

9 October 2018

Circular to intermediaries

Use of “nominees” and “warehousing” arrangements in market and corporate misconduct

It is increasingly common that “nominees” and “warehousing” arrangements are used to facilitate market and corporate misconduct. The Securities and Futures Commission (**SFC**) wishes to remind intermediaries to be mindful of red flags indicating potential improper activities, make due follow-up enquiries with clients and report promptly to the SFC and other authorities where necessary.

Background

The SFC notes with concern the increasingly prevalent use of “nominees” and “warehousing” arrangements in schemes which may amount to market and corporate misconduct. Nominee arrangements may be legitimate if they are set up and operated in a manner that complies with relevant laws and regulations. However, the SFC noted cases where nominee clients took instructions from “masterminds”, and participated in activities to manipulate share prices or voting results in general meetings of listed companies, or to conceal the actual shareholding in a listed company to evade regulatory requirements¹. These activities seriously undermine market integrity and prejudice the interest of investors.

These arrangements may be associated with one or more red flags which should arouse the reasonable suspicion of intermediaries. If intermediaries fail to take reasonable steps to detect or properly address apparent red flags, they may be in breach of legal or regulatory requirements. Intermediaries may also be exposed to civil and criminal liability as a result of their involvement in misconduct or crime.

The “I-C-E” team² of the SFC has pooled resources from different divisions to tackle these issues. In particular, the Enforcement Division is currently investigating market and corporate misconduct cases involving “nominees” and “warehousing” arrangements and scrutinising the role played by the intermediaries in these cases.

Purpose of this circular

This circular serves to -

- remind intermediaries of their existing obligations under the Code of Conduct³, the AMLO⁴ and the AML Guideline⁵;

¹ For example, the requirement of making a general offer by a person and a group of persons acting in concert with it upon acquiring 30% or more of the shares of the company under the Codes on Takeovers and Mergers and Shares Buy-backs.

² The I-C-E team consists of senior executives and officers from the Intermediaries, Corporate Finance and Enforcement divisions who collaborate to tackle difficult issues relating to listed companies.

³ Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**)

⁴ Anti-Money Laundering and Counter-Terrorist Financing Ordinance (**AMLO**)

⁵ Guideline on Anti-Money Laundering and Counter-Terrorist Financing (**AML Guideline**)



- provide examples of the more common red flags identified to date; and
- set out the standard of conduct expected from intermediaries.

Obligations of intermediaries

Intermediaries should be wary of potential red flags and critically review and enhance their systems and controls for the purpose of complying with related legal and regulatory requirements, including:

- General Principle 1 of the Code of Conduct, requiring intermediaries to act honestly, fairly, and in the best interests of their clients and the integrity of the market;
- General Principle 2 of the Code of Conduct, requiring intermediaries to act with due skill, care and diligence, in the best interests of their clients and the integrity of the market;
- Paragraph 5.1 of the Code of Conduct, requiring intermediaries 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, and investment objectives;
- Paragraph 5.4 of the Code of Conduct, requiring intermediaries to be satisfied on reasonable grounds about (i) the identity, address and contact details of (a) the person or entity ultimately responsible for originating the instruction in relation to a transaction; and (b) the person or entity that stands to gain the commercial or economic benefit of the transaction and / or bear its commercial or economic risk; and (ii) the instruction given by the person or entity referred to in (i). The intermediary should keep in Hong Kong a record of the details referred to above and give the SFC access to that record upon request;
- Section 5(1) of Schedule 2 to the AMLO, requiring financial institutions to continuously monitor their business relationship with customers by conducting appropriate scrutiny of transactions (cash and non-cash transactions) carried out for the customers;
- Paragraph 5.1 of the AML Guideline, requiring financial institutions to identify transactions that are complex, large or unusual or patterns of transactions that have no apparent economic or lawful purpose and which may indicate money laundering or terrorist financing; and
- Paragraph 4.3.3 of the AML Guideline, requiring financial institutions to make appropriate enquiries about customers who are individuals, where there are indications that the customer is not acting on his own behalf.

Red flags

Intermediaries should be vigilant in looking out for potential red flags that may suggest use of “nominee” and “warehousing” arrangements for illegitimate purposes. The following is a non-exhaustive illustrative list:

- clients effecting transactions involving large amounts of funds that are not commensurate with their financial profiles;



- clients only transacting in one or two stocks over an extended period. The circumstances would be more suspicious if the clients are walk-in clients, opening an account to effect a single transaction involving a large sum of money;
- a large number of seemingly unrelated clients having authorised the same third party (who is not a licensed representative or registered individual of the intermediary) to operate their accounts⁶;
- a large number of seemingly unrelated clients that share the same trading and settlement patterns (for example, investing in same stocks) or the same correspondence address;
- frequent and large fund transfers to and from third parties absent a credible commercial rationale or explanation; and
- clients transferring a large quantity of stock (representing a sizeable portion of the typical daily turnover of the stock on the stock exchange) to and from third parties by way of bought and sold notes which do not appear to have been concluded on a normal commercial basis (for example, the executed price is substantially below the prevailing market price or the stock has been transferred to the client unaccompanied by any payment).

Expected standards

Intermediaries should take reasonable steps and implement robust systems and procedures to know their clients, identify the beneficial owner of the account, detect potentially illegal or manipulative activities, make prompt follow-up enquiries and report suspicious transactions where necessary⁷. For example:

- Know your clients: Intermediaries should take reasonable steps to establish the true and full identify of each client and the beneficial owner.
- Third party operated accounts: Intermediaries should implement proper controls and approval procedures for the opening of third party operated accounts. When intermediaries become aware that two or more unrelated clients have authorised the same third party to operate their accounts, intermediaries should make enquiries to ascertain the relationship between the clients and the third party operator, request evidence as proof of the relationship in case of doubt, critically evaluate the reasons for the arrangement, document the same and properly monitor these accounts for irregularities. Third party authorisations should only be accepted after approvals have been obtained from senior management.

⁶ The scope of authorisation includes placing of orders, effecting of settlement and collection of statements of account.

⁷ See also "[Circular concerning Know Your Client and Account Opening Procedures](#)" dated 12 May 2015; "[Circular to Licensed Corporations Licensed for Dealing in Securities - Protecting Client Assets Against Internal Misconduct](#)" dated 5 February 2016; "[Circular to Licensed Corporations and Associated Entities - Anti-Money Laundering / Counter Financing of Terrorism \(AML/CFT\), Compliance with AML/CFT Requirements](#)" dated 26 January 2017; and "[Circular to Licensed Corporations and Associated Entities - Anti-Money Laundering / Counter Financing of Terrorism \(AML/CFT\), AML/CFT measures and controls inspection findings](#)" dated 31 August 2018.



- Third party payments: Intermediaries are expected to make payments directly to their clients (i.e. by making bank transfers to clients' designated bank account(s) or issuing crossed cheques in clients' names) and discourage third party payments. When handling a client's third party payment requests, intermediaries should make enquiries of the client and consider whether the requests are reasonable in the circumstances, the frequency of third party payments, the relationship between the client and the third party and the purported reasons for these third party payments. Third party payments should only be allowed when enquiries do not identify any concerns. Furthermore, enquiries and their results should be properly documented, and approvals from senior management should be obtained before making third party payments.
- Third party fund deposits: Intermediaries should take all reasonable steps to tighten their controls to monitor third party fund deposits. Intermediaries should, among other things, inquire about and document the reasons for the deposits and the relationship between the client and the third party, obtain supporting evidence from the client where necessary, evaluate whether the third party fund deposit is reasonable in light of the client's profile and circumstances and assess whether there are any reasonable suspicions of improper activities having regard to the circumstances of the client and the transaction.
- Suspicious transactions: Intermediaries should implement proper transaction monitoring procedures and pay special attention to transactions which may be indicative of potential illegal or manipulative activities. For example:
 - (a) Cross trades: Intermediaries should implement systems to identify cross trades between clients. If repeated patterns of cross trades are noted between the same group of clients, intermediaries should ascertain the reasons for these cross trades and assess whether these transactions are part of an improper arrangement to manipulate prices or voting results in general meetings of listed companies, or to conceal the actual shareholding in a listed company to evade regulatory requirements.
 - (b) Transfer of stocks: Intermediaries should conduct appropriate enquiries and evaluate whether there is any cause for suspicion if:
 - (i) there are transfers of stocks through bought and sold notes between parties that do not appear to be commonly controlled or have an apparent relationship, especially when transactions do not appear to be on a normal commercial basis; and
 - (ii) there are transfers of large amount of stocks of a listed company from Client A to Client B following the announcement of a major corporate action by the listed company and before the book close date, and a subsequent request by Client B to vote in relation to the said corporate action.

To the extent that any suspicions cannot be dispelled through enquiries, senior management approval must be sought (and any approval with the corresponding reasons documented) before effecting any transactions. Senior management should also consider whether it is necessary to terminate the relevant client accounts. Intermediaries should report suspicious transactions to the SFC in a timely manner, as required under paragraph 12.5(f) of the Code of Conduct, to the Joint Financial Intelligence Unit, or to both.



Cautionary statement

The SFC wishes to reiterate that it does not tolerate any form of market or corporate misconduct.

To protect investors and maintain the integrity of the markets, the Intermediaries Supervision Department will continue to look for signs that may suggest dubious “nominee” and “warehousing” arrangements in the course of our supervisory reviews (covering both onsite inspections as well as offsite monitoring work). All material issues and deficiencies identified as well as Manager in Charge responsibilities in this regard will be investigated. These will include situations where there is reason to suspect that intermediaries and their senior management have knowingly facilitated such arrangements as well as situations where it appears that they have failed to detect and act on any red flags, including inadequate systems and controls.

The SFC will not hesitate to initiate criminal or other proceedings and impose disciplinary penalties where it establishes any failings on the part of intermediaries, including suspension or revocation of a licence or a registration, as well as fines on intermediaries and senior management.

Should you have any queries regarding this circular, please contact Ms Seine Luk at 2231 1696.

Intermediaries Supervision Department
Intermediaries Division
Securities and Futures Commission

End

SFO/IS/057/2018