

# Securities and Exchange Commission of Pakistan

Securities Market Division  
Market Supervision and Registration Department  
\* \* \*

## Before the Director/HoD (MSRD)

### In the matter of Show Cause Notice issued to First National Equities Limited (FNEL)

**Date of Hearing:**

- i. May 6, 2013
- ii. May 15, 2013

**Present at the Hearing:**

*Representing FNEL:*

- i. Mr. Ali Aslam Malik *Chief Executive Officer, FNEL*
- ii. Syed Shahab Qutub *Advocate*

*Representing KSE:*

- i. Mr. Shafqat Ali *GM/Acting Chief Regulatory Officer, KSE*

*Assisting the Director/ HOD (MSRD):*

- i. Mr. Hasnat Ahmad *Director MSRD*
- ii. Ms. Saima Shafi Rana *Deputy Director*

---

## ORDER

1. This Order shall dispose of the proceedings initiated through Show Cause Notice No. 4/BRK-176/SE/SMD/2004 dated April 19, 2013 (the “SCN”) under Section 22 of the Securities and Exchange Ordinance, 1969 (the “Ordinance”) read with Rule 7(2) and Rule 5(4) of the Brokers and Agents Registration Rules, 2001 (the “Brokers Rules”) issued to M/s. First National Equities Limited (the “Respondent”), Trading Right Entitlement Certificate Holder of Karachi Stock Exchange Limited (the “KSE”) and a broker registered with the Securities & Exchange Commission of Pakistan (the “Commission”) under the Brokers Rules.

2. Brief facts of the case are that the Respondent submitted its application for renewal of certificate of registration as Broker. The scrutiny of the Respondent’s said application revealed that the calculation of Net Capital Balance (“NCB”) as on December 31, 2012 submitted by the Respondent had major irregularities as the NCB was not calculated in accordance with Third Schedule of the Securities and Exchange Rules, 1971 (the “SE Rules”) and prima facie was overstated. The adjusted NCB calculated by the Commission is as under:-

<b>First National Equities Limited</b>				
<b>Adjusted Net Capital Balance</b>				
<b>As at December 31, 2012</b>				
<b>Particulars</b>	<b>Amount In Rupees</b>			
<b>Current Assets</b>	<b>As per FNEL</b>		<b>Adjusted by SECP</b>	
<b>Cash In Hand or In Bank</b>				
Cash In Hand	9,275		9,275	
Bank Balances	1,921,826	1,931,101	1,921,826	1,931,101
<b>Trade Receivables</b>				
Book Value	601,117,101		-	
Less: Overdue for more than 14 days	(600,120,126)	996,975	1,495,378	1,495,378
<b>Investment In Listed Securities In the name of Broker</b>				
Securities on the exposure list marked to market	224,600,737		129,968,777	
Less: 15% Discount	33,690,111	190,910,626	(19,495,317)	110,473,460
<b>Securities held for client</b>		173,830,448		29,565,650
<b>Total Current Assets</b>		<b>367,669,150</b>		<b>143,465,589</b>
<b>Current Liabilities</b>				
<b>Trade Payable</b>				
Book Value	180,333,188		179,854,685	
Less: Overdue For More Than 30 Days	(160,477,464)	19,855,724	(160,168,395)	19,686,290
<b>Other Liabilities</b>		211,646,905		1,049,424,566
<b>Total Current Liabilities</b>		<b>231,502,629</b>		<b>1,069,110,855</b>
<b>Net Capital Balance</b>		<b>136,166,521</b>		<b>(925,645,266)</b>

3. Considering this major overstatement, the Commission served a SCN dated April 19, 2013 to the Respondent under Section 22 of the Ordinance read with Rule 7(2) and Rule 5 of the Brokers Rules stating that the Respondent has prima facie miscalculated the NCB in violation of Rule 3(b) of the SE Rules and given false/ misleading information in contravention of Section 18 of the Ordinance and Rule 8 of the Brokers Rules.

4. The Respondent through SCN was asked to explain its position through written reply and also appear in person or through an authorized representative before the undersigned at Commission's Head Office, Islamabad on April 26, 2013 for hearing. However, on the request of the Respondent, the hearing was rescheduled on May 6, 2013. The legal counsel of the Respondent appeared on its behalf and submitted a letter during the hearing requesting to provide the basis of calculation of the revised NCB enabling the Respondent to prepare the response to the SCN. The request was acceded to vide Commission's letter dated May 6, 2013.

Thereafter, second hearing in the matter was held on May 15, 2013, which was attended by Mr. Ali Aslam Malik, CEO and Syed Shahab Qutab, Advocate on behalf of the Respondent. The following arguments were put forward by the Respondent in its written response received on May 14, 2013 and during the course of the hearing.

**(a) Investment in Listed Securities**

In this regard, the Respondent stated that:-

*“It is submitted that the adjustment by SECP is not sustainable since SECP has, without making any attempt to identify the causes for the difference between the break-up provided by FNEL and the CDC Statement of FNEL's House Account, chosen to consider only such shares that appear in the CDC House Account. In this way SECP has arbitrarily excluded from consideration, such shares that are beneficially owned by FNEL but are not reflected in the CDC Statement of FNEL's House Account. These shares include following:-*

- i). Shares of FNEL held by SITE as security: FNEL and SITE entered into a share sale and buy-back agreement dated 13-08-2008. Since the buy-back is simultaneous and it is only the re-payment that is deferred, the beneficial ownership of the shares always remains with the original owner (FNEL). According to paras (b) & (c) of the recitals of the aforesaid Agreement dated 13-08-2008, the shares sold by FNEL to SITE were to be kept in SITE's sub-account with FNEL and were to be returned to FNEL once repayment of the entire buy-back price had been made by FNEL. The aforesaid clauses and the entire REPO Agreement dated 13-08-2008 considered as a whole clearly demonstrates that the shares that formed the subject of the transaction remained in the beneficial ownership of FNEL and were kept in SITE's sub-account as security only.*
- ii). REDCO shares held by FNEL: This exclusion is again arbitrary. SECP has failed to note that the aforesaid shares were not entered as book-entry securities in the CDC system prior to 31-12-2012 and were held by FNEL as physical share scrips. After 31-12-2012 these shares were transferred to the CDC system and the physical scrips were delivered to CDC”*

**(b) Securities Held for Clients**

In this regard, the Respondent stated that:-

*“The adjustments made by the SECP under the head of "Securities held by the Client" are not in accordance with the valuation basis provided in item 4 of the Third Schedule of the Securities & Exchange Rules 1971.*

- In the first place it is submitted that the basis for adjustments provided by the SECP to FNEL reveal that the adjustments were made on the basis of sampled data instead of analysis of the entire data. This approach is fundamentally flawed and is bound to produce inaccurate results. Furthermore an analysis on*



*the basis of sampling is not warranted by item 4 of the Third Schedule of the Securities & Exchange Rules 1971.*

- *SECP has chosen to rely on the CDC Balance Statements of the clients only to determine the securities purchased and held for clients and has not taken into consideration the shareholding statement of clients provided by FNEL. This is again an erroneous and inherently flawed approach. The reason is that there are several instances when shares purchased and held for the benefit of a client may not appear in the client's sub-account. For example in respect of several clients whose debit balance is outstanding, FNEL would bridge the gap through financing obtained against the collateral of shares held for the benefit of such defaulting clients. For this purpose FNEL would transfer the shares from the client's sub-account to the financier's sub-account. As a result the shares would not appear in the client's sub-account even though they will still be in the beneficial ownership of the client and held for the benefit of the client. As such the SECP's position that the benefit of the valuation should only be passed on to the respective clients, who hold securities in their respective CDC Sub-accounts is factually flawed, amounts to an unreasonable and non-practical restriction and is not warranted by law or facts. It should be noted that no such restriction is envisioned by item 4 of the Third Schedule of the Securities & Exchange Rules 1971.*
- *SECP has erred in restricting the valuation of the shares to the value of the overdue balance. It is submitted that item 4 of the Third Schedule of the Securities & Exchange Rules 1971 does not envision any such restriction. It is clear that if a client's debit balance has not been cleared within 14 days, all securities purchased and held for such client would be included under this head.*

### **(c) Other Liabilities**

The arguments submitted by the Respondent are as under:-

- *“Para 73 applies only to obligations under an existing loan facility. It is submitted that all such cases where the financial institution/creditor has brought a recovery case against FNEL, the finance facilities have been recalled and there is no "existing loan facility". This includes the loans/finances related to Bank of Punjab, UBL and SITE each of which has filed suits for recovery against FNEL. Para 73 clearly does not relate to such loans, the repayment whereof is contentious and is subject to determination by a court of competent jurisdiction. It is evident that the FNEL is contesting the liability in each case and the claim of the financial institutions/creditors has to be adjudicated upon by a court of competent jurisdiction. Pending such determination, there is no obligation upon FNEL to make payment and since it is not possible to determine at "the time of reporting, what decision will eventually be passed by the courts and when such decisions will be passed, the liability cannot be classified as current.*
- *As per paragraph 69 of IAS 1 an entity shall classify a liability as current if the liability is due to be settled within 12 months after the reporting period. Since*



*payment (if any) of the sub-judice loans is subject to pronouncement of judgment by the relevant courts and since it is not certain whether such judgment will be pronounced within 12 months after the reporting period, the subject liabilities cannot be classified as current liabilities. Furthermore it may be noted that any judgment pronounced by the courts of first instance are subject to appellate remedies which in the normal course are considered a continuation of the original proceedings.*

- *Also relevant in the present situation is Para 10 of IAS 8 which provides that in the absence of an accounting standard that specifically applies to a transaction; the management shall use its judgment in developing and applying an accounting policy that results in information that is reliable and represents faithfully the financial position of the Company. In the circumstances the categorization of the sub-judice loans as long term liabilities is in accordance with generally accepted accounting principles.*
- *SECP has on previous occasions accepted the classification of loans that are sub-judice as long term liabilities by brokerage concerns. FNEL therefore submits that it should also be treated on similar footing and no discrimination should be meted out in this behalf.”*

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:

**(a) Investments in Listed Securities**

The assertions of the Respondent with regard to Investments in Listed Securities are accepted.

**(b) Securities Held for Clients**

The views expressed by the Respondent with regard to securities held for client are illogical and baseless. In this regard, the grounds used are against the requirements of Third Schedule of SE Rules, therefore, cannot be accepted. The Respondent has significantly overstated its NCB by recording securities held for client on the basis of its Share Balance Report, which ideally should not be different than CDC Account Balance Report, if prepared in accordance with the requirements. In most of the instances the statement prepared by the Respondent showing excess amount of shares against overdue balance therefore value of securities held for client cannot be taken in excess of overdue balance as well as balance up to number of shares held by the Respondent on that client's behalf. The Respondent's instance that shares of a particular account has been held by it in an another account other than respective sub-account of that particular shareholder cannot be relied unless and until a proper justification and evidence is provided in respect of each instances upto entire satisfaction with reasonable legal or logical ground. However, no such justification or evidence was provided by the Respondent. Further, in certain instances the statement prepared by the Respondent also showing amount of shares as negative balance which



put a question mark on the reliability of the statement, therefore, the balance of the statement cannot be used for valuation of shares purpose.

Moreover, the Respondent's observation with regard to sampling holds no merit as the Commission, while calculating 'Trade Receivables' and 'Securities Held for Clients' selected a sample of 94.23% of total Trade Receivables. Regarding debit balances not forming part of the sample; the Commission after applying the already mentioned Rule for overdue, treated the Respondent's aging as correct and taken the value as provided by the Respondent.

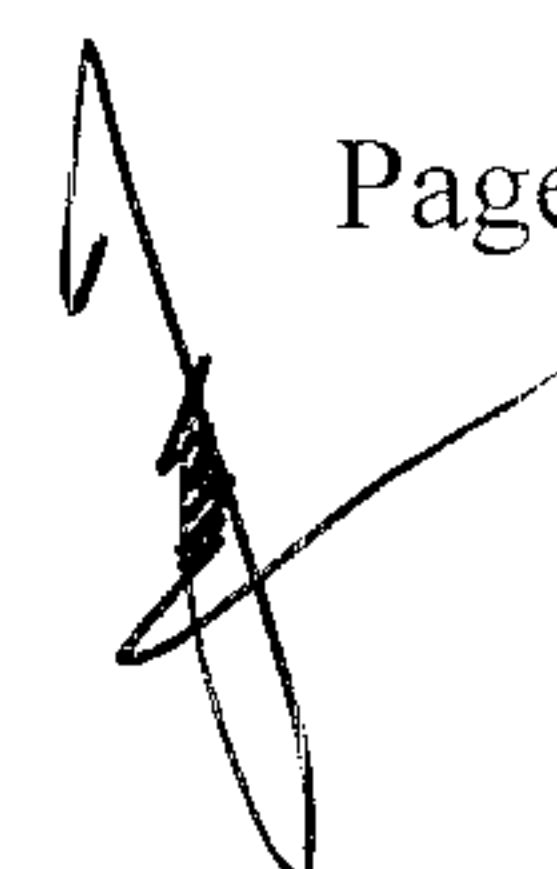
### **(c) Other Liabilities**

It is clarified that every loan is required to be classified as current unless there is a proper evidence or legal ground to reclassify the same as long term liability. The legal opinion on the basis of which the loan amount was reclassified does not provide a proper basis or justification. It is also clarified that Para 69 of IAS-1 states that "*An entity shall classify a liability as current when it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period (see paragraph 73). Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.*" The loans payable to the banks have already been accounted for by the Respondent and counter parties are demanding its payment and the matters are pending before the court. Therefore, it is obvious that the Respondent does not have an unconditional right to defer settlement of the liability, therefore, the loan liabilities cannot be reclassified as long-term.

Moreover, with regard to the 'liability payable to Bank Al-Falah', the statutory auditors of the Respondent in their annual audit report for the year ended June 30, 2012 and review report on half yearly accounts for the period ended December 31, 2012 qualified their opinion/report with regard to reclassification of short term loan as long term irrespective of the fact that the negotiation with the bank is in process. The same substantiate the Commission's stance.

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 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.

7. I am also watchful of the fact that the Respondent was also penalized in 2012 for the same violation. In this regard it is pertinent to mention here that the Commission conducted the inspection of the Respondent vides Commission's Order No. SECP/SMD-CW-(91)/2011 dated



July 19, 2011 which also highlighted similar major irregularities in the calculation of Net Capital Balance of the Respondent as on June 30, 2011. Pursuant to which, the Commission through its Order dated July 10, 2012 imposed a penalty of Rs. 500,000 on the Respondent.

8. The violation of the Rules and Regulations is a serious matter which entitles the Commission to even suspend the Respondent's registration but I have elected not to exercise this power at present considering that the decision of suspension might increase the systemic risk in the market. Further, in case of any eventuality, the weakening financial condition of the Respondent may not be adequate to settle its liabilities which can hurt the interest of its wide clientele base spreading nearly all over the country. I am also mindful of the fact that the suspension of the Respondent would have serious adverse impacts on other two brokerage houses of the Respondent's group and actual impact would be much greater.

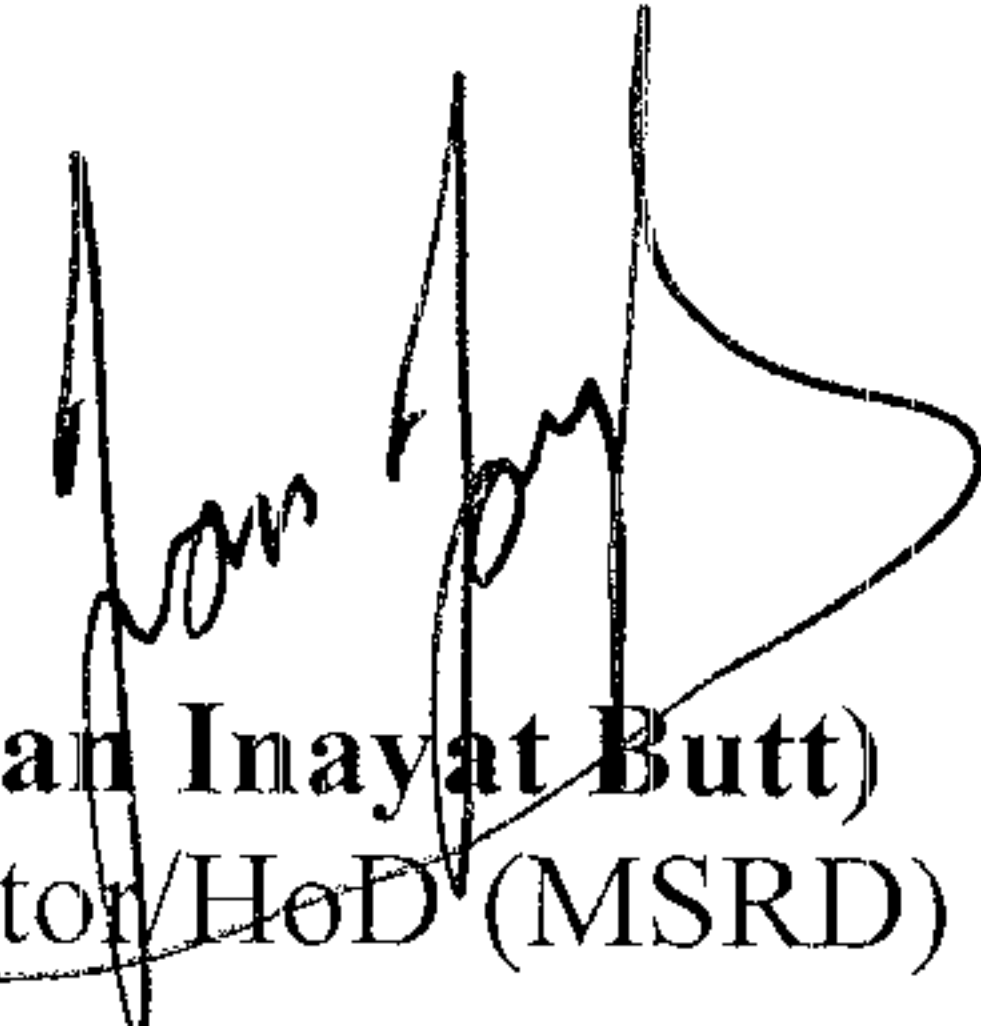
9. Considering this, I have opted to take a lenient view at the moment and decided to give another opportunity to Respondent in this matter. Therefore, in exercise of power under section 5 of the Ordinance read with Rule 7 of the Brokers Rules, I hereby renew the Certificate of Registration of the Respondent with the condition that the Respondent will be required to submit a revised Net Capital Balance Certificate (duly audited) within three months of the date of the Order which shall be in strict compliance with the Third Schedule of the SE Rules and shall meet the minimum specified requirement.

10. Further, in view of the Regulatory violations as indicated above and 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). I again direct the Respondent to ensure that full compliance be made of all rules, regulations and directives of the Commission in the future for avoiding any punitive action under the law.

11. 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 deem appropriate, till the submission of revised Net Capital Balance.

12. 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.

13. 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.

  
(Imran Inayat Butt)  
Director/HoD (MSRD)

**Announced on June 6, 2013  
Islamabad.**

