



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
Mohammad Munir Mohammad Ahmed Khanani Securities (Private) Limited
under Section 22 of the Securities and Exchange Ordinance, 1969

Date of Hearing:

February 23, 2015

Present at the Hearing:

Representing Mohammad Munir Mohammad Ahmed Khanani Securities (Private) Limited

- | | | |
|-------|--------------------------|-------------------------|
| (i) | Mr. Munir Khanani | Chief Executive Officer |
| (ii) | Mr. Abdul Razzak | Head of Operations |
| (iii) | Mr. M. Zubair Madraswala | Operations Department |

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(45) SMD/MSRD/C&IW/2014 dated January 16, 2015 ("SCN") served to Mohammad Munir Muhammad Ahmed Khanani Securities (Private) 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 August 7, 2014:

- | | | |
|----|----------------------|-----------------|
| a) | Mr. Adnan Ahmed | Deputy Director |
| b) | Mr. Mohammad Tanweer | Deputy Director |





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3. The Inspection Team submitted the report ("Inspection Report") on December 15, 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 December 31, 2014. Upon evaluation of the Inspection Report, irregularities in calculation of Net Capital Balance ("NCB") as on June 30, 2014 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 segregation of clients' assets and Standardized Account Opening Forms ("SAOFs"); did not have collateral account and duly approved Know Your Customer ("KYC") & Customer Due Diligence ("CDD") policy; was imposing late payment charges to its clients; failed to update UIN database maintained by NCCPL and was not in compliance with the Circular 34 of 2009 issued by the Commission.

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 February 3, 2015 at the Commission's Head Office in Islamabad. The Respondent vide letter dated January 27, 2015 requested for change in venue of the hearing. Acceding to the Respondent's request, hearing was rescheduled for February 23, 2015 at the Commission's Karachi Office.

5. The arguments put forward by the Respondent in its written response to the SCN submitted vide letter dated January 23, 2015 are reproduced below:

a) **Improper calculation of NCB:**

"As we informed the inspection team that this difference appeared only because of the formulae adopted by both of us for the purpose of calculation of NCB. Now we have decided to use your formula to calculate NCB, and I am sure that now the NCB will be according to your calculation."

b) **Improper Books of Accounts:**

"I would also like to inform you that the huge number of transaction through my participant account are likely to lead to some wash trading that is why we use the Mr. Saleh Muhammad account to avoid any wash trade through my brokerage house."

c) **Segregation of Clients' Assets;**

As we informed the inspection team that we only use Askari Bank account for our official expenditure and other bank accounts are used to maintain the funds of the client, however





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we have requested the banks to turn these accounts into the clients' account, (copy the requested letters to banks are enclosed for your ready reference."

d) Irregularities in SAOFs:

"We have sent sample forms with the reply to the inspection team, now we are enclosing herewith the copies of all the 14 pointed out forms by the inspection teams. In the new account opening form the authorization form place no vital role as it is going bank."

e) KYC & CDD Policy:

"We are enclosing herewith this letter a copy of the resolution passed through the meeting of the board of directors of the company held on January 20, 2015, that will certainly satisfy this point of objection."

f) UIN Database:

"I would like to inform you here that Mr. Manzoor Ahmed is one our Directors of this company and this information has been updated in UIN data base system (copy of the UIN data base report is enclosed herewith)."

g) ICM Certification:

"One of my employee Mr. M. Zubair is already an ICM certified (membership no. GF021-1375) copy of the Correspondence with ICM is enclosed for your ready reference. And the other Employee Mr. A. Razzak has just got himself registered with ICM, a copy of the program registration form is enclosed for ready reference."

6. Mr. Munir Khanani, Chief Executive Officer; Mr. Abdul Razzak, Head of Operations and Mr. Zubair Madraswala ("Representatives") attended the hearing on behalf of the Respondent on February 23, 2015. The arguments put forth by the Representatives during the course of hearing are summarized below:

- a) With regard to improper calculation of NCB, the Representatives communicated that it was because of using different methodology for calculating NCB from those as specified in the guidelines. The Representatives asserted that the Respondent did not have any mal-intent in the context, as its NCB is much more than its utilized exposure and the mandatory capital adequacy requirements. However, the Representatives assured that subsequent to the Respondent's inspection conducted by the Commission, the Respondent has completely followed the guidelines for calculation of NCB and shall submit NCB Certificate as of December 31, 2014 which will be in compliance with all the regulatory requirements.
- b) While explaining huge number of transactions appearing in the back office record of one of its clients' account with almost no trading activity being carried out under his Unique Identification Number ("UIN") at the Karachi Automated





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Trading System ("KATS"), the Representatives communicated that the said account was a joint account of the Respondent's employee with his father and with the consent of the employee all the transactions that falls under the criteria of wash trades were booked to his ledger. The Representatives further added that the referred client account has now been tagged as employee account. As per the Representatives, the said practice of recording transactions in the client's account was to avoid any letter from the Commission with reference to wash trades.

- c) With specific reference to segregation of clients' assets, the Representatives argued that the regulatory requirements in the context are not correct and claimed that why the Respondent should not be allowed to use clients' money, when commercial banks can do so. The Representatives further asserted that the Respondent has not forced any of its clients to deposit their money with it. The Representatives apprised that the Respondent is in the stock business for last 35 years and not a single investor complaint is registered with the Commission. They further informed that all the accounts are clients' account and the Respondent has requested respective banks to change title of all the bank accounts. The Representatives further accepted that it has used clients' funds, therefore, clients' related bank balance is appearing as NIL in the NCB as of June 30, 2014.
- d) The Representatives during the course of hearing communicated that board approval of KYC & CDD Policy of the Respondent has been attached with the written submission of the Respondent in respect to the SCN.
- e) With reference to the irregularities identified in the SAOFs, the Representatives apprised that the SAOFs have been updated and copy of the new form with rectifications and in compliance with the regulatory requirements has been provided to the Commission along with the written response.
- f) The Representatives apprised that the Respondent has now opened collateral account and provided evidence of the same during the course of hearing.
- g) Regarding certification from Institute of Capital Markets ("ICM") in compliance with the Circular 34 of 2009 issued by the Commission, the Representatives informed that Mr. M. Zubair, employee of the Respondent has already obtained the said certification and evidence in the context has been provided by the Respondent along with its written response. They further added that Mr. A.





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Razzak, employee of the Respondent has also registered with ICM and copy of the correspondence in this context has been provided to the Commission.

7. I have heard the arguments presented by the Representatives at length during the course of hearing. Additionally, I have perused the available record and the written response 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 irregularities in the calculation of NCB, the Representatives took a plea that the differences as identified by the inspection team was because of different formula of aging applied for the calculation of NCB. The Respondent, however, in its written response and the Representatives during the course of hearing assured that in future the calculation shall strictly be made in accordance with the guidelines issued by the Commission. The Representatives further confirmed that NCB Certificate as of December 31, 2014 that is due by March 15, 2015 is in the process and shall be prepared in strict compliance with the regulatory framework.
- b) With reference to recording of a huge number of transactions in one of its clients' ledger account wherein no trading transactions were appearing under UIN of the same client at KATS, the Representatives informed that this was done to avoid disciplinary action by the Regulator on account of wash trades. Here, it is pertinent to mention that in accordance with Rule 8 of SEC Rules the Respondent is responsible to maintain books of accounts and other documents (which includes clients' ledger) in a manner that will disclose a true, accurate and up-to-date position of its business and the recording of transactions in a clients' account which actually do not pertain to him is, prima facie, violation of the referred regulatory requirement. It is important to note that execution of wash trades is an abusive practice that misleads the market about the genuine supply and demand for a stock. During the hearing, the Representatives suggested that prohibition of execution of wash trades should be built in the system. In this context, I would like to refer to this Commission's Order dated April 15, 2011 in the matter of Show Cause Notice served to Adam Securities (Private) Limited, where the subject issue was elucidated in detail. Relevant extracts of the referred Order are reproduced below:





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"With particular reference to the assertion of the Legal Counsel that the Exchanges should be advised to restrict these types of activities at the Exchange level by making necessary changes in the trading system; I have discussed and deliberated the said matter with the Exchanges and at other relevant forums in order to assess its potential impact on the overall market and alternatives ways in which it can be addressed. Different proposals are reviewed to address this issue including post-trade volume adjustment and system modification in the trading system of Exchanges. Moreover, the possible limitations and outcomes of the above proposals have been carefully reviewed. It is pertinent to mention that applying universal changes in trading system at the Exchange level would impact overall trading system performance. Given the fact that arbitrage transactions between the two exchanges are carried out by few Brokers only, it may not be advisable to bring changes in the trading system of the Exchange which would impact the efficiency of the overall market. However, given the nature of these transactions, it is essential that the Brokers should implement the Order Management System embedded within Gateway Interface of the Exchange, wherein clear specifications should be placed by the Brokers to restrict such orders from the Brokers which may amount to Wash Trades before these are routed to the trading system of the Exchange for execution.

The execution of Wash Trades even due to the arbitrage business is not acceptable as it is still the violation of the regulatory framework as it did not result in any change in beneficial ownership of the shares and also created false and misleading impression in the market. I am of the considered view that unfair trade practices like Wash Trades are harmful for the development of the market and damage market integrity. There is no justification for the Respondent to carrying out the Wash Trades on the pretext of arbitrage business. The execution of abovementioned trades shows that the Respondent has failed to maintain high standard of integrity and has been unsuccessful in exercising due care, skill and diligence in conduct of its business. Consequently, it is established that the Respondent has contravened the provisions of the Code of Conduct."

From the above, it is very evident that execution of wash trades is a violation of the regulatory framework and that the Respondent being a registered broker should not have engaged in such practice and furthermore should not have been involved in devising mechanism to hide and conceal such transactions.

- c) Regarding segregation of clients' assets, the Respondents' stance that the regulatory requirements are not correct is no justification at all for use of clients' money by the Respondent. 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:





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(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:

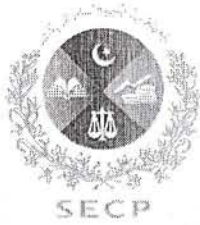
"The credit amount of the Account Holder(s) shall be kept by the broker in a separate bank account titled "Account Holder/Client Account" and shall not be used by the broker for his own business."

It is evident from the above that regulatory framework does not allow use of clients' assets other than for his/her own benefit. Under the existing regulatory requirements, the Respondent is required to ensure proper segregation of clients' assets and should at all times have an amount equivalent to its trade payables/balance of creditors in the bank account tagged as clients' account.

- d) Regarding SAOF, the Representatives provided updated SAOFs and assured that the discrepancies identified by the inspection team have now been rectified.
- e) Resolution of the Board of Directors regarding approval of the KYC and CDD Policy was provided by the Respondent vide letter dated January 23, 2015 as referred by the Representatives during the course of hearing.
- f) The Respondent vide above mentioned letter provided copies of correspondence evidencing registration of one of its staff members and copy of certificate of one of its employees from ICM to substantiate compliance with Circular 34 of 2009 issued by the Commission.

8. The Respondent is required to maintain proper and complete books of accounts depicting true nature of transactions being recorded therein. The clients' ledger referred in para 6(b) above should only be used to record transactions which are actually executed through his UIN. The Respondent should not in the first place indulge in execution of wash trades and secondly should not route the same through different client's account to avoid punitive actions of the Commission for regulatory violations. The Respondent is a





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registered broker and is expected to perform its responsibilities diligently and cautiously to ensure compliance with the regulatory framework.

9. Segregation of clients' assets is of quintessence to strengthen investors' confidence in the stock market and to avoid misuse of clients' assets by the brokers and probable default of the brokerage houses. The Respondent being custodian of clients' assets is required to perform its business with due care and conscientiousness. In order to protect the interest of investors, specific requirements pertaining to the segregation of clients' assets are detailed in the KSE Rule Book and the Respondent is bound to follow the regulatory provisions in letter and spirit and strictly keep clients' funds segregated.

10. 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 during the inspection period failed to fulfill its regulatory obligations by not maintaining segregation of clients' assets; not maintaining proper trail of transactions executing in the clients' accounts and not calculating NCB in accordance with the guidelines issued by the Commission.

11. The Respondent is expected to maintain high standards of integrity and fairness in the conduct of its business. Severe non-compliances by the provisions of rules and regulations on the part of the Respondent is a matter of grave concern, therefore, in exercise of the powers conferred upon under Section 22 of the Ordinance, I hereby impose a penalty of Rs. 500,000/- (Rupees Five Hundred Thousand Only) on the Respondent. Moreover, the Respondent is directed to:

- i) comply with the Rules 1971 and the guidelines issued by the Commission in letter and spirit;
- ii) maintain a separate bank account for clients' funds;
- iii) ensure segregation of clients' assets and provide copy of bank statement of bank account tagged as clients' account as of March 31, 2015 along with copy of trial balance of the same date depicting gross trade payables and trade receivables position of the same date by April 15, 2015; and
- iv) Immediately put in place proper checks in the system to restrict such orders which may lead to execution of wash trades instead of devising mechanism for avoidance of regulatory actions. *





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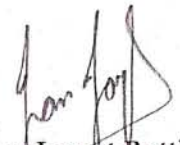
12. The matter is disposed of in the above manner and the Respondent is directed to deposit the fine in the account of the Commission being maintained in the designated branches of MCB Bank Limited not later than thirty (30) days from the date of this Order and furnish a copy of the deposit challan to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

13. 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
Islamabad.

March 12, 2015




(Imran Inayat Butt)
Director/HOD (MSRD)