STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has publicly reprimanded and fined BOCOM International Securities Limited (**BISL**) a total of $19.6 million pursuant to section 194 of the Securities and Futures Ordinance (**SFO**).

2. BISL is licensed under the SFO to carry on business in Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities) and Type 5 (advising on futures contracts) regulated activities.

Summary of facts

3. The disciplinary action addresses BISL's internal control deficiencies and a range of regulatory breaches, including failures concerning the handling of third party fund deposits and the maintenance and implementation of a margin lending and margin call policy.

Third party deposits

4. Chapter 5 of the Guideline on Anti-Money Laundering and Counter-Terrorist Financing (**AML Guideline**) requires a licensed corporation to monitor client activities and properly document the findings. The SFC's Circular of 3 December 2013[1] reminds licensed corporations that they should be vigilant in monitoring customer activities and make enquiries about funds from third party sources.

5. The SFC finds that BISL did not put in place controls to adequately and effectively identify the deposits made into client accounts by third parties. Seven third party deposits made into two client accounts in 2009 and 2011 by way of cheques, and in 2015 by way of bank transfers were not identified until April 2016.

6. In respect of bank transfers, BISL relied on disclosures made and/or bank transfer documents provided by account holders and/or its own bank records to identify third party deposits. In other words, BISL would only be aware of third party deposits that it was alerted to by the account holders and did not have effective controls to ensure third party deposits that were not brought to its attention would be identified. Similarly, for deposits made by way of cheques, BISL again relied on the account holders to provide the depositor's information and took no step to enquire if the funds came from the clients.

[1] Circular to Licensed Corporations and Associated Entities on Anti-Money Laundering/Counter Financing of Terrorism – Suspicious Transactions Monitoring and Reporting.

Margin lending policies

7. Paragraph 10 of Schedule 5 to the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**) provides, among other things, that a licensed corporation should have a clear margin lending policy developed, documented and communicated to all relevant staff for strict enforcement. Such policy should include at least the following objectives:

   (a) to provide a basis for protecting the capital of the licensed person;

   (b) to ensure adequate procedures are in place for identification of risks, effective monitoring and corrective action; and

   (c) to ensure there is a consistent risk management policy.

8. Further, among other things, paragraph 12 of Schedule 5 to the Code of Conduct provides that a licensed corporation engaged in the provision of margin financing should develop, document and strictly enforce a clear margin lending policy to address:

   (a) the use of objective proof of net income or net worth as a reference for setting credit limits (paragraph 12(a));

   (b) the triggering level for making the first and successive margin calls (paragraph 12(f));

   (c) the giving of warnings to clients with outstanding margin calls specifying the steps the firm plans to take and when (paragraph 12(g));

   (d) the maintenance of appropriate detailed records to ensure that the case history of margin calls for each individual client can be readily established (paragraph 12(h));

   (e) the triggering level for stopping further advances to clients, for example, where there are outstanding margin calls yet to be met (paragraph 12(i));

   (f) the triggering level for forced liquidation of a client's collateral (paragraph 12(j)); and

   (g) the circumstances in which deviation from the policy, supported by written explanations, may be approved by management (paragraph 12(l)).

9. Licensed corporations are also required to collect promptly from clients amounts due as margin under paragraph 3.6 of the Code of Conduct.

10. In addition, paragraph 4.3 of the Code of Conduct requires a licensed corporation to have internal control procedures to protect its operations and clients from theft, fraud, and other dishonest acts, professional misconduct or omissions.

11. The SFC found that BISL failed to document a clear margin lending and margin call policy and implement the policy accordingly. BISL had a number of written policies and procedures covering margin lending, but the triggering levels for making margin calls were not consistent in these documents. In response to the SFC's inquiries about the steps taken to issue margin calls, the practices described in BISL's submissions also differ from its written policies and procedures.

12. While BISL claimed that a number of factors (for example, liquidity of the collateral and the balances of the client's other accounts) would be taken into account in determining whether a margin call should be made, the levels at which those factors would trigger margin calls are not specified in the written policies and procedures.

13. BISL's written policies and procedures provide for applications for credit limit to be made to the risk management department and approved by the management. However, the credit limit application forms examined by the SFC show that the credit limits were not set by reference to objective proof of financial resources but tailored to accommodate the outstanding margin loans in the client accounts. Further, the SFC also found that BISL did not strictly enforce the credit limit set for client accounts.

14. With respect to the collection from clients of amounts due as margin, the SFC found that BISL failed to promptly collect from clients amounts due as margin. About 70% of the client accounts that appeared on BISL's daily call reports produced to the SFC had margin requirements which had remained unpaid for over 60 days. In certain cases, the margin requirements remained unpaid for over 1,500 days.

15. BISL's written policies and procedures before July 2016 suggested that no new buy trade was permitted in client accounts until margin requirements had been paid. This restriction was made subject to prior management approval in July 2016. However, BISL's records for 2015 show that it had deviated from its policy by approving new buy trades in accounts with outstanding margin requirements after the trades were conducted and the approvals given were not supported by written explanations on each occasion.

16. The SFC also found, from an examination of BISL's margin call history, that:

(a) when deciding if a margin call was necessary, BISL did not base its decision on the triggering level set out in the written policies and procedures;

(b) margin calls were not necessarily made to clients even when the margin calls were considered to be necessary;

(c) BISL's records do not readily show whether or not margin calls had been made;

(d) account executives or sales staff were responsible for making margin calls and BISL's former responsible officer was responsible for applying for, as well as approving, liquidation suspension in a client account; and

(e) the liquidation suspension procedures set out in BISL's written policies and procedures were not followed – there is no record of any liquidation notice issued to a client in circumstances where forced liquidation was called for in accordance with BISL's written policies and procedures, there is no record of the client's application for liquidation suspension, there is also no written explanation for deviation from the forced liquidation policy.

17. All in all, BISL's failures in respect of its margin lending and margin call policy are serious. The reliability of BISL in carrying on a business in margin financing is in serious doubt given its failures to comply with paragraphs 3.6 and 4.3 of and paragraphs 10 and 12 of Schedule 5 to the Code of Conduct, and the requirement to segregate key duties and functions under Section II of the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (**Internal Control Guidelines**).

Authorization of transactions

18. Paragraph 4.2 of the Code of Conduct provides that a licensed corporation should ensure it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed to conduct business on its behalf.

19. Paragraph 7.1 of the Code of Conduct provides that a licensed corporation should not effect a transaction for a client unless before the transaction is effected: (a) the client, or a person designated in writing by the client, has specifically authorized the transaction; or (b) the client has authorized in writing that the licensed corporation or its licensed representative may effect transactions for the client without the client's specific authorization.

20. The SFC's investigation found that:

    (a) An account executive of BISL (**Mr X**) operated the accounts of a number of clients, including during the period from 12 October 2013 to 16 November 2014 when the account executive ceased to be a representative of BISL and had written authorization from at least one of the clients to operate her account.

    (b) One of BISL's responsible officers instructed a dealer to take orders for the client accounts from Mr X during the period when he was not a representative of BISL. The dealer confirmed trades for the client accounts with Mr X and the dealing tickets he prepared showed that Mr X traded for a number of client accounts at the same time.

    (c) Mr X continued to trade for the client accounts after he re-joined BISL on 17 November 2014 as an account executive and there were no telephone recordings of the relevant order instructions for the client accounts.

    (d) Mr X's trading activities for client accounts lasted for at least three years.

    (e) One of the account holders (**Complainant**) complained to BISL about Mr X's trading activities in her accounts and asserted that Mr X promised to compensate her for trading losses.

21. BISL claimed that it had no knowledge of the trading arrangements between Mr X and the clients whose accounts he operated notwithstanding the circumstances set out in paragraphs 20(a) to (d) above.

22. BISL's purported ignorance shows that it failed to adequately and effectively supervise its representatives to ensure that transactions effected in clients' accounts were properly authorised.

Origination of instructions

23. Paragraph 5.4 of the Code of Conduct requires a licensed corporation to be satisfied on reasonable grounds about the identity of the person ultimately responsible for originating the order instruction before effecting a transaction.

24. BISL claimed that it relied on telephone recordings of client order instructions or the signed order instruction forms to identify the person who originated the order instructions.

25. Among the 712 trades executed in the Complainant's cash securities trading account and margin trading account between May 2012 and March 2016, BISL:

(a) had sample checked 100 of them and found that there was no telephone recording of order instructions but believed that the orders were placed by Mr X; and

(b) claimed that it had no information about the order records and trade confirmations for the remaining trades, and that the reason for the missing telephone recordings and the steps taken after the identification of the missing records are also not available.

26. BISL's purported ignorance about the missing telephone recordings of order instructions in the Complainant's accounts and its belief that Mr X placed the relevant order instructions show that BISL had no reasonable grounds to be satisfied about the identity of the person ultimately responsible for originating the order instructions in respect of the Complainant's accounts before effecting the trades and had no control to ensure that the person could be identified.

Telephone recording of client orders

27. Paragraph 3.9 of the Code of Conduct provides that a licensed corporation should prohibit its staff members from receiving client order instructions through mobile phones in office premises and record order instructions received through the telephone with a telephone recording system.

28. The SFC's investigation found that BISL had failed to ensure orders received through telephone were tape recorded. The sample checking exercises conducted by BISL in 2015 and 2016 indicated that almost half of its account executives had failed to comply with the order recording requirement under the Code of Conduct. BISL did not adequately follow up on the missing order recordings, nor did it immediately report its representatives' failures to comply with the order recording requirement to the SFC pursuant to paragraph 12.5 of the Code of Conduct, which requires licensed corporations to immediately report to the SFC any non-compliance or suspected non-compliance with any regulations and codes by persons it employs or appoints to conduct business.

Confirmation of transactions

29. Paragraph 8.2 of the Code of Conduct requires a licensed corporation to confirm promptly with clients the essential features of transactions conducted for them (other than for transactions conducted in discretionary accounts).

30. The reliability of BISL's trade confirmations with clients is highly questionable because the client's identity in the confirmations were not verified. BISL claims its failure to verify the client's identity is acceptable given the account executives know their clients. However, when asked to identify the clients from certain telephone recordings of trade confirmations, BISL could only confirm the persons were a man or a woman whom it believed might be the client.

Handling of client complaint

31. Paragraph 12.3 of the Code of Conduct requires a licensed corporation to ensure, among other things, that:

(a) complaints from clients relating to its business are handled in a timely and appropriate manner;

(b) steps are taken to investigate and respond promptly to the complaints;

(c) where a complaint is not remedied promptly, the client is advised of any further steps which may be available to the client under the regulatory system including the right to refer a dispute to the Financial Dispute Resolution Centre; and

(d) where a complaint has been received, the subject matter of the complaint is properly reviewed. If the subject matter of the complaint relates to other clients, or raises issues of broader concern, a licensed or registered person should take steps to investigate and remedy such issues, notwithstanding that the other clients may not have filed complaints.

32. The SFC's investigation found that BISL had failed to adequately investigate into the Complainant's complaint and issues of broader concerns raised by the complaint. For example:

(a) Its internal investigation failed to ascertain the extent of the trading activities conducted by Mr X in the Complainant's (and other clients') accounts and if Mr X actually promised to compensate the client.

(b) BISL appeared to have readily concluded that Mr X traded for the Complainant on a discretionary basis without looking into the circumstances under which the order instructions for the trades were given - why were the order instructions not tape recorded, or why were the procedures for order instructions not received through telephone not followed.

(c) BISL also did not investigate into why trading in the Complainant's margin trading account could continue without margin deposits and why third party deposits could be made into the accounts of the Complainant and another client without being identified.

33. Moreover, no formal reply was issued to the Complainant more than two years after BISL's receipt of the complaint.

Conclusion

34. BISL's failures in the circumstances have breached Chapter 5 of the AML Guideline, paragraphs 3.6, 3.9, 4.2, 4.3, 5.4, 7.1, 8.2, 12.3 and 12.5, as well as paragraphs 10 and 12 of Schedule 5, of the Code of Conduct, and the requirements under Sections II and VII of and the Appendix to the Internal Control Guidelines[2].

35. In light of the failures set out above, the SFC is of the view that BISL's internal controls are inadequate and ineffective. BISL's conduct also constitutes a failure to comply with

[2] Section VII (Operational Controls) of and the Appendix to the Internal Control Guidelines require the licensed corporation to establish processes to maintain records of client information, including persons authorized to give instructions.

General Principles 2, 3 and 7 of the Code of Conduct[3], and reflected adversely on its reliability to carry on business in regulated activities.

36. Having considered all the circumstances of the present case, the SFC considers that a public reprimand identifying the deficiencies and a fine proportionate to the gravity of BISL's failures are necessary.

37. In deciding on the disciplinary sanction against BISL, the SFC took into account the following considerations:

(a) BISL has an otherwise clean disciplinary record;

(b) BISL has taken steps to revise its policies and procedures in relation to the areas where deficiencies were identified;

(c) BISL has agreed to engage an independent reviewer to conduct a review of its internal controls;

(d) BISL's failures are serious, extensive and lasted for a substantial period; and

(e) a clear message needs to be sent to the industry that the SFC will not hesitate to take action against licensed corporations that fail to put in place appropriate internal controls to protect their operations and clients.

[3] General Principle 2 (diligence) requires a licensed corporation to exercise due skill, care and diligence when carrying on business in regulated activities. General Principle 3 (capabilities) provides a licensed corporation should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities. General Principle 7 (compliance) requires a licensed corporation to comply with all regulatory requirements applicable to the conduct of its business activities.