Before

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

In the matter of

Show Cause Notice issued
under Section 199(2) read with Section 199(6) and Section 479 of the Companies Act, 2017; Regulation 5(4) and Regulation 8 of the Companies (Investment in Associated Companies or Associated Undertakings) Regulations, 2017

Number and date of Show Cause Notice (SCN)	ADJ-I/ARN/53/2024-342 dated May 29, 2024
Date(s) of Hearing:	July 12, 2024
Present at the Hearing(s):	Mr. Rashid Ibrahim, Managing Partner, M/s Saafin Global Consulting (Authorized Representative)

ORDER

This Order shall dispose of the proceedings initiated through the Show Cause Notice No. ADJ-I/ARN/53/2024- dated May 29, 2024 (the "**SCN**") against M/s Crescent Steel and Allied Products Limited through its Chief Executive Officer (the "**Company**" or the "**Respondent No. 1**"), Mr. Ahsan M. Saleem, Chief Executive Officer (the "**Respondent No. 2**"), Mr. Ahmad Waqar, Chairman/Director (the "**Respondent No. 3**"), Ms. Farah Ayub Tarin, Director (the "**Respondent No. 4**"), Mr. Farrukh V. Junaidy, Director (the "**Respondent No. 5**"), Mr. Muhammad Kamran Saleem, Director (the "**Respondent No. 6**"), Mr. Nadeem Maqbool, Director (the "**Respondent No. 7**"), Mr. Nasir Shafi, Director (the "**Respondent No. 8**") and Mr. S. M. Ehtishamullah, Director (the "**Respondent No. 9**") for their alleged contravention of the requirements of Section 199(2) of the Companies Act, 2017 (the "**Act**") read with Regulation 5(4) of the Companies (Investment in Associated Companies or Associated Undertakings) Regulations, 2017 (the "**Regulations**"), under the penal provisions of Section 479 read with Section 199(6) of the Act and Regulation 8 of the Regulations.

2. Brief facts of the case are summarized as below:

a. A review of the annual audited financial statements of the Company for the year ended June 30, 2023 (the "**Accounts**") carried out by the Securities and Exchange Commission of Pakistan (the "Commission") revealed that (as per note 19.1.3 thereof), M/s Solution de Energy (Private) Limited (**SDE**) is a wholly-owned subsidiary of the Company.

b. Note 25.1 to the Accounts *inter alia* disclosed that the Company had extended an interest-free loan to SDE, with an outstanding amount of Rs.111.914 million.

c. Section 199(2) of the Act *inter alia* stipulates that the return on an investment in associated company or associated undertaking by way of loans or advances shall not be less than the

borrowing cost of the investing company or the rate as may be specified by the Commission, whichever is higher. Accordingly, Regulation 5(4) of the Regulations specifies that the rate of return on loans, advances and debt securities etc. shall not be less than Karachi Inter Bank Offered Rate (KIBOR) for the relevant period or the borrowing cost of the investing company, whichever is higher. In terms of Section 2(1)(4)(b) of the Act, a subsidiary company is included in the definition of associated companies and associated undertakings.

d. The relevant department of the Commission vide letter dated January 26, 2024 *inter alia* requested the Company to provide copies of requisite approval(s) in respect of loan disbursements made to SDE during the financial year in question amounting to Rs.15.122 million. The Company vide its letter dated March 11, 2024 submitted that:

(i) SDE was initially owned by M/s Shakarganj Energy (Private) Limited (SEL) when an investment was made in SDE in 2014 in terms of S.R.O. 704(I)/2011 dated July 13, 2011.

(ii) SDE became the subsidiary of the Company in the year 2020 by way of an amalgamation of SEL with and into the Company.

(iii)The board of directors of the Company in their meeting held on October 28, 2021 resolve to continue the support in terms of loan investment maximum up to Rs.150 million.

(iv) During the year ended June 30, 2023, loan amounting to Rs.15 million was extended (resulting into a total of Rs.111.914 million out of Rs.150 million), which was ratified by the board of directors of the Company in their meetings held on January 31, 2023 and August 09, 2023.

(v) The Company has complied with the requirements of Section 208 and the Companies (Related Party Transactions and Maintenance of Related Records) Regulations, 2018.

e. For reference purposes, it is mentioned that in terms of S.R.O. 1239(I)/2017 dated December 06, 2017 (superseding S.R.O. 704(I)/2011 dated July 13, 2011), the exemption provided to, among other classes of companies, a holding company to the extent of investments made in its wholly owned subsidiary only relates to the restrictions prescribed under Section 199(1) of the Act.

f. The requirements of Section 199(2) of the Act read with Regulation 5(4) of the Regulations expressly restrict the Company from extending interest-free loans to its associated companies (i.e. SDE in the instant case) and mandatorily stipulate that the rate of return shall not be less than KIBOR for the relevant period or the borrowing cost of the Company (whichever is

higher). The said Section 199(2) further stipulates that such return shall be recovered on a regular basis in accordance with the terms of the agreement.

g. The disclosures made by the Company in the Accounts and the submissions made through its letter dated March 11, 2024 depict that the Company has extended an interest-free loan to SDE with an outstanding amount of Rs.111.914 million as at June 30, 2023, and has failed to recover the interest/return thereon on a regular basis, which is *prima facie* in violation of Section 199(2) of the Act read with Regulation 5(4) of the Regulations.

3. Considering the above, a Show Cause Notice dated May 29, 2024 was served upon the Respondents for the alleged contravention of Section 199(2) of the Act read with Regulation 5(4) of the Regulations read with the penal provisions of Section 479 & Section 199(6) of the Act and Regulation 8 of the Regulations.

4. The Company vide its letter dated June 10, 2024 requested for an extension to reply to the SCN for three (03) weeks. Subsequently, the Company vide its letter dated July 02, 2024 submitted written response to the SCN, the relevant extracts of which are reproduced below:

"Solution de Energy (Private) Limited (the "SDE"), is a wholly owned subsidiary of the Company...The Company, being the sole sponsor of SDE, had been bearing expenses on behalf of SDE and extending advances for meeting day to day administrative and operational costs. It is observed that there appears an anomaly in the provisions of Section 199 of the Act, regarding investment in a wholly owned subsidiary. The law exempts the investment in wholly owned subsidiary from the requirements of sub-section (1), however sub-section (2) is applicable to the wholly owned subsidiary which serves no purpose except for an accounting entry.

It is important to observe that in terms of the provisions of Section 208 of the Companies Ordinance, 1984, the exemption to make investment in wholly owned subsidiary was not only from passing a special resolution but also from charging interest. Similarly, Notification No.704(I)2011 dated July 13, 2011 issued post amendments in the provisions of Section 208 of the ordinance clearly exempts the holding company to the extent to investment made in the wholly owned subsidiary. It is clearly logical and legal as charging interest from wholly owned subsidiary would not change the consolidated financial position of the company. However, the legislature has erred while drafting the provision of Section 199 of the Act without considering that the return on investment is removed from the provisions of Sub-section (1) and made part of Sub-section (2) of Section 199 of the Act...

The SECP till date, while adjudicating the cases under the aforementioned provisions of the Act, has failed to clarify/explain the rationale or very purpose of charging mark- up in case of a wholly owned subsidiary especially in cases where subsidiary is not yet operational. In case the Company

charge or book mark-up on advances to wholly owned subsidiary then ultimately the Company will be paying the amount of mark up to itself on behalf of the SDE. The Company will be booking mark-up income, however at the same time the Company is fully cognizant of the fact that the same cannot be recovered as SDE do not have sufficient fund to repay. In order to present a true and fair view in compliance with the requirements of IFRS, the Company has to remeasure the recoverability of the outstanding mark up and book provisions accordingly. Therefore, as per our understanding the law should be applied rationally to present a true and fair view of the financial position of the Company and complying with the requirements of section 199(2) of the Act for a greenfield project does not serve any purpose. In addition, the Company is burdened with tax inference on mark-up income which is only a book entry.

However, giving due recognition to the observation of SECP, the management has fully recovered the outstanding amount from SDE including the mark up...

Since the Company has fully complied with the requirements of the law, in letter and spirit, it is requested to close the show cause proceedings without any adverse order. There exist a number of precedents where the Commission has closed with the proceedings on subsequent compliance of the law:

a) Order dated July 07, 2022...where non-compliance of Section 199(1) of the Act (which is a more serious matter) was condoned without penalty, due to subsequent compliance;
b) Order dated July 05, 2015...where Appellate Bench of the SECP set aside the order to the extent of penalty on sequent ratification by passing a special resolution by the shareholders;
c) Order in the matter of...where no penalty was imposed and the Company was directed to recover the entire amount from associated company 2007 CLD 1708..."

5. In order to meet the ends of justice and provide an opportunity of being heard to the Respondents, a hearing was scheduled for July 12, 2024, which was attended by Mr. Rashid Ibrahim, Managing Partner, M/s Saafin Global Consulting being the Authorized Representative of the Respondents. During the course of hearing, the Representative was inquired regarding the contraventions of the law as alleged in the SCN. The Representative reiterated the written submissions earlier made in response to the SCN. The Representative further admitted that by virtue of S.R.O. 1239(I)/2017 dated December 06, 2017, the exemption only related to Section 199(1) of the Act, while the Company was required to comply with the requirements of Section 199(2) thereof. The Representative informed that the Company has till date extended an aggregate amount of approx. Rs.117 million (in principal) to SDE; however, the Representative reiterated that the Company has duly recovered the entire loan amount from SDE of Rs.117 million (principal) and Rs.79 million (interest), totaling to Rs.196 million approx. Accordingly, the Representative requested for a lenient view considering the subsequent compliance and rectification of default and given the commitment of the Respondents to ensure meticulous compliance of the applicable laws in the future.

6. Subsequent to the hearing, the Representative submitted another written response vide letter dated July 15, 2024, the relevant extracts of which are reproduced hereinbelow:

> *"...SDE was a subsidiary of Shakarganj Energy (Private) Limited ("SEL") till 2020. SEL initially extended the loan to SDE in 2014 in terms of S.R.O. 704(I)/2011 dated July 13, 2011. CSAPL and SEL amalgamated in 2020 and as result SDE became wholly owned subsidiary of CSAPL. During the financial year ended June 30, 2023, SAPL extended further loan of Rs.15 million to SDE. Loan extended by SEL to SDE complied with the requirements of Section 208 of Companies Ordinance, 1984 read with S.R.O.704(I)/2011 dated July 13, 2011 and Companies (Related Party Transactions and Maintenance of Related Records) Regulations, 2018.*
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> *After the promulgation of Companies Act, 2017 issuance of S.R.O. 1239(I)/2017 dated December 6, 2017, which superseded S.R.O. 704(I)/2011 dated July 13, 2011, CSAPL was required to comply with the provisions of sub-section (2) of Section 199 of the Companies Act, 2017...*
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> *To comply with the observation of SECP, CSAPL decided to recover the entire loan extended to SDE of Rs.117,497,525 along with the mark up over and above the markup of the financing facility of SAPL of Rs.79,006,333, a total of Rs.196,503,858. Bank statements of CSAPL and SDE evidencing recovery of loan and markup are attached...A letter from SDE requesting bank to transfer the amount is also attached...*
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> *In view of the above submissions, you are requested to close the proceedings initiated."*

7. I have gone through the relevant provisions of Section 199(2) and Regulation 5(4) of the Regulations and submissions made by the Respondents in the written response as well as during the course of hearing through their Authorized Representative. I have also perused Section 479 and Section 199(6) of the Act read with Regulation 8 of the Regulations, which stipulate penal provisions for contravention of the afore-referred provisions of law. I have noted the following pertinent aspects vis-à-vis the submissions made by the Respondents:

a. <u>Construction of Section 199 of the Act:</u>

The Respondents have contended against the construction of Section 199 of the Act and the presumed 'irrational' charge of markup on a loan extended to a wholly owned subsidiary. They have further contended that the Company is burdened with tax inference on mark-up income being only a book entry. In this respect, the Order of the Commission dated March 28, 2024 in the matter of *M/s Fatima Fertilizer Company Limited* (as quoted by the Respondents themselves in their written response dated July 15, 2024) quite clearly establishes under the heading *"<u>Whether the provisions of Section 199(2) are applicable on a wholly owned subsidiary which is not operational and the parent company is incurring its expenses</u>"* that *there is no exemption or exception to the*

requirements of Section 199(2) of the Act applicable on the transaction conducted between the Company and its wholly owned subsidiary. The said Order further pronounces under the heading *"Whether it is imperative to charge and recover mark-up on advances to a wholly owned subsidiary (non-operational) to represent a true and fair view of the group's financial position"* that *"...to present a true and fair view of the financials of a group...chargeability and recovery of the mark-up on advances in compliance to the provisions of Section 199 of the Act and the IFRS is imperative. The parent's and its subsidiary's stand-alone accounts must incorporate the financial transactions to present a true and fair view. The ultimate consolidation of the accounts does cater the intra-group transactions, therefore, the Company's stance of avoiding a book entry for chargeability/recovery thereof, is not tenable under the principles of IFRS and the Act. Furthermore, the Company's stance on tax inference on mark-up income as only a book entry is also without substance as tax chargeability / payment of the same is applicable under the relevant laws of taxation."* Thus, the above contentions of the Respondents stand redundant to the case at hand.

b. Return on Investment lower than Borrowing Cost of the Company:

Section 199(2) of the Act *inter alia* mandates that the return on such investment shall not be less than the borrowing cost of the investing company or the rate as may be specified by the Commission whichever is higher and shall be recovered on regular basis. Regulation 5(4) of the Regulations further mandatorily stipulates that the rate of return on loans shall not be less than KIBOR for the relevant period or the borrowing cost of the investing company, whichever is higher.

The disclosures made by the Company in the Accounts (note 25.1) and the submissions made through its letter dated March 11, 2024 clearly depict that the loan extended by the Company to SDE (with an outstanding amount of Rs.111.914 million as at June 30, 2023) was on interest-free basis and the Company had failed to regularly recover the interest/return thereupon.

c. Exemption from the requirements of Section 199(1) of the Act:

The argument taken by the Respondents that the initial investment made in SDE by SEL in the year 2014 was exempted by virtue of S.R.O. 704(I)/2011 dated July 13, 2011 is not considered tenable, considering the following:

i. As disclosed in note 19.1.3 of the annual audited financial statements of the Company for the year ended June 30, 2020, SDE was acquired by the Company through an amalgamation w.e.f. June 30, 2019.

ii. At that point in time, the S.R.O. 1239(I)/2017 dated December 06, 2017 was in field, which had superseded the afore-referred SRO of 2011. Under the said SRO of 2017, it has been notified that:

"...the Securities and Exchange Commission of Pakistan is pleased to specify the following classes of ***companies to which the restriction provided in sub-section (1) of section 199 of the Act shall not apply*** *to the extent provided hereunder:..*

(f) A holding company, to the extent of investments made in its wholly owned subsidiary..." (emphasis added)

Thus, it is abundantly clear that the exemption provided to a holding company is limited to the extent of investments made in its wholly owned subsidiary, and such an exemption is only from the restrictions/requirements prescribed under Section 199(1) of the Act (regarding authorization of investment by special resolution). The said SRO nowhere grants any exemption whatsoever from the requirements of Section 199(2) of the Act. Therefore, the Company was obligated under Section 199(2) of the Act read with Regulation 5(4) of the Regulations to charge and recover return/interest on the outstanding loan on regular basis, effective from the date of amalgamation.

d. Subsequent Rectification of Default:

Nevertheless, during the course of instant proceedings, the Respondents have requested for a lenient view on the basis of subsequent rectification of the identified default and the complete recovery of the outstanding loan along with markup/interest accruing from June 30, 2020 till end of June 2024. The Respondents have informed that the outstanding loan stood at Rs.117,497,525 while mark-up on the same was computed to be Rs.79,006,333, totaling to Rs.196,503,858. In this respect, the Respondents have provided a copy of bank statement of the bank account of SDE maintained with Habib Metropolitan Bank Ltd. reflecting a funds transfer of Rs.196,503,858 made by SDE with reference to a letter dated June 28, 2024. The said letter dated June 28, 2024 (as provided by the Respondents) has been addressed by SDE to the aforesaid bank with a request to transfer the above-mentioned amount to the bank account of the Company maintained with the same bank in the same branch. Similarly, the Respondents have also furnished a copy of bank statement of the above-referred bank account of the Company, indicating that the above amount was duly credited in the Company's account on June 28, 2024.

e. Relevance of other Case Laws relied upon by the Respondents:

The Respondents have also quoted case laws, based on which leniency in punitive actions has been requested. While every case has its own merits, peculiar facts & circumstances, the relevancy of

each of the said case law to the case at hand is deliberated in the succeeding paras:

i. Order dated May 28, 2022 passed in the matter of Systems Limited – the proceedings only related to non-compliance of Section 199(1) of the Act regarding obtaining of shareholders' approval, and the respondent company had already complied with the questioned requirements of law i.e. well before the initiation of adjudicatory proceedings in 2021. However, the instant case relates to alleged non-compliances of Section 199(2) of the Act i.e. failure to charge & recover interest/return on the loan/advance extended to the associated company, and the rectification of default persisting since 2020 has only been made in June 2024 i.e. subsequent to the issuance of SCN in May 2024. Thus, the referred case is not considered relevant to the case at hand.

ii. Order dated July 06, 2015 passed in the matter of Sapphire Fibres Limited – the proceedings also revolved around failure of the company/board of director to obtain approval through special resolution for making an investment in associated company while the requisite commission/return was always being received from the associated company. Further, although the imposed penalty was waived by the Appellate Bench, the violation of Section 208 of the then Companies Ordinance, 1984 was still established. Hence, the referred case is not considered relevant to the case at hand.

iii. Order dated September 17, 2007 in the matter of Exide Pakistan Limited – the proceedings were initiated under Section 472 of the then Companies Ordinance, 1984 (now Section 474 of the Act) considering the violation of Section 208 yet the nominal amount being involved. The company was thus directed under Section 472 to make good the default and recover all outstanding amounts. However, the instant proceedings have been initiated for violation of the Respondents with Section 199(2) of the Act, cognizance of which has been taken under Section 199(6) thereof, pursuant to which the Respondents are liable to punitive action for their failure to comply with the provisions of the said section. Thus, the referred case is not considered relevant to the case at hand.

f. <u>Additional Past Precedents regarding Section 199(2):</u>

Based on the facts and circumstances entailing the instant proceedings, the following past case laws are considered relevant, wherein the proceedings involving subsequent recoveries from the associated companies were still concluded by establishing default of the respondents in complying with Section 199 of the Act (or Section 208 of the then Companies Ordinance, 1984):

i. Raja Abdul Aziz vs. Executive Director SECP 2012 CLD 741 (Appeal No. 20 of 2006) – this case involved admission of default on part of the appellant company in making an unauthorized investment in its associated undertaking and subsequent rectification in the form

of repayment of outstanding principal amount of advance together with mark-up charged. The Impugned Order thereunder imposed a penalty of Rs.300,000 on each of the appellants. The said appeal was also disposed off with (reduced) penalty of Rs.100,000 on each appellant, considering the fact that the default was in fact committed.

ii. Fateh Textile Mills Ltd. 2010 CLD 36 – this case also involved admission of default on part of the respondent company who was also in the process of rectifying the same by recovering the balance of trade debts due from its associated companies along with interest. A penalty of Rs.500,000 was imposed on each of the 06 respondents for the established non-compliance of the then Section 208 of the Ordinance (now Section 199 of the Act).

iii. S. G. Power Limited 2006 CLD 997 – this case had similar conclusions as entailed in para (ii) above, and a penalty of Rs.100,000 was still imposed on each of the 07 respondent directors.

The above analysis sufficiently evidences the fact that investments in associated companies are inherently the transactions of key interest to the stakeholders of a listed company (having significant public interest), while failure to comply with the crucial requirements and conditions of law for making such investments can reasonably be expected to distort the true and fair view of the financial statements of the company.

8. In view of the above-stated facts & circumstances, particularly considering the established default of the Respondents in complying with Section 199(2) of the Act, I hereby, in exercise of powers conferred under Section 199(6) of the Act, impose a penalty of **Rs.200,000 (Rupees Two Hundred Thousand Only) on the Respondent No. 1/the Company while the Respondents No. 2 to 9 are hereby warned** to remain vigilant and ensure meticulous compliance with all applicable laws in true letter and spirit in the future.

9. The Respondent No. 1 is directed to deposit the aforesaid penalty 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 a period of thirty (30) days from the date of this Order, and furnish receipted voucher issued in the name of the Commission for information and record.

10. This Order is being issued without prejudice to any other action(s) that may be initiated/taken against the Directors, the Company and/or its officers responsible for the violations of the aforesaid provisions of the law, accordingly.

(Shahzad Afzal Khan)
Director/Head of Department

Announced:
August 5, 2024
Islamabad