

TOPIC 3 - OVERVIEW

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1. DUTIES AND LIABILITIES OF RESPONSIBLE OFFICERS AND EXECUTIVE OFFICERS

1.1 Requirements

- Every licensed corporation must have at least two responsible officers approved by the SFC, one of which must be an executive director
- A registered institution must have at least two executive officers
- Responsible and executive officers actively participate in or supervise the regulated activities
- All executive directors must obtain SFC approval as responsible officers

1.2 Fitness and Propriety

- Responsible officers, executive officers and senior management have primary responsibility to ensure SFC's fit and proper guidelines are complied with at all times
- They should ensure that the intermediary
 - Is financially sound at all times
 - Has resources (human and systems) to conduct the regulated activity effectively, efficiently, honestly and fairly
 - Has the required reputation, character, financial integrity and reliability

1.3 Management liability

- **Responsible officers, executive officers** and persons involved in management of a regulated business will be **liable for the misconduct of a licensed corporation** or a registered institution where they consented, connived or were neglectful in respect of misconduct
- **SFO gives details of liability for breaches** of certain fundamental regulatory requirements
 - Where a regulated person (i.e. a licensed person, responsible officer or management of licensed corporation) is **guilty of misconduct or is not a fit and proper person**, the SFC can **revoke a license**, prohibit further approval and order the payment of a fine
 - Where a licensed corporation commits an offence aided or abetted by an officer, the officer will be guilty of the offence
 - Discharge from liability is available if the officer honestly and reasonably believed failure would not occur

- **The Code** states that responsible officers and executive officers, or senior management should
 - be primarily responsible for ensuring maintenance of appropriate standards of conduct and adherence to proper procedures
 - properly manage risk associated with the business, including periodic evaluation of risk management processes
 - understand the nature of the business, its internal control procedures and its policies on the assumption of risk
 - understand the extent of their own authority and responsibilities
 - have access to all relevant information on a timely basis
 - have appropriate advice on the business and their own responsibilities
- **The Companies Ordinance** also contains provisions on the duties and liabilities of directors (see Topic 1)

1.4 General Duties of Management

- The duties of responsible officers and executive officers who actively participate in, or supervise, an intermediary's business, may (sic) include:
 - Ensuring there are policies appropriate for the business
 - Establishing appropriate standards of business conduct and procedures and ensuring proper compliance by staff at all times
 - Establishing adequate internal controls and suitable risk management systems and ensuring strict compliance
 - Employing only staff who meet the licensing requirements of SFC
 - Ensuring staff are competent and experienced to perform their jobs
 - Properly managing risks associated with the business
 - Establishing procedures to ensure that proper dealing practices are observed at all times
 - Establishing procedures and systems for proper handling of intermediary's and clients' assets
 - Reporting to the SFC any non-compliance with provisions and rules
 - Ensuring adequate insurance cover
 - Ensuring that the intermediary complies with the capital and financial reporting requirements of the SFC, exchange and clearing house
 - Ensuring that the intermediary and staff comply with all relevant regulations, guidelines and codes
 - Ensuring that the intermediary's systems, procedures and practices can meet all compliance requirements
 - Establishing procedures and systems for the proper handling of the intermediary's and clients' assets
 - Clearly understanding the extent of their own authority and responsibilities

2. CODE OF CONDUCT FOR PERSONS LICENSED BY OR REGISTERED WITH THE SFC

2.1 Introduction

- The Code of Conduct provides guidance on practices and standards for licensed/registered persons **dealing with external parties**, particularly clients
- The Code applies to all licensed and registered persons and their representatives
- The Code **does not have the force of law**, however it is important in two respects:
 - A **breach** can lead to license suspension or revocation;
 - It can be referred to in court legal proceedings, thereby giving it a degree of legal recognition

2.2 The Nine General Principles

1. Honesty and fairness
2. Diligence
3. Capabilities
4. Information about clients
5. Information for clients
6. Conflicts of interest
7. Compliance
8. Client assets
9. Responsibility of senior management

2.2.1 General Principle 1 – Honesty and Fairness

- A **licensed/registered person** should act honestly, fairly and in the best interests of its clients and the integrity of the market. More specifically:
 - Representations and information to clients should be **accurate and not misleading**
 - **Charges** to clients should be **fair and reasonable**
 - **Invitations and advertisements** should not contain information that is false, misleading or deceptive; no negative advertising
 - Actions should comply with the **Prevention of Bribery Ordinance** and any related guidelines issued by the ICAC
- A representative acting as an agent should not solicit or receive money/gift/employment/services without permission from the principal

2.2.2 General Principle 2 – Diligence

- A **licensed/registered person** should act with due skill, care and diligence, in the best interests of its clients and the integrity of the market. Some practical examples of this are:
 - Client orders should be executed promptly in accordance with clients' instructions – **prompt execution**
 - Client orders should be executed on the best available terms – **best execution**
 - Orders executed for clients should be promptly and fairly allocated to those clients – **prompt and fair allocation**
 - Advice should be given to clients with due skill, care and diligence
 - Separate accounts should be kept for each client and for securities, futures, cash and margin accounts
 - All orders should be timed stamped on receipt
- **Telephone orders** should be centrally recorded. Recordings should be kept for at least **6 months**
- The use of **mobile phones** for taking client orders is **discouraged, but not banned** – time of order receipt and details should be recorded immediately
- The best interests of the clients should be considered when recommending the services of an affiliated person
- Collect promptly from clients any amount due as margin
- Not offer any gift other than a discount on fees or charges when promoting a specific investment product

2.2.3 General Principle 3 – Capabilities

- A **licensed/registered person** should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities. It should have:
 - Staff who are fit and proper to carry out their duties
 - Adequate and diligent supervision of staff
 - Satisfactory internal control procedures, financial resources, operational systems and technology
- A licensed person who enters into **non-centrally cleared OTC Derivative transactions** should implement proper risk management requirements and standards

2.2.4 General Principle 4 – Information about Clients

- A **licensed/registered person** should seek information about a client's financial situation, investment experience and investment objectives.
Three sections to be covered:
 - Know your client (KYC)
 - Client agreements
 - Discretionary accounts

Know Your Client

- A **licensed/registered person** should establish a client's:
 - True and full identity
 - Financial situation or strength
 - Investment experience
 - Investment objectives
- Before executing any transaction for a client, the intermediary must **establish the identity** of the ultimately responsible for origination the transaction – exception is a CIS
- The SFC's Client Identity Rule Policy requires the identity of the ultimate client to be provided by the intermediary to the SFC **within 2 business days of the request**
- **Recommendations** made to clients should be **suitable**, given their circumstances. The primary obligation relating to suitability rests with the licensed/registered person, not the client
- When a client **without knowledge of derivatives** wishes to invest in a derivative product, the risks should be explained

Online Platforms

- The development of online distribution and advisory platforms present **special challenges** in ensuring that licensed/registered persons comply with their suitability obligations
- The SFC has issued Guidelines on Online Distribution and Advisory Platforms (**ODAP Guidelines**) effective 6 April 2019
- ODAP guidelines comprise five main parts:
 - Core principles covering platform design, information for clients, risk management, governance, review and monitoring and record keeping
 - General requirements covering conduct requirements, the offer of investments and materials posted on the platform
 - Requirements for the provision of robo-advice. Robo-advice is the provision of financial advice in an online environment where the adviser is assisted and supported by technology tools
 - Suitability and other conduct requirements
 - Requirements covering complex products

Client Agreements

- A written client agreement should be entered into with a client **before** providing services to the client
- The agreement should be in Chinese or English, at the option of the client
- Attention to relevant risks should be drawn to the client
- All client agreements should contain:
 - Full names and addresses of client (verified by reliable proof) and licensed/registered person
 - Undertakings by parties to notify material changes of information to each other
 - Full description of services to be provided and charges to be paid by the client
 - Appropriate risk disclosure statements
- the Code of Conduct requires:
 - A clause stating that any financial product solicited for sale or recommended will be suitable for the client
 - No provision in the client agreement that is inconsistent with the Code of Conduct obligations
- Client agreements should not remove, exclude or restrict the legal rights of a client or the legal obligations of the licensed/registered person
- **Practical procedures to set up an account:**
 - Face-to-face account opening is considered to be the best way to verify identity
 - If not possible, the documents should be certified by appropriate person (licensed person, JP, bank manager, accountant, lawyer, notary)
 - Certification services recognised by the Electronic Transactions Ordinance are permitted
 - Intermediary can cash a client's cheque (of at least HK\$10,000) to check identity and signatures
 - Proper records must be kept of procedures followed
 - Care should be taken with overseas companies
- **Online Client Onboarding**
 - A licensed/registered person can **onboard a client online**, via the client's Hong Kong bank account, and should:
 - obtain a client agreement, signed by the client using an electronic signature, with a copy of the client's identity document
 - make a successful transfer of an initial deposit of not less than HK\$10,000 from the client's Hong Kong bank account to the licensed/registered person's bank account

- make future deposits and withdrawals for a client's trading account via the client's designated Hong Kong bank account
- maintain proper and readily accessible records of the account opening process
- A licensed/registered person **can also onboard an overseas individual client** online via the client's overseas bank account and should comply with similar procedures
- A client agreement should contain appropriate **risk disclosure statements** covering:
 - Risks of securities trading
 - Risk of trading futures and options
 - Risk of trading GEM stocks
 - Risk of client assets received/held outside Hong Kong
 - Risk of providing an authority to lend or deposit the client's securities with third parties
 - Risk of providing an authority to hold mail or to direct mail to third parties
 - Risk of margin trading
 - Risk of trading NASDAQ-Amex securities on the SEHK

Discretionary Accounts

- A discretionary account is a client account operated by the licensed/registered person, without the client's prior approval for each transaction
- The discretion may be absolute or subject to conditions
- The Code of Conduct imposes the following on the establishment and operation of discretionary accounts:
 - The client's authority should be in writing
 - The person authorized to operate the account should be identified
 - The terms of the authority should be explained to the client
 - The authority should be confirmed annually
 - The account should be designated as a discretionary account and be approved by senior management
 - When opening an account, the licensed/registered person must inform the client of any benefits received in relation to a transaction executed for the client's account, including monetary and non-monetary benefits
 - Internal control systems should ensure that the operation of the account is properly supervised

2.2.5 General Principle 5 – Information for Clients

- The SFC expects a licensed or registered person to provide information to its clients in order to maintain transparency, as well as to let them know about their transactions. Information about the registered person includes:
 - Information about its business, including contact details, services provided, and identity/status of employees with whom the client will have contact
 - In the case of a financial services group, clear information about the particular company the client is dealing with
 - Upon client request, audited financial statements and information on corporate actions
- The Code of Conduct requires pre-sale disclosure to a client, other than a PI, to include:
 - whether the intermediary is acting a principal or agent
 - affiliation of the intermediary with the product issuer
 - any explicit monetary and any non-monetary benefits from a product issuer for distributing an investment product
 - the terms and conditions under which the client may receive a discount of fees and charges from the intermediary

2.2.6 General Principle 6 – Conflicts of Interest

- A licensed/registered person should try to avoid conflicts of interest between:
 - One client and another client
 - A client and a licensed/registered person
- If an intermediary has a material interest in a client transaction, it should not handle the transaction unless the interest has been disclosed to the client and all reasonable steps to ensure fair treatment have been taken

Handling of Client Orders

- Client orders should be handled **fairly and in the order** in which they are received
- Client orders should have **priority** over orders for the account of the licensed/registered person, or for the account of any employee or agent of the licensed/registered person
- Where there are aggregated orders for several clients, and the intermediary itself, priority must be given to client orders if all orders cannot be filled

- The unfair preference of any one client should be avoided
- When handling client orders, a licensed/registered person will acquire non-public information. This information should not be used to deal:
 - Ahead of transactions pending for other clients (front running)
 - When the release of the information will affect the price

Withdrawal from Business

- A licensed or registered person ceasing to carry out a regulated activity should promptly notify clients of the fact

Rebates, “Soft Dollars” and Connected Transactions

- An intermediary that operates a discretionary account may receive goods or services from a broker in exchange for directing a client’s business to the broker only if:
 - the goods or services are of **demonstrable benefit** to the receiver’s client;
 - the receiver applies best execution standards to the underlying business and the brokerage charges by the giver are not in excess of the normal rates;
 - the client has consented in writing to the receipt of the goods or services; and
 - disclosure is made to the client of the intermediary’s practices relating to receiving such goods or services, including their description
- Goods and services **permitted** by the SFC are:
 - research and advisory services
 - portfolio analysis, including valuations and performance measurement
 - market analysis, data and quotation services
 - computer hardware and software incidental to the above goods and services
 - clearing and custodial services
 - investment related publications
- Goods and services **not permitted** by the SFC are:
 - travel, accommodation & entertainment
 - general administrative goods or services
 - general office equipment or premises
 - membership fees
 - employee salaries
 - direct cash payments

- An intermediary may receive and retain cash or money rebates in relation to client transactions, provided:
 - The client has consented to this in writing (with disclosure at least annually of details of the goods and services received)
 - The brokerage rates are not in excess of customary full-service rates
 - The rebates and their approximate values are disclosed to the client (must provide a quantification of the rebates received in each contract note or in semi-annual statements)
- If a client exercises his right under a cooling-off mechanism, the client should receive a full refund, including sales commission less any reasonable prior-disclosed handling charge

Analysts

- A firm's commercial or investment interests may create potential conflicts of interest, which affect research recommendations made.
- The Code requires firms to establish procedures to ensure that analysts are held to high standards of integrity and ethical behaviour (see Topic 5)

2.2.7 General Principle 7 – Compliance

- Licensed/registered persons should comply with all regulatory requirements including:
 - Primary and subsidiary legislation
 - Rules, regulations and codes administered/issued by the SFC
 - Rules of exchanges and clearing houses, if participants
 - Requirements of other relevant regulatory authorities

Employee Dealings

- The licensed/registered person must have a written policy specifying whether or not employees can deal or trade for their own accounts and if they can, the policy must specify the following:
 - the conditions on which employees may deal or trade;
 - that employees should generally be required to deal through their principal or its affiliates;
 - duplicate trade confirmations should be provided to senior management if employees are permitted to deal through another dealer;
 - that employees should identify all related accounts (including amounts of their minor children and those in which the employees hold beneficial interests) and report them to senior management;
 - any such transactions should be separately identified in the intermediary's records and actively monitored by senior management (to ensure transactions are not prejudicial to client interests); and

- no intermediary should knowingly have another intermediary's employee as a client without the written consent of the employee's principal

Complaints

- Complaints should be handled in a timely and appropriate manner, investigated and responded to promptly
- If unable to investigate, licensed/registered person should advise client of further steps available

Responsibility for Acts of Employees

- A licensed corporation or registered institution should be responsible for the acts/omissions of its employees and agents

Notifications to the SFC

- A licensed/registered person is required to make reports to the SFC immediately on discovering:
 - Material breaches or suspected material breaches of any law, regulation or code
 - Insolvency situations affecting it, substantial shareholders or directors
 - Disciplinary actions taken against it
 - Material problems with business systems/equipment

2.2.8 General Principle 8 – Client Assets

- A licensed/registered person should ensure:
 - Client assets are promptly and properly accounted for
 - Client assets are adequately safeguarded
- Subsidiary legislation has applied the principle through the **Client Securities Rules** and the **Client Money Rules**

2.2.9 General Principle 9 – Responsibilities of Senior Management

- Senior management should bear **primary responsibility** for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures of the firm
- Senior management are expected to **properly manage the risks** associated with the business by understanding:
 - the nature of the business
 - its internal control systems and procedures
 - its risk management policies
 - the extent of their authority and responsibilities
- Senior management should have **access to all information** about the business on a timely basis and necessary advice on their own responsibilities

- For licensed corporations, the SFC considers the following to be **senior management**:
 - All directors, including shadow directors
 - Responsible officers
 - Any individual who is **manager-in-charge (MIC)** for one or more of the following core functions:
 - Overall management oversight*
 - Key business line*
 - Operational control and review
 - Risk management
 - Finance and accounting
 - Information technology
 - Compliance
 - Anti-money laundering and counter-terrorist financing
- Although MICs typically do not need to be licensed, the SFC expects those marked * above to be licensed and approved as responsible officers
- An individual does not need to be licensed to be identified as a MIC
- An organisational chart and the name of each MIC must be provided to the SFC, suitably updated when there are subsequent changes
- Once a person has been identified as a MIC, any changes to the person's appointment must be notified to the SFC, as for licensed staff
- MICs must be fit and proper to carry out their duties and the SFC will use its discretion to determine if a MIC is fit and proper
- SFC recognises that **representatives may not have sufficient control** to ensure compliance with parts of the Code of Conduct. When determining responsibility for any breach of the Code, the SFC will take into account an individual's **apparent or actual authority** regarding particular business operations

2.3 Professional Investors

- Professional Investors (PIs) do not need the same degree of protection that the ordinary retail investor might require
- SFC recognizes three categories of PI:
 - **Institutional PIs**: Defined in the SFO and tend to deal as principals
 - **Corporate PIs**: Prescribed in the Securities and Futures (Professional Investor) Rules that are corporates, trusts or partnerships
 - **Individual PIs**: Prescribed in the Securities and Futures (Professional Investor) Rules who are individuals

2.3.1 Institutional Professional Investors

- Exchange companies
- Intermediaries and similar overseas providers, including their wholly owned subsidiaries, holding companies and wholly owned subsidiaries of the holding companies
- AFI's and similar overseas institutions
- Insurers regulated under the Insurance Ordinance and their overseas equivalents
- CISs authorized in Hong Kong and their regulated overseas counterparts
- Registered schemes as defined in the MPFO and ORSO schemes, and their approved trustees, service providers, investment managers, their administrators and regulated overseas counterparts
- Governments, central banks and multilateral agencies

2.3.2 Corporate Professional Investors

- trustee companies responsible for total assets of not less than HK\$40m;
- corporations or partnerships having either a portfolio of not less than HK\$8m, or total assets of not less than HK\$40m; and
- corporations that act solely as investment holding companies and are wholly owned by persons who belong to any of the above two categories
- holding companies of the above two categories

2.3.3 Individual Professional Investors

- high net worth individuals having a portfolio of not less than HK\$8m; [includes spouses/children where portfolios are held jointly]
- the portfolio is held by a corporation which is wholly owned by the individual

2.3.4 Waivers Applicable to Professional Investors

- **Non-applicable SFO provisions:**
 - Unsolicited call provisions (ie PIs can be cold-called)
 - Requirements for offers by intermediaries

Above exemptions **apply to Institutional PIs, Corporate PIs and Individual PIs**

- **Non-applicable Code of Conduct requirements:**
 - a) **Information for clients:**
 - (i) The need to provide information about the licensed/registered person and its employees
 - (ii) The need to make prompt confirmation of transactions to clients
 - (iii) The need to disclose transaction related information
 - (iv) The need to provide documentation on the Nasdaq-Amex Pilot Programme
 - (v) The need to ensure the suitability of a complex product transaction; to provide sufficient information about a complex product; and to provide warning statement

All above exemptions **apply to Institutional PIs and Corporate PIs**
Exemptions (a) (i), (ii) and (iv) apply to Individual PIs

- b) **Information about clients**
 - (i) The need to establish the client's financial situation, investment experience and investment objectives (except advice on corporate finance)
 - (ii) The need to ensure the suitability of a recommendation or positive invitation
 - (iii) The need to assess the client's knowledge of derivatives

All above exemptions **apply to Institutional PIs and Corporate PIs**

- c) **Client agreement: the need to enter into a written client agreement and provide risk disclosure statements**

The above exemption **applies to Institutional PIs and Corporate PIs**

d) Discretionary accounts

- (i) The need to obtain the client's prior authority in writing before effecting transactions
- (ii) The need to explain the written authority and confirm it annually (authority should still be obtained)
- (iii) The need to disclose benefits receivable for effecting transactions for a client under a discretionary account

All above exemptions **apply to Institutional PIs and Corporate PIs**

Institutional PIs

- Licensed and registered persons are automatically exempted from the above listed requirements

Corporate PIs and Individual PIs

- To apply the exemptions, the licensed or registered person must:
 - write to the client explaining the consequences/risks of being treated as a PI, the information that he will not receive and that he has the right to withdraw from being treated as a PI
 - obtain a written and signed declaration from the person that he has been provided with the above explanations and that he wished to be treated as a PI
 - carry out confirmation exercise annually
- When the above is complied with the licensed/registered person is exempt from complying with **(a) (i), (ii) and (iv)**

Corporate PIs only

- If the licensed/registered person is satisfied that the corporate PI:
 - Has an appropriate corporate structure
 - Has appropriate investment processes and controls
 - Has investment decision makers with sufficient investment background and experience
 - Is aware of the risks involved in terms of the person(s) making the investment decisions

THEN the Corporate PI is exempt from all Code of Conduct requirements listed above

2.4 Electronic Trading

- The Code of Conduct requirements on electronic trading went into effect in January 2014. The requirements are discussed in Topic 5.

2.5 Alternative Liquidity Pools (ALP)

- A licensed/registered person who operates an ALP should comply with Code of Conduct requirements – details covered in Topic 5.

3. MANAGEMENT, SUPERVISION AND INTERNAL CONTROL GUIDELINES

3.1 Internal Control Guidelines (ICG)

- The Internal Control Guidelines (ICG) represent the way a business is structured and operated so there is reasonable assurance of:
 - Ability to carry on business in orderly and efficient manner
 - Safeguarding of its assets and clients' assets
 - Maintenance of proper records and reliability of financial and other information
 - Compliance with all applicable laws and regulatory requirements
- The ICG do not have the force of law

3.1.1 Management and Supervision

Objective

- Management should establish and operate an effective management and operational structure which ensures that the business is conducted in a sound, efficient and effective manner

Control Guidelines

- Management are responsible for:
 - Development, implementation and ongoing **effectiveness of the Internal Controls**
 - Establishing **regular communication of control information** to various levels of management, including risks, detected weaknesses, non-compliance with laws and regulations, and any deviations from business principles
 - Identifying **clear reporting lines** with reporting responsibilities
 - Detailed **definitions of authorities** for key positions
 - Assignment of management functions to **suitably qualified and experienced persons**

3.1.2 Segregation of Duties and Functions

Objective

- Incompatible duties and functions should be segregated, particularly those which, when performed by the same person, may provide opportunities for abuse or result in the overlooking of errors, thereby exposing the intermediary and its clients to risks

Control Guidelines

- Line operations staff should not conduct the following duties:
 - Policy making
 - Supervision/advisory
 - Compliance
 - Internal audit
- Sales/dealing/accounting/settlement functions should be segregated from each other
- Research functions should be segregated from sales and dealing
- Where practical, research and corporate finance functions should be segregated
- Compliance and internal audit should be separate/independent, reporting directly to Management

3.1.3 Personnel and Training

Objective

- Recruitment and training policies and procedures should be established and implemented to ensure compliance with the intermediary's operational and internal control policies and procedures, and all applicable legal and regulatory requirements

Control Guidelines

- There should be procedures to employ fit and proper persons and to have them licensed/registered where necessary
- Provision of comprehensive and up-to-date information to staff covering policies and procedures
- Provision of adequate training for specific duties and to meet CPT requirements

3.1.4 Information Management

Objective

- Policies and procedures should be established to ensure the integrity, security, availability, reliability and completeness of all information and documentation relating to the business, in whatever form it is stored

Control Guidelines

- Features of good information management are:
 - Information (physical or electronic) should be managed by qualified and experienced staff
 - The systems should be adequate and operated in a secure and controlled environment
 - Reporting requirements should be clearly defined to ensure that that internal and external reports are produced in time and contain the necessary information
 - Systems specifications are sufficiently documented and regularly reviewed for adequacy and effectiveness
 - Adequate and effective data security policies
 - Effective record retention policies which ensure that all legal and regulatory requirements are complied with

3.1.5 Compliance

Objective

- Policies and procedures shall be established to ensure that the intermediary and its staff comply with all applicable laws and regulations and with the intermediary's own internal policies and procedures

Control Guidelines

Management should:

- Establish and maintain an effective compliance function, independent of all operational and business functions
- Ensure compliance staff have the necessary skills, qualifications and experience
- Establish and enforce policies and procedures to provide compliance staff with full access to all necessary records and documentation
- Assist compliance staff to establish effective compliance procedures
- Establish proper complaint handling procedures (in writing)
- Establish prompt reporting to Management by compliance staff of material breaches of:
 - Legal and regulatory requirements
 - The intermediary's own policies and procedures
- Promptly report cases of material non-compliance with legal and regulatory requirements by the intermediary and its staff to the appropriate regulators

3.1.6 Audit

Objective

- To establish and operate an audit policy and review function which independently examines, evaluates and reports on the adequacy, effectiveness and efficiency of the intermediary's management, Internal Controls and operations. The review functions can be performed by internal staff or external consultants, such as firms of accountants who may be asked to carry out ad-hoc or regular reviews

Control Guidelines

- Management should establish internal audit as an independent function free of operating responsibilities, reporting directly to management
- The persons performing the internal audit function should have the necessary technical competence and experience
- Clearly defined terms of reference should set out the scope, objective, approach and reporting requirements
- Responsibilities and working relationship between internal and external auditors may be defined with the agreement of the external auditor
- Management should ensure adequate planning, control and recording

3.1.7 Operational Controls

Objective

- To have effective policies, procedures and controls over day-to-day business operations which ensure:
 - Communications between the intermediary and its clients are in line with the Code of Conduct
 - The integrity of the intermediary's dealing practices and the fair, honest and professional treatment of clients
 - The safeguarding of client/intermediary assets
 - Reliable and accurate records/information are kept
 - Compliance with relevant legal and regulatory requirements

Control Guidelines

- Management is required to establish policies and procedures to:
 - Obtain and confirm the true identity of every client, the beneficial owner of each client account and the persons authorized to give instructions for its operation
 - Obtain information regarding the client's financial position, experience and objectives
 - Establish precise terms and conditions for operating discretionary accounts, which should be communicated to the client
 - Ensure that any investment advice given for remuneration is supported by a contractual advisory agreement, and investment recommendations are made after thorough analysis, are suitable for the client, and are properly documented
 - Minimize the potential for conflicts of interest
 - Ensure that whenever the intermediary or its staff have a material interest in a transaction with a client, the fact is disclosed to the client prior to executing the transaction
 - Ensure that client orders are handled in a fair manner
 - Ensure that complete audit trails are created with records and times of orders received from clients or orders generated internally
 - Ensure that there is fair and timely allocation of client orders
 - Prevent the intermediary or staff from taking advantage of price-sensitive information or from participating in insider dealing
 - Prevent or detect errors, omissions, fraud and other unauthorized or improper activities
 - Protect the assets of clients and the intermediary from theft, fraud and other acts of misappropriation
 - Ensure that regular reconciliations of the intermediary's records with external records and reports are carried out

3.1.8 Risk Management

Objective

- To establish and maintain effective policies and procedures to:
 - Ensure the proper management of risks
 - Identify and quantify risks
 - Provide timely/adequate information to enable Management to take action to contain and manage risks

Control Guidelines

- The control guidelines provide for the establishment of:
 - a risk management function with suitably qualified and experienced professionals;
 - procedures to limit the exposure of the intermediary to risk of suffering loss to acceptable levels;
 - trading and position limits for proprietary trading and their monitoring at the end of the trading day;
 - comprehensive risk-focused reviews at suitable intervals or whenever there are significant changes in the business, operations or staff;
 - regular reporting of exposures and significant variances to management; and
 - risk policy defined by management including risk measurement and reporting methodologies

3.2 Additional Information about Operational Controls and Risk Management

3.2.1 Operational Controls

Account Opening

- Suggested control techniques and procedures may include:
 - Clear procedures strictly following the “know your client” principle
 - Recording all relevant client information
 - Reviewing information using management approved criteria
 - Advising the client about the firm services, risk disclosure, fees and other charges
 - Ensuring that the client is provided with information regarding his rights

Operating Discretionary Accounts

- The SFC suggests the following operational control techniques and procedures:
 - Executing a discretionary account agreement which includes: investment objectives; strategies; and terms
 - Regularly reviewing account performance
 - Providing regular client statements
 - Separating investment decision procedures from the dealing process

Providing Investment Advice

- Intermediaries being paid to advise on investments should:
 - Establish clear requirements and procedures on adequacy of research work
 - Document the rationale underlying the investment advice given and provide copies to clients
 - Provide clients with written details of applicable fees, charges and penalties

Dealing Practices (Order handling)

- Order handling procedures should cover:
 - Recording and time stamping of orders
 - Checks on availability of money and stocks to settle orders
 - Checks on any special instructions relating to the particular client, such as the operation authority and limits on the person making the order
 - Circumstances in which client orders may be delayed or withheld
 - Procedures for passing orders to the dealing room to ensure client priority and for correctly allocating orders

Chinese Walls

- Measures should be taken to ensure that price-sensitive information is not leaked to operational staff

Back Office and Accounting

- Deal tickets should be processed by back office and compared to external reports to identify errors and unusual trades
- There should be prompt confirmation of trades with clients using reliable methods
- Dealing errors should be recorded in a suspense account and investigated

Asset Protection

- Suggested control techniques and procedures may include:
 - Establishing procedures for handling licensed or registered person and client assets
 - Maintaining reliable and adequate audit trails
 - Encouraging clients to open stock-segregated accounts with CCASS so that they can receive statements directly from HKSCC
 - Conducting regular compliance reviews and audits

3.2.2 Risk Management

Identifying risk

- Intermediaries may face the following risks:
 - **Liquidity risk:** risk of not being able to meet commitments while maintaining assets
 - **Credit risk:** risk of a client or counterparty defaulting on an obligation
 - **Market risk:** risk of suffering a loss due to adverse movements in asset/liability market values
 - **Operational risk:** risk of losses from deficient or failed internal processes, systems or people
- All risks relevant to business should be identified
- All in organization should be aware of approach to risk
- Complexity of risk management should be appropriate to level of risk

Measurement of risk

- Measurement method should be appropriate to nature, scale and complexity of activities

Monitoring of risk

- Management information system should allow assessment and review of the effectiveness of its strategy, on a continuous basis
- Reporting lines and responsibilities should be clearly laid down

Controlling risk

- In order to control risk, the system of internal controls should be appropriate to the nature, scale and complexity of activities
- Roles and reporting lines should be well-defined with segregation of duties
- Compliance function should be independent
- There should be regular compliance reviews and audits, with the results communicated to the Board
- Qualified risk management staff should be employed
- Risk management policies should be established
- Targets and limits should be set for absolute and relative amounts of exposure and regularly monitored
- Management should receive exposure and variance reports
- A contingency plan to address unexpected events should be in place, including raising funds to conserve or create liquidity

3.2.3 Risk Management Techniques

Credit risk

- Establish and maintain effective system to evaluate client and counterparty credit worthiness
- Set appropriate credit limits for all clients
- Check
 - Client's credit rating
 - Past payment record and defaults
 - Client's capital base
 - Known events which might have an adverse impact
- Monitor exposure to clients, including pre-settlement and settlement
- Make appropriate haircuts to market value of securities pledged where credit extended for margin trading

Market risk

- Place restrictions on instruments which can be traded
- Establish controls to ensure restrictions complied with
- Place trading and position limits on proprietary trading
- Risk managers should control open positions
- Establish measures to check effect of adverse market conditions, such as
 - Value at Risk methodology for general market risk
 - Sensitivity checks
 - Stress testing

Liquidity risk

- Use liquidity measures
- Set concentration limits for products, markets and business counterparties
- Measure mismatches in timing of receipts and payables, receipt and delivery of products
- Monitor level of arrears and defaults
- Establish default procedures so liquidity managers have adequate time to take action

Operational risk

- Segregation of duties
- Keeping secure, reliable, proper and up-to-date records
- Analysis of records to highlight adverse trends and to detect errors
- Employment of skilled and experienced staff
- Effective business continuity and disaster recovery plan
- Adequate insurance

4. CODE REQUIREMENTS FOR LICENSED AND REGISTERED PERSONS DEALING IN SECURITIES LISTED OR TRADED ON THE STOCK EXCHANGE OF HONG KONG LIMITED

- There are specific additional requirements for all registered persons dealing in securities in addition to general obligations under The Code of Conduct
- The SFC is the front-line regulator for business conduct of all registered persons, including participants of SEHK and HKFE
- Some requirements apply to SEHK participants only, while some apply to all registered persons dealing in securities

4.1 Options Client Agreement

- All registered persons engaged in exchange traded options business (including exchange participants) should enter an options client agreement containing:
 - Client's disclosure in writing on true identity of account owner
 - Client's acceptance of terms of contract
 - Client's agreement to provide registered person with margin (cash, securities or other assets)
 - Client's agreement to indemnify registered person against all losses and expenses resulting from breach of obligations
 - Client's right to have recourse to compensation fund if registered person defaults
 - Client's confirmation he has read and agreed to terms, which have been explained to him in preferred language
 - Risk disclosure statements
 - Registered person's undertaking to:
 - Keep client's options account confidential (except from SFC, SEHK and clearing houses)
 - Provide client with product specifications for options contracts
 - Notify client of material changes in its business

4.2 Other Requirements

4.2.1 Time Stamping

- All registered persons should maintain a record of the date and time when each trading instruction is received from a client
- All instructions should be immediately time stamped

4.2.2 Options Trade Confirmations

- Confirmations should include:
 - Details of transactions
 - Risk disclosure statements
 - Statement that client has right to claim under compensation fund if registered person should default

4.2.3 Capital Adjustments

- Registered person should promptly inform client of any capital adjustments to the terms of the contracts of an option series

4.2.4 Client's Money in Relation to Exchange Traded Option Business

- An options exchange participant should pay into and maintain a trust account for all client money within one business day of receipt
- A separate ledger should be kept for each client

5. PREVENTION OF MONEY LAUNDERING AND TERRORIST FINANCING

5.1 General

- Money laundering refers to activities and processes intended to give illegally obtained money the appearance that it originates from a legitimate source
- Provisions for money laundering have been extended to terrorist financing
- In Hong Kong, money laundering is addressed through legislation, which is applicable to licensed corporations, registered institutions and associated entities
- The SFC has also issued guidelines to assist in compliance with the legislation

5.2 Hong Kong Legislation

- There are six pieces of legislation to be considered:
 - Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO)
 - Drug Trafficking (Recovery of Proceeds) Ordinance (DTRPO)
 - Organised and Serious Crimes Ordinance (OSCO)
 - United Nations (Anti-terrorism Measures) Ordinance (UNATMO)
 - United Nations Sanctions Ordinance (UNSO)
 - Weapons of Mass Destruction (Control of Provision of Services) Ordinance

5.2.1 Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO)

- The objective of AMLO is to bolster the anti-money laundering regime in Hong Kong for the financial sector
- AMLO covers:
 - Customer due diligence requirements
 - Record keeping requirements
 - Giving “relevant authorities” (eg SFC and HKMA) the power to investigate and supervise licensed corporations and registered institutions for compliance with AMLO, and discipline when necessary
 - Establishment of a disciplinary review panel
- AMLO imposes a general duty on licensed corporations and registered institutions to:
 - Ensure proper safeguards to prevent contravention of the foregoing requirements
 - Mitigate money laundering risks
- A breach of the Ordinance is a criminal offence with a maximum penalty of HK\$1million and two years imprisonment; seven years if fraud is involved:

5.2.2 Drug Trafficking (Recovery of Proceeds) Ordinance (DTRPO)

- It is an offence to deal with property known to, or believed to, represent the proceeds of drug trafficking
- Any person who knows or suspects that property relates to drug trafficking, should report it to a police officer, a customs and excise officer, or the Joint Financial Intelligence Unit (JFIU) – **failure to disclose is an offence**
- It is an offence to disclose to another person that a disclosure has been made, as above
- A person making a disclosure is excused from any resulting contract breach or professional obligation

5.2.3 Organised and Serious Crimes Ordinance (OSCO)

- Provisions are similar to DTRPO
- Police are given powers to obtain a court order to compel a person to provide information or material relating to the investigation
- Requirements to disclose and to submit to searches override any duties of secrecy and confidentiality

5.2.4 United Nations (Anti-terrorism Measures) Ordinance

- It is a criminal offence to provide financial services to terrorists or their associates
- Terrorist property can be frozen/forfeited
- It is an offence not to report knowledge or suspicions of terrorist property to an authorized officer

5.2.5 United Nations Sanctions Ordinance (UNSO)

- Enables sanctions to be imposed on persons in breach of the relevant provisions of United Nations Security Council Resolutions

5.2.6 Weapons of Mass Destruction (Control of Provision of Services) Ordinance

- Prohibits the provision of any services related to weapons of mass destruction

5.3 Guideline on Anti-Money Laundering and Counter-Terrorist Financing (GAML)

- As empowered by the AMLO, the SFC has issued guidance on implementing policies, procedures and controls to comply with the AMLO
- The GAML describes 3 common stages identified by the SFC in the process of money laundering:
 1. **Placement:** physical disposal of cash derived from illegal activities
 2. **Layering:** separation of the illicit proceeds from the source by creating a number of financial transactions (layers) – the most likely point at which a licensed corporation could become involved in a money laundering scheme
 3. **Integration:** creating an impression of legitimacy by bringing the proceeds back into the general financial system (without being connected with the illegal activity)
- The **GAML requires** licensed corporations to:
 - **Issue policies** and procedures to staff reflecting GAML provisions
 - Ensure that **staff understand** the GAML
 - **Regularly review** anti-money laundering policies and procedures through the compliance and audit functions
 - **Appoint** a money laundering reporting officer as a central reference point

5.3.1 GAML Detailed Guidelines

Client Identification

- Client risk should be considered when carrying out CDD, taking the following into account:
 - Services that provide more anonymity
 - Non face-to-face account opening
 - Background/profile (eg politically exposed persons)
 - Unduly complex ownership structure
 - Nature of business – sensitive or high-risk activities
 - Nationality/place of incorporation
 - Means/types of payments
 - Countries with critical deficiencies in their anti-money laundering systems

Ongoing Monitoring

- Client activities should be subject to ongoing monitoring to detect unusual or suspicious activities
- Activities of higher risk clients should be subject to more frequent and more intensive monitoring

Record-keeping and Retention

- There should be a satisfactory audit trail
- **Customer documents** and information should be kept throughout the business relationship and for a period of **five years** after the end of the business relationship
- **Transaction documents** and information should be kept for **five years** irrespective of whether the business relationship ends during the period

Recognition and Reporting of Suspicious Transactions

- Senior management and the money laundering reporting officer should be able to detect unusual or suspicious activities promptly
- Suspicious transactions will be unusual in relation to the client's business/financial circumstances

Examples of Suspicious Transactions

- GAML provides a list of situations that might give rise to suspicions of money laundering activity:

Customer-related

- Requests for investment management services, where source of funds are unclear or not in line with customer's financial background
- Opening of multiple accounts with same beneficial owners

Trading-related

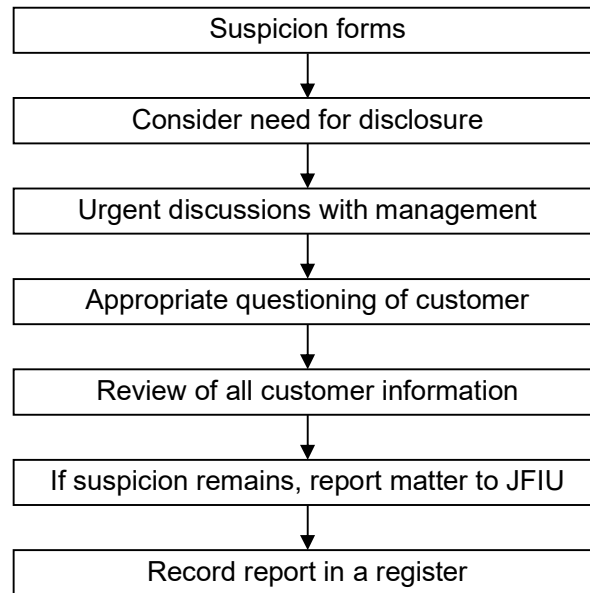
- Buying/selling activities with no obvious purpose
- Frequent small cash transactions followed by one sale transaction to a third party

Settlement/custody/transfers-related

- Large or unusual settlements in cash
- Idle client funds held by licensed corporation
- Frequent fund transfers/cheque payments to/from unverified third parties

Involving employees

- Changes in lifestyle: high spending or not taking holidays
- Unusual or unexpected increase in an employee's sales performance
- Forwarding addresses used for clients such as staff or persons connected to staff

Procedures for Disclosure (as suggested by JFIU)**Education and Training**

- Licensed corporations are required to regularly give staff information and training to keep them aware of:
 - Their obligations and potential liabilities
 - Policies and procedures relating to money laundering, including identification and reporting of suspicious transactions
 - New and emerging ways of money laundering

6. ENFORCEMENT ACTIONS IN RELATION TO BREACHES OF CODES AND GUIDELINES

Case 1: Reprimanded and fined for failure in internal controls

- A corporation, licensed to carry on Type 1 (Dealing in Securities) regulated activity was found to have a number of internal control deficiencies, including:
 - insufficient management supervision over daily operations
 - no compliance and no comprehensive manual of daily operational policies and procedures
 - weak data protection measures
- The responsible officer responsible for overseeing the compliance function failed to ensure that effective compliance procedures were in place and properly implemented
- The SFC reprimanded and fined the licensed corporation and the responsible officer

Case 2: Reprimanded and fined for negligence and non-compliance with order recording requirements

- The responsible officer was licensed for carrying out Type 1 (Dealing in Securities), Type 2 (Dealing in Futures Contracts) and Type 3 (Leveraged Foreign Exchange Trading) regulated activities
- The SFC found that the responsible officer received orders from a third party and executed trades in the client's account before the authorization form was properly lodged with its principal
- Telephone recordings and blotters of the account were also incomplete
- The SFC reprimanded and fined the responsible officer

Case 3: Reprimanded and fined for breach of GAML

- A corporation, licensed to carry on a number of regulated activities, including Type 1 (Dealing in Securities) RA and Type 4 (Advising on Securities), processed hundreds of third party payments over a two-year period the licensed corporation, of which 18% were not with proper client authorisation
- One-third of those with client authorization had no verification of any relationship between the clients and/or the third parties. The third-party payments involved millions of Hong Kong dollars
- The SFC reprimanded and fined the licensed corporation