock Exchange falls under its jurisdiction. The SECP is assisted in its supervision of the equity markets, by the PSX which functions as a self-regulatory organization making it the frontline regulator of the exchange.

The securities market in Pakistan is governed by a “multifaceted legal regime” set up by parliamentary statutes, government approved rules, SECP made regulations, and SECP approved Exchange regulations. In terms of infrastructural support of the stock market, the SECP is supported by the Central Depository Company of Pakistan Limited (‘CDC’) which was established in 1996 and which manages the Central Depository System, an “electronic book entry system for recording and transferring securities so that securities do not physically change hands.”

20 Additionally, the National Clearing Company of Pakistan Limited (‘NCCPL’) provides clearing and settlement services acting as a “central and geographically neutral clearing house for book entry securities for all three exchanges.”

2.2 Stock market crises

---


16 Ibid., 187.


21 Ibid., 11.

22 Ibid.
Since the inception of the SECP in 1999, Pakistan’s stock market has faced three major crises: in 2000, 2005, and 2008. These crises have been characterized by settlement issues and clearing default in leveraged trading products. There have also been repeated allegations of price manipulation and investor exploitation. Despite evidence of market abuses in these crises, no market participants have been held accountable. In many cases the SECP and the management of the three exchanges have intervened during the crises by taking decisions that have allegedly helped the broker dealer community accused of abuse. To fully understand the nature of Pakistan’s capital markets it is essential that the possible causes of these crises be analyzed along with events that transpired during and after. These crises have important implications for the market and understanding them will provide a sense of how the SECP, its associated regulatory institutions and broker dealers behave in a crisis environment.

2.2.1 Settlement issues and pump and dump in the KSE (1999-2001)

In May 2000, the Pakistani stock market experienced its first major crisis of the SECP era. The market fell by 27% from 1921 points on May 1, 2000 to 1399 points on June 9, 2000. The SECP Chairman at the time attributed the crisis to “out of settlement default...as a consequence of excessive overtrading and weak risk management at the stock exchanges.” At the time, margining and capital adequacy requirements for brokers were lax and the boards of the stock exchanges did not have adequate independent “non-broker” professionals as members. In its aftermath a requirement was made that the exchanges would need to have 40% independent non-broker dealer members and settlement of share transactions was reduced from a week to 3 days from the date of the transaction. From October to November 2000, the market experienced another sharp decline, in which speculators took advantage by using “blank sale” tactics according to the SECP, which they believe caused a further decline in the market. Blank selling (also known as naked shorting) is a primitive form of short selling. In short selling, broker A will borrow a particular security from broker B and sell it, with the expectation that the price will fall. Once the price falls, broker A will repurchase the security at that price and return it to broker B, profiting off the difference in price. A blank sale “means a sale by a broker on his proprietary account or on client’s account when the broker [neither] owns [the] shares,” nor has “confirmed the ability to” attain it from someone else. Their hope is that that they will be able to purchase the security at sometime within the settlement date, once the price drops, and provide it to their buyer. However,

---

25 Ibid.
26 Ibid.
27 Ibid., 13.
the market instead experienced settlement defaults, forcing the SECP to require brokers to “tender actual delivery of shares by borrowing stocks,” which meant that blank selling transitioned into traditional short selling.\textsuperscript{30}

In an analysis of KSE trade level data from 1999 to 2001, Asim I. Khwaja and Atif Mian, found that when “brokers trade on their own behalf, they earn annual returns that are 50-90 percentage points higher than those earned by outside investors.”\textsuperscript{31} They found compelling evidence that suggests this was due to a “specific trade-based “pump and dump” price manipulation scheme.\textsuperscript{32} A pump and dump scheme starts when “[stock] prices are low [and] colluding brokers trade among themselves to artificially raise prices and attract naïve positive feedback investors.”\textsuperscript{33} Brokers are able to start pump and dump schemes because they can trade on their own behalf as principal traders, however they also function as market intermediaries for retail and institutional investors.\textsuperscript{34} These positive feedback investors enter the market with the expectation that prices will continue to rise, allowing them to make a profit, which causes prices to further rise. The brokers also wait for the prices of their purchased securities to rise to a profitable level, selling those before the positive feedback investors do, “leaving [them] to suffer the ensuing price fall.”\textsuperscript{35} These brokers can then “potentially start another pump and dump cycle.”\textsuperscript{36} Khwaja and Mian consider the argument that the return differential for brokers could just be because as brokers they are more experienced, and therefore better able to profit from the market.\textsuperscript{37} However, after analyzing the data they conclude that there is evidence of price manipulation in the form of “frequent buying and selling of large numbers of shares in the process of generating artificial volume price changes.”\textsuperscript{38} Khwaja and Mian believe that for a pump and dump scheme to be economically viable, a market participant would need the advantage of limited transaction costs and access to “real time information about the movement in prices, volumes, and traders’ expectations.”\textsuperscript{39} Brokers are therefore likely to engage in such manipulation as having a brokerage license helps limit prohibitive transaction costs and “allows one to sit in close proximity to other market players and monitor information in real time.”\textsuperscript{40} Khwaja and Mian also find that pump and dump schemes are widespread across the stock market, since “the evidence is indicative of manipulation of stock prices by collusive brokers,” which allows them to earn “significant


\textsuperscript{32} Khwaja and Mian, “Unchecked Intermediaries,” 201.

\textsuperscript{33} Ibid., 205.

\textsuperscript{34} Ibid.

\textsuperscript{35} Ibid.

\textsuperscript{36} Ibid., 226.

\textsuperscript{37} Ibid., 225.

\textsuperscript{38} Ibid.

\textsuperscript{39} Ibid.

\textsuperscript{40} Ibid.
manipulation rents.” As far as Khwaja and Mian know, no broker at the time their paper was published had been prosecuted for improper activity.

2.2.2 Stock market crisis (2005)

The origins of the stock market crisis of 2005 are not dissimilar to what happened in 2000. Starting in “December 2004, and culminating in mid-March 2005, the KSE saw an unprecedented rise in the KSE 100 index, increasing by 65% from 6,218 on December 31, 2004 to 10,303 on March 15, 2005.” Subsequently, after March 15, the index experienced a “precipitous fall,” in the form of a “30 percent correction” as can be seen in the chart below.

Graph 1: Karachi Stock Exchange turnover (in billions) measured against stock market index from January 2004 till March 2005.

The graph above shows that there was a steady increase in the index from early 2004 onwards all the way till March 2005. An independent task force that investigated the crisis, believes the initial rise in the index was due to “increased liquidity due to higher remittances, a regime of low interest rates, improved corporate performance, higher oil prices, relatively liberal availability of COT (carry-over-transaction/badla) financing, initial public offerings (‘IPOs’) of public sector enterprises market for divestment and flotation of more mutual funds.” However, the sharp rise from December 2004 to March 2005, was accompanied by “exceptionally high trading volumes” with “an increase in the value traded around PKR 20 billion to a range of PKR

---

41 Ibid., 236.
42 Ibid., 212.
50-100 billion per day.” The taskforce attributed this to “increased COT financing, arbitrage between ready and futures markets, statements made by senior functionaries of the government, brokers and market analysts expressing highly optimistic view of the market index levels.” It is important, at this stage to discuss what exactly badla (translated as “in return”) or COT financing is, since it has remained a salient feature of the Pakistani capital markets and is a post-trade financing system unique to South Asia:

An investor or a broker buys shares with the intention to make a profit but without committing money directly. This is made possible by the investor carrying forward his position from one settlement date to another in a speculative trade with an agreed interest rate called the ‘badla rate’ which is determined by supply and demand. For example, suppose that an investor purchases X shares of a firm at price P on a given date. The trade has to be settled according to T+2 settlement two days later. If at the settlement date the investor does not have enough money to pay, he can arrange a financier (such as a bank or broker) to receive the shares from the seller. At the same time the financier sells those shares to the investor at a price higher than P. Thus, while the investor (speculator) enjoys the deferment of payment, the financier earns interest at a rate considerably higher than the prevailing market interest rate. The badla rates are higher due to the fact that trading is relatively insecure as the exchange does not guarantee this transaction and also because of the added uncertainty that share price in the market may go down. This is essentially a carry forward trade through a repurchase agreement but is different from futures trade since the badla rate is considerably higher than the risk-free rate which applies in the case of futures trading.

The positive market sentiment was already causing the index to rise, but according to the SECP taskforce the aggressive provision of badla financing seemingly accelerated its ascent. The task force believes that the hype created by brokers and government officials “stimulated the market sentiment, creating unwarranted confidence in the capital markets about the strength and sustainability of the escalation in the index and of the prices of listed stock.” What this meant was that the difference between ready and futures market far exceeded that which could be a result in a difference of interest rate. So liquidity holders or badla financiers, began to “purchase in the ready market with cash and sell in the futures market at the same time at inflated prices, locking in their profits.” Investors were willing to buy in the futures market because they “enjoyed huge leverage (being only required to put up 10 percent deposits initially), the mood of the market was

---

48 Ibid.
50 Ibid.
54 Ibid., 11.
bullish,” and trading profits they anticipated making far exceeded the cost of badla. The badla rates were exorbitant, capped at 17.5 percent in the KSE “but rose in the uncapped LSE to over 100%.” The “growing availability of badla financing from lenders who were largely brokers and institutions added to the buying frenzy in the market, raising stock prices on a daily basis and further amplifying expectations in the futures market.” The badla financiers in many cases “were the same people who were selling in the futures market, and thus benefitting from the heightened expectations of price rises in the future.” The task force believes that there “was a strong nexus between lenders and brokers/investors who could influence market sentiment to their own advantage.”

The task force also found evidence of wash trades, which are another way of pumping the market. A wash trade “is an illegal stock trading practice whereby an investor simultaneously buys and sells shares in a company through two different brokers … [which] … enhances the activity in the stock, giving the impression of active trading without any change in beneficial ownership, a clear violation of Section 17 of the Securities and Exchange Ordinance, 1969.” In the data the task force found “large instances of the same client or house account of a broker being both the buyer and seller” and “analysis shows that that the brokers and their clients largely dealt with each other in groups or sub groups at both a broker and client level.” The brokers were thought to have covered their tracks using other brokers and by not declaring whether their trades were on behalf of clients or themselves. They were also able to make use of benami (meaning ‘without name’) and group accounts. Benami accounts imply “use and benefit by a person other than the person who is shown as the owner.” These were only outlawed with the passage of the Benami Transactions (Prohibition) Act in February 2017. Group accounts were used by brokers to “post shares deposited with them by their investors … [made possible because] such shares were pooled together and held at the CDC, with insufficient clarity on beneficial interests.” Group accounts were eliminated in April 2005. There was “inter-trading between the top seven brokers … [i]t is noted that brokers often closed out any balance left from these trades with “off-market difference trades.”

---

55 Ibid.
56 Ibid.
57 Ibid.
58 Ibid.
59 Ibid.
60 Ibid., 13.
61 Ibid.
62 Ibid.
63 Ibid., 8.
64 Ibid.
66 Ibid.
68 Ibid.
On March 4, 2005, “the first signs of a change appeared as Badla providers started to pull Badla out.”\textsuperscript{70} The badla financiers who were “mostly brokers and to a lesser extent banks, with the five largest and ten largest financiers providing about 50 percent and 75 percent of total badla financing respectively.”\textsuperscript{71} The badla provided in the market peaked at PKR 40 billion (USD 674 million) in mid-February 2005 “falling to PKR 27 billion (USD 455 million) at end-March.”\textsuperscript{72} This sharp contraction in liquidity and turnover” caused the index to plunge with six stocks that made up 60\% of the KSE index contributing to a “75\% ... fall in the index.”\textsuperscript{73} Badla providers who also held large proprietary positions in the market as principal traders, “explained that they stopped financing because they began to worry about the sustainability of the market rise and the consequent ability of the Badla borrowers to repay their loans.”\textsuperscript{74} This seemed contrary to their original investment thesis where they seemed bullish, since they had been selling in the futures market. What happened next was immensely suspect. Many of the brokers had sold shares in the future market, locking in their arbitrage profit, but as prices began to fall (a direct consequence of a decline in badla financing), the potential of futures market buyers to default began to increase, putting the realization of these arbitrage profits at risk.\textsuperscript{75} As a result, the brokers began to lobby KSE management to design a bailout package for potential defaulters, so that they would be able to sell their shares and realize their profits. Additionally, the task force believed that some brokers who were sellers in the futures market did not in fact hold the shares they had promised to sell and were trying to deliberately depress the prices in the ready market (by pulling out badla financing) so they could pick them up cheap and then sell in the futures market, in order to maximize their profits.\textsuperscript{76} The task force believes that they were able to hide this through the use of group accounts. Investors who wanted to close their positions by selling off their securities, were unable to do so because market “circuit-breakers” kicked in.\textsuperscript{77} This meant that stock prices would not fall below a certain level, limiting the ability of investors to sell at prices that were higher than they should be, because of the circuit breaker. If investors wanted to maintain their positions, they would need to obtain financing, but since “badla financing was drying up,” it became increasingly difficult to “roll over their position” till the next settlement period.\textsuperscript{78}

On March 24, 2005, the KSE management and “some large brokers began efforts to design bail out plans for potential defaulters ... possibly aimed at protecting their own interests.”\textsuperscript{79} The task force believed that the KSE’s risk management system was adequate in dealing with default, despite which such an intervention was designed.\textsuperscript{80} In contravention of the rules, COT financing was not only extended for an additional time period to buyers in the ready market but also in the futures market which “enabled the weak buyers of March 2005 Futures Contract to manage their

\textsuperscript{70} Ibid., 15.
\textsuperscript{71} IMF, “Pakistan: Selected Issues,” 50.
\textsuperscript{72} Ibid.
\textsuperscript{73} Akhtar et al., “2005 Taskforce Report,” 17.
\textsuperscript{74} Ibid., 16.
\textsuperscript{75} Ibid., 18.
\textsuperscript{76} Ibid.
\textsuperscript{77} Ibid., 17
\textsuperscript{78} Ibid.
\textsuperscript{79} Ibid., 20.
\textsuperscript{80} Ibid.
settlement obligations due on March 30, 2005.” The task force believes that “this ingenious arrangement [that] extended COT was designed in violation of normal trading rules, benefiting some large arbitrage players … the regulators acquiesced to this procedure that circumvented the rules to benefit some large brokers who were sellers in the futures market.” Additionally there were some stocks (OGDC) for which even badla financiers were unwilling to extend financing, “so it became necessary to arrange a second and complementary bailout package for OGDC holders at the expense of public money.” A “consortium of institutions led by National Investment Trust (“NIT”) … arranged to buy shares of OGDC at Rs.117.50 from a whole range of sellers, some of whom had acquired these at the closing of the March contract.” This meant that some private investors were saved using public funds. The task force implies that the KSE board was conflicted by the presence of broker dealers who were being protected by the very intervention they had designed and “that some of the vested interest groups behind the KSE Board prevailed upon the KSE in informal meetings, of which no minutes or records have been maintained, to bend Badla rules to raise Badla rates, thereby protecting their interests and multiplying their returns.” They also found that “when the surveillance department [at the SECP] highlighted alleged serious breaches of rules, the KSE management was powerless to initiate appropriate action against rule violators mainly because of the conflict of interest at the Board.” To this day nobody has been held accountable in any way for the alleged misconduct that took place.

2.2.3 The global recession and Pakistan’s great stock market crash (2008)

Pakistan faced worsening macro-economic conditions in 2008. Rising oil prices resulted in a serious current and fiscal account deficit. The Pakistani Rupee began to significantly depreciate and there were massive levels of foreign capital flight, with foreign portfolio investment in the stock market falling. This occurred amidst a global recession and massive political sea change in Pakistan where a democratically elected government was taking over from General Musharraf’s dictatorship. At the time, the new government was also negotiating a new financial assistance package with the IMF. From May to October 2008, the credit rating agency Moody’s Investor’s Service downgraded Pakistan from B1 to B3, citing “growing economic imbalances and political difficulties.” In this context, the Pakistani stock markets began to experience a “liquidity crunch” with capital getting “diverted … to risk free investment avenues like [the government’s]

81 Ibid., 21.
82 Ibid.
83 Ibid., 23.
84 Ibid.
85 Ibid.
86 Ibid.
87 Ibid., 25.
National Savings Scheme,” investment in which increase three fold by the end of 2008. At the same time the Karachi Stock Exchange Index also began to decline. The KSE fell from an “all-time high level of 15,760 points on April 20, 2008” to “4,782” points shortly after December 14, 2008. While it would be difficult to determine what combination of macro-economic stresses, political uncertainty, and global shocks caused this fall in the market, the events that transpired in the time the decline occurred are of immense interest.

On June 23, 2008, invoking force majeure [(irresistible compulsion)] of the Exchange’s risk management regulations, it was decided by the KSE management and SECP Chairman that “to arrest the declining trend and to ensure stability of the market” a circuit breaker would be instituted whereby which prices could only fall by as much as one percent instead of the normal five percent. Short selling was also prohibited. The goal was to force the market upwards and “discourage exit of investors.” The old circuit breakers were restored on July 14, 2008, but the market continued to decline. The return to these original circuit breakers, according to an SECP mandated investigative task force, “enabled release of selling pressure which had accumulated during the period of revised circuit breaker limits.” Investors “desperate to stave off further ruin … appealed to management to put a stop to trading.” When the KSE management refused to consider their demand “the crowds stormed out, tore doors from their hinges and hurled stones through the windows.”

Consequently, a number of steps were taken to help investors exit the market including a special trading session on Saturday August 2, in which buyers and sellers could voluntary buy or sell shares at the closing price of Friday August 1, 2008. But at this time, brokers were also having difficulty meeting margin requirements. A meeting was held on August 27, 2008 between members of the KSE and its management in which “members expressed difficulty meeting the margin requirements of the exchange, the lending banks and financial institutions.” A 100 out of the 103 members urged the board to set a price floor on the market based on the “closing price of securities as of August 27, 2008.” A majority of the board decided to vote in favor of the price floor, including its five broker dealer members. The LSE and ISE also followed suit. The decision was submitted to the SECP for review where it was then approved. The “stated objective of the decision to impose the floor was to release the pressure of margin calls and to avoid multiple

---

94 Ibid., 22.
95 Ibid., 24.
96 Ibid.
98 Ibid.
100 Ibid., 30.
101 Ibid.
102 Ibid., 33.
defaults.”

During the hundred and ten days for which the exchange was closed, off market trading was also allowed and it was alleged that “brokers allegedly misused client shares by pledging the shares of their clients with the banks without authorization as well as depositing client shares for the purposes of meeting margin calls.”

The SECP filed criminal complaints in 2010 and 2011 against “five brokers guilty of failure to abide by code of conduct, failure to collect margins from the clients, non-segregation of client’s funds and shares, criminal misappropriation of property and criminal breach of trust.” Additionally, the KSE and SECP received a large number of complaints against brokers, “alleging misuse of client shares.”

The SECP task force charged with investigating this 2008 crisis, in their 2015 report, state that this misappropriation of shares can be attributed to the in house badla system. When investors purchase shares through the badla system, brokers are able to maintain custody of the shares, however no proper record of the transaction is kept, since no formal reporting system exists. This is “risky for the market [because it can lead to the] … misuse of client’s assets by the brokers in a distress situation.”

Brokers would be able to sell off their client’s securities, without informing them, to meet their own margin financing needs.

On December 25, 2008, it was announced by the NCCPL that they would be facilitating a deleveraging of the market through a voluntary square up scheme that would offset the positions of margin financers “to minimize the[ir] [losses] and “protect the financees from possible default proceedings.” This meant that brokers would receive a partial repayment of badla funds they had provided to investors so as to prevent “mass scale broker default.” Ultimately, in the 2015 report on the crisis, the SECP task force reiterated what the Competition Commission of Pakistan (“CCP”) (which holds responsibility for dealing with anti-trust issues) had asserted in 2009, that the decision of the price floor “raises questions of serious conflict on the basis of the vote of five broker directors who were to personally benefit from the decision for imposition of the floor.”

However, in the wake of this report, the current SECP Chairman stated that such an ulterior motive cannot be established and that “we do not want to waste energies on blame game and trying to see which broker made how much money in the process … best thing to do was to learn and move on so that things like this do not happen again.”

---

103 Ibid., 31.
104 Ibid., 30.
105 Ibid., 55.
106 Ibid.
107 Ibid.
108 Ibid., 76.
109 Ibid.
110 Ibid.
111 Ibid., 66.
2.3 Understanding implications of past broker dealer abuse

Despite such major crises, and in some cases clear evidence of market manipulation and abuse, the SECP has not done much in the way of prosecuting those against whom market abuse is alleged. In fact, Pakistan’s capital markets have never seen anyone go to jail for insider trading either, since it was only made a criminal offence in 2015.115 To this day, questions of accountability remain over what happened in 2000, 2005, and 2008. Badla financing was replaced with a stricter margin financing system in 2006, despite which as recently as March 2017, there have seen cases where brokerage institutions are still making illegal use of the in house badla system for trading in certain securities, that are ineligible for the current margin financing regime.116 The SECP does publically go after cases of market abuse, but it still begs the question why do we not see more cases publically highlighted? Why do we not see people go to prison? And why do market participants engage in such activities in the first place?

This question leads to the broader issue of corruption in emerging economies and what explains corrupt behavior. While the answer to the aforementioned question will surely be complex and multifaceted, it is still important to take a step towards making sense of what is going on. For the development of a robust capital market, it is essential to take steps to increase transparency in order to increase market depth and liquidity. This can only be beneficial to investors and the real economy in the long run. This paper looks at why broker dealers engage in different types of illegal trading activity such as wash trading, pump and dump and the use and abuse of badla financing in the first place through the lens of moral neutralization and rationalization. These are theories that explain how people develop ways to justify or explain away their corruption. From a policy standpoint, it is important to understand how these show up in the Pakistani context so that policy makers in the future can design effective interventions.

3. INSIGHTS FROM MARKET PARTICIPANTS

In order to understand the applicability of moral neutralization, rationalization, and ethical decision making theories, active market participants were interviewed. From these interviews emerged salient tropes regarding Pakistan’s capital markets.

3.1 Interviews with market participants

3.1.1 Interview design

A broad questionnaire was used to guide interviews, which were conducted in a conversational format. The complete questionnaire can be found in the appendix to this paper. Some of the questions asked were as follows:

1. What do you think constitutes an effective regulator i.e. what is the benchmark of an effective regulator?
2. Do you believe the SECP meets those criteria? If yes, how? And if not, why not? What are some of the SECP’s strengths and weaknesses?
3. Do you think the SECP handled the 2008 stock market crisis well?
4. Does the SECP today do a better job of mitigating systemic risk? i.e. if a crisis like the one in 2008 was to occur again, would the SECP be better prepared?
5. Under the SECP Act and its recent amendments, do you feel the SECP is provided adequate legal cover for it to be an autonomous organization?
6. Has the SECP created a regulatory regime that creates an enabling environment for investors and encourages development?
7. Do you think the criminal and civil justice system provide adequate support to the SECP in enforcing its rules and regulations?

Respondents would often stray off the topic from the question asked and discuss other facets of the market they thought interesting. There were times that questions were ignored or time would run out before the entire list was exhausted. Their assertions were nonetheless valuable in informing the claims of this paper. The pre-prepared questions were an easy way of bringing the conversation back on track so that there could be some comparability across the responses of different interviewees, which would help identify common ideas, beliefs, and themes.

3.1.2 Respondent profile

Respondents included a corporate lawyer specializing in mergers and acquisition and dispute resolution, a financial sector executive, an individual who is a former member of the Pakistani Stock Exchange (formerly the Karachi Stock Exchange) as well as another supporting regulatory institution, a partner at a major accounting firm, and two former members of the capital market regulatory regime. At this point I would like to provide a disclaimer that I have a personal connection with my respondents and in one case a pre-existing relationship, through my father who in his professional life has remained intimately involved in Pakistan’s financial markets both as a private market participant and member of the SECP. I did not use my father as an interview subject.

3.1.3 An overview of interview responses

These interviews yielded a multi-faceted portrayal of Pakistan’s capital markets and all the actors involved. The claims and assertions of the interview participants were not taken on face value, but made for a good starting point to start an investigation on a narrow topic of interest related to the SECP and Pakistan’s capital markets. Their responses were also critical in understanding if the statements of market participants support the theories espoused in this paper of what could potentially explain corrupt behavior in the Pakistani capital market. From the interviews emerged salient tropes, including common areas of concern, on which there were both converging and diverging opinions. The interview findings have been organized into these tropes, which will be referred to throughout the paper as evidence in the context of the theoretical
framework that has been adopted to answer the research question: why do market participants engage in corrupt behavior in the first place?

These tropes were as follows:

1. The SECP’s main functions are to regulate and develop but it can be heavy handed in its policing of the market without giving due attention to the developmental aspect of its mandate
2. Market participants maintain that the SECP has serious human resource constraints which handicap its enforcement capabilities
3. A perception exists that the SECP is not entirely independent since it is susceptible to undue political influence and broker exploitation which could potentially result in the poor enforcement of rules and regulation
4. The legal system provides inadequate support to the SECP in the fulfillment of its enforcement responsibilities and the SECP itself does not make full use of its judicial powers to investigate and prosecute white collar crimes
5. The 2008 crisis was created by global shocks but worsened by poor enforcement by the SECP which allowed exploitative brokers with vested interests in the market to force a price floor in their favor
6. SECP regulation is copied from Western countries and does not fit Pakistan’s unique context

3.2 Discussion of salient tropes emerging from the interviews

3.2.1 The SECP’s main functions are to regulate and develop but it can be heavy handed in its policing of the market without giving due attention to the developmental aspect of its mandate

There was a consensus amongst respondents that they see the SECP as occupying two main roles: 1) that of regulator and 2) market developer/enabler. In the words of one respondent, “the SECP should develop capital markets, match savings through potential investment, and ensure that it is well regulated and the interests of all stakeholders are looked after.” They all felt that this role as a “champion for the market” must be carefully balanced against its role as a regulator, ensuring that the markets are “fair, transparent, and have adequate liquidity.” Interestingly enough, this was a view shared broadly by private sector participants as well as individuals who have occupied various positions in the capital markets regulatory regime. Some important problems they have felt the regulator has had to address over time has been that of badla financing, proper disclosure of material information to the public, and market illiquidity. While dealing with these issues, in their view, the SECP has gone from little or no regulation since its inception through the Securities Act of 1997, to having “substantial” and “onerous” overregulation. The SECP has come a long way in terms of its ability to better regulate the Pakistani capital markets from a time of “rampant abuse” to “a real tightening of the regulatory environment, market volatility has reduced, the most blatant form[s] of abuse [such as] pump and dump, pulling of liquidity, … [the] kinds of abuse that were very common have practically disappeared.” The SECP has improved since the 2008 crash by bringing in “systems that allow it to track what happens in the market, the amount of disclosure for investors has gone up, as have trading requirements.”

Issues that remain, however, include, a lack of incentives for savings to be directed into the capital markets, reliance on volatile forms of leverage trading, ill formed margin financing regime, inadequate provision of liquidity, and failure to develop new and innovative market instruments. This emphasis on regulation, however, creates a tension with the SECP’s role as a
market enabler. In the words of one respondent “regulation has to be commensurate with the development of the economy,” while two other respondents both lamented the absence of a coherent and clear “roadmap” for the development and implementation of these regulations, to allow market participants an appropriate time horizon to adjust to changes. The criticism is that the SECP’s response to issue after issue “has been to clamp down” by behaving like a “policeman” instead of engaging in constructive reform and development, which leads to the second issue broached by most respondents: the quality and capability of the SECP’s human resource.

3.2.2 Market participants maintain that the SECP has serious human resource constraints which handicap its enforcement capabilities

A number of respondents believe that the SECP has poor human resource and this presumably contributes to its inability to implement better regulations and enforce the market properly. One respondent asked that: “they have plenty of regulation which is not the problem, [but] do they have adequ[ate]…HR capacity to complement the overall governance capacity?” It seems that other respondents believe that “quality HR and leadership has all been missing.” One private sector executive argued for the need to have “competitive” salaries and “merit based advancement in the organization,” to ensure that the best people occupy executive level positions. Pursuant to the Corporatization, Demutualization, and Integration Act, 2012, the SECP decided to sell a 40% stake in the demutualized Karachi Stock Exchange (now PSX) to a technical partner. This was sold to a consortium of Chinese investors in December, 2016. One of the respondents believes that this is a mistake, that a technical partnership will not bring in better human resource and solve the Exchange’s problems. They go on to say that the current SECP management is altogether incompetent, but does not think anything is to be gained from the technical partnership and the foreign management it might bring.

3.2.3 A perception exists that the SECP is not entirely independent since it is susceptible to undue political influence and broker exploitation which could potentially result in the poor enforcement of rules and regulation

Two respondents identify another issue with the SECP’s staff: appointment of individuals who may be corrupt, incompetent or cronies of the political establishment. One of the respondents believes that there are three ways by which the regulator can be handicapped by the regulated who do not want it to “function properly”: 1) “by making the regulatory organization toothless or disempowering it, either by getting political people to influence it or 2) by removing its authority, so you make it unable to do what it is supposed to and 3) put people who are not very capable or honest” in positions of power. This respondent goes on to say that the current SECP leadership plays to a “political agenda.” This all against the backdrop of a society that does not have “a very high moral standard” so it makes sense that “regulations [and] laws are not implemented.” The other respondent brings up the topic of parliamentary oversight and how the top appointments at the SECP are made. They believe that there needs to be a “parliamentary committee that vets the

---

117 In the United States, human resource is often understood as the management of benefits such as payroll etc. However, when these interview participants talk about human resource they are referring more broadly to the term human capital, which covers the quality of talent present in an organization.
chairman” and holds it accountable. Additionally, the same respondent cites issues with the makeup of the SECP’s policy board, which includes members of the finance ministry, whom they believe can “undermine the SECP.”

While nobody stated directly or insinuated in any way that any current member of the SECP is compromised or that the Federal Government is exerting undue influence, these responses all raise important questions about what exactly prevents the development and enforcement of good regulation, management that is honest but incompetent, competent but corrupt, both or is the issue more complex than that?

3.2.4 The legal system provides inadequate support to the SECP in the fulfillment of its enforcement responsibilities and the SECP itself does not make full use of its judicial powers to investigate and prosecute white collar crimes

Another common issue brought up was the inadequate roles the courts play in helping the SECP fulfill its regulatory responsibilities “which becomes a basic impediment to good governance” and the lack of white collar crime prosecutions coming out of the capital markets. There was a general consensus that the judicial system is “poor” and “lethargic,” but fundamental to the success of the regulator, however it will take many years for it to become mature enough to play a sophisticated role in the regulatory regime. One respondent states the following:

The regulator over time has tried to overcome and address all these issues, a lot has happened. The weak link is the court system. It is very under capacity, the ability to prosecute for white collar crime is backward, our legal structure is limited and does not cater to it. There is no prosecution of white collar crime, the test will come when we try to come to the court. Total criminal complaints filed are 3-4: that area remains extremely weak, even though the regulator may have an improved legal backing in terms of structure, the regulator’s human resources quality has gone down—there is new enactment that give it powers to prosecute and punish. But it is beyond the SECP’s control to fix the court system.

In addition to this, another respondent states that the SECP’s “primary role is to prosecute and take action against regulatees, we have not seen enough of that—we have not seen withdrawal of licenses.” This respondent believes that the SECP is not making effective use of its judicial powers, as “market abuse investigations” have simply disappeared. These are important to “ensure there is a level playing field for all stakeholders in the marketplace.” This is a particular sore point for this respondent as he believes that “market abuse was a very big factor in [the] 2008 [stock market crisis], which the SECP has simply “glossed over” not mentioning any perpetrators in its investigative report on the matter. Another respondent admit that “prosecution is not being done in the right manner.” This leads to the next point brought up in interviews, the 2008 stock market crisis, which one respondent described as a “watershed” moment in the history of Pakistan’s capital markets.

3.2.5 The 2008 crisis was created by global shocks but worsened by poor enforcement by the SECP which allowed exploitative brokers with vested interests in the market to force a price floor in their favor
One respondent drew a sharp distinction between the 2005 and 2008 crises (discussed extensively in section two). For them, “a crisis took place because a lot of people took leveraged positions but this was not a bubble like that in 2005.” This respondent states that a “run up in oil prices” and drastic fall in “domestic liquidity” resulting in a liquidity crisis caused stock market prices to come down forcing margin calls on brokers, suggesting that broker representation on the KSE board meant that the decision to institute the price floor could be taken in their favor, which is why “people” talked about the “need for demutualization” at the time. Another respondent agrees to an extent that global shocks caused a market down turn and that there was “too much” broker representation, [with] many of them conflicted at that time.” However, exacerbating reasons included speculation and market abuse in the form “a major pump and dump … [which meant that] some of the stocks were ramped up and investors were sucked in, which the regulator has not acknowledged.” There were other forms of abuses such as the “withdrawal of client securities” during the four month price floor period which the respondent believes the SECP did not try to intervene. The “inability to spot speculation and market abuse” were the “singular failings” of the regulator according to this respondent. They further assert that “the market was falling continuously…there was significant chance that market would default” since margins were not being collected properly. Eventually there were riots at the KSE and an overpowering broker representation on the KSE board, in a major conflict of interest, resulted in the price floor being set. The “prime reason for [the floor] … was to collect margins.” Summing up what the impact of the crisis was, the same respondent stated “very serious damage was done in those 4 months, investors lost because someone sold their shares, confidence was shattered, because [they were] unable to trade for so long, [KSE was] chucked out of [the Morgan Stanley Capital International (MSCI)] emerging market index, [and] foreigner[s] exited.”

On the topic of broker dealer vested interests, another respondent stated that there are “monopolies in the capital markets” and “there is exploitation,” and while the stock exchange may have been demutualized “the same brokers are there who…indirectly or directly control the exchange.” While referring to the 2008 crisis, one of the SECP members cited “regulatory capture by the private market” as an issue, stating that the SECP can only be “as effective as the ecosystem around it allows it to be.”

3.2.6 **SECP regulation is copied from Western countries and does not fit Pakistan’s unique context**

A point which the respondents did not discuss in much detail but is nonetheless important, was that they believe that much of the regulation the SECP writes is transplanted from western countries without any due consideration for local context. They find this to be problematic as they believe it hinders the SECP’s ability to develop Pakistan’s markets on the basis of its own unique context.
4. NORMALIZATION OF CORRUPTION AT THE BROKERAGE HOUSE LEVEL

The normalization of corruption refers to how norms of corrupt behavior can become deeply embedded in business organizations. The goal of this section is to understand, to what extent such normalization exists among broker dealers in Pakistan through two major explanatory factors: institutionalization and neutralization. This section also seeks to gain insight through these two factors as to why individuals in broker dealer organizations would engage in corrupt behavior at all. These theories will be tested against responses from interview participants as well as the historical record. This evaluation of the evidence would have important implications, as it would suggest that deeply embedded norms of corruption exist that are problematic since they erode trust in the market and its regulating institutions, dis-incentivizing new investment, and as a consequence preventing the market’s growth.

4.1 The multi-step normalization of corruption in business organizations

The study of moral neutralization in the context of business corruption is devoted to understanding why, otherwise good and decent people in their work environments engage in corrupt behavior. The seminal paper on moral neutralization was published in 1957 by Gresham M. Sykes and David Matza. In trying to explain juvenile delinquent behavior they realized that an “individual can avoid moral culpability for his criminal action—and thus avoid the negative sanctions of society—if he can prove that criminal intent was lacking.”118 Their argument essentially is that “much of delinquency is based on what is essentially an unrecognized extension of defenses to crimes, in the form of justifications for deviance that are seen as valid by the delinquent but not by the legal system or society at large.”119 These justifications are called rationalizations and not only do they prevent feelings of guilt in the perpetrator but also make deviant behavior possible in the first place.120 The deviant is then able to use techniques of neutralization (justifications for deviant behavior) and engage in behavior that directly contradicts the moral norms of society.121

These techniques of neutralization are discussed in the context of the normalization of corruption in business entities by Blake E. Ashforth and Vikas Anand who look at how “corruption becomes normalized, that is embedded in the organization such that is more or less taken for granted and perpetuated,” allowing “upright individuals [to] routinely engage in corruption without experiencing conflict.”122 They define corruption as the “misuse of authority for personal, subunit and or organizational gain” and look at “collective corruption” which are “acts that require cooperation among two or more individuals.”123 Their focus is more on groups engaging in such behavior inside organizations than across multiple organizations.124 They suggest three pillars on

---

120 Ibid.
121 Ibid., 667.
124 Ibid., 3.
the basis of which corruption becomes normalized in such entities: 1) institutionalization, “where an initial corrupt decision or act becomes embedded in structures and processes and thereby routinized,” 2) rationalization (a subset of neutralization), “where self-serving ideologies develop to justify and perhaps even valorize corruption,” and 3) socialization, “where naïve newcomers are induced to view corruption as permissible, if not desirable.” These pillars are “mutually reinforcing & interdependent; once established in an organization, the pillars create a situation where corruption is practiced.”

4.2 The normalization of corruption through institutionalization

For Ashforth and Anand, the first step towards normalization of corruption is the institutionalization of that corruption. Institutionalized corruption falls into the broader category of institutionalized organizational behavior, which they define as “stable, repetitive, and enduring activities that are enacted by multiple organization members.” The path from the “initial, idiosyncratic” corrupt act to pervasive corruption throughout the organization occurs in three stages: 1) the initial corrupt decision or act, 2) embedding corruption in structures and processes and 3) routinizing corruption.

4.2.1 Phase 1: the initial corrupt decision or act—price manipulation and investor exploitation on the KSE

According to Ashforth and Anand, the strongest explanation for the initial act taking place is that actors, given a “permissive ethical climate” at the firm, will engage in “amoral or immoral calculation” by analyzing the risks and rewards of a particular act, thus making corruption “economically rational.” Interview participants in this study agreed, that two of the clearly defined roles of the SECP are to regulate and to develop the market. In its regulatory role, the SECP according to one participant has led a “real tightening of the regulatory environment” since the 2008 crisis and that “the most blatant form[s] of abuse [such as] pump and dump, pulling of liquidity … [the] kinds of abuse that were very common have practically disappeared.” But the fact is that these activities do seem to have taken place in the past. Evidence of such collusive pump and dump activity was uncovered by Khwaja and Mian, and the SECP also alleged misuse of badla and wash trading during the 2005 crisis. In fact criminal complaints were instituted against brokers who misused client shares to meet the margin requirements of the in house badla system. In 2000, the SECP also noticed use of blank sales (which although legal at the time), were abused as brokers experienced repeated settlement default. It is clear that if a broker dealer was to engage in such activities, from a rational economic perspective these activities would be profitable as they are designed to exploit pricing differences. Therefore, it can be said with certainty that the initial decision to engage in corrupt action has occurred in brokerage houses. Many of the respondents also believe that the SECP does not prosecute white collar crimes properly, with one participant stating that “we have not seen withdrawal of licenses” and that “market abuse investigations” have

125 Ibid.
126 Ibid.
127 Ibid., 4. (citation omitted).
128 Ibid., 5.
129 Ibid., 6.
simply disappeared. This again implies that abuses have been thought to have taken place in the past.

Such acts of corruption are made more permissible by the presence of leadership that “reward, condone, ignore, or otherwise facilitate corruption.” Such leadership can authorize corruption, explicitly or otherwise, leaving the employees compelled to comply since the “habit of obedience … is so strong and pervasive that most people have a difficult time actively defying orders they do not condone.” Additionally if the leader is charismatic, they can use the fealty of their employees to enable corrupt activities. Neither the historical record nor the interview findings would suggest that the leadership of these brokerage firms were directly involved in compelling their employees to engage in such activities across the board. There was one case in which Munir Ladha, the owner of Eastern Capital, was directly implicated in misappropriating client shares by pledging them to banks in order to obtain financing during the 2008 crisis. His name was put on the Exit Control List but he managed to flee the country to Dubai. A former employee of the company accused Ladha of “looting the company’s employees” and the KSE Head of Operations stated that according to reports Ladha had been involved in looting money for years. In this case the leadership was directly involved in the corrupt behavior. Finally, Ashforth and Anand state that “organizational structures and processes are often contrived to insulate senior managers from blame, thereby further encouraging corruption.” They explain that in a business environment that emphasizes performance, engaging in corrupt activities to achieve good performance is made possible if the firm has “minimal oversight and documentation” of business activities. This makes it possible for managers to plausibly deny any corrupt act, since the fundamental set up of the organization facilitates secrecy. It is hard to say and would be a matter of speculation, whether such an environment exists in brokerage firms in Pakistan.

4.2 Phase 2: embedding corruption in structures and processes — a deviant sub-culture within broker organizations in Pakistan

In Phase 2 of the normalization process, Ashforth and Anand assert that once an individual corrupt act yields a positive outcome, when the same issue comes up again “if solutions are not readily obvious, answers are sought from the memory because: (1) past decisions and acts are assumed to have been made for rational reasons; and (2) following a precedent helps legitimate the decision and act.” This creates an easy heuristic that has been validated by past success and can be used again without the need to give due consideration to any ethical implications around

---

130 Ibid., 7. (citation omitted).
131 Ibid. (citation omitted).
132 Ibid.
134 Ibid.
135 Ibid.
137 Ibid. (citation omitted)
138 Ibid. (citation omitted).
139 Ibid. (citation omitted).
Therefore ‘if the renewed corrupt practice results in a positive outcome an even stronger precedent is set for the future ... [where] the organization comes to expect and depend on the payoffs from corruption.’ These heuristics slowly become embedded in the organization’s culture after repeated usage and ‘the result is institutionalized corruption: personal behaviors become impersonal norms, emergent practices become tacit understandings and idiosyncratic acts become shared procedures.’

There is limited evidence among interview responses of a precedent having been set for repeated corrupt activities. While discussing the SECP’s role as a regulator, one respondent has stated that the worst kind of abuses, including pump and dump, the pulling of liquidity from the market, have fallen since 2008 as the SECP has tightened regulation. That would suggest that a previously profitable strategy may have come to have been viewed as costly by broker dealers. The use and misuse of badla for example has repeatedly occurred over the years and this abuse has allegedly yielded positive results for brokers in the form of exorbitant arbitrage profits. More recently, since 2011, with the evolution of the margin financing regimes, the criteria of stocks for margin eligibility has become stringent. Since all stocks are not eligible for this form of financing, some brokerage houses still provide badla financing to investors as it can generate extra profits form stocks not eligible to the legal margin regime. This would mean that since badla in its least regulated form has remained such a popular and deeply embedded practice in brokerage houses, it continues to be used as an easy way to solve the problem of margin ineligibility for certain stocks, despite being illegal. If that is the case then it would seem that a precedent to circumvent the margin financing regime does exist but perhaps not as deeply as Ashforth and Anand contend that it must in order to become problematic.

As these corrupt practices become embedded in the organization’s behavior, a “deviant culture” emerges that normalizes future corruption. The payoffs that can be obtained from normalized corrupt activities result in widespread beliefs and values that “rationalize the corrupt practices in ways that neutralize the stigma of corruption.” This culture is at odds with the wider culture of fairness in society, but because of the “countervailing norms and beliefs” that have been allowed to develop within the organization, its employees become insulated from societal norms and beliefs. This breeds a climate in which secrecy and “obfuscation [are] the order of the day” and employees begin to use techniques of neutralization. Another interesting facet of this deviant culture discussed by Ashforth and Anand is how individuals possess an identity repertoire and select their identity based on the local context, which makes their behavior more permissible. Ashforth and Anand say that “an individual develops social identities specific to the social domains, groups and roles—and accompanying subcultures—that he or she occupies (e.g. manager, mother, parishioner, sports fan).” This means that an individual’s moral yardstick at work as compared

140 Ibid., 9.
141 Ibid.
142 Ibid.
145 Ibid.
146 Ibid.
147 Ibid. (citation omitted).
148 Ibid., 10.
to the outside world may be very different because of the particular identity assumed, and therefore their actions will accommodate local needs, thus neutralizing any concern of corruption and favoring their “group[s] at the expense of outsiders.”

Essentially “localized social identities and cultures tend to be highly salient.” This means that “the individual may bend his or her general commitment to ethics under the press of local circumstances.”

When discussing the role of exploitative and conflicted brokers during the 2008 crisis, one respondent stated that there are “monopolies in the capital markets” and that while the stock exchange may have been demutualized now “the same brokers are there who…indirectly or directly control the exchange.” This respondent did not elaborate on the methods whereby which such control over the exchange might be maintained. If this is indeed true then that would mean the broker dealers of the PSX operate in an environment where they see themselves as the actual controllers of the market as opposed to the SECP itself. This would mean that in an environment in which they see themselves as in charge of the market, neutralizing any concerns of fairness associated with corrupt activities becomes easy, resulting in the worsening of a deviant sub-culture. Furthermore, the idea the brokers somehow control the market means that local identities become all the more easily accessible with considerably less thought for the obligations to society at large.

It is entirely possible that corruption at a firm level may extend to an industry wide level. Such “industry level corruption is more likely in mature industries, where time and stability facilitate dissemination.” Ashforth and Anand state that “an important factor in industry wide corruption is that governing bodies that are responsible for, or have the capacity to monitor, industry behavior may themselves become part of the institutionalized system of corruption.” We know from the interview findings that a perception exists that the SECP is not entirely independent since it is susceptible to undue political influence and broker exploitation. An interview participant claims that the SECP “plays to a political agenda.” Another respondent states that the fact that the SECP’s policy board has members from the Ministry of Finance “undermine[s] the SECP” as it leaves it open to interference by politicians. This same respondent believes that political interference is how some brokers regulated by the SECP manage to make it “toothless or disempower [it]” to serve their own end. While referring to broker exploitation during the 2008 crisis, one of the respondents cited “regulatory capture by the private market” as an issue, stating the SECP can only be “as effective as the ecosystem around it.” Another respondent stated that the “CDC was being used for abuse, SECP has responsibility for monitoring CDC activity…this was a very big failure of the SECP.” They go onto say that “once in this mode, getting out of it became harder, after a while the government got involved which the brokers loved…and [the] four months, while the floor was in place, there was no proactive involvement of the SECP to prevent market abuse.” Evidently, inroads exist whereby which the SECP could become compromised either by political or broker dealer influence or sheer incompetence (not being able to pick up on market abuses in a timely fashion). This would mean that the regulator itself becomes part of a wider system of institutionalized corruption by either getting co-opted by broker dealers or inadvertently if it fails to provide adequate oversight.

---

149 Ibid. (citation omitted).
150 Ibid.
151 Ibid.
152 Ibid., 11.
153 Ibid. (citation omitted).
Ashforth and Anand state that it is entirely possible that agencies responsible for regulating a given industry may become coopted by the actors in that industry and “develop tacit agreements to turn a blind eye” especially if a revolving door is in place where the regulator plans on joining the industry at some point in a private capacity.\textsuperscript{154} None of the interviewees mentioned a direct revolving door between the SECP and the private sector. However, the perception persists that the SECP is under capture by the actors it is meant to regulate and there has been a noticeable unwillingness on the part of the SECP to prosecute brokers in the wake of major crises in the past, which could potentially encourage industry wide corruption and so, further its institutionalization.

4.2.3 Phase 3: routinizing corruption—limited evidence among interview responses

In Phase 3 of the institutionalization process, corruption becomes routinized and habitual.\textsuperscript{155} Routinizing can “neutralize the salience of corruption in four ways.”\textsuperscript{156} The first way is that corrupt activities becomes such deeply embedded and persistent norms that the organization stops reviewing and thinking about the ethical implications of these activities.\textsuperscript{157} The second way is that the corrupt act gets divided up into different specializations, with responsibility for each task spread across the entire organization.\textsuperscript{158} This means that no one person is aware of the bigger picture and so people may be performing a task that on the surface seems above board, without knowing that it is actually part of a bigger corrupt practice.\textsuperscript{159} The third way is that once an individual is in the system there is no getting out since “one is effectively locked in by dense task connections such that the whole sustains each part; one is swept by the momentum of the system.”\textsuperscript{160} Finally, with deeply embedded norms of corruption, the focus becomes on the processes involved in the corrupt activity, instead of the goal itself which means that employees are not too concerned with the corrupt nature of the activity and are habitually performing tasks.\textsuperscript{161} There is no direct evidence in the interview responses of any of these aspects of routinization. Gathering such evidence would require intimate discussions with broker dealer employees to understand if pervading routinization exists. A general comment is that given that there is evidence of pump and dump schemes, price manipulation, illegal use of badla going back over a decade, it is not unlikely that such practices or their supporting tasks could have become routinized.

4.3 Normalization of corruption through techniques of neutralization/rationalization

Techniques of neutralization are used by individuals in business organizations to justify their corruption. This according to Ashforth and Anand is the second pillar of the normalization of corruption and it focuses more on individual decision making when it comes to the question of engaging in a corrupt act or not as opposed to how such acts become norms across the entire

\textsuperscript{154} Ibid. (citation omitted).
\textsuperscript{155} Ashforth and Anand, “Normalization of Corruption,” 11.
\textsuperscript{156} Ibid.
\textsuperscript{157} Ibid., 12.
\textsuperscript{158} Ibid.
\textsuperscript{159} Ibid.
\textsuperscript{160} Ibid. (citation omitted).
\textsuperscript{161} Ibid.
organization. They find that “corrupt individuals tend not to view themselves as corrupt.”

“Individuals convicted of white collar crimes tend to acknowledge errant behavior but nonetheless deny criminal intent and the label of criminal.” These individuals may also “continue to value fairness, honesty and so forth, even as they engage in corruption.” Individuals are able to make use of rationalizations that “these ideologies help distance individuals and groups from the aberrant moral stance implied by their actions and perhaps even forge “a moral inversion, in which the bad becomes good.”

According to Ashforth and Anand, these rationalizations become more “potent when institutionalized in the collective—when they are a shared resource that all can draw on and mutually affirm.” Within the group “the rationalizations are intended for internal consumption [so] the issue is not their objective validity but whether the group accepts them as subjectively valid.” These may sound to outsiders as “patently self-serving attempts to legitimate questionable acts.”

The two rationalizations that were evidenced in interview responses were legality and social weighting.

4.3.1 Legality—brokers take advantage of legal loopholes

The concept of legality means that “actors may excuse corrupt practices on the grounds that they are not actually illegal.” Based on the investigations into all of the crises it is clear that products like badla have been misused, client securities misappropriated, regulations altered on an ad hoc basis by exchange management, benami and group accounts used to hide collusive trading activity. In the discussion of broker exploitation during the 2008 crisis, one interview participant explicitly mentions how there was a possibility of the market defaulting since margins were not being collected properly and client securities were also being withdrawn to be pledged as collateral to banks who had lent the brokers money. While defaulting is not necessarily illegal, it can still be considered unethical, especially if done deliberately. Brokers took big positions on the stock market, and it seemed that they knew full well that they did not have the collateral to meet margin requirements. This seems to have been confirmed by the government bailout. Their desire to make abnormal profit may have superseded any consideration for ethics or legality, making it permissible for brokers to engage in such activities.

This rationale could also explain the use of group or benami accounts by broker dealers in hiding their transactions. While not illegal, these accounts were used to prevent investigators from tracing the beneficial interest of trading activities. The brokers could feel that they were “simply taking full advantage of what the law … permitted.” This flexible understanding of legality is similar to the lax enforcement of regulations which could also neutralize concerns about how bad these acts really are since they do not receive punishment. We know that one of the tropes that emerged from interviews was that respondents felt the SECP did not enforce its regulations.

---

162 Ibid., 15.
163 Ibid. (citation omitted).
164 Ibid. (citation omitted).
165 Ibid., 16. (citation omitted).
166 Ibid. (citation omitted).
167 Ibid., 17. (citation omitted).
168 Ibid.
169 Ibid., 18. (citation omitted).
170 Ibid.
properly and did not have support from the legal system. One of the respondents stated that “there is not prosecution of white collar crime” with limited criminal complaints filed each year. In fact, in data provided by the SECP tells us that there have been thirty-two enquiries/investigations since 2009 but there were only two criminal complaints in 2007, one in 2011, three in 2013, two in 2015, and eight in 2017. From March 2012 till March 2017, the SECP has fined approximately PKR 55 million to market participants. It is plausible that even when known that such activities are illegal, the participants may be willing to take on fines, knowing that jail time is not a prospect they need to be concerned about. The SECP itself has shown itself to be lax in holding individuals accountable for big crises, with the current SECP chairman on record as saying that they do not wish to attribute blame to broker dealers in the 2008 crisis.

A combination of loopholes in market products, availability of group or *benami* accounts, and lax accountability by the SECP could therefore mean that the legality of their actions are not of great concern for broker dealers. This would mean that concerns of the act being illegal are neutralized.

### 4.3.2 Social weighting—the SECP has its fair share of detractors

Social weighting refers to “how much attention and credence one actor gives to the values and beliefs of another.” One subset of this, which is especially salient to Pakistan, is the condemning of the condemners “which involves impugning the legitimacy of those who would cast the act or actor as corrupt.” Ashforth and Anand suggest that “the corrupt may characterize a disliked law as vague, complex, inconsistent, rarely enforced, punitive or politically motivated such that enforcement is capricious or malicious.” This would mean that actors may not see their act as corrupt since they defy the very legitimacy of the laws and enforcers above them.

In the interviews with market participants such an image of the SECP does emerge. One of the main tropes was that the SECP has two clearly defined roles: regulator and developer with considerably less attention paid to the latter role. One respondent stated that regulation enforced by the SECP is “onerous” and burdensome for the growth of the market since it is “badly regulated.” For them much of the regulation should be “repealed” and replaced with regulation that is “pragmatic.” Another respondent said that the SECP’s regulations are not “commensurate with the growth of the economy,” that the SECP behaves like a “policeman.” For this same respondent, the SECP regulates Pakistan with laws that are meant for mature countries, such as takeover laws, and that these laws “add substantial amount of timeline on transactions.” They believe that the application of such laws can be delayed and that the SECP must think of itself “as partner in development and less as a policeman because [the] engine of growth is the private sector.” Another respondent stated that the SECP has indeed tightened regulations but they have jolted the system since this was done in a short period of time without presenting any roadmap to the intermediaries to prepare. Furthermore, a respondent stated that there should be “clarity of objectives” in what the SECP is trying to do with the market. In interviews market participants believed that the SECP does not enforce its regulations properly and that it does not enjoy enough support from legal

---

171 This data was provided to me upon my personal request to the SECP.  
172 Ibid.  
institutions like the courts. The judicial system has been described as “lethargic” and “under capacity” and the SECP as not having “taken [enough] action” against those who engage in illegal activities. The SECP as mentioned before, is also thought to be susceptible to political influence. One mechanism through which this is possible is the presence of members of the Ministry of Finance on the SECP’s policy board, which one respondent believes can “undermine the SECP”.

Finally, there also exist concerns about how the SECP has serious human resource constraints, that “quality HR and leadership has all been missing,” which raises doubts about its ability to effectively govern.

A portrait of a SECP emerges that is not considered entirely credible as a regulator of the market, with its activities constantly in questions. It is seen as a heavy-handed policeman, unable to display a well-thought-out vision for market development, at times politically motivated, and in some ways incompetent due to doubts about its staff. If such an image exists in the mind of the respondents, then it is absolutely plausible that many broker dealers think the same way, raising questions about the legitimacy of the SECP and therefore discounting their role as regulator. A lack of respect for the SECP would serve as a powerful neutralizing force for any actor wishing to engage in a corrupt activity and is highly problematic for the future of Pakistan’s capital markets.

4.4 Is there sufficient evidence of the normalization of corruption?

It would be a stretch to say that corruption has become deeply normalized across the board in brokerage houses. However, it would not be wrong to think that elements of this normalization do exist. It is clear that corrupt activities have taken place in the past and that there has been a precedent set for activities like pump and dump, misuse of badla etc. as they are immensely profitable. In that sense, such activities would seem to exist on an institutional level, where it is not only one trader engaging in them but individuals across the organization as well. We also know that evidence exists of the use of techniques neutralization by brokers such as legality and social weighting, and that these can explain why brokers engage in corruption in the first place. However, it is difficult to claim that these activities are deeply embedded.

5. A DYNAMIC CONSTRUCTIVIST APPROACH TO UNDERSTANDING BROKER DEALER CORRUPTION

5.1 Three decision frames by which individuals view corrupt activities

In “Beyond Black and White: Three Decision Frames of Bribery,” Xiao-Xiao Liu, George I. Christopoulos & Ying-yi Hong, suggest that an individual can “employ three Decision frames to [construe a bribe-giving situation]: the ethical (i.e. moral aspects), economic (financial outcomes) and relational (utility derived from social interactions).”174 The individual attaches weights to each

---

of these frames of thinking about the decision and these weights determine choice. These weights can be influenced by social-psychological factors such as moral and organizational identity and cultural factors such as institutional environment, cultural values, and social norms. It is plausible that these socio-psychological and cultural factors have salience when it comes to the Pakistan stock market and will be extending this framework to activities such as price manipulation and insider trading.

The ethical frame is “defined as the perception that the situation involves an ethical decision, which leads to subsequent ethical judgment—that there is a “right” or “wrong” dichotomy.” Because engaging in a corrupt action can “violate the rule of fairness,” a “fundamental principle of morality” and also ostensibly hurt others, framing the decision in this way would “suppress the intention to give bribes” or engage in price manipulation or insider trading. However, as discussed in the previous chapter Liu, Christopoulos, and Hong also believe that this does not always have to be the case, since individuals can morally disengage from the decision by making “use of cognitive mechanisms to reframe one’s actions to downplay the ethical aspects” which would make the corrupt decision more permissible. This is not very different from techniques of neutralization.

The economic frame “sets up a framework where within which bribery is perceived as an economic transaction.” What this essentially means is that decision makers engage in a cost benefit analysis before making a final call. They weigh the costs and benefits in economic terms. This is a straightforward decision frame which this paper will not devote too much time too as it come up time and time again in explanations of what motivates corrupt behavior. The relational frame “indicates the perception that the situation involves concerns for building interpersonal relationships.” For example, if two parties are exchanging a bribe, then maintaining the relationship could become a salient concern over the ethical implications of the act since “the act is no longer considered as bribery but as a social exchange to develop interpersonal relationships.” The question for Liu, Christopoulos, and Hong now becomes how do individuals weight these different frames and what affects these contexts i.e. socio-psychological and cultural factors. This section will use the insights uncovered from various investigative reports discussed in section two and tropes from interviews to see to what extent Liu, Christopoulos, and Hong’s framework can be used to understand the motivations of market participants in various crises, and the implications of this moving forward.

### 5.2 Identity and decision frames—broker dealer networks controlling the exchange

---

176 Ibid.
177 Ibid., 6.
178 Ibid., 6-7. (citation omitted).
179 Ibid., 7. (citation omitted).
180 Ibid.
181 Ibid.
182 Ibid., 8.
183 Ibid.
Liu, Christopoulos, and Hong, assert that an individual’s identity plays an important role in their decision making process, that “following recognition of a situation,” individual will ask “how will someone like me react to this type of situation?”

So it is entirely plausible that an individual’s organizational identity i.e. “the social classification that individuals derive from their membership with social groups,” could motivate a broker dealer to engage in price manipulation, since the organization’s success and failure could be seen as their own.

This means that the economic frame would emerge as salient, neutralizing any ethical concerns of the act. We already know from respondents when discussing broker exploitation during the 2008 crisis, that pump and dump and misappropriation of client securities was highly lucrative. Furthermore, such individuals in broker dealer organizations could also possess unique social identities by which they “classify themselves based on group memberships” that “inform who they are in their social identity, and distinguish themselves from outgroups.”

Liu, Christopoulos, and Hong, propose that “in group identity could enhance the use of the relational frame as members within the social group are bonded to form an in group and the interactions within this group are guided by interpersonal principles such as reciprocity.”

This could make it permissible to bribe or engage in the kind of collusion that Khwaja and Mian talk about since these actions are benefiting the in group members. This they believe is particularly important for the emergence of “dynamic development of bribery networks.” This could be a plausible explanation for collusive broker dealer networks.

The dynamic constructivist view of culture states that culture is the product of “shared knowledge networks among a group of people.” This implies that whether people view an act such as a bribe or price manipulation is highly dependent on what their culture dictates, and this in terms impacts the decision frame they use to evaluate their decision. So calling something a bribe is “already a perception based on an ethical frame.”

It could also be seen as “grease money from an economic frame or gift from the relational frame.”

These cultures do not simply have to be national but could also be organizational or communal.

So if indeed there has been evidence of widespread broker dealer collusion, it is entirely plausible that knowledge networks exist where individuals do not believe acts like price manipulation, the illegitimate use of badla, insider trading are morally suspect but in fact the means by which business is done. Furthermore, in respondent discussion on the 2008 crisis that there was a suggestion of a “conflict of interest” when the decision to institute the price floor was taken since there was an overwhelming broker dealer representation on the board. Another respondent states that even if the exchange has been demutualized to wrest control from brokers, there exist “monopolies in the market” and that “the same brokers are there who…indirectly or directly control the exchange.” Yet another respondent states that the exchange is subject to “regulatory capture” by the private market. This would evidence the existence of networks in the market that result in a broker dealer community that often works together to protect its own interest, which would create an environment where corrupt activities can be considered normal.

---

184 Ibid., 17. (citation omitted).
185 Ibid., 18.
186 Ibid., 20.
187 Ibid.
188 Ibid., 22. (citation omitted).
189 Ibid.
190 Ibid.
191 Ibid.
5.3 The relational frame in relationship-based cultures

It would be fair to say that Pakistan in most spheres of life has a relationship-based culture as opposed to a rules-based way of getting things done. In “a rules based system, people generally respect and trust rules and law.”\(^{192}\) Relationship based cultures “emphasize familism, a value system centered on family relationship and preferential treatments towards one’s kin.”\(^{193}\) This, according to Liu, Christopoulos, and Hong “would arguably give rise to corruption and deviance from universalist rules and merit” where fairness to the public is subordinated by in group loyalty since “not fulfilling this duty to benefit in group members can be judged as immoral, which my override the ethical concern of being fair.”\(^{194}\) Zulfiqar Ali of the University of Karachi has demonstrated that this already occurs in the political sphere in Pakistan, such that “ethnic loyalties by taking precedence over the public interest give rise to the ‘moral view of corruption’, which explains why so many people do not view the use of public office for ethnic gain to be an act of corruption.”\(^{195}\)

If we look at the network of broker dealers, then it is possible that the relationship based culture that exists where broker dealers have helped each other settle trades and engage in pump and dump activities in the past. This could have led to a culture where in group loyalties are so strong that other forms of corrupt practices could also take place, making the relational frame of ethical decision more salient in the decision-making process. As we know from the previous section, broker dealers exist as part of a larger community, and in such a setting the relational frame of decision making could take precedence over the ethical frame, arguable paving the way for individuals to engage in corrupt activities more easily.

6. CONCLUSION

In almost every report published by the International Organization of Securities Commissions, the International Monetary Fund, and the task forces established by the SECP, demutualization was recommended to wrest control of the exchanges away from brokers so that they could not make use of their networks to engage in illegal activity. It was not until 2016 when the stock exchange was finally demutualized, and its ownership rights separated from its trading rights, ensuring that broker dealers could no longer be in charge. Given that demutualization took such a long time, it is possible that deeply embedded networks of brokers are in place which could be used to exploit the market in the future and that brokerage organizations could go further down the path of corruption normalization, especially driven for how long they many of them have been allowed to persist without any significant sanction by the SECP.

This is extremely dangerous for the Pakistani capital markets as it means that the markets remain exposed to the potential of abuse in the absence of policies designed to break these networks and reverse the neutralization techniques many individuals in these brokerage houses

\(^{192}\) Ibid., 24.
\(^{193}\) Ibid.
\(^{194}\) Ibid. (citation omitted).
may have adopted to rationalize their corrupt activities. While we have discussed many of the tropes in the context of the theories used in this paper, they deserve to be mentioned again, in and of themselves as they also provide insight into other factors that may be allowing corrupt behavior.

For future research, it is essential that researchers on this topic look at the impact of a weak court system and human resource constraints within the SECP on the prosecution of white collar crime. This would help glean important insight into whether those problems create an environment in which market participants do not fear getting caught or sanctioned too harshly, and therefore become more willing to engage in corruption. The other issue to look at would be the degree of political interference in the SECP, and whether or not it really helps brokers or other market participants place cronies in the SECP and other regulatory organizations. Finally, an interesting claim was made by one of the respondents that even with demutualization, the brokers still maintain indirect control of the PSX. This would be a worthy topic to investigate, since if this claim were true, it would bring into question the benefits of demutualization which has been major inflection point in the history of Pakistan’s capital markets.
BIBLIOGRAPHY


**APPENDIX**

**Interview questionnaire**

1. In your view, what is the role of the SECP?

2. What do you think constitutes an effective securities regulator i.e. what is the benchmark of an effective regulator?

3. Do you believe that the SECP meets those criteria? If yes, how? And if not, why not? What are some of the SECP’s strengths and weaknesses?

4. What changes do you think need to be implemented to make it more effective?

5. Do you think the SECP handled the 2008 stock market crisis well? Should the degree of government intervention that took place i.e. setting of a price floor on the exchange, have been allowed to happen?

6. Does the SECP today do a better job of mitigating systemic risk? i.e. if a crisis like the one in 2008 was to occur again, would the SECP be better prepared?

7. Under the SECP Act and its recent amendments, do you feel that the SECP is provided adequate legal cover for it to be an autonomous organization?

8. Do you think the new amendment to the SECP Act which requires the initiation of a case against any entity regulated by the SECP to be first referred to the SECP is a step in the right direction?

9. NCCPL has recently started offering a facility whereby investors can keep their cash with NCCPL instead of brokers and settle their trades directly from the security / cash accounts maintained with NCCPL. This eliminates the risk of misappropriation of cash for investors. Is this another step in the right direction?

10. Has the SECP created a regulatory regime that creates an enabling environment for investors and encourages development?

11. How does the SECP rank up against other regulators in terms of effectiveness?

12. Do you have a view on how the SECP compares to regulators in other jurisdictions?

13. Do you think the criminal and civil justice system provide adequate support to the SECP in enforcing its rules and regulations?