Before Amir M. Khan Afridi, Director/HOD (Adjudication-I)

In the matter of Show Cause Notice issued to First National Equities Limited

Dates of Hearing	July 14, 2021

Order-Redacted Version

Order dated October 18, 2021 was passed by Director/Head of Department (Adjudication-I) in the matter of First National Equities Limited. Relevant details are given as hereunder:

Nature	Details
1. Date of Action	Show cause notice dated August 25, 2020.
2. Name of Respondent	First National Equities Limited (the "Respondent")
3. Nature of Offence	Alleged contraventions of rule 34 of the Securities (Leveraged Markets and Pledging) Rules, 2011 (the "Rules") read with Section 150 of the Securities Act, 2015 (the "Act").
4. Action Taken	Key findings were reported in the following manner: I have considered the written as well as verbal submissions of the Respondent and its Representatives as well as the applicable legal provisions and of the view that: i. The Respondent executed trades for its customers despite of their huge debit balances and same was admitted by the Respondent in its submission. The same fact was also admitted by the Chief Executive Officer of the Respondent, during the course of investigation, in his written statement in following words: "we allow our clients to trade on debit balances occasionally to earn commission." ii. The contention of the Respondent that rule 34of the Rules pertains to leveraged market and prohibition contained in rule 34 ibid is only applicable in cases where the funds are extended against mark up. In this regard, the Respondent referred to regulation 4.18.1(c) of the PSX Rule book and stated that the said regulation has laid down limitations

	qualifications for the brokers where client is not paying the accrued debit balance. iii. Regulation 4.18. I(c) of PSX Rule Book referred by the Respondent is reproduced hereunder for reference: "4.18.1 The Brokers shall ensure that the assets belonging to their clients are kept separated from the assets of the Broker. For this purpose, the Broker: (c) may maintain a Collateral Account under his Participant Account in CDS for all clients. This account shall be used exclusively (or instances where outstanding payment has not been received from clients in respect of securities purchased on their behalf and relevant purchase obligation is to be settled. In such cases the Broker will be allowed to transfer the securities on the respective settlement date (rom the respective sub-account to the Collateral Account for a maximum period of three (3) settlement daps only to the extent of the transaction volume (or which the client's payment is outstanding (or whatsoever reason and comply with relevant requirements contained in the CDC Regulations. The Broker shall, in addition to the electronic reporting of such transfers through ways and means as specified by the Exchange report the Exchange in writing explaining the reason for utilizing the Collateral Account and/or for holding client's securities immediately after such transfer. The notice from the Broker will be accompanied with following documents: (i) Non-payment notice served on the client through courier, personal delivery method, facsimile, email or properly recorded telephone line, advising him to make payment by the close of banking hours on the next working day after the settlement day and notifying that, otherwise the Broker shall have a right to dispose of the required securities to cover the shortfall in the client 's account at client 's risk and cost; (ii) Client 's sub-account and Collateral Account Activity Report of movement date and; (iii) Documentary evidence substantiating the genuineness and circumstances of the reason (or non-payment bp the client which may include failure of client to pap in time due to non-clearance of client's cheque. and natural calamity. law and order situation. non or delayed functioning of an automated procedure. e.g.„ NIFT Provided that for a particular client, the Broker is allowed to transfer securities from the sub-account of client to the Collateral Account only once in a calendar month.„ The Respondent contended that regulation 4.18. I(c) of the PSX Rule Book allows broker to recover its due amount by

	following the prescribed procedure, in case client has failed to relieve the accrued debit balance in its account, which implies that existence of debit balance is not prohibited under law. The aforesaid contention is untenable as the context of regulation 4.18 of PSX Rule Book is of "segregation of clients' assets by the brokers" whereby broker is prohibited to intermingle client-broker assets as envisaged in the Act, however, in case of circumstances narrated in clause (iii) of 4.18.1(c) the broker is allowed to transfer the securities on the respective settlement date from the respective sub-account of client to the Collateral Account maintained in CDS. The said Regulation allows broker to dispose of the required securities (after the requisite procedure) to cover the shortfall in the client's account at client's risk and cost. Here, it needs to be noted that circumstances specified in clause (iii) of 4.18. I(c) are of once off nature, which may include failure of client to pay in time due to non-clearance of client's cheque, any natural calamity, law and order situation, non or delayed functioning of an automated procedure. All the specified circumstances depict that regulatory framework do not envisage debt balances as routine business operation in brokerage business. The proviso of referred regulations states that for a particular client, the broker is allowed to transfer securities from the sub-account of client to the Collateral Account only once in a calendar month, which further confirms that debt balances as normal course is not envisioned and reflects once off event. However, in the case of four instances identified during the Investigations. the Respondent allowed those customers to trade despite of their respective debt balances for a considerable time period. The Respondent used its own funds for settlement of customer(s) trades and prescribed procedure of transferring of securities to Collateral Account(s) was never adopted. The use of Respondent funds for settlement of securities traded by customer on regular basis is in fact violation of the requirement of segregation of clients' assets. iv. The contention of Respondent that the identified instances of debt balances cannot be termed as financing and it should be viewed as trade credit as no markup/interest was being charged from the customers on those debt balances is not sustainable. Trade credit is a business-to business agreement in which a customer can purchase goods without paying cash up front, and paying the supplier at a later date. Usually. businesses that operate with trade credits will give buyers 30, 60. or 90 days to pay, with the transaction recorded through an

	invoice. The concept of "trade credit" in identified cases is not applicable as the Respondent was only performing regulated securities activity to provide access to trading platform of PSX. The business model of buying securities from broker's money for customer on a facility of trade credit of some predefined period is not envisaged in regulatory framework and indeed contrary to the Rules. v. The argument of Respondent that instances of debt balances was a normal course of business and trade during debt balances were allowed by considering creditworthiness of the respective customer, is flawed and actually admission of default as the term "creditworthiness" refers to suitability of a person or company to receive credit. If a lender is confident that the borrower will honour his/her debt obligation in a timely fashion, the borrower is deemed creditworthy. It is not a function of broker to extend financing/ credit to its customers even after determining their creditworthiness. vi. CEO of the Respondent in his written statement admitted that they allow their clients to trade on debit balances to earn commission. Therefore, the contention of the Respondent that the trade during debt balances may not be treated as financing activity as no mark-up was charged, is indefensible as motive of allowing customer to further trade despite of their respective trade balances was to earn commissions. Thus, Respondent was accruing benefits of extending financing from its customers. In view of the foregoing, contraventions of the provisions of rule 34 of the Rules has been established. In terms of the powers conferred under Section 150(2) of the Act read with sub-section (5) thereof, a penalty of Rs. 600,000/- (Rupees Six Hundred Thousand Rupees Only) is hereby imposed on the Respondent. The Respondent is also advised to ensure that the requirements contained in the Act are met in letter and spirit.
5. Penalty Imposed	Rs. 600,000/-
6. Current Status of Order	Penalty not deposited and Appeal has been filed by the respondents.