

### Examples of observed internal control deficiencies in FRR compliance

1. The examples are grouped into the following areas:
  - (a) inadequate or ineffective controls over liquid capital monitoring;
  - (b) failure to make proper accruals or accounting provisions; and
  - (c) incorrect treatments of certain assets or liabilities for liquid capital computation.

#### ***(a) Inadequate or ineffective controls over liquid capital monitoring***

2. In the following examples, the LCs failed to put in place adequate controls to monitor their liquid capital positions to prevent or timely detect breaches of the liquid capital requirements. Furthermore, their senior management did not demonstrate adequate oversight of FRR compliance. In certain instances, the root cause of the RLC deficits was the incompetence or lack of FRR knowledge of the persons responsible for liquid capital monitoring and FRR compliance.
3. To ascertain whether it maintains sufficient liquid capital during its ongoing monitoring process, an LC should accurately calculate its liquid capital in accordance with the FRR. However, during our review, several LCs failed to include all or certain parts of accruals and amounts payable in their ongoing liquid capital monitoring. They only considered these items when preparing their FRR returns. As a result, these LCs were unable to detect their RLC deficits until they were preparing their FRR returns. In one instance, a newly licensed LC only checked its bank balance for liquid capital monitoring. Without considering amounts payable in its ranking liabilities, the LC made a payment from its bank account without realising that it would result in an RLC deficit. The LC eventually discovered the RLC deficit when preparing its FRR return, but a month had already passed since the breach initially occurred.
4. An LC should ensure that any person employed or appointed for FRR compliance is conversant with FRR requirements. During our review of an RLC deficit incident, we noted that an LC's staff responsible for monitoring the LC's liquid capital lacked FRR knowledge. Additionally, the LC did not maintain adequate records for its liquid capital computation. Several errors were made in calculating the liquid capital in its FRR return. In the absence of the records, together with poor FRR knowledge, it took the LC more than two months during the look-back review to confirm and submit a correct liquid capital position as at the initial breach date.
5. Regarding outsourcing FRR compliance and accounting functions to a service provider, an LC should conduct sufficient due diligence in selecting the service provider and monitoring its ongoing performance. Further, the LC should ensure clear communication is maintained with the service provider. The SFC noted an incident in which an LC misreported an RLC deficit due to its failure to supervise its external accounting firm and a communication breakdown between them. Without verifying the management account prepared by the accounting firm, the LC

mistakenly identified and reported the RLC deficit. Following the SFC's inquiry, the LC discovered that, due to miscommunication, the accounting firm was unaware of a fee receivable that should have been booked months ago. After rectifying the booking error, it was found that the LC's liquid capital actually met the liquid capital requirement.

**(b) Failures to make proper accruals or accounting provisions**

6. In following cases, the LCs did not adopt proper accounting practices and procedures to ensure the timely inclusion of relevant accruals or provisions in their liquid capital computation.
7. Accruals and accounting provisions should be properly and timely recorded in accordance with the generally accepted accounting principles. A number of RLC deficit cases arose from material audit adjustments where the LCs failed to accrue certain expenses or make adequate provisions on their balance sheets prior to the year-end closing. The common issues observed include omission or material underestimation of accruals for commission expense, staff bonus, tax provision and lease liabilities.
8. In one case, an LC should have made provisions for certain fees and commissions with reference to the income earned during the year. However, without any formal procedures in place, the LC overlooked this accounting procedure before the year-end closing. As a result, the LC failed to include the relevant provisions in its balance sheets which led to an understatement of its ranking liabilities in its FRR return. Subsequently, the LC identified an RLC deficit after making significant audit adjustments for the year-end.

**(c) Incorrect treatments of certain assets or liabilities in the liquid capital computation**

*Cash held at bank*

9. Under section 20(b) of the FRR, house money held at bank cannot count as liquid assets if it is not deposited with an authorized financial institution<sup>18</sup> or an approved bank incorporated outside Hong Kong<sup>19</sup>. In some instances, LCs mistakenly included in their liquid assets house money held with brokers, other non-authorized financial institutions or banks incorporated outside the prescribed countries<sup>20</sup>, or misreported cash held with brokers as cash held at banks in their FRR returns.

*Proprietary positions*

10. Regarding proprietary investments, any bond that does not fall within the definition of qualifying debt securities or special debt securities<sup>21</sup> should be completely excluded from liquid assets<sup>22</sup>. In one situation, an LC invested in a corporate bond that initially met the relevant credit rating requirements to be treated as a qualifying

<sup>18</sup> As defined in section 2 of the FRR.

<sup>19</sup> As defined in section 2 of the FRR.

<sup>20</sup> In the definition of approved bank incorporated outside Hong Kong, the term "prescribed country" refers to a country belonging to the Organization for Economic Co-operation and Development or Singapore.

<sup>21</sup> As defined in section 2 of the FRR.

<sup>22</sup> Section 27 of the FRR.

debt security. It applied the appropriate haircut to include this bond in its liquid assets. However, the bond was later downgraded and no longer eligible as a qualifying debt security. The LC overlooked this downgrade and did not remove the downgraded bond from its liquid assets in its FRR return. The LC was found to have breached the FRR afterwards.

11. Several calculation errors were observed regarding off-exchange traded derivative contracts<sup>23</sup>. An LC held positions in total return swap (**TRS**), a type of off-exchange traded derivative contract, but failed to account for the floating losses incurred by it in respect of the positions<sup>24</sup>. In addition, the LC mistakenly included (a) the margin deposited with counterparties; and (b) the amounts receivable from clients arising from dealing in the TRS in its liquid assets. The LC also failed to notify the SFC in writing of the details of the position in TRS it intended to enter into at least 10 business days before entering into the position<sup>25</sup>.
12. Unauthorised funds are classified as illiquid investments<sup>26</sup>, which are subject to 100% haircut<sup>27</sup>. In one case, an LC invested in an unauthorised fund and included the fund in its liquid assets with a 40% haircut. The LC was found to have breached the FRR after excluding the entire sum of the fund from its liquid assets.
13. In addition to applicable haircuts<sup>28</sup>, proprietary investments are also subject to concentration charges<sup>29</sup>. Some LCs misapplied the haircut percentage to their proprietary positions or failed to properly account for the corresponding concentration charges in their ranking liabilities or committed both errors.

#### *Amounts receivable*

14. Amounts receivable from dealers<sup>30</sup> in liquid assets should not include (a) client money deposited with securities brokers to facilitate clients' trade orders in future, or (b) house money deposited with securities brokers for purchase of securities. In one case, an LC transferred some client money from its segregated bank account to a securities broker in advance to facilitate the relevant client's trade orders in future. While the LC correctly included the corresponding sum that was paid out of its segregated bank account as amounts payable to clients in its ranking liabilities<sup>31</sup>, it mistakenly included the corresponding deposits held with the broker as amounts receivable from dealers in its liquid assets. In another case, an LC transferred its house money, for the purpose of purchasing securities, to its account held with a securities broker, but incorrectly included such deposit as amounts receivable from dealers in its liquid assets.

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<sup>23</sup> The SFC has issued consultation papers on proposed changes to the FRR for activities involving over-the-counter derivatives, and LCs should have regarded to the revised FRR in final form as appropriate.

<sup>24</sup> Section 48(1) of the FRR.

<sup>25</sup> Section 55(4) of the FRR.

<sup>26</sup> As defined in section 2 of the FRR.

<sup>27</sup> Item 1 of table 9 in schedule 2 to the FRR.

<sup>28</sup> Section 27 of the FRR.

<sup>29</sup> Section 44 of the FRR.

<sup>30</sup> Section 23 of the FRR.

<sup>31</sup> Section 37 of the FRR.

15. Amounts receivable from clients in respect of purchase of securities and subscription for securities can count as liquid assets only when certain conditions are met. In one case, an LC mistakenly included as liquid assets the amounts receivable from clients in respect of purchase of securities that remained outstanding for more than one month after the settlement date<sup>32</sup>. In another case, an LC wrongly included as liquid assets the amounts receivable from a client in respect of subscription for initial public offering (IPO) securities, which was more than 90% of the total costs to the client<sup>33</sup>.
16. Regarding securities margin financing, illiquid collateral is subject to significant haircuts<sup>34</sup>. One LC failed to identify illiquid collateral based on the market capitalization of that share as at the correct month-end<sup>35</sup> specified in the FRR, and hence, the amounts receivable in respect of providing securities margin financing were miscalculated.
17. Some receivables were miscounted as liquid assets under the category of miscellaneous assets pursuant to section 35 of the FRR. For instance, an LC included amounts receivable that represented expenses recharged to its affiliated company in its liquid assets. Since this recharging amount did not arise from the LC's regulated activities, it should not have been included in its liquid assets. Separately, several LCs failed to observe the relevant timing conditions for counting amounts receivable arising from their regulated activities as liquid assets. In these cases, LCs mistakenly included in their liquid assets those receivables that (a) would only be due for billing or payment in more than three months, or (b) remained outstanding for more than one month after the date on which they were billed or fell due<sup>36</sup>.

*Amounts payable to clients and other liabilities*

18. Under section 37(a) of the FRR, any amount payable by an LC to any of its client in respect of client money that is not deposited with an authorized financial institution, an approved bank incorporated outside Hong Kong, a recognized clearing house or a person approved by the Commission cannot be excluded from ranking liabilities. There have been cases where the LCs mistakenly excluded from ranking liabilities client money deposited with brokers or banks outside the prescribed countries.
19. In one case, an LC transferred client money to an execution broker for clients' IPO applications and retained the subsequent refund of client money with the broker. The LC incorrectly excluded this client money retained with the broker from amounts payable to clients in its ranking liabilities<sup>37</sup>.
20. In a number of other instances, the LCs erroneously omitted certain amounts payable and other liabilities from ranking liabilities. For example, some LCs incorrectly excluded shareholders' loans or intercompany payables from their

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<sup>32</sup> Section 21(1)(b) of the FRR.

<sup>33</sup> Section 21(5) of the FRR

<sup>34</sup> Section 22(1)(b)(i) and (ii) of the FRR.

<sup>35</sup> Section 22(4)(a) of the FRR.

<sup>36</sup> Section 35(a) of the FRR.

<sup>37</sup> Section 37 of the FRR.

ranking liabilities, and some mistakenly excluded from their ranking liabilities the portion of approved subordinated loan that exceeded their shareholders' funds.

#### *Shareholders' funding*

21. If an LC elects to classify shareholders' funding as capital, it should ensure that the treatment is supported by corresponding evidence. For example, if the funding is used to subscribe for new shares, there should be a board resolution of the LC for the allotment of shares. If the funding is treated as a gift, there should be a written declaration from the shareholder<sup>38</sup> confirming that the capital contribution is non-refundable as well as a board resolution of the LC acknowledging the receipt of the gift. On the other hand, borrowing from shareholders should be classified as ranking liabilities. Misclassifying shareholders' funding as capital when it is actually a borrowing from the shareholder can result in an overstatement of liquid capital or even a breach of the FRR. Therefore, an LC should ensure the accurate classification of shareholders' funding and maintain proper documentary evidence for FRR compliance.
22. In one instance, an LC treated funds received from a shareholder as a capital injection and included the funds as part of shareholders' funds, thereby increasing its liquid capital. However, there was no issuance of new shares, no increase in share capital, nor written evidence of the relevant shareholder's agreement to treat the funds as a capital contribution. Subsequently, the shareholder disputed the classification of the funding and lodged a claim against the LC to demand repayment. In this case, the LC was unable to provide proper justification for treating the funds as a capital injection and incorrectly excluded the amount from its ranking liabilities.

#### *No set-off*

23. The assets and liabilities of an LC must be treated separately on a gross basis and must not be set-off against each other unless otherwise permitted under the FRR<sup>39</sup>, in particular, on inter-group outstanding balances. In one incident, an LC failed to observe the requirement and incorrectly offset receivables against payables among different group companies, resulting in an understatement of ranking liabilities in its FRR return.

#### *Failure to properly recognise transactions*

24. An asset manager LC borrowed from multiple lenders and lent to its clients on a back-to-back basis for the purpose of making investments on behalf of these clients. However, the LC failed to recognise the relevant liabilities on its balance sheet, which resulted in significant understatement of its ranking liabilities in its liquid capital computation.
25. In another instance, an LC entered into a structured note investment agreement as principal with a third party as an investment for a client, but failed to record the

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<sup>38</sup> In general, this should be executed by the shareholder as a deed.

<sup>39</sup> Section 11 of the FRR.



structured note as an asset and the amount payable to client as a liability on its balance sheet. After recognising the transaction back onto its balance sheet, this structured note did not qualify for inclusion as liquid assets under the FRR. However, the amount payable to client should still be included in its ranking liabilities, causing a significant required liquid capital deficit.