

**MANAGEMENT, SUPERVISION  
AND  
INTERNAL CONTROL GUIDELINES  
FOR PERSONS LICENSED  
BY OR REGISTERED WITH THE  
SECURITIES AND FUTURES COMMISSION**

**Securities and Futures Commission  
Hong Kong**

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## TABLE OF CONTENTS

	<u>Page</u>
BACKGROUND	1
INTRODUCTION	1
I. MANAGEMENT AND SUPERVISION	4
II. SEGREGATION OF DUTIES AND FUNCTIONS	4
III. PERSONNEL AND TRAINING	5
IV. INFORMATION MANAGEMENT	6
V. COMPLIANCE	7
VI. AUDIT	8
VII. OPERATIONAL CONTROLS	9
VIII. RISK MANAGEMENT	11
APPENDIX	
SUGGESTED CONTROL TECHNIQUES AND PROCEDURES	12
A. Operational Controls	12
B. Risk Management	19

# MANAGEMENT, SUPERVISION AND INTERNAL CONTROL GUIDELINES

## FOR PERSONS LICENSED BY OR REGISTERED WITH THE SECURITIES AND FUTURES COMMISSION

(hereafter referred to as “the Internal Control Guidelines”)

### BACKGROUND

Pursuant to section 169 of the Securities and Futures Ordinance (Cap. 571) (“SFO”), the Commission publishes the “Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission” (“the “Code”) for the purpose of giving guidance relating to the practices and standards with which intermediaries and their representatives are ordinarily expected to comply in carrying on the regulated activities for which they are licensed or registered. The Code is applicable to licensed persons<sup>1</sup> or registered persons<sup>2</sup>, and provides among other things:

#### *Paragraph 4.3*

*“A licensed or registered person should have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients and other licensed or registered persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.”*

Unless otherwise specified or the context otherwise requires, any word or phrase in the Internal Control Guidelines shall be interpreted by reference to any definition of such word or phrase in Part 1 of Schedule 1 to the SFO and the Code.

### INTRODUCTION

The Internal Control Guidelines, which are published under section 399 of the Securities and Futures Ordinance (Cap. 571), set forth hereinafter indicate the manner in which, in the absence of any particular consideration or circumstances, the Commission proposes to perform its function of ensuring that all licensed or registered persons are fit and proper in relation to the manner in which they conduct the regulated activities for which they are licensed or registered.

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<sup>1</sup> As defined in Part 1 of Schedule 1 to the SFO.

<sup>2</sup> A reference in the Code to a “registered person” means a “registered institution” and, except where the context otherwise requires, includes a “relevant individual” as defined in section 20(10) of the Banking Ordinance (Cap.155), and “registered” shall be construed accordingly.

The Internal Control Guidelines do not have the force of law and should not be interpreted in any manner which would override the provision of any applicable law, codes or any other regulatory requirements. Whereas a failure to comply with the Internal Control Guidelines shall not by itself render the licensed or registered person liable to any judicial or other proceedings, in any proceedings under the SFO before any court the Internal Control Guidelines shall be admissible in evidence, and if any provision set out in the Internal Control Guidelines appears to the court to be relevant to any question arising in the proceedings it shall be taken into account in determining the question. Furthermore, the Commission shall consider whether a failure to substantially follow the guidance tends to reflect adversely on the person's fitness and properness. A pragmatic approach will however be adopted taking into account all relevant circumstances, e.g. the inability of a small firm to segregate duties. Commission staff will also take into account whether there are compensatory management and supervisory measures implemented by Management.

The Internal Control Guidelines relate to the manner in which licensed or registered persons structure, manage and operate the respective regulated activities for which they are licensed or registered and in particular, the existence of satisfactory internal control and internal management systems (hereinafter referred to collectively as "internal controls").

In general, "internal controls" represent the manner in which a business is structured and operated so that reasonable assurance is provided of:

- a) the ability to carry on the business in an orderly and efficient manner;
- b) the safeguarding of its and its clients' assets;
- c) the maintenance of proper records and the reliability of financial and other information used within and published by, the business; and
- d) the compliance with all applicable laws and regulatory requirements.

The Internal Control Guidelines are designed to provide meaningful guidance to licensed or registered persons with respect to the Commission's expectations in relation to internal controls. Given, however, the significant differences that exist in the organisational and legal structures of these firms as well as the nature and scope of the business activities conducted by them, there exists no single set of universally applicable internal control techniques and procedures which will guarantee the adequacy of a firm's internal controls. It must, however, be emphasized that the contents of the Internal Control Guidelines are neither intended to, nor should be construed as, an exhaustive treatment of the subject matter.

The internal control needs of a licensed or registered person may vary from firm to firm depending upon a thorough analysis of each firm's particular structure and business operations and needs. The licensed or registered person and its senior management (hereinafter for convenience referred to collectively as "Management"), which may include a firm's Board of Directors, Chief Executive Officer, Managing Director, or other senior operating management personnel (as the case may be), are ultimately responsible for the adequacy and effectiveness of the internal control system implemented.

The Internal Control Guidelines set out various key controls and attributes of an adequate internal control system, as well as possible effective methods of achieving those attributes. The Commission will take into account each firm's particular circumstances when assessing the adequacy of a firm's internal controls.

#### **EFFECTIVE DATE**

The Internal Control Guidelines will become effective upon commencement of the SFO.

## I. MANAGEMENT AND SUPERVISION

### OBJECTIVE

*An effective management and organisational structure which ensures that the operations of the business are conducted in a sound, efficient and effective manner shall be established, documented and maintained.*

### Control Guidelines

1. Management assumes full responsibility for the firm's operations including the development, implementation and on-going effectiveness of the firm's internal controls and the adherence thereto by its directors and employees.
2. Regular and effective communication occurs within the firm which ensures that Management is continually and timely apprised of the status of the firm's operations and financial position, including qualitative and quantitative risks posed thereto or weaknesses detected therein, non-compliance with legal and regulatory requirements, and the overall adherence to the firm's defined business objectives.
3. Reporting lines are clearly identified with supervisory and reporting responsibilities assigned to appropriate staff member(s).
4. Detailed policies and procedures pertaining to authorisations and approvals, as well as the authority of key positions are clearly defined and communicated to and followed by staff.
5. Management ensures that management and supervisory functions are performed by qualified and experienced individuals.

## II. SEGREGATION OF DUTIES AND FUNCTIONS

### OBJECTIVE

*Key duties and functions shall be appropriately segregated, particularly those duties and functions which when performed by the same individual may result in undetected errors or may be susceptible to abuses which may expose the firm or its clients to inappropriate risks.*

### Control Guidelines

1. Management ensures that, where practicable, policy formulation, supervisory and other internal review or advisory functions, including where applicable compliance and internal audit, are effectively segregated from line operational duties. Such segregation serves to ensure the effectiveness of supervisory and other internal controls established by Management.

2. Operational functions including, but not limited to, sales, dealing, accounting and settlement are, where practicable, effectively segregated to minimize the potential for conflicts, errors or abuses which may expose the firm or its clients to inappropriate risks. Special care should be taken to ensure that the sales and dealing functions should be segregated from the research function where possibility of potential conflict of interest exists. Where practicable, the research and the corporate finance functions should be segregated to ensure the objectivity of the research function.
3. Wherever possible, the compliance and internal audit functions are effectively segregated from and independent of the operational and related supervisory functions, and report directly to Management.

### III. PERSONNEL AND TRAINING

#### OBJECTIVE

*Appropriate personnel recruitment and training policies shall be established with adequate consideration given to training needs to ensure compliance with the firm's operational and internal control policies and procedures, and all applicable legal and regulatory requirements to which the firm and its employees are subject.*

#### Control Guidelines

1. Management implements procedures to ensure that the firm only employs persons who are fit and proper to perform the duties for which they are employed and that such persons are duly registered with all applicable regulatory bodies as required.
2. All staff and other persons performing services on the firm's behalf are provided adequate and up-to-date documentation regarding the firm's policies and procedures which should include those relating to internal controls and personal dealing.
3. Management ensures that adequate training suitable for the specific duties which staff member(s) perform is provided both initially and on an ongoing basis. A firm's training programme should ensure that staff possess or acquire appropriate and practical experience through "on-the-job" training and where appropriate, structured courses.

#### IV. INFORMATION MANAGEMENT

##### OBJECTIVE

*Policies and procedures shall be established to ensure the integrity, security, availability, reliability and thoroughness of all information, including documentation and electronically stored data, relevant to the firm's business operations.*

##### Control Guidelines

1. Management of information, both in physical and electronically stored form, is assigned to qualified and experienced staff member(s).
2. Management ensures that the firm's operating and information management systems (including electronic data processing ("EDP") systems) meet the firm's needs and operate in a secure and adequately controlled environment.
3. Information management reporting requirements are clearly defined to ensure the adequacy and timeliness of production of required internal and external reports including those required by relevant regulatory and self-regulatory bodies.
4. Key components of the information management system design and implementation programme are adequately documented and regularly reviewed for effectiveness.
5. Appropriate and effective EDP and data security policies and procedures are implemented to prevent and detect the occurrence of errors, omissions or unauthorised insertion, alteration or deletion of, or intrusion into, the firm's data processing system (electronic or otherwise) and data (covering all confidential information in the firm's possession, such as clients' personal and financial information and price sensitive information).
6. Management establishes and maintains effective record retention policies which ensure that all relevant legal and regulatory requirements are complied with, and which enable the firm, its auditors and other interested parties, e.g. exchanges, clearing houses and the Commission, to carry out routine and ad hoc comprehensive reviews or investigations.



## V. COMPLIANCE<sup>3</sup>

### OBJECTIVE

*Policies and procedures shall be established and maintained to ensure the firm's compliance with all applicable legal and regulatory requirements as well as with the firm's own internal policies and procedures.*

### Control Guidelines

1. Management establishes and maintains an appropriate and effective compliance function within the firm which, subject to constraint of size, is independent of all operational and business functions, and which reports directly to Management.
2. Management ensures that staff performing the compliance function possess the necessary skills, qualifications and experience to enable them to effectively execute their duties.
3. Management establishes and enforces clear policies to ensure that the compliance function covers all relevant aspects of the firm's operations, including the unfettered access to necessary records and documentation.
4. Staff performing the compliance function, in conjunction with Management, establish, maintain and enforce effective compliance procedures. These procedures should cover legal and regulatory requirements including where applicable registration / licensing and financial resources requirements; record keeping (for management and regulatory reporting, audit and investigations); business practices (e.g. codes of conduct; commission rebates and soft dollar practices; and preparation, approval and dissemination of research reports); prevention of money laundering; internal control matters; and compliance with the relevant client, proprietary and staff dealing requirements.
5. Management establishes, maintains and enforces policies and procedures to ensure the proper handling of complaints from clients and that appropriate remedial action is promptly taken. The complaints procedures should be in writing. Where possible, complaints should be investigated by staff performing the compliance function who are not directly involved in the subject matter of complaint.

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<sup>3</sup> It should be noted that this Part is concerned with the firm's responsibility with respect to compliance. The Control Guidelines should not be taken as only applicable for staff performing the compliance functions. It is acknowledged that some of the compliance-related duties are performed by staff other than the staff designated to perform the compliance functions.

6. Staff performing the compliance function promptly report to Management all occurrences of material non-compliance by the firm or its staff with legal and regulatory requirements, as well as with the firm's own policies and procedures. Management promptly notifies the applicable exchanges, clearing houses and the Commission of occurrences of material non-compliance by the firm or its staff with relevant legal and regulatory requirements.

## VI. AUDIT

### OBJECTIVE

*An audit policy and related review function<sup>4</sup> shall be established and maintained which objectively examines, evaluates and reports on the adequacy, effectiveness and efficiency of the firm's management, operations and internal controls.*

### Control Guidelines

1. Where practicable, Management establishes an independent and objective internal audit function which is free of operating responsibilities. This function should have a direct line of communication to Management or audit committee as applicable.
2. Clearly prescribed terms of reference are developed which set out the scope, objectives, approach and reporting requirements for the external audit functions and where applicable, the internal audit functions. The relative roles and responsibilities of, and the working relationship between, internal and external auditors are clearly defined.
3. Management ensures that the person(s) performing the review function possess the necessary technical competence and experience.
4. Management ensures that there is adequate planning, control and recording of all audit and review work performed; timely reporting of findings, conclusions and recommendations to Management; and matters or risks highlighted in the relevant reports are followed up and resolved satisfactorily.

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<sup>4</sup> The review functions may be performed by any staff or external consultants (such as external auditors) meeting the skills, experience and qualification criteria. This is to be distinguished from statutory audit work which may provide limited comfort as to the firm's management, supervision and internal control systems. Where practicable, the review function should be overseen by an audit committee of the firm.

## VII. OPERATIONAL CONTROLS

### OBJECTIVE

*Effective policies and operational procedures and controls in relation to the firm's day-to-day business operations shall be established, maintained and compliance therewith ensured. The effectiveness of such operational procedures and controls will be evaluated in the light of whether they serve to ensure:*

- a) an adequate exchange of information between the firm and its clients including information from and required disclosures of information to clients;*
- b) the integrity of the firm's dealing practices, including the treatment of all clients in a fair, honest and professional manner;*
- c) the safeguarding of both the firm's and its clients' assets;*
- d) the maintenance of proper records and the reliability of the information contained therein and used within the firm or used for publication; and*
- e) the compliance by the firm and persons acting on the firm's behalf, with relevant legal and regulatory requirements.*

### Control Guidelines

1. Management establishes and maintains processes to obtain and confirm information regarding every client in relation to establishing the true identity of the client, the beneficial owner(s) and person(s) authorised to give instructions; and the client's financial position, and investment experience and objectives prior to the establishment of an account.
2. Where the firm exercises discretionary authority over a client's account, procedures are used to ensure that the precise terms and conditions under which such authority may be exercised are effectively communicated to the client, and that only transactions which are consistent with the investment strategies and objectives of the relevant client, are effected on the client's behalf.
3. Where the firm is in the business of offering investment advice for remuneration, or has entered into a contractual advisory arrangement with a client, and in the course of such business, gives investment recommendations or advice, measures and procedures are adopted to ensure that such recommendations and advice are based on thorough analysis, taking into account available alternatives and that such recommendations and advice are appropriate for the relevant client. The firm documents and retains the reasons for the recommendations and advice given.

4. Specific policies and procedures are established to minimize the potential for the existence of conflicts of interest between the firm or its staff and clients, and further, in circumstances where actual or apparent conflicts of interest cannot reasonably be avoided, that clients are fully informed of the nature and possible ramifications of such conflicts and are in all cases treated fairly.
5. Management establishes and maintains policies and procedures which ensure that whenever the firm or its staff member(s) have a material interest in a transaction with a client, this fact is disclosed, where practicable, to the client prior to the execution of the relevant transaction.
6. Management establishes and maintains policies and procedures which ensure that client orders are handled in a fair and equitable manner and, in all cases comply with order handling requirements specified in the various codes or regulations. In particular, clear and comprehensive audit trails are created to precisely record all orders (both client and internally generated) from the time of origination, including the time the order was received or initiated, through order execution and settlement, e.g. through use of sequential numbering on order tickets and the use of time stamping facilities.
7. Management establishes and enforces procedures which ensure that proper safeguards exist to prevent the firm or its staff from taking advantage of confidential price sensitive information, or executes transactions as or on behalf of insiders which may contravene Part XIV of the SFO.
8. Management establishes and maintains appropriate and effective procedures in relation to dealing and related review processes to prevent or detect errors, omissions, fraud and other unauthorised or improper activities, and which ensure the fair and timely allocation of trades effected on behalf of clients.
9. Appropriate and effective procedures are established and followed to protect the firm's and its clients' assets from theft, fraud and other acts of misappropriation. In particular, the authority of the firm and its staff to acquire, dispose of and otherwise move or utilise the firm's or its clients' assets is clearly defined and followed. All assets are properly safeguarded, while at the firm's premises and deposited into appropriate accounts at banks or securities depositories promptly. Further, adequate and reliable audit trails are maintained which enable the firm to prevent, detect and investigate suspected improprieties.
10. Regular reconciliation of the firm's internal records and reports to those issued by third parties, e.g. clearing houses, banks, custodians, counterparties and executing brokers, to identify and highlight for action any errors, omissions or misplacement of assets, are undertaken, and such reconciliations are checked/reviewed and approved by appropriate senior staff member(s).

## VIII. RISK MANAGEMENT

### OBJECTIVE

*Effective policies and procedures shall be established and maintained to ensure the proper management of risks to which the firm and, if applicable, its clients are exposed, particularly with regard to their identification and quantification, whether financial or otherwise, and the provision of timely and adequate information to Management to enable it to take appropriate and timely action to contain and otherwise adequately manage such risks.*

### Control Guidelines

1. Appropriate and effective risk management policies are established and monitored by a risk management function which, depending upon the firm's circumstances, consist of a sufficient number of suitably qualified and experienced professionals.
2. Appropriate and effective procedures are established and followed to ensure that the firm's risks of suffering loss, financial or otherwise, as a consequence of client defaults or changing market conditions, are maintained at acceptable and appropriate levels. The firm should only take on positions which it has the financial and management capacity to assume.
3. Where the firm carries out proprietary trading, appropriate trading limits and position limits are established and monitored at appropriate intervals depending on the level of activity and reviewed as part of the end-of-day processing routine. Applicable trading limits, position limits and other risk management measures should be checked and reviewed for effectiveness on a timely basis.
4. Comprehensive reviews are conducted at suitable intervals, and wherever there is significant change in the business, operation or key personnel, to ensure that the firm's risk of suffering losses, whether financial or otherwise, as a result of fraud, errors and omissions, interruptions or other operational or control failures is maintained at acceptable and appropriate levels.
5. Appropriate exposure reports are submitted regularly to Management and any significant variances are reported promptly to Management.
6. Management clearly defines its risk policies and establishes and maintains risk measurements and reporting methodologies commensurate with its business strategies, size, complexity of its operations and risk profile.

## APPENDIX

### SUGGESTED CONTROL TECHNIQUES AND PROCEDURES

In this Appendix, details of various internal control techniques and procedures commonly implemented by licensed or registered persons in the financial industry are provided. These techniques and procedures neither constitute nor should be construed as an exhaustive or comprehensive list of applicable or relevant internal control techniques and procedures. They represent suggested approaches, which when employed effectively, can serve to assist licensed or registered persons in establishing sound internal control systems and enhance their ability to comply with relevant legal and regulatory requirements. Each licensed or registered person, however, must consider carefully the specific nature and particular needs of its business when designing and implementing an internal control system.

The control techniques and procedures described in this Appendix relate to the areas of *Operational Controls* and *Risk Management* set forth in Parts VII and VIII respectively of the Internal Control Guidelines. Greater detail with respect to these areas is deemed appropriate inasmuch as they tend to be generally applicable to most licensed or registered persons. Adoption of some or all of the suggested internal control techniques and procedures contained in this Appendix is neither a necessary condition nor a guarantee that a firm's internal controls are satisfactory.

#### A. Operational Controls

##### *Opening and handling of client accounts*

1. Mandatory account opening procedures are clearly defined and followed. Such procedures may include:
  - a) recording and retention for future reference of all relevant client information (such as the true identities of the client, the beneficial owner(s) and representatives who are authorised to issue instructions, as well as the financial position and investment experience and objectives of the client), related specimen signatures, and supporting documentation;
  - b) reviewing and confirming client information gathered, using criteria approved by Management;
  - c) ensuring that the client is provided with adequate information about the firm and the services to be provided to the client, together with other relevant documents such as relevant risk disclosure statements (particularly where the firm possesses discretionary authority over the account or where derivative financial products will be transacted on the client's behalf), and the nature and scope of fees, penalties and other charges the firm may levy;

- d) ensuring that the client is provided adequate information regarding his rights including if applicable, coverage under one of the investor compensation fund arrangements;
  - e) procuring execution of applicable client account agreements as required under relevant law, rules, regulations and codes; and
  - f) review and approval of new account applications and amendments to existing accounts, along with related supporting documentation, by designated staff.
2. In the case of discretionary accounts, special procedures are implemented and followed which may include:
- a) executing a discretionary account agreement which sets out the investment objectives and strategies of the client and the precise terms and conditions under which such discretion will be exercised;
  - b) regular reviews of the performance of the account conducted by designated staff member(s) independent of the staff handling the account;
  - c) providing the client with regular statements and timely ad hoc reports on account balance and transaction details, especially when the account balance falls below agreed levels or when large orders for the account are pending or executed; and
  - d) clearly delineating the investment decision making process from the dealing process: order tickets similar to those used for non-discretionary agency business are completed and time-stamped to record the actual time orders are initiated.

*Providing investment advice*

3. Where the firm is in the business of offering investment advice for remuneration, or has entered into a contractual advisory arrangement with a client, and in the course of such business, gives investment recommendations or advice, special procedures are implemented and followed which may include:
- a) establishing clear requirements and procedures regarding adequacy of research work and preparation and retention of documentation supporting the recommendations and advice;
  - b) providing to the client in writing details of the fees, charges and penalties applicable to the recommended investment scheme; and

- c) documenting (and providing a copy to the client) the rationale underlying investment advice rendered or recommendations made. Such advice and recommendations must be suitable taking into account the client's particular investment experience and objectives and financial position.

*Dealing practices*

4. The firm puts in place procedures to ensure that its staff's trading activities are not prejudicial to the interests of its clients. Staff members are required to disclose to the firm, on joining and regularly afterwards (at least semi-annually), details of holdings and trading activities in which they have an interest in relation to specific securities, futures, other investment products or leveraged foreign exchange trading contracts in which the firm deals in or in respect of which the firm gives advice. Staff members of a firm which is, or belongs to a group within which a group member is, a member of an exchange are required to trade through staff accounts in relation to products traded on that exchange. All transactions for staff accounts must be separately recorded and diligently monitored by independent senior management.
5. The firm clearly defines parameters in relation to the acceptance by staff member(s) or the firm of gifts, rebates, benefits-in-kind or "soft-dollar" benefits received from clients or other business contacts. These include the circumstances under which acceptance is permitted and approval required.
6. Effective procedures are established to ensure that whenever the firm or its staff member(s) have an interest in a transaction with a client (i.e. a direct/cross transaction), this fact is disclosed to the client prior to the execution of the relevant transaction. For example, the firm may maintain a register of direct and cross trades which also records the name of the client and the firm account involved, the person contacted and the time when the consent was received. The register is reviewed regularly (at least monthly) by designated staff member(s) performing the compliance function or a senior staff member in the dealing department.



7. Order handling procedures are clearly documented and followed. Such procedures may include:

- a) Orders are recorded, using standard order forms, and time-stamped promptly upon initiation or receipt and are required to be transmitted to the dealer, floor trader or operators of terminals for automated trading systems within a reasonable time period, normally immediately. This applies to both agency orders and internally generated orders (e.g. orders for the proprietary accounts, staff accounts, funds managed by the firm and working orders<sup>5</sup>). This recording procedure may be modified to take into account the different types of orders in different markets so long as it provides an audit trail.
- b) Prior to executing a client order, the following items are checked by designated staff:
  - i. the status of the account (active, closed or being on an internal watch list, etc.);
  - ii. applicable account limits, if any (e.g. trade, position, credit);
  - iii. the sufficiency of available funds or available credit in the relevant account;
  - iv. in the case of a sell order, the sufficiency and availability of securities or the existence of necessary securities borrowing arrangements, if applicable;
  - v. the authority and applicable limitations thereon of the person placing the order;
  - vi. where the order is received by facsimile or telex, such order is reviewed by senior staff and, if in doubt, the client is called to check the validity and authority of the order prior to execution;
  - vii. the services and products the account is authorised to use/trade; and
  - viii. any special conditions stated in the client agreement or reported by other operating departments within the firm, e.g. margin position.

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<sup>5</sup> "Working orders" are orders generated internally by the firm to facilitate the execution of large orders or special client orders which give the dealer discretionary authority to decide the timing of putting the order or "component" orders to the market and the size of each order.

- c) Clearly defined policies and procedures are followed regarding the permitted circumstances under which a client order is not required to be immediately exposed to the applicable market for execution (for example, stop loss orders, orders which give the dealer discretionary authority to decide the timing of putting "component" working orders to the market and the size of each working order). Such procedures may include the method used to determine the acceptable price(s) at which a transaction or part transaction(s) may be executed.
- d) Management should establish criteria to cover the review of orders upon receipt or initiation to determine the execution methodology and timing of execution for each order. Clear audit trails indicating the time of transmission and reference to the originating order should be maintained.
- e) Effective procedures regarding the transmission of orders to the dealing room are established. Sufficient information should be given to enable client priority to be established.
- f) Where practicable, a designated senior staff member who is independent of the traders should be assigned to allocate trades executed in accordance with the client priority and sequence of order receipt.

#### *Chinese Wall*

- 8. The firm avoids apparent and potential conflicts of interest by establishing and maintaining adequate "Chinese Walls", such as the separation of dealers handling client funds or discretionary orders from those handling proprietary or staff accounts.
- 9. Management establishes and maintains policies and procedures regarding "Chinese Wall" to ensure that price-sensitive information privy to the research staff or staff handling corporate finance matters like a takeover and merger should not be available to staff outside those departments, except on a "need to know" basis.

#### *Back office and accounting*

- 10. Deal tickets are transmitted to the designated back office staff member(s) who enter the details into the firm's own in-house system (whether automated or otherwise). At the end of each business day, the firm's own record of trades is matched by the back office staff to the trading/clearing lists received from the exchanges or clearing houses and where applicable, to confirmation documents issued by counterparties and executing brokers. Exception reports identifying mismatched and unusual trades are produced, reviewed and follow-up actions taken, where necessary.

11. All trades are confirmed promptly with the client on whose behalf the trade was executed and, for off-exchange trades, these are also confirmed promptly with the counterparty using reliable and pre-agreed methods such as SWIFT or tested telex.
12. All trade errors are reported to the person responsible for dealing and are allocated to an "error" or "suspense" account for prompt correction or closure of the position. The transactions in this account should be supported by clear documentation explaining the relevant circumstances and reviewed by the staff member(s) performing the compliance and internal audit functions. Any unusual circumstances or patterns should be investigated.

*Asset protection*

13. Effective procedures are established and followed, when handling movements of firm and client assets. Such procedures may include:
  - a) Clearly identifying staff member(s) and representatives of clients (for client assets) with authority to acquire, dispose of, lend, pledge or otherwise part with possession of, firm and client assets, and the parameters of such authority. The authority is checked with respect to each asset movement and client withdrawal request.
  - b) Use of standardised and sequentially numbered receipts and despatch notes or other appropriate methods to acknowledge and account for asset movements.
  - c) Securely storing firm and client assets, other important documents and controlled forms such as cheque books, contract notes etc., while at the firm's premises; and promptly depositing cheques, cashier orders and other negotiable instruments and securities into the appropriate account(s) at banks or securities depositories. During the period that physical scrip or cash is held at the firm's premises, routine counts are conducted to ensure proper safeguarding of firm and client assets.
  - d) Maintaining reliable and adequate audit trails which enable the firm to thoroughly investigate suspected improprieties.
14. Payment cheques to clients are crossed "Account Payee Only" and are made payable to the beneficial owner of the account or an authorised representative in conformity with applicable written standing client instructions. Similarly, the firm requires its clients to make payments to the firm by crossed cheques payable only to the firm.
15. Third party cheques are discouraged but are only accepted after required approval(s) has been obtained from designated senior staff member(s).

16. A register is maintained and used to update client asset ledger accounts. The client asset ledger is used to prepare regular statements which are mailed directly to the client at the address recorded in the client information file; and for reconciliation with statements of asset holdings issued by third parties, such as the clearing houses, banks and custodians and, where applicable, confirmation documents provided by counterparties or executing brokers. Where applicable, clients are encouraged to open stock segregated accounts with Central Clearing and Settlement System ("CCASS") through the firm so that they can receive statements of stock movements and monthly balances from Hong Kong Securities Clearing Company Limited ("HKSCC") direct.
17. Management establishes and maintains policies and procedures to ensure that clients' requests not to mail them regular statements in respect of their accounts are genuine requests and such requests are in writing duly signed by the clients and regularly (at least annually) reconfirmed by clients.
18. Where the firm is a participant in CCASS, management establishes and maintains policies and procedures to ensure tight control over access to the CCASS, particularly the use of "free of payment" CCASS transfer instructions (both settlement and delivery instructions) which should require prior authorisation. Such operations are regularly reviewed by its internal or external auditors, or designated staff member(s) performing the compliance function, who, amongst other things, review key reports of CCASS activities.
19. Authorisation requirements and authorised cheque signatories and applicable authority parameters, are clearly defined and communicated to the relevant bank; e.g. consider the need to require two or more authorised signatures. Under no circumstances are the firm's cheques to be signed unless the date, specified payee and amount portions of the cheques are properly filled in.
20. Appropriate controls exist with respect to access to computer systems, facsimile transmission and telex devices, where such devices are used to transmit important information, e.g. funds transfer instructions, settlement instructions and trade confirmations. Clear policies regarding confidentiality of passwords are developed, e.g. passwords are regularly changed and relevant passwords disabled upon a staff member(s) leaving the firm.
21. Regular compliance reviews and audits are conducted to detect activities or conditions which may violate, or contribute to non-compliance by the firm and its staff with, legal and regulatory requirements, as well as with the firm's own policies and procedures.

## B. Risk Management

### *Risk management policy and measurements*

22. The firm's risk policies and measurements and reporting methodologies are subject to regular review, particularly prior to the commencement of the firm's provision of new services or products, or when there are significant changes to the products, services, or relevant legislation, rules or regulations that might impact the firm's risk exposure.

### *Credit risk*

23. The firm establishes and maintains an effective credit rating system to evaluate client and counterparty creditworthiness. Clearly defined objective measures should be used to evaluate potential clients and determine/review the relevant credit ratings which are used to set appropriate credit limits for all clients, including existing clients. The ratings and applicable limits reflect, among other things:
- a) the client's credit rating by reputable credit rating agencies, if any;
  - b) investment objectives, investment history, trading frequency and risk appetite;
  - c) past payment records and defaults, if any;
  - d) the client's capital base and the existence and amount of guarantees and by whom such guarantees are given, if any;
  - e) any known events which may have an adverse impact on the client's financial status, potential for default or accuracy of information stored regarding the client; and
  - f) where credit is extended to cover margin trading, appropriate haircuts are made to market value to establish the clients have adequate equity.
24. The staff performing risk management function utilises appropriate quantitative risk measurement methodologies to effectively calculate and monitor the firm's credit exposure in relation to clients, including: pre-settlement credit exposures (e.g. marking to market of outstanding trades) and settlement risk (e.g. exposure caused by timing differences between delivery versus payment).
25. The staff performing risk management function ensures that credit risks posed by all clients belonging to the same group of companies are aggregated for purposes of measuring the firm's credit exposure. Particular attention is paid to netting arrangements which may serve to reduce the firm's exposure to credit risk. Care must be taken to ensure that credit exposures are netted only if supported by appropriate executed netting agreements, or other appropriate protections.

26. The staff performing risk management function specifies trading and position limits for each client based on their respective credit rating and trading needs. These limits are enforced.
27. The firm's margin policy and procedures are clearly defined, documented and enforced. Matters to be covered in such margin policy include:
  - a) the types of margin which may be called, the applicable margin rates and the method of calculating the margin;
  - b) the acceptable methods of margin payment and forms of collateral;
  - c) the circumstances under which a client may be required to provide margin and additional margin, and the consequence of a failure to meet a margin call, including the actions which the firm may be entitled to take; and
  - d) applicable escalation procedures where a client fails to meet successive margin calls.

*Market risk*

28. Management specifies authorised products and instruments the firm may deal in and enforces effective procedures to ensure compliance. Relevant control techniques may include regular review of the balance sheet and profit and loss accounts, and records of individual traders and trading units for unauthorised investments or transactions; and confirmation of outstanding transactions with the firm's trading partners.
29. The staff performing risk management function reviews and otherwise enforces on an on-going basis compliance with trading and position limits in relation to proprietary trading and open positions with respect to each authorised product the firm trades or invests in.
30. Management establishes and maintains effective risk management measures to quantify the impact on the firm (especially if it deals in derivative financial products) and, if applicable, its clients from changing market conditions. These measures should cover all risk elements associated with the products traded or services provided by the firm. Matters to be covered in such risk measures may include:
  - a) unspecified adverse market movements - using an appropriate value-at-risk or other methodology to estimate potential losses (this is particularly important for firms which take significant proprietary positions in derivative products);
  - b) individual market factors - measures the sensitivity of the firm's risk exposure to specific market risk factors e.g. interest rate yield curve shifting and changes in market volatility; and

e) stress testing - determining the effect of abnormal and significant changes in market conditions on the firm using various quantitative and qualitative variable assumptions.

31. To discourage the firm's dealers from engaging in unauthorised trading, risk adjusted performance measures are used, which may impact a dealer's remuneration where his/her activities expose the firm to especially high risks. Dealers who have exceeded in pre-approved limits are subject to appropriate action.

#### *Liquidity risk*

32. Management sets and enforces concentration limits with respect to particular products, markets and business counterparties, taking into account their respective liquidity profile and the firm's approved liquidity risk policies.

33. Measures of maturity mismatches between sources and funding requirements and concentrations of individual products, markets and business counterparties, are established and regularly monitored.

34. Management establishes appropriate arrears and default procedures to alert staff member(s) responsible for liquidity management to potential problems and to provide them adequate time to take appropriate action to minimise the impact of client or counterparty liquidity problems.

#### *Operational risk*

35. Management regularly reviews the firm's operations to ensure that the firm's risk of losses, whether financial or otherwise, resulting from fraud, errors, omissions and other operational and compliance matters, are adequately managed. Operational matters covered may include:

- a) physical and functional segregation of incompatible duties such as trade, settlement, risk management and accounting;
- b) maintenance and timely production of proper and adequate accounting and other records, and the ability to detect fraud, errors, omissions and other non-compliance with external and internal requirements;
- c) security and the reliability of accounting and other information, such as exception reports which should accurately highlight unusual activities and facilitate the detection of fraud, errors and significant trends; and
- d) staffing adequacy including personnel with relevant and sufficient skills and experience to minimise the risk of loss due to the absence or departure of "key" staff member(s).

36. An effective business continuity plan appropriate to the size of the firm is implemented to ensure that the firm is protected from the risk of interruption to its business continuity. Key processes in this area include: a business impact study, identification of likely scenarios involving interruptions (e.g. break down in its data processing systems) and documentation and regular testing of the firm's disaster recovery plan.
37. The firm has adequate insurance cover for different types of exposures, including but not limited to fidelity insurance, and replacement of equipment and other business and data processing devices.