Corporate Supervision Department
Company Law Division

Before Abid Hussain – Executive Director (CSD)

In the matter of

First National Equities Limited

Number and date of notice:	CSD/ARN/96/2015-1348-54, dated November 13, 2015
Date of hearings:	February 22, 2016
Present:	Mr. Ali Aslam Malik, Chief Executive

ORDER

UNDER SECTION 208 READ WITH SECTION 476 OF THE COMPANIES ORDINANCE, 1984

This order shall dispose of the proceedings initiated against the following directors including the chief executive (the "respondents") of **First National Equities Limited** (the "Company"):

1. Mr. Shahzad Akbar, Chairman
2. Mr. Ali Aslam Malik, Chief Executive
3. Mr. Muhammad Iqbal Khan
4. Mr. Rais Ahmed Dar
5. Mr. Saeed Ahmad Bajwa
6. Mr. Amir Shehzad
7. Mr. Azeem Ul Hassan

These proceedings against the respondents were initiated through show cause notice (the "SCN") dated November 13, 2015 under section 208 read with section 476 of the Companies Ordinance, 1984 (the "Ordinance").

2. The brief facts of the case are that the annual audited financial statements for the year ended June 30, 2014 and subsequent quarterly accounts of the Company disclosed the following:

(Amounts in Rs.)

Head of Account	31-Mar-2015	30-Jun-2015
Receivable from associates	95,385,489	106,768,489
Markup Receivable from Associates	150,385,739	138,518,195

The breakup of the aforesaid amounts and information about the respective statutory approvals was inquired through Commission's letter dated October 16, 2015. The Company vide its letter dated October 26, 2015 provided relevant details of the amount of principal and markup due from associated companies namely, First Pakistan Securities Limited ("FPSL") and Switch Securities Private Limited ("SSL"), as given below:

Particulars	FPSL (Amounts in Rs.)			SSL (Amounts in Rs.)		
	30-Jun-14	31-Mar-15	30-Sep-15	30-Jun-14	31-Mar-15	30-Sep-15
Principle Amount	57,891,747	46,508,747	29,207,904	48,876,742	48,876,742	48,876,742
Amount of markup	72,762,503	78,759,474	81,785,062	65,755,700	71,626,265	75,547,117
Total amount	130,654,250	125,268,221	110,992,966	114,632,442	120,503,007	124,423,859

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Perusal of the information provided by the Company further revealed that it obtained members' approval through special resolution passed in the annual general meetings ("AGMs") held on November 5, 2009 and November 30, 2011 in terms whereof the amounts of Rs.90,993,621 receivable form FPSL and Rs.84,417,832 receivable form SSL were acknowledged as debts and through a resolution passed in the latter AGM, members' approval was obtained for extending the repayment period of those debts from three to ten years. In terms of the aforesaid resolution, markup was to be charged at the rate not less than borrowing cost of the Company (*Markup charged @ 16% by the Company*).

3. It further transpired that the Company has not been recovering the markup that accrued to the tune of Rs.81,785,062 and Rs.75,547,117 as on September 30, 2015 in case of FPSL and SSL, respectively. Consequently, the SCN was issued to the respondents for the following, prima facie, violations of clause (c) of regulation 7 of the Companies (Investments in Associated Companies or Associated Undertakings) Regulations, 2012 (the "Regulations"):

- ✓ As the respondents did not periodically recover the markup on the outstanding debts receivable from associated companies namely FPSL and SSL; and
- ✓ By not recovering the substantial amount of markup on the outstanding debts due from associated companies, a loss has been caused to the Company, whose funds have been stuck up resulting in opportunity cost to the Company.

4. In response to the SCN, the Company submitted reply dated November 27, 2015. A brief of the reply relevant to the contents of the SCN is given below:

- ➢ Receivables from FPSL and SSL were converted as debts through resolutions passed, however this doesn't bring the said debts under obligatory/compulsive scope of regulation 7 of the Regulations.
- ➢ It is evident from the resolution passed in AGM held on November 5, 2009 that the receivables from FPSL and SSL were not due out of any normal trading pattern but inception of these debts was circumscribed by the force majeure compulsion and events that preceded them leaving no option for the company but to treat them as debts as otherwise the very nature of these receivables would have rendered them as losses. It is pertinent to reproduce here the

relevant paras where the nature of the receivables was made obvious to everyone:

The Company being a member of the Karachi Stock Exchange offered equity brokerage services for a number of individuals and corporate bodies, including the above named Associated Companies on market terms. This activity has been ongoing since the inception of the company and was settled as per settlement terms of the Karachi Stock Exchange notified from time to time. This activity was extremely profitable for the company over a number of years. Due to the well-known local and international unprecedented turmoil in the financial markets and the Karachi Stock Exchange including disruption in normal trading activity, insertion of floor mechanism and lack of liquidity in the capital markets resulted in non-settlement of these trade debts by the debtors including Associated Company debts. This force majeure event and non-settlement by a number of trade debtors including the Associated Companies was unplanned and forced under the circumstances. [Emphasis supplied]

- It won't be out of context to briefly delineate the background circumstances that triggered the said force majeure events. In mid of April 2008 when statements attributed to the then Finance Minister of Pakistan appeared in national press to the effect that the national economy was in a virtual state of collapse as the previous government had fudged its figures and that the country was on the verge of default. Consequently, the confidence of investors in the stability of capital markets began eroding and the KSE 100 Index, began to fall sharply.
- Accordingly, in exercise of its powers under clause 8.8 of the Risk Management Regulations, (*the force majeure clause*), the KSE's Board with SECP's approval took various measures to stabilize the market of trade in securities. One of these measures was to change the "circuit breaker" in the market to 1% and 10% respectively for downward and upward movement vis-à-vis the normal circuit breakers of 5% for both.
- After initial swing upwards where short sellers made purchases to square up their positions, the market continued to trigger the circuit breaker for approximately 15 calendar days. At the same time the authorized financiers of the National Clearing Company of Pakistan Ltd (NCCPL) started gradually pulling out from their irrevocable financing commitments while the KSE and SECP took no steps to restrain this pulling out and thus failed to act in accordance with the regulations.
- The said failure of the KSE and SECP precipitated the crisis that contained havoc repercussions for all. Frustrated over rapid devaluation of their investments, on July 17, 2008, the investors attacked the KSE premises. Until July 16, 2008, KSE-100 Index had depreciated

1/3 from its zenith in April 2008 resulting in evaporation of USD 37 billion up to August 27, 2008. The KSE Management had to set floor and freeze the market to safe guard the interests of the Exchange, its members and customers. On 4th December 2008 all three stock exchanges had formally declared *force majeure*. The recent report dated June 5, 2015 published by the Committee constituted by SECP titled Study of the Pakistan Stock Market Crisis 2008, makes it clear that all regulatory bodies including SECP, KSE and NCCPL not only recognized force majeure events but also share responsibility for the same.

- These are preceding circumstances that lead to heavy losses that were treated as receivables of the associated companies and later acknowledged as debts. None of the said receivables was investment per se as meant in regulation 7 (ibid) of the Regulations, the opening lines of which read as follows:

  A company <u>intending to make investment</u> in its associated company or associated undertaking shall comply with the following conditions and restrictions ....[Emphasis supplied]
- It was never a case that the company was contemplating at making any investment in its associated companies, which contemplation, as theory implies, would have been a proactive decision at using available funds, however, contrary to that, it were actually the losses that had been incurred in consequence of the said force majeure events that the company saved by treating as receivables and afterwards acknowledging them as debts. It was made clear to the shareholders in the AGM wherein their approval was obtained. If the company had not acknowledged them as debts they would have been treated as losses and never been recoverable on account of the force majeure circumstances that were acknowledged and acted upon by none other than NCCPL, KSE and SECP.
- Without prejudice to the above averments, it is respectfully submitted that the Regulations 2012 were not existent at the time (i.e. 2009) when the said losses/receivables were treated as debts of the Associated Companies. The treatment of the said losses as debts of the Associated Companies was under agreements entered in 2009. The said agreements were entered in accordance with the resolutions that nowhere called for any compulsive payment schedule of markup amount. Therefore, under law, the debts of the associated companies acknowledged in 2009 would be treated under the terms of the resolution(s) and the agreements entered in pursuance thereof, and Regulations 2012 would not be applicable.

- Without prejudice to the preceding argument, even if that be conceded that Regulations 2012 are applicable on debts entered prior to its promulgation, still the company has not violated any of the conditions of clause "c" of regulation 7 (ibid) which only directs that a company shall follow same standard terms which the commercial banks follow in the matters of interest and make up etc.
- It is a matter of record that almost all commercial banks have waived off/right off the mark up amounts and given substantial concessions in principal due amounts on the liabilities that incurred during the said force majeure events and even afterwards. The company itself has been beneficiary on that count by commercial banks to which it owed liabilities. It is therefore wrong to assume that in the matter of associated companies, regulation 7 (ibid) has been violated. In fact contrary to the norms of the commercial banks, no waiver or right off has been extended on account of markup amounts in the matter of associated companies.
- It is evident from the Company's accounts that due amounts are being paid by the associated companies which have been adjusted against the due principal amounts, which shows that the decision of the company in treating losses out of the force majeure events as debts in 2009 was a mature decision at averting losses and was never a decision of making investment per se as the term implies.

In view of the above the respondents prayed that the show cause under reply may be withdrawn.

5. A hearing in the matter was fixed on January 20, 2016 but the Company requested for adjournment. Another hearing was fixed on February 4, 2016 and Mr. Ali Aslam Malik, the chief executive ("CEO") of the Company appeared before the undersigned and requested for further adjournment. The hearing was finally held on February 22, 2016 and the CEO appeared before the undersigned on behalf of the respondents. The statements made by him with reference to the contents of the SCN are produced below:

  - The associated companies have agreed to give assets against markup and principal amount of loan. It may include settlement against shares and / or assets. If Company's BOD approves then shareholders' approval will be sought and proposal will be submitted to the Commission.
  - The associated companies were big clients and the Company generated substantial revenues from dealings with them till the year 2008 when stock market crisis took place.

- FPSL and SSL are both unlisted companies and may have office/rooms in stock exchange, assets and memberships on offer to settle loans. Although they are in losses, but they have paid off their loans and can be revived.
- Corrective action and settlement of loan will be completed in three months' time.

Based on the above submissions, the undersigned allowed two weeks' time to the CEO for furnishing plan for settlement of debts by associated companies. Since the requisite information was not submitted, the CEO through letter dated April 1, 2016 was required to furnish written confirmation regarding timeframe for settlement of debts including principal and markup due from associated companies. In response, the company secretary through letter dated April 7, 2016 submitted minutes of the meeting of the BOD of the Company dated April 7, 2016 which contained decision of the BOD regarding debts due from associated companies. Perusal of the minutes of the meeting revealed that in respect of principal and markup due from FPSL and SSL, the BOD of the Company resolved to approve conversion of markup receivable from FPSL and SSL into equity investment of the Company after approval of the Company's shareholders. Subsequently, through letter dated May 12, 2016, the CEO informed that the Company received the entire amount of principal debt from associated companies, as under:

Company Name	Principal Outstanding	Amount Received
FPSL	23,192,655	23,192,655
SSL	48,876,742	48,876,742

It was further stated by the CEO that the associated companies have promised to convert the outstanding markup into equity within the next six months, as they are required to increase their authorized capital to issue fresh shares.

6. Before proceeding further, it is necessary to advert to the following relevant provisions of Ordinance and the Regulations notified through SRO 27(I)/2012 dated January 16, 2012:

Clause (c) of regulation 7 of the Regulations:

"Interest, mark up, profit, fees or commission etc., as the case may be, shall be recovered periodically by the investing company in line with the standard terms normally applied by the

commercial banks or the Islamic Financial Institutions on similar facilities extended to the borrowers;"

Section 208 of the Ordinance provides as under:

Sub-section (1): *Subject to sub-section (2A) a company shall not make any investment in any of its associated companies or associated undertakings except under the authority of a special resolution which shall indicate the nature, period and amount of investment and terms and conditions attached thereto:*

Provided that the return on investment in the form of loan shall not be less than the borrowing cost of investing company.

Explanation.- The expression 'investment' shall include loans, advances, equity, by whatever name called, or any amount which is not in the nature of normal trade credit.

Sub-section (2): *No change in the nature of an investment or the terms and conditions attached thereto shall be made except under the authority of a special resolution.*

Sub-section (2A): *The Commission may--*

(a) by notification, in the official Gazette, specify the class of companies or undertakings to which the restriction provided in sub-section (1) shall not apply; and

(b) through regulations made thereunder, specify such conditions and restrictions on the nature, period, amount of investment and terms and conditions attached thereto, and other ancillary matters, as it deems fit.

Sub-section (3) of section 208 of the Ordinance provides as under:

"If default is made in complying with the requirements of this section, or regulations, every director of a company who is knowingly and willfully in default shall be liable to fine which may extend to ten million rupees and in addition, the directors shall jointly and severally reimburse to the company any loss sustained by the company in consequence of an investment which was made without complying with the requirements of this section."

In terms of the Commission's notification SRO 1003 (I)/2015 dated October 15, 2015, the powers to adjudicate cases under section 208 of the Ordinance have been delegated to the Executive Director (Corporate Supervision Department).

7. I have analyzed the facts of the case, relevant provisions of the Ordinance, the Regulations made thereunder and the arguments put forth by the respondents and my observations are as under:

- Sub-section (1) of section 208 specifically requires authority of a special resolution for all investments by a company in its associated companies and undertakings. The expression 'investment' has also been explicitly explained by the section 208 stating that it *shall include loans, advances, equity, by whatever name called, or <u>any amount which is not in the nature of normal trade credit</u>*. It has further been explicitly specified by the sub-section (1) that investments by a company in associated companies shall be subject to sub-section (2)A, wherein the Commission has been authorized to promulgate Regulations that, inter alia, prescribe restrictions, terms and conditions applicable to such investments. The Regulations have been promulgated by the Commission in terms of powers conferred by sub-section (2)A of section 208 of the Ordinance, and are equally enforceable, as the penalty for violation of section 208 and the Regulations promulgated thereunder is prescribed by the same sub-section (3).
- The respondents have referred to the *force majeure* clause of the KSE's Risk Management Regulations and have enumerated the series of events in the year 2008 that led to stock market crisis resulting in evaporation of investment, huge decline in the market capitalization and freezing of trading in stocks. However, it must be noted that the Company in its AGM held on November 5, 2009 obtained the approval of members through a special resolution passed under section 208 of the Ordinance to acknowledge the amounts receivable from the associated companies namely FPSL and SSL with the amount of mark up to be charged at a rate not less than the borrowing cost of the Company. Therefore, it is clear that those were acknowledged as investment in associated companies. The need to get approval of shareholders clearly arose due to the fact that the amounts receivable from associated companies had no more remained in the nature of normal trade credit, hence, necessitating approval of shareholders under section 208 of the Ordinance. Once the amounts due from associated companies were acknowledged as debts, there does not remain any room to argue that those were not the investments made by the Company in associated companies.

- Even if the events that led to inability of the associated companies to pay the amounts due to the Company were beyond the control of the Company and its management, it was the responsibility of the directors and management of the Company to put in place appropriate controls and risk management procedures to avoid losses and or reduce them to bare minimum. They were required to including taking immediate steps to recover the due amounts, obtaining adequate security in the form of shares, mortgage of property and recovery of the amount due by selling the customer's shares in the Company's custody. Deteriorating stock market situation in latter half of 2008 warranted exercising of very stringent risk management procedures by the management to avoid or reduce losses to the Company. However, as of June 30, 2009, the amounts receivable from associated companies accumulated to the tune of Rs.175.412 million which became overdue and the Company had to obtain the shareholders' approval to treat those as investment in associated companies under section 208 of the Ordinance. Resultantly the Company's funds were stuck up causing opportunity loss to the company.
- It has been argued by the respondents that since the approval under section 208 was obtained in 2009, prior to promulgation of the Regulations, therefore, these do not become applicable to the Company and, hence, it was not required to periodically recover mark up from the associated companies. The Regulations were notified by the Commission through notification the SRO 27(I)/2012 dated January 16, 2012 and became effective immediately. Though the Regulation did not become applicable retrospectively, but after notification on January 16, 2012, those became applicable to investments by a company in its associated companies. Since application of the Regulations, the Company has not periodically recovered the amount of markup on debts due from its associated companies, which is a violation of clause (c) of regulation 7 of the Regulations.
- As has already been elaborated, the Regulation became immediately applicable after notification on January 16, 2012 and the Company was bound to recover mark up on the outstanding debts from the associated companies periodically in line with the market norms. The Company's failure to do so results in violation of the Regulations and also has caused loss to it in shape of opportunity cost of stuck up funds.
- The respondents have further pleaded that even the banks waived off interest and markup on loans to the companies due to *force majeure* nature of the events that led to defaults by

the companies and that the Company itself is a beneficiary of such waivers from banks. It has further been stated that contrary to the norms of the commercial banks, no waiver or right off has been extended on account of markup amounts in the matter of associated companies. In this regard it must be noted that the relationship of a company with the commercial banks is that of two independent parties with no conflict of interest of directors and the terms and conditions applicable thereto cannot be compared with those that are applicable to the relationship and transactions between a company and its associated companies and undertakings. The associated companies namely FPSL and SSL are unlisted companies which are directly or indirectly controlled by the sponsors and directors of the Company who have major stake in these companies.

- Investments in associated companies inherently involve interest or conflict of interest of directors or sponsors. The Ordinance, therefore, imposes a protection in shape of section 208 of the Ordinance for mandatory approval of the shareholders in case of decisions involving investments in associated companies to help manage the inherent risk that such decision making by the directors may be influenced to the detriment of the interests of members of the company. The Regulations require the companies to recover markup on debts due from associated companies, periodically, in line with standard banking practices and that requirement is mandatory. The Regulations, however, do not provide any room for allowing diversions from standard practice in case of default by associated companies, given the very nature of associated companies' relationship that involves or may involve conflict of interest of its directors.
- Given the inherent risk of conflict of interest of directors or sponsors in the decisions involving investments in associated companies, it is imperative that the protection provided by section 208 of the Ordinance and Regulations made thereunder for mandatory approval of the shareholders and by prescribing terms, conditions and restrictions on such investments, is not evaded and these mandatory provisions are strictly complied with in letter and spirit to safeguard the interest of the investing company and its shareholders.
- As subsequently communicated by the Company, it has recovered the entire principal amount of Rs.72,069,397 due from associated companies as of April 4, 2016. Furthermore, the Company has plans to convert the outstanding amount of markup which accumulated

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to the tune of Rs.157,332,179 as of September 30, 2015, by converting it into equity investment subject to approval of shareholders within six months, as the associated companies need to raise their authorized capital to issue fresh shares. This may serve as the mitigating factor but does not absolve the respondents of their responsibilities to ensure compliance with the law and regulations. The huge amounts of markup have been accumulated over the years and the same have not been recovered periodically resulting in losses to the Company in shape of opportunity cost. The company has significant long term and short term borrowings on its balance sheet mainly comprising of financing obtained from banks. The amount stuck up in shape of markup receivable from associated companies adversely affects liquidity and profitability of the Company. Moreover, it is also not substantiated as to how converting of amount of outstanding markup due from associated companies FPSL and SSL into equity investment in these companies will be beneficial to the Company and its shareholders, given the adverse financial position of the associated companies who have not even accounted for the full amount of markup payable to the Company in their financial statements. The adverse financial position of the associated companies, especially that of the FPSL, is apparent from the below synopsis:

	FPSL		**SSL**	
Financials Statements	**2015**	**2014**	**2015**	**2014**
Accumulated Loss	994.25	987.12	(356.12)	(423.15)
Net Equity excl.Share Deposit Money	(459.62)	(463.07)	(236.07)	(303.10)
Net Equity incl. Share Deposit Money	123.04	(463.07)	31.93	(303.10)
Total Assets	1,770.49	1,773.42	383.94	541.26
Trade Receivables	1,662.84	1,674.99	273.12	307.33
Total Liabilities	1,770.49	1,773.42	383.94	541.26
Long Term Financing – Secured	1,066.51	1,210.879	153.69	374.48
Revenues	1.21	1.16	57.76	34.73
Net After Tax Profit/(Loss)	(7.14)	(14.84)	67.03	59.38
Other Issues	Litigation on LT Financing Going Concern Issue Qualified Audit Report		-	

8. I deem it necessary to make some observations on the importance of compliance with provisions of section 208 of the Ordinance and the Regulation governing investments by a company in its associated companies or undertakings. The intent and purpose of the section 208 is

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to protect against diversion of a company's funds to pass on undue benefits to its associated companies or undertakings at the cost of the shareholders of such company. Due to this reason authority of special resolution of shareholders of a company is mandated by the law for making any investments including equity investments, loans, advances or allowing any amount not in the nature of normal trade credit to associated companies or undertakings. Since the law does not prescribe the detailed procedure, terms and conditions and restriction on such investments, it has provided for promulgation of Regulations by the Commission, so that a detailed procedure, terms, conditions and restrictions could be specified by the Commission to safeguard companies and its shareholders against diversion of funds or to pass on undue benefit to associated companies. Taking cognizance of time value of money and opportunity cost involved, the Regulations have made it mandatory to recover markup on debts on periodical basis from associated companies. These requirements are mandatory and must be followed in letter and spirit. The directors owe fiduciary duties to the Company they serve and being charged with governance of the company and stewardship of its resources; they have a higher level of responsibility and accountability commensurate with the authority vested in them. The concerned directors have failed to exercise reasonable care and to see that mandatory provisions of law were being violated.

9. For the foregoing reasons, I am of the view that the provisions of clause (c) of regulations 7 of the Regulations have been violated by the respondents. However, I take cognizance of the mitigating factors, including recovery of entire principal amount due from associated companies. Therefore, in exercise of the powers conferred by section 208 of the Ordinance, instead of imposing maximum fines, I hereby impose an aggregate fine of Rs400,000/- (Rupees four hundred thousand only) on the respondents. The respondents are directed to deposit the fines as under:

Name of Respondents	Amounts in Rupees
1. Mr. Shahzad Akbar, Chairman	50,000
2. Mr. Ali Aslam Malik, CEO	100,000
3. Mr. Muhammad Iqbal Khan	50,000
4. Mr. Rais Ahmed Dar	50,000
5. Mr. Saeed Ahmad Bajwa	50,000
6. Mr. Amir Shehzad	50,000
7. Mr. Azeem Ul Hassan	50,000
Total	400,000

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The aforesaid fines must be deposited in the designated bank account maintained with MCB Bank Limited in the name of the "Securities and Exchange Commission of Pakistan" within thirty days from the receipt of this order and furnish receipted bank vouchers to the Commission. In case of non-deposit of the penalties, proceedings for recovery of the fines as arrears of land revenue will be initiated. It may also be noted that the aforesaid penalties are imposed on the respondents in their personal capacity; therefore, they are required to pay the said amounts from personal resources.

Before parting with the order, I hereby invoke provisions of section 473 of the Ordinance and direct the respondents, as under:

- To immediately take steps for recovery of all the outstanding amounts of markup due from the associated companies namely FPSL and SSL within three months from the date of this order and in case it is to be converted into equity shares of these companies, then meticulous compliance with the Regulations in general and regulations 3 (3) and 6 in specific, must be ensured; and
- To furnish with the Commission the auditors' certificate regarding recovery of interest / mark up on the outstanding amounts due from FPSL and SSL.

Abid Hussain
Executive Director (CSD)

Announced:

June 6, 2016
Islamabad