



**SECURITIES AND
FUTURES COMMISSION**
證券及期貨事務監察委員會

Report on the review of internal controls for the protection of client assets and supervision of account executives

19 December 2018

Contents

A. Executive summary	2
B. Regulatory concerns	3
C. Background	5
D. Summary of findings	
I. Staff-related corporate policies	6
Remuneration structure and strategies	
Block leave and job rotation policies	
Training programmes	
II. Handling of client accounts	9
Account opening	
Amendments to clients' particulars	
Discretionary accounts	
Dormant accounts	
III. Monitoring of dealing activities	16
Handling of client orders	
Reviews of telephone records	
Staff and staff-related account trading	
IV. Safeguarding of client assets	20
Overall controls for client assets	
Involvement of AEs in handling client assets	
Direct confirmation of clients' account balances	
V. Handling of trade documents	23
Overall controls for handling of trade documents	
Follow-up procedures for undelivered or returned mail	
Hold-mail arrangements	
E. Way forward	26

A. Executive summary

1. Securities and futures brokers play a vital role in Hong Kong's financial markets as they serve a large number of investors and are entrusted with a significant amount of client assets. The vast majority of these brokers appointed account executives (**AEs**)¹ to provide brokerage services to their clients. The service quality and conduct of AEs therefore affect not only brokers' businesses but also client protection².
2. The Securities and Futures Commission (**SFC**) has identified cases of misconduct by AEs which have prejudiced clients' interests. The more serious cases involved unauthorised transactions in client accounts and misappropriation of client assets. These cases revealed serious internal control deficiencies in key operational areas and inadequate management supervision of AEs by licensed corporations (**LCs**).
3. The SFC therefore conducted a circularisation exercise³ and a thematic review last year to assess the adequacy of brokers' internal controls and management supervision over the activities of AEs. Most of the control deficiencies identified in the reviews had been identified in previous SFC circulars⁴, which is a further cause of our concern.
4. Deficiencies identified in brokers' internal controls demonstrated failures on the part of senior management to discharge their supervisory obligations over firms and staff (including AEs). This resulted in the recurrence of cases of misconduct including unauthorised trading. In particular, the SFC has concerns about deficiencies in remuneration arrangements, internal controls and management oversight of brokers including:
 - misaligned incentives for AEs which over-emphasise short-term sales targets, incentivising them to conduct improper activities;
 - insufficient segregation of duties where AEs were allowed to perform both front and back office duties, exposing firms and their clients to risks of undetected errors or abuses;
 - failures in establishing and implementing policies and procedures to prevent and detect fictitious accounts, improper or unauthorised trading activities in client accounts and misappropriation of client assets; and
 - failures in adopting risk-based sampling methods for compliance reviews to ensure effective and sufficient coverage of client accounts, and in having independent staff to follow up on any exceptions identified in these reviews.

¹ For the purpose of this report, AEs refer to the designated licensed representatives responsible for maintaining client relationships and providing trade-related services to clients of brokers.

² General Principle 8 and paragraphs 4.3 and 11.1 of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**).

³ For details, please refer to the circular "SFC notifies the industry of a circularization exercise on clients' accounts" dated 28 July 2017.

⁴ See the "Circular to Licensed Corporations Licensed for Dealing in Securities – Protecting Client Assets Against Internal Misconduct" dated 5 February 2016, "Circular to Licensed Corporations – Guarding against Risk of Client Asset Misappropriation" dated 1 February 2013, "Circular to All SEHK Exchange Participants – Reminder to ensure compliance with key requirements" dated 17 December 2008, "Circular to All Licensed Corporations Licensed for Dealing in Securities – Continuous and Close Supervision of Firm's Operations" dated 8 March 2006 and the "Circular to All Securities Dealers – Segregation of Duties" dated 22 July 2002.

5. The SFC wishes to reiterate the responsibility of the Board and senior management of LCs, including their Managers-In-Charge of the Overall Management Oversight and Key Business Line functions, to maintain effective oversight of the business activities of the firm and its staff. To assist senior management of securities and futures brokers to review and improve the firms' internal controls and supervision over AEs, we posted on our website⁵ a comprehensive self-assessment checklist of the expected control measures and good practices identified in the reviews.
6. This report, together with the self-assessment checklist and our Circular to licensed corporations – *Review of internal controls for the protection of client assets and supervision of account executives*, also issued today, provides guidelines on the standards of controls expected of LCs which are securities and futures brokers. These LCs should carefully review their internal controls to ensure compliance with regulatory requirements and, based on the results of their reviews, enhance their policies and procedures.
7. It should be noted that the observations and control measures mentioned in this report are not exhaustive. LCs should consider other appropriate measures, taking into account the nature, size and complexity of their business operations as well as the risks the firms and their clients are exposed to. Comprehensive reviews of internal controls should be conducted regularly, especially when there is a significant change in their business operations, circumstances or risks.
8. Where an LC's senior management fails to ensure compliance by the firm and its staff with regulatory rules and requirements, they could be held accountable for the non-compliance, and the SFC will not hesitate to take disciplinary action (eg, licence revocations or suspensions, pecuniary fines and reprimands) against them⁶.

B. Regulatory concerns

I. Misaligned incentives in remuneration systems

9. The majority of the AEs of the Reporting Firms were remunerated mainly or solely by variable pay, which was determined by the commission income or turnover they generated, without taking conduct and service quality into account. LCs are encouraged to avoid over-emphasising short-term sales targets in their remuneration policies. They should establish a reward system to align the firms' interests with those of AEs and their clients to incentivise good behaviour and improve the overall client experience and the firms' compliance culture.
10. Examples of reward systems which promote good behaviour include:

⁵ See <http://www.sfc.hk/edistributionWeb/gateway/EN/circular/openAppendix?refNo=18EC94&appendix=1>.

⁶ See the "Circular to Licensed Corporations Regarding Measures for Augmenting the Accountability of Senior Management" dated 16 December 2016.

- variable pay which incorporates an element of service quality to encourage positive client outcomes. For example, commissions can be reduced if there are substantiated complaints from clients about an AE's service or conduct; and
- mechanisms for reducing or clawing back variable pay to help mitigate risks which are inherent in sales-based remuneration schemes. For example, commissions can be reduced where an AE deviates from the firm's internal policies or is in breach of regulatory requirements.

II. Insufficient segregation of duties

11. Some Reporting Firms and sampled firms in the Circularisation Review allowed AEs to perform incompatible duties, for example:

- handle clients' requests for asset withdrawals from their accounts;
- collect cash, cheques and physical scrip from or on behalf of clients;
- process amendments to client information;
- investigate exceptions in telephone record reviews; and
- follow up on undelivered or returned trade documents.

12. Key duties and functions should be appropriately segregated, particularly those which when performed by the same individual may result in undetected errors or may be susceptible to abuses which may expose the firm or its clients to inappropriate risks. LCs should implement compensating controls if complete segregation is not practicable. In addition, LCs should request that clients directly submit their instructions and supporting evidence to the settlement department for withdrawals of client assets and amendments to personal particulars to prevent unscrupulous staff taking advantage of the process.

III. Inadequate controls to protect client accounts

13. The two reviews identified a number of deficiencies in controls to protect client accounts:

- a number of firms in the Circularisation Review did not establish written policies and procedures or implement maker-checker controls in various key operational areas;
- some firms were lax in controls over changes to clients' particulars;
- some firms did not have adequate reviews to identify clients' suspicious correspondence addresses;
- some firms did not identify dormant accounts or perform regular reviews of these accounts to prevent them from being misused;
- some firms did not have adequate control measures for hold-mail arrangements for clients; and
- some Reporting Firms regarded AEs as self-employed and did not subject them to their staff dealing policies to monitor trading activities in their personal or related accounts and ensure that those transactions were not prejudicial to the interests of clients.

14. LCs are expected to establish and enforce effective policies, procedures and control measures in the above areas to prevent and detect any fictitious accounts, improper or unauthorised trading activities and misappropriation of client assets.

IV. Insufficient compliance checks of client accounts

Reviews of telephone records

15. The majority of the Reporting Firms only adopted random and sequential sampling methods for their compliance reviews of telephone records. By solely relying on these methods, they may be unable to prioritise resources to review client accounts which are exposed to a higher risk of error or abuse (for example, client accounts with frequent trade amendments, trade cancellations, error trades and numbers of transactions which are inconsistent with telephone records, all of which could be indications of unauthorised trading or other improper activities). This reduces the effectiveness of the reviews. LCs should adopt a risk-based sampling method, in addition to random and sequential samplings, in their compliance reviews to ensure effective and sufficient coverage of client accounts.
16. In addition, a number of the Reporting Firms did not directly contact the clients concerned or arrange for independent staff to follow up on discrepancies identified in the reviews of telephone records. Those discrepancies are red flags indicating non-compliance and misconduct and independent staff should therefore properly follow up. Where appropriate, LCs should also arrange for independent staff to directly confirm account balances and transactions with affected clients, and assess whether other client accounts handled by the same AEs were also affected so as to promptly uncover any errors or unauthorised transactions.

Direct confirmation of clients' account balances

17. The Thematic Review found that most Reporting Firms did not regularly carry out confirmation exercises, other than those carried out for annual statutory audit purposes, for clients' account balances and transaction details.
18. LCs should adopt this control measure and apply a risk-based sampling method, in addition to random sampling, to ensure the effectiveness of confirmation exercises. They should duly follow up on any discrepancies identified in the exercises.

C. Background

19. Last year, the SFC engaged an accounting firm to perform a circularisation exercise covering 11 small to medium-sized securities brokers. The exercise included a high-level on-site review of these firms' internal controls for protecting client assets, including the maintenance of client information and handling of client assets and trade documents (**Circularisation Review**).

20. Separately, a thematic review was conducted to understand brokers' internal controls and supervision of AEs (**Thematic Review**). It covered 35 brokerage groups comprising 66 securities and futures brokers (**Reporting Firms**) which mainly served retail clients through AEs and were all local brokers licensed for dealing in securities or futures contracts, or both. Each brokerage group served more than 3,000 active clients⁷ and employed at least 50 licensed representatives as at 30 June 2017 (**Reporting Date**).
21. The Thematic Review was conducted by way of: (1) a questionnaire to collect information about the Reporting Firms' profile and internal control policies as at the Reporting Date; (2) follow-up enquiries or meetings with the Reporting Firms' senior management; and (3) a sample review of the Reporting Firms' documents. The questionnaire included questions in the following five areas. Control measures were listed under each question for the Reporting Firms to indicate whether they had such controls in place.
- I. Staff-related corporate policies
 - II. Handling of client accounts
 - III. Monitoring of dealing activities
 - IV. Safeguarding of client assets
 - V. Handling of trade documents
22. The Circularisation Review identified a number of control deficiencies in protecting client assets among the 11 firms selected for the review, while the Thematic Review provided a general understanding about the controls in the Reporting Firms' key operational areas, including their supervision of AEs' activities. Some good practices were also identified in the Thematic Review. The findings of the Circularisation Review and the Thematic Review are summarised in Part D of this report.

D. Summary of findings

I. Staff-related corporate policies

Expected standards

A firm's remuneration structure and strategies can drive performance and change behaviour. With a remuneration structure based largely on variable pay and a remuneration strategy over-emphasising AEs' short-term performance, AEs may be tempted to conduct improper activities such as churning and conducting unauthorised trading in client accounts. As such, LCs are encouraged to properly design their remuneration systems to align the firms' interests with those of AEs and their clients.

In addition, an LC's senior management, including its Managers-in-Charge, should

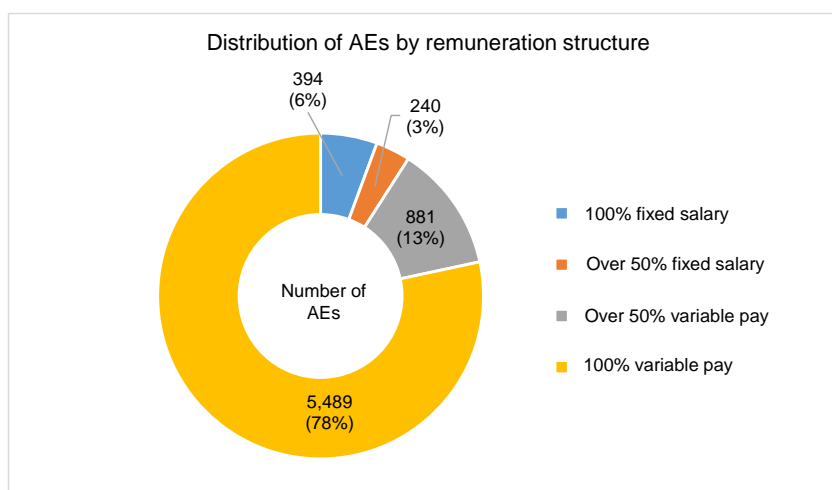
⁷ For the purpose of this report, active clients refer to clients who executed securities or futures contracts transactions through an LC or had assets under the LC's custody during the reporting period as specified in the questionnaire.

bear the primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the firm⁸. They are expected to, among other things:

- *establish appropriate personnel recruitment and training policies, giving adequate consideration to staff's training needs to ensure compliance with the firm's operational and internal control policies and procedures as well as all applicable legal and regulatory requirements to which the firm and its staff are subject⁹; and*
- *review staff's leave plans or records and evaluate whether staff resources are adequate to allow them to take leave¹⁰, including a number of consecutive calendar days of leave each year in a block.*

Remuneration structure and strategies

23. Based on the questionnaire responses, 91% of the AEs of the Reporting Firms were mainly or solely remunerated by variable pay (comprising commission, performance bonus and discretionary bonus):

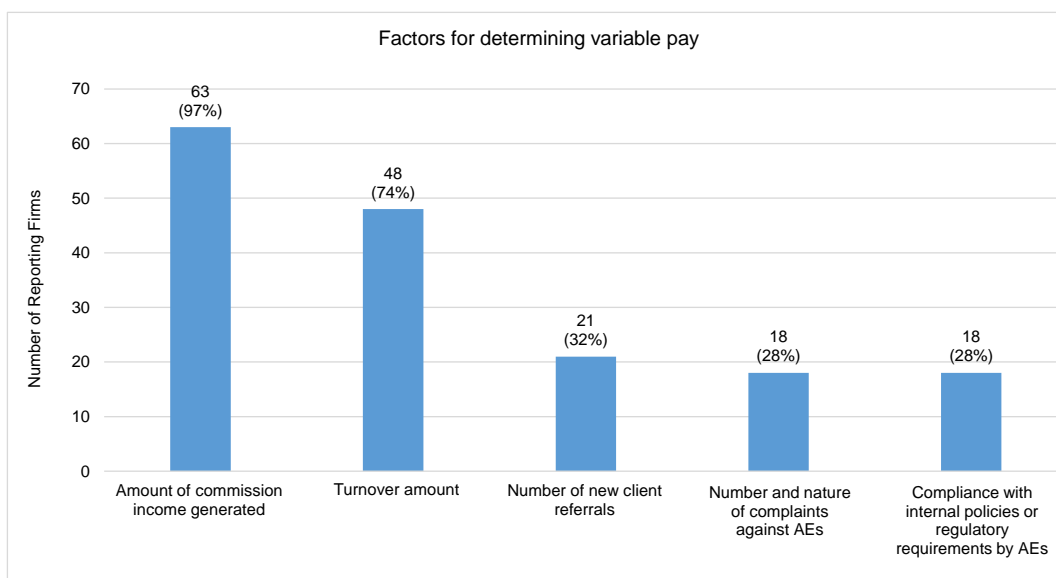


24. As shown in the chart below, in determining AEs' variable pay, most Reporting Firms took sales-related factors such as commission income and turnover generated by AEs as key considerations:

⁸ General principle 9 of the Code of Conduct.

⁹ Part III of the Management, Supervision and Internal Control Guidelines For Persons Licensed By or Registered with the SFC (**Internal Control Guidelines**).

¹⁰ Paragraph 1(n) of Appendix 2 to the "Circular to Licensed Corporations Licensed for Dealing in Securities – Protecting Client Assets Against Internal Misconduct" issued on 5 February 2016.



Note: The percentages above are calculated based on the 65 Reporting Firms which reported remunerating AEs solely or partially by variable pay.

25. Only 18 or 28% of the Reporting Firms indicated that they considered non-sales-related factors such as AEs' compliance with internal policies and regulatory requirements and service quality (as indicated by the number and nature of client complaints against them) in determining the amount of variable pay.

Examples of good practices

Some Reporting Firms took non-sales-related factors into consideration when determining the remuneration of AEs. One Reporting Firm which introduced compliance-related factors into its variable pay system in recent years advised during our follow-up meeting that its AEs' attitude towards compliance had noticeably improved.

Block leave and job rotation policies

26. Forty-four or 67% of the Reporting Firms reported having block leave and job rotation policies for staff members. Among them, only about half also applied such policies to AEs. Some Reporting Firms expressed concerns that adopting these policies might adversely affect the standard of services to clients.

Examples of good practices

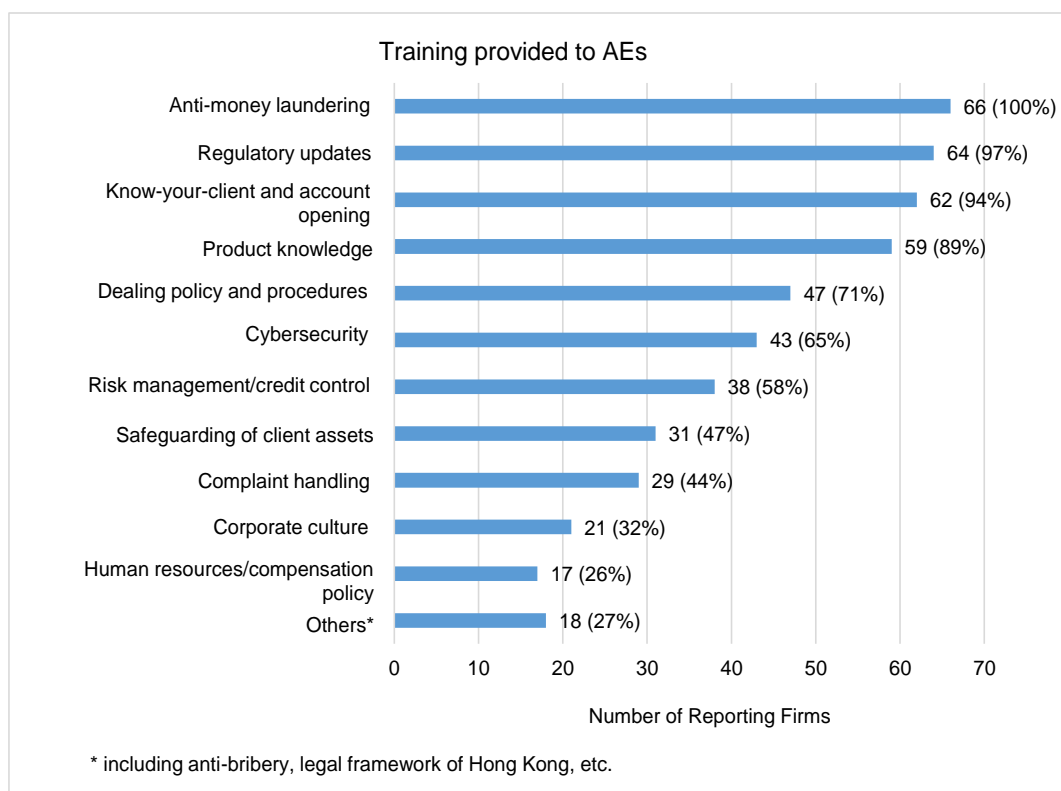
Some Reporting Firms advised that they would arrange back-up support for AEs and other staff to facilitate the taking of block leave or job rotations. These firms believed that the policies were useful to detect fraud and help uncover improper activities.

Training programmes

27. The Reporting Firms indicated that they offered internal induction and regular training sessions as well as external seminars and workshops to AEs. In addition to classroom training, the Reporting Firms also provided updates or reminders of internal policies and regulatory requirements to AEs through internal circulars and memos. Forty-two or 64% of the Reporting Firms maintained AEs' training records and ensured that they

understood the firms' internal policies and regulatory requirements through assessment quizzes.

28. The Reporting Firms were also requested to indicate the topics in which they offered training to AEs during the Reporting Period¹¹:



29. A wide range of training programmes were offered to AEs and the top three topics were anti-money laundering, regulatory updates as well as know-your-client and account opening.

Examples of good practices

A number of Reporting Firms provided training on their corporate culture to AEs to articulate the behaviour expected of them. Some Reporting Firms also shared the SFC's enforcement news with AEs to dissuade improper conduct.

II. Handling of client accounts

Account opening

Expected standards

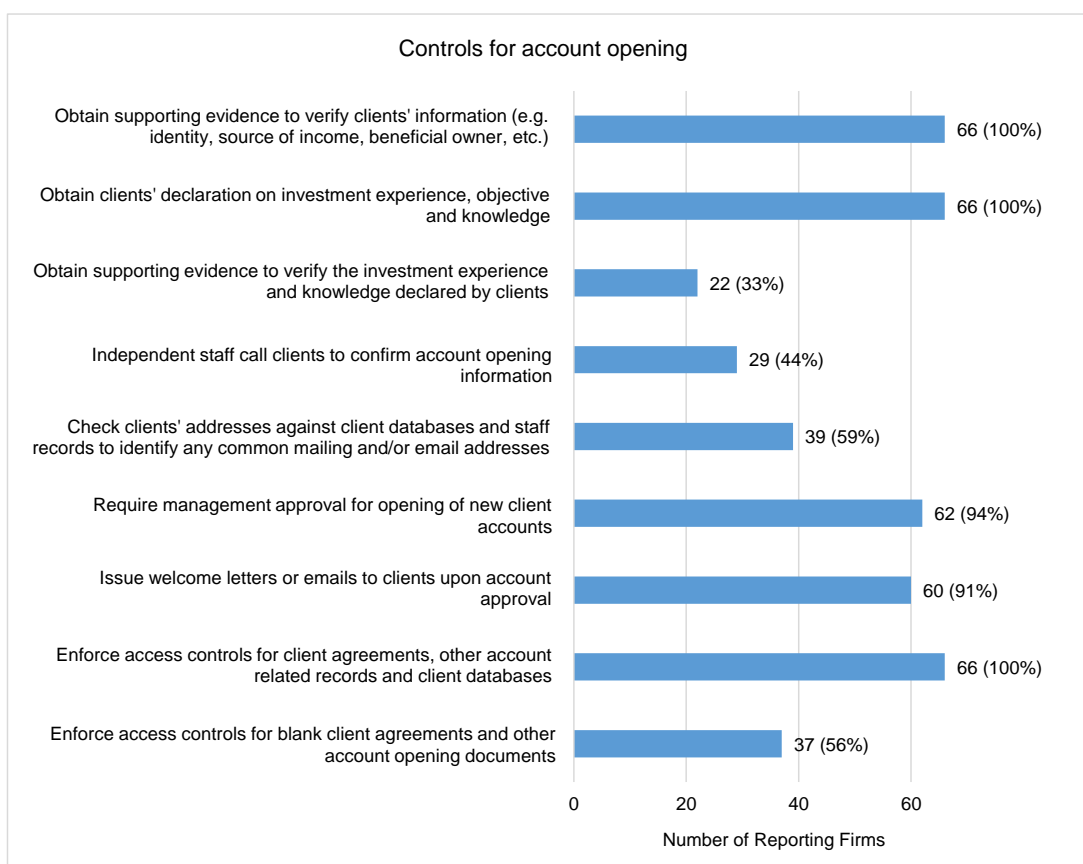
LCs are required to take all reasonable steps to establish the true and full identity of each of their clients, and of each client's financial situation, investment experience

¹¹ For the 12-month period ended 30 June 2017.

and investment objectives¹². LCs are expected to, among other things:

- clearly define and follow mandatory account opening procedures which include recording and keeping all client information and supporting documentation as well as approval of new accounts by designated staff¹³;
- review clients' addresses for anomalies such as the use of the same address by different clients¹⁴; and
- restrict access to client agreements and account opening documents¹⁵.

30. The Reporting Firms were requested to indicate whether the following control measures were in place:



31. The above chart shows that most Reporting Firms put in place a number of basic control procedures for account opening, for example:

¹² Paragraph 5.1 of the Code of Conduct.

¹³ Paragraph A1 of Appendix to the Internal Control Guidelines.

¹⁴ Paragraph 1(h) of Appendix 2 to the "Circular to Licensed Corporations Licensed for Dealing in Securities – Protecting Client Assets Against Internal Misconduct" dated 5 February 2016.

¹⁵ Paragraph 13 of the Suggested Control Techniques and Procedures for Enhancing a Firms' Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules published in April 2003 (**Suggested Control Techniques and Procedures**) and paragraph 1(l) of Appendix 2 to the "Circular to Licensed Corporations Licensed for Dealing in Securities – Protecting Client Assets Against Internal Misconduct" dated 5 February 2016.

- all firms had procedures to verify clients' identities and obtain information about clients' investment experience, objectives and knowledge;
- 94% of the firms sought management approval for opening new client accounts;
- 59% of them checked whether a client's mailing or email address was the same as those of other clients; and
- all firms had access controls to protect client account information.

32. Nevertheless, the Circularisation Review identified a number of control deficiencies in the account opening processes of the 11 sampled firms:

- two firms did not establish written policies and procedures for account opening;
- six firms had inaccurate or incomplete information in their client databases which revealed inadequate checks of the client information input process; and
- eight firms either lost or did not securely keep clients' account opening-related documents such as client agreements and copies of clients' identity documents.

Examples of good practices
Some Reporting Firms put in place robust controls to prevent and detect fictitious accounts. For example, staff who were independent of the front office called clients to confirm their account opening information, compared clients' addresses with staff records (in addition to comparing them with client databases) to identify suspicious sharing of correspondence addresses, issued welcome letters or emails to clients to confirm the opening of the account and implemented access controls for blank client agreements and other account opening documents.

Amendments to clients' particulars

<i>Expected standards</i>
<i>LCs should handle requests to amend internal records of clients' particulars with due care to ensure that they are genuine. A fraudster may divert a client's trade documents to another address to conceal improper trading activities or other transactions in the client's account.</i>
<i>Effective controls should be established for handling clients' requests to amend their particulars, including:</i>
<ul style="list-style-type: none"> ▪ <i>amendments to client particulars are properly supported by clients' written instructions¹⁶;</i> ▪ <i>clients' addresses are reviewed for anomalies such as the use of the same address by other clients¹⁷;</i> ▪ <i>designated staff review and approve these amendments, along with supporting documentation¹⁸;</i> ▪ <i>maker-checker controls are put in place to minimise inaccurate or incomplete</i>

¹⁶ Paragraph 3(b) of the Suggested Control Techniques and Procedures and paragraph 2(b) of Appendix 2 to the "Circular to Licensed Corporations Licensed for Dealing in Securities – Protecting Client Assets Against Internal Misconduct" dated 5 February 2016.

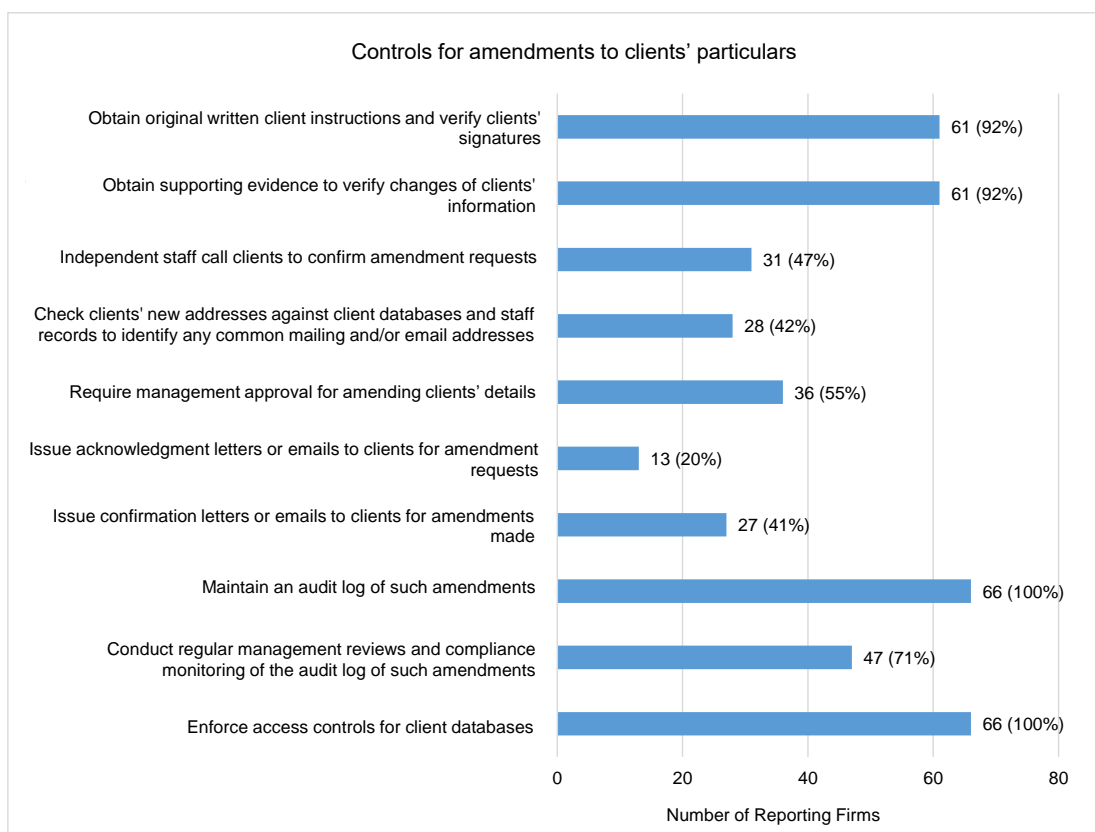
¹⁷ Paragraph 1(h) of Appendix 2 to the "Circular to Licensed Corporations Licensed for Dealing in Securities – Protecting Client Assets Against Internal Misconduct" dated 5 February 2016.

¹⁸ Paragraph A1 of Appendix to the Internal Control Guidelines.

recording of client information in client databases¹⁹; and

- *audit logs of changes to computer databases, including client databases, are regularly reviewed²⁰.*

33. The Reporting Firms were requested to indicate in the questionnaire their control procedures for effecting amendments to their internal records of clients' particulars. Their responses are summarised below:



34. The majority of Reporting Firms obtained original written instructions and supporting evidence from clients to effect amendments to their internal client records. All of them enforced access controls for client databases. Around half of the Reporting Firms also checked new addresses reported by clients against client databases to identify any common correspondence addresses which might indicate irregularities. However, it was noted that while all Reporting Firms maintained audit logs for amendments to clients' particulars, only 71% of them conducted regular management reviews and compliance monitoring of the audit logs.

35. The Circularisation Review also noted a number of control deficiencies relating to amendments to clients' particulars in all 11 of the sampled firms:

- four firms did not have written policies and procedures in place;

¹⁹ Paragraph 7 of the Suggest Control Techniques and Procedures.

²⁰ Paragraph 1(m) of Appendix 2 to the "Circular to Licensed Corporations Licensed for Dealing in Securities – Protecting Client Assets Against Internal Misconduct" dated 5 February 2016.

- one firm changed clients' information based on a written form signed by the client's AE and some firms failed to obtain signed client instructions for the amendments;
- seven firms had no maker-checker controls for amending information in client databases; and
- seven firms did not maintain an audit log for changes to clients' particulars, and one firm which had an audit log did not perform management reviews of it.

Examples of good practices
Some Reporting Firms arranged independent staff to call clients to confirm the amendment requests, checked clients' new addresses against staff records (in addition to checking them against client databases) to identify suspicious sharing of correspondence addresses and issued acknowledgement or confirmation letters or emails to clients for amendment requests and amendments made.

Discretionary accounts²¹

<i>Expected standards</i>
<i>Discretionary account arrangements are susceptible to abuse. It is therefore important for LCs to put in place stringent controls and maintain oversight of these arrangements.</i>
<i>LCs are required to obtain approval from senior management for opening discretionary accounts, designate such accounts as "discretionary accounts" for monitoring purposes and confirm with clients at least annually whether such authorities would be renewed or revoked. In addition, LCs are required to implement internal control procedures to ensure proper supervision of the operation of discretionary accounts²², including:</i>
<ul style="list-style-type: none"> ▪ <i>set out the clients' investment objectives and strategies and the precise terms and conditions under which such discretion will be exercised²³;</i> ▪ <i>establish surveillance systems to monitor trading activities in discretionary accounts;</i> ▪ <i>ensure that only transactions which are consistent with the clients' investment objectives and strategies are effected on their behalf²⁴; and</i> ▪ <i>have independent staff regularly review the performance of discretionary accounts²³.</i>

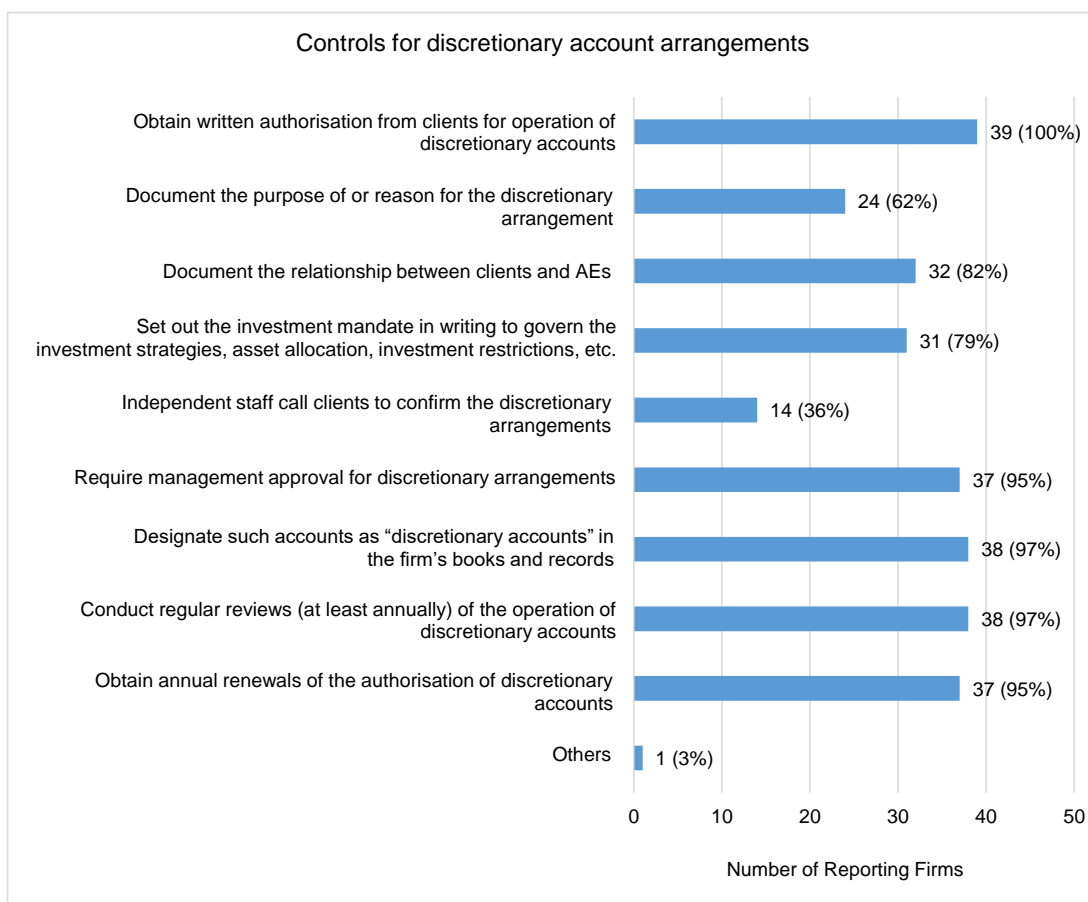
36. A total of 39 Reporting Firms provided discretionary trading services to clients as an ancillary part of their brokerage services as of the Reporting Date. They were requested to indicate in the questionnaire the types of internal controls they put in place for authorising and operating discretionary accounts:

²¹ For the purpose of this report, discretionary accounts refer to those accounts held with an LC where clients have authorised the firm or its licensed persons to effect transactions for the clients without their specific authorisation for each transaction.

²² Paragraph 7.1 of the Code of Conduct.

²³ Paragraph A2 of Appendix to the Internal Control Guidelines.

²⁴ Paragraph 2 of Part VII to the Internal Control Guidelines.



Note: The percentages above are calculated based on the 39 Reporting Firms which reported having discretionary accounts.

37. It was noted that the majority of Reporting Firms in the Thematic Review were able to meet the regulatory requirements for authorising and operating discretionary accounts. However, of the 11 firms sampled in the Circularisation Review, a number of deficiencies were identified in the seven which operated discretionary accounts for clients:

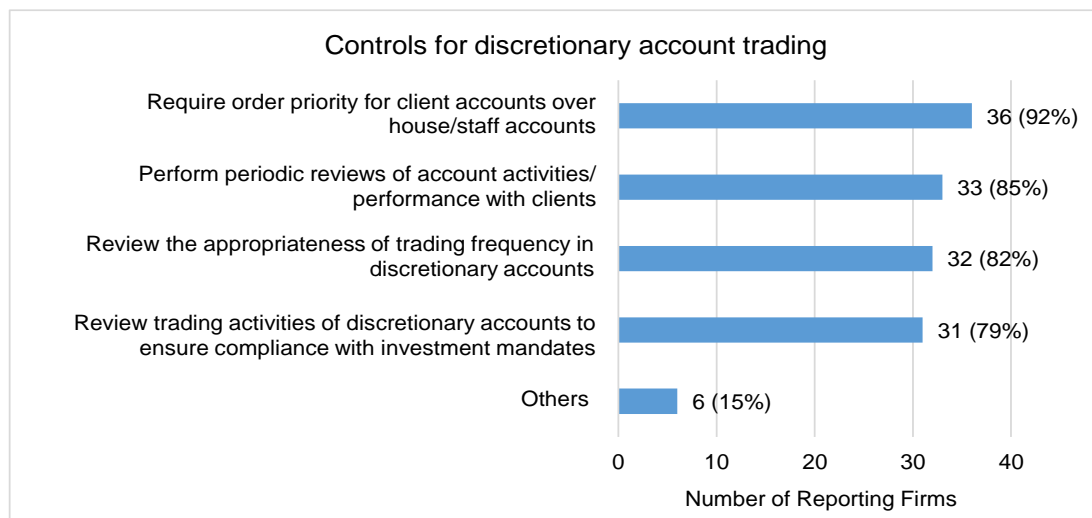
- three firms did not establish written policies and procedures regarding the handling of discretionary accounts;
- four firms failed to maintain records to demonstrate that clients' investment objectives and strategies or annual renewals of discretionary authority were obtained from clients; and
- three firms did not properly designate such accounts as discretionary accounts.

Examples of good practices

Some Reporting Firms which allowed discretionary account arrangements went one step further by enquiring into the reasons for clients to grant the discretionary authority to their AEs, as well as the relationship between them and the AEs, in order to assess the appropriateness of such arrangements.

Some Reporting Firms also arranged for independent staff to call clients to confirm discretionary arrangements and restricted the number of discretionary accounts managed by each AE.

38. Discretionary accounts are susceptible to abuse such as churning and front running. The questionnaire enquired as to how the Reporting Firms monitored the activities in discretionary accounts. Their responses are summarised below:



Note: The percentages above are calculated based on the 39 Reporting Firms which reported having discretionary accounts.

39. The majority of Reporting Firms performed regular reviews of the trading activities of discretionary accounts including order priority, account performance, trading frequency and compliance with investment mandates.

Examples of good practices
Some Reporting Firms required AEs to record the rationale for executed transactions in discretionary accounts and provided the rationale to clients. They also identified discretionary accounts with funds deposited from or withdrawn to third parties for further review.
Some Reporting Firms also conducted periodic reviews of account activities and performance with discretionary account clients or regularly confirmed account balances with them.
One Reporting Firm which prohibited discretionary account arrangements regularly checked for any undisclosed discretionary accounts by comparing executed trades with telephone records.

Dormant accounts

<i>Expected standards</i>
<i>LCs should establish policies and procedures to identify dormant accounts and properly and regularly review the trading activities and other transactions in these accounts to identify irregular movements²⁵.</i>

²⁵ Paragraph 1(c) of Appendix 2 to the “Circular to Licensed Corporations Licensed for Dealing in Securities – Protecting Client Assets Against Internal Misconduct” dated 5 February 2016.

40. Fourteen out of the 66 Reporting Firms in the Thematic Review reported having no dormant account policies in place. Among the 52 Reporting Firms which had such policies, 39 or 75% classified client accounts as dormant if there were no trading activities in the accounts for a prescribed period, ranging from six months to over three years. However, only 24 firms regularly reviewed dormant accounts to identify irregular movements.
41. Similar to the findings of the Thematic Review, the Circularisation Review found that seven out of the 11 firms under review did not establish any dormant account policies and procedures. The remaining four firms which had such policies in place did not regularly identify dormant accounts nor maintain any documentation of their reviews of the trading activities and other transactions in these accounts.

Examples of good practices

Most Reporting Firms suspended trading and asset movements in dormant accounts to prevent unauthorised access. Reactivation of suspended accounts required that independent staff confirm reactivation with clients and obtain management approval.

III. Monitoring of dealing activities

Handling of client orders

<i>Expected standards</i>

<i>LCs should establish and maintain policies and procedures which ensure that client orders are handled in a fair and equitable manner²⁶. They should also have controls in place to ascertain the origination of client orders, including the authority of the person placing the order and the applicable account limits, and they should confirm the essential features of the transaction promptly with the client²⁷.</i>
--

<i>In addition, LCs should establish and maintain appropriate and effective procedures for dealing and review processes to prevent or detect errors, omissions, fraud and other unauthorised or improper activities, and ensure the fair and timely allocation of trades effected on behalf of clients²⁸.</i>
--

42. The questionnaire sought responses from the Reporting Firms on their implementation of controls for handling client orders. All Reporting Firms had a number of such controls in place, including verifying clients' identities before order acceptance, confirming executed trades, imposing position or trading limits and requiring management approval for overriding such limits. Most Reporting Firms also indicated that controls were in place for effecting changes to executed transactions. For example, they required management approval for trade cancellations and amendments and did not allow reallocations of transactions to different client accounts.

²⁶ Paragraph 6 of Part VII of the Internal Control Guidelines.

²⁷ Paragraph 8.2(a) of the Code of Conduct and paragraph 6 of Part VII and paragraph A7 of Appendix to the Internal Control Guidelines.

²⁸ Paragraph 8 of Part VII of the Internal Control Guidelines.

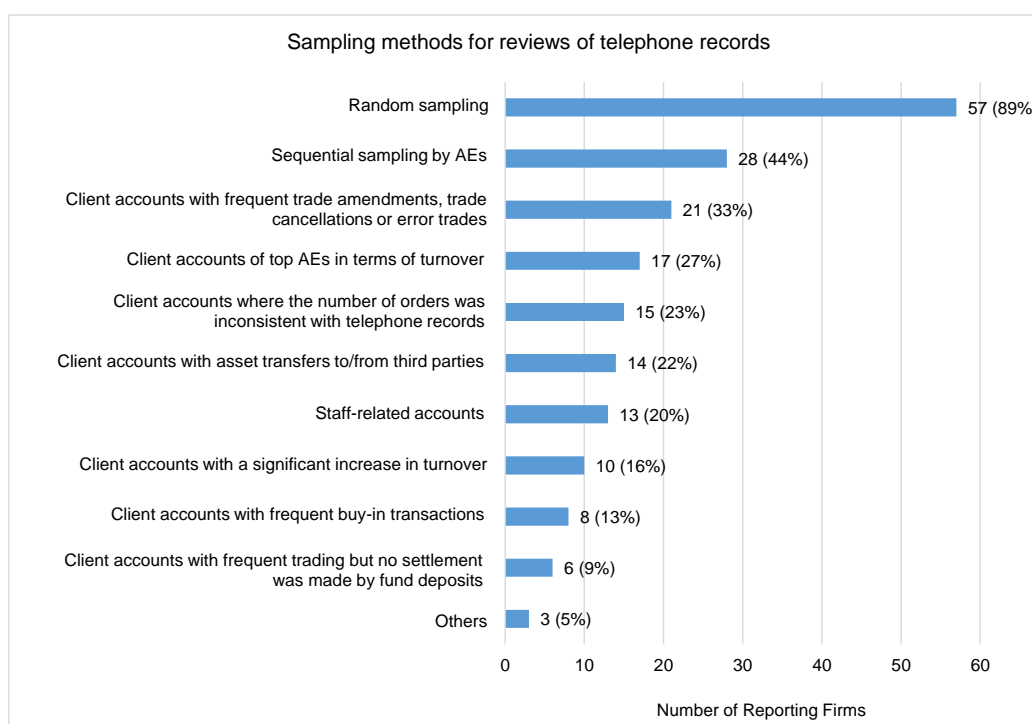
Reviews of telephone records

Expected standards

Reviews of telephone records are one of the most important compliance checks to identify irregularities such as unauthorised trading, undisclosed discretionary accounts and non-compliance with order recording requirements²⁹.

Effective sampling methods with sufficient coverage of client accounts are crucial to the compliance reviews of telephone records. LCs are expected to perform such reviews using risk-based sampling methods, in addition to random and sequential samplings, to ensure the coverage of client accounts which may be subject to a higher risk of error or abuse. Independent staff should properly follow up on any discrepancies identified in the reviews.

43. The 64 Reporting Firms which received clients' orders through telephone all reported in the questionnaire that they performed reviews of telephone records. Fifty or 78% of them performed them on a monthly basis and the remainder less frequently.
44. As illustrated in the chart below, random and sequential samplings were the most common sampling methods adopted by the Reporting Firms. Some also adopted risk-based sampling methods, such as reviews of client accounts with trade amendments, trade cancellations or error trades as well as those where the numbers of orders and telephone records were inconsistent.



Note: The percentages above are calculated based on the 64 Reporting Firms which reported receiving telephone orders. Two futures brokers reported that they only received orders online.

²⁹ Paragraph 3.9 of the Code of Conduct, paragraph 8 of Part VII of the Internal Control Guidelines and paragraph 1(i) of Appendix 2 to the "Circular to Licensed Corporations Licensed for Dealing in Securities – Protecting Client Assets Against Internal Misconduct" dated 5 February 2016.

45. Where exceptions were noted in the review of telephone records, all 64 Reporting Firms would interview AEs to ascertain the reasons for the exceptions. Some Reporting Firms advised that they contacted clients only when it was absolutely necessary to avoid any adverse impact on the client relationship. Two Reporting Firms indicated that their AEs carried out verification with clients.

Examples of good practices

While all Reporting Firms indicated that they investigated the exceptions identified in the reviews of telephone records, some also extended the sample size of the review to other clients of the responsible AEs. Some Reporting Firms arranged for independent staff to contact clients directly to verify the orders.

Staff and staff-related account trading

<i>Expected standards</i>

<i>LCs are expected to subject all staff, including AEs, to the firms' staff dealing policies as they are responsible for the acts of their employees and agents regarding the conduct of their business³⁰. LCs are required to separately record transactions for staff and staff-related accounts and diligently monitor them by independent senior management³¹.</i>

<i>LCs are required to give priority to client orders. Transactions in staff and staff-related accounts should not be prejudicial to the interests of clients. Any cross trades between staff and staff-related accounts and other clients' accounts should be disclosed to clients prior to trade execution³¹.</i>
--

<i>Management of LCs should also establish and enforce procedures which ensure proper safeguards to prevent the firms or their staff from taking advantage of confidential price-sensitive information or executing transactions as or on behalf of insiders³². Restricted stock lists should be maintained³³.</i>
--

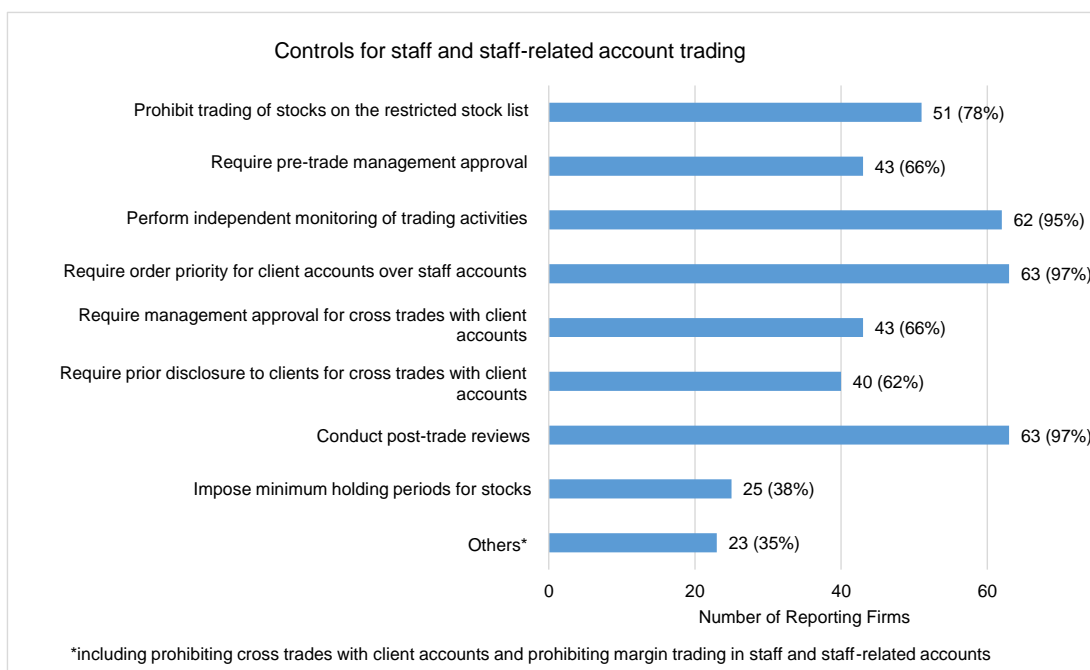
46. Sixty-five out of the 66 Reporting Firms reported having staff and staff-related accounts and they were requested to indicate whether they have the following control measures:

³⁰ Paragraph 12.4 of the Code of Conduct

³¹ Paragraphs 9.1, 9.2 and 12.2 of the Code of Conduct and paragraphs A4 and A6 of Appendix to the Internal Control Guidelines.

³² Paragraph 7 of Part VII of the Internal Control Guidelines.

³³ An LC which engages in corporate finance advisory business may possess material non-public and price-sensitive information about stock issuers. It should place such stocks on a restricted stock list to prohibit staff from trading in the stocks and mitigate the risk of insider trading as stipulated under paragraph 8.2 of the Corporate Finance Adviser Code of Conduct published in October 2013.



Note: The percentages above are calculated based on the 65 Reporting Firms which reported having staff and staff-related accounts.

47. Over 90% of the 65 Reporting Firms required order priority for client accounts over staff and staff-related accounts, performed independent monitoring and conducted post-trade reviews of these accounts.
48. Most Reporting Firms indicated that they compared transactions in AEs' and their related accounts with those in client accounts served by the AEs to ensure order priority for client accounts. Some indicated that they identified front-running transactions from post-trade reviews during the Reporting Period. In addition, for aggregated orders, about half of the Reporting Firms also performed transaction comparisons to ensure that priority was given to satisfying client orders.
49. Based on our discussions with selected Reporting Firms, we found it unsatisfactory that some did not impose staff dealing policies on AEs as they regarded AEs as self-employed rather than employees or staff. LCs are expected to subject all AEs to staff dealing policies and duly monitor the trades of AEs' and their related accounts.

Examples of good practices

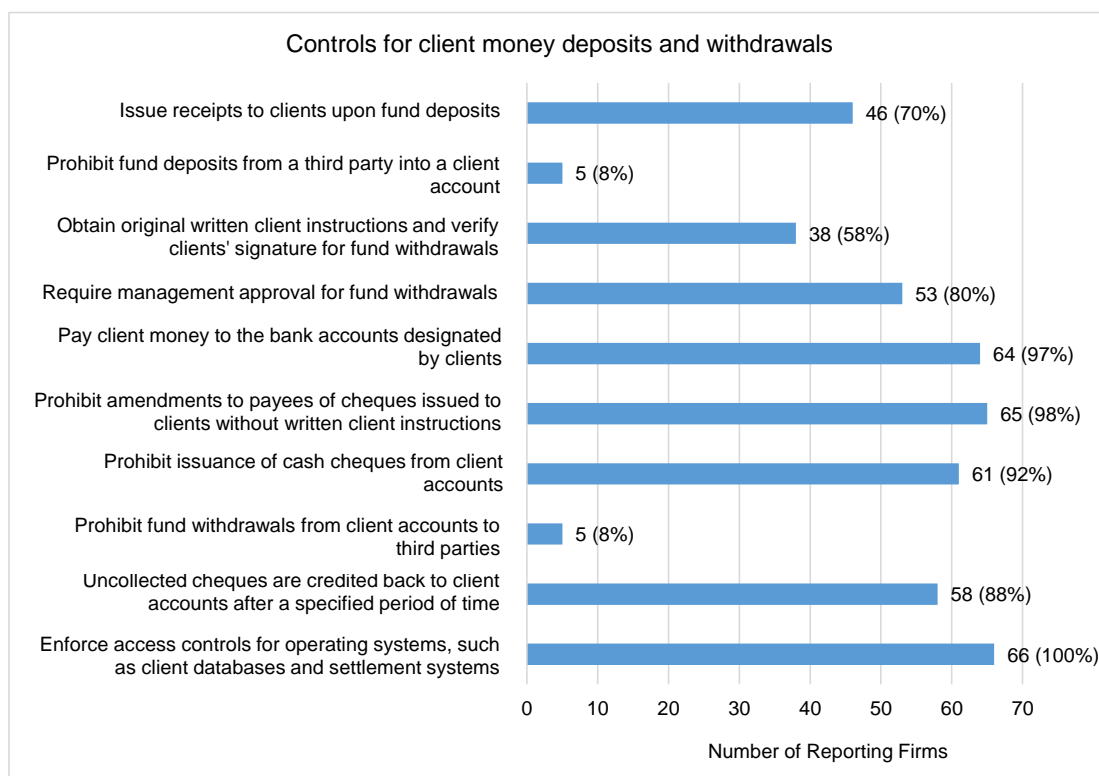
Some Reporting Firms required pre-trade approval for all trading activities, including cross trades with other client accounts, in their staff and staff-related accounts and imposed minimum holding periods for stocks acquired by these accounts. A few Reporting Firms also required staff orders to be handled separately and not to be aggregated with client orders.

IV. Safeguarding of client assets

Overall controls for client assets

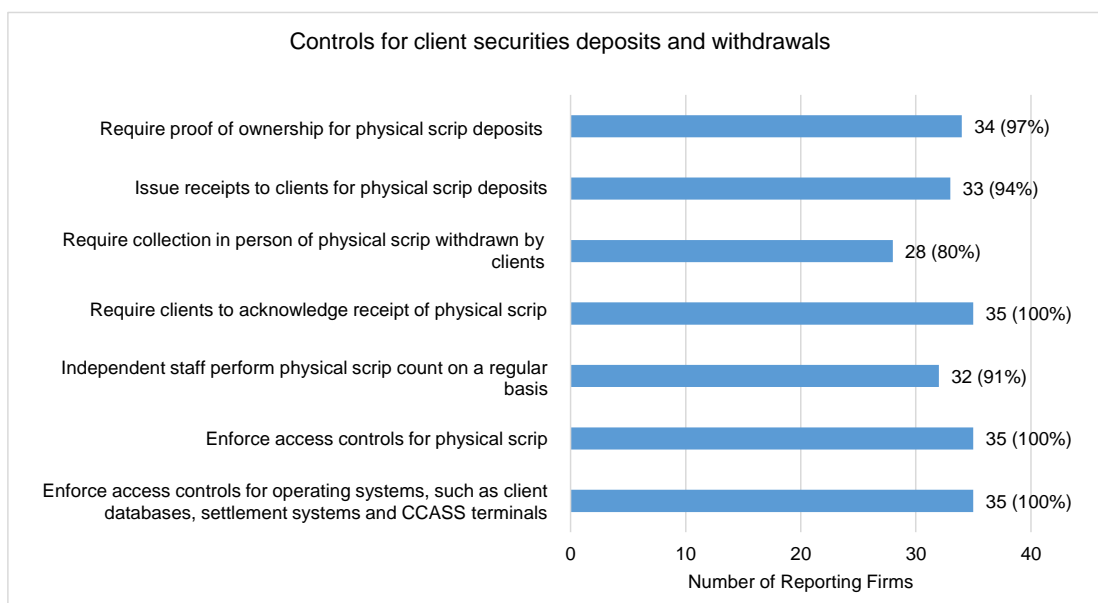
<p><i>Expected standards</i></p> <p><i>LCs are required to ensure that client assets are promptly and properly accounted for and adequately safeguarded³⁴.</i></p> <p><i>LCs should discourage fund deposits or payments between client accounts and third parties (including AEs) as a number of past cases of unauthorised trading and client asset misappropriation involved such fund movements. Where such fund movements are allowed under exceptional circumstances, they should be subject to enquiry and approval processes³⁵.</i></p>

50. In the Thematic Review, the Reporting Firms were requested to indicate the controls they had in place for handling deposits and withdrawals of client money and securities. Their responses are summarised in the two charts below:



³⁴ General principle 8 and paragraph 11.1 of the Code of Conduct.

³⁵ See the "Circular to intermediaries – Use of "nominees" and "warehousing" arrangements in market and corporate misconduct" dated 9 October 2018.



Note: The percentages above are calculated based on the 35 Reporting Firms which are securities brokers.

51. As illustrated in the charts above, most Reporting Firms had put in place various controls for handling deposits and withdrawals of client money and securities and enforced access controls for operating systems such as client databases, settlement systems and Central Clearing And Settlement System (CCASS) terminals. Five Reporting Firms also indicated that they prohibited fund deposits and payments between client accounts and third parties. However, the 11 sampled firms in the Circularisation Review were found to have the following deficiencies in safeguarding client money and securities:

- long-outstanding unpresented cheques for client withdrawals were not promptly followed up on and transferred to segregated bank accounts;
- maker-checker controls to access and operate CCASS terminals were not in place and transaction limits were not assigned based on a need-to-have basis;
- control logs were not maintained to record physical scrip movements;
- counting of clients' physical scrip was not performed; and
- AEs were allowed to access the firms' settlement systems.

Involvement of AEs in handling client assets

Expected standards

Segregation of duties is a critical control to minimise errors and fraud. It is also crucial to the effectiveness of other internal control measures implemented by an LC. LCs should therefore ensure that incompatible duties and functions, such as dealing and settlement, are properly segregated³⁶. They should prohibit their AEs from handling client assets and ask clients to contact their settlement department directly for these transactions.

³⁶ Part II of the Internal Control Guidelines.

Where complete segregation of duties is not feasible, LCs must put in place adequate compensating controls and review procedures to maintain proper checks and balances as well as to prevent potential errors, fraud and other dishonest acts or omissions.

52. While most Reporting Firms reported having different internal control measures to safeguard client assets, it was noted that a number of them allowed their AEs to handle client assets in different ways:
- over 90% of the Reporting Firms allowed their AEs to submit clients' fund withdrawal requests, notify the settlement department of clients' fund deposits and submit relevant supporting evidence;
 - 26% of the Reporting Firms allowed AEs to collect cash or cheques from or on behalf of clients;
 - of the 35 Reporting Firms which were securities brokers, 80% allowed AEs to pass clients' stock withdrawal requests to their settlement department; and
 - 29% of these securities brokers allowed AEs to collect or deliver physical scrip from or on behalf of clients.

Direct confirmation of clients' account balances³⁷

Expected standards

Confirming stockholding and cash balances with clients is an effective measure through which LCs can obtain direct confirmation from clients regarding the existence, completeness and accuracy of their account positions. It helps detect improper conduct such as unauthorised trading and misappropriation of client assets. LCs should therefore perform these confirmation exercises regularly on a sample basis³⁸.

53. Only 25 or 38% of the Reporting Firms indicated in the questionnaire that they performed direct confirmation of clients' account balances on a regular or ad hoc basis. They arranged written confirmation with clients, arranged independent staff to confirm account balances with clients via telephone or Short Message Service (SMS) or engaged external service providers to regularly confirm account balances with clients.
54. Nearly half of these 25 Reporting Firms adopted random sampling as their selection basis for the confirmation exercises while some also adopted risk-based sampling criteria covering, for example, the following client accounts:
- top clients by turnover or amount of assets in the accounts
 - accounts which were handled by the top AEs in terms of turnover
 - accounts with a significant decrease in stock level
 - accounts with a significant increase in turnover
 - accounts with amendments to clients' particulars

³⁷ Excluding the confirmation exercises carried out by auditors for annual statutory audit purposes.

³⁸ Paragraph 1(j) of Appendix 2 to the "Circular to Licensed Corporations Licensed for Dealing in Securities – Protecting Client Assets Against Internal Misconduct" dated 5 February 2016.

- accounts with frequent trade amendments, trade cancellations, error trades or buy-in transactions
 - accounts with assets deposited from or withdrawn to third parties
 - accounts with frequent trading but no settlement was made by fund deposits
 - accounts where the account holders did not access electronic trade documents for a certain period of time
 - discretionary accounts, newly opened accounts or dormant or inactive accounts
55. In respect of the follow-up actions for client accounts which did not respond to positive written confirmation requests, most Reporting Firms reported that they called the clients directly to verify their mailing or email addresses and confirm the account balances, and suspended a client's account after repeated failed attempts to contact the client.
56. Most Reporting Firms followed up on the discrepancies identified in the confirmation exercises by verifying the transactions in the client accounts against telephone records and by interviewing the responsible AEs to ascertain the reasons for the discrepancies.

Examples of good practices
Where discrepancies were identified in confirmation exercises, some Reporting Firms expanded the sample size to ascertain whether other clients had been affected, such as the clients served by the same AEs who served the client account which was noted to have discrepancies. Some Reporting Firms also performed fund tracing (eg, requesting reprinted copies of cheques from banks) to ascertain the source of the funds and hence the genuineness of the transactions in the client accounts.

V. Handling of trade documents

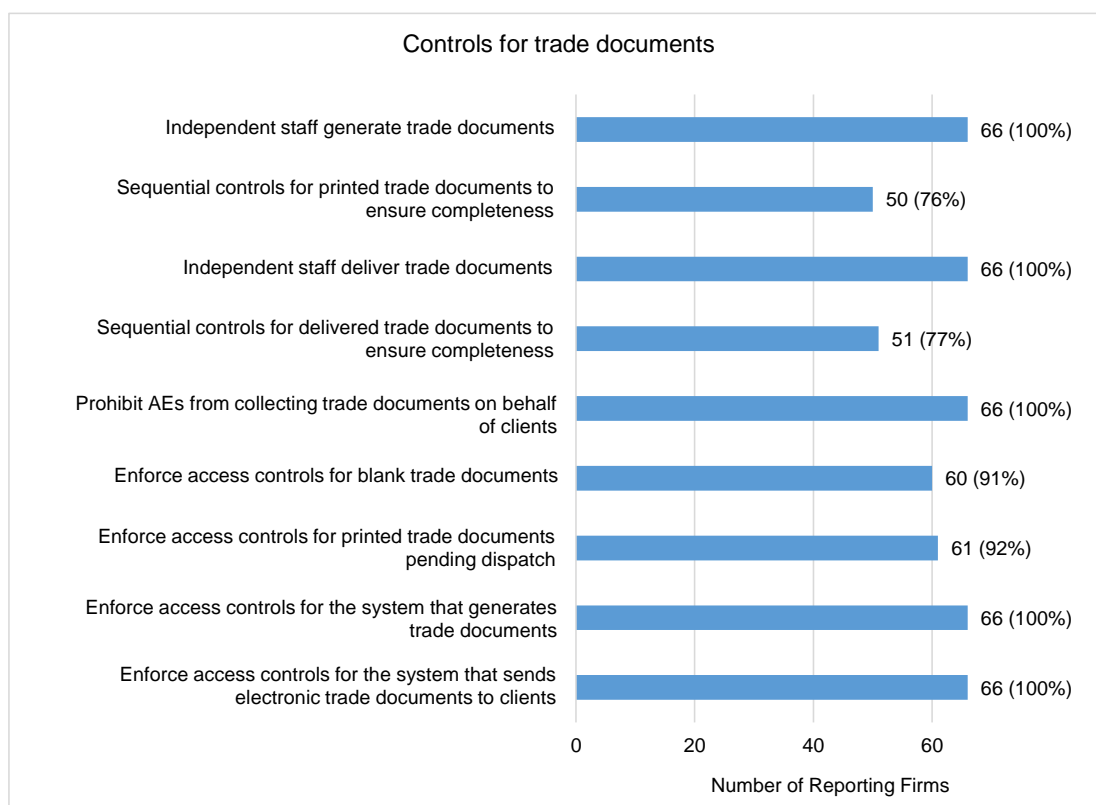
<i>Expected standards</i>
<i>Effective controls over the generation and dispatch of clients' trade documents, including strict access controls for blank and printed trade documents, should be established and strictly enforced to minimise the risks of tampering and interception by unauthorised persons. LCs should properly follow up on undelivered or returned trade documents³⁹.</i>
<i>LCs should also establish policies to monitor the collection of trade documents under hold-mail arrangements. They should, with reasonable frequency, remind hold-mail clients to collect their trade documents and confirm their account details with them⁴⁰.</i>

³⁹ Paragraphs 7 and 13 of the Suggested Control Techniques and Procedures and paragraphs 1(e) and (l) of Appendix 2 to the "Circular to Licensed Corporations Licensed for Dealing in Securities – Protecting Client Assets Against Internal Misconduct" dated 5 February 2016.

⁴⁰ Paragraphs 3 and 4 of the Suggested Control Techniques and Procedures and paragraph 2(c) of Appendix 2 to the "Circular to Licensed Corporations Licensed for Dealing in Securities – Protecting Client Assets Against Internal Misconduct" dated 5 February 2016.

Overall controls for handling trade documents

57. The Reporting Firms were requested to indicate the controls they adopted for handling trade documents. As shown in the chart below, all Reporting Firms responded that they assigned independent staff to handle trade documents, enforced access controls for systems which generated and sent trade documents to clients and also prohibited AEs from collecting trade documents on behalf of clients. Over 90% of the Reporting Firms also enforced access controls for blank trade documents in addition to printed trade documents pending dispatch, which could help mitigate the risk of internal staff using blank trade documents inappropriately.



58. Nevertheless, the Circularisation Review found that seven out of the 11 sampled firms did not establish written policies and procedures for the generation and dispatch of trade documents. In addition, five of the sampled firms did not implement any controls to ensure the completeness of trade documents generated and dispatched to clients. Besides, printers and stationery used for generating trade documents were accessible by front office staff (including AEs) in five firms, increasing the risks of tampering and interception.

Examples of good practices
Some Reporting Firms took further steps to detect any tampering or interception of trade documents by reconciling the number of printed and delivered trade documents with the number of active clients and looking into the reasons for any discrepancies.

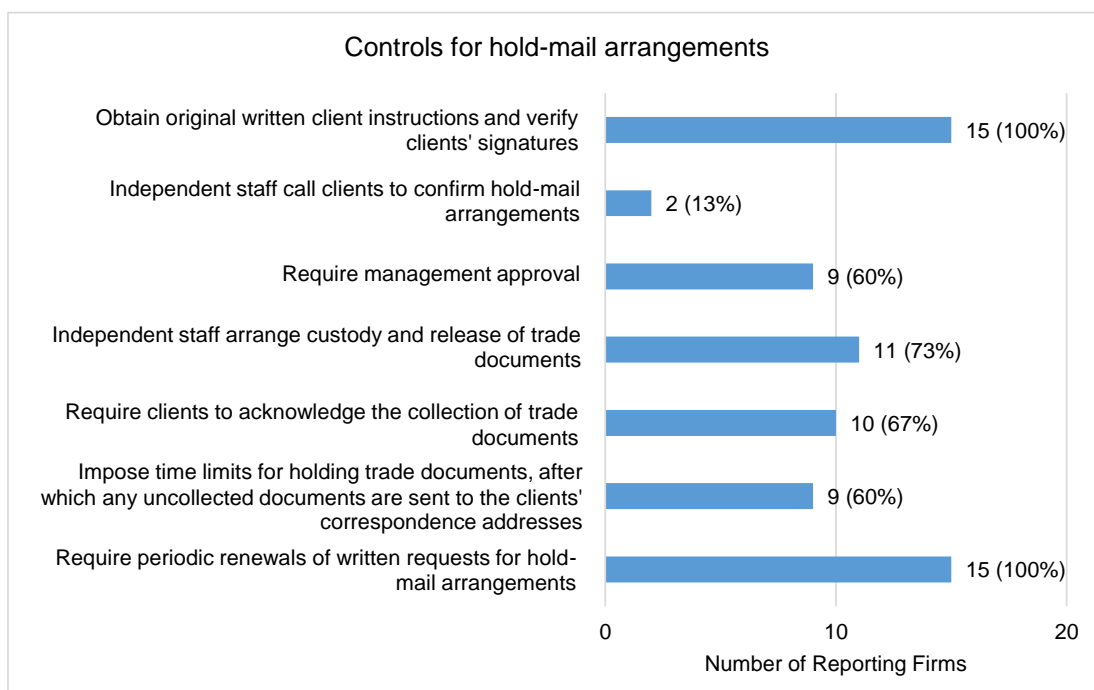
Follow-up procedures for undelivered or returned mail

59. About 80% of the Reporting Firms indicated that they arranged independent staff to call clients and verify their contact details when mail was undelivered or returned. All Reporting Firms suspended these accounts after repeatedly failing to contact the clients. However, a few Reporting Firms indicated that AEs performed these actions. This allowed dishonest AEs who had altered clients' contact details without their knowledge or consent to conceal their misconduct.
60. In addition, the Circularisation Review found that five out of the 11 sampled firms did not establish written policies and procedures for follow-up action in the event trade documents were undelivered or returned. Six firms did not handle these incidents properly, including:
- delays in identifying and following up on undelivered electronic trade documents dispatched through emails; and
 - clients' AEs, rather than independent staff, were allowed to follow up on undelivered or returned trade documents.

Hold-mail arrangements⁴¹

61. Hold-mail arrangements are risky as clients may be unable to promptly detect any irregularities in their accounts. Such arrangements should only be allowed under exceptional circumstances and supported by clients' written instructions.
62. Fifteen Reporting Firms allowed hold-mail arrangements for clients. These firms reported having put in place the following control measures:

⁴¹ For the purpose of this report, hold-mail arrangements refer to keeping clients' trade documents such as statements of accounts and receipts in LCs' office premises for clients to collect in person.



Note: The percentages above are calculated based on the 15 Reporting Firms which reported having hold-mail arrangement.

63. All Reporting Firms obtained clients' written instructions and carried out periodic renewals for hold-mail arrangements. Nevertheless, it was noted that some of them did not arrange for independent staff to handle the custody and release of trade documents and did not require clients to acknowledge the collection of these documents.
64. Similar to the findings of the Thematic Review, the Circularisation Review found that only two out of the 11 firms had hold-mail arrangements for clients. One of these two neither updated its written policy which prohibited hold-mail arrangements nor obtained written instructions from clients. In addition, neither firm monitored the collection of trade documents. For example, they did not require clients to acknowledge the collection of their trade documents.

Examples of good practices

A few Reporting Firms indicated that they took additional steps by assigning independent staff to call clients and confirm hold-mail arrangements. Some also imposed time limits for holding trade documents and delivered them to clients directly when they were not collected in a timely manner.

E. Way forward

65. To enhance the industry's compliance standards and client protection, we today issued this report, together with a circular and a comprehensive self-assessment checklist, to share the findings of our reviews and our expectations. We encourage LCs to adopt the good practices of their peers and more stringent and effective controls as set out in this report.

66. In our ongoing supervision activities, we will continue to assess LCs' internal controls, including those for the protection of client assets, and the adequacy of their supervision of AEs. We will not hesitate to take regulatory action against LCs and their senior management, including their Managers-in-Charge, for any internal control failures which may jeopardise clients' interests.