



Securities and Exchange Commission of Pakistan

Securities Market Division

Through Courier

Before The Director / HOD (MSRD)

In the matter of Show Cause Notice issued to Arif Habib Limited under Section 22
of the Securities and Exchange Ordinance, 1969

Date of Hearing:

August 8, 2014

Present at the Hearing:

Representing Arif Habib Limited

(i) Mr. Zeshan Afzal

Group Head – Corporate Finance

(ii) Mr. Sarwar Khan

Head of Risk & Compliance

Assisting the Director/HOD (MSRD)

(i) Mr. Muhammad Tanveer Alam

Joint Director

(ii) Ms. Najia Ubaid

Deputy Director

ORDER

1. This Order shall dispose of the proceedings initiated through Show Cause Notice bearing No. 1(19) SMD/MSRD/C&IW/2014 dated June 11, 2014 ("SCN") served to Arif Habib Limited ("**Respondent**"), Trading Right Entitlement Certificate Holder/Broker of the Karachi Stock Exchange Limited ("**KSE**") by the Securities and Exchange Commission of Pakistan ("**Commission**") under Section 22 of the Securities and Exchange Ordinance, 1969 ("**Ordinance**") read with Rule 8 of the Brokers and Agents Registration Rules, 2001 ("**Brokers Rules**").

2. Brief facts of the case are that the Commission in exercise of its powers under Sub-section (1) of Section 6 of the Ordinance read with Rule 3 and Rule 4 of the Stock Exchange Members (Inspection of Books and Record) Rules, 2001 ("**Inspection Rules**") ordered an inspection of the books and record required to be maintained by the Respondent. The following officers of the Commission were appointed as inspectors ("**Inspection Team**") for the purpose vide order dated October 28, 2013:

a) Mr. Muhammad Tanveer

Deputy Director

b) Mr. Mian Muhammad Imran

Deputy Director





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3. The Inspection Team submitted the report ("**Inspection Report**") on February 10, 2014 which was shared with the Respondent in accordance with Rule 7 of the Inspection Rules. The response of the Respondent in the context was received vide letter dated April 7, 2014. Upon evaluation of the Inspection Report, irregularities in calculation of Net Capital Balance ("**NCB**") as of June 30, 2013 were observed and it appeared that NCB certificate was not in accordance with the Third Schedule of the Securities and Exchange Rules, 1971 ("**SEC Rules**"). The Inspection Report further highlighted that the Respondent failed to maintain proper books of accounts; failed to maintain segregation of clients' assets and was involved in imposing late payment charges to its clients.

4. In light of the Inspection Report and the comments received from the Respondent, the Commission served a SCN to the Respondent under Section 22 of the Ordinance and Rule 8 of the Brokers Rules. Hearing in the matter of aforesaid SCN was scheduled for June 25, 2014 at the Commission's Head Office in Islamabad. However, the Respondent vide letter dated June 23, 2014 requested for extension in the date of hearing. Acceding to the Respondent's request, hearing date was rescheduled to August 8, 2014.

5. The arguments put forward by the Respondent in its written response to the SCN submitted vide letter dated July 5, 2014 are reproduced below:

a) **Net Capital Balance:**

"We would like to bring into Honorable Commission's kind notice that AHL provided comments on the said observation on page 2/46 of its comments, vide its letter dated April 7, 2014, whereby it had been stated that the specified receivables had already been adjusted by the amounts mentioned in serial No. 1, 2 and 3 of the second para of section 9.1.1.1 of the inspection report, while determining NCB. The same can be verified from the NCB as on June 30, 2013 provided by AHL to the audit team, whereby the said receivables have been classified in overdue balances (i.e. more than 14 days). As such, these receivables were not included in NCB calculation and did not have any impact upon the NCB of AHL as on June 30, 2013. With regard to receivable in serial no. 4 of the inspection report, the receivable was included for the purpose for NCB as the amount was due for less than 14 days and the client has been an active client of AHL. Further, the payment was subsequently made by the client to AHL on July 4, 2013 which substantiates that the AHL had correctly classified the said receivables in its June 2013 NCB as the same were received within 14 days more specifically within 4 days of the NCB's determination.





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Further it is pertinent to mention here that AHL had very healthy NCB as on June 30, 2013 which never gives any reason to AHL to overstate its NCB, which may contravene the Third Schedule of the SEC Rules. This is also evident from the fact that AHL has never reached to its maximum exposure limit as determined by its NCB, in all or any of the markets. The same can be verified through the NCHS data. "

b) Improper Books of Accounts:

"We would like to bring into Honorable Commission's kind notice that AHL provided comments on the said observation, vide its letter dated April 7, 2014, whereby it was stated that the above highlighted difference has been managed via reconciliation, the working of the reconciliation had been shared with the audit team along with AHL's remarks, which is enclosed herewith as well.

Particulars	Adjustments identified over and above adjusted trail balance		Impact on Balance Sheet items Increase/ (decrease)	Explanation
	Debited	Credited		
Clients Payable		4,842,555	Increased	
Payable Securities	35,893,667		Decreased	
Commission Payable		1,638,728	Increased	This amount is commission payable to trades of company, whereas, this was first recorded in clients payable. As such in accordance with the requirements of the relevant accounting standards, we have classified the same as separately as commission payable as at June 30, 2013
Payable against repurchase agreement		99,998,800	Increased	This amount is liability of AHL as the amount had been received by company against its shares that were transferred against Repo liability. As such, in accordance with the requirement of the relevant accounting standards, we have recorded the same as our investments and liability of the same amount has been created in Payables (below) as at June 30, 2013.
Deposit against future clearing	8,472,670		Increased	The amount represents receivable from KSE on the company's profit in future contracts made in different scrips in Future's market having settlement date on July 2, 2013 & August 2013. The said amount has been adjusted with Trade Deposits and Prepayments (below). This particular entry has been manually passed based as original entries were prepared and passed via system generated process and as such provisioning mechanism of the system





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				could not be bypassed. However, for proper presentation of accounts as per the relevant accounting standards, the same has been transferred to trade deposits and prepayments.
Investment	61,616,462		Increased	Net repo receivables from client was included in the client receivables. As such to comply with the requirement of the relevant accounting standards, we have classified the amount of repo receivable separately in the relevant head and have excluded the same for the purpose of reporting from trade debtors.
Car lease payable	497,375		Decreased	In Balance sheet adjusted in A/P
Other adjustment		91		
Total	106,480,174	106,480,174		

The reason as to why the figure in the TB doesn't match to that of Balance sheet is that balance sheet is prepared in accordance with IFRS and companies ordinance 1984, whereas the TB has been extracted from the back office system. Back office generated TB along with the reconciliation shall be taken as the adjusted TB and for the same reason we provided reconciliation to the audit team along with AHL's remarks so that the figures can be reconciled to the audited accounts.

It's pertinent to mention here that the above highlighted figures do appear and have been part of the TB but while preparing the balance sheet, only reclassification had been done so as to make sure Balance Sheet is prepared in accordance with IFRS and companies ordinance, 1984. As such, there has been no instance where figures do not appear in Trial Balance but have an impact on the financial statements and as such AHL has not been in violation of Rule 8 of the SEC Rules.

In view of the above, we have again enclosed herewith system generated TB along with our reconciliation (reclassification done in TB so as to make sure balance sheet is prepared in accordance with IFRS and companies ordinance, 1984) and our remarks. The above enclosures clearly substantiates the fact that; all the above specified figures do appear and have been part of the trial balance but while preparing the balance sheet, only reclassification had been done so as to make sure balance sheet is prepared in accordance with IFRS and companies ordinance, 1984 and that there has been no instance where figures do not appear in Trial Balance but have an impact on the financial statements and that AHL has been complied with Rule 8 of the SEC Rules.





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c) **Segregation of clients' funds:**

"AHL in its comments on the inspection report highlighted that AHL has been cognizant of clause 41(1)(a) of the General Regulations of KSE and has made sure that client assets are kept in segregated manner and as such clients' funds have never been utilized without their specific written authority. This is also evident from the fact that account tagged as clients' account reflects a debit balance of Rs. 30.78 million as on June 30, 2014.

Further, it's pertinent to mention here the associated of AHL have authorized AHL for utilization of their idle funds, if any. Just to quote as an example, M/s. Arif Habib Equity (Pvt) Limited has authorized AHL to utilize its idle funds, if any. The amount appearing against the said client as on 30th June, 2013 amounted to PKR. 481.167 million out of the total creditors balance of Rs. 679.85 million. As such, this single account explains 74% of the difference highlighted by the audit team on a standalone basis. Accordingly, if total percentage of AHL's associates is cumulatively taken into account (other than the total percentage), this will explain the difference highlighted by the audit team.

In view of the above observation highlighted by the honorable Commission, AHL segregated its associates credit balances as on June 30, 2014 despite its associate's specific written authorization, whereas other clients' credit balances were already segregated."

d) **Late payment charges:**

"AHL has been charging late payment charged but it's pertinent to mention here that the late payment charges booked by AHL have been decreasing both in absolute and relative terms. Late payment charges booked by AHL have decreased by more than 35% since 2012 till June 2013. This drastic decline in late payment charges over the period has been possible due to:

- a- AHL's conscious efforts to curtail late payment charges; and
- b- As a result of providing direct counseling to clients to educate them in understanding the importance of clearing their settlement balances on time.

Further there has been drastic decrease in late payment charges despite increase in volumes and business in KSE over the mentioned period.

Other than AHL's conscious and intense efforts of curtailing late payment charges, AHL certainly would share with the honorable Commission the genuine reasons faced by AHL as to why we are applying late payment charges to clients who do not clear their balances on time;

- a- It is neither advisable, nor practicable for us to immediately transfer the securities to collateral account for the purpose of disposal, especially in cases where clients do have the intention to clear their settlement at their earliest, we have to apply late payment charges.
- b- AHL has not been charging late payment across the board or as a matter of policy, in fact AHL has been charging to very few clients who do not clear their dues for





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extended period of time. Late payment charges are applied to such clients to cover AHL's financial cost as it is our responsibility/obligation to secure the interest of our shareholders as the company is a listed company. These overdue balances liability for us but we don't want to sell the clients position ruthlessly.

- c- While the clients place their trade orders, there is no financing or credit arrangement with such clients. It is only after the securities are purchased that we realize that payment is not forthcoming but AHL remains bound to pay for such purchases out of its own resources. If AHL does not recover late payment charges, this will certainly have adverse effect on AHL's financials. Further, the impression that late payment charges have been a source of revenue is not correct, as AHL has to bear the funding cost and pledging cost of its own shares.*
- d- We have been educating/encouraging clients to avail positions in MTS for trades that cannot be 100% financed by them. This is also evident from the fact that AHL has been the active/major participant in MTS market, whereby during the review period high percentage of market MTS trades had been transacted through AHL. Though we do persuade clients to transact trades in MTS for scrips that cannot be financed by them and are eligible for MTS but clients delay their settlement for scrips that aren't eligible for trading through MTS and in particular if the same cannot be financed by them. As mentioned earlier, it is only after the securities are purchased that we realize that payment is not forthcoming but AHL remains bound to pay for such purchases out of its own resources.*

Though when the matter of applying late payment charges has been highlighted by the commission, we now therefore assure the Honorable Commission despite all the above explained limitation, we will certainly follow and adopt the recommendations/guidelines that the Honorable Commission suggests in this regard."

6. Mr. Zeshan Afzal, Group Head of the Respondent and Mr. Sarwar Khan, Head of Risk and Compliance of the Respondent ("**Representatives**") attended the hearing on behalf of the Respondent on August 8, 2014 at the Commission's Karachi office. The arguments put forth by the Representatives of the Respondent during the course of hearing are summarized below:

- a) With regard to calculation of NCB, the Representatives stated that the Respondent is strictly following the guidelines issued by the Commission. The Representatives further asserted that the difference in the figure of trade receivables as identified by the inspection team was because of non-inclusion of late payment charges in the





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calculation. With regard to consistent accounting treatment of late payment charges, the Representatives added that the difference identified by the inspection team during inspection was because some of amount charged to the clients under the head was subsequently recovered. The Representatives affirmed that the NCB despite of the suggested adjustments is on higher side and the Respondent never utilized complete exposure available at its credit, which could be verified through NCHS system.

- b) The Representatives, in the context of maintenance of proper books of accounts, stated that the Respondent is maintaining proper books of accounts. For the difference identified by the inspection team, the Representatives informed that they provided system generated trial balance to the team which did not contain the adjustments made by the auditors of the Respondent. The Respondent further added that reconciliation of the identified differences was provided to the inspection team. The Representatives further assured that in future they shall provide updated trial balance to the inspection team. The Respondent in this context, subsequent to the hearing vide letter dated August 25, 2014 provided explanation as to non-recording of NCCPL payable/receivable in the trial balance provided extract of notes to the financial statements as an evidence that the Respondent was recording the trade receivables/payables of the clients on the settlement date.
- c) With regard to segregation of clients' funds and the discrepancy identified by the inspection team regarding debit balance in clients' bank account of Rs. 30 million and trade payables of the same date of Rs. 679 million, the Representatives communicated that majority of the payables appearing in the trial balance is from the associate companies of the Respondent. The Representatives further added that the associates have given them complete authority to utilize the funds and agreed to provide break up of payables to the associates (along with copy of the authority letter) and payable to other clients.
- d) Regarding late payment charges, the Representatives stated that the volumes during the recent period has been doubled, however, the amount charged on account of late payments has decreased substantially. The Representatives added that the Respondent is not involved in extension of credit to its clients or making some arrangements in that context.





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7. I have heard the arguments presented by the Representatives of the Respondent at length during the hearing. Additionally, I have perused the available record and the written reply filed by the Respondent. Accordingly, my findings on the arguments and assertions made by the Respondent to the issues raised in the SCN are as follows:

- a) With regard to calculation of NCB, the Representatives of the Respondent and the Respondent itself communicated that it is strictly following the guidelines issued by the Commission and shall continue to do so. The Representatives agreeing to the difference identified by the inspection team accepted that it was because of non-inclusion of late payment charges.
- b) Regarding improper books of account, the Representatives agreed that the adjustments were made on auditors' recommendations and were not accounted for in the ledgers. The Representatives added that the Respondent in future shall provide adjusted trial balance to the Commission and the inspection team (as and when required). I am of the view that the Respondent should have made the adjustments in the books of accounts through journal entries and the same should have been reflected in the individual ledger items as well as in the adjusted trial balance. From the above, it is evident that the adjustments suggested and incorporated by the auditors in the preparation of Balance sheet were not incorporated in the books of accounts through journal entries, so that it becomes part of the accounting record and is available in the system. The provision of reconciliation by the Respondent during the course of inspection does not constitute proper books of accounts. In this context, I hereby refer to Rule 8 of SEC Rules which states that:

"Maintenance of books of account by members: (1) Every member shall prepare and maintain, as required by sub-section (1) of section 6, the following books of account and other documents in a manner that will disclose a true, accurate and up-to-date position of his business namely:-

- (a) journal (or other comparable record), cash book and any other books of original entry, forming the basis of entries into any ledger, the books of original entry being such as contain a daily record of all orders for purchase or sale of securities, all purchases and sales of securities, all receipts and deliveries of securities and all other debits and credits;*
- (b) ledgers (or other comparable records) reflecting asset, liability, reserve, capital, income and expense accounts;*





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(c) ledgers (or other comparable records) reflecting securities in transfer, securities borrowed and securities loaned and securities bought or sold of which delivery is delayed;....."

In light of the above, the Respondent is required to record each and every transaction in the form of journal entry in its books of accounts, with complete details on gross basis, so as the amount is properly reflected into respective ledgers and then trial balance of the Respondent.

- c) With regard to segregation of clients' assets, the Representatives agreed to provide breakup of trade payables position as of June 30, 2013 from the associates of the Respondent and from its other clients. The breakup of trade payables was provided by the Respondent vide email dated September 15, 2014, which is reproduced below:

Sr. No	Name	Amount in Rs.
1.	Arif Habib Equity (Private) Limited	481,167,050
2.	Arif Habib Corporation Limited	1,227,496
3.	Arif Habib Commodities (Private) Limited	738,224
4.	A.H Investment Management	406,000
5.	Deposit in bank account of clients	30,780,000
6.	Amount not pertaining to clients	3,700,886
7.	Clients in default	5,172,495
8.	Other Clients- who has given authority	162,470,046

The Respondent provided copy of the letter issued by Arif Habib Equity ("AHE") authorizing the Respondent to utilize credit amount in its account. The authority letter states that:

"I hereby authorise M/s. Arif Habib Limited to utilize credit amount against my account, if any, to reduce its Running Finance facilities, and own any benefit accrued upon such credit balances subject to the following conditions;

- 1- The credit amount shall be immediately made available for any trades executed by me and*
- 2- The credit amount shall be immediately made available upon my withdrawal request."*

The examination of the authority letter revealed that the same was issued on a plain white paper with a single signature, which cannot be constituted as an authority from a Private Limited Company. Moreover, no board resolution was attached with it.





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Notwithstanding the above, the regulatory framework time and again provides very clear instructions to be followed by the Brokers with regard to segregation of clients' funds. Relevant extracts, in this context, are reproduced below:

(i) Chapter 4.19.1 of KSE Rule Book:

"The broker shall ensure that the assets belonging to their clients are kept separated from the assets of the Broker. For this purpose the broker shall maintain

(a) a separate bank account which will include all the funds deposits of their clients along with record/breakdown of clients' balances;"

(ii) Chapter 4.19.2 of KSE Rule Book:

"Except as permitted above, the clients funds and securities shall not be used by the broker for any purpose other than as authorized by the client in writing in the manner and procedure prescribed by the Exchange and/or CDC..."

(iii) Condition 2(a) of Special Terms and Conditions contained in the Standardized Account Opening Form, Annexure - I of KSE Rule Book:

"The credit amount of the Account Holder(s) shall be kept by the broker in a separate bank account titled "Account Holder/Client Account" and shall not be used by the broker for his own business"

It is evident from the above that regulatory framework does not allow use of clients' assets other than for his/her own benefit. Irrespective of the status of clients i.e., associate or not, the Respondent cannot use the funds of its' clients even when authorized by the client him/herself. Under the existing regulatory requirements, the Respondent is expected to ensure proper segregation of clients' assets and should at all times have an amount equivalent to its trade payables/creditors in the bank account tagged as clients' account.

The Respondent in its written response stated that it has segregated clients' funds as of June 30, 2014, however, no documentary evidence to substantiate its stance was provided to the Commission. Moreover, with regard to segregation of clients' assets the Respondent again in its written response dated August 25, 2014 has specified the purpose of investment of clients' funds referred to the authorization given by AHE regarding use of its credit amount to reduce Running Finance facilities of the Respondent.





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d) In reference to late payment charges, the Representatives during the course of hearing communicated that this amount is charged to recover balances from the Respondents' clients, the Respondent in no manner is involved in extension and/or maintenance of credit. The Representatives during the hearing stated that the amount of late payment charges have gradually decreased over time and the Respondent is also educating its clients in this context. The Representatives further asserted that the issue has also been taken up with KSE.

8. The Respondent is required to maintain proper and complete books of accounts. Accordingly, the adjustments made in the balance sheet should have been part of the system generated trial balance, routed through proper journal entries of all the transactions. Furthermore, the Respondent being custodian of clients' assets has to act in a prudent and judicious manner and should ensure segregation of clients' assets from its own. Regardless of the fact that the client is an associate of the Respondent, the Respondent should follow the regulatory provisions in letter and spirit and keep clients' funds segregated to ensure compliance with statutory requirements.

9. After a detailed and thorough perusal of the facts, evidence/information available on record, contentions and averments made by the Representatives of the Respondent during the course of the hearing, it is evident that the Respondent did not fulfil its regulatory obligations by not maintaining proper segregation of clients' assets; not maintaining proper books of accounts; and by imposing late payment charges.

10. Therefore, in exercise of the powers conferred upon under Section 22 of the Ordinance, I hereby impose on the Respondent a penalty of Rs. 100,000/- (Rupees One Hundred Thousand Only). Moreover, the Respondent is directed to:

- i) comply with the Rules 1971 and the guidelines issued in letter and spirit;
- ii) ensure segregation of clients' assets and maintain separate bank account for the clients' funds; and
- iii) stop imposing late payment charges.





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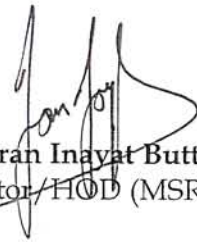
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11. The matter is disposed of in the above manner and the Respondent is directed to deposit the fine in the account of the Commission being maintained in the designated branches of MCB Bank Limited not later than thirty (30) days from the date of this Order and furnish a copy of the deposit challan to the undersigned.

12. This Order is issued without prejudice to any other action that the Commission may initiate against the Respondent in accordance with the law on matter subsequently investigated or otherwise brought to the knowledge of the Commission.

Announced on September 19, 2014
Islamabad.




(Imran Inayat Butt)
Director/HOD (MSRD)