BEFORE APPELLATE BENCH NO. 1

In the matter of

Appeal No. 13 of 2017

HG Markets (Pvt.) Limited ...Appellant

Versus

1. Mr. Muhammad Asif Jalal Bhatti,
   Executive Director,
   Public Offering and Regulated Persons Department (PRPD)
   Securities Market Division,
   Securities and Exchange Commission of Pakistan

2. Mr. Kamal Ali,
   Additional Director,
   Public Offering and Regulated Persons Department (PRPD),
   Securities Market Division,
   Securities and Exchange Commission of Pakistan ...Respondents

Date of Hearing 07/06/18

Present:

For the Appellant:

Mr. Arslan Saleem Chaudhry, Advocate High Court (Haidermota BNR & Co.)

For the Respondents:

1) Mr. Kamal Ali, Additional Director (SMD)
2) Mr. Asif Khan, Deputy Director (SMD)

ORDER

1. This Order is passed in the matter of Appeal No.13 of 2017 filed under section 33 of the Securities and Exchange Commission of Pakistan (Commission) Act, 1997 (SECP

Act) against the Order (Impugned Order) dated 09/01/17 passed by the Respondent No.1.

2. The brief facts of the case are that the Commission received a complaint from Hafiz Fawad Masood (the Complainant). In his complaint, the Complainant, inter alia, alleged that his father, Mr. Masood Habib (Client), opened a trading account with M/s. HG Markets (Pvt.) Limited (Appellant) and two employees of the Appellant, i.e. Mr. Hassan Kamal Siddiqui and Mr. Muhammad Ali (Broker) traded commodities in the account without prejudice and exhausted all funds in his account. The Client had invested Rs. 500,000/- on 18/03/16 and the account balance as at 02/05/16 was only Rs 12. The Respondent No.1 took up the matter with the Appellant and sought information relevant to the complaint.

3. After examination of the complaint in light of the response received from the Appellant, the Commission served the Show Cause Notice (SCN) dated 20/07/16 to the Appellant under Section 22 of the Securities and Exchange Ordinance, 1969 (Ordinance) read with Rule 20 of the Commodity Exchange and Futures Contracts Rules, 2005 (Rules). The hearing in the matter was held on 01/09/16. Mr. Arsalan Chaudhry, Associate Advocate from HaiderMota BNR attended the hearing on behalf of the Appellant and presented his stance supported by international definitions of "churning", ingredients of "churning" and certain international precedents encompassing decisions by the United States Court of Appeal in cases of churning. Thereafter, the Legal Counsel submitted the argument in writing vide email dated 05/09/16.

4. The Respondent No.1 dissatisfied with the response of the Appellant held that the Appellant failed to manage the account of the Client in his best interest and contravened the regulatory framework by not exercising due skill and care in executing the transactions while generating excessive commissions for itself. Furthermore, it was held by the Respondent No.1 that Quantum of LOTS traded by the Appellant were unnecessary and excessive in light of the character of the account and the main

beneficiary of the excessive transactions or churning in the account of the Client was the Appellant as it earned Rs. 118,745/- or 24% of the amount invested by the Client as Commission. Furthermore, the Respondent held that the Client did not grant any discretionary authority to Mr. Hassan Kamal Siddique and examination of the transactions executed in the account of the Client revealed that all the transactions were executed using the login ID and password of the Client. Therefore, the Respondent held that it was difficult to ascertain who executed the transactions on behalf of the Client i.e. Mr. Muhammad Ali who was provided the discretionary authority or by some other employee of the Appellant. The Respondent No.1 held that by engaging in excessive transactions in the account of the Client, the Appellant had violated Rule 20 of the Rules which states that "*a broker holding a certificate of registration under these rules shall abide by the code of conduct as provided in the Schedule*." In exercise of powers conferred under section 22 of the Ordinance read with rule 20 of the Rules, a penalty of Rs.150,000 was imposed on the Appellant by the Respondent No.1 and the Appellant was directed to refund the amount of commissions earned, i.e. Rs 118,745 to the Client, under intimation to the Respondent No.1.

5. The Appellant preferred the instant appeal on the following grounds:

(a) The Client had given discretionary authority in favour of the Broker, therefore, allegation of trading without authority is incorrect. The Impugned Order passed by the Respondent No.1 is bad in law and facts and cannot be sustained as it has been passed by the Respondent No.1 outside the domain of section 22 of the Ordinance. A plain reading of section 22 of the Ordinance would reflect that under the provision, the Respondent was only authorized to impose a penalty. However, in the Impugned Order, the Respondent No.1 not only imposed a penalty of Rs 150,000 but has further unlawfully directed the Appellant to refund the amount of commissions (i.e.Rs.118,745/-) to the Client. In view of the foregoing, the Impugned Order is unsustainable and beyond the scope of section 22 of the Ordinance;

(b) A penalty could not have been imposed on the Appellant under section 22(1)(c) of the Ordinance, unless the charge of "churning" was proven against the Appellant. The

Respondent No.1, in the Impugned Order has failed to prove the charge of "churning" against the Appellant, inter alia, on the following grounds:

(i) The term "churning" has been defined in Black Law's Dictionary, Sixth Edition, p. 242, in the following terms:

Churning. Churning occurs when a broker, exercising control over the volume and frequency of trades, abuses his customer's confidence for personal gain by initiating transactions that are excessive in view of the character of account and the customer's objectives as expressed to the broker. As a scheme, the essence of which is deception of a relying customer, churning, as a matter of law, is considered a violation of federal securities law proscribing fraud in connection with the purchase and sale of securities. Securities Exchange Act of 1934, ss10(b), 15 U.S.C.A. ss 78j(b).

Similarly, the American treatise Fundamentals of Securities Regulations, in the relevant part notes as below:

Under the antifraud provisions the law is settled that the plaintiff in a churning case must show (1) that the broker or dealer exercised control over the trading of the account in question, (2) that the trading in the account was excessive in light of the customer's investment objectives.

(ii) The Respondent No.1 was under strict obligation to prove that trades executed in the account of the Client were excessive considering the Client's investment objectives and the Appellant acted with requisite scienter (as also required under section 22 of the Ordinance). The term "scienter" has been defined in the Black Law's Dictionary, Sixth Edition, at p.1345, in the following terms:

Scienter. Knowingly. The term is used in pleading to signify an allegation (or that part of declaration or indictment which contains in) setting out the defendant's previous knowledge of the cause which led to the injury complained of, or rather his previous knowledge of a state of facts which it was his previous knowledge of a state of facts which it was his duty to guard against, and his omission to do which has led to the inquiry complained of. The term is frequently used to signify the defendant's guilty knowledge. Knowledge by the misrepresenting party that material facts have been

falsely represented or omitted with an intent to deceive. Myzel v. Fields, C.A. Minn,. 386 F. 2d 718, 734.

(c) "Churning" is cognizable as a fraud as per various judicial pronouncements on the subject also cited by the Appellant at the time of hearing before Respondent No.1. Therefore, when pleading "churning" specificity is required so as to establish fraud and excessive trading. The Respondent No.1 was required under the law to identify and prove each and every Lot traded against the character of the account and Client's objectives which would reflect that they were solely executed for the purposes of generating commission. The Respondent No.1 failed to identify the Lots which would constitute "churning" and simply stated that "*In some trades, consecutive lots of a particular commodity were bought at very thin price differentials and offloaded entirely as soon as the market went against the Client…such a strategy is perceived to be risky considering the fact that risk increased substantially as conservative lots were purchased and losses were amplified when the market went against the Client, not to mention the impact of commissions generated which further eroded equity of the Client*". Given the prevailing law on the subject matter, such a cursory and a passing suggestion that "some trades" were made with the sole intent of generating commission and without due care and skill is totally unsustainable and contrary to law. The Impugned Order is also completely silent to suggest any remote inquiry made by the Respondent No.1 as to the nature of trades executed or to demonstrate that such conduct of the Broker was "willful" with requisite "scienter" and with the sole object of generating commission as required to establish "churning". Reliance is also placed on the judgment of the United States District Court, E.D. Michigan, Southern Division in the case titled *M&B Contracting Corporation v. David Dale and Merrill and others 601 F.Supp.1106 (1984)*, wherein, it was held that, *"…three elements are necessary to establish churning: 1) control of the account by the broker; 2) excessive trading in light of the customer's objectives; and scienter, which is defined as intent to defraud, or a reckless disregard by the broker of the customer's best interests…"*.

(d) The Respondent No.1 in the Impugned Order only held that "*some trades...* " would appear to have executed without due care, therefore, it cannot in any event be correlated in a cursory manner to reflect that all trades in the Client's account were excessive. The penalty, if any, should have been limited to those Lots only after proving the aforesaid elements of "willful" and "scienter" on part of the Broker.

(e) The Respondent No.1's finding that a total of 812 lots were traded by Appellant/Broker in the trading account of the Client is wholly incorrect. The actual position of the transactions and lot size may be reflected as below:

Actual Lot Size per IMM Contract Specification		
Product	**Lots per SECP record**	**Actual Lots traded**
Crude 10 barrel	262 trades	2.62 lots
Crude 100 barrel	20 trades	2 lots
Gold 10 oz	77 trades	7.7 lots
Gold 1 Oz	261 trades	2.61 lots
Gold EUR USD	50 trades	4 lots
Gold GBP USD	115 trades	18.4 lots
Gold USD JPY	31 trades	2.16 lots
Total Actual Lots (buy and sell both sides)		39.49 lots

Pakistan Mercantile Exchange (PMEX) is non deliverable cash settled market. It is a rare case where actual delivery takes place only in the case of gold. In such trading, money is made or lost in the price difference between the original contract (buy) and the offsetting transaction (sell). Given such background, it becomes very apparent that the actual Lots bought were 19.745 Lots only. Even otherwise, the total number of Lots traded (buying and selling) are 39.49 and the corresponding rate of commission charged (Rs.118,745/-) with respect to the Lot traded is approximately the same which reflects that the assertion of the Commission with respect to the total number of Lots traded in the account of the Client is factually incorrect. The amount of commission charged by the Appellant was not dependent upon the number of transactions (in Appellant's case 565), but upon the number of Lots traded (buying and selling amount to Rs 39.49 Lots only) in the account of the Client. The Client at the time of opening

his account with PMEX and engaging the services of Appellant to execute trades on his behalf, was put on notice of the rates of commission charged by Appellant. It is settled law that parties to the contract are bound by the terms that they have agreed to; and Respondent No.1 cannot sit in as an investigator and adjudicate upon the reasonability or the rate of commission charged by Appellant for its brokerage services. The assertion of the Respondent No.1 that the Appellant did not conduct the risk analysis of the Client whilst exercising the discretionary authority is wholly misplaced and factually incorrect on, inter alia, the following grounds:

(i) The Appellant as a matter of practice issued adequate warnings and disclaimers at the time the Client opened the trading account with PMEX and at the time the Client gave his discretionary authority to the Broker. In particular, these warnings and disclaimers appear in each of the multiple documents (i.e.an account opening form, risk warning and notices & undertakings). Therefore, the Client, at the time of opening account with PMEX and engaging brokerage services of the Appellant, was fully aware of the risks associated with such trading. Moreover, it is submitted that the Client by opening a commodity futures contract i.e. contract for difference, with PMEX out of his own free will and volition, represented himself as a risk taking trader with short-term high investment objectives. The futures commodities market is highly volatile and unpredictable and the traders are basically speculating in a highly volatile market to make short-term profit and gains. Resultantly, there is a high risk associated with such trading. The Client at the time of opening an account with PMEX, was fully aware of the risks of such trading after signing the risk disclosure forms both in English and Urdu.

(ii) The Broker was very considerate and risk averse whilst executing trades on behalf of the Client. The Commission charged by the Broker is not dependent upon the total number of transactions i.e.565 trades, but upon the total number of Lots traded (buying and selling) which stands at only 39.49. The risk averse behavior of the Broker becomes obvious from the fact that only 39.49 Lots were traded which were settled over 565 different entries as the same 39.49 Lots could have been bought and sold in 39 transactions and the Appellant would still have been entitled, as per

the contract, to the same commission. The contract for difference are classified as "cash settled" contracts i.e. for each buy one must have a sell so that one makes a profit or loss depending upon the difference between them. The entire objections and contentions of the Respondent No.1 are wrong given the nature of the trading account. It appears that the Respondent No.1 is confused between the workings of the stock market as against the commodity futures contract which is totally different.

(iii) The Client before filing of the alleged complaint with the Commission, never intimated or otherwise protested against the transactions made in his account. It was only after the account balance of the Client hit below the mark of Rs 10,000/- that the complaint, if any, was lodged with the Commission. It is reiterated that the Client had access at all times to his account and was fully aware and acquainted with the transactions made in his account. In case he was not satisfied with the trades executed in his account, he could have simply revoked the discretionary authority and stopped the trading.

(iv) The Respondent No.1 is surprisingly only focused upon the amount of commission charged by Appellant i.e. Rs 118,745 in return for its brokerage services while it has completely ignored the fee charged by PMEX amounting to Rs 76,452. This may be termed as discriminatory against the Appellant. Moreover, the Respondent No.1 has in the SCN and in the Impugned Order highlighted that the commission generated by Appellant is 24% of the value of the account of the Client which is contrary to the workings of the commodity futures market and to the nature of the account of the Client. It is reiterated that the Client opened a contract for difference i.e. marginal trading account, in a commodity futures market which is virtually a speculative trading and a highly leveraged market. PMEX allows various futures commodity contract trading on 3 to 7 percent margins as also reflected in the account opening form. Simply put, if at an average a PMEX product provides 5% leverage then a Rs 500,000 account, as in the instant case, has a buying power up to Rs 10 million for which the Client was allowed to trade in the market. In view

of the above, commission charged by Client is only 1.18% of the value for which the trades were done.

(v) A penalty could not have been imposed on Client under section 22(1) of the Ordinance, unless it was proven that the loss sustained by the Client on account of the trades executed by the Broker was caused by Broker's willful refusal, contravention or failure to abide with rule 20 of the Commodity Exchange and Futures Contracts Rules, 2005 (Rules) dealing with the "code of conduct for brokers". The Impugned Order is devoid of such necessary determination.

(vi) The Respondent No.1 despite repeated requests made by Appellant before and after the hearing held on 10/08/16 and on 01/09/16 failed to give a copy of the complaint as registered with the Commission. At the first hearing on 10/08/16, upon protest of the Counsel for acting for the Appellant, Respondent No.2 by his letter dated 11/08/16 produced the complaint. The complaint suffers from many obvious defects as it does not provide the necessary details i.e. date when it was filed, the complaint number and the mode through which the same was lodged. In this background, the whole exercise conducted by the Respondent No.1 and 2 are without any justifiable cause.

(vii) The Respondent No.1 did not give detailed facts as required under law to prove "churning" on part of Appellant. The Impugned Order given the factual and legal position is not at all a speaking order which in no manner could be called a "judicial order within the parameters of law".

6. The Respondents rebutted the arguments of the Appellant on the following grounds:

(a) The complaint cannot be dismissed merely on the premise that the Client had provided discretionary trading authority to the Broker. Compliance with the code of conduct applicable to brokers needs to be ensured. Copy of the complaint was also provided to the Appellant on request. The Complaint did not suffer from any defects and was received by the Commission in a proper manner through the Commission's Service Desk Management System.

(b) The factual basis also includes the apparent act of "churning" by the Appellant. Refund of commissions to the Client is part of penalty imposed on the Appellant. The penalty amount, on the other hand, could have been simply raised to the extent of the commission amount, otherwise demanded from the Appellant.

(c) The Appellant is misleading by counting the lots as standard lots. In that case, a standard lot is even more risky and in no manner justifies the risk profile of a retired individual. Rate of commission charged by the Appellant has not been contested at all and rate sheet, undoubtedly, must have been provided to the Client and the commissions charged accordingly. Similarly, PMEX fees also triggers from the number of contracts initiated by a broker and the more the contracts, the more the commissions. There is no question of discrimination against the Appellant as the instant case pertains to churning, i.e. earning those commissions without any meaningful trades.

(d) Risk profiling is different from merely stipulating warnings/disclaimers on an application form. It is about assessing the risk appetite of an individual to be able to rightly categorize him as being conservative, moderate, or aggressive in his approach towards an investment. More so, the Client is not educated to a level whereby he could have reasonably understood the prevalent risks in the futures market. Risk profiling would have placed the Client in a suitable category for trades to be executed according to his risk profile. Furthermore, by merely signing the application form full of disclosures, one cannot deduce that the Client had a risk taking ability and short term high investment objectives as stated by the Appellant.

(e) Risk aversion can nowhere be seen in the trading pattern adopted by the Appellant. 39 standard lots in 30 trading days for a retired person with unknown risk profile is a huge gamble, and not a risk-averse strategy. The argument of breaking 39 standard lots into various small lots is illogical; exposure at the end of the day was 39 standard lots. The Client is not tech-savvy and does not even know how to check emails. As per information provided by the Client, he did not even have an email account which was opened for him by the Appellant in its office. Therefore, he was not even aware of the transactions made in the account. PMEX fees is triggered from the number of contracts

initiated by the broker, therefore, the more the contracts, the more the commissions and resultantly PMEX fees. There is no question of discrimination. The complaint has been filed against the Appellant and not PMEX. The Impugned Order has very well established the case of churning and imprudence by the Appellant.

7. We have heard the parties i.e. the Appellant and the Respondents. The Appellant has argued that the Respondent No.1 has failed to prove the charge of "churning" as according to Black Law Dictionary Sixth Edition, p. 242, churning occurs "*when a broker, exercising control over the volume and frequency of trades, abuses his customer's confidence for personal gain by initiating transactions that are excessive…*". The Appellant argued that the Respondent No.1 could not establish which Lots had constituted churning and the risk averse behavior of the Broker is apparent from the fact that only 39.49 Lots were traded which were settled over 565 different entries. Furthermore, the Appellant argued that the Client had given discretionary authority in favour of the Broker and prior to the complaint lodged with the Commission, never complained to the Appellant about the trading in his account. The Appellant further argued that the Respondent No.1 was under strict obligation to prove which trades executed in the account of the Client were excessive. The Appellant further argued that the Respondent No.1 had to prove that the Appellant acted willfully with requisite scienter (Knowingly) and penalty should have been limited to those Lots only after proving the aforesaid elements of "willful" and "scienter" on part of the Broker. Furthermore, the Appellant argued that only penalty could have been imposed under section 22 of the Ordinance and no further direction could be given to the Appellant to return the commission of Rs 118,745 to the Client. Furthermore, the Appellant argued that the Respondent No.1 completely ignored the fact that PMEX also earned a commission of Rs 76,452. The Appellant further argued that initially, copy of the complaint was also not provided to them despite repeated requests, however, subsequently it was given to them but the complaint lacked necessary details and suffered from multiple defects. The Respondents argued that the issue raised and penalized in the order pertains to churning, i.e. earning those commissions without any meaningful trades, therefore, the issue does not pertain to rate of commissions charged

by the Appellant and PMEX and that copy of the complaint was also provided to the Appellants on request and that it was received in a proper manner through the Commission's Service Desk Management System. The Respondents further argued that risk profiling would have placed the Client in a suitable category for trades to be executed and simply because the Client signed the application form and gave discretionary authority in favour of the Broker did not imply that the Client had agreed to take on unnecessary risks vis-à-vis his investment. The Respondents further argued that the Client did not have an email account which was also opened for him by the Appellant in its office and, therefore, the Client was not aware of the transactions made in the account.

8. We have perused rule 20 of the Rules which states that, "*a broker holding a certificate of registration under these rules shall abide by the code of conduct as provided in the Schedule.*" Clause 1(a) of the Schedule provides, *"1(a) Exercise of due skill and care – A broker shall act with due skill, care and diligence in the conduct of all his business.* Clause 2(d) of the Schedule provides that, *"A Broker shall not encourage sales or purchase of Commodity Futures Contracts with the sole object of generating brokerage or commission.*" We are of the view that while it is true that the futures commodities market is highly volatile and unpredictable, we concur with the Respondents that for the amount of investment, trading in the Client's Account was in breach of the Rules. The Respondent No.1 was not required to identify each and every Lot which constituted churning as 39 standard lots in a short period of time i.e. just 30 trading days for a retired person with an unknown risk profile was a huge unnecessary risk and not a risk averse strategy which in turn establishes that the Appellant did not exercise the due care and diligence required of a broker in trading in the Client's Account. The Client did not have any experience or knowledge of the working of the equity or commodity markets and had never executed any trade in the securities market. The risk increased substantially as consecutive lots were bought at very thin price differentials and losses also increased considerably which eroded the equity of the Client. While we agree that the Client had given discretionary authority to the Broker, the Broker was expected to exercise due skill

and care and trade in the Client's account in a reasonable manner. The Appellant's assertion that the Client did not lodge a complaint sooner or the complaint had defects also does not hold any merit. The action against the Appellant was initiated by the Respondent No.1 after careful evaluation of all the facts and circumstances. Furthermore, it seems that the Client was unaware of the transactions and the Appellant exploited his vulnerabilities to its advantage by gaining a considerable amount of Commission on the trades.

9. We are of the view that the issue at hand is not whether the Appellant was entitled to a commission but the excessive trading in the Client's account. The word "willful default" has been defined in Oxford Dictionary of Law Fifth Edition as "*The failure of the person to do what he should do, either intentionally or through recklessness.*" The term "scienter" has been defined in the Black Law's Dictionary, Sixth Edition, as, "*Knowingly. Knowledge by the misrepresenting party that material facts have been falsely represented or omitted with an intent to deceive...*". In the instant case, the argument of the Appellants that the default was not "willful" holds little merit as even though there may not be knowledge or intent, the Appellants did not exercise the due skill and care required of them as brokers. Section 22 of the Ordinance provides that penalty can be imposed on any person who fails to comply with the provisions of the Ordinance or any rules or regulations made thereunder, therefore, penalty was rightly imposed on the Appellant. However, section 22 of the Ordinance does not empower the Respondent No.1 to give any further directions. Therefore, we concur with the Appellant that direction by the Respondent No.1 to refund the commission amount of Rs 118,745 to the Client under intimation to the Respondent No.1 was beyond the scope of section 22 of the Ordinance.

10. In view of the above, the Impugned Order is upheld to the extent of penalty with no order as to costs.

(Shaukat Hussain)
Chairman/Commissioner (CCD-CLD)

(Shauzab Ali)
Commissioner (SCD-S&ED/IE & IR)

Announced on: 13 JUL 2018