Securities and Exchange Commission of Pakistan

BEFORE APPELLATE BENCH NO. II

In the matter of

Appeal No. 59 of 2010

i. Prudential Capital Management Limited, through CEO/Chairman
ii. Mr. Fazal M. Mughal
iii. Mr. Muhammad Asif
iv. Mr. Asad Iqbal Siddiqui
v. Mr. Muhammad Hussain
vi. Mr. Ataullah Khan
vii. Mr. Mazhar-ul-Haq Siddiqui
viii. Mrs. Kishwar Jabeen, Ex-Member Management Committee
ix. Mr. Javed Parwaz, Ex-Chief Executive

(All Directors & Ex-Directors of Prudential Capital Management Limited)

...Appellants

Versus

i. The Executive Director (SCD),SECP
ii. The Registrar Modarabas

...Respondents

Dates of hearing: 16/08/11, 02/04/15 and 11/11/15

Present:

For Appellants:

i. Raja Zafar Khaliq Khan, ASC
ii. Mr. Ahsan Naveed Cheema, AHC

For Respondents:

i. Mr. Shahid Naseem, Executive Director (SCD)
ii. Mr. Shahid Mahmood, Registrar Modaraba

iii. Mr. Asif Paryani, Joint Director (SCD)

ORDER

1. This order shall dispose of appeal No. 59 of 2010 filed under section 33 of the Securities and Exchange Commission of Pakistan Act 1997 by the Prudential Capital Management Limited and eight others (the Appellants) against the order dated 11/11/2010 (the Impugned Order) passed by the Executive Director (the Respondent no.1) and the Original Order dated 24/03/2010 passed by the Registrar Modarabas (the Respondent no.2). The Impugned Order was the consequential outcome of the appeal against the Original Order therefore, the Appellate Bench (the Bench) shall decide the appeal in view of the grounds of appeal and the Impugned Order.

2. The Brief facts of the case are that the Respondent No.2 vide order dated 11/01/07 initiated an inquiry under the powers conferred by section 21 of the Modaraba Companies and Modaraba (Floatation and Control) Ordinance 1980 (the Ordinance 1980) into the affairs of First Prudential Modaraba (the Modaraba) managed by the Prudential Capital Management Limited (Appellant No.1). The Inquiry report dated 10/04/07 pointed out various violations of the Ordinance 1980, the Modaraba Companies and Modaraba Rules, 1981 (the Rules), Prudential Regulations for Modarabas (the PRMs) and the Companies Ordinance 1984 (the Ordinance). Therefore, the Respondent no.2 issued, a Show Cause Notice (the SCN) dated 02/05/2007 to the Appellants under section 19, 20 and 32 of the Ordinance 1980 and section 204-A read with section 498 and 503(1) (c) of the Ordinance for violating various provisions of the Ordinance 1980, the Rules, the PRMs and the Ordinance. The Respondent no.2 passed the Original Order on 24/03/10. The Appellants preferred an appeal against the Original Order under section 32(2) of the Ordinance 1980 before the Respondent no.1 however; Original Order was upheld except to the extent of appeal of Col. (Retd) Abdul Rauf wherein penalty imposed on him was set-aside.

3. The Appellants have preferred the instant appeal against the Impugned Order on the following grounds:

   a. The Respondent no.1 was legally barred from hearing and deciding the appeal as the entire proceedings against the Appellants were initiated under his supervision. The delegations of the powers vide S.R.O. 1061(1)/2005 to decide the appeals given to the Respondent No.1 was unlawful and contrary to all legal norms.
   b. The Impugned Order was passed without considering the averments and arguments of the Appellants.
   c. The Appellants have not violated the Islamic Financial Accounting Standard-I (the IFAS-1) in the case of M/s Management Education Trust (the MET) by rolling over the Morabaha facility. As matter of fact, two Morabaha facilities were secured through two different collaterals described as (i) House No. 11-B, Street No. 30, F-8/1, Islamabad measuring 1000 Sq. Yards and (ii) Plot No. 58, Sector H-8/4, Islamabad measuring 1984 Sq. Yards, respectively. Each of the Morabahas were separate and distinct facilities and the Respondents had wrongly pointed out that the transaction was a roll over, because the MET, had settled the respective facilities, which were protected through separate collaterals, before availing a new one.
   d. The retrospective effect of IFAS-1 cannot be given where Modaraba had already granted and disbursed the Morabaha facilities to the MET.
   e. The Appellants had not violated the Regulation 1 of Part IV of the PRM because several officers served as independent internal auditors. The Respondents did not consider the argument that the admin manager, who was qualified MBA was given the additional charge of internal audit as a stop-gap arrangement pending appointment of a regular internal auditor. The Respondents failed to appreciate the fact that the Appellants had an internal auditor and still have an internal auditor. The Appellants' Modaraba being a

small financial institution cannot afford to have a full-fledged internal audit department where only 05 (five) vouchers on average are required to be audited daily. This requirement having been implied by the Respondents, and there being no law or regulation to support it. It is also pertinent to mention that one internal auditor can simultaneously be employed by more than one group companies and this contention is fully supported by the response to question no. 21 of the frequently asked questions (FAQ) duly published by the Securities and Exchange Commission of Pakistan (the Commission).

f. The Appellants have not violated Section 21(2) of the Ordinance 1980 and as matter of fact minutes of meeting dated June 10, 2006 were not signed and approved by the Board of Directors (the BOD), therefore were not provided to the Respondents.

g. The Appellants have not contravened Regulation 5 (3) of Part III of the PRMs. The Appellants had a well-reasoned argument supported by the PRMs, under which provisioning was not required as the forced sale value of the collateral provided by M/s Famous Franchise exceeded the outstanding liability at any point of time. Furthermore, the external auditors had not required any "Provisioning" because the Modaraba facility was fully secured and no provisioning under the rules was required.

h. The Appellants have received an amount of Rs.23.059 million from M/s Famous Franchise and only an amount of Rs.5.69 million is outstanding against M/s Famous Franchise, whereas the forced sale value of the collateral is Rs.17.65 Million, which is over three times the recoverable amount. This contention is also supported by the PRMs.

i. The facility granted to M/s Rex Video was provided under the force and coercion of the inspectors and the external auditors, in league with Col (Retd) Abdur Rauf Sandhu, the then Managing Director (the MD) and member Managing Committee. The MD has been declared "Not Guilty" by the Respondent no.1 which clearly establishes that they all were in league.

Further, the stance of the Appellants with regard to non-applicability of creation of provisioning for the Forced Sale Value of collateral, under the PRMs proved correct because the external auditors reversed the provisioning in the annual audit conducted for the year 2009-10. In this regard when the Appellants attempted to sell the property through the court, certain individuals filed an application before the court that they had entered into an agreement to sell in respect of the collateral. However, the court dismissed the application holding that the mortgage charge ranked superior and was created prior to the agreement of sale, however, the Respondents have not considered this fact while passing the Original Order and the Impugned Order.

j. The Respondent no.2 direction to the Appellants for making provision against the facility is in conflict with the same Regulation 5 (3) (Part III of the PRMs), which provides that if the forced sale value of the assets is more than the amount to be secured, then no provisioning of such amount is required.

k. The Appellants has presented the accounts as per law and did not hide anything from the certificate holders and always made full provisions as required under the Law (Part III Rule 6 PRMs). The Respondents allegation of short provisioning is not correct, as matter of fact the Appellants has already provided excess amount of provisioning.

4. The Respondents have denied the grounds of the appeal in the following manner:

   a. The contention that the enquiry was initiated and report was prepared under the instructions of the Respondent no. 1. is vehemently denied. As a matter of fact the Respondent no. 2 has used his powers under section 21 of the Ordinance 1980 and appointed the inspectors and conducted the enquiry and passed the Original Order. Furthermore the Respondent no.1 was fully authorized to proceed with the matter.

b. The Respondents had considered the arguments and documents presented by the Appellants during the hearings.

c. The Appellants have violated the IFAS-1 and the claim of the Appellants that two Murabaha facilities extended to the MET were secured through two different collaterals is not correct. The copy of registered mortgage deed for house no. 11-B, street no. 30, F-8/1, Islamabad provided by the Appellants with the memo of appeal is incomplete (pages 126-128 of the appeal) and the relevant pages containing the details of the Murabaha facility, its amount and the name of the client etc. are missing from the deed. Therefore, it cannot be relied upon. Moreover, the amount secured under the said mortgage deed is Rs.100,000 which is less than the amount of collateral as mentioned in the offer letter of Murabaha financing. The review of the copy of the other registered mortgage deed for plot no. 58, sector H-8, Islamabad transpires that the deed was not executed to secure the Murabaha facility against offer letter as claimed (Paragraph "A" Page 136 of the Appeal is referred). Similarly, the amount secured under mortgage deed is Rs.30,000 which does not tally with the detail of collateral mentioned in the offer letter.

   Furthermore, the Appellants during the proceedings before the Respondents failed to prove that the Murabaha facilities extended to the MET were separate and fully adjusted. The documents provided by the Appellants clearly corroborate this fact that on the date of final adjustment of the previous facility, a new set of documents was prepared to roll-over the previous facility without settlement. The Appellants violated IFAS-1 notified on 24/08/05 (read with Rule 10 of the Modaraba Rules, 1981) which prohibits roll-over of any Murabaha facility. Documentary evidence exhibits that there was concealment and distortion of facts by the Appellants in respect of this facility.

d. The IFAS-1 was notified on 24/08/05 and at the time of second roll-over on 28/09/06 it was applicable. In violation of IFAS-1 read with rule 10 and 32 of

the Modaraba Rules, the Murabaha facility extended to MET in 2003 was rolled-over twice in the years 2005 and 2006 by the Appellants.

e. It is admitted position of the Appellants that several persons served as independent internal auditor of the Modaraba. The internal audit department may consist of only one person but he should independently perform his functions without any conflict of interest, whereas, in the instant case, the Appellants have appointed a person as internal auditor who was also working as manager admin/operations of the Modaraba, which shows a clear conflict of interest in his duties. As matter of fact the internal auditor of the Modaraba was not directly reporting to the BOD rather reporting to the Chief Executive Officer (the CEO), which was a conflict of interest and against the spirit of independent internal audit function envisaged under Regulation 1 of Part-IV of the PRMs. The submission of the Appellants that the manager admin was given additional charge of internal auditor as a stop gap arrangement pending the appointment of a regular internal auditor is in fact an admission of noncompliance of the requirement of appointing an independent internal auditor since the so called stop gap arrangement continued for a period of 3 years from 2003-2006. Further, the reference of question no. 21 of the FAQ published by the Commission as quoted by the Appellants is not relevant in this case as it pertains to working of a full time employee of a listed company in a similar position in a group company.

f. The Appellants have violated section 21(2) of the Ordinance 1980 by concealing the minutes of meeting dated June 10, 2006 and extracts of which have already been provided to the bank for change of authorized signatories in the Modarabas' bank accounts. Therefore, the Appellants cannot deny that the minutes were not approved by the BOD.

g. The Modaraba granted Murabaha facilities to M/s. Famous Franchises which were secured against equitable and token registered mortgage on agricultural property. Both the facilities remained unpaid at maturity. In terms of

provisioning criteria prescribed under Regulation No. 5 of Part- III of the PRMs, the provisioning should have been made after the facility remained overdue for 90 days and above but the Appellants failed to do so. The Appellants neither classified the facilities nor created the provisions as required under the said Regulation. The overdue facilities were required to be classified in the category of "Loss" for which provision of 100% of the difference resulting from the outstanding balance of principal against the facility less the amount of liquid assets realizable without recourse to a court of law and forced sale value (as valued by valuers) of collateral held by the Modaraba was required to be made, but the Appellants failed to do so. It is pertinent to mention that the Appellants did not hold any liquid realizable assets on the basis of which the provisioning was not required. The claim of the Appellants that the external auditors of the Modaraba had not required any provisioning because the Modaraba was fully secured is not tenable as it was the responsibility of the Appellants to make the required provision under the Prudential Regulation to present a true and fair view of the state of affairs of the Modaraba and not of the external auditors.

h. The Appellants' claim that the forced sale value of the collateral held by the Modaraba is Rs.17.65 million which is over three times of the recoverable amount is not correct as the collateral held by the Modaraba is not realizable without recourse to the court of law and it is under litigation as per appellants own statement. The relizability of the amount is the key determinant for making provisions in terms of Regulation 5 of the Prudential Regulations.

i. It is vehemently denied that the inspectors had any role in grant of facility to M/s. Rex Video. The Appellants have not substantiated their claim with documentary evidence that the external auditors of the Modaraba have reversed the provision in the annual audit conducted for the year 2009-2010. The assertions of the Appellants regarding acquittal of Col. (Retd.) Abdur Rauf Sandhu is also baseless because he was exonerated on the basis of

record. The facility extended to of M/s. Rex Video was required to be paid in 36 monthly installments however, it remained overdue since its disbursement. The case for recovery is in process and no execution or attachment of properties has been materialized yet. In terms of provisioning criteria prescribed under Regulation No. 5 of Part- III of the Prudential Regulations for Modarabas, the provisioning should have been made after the facility remained overdue for 90 days and above but the Appellants failed to do so. The overdue facilities were required to be classified in the category of "Loss" for which provision of 100% of the difference resulting from the outstanding balance of principal against the facility less the amount of liquid assets realizable without recourse to a court of law and forced sale value (as valued by valuers) of collateral held by the Modaraba was required to be made, but the Appellants failed to do so. The collateral held by the Modaraba is not realizable without recourse to the court of law and it is under litigation as per Appellants own statement. The relizability of the amount is the key determinant for making provisions as per requirement of Regulation 5 of the Prudential Regulations.

j. It is incorrect that the recommendation of Respondent no. 2 for making provision against the facility is in conflict of Regulation 5(3) of Part III of the PRMs. As matter of fact the Appellants have wrongly quoted Regulation 5(3) which provides criteria of provisioning in case of rescheduling/restructuring of the facilities and it has nothing to the do with the issue in hand.

k. The Appellants claim that they always made full provisions as required under the law (Part III of Rule 6 PRMs) is contrary to their stance taken in the appeal that no provisioning was required against the alleged facilities. Moreover, Sub-Regulation (6) of Regulation 5 of the PRMs referred by the Appellants only authorizes deduction of realizable value of collateral from the outstanding principal amount of facilities whereas, the collaterals held by the Modaraba in the above mentioned cases were under litigation and as such

were not realizable. Therefore, the Appellants were required to create the provisions as per criteria provided under Regulation 5 of the PRMs.

5. We have heard the parties and perused the record with the able assistance of parties i.e. Appellants and Respondent. The Appellants also presented written arguments on 16/11/15 which shall be treated as integral part of the appeal.

6. The record exhibits that the penalty was imposed on the basis of four contraventions committed by the Appellants as follows:

   a. Violation of IFAS-1 which is contravention of Rule 10 of the Modaraba Rules
   b. Violation of Regulation 1 of Part-IV of PRMs
   c. Violation of Section 21(2) of the Modaraba Ordinance
   d. Violations of Regulation 5 (3) of Part III of PRMs

7. We have gone through the record and our findings on the violations stated in para above are as follows:

   a. The Appellants had not provided any documentary evidence that the Murabaha facility sanctioned to the MET was fully paid and adjusted before grant of the new Murabaha facility and that it was not a case of roll-over of the facility. Therefore the Appellants have not complied with the mandatory requirements of IFAS 1 which is contravention of Rule 10 of the Modaraba Rules.
   b. The requirements of Regulation 1 of Part-IV of PRMs are also binding for the Appellants which states "every modaraba shall have an Internal Audit Department whose head shall report to the board of directors directly and shall inter alia be responsible for compliance with these guidelines and for establishing an effective means of testing, checking and compliance with the policy and procedures established by it." As admitted by the Appellants, the

internal audit function of the Modaraba was looked after by the person who was also serving as manager admin/ operations. He was not directly reporting to the BOD rather reporting to the CEO which was a conflict of interest and against the spirit of independent internal audit function envisaged under Regulation 1 of Part-IV of the PRMs.

c. Section 21 (2) of the Modaraba Ordinance explicitly states that the Modaraba Company and Modaraba or any other person is liable to furnish every information in his custody required by the enquiry officers appointed by the Registrar to conduct an enquiry into the affairs of a Modaraba and Modaraba Company. In the present case minutes of the meeting of BOD held on 10/06/06 were not provided to the inspectors on the pretext that said minutes are not approved yet by the BOD. However the Appellants should have provided draft minutes stating that these are not yet approved instead of flatly refusing the provision of the said document. Further if the minutes were not approved then why were the same provided to the bank for change in bank authorized signatories.

d. The Appellants granted Murabaha facilities to M/s. Famous Franchises and M/s. Rex Video however, the facilities remained unpaid at maturity. In terms of provisioning criteria prescribed under Regulation No. 5 of Part- III of the PRMs, the provisioning should have been made after the facility remained overdue for 90 days and above but the Appellants failed to do so. The Appellants neither classified the facilities nor created the provisions as required under the said Regulation. The overdue facilities were required to be classified in the category of "Loss" for which provision of 100% of the difference resulting from the outstanding balance of principal against the facility less the amount of liquid assets realizable without recourse to a court of law and forced sale value (as valued by valuers) of collateral held by the Modaraba was required to be made, but the Appellants failed to do so. Further, the Appellants did not hold any liquid realizable assets on the basis

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of which the provisioning was not required. The assets available through collateral with the Modaraba were under litigation with the court of the law as such 100% provisioning was required against the aforementioned Murabaha facilities.

8. The Appellants objection regarding the jurisdiction of the Respondent No.1 to hear and decide the appeal against the order of Registrar Modaraba is not tenable as the section 10 of the Securities and Exchange Commission of Pakistan Act 1997 (the SECP Act) empowers the Commission to delegate any of its powers or functions to any of its Commissioners or any officer. S.R.O. 1061(1)/2005 holds legal sanctity which is upheld by the Honorable High Court of the Sindh in the order dated 1.9.2010 passed in appeal under section 34 of the SECP Act (Miscellaneous Appeal No. 03/2009). In terms of the said SRO, power to hear appeal under section 32(2) of the Ordinance 1980 has been delegated to the Respondent No.1, therefore, he was legally competent to hear and adjudicate on the appeal filed by the Appellants.

9. In the view of the aforesaid facts, we find no reason to interfere with the Impugned Order, therefore the Appeal is hereby dismissed.

10. Parties to bear their own cost.

(Fida Hussain Samoo)
Commissioner (Insurance)

(Tahir Mahmood)
Commissioner (CLD)

Announced on: 09 DEC 2015