



REGULATIONS GOVERNING SYSTEM  
AUDIT [REGULATORY COMPLIANCE]  
OF THE BROKERS  
OF  
THE KARACHI STOCK EXCHANGE

(AS AMENDED ON JULY 17, 2012 AND SENT FOR GAZETTE NOTIFICATION)

## **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**

1.1 These Regulations may be called the "Regulations Governing System Audit [Regulatory Compliance] of the Brokers of the Karachi Stock Exchange".

1.2 They shall come into force with immediate effect.

### **2. DEFINITIONS**

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

2.1.1 "Articles" means the Articles of Association of the Exchange.

2.1.2 "Audit" means the System Audit of Brokers conducted as per these Regulations.

2.1.3 "Auditor(s)" means the Auditor(s) selected, in accordance with the criteria approved by the Board with the prior approval of the Commission as per these Regulations.

2.1.4 "Board" means the governing board of directors of the Exchange.

2.1.5 "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.

2.1.6 "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.

2.1.7 "Exchange" means the Karachi Stock Exchange (Guarantee) Limited

2.1.8 Leveraged Market shall have the same meaning as ascribed thereto under the Securities (Leveraged Markets and Pledging) Rules, 2011.

2.1.9 "Commission" means the Securities & Exchange Commission of Pakistan.

2.1.10 "Report" means the compliance report submitted by the Auditor under these Regulations.

2.2 All other words and expressions used but not defined in these Regulations shall, unless there is anything repugnant in the subject or context, have the same meanings as assigned to them in the Articles, Regulations of the Exchange, Securities and Exchange Ordinance, 1969 (XVII of 1969) and the Companies Ordinance, 1984 ((XLVII of 1984) and Rules and Regulations made there-under.

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

3.1 The Exchange shall declare from time to time, the Panel of Auditors who shall be eligible to conduct Audit of the Brokers. The panel would consist of at least 10 Auditors and would fulfill the following prerequisites:

- 3.1.1 The Auditors shall be a Chartered Accountants firm within the meaning of the Chartered Accountants Ordinance, 1961; and
- 3.1.2 The Auditors must have been given a satisfactory rating under the Quality Control Review Program of the Institute of Chartered Accountants of Pakistan.
- 3.1.3 The Auditors shall satisfy the criteria devised by the Exchange from time to time in accordance with the Clause 2.1.3 of these Regulations.
- 3.2 Further, the Exchange shall annually review the Panel of Auditors to ensure ongoing eligibility of auditors on the Panel in line with the criteria.
- 3.3 No Auditor shall be appointed to conduct the Audit of a broker, if that Auditor has conducted the audit or other assignment of such Broker, at any time during the past two years immediately preceding from the date of balloting in which such Broker is selected for the Audit.
- 3.4 An officer designated by the Managing Director, not below the rank of Deputy General Manager level, shall liaise with the Broker(s) and the Auditor(s) conducting the Audit of the Brokers.
- 3.5 The list of Auditors eligible to conduct the Audit shall be placed on the website of the Exchange and the same shall be updated as and when required.

#### **4. ELIGIBILITY FOR AUDIT**

The Audit shall be conducted of eligible brokers. An eligible broker means a Broker who has operational track record of at-least one year preceding the ballot.

#### **5. SELECTION OF BROKERS AND STATUS OF COMPLIANCE**

- 5.1 The selection of Brokers for the Audit shall be through random balloting. All eligible Brokers, as defined in clause 4 above, shall be audited once in each 'cycle' of two-year period. The selection shall be made through biannual balloting to be held in every calendar year latest by 31<sup>st</sup> January and 31<sup>st</sup> July.

The Exchange at the ballot date shall determine the total number of Brokers eligible for audit in the remaining ballots of a cycle by dividing the number of Brokers still to be audited in the cycle with the remaining ballots of the cycle to arrive at the optimum number of Brokers to be audited in a ballot. Provided the Brokers audited in the last two ballots of a cycle shall not be included in initial two ballots of the next cycle.

*"Explanation, if the total number of eligible Brokers at the first ballot of the cycle is 140. These shall be divided by 4[number of ballots in 2 years]. Hence, 35 Brokers will be selected in the first ballot. At the next ballot date, assume that total eligible Brokers are reduced to 130. Then the number of Brokers selected shall be 32 [130 less 35 audited in previous ballot of a cycle divided by the 3 remaining ballots of a cycle]."*

- 5.2 If the Report contains any non-compliance(s), the Broker shall rectify the same immediately and such Broker shall be subject to limited scope audit in the following year to confirm that such Broker is now compliant of those particular non-compliances where the Auditor found such Broker non-compliant. The period for limited scope audit shall not be less than 3 months ensuring the discrepancies identified in the Report are rectified and the Broker has remained compliant during the said period. The limited scope audit may be conducted by the Exchange itself, which shall not alter or affect the Broker's normal selection process or timing through random balloting. The Exchange shall also provide a copy of such report of limited scope audit to the Commission within 15 days of conclusion of the same.

#### **6. SCOPE OF AUDIT**

The Auditor shall carry out the Audit to ensure compliance with the requirements of the Securities and Exchange Ordinance, 1969, the Securities and Exchange Rules, 1971, the Code of Conduct for Brokers as enshrined in the Third Schedule of the Brokers and Agents

Registration Rules, 2001, any other relevant Rules of the Commission, the Articles and Regulations of the Exchange including any modification or amendments made therein, any new Rules and/or Regulations made from time to time, and the directives/circulars/guidelines issued by the Commission/Exchange from time to time. However the scope of Audit shall at least include the minimum activities as specified in Schedule A hereof.

**7. AUDIT PERIOD**

The Audit period shall be preceding twelve months as specified by the Exchange.

**8. AUDIT PROCESS**

8.1 The Exchange shall intimate, by 31<sup>st</sup> JANUARY and 31<sup>st</sup> JULY of each year to the selected eligible Broker whose Audit is to be conducted as per these Regulations.

Within 30 days of intimation thereof, such Broker shall appoint an Auditor from the approved panel and submit the Auditor's declaration to the Exchange in the format prescribed by the Exchange from time to time.

8.2 If the Broker fails to appoint an Auditor within the time specified in these Regulations, the Exchange shall appoint the Auditor for such Broker within 14 days after expiry of the requisite time period and may impose a fine not exceeding Rs. 50,000/-.

8.3 Such Broker shall provide required access to the information and documents needed by the Auditor for the Audit and co-operate with the Auditor for timely and smooth completion of the Audit.

8.4 Such Broker shall require the Auditor for submission of the Report directly to the Managing Director of the Exchange in the format prescribed by the Exchange, within two months from the date of appointment of the Auditor.

8.5 The Exchange shall forward to the Commission copies of the Reports of the Brokers audited, along with the views, counter views and comments of the Brokers and the Exchange on the discrepancies/observations, within 45 days of submission of the Reports.

Provided that, if the Report highlights any material non-compliance by the Broker, such Report shall be immediately forwarded to the Commission.

**9. ENFORCEMENT ACTIONS**

9.1 If the Report identifies any non-compliance(s) including that of the Articles, Rules, Regulations and directives/notices/circulars/ guidelines of the Commission, Exchange etc., the Exchange may, after giving the Broker an opportunity of being heard and considering the severity and materiality of the non-compliances, take appropriate enforcement action including issuing warnings, imposing fines, suspension of membership rights with the approval of the Board etc. The Exchange may by order, direct the broker to pay a fine amounting to not less than Rs. 10,000/- but not exceeding Rs. 200,000/- per instance of non-compliance, in addition to the specific penalty/enforcement action as provided in the relevant law, rules and regulations.

9.2 If a Broker fails to co-operate with the Auditor, the Managing Director shall upon receiving a written complaint from the Auditor, call a hearing of the Broker and the Auditor and may issue a warning letter or may impose a fine 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 actions under the General Regulations of the Exchange.

9.3 If any Broker fails to pay the audit fees and charges within the specified time, the Exchange may impose a penalty on such Broker as it may deem fit.

9.4 Where the Exchange neglects or otherwise fails to take necessary action against a Broker, the Commission may *suo-moto* or on receiving any complaint after giving due opportunity of hearing to the Broker, impose penalties as provided under clauses 9.1 and 9.2 and take such other necessary action as deemed fit by the Commission.

**10. 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.

**11. SPECIAL AUDITS/ INVESTIGATIONS**

The Exchange in addition to the Audits conducted under these Regulations, may at any time, have a Broker audited/inspected/ investigated or itself conduct audit/inspect, with expanded, restricted or different scope or period of audit given in these Regulations.

**SCOPE OF AUDIT**

**1. Client level compliance**

Check the complete trail of following for selected clients.

1.1 The Standardized Account Opening Form (SAOF) of the selected clients is in compliance with the requirements of the General Regulations and any provision of such SAOF is not in contravention of the terms and conditions as laid down in the Annexure II to the General Regulations.

1.2 Obtain the understanding of Broker's Client Order mechanism.  
If the orders for sale or purchase of securities are taken verbally by the Broker, check that Broker is authorized to take verbal orders as per the SAOF or otherwise written instructions for orders for sale or purchase of securities to the Broker are available.

For telephonic orders, also match the telephonic recording with orders placed.

1.3 Check that Broker has mandatorily collected margins from his clients in accordance with the Regulations Governing Risk Management of the Exchange.

Further, applicable margins were available in the clients account and reflected in books of accounts in identifiable and verifiable manner at the relevant times.

1.4 Check that confirmations are transmitted within twenty-four hours of execution of client order and such confirmations complied with the requirements mentioned in General Regulations of the Exchange.

Further, duplicates or counterfoils of memos / confirmation issued to clients are preserved for a period of not less than five years.

1.5 Check that movements from clients' Sub-accounts through free-delivery facility are made in accordance with the CDC Regulations and/or after obtaining due authorization from clients.

1.6 Check that Broker has not pledged or deposited any security on account of a client as collateral in contravention of the Regulations of the Exchange and the CDC.

1.7 Check in respect of selected clients that all transactions for buying, selling in all markets, margins, payments, receipts, brokerage commissions charged, payable and receivable are recorded in records and books of accounts [manually or electronically] in timely, adequate, proper, identifiable and in a manner verifiable on UIN / Client Code basis.

1.8 Check that the Broker has maintained record of extension or maintenance of credit or arranging for the extension or maintenance of credit to the clients for the purpose of purchasing or carrying any security in compliance with the relevant rules and regulations.

1.9 Check that the Broker has maintained record of borrowing on any security or lending or arranging for the lending of any security carried for the account of the clients in compliance with the relevant rules and regulations.

1.10 Check that the Broker has maintained order register /KATS generated daily activity log and order log maintained by telephone recording, in compliance with the relevant rules and regulations.

1.11 The minimum suggested sample size for client level compliance is:

- 50% or 100 clients whichever is less, out of which there must be 50% "new clients" (client registered in last 12 months); and

- minimum 5 random orders at 5 different dates of each selected client are checked/confirmed with complete trail of steps from placement of order till settlement of securities in their respective accounts.

**2. Recording of Orders Placed through Telephone**

Check the following:

- 2.1 Clients' orders received and/ or confirmed via telephonic [landline] communications must be recorded in the manner specified by the Exchange.
- 2.2 Where orders are received by mobile phones, an appropriate and reliable recording of the time of receipt and order details are being maintained.
- 2.3 Effective procedures are in place to ensure the integrity, reliability and security of the telephone recording system and timely detection of any malfunctioning therein.
- 2.4 Adequate compliance monitoring is exercised over the office staff that is responsible for recording the telephone order instructions.
- 2.5 Telephone Recordings are being retained for a minimum period of six months or any other period specified by the Exchange and/or Commission. Further, in case of any complaint lodged by an investor, the Broker has retained the record of such investor till the resolution of the complaint.
- 2.6 All telephone lines under use of the traders, agents, dealers and authorized persons who are involved in trading, are connected to the telephone recording system of the Broker.

**3. Details to be Printed on Broker's Correspondence and Contract Notes**

Review that the Broker's correspondence /contract notes relating to the transactions of business contain the information as specified by the Exchange from time to time and bear the name of the Broker along with address of principal place of business, as per the Articles and relevant regulations of the Exchange.

**4. Registration with the Commission**

Review that the persons working as agents of the Broker have obtained certificate of registration from the Commission and such certificate of registration is being renewed every year.

**5. Branch Offices & Agents**

In case the Broker has any branch office for conducting the business and trading of securities within and outside premises of the Exchange:

- 5.1 Check that the Broker has obtained certificate of registration for all of its branch offices from the Exchange.
- 5.2 Check that the Broker has kept and maintained all the clients' related records/information of the Office/Branch Office at the Head Office.
- 5.3 Check that printed stationery of the Broker including confirmation/contract notes /cash memo/any other document is issued only in the Broker name along with address of principal place of business.  
  
Check that addresses of all offices/branches are clearly stated on such printed stationery.
- 5.4 Check that name of the Broker is prominently displayed outside the branch.
- 5.5 Check that Registration Certificate of Office/Branch Office is prominently displayed at the Office(s)/Branch Office(s).

- 5.6 Check that the Certificate of Registration of Manager as Agent with the Commission except in case of Member's Main Office is displayed.
- 5.7 Check that a board at a conspicuous place at the reception/front office is displayed which contains the requirements as mentioned in Regulations governing KSE Members' Office(s)/Branch Office(s) for conducting the business and trading of securities within and outside the Exchange.
- 5.8 a) Obtain list of all agents from the Broker and check that Broker properly maintains the register [manual or electronic form] of accounts of all agents.
  - b) Check that list of agents is matched with list of registered agents appearing in the records / website of the Exchange.
  - c) Review that all the managers of the branch offices have obtained certificate of Registration from the Commission and such Certificate of Registration is being renewed every year.
  - d) Verify the transactions to ensure that the agent does not deal with his clients in his own name. Dealing with clients includes receiving cash or cheque from the client in the agent's own name and issuing cash memos, receipts, delivery notes or any other document in his name.
- 5.9 Review the authority given to the agent or employee to perform all acts on behalf of the Broker.
 

Review the agreement with the agent specifying the scope of authority and responsibilities of the Broker and his agent.
- 5.10 Check that the business being done at the branch office is in the name of the Broker.
- 5.11 Check that the remedies available to investors and procedures for dispute resolution and arbitration in case of non-resolution of complaints are displayed at all times at a conspicuous location at the reception/front office of the Office(s)/Branch Office(s).
- 5.12 Check that branch offices bank accounts are maintained in the name of the Broker.
- 5.13 Check that customer accounts are properly maintained or electronically accessible at the branch offices.

## **6. Segregation of Clients' Assets**

Review compliance with the following as required in the General Regulations:

- a) Clear segregation of clients' assets from the Broker's assets.
- b) Maintenance of necessary records and books of accounts to distinguish clients' 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.
- 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.
- d) The clients' funds and securities are not used by the Broker for any purpose other than as authorized by the client in writing.
- e) The Broker has moved securities from Sub-Account of his Client to Collateral Account only after following the regulatory requirement mentioned in the relevant Regulations.

## **7. Trading by employees of the Broker**

- 7.1 Check that employees of the Broker who wish to trade have obtained prior written authorization from the Broker.



- 7.2 Check the Broker has registered all its employees into the UIN database with all registration details including their respective designations and updates / modifies the registration details whenever any change occurs.
- 7.3 Check that employees (who are trading) have submitted to the Broker a written undertaking of their understanding and willingness to strictly abide by all the relevant rules, regulations, codes and procedures as prescribed by the Commission, the Exchange, the Central Depository Company of Pakistan Limited and the National Clearing Company of Pakistan Limited.
- 7.4 Check that any mechanism is in place by the Broker to monitor their employees' trades regularly.
- 7.5 Check the Compliance Officer/Internal Audit Department of the Broker ensures compliance of relevant rules & regulations and any violation is communicated to Audit Committee/Chief Executive Officer of the Broker.

**8. Illegal Financing**

Check that Broker has not carried on any financing, borrowing, lending and pledging activity which is in contravention of applicable rules and/or regulations.

**9. Internet Trading**

If the Broker is providing Internet Trading services, check that the Broker has fully complied with the following in accordance with the Internet Trading Regulations of the Exchange:

- 9.1 The Broker has minimum net worth as prescribed in the Internet Trading Regulations.
- 9.2 The Broker has well-defined procedures for allowing clients' access to its Internet Based Trading System (IBTS) including agreement with the Broker, assigning of trading limits, placement and execution of clients' orders, mode and timing of reporting of trade confirmation to the clients and margin requirements and margin calls. Further, the above procedures are available in writing and on the Broker's website for easy access by the clients.
- 9.3 The Broker has maintained monthly reports on the reliability and compliance status of the IBTS.
- 9.4 The Broker has not continued to provide IBTS without a valid internet trading certificate which has not been suspended or cancelled during such period.
- 9.5 The Broker's Service Requirements are as per the requirements given in the applicable Regulations.
- 9.6 The Broker has sufficient infrastructure, internal control procedures and technological and security measures and its encryption technology complies with the minimum requirements as prescribed by the Exchange from time to time.
- 9.7 The Broker's website meets all requirements as stipulated under the Internet Trading Regulations of the Exchange.

**10. Leveraged Trading**

- 10.1 Check that no transaction is executed by the Broker on behalf of a client in the Leveraged Market unless an appropriate agreement has been executed between the broker and such client.
- 10.2 Check the Broker has fully disclosed all risks involved in the relevant transactions and has obtained a written confirmation from the client that they have understood and have the ability to bear the risks in such transactions.
- 10.3 Check that the Broker has fully disclosed and explained the options available to a client in respect of various financing facilities in the securities markets.

- 10.4 Check the Broker has evaluated the credit worthiness of the clients through a proper credit risk assessment methodology. Also check that credit limits are assigned to each client beyond which the client shall not be allowed to take a position in the Leveraged Market.
- 10.5 Check that adequate records are maintained by the broker, evidencing compliance with the obligations of the clause 42A of the General Regulations.
- 10.6 Minimum suggested sample size is 50 leveraged clients or 10% of leveraged clients whichever is lower.

**11. General Obligations of the Broker**

The Auditor shall also check the compliance in respect of the following:

- 11.1 The Broker has not advertised his business publicly unless permitted by the Exchange, as required by Clause C-4 of Code of Conduct of the Brokers and Agents Registration Rules, 2001;
- 11.2 All traders employed and working with the Broker meet the eligibility criteria mentioned in Rule 3(1) of Members' Agents and Traders (Eligibility Standards) Rules, 2001;
- 11.3 The Broker has not, without the special permission of the Board, taken into or continued in his employment in any capacity in any business carried on by him, a former Member who has been suspended or expelled, as required by the General Regulations;
- 11.4 The Broker has circulated research reports on securities only to its clients, joint stock companies and banks and such reports are not published in press and general circulation as required by the General Regulations;
- 11.5 The Broker has taken prior permission of the Board, to carry on business for or with a person who has been declared a Defaulter by the Exchange and notice regarding such prohibition has been issued by the Exchange;
- 11.6 As laid down in the General Regulations, the Broker has formulated and implemented an effective Know-Your Customer (KYC) and Customer Due Diligence (CDD) internal policy and framework in accordance with the guidelines issued by the Exchange with the prior approval of the Commission and any notices/circulars issued by the Commission from time to time. Further, the said policy has been appropriately communicated to all the agents and branches of the Broker and the Broker has ensured that the said policy is understood by the relevant personnel;
- 11.7 All provisions of the Anti-Money Laundering Act, 2010 (Act VII of 2010) and any rules and regulations made there-under are complied with at all times;
- 11.8 The Broker has activated SMS and E-alerts services provided by the CDC to its clients and has obtained written instructions along with the rationale from the selected clients who intentionally requested for not availing these services.

**12. Sampling Technique**

While selecting a sample for the verification, the Auditor shall use random sampling technique to ensure that the selected sample is true representative of the population and its result can reasonably be used to draw conclusion for the whole population.