

# Securities and Exchange Commission of Pakistan

## BEFORE APPELLATE BENCH NO. I

In the matter of

### Appeal Nos. 26, 27 & 28 of 2014

- i. Karachi Stock Exchange Limited ...Appellant in Appeal No. 28
- ii. Mr. Nadeem Naqvi  
(Managing Director, Karachi Stock Exchange Ltd) ...Appellant in Appeal No.27
- iii. Mr. Haroon Askari  
(Deputy Managing Director, Karachi Stock Exchange Ltd).Appellant in Appeal No. 26

Versus

Director and Head of Department (Market Supervision and  
Registration Department), SECP, Islamabad ...Respondent

Date of Hearing 08/07/15

#### Present for the Appellants:

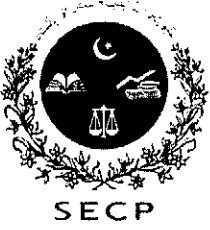
Mr. Ijaz Ahmed, Advocate Supreme Court

#### Appellant No.3:

Mr. Haroon Askari, Deputy Managing Director, KSE

#### Present for the Respondent:

- i. Mr. Imran Inayat Butt, Director (SMD)
- ii. Ms. Najia Ubaid, Deputy Director (SMD)



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### ORDER

1. This order is in appeal Nos. 26, 27 and 28 of 2014 filed under section 33 of the Securities and Exchange Commission of Pakistan Act, 1997 (SECP Act) against the order (Impugned Order) dated 23/05/14 passed by the Respondent.
2. The brief facts of the case are that Karachi Stock Exchange Limited (KSE) was incorporated under the Companies Ordinance, 1984 and registered as Stock Exchange under section 5 of the Securities and Exchange Ordinance, 1969 (the Ordinance) and was demutualized under section 6 of Stock Exchanges (Corporatization, Demutualization and Integration) Act, 2012. The Regulations Governing System Audit (Regulatory Compliance) of the Brokers of the Karachi Stock Exchange Governing System Audit (System Audit Regulations) were promulgated under sub-section 1 of section 34 of the Ordinance for conducting System Audit of the Brokers in order to ensure compliance with the requirements of the Ordinance; Securities and Exchange Rules, 1971; the Articles of Association of KSE; Brokers and Agents Registration Rules, 2001; Regulations of KSE and the directives issued by the Commission from time to time. In pursuance of Clause 5.1 of System Audit Regulations, two ballots were held on 31/07/12 (Ballot No. 17) and 28/01/13 (Ballot No 18). Clause 8.5 of System Audit Regulations requires that the KSE shall forward the System Audit Reports (Reports) along with its views 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/counter views of the KSE and counter views of the non-compliant Brokers. 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



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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 19/03/13 onwards. Moreover, perusal of the information revealed that the Appellants failed to take appropriate enforcement actions in a timely manner in respect of non-compliances reported in various Reports including Moosa Noor Muhammad Shahzada & Company (Private) Limited (MNS) and B&B Securities (Private) Limited (BBSL).

3. Show Cause Notice dated 25/02/14 was served on the Appellants under section 7 read with section 22 of the Ordinance. The Appellants submitted their written response to the SCN vide letter dated 17/03/14. Hearing on the matter was held on 08/04/14. Mr. Nadeem Naqvi, Managing Director, (Appellant No.2), Mr. Shafqat Ali, Chief Regulatory Officer and Mr. Haroon Askari, Deputy Managing Director (Appellant No.3) attended the hearing and made their submissions before the Respondent.
4. The Respondent dissatisfied with the response of the Appellants held that 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. It was evident that the Appellants failed to ensure that appropriate enforcement actions were initiated by KSE in a timely manner against non-compliant Brokers as required under the regulatory framework. It was the responsibility of the Managing Director and Deputy Managing Director to ensure that the KSE performs its functions 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. The Appellants, therefore, have failed to perform their responsibilities and are negligent



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in the discharge of their duties and obligations. In exercise of powers conferred under section 22(c) of the Ordinance, a penalty of Rs.1,000,000 was imposed on KSE, a penalty of Rs.200,000 was imposed on Appellant No.2 and a penalty of Rs.500,000 was imposed on Appellant No 3.

5. The Appellants have preferred the instant appeal against the Impugned Order. The Appellant's counsel argued that:

- (a) the regulations for System Audit of the Brokers of the Exchange, 2004 were initially promulgated with effect from 05/05/04 which were materially revised with effect from 08/08/12 and renamed as Regulations Governing System Audit (Regulatory Compliance) of the Brokers of the Karachi Stock Exchange. The period for which the SCN was served was a transitory period due to demutualization and corporatization of the exchange. The changes were carried out in the governance structure of exchange and the management responsibilities were being segregated into commercial and regulatory functions during this period. Pursuant to the System Audit Regulations, the KSE has been conducting ballots for selection of Brokers for the purpose of conducting their system audit as envisaged in these Regulations. Furthermore, KSE has been taking remedial as well as disciplinary action against the non-compliant Brokers and the effectiveness of KSE's disciplinary proceedings is manifest from the fact that in an over-whelming majority of cases, the incidents of non-compliances were rectified.

The System Audit Regulations need to be viewed as a whole for a consistent interpretation of various regulations. Regulation 5 of the System Audit Regulations deals with the selection of Brokers for audit to review their status of compliance. Regulation 5.2 of the System Audit Regulations provides 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



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the Brokers remain compliant during such period. Disciplinary action, therefore, 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. The penal action, if, initiated and concluded without allowing the opportunity to the Broker to rectify the non-compliance, would be rendered a nullity. Furthermore, after following the process of ballot, there is a rectification process. This process is consistent with all the Brokers to ensure compliance and no penalty could be imposed if rectification has taken place. In the instant case, the Appellants took appropriate disciplinary action against MNS in accordance with Regulation 9.1 of the System Audit Regulations for unrectified non-compliances and the Appellant No.1 in its meeting held on 25/07/13 resolved that TREC Certificate of MNS be forfeited with immediate effect. As regards BBSL, Limited Scope Audit was conducted by the auditor and after the review it transpired that the Broker has rectified 9 out of 11 non compliances reported in the audit report. The same was forwarded to the Commission on 18/02/13. Hearing on the matter was held on 27/03/13 where the Broker provided evidence of compliance of requirement of segregations of clients' funds. It is only after verification of this fact that the Broker's status was stated as compliant in this regard. Furthermore, reports of Intermarket Securities Limited (IML) relating to Ballot No. 17 and Invest Capital Market Limited (ICML) and First National Equities Limited (FNEL) relating to Ballot No. 18 were provided to the Commission. Internal audit reports along with Brokers comments on the same were also submitted to the Commission for Ballot 17 vide letter dated 02/11/12, however, regarding the comments of Appellant No.1 prior to the rectification, the Appellant No.1 vide letter dated 26/02/13 intimated to the Commission that the Appellant No.1 shall be able to provide them after completing the enforcement actions. Ballot 18 was held on 28/01/13 and the Appellant No.1 vide letter dated 06/05/13 submitted audit reports of 31 Brokers to the Commission;



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- (b) the Appellant No. 2 as Managing Director of KSE is not personally involved in process of system audit other than the computerized balloting. From that point onwards, the system audit process has followed long-standing and accepted procedures involving the internal audit department and offices of the relevant officers involved in system audit, its monitoring, compliance and enforcement. No penalty, therefore, can be imposed on the Appellant No. 2 for the acts of the other officers of KSE. The Appellant No.3 within the scope of his authority as Deputy Managing Director has always supported proper implementation of Regulations of KSE. The Appellant No. 3 as Deputy Managing Director of KSE has been performing certain functions as and when delegated and had not undertaken any such functions with regard to the 18<sup>th</sup> Ballot. The Impugned Order, has imposed penalty for matters relating to the 18<sup>th</sup> Ballot and no penalty can be imposed on the Appellant No.3 for the acts of other officers of KSE; and
- (c) the Ordinance only envisages a penalty where “refusal, failure or contravention was willful”. The Impugned Order has neither recorded any finding nor contains any basis to support any conclusion that there was any willful refusal, failure or contravention on the part of the Appellants. The exercise of the discretionary power, if not exercised cannot be termed as a willful contravention of the System Audit Regulations. The Impugned Order, therefore, is beyond the scope of section 22 of the Ordinance and is liable to be set aside.

### 6. The Respondent argued that:

- (a) the Appellants failed to follow the directions and comply with the provisions of System Audit Regulations. The Appellants were required to take certain enforcement actions against the Brokers for non-compliance of the provisions prescribed by System Audit Regulations. Further, the Appellants are not only required to assure that the non-compliance is rectified but also to take action where provided by the law. The Appellant misinterpreted the time of Limited Scope Audit. Regulation 5.2 of the System Audit Regulations states that the Broker shall be



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subject to Limited Scope Audit in the following year covering three months' period and not immediately after the submission of Reports within 3 months. The immediate rectification of non-compliance followed by Limited Scope Audit in the following year is to ensure that recalcitrant Broker is compliant with the Regulations. This process of rectification, however, does not stall the enforcement action provided in Regulation 9 of the System Audit Regulations. 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. Furthermore, the Appellant No.1 failed to comply with Regulation 8.5 of System Audit Regulations by not providing the Reports of non-compliant Brokers along with the views of the Broker. The Appellant was required to immediately share the Reports along with its own comments and the comments on the identified non-compliances to the Commission which it failed to do so;

- (b) the Appellant No. 2 being the Managing Director and the Appellant No. 3 being the Deputy Managing Director were assigned the primary responsibility of compliance and enforcement of the System Audit function of the KSE. The compliance level among the Brokers, with specific regard to risk management and segregation of clients' assets, would have improved if the duties were performed diligently by the Appellants. It was their duty to keep a close watch on the system audit process and ensure that process was conducted and concluded in a transparent and timely manner. However, serious lapses and delays on part of the Appellants in the enforcement process lead to instances such as default of MNS which could have otherwise been avoided. As per Article 167 of the Articles of Association (AOA) of KSE, for the discharge of its responsibilities, the officers of the Exchange shall observe and confirm to the regulations of the time being in force and as per Article 170 of the AOA, the exchange and its directors and employees of the exchange strictly adhere to articles and other regulatory framework in discharging their function and responsibilities; and
- (c) section 22 of the Ordinance is invoked if one has failed or contravened to act in accordance with the Ordinance or any rules or regulations made there under. The Appellants failed to comply with the provisions of System Audit Regulations and perform their duties in a diligent manner.

7. We have heard the arguments and perused the record with the assistance of parties i.e. Appellant and Respondent. Section 5.1, 5.2, 8.5 and 9.1 of the System Audit



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Regulations, Articles 167, 170 of the Articles of Association of KSE, section 7 and section 22 of the Ordinance are reproduced for ease of reference:

### **5. Selection of Brokers and Status of Compliance**

*5.1 The selection of Brokers for the Audit shall be through random balloting. All eligible Brokers, as defined in clause 4 above, shall be audited once in each 'cycle' of two-year period. The selection shall be made through biannual balloting to be held in every calendar year latest by 31st January and 31st July.*

*The Exchange at the ballot date shall determine the total number of Brokers eligible for audit in the remaining ballots of a cycle by dividing the number of Brokers still to be audited in the cycle with the remaining ballots of the cycle to arrive at the optimum number of Brokers to be audited in a ballot. Provided the Brokers audited in the last two ballots of a cycle shall not be included in initial two ballots of the next cycle.*

*5.2 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.*

### **8. Audit Process**

*8.5 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.*

### **9. Enforcement Actions**

*9.1 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*



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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.

### **Article 167:**

"...the rules and regulations for the time being in force shall be binding on all TRE Certificate Holders and Officers of the Exchange shall respectively observe and conform to the regulations for the time being in force."

### **Article 170:**

"The Exchange and its directors and employees of the stock exchange shall strictly adhere to Articles, all applicability rules, regulations and any other securities market laws in discharging their functions, duties and responsibilities."

**7. Cancellation of registration, etc.-** (1) Where the [Commission] is of opinion that Exchange or any member, director or officer of an Exchange has contravened any provision, or has otherwise neglected or failed to comply with any requirement, of this Ordinance, or of any rule, regulation or direction made or given thereunder, the [Commission] may, if it considers it necessary for the protection of investors or to ensure fair dealings or fair administration of the Exchange so to do, by order in writing-

(a) suspend for such period as may be specified in the order the transaction of any business on the Exchange;

(b) cancel the registration of the Exchange;

(c) supersede the governing body or other authority of the Exchange;

(d) [suspend or] remove the director, officer or member from his office in, or membership of, the Exchange;

Provided that no such order shall be made except after giving the governing body or other authority or, as the case may be, the director, officer or member, an opportunity of being heard.

**22. Penalty for certain refusal or failure. -** (1) If any person-

(a) refuses or fails to furnish any document, paper or information which he is required to furnish by or under this Ordinance; or

(b) refuses or fails to comply with any order or direction of the [Commission] made or issued under this Ordinance; or



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*(c) contravenes or otherwise fails to comply with the provisions of this Ordinance or any rules or regulations made thereunder:*

*the [Commission] may, if it is satisfied after giving the person an opportunity of being heard that the refusal, failure or contravention was willful, by order direct that such person shall pay to the [Commission] by way of penalty such sum not exceeding [fifty million] rupees as may be specified in the order and, in the case of a continuing default, a further sum calculated at the rate of [two hundred] thousand rupees for every day after the issue of such order during which the refusal, failure or contravention continues.*

*(2) Any sum directed to be paid under sub-section (1) shall be recoverable as an arrear of land revenue.*

*(3) No prosecution for an offence against this Ordinance shall be instituted in respect of the same facts on which a penalty has been imposed under this section.*

Emphasis Added

8. The Appellants have argued that in a vast majority of cases the incidents of non-compliances were rectified. Further, the period for which the SCN was served was a transitory period due to demutualization and corporatization of the exchange and KSE has also been taking remedial as well as disciplinary action against the non-compliant Brokers from time to time. The Respondent has argued the Appellants must not only ensure that the non-compliance is rectified but take action where provided by the law. We are of the view that the Appellants have been taking disciplinary action against non-compliant Brokers from time to time. Regulation 5.2 of the System Audit Regulations provides that, "If the Report contains any non-compliances, 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..." In the instant case, appropriate action was taken and the non-compliances were reported to the Commission. Further, we agree with the Appellants that as mandated by Regulation 5.2 the System Audit Regulations, no penal action can be taken without allowing the Broker an opportunity to rectify such non-compliance and action can only be taken if it is reported that the non-compliances are not rectified in the Limited Scope Audit. Regulation 8.5 of the System Audit provides



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that, "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". The Appellants have stated that the Reports were submitted but the reason for the delay for the submission of its own comments and comments of the Brokers on the identified non-compliances was due to enforcement or disciplinary action being taken against the said Brokers and their awaited outcome. We concur with the Respondent that the comments should still have been submitted to the Commission in compliance of the said Regulation and there should have been no delay in this regard. Regulation 9.1 of the System Audit Regulations provides that the Exchange can, "...take appropriate enforcement action..." should there be any non-compliance identified in the Report on part of the Broker. The Commission, however, if the Appellant failed to take necessary action against the Broker, "... may suo-moto or on receiving any complaint after giving due opportunity of hearing to the Broker, impose penalties as provided under clauses 9.1 and 9.2 and take such other necessary action as deemed fit by the Commission." The Respondent, therefore, can only take necessary action against the Broker and cannot penalize the Appellants for failure to take action.

9. Article 170 of the AOA of KSE provides that, "The Exchange and its directors and employees of the stock exchange shall strictly adhere to Articles, all applicability rules, regulations and any other securities market laws in discharging their functions, duties and responsibilities." The Respondent has not been able to establish how the Appellant No.2 as Managing Director and Appellant No.3 as Deputy Managing Director have failed in their responsibilities towards ensuring compliance level among Brokers and violated Article 170 of the AOA of KSE. We are of the view that the Appellants have demonstrated their ability to diligently perform their functions and duties towards the protection of investors with the exception of not being able to comply with Regulation



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8.5 of the System Audit Regulations for reasons cited in paragraph 8 above, therefore, the imposition of penalty on Appellant No.2 and Appellant No.3 could not be justified.

10. Section 22 of the Ordinance only imposes penalty if the said contraventions were willful. The word “willful” can be used interchangeably with the word “intentional”. Reliance is placed on the Lahore High Court judgment of Pakistan Industrial Promoters Limited versus Monopoly Control Authority cited at 1990 CLC 1008, wherein, it was held that, that the word willful means, “...an act done intentionally, knowingly or purposely as distinct from the one done carelessly, thoughtlessly, heedlessly or inadvertently.” It is established on the facts of the instant case that there was no malafide; the Appellants fully intended to comply with the System Audit Regulations and contravention of Regulation 8.5 of System Audit Regulations as mentioned in paragraph 8 above, seem unintentional on the facts of the case which did not have any adverse impact on the interests of the investors.

11. In view of the foregoing, we set aside the Impugned order with no order as to costs.

**(Fida Hussain Samoo)**  
Commissioner (Insurance)

**(Tahir Mahmood)**  
Commissioner (CLD)

Announced on: **26 AUG 2015**