



Securities and Exchange Commission of Pakistan

Securities Market Division

Through Courier

Before The Director / HOD (MSRD)

In the matter of Show Cause Notice issued to KASB Securities Limited under
Section 22 of the Securities and Exchange Ordinance, 1969

Date of Hearing:

February 19, 2014

Present at the Hearing:

Representing KASB Securities Limited

- (i) *Mr. Nadir Rahman*
- (ii) *Mr. Tahir Iqbal*
- (iii) *Mr. Asad Shafqat*
- (iv) *Mr. Zia Ahmed*
- (v) *Mr. Asif Riaz*

Chief Executive Officer
Head of Operations
ED & Chief Financial Officer
Company Secretary
Head of Finance

Assisting the Director/HOD (MSRD)

- (i) *Mr. Muhammad Tanveer Alam*
- (ii) *Ms. Najia Ubaid*

Joint Director
Deputy Director

ORDER

1. This Order shall dispose of the proceedings initiated through Show Cause Notice bearing No. 1(15) SMD/MSRD/C&IW/2013 dated January 17, 2014 ("SCN") served to KASB Securities Limited ("Respondent"), Trading Right Entitlement Certificate Holder/Broker of the Karachi Stock Exchange Limited ("KSE") by the Securities and Exchange Commission of Pakistan ("Commission") under Section 22 of the Securities and Exchange Ordinance, 1969 ("Ordinance") read with Rule 8 of the Brokers and Agents Registration Rules, 2001 ("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 ("Inspection Rules") ordered an inspection of the books and records required to be maintained by the Respondent. The following officers of the Commission were appointed as inspectors ("Inspection Team") for the purpose vide order dated August 27, 2013:

SECURITIES & EXCHANGE
COMMISSION OF PAKISTAN
NIC Building, 63 Jinnah Avenue,
Islamabad, Pakistan





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- a) Mr. Adnan Ahmed Deputy Director
b) Mr. Kashif Ali Deputy Director

3. The Inspection Team submitted the report ("**Inspection Report**") on November 7, 2013 which was shared with the Respondent in accordance with Rule 7 of the Inspection Rules. The response of the Respondent in the context was received vide letter dated December 5, 2013. The Inspection Report highlighted that the Respondent failed to maintain segregation of client's assets; not complied with Securities (Leveraged Markets and pledging) Rules 2011 ("**Leverage Rules**"); failed to classify its employees as proprietary under Regulations for Proprietary Trading 2004 ("**Proprietary Trading Regulations**") and was involved in imposition of late payment charges to its clients.

4. In light of the Inspection Report and the comments received from the Respondent, the Commission served a SCN to the Respondent under Section 22 of the Ordinance and Rule 8 of the Brokers Rules. Hearing in the matter of aforesaid SCN was scheduled for February 3, 2014 at the Commission's Head Office in Islamabad. The Respondent vide e-mail dated January 30, 2014 requested for change in date of hearing. Acceding to the request of the Respondent hearing in the matter of SCN was rescheduled to February 17, 2014 at the Commission's Head Office in Islamabad. The Respondent again vide email dated February 11, 2014 asked, if the venue of hearing be changed to the Commission's Karachi Office. Acceding to the request of the Respondent, the hearing was rescheduled for February 19, 2014 at the Commission's Karachi Office.

5. The Respondent submitted its written response to the SCN vide letter dated February 3, 2014. Mr. Nadir Rahman, Chief Executive Officer; Mr. Tahir Iqbal - Head of Operations; Mr. Asad Shafqat - ED & Chief Financial Officer; Mr. Zia Ahmed - Company Secretary and Mr. Asif Riaz - Head of Finance of the Respondent attended the hearing on behalf of the Respondent ("**Representatives**"). The following arguments were put forward by the Respondent in its written response and by the Representatives of the Respondent during the hearing held on February 19, 2014:





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- a) **Segregation of Clients' Assets:** The Respondent in its written response to the SCN communicated that:

"The allegation of violation of KSE's Regulations contained in para 3 of the SCN seem to be based on a difference of interpretation. KASB vide its letter dated December 5, 2013 had provided detailed point by point comments/reply on the findings of the inspection team on the Commission's prescribed format. The contents of the comments are reiterated and be treated part of this reply to the SCN."

The Respondent vide letter dated December 5, 2013 in this context stated that:

"Clients funds are recorded separately in KSL's books and KSL already maintain a separate account for the funds of the clients. Funds of the clients with breakdown of balances are duly recorded in KSL's books. Payments and transfers to KSL were paid from KSL's main account with KBL. There is therefore no misuse of funds of the clients."

During hearing the Representatives of the Respondent while referring to para 11.4.1 of the Inspection Report communicated that the figure of creditors reflected in the referred para of Rs. 871.910 million is not correct as it is Rs. 819 million. The Representatives of the Respondent communicated that Rs. 434 million out of this Rs. 819 million was to be settled on T+2 basis on July 2, 2013. Rs. 300 million was related to pre-trade exposure, Rs54 in other bank and the remaining amount after these adjustments are lying in clients' bank account. The Representative of the Respondent agreed to provide reconciliation of the above to the Commission. They further added that all their clients can access their ledger statements at any time and none of them has lodged any complaint neither with the Commission nor with them, which reflects that there is no problem in recording of the receivable and payable balance of the clients' accounts.

- b) **Misuse of clients' assets:** The Respondent in its written response stated that:

"The contents of para 5 are based on misconception. As mentioned in the Comments, clients' funds are recorded separately in the books of KASB and a separate bank account for the funds of all clients is already maintained Funds of the Clients with breakdown of balances are duly recorded in the books, whereas payments and transfers referred to in the Report relate to KASB itself and are paid from KASB's main account. In this regards, KASB denies any innuendo contained in para 5 of the SCN that KASB, as trading financier, is using funds of





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any client from providing margin financing to other persons or for Proprietary Account. In particular, the Commission's view that absence of segregation of funds itself implies non-compliance of Rules 22(1)(b) of Leverage Rules is a view that KASB does not agree with. Nobody can be charged with violation of any Law merely on the basis of implication. This is without prejudice to the correct factual position enunciated above that there is no misuse of funds and KASB maintains separate accounts for its Clients with breakdown of balances duly recorded. Moreover, as mentioned in the Comments, no loss whatsoever has been caused to any client.

Further we would like to highlight here that mere difference in the creditors' ledger balance and Clients' bank account balance does not imply that KASB does not maintain segregation of Clients' assets. If on one side KASB keeps the Clients' custody in their respective sub-accounts, on the other side KASB ensures that the Clients' funds are also secure and paid to the Clients as and when they demand without any delay. It is KASB's transparent and uncompromising custodianship due to which our Client base is increasing with each passing day.

We wish to further point out that money is a fungible commodity and money belonging to difference Clients cannot be identified by a simple bank statement. The cash balance of the Clients has always been reflected in their respective sub-ledgers which are readily accessible to all the clients."

The Representatives of the Respondent with respect to other payments made from clients' account communicated that those payment were of minor nature and were made by error, which should have not in the first place be made from the bank account maintained for the clients. The Representatives of the Respondent further stated that it shall provide complete reconciliation of the account and shall be cautious in future.

- c) **Late Payment Charges:** With reference to the imposition of late payment charges, the Respondent communicated that:

"The objective and justification of late payment charges have perhaps been misunderstood. There is no imposition of late payment charges by KASB as mentioned in para 6 of the SCN, since KASB does not impose late payment charges, as penalty. Additional commission is being paid by clients on overdue payments (please refer clause 18 of the special terms and conditions of KASB's SAOF attached herewith), which is also permissible under Law. This has no bearing on sale of securities through Collateral Account, which comes into play only when KASB decides to sell the securities. Clause 7(b) of the special terms and conditions of SAOF





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annexed to the General Regulation of the Karachi Stock Exchange stipulates that the broker may transfer such securities. KASB therefore believes that the Regulation does not make it mandatory for a broker to immediately transfer the securities to the Collateral Account and there is no timeframe for such action or activity.

It is also pertinent to mention that due to pleasant working relations with prestigious clients, it is not desirable to immediately transfer the securities to the Collateral Account as it would be in the interest of the broker and the capital markets to give some time to the client. Please note that given the volatile nature of the stock market, country's law and order situation and limited number of investors in the market, situation that alienate genuine investors from participating in the capital markets should be avoided."

The Representatives of the Respondent asserted its above stance and stated that if they transfer the securities to the collateral account, their business will be reduced in large proportion. They further added that the shares are available in CDC sub account of the clients. The Representatives stated that it is a market anomaly and they are trying to be in compliance of the applicable laws. The Representatives communicated that all the lawyers to whom they contacted has communicated that late payment charges can be imposed on the clients' who have debit balances in their accounts. The Representative agreed to provide copies of such opinions to the Commission.

- d) **Classification of employees in the NCCPL database:** In this context, the Respondent in its written response stated that:

"'Employee' category has been assigned for employees of KASB in the unique Identification Database maintained by National Clearing Company of Pakistan Limited. Therefore all employees trading accounts are clearly distinct from the Clients of KASB, and all trades on account of the employees are being recorded correctly."

The Representatives of the Respondent communicated that they have classified all the employees in the database of National Clearing Company of Pakistan Limited and the delay was because one of their client had NICOB as identity document which was not accepted by the system. However, the Respondent did not communicate this fact at the time of submission of comments to the Inspection Report neither was communicated in the written response to the SCN.





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6. I have heard the arguments presented by the Representatives of the Respondent at length during the hearing. Additionally, I have perused the available record and the written reply filed by the Respondent with regard to the issues raised in the SCN. The Respondent in its written response and the Representatives during the course of hearing confirmed that it has properly classified its employees in the NCCPL database. In connection with the remaining issues communicated through the SCN, my findings based on the arguments and assertions made by the Respondent in its written response and by the Representatives of the Respondent during the course of hearing are as follows:

- a) The Respondent in its written response and the Representatives of the Respondent during the course of hearing communicated that they will ensure proper segregation of clients' funds in future. The Respondent subsequently provided reconciliation of the creditors position as was agreed during the hearing.
- b) It is pertinent to mention here that the Respondent neither in its comments to the Inspection Report nor in its written response to the SCN communicated the difference in the value of creditors, which the Representatives highlighted during the course of hearing and in the reconciliation submitted subsequently. The reconciliation provided by the Respondent in the context, is reproduced below:

KASB Securities Limited
Reconciliation of Trade Creditors

	Jun 30, 2013 (PKR 000)	REFERENCE
<u>Net Trade Creditors</u>		
Trade creditors as per Accounts	819,591	
Less:		
Payable KSE against settlement	(88,000)	Annexure-1
Payment withheld-KSE against forward clearing	(22,411)	Annexure-2
Trade creditors - Unilever	(77,642)	Annexure-3
Accrued trade dated at period end which settled subsequent to period / year end	(259,097)	Note
	(447,150)	
	372,441	
<u>Reconciliation</u>		
Bank balance in Bank Accounts - Client	34,416	
Bank balance in other Bank accounts	26,775	
Exposure deposit with KSE	290,767	Annexure-4
	351,958	
<u>Net Cash Balance (shortfall)/ excess</u>	(20,483)	





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c) From the above reconciliation, it is evident that the Respondent had only Rs. 34.416 million available in the bank account tagged for clients for meeting the creditors. However, Rs. 20.483 million still stands un-reconciled and the Respondent failed to provide necessary information and detail including whereabouts of the said amount. As per the reconciliation and the information provided, the Respondent used Rs. 290.767 million for exposure requirement with KSE, which includes propriety investments in the units of various open end mutual funds amounting to Rs. 220.767 million and Rs. 70 million in respect of cash exposure. In this regard it is asserted that mere pledge of securities owned by the Respondent cannot make it deemed part of clients' assets. With regard to cash exposure in Ready Market, the Respondent vide email dated March 31, 2014 provided client wise break up for June 28, 2013 and communicated that report for July 1, 2013 is awaited from the KSE.

d) The Respondent vide email dated March 31, 2014, in respect of proprietary investments in open end mutual funds amounting to Rs. 220.767 million communicated that:

"It is incorrect to say that KASB Securities has used clients' funds to make investments of its own in open ended funds. Standard accounting treatment defines current liabilities (in this case, client payables) with corresponding current asset entries (cash, short term investments, receivables). Hence, irrespective of the nature of the short term liability, the corresponding entry in KASB's books would be cash / investments / receivables. As further background, KSE allows brokerage firms to place exposure on behalf of its clients with it in the form of cash or securities. It is thus standard market practice that all clients of a brokerage firm authorise the firm to place exposure with KSE. All the clients of KASB Securities authorized KASB Securities at the time of opening their accounts through the SAOF to place exposure with respect to their trading.

To reiterate, the reason that these open ended funds of PKR 220.767 million are being shown as KASB Securities' short term investments in its interim financial statements of June 2013 is because of standard accounting treatment of such investments, just as clients funds in the form of cash deposited with KASB Securities would have been shown as cash / bank balances





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of KASB Securities in its accounts. We trust that you will appreciate that there has been no misuse of clients' funds and that no illegality or irregularity has been committed."

The Respondent in the above email communicated that the investments appearing in the name of the Respondent in its financial statements is because of standard accounting treatment of such investments, just as clients' funds in the form of cash deposited with the Respondent would have been shown as cash/ bank balances of the Respondent in its accounts. The Respondent, thereby, with regard to proprietary investments, in the email confirmed that:

- i). The open end mutual funds worth Rs. 220 million appearing in its own name are actually clients' funds;
- ii). These investments were classified as proprietary investments in the books of accounts of the Respondent;
- iii). No specific authority was given to the Respondent by its clients to invest their funds in open end funds.

From the above, it is evident that the

- I. Respondent by purchasing the open end mutual funds in its own name misused the clients' funds. If the funds were available in the bank account maintained by the Respondent for its clients, the benefit of the amount would have been accrued to the clients. In the present instance, the benefit if any, was accrued and shall continue to accrue to the Respondent. Moreover, the Respondent has full authority in respect of selling of the proprietary investments, which makes it more of the assets of the Respondent than of its clients'.
 - II. Respondent failed to provide any evidence from which bank account the amount for purchase of these open end mutual funds was released. Accordingly failed to maintain segregation of clients' assets.
- e) Moreover, in said reconciliation, the Respondent included bank balance held in other bank account amounting to Rs. 26.775 million and thus the Respondent has confirmed that clients' funds are lying in other bank accounts instead of bank accounts being used for segregation of clients' funds. In light of the above, it is evident that the

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Respondent failed to maintain proper segregation of clients' funds/assets and is in violation of the applicable regulatory framework.

- f) With regard to late payment charges imposed on clients having debit balance, the Respondent and the Representatives of the Respondent stated that it is inevitable and as per the opinion obtained from different lawyers, the Respondent can impose late payment charges to its clients. The Representatives during the course of hearing agreed to provide the communication with the lawyers in this context. The Respondent vide email dated March 5, 2014 provided comments of Ahmed & Qazi (Advocates and Legal Consultants) and Bawaney and Partners (Advocates & Investment & Corporate Advisors) with regard to imposition of late payment charges on the clients having debit balances in their account. However, the Respondent by imposing late payment charges is in violation of applicable regulatory framework.

7. After a detailed and thorough perusal of the facts, evidence/information available on record, contentions and averments made by the Representatives of the Respondent during the course of the hearing, it is evident that the Respondent failed to maintain proper segregation of clients' funds/assets; used clients' funds and was involved in imposition of late payment charge.

8. Broker holding certificate of registration has to at all times, abide by the applicable regulatory framework and should not engage in any conduct and practice that may harm the interest of its clients. A broker is custodian of its clients' assets and is responsible to ensure that clients' assets are safeguarded and used in the best interest of its clients.

9. The violation of the Rules and Regulations is a serious matter. Therefore, in exercise of the powers under Section 22 of the Ordinance, I hereby impose on the Respondent a penalty of Rs. 500,000/- (Rupees Five Hundred Thousand Only). The Respondent is further directed to:

- a) Comply with the Rules 1971 and the guidelines issued by the Commission;
- b) Ensure proper segregation of clients' assets;





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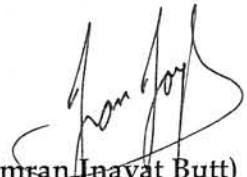
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- c) Convert its investments in the open end mutual funds worth Rs. 220.767 million to cash and deposit the same in the clients' bank account; and
- d) Stop imposing late payment charges.

10. The matter is disposed of in the above manner and the Respondent is directed to deposit the fine 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 a 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 matter subsequently investigated or otherwise brought to the knowledge of the Commission.




(Imran Inayat Butt)
Director/HOD (MSRD)

Announced on March 31, 2014
Islamabad.