

SFC reprimands and fines Standard Chartered Securities (Hong Kong) Limited \$2.6 million

18 Dec 2017

The Securities and Futures Commission (SFC) has reprimanded and fined Standard Chartered Securities (Hong Kong) Limited (SCSHK) \$2.6 million for internal control failures relating to short selling orders and breach of the Securities and Futures (Financial Resources) Rules (FRR) (Note 1).

The SFC found that, from January 2014 to August 2015, SCSHK failed to put in place adequate system and control procedures that resulted in at least 61 instances of regulatory breaches involving short sales executed by 11 traders from different trading desks.

The SFC also found that SCSHK mis-interpreted and breached the FRR by incorrectly including the amounts receivable from its clearing agent, Standard Chartered Bank (Hong Kong) Limited (SCBHK), as liquid assets in its financial returns for January to September 2015. **As at 31 August 2015, SCSHK had a required liquid capital deficit of \$2 billion when the receivables from SCBHK were excluded from its liquid assets** (Note 2).

The SFC is of the view that SCSHK was in breach of the Code of Conduct and the Management, Supervision and Internal Controls Guidelines (Notes 3 & 4).

In deciding the sanction, the SFC took into account all relevant circumstances of the case, including:

- the duration and extent of SCSHK's failures;
- SCSHK's cooperation with the SFC in resolving the disciplinary proceedings;
- SCSHK has taken immediate steps to rectify the FRR breach and other remedial measures;
- SCSHK has improved its short selling internal control systems; and
- SCSHK's otherwise clean disciplinary record.

End

Notes:

1. SCSHK is licensed under the Securities and Futures Ordinance (SFO) to carry on business in Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts) and Type 6 (advising on corporate finance) regulated activities.
2. On 15 January 2015, SCSHK appointed SCBHK as a Third Party Clearing Participant to perform clearing and settlement functions under the Central Clearing and Settlement System in relation to SCSHK's transactions executed on The Stock Exchange of Hong Kong Limited. **Under the FRR, the amounts receivable from SCBHK, as a general clearing participant (GCP), could not be admitted as liquid assets and the amounts receivable from and payable to the GCP could not be set off.**
3. Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct).
4. The Management, Supervision and Internal Controls Guidelines for Persons Licensed by or Registered with the SFC published under the SFO.

[A copy of the Statement of Disciplinary Action is available on the SFC website](#)

Page last updated : 18 Dec 2017

STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has reprimanded and fined Standard Chartered Securities (Hong Kong) Limited (**SCSHK**) a total of \$2.6 million pursuant to section 194 of the Securities and Futures Ordinance (**SFO**) for its failure to:
 - (a) put in place adequate system and control procedures to ensure compliance with the disclosure requirements in relation to short selling orders under sections 171 and 172 of the SFO (**Short Selling Provisions**); and
 - (b) comply with the Securities and Futures (Financial Resources) Rules (**FRR**).
2. The failures constitute a breach of General Principles 2 (Diligence) and 7 (Compliance), paragraphs 4.3 and 12.1 of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**) and paragraph 8 of Part VII of the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (**Internal Control Guidelines**).

Summary of facts

3. SCSHK is the securities brokerage arm of the Standard Chartered Bank Group and is a wholly-owned subsidiary of Standard Chartered Bank (Hong Kong) Limited (**SCBHK**).
4. Prior to October 2015, the Equity Derivatives & Convertible Bonds (**ED/CB**) businesses of SCSHK operated through a number of trading desks. Each desk maintained separate trading books. For the purpose of the short selling requirements, SCSHK adopted the individual trading desk approach¹. Internal stock borrowing and lending were allowed among these trading desks.
5. In September 2015, SCSHK reported to the SFC that a trader of its ED/CB businesses had placed at least 33 sell orders to the market as long sells, when the positions should have been flagged as covered short sells during the period from January 2014 to January 2015. For some of the orders, there were inadequate written records of the stock borrowing arrangements between different trading desks within SCSHK.
6. As a result, the SFC conducted an investigation into SCSHK's internal controls in relation to short selling.

¹ For the purpose of adhering to "The Guidance Note on Short Selling Reporting and Stock Lending Record Keeping Requirements" (SS No 4 to Gazette No 11/2003) (the **SFC Guidance Note**), SCSHK adopted the trading desk approach mentioned in paragraph 8.2(a) of the SFC Guidance Note which referred to the position of the seller's own trading book i.e. the inventory held by the trader or books under his/her control. If there is adequate inventory in the books for covering the sell order quantity at the time of sale, it would not be considered as short sale regardless of whether the legal entity was overall short.

The applicable rules

7. Section 171 of the SFO requires both the seller (as a principal, whether he is a client or an intermediary) and the execution intermediary (as an agent), at the time of placing the order, to report if it is a short selling transaction. An intermediary who receives a “selling order”, knowing it to be a “short selling order”, must ensure that he obtains confirmation (a **documentary assurance**) from the seller prior to transmitting the order to the Hong Kong Exchanges and Clearing Limited (**HKEx**) for execution. The broker or agent receiving the order must also ensure that it retains a copy of the documentary assurance from the seller for at least 12 months.
8. Section 172 of the SFO requires an exchange participant or its representative who knows an order is a short selling order to, when passing the order to another person to input the order, disclose that the order is a short selling order and, when inputting the order into the trading system of a recognized stock market, to indicate that the order is a short selling order in accordance with the Rules of the Exchange.
9. General Principles 2 and 7 of the Code of Conduct require a licensed person to act with due skill, care and diligence and in the best interests of its clients and market integrity, and comply with all regulatory requirements applicable to the conduct of its business activities respectively.
10. Paragraph 4.3 of the Code of Conduct requires a licensed person to have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients and other licensed or persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.
11. Paragraph 12.1 of the Code of Conduct requires a licensed person to comply with and maintain appropriate measures to ensure compliance with all applicable regulatory law, rules, regulations and codes administered or issued by the SFC, exchanges, clearing houses and other regulatory authorities which apply to the licensed person.

Failure to put in place adequate controls to ensure compliance with the Short Selling Provisions

12. SCSHK had the following internal policies, procedures and controls for short selling activities during the period from 1 January 2014 to 30 January 2015:
 - (a) Compliance Guidance Note on Inter-Desk Securities Borrowing and Lending Activities and Short Selling of Securities on the Stock Exchange of Hong Kong dated 15 November 2013 (**Compliance Guidance Note**);
 - (b) Short selling requirements outlined in Section D9 of the Hong Kong Wholesale Bank Securities Compliance Manual (**Compliance Manual**);
 - (c) compliance training; and
 - (d) monthly review by SCSHK’s surveillance of short sell orders executed by its ED/CB businesses selected on a sample basis.
13. The SFC investigation found that notwithstanding the above, there were at least 61 instances of breaches of regulatory requirements by 11 traders of different

trading desks from January 2014 to August 2015. These breaches were not detected or identified by SCSHK until months after the event.

14. The Compliance Guidance Note and Compliance Manual set out the regulatory requirements to identify an order as a short selling order and be in possession of “documentary assurance” that the sale would be covered under the Short Selling Provisions. Specifically, a trading desk, as a stock borrower, would be required before placing any covered short sale order, to receive a written confirmation in the form of a Bloomberg message or internal email from the other trading desk as stock lender at the time that the stock borrow was made effective.
15. During compliance training which covered short selling requirements in Hong Kong, traders were reminded that the individual trading desk approach would be adopted. They were expected to check their positions to ascertain whether the sale was long or short. If it was a short sell order, they should ensure a valid stock borrowing arrangement was entered into, so that the sale would be covered. They were also responsible for ensuring accuracy in their inventory position in order to indicate the correct long or short marking and to have the required covered short documentation in place.
16. The numerous instances of SCSHK’s failure to flag a short sell order and/or obtain documentary assurance for a short sell order as required by the Short Selling Provisions between January 2014 and August 2015 revealed that SCSHK was heavily reliant on individual traders to identify and flag a short sell order and to maintain an accurate inventory position. SCSHK’s systems were ineffective in firstly, identifying short positions for which stock borrowing arrangements were required to be made and which should have been flagged, and secondly, providing its traders with readily accessible real time data on its inventory position to enable them to identify short positions in the first place. Such systems failed to ensure that the relevant regulatory requirements would be adhered to by its traders or to cross check their positions.
17. SCSHK’s inventory management system also had limitations which led to a failure to reflect the correct level of inventory where there were multiple outstanding orders. In light of the inability of the inventory management system to account for multiple outstanding orders being executed which gave rise to the traders’ belief that there was sufficient inventory, it was not possible to ensure compliance with the Short Selling Provisions.
18. SCSHK’s surveillance team performed a monthly review of 20 short sell orders selected on a random sampling basis. The purpose of the review was to confirm that the borrowed inventory would be sufficient to cover the quantity of the short sell order, based on the trading desk approach, at the time the order was placed, where the order had been flagged by the trader as a short sell order.
19. However, SCSHK’s monthly sampling check was likewise an ineffective monitoring tool. Apart from the small sample size, such checks relied on the short sell orders being identified through the correct use of short sell flag in the inventory management system. If the flag was not used, short sell trades would not form part of the sample being reviewed. In short, if a trader did not indicate that an order constituted a short sale when placing it, the order could not have been detected.
20. SCSHK implemented remedial measures in order to guard against either failure to flag short sale orders or erroneous flagging of the same. These measures should

have been in place at the outset. The lack of such measures show the inadequacy of SCSHK's internal controls in ensuring compliance with the Short Selling Provisions. This constituted a breach of General Principles 2 and 7 and paragraphs 4.3 and 12.1 of the Code of Conduct as well as paragraph 8 of Part VII of the Internal Control Guidelines.

Breach of the FRR

21. On 15 January 2015, SCSHK appointed SCBHK as a Third Party Clearing Participant to perform clearing and settlement functions under the Central Clearing and Settlement System in relation to its transactions executed on The Stock Exchange of Hong Kong Limited. Under the FRR, the amounts receivable from SCBHK, as general clearing participant (**GCP**), could not be treated as liquid assets, and the amounts receivable from and payable to the GCP could not be set off.
22. It came to the attention of the SFC on 24 September 2015 that SCSHK appeared to have included amounts receivable from the GCP in the calculation of its liquid assets since January 2015. SCSHK formally reported the breach to the SFC on 25 September 2015.
23. SCSHK claimed that it had included the amounts receivable from SCBHK on trade receivables as liquid assets because it had mis-interpreted section 23 of the FRR regarding accounts receivable from counterparties in respect of dealings in securities, and only realized that its interpretation was incorrect when it discussed the matter with the SFC on 24 September 2015.
24. Under rule 11 of the FRR, the assets and liabilities of a licensed corporation must be treated separately on a gross basis and shall not be set-off against each other, subject to certain exceptions. Rule 28 of the FRR relates to amounts receivable from clearing houses. As SCBHK was not a clearing house, the amounts receivable from it would not be qualified and could not be included as liquid assets.
25. Accordingly, the amounts receivable from and payable to SCBHK as the GCP must be treated separately on a gross basis and should not be set-off against each other. The amounts receivable from SCBHK could only be included as its liquid assets if an application for modification had been approved by the SFC.
26. In the financial returns submitted by SCSHK for the months from January to September 2015, SCSHK had breached the FRR by wrongly including the amounts receivable from SCBHK as liquid assets. As at 31 August 2015, SCSHK had a required liquid capital deficit of \$2 billion when such receivables from SCBHK were excluded from liquid assets. SCSHK therefore failed to maintain the required amount of liquid capital in breach of rule 6(1) of the FRR for almost 9 months since January 2015 when it appointed SCBHK as the GCP.

Conclusion

27. Having considered all the circumstances, the SFC is of the view that the failures constitute a breach of General Principles 2 (Diligence) and 7 (Compliance), paragraphs 4.3 and 12.1 of the Code of Conduct and paragraph 8 of Part VII of the Internal Control Guidelines.
28. The SFC has accordingly decided to publicly reprimand and fine SCSHK \$2.6 million.

29. In coming to the decision to take disciplinary action against SCSHK, the SFC has taken into account all the circumstances of this case, including:
- the duration and extent of SCSHK's failures;
 - SCSHK's cooperation with the SFC in resolving the disciplinary proceedings;
 - SCSHK has taken immediate steps to rectify the FRR breach and other remedial measures;
 - SCSHK has improved its short selling internal control systems; and
 - SCSHK's otherwise clean disciplinary record.