

Regulations Governing System Audit (Regulatory Compliance) of the Brokers of Pakistan Mercantile Exchange Limited.

Whereas it is considered expedient to introduce Regulations for System Audit of brokers in order to ensure compliance with the requirements laid down under the Securities and Exchange Ordinance, 1969, (XVII OF 1969), the Commodity Exchange and Futures Contract Rules, 2005 as well as the directives and/or circulars issued by the Commission and with the Regulations and Articles of the Exchange as well as the directives and/or circulars issued by it in order to enhance investor confidence by ensuring fair dealings by the Brokers with their clients and to bring more transparency in such transactions.

NOW THEREFORE, the Pakistan Mercantile Exchange Limited in exercise of its powers conferred under section 34 of the Securities and Exchange Ordinance, 1969, framed, with prior approval of the Securities and Exchange Commission of Pakistan, the following regulations:

1. Short Title and Commencement

- a) These regulations may be called the “Regulations Governing System Audit (Regulatory Compliance) of the Brokers of Pakistan Mercantile Exchange Limited, 2012”.
- b) They shall come into force with immediate effect.

2. Definitions

- (1) 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, in accordance with the criteria approved by the Board with the prior approval of the Commission as per these Regulations or alternatively, the Commission may communicate to the Exchange minimum criteria to be adhered to for selection of the panel of Auditors;
 - d) “Broker” means a member who is registered with the Commission and is allowed to trade on the Exchange;
 - e) “Exchange” means Pakistan Mercantile Exchange Limited;
 - f) “Report” means the compliance report submitted by the Auditor under these Regulations;

(2) Words and expressions used in these Regulations in singular shall include plural and vice versa, words importing masculine gender shall be taken to include the female gender

and words importing natural persons shall be taken to include the artificial legal person(s).

(3) 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 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

(1) The Exchange shall declare from time to time, the panel of auditors that shall be eligible to conduct Audit of the Brokers. The panel would consist of at least 10 Auditors and would fulfill the following prerequisites:

- a) The Auditor shall be a firm of chartered accountants within the meaning of the Chartered Accountants Ordinance, 1961; and
- b) The Auditors shall satisfy the criteria devised by the Exchange from time to time in accordance with Regulation 2(1)(c) of these Regulations.

(2) The Exchange shall annually review the panel of Auditors to ensure ongoing eligibility of auditors on the panel in line with the criteria.

(3) No Auditor shall be appointed to conduct the Audit of a broker, if that Auditor has conducted the statutory 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.

(4) An officer designated by the Managing Director shall liaise with the Broker(s) and the Auditor(s) conducting the Audit of the Brokers.

(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

(1) All eligible Brokers, as defined in Regulation 4 above, shall be audited every year. On 1st January each year the Exchange shall determine the total number of Brokers becoming eligible for audit during the year and divide them by two to arrive at the equal number of Brokers to be audited in both halves of the year on the basis of their membership code.

(2) The Exchange shall intimate latest by 15th January and 15th July of each year to the selected eligible Brokers for appointment of an Auditor from the approved panel.

(3) Within 30 days of intimation thereof, such Broker shall appoint an Auditor as per Annexure B and submit the Auditor's declaration to the Exchange in the format prescribed by the Exchange from time to time.

6. Scope of Audit

The Auditor shall carry out the Audit to ensure compliance with requirements of the Securities and Exchange Ordinance, 1969, (XVII OF 1969), the Commodity Exchange and Futures Contract Rules, 2005 as well as the directives and/or circulars issued by the Commission and with the Regulations and Articles of the Exchange as well as the directives and/or circulars issued by it from time to time. However the scope of Audit shall, inter alia, include the minimum activities as specified in “Annexure A” to these Regulations.

7. Audit Procedure and Status of Compliance

- (1) The Audit period shall be preceding twelve months as specified by the Exchange including the quarter in which audit is being carried out.
- (2) The Auditor shall provide in its report the basis and rationale for selection of sample of information to be audited.
- (3) The Auditor shall also ensure that the Broker has rectified non-compliances identified in the previous Report and specify the areas along with the reasons where Broker has continued the non-compliance(s), if any.
- (4) The Auditor shall carry out the Audit in terms of the agreed upon procedures and in accordance with the scope defined in the Regulations and submit its Report as per the format prescribed by the Exchange directly to the Managing Director within 30 days from the appointment of the Auditor. The Auditor shall also forward a copy of the said report to the Broker.
- (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 Broker and the Exchange on the discrepancies/observations, within 15 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.

- (6) The 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.
- (7) The Broker shall rectify non-compliance(s) identified in the Report immediately.

8. Enforcement Actions

- (1) If the Report identifies any non-compliance(s) including that of the Articles, Rules, Regulations and directives/notices/circulars/guidelines of the Commission and/or Exchange, the Managing Director 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 Managing

Director 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.

- (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.
- (3) 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/-.
- (4) If the 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.
- (5) If the Auditor who has been appointed under these Regulations to conduct system audit fails to discharge his duties or does not carry out the system audit in accordance with the scope of the audit, the Exchange shall, upon giving an opportunity of hearing, remove the Auditor from the panel. Additionally, the Exchange shall refer the case to the Commission to initiate such action against the auditor as deemed appropriate by the Commission in the interest of the capital markets.
- (6) Where the Managing Director & the Exchange neglect or otherwise fail 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 8.1, 8.2, 8.3 and 8.4 and take such other necessary action against the Managing Director & Exchange as it may deem fit for such neglect and failure.

9. 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 on the date the auditor is appointed by the said broker, for onward payment to the Auditor.

10. 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.

Annexure A

SCOPE OF AUDIT

1. Client level compliance

Check the complete trail of following for selected Clients.

(i) The standardized Account opening Form (SAOF) and Risk Disclosure Document are in compliance with the requirements of the General Regulations and any provisions thereof are not in contravention of the terms and conditions laid down by the Exchange.

(ii) Check that the Broker entered into an agreement with each of his Clients, before allowing trading to these Clients and that such agreements specified the minimum condition specified by the Board.

(iii) Confirm that the Broker made the Client aware of the risk associated with the business in Futures Trading including any limitations on the liability and the capacity in which the Broker acts and the Client's liability thereon by issuing to the Client a copy of the Risk Disclosure Document as specified by the Exchange. Also confirm that the Risk Disclosure Document has been duly signed by the Client and maintained and retained by the Broker.

(iv) Check that the Broker issued trade confirmation for each and every online transaction undertaken by him on behalf of Clients within 24 hours in the format specified by the Exchange and acknowledgments thereof are also kept in record.

(v) Check that the Broker has not utilized funds of Clients for and on behalf of another Client or himself. Also ensure that the Broker has appropriate systems and controls in place to prevent from using funds of its Clients.

(vi) Check that the Broker deposited such amount as initial margin, including special, variation and additional margin on behalf of Clients, as specified by the Exchange.

(vii) Confirm that the Broker furnished to his selected Clients in writing such reports and at such intervals as specified by the Exchange.

(viii) Check that the Broker closed out an open position of a Client when a margin call or any other payment due is not complied with by the Client within time period specified by the Exchange.

2. Broker Level Compliance

Check the following for selected Clients.

(ix) Check that the Broker has maintained separate records of all his proprietary account transactions and those of his Clients, including orders from Clients for execution of transactions in all Future Contracts as well as acknowledgement thereof for five years. For the Clients on whose behalf orders are executed by the Broker, the Broker has

preserved the records of orders for transactions for such Client separately with the time and date of receipt of order, details of executed transactions and books of accounts relating to the same, for a period of last five years.

(x) Check that the Broker is compliant with the minimum Net Capital Balance & minimum Net Worth requirement.

(xi) Conform that the Broker has segregated for each of his clients all monies, securities and property received to margin and to guarantee or secure the trades on Commodity Futures Contracts of his Clients, including delivery obligations.

(xii) Check that the Broker maintained the necessary administrative and other systems, facilities, resources and expertise as required under Regulation 3.13 of the PMEX General Regulations of 2007.

(xiii) Check that the Broker has complied with the conditions stipulated in the notice of approval of its Membership and/or the certificate of registration as Broker.

(xiv) Confirm that the Broker has provided any information in respect of any of his key employees as required by the Exchange as and when applicable.

(xv) Confirm that the broker has paid to the Exchange contributions in respect of the settlement guarantee fund.

(xvi) Confirm that the Broker immediately notified the Exchange in writing upon happening of any of the instances as mentioned in Regulation 3.21 of the PMEX General Regulations of 2007.

(xvii) Check that the Broker is carrying on the business under his own name only.

(xviii) Check that the Broker has deposited the minimum security deposit amounts for obtaining the clearing privileges and in such manner as determined by the Exchange and any other requirements. Confirm that in respect of all Commodity Futures Contracts executed by the Brokers, it paid all applicable statutory fee, stamp duty, service tax, taxes and levies, in respect of all deliveries as well as Commodity Futures Contracts directly or indirectly to the concerned Government Departments.

(xix) Check that the Broker has not entered into a Commodity Futures Contract before trading therein had been commenced or after trading therein had been ended.

(xx) Confirm that the Broker has maintained a record of all his transactions in all Commodity Futures Contracts for five years. Further, that is has separate records of all proprietary account transactions and those of the Clients including orders from Clients for execution of transactions in Commodity Futures Contracts as well as acknowledgements thereof.

(xxi) Check that for the Clients on whose behalf orders are executed by the Broker, he preserves the records of orders for transactions for such Client separately with the time and date of receipt of order, details of executed transactions and books of accounts relating to the same, for a period of five years.

(xxii) Check that the Broker has segregated trading by him on his own account from that of his Clients in such manner as the Exchange has provided.

(xxiii) Confirm that for transaction entered into on behalf of the Director or an employee of the Broker or for transactions in which the Director or employee has beneficial interest, have been considered as proprietary trades of the Broker and margins were collected for each such transaction separately.

(xxiv) Confirm that the Broker has remained compliant with such terms and conditions as the Exchange has determined for granting permission to use the ETS.

(xxv) Check that the Direct Feed (from the trading system) is not marketed by the Broker or his employees to any person for any financial consideration or otherwise.

(xxvi) Check that the Broker has allowed only his Authorized persons to operate ETS.

(xxvii) Check that the Broker and his Authorized persons have ensured to maintain complete secrecy of their passwords/pin codes.

(xxviii) Check that the Broker and his Authorized persons have ensured complete safety against misuse of the software provided by the Exchange.

(xxix) Check that the Broker has not appointed a person as authorized person who is already appointed in this capacity by any other Broker.

(xxx) Check that the Broker is compliant with the specifications/descriptions of hardware, software and equipment and the specifications to carry out the required testing thereof in such manner and time as specified by the Exchange from time to time, which a Broker is required to strictly adhere to have connectivity with, or use of the ETS or any other trading system of the Exchange, to ensure compatibility and minimize/avoid technical issues arising out of incompatibility of hardware, software and equipment.

(xxxi) Confirm that the Broker has not entered into any Commodity Futures Contract on his own account, with his client, or with another Broker of the Exchange.

(xxxii) Check that the Broker has not collected the margins from the Clients not less than specified by the Exchange against their open positions within such time as may be specified by the Exchange.

(xxxiii) Check that Margin deposits received by the Broker from his Clients in any form as specified by the Exchange are accounted for and maintained separately in completely segregated accounts without any commingling between his own funds and his Clients

funds, or between any of his Client's, and used solely for the benefit of the respective Client's positions.

(xxxiv) Check that the Broker accepted margin deposits only in such form as permitted by the Exchange.

(xxxv) Confirm that the Broker maintained such banking arrangements with the designated clearing banks as specified by the Exchange so as to permit the transfer of funds and to maintain funds in a segregated manner between his own funds and the funds of his Clients.

(xxxvi) Check that the Broker obtained written request in advance from the Client for each account of such Client on the Broker's books that all open positions are to be completed by delivery which were not offset on the last day of trading. If any Client is unwilling or unable to provide such evidence, then the Broker liquidated the position on or before the last day of trading.

(xxxvii) Confirm that the Broker notified the Exchange of any incident, which may have endangered the Brokers' financial soundness or interfere with the Brokers ability to conduct his business in the best interest of the Exchange.

(xxxviii) Confirm that the Broker maintained such Books of Accounts, Registers, Statements and other Records, in physical form or electronically, as specified by the Exchange, or the Commission. All such documents and records are kept in good order and preserved at least for such period, as specified by the Commission.

(xxxix) Review that the Broker's correspondence/contract notes relating to the transactions of business bear the name of the Broker along with address of principal place of business.

(xI) Check that the Broker has not, without the special permission of the Commission, shared brokerage with or carried on business or made any deal for or with any Broker who had been suspended, expelled or declared a defaulter.

(xIi) Confirm that the Broker has not transacted business directly or indirectly for or with or executed a deal for an Authorized person of another Broker without the written consent of such employing Broker.

(xIii) Check that the Broker has not advertised for business purposes or issued regularly circular(s) or other business communication to persons other than his own Clients, without the inclusion of the Exchange specified disclaimer, as specified by the Exchange from time to time.

3. Risk Management

(xliii) Check that the Broker has contributed to and provided a minimum security deposit, as determined by the Board from time to time, to the settlement Guarantee Fund.

(xliv) Check that the Broker has paid to the Investor Protection Fund upon execution of his trades such charges as decided by the Board.

(xlv) Check that the Broker deposited initial, variation, or any additional margin or deposits with the Clearing House/Exchange through the designated Clearing Bank(s), as directed by the Exchange, within the specified time and in the specified manner.

4. Recording of Orders through Telephone

(xlvi) Clients' orders received and/or confirmed via telephonic (landline) communications are recorded in the manner specified by the Exchange.

(xlvii) Where orders are received by mobile phones, an appropriate and reliable recording of the time of receipt and order details are being maintained.

(xlviii) Effective procedures are in place to ensure the integrity, reliability and security of the telephone recording system and timely detection of any malfunctioning therein.

(xlix) Adequate compliance monitoring is exercised over the office staff that is responsible for recording the telephone order instructions.

(I) Telephone Recordings are being retained for a minimum period of two years 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.

(ii) 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.

5. Branch Offices and Authorized Persons

In case the Broker has any branch office/Authorized Person:

(ii) Check that the Broker has obtained certificate of registration for all of its branch offices and Authorized Persons from the Exchange.

(iii) Check that the Broker has kept and maintained all the clients' related records/information of the Office/Branch Office at the Head Office.

(iv) Check that printed stationery of the Broker including confirmation/contract notes/cash memo/any other document is issued only in the name of Broker along with address of principal place of business.

(Iv) Check that addresses of all offices/branches are clearly stated on such printed stationery.

(Ivi) Check that name of the Broker is prominently displayed outside the branch.

(Ivii) Check that registration certificate of Office/Branch Office is prominently displayed at the Office(s)/Branch Office(s).

(Iviii) Obtain list of all Authorized Persons from the Broker and check that Broker properly maintained the register (manual or electronic form) of accounts of all Authorized Persons.

(Iix) Check that the list of Authorized Persons matched with list appearing in the records / on website of the Exchange

(Ix) Verify the transactions to ensure that the Authorized Person does not deal with Clients in his own name.

(Ixi) Review the authority given to the Authorized Person or his employee to perform all acts on behalf of the Broker.

(Ixii) Review the agreement with the Authorized Person specifying the scope of authority and responsibilities of the Broker and his Authorized Person.

(Ixiii) Check that the business being done at the branch office is in the name of the Broker

(Ixiv) 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).

(Ixv) Check that branch offices bank accounts are maintained in the name of the Broker.

(Ixvi) Check that the accounts for all clients of the Broker are properly maintained or electronically accessible at the branch offices

6. Sampling Technique

(Ixvii) 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.

Annexure B

[ON THE LETTER HEAD OF THE BROKER]

To

[Name of Auditor]

[Address of Auditor]

Subject: Appointment as Auditor under the Regulations Governing System Audit (Regulatory Compliance) of the Brokers of Pakistan Mercantile Exchange Limited, 2012

With reference to your consent letter, we are pleased to appoint you as Auditor of [Name of the Broker] to carry out Audit under the Regulations Governing System Audit (Regulatory compliance) of the Brokers of Pakistan Mercantile Exchange Limited, 2012 (“System Audit Regulations”) for the period _____.

The purpose of the audit would be to ensure compliance with requirements of the Securities and Exchange Ordinance, 1969, (XVII OF 1969), the Commodity Exchange and Futures Contract Rules, 2005 as well as the directives and/or circulars issued by the Commission and with the Regulations and Articles of the Exchange as well as the directives and/or circulars issued by it from time to time. The scope of Audit shall, inter alia, include the minimum activities as specified in “Annexure A” of the system Audit Regulations (as enclosed for ready reference).

Kindly acknowledge receipt of the same.

Thanking you

[Name and Seal of the Broker]