



Securities and Exchange Commission of Pakistan

BEFORE APPELLATE BENCH NO. I

In the matter of

Appeal No. 54 of 2012

East West Life Assurance Company Limited

.... Appellant

Versus

Executive Director (Insurance), SECP

.... Respondent

Date of hearing

6/05/2015

Present:

For the Appellant:

1. Maheen Younus, CEO, East West Life Assurance Company Limited
2. Imran Ali Dodani, COO, East West Life Assurance Company Limited
3. Sayed Younas Saeed, East West Life Assurance Company Limited

For the Respondent

1. Mr. Shahid Naseem, Executive Director (Insurance)
2. Mr. Tariq Hussain, Director (Insurance)
3. Mr. Obaid-ur-Rehman Qaiser, Joint Director (Insurance)



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ORDER

1. This Order shall dispose of Appeal No. 54 of 2012 filed under section 33 of the Securities and Exchange Commission of Pakistan Act, 1997 against the order dated 28/09/12 (Impugned Order) passed by the Respondent.
2. The brief facts of the instant Appeal are that an "Onsite Inspection" of East West Life Assurance Company Limited (Company) was conducted under the Order of the Executive Director of the Insurance Division dated October 20, 2011, which was issued in exercise of the powers conferred under Section 59A of the Insurance Ordinance, 2000 (Ordinance).
3. The Company's Guaranteed Income Plan (GIP-term insurance plan for Individual Accident) was allegedly offered to public as an investment plan and public in general was misled.

As per the newspaper dated October 4, 2011, the Company's Hyderabad branch was closed down by the management, and staff of the branch was terminated.

Concurrently, different FIRs were lodged by the affectee's against the Company, whereas management of the Company has also lodged an FIR against Mr. Dilshad Ali Shaikh ex-branch manager and other staff of Hyderabad branch. Mr. Dilshad Ali Shaikh has also lodged complaint before the National Accountability Bureau (NAB) against the Company's management taking the plea that GIP was sold with the consent of the management, and he and others have not committed any crime. As per management of the Company, the total amount involved in the scam amounted to Rs.3.139 million.



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Federal Investigating Agency ("FIA") has investigated this scam in which Mr. Dilshad has been found guilty as a result of preliminary investigation and a challan has been filed against him in the Hon'ble Court of District and Session Judge, (South) Karachi, Sindh.

The Inspection team uncovered several internal control weaknesses in the operations of the Company which provided opportunity to the ex-employee to indulge in such fraudulent activities. Besides control weaknesses, areas of conflict of interests were also noticed.

4. It was also observed during the course of Inspection that the Company has its own Internal Audit Department, which is supposed to carry out Internal Audit of the Company. However, no member of the Internal Audit Department including the Head of Internal Audit had prior adequate experience of Audit. Essentially, the Internal Audit Department could not uncover the fraudulent scheme. Therefore, in view of the above, the Internal Audit Department of the Company cannot be termed as satisfactory, which shows the weakness in the internal control system of the Company.
5. The Board of Directors and Audit Committee have not paid attention towards the development and implementation of proper system of internal controls. The Audit Committee did not take serious steps towards strengthening the Internal Audit Department. Further it has not paid any consideration towards the development of the operational manuals and guidelines.
6. There was neither proper investment decision making mechanism in the Company nor any Investment Committee. The investment decisions were made by CEO in consultation with CFO.



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7. Therefore, in view of the foregoing facts, it prima facie appeared that the internal controls system of the Company were very weak particularly due to the absence of operational policies, procedures and manuals that are vital for carrying out the operations of the Company. This also indicated that the business of the Company was not being carried out with due care and professional skills, as required by the provisions of Section 11 and Section 12 of the Ordinance.
8. In view of above, a Show Cause Notice (SCN) dated July 5, 2012 under Section 12 read with Section 11(1)(f) and Section 156 of the Ordinance was served to the Directors and Chief Executive of the Company, whereby the Company was asked to clarify their position as to why the penalty under Section 156 of the Ordinance may not be imposed on them for negligence on part of the management of the Company in respect of inadequate internal control system of the Company and carrying out the business without due care and diligence, thereby contravening the provisions of Section 12 and Section 11(1)(f) of the Ordinance.
9. The Company in response to the SCN submitted a written reply through letter dated August 1, 2012. The Company while defending the assertions made in the SCN stated that Mr. Dilshad was working with the Company at Hyderabad Office and was appointed on contractual basis. He was selling the Company's approved policy of Guaranteed Income Plan (GIP) as an investment plan with attractive rate of returns for his ulterior motives and personal gains. Later on, he disappeared and different FIRs were lodged by the public against Mr. Dilshad Ali Sheikh and others including the Company at Saddar Cantonment, Hyderabad police station. However, eventually those FIRs were transferred to Federal Investigation Agency (FIA), Corporate Crime Circle for investigation. The company has also lodged an FIR at Kharadar, Karachi police station against Mr. Dilshad Ali Sheikh and others.



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10. The investigation team of FIA has thoroughly investigated the entire case including complete records and bank accounts of the Company as well as personal accounts of directors and concerned employees. Accordingly, as also mentioned in the SCN, Mr. Dilshad Ali Sheikh has been found guilty and challans have been submitted in the Court against him and his accomplices. It is important to note that these challans do not, in any shape or form, implicate the Company or any staff member of the Company.

Further, the Company stated that Mr. Dilshad Ali Sheikh and his accomplices have been arrested by the FIA and, presently, they are in jail custody while their bails have been rejected by the Court. In the light of the above, it can be confirmed that the incident was an individual act of the fraud committed by an agent, for which the Company could not be held responsible.

11. The Company asserted that the internal control systems are in place and the management has made changes to further reinforce the policies of the Company for effective management.

12. The reply of the Company revealed that the Company still considers that if an employee / agent of the Company commits fraud then the Company should not be held responsible for such a fraud, which is in contradiction with the provisions of Section 95 of the Ordinance.

15. The reply further reveals that one of the main reasons behind the fraud was the acceptance of premium in cash, which is the industry practice. This is one of the major weaknesses in the internal controls, as it increases the likelihood of frauds committed by the agents of the insurer.



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16. Subsequently, hearing in the matter was held on September 13, 2012, wherein the Company and its Directors were represented by Mr. Maheen Yunus, Managing Director and Chief Executive Officer of the Company and Mr. Imran Dodani, the Chief Operating Officer of the Company ("Company's representatives"). The stance of the Company's representatives was considered which mainly reiterated the contents of the reply filed in response to the SCN
17. Dissatisfied with the response of the Company and in exercise of the power conferred under Section 156 of the Ordinance, instead of imposing the maximum penalty, a nominal fine of Rs. 500,000/- (Rupees Five Hundred Thousand Only) was imposed on the Company due to the fact that the Company had not complied with the provisions of Section 11(1)(f) read with Section 12 of the Ordinance, by not establishing and maintaining proper system of internal controls all across the Company.

Further, the Company was directed to:

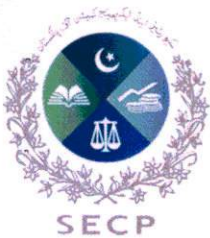
- (a) take immediate measures for the establishment of the effective and efficient system of internal controls so as to comply with the requirements of Section 11(1)(f) read with Section 12 of the Ordinance;
- (b) conduct a thorough inquiry into the matter and investigate the role of Chief Internal Auditor, Chief Financial Officer, Head of Underwriting and any other officer who is directly / indirectly responsible or involved in the fraud, and if found guilty, take appropriate action(s) under intimation to the Commission within 90 days from the date hereof; and
- (c) compensate all the affected policyholders of the Company who have suffered losses due to the fraudulent activities at the Company's Hyderabad Regional Office.



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18. Aggrieved of the Impugned Order, the Appellant has preferred the instant Appeal on the following grounds:

- a. Proper system of internal controls was in place and operational in the Company. An occurrence of only one incident of fraud committed by a contractual employee of the Company does not necessarily indicate weakness in internal control system as internal control system is subject to some inherent limitations, which can never be avoided. Further, an adequate system of controls reduces the element of fraud, but it cannot entirely eliminate the factor of fraud.
- b. The Ordinance has not provided any minimum set of criteria / benchmark to evaluate adequate internal control system of a company, which, consequently, makes it difficult to establish objective non-compliance of the Company with the Ordinance regarding weak internal control system. However, at the same time, it is reiterated that the Board of Directors, Audit Committee and management has always taken proper steps in order to ensure the smooth, efficient and effective functions of the Company. The business of insurance has always been carried out with due care and professional skills as required by Sections 11 and 12 of the Ordinance. Thus we reiterate that there is no non-compliance of Section 12 read with Section 11(1)(f) of the Ordinance.
- c. In light of the above facts and submissions and, once again keeping in view that it was the first onsite inspection, the observations noted by the inspection team could not be termed as non-compliance and needs only to be discussed and notified by them to the management to avoid the same in future rather than serving SCN followed by hearing and afterward penal action. Whereas, we have also assured in our reply and during the hearing that there is always a room for the improvement and, therefore, further adequate control measures are in process of implementation for effective system of control.



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- d. Fine of Rs.500,000 has been imposed on our Company for alleged subjective non-compliance of Section 12 read with Section 11(1)(f) of the Ordinance. In light of the above, foregoing it is explained that under Section 11(1)(f) being the insurers registered under the Ordinance we have fulfilled our all duties and obligations in accordance with the applicable rules and laws, hence, there is no non-compliance on the part of the Appellant. Further, the provisions of Section 12 speak regarding “adequate system of control”. Whereas, the Ordinance does not provide any parameters of adequate systems of controls. According to the Black’s law Dictionary, the meaning of “Adequate” is sufficient” and the word sufficient cannot be termed as fool proof. In lieu of the above submissions, we emphasize that the internal control system of the Company was sufficient as the Company has proper implemented policies and qualified internal audit department and all other requirements of applicable laws and rules were fulfilled by all means. Hence, the system of control was adequate.
- e. It appears from the SCN and Impugned Order that the happening of an isolated fraud event in the Company has caused the inspectors and officers of the Commission to believe in the weak internal control system and all the proceedings by the Commission has been carried under the same impression, which is not the fact. It is a well-known fact that even a sound internal control system cannot guarantee about the elimination of fraud as it is subject to some inherent limitations. In this regard para A46 “Limitations and Internal control” of the International Accounting Standards No. 315 states “Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity’s financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an



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error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.”

- f. In the light thereof, the Appellant stated that all systems of control of the Appellant are in place and operational according to rules and laws and happening of an isolated fraud event should not be made the basis of for weak internal control system. Further, when no accurate parameters of the adequacy of the systems have been described in the Ordinance, imposition of fine against Section 12 of the Ordinance is unjust and unlawful.
- g. The Appellant referred to certain orders whereby insurers were not penalized and rather warnings were issued to the non-compliant companies.

20. The Respondent has rebutted the grounds as follows:

- a. It looks very strange that after having made the implicit confession of all the findings and charges made therein the Inspection Report, SCN and in the Order and offering no repudiation of any observation, the Company submits that, “...that the proper system of internal control was in place and operational in the company”, whereas in all the issues discussed above the shortcomings discovered and brought forth were blatant and thus no denial could have been made by the Company. Tragically these deficiencies logically and finally culminated into massive scam in which thousands of the poor villagers were looted to the extent of well above the three million rupees so far. Still the Company asserts the since, “An occurrence of only one incident of frauddoes not necessarily indicate weakness in internal control system.....as the system is subject to some inherent limitations, which can never be avoided.”

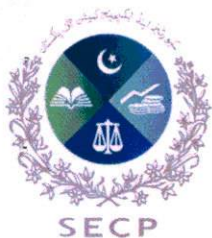


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The maintenance of such assertion by the Appellant is another example of distorting the factual position and twisting the issues at hand in their favor. The net issue at hand is not the occurrence of fraud but the lack of internal control and existence of the element of conflict of interest in the company. And in whatever organization such offensive milieu crept in, the chaos and scams are bound to ensue. Conversely speaking it is also incorrect to argue that, "An occurrence of only one incident.....".

- b. The hollowness of the statement floats on the surface before a regulator whose job is to deal with the companies in total. It is worth noting that currently the Respondent has been trying the Appellant on another case of another instance of scam wherein the Company officials swindled a widow, a mother of five small children of all her saving by giving her fake premium receipts and then tried to refund the amount by the bank cheques which were dishonored.
- c. Furthermore the Appellant Company perhaps surpasses the competitors in a number of complaints by the public to this office. Thus one is left with no option but to conclude that the Appellant Company has fell the victim of internal chaos and anarchy, battering the dictates of the sections 11 and 12 of the Ordinance.
- d. The statement by the Appellant, "...that under section 11 (1) (f) ...we have fulfilled our all duties and obligations in accordance with applicable rules and laws...." the assertion regarding fulfillment of obligation falls flat in face of the discussion made above and seemingly obviates the need of making any further comments.

The Appellant has stated that the Ordinance does not provide any parameters of adequate systems of control. This is not correct as Section 12 of the Ordinance requires insurance companies to maintain adequate accounting and other records of business and adequate systems of control of its business and records. The word adequate has been defined in The Free Online Dictionary as "Sufficient to



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satisfy a requirement or meet a need” which implies that the system should be able to detect fraud and errors.

- e. Furthermore the Ordinance itself defines the word, “adequate” in the Section 12(2) as “Accounting and other records shall not be regarded as adequate for the purposes of clause (d) of sub-section (1) unless they are such as (a) to enable the business of the insurer or applicant to be prudently managed; and (b) to enable the insurer or applicant to comply with the obligations imposed on it by or under this Ordinance.”
- f. In the back drop of the above given self-explanatory clauses, the Inspection Team formed u/s 159(A) has observed the following:
 - i. The paid-up capital of the company has eroded from Rs.500 million to 124 million (approx.)
 - ii. Receipt of the premium in cash which enabled Mr. Dilshad head of Hyderabad Branch in designing such activity to rob the poor people
 - iii. Only three audits of three different stations by an internal audit team whose qualification and experience inspire no confidence in the audit activity
 - iv. Irresponsible financial relationship and obligations of the key employees with the head of the Hyderabad branch,
 - v. Premium received in advance has been recorded as income instead of liability and executives of the company carrying out insurance business and also taking commission which caused major conflict of interest and hampered their independence
 - vi. Premium expenses booked in Accident and Health Fund, Ordinary life Fund instead Shareholders Fund
 - vii. No proper investment decision making mechanism in the company nor there is any investment committee
 - viii. Non-independent non-executive directors on the board



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ix. No policies, manuals, SOPs formulated since 1993

These depict the state of internal control system implemented by the Company.

- g. As far the contention of the Company that the Respondent did not impose the penalties in a number of cases concerning the companies like EFU General, New Jubilee, Atlas, Ace and IGI despite their non-compliance with the S.11 (1) (b) etc., it rather shows the liberal and open-minded policies of the Respondent when it comes to take the disciplinary action. It is only the unrestrained and persistent casual handling of the Company towards the compliance with the law which called for the penal action under section 156 of the Ordinance as a matter of last resort.
22. We have heard the parties and taken into consideration written submission by the Appellant and Respondent. We have also perused the relevant provisions of the Ordinance which have been referred above.
23. After perusing the record of the matter and a review of the scam which resulted in loss to the general public, it can be safely concluded that the Company has not fulfilled its obligations of maintaining adequate internal control systems of its business as laid down in Section 12 of the Ordinance. The provision of the Ordinance with respect to maintenance of adequate internal control systems is mandatory in nature for the insurers. Had the Company been vigilant in implementing such internal controls then such a scam would not have resulted while causing loss to the public at large.
24. The plea taken by the Appellant concerning inherent restrictions with respect to the internal control cannot be termed as a satisfactory response. The negligence and ineffective internal control of the Company is evident from the record of the instant matter which highlights the incapacity of the Company in handling its



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business affairs.

25. Furthermore, the involvement of the management of the Company with its employees in personal transactions also raises concerns with respect to conflict of interest.
26. In view of the foregoing, the Impugned Order does not require interference by this Bench in exercise of its powers under Section 33 of the SECP Act, 1997. Accordingly the instant Appeal is dismissed.
27. Parties to bear their cost.

(Fida Hussain Samoo)
Commissioner (Insurance)

(Tahir Mehmood)
Commissioner (CLD)

Announced on: **20 AUG 2015**