Securities and Exchange Commission of Pakistan

Securities Market Division
Market Supervision and Registration Department
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for scanning

File No. SMD-/MSRD-C&IW/4-1(246) 2013 December 20, 2013

Mr. Shafqat Ali,
Chief Regulatory Officer,
Karachi Stock Exchange Limited,
Stock Exchange Building,
Stock Exchange Road,
Karachi

Subject: **CLARIFICATIONS/GUIDELINES IN REPSECT OF THIRD SCHEDULE OF SECURITIES AND EXCHANGE RULES, 1971 ("SE RULES")**

Dear Sir,

This is with reference to your email dated November 12, 2013 wherein KSE has submitted various recommendations to the Commission for its consideration and revising the clarifications/guidelines dated July 3, 2013 issued in respect of calculation of Net Capital Balance (NCB) as per Third Schedule of SE Rules.

In this regard, the Commission has reviewed the comments/recommendations forwarded by KSE in detail and para wise comments/reply of the Commission in respect of each recommendation is attached as **Annexure-A.**

Although, already elucidated in our earlier letters dated July 3, 2013 and September 18, 2013, we reiterate here that the subject clarifications/guidelines were issued in view of inconsistent approach being followed by the brokers/auditors to calculate NCB and misinterpretation of the requirements prescribed in the Third Schedule of SE Rules was resulting in miscalculation of NCB. Hence, in the light of the queries and suggestions received from different market participants from time to time and after due deliberation with KSE, the Commission issued these clarifications/guidelines in this regard to ensure clarity and consistency.

Moreover, the clarifications/guidelines issued by the Commission did not propose any change in the requirements for calculation of NCB for purpose of Rule 2(d) as prescribed in the Third Schedule of the SE Rules rather these were issued to clarify ambiguity, if any, with regard to inclusion/exclusion/interpretation of certain items while calculating NCB.

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In view of above and based on review of comments/recommendations of the KSE Board, the Commission is of the view that the KSE's request to revise the clarifications/guidelines in relation to Third Schedule of SE Rules is not pertinent and valid. Therefore, all the TREC holders and their Auditors are required to calculate NCB strictly in accordance with Third Schedule of SE Rules and follow the clarifications/guidelines issued by the Commission in letter and spirit.

Yours sincerely,

(Imran Inayat Butt)
Director/HOD (MSRD)

C.C:

1. Chairman, KSE
2. Chairman RAC, KSE
3. Managing Director, KSE
4. Managing Director, LSE
5. Managing Director, ISE

ANNEXURE-A

SUBJECT MATTER	CLARIFICATION/ GUIDELINES ISSUED	RECOMMENDATION OF KSE BOARD	COMMISSION'S COMMENTS
1. Cash in hand and bank balances			
1.2 Cash Deposited as Basic Deposits with Stock Exchanges and NCCPL	Cash deposited with the Stock Exchanges and NCCPL as basic deposits by the brokerage houses may not be incorporated as Cash and Cash Equivalent.	Agreed with Broker's view to include the same in NCB calculations.	As per Rule 2(d) of SECP Rules "net capital" means excess of current assets over the liabilities determined in accordance with the Third Schedule to these rules. The basic deposits with stock exchanges and NCCPL are mandatorily required to be maintained for existence in a particular market and therefore, these are unrealizable, inconsumable and are not convertible into cash or cash equivalent in normal course of business and are not withdrawn unless the broker abandons brokerage business or a particular market. The allowable current assets as provided under Third Schedule does not include deposits and advances; hence subject matter may not be allowable. In view of above facts, basic deposits with KSE and NCCPL is not permissible for NCB purpose, however, it may be noted that impact of basic deposit on NCB is not material. For ready reference, information and details relating to basic deposits is illustrated below: 1. Deposit with NCCPL for broker clearing member Rs200,000 2. Deposit with NCCPL for broker clearing member for BTB / MF facility Rs100,000 3. Security Deposit with NCCPL from Broker CFS Financier CM Rs200,000 4. Basic Deposit for Index Options Market Rs25,000 5. Basic Deposit for Futures Trading in Provisionally Listed Companies Market Rs100,000 6. Basic Deposit for Market Makers Rs25,000 7. Basic Deposit for Ready Market Rs200,000
1.3 Cash Deposited as Base Minimum Capital (BMC) with Stock Exchanges	Cash deposited as part of BMC may not be incorporated as Cash and Cash Equivalents for calculation of NCB.	Did not agree with Broker's view as BMC should not be mingled up with NCB, both are separate legal requirements.	No comments required.

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1.4 Term Deposit/Other Deposit Receipts with Banks	Both items are in nature of cash equivalent and TDR/DR up to one year maturity may be included under the head "cash in hand and with Bank", provided the said deposit is free from any third party interest and free from any lien.	Agreed with SECP interpretation given to a Broker.	The Third Schedule does not deal with long term assets; hence, investment classified in books of accounts as long term may not be included. TDR / other Deposit Receipts (DRs) having maturity of more than one year and/or having third party interest or lien may not be included. However, TDR/DRs reported under current assets and are pledged with bank for arranging Bank Guarantees for the Exchange or NCCPL may be allowed to be included as Cash/Cash Equivalents provided the said TDR/DRs are free from further lien or third party interest.

2. Trade Receivables

2.4 Receivables pertaining to Pakistan Mercantile Exchange Limited (PMEX).	These receivables should not be included in calculating NCB of the brokerage house of a Stock Exchange.	Recommended that receivable pertaining to PMEX should be allowed for including in NCB calculations because common Brokers are required to submit their NCBs with all Exchanges and PMEX, therefore, any verification in NCB calculations may attract undue additional cost.	Calculation of NCB for PMEX purpose does not fall under Third Schedule, therefore, receivables pertaining to PMEX may not be included for calculating NCB under Third Schedule. In this regard it may further be noted that as per Para 6.1 of the Guidelines all the liabilities relating to PMEX may be excluded if the current assets items such as trade receivables, deposit and bank balances pertaining to PMEX have been excluded. In view of the above, receivables from PMEX is required to be excluded for NCB as provided in para 2.4 of the Guidelines. However, if receivables balance from PMEX pertaining to clients' trading is included in NCB, the corresponding liabilities of PMEX's clients will be required to be classified in other liabilities to nullify the impact of said receivables from NCB.
2.8 Other assets	The current assets item not prescribed in Third Schedule of SEC Rules should not be included for the purpose of calculation of NCB, for	Agreed on SECP's clarification vide its letter dated July 15, 2013 allowing Commission Receivable as Current	No comments required.

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	instance: 1) Loan and Advance to employees 2) Loan and Advances to associated companies 3) Income tax receivable/refundable **4) Commission receivable** 5) Advance to suppliers or advance to customers 6) Mark up or interest receivable on loan balance 7) Prepayments 8) Deposits for office rent, telephone etc.	Assets.	
3. Investment in listed securities in the name of brokerage house			
3.2 Investment classified in books of account as long term	Where investment in listed securities has been made for more than one year or an investment has been classified as long term in books of accounts such investment should not be included for the purpose of calculation of NCB.	Considering the fact that in case of need this can be liquidated by the Broker, Board on RAC's recommendation agreed that same should be treated as liquid/current asset for this regulatory purpose only.	The Third Schedule does not deal with non-current assets; hence investment classified in books of accounts as long term may not be included. However, investment in listed securities, which is classified as short term investments, and is held for more than one year may be included in calculation of NCB under Third Schedule of SECP Rules if the said classification has not been made in contradiction with Generally Acceptable Accounting Principles and/or relevant regulatory/statutory requirement as applicable from time to time. However, any improper classification of long term investment into short term may not be allowed.

ANNEXURE-A

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6. Valuation of trade payables			
6.1 Overdue trade payables	All 30 days overdue balance of trade payables which have been deducted from the balance of total trade payables should be classified as other liabilities for the purpose of NCB calculation. However, all the liabilities relating to PMEX may be excluded if the current assets items such as trade receivables, deposit and bank balances pertaining to PMEX have been excluded.	The Board was of the view that there has been a practice to treat trade payables over 30 days as effectively a part of equity and any immediate and non-transitional change will not be practically possible, therefore the Board considered that a mechanism be introduced where any amount held to be subordinated to other liabilities will remain outside the calculation for this purpose	The Third Schedule deals with current assets and current liabilities therefore; question of subordinated loan does not arise. Moreover, the current practice with regard to trade payables over 30 days does not resemblance with the treatment of trade receivables. The overdue trade receivables more than 14 days are excluded but securities against such overdue balance are allowable. Similarly with regard to other liabilities the Third Schedule prescribe to include those items which are classified under generally accepted accounting principles. Therefore, trade payables more than 30 days are required to be included in other liabilities for calculating NCB. Moreover, as far as any transitional change is concerned, it may be noted that as per request of the brokers the Commission has already provided six months period and further extension in this regard may not be allowed and brokers are required to maintain NCB as per regulatory requirements.
6.3 Loan account	List of trade creditors should not include such account in which only receipts and payments are appearing, and no transaction relating to products traded on the Exchange are recorded. All such accounts should be classified as loan account and will be included in other liabilities section of NCB.	The Board was of the view that if Trade Payable overdue more than 30 days is addressed as recommended above then clients' deposits may not be the issue for treating them as other liability.	During onsite inspection of brokerage houses the Commission has observed certain accounts in which only receipts and payments were recorded and no transaction relating to products traded on the Exchange were recorded. In most of the cases the concerned brokers accepted Commission's stance that such accounts are of loan nature and have given assurance to the Commission that in future such accounts will be classified as loan and not as trade creditors/debtors as the case may be.
7. Valuation of other payables			
7.1 Loan from Director(s)	The balance of director's loan account in which receipts/payments transactions pertaining to one year period till the date of reporting period	The Board on RAC's recommendation agreed that Loan from Directors classified as Long-Term Loan in the Books of	The Commission during onsite inspection noted instances that frequent receipts/payments transactions were recorded in directors' loan account during current period as well as in subsequent period but such account was classified as long term and thus excluded from NCB. The purpose of the Guidelines issued by the Commission was to

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	for NCB are recorded should be classified as short term loan for NCB purpose irrespective of its classification/ disclosure in the books of accounts of the brokerage house.	Broker should be allowed provided Broker must report to the Exchange if the same is repaid any time before next NCB review. The Exchange will be required to reduce the paid liability form the NCB of the Broker immediately in the event of repayment.	prevent misuse, malpractices and wrong interpretation. Moreover, in this connection reference may also be made to Para 72 of IAS-1 which prescribes as follows: *72 An entity classifies its financial liabilities as current when they are due to be settled within twelve months after the reporting period, even if:* *(a) the original term was for a period longer than twelve months, and* *(b) an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are authorised for issue.*
8. Format of Certification			
8.1 Format for Certification of NCB	Certification of NCB is a regulatory requirement. The auditors are required to perform appropriate assurance procedures to enable them to issue the required certificate on the format notified by the Exchange. It is a regulatory requirement that the certificate should specify that the NCB have calculated duly verified/audited by the Auditors.	The Board on RAC's recommendation agreed with Auditors' limitation.	Under Regulation 2.2(b) of Regulations governing risk management brokers are required to confirm that their NCB are on the format prescribed by the Exchange on the dates and within such time as may be notified by the Exchange for this purpose. Moreover, under Regulation 2.2(c) it is mandatorily required that the certificate should specify that the Net Capital Balance calculated have been duly verified/audited by the auditor. With regard to above, reference may be made to Para 2.4 of Selected Opinion No. XVI issued by ICAP on the subject. Extract from selected opinion is stated below for ready reference: **2.4 CERTIFICATE OF NET CAPITAL OF MEMBERS OF KARACHI STOCK EXCHANGE (KSE)** *Enquiry: With reference to above subject matter, we are enclosing herewith form of certificate issued by the KSE for reporting on net capital of members of the KSE. The format uses the words 'audited' whereas auditors only arrives at figure by examining ledgers and no other audit procedures are performed. We understand that this engagement may be undertaken as per ISRS No. 4400 'Engagement to*

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			perform Agreed upon Procedures Regarding Financial Information'. Considering this, we request you to provide us appropriate advice to understand and appropriately discharge our reporting responsibilities. ***Opinion:*** *The Committee considered your enquiry and is of the view that the certification of Net Capital Balance does not fall under the scope of ISRS No. 4400 'Engagement to perform Agreed upon Procedures Regarding Financial Information' rather it is an Assurance Engagement and appropriate assurance procedures would need to be performed to enable the auditor to issue the required certificate.* *Further, as this certification is a regulatory requirement on the basis of audit/ review therefore the form of certificate provided by KSE may be followed for the purpose. (April 15, 2011)* Moreover, Regulation 2.2(b) and (c) are reproduced below for ready reference: **Regulation 2.2(b):** *The Brokers of the Exchange shall submit bi-annually a certificate from an Auditor selected from the panel of auditors prescribed by the Exchange under relevant Chapter of these Regulations Governing System Audit of the Brokers of the Exchanges confirming their NCB on the format prescribed by the Exchange on the dates and within such time as may be notified by the Exchange for this purpose;* **Regulation 2.2(c):** *The certificate shall specify that the Net Capital Balance calculated have been duly verified/audited by the auditor referred in 2(b) above;*
General Observation	1. As per SE Rule 3(b) {**Qualification for stock**	The Board on RAC's recommendation was of the	No comments required.

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	Exchange membership (TRE Certificate Holder-ship)} read with Third Schedule, KSE TRE Certificate Holder is required, at all times, to maintain a Net Capital Balance of an amount of Rs. 2.5 million. As per clause 2,2(a) of the Regulations Governing Risk Management read with Schedule-2, a Broker may take Exposure in different market-wide limits based on its NCB such as 25 times in Ready Market and 7.5 time in all Futures Markets subject maximum 25time NCB in all market.	view that as such NCB is regulatory requirement for the time being, therefore, this observation should be addressed at a separate forum.	