



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

Inspection findings and other supervisory observations on AML/CFT

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Disclaimer and Reminder

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Inspection findings and other supervisory observations on AML/CFT

(1) Control failures over third-party deposits and payments

(2) Use of “nominees” and “warehousing” arrangements in market misconduct

(3) Other deficiencies and inadequacies found in LCs’ AML/CFT measures and controls

Circular on third-party deposits and payments

The SFC issued a circular on third-party deposits and payments on 31 May 2019 ^{Note} to elaborate expected standards in areas where LCs were often found to have failed to implement adequate policies and controls to mitigate the risks associated with third-party deposits and payments.

Expected standards

- ✓ LCs should only accept third-party payment arrangements when adequate control measures are properly implemented to mitigate the associated risks
- ✓ MIC of AML/CFT should be designated to oversee the proper design and implementation of the policies and procedures for handling third-party deposits and payments as well as the ongoing monitoring of client accounts involving such arrangements
- ✓ LCs should adopt a policy which discourages third-party deposits and payments and only accept them under exceptional and legitimate circumstances having regard to the client's profile and normal commercial practices
- ✓ The acceptance of a third-party deposit or payment should be approved by the MIC of AML/CFT or MLRO. Where it involves a third-party payor or payee who might pose higher risks, it should be subject to a dual approval process.
- ✓ LCs should step up their ongoing monitoring of client accounts involving third-party payment arrangements, make prompt follow-up inquiries and report any suspicious transactions to the JFIU.



^{Note} <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/aml/doc?refNo=19EC39>

Circular on third-party deposits and payments

– *Key control measures and examples of effective practices*

Policies and procedures (approved by senior management)

Applicable to third-party deposits and payments

- Clearly define the exceptional and legitimate circumstances under which third-party deposits / third-party payment requests may be accepted
- Set out the control measures to be carried out before accepting any such deposits / payment request
- Designate the managers and staff members responsible for carrying out these control measures

Applicable to third-party deposits only

- Put in place effective monitoring systems and controls to identify third-party deposits into the LC's bank accounts
- Rejected third-party deposits should be returned to their payment sources as soon as practicable



Circular on third-party deposits and payments

– Key control measures and examples of effective practices

Due diligence and evaluation

- Due diligence on any third-party deposit / payment to determine:
 - a. the identity of the third-party payer / payee
 - b. the relationship between the client and the third-party payer / payee
 - c. the reason for receiving the deposit from / making the payment to the third-party
- Take reasonable measures on a risk-sensitive basis to verify the identities of third-party payers / payees and ascertain their relationships with clients. Apply enhanced scrutiny on third-party payers / payees of higher risks
- Critically evaluate the reasons and need for third-party deposits / payments



Ongoing monitoring

- Step up ongoing monitoring of client accounts involving third-party deposits or payments, paying special attention to red flags relating to third-party transactions (including be alert to the possibility that the third-party payer is the true beneficial owner and the associated risk)
- A suspicious transaction report should be made to the JFIU when there are grounds for suspicion of ML or TF



Circular on third-party deposits and payments

– *Key control measures and examples of effective practices*

Designated bank accounts

- Firms are strongly encouraged to require their clients to designate bank accounts held in their own names or the names of acceptable third parties for the making of all deposits and withdrawals



Staff training, record keeping and client communication

- Provide clear and sufficient guidance to the staff responsible for evaluating third-party deposits or payments
- Properly document the findings of inquiries made and corroborative evidence obtained during the evaluation and approval of a third-party deposit or payment
- Clearly inform clients in writing of their policies for handling third-party deposits and payments



Case sharing

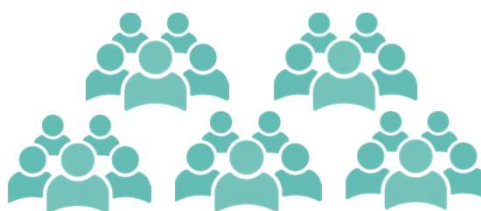
– *serious control failures over third-party deposit transactions*

LC processed **10,000 third-party deposits** totalling approximately **\$5 billion** for more than **3,500 clients**



Third parties

Certain third-party deposits were made for credit to the accounts of clients and these third parties had no apparent relationships with these clients



Clients of Company X

Over 100 clients received third-party deposits that were incommensurate with their financial profiles



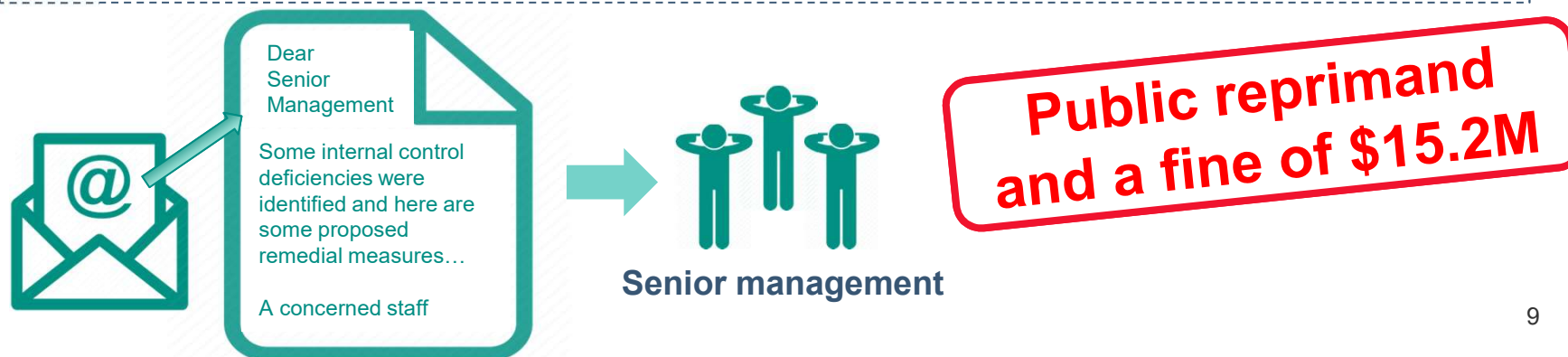
Some third-party deposits were withdrawn by clients shortly after receiving the funds without being used for trading

Case sharing

– serious control failures over third-party deposit transactions

The LC concerned failed to:

- ❌ have in place any policies or procedures to verify the identities of third-party depositors, ascertain the relationship between its clients and third-party depositors, and scrutinise the reasons for making third-party deposits
- ❌ have in place an effective approval process for third-party deposits
- ❌ have in place any systems and controls to identify and monitor third-party deposits made into the bank sub-accounts maintained by the LC for its clients
- ❌ identify and make enquiries about third-party deposits with AML red flags and report the same to JFIU in a timely manner
- ❌ conduct adequate ongoing monitoring of its business relationship with clients
- ❌ put in place an effective compliance function



Other control failures over third-party deposits and payments noted in inspection

Third-party deposits and payments



- third-party deposit and payment of the same amount were processed for a client account with no trading activities noted in the 2-month period
- Failed to document its enquiry and evaluation of these potential suspicious transactions despite they matched one of the red-flag indicators set out in the LC's policies and procedures

Inspection findings and other supervisory observations on AML/CFT

(1) Control failures over third-party deposits and payments

(2) Use of “nominees” and “warehousing” arrangements in market misconduct

(3) Other deficiencies and inadequacies found in LCs’ AML/CFT measures and controls

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

It is increasingly common that “nominees” and “warehousing” arrangements are used to facilitate market misconduct.

- The SFC noted cases where nominee clients took instructions from “masterminds”, and participated in activities to manipulate share prices, which may constitute market misconduct that generates illicit proceeds to be laundered.
- The SFC issued a circular on 9 October 2018 to alert the industry of the risk of “nominees” and “warehousing” arrangements being used for market misconduct and other illegitimate purposes. ^{Note}

Note <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=18EC73>



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

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

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:

- 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



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

Suspicious transactions monitoring

Intermediaries should implement proper transaction monitoring procedures and pay special attention to transactions which may be indicative of potential manipulative activities.

Examples of transactions that should be subject to monitoring:

Repeated patterns of cross trades between the same group of clients

- Ascertain the reasons for these cross trades
- Assess whether these transactions are part of an improper arrangement

Third-party deposits and payments

- Please refer to the key control measures together with examples of effective practice to implement them detailed in the Circular on “Third-party deposits and payments” issued by the SFC on 31 May 2019 ^{Note}

Transfer of stocks not on normal commercial basis

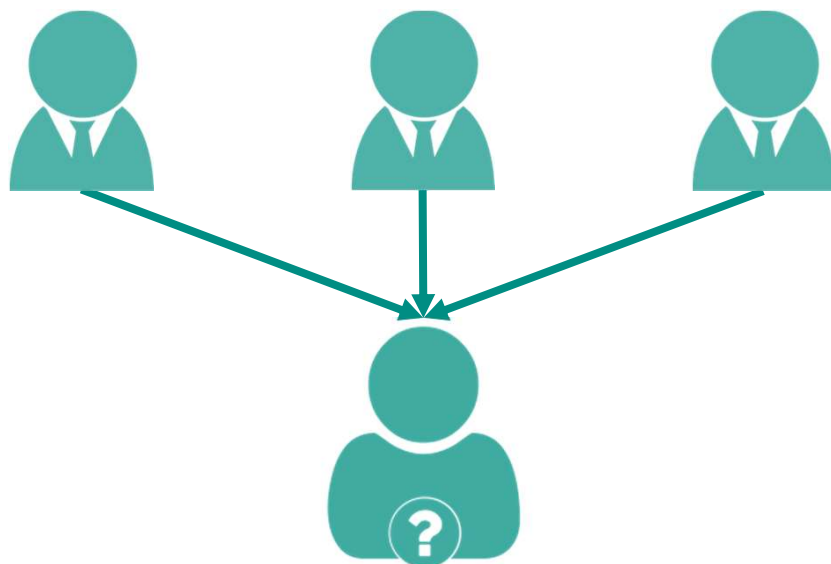
- Conduct appropriate enquiries and evaluate whether there is any cause for suspicion if transfers of stocks through bought and sold notes between parties that do not appear to be commonly controlled or have an apparent relationship, especially when transactions do not appear to be on a normal commercial basis

Note <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/aml/doc?refNo=19EC39>

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

Intermediaries should be vigilant in looking out for potential red flags that may suggest use of “nominee” and “warehousing” arrangements for market manipulation purposes.

Examples of client-related red flags:



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 accounts.

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



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

Examples of fund-related red flags:



Clients effecting transactions involving large amounts of funds that are not commensurate with their financial profiles



Frequent and large fund transfers to and from third parties absent a credible commercial rationale or explanation

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

Examples of stock-related red flags:



Clients transferring a large quantity of stock with third parties (representing a sizeable portion of the typical daily turnover of the stock on the stock exchange)



Clients using 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)



Clients only transacting in one or two stocks over an extended period

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



- 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 any transactions suspected to be in breach of market misconduct provisions 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

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Senior management oversight



- ✓ AML/CFT related matters were discussed in the monthly board meeting with the presence of all responsible officers
- ✗ No record of such discussion

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- ✗ Inadequate management information provided to the senior management for them to exercising oversight effectively on AML/CFT matters

- Backlog of over 16,000 screening alerts for PEPs, terrorists or designated parties pending for review and resolution was not brought to the attention of the senior management



Compliance monitoring



- Failed to put in place any compliance monitoring and testing programme for monitoring the effective implementation and operation of AML/CFT controls and procedures
- Firm's AML/CFT systems were not subject to any independent review by its internal audit function



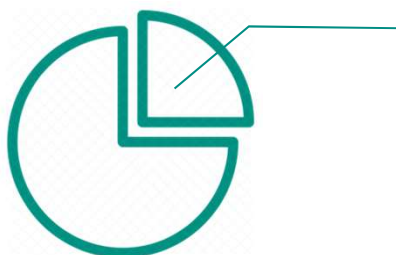
Some of the AML/CFT policies and procedures were not implemented or adhered to in practice

- Staff are required to assess ML/TF risk of a customer during the account opening process, but the firm in practice ONLY conducted customer risk assessment for brokerage business but not for other regulated activities of the LC

Institutional risk assessment

Consideration of risk factors

- Failed to consider a comprehensive range of risk factors which were relevant to the LC to identify and assess the ML/TF risks to which the firm was exposed



Failed to reflect the risk profile of the LC's entire customer base

Quantitative analysis of customers used by the LC to support the assessment of its vulnerability to customer and country risks limited to the customers on-boarded in the past 12 months

- Failed to consider the ML/TF threats and vulnerabilities identified in the Hong Kong's ML/TF Risk Assessment Report, e.g. transnational ML threats arising from the exposure to non-Hong Kong customers who may be connected with corruption and tax evasion

Consideration of risk mitigating measures

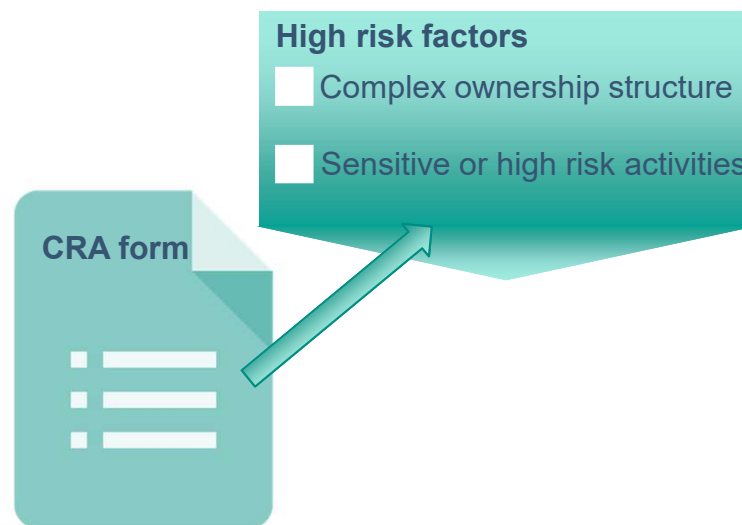
- Failed to evaluate the adequacy and appropriateness of the AML/CFT policies, procedures and controls in light of the risk assessment results

Customer risk assessment

– Robustness of framework and methodology

Insufficient guidance on risk factors definition

- No guidance provided as to what constitute “complex ownership structure” or “sensitive or high risk activities”
- Failed to define what further due diligence should be conducted for assessing the ML/TF risk of a customer with complex ownership structure (e.g. if there is a legitimate reason behind a particular structure employed)



Beneficial owner was located in Ukraine



Designated bank accounts were located in Denmark and Luxemburg



Authorised persons were located in Switzerland and Ukraine

Insufficient guidance on risk factors definition

- Failed to take into account and evaluate whether onboarding a customer who ties to multiple jurisdictions via non-face-to-face channel would bring heightened ML/TF risk to the business of the LC

Customer risk assessment (“CRA”)

– Deficiencies in re-assessment

LCs would generally re-assess the risk rating of customers during the performance of periodic review of their customers or upon the occurrence of trigger events.

1 Limitation

The re-assessment was solely based on whether there were any irregularities identified from the review of the customers’ transaction records and whether the customers were identified to be a PEP. It did not follow the CRA methodology adopted during customer on-boarding.

2 Limitation

2

The re-assessment results were not updated to the customer database, which served as the basis for determining the extent of ongoing monitoring of customers.

Customer risk assessment

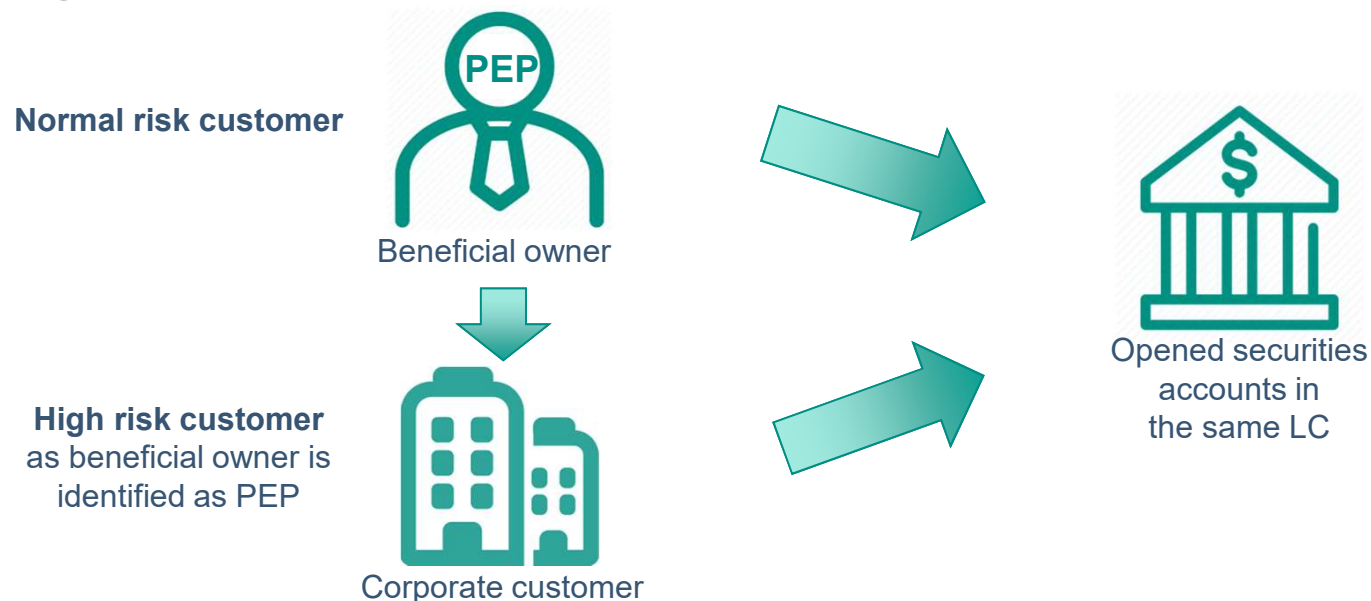
– Non-compliance with internal policies and procedures

Inconsistent risk assessment results in multiple accounts opening

- A customer which has opened more than one accounts during different time periods was assigned different risk rating for the accounts.



Categorisation of customer risks



Customer due diligence

– Source of Fund (“SoF”) & Source of Wealth (“SoW”)



- Failed to take any additional measures for establishing SoF and SoW of customers or beneficial owners who were:
 - Foreign PEPs, high risk domestic or international organisation PEPs, and other high-risk customers.

Only some general financial information in the account opening form (which were applicable to all customers) were collected

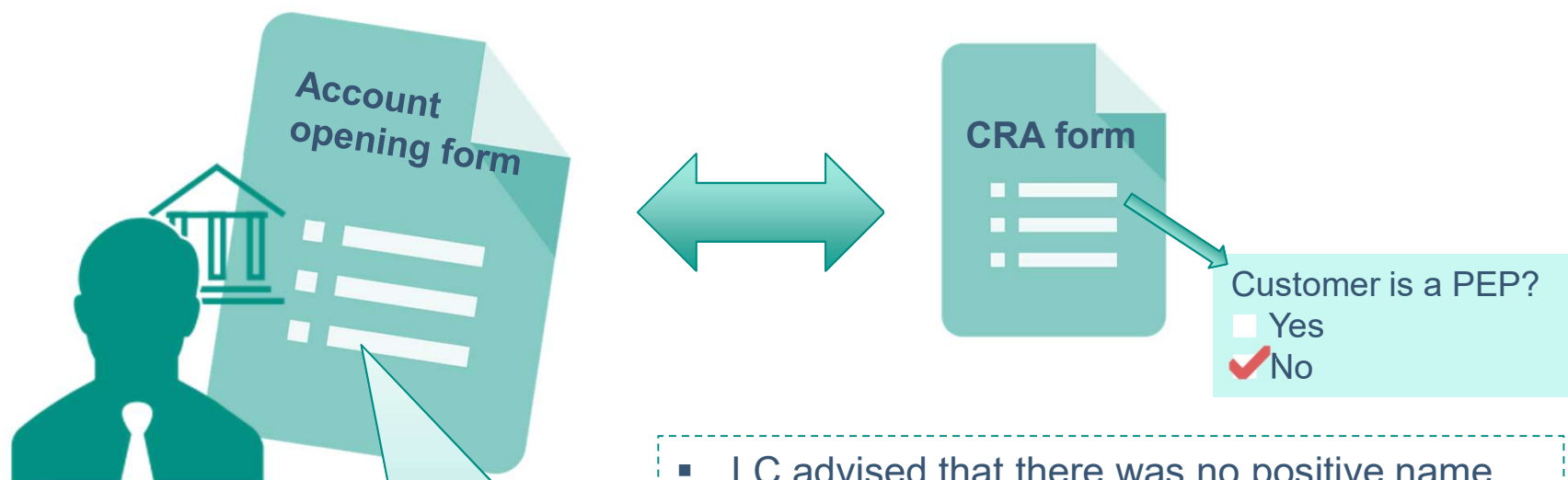
- Staff normally selected “transfer from customer’s bank accounts” as SoF of the customer without providing additional information about the activity that generated the funds



Source of funds: <input checked="" type="checkbox"/> Transfer from customer’s bank account <input type="checkbox"/> Others, please specify each item: _____	Additional information: _____ _____ _____
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Customer due diligence

– Identification of PEPs



Occupation:
Government Official

- LC advised that there was no positive name match to a PEP when screening the customer against the database
- No documentary evidence showing that LC had taken any other reasonable measures, e.g., making further enquiry with the customer, to understand the occupation and employer of the customer for the determination of whether or not the customer was a PEP

Screening effectiveness and database maintenance

“Exact Match” search mode

- Names with minor alterations such as reverse order, partial name and abbreviated forms would not be identified
 - Risk of missing genuine matches and TF, financial sanctions or proliferation financing violation by the firm may increase

Omission

- Failed to identify that the customer lists used for ongoing screening had omitted to include customers on-boarded after a particular date
- Beneficial owners and other connected parties of customers were excluded from the ongoing screening process

Chinese names’ screening

- For customer’s name in Chinese characters, only screening using the English transliteration of the customer’s Chinese name was performed

Completeness

- No measures to ensure the completeness and accuracy of the screening database maintained by third-party service providers

Suspicious transaction monitoring and reporting

Handling of suspicious transactions related to market misconduct activities

- Frontline staff would contact the customer concerned and warn them not to conduct similar transactions repeatedly when suspicious market misconduct activities identified
- Frontline staff were not required to report these activities to MLRO
- No further evaluation of the suspicious activities by considering all relevant information of the customer concerned, nor consideration of whether a report should be made the SFC and/or the JFIU



Suspicious transaction monitoring and reporting

Exception reports failed to capture the intended scenarios



Exception report

Unidentified

- An exception report, which was designed to identify customers' transactions that were not commensurate with the customers' financial profiles, failed to identify suspicious situations according to the established rules and parameters, for example:
 - Customers effected fund deposit or withdrawals in amount significantly higher than their annual income and/or net asset value
 - A student customer without stable income who effected purchases of securities for a consideration totalling over \$1 million in ten consecutive days



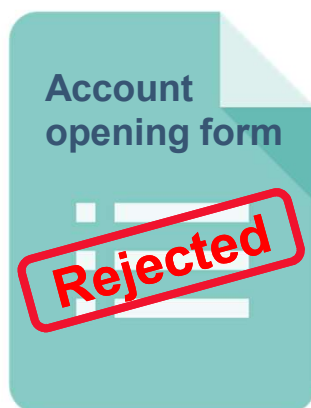
Trade surveillance report

- A trade surveillance report, which was designed to identify accounts with large trading turnover within a short period of time followed by a sharp decline in the account balance, identified some transactions which did not fulfil the established rules and parameter, for example:
 - A customer without any change in its account or securities balances for the past 30 days was also captured in the report



Suspicious transaction monitoring and reporting

Prospective client appeared to have been involved in fraud and tax evasion



A genuine hit identified during the name screening process which indicated that the prospective client appeared to have been involved in fraud and tax evasion.



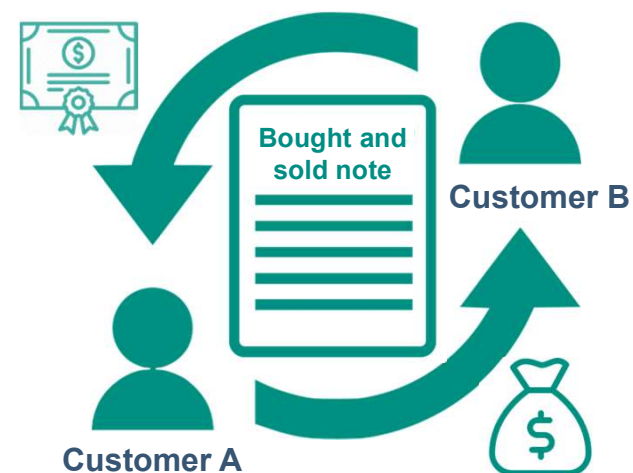
Deficiencies

- No assessment was conducted to evaluate whether there was ground for suspicion of ML/TF
- Whether a STR should be reported to the JFIU in relation to the prospective client

Sizable stock transfer via bought and sold note

Deficiencies

- Failed to properly scrutinize these stock transfers to ensure that there were no grounds for suspicion
- Failed to inquire into the relationship between the customers or obtain corroborative evidence from relevant sources to ensure that the transfer was reasonably in line with the customers' profile and normal commercial practices



Account opened for a few days before the share transfer

Consideration payable was not commensurate with Customer A's financial status

A large, stylized teal graphic of a bird, possibly a phoenix or eagle, is positioned in the background. The bird is facing right, with its wings spread upwards and outwards. The graphic is semi-transparent and serves as a decorative element for the slide.

Thank you

AML/CFT section on the SFC's website:

<https://www.sfc.hk/web/EN/rules-and-standards/anti-money-laundering-and-counter-terrorist-financing/>