

Before the Director (Market Supervision & Registration Department)
Securities Market Division
Securities and Exchange Commission of Pakistan

In the matter of Show Cause Notice Dated January 23, 2013 issued to
First Equity Modaraba, Broker Karachi Stock Exchange Limited

Date of Hearing: March 14, 2013

Present at the Hearing:

1. Mr. Adil A. Ghaffar (CEO)
2. Mr. Qazi Obaid Ullah, (CFO)

Representing SECP (SMD): Ms. Saima Shafi Rana (Deputy Director-MSRD)

ORDER

1. This Order shall dispose of the proceedings initiated through Show Cause Notice No. 4(BRK-148)SE/SMD/02 dated January 23, 2013 ("SCN") under Section 22 of the Securities and Exchange Ordinance, 1969 (the "Ordinance") issued to M/s. First Equity Modaraba (the "Respondent"), TREC Holder of the Karachi Stock Exchange Limited (the "KSE") and a broker registered under the Brokers and Agents Registration Rules, 2001 (the "Brokers Rules").

2. Brief facts of the case are that the Securities & Exchange Commission of Pakistan (the "Commission") in exercise of its powers under Sub section (1) of Section 6 of the Ordinance read with Rule 3 and Rule 4 of the Stock Exchange Members (Inspection of Books and Record) Rules, 2001 (the "Inspection Rules") ordered an inspection of the books and records required to be maintained by the Respondent.

3. The report dated November 27, 2012 submitted by the Inspection Team highlighted major irregularities in calculation of Net Capital Balance ('NCB') of the Respondent as on June 30, 2012 and it appeared that NCB was not in accordance with the Third Schedule of the Securities and Exchange Rules, 1971 (the "SE Rules"). Thereafter, the Commission served a SCN to the Respondent, the contents of which are reproduced below:-

SUBJECT: SHOW CAUSE NOTICE UNDER SECTION 22 OF THE SECURITIES AND EXCHANGE ORDINANCE, 1969 READ WITH RULE 8 OF THE BROKERS AND AGENTS REGISTRATION RULES, 2001

WHEREAS, M/s. First Equity Modaraba ("FEM") is a Trading Rights Entitlement Certificate ("TREC") Holder of the Karachi Stock Exchange Limited and registered as a broker with the Securities and Exchange Commission of Pakistan ("Commission") under the Brokers and Agents Registration Rules, 2001 ("Brokers Rules").

2. *AND WHEREAS, the Commission in exercise of its powers under Sub-section (1) of Section 6 of the Securities and Exchange Ordinance, 1969 ("Ordinance") read with Rule 3 and Rule 4 of the Stock Exchange Members (Inspection of Books and Record) Rules, 2001*

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(*"Inspection Rules"*) ordered an inspection vide order No. SMD/MS&CID-C&IW/10-1(162)/2012 dated September 24, 2012 of the books and record required to be maintained by FEM. The Inspection Team after conducting inspection of Books and Record of FEM submitted the inspection report to the Commission on November 27, 2012 which was forwarded to FEM in accordance with Rule 7 of the Inspection Rules and response thereof was received on December 17, 2012.

3. **AND WHEREAS**, on review of the inspection report, it has been observed that the Net Capital Balance (**"NCB"**) of FEM as on June 30, 2012 is not in accordance with the Third Schedule of the Securities and Exchange Rules, 1971 (**"1971 Rules"**) and following discrepancies were observed which resulted in overstatement of NCB by an amount of Rs. **38,584,903**.

- a. Trade Receivables were **understated** by an amount of Rs. 1,303,399
- b. Investments in the listed securities in the name of the company were **overstated** by an amount of Rs. 24,069,259
- c. Securities purchased for clients were **understated** by an amount of Rs. 9,375,405
- d. Total current assets **overstated** by an amount of Rs. 13,390,455
- e. Trade payables were **understated** by an amount of Rs. 923,008
- f. Other liabilities were **understated** by an amount of Rs. 24,271,440
- g. Total current liabilities were **understated** by an amount of Rs. 25,194,448

4. **AND WHEREAS**, prima facie it appears that FEM by submission of overstated NCB has given information which it had reasonable cause to believe to be false or incorrect in material in violation of Section 18 of the Ordinance, which reads as follows:-

"No person shall, in any document, paper, accounts, information or explanation which he is, by or under this Ordinance, required to furnish, or in any application made under this Ordinance, make any statement or give any information which he knows or has reasonable cause to believe to be false or incorrect in any material particular."

5. **AND WHEREAS**, in light of the facts mentioned above, prima facie it appears that FEM is in contravention of Third Schedule of the 1971 Rules read with Section 18 of the Ordinance, the contravention of which invokes penalty under Section 22 of the Ordinance and Rule 8 of the Brokers Rules.

6. **AND WHEREAS**, sub-section (1) of Section 22 of the Ordinance provides that:

" If any person refuses or fails to furnish any document, paper or information which he is required to furnish by or under this Ordinance; or refuses or fails to comply with any order or direction of the Commission made or issued under this Ordinance; or contravenes or otherwise fails to comply with the provisions of this Ordinance or any rules or regulations made thereunder, the Commission may if it is satisfied after giving the person an opportunity of being heard that the refusal, failure or contravention was willful, by order direct that such person shall pay to the Commission by way of penalty such sum not exceeding fifty million rupees as may be specified in the order and in the case of continuing default, a further sum calculated at the rate of two hundred thousand rupees for every day after the issue of such order during which the refusal, failure or contravention continues."


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7. *AND WHEREAS Rule 8 of Brokers Rules provides that:*

"...Where the Commission is of the opinion that a broker has furnished wrong or false information, the Commission may, if it considers necessary in the public interest so to do, by order in writing suspend the registration of a broker for such period as may be specified in the order or impose on a broker a fine .."

8. *NOW THEREFORE, you are hereby called upon to show cause in writing by February 8, 2013, as to why action as provided under Section 22 of the Ordinance and/or with Rule 8 of the Brokers Rules may not be initiated against FEM for violation as indicated above. You are further directed to appear in person or through an authorized representative (with documentary proof of such authorization), on February 12, 2013 at 11:00 a.m. at the SECP Headquarters – Islamabad. You are advised to bring all relevant record in original, which you may consider necessary for clarification or in your defense. This notice sufficiently discharges the Commission's obligation to afford FEM an opportunity of hearing in terms of Section 22 of the Ordinance and Rule 8 of the Brokers Rules. In case of your failure to appear on the stated date of hearing it will be deemed that FEM has nothing to say in its defense and the matter will be decided ex-parte on the basis of available record.*

9. *Please note that this show cause is being issued without prejudice to any action, which may be taken or warranted for the above said or any other default under the above referred or any other provisions of law. Kindly acknowledge receipt of this show cause notice through return fax or courier at your earliest.*

*Sd/-
Hasnat Ahmad
Director*

4. The Respondent submitted a written response to the SCN dated vide letter February 7, 2013. The hearing scheduled for February 12, 2013 was adjourned on the request of the Respondent. During the hearing held on March 14, 2013 and through its written response, the following arguments were put forward by the Respondent.

a) Understatement of Trade Receivables

In this connection, the Respondent in its written response stated as follows:

"..The requirement to calculate Receivables of the last 14 days unsettled transactions have been mitigated in the presence of your inspecting team and will be followed in letter and spirit... our practice of deducting overdue for more than 14 days resulted in understatement of Trade Receivables; hence the understatement of NCB.."

b) Overstatement of Investment in Listed Securities

In this connection, the Respondent in its written response stated as follows:

"NCB requires the current assets to be taken in its calculation. Investment in capital market instruments are generally current in nature but to cater IAS requirements these are classified as Long Term (available for sale) and Short Term (held for trading). However, you will appreciate from September 15, 2012


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the date of submission that our trade pattern shows well under the prescribed limit, which is evident of its being unintentional... ”

During the hearing, the Respondent argued that Investments in Listed Securities are classified as Available for Sale (Long Term) and Held for Trading (Short Term). This classification was merely for compliance of the Accounting Standards. The Respondent further argued that both these heads are readily salable irrespective of their classification; therefore both were included while calculating the NCB.

c) Understatement of Securities Purchased for Clients

In this connection, the Respondent in its written response stated as follows:

“Nothing was reported which resulted in understatement of NCB,”

d) Understatement of Trade Payables

In this connection, the Respondent in its written response stated that the reason for said understatement is same as given for Trade Receivables.

e) Understatement of Other Liabilities

In this connection, the Respondent in its written response stated as follows:-

“.. While calculating the NCB, we don't account the following because:-:


- *All those Dividends Payable that pertain to distribution of profit before the commencement of brokerage activity and registration. Our logic is that liability has nothing to do with the brokerage house and would be met and or settle with other current assets.*
- *Provision for taxation is merely a presentation requirement; otherwise it would have been set off with the advance tax in the current assets..”*

During the hearing, the Respondent further informed that it had commenced its brokerage business effective from September 2002; therefore any profit distribution prior to September 2002 was not directly or indirectly related to brokerage business. That's why it did not account for dividend payable prior to 2002 while calculating the NCB.

f) Overstatement of NCB

In this connection, the Respondent in its written and verbal response stated that the overstatement of NCB was unintentional and it has never attained even 10% of the allowable limit based on the Inspection Team's calculation.

5. I have examined the facts, evidences and documents on record, in addition to the written and verbal submissions made on behalf of the Respondent. It is evident that the Respondent calculated Trade Receivables and Trade Payable on the basis of overall position


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rather than individual transaction basis. It is clarified that Third Schedule of SE Rules clearly provides for consideration of Trade Payables and Trade Receivables, separately and netting of Trade Receivables and Trade Payables should be allowed in the case of same client only. With regards to 'Investment in Listed Securities'; the Third Schedule of SE Rules considers only Current Assets and Current Liabilities. Accordingly Long Term Investments cannot be made part of NCB.

6. Regarding the Respondent's observation concerning "Other Liabilities", it is clarified that according to Third Schedule of the SE Rules all Current Liabilities, irrespective of their aging, should be included in calculation of the Net Capital Balance. Hence the Respondent's argument that the Respondent's Liabilities prior to the date of obtaining membership of the stock exchange cannot be considered for calculation of NCB does not hold any merit.

7. It is evident that the NCB as calculated by Respondent is not in accordance with the Third Schedule of the SE Rules. It was further evident that the violation was not willful. The "Investments in Listed Securities" and "Other Liabilities" were main contributors towards the Overstatement in NCB. However, it was observed that the said miscalculations were mainly due to the peculiar nature of the business of Modaraba and its regulatory structure.

8. The violation of the Ordinance, rules and regulations is a serious matter. However, considering the violation was not willful and that mostly because of the interpretation issues and peculiar issues regarding Modaraba business and its regulatory structure, I have adopted to take a lenient view and therefore no penalty has been imposed on the Respondent. However, since the Respondent, apart from being a Modaraba, is also holding the certificate of registration as a broker; therefore, the Respondent is strictly advised to adhere to securities laws particularly requirements of the SE Rules pertaining to calculation of Net Capital Balance. The Respondent is also warned to be vigilant in future and is directed to ensure full compliance with the Ordinance, rules, regulations and directives of the Commission in future.

9. The matter is disposed of in the above manner. This Order is issued without prejudice to any other action that the Commission may initiate against the Respondent in accordance with the law on matters subsequently investigated or otherwise brought to the knowledge of the Commission.


Hasnat Ahmad
Director (MSRD)

Announced on April 26, 2013
Islamabad.

