



Securities and Exchange Commission of Pakistan

BEFORE THE APPELLATE BENCH

In the matter of

Appeal No. 26 of 2018

First Dawood Investment Bank Limited

... Appellant

Versus

Commissioner Specialized Companies Division, SECP

... Respondent

Date of Hearing: 04/06/2020

Present:

For the Appellant:

- i. Mr. Sohaib Shahid, Advocate (Raza Khalil Abbasi Hafeez Suhrawardy)

For the Respondent:

- i. Ms. Amina Aziz, Director (Adjudication-1)
- ii. Ms. Tanzila Mirza, Additional Director (Adjudication-1)

ORDER

1. This Order is passed in Appeal No. 26 of 2018 filed under section 33 of the Securities and Exchange Commission of Pakistan (Commission) Act, 1997 (SECP Act) against the Order dated 24/05/18 (the Impugned Order) passed by the Commissioner, Specialized Companies Division (the Respondent).
2. First Dawood Investment Bank Limited (the Appellant) is licensed by the Securities and Exchange Commission of Pakistan (the Commission) to provide investment finance services. The brief facts of the case are that license of the Appellant expired in 2009 and was not renewed owing to non-compliance with the Minimum Equity Requirement (the MER). The audited annual accounts of the Appellant for the year ended 30/06/16 reported equity of Rs.676 million and that the Appellant also recorded deferred tax assets (the DTA) amounting to Rs.680 million. The statutory auditor of the Appellant gave a qualified opinion on the accounts of 30/06/16 due to recording of the DTA. After deducting the DTA, adjusted equity was calculated as negative 3.64 million. The



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Commission took up the matter with the management of the Appellant vide letter dated 24/07/17 and it was informed that necessary provisions are required to be made in the books of the Appellant for providing for DTA. The Appellant responded vide its letter dated 22/08/2017 stating, “DTA raised in the balance sheet is not against any accounting principles or rules and it has merely been qualified since it does not have a valid license...” The Appellant, thereafter, provided a copy of letter issued by its auditor wherein the auditor stated, “we have qualified DTA, because presently FDIBL does not have a valid license to ensure future taxable income for FDIBL... we hereby confirm that upon renewal of license FDIBL will have a clear roadmap to attract interest of possible right issue/new equity partner(s) to ensure liquidity... we further confirm that the aforesaid development will result in removal of the qualification”. The Commission informed the Appellant vide letter dated 12/10/17 that DTA cannot be considered for regulatory MER purposes. The reported equity of the Appellant for the year ended 30/06/17 decreased to 409.95 million with reported DTA amounting to 381.21 million and the statutory auditor once again gave a qualified opinion on its accounts.

3. The Commission took cognizance of the matter and show cause notice dated 28/12/17 (the SCN) was issued to the Appellant through its Chief Executive Officer. Hearing was fixed on 05/03/2018 after the Appellant’s request for extension in time of hearing. On the given date, Mr. Rizwan-ul-Haque, Senior Executive Vice President and Mr. Syed Musharaf Ali, Company Secretary of the Appellant (the Authorized Representatives) appeared through video conferencing from CRO Karachi. During the hearing, the Authorized Representatives submitted that the Appellant was compliant with licensing requirements and its license may be renewed and they were advised by the Respondent to submit documentary evidence in support of their verbal assertions.
4. The Respondent dissatisfied with the response of the Appellant held that it is established that the Appellant is non-compliant with the MER, therefore, cancellation of license under section 282J(2) of the Companies Ordinance, 1984 (the Ordinance) and winding up of the Appellant under section 282J(3) of the Ordinance can be initiated immediately. The Appellant, however, was provided one final opportunity to comply with the MER and submit the statement of equity by 30/06/18, accompanied by a certificate from its statutory auditor on or before 31/07/18 but in the event of failure to comply, its license to undertake investment finance services shall stand cancelled under section 282J(2) of the Ordinance



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and the Respondent shall initiate proceedings for its winding up under section 282J(3) of the Ordinance.

5. The Appellant has challenged the Impugned Order *inter alia* on the following grounds:
- i. The Impugned Order entirely excludes substantial amount of unrealized gain on associate shares and marketable securities from the Appellant's "*Equity as per financial statements*" despite this accounting item expressly listed therein. Furthermore, the Impugned Order fails to provide any reasoning for such exclusion and in not providing the Appellant an opportunity to make its representations with respect to unrealized gain on associate shares and marketable securities, the Respondent has condemned the Appellant unheard, without providing them a fair hearing. The Impugned Order is liable to be set aside on the grounds of this illegality alone.
 - ii. The Impugned Order in failing to calculate the Appellant's DTA as part of its equity has proceeded in contravention of the principles and practice of equity calculations not only prevalent in Pakistan but also exercised by the State Bank of Pakistan (the SBP), being the apex banking regulator. The aforementioned illegality renders the Impugned Order liable to imminent correction bringing it in line with the prevalent banking and accounting practices of Pakistan. The Appellant having been denied the benefit of the inclusion of its DTA in its equity has consequently not been treated on an equal footing with similarly placed finance companies who have been awarded that benefit.
 - iii. The Impugned Order took into consideration the statement of the Appellant's auditors of their qualified opinion pertaining to its DTA excluding it from the Appellant's equity calculations, however, in the same opinion, the auditors have clarified that the qualification by the auditor is because of the Appellant being denied a renewal of its license. It is further emphasized that a qualified opinion of the Appellant's external auditors with respect to its DTA does not result in it being excluded from its equity calculations. The Respondent has proceeded to unjustly penalize the Appellant and the Commission in denying such renewal is not only responsible for such qualification by the auditor but also for the effect on its equity accounting.
 - iv. The Impugned Order incorrectly dismissed the reversal of mark-up of Rs 62.4 million by the Appellant of its loan from House Building Finance Corporation (the HBFC). The cost of funds on the repayment of the Appellant's loan from HBFC was calculated by the SBP to be 14.33% while the recent SBP notification had increased it to 34.64%.



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These rates have been objected to by the Appellant as the calculation of the cost of funds to be payable to HBFC cannot be calculated impartially by the SBP since it has become a major shareholder of HBFC. The Honourable Supreme Court of Pakistan (the Honourable Supreme Court) vide its order dated 31/03/16 had ordered the Appellant to make payment of the loan to the HBFC along with cost of funds in monthly installments and had also ordered that security deposited by the Appellant with the Nazir, Honourable Sindh High Court (the Honourable Sindh High Court) to be proportionately released. In the instant case, securities were not proportionately released, therefore, the Appellant made payments after deducting the amount of securities to be released. The Impugned Order failed to provide sufficient or any reasoning for its exclusion of substantial amounts from the equity calculation of the Appellant.

6. The Respondent rebutted the arguments of the Appellant on the following grounds:
- i. The matter of DTA, reversal of mark-up and reversal of provisioning were taken up several times with the management of the Appellant and their reply was duly considered. The statement of the Appellant that SBP takes into account DTA while calculating the equity of the banks is not based on facts. In this regard, attention is drawn towards "*Instructions for Basel III Implementation in Pakistan*" issued by SBP. The SBP has clearly mentioned in the instructions that DTA which rely on future profitability of the bank to be realized will be deducted from Capital Equity Tier 1 (CET1). The Appellant was informed vide letter dated 24/07/17 that in view of the concerns raised by the statutory auditor, necessary provisions are required to be made in the books of the Appellant for providing the DTA. Furthermore, the Respondent once again informed the Appellant vide letter dated 12/10/17 that DTA cannot be considered for regulatory MER purposes. Therefore, the Appellant's statement that DTA qualified as part of equity of a finance company is incorrect and exclusion of DTA from the capital is neither uncommon nor unjustified. The Impugned Order was, therefore, passed after considering all the facts and circumstances of the case.
 - ii. Rule 2(xix)(i) of Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 (the Rules) provides that, "*equity includes paid up ordinary share capital, preference shares which are completely convertible into ordinary shares, general shares, statutory reserves, balance in share premium account, reserve for issue of bonus shares, subordinated loans and unappropriated profits, excluding accumulated losses.*"



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Explanation: (i) Surplus on revaluation of fixed assets as described in section 235 of the Ordinance, treasury stocks, intangible assets, deferred tax reserves, and surplus on revaluation of investments shall not be included in the equity.” In terms of the above rule, therefore, unrealized gains on investments are not included for the calculation of MER.

- iii. The Appellant obtained a loan from HBFC and the repayment of the loan was under litigation. The Honourable Supreme Court vide its order dated 31/03/16 ordered the Appellant to make payment of the loan to HBFC along with cost of funds. A dispute emerged between the Appellant and HBFC with regard to “cost of funds” allowed by the Honourable Supreme Court of Pakistan and HBFC reportedly approached the Honourable Sindh High Court for resolution of the matter instead of approaching the Honourable Supreme Court. The Appellant made payments on the basis of cost of funds appearing in the credit rating report of HBFC issued by JCR-VIS and reversed the mark up payable to HBFC based on the legal opinion obtained by the Appellant from a law firm. The statutory auditors added an emphasis para on the reversal of mark-up in the half yearly accounts for the period ended 31/12/17 and the matter was not resolved as HBFC approached the Honourable Sindh High Court in March 2017 for recovery of an amount of Rs 133.93 million along with cost of funds from 10/03/17 till the date of realization of the whole amount. The Appellant took the plea that since the securities were not proportionately released, therefore, it made payments after deducting the amount of securities to be released. Reading of the order, however, of the Honourable Supreme Court revealed that it did not allow such privilege to the Appellant and the Appellant should have approached the Honourable Supreme Court of Pakistan for initiating the appropriate proceedings. The reversal of mark-up by the Appellant, therefore, was not appropriate in light of the above facts. The mark-up payable to HBFC was reversed by the Appellant after issuance of SCN by the Respondent and was reversed despite the fact that the matter is still under litigation. Therefore, it is apparent that this reversal was an attempt to artificially increase the profits of the company for the period ended 31/12/17 and resultantly increase the equity to meet equity shortfall. Moreover, the Impugned Order has adequately discussed in detail the reasons for the objections raised by the Respondent on the aforesaid reversal.

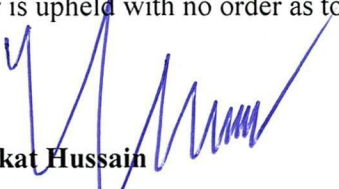
7. We have heard the parties i.e. the Appellant and the Respondent. We have reviewed Clause 2.4.4 of the Instructions for Basel III Implementation in Pakistan issued under BPRD circular



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#6 dated 15/08/13 by the SBP which provides that, “*Deferred tax assets (DTA), which rely on future profitability of the bank to be realized, will be deducted from CETI...*”. Therefore, we are of the view that in light of the aforementioned circular, it is clear that SBP does not include DTA based on future profitability in the calculation of the MER. Furthermore, we have observed that there were doubts about the recoverability of DTA recorded by the Appellant as evidenced by its failure to recover DTA over the past few years and given the qualified opinion by its auditors, the Respondent has quite justifiably required the Appellant to meet the MER without taking benefit of DTA. The Appellant’s assertion that they have been unfairly targeted as other finance companies have been permitted to include DTA in its equity is without any evidence or substance. Furthermore, Rule 2(xix)(i) of the Rules indicates that unrealized gains on investments are not included in the calculation of MER. The Respondent was also correct to dismiss the reversal of mark-up of Rs 62.4 million by the Appellant of its loan to HBFC since the matter is under litigation and cannot be included in calculation of the Appellant’s equity.

8. In view of the above, we see no reason to interfere with the Impugned Order. The Impugned Order is upheld with no order as to cost.


Shaukat Hussain
Commissioner (CCD, Insurance)


Shauzab Ali
Commissioner (SMD)

Announced on: **06 AUG 2020**