

STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. Pursuant to section 194 of the Securities and Futures Ordinance (**SFO**), the Securities and Futures Commission (**SFC**) has reprimanded and fined XHK Limited (**XHK**)¹ HK\$2.5 million.
2. The disciplinary action is taken because XHK failed to:
 - (a) ensure the monthly financial returns (**FRR Returns**) submitted to the SFC were accurate, and maintain its required level of liquid capital (**RLC**);
 - (b) ensure client money was maintained in segregated accounts and not transferred out of the accounts except in accordance with a written direction or standing authority from the client;
 - (c) transfer non-client money out of segregated accounts within one business day of becoming aware that such money was not client money; and
 - (d) transfer interest on client money out of segregated accounts within one business day after becoming aware that the interest had been credited,

in breach of the Securities and Futures (Financial Resources) Rules (**FRR**), the Securities and Futures (Client Money) Rules (**CMR**) and the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**).

Summary of Facts

3. Following self-reports made by XHK, the SFC conducted an investigation into XHK's practices in preparing the FRR Returns, handling client money and assets and monitoring liquid capital.

Non-compliance with the FRR

4. Section 4 of the FRR provides that a licensed corporation must at all times maintain financial resources in the amount required of it under Part 3 of the FRR.
5. Section 6(1) of the FRR provides that a licensed corporation must at all times maintain liquid capital which is not less than its RLC.

Failure to ensure the FRR Returns were accurate and the RLC was maintained

6. Our investigation found that XHK made various accounting errors in the FRR Returns submitted to the SFC under the FRR, which resulted in overstating and understating its liquid capital from January 2020 to June 2021. After correcting the errors, it came to light that XHK's RLC was in deficit, ranging from HK\$3.6

¹ XHK has been licensed under the SFO to carry on Type 1 (dealing in securities) and Type 2 (dealing in futures contracts) regulated activities since 29 January 2019.

million to HK\$32.3 million, for 4 months from February to March 2020 and March to April 2021, in breach of sections 4 and 6(1) of the FRR.

7. Between January 2020 and June 2021, XHK did not put in place any written policies and procedures for (a) preparing and reviewing FRR Returns; and (b) ensuring compliance with the FRR.
8. XHK outsourced the preparation and compilation of FRR Returns, including the calculation of liquid capital, but did not ensure that the persons appointed for these duties were competent and possessed the relevant knowledge and experience. Furthermore, XHK's staff were not familiar with the FRR requirements and consequently failed to identify the errors in the FRR Returns before submission to the SFC.
9. In August 2021, XHK updated its standard operating procedures to (a) strengthen its internal process of FRR compilation and liquid capital monitoring; and (b) articulate the roles of each relevant department in such process.

Non-compliance with the CMR

10. The CMR prescribes the manner in which a licensed corporation should treat and deal with client money received or held in Hong Kong. Salient requirements of the CMR that are relevant to the present case include:
 - (a) A licensed corporation that receives or holds client money should establish and maintain in Hong Kong one or more segregated accounts for client money with an authorized financial institution² or any other person approved by the SFC and designate each account as a trust account or client account (sections 4(1) and (2)).
 - (b) A licensed corporation should deposit client money into a segregated account within one business day after receipt of the client money (section 4(4)).
 - (c) A licensed corporation should retain client money in a segregated account until it is:
 - (i) paid to the client on whose behalf it is being held;
 - (ii) paid in accordance with a written direction or standing authority from the client;
 - (iii) required in order to meet the client's obligations to meet settlement or margin requirements in respect of dealing in securities or futures contracts carried out by the licensed corporation on behalf of the client; or
 - (iv) required to pay money that the client owes to the licensed corporation in respect of regulated activity (section 5).
 - (d) A licensed corporation that is entitled, under a written agreement with a client, to retain any amount of interest credited to a segregated account in which client money is held, must pay that interest out of the account within

² According to Schedule 1 of the SFO, an "authorized financial institution" means an authorized institution as defined in section 2(1) of the Banking Ordinance, i.e. a bank, a restricted licence bank, or a deposit-taking company.

one business day after either the interest is credited to the account or the licensed corporation becomes aware that the interest has been credited to the account, whichever is later (section 6(2)).

- (e) A licensed corporation which becomes aware that it is holding an amount of money in a segregated account that is not client money should, within one business day of becoming so aware, pay that amount of money out of the segregated account (section 10).
11. Section 8(1) of the CMR provides that a standing authority is a written notice that (a) is given to the licensed corporation by the client; (b) authorizes the licensed corporation to deal with client money from time to time received from or held on behalf of the client in one or more specified ways; (c) unless the client giving the standing authority is a professional investor, specifies a period not exceeding 12 months during which it is valid; and (d) specifies the manner in which it may be revoked.
 12. In the Frequently Asked Questions about the “Client Money Rules” issued by the SFC on 17 March 2003³, the SFC specifically reminds licensed corporations that the CMR requires segregation of client money in a segregated account maintained in Hong Kong with an authorized financial institution. Client’s written direction or standing authority must be obtained if client money received or held in Hong Kong is to be transferred and segregated outside Hong Kong.

Failure to maintain client money in segregated accounts and not transfer out except in accordance with a written direction or standing authority from the client

13. Our investigation found that, in March and April 2021, XHK made net transfers totalling approximately HK\$206 million of client money⁴ from its segregated accounts to its overseas brokers’ accounts. XHK designated these funds as “buffer money” intended to facilitate client trading activities⁵.
14. The overseas brokers’ accounts were not accounts established and maintained with an authorized financial institution or any other person approved by the SFC, as required under sections 4(1) and (2) of the CMR.
15. XHK relied on provisions in its Terms of Business, signed by the client, as the purported standing authority for these transfers. The Terms of Business provided that XHK “will keep, transfer or deposit such Money as may be required to place Orders, enter into Contracts or carry out any Transactions from time to time, on or to one or more accounts maintained with, the relevant Counterparty/-ies or Delegate for trading purposes ...” and “may ... deposit all or part of the Client Money ... to or with such Delegate(s).”

³ <https://www.sfc.hk/en/faqs/intermediaries/supervision/Client-Money-Rules/17-Mar-2003---Client-Money-Rules#302D1B0031CE497EAD7151EC6362339C>

⁴ The client money in issue related to one client, which was an institutional professional investor at the time.

⁵ XHK explained that its operating model requires access to multiple stock and futures exchanges. As XHK is not a participating member of these exchanges, it must transfer client money to other liquidity providers to execute transactions. Thus, in order to avoid execution and liquidity problems, some client money was maintained in the accounts of its overseas brokers as buffer money.

16. However, the Terms of Business did not meet all the applicable requirements set out in section 8(1) of the CMR. Specifically, they failed to specify the manner in which the standing authority could be revoked by the client. As such, the Terms of Business do not constitute a valid standing authority for the purposes of the CMR.
17. By transferring client money out of segregated accounts to its overseas brokers' accounts in the absence of a written direction or valid standing authority from the client, XHK has breached sections 4 and 5 of the CMR.
18. In September 2021, XHK enhanced the process by creating a client money standing authority which also sets out the manner in which it can be revoked by a client.

Delay in transferring commissions out of segregated accounts

19. Between February 2019 and October 2021, XHK executed approximately 611,726 transactions for 212 clients, generating total commission income of around HK\$38 million.
20. XHK booked and reflected commissions on client trades on clients' trading accounts in real time. However, XHK continued to retain these commissions in segregated accounts and only transferred the accumulated amounts to its house account on a monthly basis. As a result, XHK was holding non-client money in segregated accounts for extended periods.
21. By failing to transfer commissions out of segregated accounts within one business day of becoming aware that such amounts were not client money, XHK has breached section 10 of the CMR.
22. In around October 2021, XHK implemented the process of conducting daily transfer of the commissions from segregated accounts to the house account.

Delay in transferring interest income out of segregated accounts

23. During the period from February 2019 to October 2021, there were 184 instances in which XHK transferred bank interest on client money held in segregated accounts to its house accounts, involving a total of around HK\$10,000. However, the transfers were not made within one business day after XHK became aware that interest had been credited to the segregated accounts, contrary to section 6(2) of the CMR.
24. In November 2021, XHK implemented the process of transferring bank interest out of segregated accounts within one business day upon receiving from the banks.

The SFC's findings

25. XHK's conduct breached the FRR and the CMR, as well as:
 - (a) General Principle (GP) 2 (Diligence) of the Code of Conduct as it failed to act with due skill, care and diligence, in the best interests of its clients and the integrity of the market in conducting its business activities.

- (b) GP 3 (Capabilities) and paragraph 4.1 (Fit and proper staff) of the Code of Conduct as it failed to employ qualified and competent staff to ensure compliance with the FRR and the CMR;
- (c) GP 7 (Compliance) and paragraph 12.1 (Compliance: in general) of the Code of Conduct as it failed to comply with, and implement and maintain measures appropriate to ensuring compliance with the FRR, the CMR and the Code of Conduct; and
- (d) GP 8 (Client Assets) and paragraph 11.1 (Handling of client assets) of the Code of Conduct as it failed to ensure that client assets are promptly and properly accounted for and adequately safeguarded.

Conclusion

- 26. Having considered all relevant circumstances, the SFC is of the opinion that XHK is guilty of misconduct.
- 27. In deciding the disciplinary sanction set out in paragraph 1 above, the SFC has taken into account all relevant circumstances, including:
 - the duration and extent of XHK's failures;
 - XHK has taken remedial measures to enhance its procedures and processes for compiling financial returns and segregating client money;
 - no client has suffered loss as a result of XHK's failures;
 - XHK's otherwise clean disciplinary record; and
 - XHK's co-operation with the SFC and acceptance of the SFC's findings and disciplinary action facilitated resolution of the matter.