



# SECURITIES & EXCHANGE COMMISSION OF PAKISTAN

(Securities Market Division)

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**Before the Joint Director (Securities Market Division)**

**In the matter of Show Cause Notice dated 26.08.2005**

**Issued to Escorts Investment Bank Limited**

**Date of Hearing**

**5<sup>th</sup> September 2005**

**Present at the Hearing:**

Representing Escorts Investment Bank Limited:

*Mr. Azhar Ahmed Batle, Head of Capital Market.*

*Mr. Farooq Hameed Khawaja, Chief Financial Officer.*

## **ORDER**

1. The present matter arises out of a Show Cause Notice bearing No. SMD/SCN/17/2005 dated 26.08.2005 issued to Escorts Investment Bank Limited., a Corporate Member of the Karachi Stock Exchange (G) Ltd. (the "Respondent").
2. Brief facts of this case are that between 02.03.2005 and 31.03.2005, the Respondent carried out 6 trades involving total 21,800 shares of Oil & Gas Development Company ("OGDC"), Pakistan Oil Field Limited ("POL"), Pakistan Petroleum Limited ("PPL") and Pakistan Telecommunication Company Limited ("PTC") through the Karachi Automated Trading System ("KATS") on behalf of 3 of its clients.
3. In the course of these trades, the Respondent purchased and sold, on behalf of the said 3 clients, 15,200 shares of OGDC, 1,000 shares of POL, 600 shares of PPL, and 5,000 shares of PTC. Each of these trades cancelled each other out with the effect that there was no change in the beneficial ownership of the shares.



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4. The Securities and Exchange Commission of Pakistan (the ‘Commission’) obtained the KATS data from the Karachi Stock Exchange (G) Ltd. (“KSE”) for the relevant period, which revealed that during the month of March 2005 the Respondent had executed the following trades which cancelled each other out and did not result in change of beneficial ownership:

DATE	CLIENT CODE	NAME OF SHARE	NUMBER OF SHARES	PURCHASE AND SALE RATE	TIME OF EXECUTION
02/03/2005	A044	OGDC-REG	1000	125	955050065
15/03/2005	018	OGDC-REG	13600	188.15	1242160046
31/03/2005	901	OGDC-REG	600	117.6	1115090002
10/03/2005	A044	POL-REG	1000	362.25	1050210055
29/03/2005	018	PPL-REG	600	212	1310460034
04/03/2005	A044	PTC-REG	5000	76.55	1558030030

5. In view of the preceding a Show Cause Notice was issued to the Respondent on 26.08.2005, detailing the aforesaid facts and asking it as to why action should not be initiated against it under Brokers and Agents Registration Rules, 2001 (the ‘Rules’). A copy of the KATS data was also sent to the Respondent in order to allow it an opportunity of answering the same. The Respondent was asked to submit a written reply within 7 days from the date of the Show Cause Notice and the hearing was fixed in Islamabad for 05.09.2005.
6. The Respondent submitted a written reply dated 02.07.2005 to the Show Cause Notice and also appeared in person through its authorized representatives Mr. Azhar Ahmed Batle, Head of Capital Market and Mr. Farooq Hameed Khawaja, Chief Financial Officer. The main points raised by the Respondent in its written reply and in the course of hearing were as follows:
- (a) The Board of Directors and the Management of the Respondent are and would always remain committed to the principals of Good Corporate Governance and Best Business Practices as prescribed by the Securities and Exchange Commission of Pakistan and is also enshrined in our own Statement of Ethical Business Practices.



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- (b) The transactions highlighted in the Show cause notice are apparently the same as highlighted in the “Report into Stock Market situation March 2005” by the Stock Market Review Task force released on 04.08.2005. The report has classified these transactions as ‘potential cases’ of market abuse, where players had undertaken “Wash Trades”. The said report while discussing these transactions highlighted the purpose of these transactions i.e. “to pump” the market.
- (c) A review of the trades in question shows that the transactions highlighted in the Show cause Notice were not at all undertaken with the intention of creating false impression of the activity in the said securities or to pump up the market. This is evident from the percentage of the highlighted transactions in comparison to the total market volume in each security. None of these transactions are material enough to represent significant proportion of the total volume to have an impact on market activity, accordingly these do not fall within the definition of “Wash Trades” as defined in the Report of the Stock Market Review Task force.
- (d) During the hearing the Respondent provided the following details of accounts in which the aforesaid trades were executed:

<u>Client Code</u>	<u>Client Name</u>	<u>Description</u>
A044	Black Stone Equities (Pvt) Ltd.	Corporate Member of Islamabad Stock Exchange
901	Omar Malik	Individual
018	EIBL Hedging A/C	Proprietary account Escort Investment Bank Limited

- (e) The Respondent further explained that its client Black Stone Equities (Pvt) Ltd., (“Member Client”) bearing Code A044 is a Corporate Member of Islamabad Stock Exchange. The aforesaid Member Client places with the Respondent orders for sale or purchase on behalf of its different clients. It is probable that in some cases the orders placed by the aforesaid Member client on behalf of its client may be squared up with another order placed by a different client of the same Member Client. In the aforementioned scenario, the Member Client deals on behalf of its various clients, so change of ownership actually takes place at the end of the Member Client.



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- (f) The Respondent further stated that the account bearing code 018 is its proprietary account. This account is an Arbitrage account and all trades in this account are executed by the Arbitrager appointed by the Respondent. The Arbitrager deals in both Ready and Futures Market. It is the Respondent's policy not to allow Arbitragers to keep open positions i.e. the buy or sell positions in ready market of particular scrip are required to be equal to sell or buy position in Futures contracts of the same share. If there is a difference in the position held, in particular scrip, by the Arbitrager in ready and future markets then the Arbitrager buys or sells the scrip in the ready market to square off his position. This may result in matching of the new order with the unexecuted order of the Arbitrager previously placed in the market. However this is purely coincidental and a result of error of judgment and in no way involves mala fide intentions to manipulate the market price.
- (g) Further the Respondent contended that the accounts in question had very high volume during the month of March therefore in some cases it is possible that the clients or the KATS operator failed to keep track of the unexecuted orders. In such circumstances it is possible that the client's new order may be cancelled out by an unexecuted or partially executed order previously placed in the market by the same client.
7. On the basis of the aforesaid the Respondent requested that the Show Cause Notice be withdrawn as it had not violated any of the clauses of the Rules.
8. I have heard the Respondent at length after carefully examining the record and I find that the following issues arise out of this matter:
- (a) Whether the acts of commission and omission as alleged against the Respondent constitute a breach of the Rules? If so, up to what extent?
- (b) What should the order be?

Each of these issues has been examined seriatim:



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*(a) Whether the acts of commission and omission as alleged against the Respondent constitutes a breach of the Rules? If so, up to what extent?*

9. In the course of its written as well as oral contentions, the Respondent has neither generally nor specifically denied the fact of carrying out all 6 trades detailed in the Show Cause Notice. Further the Respondent vide its written reply and during the course of the hearing reiterated its commitment towards the Code of Corporate Governance and Best Business Practices as prescribed by the Commission, which both require establishment of sound system and controls, compliance with statutory requirements and adoption of best business practices. However the trades in question executed by the Respondent clearly shows that the Respondent failed to follow the law and adopt business best practices. Securities and Exchange Ordinance 1969 (the "Ordinance") clearly prohibits the execution of such trades where the buyer and the seller is the same person and no change in beneficial ownership of the scrip takes place. It is evident from the relevant KATS data obtained from KSE, (which has not been disputed by the Respondent) that the aforesaid trades did not result in a change in beneficial ownership of shares involved which is a clear violation of the provision of the law. Further, the execution of trades in question also negates the principles of Best Business Practices as such trading activity interferes with the fair and smooth functioning of the market due to the fact that it gives the impression of shares being traded in the market when in fact the scrips remain in the possession of the same person. The interests of the investor suffer in turn due to the fact that they receive a false impression of trading in the market which influences their financial decision to invest or trade in the market. Therefore the execution of trades in question proves that the Respondent has failed to follow the Code of Corporate Governance and adhere to the Best Practices of the Business.
  
10. Further the assertion by the Respondent that the trades given in the Show Cause Notice constitute a nominal percentage of the total traded volume of a particular day and therefore cannot in any way affect the market price of shares is not accepted. Although the minimal percentage of trades in question might not have affected the price of a share in the instant matter however the fact that these trades did become a part of the over all trading volume and such trades gave a false impression of active trading in these scrips at the time of execution cannot be ignored



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11. Moreover, the Respondent has also asserted in the matter of execution of transactions on behalf of its client bearing Code A044, which is a member of ISE (“Member Client”), that a change in the beneficial ownership of the shares did take place at the end of the Member Client. However neither during the course of hearing nor vide his written reply the Respondent submitted any documentary evidence in support of his abovementioned claim. Further Section 8 (1) of the Ordinance states that “No person shall transact any business in securities on any Stock Exchange unless he is a member thereof”. However the aforesaid assertion of the Respondent clearly proves that the Member Client is transacting its business on KSE through the Respondent by placing its client’s orders with the Respondent and the same is also in the knowledge of the Respondent. Therefore the business conducted by the Member Client on behalf of its clients through the Respondent is illegal and a gross violation of the law.
12. Further the Respondent’s contention that the trades in question that were executed in its Proprietary account bearing Code 018 were a result of “Error of Judgment” shows that the Respondent’s Arbitrager failed to exercise due care and skill while entering orders on the KATS. Had the Arbitrager been alert and kept proper record of executed and unexecuted orders the trades in question would not have occurred. As the aforesaid account is a Proprietary Account of the Respondent therefore the Respondent should have exercised utmost care and ensured that proper system and controls are in place.
13. Further the plea of the Respondent that the accounts in question had very high trading volume during the month of March because of which it is possible in some cases that a particular order may be squared up with another order previously placed in the market, by the same client as he may not be able to keep track of his unexecuted orders is not tenable. It is the duty of the Respondent to inform the client about his unexecuted orders and abstain from placing a new order on the KATS. Moreover, this also proves the negligence on the part of the Respondent and clearly shows that the Respondent did not at all times maintain high standards of integrity, promptitude and fairness in the conduct of all its transactions as required under the Code of Conduct prescribed in the Third Schedule to the Rules.
14. In engaging in and allowing trading in the ready market merely for the purpose of creating a false impression of trading activity in particular scrips, is not only contrary to high standards of integrity but is also improper, dishonorable, disgraceful and contrary to the law.



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15. It is evident from the facts detailed above that the Respondent failed to follow the requirements of the Code of Conduct prescribed for brokers in that by executing and permitting to execute trades which cancelled each other out and did not result in the transfer of beneficial ownership, it has indulged in acts which have interfered with the fair and smooth functioning of the market to the detriment of the interest of investors.
16. In failing to ensure that a proper system was in place to avoid repeated occurrence of these trades where buy and sell orders by the same client cancel each other out, the Respondent has failed to act with due skill, care and diligence in the conduct of its business. Consequently, the Respondent has failed in its duty to maintain high standards of integrity, promptitude and fairness in the conduct of all its business and has in fact indulged in dishonorable, disgraceful and improper conduct on the Stock Exchange and has therefore acted in gross and blatant violation of Rule 8(iv) read with Rule 12 of the Rules.

(b) *What should the order be?*

17. From the aforesaid it is clear that the Respondent has failed to maintain high standards of integrity, exercise due skill and care in the conduct of business, comply with the statutory requirements and has engaged in transactions which distorted the market equilibrium. This conduct of the Respondent is a violation of General provisions 1, 2, 4 and 5 of the Code of Conduct prescribed for the broker in the Rules in violation of Rule 8(iv) read with Rule 12 of the Rules. The violation of the Rules is a serious matter which entitles the Commission to suspend the Respondent's license; however, I have elected not to exercise this power at present. Therefore in exercise of the powers under Rule 8(b) of the Rules, I hereby impose on the Respondent, the penalty of Rs.50,000.00 (Rupees Fifty thousand). This sum of Rs. 50,000.00 should be deposited in the account of the Commission being maintained in the designated branches of Habib Bank Ltd., no later than thirty (30) days from the date of this Order. A copy of the Challan form evidencing the deposit of penalty amount must be sent to the Commission.
18. In addition to the aforesaid, I hereby direct the Respondent to abstain from buying and selling of shares in a manner that these do not result in a change in the beneficial ownership of the shares failing which action will be taken against him in accordance with the law.



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19. This Order is issued without prejudice to any other action that the Commission may initiate against the Respondent in accordance with the law on matters subsequently investigated or otherwise brought to the knowledge of the Commission.

**Ikram Ul Haque**

Joint Director (SM)

Date of Order: 15.09.2005