



## Regulations Governing System Audit of the Brokers of the Exchanges, 2004

(Amended clause 2(f) and Schedule A as per approval of SECP dated 25-11-09  
and sent for gazette notification on 1-12-09)

## **PREAMBLE**

Whereas it is considered expedient to have Regulations for conducting the System Audit of brokers in order to ensure compliance with the requirements of the Securities and Exchange Ordinance, 1969, Securities and Exchange Rules, 1971, Code of Conduct for Brokers as enshrined in the Third Schedule of the Brokers and Agents Registration Rules, 2001 the Articles, Rules and Regulations of the Exchange and the directives issued by the Commission from time to time and thereby promote investor confidence in fair dealings at the Exchange which is one of the key ingredients in the development of the securities markets.

NOW THEREFORE, the Securities and Exchange Commission of Pakistan in exercise of the powers conferred under section 34 (1) of the Securities and Exchange Ordinance, 1969, hereby approves the following Regulations with certain amendments:

### **1. SHORT TITLE AND COMMENCEMENT**

- a) These regulations may be called the “Regulations Governing System Audit of the Brokers of the Exchanges, 2004”.
- b) They shall come into force with immediate effect.

### **2. (I) DEFINITIONS**

The terms used in these Regulations shall have the following meanings:-

- a) “Articles” means the Articles of Association of the Exchange.
- b) “Audit” means the System Audit of Brokers conducted as per these Regulations.
- c) “Auditor(s)” means the auditor(s) selected, every year, by the Board to be on the panel of auditors as per Regulation 4(a) hereof.
- d) “Board” means the governing board of directors of the Exchange.
- e) “Branch office” means an office, or branch thereof, opened and maintained by a broker within or outside the premises of a stock exchange for conducting the business and trading of securities.
- f) “Broker” means any member of the Exchange engaged in the business of executing transactions in securities for the account of others and for his own account and is registered with the Commission under the Brokers and Agents Registration Rules, 2001.
- g) “Director” means a director of the Board.
- h) “Exchange” means the stock exchange formed and registered under the Securities and Exchange Ordinance, 1969.
- i) “HOIA” means the Head of the Internal Audit of the Exchange.
- j) “Audit Committee” means the audit Committee of the Board.

- II) All other words and expressions used but not defined in these Regulations shall have the same meaning as assigned to them in the Securities and Exchange Ordinance, 1969(XVII of 1969) and the Companies Ordinance, 1984 (XLVII of 1984).

### **3. PANEL OF AUDITORS**

- a) The Audit Committee shall, every year, recommend to the Board for its approval, a panel of auditors not being less than ten (10) in number, to be on the panel of auditors of the Exchange. The Auditors shall fulfill the following criteria:-
- i. The Auditors are a firm and all of its partners practicing in Pakistan are Chartered Accountants within the meaning of the Chartered Accountants Ordinance, 1961; and
  - ii. The firm has been given a satisfactory rating under the Quality Control Review Program of the Institute of Chartered Accountants of Pakistan.
  - iii. No broker shall appoint as auditors a firm of auditors which firm or a partner of which firm is non-compliant with the 'International Federation of Accountants' (IFAC) Guidelines on Code of Ethics, as adopted by the Institute of Chartered Accountants of Pakistan.
  - iv. No broker shall appoint or continue to retain any person as an auditor, who has been found guilty of professional misconduct by the Commission or by a Court of Law, for a period of three years unless a lesser period is determined by the Commission.
- b) No Auditor shall be appointed to conduct the System Audit of a broker, if that Auditor has conducted the audit or other assignment of that broker or his associated undertakings, at any time during the past two years. The broker shall appoint an auditor within two weeks of the selection of brokers as specified in clause 4 to conduct the System Audit of a broker from the panel approved by the Board of Directors. In case the concerned broker fails to appoint an auditor within the time specified, the Managing Director shall appoint the auditor.
- c) The HOIA shall liaise between the broker(s) and Auditor(s) conducting the audit of the said broker(s).

### **4 TYPES OF SYSTEM AUDIT**

The System Audit of the brokers shall be of two types:

- a) Compulsory System Audit

The Managing Director shall, after every six months in a calendar year, select a minimum of 25% of the Broker of the Exchange, through random balloting. The selection for the first half of the calendar year shall be made at a date not later than January 31, in each calendar year and the selection for the second half of the calendar year shall be made by a date not later than July 31, in each calendar year. The results of the ballots shall be intimated to the broker(s) by the Managing

Director. The brokers selected and placed under Audit, shall be excluded from future ballotings until such time, all the brokers of the Exchange have been selected

b) Voluntary System Audit

A broker(s) may volunteer before the Managing Director to be audited. Such a Broker(s) shall not be included in the future ballotings until such time, all the brokers of the Exchange have been selected.

**5 SCOPE OF AUDIT**

The System Audit will be carried out in a manner as specified in Schedule A hereof, to ensure compliance with the requirements of the Securities and Exchange Ordinance, 1969, the Securities and Exchange Rules, 1971, Code of Conduct for Brokers as enshrined in the Third Schedule of the Brokers and Agents Registration Rules, 2001, the Articles, Rules and Regulations of the Exchange and the directives issued by the Commission from time to time.

**6 AUDIT REPORT**

- a) The Auditor(s) shall within two months from the date of assignment of the System Audit of a Broker(s), for the preceding financial year by the Managing Director, complete the System Audit and prepare a report to be submitted to the Managing Director. The Managing Director of the exchange shall immediately forward a copy of the Audit Report to the Securities and Exchange Commission of Pakistan.
- b) After the Auditor(s) have filed a report, in respect of a broker, with the Managing Director and there are no material violation appearing therein, the Auditor shall issue a Certificate of compliance to the broker.

**7 FINES**

If the Audit Report identifies any default(s) / non-compliance(s) on the part of the broker with the provisions of the Articles, Rules and Regulations of the Exchange, the Exchange may, after giving him an opportunity of hearing, by order direct the broker to:

- a) Pay a fine amounting to not less than Rs. 10,000/- per default but not exceeding Rs. 25,000/- per default. However, in case a broker has volunteered to have the System Audit, then in case of any violations of the Articles, Rules and Regulations of the Exchange, committed by him, the fine to be imposed hereunder shall be reduced to half of the aforesaid amount.
- b) If a broker fails to co-operate with the Auditor(s), the Managing Director shall upon receiving a written complaint from the Auditor, call a hearing of the broker and the Auditor and may impose a fine of not less than Rs. 25,000/- but not exceeding Rs. 100,000/- on the said broker. If the broker, subsequent to the imposition of the said fine fails to cooperate with the auditor or fails to pay the

fine, the Managing Director shall refer the matter to the Board for initiation of disciplinary proceedings under the Articles of the Exchange.

- c) Where the Exchange neglects or otherwise fails to take action under clause 7 of these Regulations, the Commission may suo moto or on receiving any complaint after giving due opportunity of hearing impose such penalty as provided under clause 7 and take such other necessary action as deemed fit by the Commission.

## **8 COSTS**

The broker who is being audited shall pay all the fees, charges and costs of the Auditors. The said fees, charges and costs shall be deposited with the Exchange, by the said broker, for onward payment to the Auditor.

**Schedule “A”**

**SCOPE OF AUDIT**

Without limiting the scope of the Audit in any way, the system audit will be carried out to review compliance with the requirements of the Securities and Exchange Ordinance, 1969, the Securities and Exchange Rules, 1971, Code of Conduct for Brokers as enshrined in the Third Schedule of the Brokers and Agents Registration Rules, 2001, the Articles, Rules and Regulations of the Exchange and the directives issued by the Commission from time to time.

**Standardized Account Opening Form (SAOF)**

1. Review the compliance with the SAOF as per the directives of the Commission dated November 19, 2003 and January 20, 2004.

**Manner of Transaction of Member’s Business**

1. Review the compliance of Rules 4 of Securities and Exchange Rules 1971 that stipulates following requirements regarding manner of transaction of member’s business:
  - a) Rules 4(1) requires that brokerage house should enter all orders in the chronological order, in a register maintained in a form which should identify the person who placed the order, name and number of the securities, nature of transaction and the limitation, if any, as to the price of the securities or the period for which the order is to be valid
  - b) Rules 4{2(a)} and 4{2(b)} restricts members to buy and sell security on their own account where client’s “best order” to buy and sell the same security respectively, remains unexecuted.
  - c) Rules 4{2(c)} restricts members to buy security at or below the limit price on their own account where client’s “limited order” to buy the same security remains unexecuted.
  - d) Rules 4{2(d)} restricts members to sell security at or above the limit price on their own account where client’s “limited order” to sell the same security remains unexecuted.

**Confirmation of Client Order**

1. Review that the brokerage house transmits a confirmation within twenty-four hours of execution of an order and contains following information:
  - a) Date on which order is executed;
  - b) Name and number of securities;
  - c) Nature of transaction (spot, ready, future and also whether bought or sold);
  - d) Prices/rates;
  - e) Commission if the member is acting as broker;
  - f) Whether the order is executed for the member’s own account or from the market.

*{Rule 4(4) of Securities and Exchange Rules 1971}*

### **Maintenance of Accounts**

1. Review that the following requirements are being fulfilled:
  - a) A balance sheet and a statement of income and expense account are being prepared once in a year; {U/S 233(1) of Companies Ordinance 1984 and U/R 5(1) of Securities and Exchange Rules 1971}.
  - b) In case of a corporate brokerage house, accounts are audited by an auditor who must be a Chartered Accountant {U/S 233(3) of Companies ordinance 1984}.

### **Maintenance of Books of Accounts**

1. Review that all the books of account and other related documents mentioned below are being maintained:

*{Rule 8(1) of Securities and Exchange Rules 1971}*

- a) Journals (or other comparable records), cash books and any other records of original entry forming the basis of entries into any ledger, the books of original entry being such as contain a daily record of all orders for purchases or sale of securities, all purchases and sales of securities, all receipts and deliveries of securities and all other debits and credits;
- b) Ledger (or other comparable records), reflecting assets, liability, reserve, capital, income and expense account;
- c) Ledger (or other comparable records), reflecting securities in transfer, borrowed and lent and securities bought or sold of which the delivery is delayed;
- d) Record of all balance of all ledger accounts in the form trial balance to be prepared at least at the end of six month;
- e) Record of transactions with banks; and
- f) Duplicates or counterfoils of memos, of confirmation issued to customers.

*{Rule 5(2) of Stock Exchange Members (Inspection of Books and Record) Rules, 2001}*

- g) Margin deposit book;
- h) Registers of accounts of agents;
- i) An agreement with an agent specifying the scope of authority and responsibilities of the member and his agent;
- j) Record of pledging or arranging for the pledging of any security carried for the account of any customer, whether physically held or in the Central Depository System with a commercial bank;
- k) Record of extension or maintenance of credit or arranging for the extension or maintenance of credit to the customers for the purpose of purchasing or carrying any security;

- l) Record of borrowing on any security or lending or arranging for the lending of any security carried for the account of the customer;
  - m) Record of dealing in foreign currencies as a dealer duly authorized by the State Bank of Pakistan within the brokerage house at the stock exchange premises.
2. Further review that above referred books of accounts and documents are preserved for a period of not less than five years. {Rule 8(2) of Securities and Exchange Rules 1971 and Rule 5(6) of Stock Exchange Members (Inspection of Books and Record Rules. 2001)}

### **Reporting by Corporate Brokerage Houses**

1. Review that the brokerage house (Corporate member) communicates the following to the Exchange:
  - a) Annual Accounts(Audited) and Half Yearly Accounts of the company are being submitted within the specified time;
  - b) List of Directors containing names, addresses and number of shares held by each as at 30<sup>th</sup> June and 31<sup>st</sup> December is being submitted within thirty days;
  - c) List of shareholders containing names, addresses and number of shares held by each as at 30<sup>th</sup> June and 31<sup>st</sup> December is being submitted;
  - d) All changes in the management of the company including directorship are being submitted immediately.

*{As per the Memorandum & Articles of Association of the exchanges}*

### **Details to be Printed on Member's Correspondence and Contracts**

1. Review that the Member's correspondence/contract notes relating to the transactions of business contain the clause "subject to Rules of the Exchange" and bear the name of the member along with address of principal place of business.

*{As per the Memorandum & Articles of Association of the exchanges}*

### **Registration of Brokers**

1. Review that the brokerage house has obtained a certificate of Registration from SECP to act as a Broker and such certificate is being renewed every year.

*{Rule 5 & 7 of Broker and Agents Rules, 2001}*

### **Registration of the Agents**

1. Review that the persons working as an agent of the brokerage house have obtained certificate of Registration from SECP and such Certificate of Registration is being renewed every year.

*{Rule 14 & 16 of Broker and Agents Rules, 2001}*

### **Agent Dealings**

1. Obtain representation that the agent does not deal with his clients in his own name. Dealing with clients including receiving cash or cheques from the client in the agent's own name and issuing cash memos, receipts, delivery notes or any other documents in his name. All the transactions are made in the name of his member or broker and settled with broker or member only

*{Rule 17(1) of Broker and Agents Rules, 2001}*

### **Regulation Governing Future Contracts**

1. In respect of trading under Future Contract, Review that the brokerage house:
  - a) Takes margin from its clients in accordance with the rates prescribed by the Exchange. {Regulation 14(a)}
  - b) Has proper procedures for identification of clients for effective risk management by the Clearing House. {Regulation 14(b)}

### **Regulations Governing Deliverable Futures Contract**

In respect of trading under Deliverable Futures Contract, review that the brokerage house has complied with Regulation No. 6 of the said Regulations with respect to Blank Selling.

### **Regulations Governing Short Selling under Ready Market**

To check the compliance of the following:

- (1) Brokerage house is not involved in 'Blank Sales', which are not permissible. (Regulation 4)
- (2) Member on his Proprietary Account or Client's Account has not made a Short Sale unless:
  - (a) Prior contractual borrowing arrangement has been made;
  - (b) The sale is made at an Uptick or Zero-Plus Tick;
  - (c) The trade is declared as a Short Sale at the time of placement of order through LOTS/ULTRA in a special Short Sale Order Window designated in the system for the purpose. (Regulations 5 & 6); and
  - (d) The sale has been made only in the securities eligible for short-selling as prescribed by the Exchange with prior approval of the Commission, based on the criteria laid down in the Regulations governing Short Selling under Ready Market.

### **Margin Deposits**

Review the following:

(a) Margins have been deposited with the Exchange by the Member in accordance with Regulations Governing Risk Management of the Exchange.

(b) Member has mandatorily taken margins from his clients in accordance with Regulation 9.4 of the Regulations Governing Risk Management of the Exchange.

### **Segregation of Client's Funds and Securities**

Review the following as required in the General Regulations:

- (a) Clear segregation of client's assets from the Member's assets. (Regulation 75)
- (b) Maintenance of necessary records and books of accounts to distinguish client's funds and securities from broker's funds and securities including maintenance of a separate bank account which will include all the funds deposits of their clients along with record/breakdown of client position. (Regulation 75)
- (c) Margins deposited by the clients of a broker in the form of securities, are maintained in the respective sub-accounts of such clients at CDC. (Regulation 75)
- (d) The clients' funds and securities are not used by the member for any purpose other than as authorized by the client in writing. (Regulation 75).

### **Regulation Governing Members Branch Offices**

1. In case the brokerage house has its any branch office for conducting the business and trading of shares and securities within and outside premises of the Exchange, Review that

- a) Brokerage house has obtained a Certificate of Registration from the Exchange;
- b) Maintained all client related record/information at the Head Office;
- c) Confirmation/contract/cash memo/other documents are issued on only printed stationery on which addresses of all branches are clearly stated;
- d) Name of Stock Exchange Member is prominently displayed outside the branch;
- e) Registration Certificate is prominently displayed at the branch;
- f) Status of the person authorized to manage the branch office whether as an authorized agent or an employee as per the Stock Exchange Regulations (Rule 5{1(iii)} of Stock Exchange Members (Inspection of Books and Record) Rules, 2001);
- g) Authority given to the agent or employee to perform all acts on behalf of the member {Rule 5[1(v)]} of Stock Exchange Members (Inspection of Books and Record) Rules, 2001};
- h) Proof of the following:
  - Business being done at the branch office in the name of the member;
  - maintenance of the branch offices bank accounts in the name of the member;
  - proper maintenance of accounts of the customers at the branch offices.

- i) Any other documents and records required to be maintained under regulations made by the stock exchange.

### **Regulation Governing Automated Trading System**

{Deleted}

### **Capital Adequacy Requirement**

1. Review that the Certificate of Net Capital Balance as per the prescribed format certified by any practicing Chartered Accountant is being submitted with the Exchange on biannually basis.
2. Review that the Net Capital Balance have been computed in accordance with Rule 2(d) of, and third schedule to, the Securities and Exchange Rules, 1971.

### **Carry Over Transactions**

{Deleted}

### **Margin Deposits**

1. Review the following:
  - a) Margin Deposits with the Exchange, NCCPL etc.
  - b) Margin Deposits with the Exchange with respect to trading in Future Contracts.
  - c) Margin Deposits of Investors with Members along with written consent of Investors.

### **Segregation of Client Funds and Securities**

1. Review the following:
  - a) Clear segregation and maintenance of separate bank account of clients' and the broker's money;
  - b) Maintenance of necessary records and books of accounts to distinguish client's cash and securities from broker's cash and securities.

(iv) No broker shall appoint or continue to retain any person as an auditor, who has been found guilty of professional misconduct by the Commission or by the Court of Law for a period of three year unless a lesser period is determined by the Commissioner.

(b. No Auditor shall be appointed to conduct the System Audit of a broker, if that Auditor has conducted the audit or other assignment of that broker or his associated undertakings at any time during the past two years. The broker shall appoint an auditor within two weeks of the selection of brokers as specified in Clause 4 to conduct the System Audit of a broker from the panel approved by

the Board of Directors. In case the concerned broker fails to appoint an auditor within the time specified, the Managing Director shall appoint the auditor.

- (c. The HOIA shall liaise between the broker(s) and Auditor(s) conducting the audit of the said broker(s).

### **Trading by Employees of Brokerage Houses**

Review that the provisions relating to trading by employees of brokerage houses have been followed as required under the Regulations of the Exchange.

### **Prohibition on in-house badla financing**

Review that the Broker has not provided any sort of illegal financing/funding including in house funding/ financing to any other Broker, its client or any other person, whosoever.

### **UIN verification**

Review that the provisions relating to UIN have been strictly followed in letter and spirit by the brokerage house in accordance with Regulations of the Exchange and to ensure that the usage of UIN has not resulted in any undesirable practice which may defeat the purpose of introduction of UIN such as

- (a) concealing the traceability of the trades of the beneficial owners,
- (b) reduction of impact on client level netting regime,
- (c) concealing of short selling, etc.

### **Compliance with Internet Trading Guidelines**

Review that the brokerage house has fully complied with the Internet Trading Guidelines issued by SECP from time to time.

## **4. TYPES OF SYSTEM AUDIT:**

The System Audit of the brokers shall be of two types:

### **(a). Compulsory System Audit:**

The Managing Director shall, after every six months in a calendar year select a minimum of 25 % of the brokers of the Exchange through random balloting. The selection for the first half of the calendar year shall be made at a date not later than January 31 in each calendar year and the selection for the second half of the calendar year shall be made by a date no later than July 31 in each calendar year. The results of the ballots shall be intimated to the broker(s) by the Managing Director. The brokers selected and placed under Audit, shall be excluded from future balloting until such time all the brokers of the Exchange have been selected.