

# Measures to Prevent Unauthorised Trades and Over-trading

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## Introduction

In March 2001, the SFC issued to all broker firms a paper entitled “Analysis of Misappropriation of Assets Cases”. At the same time, the SFC prepared for investors a leaflet entitled “Take Care of Your Money”, listing ten ways to protect their investment. These are initiatives to reduce fraudulent activities through the concerted actions of the SFC, broker firms and investors.

The SFC now wishes to provide advice on measures to prevent two other types of improper activities: unauthorised trades and over-trading.

Complaints and disputes in these two areas could be avoided or their incidence reduced if registered persons take the measures suggested below to protect themselves against improper conduct. **The SFC believes that failure to adopt these measures without any other compensating control may cast doubts on the effectiveness and adequacy of a firm’s internal control procedures and may reflect adversely on its fitness and properness. Where there is a dispute of fact between an investor and a broker firm, the SFC will generally be more inclined to draw an inference in favour of the investor and against the broker firm where these suggested control procedures are not in place.**

## Unauthorised trades

Allegations of unauthorised trades arise when the account holders dispute transactions on grounds that they have not placed the orders or they have not authorised the account executive or the third party to operate their account. Many of these allegations are not able to be supported by clear and strong evidence and the SFC must consider one person’s word against another’s. An account executive will assert that instructions or authorisations were given and a client will say they were not. Unless there is good circumstantial evidence to support the complaints, the SFC is often unable to form a view on the validity of the complaints that would allow it to be satisfied to the required standard.

There are several types of unauthorised trades. The most blatant type is where the account executive conducts his personal trades through the clients' accounts without the clients' knowledge. There are also cases where a registered person is alleged to have conducted trades on behalf of the client but in excess of authorisation. In some cases, these trades were conducted solely for generating more commission income for the account executives or for booking the account executives' own investment. There are also cases where these trades were conducted as part of a scheme to misappropriate the stocks or funds of the account holders. On the other hand, the SFC has encountered cases where the client allow his account to be used by the account executive or a third party but when losses were incurred in the account, and the party granted with the authorisation failed to take responsibility for the losses, the account holder alleges unauthorised trades.

Cases of unauthorised trading usually have some of the following features:

- The account holder has not provided any written authorisation to any third party to conduct trades in his account.
- The account holder has not provided any written authorisation to the account executive to conduct trades in his account on a discretionary basis but a verbal agreement is alleged.
- These cases are difficult to prove because there is no record of the orders being given by the account holder or the verbal authorisation.
- The trades cause loss to the account holder.
- The account holder claims that he was not aware of the trades as he did not review the contract notes and the statements of account sent by the broker firm or did not receive contract notes and statements.
- The matter was not brought to the attention of the management of the broker firm immediately after unauthorised trades were suspected by the account holder.
- There was no telephone record of the instructions placed with the account executive because no telephone recording system was installed, the tapes have already been recycled or the orders were placed through the account executive's mobile phone.

The existence of some of the above features would clearly be in breach of the requirement of the Code of Conduct for Persons Registered with the Securities and Futures Commission.

### **Advice to registered persons**

The following are some internal control measures that broker firms can take to reduce the risk of unauthorised trading.

- Ensure that all account executives are aware of the requirement that clients' written authorisation is needed for:
  - a third party to operate the account; or
  - the account executive to operate the account on a discretionary basis.
- Never allow a third party to operate a client's account, regardless of how close the relationship between the account holder and the third party is, unless there is written authorisation from the client.
- Ensure that both the client agreement and the broker firm's records have designated such accounts as "discretionary accounts" if the account holder has granted authorisation to the account executive to conduct trades in the account on a discretionary basis.
- Keep a proper record of clients' written trade authorisations.
- Ensure that a telephone recording system is installed. A broker firm should retain the original tapes containing the telephone records relating to the account in question until any dispute is completely resolved.
- Discourage the use by account executives of mobile phones or any phone that is not connected to the telephone recording system when accepting orders from clients. Where orders are received by mobile phone, record them in writing or by phoning them through to recorded lines as soon as possible, and record if possible the confirmation of such trades with the clients.
- Discourage hold mail arrangements. If a client really requires a hold mail service, a broker firm should pass the appropriate risk disclosure statement to the client and obtain his written acknowledgement before effecting the arrangement.
- Ensure that there is a segregation of front office and back office functions, including issuance of contract notes or statements of accounts to clients and the placement of orders for clients.
- Do not accept cash or third party cheques from persons other than the account holder for deposit into the accounts of the account holder.

- If clients are allowed to make payment directly to the bank account of the broker firm, the clients should be required to pass to the settlement department of the broker firm a copy of the deposit slip with the client's name, account number and signature written on it.
- All payments to clients should be crossed and made to the order of the clients only. A broker firm should mail or hand these cheques to clients or deposit them in the clients' designated accounts directly. A broker firm should not pass these cheques to the account executives.
- Circularise the clients on a routine basis to confirm their account balances.

The absence of arrangements of this type may reflect adversely on the management of a broker firm if allegations of unauthorised trading are made.

## **Over-trading**

To limit their exposures to cash account clients, broker firms usually set a limit for such trading in their accounts. Cash clients are expected to trade within the limit and settle the purchase on or before the settlement date. However, in a number of complaint cases, cash account holders were allowed to trade and make further substantial purchases of securities notwithstanding that the clients concerned had not settled, or fully settled, their earlier purchases by the settlement date. This practice, which in effect amounts to treating a cash account client as a margin account client, can lead to the following problems:

- The clients concerned (mostly retail clients) might not have been adequately aware of the greater degree of risks that they have undertaken, i.e., they might not have realised the effectively leveraged nature of their transactions.
- The clients might, as a result, be encouraged, to over-trade.
- The mode of trading in question might not be suitable for the cash clients concerned in the light of their investment experience, objectives and financial situation.
- The broker firm might not have adequately disclosed the risks involved to the clients.
- The broker firm's credit management system might not adequately monitor such leveraged "cash accounts".
- The broker firm might be subjected to much higher risks than it has anticipated for a cash client.

The SFC has also found that in a number of the complaint cases, broker firms placed little emphasis on the financial situation and investment objectives and experience of the clients concerned. Instead, broker firms have placed too much reliance on the credit standing of the account executives as it is a common industry practice for the account executives to enter into agreements with the broker firms for assuming the default risks of their clients. Such a practice may give rise to the following concerns:

- The broker firm's credit management system may not adequately capture the credit risks of such clients.
- The level of credit or trading limits granted to the clients might not be appropriate in the light of their investment experience, objectives and financial situation.
- The clients might, as a result, be encouraged, to over-trade.

#### **Advice to registered persons**

There are a number of internal control measures that broker firms can take to minimise the risk. They are as follows:

- Ensure that cash clients are not allowed to make additional purchases until they have settled the amount due.
- Closely monitor the accounts with overdue balance and consider liquidating the position if clients fail to settle within a reasonable period.
- Ensure account executives are fully aware of the broker firm's credit and settlement policies.
- Ensure that credit and settlement policies are adhered to.
- Ensure that any limit granted to clients takes into account their financial situation, investment experience and investment objectives.

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