STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has publicly reprimanded and fined China Industrial Securities International Brokerage Limited (**China Industrial**) $3.5 million pursuant to section 194 of the Securities and Futures Ordinance (**SFO**).

2. The disciplinary action is taken in relation to China Industrial's internal control failures relating to monitoring of suspicious trading activities and recording of client order instructions.

A. Monitoring of suspicious trading activities

Applicable requirements

3. The Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**) provides that a licensed corporation should act with due skill, care and diligence, in the best interests of its clients and market integrity[1].

4. At all material times, the Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (**AML Guideline**) stipulates, among other things, that a licensed corporation:

   (a) must continuously monitor its business relationship with clients (and the clients' activities and transactions) to ensure they are consistent with the clients' business, risk profile and source of funds, and identify transactions that are complex, unusually large in amount or of an unusual pattern (**Unusual Transactions**)[2]; and

   (b) should examine the background and purpose of Unusual Transactions, and properly document in writing the findings and outcomes of these examinations and the rationale of any decision made[3].

5. Among other things, the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (**Internal Control Guidelines**) provide that staff performing compliance function and the management of licensed corporations should establish, maintain and enforce effective compliance procedures, which should cover legal and regulatory requirements, including record keeping and prevention of money laundering[4].

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[1] General Principle 2.
[2] Paragraph 5.1 of the AML Guideline (all applicable versions); section 5 of Schedule 2 to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (**AMLO**).
[3] Paragraphs 5.10 and 5.11 of the AML Guideline (April 2015 & March 2018 versions); paragraphs 5.13 and 5.17 of the AML Guideline (November 2018 & September 2021 versions); section 5 of Schedule 2 to the AMLO.
[4] Paragraph 4 of Section V.

Failures to ensure all identified Unusual Transactions were properly examined and the relevant examination findings and outcomes were adequately documented

6. Since June 2015, China Industrial has been using a third-party post-trade surveillance system (**Surveillance System**) to detect suspicious trading activities.

7. At all material times, China Industrial's internal policy on post-trade monitoring (**Post-Trade Monitoring Policy**) provided that the Compliance Department would circulate reports (**Daily Reports**) on the alerts generated by the Surveillance System (**Alerts**) to the responsible officers (**ROs**) of the relevant departments that handled client accounts[5] for review on a daily basis. Each department would receive and assess Alerts that were relevant to the client accounts they handled and the ROs were required to make specific enquiries with the relevant account executives and/or clients for different types of Alerts.

8. However, the evidence shows that:

    (a) prior to May 2018, the Daily Reports were not sent to 2 of the 4 Frontline Departments that handled client accounts;

    (b) between 29 March and 7 September 2016, there were a total of 1,607 Alerts. However, there is no review record for these Alerts; and

    (c) during the periods from 1 August 2017 to 31 July 2019 (**Period 1**) and from 1 June to 31 October 2020 (**Period 2**) (collectively, the **Relevant Periods**), there were a total of 18,008 Alerts[6]. However, there are review records for only around 5,000 Alerts (**Alert Review Records**).

9. The SFC's investigation revealed that the Alert Review Records are fragmented and cannot adequately explain the rationales of the findings and outcomes of China Industrial's examinations of the Unusual Transactions flagged by the Alerts.

10. Further, according to China Industrial's former ROs, the Surveillance System generated many false Alerts, which they would discuss, review and remark on the list of Alerts. Nevertheless, the evidence suggests China Industrial failed to properly maintain the ROs' Alert review records and/or to ensure that the ROs adequately record their examination remarks.

Failure to implement effective compliance procedures in relation to the Alert reviews

11. During the Relevant Periods, the Compliance Department would select 5 to 8 sample Alerts per month for review (**Monthly Checks**) and the review findings and follow-up actions were recorded in writing. China Industrial claims that the purpose of the Monthly Checks is to ensure the effectiveness of the Post-Trade Monitoring Policy and reduce suspicious market misconduct risks.

12. However, the Monthly Check records show the Compliance Department focused on examining the actual sample Alerts (e.g. comparing the specific

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[5] Namely, Hong Kong Brokerage Department (**Brokerage Department**), (ii) Mainland Business Department, (iii) Institutional Sales Department, and (iv) Global Business Department (collectively, **Frontline Departments**).

[6] There were 15,869 Alerts in Period 1 and 2,139 Alerts in Period 2.

trade and client profile covered in each sample Alert), and never reviewed the adequacy of the records kept and whether the steps taken by the ROs to examine the Unusual Transactions flagged by the Alerts were compliant with the Post-Trade Monitoring Policy.

The SFC's findings

13. In light of the matters set out in paragraphs 6 to 12 above, China Industrial had failed to take due skill, care and diligence to:

    (a) effectively implement the Post-Trade Monitoring Policy and ensure all Unusual Transactions flagged by the Alerts were properly examined during the Relevant Periods;

    (b) ensure the findings and outcomes of the Alert examinations were adequately documented in a comprehensible form from March 2016 to October 2020; and

    (c) have in place effective compliance procedures to ensure the proper implementation of the Post-Trade Monitoring Policy and documentation of the Alert examinations during the Relevant Periods,

    in breach of the applicable requirements set out in paragraphs 3 to 5 above.

B. Recording of client order instructions

Applicable requirements

14. Among other things, the Code of Conduct stipulates that licensed corporations should:

    (a) prohibit its staff members from receiving client order instructions through mobile phones in office premises and ensure that client order instructions received through the telephone are recorded[7];

    (b) ensure that they diligently supervise persons employed or appointed to conduct business on their behalves[8];

    (c) have internal control procedures which can be reasonably expected to protect its operations and clients from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions[9];

    (d) comply with, and implement and maintain measures appropriate to ensuring compliance with, all applicable legal and regulatory requirements[10]; and

    (e) immediately report to the SFC any material or suspected material breach, infringement of or non-compliance with any laws, rules,

[7] Paragraph 3.9 (b) & (c).
[8] Paragraph 4.2.
[9] Paragraph 4.3.
[10] General Principle 7 and paragraph 12.1.

regulations and codes administered by the SFC by themselves or their employees[11].

15. In this regard, the Internal Control Guidelines provide that:

    (a) the management of licensed corporations should establish and maintain policies and procedures to ensure client orders are handled in compliance with the order handling regulatory requirements. In particular, clear and comprehensive audit trails are created to precisely record all order details from the time of origination through order execution and settlement. These audit trails should be maintained to enable the firm to prevent, detect and investigate suspected improprieties[12]; and

    (b) staff performing compliance function should promptly report to management all occurrences of material non-compliance by the firm or its staff of legal and/or regulatory requirements, as well as with the firm's own policies and procedures. In turn, the management should promptly notify the SFC of occurrences of these incidents[13].

16. The Securities and Futures (Keeping of Records) Rules require licensed corporations to, among other things:

    (a) keep such accounting, trading and other records that are sufficient to account for all client assets that it receives or holds, and enable all movements of client assets to be traced through its accounting and stock holding systems. These include records showing particulars of all orders or instructions concerning securities that it receives or initiates[14]; and

    (b) give notice in writing to the SFC within one business day after they became aware of their non-compliance of the requirements set out in sub-paragraph (a) above[15],

    (the applicable requirements set out in paragraphs 14 to 16 above are collectively referred to as the **Telephone Order Requirements**).

Failures relating to recording of client telephone order instructions

17. During the Relevant Periods, China Industrial's internal policies required account executives (**AEs**) to use the firm's recorded line when taking client telephone order instructions. If an AE was not at China Industrial's office premises, he/she must request the client to telephone China Industrial so that the order could be taken using the recorded line (**Telephone Order Policy**).

18. China Industrial submits that it would review samples of client telephone orders taken by its AEs to ensure compliance with the Telephone Order Policy (**Telephone Order Reviews**). Specifically:

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[11] Paragraph 12.5.
[12] Paragraphs 6 & 9 of Section VII.
[13] Paragraph 6 of Section V.
[14] Section 3(1) and section 1 of the Schedule.
[15] Section 11.

(a) the review would check whether the relevant telephone conversations between the clients and the AEs had been recorded, and particulars, such as account number, client's identity, order quantity and price, had been confirmed; and

(b) the relevant ROs of each of the Brokerage Department, Mainland Business Department and Dealing Department (**Three Departments**) would review telephone orders taken by their respective AEs, and the Compliance Department and Customer Services Department[16] would review telephone orders taken by all AEs.

19. During Period 1, there was no written procedure on when and what follow-up actions would be taken against AEs for breach of the Telephone Order Policy. In practice:

(a) the Compliance Department would issue reminders to AEs who had breached the Telephone Order Policy and would additionally inspect telephone order recordings relating to AEs with non-compliance records. For repeat offenders, the Compliance Department would issue warning letters and might restrict their trading rights; and

(b) the ROs of the Three Departments would issue verbal reminders or warnings to the offending AEs, though these verbal warnings and reminders were not put on record.

20. The Telephone Order Review records of the Compliance Department and the Brokerage Department[17] from Period 1 show that:

(a) there were 873 orders involving 29 AEs with missing telephone order placing instructions. Among these 29 AEs, 21 AEs had failed to comply with the Telephone Order Policy multiple times (with 8 AEs breaching the policy 10 to 702 times); and

(b) China Industrial had only issued 6 written reminders and 1 warning letter to 7 AEs for the breaches. The reminders were not issued until 38 to 137 days after the trades were conducted and it is unclear from the warning letter when the AE placed the relevant order(s).

21. During Period 2, the follow-up actions to be taken against AEs for breach of the Telephone Order Policy were stipulated in the circulars issued by the Compliance Department, which provided that:

(a) for the first breach, the AE would receive a compliance reminder;

(b) for the second breach, the AE would receive a warning letter and his/her trading rights would be restricted[18]; and

(c) for the third breach, the SFC would be notified.

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[16] The Customer Service Department took over the Telephone Order Reviews from the Compliance Department from June 2020, i.e. since the beginning of Period 2.

[17] China Industrial submits that among the Three Departments, only Brokerage Department had identified irregularities during the Telephone Order Reviews in Period 1.

[18] The trading rights restriction follow-up action began in July 2020 and the relevant AE would not be able to take orders from clients.

22. Nevertheless, the Telephone Order Review records of the Customer Services Department and Brokerage Department[19] show that during Period 2:

    (a) there were 161 orders involving 11 AEs with missing telephone order placing instructions. Among these 11 AEs, 8 AEs had failed to comply with the Telephone Order Policy multiple times (with 4 AEs breaching the policy 2 to 54 times); and

    (b) China Industrial had issued 4 warning letters to 4 AEs 90 days after the first orders with missing client telephone instructions were placed from the relevant client accounts.

23. China Industrial claims that, during Period 2, its ROs had warned some of the AEs verbally instead of issuing written warnings to them after considering the circumstances of each case. The Customer Services Department had also verbally reminded the offending AEs. However, it is again unclear which AEs had received verbal reminders and warnings.

24. In the circumstances, the Telephone Order Reviews were ineffective in ensuring AEs complied with the Telephone Order Policy during the Relevant Periods because the follow-up actions taken by China Industrial were inadequate.

25. It is also concerning that China Industrial did not notify the SFC about the breach of the Telephone Order Requirements by its AEs notwithstanding the Telephone Order Reviews had identified around 56% and 31% of its total AEs during Period 1 and Period 2 respectively had failed to comply with the Telephone Order Policy, with some AEs failing to comply multiple times.

The SFC's findings

26. In light of the matters set out in paragraphs 17 to 25 above, China Industrial had, during the Relevant Periods, failed to:

    (a) effectively implement the Telephone Order Policy and properly record and keep client order instructions for at least 1,034 orders, i.e. the orders set out in paragraphs 20(a) and 22(a) above;

    (b) diligently supervise its AEs and take adequate and timely follow-up actions against those in breach of the Telephone Order Policy; and

    (c) immediately report to the SFC after it became aware of the AEs' breaches of the Telephone Order Requirements,

    in breach of the Telephone Order Requirements.

Conclusion

27. Having considered all the relevant circumstances, the SFC is of the view that China Industrial is guilty of misconduct for the purpose of sections 194(1)(a) and (2)(a) of the SFO.

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[19] China Industrial submits that among the Three Departments, only Brokerage Department had identified irregularities during the Telephone Order Reviews in Period 2.

28. In deciding the disciplinary sanction set out in paragraph 1 above, the SFC has taken into account China Industrial's cooperation in resolving the SFC's concerns and its otherwise clean disciplinary record.