

Securities and Exchange Commission of Pakistan

BEFORE APPELLATE BENCH

In the matter of

Appeal No. 102 of 2017

Mohammad Munir Mohammad Ahmed Khanani Securities (Private) Limited

Appellant

Versus

The Commissioner, (SMD), SECP, Islamabad.

Respondent

Date of hearing:

December 19, 2019

Present:

For Appellant:

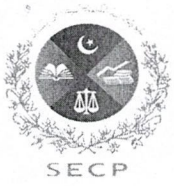
- i. Mr. Muhammad Munir Khanani,
- ii. Mr. Abdul Razzaq,
- iii. Mr. Abdallah Azzaam Naqvi, Advocate

For Respondent:

- i. Mr. Osman Syed, Joint Director (Adjudication-I), SECP
- ii. Mr. Sabeel Ahmed, Assistant Director (SMD), SECP
- iii. Ms. Mehwish Naveed, Management Executive (Adjudication-III), SECP

ORDER

1. This Order shall dispose of Appeal No. 102 of 2017 filed by the M/s. Mohammad Munir Mohammad Ahmed Khanani Securities (Private) Limited (the Appellant) against the Order dated September 20, 2017 (the Impugned Order) passed by the Executive Director, PRPD (the Respondent) under the Securities Brokers (Licensing and Operations) Regulations, 2016 (the Regulations) read with the Securities Act, 2015 (the Act).
2. Brief facts of the case are that the Appellant is a Trading Right Entitlement Certificate holder of the Pakistan Stock Exchange (PSX), licensed as a securities broker with the Securities and Exchange Commission of Pakistan (the Commission) and a clearing member of the National Clearing Company



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of Pakistan Limited (NCCPL). The Appellant was not registered as a Finanee/Financier for Margin Financing (MF), Margin Trading System (MTS) and securities lending and borrowing with NCCPL under the NCCPL Regulations, 2015 (the NC Regulations) read with Securities (Leveraged Markets and Pledging) Rules, 2011 (the Rules). However, subsequent to the issuance of the Show Cause Notice dated January 27, 2017 (the SCN), the Appellant obtained registration as a Finanee/Financier for MF, MTS and securities lending and borrowing. The Commission conducted a compliance review under section 79(3) of the Act (the Review) to ascertain the Appellant's compliance with the regulatory framework regarding financing and extending credit (the Framework) during the period from March 1, 2016 to November 30, 2016. The Review, revealed following the non-compliances of the Appellant;

- a. The Appellant was extending financing/credit to its clients for trading of securities, without registration as Finanee/Financier and such financing/credit resulted in clients' continued debit balance. Margins payments by the Appellant on behalf of its clients and continued debit balance of clients was violation of Rule 34 of the Rules. Financing through other than regulated modes was violation of the Rule 34 of the Rules and the Appellant was also charging mark-up from its clients in guise of late payment charges.
 - b. In violation of the Regulation 4.18.1 (c) of the PSX Rule Book (the Book), the Appellant had not maintained collateral account under its participant account and failed to reduce continued debit balances of clients.
 - c. In violation of the Regulation 19.5 of the Book read with Regulation 12.9.3 of the NC Regulations, the Appellant had failed to recover margins from its clients for the trades executed in the ready market.
 - d. In violation of the Regulation 19.5 of the Book read with Regulation 12.9.3 (a) of the NC Regulations, the Appellant failed to recover mark to market (MtM) losses of Future Market, in form of cash from its clients.
 - e. In violation of the Regulation 34 of the Securities Brokers (Licensing and Operations) Regulations, 2016 (the Regulations), the Appellate failed to make additional disclosures in quarterly accounts for the period ended September 30, 2016.
 - f. In violation of Section 64 of the Act, the Appellant provided finance facility to various brokerage houses. The extension of finance facilities to brokerage houses was beyond the scope of regulated and permissible securities activities.
3. In view of the violations highlighted during the Review, the SCN was served on the Appellant under Section 150 of the Act. The Appellant's written reply (the Reply) was received on February 15, 2017

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whereas, hearing in the matter was held on February 17, 2017. The Appellant's representatives reiterated assertions contained in the Reply and stated that the Appellant is significantly compliant with the Framework and requested to investigate the remedial measures adapted by the Appellant after the Review. In order to verify the Appellant's claim and assess the status of compliances with the Framework, the Securities and Exchange Commission of Pakistan (the Commission) conducted a Appellant's Follow up Review (the FL Review) for the period May 1, 2017 to May 31, 2017. The FL Review revealed the following:

- i. The Appellant collected late payment charges of Rs. 842,050/- from its 427 clients for the month of May 2017. Whereas, the aggregate late payment charges were Rs. 39.76 million by May 31, 2017.
 - ii. Instances of non-collection of margins in the ready market and MtM losses in future market from its clients.
 - iii. Instances with regard to execution of trades of clients despite existence of continued debit balances.
4. The details of the FL Review were shared with the Appellant for its comments on July 13, 2017. The Appellant was provided another opportunity of hearing on August 10, 2017. After the Review and the FL Review, following violations of the Framework were observed;
- I. Appellant was extending financing/credit to clients, in violation of Rule 34 of the Rules and in violation of para 2.1 of the guidelines dated July 3, 2013 issued by the Commission, charging mark up on receivables (continued debit balances) from clients.
 - II. In violation of the Regulation 19.5 of the Book read with Regulation 12.9.3 of the NC Regulations, the Appellant had failed to recover margins from its clients for the trades executed in the ready market.
 - III. In violation of the Regulation 19.5 of the Book read with Regulation 12.9.3 (a) of the NC Regulations, the Appellant failed to recover MtM losses of Future Market, in form of cash from its clients.
 - IV. In violation of the Regulation 34 of the Regulations, the Appellate failed to make additional disclosures in quarterly accounts for the period ended September 30, 2016.
5. In view of the above violations of the Framework, the Respondent instead of imposition of monetary penalty, issued a strict warning to the Appellant for its failure to collect margins, recover MtM losses



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and non-disclosure of requisite information in quarterly Accounts. Whereas, the Respondent had imposed a monetary penalty of Rs. 1,000,000/- for the violation of the Framework regarding unregulated financing/credit extended by the Appellant to its clients and charging markup thereon.

6. The Appellant has challenged the Impugned Order *Inter alia* on the grounds that the Respondent had failed to consider the fact that the volume of receivables from clients was reduced significantly. The Appellant further stated that late payment charges were being collected from clients, who did not clear their dues for extended periods. The Appellant stated that late payment charges are applied to cover the Appellant's financial cost as it is the Appellant's duty to secure the interest of its shareholders. The Appellant contended that late payment charges should not be confused with the practice of in-house financing as the Appellant imposed late payment charges to clients at a rate of KIBOR + 3/4% despite the fact the Appellant has to finance such purchases itself at a rate of KIBOR + 2/3%, hence, the Appellant ends up charging a spread of barely 1% on the overdue balances of the clients to cover its administrative cost of managing bank accounts, bank charges, and rigorous follow-ups with clients. The Appellant submitted that late payment charges had never been a source of income to the Appellant but are applied so that the clients settle their overdue balances promptly. The Appellant further stated that it is maintaining a 35% Financing Participation Ratio, (FPR) from each of its clients which is more than the minimum NCCPL requirement of 25% FPR (or VAR, whichever is higher). The Appellant stated that any MtM profits gained by clients whose margins have fallen below the 35% FPR had not been automatically released, which resulted as debit balance due to unreleased MtM profits.
7. The Appellant stated that the Respondent had failed to consider the Appellant's written and oral arguments with regard to collection of margin from its clients. The Appellant had a pre-settlement delivery system, whereby exposure margins are waived in case the delivery of purchased securities is made before the settlement date. The Appellant further stated that in order to meet the spirit of the requirements as set out in the Book and in NC Regulations, clients in general are required to ensure they maintain adequate margins (in shape of cash and or securities) upon taking exposure in any market. The Appellant contended that requiring the clients to maintain margins in the shape of cash and or securities is also in line with requirements stated under Schedule II of the NC Regulations, which specifies the form of exposure margins requirement as follows in Ready Delivery Contract Market. The Appellant stated that the Respondent failed to appreciate that majority of the clients pay margins in the form of cash.



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8. The Respondent has rebutted the grounds of Appeal and stated that the Appellant was extending credit by providing finance to its clients for trading of securities. The Respondent submitted that the Appellant also charged mark-up from its clients in the guise of late payment charges. The Commission conducted FL Review of the Appellant for the period of 01/5/17 to 31/5/17. The FL Review revealed that the Appellant collected late payment charges of Rs.842,050/- from its 427 clients for the month of May, 2017. The total late payment charges aggregated to Rs.39.76/- million as of May 31, 2017. It is pertinent to mention here that the Commission issued guidelines on July 3, 2013 for calculation of net capital balance. At para 2.1 of the Guidelines, it was explicitly mentioned that "charging mark-up, late payment charges or any charges with any other name on the balance of trade receivable is strictly prohibited if the same are charged for arranging/extending credits for /to the clients other than allowed under section 16 of the Securities and Exchange Ordinance, 1969. Given that, the Appellant was not allowed to charge mark-up or late payment on the receivables from its clients.
9. The Respondent further stated that the Appellant had admitted that it had maintained 35% FPR from each of its clients, which is more than the minimum NCCPL requirement of 25%. The Respondent submitted that the Appellant is trying to form its own regulatory regime which is not allowed under the law, therefore, increase in FPR was a violation of the applicable laws. The Respondent stated that in terms of section 64 of the Act, a securities broker is restricted to carry out such regulated activities for which it has obtained licence and can only extend regulated modes of financing, therefore, extending finance beyond the prescribed limit is considered to be in violation of regulatory obligations. The Respondent contended that the Appellant has not provided any evidence with regard to the highlighted instances to substantiate the collection of MtM losses for trades executed in the future market and collection of margins in cash from its clients/pledged securities of its clients for trades executed in the ready market, hence, the violation of Regulation 19.5 of the Book read with regulation 12.9.3 of NC Regulations is established.
10. The Appellate Bench (the Bench) has heard the parties and perused the record. The Appellant's representatives (the Representatives) reiterated the grounds of Appeal, whereas, the Respondent's representatives rebutted the comments thereof. In view of the record, the Bench has observed that the Appellant's compliance status with regard to the Framework was examined in two phases i.e. the Review and the FL Review. The Bench has observed that certain violations of the Framework, which were highlighted during the Review were rectified before the FL Review. The Bench has further



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observed that the FL Review highlighted five violations of the Framework, however, the monetary penalty was imposed on two counts only, whereas, warning was issued against three other violations.

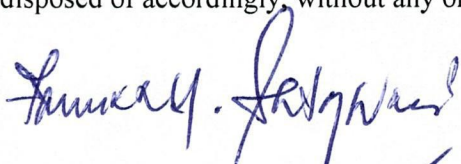
11. In view of the record, the Bench has no doubt that that violations of the Framework regarding failure to collect margins, recovery of MtM losses and failure to make additional disclosures in quarterly accounts were established against the Appellant. The Bench is of the view that instead of issuance of warning against the aforesaid three violations, the Respondent should have imposed monetary penalty on the Appellant. As per law the Respondent was empowered to suspend, cancel the Appellant's license and impose monetary penalties, however, by issuing warning a lenient view was taken. The Bench has considered the Representatives conduct during the hearing whereby, they have not specifically contested the issuance of warning against the above three instances, therefore, we restrain ourselves to convert the warning into monetary penalty on three above counts.
12. The Bench has noted that the Appellant has never denied the existences of the receivables (continued debit balances) from its clients. The Bench has reviewed the contents of the para "O" of the memorandum of the Appeal wherein, the Appellant had stated that receivables from the clients had been decreased significantly. The Bench has no doubt that as per Rule 34 of the Rules, extending credit to clients through modes other than permissible under Rule 34 of the Rules was a grave violation and the Appellant was not licensed to operate in that manner. Furthermore, charging markups on continued debit balance of clients was also a violation of para 2.1 of the guidelines dated July 3, 2013 issued by the Commission. The Bench is of the view that the Appellant's failure to stop charging markup on receivables (continued debit balances) from its clients after Review and FL Review is evidence that it has undermined the sanctity of the Framework. The Bench is not inclined to accept the Appellant's assertion that it only recovered late payment charges to cover the Appellant's financial and administrative cost because the Appellant's receivable policy clearly describe that *"No markup would be charged if client make payment of his receivable before settlement"*. The Bench believes that this policy statement implies that the Appellant will charge markup, if receivables are not paid before settlement. The Bench has also reviewed the record which revealed that even after the FL Review, the Appellant never stopped its practice of charging markup on clients' receivable and as of July 5, 2017 aggregate markup was 41.10 million.
13. The Bench has also examined the Representatives arguments with regard to the enhanced FPR ratio of 35%. We are of the view that when NC Regulations had provided 25% FPR ratio then the Appellant was bound to maintain that ratio, therefore, self enhancement is a clear violation of the Framework.



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Accordingly, the Representatives arguments, that withholding of MtM profits of the clients who failed to maintain 35% FPR, caused increase in debit balance, are not plausible and insignificant to distort the findings of the Impugned Order.

14. The Bench has noted that the Appellant and the Respondent had not mentioned the registered name of the Appellant in memorandum of Appeal and in the Impugned Order. The Appellant's registered name is "**Mohammad Munir Mohammad Ahmed Khanani Securities (Private) Limited**", however, the Appellant had mentioned it as "Muhammad Muneer Muhammad Ahmed Khanani Securities (Pvt) Limited". Whereas, the Respondent had mentioned it as "**Muhammad** Munir **Muhammad** Ahmed Khanani Securities (Pvt) Limited". The Bench is of the view that a company being a juristic person has certain rights and liabilities, which includes specific name of the company. We believe that adjudication is a sensitive matter, therefore, it should not be dealt in a casual manner. We, expect that in future, the Appellant and the Respondent shall be vigilant in this regard.
15. In the above circumstances, we have no doubt that violations against the Appellant are established, however, Appellant has significantly reduced the quantum of continued debit balance of clients and markup. Therefore, keeping in view the Appellant's efforts to become compliant with the requirements of the Framework, while maintaining the verdict of the Impugned Order, we hereby reduce the penalty of fine from Rupees 1,000,000/- to Rupees 500,000/- and direct the Appellant to comply with the requirements of the Framework in letter and spirit, to avoid strict penal action in future. The Appeal is disposed of accordingly, without any order as to cost.


(Farrukh Hamid Sabzwari)
Commissioner (SCD,AML)


(Shaukat Hussain)
Commissioner (C&CD, Insurance)

Announced on: **29 JAN 2020**