



Securities and Exchange Commission of Pakistan

Securities Market Division
Market Supervision and Registration Department

Before the Director (MSRD)

In the matter of Show Cause Notice issued to Invest Capital Markets Limited (ICM)

Date of Hearing:

September 30, 2013

Present at the Hearing:

Representing ICM:

- i. Mr. Khurshid Malik* *Chief Executive Officer, ICM*
- ii. Mr. Ahmad Usman* *Chief Financial Officer, ICM*

Assisting the Director (MSRD):

- i. Ms. Saima Shafi Rana* *Deputy Director (MSRD)*
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ORDER

1. This Order shall dispose of the proceedings initiated through Show Cause Notice No. 4(BRK-53) SE/SMD/01 dated July 30, 2013 (the "SCN") under Section 22 of the Securities and Exchange Ordinance, 1969 (the "Ordinance") read with Section 28 of the Central Depositories Act, 1997 (the "CD Act") issued to M/s. Invest Capital Markets Limited (the "Respondent"), Trading Right Entitlement Certificate Holder of the Karachi Stock Exchange Limited (the "KSE") and a broker registered with the Securities & Exchange Commission of Pakistan (the "Commission") under the Brokers and Agents Registration Rules (the "Brokers Rules").

2. Brief facts of the case are that 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 May 15, 2013 submitted by the Inspection Team disclosed that the Respondent was mishandling the securities of its clients and was involved in imposing late payment charges to the clients. Moreover, major irregularities in calculation of Net Capital Balance ('NCB') as on December 31, 2012 were also observed and it appeared that NCB was not in accordance with the Third Schedule of 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 IN THE MATTER OF INSPECTION OF BOOKS AND RECORD OF M/S. INVEST CAPITAL MARKETS LIMITED – TREC HOLDER KARACHI STOCK EXCHANGE LIMITED.

WHEREAS, M/s. Invest Capital Markets Limited ('ICM') is a Trading Right Entitlement Certificate (TREC) Holder of the Karachi Stock Exchange and registered as a

broker with the Securities and Exchange Commission of Pakistan (the “**Commission**”) under the Brokers and Agents Registration Rules, 2001 (the “**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 (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 vide order dated January 30, 2013 of the books and record required to be maintained by ICM. The Inspection Team submitted the inspection report to the Commission on May 15, 2013 which was forwarded to ICM in accordance with rule 7 of the Inspection Rules.

3. **AND WHEREAS**, on review of the inspection report, prima facie it appears that ICM is mishandling the securities of its clients. The detail of such mishandling is given as under:-

- a. Instances of CDS intra account transfers were observed, which were narrated as off- market trades; however the same were not found in the off-market trading data of ICM.
- b. The Books of Accounts of ICM as at December 31, 2012 disclosed investments amounting to Rs. 26.461 million; whereas, CDC statements balance of ICM's house account reflected 41.68 shares of various companies amounting to Rs. 395.421 million as at December 31, 2012. It was pointed out that these excess shares lying in house account were in fact client's securities that were transferred due to non-payment of outstanding balances. Keeping clients' securities in House Account is in violation of Central Depository Company of Pakistan Limited Regulations whereby House Account has been defined as an account maintained on the Central Depository Register (“**CDR**”) by an account holder for recording book-entry securities beneficially owned by the said account holder.
- c. It was observed that out of 41.618 million shares, 37.816 million shares amounting to Rs. 373.814 million were pledged including 1200 shares of Pakistan International Container Terminal (PICT), which were not owned by ICM. Accordingly the aforesaid intra account transfers appeared to be instances of indirect pledge.

4. **AND WHEREAS**, prima facie it appears that ICM moved and/or pledged the shares with the Banks/others without authorization in sheer violation of Section 24 of the Central Depositories Act, 1997 (the “**CDC Act**) which reads as follows:

“(1) A Participant shall not handle or authorize or permit any handling of book-entry securities entered in the subaccounts maintained under his account without authority of sub-account holder (2) A participant shall not expect with the authority of his clients, handle or authorize or permit any handling of book- entry securities beneficially owned by such clients and entered in his account.”

5. **AND WHEREAS**, Regulation 41(1)(c) of the General Regulations of the Exchange (“**General Regulations**”) requires the broker to maintain a collateral account under his

participant account in CDS for all the clients. The said account is required to be used exclusively for instances where outstanding payments are not received from the clients in respect of securities purchased on their behalf and relevant purchase obligations are to be settled. However, the inspection report revealed that ICM did not open the collateral account under its participant account, thereby, violating the said requirement.

6. **AND WHEREAS**, the inspection report further revealed that ICM was imposing late payment charges ranging from 22% to 24% p.a. to its clients, who did not clear their dues in time, and resultantly earned Rs. 7.564 million as per trial balance as at December 31, 2012 in contravention of Section 16 of the Securities & Exchange Ordinance, 1969, which is reproduced below for convenience.

“No member or associate shall, in contravention of any rules made under this Ordinance, directly or indirectly extend or maintain credit, or arrange for the extension or maintenance of credit, to or for any person for the purpose of purchasing or carrying any security.”

7. **WHEREAS**, as per Regulation 41(1) (a) of the General Regulations of the exchange, the Brokers are required to ensure that the assets belonging to their clients are kept separated from the assets of the Broker. For this purpose, the Brokers are required to maintain a separate bank account which will include the fund deposited/paid to their clients along with record/breakdown of clients' balances. In this connection, ICM has its Client Bank account with JS Bank Limited. However, it was pointed out in the inspection report that payments and receipts were made to/received from clients through other bank accounts as well; thereby violating the subject regulations.

8. **AND WHEREAS**, on review of the inspection report it came to the notice of the Commission that calculation of Net Capital Balance (“NCB”) of ICM as on December 31, 2012 had the following irregularities:-

- a. Overstatement of Trade Receivables by Rs. 10,678,034
- b. Overstatement of Securities Purchased for Clients by Rs. 95,167,465
- c. Overstatement of Trade Payable by Rs. 7,889,920
- d. Understatement of Other Liabilities by Rs. 1,622,804,703
- e. Overstatement of NCB by Rs. 1,720,760,282

9. **AND WHEREAS**, prima facie, it appears that the NCB as calculated by ICM is not in accordance with the Third Schedule of the 1971 Rules and that ICM by submission of overstated NCB has given information which it had reasonable cause to believe to be false or incorrect in material particular 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.”

10. **AND WHEREAS**, in light of the facts mentioned above, prima facie it appears that ICM is in contravention of Section 24 of the CDC Act, Section 16 of the Ordinance, Third Schedule of the 1971 Rules read with Section 18 of the Ordinance and Regulations 41 (1)

(a) and (c) of the General Regulations the contravention of which invokes penalty and/or punishment under section 22 of the Ordinance and section 28 of the CDC Act.

11. **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.”

12. **AND WHEREAS**, Section 28 of the CDC Act provides that:

“... whoever knowingly and willfully contravenes or attempts to contravene or abets the contravention of the provisions of section 24 shall be punishable with a fine which may extend to one million rupees and to a further fine not exceeding twenty thousand rupees for every day after the first contravention during which the contravention continues or with imprisonment for a term which may extend to five years, or with both...”

13. **NOW THEREFORE**, you are hereby called upon to show cause in writing by August 5, 2013, as to why action as provided under section 22 of the Ordinance and section 28 of the CDC Act may not be initiated against ICM 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 August 6, 2013 at 3:00 p.m. at the SECP Headquarters – Islamabad. You are advised to bring all relevant record in original, which you may consider necessary for clarification/defense of your stance.

14. This notice sufficiently discharges the Commission’s obligation to afford ICM an opportunity of hearing in terms of section 22 of the Ordinance and in case of failure to appear on the stated date of hearing it will be deemed that ICM has nothing to say in its defense and the matter will be decided on the basis of available record.

Sd/-
Hasnat Ahmad
Director

4. Thereafter, the hearing fixed for August 6, 2013 was adjourned on the request of the Respondent. The Respondent submitted a written response to the SCN dated September 27, 2013. The following arguments were put forward by the Respondent in its written response and during the hearing held on September 30, 2013:



I. Mishandling Securities of Clients:

- a) CDC Intra Account Transfers: *The issue arose due to lack of understanding of new CDS transfer system and regulations. However, we are taking proper measures to regularise the issue and compliance with the regulations.*
- b) Excess shares lying in House Account and Pledge of Shares: *“Excess shares lying in House account of ICM were on account of amount receivable from clients against their shares purchased and awaiting settlement of the amount due. Further, we had to arrange liquidity from banks against these shares to finance the purchases.*

ICM intends and is making best efforts to settle the shares borrowed from clients. In this respect we inform you that the amount of shares held in the House Account as on December 31, 2012 amounted to PKR 412.79 million whereas as on September 25, 2013 the amount has been reduced to PKR 200.38 million thereby a reduction of PKR 212.41 million has been achieved. Further, as on December 31, 2012 the amount of shares pledge were PKR 418.36 million whereas as on September 25, 2013 the amount has been reduced to 203.172 million thereby reduction PKR 215.18 million has been achieved. We are very hopeful and making our best efforts to achieve the ultimate settlement of the issue. In this respect, CDC statements along with calculation of share values as on December 31, 2012 and as on September 25, 2013 are enclosed herewith.

We further state that we are actively pursuing our clients who have debit/receivable balances to either liquidate their positions or adjust their debit/receivable balances to enable us to transfer their shares to their respective CDC Accounts Further, we are also convincing and educating our clients who trade on margin/leverage to avail the approved financing products of the Exchange and we assure you that we will be complied with the rules and regulations of the Exchange.

Further, in order to generate the liquidity we are also working on the following arrangements:

- i). *We have acquired a property located at Malir Karachi measuring 17.2 Acres with an assessed market value of PKR 1,634 million (copy of valuation report enclosed herewith). The said property will be used as security against borrowing and shares borrowed from clients will be settled, accordingly. In this respect, we would like to inform you that our negotiations with a financial institution are in very advanced stages and we are hopeful that arrangement will be completed in near future.*
- ii). *The other option available in this respect is to sell the aforesaid property and settle the borrowings from financial institutions and thereby settle the shares borrowed from clients.*

II. Collateral Account:

In this regard, the Respondent stated that:-

“This issue was taken up and we have requested CDC to open the collateral account under our participant ID”.

III. Late payment Charges:

The arguments submitted by the Respondent are as under:-

“Late payment charges imposed were on the clients who purchased securities through us but unable to make the payments. To settle these transactions we have to avail financing from the banks. The financing facilities incurred mark-up and other handling costs which we charge to our clients. Further, it is brokerage industry norm to provide such services to clients and if we do not recover late payment charges, there will be serious impact on our financials. However, effective from July 2013 we discontinue the practice of charging late payment charges to the clients”

IV. Maintenance of separate Bank Account:-

The arguments submitted by the Respondent are as under:-

“In this respect we state that for equity brokerage client's transactions we use separate bank account. Since we are service oriented business and sometimes our clients' request us to make the payment form bank suitable to them and therefore, we have to accommodate our clients for better services and client retention. Further, the instances of using other banks are very few; however, the issue has been noted for future compliance”

V. Irregularities in Calculation of Net Capital Balance

The arguments submitted by the Respondent are as under:-

- i). Overstatement of Trade Receivables: *“The amount for PKR 849.36 million was netted off on the basis that as per Master Business Transfer Agreement (MBTA) signed between ICM and Invest Capital Investment Bank Limited (ICIBL), ICM has to take over or settle the liabilities and acquire the assets of brokerage division on the books of ICIBL. In this respect, ICM has settled ICIBL borrowing from Silkbank in December 2012. For this purpose ICM acquired a property for PKR 849.359mn. As per understanding and arrangement the purchase price of the property is to be settled / paid against receipts from account balance of KF013 for PKR 854.343mn. The Inspection Team has reversed the netting off and this result in increase in amount of trade debtors for PKR 8.9million.*

The Inspection Team while calculating the revised Net Capital Balance did not account for trade debtors for PKR 24.09 million for our Money Market and Forex Brokerage operations. Further, KSE Deposit future trading for PKR 3.8 million was excluded by us being the overdue for more than 14 days.

Further there are differences on the calculation of amount of trade debtors overdue for more than 14 days as aging reports are not generated from our system. For calculation of trade debtors overdue for more than 14 days we took the account balances as on December 31, 2012 and as on December 17, 2012 from where we identify the amount receivable for more than 14 days, whereas Inspection Team has bifurcated transactions with particular customers between 14 days and more than 14 days. The issue has been noted for future compliance.

- ii). Overstatement of securities held for clients: *The reason for the difference is that while calculating the net capital balance Inspection Team has not considered*

shares held on behalf of clients in the House Account and only accounted for securities held in the CDC Sub Account of the clients.

- iii). *Overstatement of trade payables:* *The accounts were opened for equity trading purpose however, due to liquidity crunch ICM requested the clients not to withdraw the credit balance and allocate/charge mark-up on the balance. We state that we have not entered into any agreement for charging of mark-up with clients. Further, we have intimated clients that no mark-up shall be paid hereafter and they may withdraw their funds if they so desire or use the accounts for trading purpose.*

There are the differences on the calculation of amount of trade payable overdue for more than 30 days as aging reports are not generated from our system For calculation of trade payables overdue for more than 30 days we took the account balances as on December 31, 2012 and as on December 01, 2012 from where we identify the amount payable for more than 30 days, whereas SECP inspections team has bifurcated transactions with particular customers between 30 days and more than 30 days. The issue has been noted for future compliance.

- iv). *Understatement of other Liabilities:* *As per Third Schedule [Rule 2(d)] of Securities & Exchange Rule, 1971 the liabilities to be taken for calculation of Net Capital Balance is Trade Creditors and Other liabilities and it does not require to account for Bank Borrowings in the calculation of Net Capital Balance. Further, this is a matter of interpretation and if we are required to account for bank borrowings then we may please be allowed to account for the fixed assets being held as security with the bank against the borrowing.*

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. The arguments raised by the Respondent are discussed and appraised hereunder in seriatim:

I. Mishandling Securities of Clients:

The Respondent contended that shares of various clients were kept in its House Account as the said clients did not clear the outstanding balances. The Respondent stated that the shares in House Account were kept to arrange the liquidity.

Further, while accepting the instances of CDS Intra Account Transfers; the Respondent narrated that CDC Intra Account transfers were basically due to lack of understanding of new CDS transfer system. However, scrutiny of the documents depicted that instances of intra account transfers (which were wrongly labeled by the Respondent as off-market trades) were in fact the instances of indirect pledge. The Respondent was moving and/pledging the shares of the clients without authorization and holding the securities of its clients in its House Account.

With regard to the issue relating to unauthorized movement and unauthorized pledging of clients' securities; it is pertinent to mention that using client's funds/shares without proper authorization is a violation under CD Act. Section 12 (6) of the CD Act stipulates that a participant shall not create a pledge over any book-entry securities entered in any sub-account maintained under its account with the Central Depository without the authorization of the sub-account holder concerned. In line with that Section 24 of the CD Act also prohibits handling of book entry securities entered in the sub-accounts without the authority of the sub-account holder. Moreover, as per Part (G) of the

Standardized Account Opening Form, the Respondent was required to obtain specific authority from the sub-account holder(s) for transfer, pledge and withdrawal of book-entry securities.

II. Collateral Account and Late Payment Charges:

Regarding maintenance of collateral account and imposing late payment charges; the Respondent admitted the practice of charging late payment charges/liquidation damages @18% to 22%. This practice is identical to inhouse/ badla financing, which is prohibited under the law and is a blatant violation of Section 16 of the Ordinance. It is clarified that Section 16 of the Ordinance clearly states that *no member or associate can directly or indirectly extend or maintain credit or arrange for the extension and maintenance of credit to or for any person for the purpose of purchasing or carrying any security*. The Respondent further accepted that it was not maintaining a collateral account and has requested CDC to open a collateral account. Non maintenance of collateral account is violation of Regulation 41(1)(c) of the General Regulations of the KSE.

III. Irregularities in Calculation of Net Capital Balance

With regard to overstatement of Trade Receivables; the Respondent accepted that Capital Gain Tax amounting to Rs. 4.68 million was wrongly added in the Trade Receivables. Further; the Respondent claimed that debit balance of Rs. 849.359 million lying in the account of a client was adjusted against the same balance lying in other liabilities as a result of the 'Master Business – Transfer Agreement' signed between the Respondent and InvestCap Investment Bank Limited (ICIBL). However, no such justification or evidence was provided by the Respondent thereby implying that Trade Receivables were wrongly calculated. Further, the views expressed by the Respondent with regard to securities held for clients were illogical and baseless. In this regard, the grounds used were against the requirements of Third Schedule of SE Rules, therefore, could not be accepted. The Respondent overstated its NCB by recording securities held for clients on the basis of its Share Balance Report, which ideally should not have been different from CDC Account Balance Report, if prepared in accordance with the requirements.

With regards to Trade Creditors; the arguments of the Respondent clearly showed that the credit balances were in fact loan taken from various clients and it should not have been classified as Trade Creditors. Moreover, the arguments of the Respondent with respect to 'Other Liabilities' could not be accepted mainly because as per the requirements of the Schedule III of the SE Rules; all current liabilities, other than those reported under Trade Creditors, were required to be reported under this head.

6. After a detailed and thorough perusal of the facts, evidence/information available on record, contentions and averments made by the Respondent during the course of the hearing, it is established that the Respondent has moved/pledged the shares without proper authority of the sub-account holders. Moreover, the Respondent was holding the shares of its clients in its House Account. Such mishandling of clients' securities is a clear violation of Section 24 of the CD Act, which is punishable under Section 28 of the CD Act.

7. It is evident that the Respondent was imposing late payment charges in violation of Section 16 of the Ordinance. It is established that the NCB submitted by the Respondent was overstated by a large amount and if calculated in strict compliance with the requirements of the SE Rules; the NCB of the Respondent would have been in negative thereby implying that the Respondent has intended to attain much higher trading exposure and increasing the systemic risk in the market. Therefore, it stands established that the NCB as calculated by Respondent is not in accordance with the Third

Schedule of the SE Rules and that Respondent by submission of overstated NCB has submitted a statement and given information which it had reasonable cause to believe to be false or incorrect in material particular in violation of Section 18 of the Ordinance and violation of Rule 8 of Brokers Rules.

8. The violation of the Ordinance, rules and regulations is a serious matter and in view of the regulatory violations as discussed above, through this Order, the Respondent is directed to deposit a sum of Rs. 500,000 (Rupees Five Hundred Thousand Only) under Section 22 of the Ordinance and Section 28 of the CD Act to the Commission by way of penalty. The Respondent is directed to:-

- i). Ensure that the shares of the investors are transferred to the respective sub-accounts at the earliest;
- ii). Discontinue the practice of keeping shares in its House Account;
- iii). Submit revised NCB as per the format specified in Third Schedule of SE Rules
- iv). Immediately discontinue imposing late payment charges to its clients

9. The Respondent is further directed to ensure full compliance with the Ordinance, rules, regulations and directives of the Commission in future. Moreover, through this Order KSE is directed to vigilantly monitor the trading positions and exposure of the Respondent and to curtail the capital adequacy/exposure limit of the Respondent, as deemed appropriate, till submission of the revised NCB.

10. The matter is disposed of in the above manner and the Respondent is directed to deposit the penalty in the account of the Commission being maintained in the designated branches of MCB Bank Limited not later than thirty (30) days from the date of this Order and furnish copy of the deposit challan to the undersigned.

11. 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.

**Announced on December 18, 2013
Islamabad.**




(Hashat Ahmad)
Director (MSRD)