

Annex

The standards of conduct and internal controls the SFC expects of intermediaries carrying out prime services include:

1. Governance and management supervision

- 1.1. PBs should ensure adequate and effective management and supervision over prime services activities. While operating models for prime services can be complex and may involve multiple legal entities of a financial institution across different jurisdictions, if clients are serviced in Hong Kong or if PBs are carrying out their prime services in Hong Kong, PBs are expected to comply with the applicable rules and regulations in Hong Kong regardless of where the risk positions are booked. In addition, PBs acting as the Asia hub to conduct business activities for their groups should also have adequate controls and procedures in place to follow the standards established by their group companies to facilitate the group companies' compliance with the rules and regulations which apply to them.
- 1.2. Sufficient management oversight¹ should be in place to ensure that matters related to prime services activities are brought to management's attention for timely review, and there is adequate accountability for the business and related risks².
- 1.3. Where the oversight of a certain process is performed by a committee, PBs should clearly define the roles and responsibilities of the committee and ensure the composition of the committee is appropriate to provide proper oversight.
- 1.4. Effective policies and procedures should be established to identify and manage the conflicts of interest³ relevant to prime services activities. These policies and procedures should be reviewed periodically to ensure they remain robust and effective and all relevant staff should be provided with training on a regular basis.

2. Client life cycle management

- 2.1. PBs should take all reasonable steps to establish the true and full identity of their clients⁴ and to assess a client's credit worthiness and overall risk profile including through forming an understanding of its corporate structure, investment processes, risk management capabilities, governance and controls, pricing and valuation, investment experience of the persons responsible for making investment decisions, investment strategy, past performance and the investment portfolio's composition, complexity, liquidity profile and leverage.

¹ General Principle 9 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct).

² Circular to Licensed Corporations Regarding Measures for Augmenting the Accountability of Senior Management issued by the SFC on 16 December 2016.

³ General Principle 6 of the Code of Conduct.

⁴ General Principle 4 and paragraphs 5.1 to 5.4 of the Code of Conduct.

- 2.2. PBs should also assess the money laundering and terrorist financing risks⁵ when accepting and on-boarding a client. Customer due diligence should be conducted by a PB on all clients to whom it provides services which are regulated activities (eg, taking trade orders for execution) in accordance with the anti-money laundering requirements⁶, even when clients serviced in Hong Kong are contracted with overseas affiliates.
- 2.3. PBs should conduct on-going assessments of clients' risk profiles to determine whether to continue the client relationship, taking into account factors including clients' strategies and the complexity of the products they trade. PBs should also identify triggers for ad-hoc reviews, for example, a material change in a client's strategy or products traded, a significant decrease in the value of assets under management or a large redemption. Client information, data and documents obtained by the PB should be periodically reviewed to ensure they remain up-to-date and the PB's assessment of clients' overall risk profile remains valid.
- 2.4. PBs should also ensure that information about the fees and charges for their products and services is clearly disclosed.

3. Margin financing

- 3.1. Given that the entities which provide credit to clients are the overseas group contracting entities, PBs in Hong Kong act as a hub to conduct business activities for their groups. In this regard, PBs should have adequate controls and procedures in place to follow the standards established by their group companies to facilitate the group companies' compliance with the rules and regulations which apply to them.
- 3.2. Written guidelines should be established to provide adequate guidance when PBs apply the group-wide margin financing policies and procedures set out by their head offices, having regard to the nature, scale and complexity of the risks associated with the business operations in Hong Kong.
- 3.3. Adequate controls and procedures for critical work processes in the provision of margin financing should be put in place, for example:
 - a) Instituting effective on-going monitoring procedures for clients' margin profiles to ensure the margin terms extended to clients are appropriate;
 - b) Establishing procedures to ensure collateral pricing exceptions are identified for appropriate follow-up action and that manual price overrides are subject to review to ensure appropriate prices are used to value collateral;
 - c) Enforcing margin call policies to ensure credit risk is effectively managed;

⁵ Money laundering and terrorist financing risk factors include country risk, customer risk, product or service risk and delivery or distribution channel risk.

⁶ As set out in the Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporation) and the Anti-Money Laundering and Counter-Terrorist Financing Ordinance.

d) Establishing procedures for adjustments or waivers of margin calls to ensure they are supported by sound justifications and relevant approvals are properly obtained.

3.4. Where deviations from the policies and guidelines may be approved by management, the factors to be assessed and the approval criteria should be clearly specified.

4. Short selling and securities lending

4.1. Effective controls should be in place to ensure compliance with the short selling requirements under the Securities and Futures Ordinance and its subsidiary legislation⁷.

4.2. Pre-trade controls over both agency and principal short selling should be established to ensure that assurance, or cover, has been obtained for any short selling orders.

4.3. Post-trade controls over both agency and principal short selling should be in place to review and reconcile orders with the relevant documentary assurances to ensure that flagging errors and instances of uncovered short selling are identified in a timely manner.

4.4. Paragraph 8 of the Guidance Note on Short Selling and Reporting and Stock Lending Record Keeping Requirements issued by the SFC sets out three acceptable approaches for the purpose of determining whether a seller has a presently exercisable and unconditional right to vest the securities in the purchaser of them: (a) the position of the seller's own trading book, (b) the aggregated positions of a number of trading books which the seller controls or has knowledge of (aggregation unit approach), or (c) the aggregated position of the entire legal entity.

4.5. For principal trading, regardless of which acceptable approach is adopted, it should be consistently applied with proper controls to ensure that the positions of the relevant proprietary trading units or books are appropriately aggregated to determine whether the trading book, aggregated unit or legal entity is net long or net short in a security, so as to prevent any short sell order flagging errors. Where an aggregation unit approach is adopted, appropriate personnel from a different line of defence should be involved in the control processes for the set-up, amendment and deletion of aggregation units, as well as their underlying trading books, to prevent inappropriate or unchecked changes to aggregation unit structures.

4.6. Controls over securities borrowing and lending (SBL) inventory management should be in place, such as applying haircuts on SBL inventory sources where appropriate, to avoid over-lending securities.

⁷ Including section 170 to 172 of the Securities and Futures Ordinance and the Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous)) Rules.

5. Handling of client assets

- 5.1. Given that client assets may be kept by PBs as sub-custodians, and in performing their role as the Asia hub for their groups, PBs may also be involved in the handling and returning of rehypothecated assets to clients. PBs should have sufficient controls in place to ensure client assets are promptly and properly accounted for and adequately safeguarded⁸.
- 5.2. Regardless of the type of custody arrangements under which client assets are held, PBs should properly maintain a client's entitlement to the relevant assets in their own books and records and keep client assets separate from the assets of the PB to ensure protection and prevent the misuse or offset of PBs' own liabilities.
- 5.3. Management oversight should be in place for the rehypothecation of client assets based on client indebtedness with adequate monitoring and controls established to ensure assets which are no longer available for rehypothecation are returned to clients in a timely manner.

6. Risk management and controls

- 6.1. While PBs usually adopt the risk management framework set out at the group level, they should take reasonable steps to ensure that they operate within a holistic and robust risk management framework, with reporting and accountability processes clearly defined and suitably integrated across the different jurisdictions involved. PBs should overlay their risk management programmes with relevant local regulatory requirements and operational needs to ensure the standards are not less stringent than the applicable local rules.
- 6.2. In addition, PBs should establish and maintain effective policies and procedures to ensure the proper management of the risks to which they are exposed and that adequate information is provided to enable management to take appropriate and timely action to contain and otherwise adequately manage risks⁹.
- 6.3. At a minimum, PBs should implement the following risk management measures in accordance with their business models to ensure the risks associated with the provision of prime services can be detected and mitigated effectively and in a timely manner:
 - a) Risk limits should be established for individual funds, clients, counterparties, business units, specific risk categories, legal entities and others as appropriate. The risk limits should be periodically assessed for appropriateness, adherence to group policy and, where applicable, compliance with regulatory requirements both locally and at the group level.

⁸ General Principle 8 and paragraph 11.1 of the Code of Conduct.

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

- b) Monitoring procedures should be established to ensure that any breach of risk limits are escalated to management as well as independent control functions for appropriate follow-up actions.
- c) Stress testing should be conducted regularly to assess the impact of market stress on prime services activities. It should also be tailored to special situations, for example, when client portfolios hold illiquid positions or products with complex features and risk profiles and in cases where risk mismatches exist.
- d) Stress testing methodologies should be properly defined. They should cover extreme scenarios such as lack of market liquidity and flash crashes of securities or commodities prices. Methodologies should also be periodically reviewed.
- e) When issues are identified, they should be escalated to management in a timely manner for appropriate follow-up action. Contingency plans should be in place in the event of a “black swan” market scenario.