

Securities and Futures Commission

Self-assessment checklist for internal controls for the protection of client asset and supervision of account executives

Purpose

The Securities and Futures Commission (SFC) has identified a number of serious misconduct cases involving account executives (AEs). Some involved unauthorised trading in client accounts and misappropriation of client assets. In the course of the SFC's supervisory work, we have observed that licensed corporations (LCs) with weak internal controls and lax management supervision, including supervision of AEs, are particularly susceptible to fraud and internal misconduct.

This comprehensive checklist has been published by the SFC to assist LCs which are securities and futures brokers to review and improve their internal controls for the protection of client assets and supervision of AEs. The checklist is divided into the following areas:

- A. Internal control framework
 - B. Staff-related corporate policies
 - C. Account opening and maintenance of clients' records
 - D. Discretionary accounts
 - E. Dormant accounts
 - F. Handling of client orders and reviews of telephone records
 - G. Staff and staff-related account trading
 - H. Handling of deposits and withdrawals of client money
 - I. Handling of deposits and withdrawals of client securities
 - J. Direct confirmation of clients' account balances
 - K. Handling of trade documents
 - L. Hold-mail arrangements
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Important notes

1. General Principle 8 and paragraph 11.1 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) require licensed corporations to ensure that client assets are promptly and properly accounted for and adequately safeguarded. Paragraph 4.3 of the Code of Conduct requires licensed corporations to have internal control procedures and financial and operational capabilities which can be reasonably expected to protect their operations and clients from financial loss arising from theft, fraud and other dishonest acts, professional misconduct or omissions.
2. This checklist helps LCs, their responsible officers (ROs) and Managers-in-Charge (MICs) to review and improve their internal control policies and procedures by setting out critical controls which require management's attention. LCs, their ROs and MICs should review their internal controls against this non-exhaustive list of control measures and other guidance published by the SFC from time to time to ensure compliance with regulatory requirements

and, based on the results of their reviews, enhance their internal control policies and procedures.

3. "Staff" covers AEs who are the designated licensed representatives responsible for maintaining client relationships and providing trade-related services to clients of brokers.
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Checklist

A. Internal control framework

1. Has the firm established clear and detailed written policies and procedures for the following areas?
 - (a) Handling of client accounts
 - Account opening
 - Amendment to clients' particulars
 - Discretionary accounts
 - Dormant accounts
 - (b) Monitoring of dealing activities
 - Handling of client orders
 - Staff and staff-related account trading
 - Reviews of telephone records
 - (c) Safeguarding of client assets
 - Deposits and withdrawals of client assets
 - Custody and segregation of client assets
 - Direct confirmation of clients' account balances
 - (d) Handling of trade documents
 - Generation and dispatch of trade documents
 - Undelivered or returned trade documents
 - Hold-mail arrangements
2. Does the firm have the following measures in place to ensure the effectiveness and proper enforcement of its written policies and procedures?
 - Review policies and procedures on a regular basis and update them when there are any major changes in risks, operations or other circumstances
 - Communicate policies and procedures to staff, including subsequent updates
 - Monitor staff's adherence to the policies and procedures by independent compliance and internal audit functions
3. Does the firm have the following general control framework and policies in place?
 - Enforce both physical and functional segregation of incompatible duties (eg, dealing, settlement, compliance, risk management and accounting)
 - Set out clear reporting lines and assign supervisory and reporting responsibilities to appropriate staff members

- Grant access to computer systems, client databases, books and records to appropriate staff members on a need basis only
- Set transaction limits for individual staff in the firm's computer systems according to their operational needs
- Perform regular reconciliation of the firm's internal records and reports of client assets with those issued by third parties, eg, clearing houses (including reconciliation with Central Clearing and Settlement System (CCASS) records on a sub-account basis), banks, custodians, counterparties and execution brokers, and properly follow up on any discrepancies
- Maintain a proper audit trail for the control procedures implemented and compliance monitoring work performed by the firm in different areas
- Establish effective communication within the firm for regular internal reporting and timely escalation to management of risks, instances of non-compliance or irregularities

B. Staff-related corporate policies

4. Does the firm have the following staff policies in place to address internal fraud risk?
 - Mandatory block leave (ie, taking a number of consecutive calendar days of leave each year)
 - Job rotation

5. Apart from sales-related factors (eg, commission income and turnover), does the firm take into account the following non-sales-related factors in determining the remuneration of AEs?
 - Quality of service as indicated by the number and nature of complaints against the AEs
 - AEs' compliance with internal policies
 - AEs' compliance with regulatory requirements

6. Does the firm provide training to staff through the following channels to keep them abreast of the latest applicable internal policies and procedures and regulatory requirements?
 - Induction training (covering the corporate culture, internal policies and regulatory requirements) for all new joiners
 - Regular training (including refresher course) for all staff
 - Internal circulars or memos
 - Seminars or workshops organised by external parties
 - Sharing of enforcement news and circulars published by regulators

7. Does the firm have the following measures to ascertain staff's awareness and understanding of the latest applicable internal policies and procedures and regulatory requirements?
 - Retention of training attendance records
 - Assessment quizzes
 - Annual declaration of compliance with Continuous Professional Training requirements

C. Account opening and maintenance of clients' records

8. Does the firm have the following controls for account opening?

- Obtain supporting evidence to verify clients' information (eg, their identities, sources of income, beneficial owners)
- Obtain supporting evidence to verify the investment experience and knowledge declared by clients
- Check clients' addresses against client databases and staff records to identify any common mailing or email addresses, and properly follow up on any anomalies
- Independent staff¹ contact clients at their registered phone numbers to confirm account opening information
- Require approval from management for opening new client accounts
- Back office staff input clients' particulars into the firm's systems
- Issue confirmation letters or emails to clients upon account approval
- Enforce access controls for client agreements and account-related documents, client databases and other systems with client records
- Enforce access controls for blank client agreements and other account opening documents

9. Does the firm have the following controls for amendments to clients' particulars?

- Request that clients directly submit amendment instructions to back office staff
- Verify the original instructions submitted by clients
- Obtain supporting evidence to verify amendments to clients' information
- Issue acknowledgement letters or emails to clients for amendment requests
- Check clients' new addresses against client databases and staff records to identify any common mailing or email addresses, and properly follow up on any anomalies
- Independent staff contact clients at their registered phone numbers to confirm amendment requests
- An independent checker reviews and approves amendment requests along with the supporting evidence
- Back office staff amend client particulars in the firm's systems
- Issue confirmation letters or emails to clients for amendments made
- Maintain an audit log of amendments and conduct regular reviews of the log to identify any irregularities
- Enforce access controls for the records of client instructions and supporting evidence for amendment to personal particulars

D. Discretionary accounts²

10. Does the firm have the following controls in place for the approval and operation of discretionary accounts?

- Verify the original written authorisation submitted by clients by matching their signatures with the specimens maintained by the firm

¹ For the purpose of this checklist, independent staff refer to the staff who are independent of the front office.

² Discretionary accounts refer to accounts held with a broker where clients have authorised the firm or its licensed persons to effect client transactions without the clients' specific authorisation for each transaction.

- Document the relationship between the clients and their authorised AEs and the reasons for such arrangements
- Set out investment mandates in writing to govern the investment strategies, asset allocation, investment restrictions, etc, and provide a copy of the rationale for the suitability of such mandates to the clients
- Independent staff contact clients at their registered phone numbers to confirm such arrangements and explain to them the terms of the authorities
- Require approval from management for such arrangements
- Designate these accounts as discretionary accounts in the firm's computer systems, books and records
- Perform annual renewals of the authorisation of discretionary accounts

11. Does the firm have the following controls for monitoring discretionary account trading?

- Require order priority for client accounts over house and staff and staff-related accounts
- Provide reports on account balances and transaction details to clients in a timely manner, especially when their discretionary account balances fall below the agreed levels or when large orders for the accounts are pending or executed
- Independent staff review trading activities of discretionary accounts to ensure compliance with respective investment mandates
- Independent staff review the appropriateness of trading frequency in discretionary accounts
- Identify discretionary accounts with funds deposited from or withdrawn to third parties for further review
- Perform periodic reviews of clients' account activities and performance
- Independent staff regularly confirm account balances with clients
- Implement measures such as comparing executed trades in client accounts with telephone records to identify any undisclosed discretionary arrangement³ **(Note: this control is also applicable to LCs which have internal policies prohibiting discretionary account arrangements)**

E. Dormant accounts

12. Does the firm have the following controls for dormant accounts?

- Independent staff regularly identify and review dormant accounts to identify any irregular account movements and properly follow up on any anomalies
- Suspend trading as well as deposits and withdrawals of account assets in dormant accounts unless:
 - verification of clients' identities and updating of their personal particulars have been performed by independent staff
 - approval from management has been obtained

³ The SFC received a number of reports in the past relating to undisclosed discretionary account arrangements between clients and AEs from both brokers which allowed and which prohibited such arrangements.

F. Handling of client orders and reviews of telephone records

13. Does the firm have the following controls for handling client orders?

- Verify clients' identities before order acceptance
- Record the identities of clients and the AEs who receive and handle the orders
- Impose position or trading limits on client accounts
- Require management approval for overriding position or trading limits
- Require management approval for trade cancellations and amendments
- Prohibit reallocations of executed trades to different client accounts
- Provide trade confirmations to clients upon order execution
- Regularly sample check client transaction records against telephone records and other order placing records and vice versa to identify unauthorised or unrecorded client transactions

14. Does the firm adopt the following risk-based sampling methods, in addition to random or sequential sampling, which enable effective and sufficient coverage of clients and AEs for the review of telephone records of client orders?

- Accounts which are handled by the top AEs in terms of turnover
- Accounts in which the number of orders is inconsistent with telephone records
- Accounts with a significant increase in turnover
- Accounts with assets deposited from or withdrawn to third parties
- Accounts with frequent trade amendments, trade cancellations, error trades or buy-in transactions
- Accounts with frequent trading but no settlement was made by fund deposits
- Accounts with third-party authorisation
- Accounts handled by AEs with unsatisfactory compliance records
- Staff-related accounts

15. Does the firm take the following measures for exceptions identified from the review of telephone records⁴?

- Independent staff follow up and determine the root causes of such exceptions
- Interview the AEs who handled the orders to ascertain the reasons for the exceptions
- Independent staff contact clients at their registered phone numbers to verify the orders
- Expand the sample size of the review to cover other clients of the relevant AEs

G. Staff and staff-related account trading

16. Does the firm have the following controls for staff and staff-related account trading?

- Require staff to identify and report all staff-related accounts to the firm
- Require staff to deal through the firm

⁴ LCs should diligently follow through with the exceptions identified from the reviews as they are red flags for non-compliance and misconduct. Any irregularities, including AEs' refusal to cooperate and assist in the investigation, should be promptly escalated to management independent of sales functions.

- Prohibit trading in stocks on the firm's restricted stock list⁵
- Require pre-trade management approval for staff account trading (including cross trades with client accounts)
- Require order priority for client accounts over staff accounts
- For aggregated orders, require priority to be given to satisfying client orders
- Require prior disclosure to clients for cross trades between clients and staff accounts
- Require transactions for staff and staff-related accounts to be recorded separately
- Management or independent staff monitor the trading activities in staff and staff-related accounts for any irregularities
- Impose minimum holding periods for stocks acquired by staff accounts
- Require duplicate trade confirmations and statements of accounts to be provided to the firm for review if staff are permitted to deal through other brokers
- Independent staff conduct post-trade reviews of staff and staff-related accounts, and such reviews should at least include a comparison of transactions in AEs' accounts with those in client accounts under the care of the respective AEs to identify any front-running trades, to ensure order priority for client accounts and to ensure priority is given to satisfying client orders for aggregated orders

H. Handling of deposits and withdrawals of client money

17. Does the firm have the following controls for deposits of funds into client accounts?

- Request clients to directly notify and provide supporting evidence of fund deposits to the settlement department
- Promptly track client deposits and follow up on unknown receipts
- Discourage fund deposits from third parties (including staff) into client accounts
- Conduct regular reviews of fund deposits in client accounts and properly follow up on any anomalies

18. Does the firm have the following controls for withdrawal of funds from client accounts?

- Request clients to directly give fund withdrawal instructions or standing authorities to the settlement department
- Verify the original instructions submitted by clients
- Pay client money to the bank accounts in clients' names as designated by the clients or issue crossed cheques in clients' names
- Prohibit amendments to the payees of cheques issued to clients without their written instructions
- Prohibit the issuance of cash cheques from client accounts
- Impose dual controls and appropriate authorisation limits for payments of client money
- Discourage fund withdrawals from client accounts to third parties (including staff) except with valid reasons provided by the clients and approval from management
- Uncollected cheques are credited back to client accounts after a specific period of time
- Renew any standing authorities given by clients who are not professional investors at least annually

⁵ An LC which engages in corporate finance advisory business may possess material non-public and price-sensitive information about stock issuers. It should place such stocks on a restricted stock list to prohibit staff from trading in the stocks and mitigate the risk of insider trading.

- Conduct regular reviews of fund withdrawals from client accounts and properly follow up on any anomalies

I. Handling of deposits and withdrawals of client securities (including physical scrip)

19. Does the firm have the following controls for deposits and withdrawals of client securities?

- Request clients to directly pass their written instructions for deposits and withdrawals of securities to the settlement department
- Require proof of ownership for deposits of client securities
- Promptly deposit the physical scrip collected from clients to securities depositories
- Independent staff directly confirm the transfer of securities to or from third parties with clients and obtain supporting documents (including stamped bought or sold notes)
- Confirm with counterparty brokers the identities of persons who transfer securities to or from the firm's client accounts through settlement instructions
- Require approval from management for deposits and withdrawals of client securities
- Independent staff directly confirm the collection of physical scrip by third parties with clients
- Require clients or authorised third parties whose identities have been verified to acknowledge the receipts of physical scrip
- Maintain an audit log to record movements of physical scrip
- Enforce access controls for the CCASS terminals and assign transaction limits on a need-to-have basis
- Enforce access controls for physical scrip held in vaults
- Independent staff perform physical scrip count and reconcile against the firm's internal records on a regular basis and promptly follow up on identified discrepancies
- Conduct regular reviews of deposits and withdrawals of securities in client accounts and properly follow up on any anomalies

J. Direct confirmation of clients' account balances

20. Does the firm conduct regular confirmation exercises (excluding the confirmation exercises for statutory audit purpose) to confirm clients' account transactions and balances and have the following controls when obtaining direct written confirmation of client accounts?

- Designate independent staff who are not usually involved in maintaining client asset records to perform confirmation exercises
- Oversee the generation of sampled client statements to be sent out with letters of confirmation in order to minimise the risk of tampering by unauthorised persons
- Verify clients' names and addresses printed on statements against the records in client databases before sending out the letters of confirmation and sampled client statements
- Verify stock holding and cash balances in statements against the firm's internal records and reconcile these records with external custodian statements before sending out the letters of confirmation and sampled client statements
- Request that clients sign and return the confirmations to independent staff directly
- Request that clients contact the firm's management, complaint officer or independent staff if they notice any issues or discrepancies with their accounts or records from the confirmation exercises

21. Does the firm adopt the following sampling methods, in addition to random sampling, which enable effective and sufficient coverage of clients and AEs by confirmation exercises?

- Top clients by turnover or amounts of assets in the accounts
- Accounts which are handled by the top AEs in terms of turnover
- Accounts with discretionary trading arrangements
- Accounts with amendments to client particulars
- Accounts with a significant decrease in stock level
- Accounts with a significant increase in turnover
- Accounts with assets deposited from or withdrawn to third parties
- Accounts with frequent cash deposits
- Accounts with frequent trade amendments, trade cancellations, error trades or buy-in transactions
- Accounts with frequent trading but no settlement was made by fund deposits
- Accounts for which the account holders did not access electronic trade documents for a certain period of time
- Newly opened accounts
- Dormant or inactive accounts

22. Does the firm take the following measures for client accounts which do not respond to confirmation requests?

- Independent staff contact clients at their registered phone numbers to verify their mailing or email addresses and obtain the latest address proof where appropriate
- Independent staff contact clients at their registered phone numbers to confirm account transactions and balances
- Suspend clients' accounts after repeated failures to contact them
- Reactivate suspended accounts only after independent staff confirm clients' particulars with them and management's approval is obtained

23. Does the firm take the following measures when clients do not agree to the transactions and balances in the trade documents?

- Conduct reviews of telephone records and other order placing records to match the clients' order instructions with the transactions executed for the accounts
- Interview the AEs responsible for the client accounts to ascertain the reason
- Conduct fund tracing (eg, requesting reprint copies of cheques from banks) for the client accounts to ascertain the source of the funds and the genuineness of the transactions in the client accounts
- Expand the sample size of the confirmation exercise to ascertain whether other clients are affected

K. Handling of trade documents

24. Does the firm have the following controls for handling trade documents?

- Independent staff generate trade documents
- Impose sequential controls for printed trade documents to ensure completeness
- Verify clients' names and addresses printed on the trade documents against the records in client databases on a sampling basis

- Compare transactions and position balances in the trade documents with internal records on a sampling basis
- Independent staff deliver trade documents
- Reconcile the total number of printed and delivered trade documents with the number of active clients
- Prohibit staff from collecting trade documents on behalf of clients
- Request clients to contact the firm's management, complaint officer or independent staff if they notice any issues or discrepancies with their accounts or records in the trade documents
- Enforce access controls for blank trade documents
- Enforce access controls for printed trade documents pending dispatch
- Enforce access controls for the system which generates trade documents
- Enforce access controls for the system which sends electronic trade documents to clients

25. Does the firm take the following measures for undelivered or returned trade documents?

- Independent staff contact clients at their registered phone numbers to confirm their mailing or email addresses
- Independent staff contact clients at their registered phone numbers to confirm the latest transactions and account balances
- Suspend clients' accounts after repeated failures to contact them
- Reactivate suspended accounts only after independent staff confirm clients' particulars with them and management's approval is obtained

L. Hold-mail arrangements

26. Does the firm have the following controls for hold-mail arrangements?

- Request clients to give written instructions for hold-mail arrangements directly to the settlement department
- Verify the original written instructions submitted by clients
- Independent staff contact clients at their registered phone numbers to confirm hold-mail arrangements and explain the risk of such arrangements
- Require approval from management for such arrangements
- Independent staff arrange custody in a secured location and release of the trade documents
- Require clients or their authorised third parties (who are not the firm's staff) whose identities have been verified to acknowledge the collection of trade documents
- Monitor the collection status of hold-mail trade documents and remind clients to collect them in a timely manner
- Impose time limits for holding trade documents, after which any uncollected documents are sent to the client's correspondence address
- Perform periodic renewals of written requests for hold-mail arrangements