SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
Securities Department
Securities Market Division

NIC Building Jinnah Avenue, Blue Area, Islamabad

Before The Executive Director (Securities Department)

In the matter of Recovery of Tenderable Gain
Under Section 224(2) of the Companies Ordinance, 1984
From Mr. Ruhail Mohammad, Chief Accountant,
Engro Corporation Limited, Formerly Engro Chemical Pakistan Limited.

Date of Hearing : 06/05/2010

Present at hearing :

Representing the Respondent: The Respondent in Peron

Assisting the Executive Director (SD) :

(i) Mr. Imran Inayat Butt — Director (SD)

(ii) Mr. Muhammad Farooq — Joint Director (SD)

Order

This order will dispose of the proceedings initiated under Section 224(2) of the Companies Ordinance, 1984 (the "**Ordinance**") by the Securities and Exchange Commission of Pakistan (the "**Commission**") through Show Cause Notice No S.M.(B.O)C.O.222/14(122)05 (the "Notice") dated 18/03/2010, against Mr. Ruhail Mohammad (the "**Respondent**"), Chief Accountant Engro Corporation Limited, Formerly Engro Chemical Pakistan Limited (the "**Issuer Company**").

2. Brief facts of the case are that:-

a) It was observed from the returns of beneficial ownership furnished by the Respondent under Section 222 of the Ordinance that he has made the following purchase and sale transactions, within a period of less than six months:-

Date	Nature of Transaction	No. of Shares	Rate per Share (Rs.)
08/05/2008	Sale	29,450	330.00

09/05/2008	Purchase	29,450	330.00
06/08/2008	Purchase	15,000	188.20

b) On account of the aforementioned transactions, the Respondent made gain of Rs. 2,127,000/- (Rupees two million one hundred twenty-seven thousand only), computed in the manner prescribed in Rule 16 of the Companies (General Provisions and Forms) Rules, 1985 (the "**Rules**").

3. Section 224 of the Ordinance provides that where *inter alia* Chief Accountant of a listed company who is or has been the beneficial owner of any of its equity securities makes any gain by purchase and sale, or the sale and purchase, of any such security within a period of less than six months, such person is required to make a report and tender the amount of such gain to the company and simultaneously send an intimation to that effect to the Registrar of Companies and the Commission. The said Section further provides that where such person fails or neglects to tender or the company fails to recover, any such gain within a period of six months after its accrual, or within sixty days of a demand thereof, whichever is later, such gain shall vest in the Commission and unless such gain is deposited in the prescribed account, the Commission may direct recovery of the same as an arrear of land revenue.

4. In the instant case, neither the matter of accrual of the aforesaid gain was reported by the Respondent in Part-D of the prescribed returns of beneficial ownership filed by him with this Commission for the aforementioned transactions, nor its tendering or recovery was reported to the Commission, as provided in Section 224 of the Ordinance. The Respondent was, therefore, intimated vide letter dated 12/11/2009 that the aforementioned liability accrued under Section 224(1) of the Ordinance is apparently still outstanding and the same may now be discharged by tendering the aforementioned amount of gain in favour of the Commission. The Respondent responded the matter on 18/11/2009 and stated that Section 222-224 of the Ordinance as well as Rule 16 of the Rules are designed to penalize trading gain (made within 6 months) but no such gain has been made by him.

5. The plea of the Respondent was examined in the light of provisions of Section 224 of the Ordinance and Rule 16 of the Rules and was considered to be unsatisfactory. Thus, Notice under Section 224(2) of the Ordinance was served upon the Respondent on 18/03/2010 and personal hearing in the matter was fixed for 15/04/2010, which on the request of the Respondent was

adjourned to 06/05/2010. On the given date, the Respondent appeared before me in person and requested to withdraw the Notice on the plea that the sale and purchase transactions made by him do not attract the provisions of Section 224(2) of the Ordinance. The arguments advanced by the Respondent in support of aforementioned contention in writing as well as verbally are summarized hereunder:-

a) **No gain has been made:** The Respondent argued that *"in first two transactions he sold and purchased the equal number of shares at the same rate of Rs. 330/- per share and therefore no gain was made. Consequently, these should really be considered to be one transaction. These shares were beneficially owned by me for a period much longer than six months. While, in the last transaction I purchased 15,000 shares but have not sold them to date nor I have sold earlier 29,450 shares. Rule 16 as well as Sections 222-224 of the Companies Ordinance are designed to penalize trading 'gains' (made within 6 months) but I have made no such gain.*

b) **Purpose of sale and purchase transactions:** The Respondent stated that *"First two transactions were done for the tax purposes. Hence intent behind the Section and the Rule is not attracted in the case".*

6. I have considered the facts of the case, written and verbal submissions made by the Respondent during the course of hearing and relevant provisions of law. My observations in this regard are as under;-

a) **No gain has been made**: The assertion of the Respondent that *"no gain was made"* has been considered and observed that the Respondent has computed the gain by :-

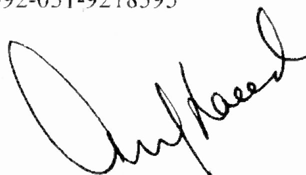
   I. Considering that shares of the same class of the same listed company are not interchangeable/fungible

   II. Matching the transactions on chronological order instead of by applying the manner prescribed in Rule 16 of the Rules.

   Thus, the primary issue, which in my opinion is to be determined here is whether the securities of the same class are fungible/interchangeable or not and how the purchases and sales would be matched for computation of amount of tenderable gain.

   In order to address the issue, the legal frame work given in Section 224 of the Ordinance and Rule 16 of the Rules is needed to be addressed in detail. Section 224(1) of the Ordinance provides that:-

   "Where any director, chief executive, managing agent, chief accountant, secretary or auditor of a listed company or any person who is directly or indirectly the beneficial owner of more than ten per cent of its listed ***equity securities*** *makes any gain by the purchase and sale, or the sale and purchase, of* ***any such security*** *within a period of less than six months, such director, chief*



executive, managing agent, chief accountant, secretary or auditor or person who is beneficial owner shall make a report and tender the amount of such gain to the company and simultaneously send an intimation to this effect to the registrar and the Commission"

I am of the view that the phrases "equity securities" and "any such security" appear in the Section 224(1) have very much significance here. The words "equity securities" signifies that a beneficial owner may own simultaneously more than one class of shares, while the word "such security" symbolizes here security of same class. Furthermore, noticeably the word "any" appears before the words "such security". Thus, it is emphasized here that the law uses word "any" instead of the word "particular". Hence, the tenderable gain will arise through purchase and sale or sale and purchase of "any security of same class" instead of "particular security of same class, by a beneficial owner of a listed company. This suggests that securities of same class of a same listed company are interchangeable/ fungible. And this concept has explicitly been expressed in Rule 16(1)(b) of the Rules, which states that;-

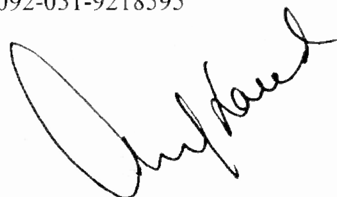
"-------the purchases and sales shall be matched as aforesaid so long as the securities involved in the purchase and sale are of the same class and of the same listed company and for this purpose the shares shall be deemed as fungibles.

It is further pointed out that the concept "shares of same class are fungible in nature" is not a new concept, as it is prevailing since the promulgation of Securities and Exchange Ordinance, 1969 ("**SE Ordinance**"), when the subject matter of trading by officers and principal shareholders of listed companies was monitored under the SE Ordinance. The issue was elaborated in Circular No. 2 of 1971 dated 26/06/1971 of the then Securities and Exchange Authority of Pakistan. The said Circular inter alia states:-

"A view has been expressed that for the purpose of matching sales and purchases, the securities sold should be same as were purchased during the period. This view is not correct. Securities are fungible and it would, therefore, not be necessary ever to show that the particular security which is sold is the one which was purchased. Purchases and sales would be match-able so long as the securities involved in the purchase and sale are of the same class."

International Practice:-

In order to know the international practice on the subject matter, the prevailing legal frame-work in United States of America (the "**USA**") has been consulted. In USA, the matter of trading by directors, officer and principal shareholders is dealt under Section 16 of the Securities and Exchange Act, 1934 (the "**SEC Act, 1934**"). It is worth mentioning that *Smolowe v. Delendo Corp. (1943, Circuit Court of Appeals, Second Circuit)* is the leading case regarding the construction of liability under Section 16(b) in the USA, wherein after detailed discussion, the court held that:-



"----where an insider purchases one certificate and sells another, the purchase and sale may be connected, even though the insider contends that he is holding the purchased security for sale after six months".

The aforementioned discussion as well as judgment of Circuit Court of Appeals of USA clearly states that shares of same class are identical and substitutable. It is worth mentioning that each share of same class carries same denomination/par value, fetches same market price, same payout and same voting rights. Even delivery of any share of same class may be received and made at the time of purchase and sale respectively. Hence no distinction can be made among the shares of the same class on the basis of rights attached thereto, as these are same for all shares of the same class.

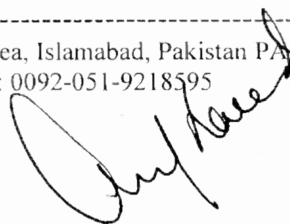
<u>Computation of Tenderable Gain:-</u>

Subsequent to establish that "*securities of the same class are fungible*" the legitimacy of the manner applied by the Respondent for calculation of tenderable gain is examined. For this purpose, we again go through the contents of Section 224(1) of the Ordinance. It is pertinent to mention here that the said Section of the Ordinance requires tendering of "any gain" made by the purchase and sale, or the sale and purchase, of securities. So, the word "any" before the word "gain" has significance.

Perusal of Section 224(1) of the Ordinance reveals that it inter alai imposes certain conditions for accrual of tenderable gain i.e. the transactions must be made in <u>same class of equity security</u> of <u>same listed company</u> <u>by a beneficial owner</u>, <u>within the period of less than six months</u>. When these conditions are met, then the matter requires analysis whether "any gain", has accrued or not, which means it necessitates a manner for computation of "any gain" which has been given by the Federal Government in Rule 16 of the Rules. The said Rule provides that for the purpose of computation of tenderable gain <u>*the purchase at lowest rates shall be matched against the sales at highest rates prevailing within the six months.*</u>

In my opinion this manner of computation of gain has been formulated by the Federal Government in accordance with the spirit and objectives of Section 224(1) of the Ordinance, which speaks about the recovery of "any gain". Furthermore, this manner of computation of tenderable gain is also in line with international practice.

As earlier mentioned that in order to know the international practice, the prevailing legal framework on the subject matter in USA has also been consulted. The perusal of the said legal structure reveals that Section 16 of the SEC, Act 1934 does not specify any method for computation of amount of profit (short swing profit). <u>However, in USA the Court has determined, a methodology for calculation of short-swing profit, which is same as in Pakistan i.e. Lowest-in Highest-out rates are matched</u>. In the case of *Smolowe v. Delendo Corp. (1943, Circuit Court of Appeals, Second Circuit)* the court held that:

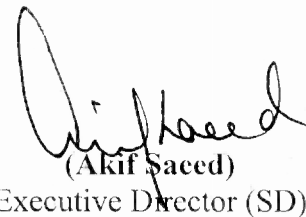


"---The only rule whereby all possible profits can be surely recovered is that of lowest price in, highest price out-- within six months-- as applied by the district court. We affirm it here, defendants having failed to suggest another more reasonable rule....

In view of the foregoing discussion, I am of the view that the contention of the Respondent that "*no gain was made*" does not have any merit. In the instant case, the Respondent has sold 29,450 shares on 08/05/2008 at the rate of Rs. 330/- per share and later on made two purchase transactions, within the period of less than six months of the said sale at the rate ranging from Rs. 188.20 to Rs. 330/- per share. Since the transactions have been made in same class of the shares as well as within the period of less than six months, therefore, the instant case falls in the ambit of Section 224 of the Ordinance. And pursuant to Rule 16 of the Rules purchase of 15,000 shares dated 06/08/2008 would be matched with sale dated 08/05/2008 for computation of tenderable gain.

b) **Purpose of sale and purchase transactions:** The contention of the Respondent has been examined in the light of proviso to Section 224(1) of the Ordinance and observed that the only exception mentioned in the law relates to securities acquired in good faith in satisfaction of debt previously contracted. The transactions made for tax purpose or any other purpose cannot therefore be exempted from the purview of Section 224 of the Ordinance. Since the transactions made by the Respondent do not be categorized as given in the proviso, therefore, claimed exemption can not be granted. It is pertinent to mention here that section 224 of the Ordinance 1984 intends to recover "any" gain made by the purchase and sale, or the sale and purchase, of securities. So, capital gain or any other gain is squarely covered under the provisions of Section 224 of the Ordinance. Thus, the contention of the Respondent has no merit.

7. In view of the foregoing, I am of the considered opinion that the arguments presented by the Respondent do not have any merit and substance. Hence, the request to withdraw the Notice is rejected and the Respondent is, hereby, directed to tender Rs. 2,127,000/- (Rupees two million one hundred twenty-seven thousand only) to the Securities and Exchange Commission of Pakistan as provided in section 224(2) of the Companies Ordinance, 1984, through a demand draft in favour of the Commission, within thirty days of the issue of this order.



(Akif Saeed)
Executive Director (SD)

Islamabad.
Announced on March 18, 2011