

## **Legislative Council Panel on Financial Affairs**

### **Regulation of securities firms**

1. This paper sets out the Securities and Futures Commission (SFC)'s response to the issues raised by the Financial Affairs Panel regarding the regulation of securities firms.
  - (I) The regulatory framework currently in place to safeguard the interests of retail investors
2. Under the SFC's licensing regime, any person who conducts the business of dealing in securities has to be licensed by the Commission. Licensed securities firms are subject to detailed rules, codes and guidelines that govern how they:
  - (i) handle client securities and client money;
  - (ii) maintain adequate financial resources for their operations;
  - (iii) issue contract notes and statements of account to clients on a timely basis;
  - (iv) keep proper accounting and other records to explain their activities; and
  - (v) submit their annual financial statements, including a report from the auditors on the firm's key control systems and any non-compliance with the rules on client securities and client money.
3. The SFC regulates 430 stock exchange participant brokers. We adopt a risk-based approach in supervising securities firms. For example, we conduct reviews, meet with management, and carry out onsite inspections to help intermediaries maintain and raise their standards. We work with securities firms closely to manage down the problems that they encounter.
4. However, in cases where the integrity of the management is in doubt, the SFC will not hesitate to take restrictive action and, seek appropriate Court orders in order to protect the interests of the firm's clients.
5. In addition, the SFC will take appropriate regulatory action in relation to any broker misconduct. To ensure that clients' interests are adequately protected, we are reviewing the disciplinary sanctions imposed on firms and are considering raising penalties for certain types of misconduct and deficiencies. Where appropriate, we will refer cases to the police.

- (II) The misconduct involved in the three recent broker incidents and the deficiencies in the current regulatory regime as reflected in these cases
6. The SFC conducted a rapid onsite inspection in all three cases of broker misconduct once we identified certain unusual patterns in the financial returns submitted by these brokers. The inspection focused on verifying the firm's financial resources and employing means to safeguard client assets. Once these brokers were subjected to close scrutiny, we were able to confirm our suspicions and uncover the specific misconduct. We found that besides breaching the financial resources rules,
    - (a) Whole Win Securities Limited also pledged cash clients' securities to obtain bank financing which is a blatant breach of the relevant law; and
    - (b) In the case of Tiffit Securities (Hong Kong) Limited ("Tiffit") and Wing Yip Company Limited ("Wing Yip"), client securities were sold or transferred without client knowledge or authorization. Both brokers covered up their wrongdoings by sending falsified statements to their clients.
  7. From these incidents, it is clear to us that because the misconduct was very well hidden, an inspection may not always reveal or uncover the problems. In the circumstances, it may require a large-scale circularization exercise (i.e. by seeking direct confirmation from clients of a broker as to their stock holding and account balance, typically on a sample basis) to uncover the misappropriation.
  8. In all the three cases, we acted immediately on uncovering the misconduct to stop further dissipation of client assets, by issuing restriction notices and applying for the appointment of administrators. In one case, we have also managed to obtain a prohibition order from the Court to stop the owner of the broker firm from leaving Hong Kong as well as an interim order to freeze his and his wife's personal assets in or out of Hong Kong. In addition, we have regular meetings with the administrators to make sure that they are making good progress in returning assets to clients. We also issue press releases regularly to inform the market on significant developments on the cases. In addition, we are conducting investigation into these cases and have been working closely with the Police. The Investor Compensation Fund is also handling investor compensation matters.
  9. All three cases had the following common features and deficiencies:
    - (a) The root of the problem was a serious integrity issue where the senior management of the firm (usually the principal owner/shareholder) abused the trust placed in them by their

clients and failed to discharge their duty of care in safekeeping their clients' assets.

- (b) All three firms were relatively small, family-run businesses without proper segregation of duties or checks and balances. The principal owner/shareholder effectively controlled the entire operation.
- (c) The vast majority of the firms' clients did not maintain an Investor Participant Account (IP Account) or a Stock Segregated Account (SSA) on CCASS which could have reduced the risk of their securities being misappropriated by broker firms.
- (d) None of the firms' auditors had expressed an adverse opinion on the systems of control for ensuring compliance with the rules on client securities and client money or reported any non-compliance with such rules.

### (III) Action Plan

- 10. Based on these findings, we have devised a 3-pronged action plan to help identify brokers with potential integrity concerns and deter misconduct.

#### (i) Rigorous supervision of brokers

- 11. As our supervision methods to date have been effective in identifying potential problems, we will continue our rigorous supervision of brokers, keeping a close eye on their financial positions and following up on any anomalies or suspicious behaviour.
- 12. In addition, SFC has also taken the initiative to amend the client securities rules to enhance the protection to investors by imposing a repledging limit on firms licensed for dealing in securities or securities margin financing<sup>1</sup> –
  - (a) a repledging limit of 180% will come into effect on 1 October 2006; and
  - (b) after a further period of 12 months, i.e. on 1 October 2007, the repledging limit will be fixed at 140%.

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<sup>1</sup> In addition, the SFC has also made amendments to the financial resources rules (FRR) to raise certain FRR haircut percentages, and to the contract notes rules to impose additional disclosure requirements in monthly client statements on any firm which has repledged securities collateral. The amendments will come into operation on 1 October 2006.

(ii) Educate investors

13. Investors play an important part in safeguarding their own interests. As such, investor education is a key area that the Commission has always focused on.
14. We are keen to promote the IP accounts because IP accounts protect investors' shares as brokers do not control these accounts and transfers of shares from these accounts cannot be processed without client's instructions directly given to CCASS. However, we understand that despite the security offered by IP accounts, they are not popular amongst investors for various reasons:
  - (a) investors were not aware of these accounts;
  - (b) their brokers have not promoted the use of IP accounts to them;
  - (c) the accounts are not sufficiently user-friendly; and
  - (d) there are costs involved in using the accounts (i.e. the fees etc charged by the Hong Kong Securities Clearing Company Limited (HKSCC)).
15. To address these issues, apart from our investor education efforts to encourage the greater use of IP accounts, we have recently issued a circular to the brokerage community urging them to promote the IP accounts to their clients. We have started a dialogue with the HKSCC with a view to making the use of the service of IP accounts more attractive to investors.

(iii) Collaboration with the Audit Profession

16. It is very difficult to detect falsification of accounting records and trade documentation by way of a financial audit by auditors. A more effective way to detect fraud is by circularization so that clients get to independently confirm their positions. If circularization is not implemented properly or at the appropriate time, the likelihood of fraud or misconduct going undetected is significantly increased. We are concerned over this issue and have since referred a suspected case of sub-standard audit work to the Hong Kong Institute of Certified Public Accountants (HKICPA) for investigation.
17. At present, auditors can exercise their discretion as to whether they should conduct circularization of client accounts. For the reasons given above, we take the view that circularization is an effective audit step to uncover fraud. We have entered into a dialogue with the HKICPA to further discuss this and recently the HKICPA announced that they support the idea of more effective circularization.

Long term fixes to reduce the risks inherent in the asset custody arrangements

18. While the proposals above may help in enhancing supervision and controls of brokers, the more fundamental need is to review the structure of the existing asset custody arrangements. In Hong Kong, brokers are allowed to operate omnibus accounts under CCASS for their clients and the vast majority of investors, especially at the retail end, deposit their securities with their brokers. In this respect, we are conducting a longer term review to identify the ways to address the inherent problems with the current asset custody arrangements.

Securities and Futures Commission  
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