Circular

3 July 2024

Circular to licensed corporations

Financial resources management and compliance with the Securities and Futures (Financial Resources) Rules

1. This circular elaborates on the Securities and Futures Commission's (**SFC**) expectations regarding the governance and internal control standards of licensed corporations (**LCs**) for monitoring the adequacy of financial resources and compliance with the Securities and Futures (Financial Resources) Rules (**FRR**).

2. During its monitoring of LCs' financial resources adequacy, the SFC has observed various undesirable practices and internal control deficiencies that led to abrupt declines in excess liquid capital (**ELC**), or breaches of the liquid capital requirement under the FRR. In some cases, deficits in the required liquid capital (**RLC deficits**) remained outstanding for months. Typical deficiencies (see examples in **Appendix A**) include:

    (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.

3. These deficiencies are mainly attributable to:

    (a) ineffective management oversight; and

    (b) failure to employ competent and qualified persons for calculating and monitoring liquid capital, as well as preparing and reviewing financial returns (**FRR returns**).

4. Some LCs were also late in reporting their RLC deficits to the SFC, thus contravening the relevant notification requirements under the Securities and Futures Ordinance (**SFO**), the FRR and the Code of Conduct[1]. While these problems were predominantly found in LCs with smaller operations and those with weaker governance, all LCs should comply with the FRR and employ adequate resources to properly carry out their business activities.

Expected standards

5. Pursuant to section 6(1) of the FRR, an LC must <u>at all times</u> maintain liquid capital which is not less than its required liquid capital. Under sections 146(1) and (2) of the SFO[2], an LC shall notify the SFC in writing and immediately cease carrying on any

[1] Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**).
[2] Under sections 146(13) and (14) of the SFO, it is an offence if an LC contravenes sections 146(1) or (2).

regulated activity for which it is licensed if it becomes aware that it is unable to maintain, or to ascertain whether it maintains, the financial resources required of it, unless otherwise permitted by the SFC.

6. Under General Principle 3 of the Code of Conduct, an LC is required to have and effectively employ the resources and procedures which are needed for the proper performance of its business activities. This includes the need for sufficient liquid capital that enables the LC to operate in the normal course of business as a going concern.

7. Inadequate internal controls over FRR compliance may lead to an abrupt cessation or interruption of an LC's regulated activities and impact its clients' interests. In addition, poor controls may expose an LC to the risk of theft, fraud[3], and other dishonest acts, professional misconduct or omissions[4].

8. Contravention of the FRR has a direct bearing on an LC's ongoing fitness and properness to remain licensed with the SFC. If an FRR breach is attributable to inadequate governance or internal control standards, the fitness and properness of the LC's senior management[5] will also be called into question. The SFC expects an LC and its senior management to establish and enforce effective policies, procedures and internal controls to ensure that the LC is able to ascertain the sufficiency of its liquid capital, fully comply with all relevant FRR requirements, and maintain sufficient resources to operate its business as a going concern. For this purpose, LCs are expected to meet the standards set out in this circular, which represent the minimum standards. Each LC should implement internal controls commensurate with its size, structure, business operations and needs.

Governance

Management oversight

9. An LC's responsible officers (**ROs**) and Managers-In-Charge of Core Functions (**MICs**) are responsible for properly managing the risks associated with the LC's business and ensuring the LC's compliance with relevant legal and regulatory requirements. This includes effectively managing financial resources and ensuring compliance with the FRR.

10. It is an existing requirement that each LC should designate at least one RO or MIC responsible for each of the following areas: (a) ensuring the availability of the financial resources needed for the proper performance of the LC's business activities; and (b) full compliance with the financial resources requirements under the FRR at all times[6].

[3] Such as window dressing of liquid capital.
[4] Paragraph 4.3 of the Code of Conduct.
[5] General Principle 9 and paragraph 14.1 of the Code of Conduct, and Part I of the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (**Internal Control Guidelines**).
[6] The SFC's 28 June 2021 Circular to licensed corporations – Operation of bank accounts.

11. Accordingly, an LC's senior management should designate at least one RO or MIC[7] to be responsible for overseeing the adequacy of financial resources and FRR compliance. The designated RO or MIC should have the following responsibilities[8]:

(a) overseeing the calculation, monitoring and reporting of liquid capital;

(b) establishing and enforcing policies, procedures and internal controls to ensure the adequacy of financial resources and compliance with the FRR. These include setting up alerts based on liquid capital levels and material drops in ELC, which would require the attention of senior management for further escalation; and

(c) identifying the root cause of any FRR compliance failure and implementing appropriate remedial measures promptly.

Competence

12. To the extent that the designated RO or MIC delegates or outsources the calculation, monitoring or reporting of liquid capital, they should ensure that any person employed or appointed for these duties, including preparing and reviewing the liquid capital as reported in FRR returns, is competent and possesses the relevant qualification, knowledge and experience. In any case, the LC remains responsible for compliance with the FRR and this circular notwithstanding the outsourcing.

FRR returns

13. The FRR regime and the submission of FRR returns to the SFC provide significant statutory safeguards for investors, and enable the SFC to monitor the risks and liquidity level of LCs. Under section 56(6) of the FRR, the FRR returns of an LC must be signed by its RO or officer approved by the SFC (each a **Signer**). The Signer must certify, in the declaration form of the FRR return, that the information provided in the FRR return is true and correct to the best of his/her knowledge. To discharge this duty, the Signer is expected to have verified the liquid capital computation against relevant records, conducted necessary inquiries, and assessed whether the LC's systems and procedures can produce reliable, up-to-date and accurate financial information. It is expected that the FRR return be signed by an RO or MIC in normal circumstances. It is important to note that provision of false or misleading information to the SFC may constitute a criminal offence under the SFO.

Internal control standards

14. According to the Internal Control Guidelines, policies and procedures shall be established and maintained to ensure the firm's compliance with all applicable legal

[7] The Core Function of MIC of Finance and Accounting is to ensure the timely and accurate financial reporting and analyses of the operational results and financial positions of an LC. It is expected therefore that it would be appropriate for the MIC of Finance and Accounting to be designated for the purpose set out in this paragraph because he/she should have sufficient authority and information for managing the LC's financial resources.
[8] If more than one RO or MIC is designated for the role, the allocation of responsibilities should be clearly defined among them.

and regulatory requirements[9]. Accordingly, an LC should implement effective controls for FRR compliance[10] in the following areas, among other things:

(a) sound accounting policies and procedures[11], including month-end and year-end closing procedures, for timely and proper recognition of revenues, accruals and provisions;

(b) a maker and checker mechanism for the calculation, monitoring and reporting of liquid capital;

(c) effective processes for ongoing liquid capital monitoring commensurate with the nature, scope, size and complexity of the LC's business activities and operations;

(d) regular liquid capital projections[12] for preparing and maintaining a sufficient liquid capital buffer;

(e) a liquidity management framework for handling thin ELC situations[13] that entails effective alerts, relevant mitigation measures[14] and escalation procedures with clear steps and timelines;

(f) procedures for ensuring compliance with all relevant notification requirements; and;

(g) where applicable, clear allocation of scope, roles and responsibilities between the LC and its external service providers regarding outsourced accounting and FRR compliance functions[15].

15. The frequency of liquid capital monitoring should be commensurate with the operational complexity of an LC. For instance, the ELC of a brokerage firm may fluctuate significantly on a day-to-day or intraday basis due to its business activities or market conditions, while the ELC of an asset management firm may be less volatile if it has stable income and predictable expenses. Therefore, an LC should consider the potential fluctuation of its ELC (eg, whether the ELC changes daily or is prone to abrupt changes from time to time) to set the monitoring frequency. If an LC's operation is simple with substantial liquid capital buffer and proper liquid capital projections, the monitoring frequency can be reduced.

[9] Part V
[10] Part V(4) of the Internal Control Guidelines.
[11] Under section 3(1)(a) of the FRR, an LC must account for all assets and liabilities in accordance with generally accepted accounting principles, unless otherwise specified in the FRR.
[12] The liquid capital projection, where applicable, should consider, among others, any expected material cash outflows, future liabilities, ageing of account receivables, and potential impact arising from proprietary positions under stress scenarios, such as abnormal and significant changes in market conditions, stock suspension and downgrading of debt securities.
[13] As outlined in the SFC's Circular to Licensed Corporations on 4 March 2022 – Measures to deal with disruptions caused by financial distress and insufficient responsible officers (**Dealing With Disruptions Circular**), the SFC adopts a risk-based approach to monitor the adequacy of each LC's liquid capital on an ongoing basis. The SFC may make enquiries with an LC when its ELC is projected to run out in less than 12 months, and request the LC to provide a funding plan and an exit plan if its financial position continues to deteriorate.
[14] For example, an LC should consider collecting outstanding accounts receivable, refraining from providing new loans or any form of advances to related parties, suspending dividend distributions to its shareholders, adopting cost-cutting measures, seeking capital injection and working out a funding plan with shareholders.
[15] If an LC outsources any part of its FRR compliance function to an external service provider, the LC is expected to conduct sufficient initial due diligence and ongoing monitoring to ensure that the external service provider is competent in providing such service.

16. FRR compliance controls should be implemented with proper segregation of duties and functions.

17. LCs should thoroughly review their governance practices, policies, procedures and internal controls to ensure effective liquid capital monitoring and FRR compliance, including observing the expected governance and internal control standards as elaborated in this circular. The SFC will not hesitate to take regulatory actions against LCs and their senior management if their conduct does not meet the expected standards. It should also be noted that the SFC has the power to suspend an LC's licence under section 146(5) of the SFO where the LC is unable to maintain, or to ascertain whether it maintains, the required liquid capital.

Incident report and remedial measures

18. Under section 54(1) of the FRR, where an LC notifies the SFC pursuant to section 146(1) of the SFO that it has failed to maintain the minimum required liquid capital, it must include in its notice full details of the matter, the reason therefor and any steps to redress the inability. Pursuant to section 54(2) of the FRR, the SFC may request additional information and document. For this purpose, an LC that incurs an RLC deficit is expected to complete and submit an incident report as set out in **Appendix B**. The incident report should be submitted to the SFC within three weeks from the date of first identifying the RLC deficit[16]. An LC that ceases to carry on regulated activities should notify its clients[17] of the same as soon as practicable.

Financial distress situation

19. LCs encountering financial difficulties are reminded to observe the Dealing With Disruptions Circular. They are also reminded of their obligations to comply with all relevant regulatory requirements until licence revocation. In this regard, an LC which has ceased business operation is still subject to all FRR requirements and, where applicable, it should procure sufficient financial, human and operational resources necessary for handling the return of client assets and winding down its regulated business in an orderly manner.

Should you have any queries regarding this circular, please contact your case officers-in-charge.

Intermediaries Supervision Department
Intermediaries Division
Securities and Futures Commission

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[16] The submission of the incident report is not a substitute for the need under section 146(1) of the SFO to notify the SFC of the RLC deficit before the report is submitted.
[17] Including fund investors if the LC is responsible for the overall operation of the fund.