



# SFC Compliance Bulletin: Intermediaries

## Modernising our licensing processes

To keep abreast of fast-changing market developments, we recently refined our licensing approach to better utilise our available tools and concentrate on key risks. This marks a change from how we traditionally carried out our gatekeeping function.

For example, new licensing forms which became mandatory from 11 April 2019 allow us to more effectively gather the information we need to assess the fitness and properness of a corporate applicant, focusing on five key elements, namely its business, controller, management, financial strength and internal controls. Collecting and analysing the relevant data upfront makes our licensing process more efficient and transparent and helps us get a proper handle on some recurring problems.

This edition of the *SFC Compliance Bulletin: Intermediaries* highlights our efforts in adopting an outcome-oriented, risk-based approach and includes case studies illustrating how we apply this in practice to prevent the movement of employees with a history of misconduct within or between firms and address the risks posed by the controllers and affiliates of licensed corporations (LCs).

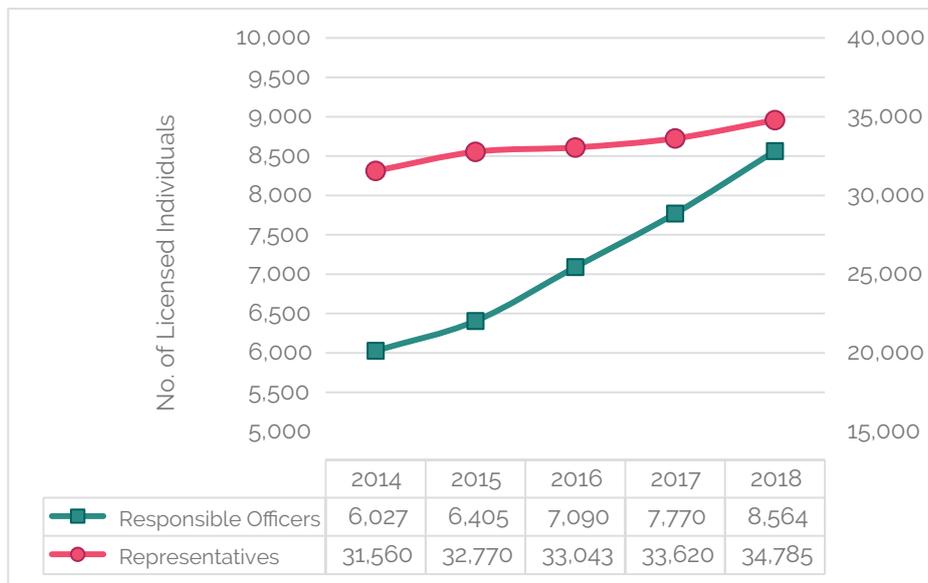
Widespread misconduct in the financial services sector may pose systemic risks to the financial system and weaken the confidence of the investing public. Therefore, mitigating misconduct risk is an important issue for both regulators and the financial industry. Firms are collectively responsible for upholding the integrity of the industry and it is in their interest to conduct thorough due diligence on the individuals they seek to employ.



Bad apples can potentially repeat their misbehaviour at another firm.

## Number of licensed individuals on the rise

### Number of responsible officers and representatives, 2014-2018



From 2014 to 2018, the number of responsible officers increased 42% to 8,564 and the number of representatives rose 10% to 34,785.

### Applications processed in 2018



Compared to 2014, we processed significantly more new representative and responsible officer applications and requests for transfer of accreditation during 2018.

## Introducing front-loaded regulation to our gatekeeping function

Following a strategic review of our licensing processes, we recently introduced reforms to bring our gatekeeping function in line with the Securities and Futures Commission's (SFC) front-loaded regulatory approach, which emphasises earlier, more targeted and systematic intervention to tackle market irregularities and corporate misconduct.

## Movement of licensees with poor compliance records

The rise in the number of applications we receive and increasing mobility within the industry were key considerations behind our strategic licensing reform. Compliance history is a vital element in assessing an individual's fitness and properness. Obtaining more specific information about an individual's conduct helps us assess licensing applications more effectively with the resources at our disposal.

In April 2018, the Financial Stability Board released "Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors", which sets out preventive approaches for firms and regulators to strengthen governance frameworks and mitigate misconduct risk by improving corporate culture, clarifying individual responsibility and accountability and tracking the movement of "bad apples".

"Rolling bad apples" are people with a record of misconduct which is wiped clean when they change jobs, allowing them to potentially repeat their misbehaviour at another firm. To better track "bad apples", the recent strategic reform of our licensing forms and processes introduced more effective mechanisms to address the issue of licensed individuals moving between LCs without their misconduct being reported to and scrutinised by the SFC in a timely manner.



### New disclosure requirement for investigations of outgoing licensed individuals<sup>1</sup>

For example, changes were made to the form LCs use to notify the SFC of the cessation of accreditation of a licensed individual. LCs are now required to disclose whether the individual was the subject of an internal investigation commenced within six months of the cessation as well as the details of the investigation. They are also required to notify the SFC as soon as practicable if an investigation is commenced after the initial notification of cessation, regardless of how long ago the individual left the firm.

### Heightened disclosure of investigations, disciplinary actions and civil litigation

The new licensing forms also emphasise the disclosure of more recent and significant investigations, disciplinary actions and civil litigation. Collecting more specific information about these matters enables us to better gauge their impact on the application.

### Case studies

The following case studies are examples of non-disclosure of misconduct or disclosure which was not otherwise full and frank, or not made in a timely manner.

### Failure to report significant misconduct in a timely manner

- Mr X, a licensed trader on secondment from an overseas office, made false manual entries in the LC's risk management system to conceal the actual risk exposure of his trading activities and provided false information to the LC. At the time the LC reported his trading loss to the SFC, Mr X had admitted his actions and the LC had commenced an internal investigation. However, the LC failed to report these crucial facts to the SFC. In response to the SFC's follow-up inquiry, the LC reported the misconduct and provided its investigation report. The LC was reprimanded and fined for failure to report significant misconduct in a timely manner.

Paragraph 12.5 of the Code of Conduct for Persons Licensed by or Registered with the SFC requires LCs to report to the SFC immediately upon any material breach, infringement of or non-compliance with any law, rules, regulations and codes administered or issued by the SFC, or where it suspects any such breach, infringement or non-compliance whether by itself or persons it employs or appoints to conduct business with clients or other licensed persons.

<sup>1</sup> See FAQs issued on 21 May 2019 for further guidance on this new disclosure requirement.

### Misrepresenting the reason for cessation of employment

- An LC terminated the employment of a staff member, Mr Y, after he admitted misappropriating client money. However, the LC reported the reason for cessation as "job rotation" in its notification form submitted to the SFC and provided no information about the misappropriation. This misleading report delayed the SFC's follow-up action. Mr Y was banned from re-entering the industry for life for misappropriating client money and misleading the client with false account statements. The LC and the responsible officer declaring the information in the notification form to be complete, true and correct were convicted and fined.

Information provided to the SFC in notification forms is subject to section 384 of the SFO, which prescribes that a person commits an offence if the information he provides in such notification is false or misleading in a material particular and he knows that, or is reckless as to whether, the information is false or misleading in a material particular.

- An LC, which is also an Exchange Participant registered with The Stock Exchange of Hong Kong Limited (SEHK), failed to report certain trades to the SEHK as required under the Rules of the Exchange. In reporting this incident to the SFC, the LC mentioned that the employment of Mr Z, who at the time was the Head of the Dealing Desk, had been terminated as a disciplinary action for failing to escalate the matter to management.

However, the LC's notification of the cessation of Mr Z's employment submitted to the SFC two months later gave the reason for cessation as "redundancy" instead of "dismissal". The SFC made several rounds of inquiries with the LC and Mr Z about this discrepancy. The LC was reminded of its obligation under section 384 of the Securities and Futures Ordinance (SFO).

### Concealing a criminal conviction

- Soon after joining a Hong Kong firm as a licensed representative, Ms L was convicted overseas on a criminal charge relating to the provision of financial services without approval. She failed to give notice in writing to the SFC within seven days as required by law. Subsequently, she was able to move on to a registered institution (RI) as a relevant individual, but she made a false declaration when she did not disclose the criminal conviction in her job application and self-declaration forms. We found that she had deliberately, or at least recklessly, concealed her overseas conviction and banned her from re-entering the industry for eight months.

Section 4 of the Securities and Futures (Licensing and Registration) (Information) Rules requires a licensed representative to give notice in writing to the SFC within seven days where there is a change to the licensed representative's relevant information, including a criminal charge in Hong Kong or elsewhere.

## Fitness and properness of controllers and affiliates

Controllers are a key focus in our assessment of corporate applicants. The fitness and properness of an LC's controllers may have a direct impact on the LC. In some instances, issues with an LC's affiliates may spill over to the LC and the group as a whole.

The following case studies illustrate how an LC could be affected by the non-regulated activities conducted by its controller and affiliate and how the SFC has used its regulatory tools to contain the risks under its front-loaded regulatory approach.

- Mr W was the ultimate sole owner of an LC and a sister company which had co-location arrangements and shared resources such as websites and personnel, including the responsible officers and licensed representatives of the LC. Mr W was arrested by the Hong Kong Police for the alleged offence of conspiracy to defraud in connection with the sister company.

We expressed our serious concerns to the LC about the implications for its fitness and properness given the perception that the LC might be associated with this alleged fraudulent business. The LC relocated to a new office and discontinued the personnel sharing arrangements. Upon our request, Mr W also stepped down from his management roles in the LC.

- A financial group controlled a number of LCs and also operated an online lending platform outside Hong Kong which collapsed. This raised concerns about the financial integrity and reputation of the group's owner as well as the possible impact on the LCs. We communicated our concerns to the owner and the LCs' senior management, and the LCs agreed to cease the owner's involvement in the LCs' businesses and not to advance loans to the owner or his associates.

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