SFC Compliance Forum 2019
Opening Remarks – Morning session

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Welcome to the SFC Compliance Forum. As in previous years, the aim of this Forum is to serve as a platform to exchange views and enable in-depth discussions with the industry. I believe everyone here is familiar with the expression: "poor in May, hopeless in June and bouncing back in July". It is June now. Whether this saying is correct or not, it is indeed somewhat thought-provoking – it relates to a common stock market phenomenon – price volatility. Fittingly, one of the topics today is risk management.

You may recall several intraday crashes of small-cap stocks in the local market in the past year. These share price plunges might be primarily triggered by a sudden market sell-off if the company is at risk of default or there is other bad news. Given their lower daily turnover and higher shareholding concentrations, these stocks were prone to steep declines in prices when there were numerous sell orders in an illiquid market.

Under these circumstances, if a client obtains extensive margin financing against one of these stocks, the broker may liquidate the client's positions by disposing of it and his other stocks once the value of his shareholdings falls below a certain level. If the other stocks held by the client are also low in liquidity and turnover, their sale will have a domino effect, causing a downward price spiral within a short period of time. As a result, the client's account will become insolvent and the broker could suffer significant losses if its client defaults on the margin loan.

To address this risk, the SFC recently issued consultation conclusions providing new guidelines for connected and major securities collateral as well as other matters in securities margin financing[1] with an aim to enhance the risk management of brokers.

The financial returns submitted by brokers help us understand the risks associated with their margin financing activities. However, when financial and credit risks are concealed behind complex trading arrangements, it may not be easy for the parent company or the regulator to identify them.

Note: This is a translation of the speech as drafted in Chinese. It may differ from the one delivered.

[1] Consultation Conclusions on the Proposed Guidelines for Securities Margin Financing Activities published by the SFC on 4 April 2019.

In our on-site inspections, we found that some licensed corporations or their affiliates:

- Provided equity financing in the guise of investments which operated through multiple layers of funds, special-purpose vehicles (SPVs) or discretionary accounts.

- Set up private funds and categorised investors into two classes – preferred class, who provided the money, and subordinated class, who borrowed it. The funds' underlying investments were stocks as agreed between both classes of investors and these stocks would serve as collateral for loans. When the value of the collateral fell below a pre-determined level, subordinated class investors would be required to provide additional capital or collateral, similar to meeting a margin call. Preferred class investors were entitled to a guaranteed or pre-determined yield similar to margin interest.

- Invested in a preferential stock issued by a Hong Kong-listed company or a bond issued by a Mainland financial institution via convoluted methods such as fund-linked notes or discretionary account-linked notes.

Accordingly, the SFC has concerns about group-wide internal risk management and compliance issues:

1. When lending is disguised as an investment in private funds through multi-layer transactions and opaque financing structures, is it aiming to circumvent rigorous credit risk assessments as investments are subject to different internal approval procedures?

2. It is illegal to conduct margin financing business without a licence.

3. As an intermediary, has it used funds to help its clients to conceal the shareholders' total holdings or disguise the control held by them or their affiliates, thereby jeopardising the fairness of the market?

4. If loans secured by low-quality shares are provided by a licensed money lender which is an affiliate of a licensed firm, the money lending business will not be subject to the SFC's regulation. However, where a business segment of a group suffers substantial losses, it could create a chain reaction which will directly or indirectly affect the financial soundness of the licensed firm within the group.

Nowadays, financial institutions have diversified operations, meaning that they may conduct business as a bank, broker and money lender and be regulated by different authorities. In view of this, the Hong Kong Monetary Authority (HKMA) and the SFC, the leading financial regulators in Hong Kong, conducted a coordinated on-site inspection of one financial conglomerate. Through sharing information obtained during the inspection, we thoroughly and holistically analysed and assessed the conglomerate's operations and potential risks.

In April, the HKMA and the SFC published a joint circular to encourage all financial institutions to review their complex financing arrangements involving subsidiaries or affiliates of licensed firms. The review is not targeted at all financial activities conducted through private funds or SPVs, as we understand the use of these structures may have tax and other economic benefits.

Our concern is about financial risks and compliance issues concealed behind multi-layer structures. The financial institutions, being licensed firms and their substantial shareholders, are expected to perform their obligations to ensure the financial soundness of their groups and address financial risks and compliance issues in a timely manner.

Your client could ask to set up special purpose funds or make complex financial arrangements while arranging for himself or some seemingly unrelated person to be the fund holder, and the purpose of these funds is to invest in designated stocks or subscribe for new shares, or assets are injected into these funds through transfer of shares. As an intermediary, you should implement effective policies and procedures to establish the true and full identities of clients and identify the beneficial owners of the accounts, detect potential illegal or manipulative activities, make prompt follow-up enquiries and report suspicious transactions as appropriate.

Also, watch out for different red flags, including unusual transactions, suspicious third party payments or dubious “nominees” and “warehousing” arrangements. If an intermediary and its senior management knowingly facilitate these arrangements, or these arrangements are made due to serious inadequacies in their systems and controls, we will not hesitate to take action against them.

We hope you will actively share your views in the Forum today. Thank you.

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