Before
Shahzad Afzal Khan, Director/ Head of Department
(Adjudication Department-I)
In the matter of

Cashew Financial Services Limited

Show Cause Notice No. & Issue Date:	No. SECP/SCD/ADJ-I/CashewFin/60/2022-3046, dated May 09, 2023
Date of Hearing:	July 27, 2023
Present at the Hearing Representing the Respondent	Mr. Moeed Qamar, Chief Operating Officer Usman Ali Khan, Chief Financial & Risk Officer (Authorized Representative)

ORDER

UNDER SECTION 282 J (1) OF THE COMPANIES ORDINANCE, 1984 FOR CONTRAVENTION OF RULES 5(6)(E), 7(3) AND 9 OF THE NON-BANKING FINANCE COMPANIES (ESTABLISHMENT AND REGULATIONS) RULES, 2003; AND REGULATION 4 OF THE NON-BANKING FINANCE COMPANIES AND NOTIFIED ENTITIES REGULATIONS, 2008

This Order shall dispose of the proceedings initiated through the Show Cause Notice dated May 09, 2023 **(the SCN)** by the Securities and Exchange Commission of Pakistan **(the Commission)** against Cashew Financial Services Limited **(the Company and/or Respondent)**, issued under Section 282 J (1) of the Companies Ordinance, 1984 **(the Ordinance)** for contravention of rules 5(6)(e), 7(3) and 9 of the Non-Banking Finance Companies (Establishment and Regulations) Rules, 2003 **(the NBFC Rules)** and regulation 4 of the Non-Banking Finance Companies and Notified Entities Regulations, 2008 **(the NBFC Regulations)**.

2. Brief facts leading to this case are that the Company was incorporated on October 6, 2020, as a public unlisted company under the Companies Act, 2017 **(the Act)** and licensed by the Securities and Exchange Commission of Pakistan **(the Commission)** on June 29, 2021, to undertake Non-Banking Microfinance business as an NBFC under the NBFC Rules and the NBFC Regulations. A review of the record/information of the Company maintained with the Commission, depicts that the Respondents, *prima facie*, were non-compliant with the provisions of rules 5(6)(e), 7(3) and 9 of the NBFC Rules and regulation 4 of the NBFC Regulations, for which the penalty has been provided under **Section 282 J (1)** of the Ordinance, 1984 **(the Ordinance)**. Therefore, the SCN was issued to the Company.

3. In response to the SCN, the Company vide its letter dated June 26, 2023, submitted on merits as under:

(i) The Company was compliant with the minimum equity requirement **(MER)** at the time of incorporation/license, however, due to the economic slowdown and high inflation in the country equity was eroded over time. The country's political instability and sudden economic turndown affected investment activities. As attracting investments from abroad is the main bloodline for start-ups however due to prevailing conditions it has become extremely difficult to raise any capital either within Pakistan or from abroad. The current situation has limited the Company's ability to strengthen its equity position and meet the Commission's requirements. However, this situation is temporary as the Company has adopted a comprehensive and robust approach to governance, risk and compliance in all areas thereby protecting both its investors and borrowers.

The Company has disbursed an aggregate loan amount of PKR 1.283 Billion over the last two years thereby supporting micro-business, generating financial inclusion by reaching out to the unbanked sectors and creating value for both the economy and society increased demand in the supply chain but also creating better economic opportunities for the low-income/micro business. It is also pertinent to mention here that over these two years, the Company has attracted USD 762,000 from investors abroad contributing to the country's forex inflows.

Despite the said operation/economic conditions in the country, the sponsors and management have timely taken steps to ensure compliance with the MER which includes injecting funds in the shape of subordinated/ sponsor loan of PKR 30 Million and has taken advance for issuance of new shares that have accumulated to PKR 96.935 Million as of June 2022 that increased to PKR 111.985 Million by December 2022 and now stands at PKR 194.664 Mullion in May 2023. These timely measures taken by the management have helped ensure the equity of the Company was PKR 84.177 Million as of 30 June 2022. A transfer of USD 102,000 (amounting to PKR 29,580,000) is currently in process and the remittance has been initiated by an investor. It is expecting to receive this amount in the Company's accounts very soon. With the receipt of this amount, the Company's equity shall be in excess of PKR 50 Million.

The Commission has pointed out that share deposit money does not fall into Equity definition. It is submitted that the Company has filed Form 3 i.e. application for issuance of fresh shares with the concerned Registrar in October 2022, however, response from the Commission is awaited as of today. They are following up with the Registrar to expedite the approval. It is evident from the above-stated status that the non-issuance of shares is due to reasons beyond the control of the Company. Furthermore, necessary accounting entries are being made so that the amount received against the issuance of shares temporarily parked as Share Deposit Money can be transferred to share capital and will be reflected in the next Specialized Companies Returns System (**SCRS**) reports as well.

Further; as pointed out by the Commission sponsor loan does not meet the eligibility criteria provided per NBFC Rules, hence, cannot be classified as subordinated loan and also as part of equity. It is stated that the Company has initiated the process of conversion of sponsor loan of PKR 30 million into subordinated loan and the application for approval of subordinated loan has been submitted to the Commission on June 12, 2023.

Besides all, the afore-said arguments, it is important to state that the Commission vide S.R.O. No. 592(1)/2023 dated May 17, 2023 has reduced the MER for Non-Banking Microfinance Companies for Investment Finance Services License undertaking microfinancing through digital means to PKR 20 Million from original requirement of PKR 50 Million. The Company, as mentioned above, is undertaking microfinancing activities only digital means, is now required to maintain MER of Rs. 20 million only. This timely measure by the Commission will ease their efforts to comply with MER.

(ii) The statutory meeting of the Company was held on June 29, 2021. Form 25 i.e. Report of statutory meeting along with other relevant forms were submitted to the Registrar Commission but the same were accepted by the Registrar on July 21, 2022. After the acceptance by Registrar, the Company initiated the process of depositing shares of the promoters, major shareholders, and directors with the Central Depository Company of Pakistan (**CDC**). The process is a cumbersome one and took extended time, however, the Company is at the final stage of complying with the requirement and is currently in the process of transferring all eligible shares to CDC for placing them in an account marked as blocked.

The Company deposited shares of its promoters with the CDC for blockage. 98% of the Company's initial sponsors/promoters' shares stand blocked with CDC. The process for the balance of 2% shares is in process and is expected to be completed by 31st July'2023.

(iii) The Company has already taken up the matter of obtaining sufficient insurance coverage to comply with the requirements of Rule 9 of the NBFC Rules, with leading insurance companies. It is informed that negotiations for obtaining insurance coverage is currently at a stage and, are expected to be finalized before 31st July 2023.

(iv) The Company assured that they have no intention of violating any legal and regulatory requirement and, the management of the Company takes, this responsibility very seriously and has made all efforts to comply with all relevant rules and regulations. In the current situation, a penalty imposed by the Commission would have an adverse impact on the Company, arresting its efforts to meet the Commission's new digital equity requirements and bring further forex for the country.

4. In order to afford the Respondent an opportunity of personal representation, a hearing in the matter was fixed for July 27, 2023, before the undersigned, wherein Mr. Moeed Qamar, Chief Operating Officer; and Mr. Usman Ali Khan, Chief Financial & Risk Officer; appeared as the Authorized Representatives of the Respondent **(Representatives)**. The Representatives reiterated the stance taken in the above stated written response to the SCN.

5. Subsequent to the hearing, the Respondent submitted the Auditor Certificate for its Equity position as of July 15, 2023, showing a balance Rs. 43 million, which includes an amount of Rs.110 million as "Advance against Ordinary Shares" and Rs.30 million under the head of "Subordinated Loan" (for which the Commission's approval is pending); and a copy of letter dated July 26, 2023, soliciting the Commission's approval for converting its license to Digital Lending only. Moreover, the Respondent also submitted that they are in negotiation with the insurance company in respect of obtaining the insurance coverage and the same will be finalized by August 31, 2023, and the process of blocking the remaining 2% of the sponsor's shares will be completed by September 15, 2023.

6. I have examined the facts of the case in light of the applicable provisions of the law and have given due consideration to the written as well as verbal submissions and arguments of the Respondents and their Representative. I have noted the following pertinent aspects in the matter at hand:

(i) Non-Compliance with Minimum Equity Requirements (rules 7(3) of the NBFC Rules read with regulation 4 of the NBFC Regulations)

Rule 7(3) of the NBFC Rules read with regulation 4 of the NBFC Regulations requires an NBFC to maintain MER at all time as provided/specified for each form of business in Schedule-I of the NBFC Regulations. However, as per Annual Audited Account of the Respondent as of June 30, 2022, and the information submitted through SCRS for the period December 2022, the Respondent failed to maintain the prescribed MER of Rs.50 million as its equity for the said period was Rs. (28.5) million and Rs. (108.5) million respectively. However, the Respondent claimed its equity to be Rs. 82.375 million as on June 30, 2022, by including ab amount of "Advance against Ordinary Share / Share Deposit Money" of Rs.96.935 million and a "Subordinated Loan" of Rs. 14 million. Whereas as per the definition of equity provided under rule 2(xix) of the NBFC Rules, an amount against "Advance against Ordinary Shares / Share Deposit Money" could not be included in the Equity, and classification of a loan as a Subordinated Loan is also subject to certain conditions as prescribed under rule 2(xix) of the NBFC Rules, inter alia including, rate of profit on subordinated loan, if any, be decided by NBFC subject to the clearance of the Commission.

At the outset, it is mentioned that the Ordinance, Rules, Regulations, Guidebook and akin laws are the primary constituents that an NBFC is required to comply with in preparation of its financial statements, and as a generally established rule, where provisions and directives issued under the Rules, Regulations, Company Law (or akin) differ from the general accounting practice, and/or IFRS, the provisions of Rules, regulations and directives issued under the said law are required to be followed. Thus, it is abundantly clear that the computation and reporting of Equity is essentially a regulatory requirement stipulated/defined under rule 2(xix) of the NBFC Rules (i.e. which do not include Share Deposit Money and classification of Subordinated Loan is subject to certain condition), and the NBFC is obliged to comply with the computation requirements strictly in the manner specified.

The Respondent and its Representatives asserted that they were fully compliant with the requirement of MER at the time of incorporation and grant of a license, but afterward, their equity eroded due to the economic condition of the country. However, the sponsors and management of the Respondent have taken timely action to ensure MER compliance, including the injection of funds in the form of the subordinated loan of Rs.30 million and advance for issuance of new shares that amounted to Rs. 96.935 million as of June 30, 2022, and are currently at Rs. 194.664 million. Furthermore, the investor has initiated the remittance of USD 102,000 (equivalent to Rs. 29,580,000), and the transfer is currently underway.

The Respondent and its Representatives claimed that they submitted Form 3 for the issuing of new shares to the relevant Registrar in October 2022, and that Form 3 is still pending. In this regard, it may be observed that the aforementioned Form 3 was submitted in October 2022 for the issuing of shares of Rs. 21.5 million, whereas the alleged violation periods are June and December of the same year. Since Form 3 for the issuance of ordinary shares submitted by the Respondent is still pending and/or not yet effective, the aforementioned advance against ordinary shares or share deposit money could not be considered for the calculation of equity until it was actually converted into shares. Furthermore, the Respondent's Auditor Certificate of Equity as of July 15, 2023, still includes Rs. 110 million under the category of an advance against ordinary shares; if this amount of an advance against ordinary shares is removed from the computation of equity, the MER would be negative.

Additionally, the Respondent has initiated the process of converting the sponsor loan of Rs. 30 million into a subordinated loan, and an application in this regard was submitted to the Commission on June 12, 2023, and is currently being processed. Therefore, until the process of converting the sponsor's loan into a subordinated loan was complete, the claimed sum of Rs. 30 million could not be categorized as such. According to the Auditor's Certificate for the Respondent's equity position as of July 15, 2023, the Commission's approval for the subordinated loan is still pending,

Moreover, the Respondent and its Representatives have also drawn attention to the Commission's SRO No. 592(I)/2023 dated May 17, 2023, notifying the amendments in NBFC Regulations, through which MER for the Microfinance Companies and Investment Finance Companies undertaking microfinancing through digital means has been reduced to Rs. 20 million. The Respondent also applied to the Commission on July 26, 2023, for converting its license to Digital lending only. In this regard, it is emphasized that the aforesaid NBFC Regulations change/amendment does not apply retroactively, therefore, during the period under review the Respondent was required to maintain MER to at least Rs.50 million.

In view of the above, the Respondent's MER as of June 30, 2022, and December 31, 2022, fell below the minimum amount of Rs. 50 million that must be maintained at all times. Although the Respondent has taken some actions to address the MER shortfall, including starting the process of issuing share capital in exchange for an advance against ordinary share or share deposit money, converting the sponsor's loan into a subordinated loan, and applying to the Commission to change its license to only allow for digital lending, nothing has yet been materialized. The Respondent must put an effort to complete these procedures as soon as possible in order to address its MER concern. The amendments notified in NBFC Regulations on May 17, 2023, which reduced the MER requirement to up to Rs. 20 million, do not exonerate the Respondent from the non-compliances identified as of June 2022 and December 2022. Thus, non-compliance with the requirement of rule 7(3) of the NBFC Rules and regulation 4 of the NBFC Regulations has been established on the part of the Respondent.

(ii) <u>Blocking of promotors and directors shares (rules 5(6) (e) of the NBFC Rules): -</u>

Rule 5(6) (e) of the NBFC Rules requires the promotors/majority shareholder and directors of an NBFC to deposit their shares with CDC in an account marked as blocked and such shares could not be sold or transferred without prior approval of the Commission. Accordingly, the Respondent, by way of license condition imposed on it at the time of grant of license on June 29, 2021 was required to submit the CDC Account statement of the blocked shares of the sponsors/promotors within two (2) months of the grant of license i.e. by August 29, 2021. Whereas, the Respondent failed to fulfill the aforesaid condition.

In this regard the Respondent and its Representatives asserted that they initiated the process of depositing shares of the promotors/sponsors and directors of the Respondent with the CDC after the acceptance of their statutory forms, (Form 25 i.e. Report of statutory meeting along with other relevant forms) by the Registrar of the Commission, on July 21, 2022. Since the process of blocking shares with CDC is quite cumbersome, therefore it took extended time and as of today, 98% of sponsor/promoters' and director's shares have been blocked. With regard to blocking the remaining 2% shares, the Respondent in its written response to the SCN gave a tentative timeline for completion of the process by July 31, 2023, which has now been extended to September 15, 2023. It is pertinent to mention that the Respondent was required to provide the statement of the CDC blocked Account within two (2) months of the grant of license, however, the process of blocking the shares has yet not been completed even after the lapse of a considerable time period, instead, the tentative timeline for its conclusion has been extended from July 31 to September 15, 2023. Thus, non-compliance with the requirement of Rule 5(6)(e) of the NBFC Rules has been established on part of the Respondent.

(iii) Failed to obtain insurance coverage (Rule 9 of the NBFC Rules): -

With regard to non-compliance with the requirement of obtaining sufficient insurance coverage, as required under rule 9 of the NBFC Rules, the Representative admitted that currently they don't have requisite insurance coverage, however, they are in the process of obtaining the said insurance coverage and will obtain the same shortly i.e. August 31, 2023. Thus, the Respondents have admitted the default with the requirements of rule 9 of the NBFC Rules, and corrective measure for the same has yet to be completed (i.e. obtaining the insurance coverage is still in process), hence, non-compliance thereof is established.

7. In view of the above-stated facts, circumstances, and submissions made by the Respondent and its Representatives, the Respondent has failed to comply with the requirements of rules 7(3), 5(6)(e), and 9 of the NBFC Rules; and regulation 4 of the NBFC Regulations; which attracts the imposition of penalty. Therefore, in exercise of the powers conferred under Section 282 J (1) of the Ordinance, I hereby, impose a fine of **Rs.500,000/- (Rupees, Five Hundred Thousand Only)** on the Respondent on account of the aforesaid established and conceded non-compliance. The Respondent is also advised to ensure meticulous compliance with all applicable laws in true letter and spirt, henceforth.

8. The Company is hereby directed to deposit the afore-mentioned fine in the designated Bank Account maintained in the name of the Securities and Exchange Commission of Pakistan with MCB Bank Limited or United Bank Limited within thirty (30) days of the date of this Order and furnish receipted voucher evidencing payment of the same.

9. This Order is issued without prejudice to any other action that the Commission may initiate against the Company and/or its CEO in accordance with the law on matters subsequently investigated or otherwise brought to the knowledge of the Commission.

(Shahzad Afzal Khan)
Director / Head of Department
Adjudication Department-I

Announced:
August 15, 2023
Islamabad.