SFC reprimands and fines Morgan Stanley Hong Kong Securities Limited $18.5 million over internal control failures

24 Aug 2016

The Securities and Futures Commission (SFC) has resolved its concerns with Morgan Stanley Hong Kong Securities Limited (MSHK) over its internal control failures. Under the resolution, the SFC reprimanded and fined MSHK $18.5 million for breaches of the Code of Conduct (Notes 1 & 2).

The internal control failures of MSHK related to avoidance of conflicts of interest; comprehensive documentation of its electronic trading systems; disclosure of short selling orders; compliance with position limits and reporting of Large Open Positions; and execution of client instructions in connection with futures and stock options contract reporting obligations.

Specifically, the SFC's investigations found that MSHK failed to:

- adequately avoid conflicts of interest between principal and agency trading and obtain client consent for a facilitation execution in June 2013;
- comprehensively document the design and operation of the price checks and controls applied to orders executed through its electronic trading systems after the electronic trading provisions in the Code of Conduct took effect in January 2014;
- ensure compliance with the disclosure requirement in relation to approximately 29,000 short selling orders between January and November 2014;
- ensure compliance with the position limits, which resulted in one stock option contract exceeding the limit by more than 300 contracts on a trading day in February 2015;
- report the reportable Large Open Positions of two of its affiliate companies to the Exchange between December 2010 and December 2015;
- keep positions held on a gross basis in accordance with the instructions of a client from April 2012 to December 2015; and
- follow the instruction of an asset manager to report the Large Open Positions on a delegated basis from June 2012 to March 2016.

In reaching this resolution, the SFC took into account that:

- MSHK co-operated with the SFC in resolving regulatory concerns;
- MSHK agreed to engage an independent reviewer to conduct a forward-looking review of its internal controls to ensure compliance with the relevant regulatory requirements; and
- MSHK has no disciplinary record in respect of the present failures.

End

Notes:

1. MSHK is licensed under the Securities and Futures Ordinance to carry on business in Type 1 (dealing in securities), Type 2 (dealing in futures contracts) and Type 7 (providing automated trading services) regulated activities.
2. The Code of Conduct for Persons Licensed by or Registered with the SFC.

A copy of the Statement of Disciplinary Action is available on the SFC website

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STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has publicly reprimanded and fined Morgan Stanley Hong Kong Securities Limited (**MSHK**) HK$18.5 million pursuant to section 194 of the Securities and Futures Ordinance (**SFO**).

2. The disciplinary action is taken according to an agreement pursuant to section 201 of the SFO dated 19 August 2016 in relation to MSHK's internal control failures related to avoidance of conflicts of interest, comprehensive documentation of its electronic trading systems, disclosure of short selling orders, compliance with position limits and reporting of Large Open Positions, and execution of client instructions in connection with futures and stock options contract reporting obligations.

3. MSHK is licensed under the SFO to carry on business in Type 1 (dealing in securities), Type 2 (dealing in futures contracts) and Type 7 (providing automated trading services) regulated activities.

Summary of facts

Conflicts of interest and client consent

4. The Management, Supervision and Internal Controls Guidelines for Persons Licensed by or Registered with the SFC (**Internal Control Guidelines**), which has taken effect since April 2003, provides that 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.

5. Paragraph 8 of the Appendix to the Internal Control Guidelines further indicates that a firm should avoid apparent and potential conflicts of interest by establishing and maintaining adequate "Chinese Walls", such as the separation of dealers handling discretionary orders from those handling principal accounts.

6. In the investigation of the irregular price movement of two stocks during the last minute of trading on 21 June 2013, it was found that MSHK's traders responsible for agency execution also traded the stocks contained in the client's basket order on a principal basis.

7. MSHK explained that part of the principal trading was for the facilitation of execution of client orders. As a measure to avoid conflicts of interest, clients should be informed of conflicts of interest that might arise in the facilitation trades before the service is provided to the relevant client. Notwithstanding MSHK's policies and procedures required the client's consent for principal trading if the principal trade is the subject of a client order, the client's consent in relation to the relevant principal trading activities on 21 June 2013 was not obtained.

8. MSHK's policies and procedures did not strictly forbid traders to trade on a principal basis against or in the same direction as the client orders. The inherent conflict was left to the trader to manage. It was not until October 2014 that the agency execution function of MSHK and principal trading activities were separated.

9. In summary, MSHK's failures to separate agency execution and principal trading, and to obtain client consent for a facilitation execution are breaches of General Principles 2 and 6 of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**).

Documentation of the electronic trading systems

10. As a licensed corporation that conducts electronic trading of securities, MSHK is required under paragraph 18 of the Code of Conduct to keep proper records on the design, development, deployment and operation of its electronic trading systems, and have controls that are reasonably designed to ensure its algorithmic trading system and trading algorithms operate in the interest of the integrity of the market.

11. Paragraph 3.3.1 of Schedule 7 to the Code of Conduct further provides controls should be reasonably designed to monitor and prevent the generation of or passing to the market for execution order instructions from its algorithmic trading system which may interfere with the operation of a fair and orderly market.

12. Moreover, paragraphs 1.3 and 3.4 of Schedule 7 to the Code of Conduct provide that a licensed corporation should, among other things, keep comprehensive documentation of the design and development of its electronic trading systems and the risk management controls of its systems, and ensure that the design and development of its algorithmic trading system and trading algorithms are documented in writing and that the documentation should show the rationale for the design, development and modification and their intended outcome.

13. In the investigation of certain price checks and controls applied to orders executed through MSHK's electronic trading systems and designed to prevent the trading algorithms from causing undue market impact, the SFC found that apart from a general description of the checks and controls, which suggested that the relevant checks and controls existed, MSHK's documentation did not set out and explain the operation and design of each of these checks and controls. In other words, MSHK's documentation was not sufficiently comprehensive in setting out the design and operation of its electronic trading systems.

Disclosure of short selling orders

14. In February 2015, MSHK reported to the SFC that some of its short selling orders were not disclosed in accordance with the requirement under section 172 of the SFO.

15. Specifically, MSHK's inventory management systems allowed stock positions based on borrowed stock to be re-characterized as long stock positions when the positions were moved across certain internal accounts.

16. According to MSHK's estimation, approximately 29,000 orders sent to the HKEx for execution were affected from January to November 2014.

17. MSHK's failure to ensure compliance with the disclosure requirement of short selling orders breached General Principles 2 and 7 of the Code of Conduct, which require MSHK to act diligently and to comply with the applicable regulatory requirements.

Compliance with contract limits

18. On 25 February 2015, an affiliate of MSHK breached the position limit for a stock option contract by more than 300 contracts after the relevant trader was told the limit was approaching.

19. General Principle 2 requires a licensed corporation to act in the interests of market integrity. Being the execution broker, MSHK should have adequate controls to prevent orders that have the effect of exceeding the position limit from being passed to the HKEx.

20. The SFC found that MSHK put primary responsibility on its traders to ensure compliance with the position limits. The controls were inadequate in that relying primarily on traders did not ensure trading would be stopped or the position would be reduced when the limit was approaching.

Reporting of Large Open Positions

21. As an Exchange Participant, MSHK is required to report the reportable Large Open Positions held for its own account or for any client. In August 2015, MSHK reported to the HKEx that it had failed to report the reportable Large Open Positions of two of its affiliates to the HKEx and the failure appears to have lasted for a period of time. The two affiliates are the client facing entities of the Morgan Stanley group of companies which hold omnibus accounts of the clients.

Client instructions

22. In August 2015 MSHK reported to the HKEx that it had failed to effect the instruction of a client to hold the client's positions on a gross basis. The instruction should have been effected on the HKEx through the implementation in the omnibus account of one of MSHK's affiliates. Instead of holding the positions on a gross basis, matching positions had been closed out or netted off since the client started trading through MSHK in April 2012.

23. In March 2016, MSHK found that it failed to follow the instruction of an asset manager to operate as a delegated reporting client.[1] The asset manager reported to the SFC that MSHK had only reported its positions when there were reportable positions and failed to report, on a delegated basis, positions which were below the reportable threshold during the period from June 2012 to March 2016.

[1] Under the Guidance Note on Large Open Position Reporting Requirements, a person holding or controlling a reportable position in accounts at more than one Exchange Participant can ask all of its brokerages to report positions in each of the accounts to the HKEx even though positions in the individual accounts may not have reached the reportable level.

Conclusion

24. In coming to the decision to resolve the SFC's concerns over MSHK's internal controls, the SFC took into account:

- MSHK co-operated with the SFC in the resolution;
- MSHK agreed to engage an independent reviewer to conduct a forward-looking review of its internal controls; and
- MSHK has no disciplinary record in respect of the present failures.