



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

## **Report on the SFC's review of global financial groups' foreign exchange activities in Hong Kong**

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27 January 2022

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## Executive summary

1. This report shares key observations from the thematic review conducted by the Securities and Futures Commission (SFC) in 2019-2021 of selected firms<sup>1</sup> foreign exchange (FX) business in Hong Kong. We observed a high level of compliance<sup>2</sup> with the rules and regulations and also identified good practices and some key areas for improvement.
  - Supervision and risk management: Some firms did not have sufficient controls in place to ensure that excessive counterparty risks originating from locally-executed FX trades would not build up during the day. Also, some firms did not clearly segregate the duties of their first and second lines, which undermined the purpose of the independent challenges under the “three lines of defence” framework.
  - Trade execution: Most firms handled and executed client orders in a transparent manner. Internal control policies and procedures were in place for last look<sup>3</sup> and mark-up<sup>4</sup>. However, some firms should enhance their system access rights and controls to protect confidential client information.
  - Post-trade surveillance: We noted deficiencies in some firms’ surveillance processes for detecting irregularities and suspicious transactions. For example, the scope of their trade surveillance frameworks did not cover all FX transactions and their communication surveillance systems did not cover the languages which were commonly used by staff members and clients.
  - Staff dealing and training: In some cases, personal dealing policies and procedures for staff members’ FX trading were inadequate. In addition, some firms did not provide adequate training to ensure that their staff had sufficient knowledge to perform routine tasks.

## Background

2. As financial markets evolve, financial institutions may leverage their global presence and network to provide a wider range of financial services and solutions, including FX products. In April 2019, the sales desks of five major markets<sup>5</sup> (including Hong Kong) facilitated 79% of global FX trading. Turnover in the Hong Kong dollar more than doubled from 2016, and the currency ranked ninth in global rankings<sup>6</sup>.
3. While plain vanilla products dominate in terms of trading volume, structured products are popular amongst sophisticated investors. Investors may access the global FX market by

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<sup>1</sup> Selected licensed corporations of global financial groups in Hong Kong.

<sup>2</sup> In addition, selected firms generally followed the industry standards set out in the [FX Global Code](#) (published in 2017), which is a set of global principles for good practices in the wholesale FX market. The code was updated in 2021 following market consultation and feedback from the public.

<sup>3</sup> The term “last look” is defined in Principle 17 of the FX Global Code.

<sup>4</sup> The term “mark-up” is defined in Principle 14 and Annex 2 of the FX Global Code.

<sup>5</sup> The United Kingdom, the United States, Singapore, Hong Kong and Japan.

<sup>6</sup> Data extracted from the [Triennial Central Bank Survey](#) published by the Bank for International Settlements in 2019.

trading directly through multiple brokers, dealers and liquidity providers. The market trend is progressing towards electronic trading, but voice trading remains prominent for block trades and structured products. As such, the FX market remains highly fragmented and this makes regulatory supervision increasingly challenging.

## The SFC's thematic review

4. In light of Hong Kong's fast-growing FX market, the increasing complexity of FX products and market fragmentation, the SFC commenced a thematic review of FX activities carried out by licensed corporations in July 2019.
5. The scope of our thematic review primarily covered:
  - supervision and risk management; and
  - internal controls, including trade execution, post-trade surveillance and staff personal dealing and training.
6. In 2019, we surveyed licensed corporations under 20 global financial groups to assess their FX business practices. Licensed corporations<sup>7</sup> from four global financial groups responded that they offered FX products in Hong Kong. They were then selected for a limited-scope inspection of their risks and controls, the front-to-end operation of their FX business and their policies and procedures.
7. This report shares our key observations of selected firms' risks and controls and some of their better practices when conducting FX business. Licensed corporations are encouraged to adopt these good practices and take note of the deficiencies described below.
8. The recommendations in this report are not exhaustive. Each licensed corporation should implement appropriate policies and procedures based on the scope and complexity of its FX business. The precise structure to be adopted by each firm should be commensurate with the size and complexity of its FX market activities and the nature of its engagement in the FX market, taking the applicable rules and regulations into account.

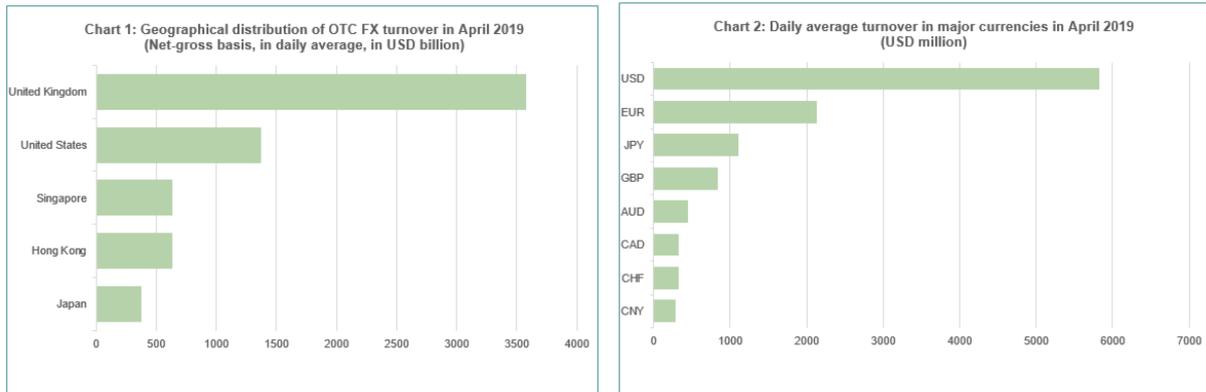
### Business models of selected firms

9. In April 2019, Hong Kong was the world's fourth-largest over-the-counter FX trading centre and the second-largest trading centre in Asia (see Chart 1). Daily market turnover in Hong Kong was US\$632.1 billion, accounting for 7.6% of global turnover<sup>8</sup>. In addition, Hong Kong has been one of the key offshore markets for Renminbi products. Renminbi (CNY) ranked eighth in terms of daily average turnover in April 2019 (see Chart 2).

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<sup>7</sup> The term "licensed corporations" in this report refers to those which engage in dealing in FX products falling within the definitions of "securities" and "structured product" under Part 1 and Part 1A of Schedule 1 of the Securities and Futures Ordinance (SFO), respectively, or "futures contracts" as defined in section 1 of the SFO. Licensed corporations which are licensed to carry on Type 3 regulated activity (leveraged foreign exchange trading) in Hong Kong, as defined in Part 2 of Schedule 5 to the SFO, were excluded.

<sup>8</sup> See footnote 6.



Source: [Triennial Central Bank Survey](#)

10. All selected firms offered both voice order services and electronic channels to clients. Through a voice channel, clients may obtain quotes from sales staff and instruct them to execute orders verbally. Alternatively, clients may place order instructions directly on firms' electronic order execution platforms.
11. When executing client orders, the role of selected firms may vary: they could act as an agent executing orders on behalf of the client or act as a principal taking on the risk in connection with an order. Most selected firms engaged in principal trading in Hong Kong. Their major clients were professional investors such as hedge funds, asset managers and banks.
12. Most firms adopted a centralised risk management and control framework by transferring local risks to designated regional hubs or legal entities via back-to-back transactions or remote booking. Therefore, the market risk arising from FX transactions in Hong Kong was managed by their overseas affiliates.
13. The review noted that plain vanilla products (such as FX spot and forwards) were the major FX products offered. Structured products with complex payoff structures (such as FX accumulators, decumulators, target redemption forward notes and exotic options) were also available to sophisticated investors. Key currencies offered included the G10 currencies, CNH and emerging market currencies in Asia.

## Observations

14. An effective supervision and risk management framework is essential for licensed corporations to maintain sound operations, safeguard their business and reduce vulnerabilities during a crisis.
15. All the firms under our review were part of global financial groups operating through multiple legal entities. Generally, a group-level supervision and risk management framework was in place, but this varied amongst local legal entities depending on their business strategies and organisational structures. This gave rise to challenges when implementing appropriate supervision and risk management measures as the framework

may be designed largely to oversee risk exposures at a group level. As such, local legal entities should adopt appropriate management tools and exercise sufficient oversight to ensure the resilience of their local operations.

## I. Supervision and risk management

### Supervision

16. In accordance with paragraph II of the Internal Control Guidelines<sup>9</sup>, key duties and functions should be appropriately segregated. Supervisory and other internal review functions including compliance and internal audit should be effectively segregated from line operational duties.
17. Licensed corporations are expected to have a sound and effective supervisory structure to ensure clear responsibilities and comprehensive oversight of their FX business activities. The supervisory structure should be commensurate with the size and complexity of their FX business activities and the nature of their engagement in the FX market<sup>10</sup>.
18. In some cases, FX activities only served as an ancillary part of the main business, eg, for FX hedging activities. Licensed corporations are reminded to supervise FX activities regardless of whether they are carried out as a separate business or an ancillary function.
19. During our review, we noted that licensed corporations widely adopted a “three lines of defence” framework designating responsibilities amongst different functions to meet the segregation of duties requirement set out in the Internal Control Guidelines. Each line of defence was independent—the first line of defence was provided by the business where the risks were taken; the second was provided by independent risk management and compliance functions overseeing risk-taking activities, undertaking risk assessments and reporting independently from the business line; and the third was provided by an independent internal audit function responsible for providing assurance for the effectiveness of the licensed corporation’s control framework as a whole<sup>11</sup>.
20. Conflicts of interest may arise if the risk-taking activities and assessments are both undertaken only by the first line of defence without any independent assessment by the second line of defence.
21. The post-trade surveillance work of one firm was only performed by its business line without independent reviews or supervision by the second line of defence. This undermined the independence of the firm’s surveillance work.

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<sup>9</sup> Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission.

<sup>10</sup> Please refer to the leading principle of Governance in the [FX Global Code](#).

<sup>11</sup> See the Bank of International Settlements’ Occasional paper No.11—[The “four lines of defence model” for financial institutions](#) (December 2015) and the Hong Kong Monetary Authority’s [Supervisory Policy Manual—Risk Management Framework](#).

### *Examples of good practices*

22. Generally, firms had robust supervision of how they delivered their corporate values, priorities and business goals and operated within their risk appetite. Senior management was responsible for providing clear directions to staff on how to respond to risks and ensuring that the firm's risk culture remained consistent over time and across different functions. The "three lines of defence" framework was also widely adopted.
23. When designing the composition of various committees to oversee their operations and businesses, the selected firms took a number of factors into consideration to ensure that they could oversee the business effectively, including the firms' size, operational processes and reporting structures. They also had a good balance of representatives from business and controls functions to uphold accountability.
24. Committee meetings were held regularly. Under special circumstances, ad hoc risk committee meetings were held and subject matter experts were invited to attend the meetings to assist the committees in performing their functions.
25. Specifically, some firms set up independent risk management committees to promote open discussions regarding risk management and maintain the visibility of risk management practices across various functions. Exceptions and matters of importance were brought to management's attention to ensure that the FX business was carried out within their risk appetite.

### **Risk management**

26. Under paragraph 4.3 of the Code of Conduct<sup>12</sup>, licensed corporations should have internal control procedures and financial and operational capabilities to protect their operations from financial loss. In particular, paragraph VIII of the Internal Control Guidelines sets out the requirement for licensed corporations to establish and maintain effective policies and procedures from time to time to ensure appropriate and prompt responses to the risks that the firm is exposed to.
27. Appropriate risk management, compliance and review functions should be in place to manage and mitigate the risks arising from FX activities. As previously discussed, the business models amongst selected firms varied in terms of scope and complexity and the firms generally had a comprehensive risk management framework carried out by the second line of defence to address major risks arising from FX activities.
28. For example, one firm, acting as a principal, booked risk positions in its own entity and offset its market risk by entering into back-to-back transactions with an overseas affiliate. Another selected firm acted as an agent to deal with exchange-traded futures and options on behalf of its clients. Some firms engaged multiple legal entities across different jurisdictions in conducting FX activities. Under this business model, overseas entities were

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<sup>12</sup> Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

both the contracting entities with clients and the risk booking and management centres even though the risk positions originated from the selected firms in Hong Kong.

29. The above examples are not meant to promote a specific risk management model. Rather, they illustrate that licensed corporations should understand the characteristics of their unique risk management models and adopt one suitable to ensure that material risks arising from their FX business are appropriately evaluated and addressed. A summary of our key observations of selected firms' risk management and our suggestions are set out below.

(i) Market risk management

30. Market values of FX products might change rapidly during the day. As such, it is necessary for licensed corporations to monitor, assess and manage the risks of events which may have an adverse impact and ensure that the risk exposures of their trading positions and business activities are identified and managed effectively within their risk appetite.

31. Licensed corporations should establish and maintain effective policies and procedures to ensure proper management of the risks to which they are exposed and that adequate information is provided to enable management to take appropriate action to detect and mitigate the associated risks effectively and in a timely manner. Licensed corporations should implement risk management measures including establishing risk limits, monitoring procedures, stress tests and escalation procedures in accordance with their business models.

32. Regardless of whether the licensed corporation is the risk booking entity or the risk is managed at the group or regional level, it should take reasonable steps to ensure that it operates within a holistic and robust risk management framework, with reporting and accountability processes clearly defined and suitably integrated across different jurisdictions.

*Examples of good practices*

33. Where risk positions were booked into overseas entities, the selected firms maintained sufficient controls and supervision of positions in the trade books locally. Trader mandates were in place to strictly limit the business line's ability to move or manipulate trades amongst trade books. Also, re-allocation of positions amongst trade books required special approval from supervisors. These practices ensured that market risks could be subject to risk oversight and the gains or losses arising from the trade books could be recognised promptly and accurately.

(ii) Counterparty credit risk and collateral management

34. Counterparty credit risk management is essential for licensed corporations to mitigate the potential risk that counterparties fail to meet their obligations in accordance with the agreed terms. During our review, one firm integrated its FX business operations with its group affiliates to provide client servicing around the clock. The firm's counterparty credit risk was monitored continuously across different entities.

35. One firm did not effectively implement counterparty credit risk management practices. For example, its clients' credit utilisation and available margin limits were not refreshed within a reasonable timeframe for the firm to perform an appropriate counterparty credit risk assessment before engaging in trades with clients.
36. Licensed corporations adopting an integrated business model are reminded to have proper oversight of counterparty credit risk exposures for trades executed locally to avoid over-aggregation or a build-up of excessive counterparty credit risk exposures. In addition, special attention should be paid to concentration risk or large exposures to some counterparties.
37. In managing collateral, some firms determined the margin ratios for the collateral collected from clients based on the collateral's risk profile. However, one firm added a uniform fixed percentage buffer, on top of the margin ratios, to all FX transactions irrespective of the risks (such as volatility) of the different currencies and products. Moreover, it did not conduct regular stress tests to assess whether the updated margin ratios were sufficient.

*Examples of good practices*

38. Stress tests on margin ratios should form an integral part of licensed corporations' risk management and controls. Most firms regularly validated margin ratios by conducting scenario analyses and stress tests using historical data.
39. Some firms implemented counterparty risk limits for the exposures arising from their clients.
40. Some firms adopted procedures where the clients' credit utilisation and available margin limits were refreshed within a reasonable timeframe to perform appropriate counterparty credit risk assessments before engaging in trades with clients.

## **II. Internal controls**

### **Trade execution**

41. General Principle 1 of the Code of Conduct sets out that licensed corporations should act honestly, fairly, and in the best interests of their clients and the integrity of the market. Furthermore, licensed corporations should disclose relevant material information about their dealings with clients under General Principle 5 of the Code of Conduct. During our review, selected firms in general had robust trade execution processes and monitoring in place.
  - (i) Last look
42. Last look is a common execution practice in electronic trading activities whereby a firm receiving a trade request will have a final opportunity to accept or reject the request against its quoted price. A price comparison process would be conducted within the firm to consider whether a trade at the requested price would exceed a pre-set tolerance band owing to market movements. Where the comparison shows that a market move does not exceed the

tolerance band, the trade request will be accepted. Otherwise, the firm would reject the trade request and this may incur costs for clients who place another order.

43. While a firm has sole discretion to accept or decline a client's trade request based on the validity<sup>13</sup> and price<sup>14</sup> check processes, it should communicate to clients how their trade requests have been handled<sup>15</sup>. Also, last look should not be used to collect client trade information if the firm has no intention of accepting a client's trade request.

*Examples of good practices*

44. Some firms adopted a transparent approach to last look practices in which their disclosures to clients, including information about the use of last look practices (eg, applicability to the type of product, the basis for rejecting a client order, hold times and their symmetric or asymmetric application, client trade information), were generally clear and accessible to clients.
45. Some firms had clear policies and procedures for last look settings in their system, such as the minimum and maximum lengths of a last look window and whether or not price check is applied symmetrically. Regular reviews of the use of last look were also performed.
46. We noted that selected firms' rejection rate in last look ranged from 1.48% to 2.80%, which according to a global survey<sup>16</sup> was relatively lower than the industry average of 3.15%.

(ii) Protection of confidential information

47. In addition to protecting confidential information obtained during the last look practice, licensed corporations should implement robust controls to limit staff members' access to client order information, which is confidential and should not be shared except when necessary for order execution.
48. One firm allowed client orders executed via electronic means to be visible to sales and trading personnel who were not responsible for electronic trading. Conflicts of interest amongst the licensed corporation, its staff and clients may arise without proper monitoring and oversight of staff personal dealing (which is set out in the latter section in detail), eg, staff may take advantage of the clients' trading intent and move market prices against them, such as through front-running activities.

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<sup>13</sup> The validity check should be intended to confirm that the transaction details in the trade request are appropriate from an operational perspective and there is sufficient available credit to enter into the transaction contemplated by the trade request.

<sup>14</sup> The price check should be intended to confirm whether the price at which the trade request was made remains consistent with the current price that would be available to clients.

<sup>15</sup> These include the metrics which facilitate transparency around the pricing and execution of a client's trade requests and assist the client in evaluating how trade requests were handled and whether the execution methodology meets the client's needs over time.

<sup>16</sup> See [The FX Global Code: Changing Transparency and Behaviours](#).

*Examples of good practices*

49. Some firms adopted a “need to know” policy and assigned limited system access rights to staff only for specific purposes or to perform necessary tasks based on their roles and responsibilities. They also conduct regular reviews and comprehensive risk assessments. For example, system access to a client’s fixing order was only granted, upon appropriate review and approval processes, to staff who needed the information to perform their work.
50. Additional controls to restrict, record and monitor users’ access to sensitive information, including client’s orders and trading data as well as periodic reviews of access rights, were in place.

(iii) Mark-up

51. Mark-up is a spread or charge included in the final price of a transaction to compensate the firm for a number of considerations, which might include the risks taken, costs incurred and client services rendered.
52. While mark-up practices are not specific to the FX market, licensed corporations should comply with General Principle 2.2 of the Code of Conduct in the general course of dealing or advising a client. The charges, mark-ups or fees affecting a client should be fair and reasonable and be characterised by good faith<sup>17</sup>.
53. In addition, licensed corporations should have in place policies and procedures which enable staff members to determine appropriate and fair mark-ups and have proper oversight and an escalation process to ensure that mark-up practices are consistent with their policies and procedures.

*Examples of good practices*

54. Some firms adopted a transparent approach to disclosing mark-up practices. These disclosures were generally clear and accessible to clients. For example, the factors considered for mark-ups were specifically disclosed in client agreements prior to order execution.
55. To prevent misconduct and inappropriate use of mark-up practices, selected firms had clear policies guiding their business functions in determining appropriate and fair mark-ups for FX transactions. In addition, surveillance was performed on a regular basis to review the use of mark-ups in accordance with their policies.

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<sup>17</sup> Licensed corporations may also make reference to Principle 14 of the [FX Global Code](#) in relation to promoting transparency and disclosures to their clients.

## **Post-trade surveillance**

56. Given the fragmentation of FX trading infrastructure and platforms, investors may source liquidity or obtain price quotations from brokers via multiple channels such as calls, direct single dealer portals or chatrooms, before sending orders to brokers for execution. Market surveillance and monitoring of FX transactions could be particularly challenging when there are multiple communication channels.
57. A holistic trade surveillance framework and effective monitoring tools are critical for licensed corporations to detect market manipulation and abuse. Our review identified some obvious deficiencies in post-trade surveillance:
- (i) Unclear trade surveillance framework
58. Some firms did not have a clear trade surveillance framework and policies specifying how FX trades were sampled for review and investigation. One firm simply selected a fixed number of samples of particular FX products rather than selecting from the entire trading portfolio. We have concerns about situations where a wide range of FX products were traded but the firm's sampling process is restricted to particular products. This may result in potential misconduct and failure to identify high-risk activities systematically and effectively.
- (ii) Inadequate product and staff coverage in trade surveillance
59. Trade surveillance should be able to monitor all business lines and detect a wide range of market abuse. As such, a firm's trade surveillance should include an analysis of the full set of order books and products, covering the whole order execution process as well as its sales and trading staff.
60. While FX products should generally be included in the surveillance programme, some firms did not extend their surveillance to cover FX structured products and it did not include all staff who were responsible for handling FX trade orders.
61. One firm offered voice ordering services to non-English-speaking clients, but its communication surveillance systems did not cover languages other than English. As such, prohibited keywords and sensitive sentences in other languages were not identified.
- (iii) Static market data used in trade surveillance
62. Some licensed corporations used market data for benchmarking and trade analysis in their surveillance processes to identify suspicious trades or trade patterns. Market data should be refreshed in a timely manner to reflect the evolving market situation.
63. One firm did not perform regular sanity checks on market data. As such, it relied on out-of-date, static market data in its trade surveillance, and thus a large volume of false alerts were generated and suspicious trades were not captured.

*Examples of good practices*

64. There is no “one size fits all” approach to post-trade surveillance. In addition to using automated systems to monitor all trades, some firms adopted a risk-based approach to sample higher-risk trades for review based on their FX business models and the market situation. The sampling methodology, review procedures, responsible teams and escalation procedures were well defined in their surveillance manuals. In addition, sample sizes were proportionate to a number of factors including the firms’ risk exposures and the complexity of the products.
65. Some firms had both audio and electronic communication surveillance in place to cover all staff front-to-end. Moreover, the tracking and identification of suspicious conversations and communications covered the languages commonly used when staff communicated with clients.
66. Some firms’ post-trade surveillance functions were independent of their business units to maintain a high level of independence and objectivity. Their post-trade surveillance included responsibilities for overseeing, reviewing and investigating suspicious trade activities and the conduct of their business lines.

**Staff personal dealing**

67. Conflicts of interest may arise if staff engage in personal dealing with the use of confidential client information. To avoid conflicts of interest, staff performing services on a licensed corporation’s behalf should be provided with personal dealing policies and procedures. In accordance with paragraph 12.2 of the Code of Conduct, while licensed corporations may permit employees to deal or trade in their own accounts, there should be a written policy specifying the conditions under which employees may deal in their own accounts. Firms should also maintain procedures to detect irregularities and ensure that employees’ personal dealing is not prejudicial to the interests of clients.
68. One firm had staff dealing policies and procedures in place but it did not include those staff who engaged in trading FX products. At one firm, personal FX trading carried out by staff was not subject to surveillance and monitoring, so the firm was unable to assess whether there was any potential misconduct.

*Examples of good practices*

69. Most firms adopted a personal dealing policy applicable to all employees. Staff were required to report their personal trading accounts and prohibited from engaging in certain types of transactions in their personal accounts if they were involved in the FX business.

**Staff training**

70. According to Paragraph III of the Internal Control Guidelines, licensed corporations should ensure that staff comply with their operational and internal control policies and procedures as well as all applicable legal and regulatory requirements. Training should cover regulatory

requirements, markets, products, compliance and risk management, depending on the roles of the staff.

71. One firm did not provide product training to staff who were responsible for carrying out supporting roles and monitoring functions for FX activities. As a result, staff could not develop sufficient capabilities and acquire relevant knowledge to identify potential issues and make appropriate decisions.

*Examples of good practices*

72. Most firms provided regular product training to equip staff with sufficient market knowledge and competencies to perform their daily work. In particular, some firms maintained adequate systems to regularly monitor and review the competence of their staff. For example, managers kept track of their team member's training progress.