Highlights of first SFC supervisory briefing for market intermediaries

Hong Kong, 2 September 2014

The Securities and Futures Commission (SFC) held its first supervisory briefing on 2 September 2014 to share major findings and observations noted from a recent series of inspections on a number of larger licensed firms. The half-day event was attended by more than 200 representatives from different investment banks[1] as well as regulatory practice advisers.

Mr Ashley Alder, SFC Chief Executive Officer, joined senior executives of the Intermediaries and Enforcement divisions in delivering a clear and consistent message to those present that senior management is responsible for implementing proper controls, maintaining appropriate standards of conduct and adhering to proper procedures. Initiatives such as this briefing will foster closer communication between industry participants and the regulatory community as well as help minimise undesirable outcomes and enhance the quality of Hong Kong's markets. The briefing also highlighted the SFC's commitment to pursue criminal or civil actions against individuals or firms when material misconduct is detected.

Complacency would be an error

Mr Alder began the briefing by strongly encouraging senior management to properly develop and test systems, processes and controls which are identified as being weak. This is particularly important when behavioural incentives such as bonuses remain severely distorted. In such cases, management should monitor the effectiveness of the three lines of defence—business, compliance and internal audit—paying close attention to their effectiveness within large and complex global banks as well as the alignment of management responsibilities at local, regional and global levels with proper accountability under Hong Kong laws and regulations.

Mr Alder also asked attendees to reflect on these issues within the broader context. Growth in the financial industry has been strong and the banking sector is more concentrated than ever. Now is not the time to be complacent. "Too-big-to-fail" subsidies provided in Europe and the US prompted risk-taking and distorted incentives among industry participants, resulting in the emergence of conduct scandals in wholesale and retail markets. At the same time, banks in the United States continued to report strong net income, bringing into question the relationship between enhanced regulation and falling corporate profitability.

[1] Including business heads, chief risk officers, chief operating officers and chief compliance officers.

Achieving a "no surprises" culture

Mr James Shipton, Executive Director of the Intermediaries Division, emphasised that it is the senior management's responsibility to supervise their firms' operations in accordance with General Principle 9 of the Code of Conduct[2]. He encouraged senior management to take ownership of regulatory issues and to ensure a change in attitudes, conduct and culture. Their genuine and dedicated commitment is crucial in setting the tone from the top, which needs to be cascaded through a strong tone in the middle.

Mr Shipton added that it is vital to put in place effectively run and consistent control systems that in turn require delineating specific management responsibilities and ownership of those controls. Noticing that a degree of scepticism, cynicism and regulatory fatigue has set in across the industry, he acknowledged that there is still some way to go and that the industry, particularly senior managers, need to adopt a proactive, and not just reactive, attitude to conduct, culture and behavioural issues.

Echoing Mr Alder's view on the importance of communication, Mr Shipton emphasised that firms should be more proactive in communicating with the SFC, particularly when "front page" issues arise. Efforts must be directed toward achieving a culture of disclosure, openness, communication and, ultimately, a culture of "no surprises" between firms and regulators.

No compromise on enforcement

Mr Mark Steward, Executive Director of the Enforcement Division, stated that the SFC's unrelenting approach has been to pursue criminal, disciplinary or penal sanctions as well as remedial outcomes against both individuals (including senior management) and firms. The Lehman Brothers Minibond cases were a classic example of how the SFC conducted top-down investigations, scrutinising the management problems which gave rise to the issues uncovered. Mr Steward added that active management by decision makers is the best defence.

He said firms have been prepared to protect senior management from liability by agreeing to pay substantial remediation to affected investors and the SFC will continue to seek these types of outcomes but that senior management, in particular, ought not expect to escape disciplinary consequences for management failures that give rise to misselling problems, where that occurs a second time.

On the SFC's enforcement and surveillance work, Mr Steward reported that more than 300 Compliance Advice letters were sent out last year, many of which fell under the senior management and corporate responsibility category and touched on new areas such as IT-related systems issues. These letters are red flags for compliance which should not be ignored.

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[2] General Principle 9 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission stipulates that the senior management should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the firm.

Future inspection focus and summary of inspection observations and findings

Mr Stephen Po, Senior Director of the Intermediaries Supervision (IS) Department, informed the group that SFC inspections have recently focused and shall continue to focus on three key areas: electronic trading controls, anti-money laundering (AML), and supervision and controls.

Mr Po reminded the participants that the Electronic Trading Guidelines issued by the SFC became effective on 1 January this year. The IS Department will continue to carry out onsite examinations of electronic trading controls such as information security measures and dark pool operations. He also reminded industry participants to comply with AML requirements, the failure of which could result in supervisory interventions as well as criminal sanctions. Firms should focus on the following major areas: money laundering risk assessment, customer due diligence, identification and reporting of suspicious transactions, as well as management accountability.

Finally, Mr Po reiterated that senior management should take ownership and be committed to facilitating compliance, collaboration and communication among different functions. Firms should also address conflicts of interest issues and maintain robust control functions.

Staff from the IS Department then concluded the briefing with an overview of the areas of concern arising from the SFC's recent inspections on a number of larger licensed firms. The areas of concern included inadequate coordination amongst different functions over control strategy, including policy setting, monitoring and testing of systems, processes and controls; inadequate documentation, policies and procedures; and failure to take comprehensive remedial actions to address known lapses. This was supplemented by examples of control deficiencies and non-compliance identified during the SFC's review of client facilitation, short-selling, stock borrowing and lending, cancellations of and amendments to transactions, and dark pool operations.