



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 the Managing Director and Deputy
Managing Director of the Karachi Stock Exchange Limited under Section 7 read with
Section 22 of the Securities and Exchange Ordinance, 1969

Date of Hearing:

April 8, 2014

Present at the Hearing:

(i) Mr. Nadeem Naqvi

Managing Director

(ii) Mr. Haroon Askari

Deputy Managing Director

Assisting the Director/HOD (MSRD)

(i) Mr. Muhammad Tarveer Alam

Joint Director

(ii) Mr. Kashif Ali

Deputy Director

(iii) Ms. Najia Ubaid

Deputy Director

ORDER

1. This Order shall dispose of the proceedings initiated through Show Cause Notice bearing No. 1(24) SMD/MSRD/C&IW/2014 dated February 25, 2014 (“**SCN**”) served to Mr. Nadeem Naqvi – Managing Director, Karachi Stock Exchange Limited (“**Respondent No. 1**”) and Mr. Haroon Askari – Deputy Managing Director, Karachi Stock Exchange Limited (“**Respondent No. 2**”).

2. Brief facts of the case are that Regulations Governing System Audit [Regulatory Compliance] (“**System Audit Regulations**”) were promulgated under Sub-Section 1 of Section 34 of the Securities and Exchange Ordinance, 1969 (“**Ordinance**”) for conducting System Audit of the Brokers in order to ensure compliance with the requirements of the Ordinance; Securities and Exchange Rules, 1971; Brokers and Agents Registration Rules, 2001; Regulations of the Karachi Stock Exchange Limited (“**KSE**”) and the directives issued by the Securities and Exchange Commission of Pakistan (“**Commission**”) from time to time.

3. The Respondent No. 1 and Respondent No. 2 were responsible to ensure that System Audit Regulations are efficiently and effectively enforced. Brief facts of the SCN are that two ballots were held on July 31, 2012 (‘Ballot No.17’) and January 28, 2013 (‘Ballot No. 18’) in pursuance of Regulation 5.1 of the System Audit Regulations. Clause





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8.5 of System Audit Regulations requires that the KSE shall forward the System Audit Reports (“**Reports**”) along with its and counter comments of the Brokers to the Commission within 45 days of submission of Reports. However, First Reports of non-compliant Brokers of Ballot No. 17 and Ballot No. 18 as submitted to the Commission did not contain views of the KSE and counter views of the non-compliant Brokers.

4. Moreover, enforcement actions in respect of Ballot No. 17 and Ballot No. 18 were taken based on Second Reports instead of First Reports in violation of the requirement as laid down under Clause 9.1 of System Audit Regulations. The First Reports of Ballot No. 17 were received from respective Auditors by the KSE till October 2012; however, enforcement process was initiated by the KSE from March 19, 2013 onwards. Moreover, perusal of the information revealed that the Respondents failed to ensure that timely and appropriate enforcement actions in respect of non-compliances reported in various Reports including Moosa Noor Mohammad Shahzada & Company (Private) Limited (“**MNS**”) and B&B Securities (Private) Limited (“**BBSL**”) were initiated.

5. In light of above, the Commission served above referred SCN to the Respondent No. 1 and Respondent No. 2. Hearing in the matter of aforesaid SCN was scheduled for March 11, 2014 at the Commission’s Head Office in Islamabad. The Respondent No. 1 vide letter dated March 6, 2014 requested for change in date of hearing. Acceding to the request, hearing in the matter was rescheduled to March 24, 2014 at the Commission’s Head Office in Islamabad. However, the Respondent No. 1 vide letter dated March 21, 2014 requested for another extension in the date of hearing and change of venue. Acceding to request of the Respondent No. 1, hearing was rescheduled for April 8, 2014 at the Commission’s Karachi Office.

6. The Respondents submitted their written responses to the SCN vide letters dated March 17, 2014. The arguments put forward by the Respondents in their written responses, on the issues raised in the SCN are summarized below:

a) Enforcement actions – based on Second Reports instead of First Reports:

- *System Audit Regulations need to be viewed as a whole for harmonious and consistent interpretation of various regulations. This regulation allows the Brokers to rectify any non-compliance identified in the Audit Report. Such rectification is then required to be confirmed by a Limited Scope Audit after a period of three months to ensure that the Brokers remain compliant during such*





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period. It is therefore obvious that the disciplinary action can only be initiated if any non-compliant Broker remains so after the Audit Report and the non-compliances are also reported in the Limited Scope Audit Report. If the penal action is initiated and concluded without allowing the opportunity to the Broker to rectify the non-compliance, the provisions of Regulation 5.2 would be rendered a nullity.

- Reference to "Report" in Regulation does not change the aforesaid position. The basis for identification of non-compliance remains the Audit Report since the Limited Scope Audit Report is only required to confirm if the non-compliance has been rectified. The Limited Scope Audit Report itself does not contain the basis of the non-compliance and therefore the action is to be initiated on the basis of the Audit Report and for this reason Regulation 9.1 refers to the "Report" instead of the Limited Scope Audit Report. This, however, does not in manner imply that the actions against a Broker found to be non-compliant has to be initiated without allowing him an opportunity to rectify such non-compliance as mandated by Regulation 5.2

b) Non-inclusion of views/counter views of the Respondent:

- Initial audit reports along with Brokers comments on the same were submitted to the Commission for Ballot 17 vide KSE's letter No. KSE/SECP -7907 dated November 2, 2012. However, regarding the comments of KSE on the same prior to their rectification, KSE vide letter no. KSE-908 dated February 26, 2013 explained that KSE shall be able to provide its comments after completing the enforcement actions. No further instructions in this regard were received from the Commission.
- Ballot 18 was held on January 28, 2013 and audit reports were received from respective auditors from March 27, 2013 to May 2, 2013. Exchange vide letter dated May 6, 2013 submitted Audit Reports of 31 Brokers to the Commission.

c) Non-sharing of the Reports of Intermarket Securities Limited ("IML"); Invest Capital Markets Limited ("ICSL") and First National Equities Limited ("FNEL") by the Respondent:

IML

- Initial audit report for IML under Ballot – 17 was submitted to KSE on October 24, 2012, by the Auditor, Riaz Ahmed & Company. The report contained Broker's comments on the reported non-compliances. The same was forwarded to the Commission on November 2, 2012, vide above referred KSE's letter dated November 2, 2012.
- This IML initial audit report dated October 24, 2012 identified 15 non-compliances. The auditor after about three months submitted Limited Scope Audit Report and found that the Broker still had 14 out of 15 non-compliances reported earlier in the initial report. The Limited Scope Audit Report was submitted to KSE on January 14, 2013 which was also forwarded to the Commission on January 23, 2013





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- Hearing was held on March 29, 2013. During the hearing the CEO of the Broker responded on Limited Scope Audit Report as under:
IML's Limited Scope Audit Report point 1.2 – pertained to obtaining the understanding of Broker's Client Order mechanism. The Broker's response was that all orders which were taken by phone were duly recorded however; due to unavailability of their activity log the auditors were unable to match specific order with recording of the telephone. The KATS record was requested and provided by Exchange to the Broker. The Broker also highlighted the fact that they used to send all confirmation to their clients on daily basis and their ledger balances are reconciled on regular basis, as such all order were fully match with all clients' orders. He pointed out, "till to date we don't have any investor's complaint regarding any issue related with order execution and account maintenance.
- Taking this into consideration the Broker was stated as compliant in this regard.

FNEL

- Auditor vide its letter No. NZAJ/SYS-AUD/KHI/13/FNEE dated May 2, 2013 submitted its Audit Report on FNEL for the period from January 01, 2012 to December 31, 2012.
- KSE vide letter No. KSE/SECP-2324 dated May 6, 2013 submitted System Audit Reports of all 31 Brokers including FNEL to SECP.

d) MNS – Non-initiation of enforcement action in a timely manner:

KSE did not fail to take timely action against MNS. The chronological summary of the events and actions taken by KSE in this regard is as follows:

- MNS was selected in ballot 17 on July 31, 2012.
- Audit was conducted by Naveed Zafar Ashfaq Jaffery & Co in August 2012.
- Internal audit compiled all initial reports of all non-compliant Brokers including MNS for ballot 17 and submitted the same to SECP vide letter dated November 2, 2012. Immediately after this the review of reported noncompliance and rectification process started by the Broker and the same was re-examined by the Auditor who submitted their final report to the Exchange on February 2, 2013.
- In accordance with Regulation 9.1 of the System Audit Regulations, and to take possible enforcement action against the company for un-rectified noncompliances disciplinary proceedings were initiated and hearing notice was issued to the company on March 19, 2013, the hearing was scheduled for March 22, 2013.
- The Broker through Nominee Director attended the hearing and informed that he has addressed all issues and has made his Brokerage house fully compliant in line with the advice of the Auditor and he will be able to submit the relevant documents and evidence to show his compliance in next two to three working days. His request was granted, the date of hearing was fixed as March 28 2013. But he failed to appear for the scheduled second hearing.





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- On April 9, 2013, KSE received information that the Nominee Director and CEO were not in the city. On the same day NCCPL vide their Notice dated April 9, 2013 suspended the Broker due to non-payment of their financial obligation to the clearing house.
 - The absence of the Nominee director of the Company from the scene continued while KSE started receiving various investors' claims against MNS.
 - Since the TREC holder was already suspended, no further enforcement action related to System Audit was possible and the matter was being dealt with at the board level.
 - The KSE Board in its meeting held on July 25, 2013 resolved that TREC Certificate of MNS be forfeited with immediate effect.
 - KSE has invited claims from all clients through Notice to market participants and via newspaper advertisement. KSE is in a process of selling the assets in its custody. Sale proceeds from these assets along with contribution from IPF. KSE will settle the verified claims on pro rata basis.
- e) BBSL – Non-initiation of proper enforcement action:
- B&B was selected for System Audit under Ballot 17 on July 31, 2012. The audit period was July 2011- June 2012.
 - M/s Haroon Zakaria was the auditor. The audit report was submitted to KSE on October 24, 2012, in which total of 11 non-compliances were reported. The report also contained Broker's comments. This report was forwarded to the Commission on November 2, 2012.
 - A limited scope review was conducted by the auditor and he submitted his final report to the Exchange on February 7, 2013. After the review it transpired that the Broker has rectified 9 deficiencies out of 11 non-compliances reported in the audit report.
 - The same was forwarded to the Commission on February 18, 2013.
 - The date of hearing was fixed as March 27, 2013. During the hearing, the Broker provided a copy of his clients' bank account statement showing a balance of Rs. 900,000 representing clients' funds with the Broker as evidence that he is compliant of the requirement of segregation of clients' funds. Only after verification of this, the Broker's status was stated as compliant in this regard.
 - KSE has therefore taken appropriate action in accordance with the System Audit Regulations and any assertion contrary to the aforesaid is denied being incorrect.
- f) Non-initiation of enforcement action and subsequent declaration as compliant:
- First Capital Equities Limited (FCEL)
- The Broker was selected for system audit under Ballot 17 on July 31, 2012. The audit period for this audit was July 2011 to June 2012.





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- *M/s. Naveed Zafar Ashfaq Jaffery & Co was the auditor. The audit report was submitted to KSE on October 30, 2012 which contained one non-compliance relating to the "clients funds and securities not being used by the Broker for any purpose other than authorized by the clients in writing.*
- *The Limited Scope Audit Report was also forwarded to the Commission on January 23, 2013.*
- *On April 12 they provided a letter from the auditor M/s. Naveed Zafar Ashfaq Jaffery & Co which states "FCEL is not using clients' funds for any purpose other than they are authorized by the client."*
- *Only after this, status of the Broker was stated as compliant in this respect.*

Gazipura Securities and Services (Private) Limited (GSL)

- *The Broker was selected for system audit ballot 17.*
- *M/s. Naveed Zafar Ashfaq Jaffery & Co was the auditor. The report contained Brokers comments.*
- *The auditor conducted a limited review and submitted their final report to the Exchange on February 11, 2013. The same was forwarded to SECP on February 18, 2013. It still contained some non-compliance.*
- *The hearing date was fixed for March 25, 2013. During the hearing the Broker confirmed in writing that " No employee of our Brokerage house is allowed to trade on any stock exchange and in this respect the compliance officer of the Broker has already submitted list to NCCPL which is system generated and as such the same does not require to be reported separately.*
- *As regards the Research report, the Broker affirmed that they do not circulate any research to anybody as they are execution Broker only.*
- *Only after the scrutiny and verification of the above, the Broker was declared as compliant.*

Oriental Securities (Private) Limited (OSL)

- *The Broker was selected under ballot 17. M/s. Riaz Ahmed Saqib Gohar & Co was the auditor.*
- *The report was submitted to KSE on October 31, 2012 which was forwarded to the Commission on November 2, 2012. The Limited Scope Audit Report was forwarded to the Commission on February 18, 2013*
- *The date of hearing was fixed for March 26, 2013. Regarding KYC & CDD they informed that they had a policy in this regard as circulated by KSE and disseminated through its website.*
- *In view of the above, the Broker's status regarding reported non-compliances was stated as compliant.*

Foundation Securities (Private) Limited (FSL)

- *The Broker was selected for system audit under ballot 17. The audit was conducted by M/s. Nadir Javaid Maqsood Imran.*





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- A limited scope review was conducted by the Auditor and they submitted the Limited Scope Audit Report to KSE on January 22, 2013 which was forwarded to the Commission on January 23, 2013.
- The hearing was fixed for March 26, 2013. FSL submitted a letter during hearing from the auditor stating that "we have received a copy of the agreement for securities trading through KSE Fix Gateway between KSE and FSL dated October 11, 2011 and received copies of monthly receipts according to KSE Regulations.
- In view of this, the Broker was stated as compliant.

Alpha Adhi Securities (Private) Limited (ASL)

- The Broker was selected for system audit under ballot 17. The Auditor was M/s. Nasir Javiad Maqsood Imran.
- The report contained Brokers comment and the same was forwarded to SECP on November 2, 2012. The Limited Scope Audit Report was also forwarded to SECP on January 23, 2013.
- KSE therefore has proceeded properly and in accordance with the System Audit Regulations and have only declared Brokers compliant after being reasonably satisfied of the relevant facts and any assertion contrary to the aforesaid is denied being incorrect.

The Respondent with regard to declaration of non-compliant Brokers as compliant communicated that:

- As stated above, the audit reports contained total 76 non-compliances among 20 Brokers and after limited scope review this was reduced to 42 between 13 Brokers. Therefore, the enforcement action was initiated against 13 Brokers and after proper hearing and upon seeing sufficient evidences regarding Brokers' compliance with regulatory requirements the respective proceedings against 12 Brokers were disposed of.

g) **Non-initiation of enforcement action against non-complaint Brokers:**

Ballot No. 17:

- The contents of paragraph 15 of the Notice are denied being incorrect except for the reproduction of Regulation 5.2.
- This regulation allows the Brokers to rectify any non-compliance identified in the Audit Report. Such rectification is then required to be confirmed by a Limited Scope Audit after a period of three months to ensure that the Brokers remain compliant during such period.
- It is therefore, obvious that the disciplinary action can only be initiated if any non-compliant Broker remains so after the Audit Report and the non-compliances are also reported in the Limited Scope Audit report. If the penal action is initiated and concluded without allowing the opportunity to the Broker to rectify the non-compliance, the provision of Regulation 5.2 would be rendered a nullity.





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- It has been amply demonstrated above that KSE has not merely relied upon assurances of Brokers and has taken appropriate proceedings where necessary. The Brokers have only been treated as compliant upon submission of sufficient evidence.

Ballot No. 18:

- The Limited Scope Audit Reports showed that IGI Finex Securities Limited and M.H.Securities (Pvt.) Limited were fully compliant.
- The exchange initiated disciplinary action and issued notices for hearing to Dattoo Securities (Private) Limited ('Dattoo') and Moonaco Securities (Private) Limited ('Moonaco') on September 10, 2013.
- On September 23, 2013 Dattoo was issued an advice.
On September 23, 2013 a penalty of Rs. 100,000 was imposed on Moonaco with directions to rectify all non-compliances by October 8, 2013. However, after hearing of his appeal against imposition of penalty, KSE Management Committee on December 23, 2013 upheld the appeal and reversed the enforcement action in favour of Moonaco

h) Non-submission of Limited Scope Audit Reports to the Commission within prescribed time of 15 days of conclusion of the same:

- KSE has previously also explained to the Commission that the Limited Scope Audit Report is to be forwarded after conclusion of the same and this is concluded when the disciplinary procedure is concluded. The disciplinary procedure was concluded on September 10, 2013 and the reports were submitted on September 25, 2013. Accordingly there is no delay in providing these reports.

i) The approaches and procedures adopted by the Respondent in taking enforcement actions against non-complaint Brokers:

- KSE has been proceeding properly and diligently and have accepted compliances based on the Auditors reports or other reliable evidence. The Commission has never asked for evidence of independent verification of this evidence nor has questioned the quality of such evidence before this Show Cause Notice. The Commission, despite ample powers to take independent inspection or action, has not proceeded on any occasion against any of the Brokers on the basis of the Audit Reports of Ballot 17 and 18.

7. The Respondents further in the written responses stated that:

"KSE as noted above has kept the Commission updated with all developments and all matters raised in the Show Cause Notice have been discussed in various meetings held with the Commission as reflected in the minutes of such meetings, as well as through various correspondence with the Commission KSE had been given the understanding that the Commission did not require any further actions in regard to these issues. Regulation





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9.4 of the System Audit Regulations empowers the Commission to take action against a broker if the Commission is of the view that KSE has neglected or failed to take action in accordance with the System Audit Regulations. To the best of KSE's knowledge no action has been ever initiated by the Commission under Regulation 9.4."

8. The Respondent No. 1 vide letter dated March 17, 2014, in addition to above in response to the SCN communicated that:

"I would like to respectfully point out that as the Managing Director of KSE, I have not personally been involved in the process of system audit other than the computerized balloting. From that point onwards, the system audit process has followed procedures involving the internal audit department and the offices of relevant officers involved in the system audit process, its monitoring, compliance and enforcement.

Further, in so far as the specifics of SCN mentioned above are concerned, I would like to strongly reiterate that the KSE and myself take the compliance function very seriously and have strived to improve the same overtime.....it appears to me that while procedures related to system audits 17 and 18 were substantially followed and there was no malafide or willful negligence of the said procedure, some instance of procedural delays in reporting to SECP may have occurred.

I would respectfully also submit to the Commission that in view of demutualization and corporatization of KSE, the SECP itself approved the Plan for Segregation of Commercial Function of Stock Exchanges in July 2012. I was involved at the strategic and policy level to put together the implementation plan of the said segregation.....and that such structural changes in an organization have a transition phase. It is my respectful submission that if the Commission believes that there are some instances of omission on the part of the exchange, they would be primarily due to this transition phase."

9. Hearing in the matter of aforesaid SCN was held on April 8, 2014. Respondent No. 1 and Respondent No. 2 attended the hearing. The assertions made by the Respondents during the course of hearing are summarized below:

- a) The Respondents communicated that they always endeavored to abide by the regulatory regime and there was no intent to circumvent any regulation. The Respondents added that the period for which SCN has been served was a transitory period for KSE due to demutualization and corporatization of the exchange. They explained that changes were being carried out in the governance structure of KSE and the management responsibilities were being segregated into commercial and regulatory functions during this period. The Respondents added that these changes were undertaken with a clear vision of improving the governance of the stock exchanges in Pakistan.





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- b) The Respondents explained that due to some confusion and misunderstanding, enforcement actions against non-complaint Brokers were not initiated on the basis of First Reports and assured that in future enforcement actions will be initiated on the basis of Reports of non-compliant Brokers and in accordance with the applicable regulatory framework. They apprised that Ballot No. 17 was held immediately after the promulgation of the revised System Audit Regulations wherein major changes were carried out in audit process and the scope was enhanced, as a result of which KSE faced some operational issues which have now been rectified.
- c) The Respondents informed that KSE has created a separate department specifically for the monitoring of the system audit and as of now, immediate enforcement actions are being taken on the basis of the Reports. The Respondents added that this creation of separate department shall enable the KSE to closely monitor the process and ensure compliance with the regulatory framework more efficiently. They further stated that affairs of Ballot No. 19 are now proceeding satisfactorily and compliance level by the Brokers has also been increased. The Respondents emphasized that the purpose of system audit is to increase the compliance level among Brokers and not to penalize them.
- d) With regard to non-compliances identified in the Report of FNEL, the Respondents apprised that it has almost paid all penalties and complied with directives issued by the Respondent. They further added that there is a need to prioritize the issues according to their seriousness and at present major one is segregation of client's assets and should be our prime focus.
- e) The Respondents were enquired about the discrepancies identified in the financial statements of BBSL as of June 30 2012; non-initiation of enforcement action on the basis of Report of BBSL and subsequent declaration of BBSL as compliant. They assured that the requisite information will be provided to the Commission shortly.
- f) The Respondents concluded that there was no malafide or willful negligence of the procedures on part of the Respondents and KSE, there might be some instances of omissions which would primarily be due to this transition phase but would have not been otherwise. They assured that KSE hold the Commission in the highest respect





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and esteem and laud its endeavours towards improving and developing the KSE specifically and capital market's in particular.

10. I have heard the arguments presented by the Respondents at length during the hearing. Additionally, I have perused the available record and the written responses filed by the Respondents. Accordingly, my findings on the arguments and assertions made by the Respondents to the issues raised in the SCN are as follows:

- a) With regard to Regulation 5.2 of the System Audit Regulations, it is noted that the Respondents misinterpreted the time of Limited Scope Audit. Regulation 5.2 of the System Audit Regulations states that:

"If the Report contains any non-compliance(s), the Broker shall rectify the same immediately and such Broker shall be subject to limited scope audit in the following year to confirm that such Broker is now compliant of those particular non-compliances where the Auditor found such Broker non-compliant. The period for limited scope audit shall not be less than 3 months ensuring the discrepancies identified in the Report are rectified and the Broker has remained compliant during the said period. The limited scope audit may be conducted by the Exchange itself, which shall not alter or affect the Broker's normal selection process or timing through random balloting. The Exchange shall also provide a copy of such report of limited scope audit to the Commission within 15 days of conclusion of the same".

It is clear from the review of the Regulation 5.2 that Broker shall be subject to Limited Scope Audit in the following year covering three months' period and not immediately after the submission of Reports within three months. In this regard, the Respondent's stance cannot be accepted. Regulation 5.2 envisages two rectification processes to be initiated. One is the immediate rectification of non-compliance followed by Limited Scope Audit in the following year to ensure that recalcitrant broker is compliant with the Regulations. This process of rectification, however, does not stall the enforcement action provided in the Regulation 9. The provision of Limited Scope Audit is to provide an exception to audit process prescribed in the Regulation 5.1 i.e. random balloting and be construed to provide respite to a non-compliant broker. The Regulations cannot be attributed such a meaning whereby its provisions are rendered redundant. The clear language and intent of rules and regulations cannot be subservient to perverse interpretation. On the contrary the penal provisions are to be construed strictly.





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- b) With regard to non-sharing of the Reports of non-compliant Brokers i.e. IML, ICML and FNEL, the Respondents in their written stance asserted that KSE shared the Reports with the Commission. However, the Respondent ignored the fact that these Brokers were having material and serious nature of non-compliances and KSE was required to immediately share the Reports along with its own comments and the comments of the Brokers on the identified non-compliances to the Commission, which they failed to ensure. However, admittedly they failed to share their views and counter views which were *sin qua non* of the reporting procedure enunciated in the Regulation 8.5, reproduced hereunder for ease of reference:

"The Exchange shall forward to the Commission copies of the Reports of the Brokers audited, along with the views, counter views and comments of the Brokers and the Exchange on the discrepancies/observations, within 45 days of submission of the Reports. Provided that, if the Report highlights any material non-compliance by the Broker, such Report shall be immediately forwarded to the Commission."

The Reports submitted were deficient in material particulars as per scheme of System Audit Regulations and without essential prerequisites, stalling any punitive action thereto.

- c) With regard to the enforcement actions against the specific Brokers, which mainly include BBSL, MNS, IML, FNEL and ICSL, the Respondents communicated that disciplinary process was initiated by KSE on the basis of Limited Scope Audit Report, whereas, Regulation 9.1 of the System Audit Regulations requires that disciplinary proceedings be initiated on the basis of Reports of the non-compliant Brokers, which provides that:

"If the Report identifies any non-compliance(s) including that of the Articles, Rules, Regulations and directives/notices/circulars/ guidelines of the Commission, Exchange etc., the Exchange may, after giving the Broker an opportunity of being heard and considering the severity and materiality of the non-compliances, take appropriate enforcement action including issuing warnings, imposing fines, suspension of membership rights with the approval of the Board etc. The Exchange may by order, direct the broker to pay a fine amounting to not less than Rs. 10,000/- but not exceeding Rs. 200,000/- per instance of non-compliance, in addition to the specific penalty/enforcement action as provided in the relevant law, rules and regulations."

The Respondents by not initiating the proceedings on the basis of Reports failed to ensure compliance with the regulatory framework. Moreover, the Respondents' stance that Ballot No. 17 was held immediately after amendments in the System





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Audit Regulations, does not absolve the Respondents from their responsibility of proper compliance and enforceability of the applicable regulatory framework.

- d) The Respondents in the written response, while explaining their stance about the status of non-compliant Brokers as compliant, stated that the information was provided to the KSE during the course of hearing by the Brokers. Here, it is pertinent to mention that all the evidences on the basis of which KSE has declared the non-compliant Brokers as compliant; pertains to the same period for which the said Brokers were declared as non-compliant by the respective system auditors. This leads to two of the following possibilities:

- i). The said information was not provided by the Brokers to the respective auditors in a timely manner or;
- ii). The Brokers were non-compliant during the period and subsequently made the requisite changes to make itself compliant and submitted the evidence of the same to the KSE.

In either of the above referred possibilities; the Brokers' status is non-compliant and the KSE should have enquired the Brokers in this aspect and ensured that all the non-compliances were addressed properly in conformity with the true spirit of the regulatory framework.

- e) The Respondents while accepting that IML, BBSL and FCEL were non-compliant initiated disciplinary proceeding against these Brokers. The Respondents in the written response, with particular reference to segregation of clients' assets and maintenance of books of accounts, communicated that:

- i). *IML provided copy of the bank account and a letter from their Auditor M/s. Rahman Sarfraz Rahim Iqbal Rafiq certifying that IML has opened separate bank account.*
- ii). *BBSL was declared as compliant on the basis of its statement that the current liabilities as of March 26, 2013 are Rs. 850,000 and it has placed an amount of Rs. 900,000 in the bank account tagged for clients' money.*
- iii). *FCEL was declared compliant on the basis of auditors' statement submitted to the Respondent that FCEL is not using clients' funds for any purpose other than they are authorized by the client.*

In the above referred instances, the KSE declared the Brokers as compliant on the basis of either a simple letter from respective auditor or copy of the bank statement (tagged as clients'), which cannot be adequately considered as confirmation of the





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- maintenance of segregation of clients' assets by the Brokers. The KSE should have enquired specific reconciliation as of a date to ensure that the Broker is maintaining segregation of clients' assets. In cases of non-compliant Brokers specifically regarding segregation of clients' assets, it was the responsibility of the Respondents to ensure that the requirement was complied with and enforced in letter and spirit.
- f) With regard to the Respondents' stance that the purpose of the System Audit Regulations is to increase compliance level among the Brokers and not to penalize them, such a perverse interpretation of a penal provision cannot be appreciated. The Regulations were made to safeguard the interest of investors and infuse confidence in the market. If the delinquent broker is not to be penalized than such a toothless Regulation would not have served any purpose. The very object of clear cut and unambiguous language of Regulations 9 under the heading "Enforcement" was to ensure compliance and penalty was prescribed to punish non-compliant broker. Be that as it may, the stance of the Respondents is also negated from its actions in the case of FNEL, to whom KSE has penalized time and again is still a non-compliant Broker (as communicated by the Respondent). It is imperative that the KSE should have strong mechanism in place to handle such instances as the Brokers are custodian of the investors' money and KSE is responsible to ensure that investors' assets are not mishandled by the Brokers in any form.
- g) With regard to MNS, non-compliances were identified in the Report submitted to the Respondent in August 2012 and the Respondent initiated disciplinary proceeding in March 2013 (almost after 7 months). The Respondent's laid back attitude in the matter of non-compliances identified in the Report of MNS led to the default of the Broker and non-settlement of number of investors' claims. Had the Respondent initiated timely enforcement action, the suspension of the Broker could have been avoided and may have resulted in less damage to the investors. The inaction of the Respondents cannot be condoned on flimsy grounds or innovative meaning attributing to plain and simple language of the System Audit Regulations of which Respondents miserably failed to comply and enforce.
- h) With regard to BBSL, the Respondents agreed to provide the requisite information to substantiate the basis due to which enforcement action was not initiated against the Broker. However, subsequent to the hearing the KSE wrote various letters to





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BBSL and enquired about the information and the noncompliances by the Broker. Here, it is pertinent to note that the above referred conduct of the KSE showed that BBSL was non-compliant and was falsely declared as compliant. Accordingly, the Respondents failed to take appropriate action in a timely manner in the matter of BBSL.

- i) With regard to the Respondents' stance that the Commission was aware of all the happenings at the KSE and could have initiated disciplinary proceedings against the non-compliant Brokers under System Audit Regulations does not absolve the Respondents from performance of their responsibilities in a diligent manner. The Commission being Apex Regulator is envisaged with all the powers and can initiate disciplinary proceedings, as and when required. However, the Commission is not expected to involve in the micromanagement of the day to day affairs and functions of the exchange including the system audit process. Furthermore, KSE being the primary recipient of the Reports containing non-compliances of the Brokers is required to initiate enforcement actions against the non-compliant Brokers and ensure compliance with the System Audit Regulations. The exchange is expected to take ownership of the responsibilities assigned under the regulatory framework and cannot shift its responsibilities towards others. In this regard, it is also clarified that on the persistence of the Commission two meetings were held with KSE team to discuss procedures applied by KSE to ascertain compliance status of regulations; however, no understanding was ever given to the exchange that Commission did not require any further actions with regard to the issue.

11. It is pertinent to mention here that the spirit of System Audit Regulations is to uphold the integrity of stock market and safeguard the interest of investors while putting in place effective checks and balances to deter, detect and rectify instances of non-compliances. Moreover, the System Audit Regulations have been promulgated to strengthen risk management; monitoring and oversight of the market intermediaries with applicable regulatory framework which also includes conformity with the requirements of effective Know Your Customer and Customer Due Diligence policies at the Broker level and formulation of framework to reinforce requirements of the Anti-Money Laundering Act.





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12. I am of the view that regulations are rendered ineffective if not followed in letter and spirit. The KSE, being Frontline Regulator, is required to vigilantly monitor and oversee the process of system audit of Brokers by the Auditors, properly follow the regulations and enforce it firmly for the protection of investors' interest and to ensure the safety and fairness of the market. The System Audit Regulations, if properly enforced, shall increase the compliance level among the Brokers, in particular aspect of the Risk Management which cover the capital adequacy requirements and segregation of clients' assets. The Respondents, during the course of hearing, agreed that enforceability of the segregation of clients' assets is the need of the hour and would be of greater value to protect assets of the investors' and strengthening of the capital markets' integrity and credibility.

13. After a detailed and thorough perusal of the facts, evidence/information available on record, contentions and averments made by the Respondents during the course of the hearing, it is evident that with regard to the instances highlighted in the SCN, the Respondents failed to ensure that appropriate enforcement actions were initiated by KSE in a timely manner against non-complaint Brokers as required under the regulatory framework. It is the responsibility of the Respondent No. 1 and Respondent No. 2 to ensure that the KSE performs its function in an objective and just manner as it has to set an example for the intermediaries related to its business, enhance the confidence of investing public and promote healthy development of the securities market.

14. The Respondent No. 1 in the written comments and during the course of hearing communicated that although he was not personally involved in the process of System Audit other than the computerized balloting but he takes the compliance function very seriously. However, being the Managing Director of KSE, it is his responsibility to ensure that the KSE is performing its fiduciary duty for the protection of interest of investing community. By virtue of being the Managing Director of the KSE, the duty to exercise reasonable care, skill and diligence in case of the Respondent No. 1 is heightened. It is noted with deep concern that the Respondent No. 1 failed to ensure the placement of mechanisms and resources necessary to ensure effective compliance of the regulatory framework.

15. The Respondent No. 2, being the Deputy Managing Director was assigned the primary responsibility of compliance and enforcement of the System Audit function of the

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KSE. If the duties were performed diligently by the Respondent No. 2 the compliance level among the Brokers, with specific regard to risk management and segregation of clients' assets, would have improved. It was the duty of Respondent No. 2 to keep close watch on the system audit process and ensure that process was conducted and concluded in transparent and timely manner. However, serious lapses and delays on part of the Respondent No. 2 in the enforcement process lead to instances such as default of MNS which could have otherwise been avoided. The declaration of non-compliant Brokers as compliant by the KSE depicts laid back attitude of the Respondent No. 2 towards discharge of his responsibilities.

16. Having considered the facts and circumstances described in the above paragraphs and my observations/findings in the matter, I am of the considered view that the Respondents have failed to perform their responsibilities as envisaged to them and are negligent in the discharge of their duties and obligations. Therefore, in exercise of powers conferred under sub-section (c) of Section 22 of the Ordinance I hereby impose a penalty of Rs. 200,000 (Rupees Two Hundred Thousand Only) on the Respondent No. 1 and a penalty of Rs. 500,000 (Rupees Five Hundred Thousand Only) on the Respondent No. 2.

17. 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 Respondents in accordance with the law on matter subsequently investigated or otherwise brought to the knowledge of the Commission.

Announced on May 23, 2014
Islamabad.



(Imran Inayat Butt)
Director/HOD (MSRD)