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

19 December 2018

Circular to licensed corporations

Review of internal controls for the protection of client assets and supervision of account executives

The Securities and Futures Commission (SFC) has identified a number of cases of misconduct by account executives[1] (AEs) which have jeopardised clients' interests. The more serious cases involved unauthorised trading and misappropriation of client assets. These cases revealed serious internal control deficiencies in key operational areas and inadequate management supervision of AEs by licensed corporations (LCs).

Subsequently, the SFC conducted a high-level review[2] of control measures for protecting client assets and a thematic review of brokers' internal controls, including their supervision of AEs. In the Report on the review of internal controls for the protection of client assets and supervision of account executives released today, the SFC summarises the findings of these reviews and shares some good practices for LCs to consider in reviewing their control policies and procedures.

Today the SFC also published a comprehensive self-assessment checklist to assist securities and futures brokers with their internal control reviews. The checklist covers the key control measures the SFC expects of a broker as well as some good practices identified from the high-level and thematic reviews. LCs should carefully review their internal controls to ensure compliance with the regulatory requirements and, based on the results of their reviews, enhance their policies and procedures. The checklist is posted on our website.

Overview

The high-level review covered 11 small to medium-sized securities brokers by way of on-site reviews by an accounting firm engaged by the SFC, focusing on the brokers' internal controls for protecting client information, safeguarding client assets and handling trade documents.

Separately, the thematic review covered 35 brokerage groups comprising 66 securities and futures brokers which provide brokerage services to retail investors mainly through AEs. Each broker was required to complete a questionnaire. This was followed by the SFC's enquiries or meetings with senior management as well as sample reviews of documents. The review focused on five areas: staff-related corporate policies, the handling of client accounts, monitoring of dealing activities, safeguarding of client assets and the handling of trade documents.

[1] For the purpose of this circular, AEs refer to the designated licensed representatives responsible for maintaining client relationship and providing trade-related services to clients of brokers.
[2] This high-level review was conducted as part of a circularisation exercise. For details, please refer to the circular "SFC notifies the industry of a circularization exercise on clients' accounts" issued on 28 July 2017.

Regulatory concerns

The report sets out the SFC's key regulatory concerns identified in the reviews, which include:

1. Misaligned incentives in remuneration systems – The remuneration of AEs was generally determined by the commission income or turnover they generated, which may lead to an over-emphasis on short-term sales targets at the expense of a good compliance culture and client experience.

2. Insufficient segregation of duties – Some brokers allowed AEs to carry out incompatible duties in some critical processes, such as handling client assets, amending client information and following up on exceptions found in telephone record reviews and on undelivered or returned trade documents, which may expose the firms and their clients to the risks of undetected errors or abuses.

3. Inadequate controls to protect client accounts – The reviews identified various control deficiencies, including failure to establish written policies and procedures or implement maker-checker controls in key operational areas, lax controls over changes to clients' particulars, inadequate reviews to identify clients' suspicious correspondence addresses, a lack of policies to identify and protect dormant accounts as well as insufficient control measures for hold-mail arrangements[3]. Some brokers did not subject their AEs to their staff dealing policies and hence did not monitor trading activities in the AEs' personal or related accounts to ensure clients' interests were not prejudiced.

4. Insufficient compliance checks of client accounts – Most brokers selected client accounts for telephone record reviews and confirmation exercises based solely on random or sequential samplings, which might omit client accounts with a higher risk of error or abuse. Some brokers also failed to properly follow up on identified exceptions.

Expected standards

LCs should implement and enforce internal control policies and procedures which can be reasonably expected to protect their operations and clients from financial loss arising from theft, fraud and other dishonest acts, professional misconduct or omissions[4]. For example:

1. LCs are encouraged to implement a remuneration system for AEs which takes into account both sales and non-sales-related factors to encourage a good compliance culture and client experience. Where appropriate, they should implement policies requiring AEs to take mandatory block leave (ie, taking a number of consecutive calendar days of leave each year) and rotate jobs;

2. LCs should enforce the physical and functional segregation of incompatible duties. In particular, AEs should not be allowed to handle client assets or have access to client databases as well as blank and printed trade documents. They should also encourage clients to submit their non-trade-related instructions directly to the back office and report

[3] These refer to keeping clients' trade documents such as statements of accounts and receipts in LCs' office premises for clients to collect in person.

[4] Paragraph 4.3 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

any issues or irregularities with their accounts to the firms' management or independent staff;

3. LCs should establish and enforce written policies and procedures for key operational areas, communicate them to staff, monitor staff's adherence and keep them updated to reflect changes in risks, operations or other circumstances. Senior management of LCs are reminded of their supervisory obligations over AEs, which include subjecting them to staff dealing policies and monitoring trading activities in their personal and related accounts to ensure that their transactions are not prejudicial to the interests of clients; and

4. LCs should ensure that compliance checks, including reviews of telephone records and confirmation exercises for client account activities and balances, sufficiently cover client accounts and AEs. Independent staff should follow up on any discrepancies identified in compliance checks.

The SFC wishes to emphasise that LCs and their senior management, including Managers-in-Charge, bear the primary responsibility for maintaining appropriate standards of conduct and robust policies and procedures to adequately protect client assets and diligently supervise their staff. Failure to put in place effective supervisory and control systems for these purposes may subject LCs and their senior management to the SFC's regulatory action.

Should you have any questions regarding the contents of this circular, please contact Ms Jacquline Yip at 2231 1530 or the case officers in charge.

Intermediaries Supervision Department
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Enclosure

End

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