

**Process Review Panel**  
**for the**  
**Securities and Futures Commission**

**Annual Report**  
**to the Financial Secretary**  
**for 2008-09**



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## **Chapter 1      General Information**

### **Background and purpose of the PRP**

1.1            The Process Review Panel for the Securities and Futures Commission (“PRP”) is an independent, non-statutory panel established by the Chief Executive in November 2000 to review the internal operational procedures of the Securities and Futures Commission (“SFC”) and to determine whether the SFC has followed its internal procedures, including procedures for ensuring consistency and fairness.

1.2            Since its inception, the SFC has been subjected to various checks and balances designed to ensure fairness and observance of due process. These include statutory rights of appeal, judicial review, and scrutiny by The Ombudsman and the Independent Commission Against Corruption.

1.3            In the course of reforming the regulatory regime for the securities and futures markets in 1999, the regulatees pointed out to the Administration that the checks and balances set out in paragraph 1.2 above could only apply in specific cases. The Administration, in consultation with the SFC, concluded that it would be preferable to improve the transparency of the SFC’s internal processes across the board, so that the public would be better able to see for itself that the SFC did act fairly and consistently in exercising its powers.

1.4            The SFC’s ability to demonstrate that it already operates in this fashion is however constrained by statutory secrecy obligations which limit the extent to which the SFC can divulge information to the public regarding what it has or has not done when performing its regulatory functions.

1.5            In order to enhance the transparency and public accountability of the SFC, without compromising its confidentiality, the Administration saw merit in establishing an independent body to review the fairness and reasonableness of the SFC’s operational procedures on an on-going basis, to monitor whether its procedures are consistently followed and to make recommendations to the SFC in relation to these objectives.

1.6 The establishment of the PRP demonstrates the Administration's resolve to enhance the transparency of the SFC's operations, and the SFC's determination to strengthen public confidence and trust. The PRP supports the objective to ensure that the SFC exercises its regulatory powers in a fair and consistent manner.

### **Terms of reference**

1.7 The PRP is tasked to review and advise the SFC on the adequacy of the SFC's internal procedures and operational guidelines governing the actions taken and operational decisions made by the SFC and its staff in the performance of its regulatory functions, including, for instance, the receipt and handling of complaints, licensing and inspection of intermediaries, and disciplinary action.

1.8 To carry out its work, the PRP receives and considers periodic reports from the SFC in respect of the completed or discontinued cases, including complaints against the SFC or its staff. In addition, the PRP may call for, and review, the SFC's files to verify that the actions taken and decisions made in relation to any specific case or complaint are consistent with the relevant internal procedures and operational guidelines.

1.9 The PRP is required to submit its reports to the Financial Secretary annually or otherwise on a need basis. The Financial Secretary may cause these reports to be published as far as permitted under the law.

1.10 The terms of reference of the PRP, as approved by the Chief Executive, are at **Annex A**.

### **Constitution of the PRP and Working Groups**

1.11 The PRP comprises eleven members, including eight members from the financial sector, academia and the legal and accountancy professions, a Legislative Councillor and two ex officio members including the Chairman of the SFC and the representative of the Secretary for Justice.

1.12 To facilitate execution of its roles and functions, the PRP has set up two working groups. The Working Group on Licensing, Intermediaries Supervision and Investment Products focuses on cases involving application for registration, approval of investment products and inspection of intermediaries. The Working Group on Corporate Finance and Enforcement focuses on cases concerning investigation and disciplinary action, takeovers and mergers transactions and prospectus-related matters.

1.13 The membership of the PRP and the two Working Groups is at **Annex B**.

## **Chapter 2      Work of the PRP in 2008-09**

### **Highlights of work**

2.1            This report covers the work of the PRP in 2008-09 in relation to the review of cases concluded by the SFC in 2007-08.

### **Mode of operation**

2.2            In accordance with its terms of reference, the PRP may select any completed or discontinued cases for review to examine if the actions taken and decisions made by the SFC are consistent with the relevant internal procedures and operational guidelines. Cases under review cover the following areas –

- (a)    licensing of intermediaries;
- (b)    inspection of intermediaries;
- (c)    authorisation of collective investment schemes;
- (d)    handling of complaints;
- (e)    investigation and disciplinary action; and
- (f)    processing of listing applications under the Dual Filing regime.

2.3            In practice, the SFC provides the PRP with monthly reports on all cases completed or discontinued within the month. Members of the PRP then select individual cases from these monthly reports for review with a view to examining cases of different areas and having due regard to the processing time required.

2.4            The SFC also provides the PRP with monthly reports on on-going investigation and inquiry cases that have been outstanding for

more than one year. The PRP may also select these cases for review upon their completion or closure.

2.5 In addition to reports from the SFC, the PRP will gather views from market practitioners as well as the general public on the performance of functions by the SFC with a view to identifying areas for review and improvement to the procedures and processes.

### **Meetings of the PRP in 2008-09**

2.6 PRP members conducted two rounds of review in 2008-09 and held a total of 13 meetings with the SFC's case officers on the 55 cases selected. In addition to seeking clarifications on selected cases at the review meetings, members also conducted file reviews as and when necessary to assess if the standard procedures laid down in the operational manuals were complied with. Furthermore, members had taken the opportunity to review the adequacy of the manuals from the perspective of fairness and reasonableness.

2.7 Besides case review meetings, the full Panel met to consider reports from members on the case reviews, set out observations and recommendations, and discussed specific issues relating to the SFC's internal procedures. The distribution of the 55 cases reviewed in 2008-09 are summarised below–

	No. of Cases
Licensing	9
Intermediaries supervision ( <i>inspections</i> )	5
Investment products	5
Complaints ( <i>including one against the SFC</i> )	10
Enforcement	24
Corporate finance ( <i>processing of listing applications under the Dual Filing regime</i> )	2
<b>Total</b>	<b>55</b>

## **Chapter 3            Observations and recommendations on review of individual cases**

3.1            From the 55 cases reviewed in 2008-09, the PRP concluded that the SFC had generally followed its internal procedures and complied with operational guidelines in handling those cases. There were however several areas where the PRP had made recommendations to the SFC for enhancement of procedures or guidelines. The PRP noted that the SFC had responded positively to the recommendations made by the PRP through explaining in detail their prevailing arrangements and putting in place improvement measures where appropriate. The observations and recommendations made by the PRP are summarised below. Details of the SFC's responses to the recommendations are quoted at **Annex C**.

### **(A)    Licensing of intermediaries**

3.2            The PRP reviewed nine cases on licensing of intermediaries. The PRP was satisfied that the SFC had generally followed the standard procedures in processing those cases. The relatively long processing time taken in most cases was mainly attributable to the slow response of the applicants in providing requisite information and documents to the SFC, and the extra time taken to assess the fitness and properness of applicants in light of their involvement in past or on-going enforcement cases.

#### ***Timely processing of licence applications***

3.3            The PRP noted that on application, the SFC would normally grant a provisional licence to an applicant pending completion of the whole assessment process and the issue of a full licence. The PRP considered it undesirable to have an intermediary carrying out regulated activities with a provisional licence for longer than eight weeks (the time pledged by the SFC for processing a full licence), because the public might overlook the risks in dealing with provisional licence holders who had yet to complete the whole assessment process. In 2007, the PRP suggested<sup>1</sup> the SFC consider imposing a validity period for provisional licence. In response, the SFC explained that under the Securities and Futures Ordinance ("SFO"),

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<sup>1</sup> This subject was described in paras. 3.15 to 3.18 of PRP Annual Report for 2007.

a provisional licence would only lapse either upon issue of a full licence or refusal of the application. Noting the SFC's response, the PRP invited the SFC to put in place a monitoring system to track and deter undue delays in the processing of licence applications. The SFC pointed out that an intermediary carrying out regulated activities should always be encouraged to have a full rather than a provisional licence. In this regard, the Associate Director or Senior Manager of the processing team would monitor progress to minimise any delays in the processing of the full licence.

3.4 In 2008-09, the PRP followed up on the observation and examined more licence applications with a view to identifying ways to shorten the processing time of full licences. In a case that the PRP reviewed, the PRP noted that the SFC had taken five months to issue a provisional licence to the applicant because there was adverse information on the applicant from an overseas regulator, and a full licence was not issued until another nine months later. The SFC explained that the long time taken was attributable to a communication gap arising from a re-assignment of the case to another processing team.

3.5 Noting that this was an isolated incident probably due to the large number of cases being processed at the time, the PRP suggested the SFC consider enhancing its status report on outstanding cases in the event of re-assignment of cases and change of processing officers. The SFC acknowledged that the tracking system did not work as effectively as it could have and agreed to "re-engineer" the licensing system to better alert officers about the progress of individual cases.

3.6 The PRP noted that the percentage of full licence applications completed within eight weeks as pledged had improved from 65% in 2006-07 to 86% in 2008-09. It showed that there was a conscious effort on the part of the SFC to minimise the period during which a person would hold a provisional licence. The PRP also noted that the SFC would strive to expedite the processing of a full licence where possible.

### ***Keeping applicants and their employers informed about the progress of applications***

3.7 The SFC undertook in its performance pledge that a provisional licence would be issued within seven business days and a full representative licence within eight weeks. In case the applications would take longer to process e.g. because the applicants were involved in the SFC's past or on-going investigations, the SFC would inform the applicants or their employers accordingly. The PRP recognised the SFC's effort in keeping track of the progress. However, the PRP noticed that there was no standardised notification arrangement. For example, the SFC notified the applicants in two cases but in another two cases the employers of the applicants. The SFC explained that they would respond to the enquirer who could either be the applicant or the employer. In response to the PRP's suggestion, the SFC agreed that since the applicant and his employer were both likely to have an interest in the matter, it would be appropriate for such notification to be issued to the enquirer and copied to the other party, unless it was inappropriate to do so, e.g. due to the need of preserving secrecy arising from on-going enforcement actions.

### ***Following up on new licensees***

3.8 In one case reviewed by the PRP, a subsidiary company of a conglomerate applied for a corporate licence to distribute investment funds. The Licensing Department of the SFC raised concerns about the adequacy of the company's internal control measures, which should ensure proper segregation of its regulated activities from the other businesses of its controlling group, and avoid possible confusion of its identity with unlicensed entities within the same group. Given the large size of the sales team, the Licensing Department also considered that the proposed management resources were inadequate. After some lengthy discussions, the company finally undertook to address these concerns, and the application was subsequently approved with conditions imposed.

3.9 The PRP noted that the Licensing Department had raised valid concerns in processing this case. However, the PRP had reservation about the effectiveness of the measures proposed by the company, which could not be ascertained at the licensing stage. The PRP suggested the case be

brought to the attention of the Intermediaries Supervision Department of the SFC for considering if regular inspections were warranted. The PRP further suggested the SFC consider putting in place a “red flag” system, which would refer any conduct concerns of intermediaries to the relevant department for follow-up.

3.10 The SFC agreed that during the licensing process, certain issues might arise and need to be followed up even after licences had been granted. The Licensing Department would stay vigilant and alert the relevant department to follow up as appropriate. In addition, the Intermediaries Supervision Department, when conducting inspections on new licensees, would take into account all information, including records on licensing application for more focused review and better design of audit steps.

### **(B) Inspection of intermediaries**

3.11 The PRP reviewed five cases on inspection of intermediaries. The PRP noted that the SFC had generally followed the standard procedures in processing those cases.

#### ***Management of circularisation exercises***

3.12 In a special theme inspection exercise on the proper safeguard of client assets by over ten brokerage firms, the SFC had engaged an external accounting firm to conduct a circularisation exercise<sup>2</sup> to verify the records of the brokerage firms. The PRP noted that the SFC had taken nine months to issue the final letter of deficiencies to one of the brokerage firms. The case was closed about nine months later pending the final report on the whole circularisation exercise to be submitted by the external accounting firm. The PRP suggested the SFC consider engaging additional accounting firms, or agreeing in advance with the appointed accounting firm a pre-set timeframe so as to avoid undue delay in the conclusion of inspections.

3.13 The SFC advised that the inspection and circularisation exercise involved a lot of detailed work on a significant number of client

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<sup>2</sup> In a circularisation exercise, the external accounting firm will issue letters to invite clients to verify and confirm the amount of cash and securities held by the broker. The process aims at verifying the accuracy of the brokerage firm’s books and records.

accounts. In this case, the SFC had issued an interim letter of deficiencies within four months after the commencement of the inspection and followed up with the brokerage firm on the rectification measures. After the final letter of deficiencies had been issued, the SFC carried out a follow-up visit to review the implementation of the rectification measures, and had worked closely with the accounting firm and the brokerage firm on the circularisation results. The SFC pointed out that engaging a single accounting firm to conduct the circularisation exercise for a group of brokerage firms would have the benefits of greater synergy and cost-effectiveness. In response to the observations made by the PRP, the SFC advised that it would be prepared to explore options that could enhance efficiency and lower cost, and explore with the appointed accounting firm in future the feasibility of issuing a report for each brokerage firm instead of one overall report for all in order to facilitate the timely conclusion of individual inspections.

### **(C) Authorisation of collective investment schemes**

3.14 The PRP reviewed five cases on authorisation of collective investment schemes and noted that the SFC had generally followed the standard procedures in processing these cases.

#### ***Inactive applications***

3.15 The PRP noted that the relatively long processing time in certain cases was attributable to the time taken on the part of the applicants to respond to the SFC's enquiries and requests for information. The PRP had made similar observations in 2007<sup>3</sup> that some applicants might have taken the advantage of the application system to keep pre-mature applications open. Although the SFC had been monitoring the situation and considered that there was no serious abuse of the application system, the PRP noted that it was not uncommon for companies to file a number of applications and focus on only the ones that meet their business priorities and prevailing market needs. Since there would be resource implications on the part of the SFC to process all the inactive applications, the PRP invited the SFC to discuss with market practitioners and put in place a due process to tackle the situation.

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<sup>3</sup> The subject was described in paras. 3.20 to 3.21 of the PRP Annual Report for 2007.

3.16 The SFC replied that in response to the PRP’s recommendation made in 2007, a revised reminder letter carrying a warning that an application could be refused after an unduly long period of non-response from the applicant<sup>4</sup> was introduced in 2008. The SFC had publicised the new arrangement and was monitoring the situation, and would continue to have a close dialogue with market practitioners to discuss how the process could work better.

### ***Product knowledge***

3.17 In the course of reviewing the procedures of authorising a “Fund-of-Hedge-Funds<sup>5</sup>” (“FoHF”), it came to the PRP’s notice that the fund had imposed substantial fees and charges that would reduce the returns to investors. The PRP considered that the fee structure of FoHFs should be disclosed explicitly as a warning in the prospectus. The SFC advised that the Code on Unit Trusts and Mutual Funds required appropriate warnings to be made in offering documents about the fees at various levels within an FoHF. Noting that investors tended to overlook details in the offering documents and might not pay attention to the risk warnings, the PRP suggested the SFC consider strengthening education to investors about the importance of understanding a product, including its fee structure, for making an informed decision.

3.18 The SFC took note of the PRP’s observations and agreed that it was important to educate investors. In the case of FoHF, the SFC had published a leaflet on hedge funds and uploaded relevant information on its InvestEd website. The SFC indicated that it was committed to continuing with its efforts in investor education.

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<sup>4</sup> According to the SFC’s standard procedures, the SFC issues reminder letters at different stages of the processing work if a response from the applicant remains outstanding for months. If a substantive response remains outstanding for three months from the SFC’s last request for information, an application may be refused on the grounds that the SFC could not be satisfied that the requirements in the relevant code on collective investment scheme have been met.

<sup>5</sup> An FoHF is a fund that exclusively invests in other hedge funds, i.e. an FoHF is a basket of hedge funds, with the FoHF being the parent with a number of underlying baby funds in its portfolio. Since the FoHF manager provides additional service in selecting the baby funds and monitoring their performance, an FoHF has an extra layer of fees - one at the parent level and one at the baby funds level.

## **(D) Handling of complaints**

3.19 The PRP reviewed ten complaint cases and concluded that the SFC had generally followed the standard procedures in handling these cases.

### ***Decision of taking no further action***

3.20 In one of the cases reviewed, the PRP noted that the SFC had received several complaints and reports alleging that an investment company had, without a proper licence, marketed an investment product on behalf of an overseas associate. While the Intermediaries Supervision Department considered that there was prima facie evidence that the company had breached relevant provisions under the SFO and the Code of Conduct for Persons Licensed by or Registered with the SFC (“the Code of Conduct”), the Enforcement Division of the SFC decided not to take further action against the company. The Licensing Department subsequently further discussed with the company, which had eventually ceased the marketing activities.

3.21 In response to the PRP’s enquiry about the decision on taking no further action in this case, the SFC clarified that enforcement action was only one of the possible regulatory means. The Enforcement Division had considered a number of factors in reaching the decision, including nature of the breaches, loss to investors and sufficiency of evidence. The breaches were considered technical in nature, and it involved overseas investment products that fell outside the SFC’s licensing regime. After consideration, the SFC had decided to follow up on the case by requiring the company to rectify the breaches. The SFC would also continue to monitor compliance by the company on an ongoing basis.

3.22 Separately, in another case reviewed, an investor alleged that the SFC had not properly handled his complaint against the investment company for opening additional accounts by forging his signature. The SFC explained that it had decided not to pursue this matter further because the complainant had already made a report to the Police, which was the appropriate law enforcement agency to investigate fraud or forgery.

## **(E) Investigation and disciplinary action**

3.23 In 2008-09, the PRP reviewed 24 enforcement cases relating to prosecution, fining, revocation or suspension of licence, disqualification order on a director of a listed company, issuance of compliance advice letter and settlement of disciplinary action. The PRP noted that the SFC had generally followed the prescribed procedures in handling these cases.

### ***Issuance of compliance advice letters***

3.24 The PRP reviewed a case concerning suspected manipulative activities conducted by two clients of a brokerage firm. While there was insufficient evidence to prosecute these clients, the SFC considered that the dealer handling these trades had failed to detect and inquire into the suspicious activities conducted by his clients. As a result, the SFC issued a compliance advice letter to remind the dealer to remain vigilant about suspicious orders placed with him.

3.25 Drawn on this case, the PRP considered it important to cultivate a compliance culture through education. Apart from issuing a compliance advice letter to the dealer, the PRP suggested the SFC consider bringing the compliance issue to the attention of the responsible officers of the brokerage firm for seeking improvements to the internal control measures.

3.26 The SFC advised that the purpose of compliance advice letter was to address areas of regulatory concern and to raise standards of future conduct and compliance, which in turn would better protect investors. Where a formal disciplinary action is not considered necessary, the SFC would give timely and specific advice to a brokerage firm on how to improve its internal controls and compliance. For the case in question, the SFC explained why it had issued a compliance advice letter to the dealer but not the brokerage firm. Firstly, it was the dealer who had a better knowledge of his clients' trading rather than the brokerage firm. In the circumstances, it was difficult for the firm to take timely measures to reasonably prevent the dealer's conduct. Secondly, the issue of an advice to the firm would no longer be necessary given the long lapse in time.

### ***Maintenance of tape-recording of orders***

3.27 The SFC's Code of Conduct provides that a licensed person should record and immediately time stamp records of the particulars of instructions for agency orders and internally generated orders (such as proprietary accounts and staff accounts). Where order instructions are received from clients through the telephone, a licensed person should use a telephone recording system to record the instructions and maintain telephone recordings as part of its records for at least three months.

3.28 During an investigation into suspicious trades of the securities of a listed company, the SFC found that two account executives of two brokerage firms had failed to tape record the orders placed by their clients. Their failure to produce the tape recording constituted a breach of the Code of Conduct. As a result, the SFC issued compliance advice letters to both brokerage firms and to an account executive<sup>6</sup> to remind them of the importance to implement proper control measures, maintain proper records of client orders and ensure compliance with the Code of Conduct.

3.29 Noting that tape-recording of orders served as a form of proper record which offered protection to both clients and dealers against disputes, the PRP suggested the SFC convey a strong message to licensed persons about the importance of proper tape recording of orders. In response, the SFC agreed to take forward the recommendation.

### ***Compliance responsibility of responsible officers in the conduct of regulated activities***

3.30 Arising from a case of misappropriation of client assets by an account executive, the SFC found that the brokerage firm concerned had failed to implement adequate internal controls. The SFC took disciplinary action against the firm and the director who was also the compliance officer on the ground that the director was involved in the management of business and was a "regulated person"<sup>7</sup>, hence subject to the SFC's disciplinary

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<sup>6</sup> The SFC decided not to take further action against the other account executive in view of isolated incidents that orders were not recorded.

<sup>7</sup> Under s. 194(1) and (2) of the SFO, the SFC may take disciplinary action against a "regulated person" which includes "a person involved in the management of the business of a licensed corporation" as defined in s. 194(7) of the SFO.

regime under the SFO. The SFC did not take action against the two responsible officers in the firm, as the director was the person responsible for the firm's operations and compliance, and had direct responsibility for the firm's failure.

3.31 In another case, two analysts of a research firm traded securities within several weeks before and after the firm had issued research reports on the subject securities. The SFC alleged that the two analysts placed themselves in a position of conflict and that the research firm had failed to put in place adequate internal controls to monitor staff's dealings in securities. The two analysts were reprimanded and fined. The SFC also took disciplinary action against one of the responsible officers of the research firm. The SFC however did not take action against the compliance officer, who was not a "regulated person".

3.32 The PRP noted some discrepancies in the way the SFC imposed disciplinary actions in the two cases. Given that the primary role of a responsible officer was to monitor the regulated activities of a licensed corporation, it appeared unusual that the disciplinary action was not taken against the responsible officers in the case mentioned in paragraph 3.30. Noting that the SFC might target its disciplinary action at a compliance officer who was a "regulated person", there were concerns that a responsible officer could evade disciplinary action by shifting his responsibility to a compliance officer. The PRP invited the SFC to advise the process in dealing with such circumstances. In addition, the PRP suggested the SFC consider whether it would help promote market integrity by entrusting the compliance responsibility in the conduct of regulated activities with the responsible officers, instead of a director or a compliance officer who might not be a licensee.

3.33 The SFC took note of the PRP's observations and explained that each case had to be determined on its merits in accordance with the evidence available. The SFC would look into the fault element in each case to establish individual liability against a person, no matter whether he was a director, a responsible officer, a senior manager or an employee. In general, responsible officers held the role of supervising the regulated activities of the licensed corporation to which they were accredited. They might delegate part of their supervisory functions, e.g. the compliance

function, to designated staff having the required expertise to perform those functions, but the responsible officers would retain the overall responsibility for supervising the firm. The SFC also confirmed that supervisory failure could be a cause of the SFC's disciplinary action against the responsible officers.

### *Ongoing process to review compliance*

3.34 In the case mentioned in paragraph 3.31 above, the PRP noted that the SFC had reached a settlement agreement with the company, under the terms of which the company's licence would be suspended if repeated failings were found within a specified period. In addition, the company would engage an independent audit firm to carry out a review on its internal controls. The SFC advised that the settlement terms were conducive to better compliance by the company through a "suspended sentence", which would loom over the company during the specified period. In addition, a random surprise inspection would be made to ascertain its compliance within this period.

3.35 The PRP noted that in this case, the Discipline Department of the SFC had yet to convey in detail the objective of the "suspended sentence" and the need to conduct an inspection to the Intermediaries Supervision Department. The PRP suggested the Discipline Department liaise with the Intermediaries Supervision Department so that an inspection would be conducted in a timely manner. Regarding the review on internal control measures, the PRP urged the SFC to take measures to ensure that the company would duly follow up the recommendations made by the independent audit firm.

3.36 The SFC explained that the Discipline Department had kept the Intermediaries Supervision Department informed of the enforcement actions taken against the company. The Discipline Department would follow up by designing the terms of reference and overseeing the engagement of an audit firm by the company to review its internal controls and systems within a specified period. The Discipline Department would also notify the Intermediaries Supervision Department when the review was conducted and pass the recommendations of the audit firm to the Intermediaries Supervision Department for follow-up as appropriate.

### *Handling of suspected market misconduct cases*

3.37 In a case reviewed, the PRP noted the SFC's findings that a trader might have engaged in manipulative trading in several stocks. After consulting its internal Legal Services Division, the SFC referred the case to the Department of Justice to consider taking prosecution action against the trader for market manipulation. The Department of Justice advised against prosecution because the evidence did not appear to be strong enough. On the basis of the advice and considering that the trader was not an SFC licensee, hence no disciplinary action could be taken under the SFO, the SFC decided to close the case.

3.38 In another case, the SFC found that a licensed representative of a brokerage firm had placed a large number of bid orders for a stock and cancelled the orders after his ask orders were executed, which might have created a false picture of a huge demand for the shares, and facilitate off-loading of the shares at a higher price. Nevertheless, given the specific circumstances of the case, expert advice was that it was difficult to prove a case of market manipulation. Having regard to the expert advice, the SFC decided not to take further action.

3.39 Parts XIII and XIV of the SFO respectively provide civil and criminal routes to deal with suspected market misconduct cases. The SFC may refer a case to the Department of Justice to consider taking prosecution, or to the Financial Secretary to consider referral to the Market Misconduct Tribunal ("MMT") which adopts the lower standard of proof applicable to civil proceedings. Since the files reviewed by the PRP did not document the deliberations of the SFC, the PRP invited the SFC to clarify whether it had considered both prosecution and referral to the MMT in the decision making process.

3.40 The SFC confirmed that in the two cases, it had thoroughly deliberated on their merits before it came to the conclusion that referral to the Financial Secretary for instituting proceedings before the MMT was not appropriate, and the final decisions had been documented. In the first case,

the sanctions available to the MMT<sup>8</sup> would not have the necessary regulatory or deterrent effect as the trader concerned was neither a director of any company nor did he make any profits from the trade. In the second case, the SFC considered that there was insufficient basis to take further action.

#### **(F) Processing of listing applications under the Dual Filing regime**

3.41 The Securities and Futures (Stock Market Listing) Rules (“the Rules”) require a corporation applying for listing of its securities to file copies of the application with the SFC after the same is submitted to a recognised exchange company. To facilitate compliance and minimise any additional cost to a listing applicant, the Rules enable the applicant to fulfil this obligation by authorising the exchange company to file the material with the SFC on its behalf. This arrangement is known as “Dual Filing”.

3.42 The PRP reviewed two cases relating to the processing of listing applications under the Dual Filing regime. The PRP noted that in both cases, the SFC had provided its comments to The Stock Exchange of Hong Kong Limited within the statutory timeframe. The PRP noted that the SFC had followed the established procedures in processing the cases, and made no other observation.

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<sup>8</sup> Under s. 257 of the SFO, the MMT may order a person identified as having engaged in market misconduct pay to the Government an amount not exceeding the amount of any profit gained or loss avoided by the person as a result of the market misconduct in question. It may also make an order that the person shall not, without leave of the Court of First Instance, be a director, liquidator, or receiver or manager of a corporation or acquire, dispose of or deal in any securities, etc.

## Chapter 4      Observations on specific areas

4.1            In the course of reviewing individual cases, the PRP would also bring up specific areas of the SFC's procedures for examination. The aim is to identify areas for improvement with a view to enhancing compliance processes and maintaining the quality and integrity of regulation. In 2008-09, the PRP identified two issues for examination through case reviews, and furnished the SFC with its observations and comments. The PRP's deliberations and considerations are summarised below. Details of the SFC's response are at **Annex C**.

### **(A) Handling of cases involving misappropriation of client assets**

4.2            Arising from the spate of broker misconduct cases involving misappropriation of client assets in 2006, there were requests for the PRP to review the SFC's procedures in handling such cases. In 2007, the PRP reviewed one case<sup>9</sup> and discussed with the SFC ways to expedite the return of client assets after a brokerage firm had been put into administration or liquidation<sup>10</sup>. In 2008, the PRP completed the review of three additional cases. The PRP concluded that the SFC had followed its established procedures in handling cases involving misappropriation of client assets.

4.3            In one of the three cases, the SFC was initially investigating the short-selling activities of a brokerage firm but later found out that the firm had failed to handle funds and securities of its clients properly. From a circularisation exercise conducted by an external accountant to confirm the balance of client accounts, a huge discrepancy in the worth of client securities was identified between the firm's internal records and the records of the central clearing and settlement system. The case was referred to the Police for investigation of alleged theft, false accounting and conspiracy to defraud. Noting that misconduct by brokers was usually difficult to detect and that the current case was uncovered inadvertently, the PRP suggested the SFC step up supervision of intermediaries to ensure that there were

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<sup>9</sup> The PRP received in October 2006 a request for review on three cases involving broker misconduct. As the PRP's terms of reference provide that it may review completed or discontinued cases, the PRP reviewed one case completed in 2007 and the findings were reported in paras. 4.11 to 4.13 of the PRP Annual Report for 2007. The PRP reviewed the other two cases upon their conclusion in 2008.

<sup>10</sup> The findings were reported in paras. 4.5 to 4.6 of the PRP Annual Report for 2007.

adequate internal control measures to prevent unauthorised transfer of client assets.

4.4 The SFC assured the PRP that it had remained vigilant in supervising brokers' activities. The three misappropriation cases reviewed by the PRP in 2008 were all uncovered by the SFC through its on-site inspections and follow-up actions. Under the current regulatory regime, brokers were required to comply with strict rules and regulations in relation to handling of client assets, including segregation of client assets in designated accounts and seeking client's written authorisation for transfer of client assets to third parties. In addition, brokers were required to maintain adequate internal control measures for safeguarding client assets. Every year, auditors of brokers must review the broker's compliance and controls and report to the SFC for any non-compliance or control weaknesses. Brokers were also required to issue to their clients contract notes and periodic account statements so that unauthorised transactions could be detected at the earliest opportunity.

4.5 The SFC considered it important for intermediaries, regulators, auditors, and investors to work together to combat fraud and misconduct, and had adopted the following three-pronged actions—

- (a) Continuing rigorous supervision of brokers to deter misconduct

The SFC adopted a risk-based approach to supervise brokers, and monitored their compliance with applicable regulatory requirements. It also applied more forensic testing techniques in broker inspections, such as fund tracing and circularisation, to help detect irregularities in the handling of client assets. If control deficiencies were identified in an inspection, the SFC would take appropriate regulatory actions against the broker concerned.

- (b) Engaging the accounting profession to enhance the quality of broker audits

The SFC had worked closely with the Hong Kong Institute of Certified Public Accountants ("HKICPA") to revise the

guidance notes on audit of the SFC's licensed corporations. The revised guidance notes encouraged auditors to conduct verification of client assets against records kept by the brokers. The SFC also reached out to the accounting profession through seminars to explain the auditors' reporting duties under the SFO<sup>11</sup> and to share experience on detection of broker fraud and misconduct. The SFC would refer suspected cases of auditor negligence to the HKICPA for their action.

- (c) Stepping up investor education on fraud risks and the use of Investor Participant Accounts<sup>12</sup>

The SFC had launched an intensive investor education programme with a view to raising investors' awareness of the risks arising from broker misconduct and promoting the use of Investor Participant Accounts. The SFC also collaborated with the Hong Kong Exchanges and Clearing Ltd and the industry in its publicity work, including organisation of public seminars and production and distribution of information leaflets and feature articles.

## **(B) SFC's complaint handling procedures**

4.6 Arising from the complaint cases reviewed by the PRP, the PRP saw merits to better understand the complaint handling procedures adopted by the SFC, in particular how the Complaints Control Committee worked and how a decision was reached.

4.7 The Complaints Control Committee comprises the Chief Operating Officer as the chairman and senior representatives from all

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<sup>11</sup> Pursuant to section 157 of the SFO, an auditor of a licensed corporation is required to report to the SFC if he becomes aware of failure by the licensed corporation to comply with rules in relation to safe custody of client assets, keeping of accounts and records and provision of contract notes and statements, etc., or if he proposes the inclusion of the qualification or adverse statement in any report prepared by him on the financial statements or other documents of the listed corporation. The same requirement is applicable to the auditor of an associated entity of an intermediary.

<sup>12</sup> An Investor Participants Account is an account opened in an investor's own name at the Central Clearing and Settlement System. It provides investors with the convenience of electronic book-entry settlement. In addition, an investor has full control of his shares kept in his Investor Participant Account and only the investor can authorise the transfer of shares out of his account.

operational divisions/departments as members. The primary functions of the Complaints Control Committee are to –

- (a) receive and consider all investor complaints which are received by the SFC<sup>13</sup>;
- (b) conduct an assessment of each complaint to decide whether or not further action is appropriate;
- (c) refer a complaint to the division/department concerned, with a recommendation as to what further action should be taken, if appropriate; and
- (d) receive and consider recommendations from the division/department concerned, following referral of a complaint to that division/department recommending it seek further information or explanation from the complainant.

4.8 The assessment criteria for prioritisation, allocation and handling of complaints include the nature of the matter; whether it gives rise to any systemic concern; whether it falls within the regulatory priority; the availability and likely quality of evidence; the licence status of the subject of complaint; and the resource commitment relative to the likely outcome.

4.9 The PRP noted that whether to refer a complaint to the division/department concerned within the SFC or to close the case was a collective decision made by the Complaints Control Committee after thorough discussion. The decisions were properly recorded. The PRP was satisfied that this mechanism should be generally effective and adequate in handling complaints.

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<sup>13</sup> The External Relations Department is responsible for receiving complaints and performing an initial screening before referring them to the Complaints Control Committee for consideration. These do not include complaints against SFC staff, which are dealt with under a separate set of complaints handling procedure.

## Chapter 5      Way forward

5.1            In 2008-09, the PRP endeavoured to discharge its functions through a comprehensive review of completed or discontinued cases and selected topics of the SFC's operational procedures, and the drawing up of valid observations and recommendations to the SFC.

5.2            In 2009-10, the PRP will follow up a number of recommendations made in 2008-09 in relation to the SFC's internal procedures. The areas include the processing of applications for authorisation of collective investment schemes, and the deliberation processes and procedures of the Enforcement Division in deciding whether and how a case should be taken forward.

5.3            The PRP will continue its work to ensure that the SFC adheres to its internal procedures consistently. It will maintain a dialogue with market players to gauge their views about the exercise of powers by the SFC.

5.4            The PRP welcomes and attaches great importance to the views from market practitioners as well as the public on the SFC's operational procedures which fall within the PRP's terms of reference<sup>14</sup>. Suggestions and comments can be referred to the PRP through the following channels –

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<sup>14</sup> The PRP reviews completed or discontinued cases of the SFC in order to assess whether the SFC has followed its internal procedures in handling the cases. Enquiries or complaints relating to non-procedural matters could be made to the SFC –

By post to            : The Securities and Futures Commission, 8<sup>th</sup> Floor, Chater House, 8 Connaught Road, Central, Hong Kong  
By telephone to    : (852) 2840 9222  
By fax to             : (852) 2521 7836  
By email to          : enquiry@sfc.hk (for general enquiries, comments and suggestions, etc.)  
                             : complaint@sfc.hk (for public complaints)

By post to: Secretariat of the Process Review Panel for the  
Securities and Futures Commission  
18<sup>th</sup> Floor, Tower 1, Admiralty Centre  
18 Harcourt Road  
Admiralty  
Hong Kong

By email to: [prp@fstb.gov.hk](mailto:prp@fstb.gov.hk)

## **Chapter 6      Acknowledgement**

6.1            The PRP would like to express its gratitude to the SFC and its staff for their assistance in facilitating the review work, and their co-operation in responding to the PRP's enquiries and recommendations in the past year.



**Process Review Panel for the  
Securities and Futures Commission**

**Terms of reference**

1. To review and advise the Commission upon the adequacy of the Commission's internal procedures and operational guidelines governing the actions taken and operational decisions made by the Commission and its staff in the performance of the Commission's regulatory functions in relation to the following areas -
  - (a) receipt and handling of complaints;
  - (b) licensing of intermediaries and associated matters;
  - (c) inspection of licensed intermediaries;
  - (d) taking of disciplinary action;
  - (e) authorisation of unit trusts and mutual funds and advertisements relating to investment arrangements and agreements;
  - (f) exercise of statutory powers of investigation, inquiry and prosecution;
  - (g) suspension of dealings in listed securities;
  - (h) administration of the Hong Kong Codes on Takeovers and Mergers and Share Repurchases;
  - (i) administration of non-statutory listing rules;
  - (j) authorisation of prospectuses for registration and associated matters; and
  - (k) granting of exemption from statutory disclosure requirements in respect of interests in listed securities.
  
2. To receive and consider periodic reports from the Commission on all completed or discontinued cases in the above-mentioned areas, including reports on the results of prosecutions of offences within the Commission's jurisdiction and of any subsequent appeals.

3. To receive and consider periodic reports from the Commission in respect of the manner in which complaints against the Commission or its staff have been considered and dealt with.
4. To call for and review the Commission's files relating to any case or complaint referred to in the periodic reports mentioned in paragraphs 2 and 3 above for the purpose of verifying that the actions taken and decisions made in relation to that case or complaint adhered to and are consistent with the relevant internal procedures and operational guidelines and to advise the Commission accordingly.
5. To receive and consider periodic reports from the Commission on all investigations and inquiries lasting more than one year.
6. To advise the Commission on such other matters as the Commission may refer to the Panel or on which the Panel may wish to advise.
7. To submit annual reports and, if appropriate, special reports (including reports on problems encountered by the Panel) to the Financial Secretary which, subject to applicable statutory secrecy provisions and other confidentiality requirements, should be published.
8. The above terms of reference do not apply to committees, panels or other bodies set up under the Commission the majority of which members are independent of the Commission.

**Membership of the PRP**

- Chairman: Mr. CHOW Wing Kin, Anthony, SBS, JP
- Members: Professor CHAN Yuk Shee, BBS, JP
- Mr. CHIU Chi Cheong, Clifton
- Mr. FUNG Hau Chung, Andrew
- Dr. KAM Pok Man
- Mr. LEE Jor Hung, Dannis, BBS
- Dr. the Honourable LEUNG Mei Fun, Priscilla  
*(with effect from 1 February 2009)*
- Mr. LIU Che Ning
- Mr. SUN Tak Kei, David, BBS, JP
- Ex officio members: Chairman, Securities and Futures Commission  
(Mr. FONG Ching, Eddy, GBS, JP)
- Representative of Secretary for Justice  
(Mr. LAI Ying Sie, Benedict, JP)

## **Membership of Working Groups**

### **Working Group on Corporate Finance and Enforcement**

Chairman: Professor CHAN Yuk Shee, BBS, JP

Members: Mr. CHOW Wing Kin, Anthony, SBS, JP

Mr. FONG Ching, Eddy, GBS, JP

Mr. LEE Jor Hung, Dannis, BBS

Mr. LIU Che Ning

### **Working Group on Licensing, Intermediaries Supervision and Investment Products**

Chairman: Dr. KAM Pok Man

Members: Mr. CHIU Chi Cheong, Clifton

Mr. FUNG Hau Chung, Andrew

Mr. LAI Ying Sie, Benedict, JP

Dr. the Honourable LEUNG Mei Fun, Priscilla  
*(with effect from 1 February 2009)*

Mr. SUN Tak Kei, David, BBS, JP

## SFC's responses<sup>1</sup> to the PRP's observations and recommendations

### (A) Licensing of intermediaries

Item (1) <sup>2</sup>
<p><u>Case findings</u></p> <p>In 2007, the PRP suggested the SFC consider imposing a validity period for provisional licence. In response, the SFC explained that under the Securities and Futures Ordinance ("SFO"), a provisional licence would only lapse either upon issue of a full licence or refusal of the application.</p>
<p><u>PRP's recommendation/observation</u></p> <p>The PRP invited the SFC to put in place a monitoring system to track and deter undue delays in the processing of licence applications (para. 3.3 of Chapter 3).</p>
<p><u>SFC's response</u></p> <p>The SFC accepted that it was preferable for an intermediary to be carrying on regulated activities with a full licence rather than a provisional one. Accordingly, there was a conscious effort to minimise the period during which a person would hold a provisional licence. In other words, the processing of the full licence would be expedited where possible. The Associate Director or Senior Manager overseeing a team that had issued a provisional licence would specifically monitor the subsequent licensing process to ensure that unnecessary delay would not occur in the processing of the full licence.</p>

Item (2)
<p><u>Case findings</u></p> <p>In a case, the PRP noted that the SFC had taken five months to issue a provisional licence to the applicant because there was adverse information on the applicant from an overseas regulator, and a full licence was not issued until another nine months later. The SFC explained that the long time taken was attributable to a communication gap arising from a re-assignment of the case to another processing team.</p>
<p><u>PRP's recommendation/observation</u></p> <p>Noting that this was an isolated incident probably due to the large number of cases being processed at the time, the PRP suggested the SFC consider enhancing its status report on outstanding cases in the event of re-assignment of cases and change of processing officers (para. 3.5 of Chapter 3).</p>

<sup>1</sup> Editorial changes are made mainly to remove case specific information.

<sup>2</sup> This is a follow-up item in relation to a recommendation made by the PRP in 2007. The discussion in paras. 3.15 to 3.18 of the PRP Annual Report for 2007 is relevant.

SFC's response

The SFC considered that this case was an aberration, resulting from the re-assignment of the file from one team to another. However, the fact that it occurred meant that the tracking system did not work as effectively as it could have and that there was room for improvement. The SFC would "re-engineer" the licensing system and expected that this would result in changes that would better alert case officers to situations of this type.

**Item (3)**

Case findings

The SFC undertook in its performance pledge that a provisional licence would be issued within seven business days and a full representative licence within eight weeks. In case the applications would take longer to process e.g. because the applicants were involved in the SFC's past or on-going investigations, the SFC would inform the applicants or their employers accordingly.

PRP's recommendation/observation

The PRP recognised the SFC's effort in keeping track of the progress. However, the PRP noticed that there was no standardised arrangement. For example, the SFC notified the applicants in two cases but in another two cases the employers of the applicants. The SFC explained that they would respond to the enquirer who could either be the applicant or the employer. In response, the PRP suggested the SFC consider standardising the arrangement (para. 3.7 of Chapter 3).

SFC's response

The SFC considered it appropriate that the response be addressed to the party making the enquiry. However, since both the applicant and his or her employer were likely to have an interest in the matter, the SFC accepted that such letter should be copied to the other party unless this was inappropriate for any reason in the particular circumstances of that case.

**Item (4)**

Case findings

In one case reviewed by the PRP, a subsidiary company of a conglomerate applied for a corporate licence to distribute investment funds. The Licensing Department of the SFC raised concerns about the adequacy of the company's internal control measures, which should ensure proper segregation of its regulated activities from the other businesses of its controlling group, and avoid possible confusion of its identity with unlicensed entities within the same group. Given the large size of the sales team, the Licensing Department also considered that the proposed management resources were inadequate.

PRP's recommendation/observation

The PRP suggested the case be brought to the attention of the Intermediaries Supervision Department of the SFC for considering if regular inspections were warranted. The PRP further suggested the SFC consider putting in place a “red flag” system, which would refer any conduct concerns of intermediaries to the relevant department for follow-up (para. 3.9 of Chapter 3).

SFC's response

The SFC agreed that certain responses made by applicants during the licensing process might need to be followed up after the relevant licences were granted. The Licensing Department would refer relevant information about licensed corporations, including information collected during the licensing process, from time to time to other Divisions/Departments such as the Intermediaries Supervision Department and the Enforcement Division for follow-up where necessary.

Even where any information collected during the licensing process had not been specifically referred to the Intermediaries Supervision Department, inspection staff of the Intermediaries Supervision Department would, before commencement of the fieldwork of an inspection, review various available relevant information including licensing files of the inspection target on a risk sensitive basis and take the information into consideration in identifying the focus review areas and “tailoring” the audit steps for the inspection.

**(B) Inspection of intermediaries**

**Item (5)**

Case findings

In a special theme inspection exercise on the proper safeguard of client assets by over ten brokerage firms, the SFC had engaged an external accounting firm to conduct a circularisation exercise to verify the records of the brokerage firms. The PRP noted that the SFC had taken nine months to issue the final letter of deficiencies to one of the brokerage firms. The case closed about nine months later pending the final report on the whole circularisation exercise to be submitted by the external accounting firm.

PRP's recommendation/observation

The PRP suggested the SFC consider engaging additional accounting firms, or agreeing in advance with the appointed accounting firm a pre-set timeframe so as to avoid undue delay in the conclusion of inspections (para. 3.12 of Chapter 3).

SFC's response

The SFC advised that the inspection and circularisation exercise involved a lot of detailed work on a significant number of client accounts. In the particular case reviewed by the PRP, the SFC issued an interim letter of deficiencies within four months after the commencement of the inspection, followed up with the brokerage firm on its response to the interim letter, issued the final letter of deficiencies, carried out a follow-up visit to review the rectification measures taken by the brokerage firm, and worked closely with the

accounting firm and the brokerage firm on the circularisation results. Generally, using one single accounting firm to conduct client circularisation for a group of brokers might benefit the circularisation exercise with greater synergy and lower cost, compared to dividing the job between different accounting firms. That said, the SFC agreed to consider any option provided that it would benefit the overall efficiency and lower the costs. In future, the SFC would explore with the appointed accounting firm the feasibility of issuing a report on an individual broker basis in order to facilitate the timely conclusion of individual inspections.

### (C) Authorisation of collective investment schemes

#### Item (6)

##### Case findings

The PRP noted that the relatively long processing time in certain cases was attributable to the time taken on the part of the applicants to respond to the SFC's enquiries and requests for information. The PRP had made similar observations in 2007 that some applicants might have taken the advantage of the application system to keep pre-mature applications open. Although the SFC had been monitoring the situation and considered that there was no serious abuse of the application system, the PRP noted that it was not uncommon for companies to file a number of applications and focus on only the ones that meet their business priorities and prevailing market needs.

##### PRP's recommendation/observation

Since there would be resource implications on the part of the SFC to process all the inactive applications, the PRP invited the SFC to discuss with market practitioners and put in place a due process to tackle the situation (para. 3.15 of Chapter 3).

##### SFC's response

There was no evidence of any serious abuse of the application system. The SFC considered that there was an adequate procedure in place to deal with inactive applications, which was reinforced by the revised reminder letters that an application would be refused if the applicant did not respond for a long time. The SFC would keep monitoring the situation and keep market practitioners informed. The SFC would also continue to have a close dialogue with relevant market practitioners to discuss how the process could work better with their marketing plan and better utilise the SFC's resources.

#### Item (7)

##### Case findings

In the course of reviewing the procedures of authorising a "Fund-of-Hedge-Funds" ("FoHF"), it came to the PRP's notice that the fund had imposed substantial fees and charges that would reduce the returns to investors. The PRP considered that the fee structure of FoHF should be disclosed explicitly as a warning in the prospectus. The SFC advised that the Code on Unit Trusts and Mutual Funds required appropriate warnings to be made in the offering documents about the fees at various levels within an FoHF.

PRP's recommendation/observation

Noting that investors tended to overlook details in the offering documents and might not pay attention to the risk warnings, the PRP suggested the SFC consider strengthening education to investors about the importance of understanding a product, including its fee structure, for making an informed decision (para. 3.17 of Chapter 3).

SFC's response

The SFC agreed that it was important to educate investors, alert them the importance of understanding an investment product before investing and remind them to pay attention to the fee structure, particularly in the case of funds of hedge funds. Accordingly, the SFC kept reminding the public on this. For example, in the leaflet on hedge funds, the SFC highlighted that funds of hedge funds had an extra layer of fees, one at the parent level and one at the underlying fund level. The SFC also published a Q&A under the topic of Alternative Investment: Hedge Funds on its InvestEd website on this point. The SFC would continue its efforts on investor education work on this.

**(D) Handling of complaints**

**Item (8)**

Case findings

The PRP noted that the SFC had received several complaints and reports alleging that an investment company had, without a proper licence, marketed an investment product on behalf of an overseas associate. While the Intermediaries Supervision Department considered that there was prima facie evidence that the company had breached relevant provisions under the SFO and the Code of Conduct for Persons Licensed by or Registered with the SFC (“the Code of Conduct”), the Enforcement Division of the SFC decided not to take further action against the company. The Licensing Department subsequently further discussed with the company, which had eventually ceased the marketing activities.

PRP's recommendation/observation

The PRP invited the SFC to elaborate on the reasons for taking no further action in this case (para. 3.21 of Chapter 3).

SFC's response

Before deciding to take no further action, the SFC had considered a number of factors relevant to the circumstances of the case. The SFC pointed out that enforcement action was not the only possible regulatory response. In this case, compliance was monitored further or on an ongoing basis by the Intermediaries Supervision Department.

As for the decision making process, the Enforcement Division would assess the case upon referral from the Intermediaries Supervision Department. The Enforcement Division conducted preliminary analysis and set out the recommendations for the management's decision.

To ensure consistency of decisions, cases were tabled and discussed within the Enforcement Division.

## (E) Investigation and disciplinary action

<b>Item (9)</b>
<p><u>Case findings</u></p> <p>The PRP reviewed a case concerning suspected manipulative activities conducted by two clients of a brokerage firm. While there was insufficient evidence to prosecute these clients, the SFC considered that the dealer handling these trades had failed to detect and inquire into the suspicious activities conducted by his clients. As a result, the SFC issued a compliance advice letter to remind the dealer to remain vigilant about suspicious orders placed with him.</p>
<p><u>PRP's recommendation/observation</u></p> <p>The PRP considered it important to cultivate a compliance culture through education. Apart from issuing a compliance advice letter to the dealer, the PRP suggested the SFC consider bringing the compliance issue to the attention of the responsible officers of the brokerage firm for seeking improvements to the internal control measures (para. 3.25 of Chapter 3).</p>
<p><u>SFC's response</u></p> <p>Compliance advice letters were issued to address areas of regulatory interest and to raise standards of future conduct and compliance, which in turn would better protect investors. The advice given should be timely and specific. The SFC agreed that if appropriate, it would give advice to a brokerage firm to improve their internal controls and so improve compliance.</p> <p>For the case in question, the SFC explained why it had issued a compliance advice letter to the dealer but not the brokerage firm. Firstly, it was the dealer who had a better knowledge of his clients' trading rather than the brokerage firm. In the circumstances, it would have been extremely difficult for the firm to take timely measures to reasonably prevent the dealer's conduct. Secondly, the issue of an advice to the firm would no longer be necessary given the long lapse in time.</p>
<b>Item (10)</b>
<p><u>Case findings</u></p> <p>During an investigation into suspicious trades of the securities of a listed company, the SFC found that two account executives of two brokerage firms had failed to tape record the orders placed by their clients. Their failure to produce the tape recording constituted a breach of the Code of Conduct. As a result, the SFC issued compliance advice letters to both brokerage firms and to an account executive to remind them of the importance to implement proper control measures, maintain proper records of client orders and ensure compliance with the Code of Conduct.</p>
<p><u>PRP's recommendation/observation</u></p> <p>Noting that tape-recording of orders served as a form of proper record which offered protection to both clients and dealers against disputes, the PRP suggested the SFC convey</p>

a strong message to licensed persons about the importance of proper tape recording of orders (para. 3.29 of Chapter 3)

SFC's response

The SFC agreed with the recommendation and would convey the message to market practitioners through an appropriate channel.

**Item (11)**

Case findings

Arising from a case of misappropriation of client assets by an account executive, the SFC found that the brokerage firm concerned had failed to implement adequate internal controls. The SFC took disciplinary action against the firm and the director who was also the compliance officer on the ground that the director was involved in the management of business and was a “regulated person”, hence subject to the SFC’s disciplinary regime under the SFO. The SFC did not take action against the two responsible officers in the firm, as the director was the person responsible for the firm’s operations and compliance, and he had direct responsibility for the firm’s failure.

In another case, two analysts of a research firm traded securities within several weeks before and after the firm had issued research reports on the subject securities. The SFC alleged that the two analysts placed themselves in a position of conflict and that the research firm had failed to put in place adequate internal controls to monitor staff’s dealings in securities. The two analysts were reprimanded and fined. The SFC also took disciplinary action against one of the responsible officers of the research firm. The SFC however did not take action against the compliance officer, who was not a “regulated person”.

PRP's recommendation/observation

The PRP had concerns that a responsible officer could evade disciplinary action by shifting his responsibility to a compliance officer, and invited the SFC to advise the process in dealing with such circumstances. In addition, the PRP suggested the SFC consider whether it would help promote market integrity by entrusting the compliance responsibility in the conduct of regulated activities with the responsible officers, instead of a director or a compliance officer who might not be a licensee (para. 3.32 of Chapter 3).

SFC's response

Responsible officers were responsible for supervising the regulated activity of the licensed corporation to which they were accredited. They might delegate part of their supervisory functions, e.g. the compliance function, to other directors or designated staff having the required expertise to perform those functions but the responsible officers would retain overall responsibility for supervising the firm. The SFC could discipline responsible officers if they failed to properly supervise their delegates.

The possibility that a responsible officer could evade disciplinary action did not arise in this case. Each case was determined on its merits in accordance with the evidence. At

the same time, it would be important to understand that in each case in which the SFC sought to establish individual liability against a person (either a director, a responsible officer, a senior manager or an employee), some fault element had to be established against that person and fairness obliged the SFC to ensure the fault element in each case was a causative or material factor in occurrence of the failure.

## Item (12)

### Case findings

The PRP noted that in the second case mentioned in Item (11), the Discipline Department of the SFC had yet to convey in detail the objective of the “suspended sentence” and the need to conduct an inspection to the Intermediaries Supervision Department.

### PRP’s recommendation/observation

The PRP suggested the Discipline Department liaise with the Intermediaries Supervision Department so that an inspection would be conducted at in a timely manner. Regarding the review on internal control measures, the PRP urged the SFC to take measures to ensure that the company would duly follow up the recommendations made by the independent audit firm (para. 3.35 of Chapter 3).

### SFC’s response

The Enforcement Division notified the Intermediaries Supervision Department of all enforcement actions relevant to the latter’s role. In this case, the Enforcement Division designed the terms of reference for review and oversaw the engagement of an audit firm by the company. The audit firm was required to review the company’s internal controls and systems which were relevant to the conduct in question and to provide a review report. The review would happen randomly within the specified period. The Enforcement Division would notify the Intermediaries Supervision Department when the review was triggered and pass a copy of the review report to it. The purpose of the review was to check whether similar conduct had occurred. That was why the Enforcement Division was responsible for the process and the Intermediaries Supervision Department was not involved except where and when necessary.

## Item (13)

### Case findings

In a case, the PRP noted the SFC’s findings that a trader might have engaged in manipulative trading in several stocks. After consulting its internal Legal Services Division, the SFC referred the case to the Department of Justice to consider taking prosecution against the trader for market manipulation. The Department of Justice advised against prosecution because the evidence did not appear to be strong enough. On the basis of the advice and considering that the trader was not an SFC licensee, hence no disciplinary action could be taken under the SFO, the SFC decided to close the case.

In another case, the SFC found that a licensed representative of a brokerage firm had placed a large number of bid orders for a stock and cancelled the orders after his ask orders were executed, which might have created a false picture of a huge demand for the shares, and facilitate off-loading of the shares at a higher price. Nevertheless, given the specific circumstances of the case, expert advice was that it was difficult to prove a case of market manipulation. Having regard to the expert advice, the SFC decided not to take further action.

PRP's recommendation/observation

The PRP noted that the SFC might refer a case to the Department of Justice to consider taking prosecution, or to the Financial Secretary to consider referral to the Market Misconduct Tribunal ("MMT") which adopted the lower standard of proof applicable to civil proceedings. Since the files reviewed by the PRP did not document the deliberations of the SFC, the PRP invited the SFC to clarify whether it had considered both prosecution and referral to the MMT in the decision making process (para. 3.39 of Chapter 3).

SFC's response

The possibility of referring the case to the MMT was considered but ruled out. As the case officer explained to the PRP, referral to the MMT was not appropriate because the sanctions available to the MMT would not have much regulatory effect in this case. The trader was not a director of any listed company and he had not made any profit from the trades. Therefore the power of the MMT to disqualify a person from being a director of a company and/or to disgorge profits would be of little value in this case and be unlikely to create any deterrent effect.

The SFC had reviewed the documentation on the file and advised that the rationale for the decision had been clearly recorded.

**Item (14)**

Case findings

In one of the three misappropriation cases reviewed, the SFC was initially investigating the short-selling activities of a brokerage firm but later found out that the firm had failed to handle funds and securities of its clients properly. From a circularisation exercise conducted by an external accountant to confirm the balance of client accounts, a huge discrepancy in the worth of client securities was identified between the firm's internal records and the records of the central clearing and settlement system. The case was referred to the Police for investigation of alleged theft, false accounting and conspiracy to defraud.

PRP's recommendation/observation

Noting that misconduct by brokers was usually difficult to detect and that the current case was uncovered inadvertently, the PRP suggested the SFC step up supervision of intermediaries to ensure that there were adequate internal control measures to prevent unauthorised transfer of client assets (para. 4.3 of Chapter 4).

### SFC's response

The SFC had always been rigorously supervising brokers' activities. In fact, three misappropriation cases reviewed by the PRP in 2008 were uncovered by the SFC through its on-site inspections and follow-up actions. In addition to the supervision work, the SFC reminded the brokerage industry to step up their controls, worked closely with the accounting profession to assist them to enhance the quality of audits in broker firms, and launched intensive investor education programmes to educate investors how to safeguard their securities.

Under the current regulatory regime, brokers were required to comply with strict rules and regulations in relation to handling of client assets, including segregation of client assets in designated accounts and seeking client's written authorisation for transfer of client assets to third parties. In addition, brokers were required to maintain adequate internal controls for safeguarding client assets. Every year, auditors of brokers must review the broker's compliance and controls and report to the SFC any non-compliance or control weaknesses. Brokers were also required to issue to their clients contract notes and regular account statements to update clients of activities of their accounts. It would be important for intermediaries, regulators, auditors, and investors to work together to combat fraud and misconduct.

In view of the past broker fraud cases, the SFC had adopted a three-pronged action plan to step up the supervision of brokers and deter misconduct: continue the rigorous supervision of brokers, engage the accounting profession to enhance the quality of broker audits, and increase investor education on fraud risks and use of Investor Participant Accounts.

The Intermediaries Supervision Department adopted a risk-based approach to supervise brokers, and monitored their compliance with applicable regulatory requirements. They had adopted more forensic testing techniques in their broker inspections, such as fund tracing and circularisation of client stocks and cash balances to help them detect irregularities in handling of client assets. If control deficiencies were identified by their inspection, they would take appropriate regulatory actions against the broker, including referral to Enforcement Division for disciplinary action.

The Intermediaries Supervision Department had also worked closely with the Hong Kong Institute of Certified Public Accountants ("HKICPA") in their revision of their guidance notes on audits of licensed corporations. The revised guidance notes, among other matters, encouraged auditors to conduct client circularisation in their audits. Staff of the Intermediaries Supervision Department also spoke in HKICPA's training seminars explaining auditors' reporting duties under the Securities and Futures Ordinance and sharing experience with broker fraud detection. They also referred cases of suspected auditor negligence to HKICPA for further action.

In addition, the SFC had launched intensive investor education programme with a view to raising investors' awareness of fraud risks and promoting the use of Investor Participant Accounts by investors. The SFC had also reminded all brokers to provide assistance to those clients who wanted to open such accounts. In this regard, the SFC and the Hong Kong Exchanges and Clearing Ltd would continue to collaborate with the industry and had been implementing certain respective measures, which included organising public seminars, distributing information leaflet and issuing feature articles, etc.

## (F) SFC's complaint handling procedures

Item (15)
<p><u>PRP's recommendation/observation</u></p> <p>Arising from the complaint cases reviewed by the PRP, the PRP saw the merits to better understand the complaints handling procedures adopted by the SFC, in particular how the Complaints Control Committee worked and how a decision was reached (para. 4.6 of Chapter 4).</p>
<p><u>SFC's response</u></p> <p>The Commission had set up the Complaints Control Committee (“the Committee”), which was chaired by the Chief Operating Officer and included senior representatives from all operational divisions, to consider all investor complaints referred to it by the External Relations Department following initial screening. These did not include complaints against Commission staff which were separately dealt with by the Commission Secretary.</p> <p>The Commission did not have statutory power to arbitrate civil disputes or order compensation. All investor complaints dealt with by the Committee were in respect of suspected breaches of the rules and regulations administered by the Commission. As set out in its Terms of Reference, one of the functions of the Committee was to “refer a complaint to an operational division, with a recommendation as to what further action should be taken, if appropriate.” All decisions (including recommendations, if appropriate) to refer a complaint to an operational division, including Licensing and Intermediaries Supervision, were made collectively by consensus after thorough discussions and recorded in the minutes of the Committee meeting in which the decisions were made.</p> <p>The Procedures for Handling Complaints set out the assessment criteria for prioritisation, allocation and handling of complaints as follows:</p> <ul style="list-style-type: none"><li>• age of matter complained of;</li><li>• significance of matter;</li><li>• systemic issue;</li><li>• regulatory priority;</li><li>• availability and likely quality of evidence (including consideration of availability and reliability of complainant);</li><li>• current licence status of those complained of; and</li><li>• resource commitment relative to likely outcome.</li></ul>