

VIS

Credit Rating Company Limited

BROKER MANAGEMENT RATINGS

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SCOPE OF CRITERIA

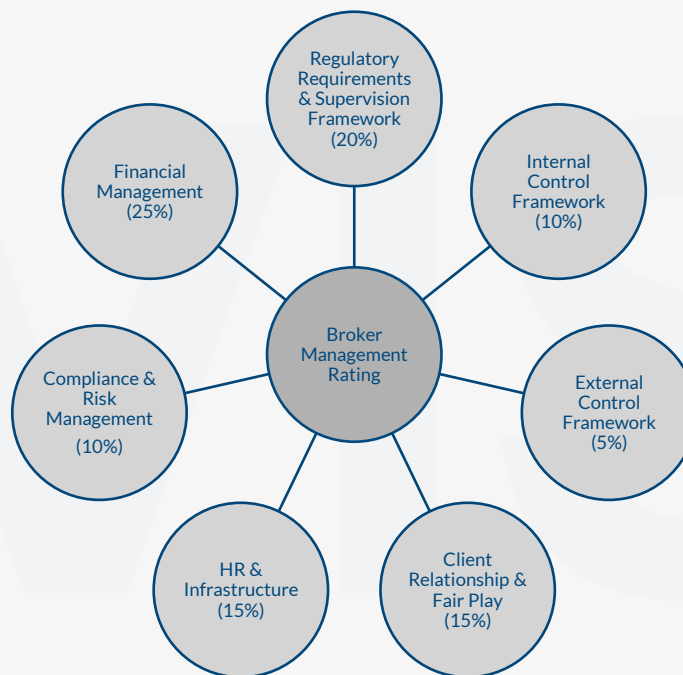
The criteria titled “*Brokerage Management Ratings*” apply to the evaluation of entities formally recognized as Stock brokerage firms which serve as essential intermediaries in capital markets, assisting both individual and institutional investors in the trading of listed securities. The quality of service provided by these firms is fundamentally determined by their financial robustness, the comprehensiveness of their governance frameworks, the effectiveness of their risk and internal control mechanisms, and the strength of their human resources and business infrastructure. Evaluating the fiduciary responsibility upheld by brokers in the trading of listed securities is crucial; the aforementioned elements are key indicators of a brokerage firm's capacity to fulfill this role.

SUMMARY OF CRITERIA CHANGES

The Broker Management Rating Methodology dated February 2024 has been reviewed, and the fundamental criteria outlined therein remain unchanged.

AN OVERVIEW OF RATINGS FRAMEWORK

A firm's financial strength signals its ability to withstand market volatility and safeguard client assets. A deep and well-structured governance framework reflects a commitment to transparency, ethical practices, and accountability. Responsive risk and internal control systems are vital for adapting to changing market conditions and protecting against financial misconduct and operational failures. Moreover, a robust HR and business infrastructure enable the delivery of innovative services and efficient client support, further reinforcing the firm's role as a trusted partner in the capital markets.



In addition, the integration of technology and compliance with evolving regulatory standards are also vital in enhancing the operational efficiency and regulatory compliance of brokerage firms. These elements combined ensure that brokerage firms not only meet but exceed the expectations of their clients while upholding their fiduciary duties, thereby playing a pivotal role in the integrity and functioning of the capital markets. VIS Credit Rating Co. Ltd. (VIS) has developed a rating system that evaluates brokerage firms on basis of such practices and the systems instituted to safeguard investor interests.

The methodology for Broker Management Rating (BMR) developed by VIS is unique in the sense that it utilizes a comprehensive and client-friendly interactive web-based portal to capture client information and responses which are then assimilated into a rating. The process is supported at the back-end by rating staff who review the provided information online and interacts with the client to complete the assignment of respective BMR.

THE BMR 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 Securities and Exchange Commission of Pakistan (SECP) which has established rules to regulate brokers and listed companies. The SECP and PSX have imposed strict restrictions on trading procedures 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; wherever available VIS uses the relevant findings of these in its assessment for BMR methodology.

To assess the quality of operations of a brokerage firm, various factors are examined and analyzed. While tables below summarize critical individual factors and related parameters, BMR is not limited to only these.

INDIVIDUAL RISK FACTORS AND ASSESSMENT

A. REGULATORY REQUIREMENTS AND SUPERVISION FRAMEWORK

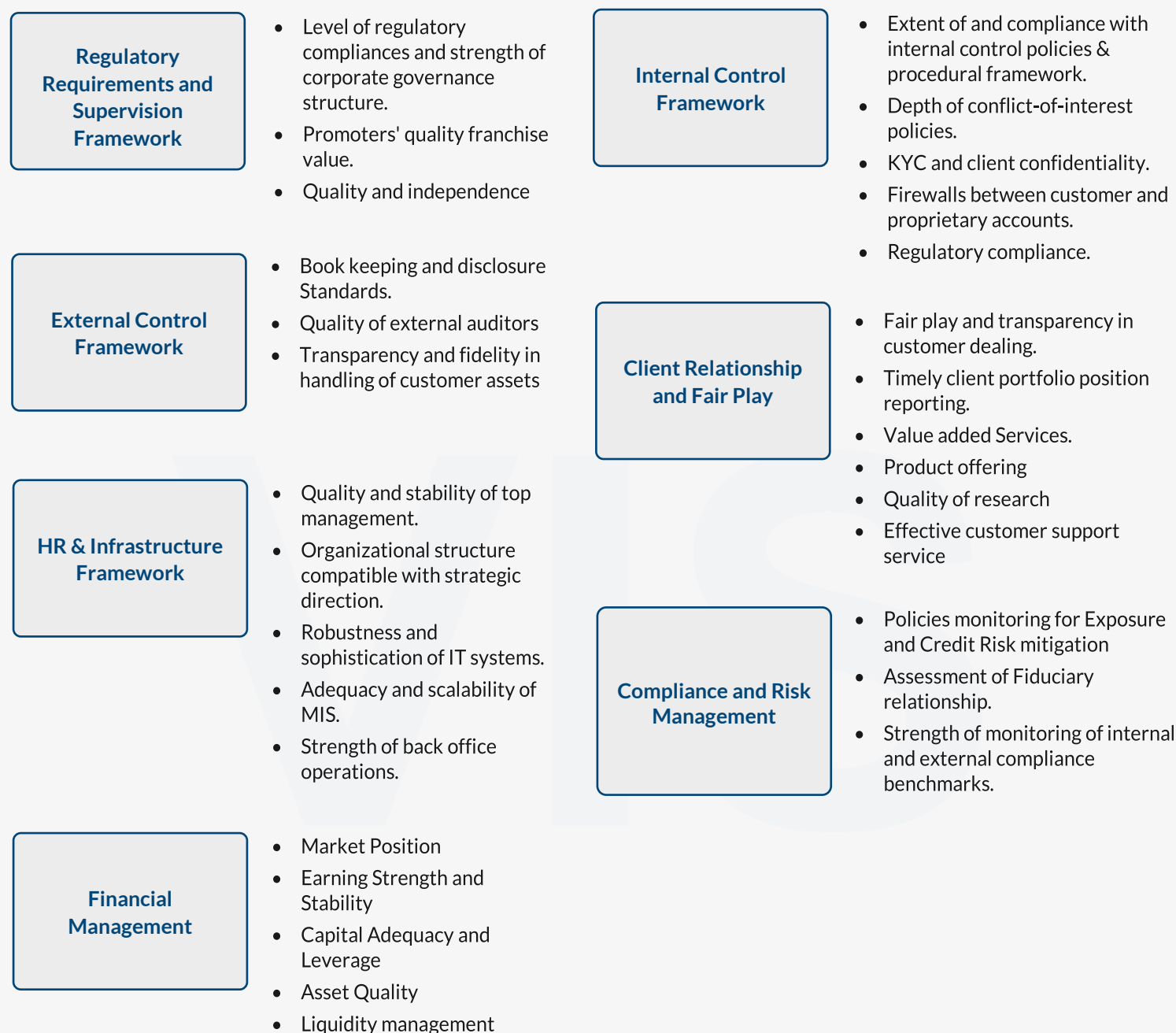
Brokerage firms are part of an intensely competitive sector where trading operations are significantly influenced by the economic landscape and cycles. Market indices' volume and value can be heavily swayed by event risks, especially those stemming from economic, regulatory, and political changes. These elements can cause brokerage earnings and profitability to fluctuate more than in other sectors. The regulatory environment, while mandatory, plays a crucial role in safeguarding investors and mitigating risks; thus, strict compliance is imperative. Brokerage firms must also adhere to international standards and regulations regarding conflicts of interest and ethical conduct in their operations. An assessment of the company's structure considers the reputation and financial robustness of promoters, as well as the quality and autonomy of its Board, to ensure stakeholder protection.

The Securities and Exchange Commission of Pakistan (SECP) from time to time reviews and amends the Securities Brokers (Licensing and Operations) Regulations, 2016. In the last few years it has introduced several amendments to broker regulations. These changes classify securities brokers under a framework that enhances investor protection by ensuring the secure storage of assets, elevating governance standards, and promoting transparency and risk management. The Online Only category under Trading Only category has also been introduced to widen the scope of

investment horizon for investors. The effects of these regulatory updates and their influence on the brokerage industry are critical components of the rating process.

B. INTERNAL CONTROL FRAMEWORK

The internal control framework within a brokerage house covers several critical areas, including managing conflicts of interest between the brokerage's own trades and those of its clients. It is tasked with conducting Know Your Customer (KYC) procedures to verify client identities and ensuring the confidentiality of client trading activities. Additionally, this framework is responsible for ensuring that policies and manuals for different operational areas are not only available but also regularly updated according to predefined schedules. It also verifies that these documents receive approval from the appropriate authority levels within the organization.



The framework emphasizes strict accountability and the adherence to fair practices throughout the firm. This includes monitoring compliance with established protocols and regulations, safeguarding against fraudulent activities, and ensuring that all employees act in the best interest of their clients and the integrity of the market. By doing so, the internal control framework plays a pivotal role in maintaining the brokerage house's reputation and operational efficiency, while also protecting client investments and contributing to a transparent and trustworthy trading environment.

C. EXTERNAL CONTROL FRAMEWORK

The standards of bookkeeping within a brokerage house serve as a measure of its commitment to transparency, both in managing its operations and in handling client transactions. The quality of these standards, along with the adherence to disclosure norms and regulatory mandates, is crucial from the perspective of financial stakeholders. A key aspect of transparency is the clear separation of client assets within the accounting records, along with regular updates and confirmations provided to clients regarding their assets. These practices are vital indicators of a brokerage firm's integrity.

The external control framework gains its robustness from the quality control review (QCR) ratings assigned to external auditors by the Institute of Chartered Accountants of Pakistan (ICAP), as well as their categorization under the State Bank of Pakistan (SBP)'s auditor classification. Furthermore, the outcomes of external regulatory inspections, carried out by entities such as the Pakistan Stock Exchange (PSX), the Central Depository Company (CDC), and the National Clearing Company of Pakistan Limited (NCCPL), play a significant role. These inspections assess compliance with financial regulations and standards, thus providing another layer of accountability and transparency in the brokerage industry's operations. This comprehensive approach to both internal and external oversight ensures that brokerage houses operate with the highest levels of transparency and integrity, safeguarding the interests of all stakeholders involved.

D. CLIENT RELATIONSHIP AND FAIR PLAY

In the customer-centric world of stock brokerage, the quality of service offered stands as a critical differentiator. Evaluating the brokerage's standard practices in client facilitation involves examining several key aspects. These include the breadth of products available, the caliber of research provided, the transparency with which information is shared, the promptness in executing transactions, and the cost-effectiveness of services offered. Additionally, the procedures established for addressing customer grievances, the quality and frequency of updates provided to clients about the status and value of their portfolios, and the provision of trade alerts through various channels are essential factors in assessing service quality.

The effectiveness of these communication channels and their integration with the brokerage's IT infrastructure significantly influence this assessment. The approach towards institutional versus individual investors may differ, with institutional investors often receiving a more favorable consideration due to their larger investment capacities and different service needs. Another critical area of evaluation is the quality and comprehensiveness of research made available to clients, which can significantly impact their investment decisions. Together, these elements paint a comprehensive picture of a brokerage's dedication to serving its clients, ultimately reflecting on its reputation and success in the competitive market.

E. HR AND INFRASTRUCTURE

The success of any organization is significantly tied to the consistency of its business strategy and the robustness and stability of its management team. The experience and track record of senior management in navigating capital markets and enduring various business cycles are invaluable assets. Compensation strategies for key personnel, particularly those managing client accounts and the firm's own investments, are scrutinized for potential conflicts of interest. Furthermore, the importance of succession planning, training programs, and the ability to attract and retain talented individuals cannot be overstated.

VIS underscores the importance of stringent controls to uphold the broker's fiduciary duties, ensuring that client assets are securely separated from the firm's assets and those of other clients, thereby protecting them from being entangled in legal issues in the event of the broker's default. Effective approval mechanisms for trade executions are seen positively, as are any measures brokers take that go above and beyond standard regulatory requirements.

In the brokerage industry, the precision and promptness of information delivery are crucial for investors. Hence, the efficient execution of orders is a key indicator of a broker's performance. A robust IT infrastructure is essential for fulfilling trade orders swiftly and is reliant on the processes, practices, and systems in place to minimize risks to both investors and intermediaries. System audits are crucial for offering an independent assessment of the IT infrastructure's strengths and weaknesses.

Developing an operational infrastructure that not only adheres to established policies and procedures but also has the capacity for growth is highly regarded. Inadequate infrastructure can lead to compromised customer service and risk management. VIS assesses the integrity and reliability of the IT systems that facilitate daily operations. Disaster Recovery Plans are vital for protecting investor interests and ensuring business continuity. Meanwhile, BMR focuses on the IT system's ability to promptly identify and manage exposure limits, including issuing early warnings for breaches of these limits, as a measure of the system's adaptability and effectiveness in risk management.

F. COMPLIANCE AND RISK MANAGEMENT

The comprehensive scope of risk factors encompasses price, credit/counterparty risk, and operational risk. Market risk gains prominence for brokers engaged in proprietary trading, necessitating controls to avoid conflicts of interest between managing the firm's own investments and client transactions.

VIS scrutinizes the risk management protocols established by the company, particularly examining any deviations from these protocols. At a minimum, these guidelines should cover the overall exposure level to clients collectively compared to the broker's assets, the maximum exposure to any single client, the evaluation process used, the quality of collateral, the timeframe for liquidating stock purchased on behalf of a client, and the margin cover maintained. Effective internal controls to counter operational risks, such as trading errors, fraud, and embezzlement, are imperative. Risk management should be an ongoing effort within the firm, employing tools that are dynamic enough to meet the evolving needs of the company and its operating environment. VIS favorably regards a commitment to risk management that exceeds regulatory requirements.

The institutionalization of the risk management function is evaluated in terms of its independence, and the caliber and resources of the personnel involved.

An efficient compliance function is crucial for monitoring adherence to internal controls and consistently reporting any deviations to management. The effectiveness of this function is gauged by the frequency and quality of compliance

reports. Regulatory feedback or actions taken by the regulator serve as key indicators of the compliance function's robustness. Additionally, the strength of the compliance function is assessed through regulator inspection reports and the punctuality of mandatory filings, underscoring the importance of a proactive and vigilant compliance posture in managing risk and ensuring regulatory compliance.

G. FINANCIAL MANAGEMENT

Analyzing the relative financial health of a firm involves both trend analysis and industry benchmarking. This process entails dissecting revenue and cost streams by distinct business/product lines and assessing contributions from various customer segments. A firm benefits significantly from having diversified revenue sources and a broad customer base, as these elements enhance its financial stability. The assessment also considers the earnings from the firm's own investment portfolio and income generated from client transactions. A critical metric in this analysis is the ratio of brokerage income to the gross value of shares traded, which offers insights into the firm's efficiency in generating revenue from its core brokerage activities, including fees and commissions. This core income is essential for covering the primary operating costs of the company.

The strategic and cautious use of leverage is another crucial factor influencing the BMR. VIS evaluates the financial agility of the firm, including its capacity to adjust costs during slow market periods. Larger firms typically have an advantage in achieving economies of scale, which can bolster their financial resilience.

Stock markets mandate specific capital requirements for their Trading Right Entitlement Certificate (TREC) holders, setting minimum capitalization standards. However, a deeper assessment of capital adequacy is conducted relative to the risks associated with the company's business activities. The analysis extends to the composition, maturity, diversity, and cost of funding sources, alongside the identification of future funding requirements. Liquidity analysis encompasses the firm's ability to swiftly liquidate its investment portfolio, secure loans or tap into unused credit lines, and manage liability repayments.

BMR SCALE & VALIDITY

VIS BMR Scale extends from BMR1A to BMR5. BMR1A may be assigned to institutions with strong operational platform and having diversified international reach (or foreign presence) on account of being market leaders in terms of adopting global corporate governance best practices. BMR 5 is assigned to institutions with weak regulatory compliance levels and financial management. The grade assigned to a 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>)

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** – crislbd.com

Collaborations

Japan Credit Rating Agency, Ltd. - **Japan**

China Chengxin International Credit Rating Company Limited - **China**

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