

VIS

Credit Rating Company Limited

BROKER FIDUCIARY RATINGS

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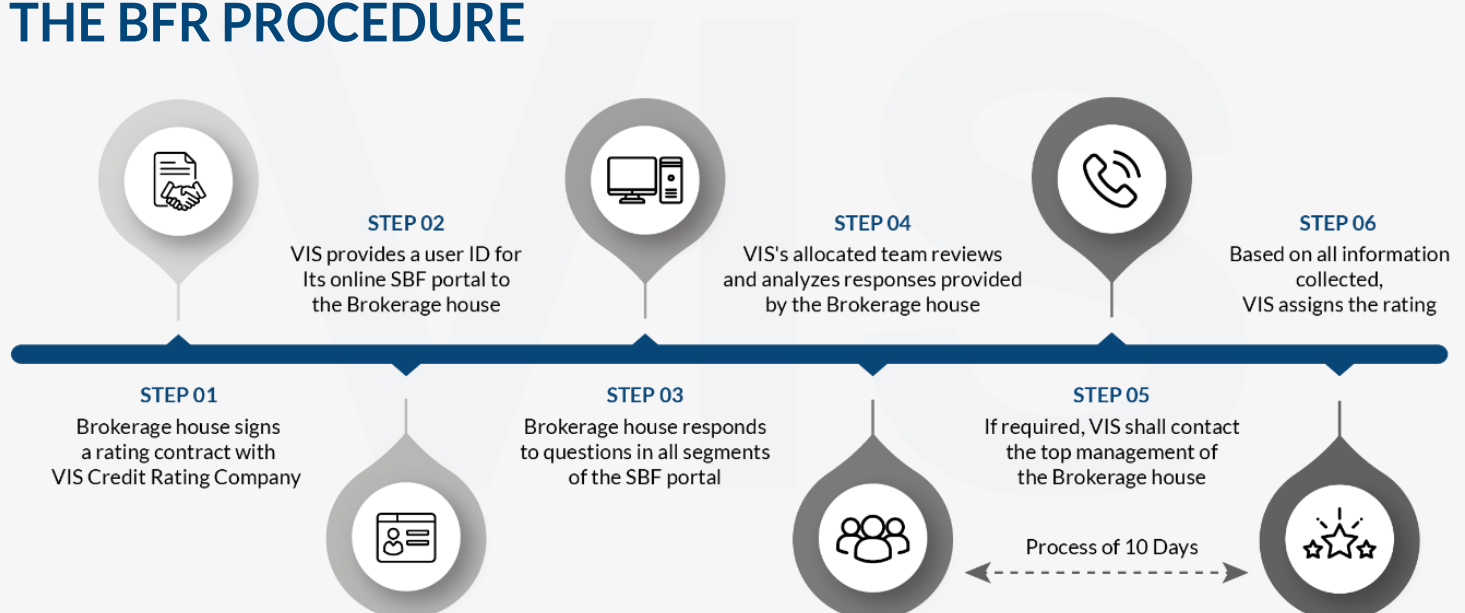
Securities brokerage firms play a critical intermediary role in the capital markets for individuals as well as institutional investors by facilitating the trading of listed securities and fixed income debt instruments. Generally, these firms serve the basic function of distributing and trading financial instruments for customers, financing customer positions, and providing advisory and underwriting services. The assessment of the fiduciary role of a broker in the equities and fixed income securities trading process is very important as in this capacity a brokerage firm is responsible for managing the client's assets for the benefit of the client, rather than own profit.

In Pakistan, securities brokers are governed by the regulations issued by the Securities and Exchange Commission of Pakistan (SECP). In March 2023 through the issuance of S. R. O. 361 (I)/2023, SECP rationalized the rating requirements for securities brokers and proposed to move towards a single rating regime, Brokers Fiduciary Rating (BFR). As per the said SRO, the minimum rating requirement for Trading & Clearing (TC) brokers under Brokers Licensing Regulations shall be BFR 2. The minimum BFR required to be maintained by Trading & Self-Clearing (TSC) brokers under Brokers Licensing Regulations shall be specified as BFR 3. The BFR required to be maintained by brokers applying for the license of Consultant to Issue (CTI) under Public Offering Licensing Regulations shall be specified as BFR 3+. The brokers applying for the license of the Underwriter are required to maintain a minimum of BFR 3++.

Under the BFR methodology, the strength of fiduciary role of the securities brokers is captured through the relative financial strength of the securities broker firm and its sponsors along with depth of internal control and governance framework, which are key rating ingredients. Responsiveness of the risk and internal control structure, quality of HR and soundness of the business infrastructure determine the strength of management and level of service quality of a securities broker. VIS Credit Rating Co. Ltd. (VIS) has developed a rating system that evaluates brokerage firms on the basis of such practices and the systems instituted to safeguard investor interests are at the forefront.

The methodology for BFR developed by VIS is unique in the sense that it utilizes a comprehensive, client friendly interactive web-based portal to capture client information and responses and then assimilates them into a rating. The process is supported at the back-end by rating staff who review the information online and interact with the client to complete the assignment of the respective SB.

THE BFR PROCEDURE



All brokerage firms in Pakistan have to be TREC (Trading Right Entitlement Certificates)-holders of Pakistan Stock Exchange (PSX). The PSX is regulated by the Securities and Exchange Commission of Pakistan (SECP) which has established rules to regulate the brokers and listed companies. The SECP and PSX have imposed strict restrictions on securities trading in order to protect market participants. These rules provide investor protection through minimum capital, exposure limits and margin requirements. Financial audit, system audit, in-depth surveillance by the SECP and PSX as well as the CDC audit is mandatory for brokerage firms; VIS also utilizes the findings of these in its assessment for this BFR methodology.

To assess the quality of operations of a brokerage firm, various factors are examined and analyzed. While the table below summarizes the individual factors and related parameters considered critical, the BFR is not limited to these factors alone.

1	Ownership and Governance	Sponsors financial strength, depth of corporate structure and implementation of governance principles from risk and regulatory perspective
2	Business and Financial Stability	Strength of capitalization, core revenue contribution and growth. Prudence in risk limits for business lines and leveraging. Sound asset quality with sustained profitability and robust liquidity. Recognized franchise value in market sphere.
3	Management and Client Services	Well documented and defined business process flow focused on transparency and free of any conflict of interest. Responsive and interactive client management systems managed by professionally competitive personnel.
4	Control Framework and Regulatory Compliance	Robust internal control systems dovetailed with business process flows to ensure timely adherence to internal policy frameworks and regulatory compliances.

A. INDIVIDUAL RISK FACTORS AND ASSESSMENT

A. (i) Ownership and Governance

Brokerage firms operate in a fiercely competitive sector, where their trading operations are significantly influenced by the economic climate and market cycles. The goal of VIS's rating for securities brokerage firms is to evaluate their ability to offer professional advisory and transaction services in an environment free of conflicts of interest, ensuring the secure handling of client assets and prompt fulfillment of financial obligations. This evaluation includes an analysis of the financial robustness of the firm's backers, assessing whether they have sufficient resources to manage the risks they face. The assessment also extends to corporate governance practices to verify that the interests of all stakeholders are adequately safeguarded. In examining governance standards, VIS reviews the board's composition, its collective experience, and the effectiveness of its oversight functions. The presence of independent directors is viewed favorably.

Furthermore, the assessment encompasses a comprehensive view of the firm's corporate structure, which goes beyond the financial strength of its promoters to include their reputation and the value of their brand. This holistic approach ensures a thorough understanding of the firm's operational integrity, governance frameworks, and the effectiveness of its risk management and internal control systems, providing insights into how well the securities firm upholds its fiduciary duties. B. Business and Financial Stability.

B. (i) Capitalization, Debt and Liquidity

PSX has established capital requirements for TREC-holders and have also imposed allowable trade limits in relation to capital which establishes the maximum trading activity that can be undertaken by a SB. This, in addition to the risk arising

from other lines of business undertaken by a company, will be evaluated to determine the adequacy of capitalization and the extent of its leveraging. While credit, liquidity, concentration and market risks may be apparent from the company's financial statements, judgment is required on the level of operational risks, litigation and reputational risks involved in the business being undertaken. Composition of funding sources, maturity profile, and diversity is also taken into consideration, while future funding needs and sources are also identified. Analysis of liquidity would include the company's ability to liquidate its investment portfolio in a short span, raise borrowings/ avail un-utilized credit lines and cover repayment of liabilities.

B.(ii) Profitability

Trend analysis and comparisons with industry benchmarks are employed to evaluate the relative financial performance of a company. This process involves dissecting revenue and cost structures by distinct business or product lines and analyzing contributions from various customer segments. The evaluation takes into account the performance of the company's investment portfolio, gains from proprietary trading, revenues from client transactions, and other consistent income streams. Such analyses over time and against industry peers shed light on a brokerage firm's (SB) risk management efficacy relative to its competitors.

Key performance indicators include the pre-tax return on funds employed, revenue volatility, operational efficiency, and any deviations from market performance, with an analysis of the underlying causes. The firm's actual performance is also measured against its forecasts, with investigations into any discrepancies.

VIS examines a company's financial agility, particularly its ability to adapt costs during downturns in market activity and to leverage fixed costs across a broader operational scale. The ongoing ability to cover both fixed and variable costs with core earnings is a testament to financial flexibility. Analyzing the cost per transaction provides insights into the pricing flexibility a company possesses. It is generally expected that larger companies will benefit from economies of scale, enhancing their competitive edge and financial sustainability in the market. C. Management & Client Services.

C. (i) Human Resources

The success of an organization is deeply rooted in the consistent application of its business strategy and the robustness and steadiness of its management team. The experience and historical performance of top management, especially through various economic cycles in the capital markets, are crucial assets. The way key personnel, including client managers and portfolio managers, are compensated is indicative of the organization's approach to mitigating potential conflicts of interest.

Moreover, the processes of succession planning and the development of employees through training are pivotal. The ability to attract and retain talented professionals is essential for maintaining the quality of the organization's operations and ensuring its long-term success. A comprehensive approach to human resources, focusing not just on recruitment but also on nurturing and professionally developing staff, underpins the organizational resilience and adaptability. This multifaceted strategy towards management and staff fosters a culture of excellence, innovation, and ethical practice, which are key determinants of an organization's sustained success and competitive advantage in the market. C. (ii) Client Services.

Timely execution of orders is a critical determinant of broker effectiveness, necessitating a robust IT infrastructure as its cornerstone. This infrastructure ensures that trade orders are processed promptly, minimizing risk for both the investor and the brokerage firm. The integrity and efficiency of these IT systems hinge on well-established processes, practices, and technological solutions designed to safeguard investments. Regular system audits are vital, offering an independent

evaluation of the IT infrastructure's capabilities and potential weaknesses, thereby ensuring continuous improvement and reliability.

The Securities Brokerage Firms Best Practices Framework (SBFBFR) underscores the importance of an IT system's ability to swiftly detect and manage exposure limits, and to issue timely warnings when these limits are approached or breached. Such functionality is essential for maintaining operational integrity and managing risk effectively.

In the client-centric world of stock brokerage, service quality significantly impacts a firm's competitive edge. Evaluating a broker's performance involves looking at the diversity and quality of products offered, the depth of research provided to clients, the transparency of information dissemination, and the efficiency and cost-effectiveness of executing transactions. Additionally, the procedures for handling customer complaints and the regularity and quality of communications about clients' portfolio statuses, values, and trade alerts across multiple platforms play a pivotal role in assessing a brokerage firm's commitment to customer satisfaction and service excellence. These elements collectively contribute to a brokerage firm's reputation, client loyalty, and operational success in a highly competitive market.

D. CONTROL FRAMEWORK & REGULATORY COMPLIANCE

D. (i) Control Framework

The internal control framework of a brokerage house is pivotal in addressing potential conflicts of interest between the brokerage's own trades and those of its clients. It ensures rigorous Know Your Customer (KYC) processes are in place for client verification and maintains the confidentiality of client transactions. This framework mandates that operational policies and manuals are regularly reviewed, updated, and approved by the appropriate organizational levels to ensure compliance and efficiency.

VIS underscores the importance of robust controls designed to protect the fiduciary duty of brokers. This includes safeguarding client assets—specifically, ensuring that clients' positions and cash balances are securely separated from those of the brokerage and other clients. This separation is crucial to prevent the entanglement of client assets in legal disputes in the event of the brokerage's failure. A strong system for authorizing trade executions is also regarded favorably, as it contributes to the integrity and reliability of brokerage operations.

The external control framework benefits significantly from the Quality Control Review (QCR) ratings awarded to external auditors by the Institute of Chartered Accountants of Pakistan (ICAP) and their classification within the State Bank of Pakistan (SBP)'s auditor categories. These ratings and classifications provide a benchmark for the external auditors' credibility and the reliability of their audits, enhancing the overall governance and accountability within the brokerage industry.

D. (ii) Regulatory Compliance

The regulatory landscape for brokerage firms is not only a legal necessity but also a crucial mechanism for safeguarding investor interests and minimizing risk exposures. Adherence to these regulations is fundamental for maintaining the integrity of financial markets. Brokerage firms are required to align not only with local laws but also with international standards and guidelines related to conflicts of interest and ethical conduct, ensuring these principles are at the forefront of their operations.

VIS conducts thorough reviews of the regulatory frameworks governing securities firms, including any updates or changes, to assess the level of protection provided to market participants and the potential risks that securities firms

might undertake. This evaluation includes an analysis of the information that these firms are mandated to report to regulatory bodies at specified intervals. Such scrutiny helps VIS form an informed opinion on the robustness of a firm's regulatory compliance and its commitment to upholding high standards of investor protection and risk management. This ongoing review process is integral to ensuring that securities firms operate in a manner that is both compliant and conducive to fostering trust and stability in the financial markets.

BFR VALIDITY

The rating assigned to a security brokerage firm will be valid till such time as withdrawn and is reviewed generally, on an annual basis. VIS may at any time deem necessary to change the rating assigned to the firm depending on changes to corporate practices affecting the governance profile of the institution.

RATING SCALE & DEFINITIONS

Rating scale and Definitions may be accessed at (<https://docs.vis.com.pk/docs/VISRatingScales.pdf>)





Faheem Ahmad

President & CEO, VIS Credit Rating Company Limited
 Founder, VIS Group Chairman,
 Vice-Chairman, Association of Credit Rating Agencies in Asia

Mr. Ahmad possesses 30+ years' experience in financial risk assessment with focus on Islamic finance, venture capital and general management. He has top level management experience at international level in the fields of credit ratings, Islamic and conventional financial risk assessment modeling, industrial management and construction engineering. Mr. Ahmad is an active participant at international forums on Credit Ratings. He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters Degrees in Engineering and Business Administration from USA.



Javed A. Callea - Member

Advisor

Mr. Callea is a professional in the financial sector with over 35 years of experience mostly in the financial institutions with certain exposure to service and infrastructure sectors in Pakistan. He has held the position of Chief Executive of a leasing company for 10 years. His core areas of expertise cover leasing, development financing, project management, investment & merchant banking, strategic investment management and real estate. Major financial institutions he worked for include Pakistan Industrial Credit and Investment Corporation, State Life Insurance Corporation, Bankers Equity, Crescent Leasing Corporation and Saudi Pak Ind. & Agri. Inv. Company. He has also served as Member Finance of Water & Power Development Authority of Pakistan and as member of the Inquiry committee on stock exchange crises in 2000 commissioned by the SECP. He earned his MBA degree from the Institute of Business Administration in 1974.



Muhammad Bilal Aftab

Director

Bilal joined VIS Group at its inception and since has been engaged in most research and development ventures undertaken by the group companies. Prior to joining JCR-VIS, he has been engaged with other VIS Group Companies in different capacities. Bilal was also a key resource in coordinating and developing the methodology for "Mapping National Scale Ratings over Sovereigns in Asia", which was spearheaded by the CEO, JCR-VIS. His career spans over 25 years and includes work experience in the Middle East and local stock market brokerage houses. He holds an MBA degree and has also completed various courses in Economics and Investment Analysis and Data Science.

NATIONAL EXCELLENCE

INTERNATIONAL REACH

Jahangir Kothari Parade (Lady Lloyd Pier) Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavilion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose generosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

Dome: A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.

Origins: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.

VIS Credit Rating Company Limited is committed to the protection of investors and offers a blend of local expertise and international experience to serve the domestic financial markets. With its international reach, VIS is positioned to aim for an international mark. In this regard, the global experience of our international affiliates and partners have been invaluable towards adding depth to our ongoing research endeavors, enriching us in ways, that enable us to deliver our responsibilities to the satisfaction of all investors. The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its 'Dome' as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, VIS continues its endeavour to remain an emblem of trust.

INTERNATIONAL

Affiliates

Islamic International Rating Agency – **Bahrain** – iira.com
Credit Rating Information & Services Ltd. – **Bangladesh** – crislbld.com

Collaborations

Japan Credit Rating Agency, Ltd. – **Japan**
China Chengxin International Credit Rating Company Limited – **China**

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