



LC Paper No. CB(1)2290/05-06(01)

# **Regulation of Securities Firms**

## *Framework to Safeguard Stockbrokers' Client Assets*

*Martin Wheatley*

**Chief Executive Officer**  
**Securities & Futures Commission**

**29 September 2006**



## *Outline*

- ➊ Overview of the brokerage industry
- ➋ Framework to safeguard client assets
- ➌ Lessons learnt from recent incidents of broker misappropriation of client assets
- ➍ Action plan

## Overview of the brokerage industry

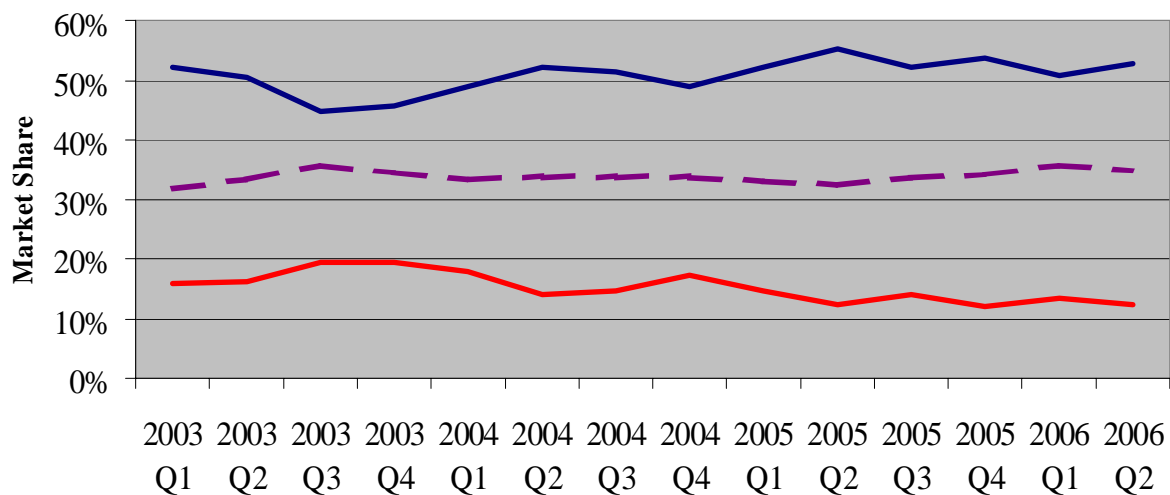
- As of 30 June 2006, SFC regulates 430 SEHK brokers

As of 30 June 2006	Cat A	Cat B	Cat C
No. of firms	14	51	365
Average client no. per firm	2,446*	5,596	928
Average daily turnover (\$bn) in June 2006	16.4	10.3	3.3
Total client assets held (\$bn)	484	403	308

Source: HKEx and SFC

\* - A broker under this category reported that it had about 27,000 active clients as of end June 2006 whilst other Cat A brokers reported their no. of clients in average of around 550. 3

## Change in market share – 2003 – June 2006

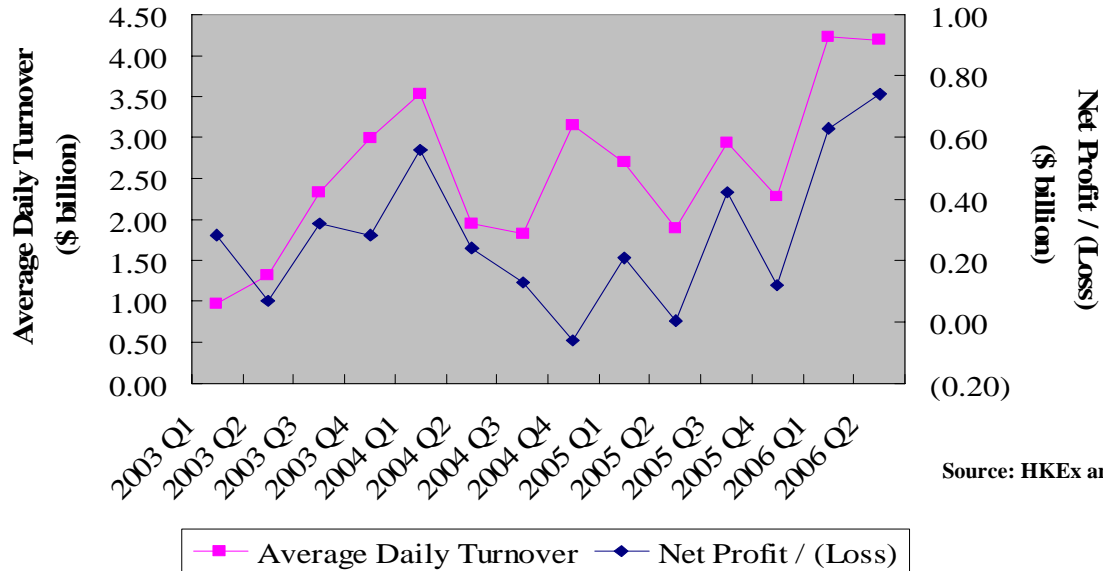


Source: HKEx



## Category C Brokers profit from increased turnover

Aggregate net profits of Category C brokers in 1H 2006 (\$1.3 billion) increased by 5 times as compared with 1H 2005



5

## Framework to safeguard client assets

- ❖ Safekeeping of client securities at CCASS
- ❖ Brokers' responsibilities under the SFO
- ❖ SFC oversight
- ❖ Investor Compensation Fund

## *Safekeeping of client securities at CCASS*

- ⊕ Under the current regime, most client securities are deposited with CCASS in brokers' omnibus accounts with brokers issuing statements to clients at month-end
- ⊕ As an improvement, clients have option to open SSA with brokers
- ⊕ The best solution is for clients to open IP accounts in their *own* name to safeguard their securities

7

## *Features of IP account & SSA*

<b>IP Account</b>	<b>SSA</b>
In clients' own name	In brokers' name, but in separate sub-accounts
Clients have full control – investors' instructions required for every withdrawal or deposit	Brokers have full control
CCASS provides statements for share balance and activities in IP account	Clients receive a CCASS statement for every stock movement
Around 14,000 accounts	Around 2 – 3,000 accounts

**The SFC supports the use of IP accounts for the above reasons**

8

## *Brokers' responsibilities under SFO*

- Brokers required to **act in clients' best interests** and have adequate **internal controls to guard against fraud**

There are strict rules/guidelines requiring brokers to:

- Segregate securities of cash clients
- Segregate client money
- Issue timely contract notes and account statements to their clients
- Appoint auditors to annually audit their financial positions and review regulatory compliance

9

## *SFC oversight*

- ⊕ **Risk based supervisory approach** used to identify and focus on risky areas
- ⊕ We perform off-site reviews of information submitted by brokers and their auditors and onsite inspections
- ⊕ We take appropriate action in relation to any broker misconduct e.g. issuing restriction notice to protect investor interest and referring fraud case to the Police

10

## *Investor Compensation Fund*

- ⊕ Maximum compensation amount was increased to \$150K per investor in April 2003
- ⊕ Fund used as last resort to safeguard against investor losses due to fraud and firm collapse
- ⊕ As of end August 2006, the net asset value of the Investor Compensation Fund is about \$1.7 billion

11

## *Lessons learnt from the 3 recent incidents*

- ⊕ Lack of integrity of owner; abuse of trust
- ⊕ Small business without proper segregation and checks & balances
- ⊕ Majority of clients did not have an IP account or SSA
- ⊕ In cases where shares were stolen, the brokers sent falsified statements to clients
- ⊕ Recent auditor reports did not reveal any apparent issues with these firms

12

### *3-Prong action plan*

- ✦ Continue our rigorous supervision of brokers
- ✦ Educate investors to encourage use of IP accounts and to check their statements
- ✦ Greater collaboration with auditors to use circularization more effectively to uncover fraud

13

### *Longer term strategy*

- ✦ We consider conducting a review of the existing asset custody arrangements and to strengthen the existing supervision of the broker industry by:
  - ❖ Reviewing governance standards and internal control requirements for brokers who handle client assets
  - ❖ Working with HKEx to explore further enhancement of IP accounts
  - ❖ Considering tougher disciplinary sanctions and penalties imposed on firms for certain types of misconduct and deficiencies

14

## *Concluding remarks*

- ❖ Even the most stringent regulations cannot prevent deliberate fraud, especially by firms' principal
- ❖ Regulators, auditors, intermediaries and investors need to work together to minimize fraud and misconduct