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## STATEMENT OF DISCIPLINARY ACTION

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### The disciplinary action

1. The Securities and Futures Commission (**SFC**) has reprimanded and fined Citigroup Global Markets Asia Limited (**CGMAL**)<sup>1</sup> HK\$348.25 million pursuant to section 194 of the Securities and Futures Ordinance (**SFO**).
2. The disciplinary action is taken in respect of CGMAL's serious regulatory breaches and internal control failures in relation to issuance of Indications of Interest (**IOIs**) and client facilitation activities by its Cash Equities business (**Business**), which included the High Touch Equities Sales Trading Desk (**HT Desk**), Programme Trading Desk, Electronic Execution Desk, Multi-Product Trading Team and Facilitation Desk (collectively, the **Desks**), from 2008 to 2018.

### Summary of facts

#### A. Discovery of the misconduct

3. During an on-site inspection conducted by the SFC in October / November 2018 (**2018 Inspection**), CGMAL was asked to submit trade data and client communication records in respect of a number of sample trades executed by the HT Desk.
4. Upon reviewing the relevant trade data, CGMAL's Independent Compliance Risk Management (**Compliance**) noted that certain traders appeared to have made misrepresentations to clients in the course of executing some of the sampled facilitation trades. CGMAL commenced an internal investigation into the potential conduct issues as well as its controls and monitoring framework with respect to facilitation trading.

#### B. Mislabelled IOIs

5. According to CGMAL's internal investigation report, since at least 2008, the HT Desk had sent IOIs tagged as "Natural", "In Touch With" and / or "P:1" to clients when there was no genuine client interest or specific client that CGMAL was in touch with (**Mislabelled IOIs**)<sup>2</sup>.
6. The Mislabelled IOIs were generated with reference to certain percentage of the average daily volumes of selected blue-chip stocks in the market. The

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<sup>1</sup> CGMAL is licensed under the SFO to carry on Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts), Type 6 (advising on corporate finance) and Type 7 (providing automated trading services) regulated activities.

<sup>2</sup> According to the AFME/IA Framework for Indications of Interest (**AFME Framework**) issued by the Association for Financial Markets in Europe and the Investment Association in March 2017, "P:1" or "In Touch With" IOIs can be issued where there is a reasonable expectation of interest from a specific client and resulting trades are expected to be of a riskless nature. Since early 2017, CGMAL represented to clients that the AFME Framework was adopted in classifying and qualifying its IOIs.

purpose was to provoke client enquiries with a purported belief that traders would be able to find natural opposite flows to cross with the client order given the active trading of the stocks and the size of CGMAL's trading platform. The Facilitation Desk would step in to provide liquidity when traders failed to source natural liquidity upon client enquiry.

7. In 2015, the then head of the HT Desk (**X**) introduced an Excel spreadsheet with built-in macros to allow bulk generation and uploading of Mislabeled IOIs by reference to the top 30 or 40 most actively traded stocks in the market on the previous day (**Spreadsheet**). The list of Mislabeled IOIs would be shown to the then head of the Facilitation Desk for agreement before they were posted. This practice of using the Spreadsheet to generate and disseminate Mislabeled IOIs lasted until December 2018.
8. Contemporaneous correspondence reveals that X (who was promoted in 2016 as CGMAL's Head of Pan Asia Execution Services and an RO with supervisory duties over all the Desks) referred to the "In Touch With" and "P:1" IOIs generated using the Spreadsheet as "*fake flow*" or "*the fakes*". The SFC's investigation also revealed that the heads and members of the Desks, as well as CGMAL's senior management knew or must have known that such IOIs were not backed by any reasonable expectation of interest from a specific client, and therefore should not have been labelled as "In Touch With" or "P:1"<sup>3</sup>.
9. A number of clients had pointed out to CGMAL that it was unacceptable to advertise facilitation flow using "In Touch With" IOIs. A number of clients had complained about the quality and accuracy of CGMAL's IOIs and / or emphasised the importance of accuracy around IOIs in meetings with CGMAL. Although these complaints were recorded in writing and brought to the attention of Desks heads and members of CGMAL's senior management, none of them took any steps to investigate and address the client complaints and / or stop the dissemination of Mislabeled IOIs. This suggests that the dissemination of Mislabeled IOIs was intentional.
10. CGMAL's mislabelling of IOIs was not only contrary to the relevant industry guidelines that it claimed to have adopted but, more importantly, inconsistent with the fundamental principles of being honest with clients and treating clients fairly. The SFC is of the view that CGMAL has failed to:
  - (a) act honestly, fairly, with due skill, care and diligence, and in the best interests of their clients under General Principles 1 and / or 2 and paragraph 3.10 of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**);
  - (b) make adequate disclosure of relevant material information to clients under General Principle 5 of the Code of Conduct;
  - (c) avoid conflicts of interest and ensure fair treatment of clients under General Principle 6 and paragraph 10.1 of the Code of Conduct; and

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<sup>3</sup> The arrangement for the Facilitation Desk to step in to provide liquidity to clients reacting to such IOIs when needed also meant that such IOIs should not have been classified as natural.

- (d) ensure that any representations made and information provided to clients and advertisements are accurate and not misleading under paragraphs 2.1 and 2.3 of the Code of Conduct.

**C. Misrepresentation and non-disclosure to conceal the principal nature of facilitation trades**

11. The SFC has reviewed 174 sample facilitation trades executed by the Desks during the period from January 2014 to December 2018 and found that in 127 of the sample trades, 23 traders / heads of the Desks:
  - (a) gave factually incorrect information to the client or took positive steps to conceal the principal nature of the trade (i.e. express misrepresentation);
  - (b) made misleading statements that could be interpreted by the client as indicating that the trade would be executed on an agency basis, or remained silent notwithstanding some indication of the client's belief that the trade was an agency trade (i.e. misrepresentation by omission); and / or
  - (c) remained silent or were not explicit with the client about the involvement of the Facilitation Desk (i.e. non-disclosure) and failed to obtain client's consent before routing the client's order to the Facilitation Desk for execution.
12. This shows that the practice of making misrepresentations to clients about, or refraining from disclosing, the true nature of the trades existed at least since 2014, and dominated the facilitation trades conducted by CGMAL during the period examined<sup>4</sup>.
13. Some of the sample trades show that the traders had made misrepresentations or was not explicit with clients about the involvement of the Facilitation Desk in trades where the client was responding to a Mislabeled IOI. There were also instances where after a client found out that CGMAL had incorrectly advertised facilitation flow using natural or "In Touch With" IOIs, X continued to misrepresent that the IOI in question was correctly classified.
14. The SFC found that the main root cause for the Desks' misconduct was the commercial pressure faced by traders to solicit more business from clients and increase CGMAL's market share, which was a heavy directive from CGMAL's senior management. Clients generally prefer transactions on an agency basis (i.e. natural liquidity) over facilitation. By misrepresenting a facilitation trade as an agency trade or refraining from informing the client about the involvement of the Facilitation Desk, CGMAL could avoid "losing a trade" to a competitor.
15. The prevalence of the misrepresentation and non-disclosure among the Desks that lasted over an extended period of time exposed a culture within CGMAL which encouraged chasing revenue at the expense of basic standards of honesty and clients' interests. It is also a further demonstration that CGMAL has breached General Principles 1, 2, 5 and 6 and paragraphs 2.1, 3.10 and 10.1 of the Code of Conduct (see paragraph 10 above). Such conduct is also

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<sup>4</sup> The SFC has not reviewed any facilitation trades prior to 2014, as CGMAL no longer retained audio records for such period.

contrary to paragraph 3.2 of the Code of Conduct, which requires a licensed person to execute client orders on the best available terms.

#### **D. Internal control failures**

16. The prevalence of the dishonest behaviour among the Desks over a period in excess of 10 years, which CGMAL's first and second lines of defence failed to detect until the internal investigation triggered by the 2018 Inspection, exposed serious and systemic lapses across CGMAL's governance and controls framework.
17. CGMAL had a number of opportunities to identify and rectify the misconduct of the Desks set out in sections B and C above as well as the internal control failures set out in paragraphs 20 to 37 below (collectively, the **Misconduct**) since at least 2014:
  - (a) In July 2014, CGMAL's senior management attended a roundtable meeting with the SFC, during which attendees' attention was drawn to common deficiencies found in client facilitation activities in the market, including missing explicit client consent and lack of independent checking of client consent.
  - (b) On 14 February 2018, the SFC issued a circular to licensed corporations on client facilitation (**2018 Circular**) to remind intermediaries that when they assume a risk-taking principal position in client facilitation activities, the nature of the trades should be disclosed to clients and their prior consent obtained so that they would be fully aware of the inherent conflicts of interest. The 2018 Circular also states that IOIs should only be disseminated when they are based on a genuine client or proprietary intent to trade, they should provide sufficient details, and controls and monitoring should be implemented to ensure they are accurate and updated in a timely manner.
18. Although CGMAL conducted a gap analysis following the roundtable meeting in 2014 and a further gap analysis after the publication of the 2018 Circular (**2018 Gap Analysis**), it failed to identify and rectify the Misconduct until its discovery during the 2018 Inspection.
19. Since then, CGMAL has taken remediation steps and enhancement measures to rectify and strengthen its internal controls in respect of IOIs and client facilitation activities, including the appointment of an independent reviewer to review and validate its controls framework.

#### ***Lack of internal controls relating to "In Touch With" IOIs***

20. The SFC found that, prior to 2018, CGMAL did not have any policies to guide and monitor its issuance of IOIs, or any controls to ensure that the traders properly understood and followed the relevant industry guidelines that it claimed to have adopted (see footnote 2 above).
21. Although CGMAL started to implement some procedures to ensure the accuracy of certain type of IOIs after the publication of the 2018 Circular, "P:1" IOIs were left out as neither Business nor Compliance saw the need to

implement any procedures to check that “P:1” IOIs were backed by specific client interest.

***Inadequate / failure to enforce internal guidelines in relation to pre-trade disclosure of and client consent for facilitation activities***

22. Prior to 2018, various versions of CGMAL’s internal policies purportedly required the traders to make pre-trade disclosure and / or obtain client consent before executing a facilitation trade. However, the SFC’s investigation revealed that such requirements were not enforced in practice.

23. In particular:

(a) Since at least September 2011, the language prescribed by CGMAL’s internal guidelines for making disclosure was along the line “*We buy / sell 5 million 1234.hk from / to you at VWAP / X (price)*” (**Prescribed Language**).

(b) Since mid-2014, traders were permitted / instructed by Compliance to make disclosure / obtain client consent by sending a Bloomberg message or email to the client, which stated that “*one or more affiliates of Citi may have acted on either partially or fully principal basis*” (**Bloomberg Notification**), after the execution of a facilitation trade (including where an “In Touch With” IOI turned out to have been executed against the Facilitation Desk) as long as it was sent no later than 5 pm.

(c) Since at least September 2015, CGMAL automated the following FIX message which would be sent to the client whenever an order was received through FIX<sup>5</sup> (**Auto FIX Message**):

*“Unless separately agreed, Citi may transact this order with you either partially or fully on a principal basis.”*

24. The Prescribed Language, Bloomberg Notification and Auto FIX Message were equivocal and insufficient for the purposes of informing clients that CGMAL would be acting on a principal basis and / or obtaining their prior consent for facilitation trades. The vagueness of the Prescribed Language, Bloomberg Notification and Auto FIX Message was aggravated by the fact that:

(a) X and other traders had represented to clients that their use and sending of the Prescribed Language / Bloomberg Notification did not mean that the client’s order was facilitated but was a precautionary measure to protect themselves;

(b) it was the practice of some traders to send the Bloomberg Notification to a client regardless of whether the client’s order was facilitated or crossed with natural liquidity; and

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<sup>5</sup> Financial Information eXchange (**FIX**) is an electronic communications protocol for the international real-time exchange of securities transaction information.

- (c) the Auto FIX message was sent to every client who placed its order with CGMAL via FIX as part of order acknowledgment, regardless of whether the order would be executed by CGMAL on an agency or principal basis.

***Deliberate exclusion of the requirement for prior client consent for facilitation trades from internal guidelines***

- 25. Despite the 2018 Circular and 2018 Gap Analysis, CGMAL deliberately excluded the consent requirement in at least two revisions of CGMAL's internal guidelines in relation to client facilitation in 2018.
- 26. The exclusion was suggested / endorsed by Compliance, which wrongly advised Business that a client could be deemed to have given implied consent if it continued to trade with CGMAL after receiving the Auto FIX Message and Bloomberg Notification without raising any objection. Such view was misconceived and directly in contradiction with the 2018 Circular.

***Ineffective compliance monitoring***

- 27. CGMAL had no compliance monitoring at all with respect to both the accuracy of IOIs and the disclosure of CGMAL's capacity in and obtainment of client consent for facilitation trades prior to 2014.
- 28. Since around mid-2014, Compliance started to check whether traders had sent the Bloomberg Notification for facilitation trades executed on the same day. However, this was ineffective for the purpose of ensuring that the traders had made pre-trade disclosure of CGMAL's principal capacity and obtained clients' prior consent for facilitation activities.

***Lack of training***

- 29. CGMAL did not provide any training or guidance to traders on the categorization of IOIs or how traders should communicate with clients when they responded to CGMAL's IOIs. Likewise, Compliance training in relation to facilitation trading activities did not mention the need to obtain prior client consent.
- 30. The lack of training contributed to the traders' failure to adhere to the applicable regulatory requirements.

***Communications between agency and facilitation traders not recorded / monitored***

- 31. The 2018 Circular provides that, for client facilitation orders, communications between agency and client facilitation traders should be recorded and monitored on a timely basis. However, this requirement was excluded from CGMAL's internal guidelines as management considered that it was unnecessary, given that traders' telephone lines were recorded.
- 32. In practice, CGMAL's agency traders usually communicated with facilitation traders by shouting across the trade floor. As such, their communications were neither recorded nor monitored.

***Insufficient segregation between agency and facilitation desks***

33. Although CGMAL's internal guidelines provided that the Facilitation Desk should not have system view access to agency order flow information and agency desks should only share client orders with the Facilitation Desk upon client's request for facilitation, the SFC found that:
- (a) The HT Desk showed the head of the Facilitation Desk a list of "In Touch With" IOIs generated using the Spreadsheet every morning. The list sometimes contained IOIs referable to specific clients.
  - (b) There were instances where the traders shared agency flow information with the Facilitation Desk without the client's knowledge.
34. The above practices show that CGMAL failed to ensure sufficient segregation between its agency desks and the Facilitation Desk.

***Incorrect tagging of trading capacities in the FIX system***

35. FIX Tag 29, a field showing the capacity in which a broker executed the order, has been included in CGMAL's FIX messages to clients since January 2008<sup>6</sup>.
36. The SFC's investigation revealed that the FIX Tag 29 wrongly showed that CGMAL executed a facilitation trade as agent in over 90% of the sample facilitation trades reviewed (see paragraph 11 above). CGMAL attributed the errors to a number of issues with the configuration of its systems in different points in time since November 2011.
37. Although a limited review of the business activities of CGMAL conducted by the SFC between September 2014 and January 2015 had identified certain red flags concerning the tagging of CGMAL's trading capacities in various internal systems, the issues with FIX Tag 29 were not discovered until January 2019, when CGMAL reviewed its facilitation activities following the 2018 Inspection.

***The SFC's concerns***

38. In light of the matters set out in paragraphs 16 to 37 above, the SFC is of the view that CGMAL has failed to:
- (a) comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of clients, in breach of General Principle 7 and paragraph 12.1 of the Code of Conduct;
  - (b) supervise diligently persons employed or appointed by it to conduct business on its behalf, in breach of paragraph 4.2 of the Code of Conduct;
  - (c) have internal control procedures and operational capabilities which can reasonably be expected to protect its operations and clients from financial loss arising from dishonest acts, professional misconduct or omissions, in breach of paragraph 4.3 of the Code of Conduct;
  - (d) establish and maintain policies and procedures to ensure the firm's compliance with all applicable regulatory requirements as well as with the

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<sup>6</sup> When CGMAL received an order via FIX, an automatic FIX message would be sent back to the client after execution of the order. Details of the execution were represented under different FIX tags.

firm's own internal policies and procedures, in breach of Part V of the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (**Internal Control Guidelines**);

- (e) establish and maintain specific policies and procedures to minimize and ensure prior disclosure of conflicts of interest between the firm and clients, in breach of paragraphs 4 and 5 of Part VII of, and paragraph 6 of the Appendix to Internal Control Guidelines; and
  - (f) comply with the 2018 Circular.
39. The breakdown in CGMAL's internal controls exposes serious supervision failures on the part of CGMAL's senior management, who failed to discharge their duties to properly manage the risks associated with the Business and ensure the maintenance of appropriate standards of conduct and adherence to proper procedures by the firm, in breach of General Principle 9 and paragraph 14.1 of the Code of Conduct.

#### **E. Senior management responsibility<sup>7</sup>**

40. The SFC is of the view that the Misconduct was attributable to the failures by certain former members of CGMAL's senior management to discharge their supervisory duties. The SFC will commence disciplinary proceedings against these individuals in due course.

#### **Conclusion**

41. Having considered all relevant circumstances, the SFC is of the opinion that CGMAL is guilty of misconduct and its fitness and propriety to carry on regulated activities have been called into question.
42. In deciding the disciplinary sanction set out in paragraph 1 above, the SFC has had regard to its Disciplinary Fining Guidelines and has taken into account all relevant circumstances, including:
- (a) the dissemination of Mislabeled IOIs, misrepresentation of the source of liquidity when executing facilitation trades and the exclusion of the requirement for prior consent for facilitation trades from CGMAL's internal guidelines were dishonest and intentional;
  - (b) the duration of the misconduct exceeded 10 years and only came to light as a result of the 2018 Inspection;
  - (c) CGMAL's senior management turned a blind eye to the misconduct by allowing the Desks to adopt Mislabeled IOIs and perpetrate misrepresentation with a view to achieving business growth;
  - (d) CGMAL's compliance function failed to properly discharge its duties;

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<sup>7</sup> The SFC is of the view that senior management of a licensed corporation includes, among others, directors of the corporation, responsible officers of the corporation, and Managers-In-Charge of Core Functions. See the SFC's circular to licensed corporations regarding measures for augmenting the accountability of senior management dated 16 December 2016.



- (e) CGMAL has since then taken disciplinary actions against and summarily dismissed employees who had engaged in the misconduct;
- (f) CGMAL has taken remediation steps and enhancement measures to stop the misconduct and address the SFC's regulatory concerns;
- (g) CGMAL's cooperation with the SFC in resolving the SFC's concerns and accepting the SFC's findings and disciplinary action; and
- (h) a strong message needs to be sent to the industry to deter other market participants from permitting similar failures to occur.