

# *IFA and SFC Investigations*

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# INTRODUCTION

What law and code regulate IFAs?

## Principal Sources

- Securities and Futures Ordinance (Cap. 571) (“Ordinance”) (Effective: April 2003)
- Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (“Code”) (Effective: April 2003)
- Fit and Proper Guideline
- Other codes & guidelines: SFC is empowered to publish such codes & guidelines as it considers appropriate (s.399 of the Ordinance)

# Regulated Activities

## 9 types of regulated activities

- Type 1 (dealing in securities)
- Type 2 (dealing in futures contracts)
- Type 3 (leveraged foreign exchange trading)
- Type 4 (advising on securities)
- Type 5 (advising on future contracts)
- Type 6 (advising on corporate finance)
- Type 7 (providing automated trading services)
- Type 8 (securities margin financing)
- Type 9 (asset management)

# Regulated Activities (Type 4)

Type 4 (advising on securities – 就證券提供意見 ) means:-

- a) giving advice on i) whether; ii) which; iii) the time at which; or iv) the terms or conditions on which, securities should be acquired or disposed of;
- or
- b) issuing analyses or reports relating to the above

# Regulated Activities (Type 4) (cont')

## But exclude (not regarded as Type 4 activities)

- A holding company giving advices/issuing reports to its subsidiary company or vice versa
- Type 1 (dealing in securities) licensed person giving advices/issuing reports incidental to the carrying out of Type 1 regulated activities
- Type 9 (asset management) licensed person or person who provides a service of managing a portfolio of securities under a collective investment scheme for another person

## Regulated Activities (cont')

- Solicitor, barrister, accountants acting in his/her professional capacity
- a trust company acting so in discharge of its duty
- a person giving advices/issuing reports through public media such as TV or newspaper etc.

# Regulated Person

- Licensed Representative (“LR”)
- Licensed Representative (temporary)
- Responsible Officer (“RO”)
- Licensed Corporation (“LC”)

# Licensed Representative

- application by an individual
- one or more regulated activity
- fit and proper

## **(s.120 of the Ordinance)**

- temporary licence to carry on one or more regulated activity (other than Type 3, 7, 8 & 9) for a period of not exceeding 3 months

## **(s.121 of the Ordinance)**



# Responsible Officers (“RO”)

- At least 2 ROs
- Fine of up to \$100,000 and a further fine of \$2,000 per day if breach continues, if no (or not enough) ROs.

## **(s.125 of the Ordinance)**

- LR can apply to be an RO
- Fit and proper person
- Has sufficient authority within the licensed corporation

## **(s.126 of the Ordinance)**

# General principles of the Code of Conduct

- GP1 Honesty and fairness
- GP2 Diligence
- GP3 Capabilities
- GP4 Information about clients
- GP5 Information for clients
- GP6 Conflicts of interest
- GP7 Compliance
- GP8 Client assets
- GP9 Responsibility of senior management

# The Code of Conduct applies to

- To all licensed or registered persons
- Conduct of persons depends on levels of responsibility, supervisory duties, levels of control or knowledge concerning any failure by their firms or persons under supervision

**(Paragraph 1.3)**

# Effect of breach of the Code

- The Commission will determine whether person is guilty of misconduct or is a fit and proper person to remain registered.

**(Paragraph 1.5)**

# Fit and Proper

- Persons applying for licenses and registrations under the Ordinance must be “fit and proper” persons
- “Fit and Proper” means financially sound, competent, honest, reputable and reliable
- Fit and Proper Guidelines
- SFC, in determining “fitness and properness”, will follow the Guidelines

# Fit and Proper from a legal perspective

Regard shall be made to –

- a) financial status or solvency
- b) educational, other qualifications or experience
- c) ability to carry on the regulated activity competently, honestly and fairly
- d) reputation, character, reliability and financial integrity

**(s.129 (1) of the Ordinance)**

# Power of SFC to take disciplinary action

- In case of misconduct or “not fit and proper”, SFC may revoke; or suspend license

**(s.194 of the Ordinance)**

## Power of SFC (cont')

- Publicly or privately reprimand the regulated person; or
- In addition, SFC may order to pay a fine; the greater of –
  - i) \$1 million
  - ii) 3 times the profit gain or loss avoided by the regulated person



# Principles of regulation taken by SFC

## Regulatory Philosophy of the SFC

- Firmness : firm action will be taken against persons who harm investors & market integrity
- Fairness : procedural fairness and natural justice for everyone
- Consistency : consistent in decisions/actions subject to special circumstances
- Proportionality : decisions and actions are proportionate or balanced. e.g. serious misconduct v.s. minor misconduct
- Negotiate: SFC maintains open dialogue and negotiation whenever possible

# **Q & A *Sessions***

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# Case study 1

## Breach:

- Diligence (GP2) of RO and LR

## Facts:

- Irregularity of warrants, prices sold at ridiculous levels, even higher than the underlying stocks. No sensible investor would be buying at such extremely high price levels

## Findings:

- RO failed to detect the irregular features of the transaction
- LR failed to make reasonable enquiries with clients despite knowledge of the irregular features of the transactions

# Case study 1 (cont')

## Conclusions:

- “Fitness and properness” of RO & LR was called into questions
- Suspension of RO & LR for 9 months and 6 months respectively

# Case Study 1 (cont')

Lesson:

- Where irregularity in trading is noted, one should make reasonable enquiries with clients whether there is any error in the dealing instructions and advise the clients of the irregularity accordingly
- If no error, one should ask the reason for the transactions to determine if they are legal or proper. If clients fail to satisfy the transactions are legal or proper, one should cease to trade on their behalf

# Case Study 2

Breach of Code :

- Conflict of interest (GP6) – LC and its director

Facts:

- Company introduced overseas funds to client and Mr. H was responsible for conducting due diligence
- Mr. H failed to notice warnings issued by overseas regulators
- Later, Mr. H became aware the Group faced liquidity problems but did not disclose this information to his clients
- Funds still being sold to clients and Mr. H placed himself in a conflict of interests

## Case Study 2 (cont')

### Conclusions:

- Mr. H's Company & Mr. H were guilty of serious misconduct and his "fitness and properness" were called into question
- Licences of Company & Mr. H to be revoked
- Following negotiation, Mr. H agreed to be suspended and resigned as a director of the Company and refrained from being involved in Company's management and operations

## Case Study 2 (cont')

### Lessons:

- Investment adviser should be vigilant
- Must act in the best interest of clients and avoid conflict of interest.
- Must disclose all material, relevant information whether favourable or otherwise



# Case Study 3

Breach of Code :

- Diligence (GP2), Capabilities (GP3), Information about clients (GP4) – LR, LC

Facts:

- Investors intended to retire and followed recommendation of LR to “gear up” 4 times their investment. Investors ended up losing more than their initial investment
- LR failed to consider suitability of investment strategy in view of
  - investors’ investment objective
  - risk profile and
  - financial circumstances

## Case Study 3 (cont')

### Conclusions:

- LC's fitness and properness was called into question and was reprimanded by SFC
- Although LR no longer licensed with SFC, he would be subject to SFC's disciplinary jurisdiction and have to answer SFC's concerns if reapply for licences in the future

## Case study 3 (cont')

### Lessons:

- It is Primary Duty of LR to ensure investment recommendations are reasonable
- LC has a duty to supervise their staff to ensure the investment recommendations are suitable for clients
- Written financial plan should be prepared and reviewed against the profile of an investor
- Investment advisers should take into account the investor's investment objective, risk profile and financial circumstances and whether the recommendation is in the interest of clients

# Case study 4

Breach of Code:

- Conflict of interest (GP6) – RO, LC

Facts:

- RO obtained funds from clients to finance LC's activities. She was aware of financial difficulties facing the LC
- RO clients were not told they were loaning money to a company in financial difficulties
- Clients' shares were pledged to LC's bankers and shares were sold by bank without clients' consent

## Case study 4 (cont')

### Conclusions:

- RO owes clients a positive duty to act in their best interests
- RO should ensure clients understand the nature of investment and the risk and evaluate clients' appetite for risk
- RO should also ensure client to invest on a fully informed basis
- Suspended for 5 years

## Case study 4 (cont')

### Lessons:

- Conflict of interest might be avoided if RO informed clients about the identity of the borrower, its financial situation and the risks involved
- RO obliged to inform clients of up-to-date financial position but not out-dated published accounts

# Case Study 5

## Breach:

- Capabilities (GP3) (improper conduct in handling internal client administration documents) - RO

## Facts:

- Discovered during routine inspection
- LR received commission for selling unit funds to clients whilst unregistered
- RO negligently signed on an internal client administration form as the consultant to a client when in fact the unlicensed representative was the consultant

## Case Study 5 (cont')

### Conclusions:

- RO was found breach of Code and being suspended for 1 month
- RO negotiated with SFC and SFC accepted voluntary payment in lieu of suspension



## Case study 5 (cont')

### Lessons:

- Even though the documents in question are internal company documents
- Licensees must take care to ensure all material paperwork we done properly SFC monitor compliance

# Case study 6

## Breach:

- Compliance (GP7) Assisting an unlicensed person to conduct regulated activities - LR

## Fact:

- A new recruit, despite company's instruction, engaged in regulated activities (opened a/c for clients, took and executed orders and gave investment advice to clients)
- LR assisted new recruit's unlicensed activities by signing as a witness in a/c opening documents, executing orders taken by new recruit etc.
- Company reported the matter to SFC following an internal investigation

## Case study 6 (cont')

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### Conclusions:

- LR was guilty of misconduct and his “fitness and properness” was called into question
- LR was reprimanded and fined \$21,000

## Case study 6 (cont')

### Lessons:

- Only licensed representative can conduct regulated activities on behalf of a LC
- When a LR changes employer, he has to obtain approval from SFC before he can carry on regulated activities with a new employer

# Case study 7

Breach:

- Diligence (GP2), Information about clients (GP4)

Facts:

- LR claimed to have explained risk disclosure statement to a client during account opening but in fact he did not know the client
- LR had rebated commission to a person engaging in unregistered dealings and facilitated his illegal activity

## Case study 7 (cont')

### Conclusion:

- SFC concluded LR was guilty of misconduct and called into question about LR's "fitness and properness"
- 2 month suspension by SFC, reduced to 5 weeks upon appeal by LR

### Lesson:

- Witnessing documents to say that documents have been explained to a client whom one had never met is improper

# Case study 8

## Breach:

- Internal control failings, Compliance (GP7) – LC, RO

## Facts:

- LC re-pledged securities of clients to banks without valid authority from clients
- LC transferred interest accrued from client money to its own account without clients' consent
- Inadequate audit trails of client orders, inadequate monitoring of staff dealing accounts and inadequate supervision

## Case study 8 (cont')

### Conclusions:

- Failings were unintentional and a result of omissions and oversights
- RO should bear responsibility of the negligent failings
- Fitness and properness of LC & RO were called into question
- Upon negotiation, LC & RO were fined \$150,000 and \$30,000



# Case study 8 (cont')

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## Lessons:

- It is paramount for LC to have adequate internal controls
- RO has a duty to ensure adequacy of internal control

# Case study 9

Breach:

- Dishonesty – deceiving employer (GP1)

Facts:

- An LR, through an account opening in the name of his friend, conducted his own securities trading and earned bonuses from his employer to which he was not entitled
- An LR provided false information about his friend's background e.g. exaggerating his friend's income
- An LR deceived employer that he owned the account and recorded wrong information about his friend

## Case study 9 (cont')

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### Conclusions:

- Guilty of misconduct and “fitness and properness” was called into question
- Suspended for 4 months

## Case study 9 (cont')

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### Lessons:

- Complete honesty is expected from LR
- Dishonesty in any form or shape would cast doubt on a LR's reliability and will not be tolerated by the SFC

# **Q & A *Sessions***

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## **PLEASE NOTE**

The law and procedure on this subject are very specialised. This article is a general explanation for your reference only and should not be relied on as legal advice for any specific case. If legal advice is needed, please contact our solicitors.

## **請注意**

本題目之法律及程序十分專門。此文章只屬一般性之解釋，供你參考，而不應被依賴為關於任何特定事件之法律意見。如需法律意見，請與我所律師聯絡。

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