

## STATEMENT OF DISCIPLINARY ACTION

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### The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has reprimanded and fined South China Commodities Limited (**SCCL**)<sup>1</sup> \$4,800,000 pursuant to section 194 of the Securities and Futures Ordinance (**SFO**).
2. The disciplinary action is taken because SCCL failed to:
  - (a) perform adequate due diligence on the customer supplied systems (**CSSs**)<sup>2</sup> used by clients for placing orders, and assess and manage the associated money laundering and terrorist financing (**ML/TF**) and other risks;
  - (b) conduct proper enquiries on client deposits which were incommensurate with the clients' financial profiles declared in their account opening documents; and
  - (c) establish effective ongoing monitoring system to detect and assess suspicious trading pattern in client accounts.

### Summary of Facts

#### A. *Background*

3. The SFC received complaints against various licensed corporations (**LCs**), including SCCL, for allowing clients to place orders to their broker supplied system (**BSS**)<sup>3</sup> through a software called Xinguanjia (**XGJ**). XGJ was developed and/or provided by Hengxin Software Limited.
4. The complainants alleged that XGJ permitted the LCs' clients to create sub-accounts under their accounts maintained with the LCs, and the clients had solicited investors in Mainland China to trade through the sub-accounts via XGJ without having to open separate securities accounts with the LCs in Hong Kong.
5. Between June 2017 and October 2018 (**Relevant Period**), SCCL has permitted 19 clients to use their designated CSSs (including XGJ) for placing orders<sup>4</sup>. From June to October 2017, the number of futures contracts transacted by SCCL clients through orders placed via CSSs accounted for 89.4% of its total trading volume.

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<sup>1</sup> SCCL is licensed to carry on Type 2 (dealing in futures contracts) regulated activity under the SFO.

<sup>2</sup> CSSs are trading software developed and/or designated by the clients that enable them to conduct electronic trading through the internet, mobile phones and other electronic channels.

<sup>3</sup> BSSs are trading facilities developed by exchange participants or vendors that enable exchange participants to provide electronic trading services to investors through the internet, mobile phones, and other electronic channels.

<sup>4</sup> The CSSs were connected to SCCL's BSS through application programming interface (a set of functions that allows applications to access data and interact with external software components or operating systems).

- B. Failure to perform adequate due diligence on the CSSs and assess and manage the associated ML/TF and other risks*
6. Before allowing its clients to connect their CSSs to its BSS, SCCL would require its clients to complete an electronic trading user assessment form (**ETA form**). The ETA form required clients to, among other things:
- (a) confirm whether the CSS operated as a pure order routing system (ie, without any non-pure order routing function such as cross trade function, algorithmic trading function);
  - (b) confirm that there was no connection between the client's CSS and other internet trading facility which allowed third parties to place orders to SCCL;
  - (c) indicate whether the client's CSS was developed by a third party service provider and if so, whether the client had conducted due diligence before using the system to ensure compliance with the relevant regulatory requirements; and
  - (d) indicate whether the client had entered into a service agreement with the service provider and if so whether the service provider had a contractual obligation in relation to, among other things, system testing.
7. For those clients who did not complete the ETA form, SCCL would provide them with a demo account created in BSS to allow them to conduct compatibility testing with their CSSs.
8. Our investigation revealed that:
- (a) SCCL had not conducted any due diligence on the CSSs before allowing them to be connected to its BSS. Other than XGJ, SCCL did not know the names of these CSSs and whether any of the CSSs had the function to allow users to create or manage sub-accounts.
  - (b) SCCL claimed that it would permit the CSSs to be connected to its BSS if it was satisfied with the client's responses given in the ETA forms or upon receiving a client's verbal confirmation that they had performed the compatibility test. However:
    - (i) Only six out of 19 clients who used CSSs to place orders completed an ETA form.
    - (ii) Although SCCL claimed that it had relied on its clients' confirmation given in the ETA forms that (1) its CSS provider was contractually obliged to conduct system due diligence and relevant testing on the CSS, and (2) they had conducted conformance tests to ensure that the CSSs operated as designed, SCCL did not request any of its clients to confirm whether their CSS provider had in fact conducted the due diligence and testing or to provide supporting records. Nor did

SCCL have any record of the due diligence or conformance tests purportedly conducted on the CSSs by its clients.

(iii) While the ETA forms were for the purpose of enabling SCCL to assess whether it would allow its clients to place orders via the CSSs to its BSS, there were no details as to how the assessment was conducted.

(iv) For the clients from whom SCCL accepted verbal confirmations that they had performed compatibility testing, SCCL was unable to provide the SFC with any records of the testing or confirmation by the relevant clients. In any event, even if such testing was performed, they related to the compatibility of the CSSs with SCCL's BSS and would not constitute due diligence for the purpose of understanding the operation and features of each CSS.

(c) SCCL's BSS service provider had not conducted any due diligence or testing on the CSSs to examine their design and functions.

9. Without thorough knowledge of the features and functions of the CSSs, SCCL was not in a position to properly assess the ML/TF and other risks associated with the use of the CSSs and implement appropriate measures and controls to mitigate and manage such risks.

10. In the absence of proper control over the use of CSSs by its clients, SCCL has exposed itself to the risks of improper conduct such as unlicensed activities, money laundering, nominee account arrangement and unauthorized access to client accounts.

C. *Failure to conduct proper enquiries on client deposits which were incommensurate with the clients' financial profiles*

11. The SFC's review of the fund movements in sample client accounts showed that the amounts of deposits made into the accounts of four clients (**Four Clients**) were incommensurate with their financial profiles declared in their account opening documents, which were unusual and/or suspicious (**Anomalies**).

12. SCCL claimed that firstly, it was not aware of the Anomalies during the Relevant Period; and secondly, a former responsible officer (**RO**) monitored the activities in the Four Clients' accounts on a daily basis (**Daily Monitoring**). SCCL also submitted that its Credit Department monitored the trading activities of its clients in accordance with its credit policies and would notify the Compliance Department of any abnormal trading frequency and hours by its clients. SCCL further stated that its Settlement Department and Finance Department reviewed the fund deposit and withdrawal of clients' accounts to monitor any abnormal or irregular transactions.

13. However, the measures in paragraph 12 above could not resolve the concerns associated with the Anomalies:

(a) SCCL has not maintained any record of the Daily Monitoring.

- (b) In the absence of any record, it is not clear what enquiries were made and how they enabled SCCL to detect unusual fund movements in client accounts. SCCL is unable to demonstrate that it has made proper enquiries with the Four Clients and satisfactorily addressed the concerns associated with the Anomalies.
- (c) The monitoring allegedly conducted by SCCL's Credit Department is not relevant to its monitoring of client deposits to ensure that they are commensurate with the clients' financial profiles. Similarly, while SCCL claimed that its Settlement Department and Finance Department had reviewed the fund deposit and withdrawal of clients' accounts, such monitoring appears to have been ineffective given it did not detect the Anomalies.

*D. Failure to maintain effective ongoing monitoring system to detect and assess suspicious trading patterns in client accounts*

- 14. The SFC's review of the transactions in sample client accounts showed that there were 3,783 self-matched trades (ie, the client's order matched with his/her own order in the opposite direction) (**Matched Trades**) in nine client accounts during the period from June to October 2017.
- 15. SCCL claimed that it had implemented various pre-trade and post-trade controls and monitoring processes to monitor and detect suspicious trading activities of its clients. However, these appear to be neither adequate nor effective:
  - (a) The pre-trade controls appear to have focused only on whether clients were able to meet margin requirements and whether their trading was within their credit limit and/or trading limit.
  - (b) SCCL applied a "self-matching prevention" functionality in respect of futures trades conducted by its clients on the Chicago Mercantile Exchange (**CME**), to avoid self-matching trades, but this was only launched in October 2017 and applied to trades conducted on CME only.
  - (c) SCCL failed to maintain adequate records to demonstrate its monitoring of clients' activities to detect any unusual or suspicious transactions and its compliance with the Guideline on Anti-Money Laundering and Counter-Terrorist Financing (April 2015 and March 2018 editions) (**AML Guideline**):
    - (i) SCCL was unable to confirm whether it was aware of the Matched Trades because of the departure of a former RO. SCCL's reliance upon individual staff members to maintain records of its monitoring of suspicious transactions was unsatisfactory.
    - (ii) Although SCCL claimed that (1) it had sent trade confirmations in October 2017 to two of the clients in whose accounts Matched Trades were found, with a view to confirm that the trades were conducted by them, and (2) telephone enquiries were made by a former staff member with the relevant clients, SCCL did not receive any reply to the trade confirmations and

could not locate the telephone recordings relating to the trade confirmations or even confirm whether the telephone enquiries were in fact made with the two clients. In any event, the trade confirmations did not mention the Matched Trades in the relevant clients' accounts or make enquiries about the unusual or suspicious nature of their trading activities.

16. The inadequacy and ineffectiveness of SCCL's systems and controls for monitoring and detecting suspicious transactions was corroborated by its failure to detect the Matched Trades.

### **The SFC's findings**

17. SCCL's failures set out above constitute a breach of:
- (a) General Principle (**GP**) 2 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**), which requires an LC to act with due skill, care and diligence, in the best interests of its clients and integrity of the market in conducting its business activities.
  - (b) GP 3 and paragraph 4.3 of the Code of Conduct, which provide that an LC should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities and have internal control procedures and operational capabilities 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.
  - (c) Paragraph 5.1 of the Code of Conduct which requires an LC to take all reasonable steps to establish the true and full identity of each of its clients, and of each client's financial situation, investment experience, and investment objectives.
  - (d) Section 23 of Schedule 2 to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (**AMLO**) and paragraph 2.1 of the AML Guideline, which require an LC to mitigate the risks of ML/TF and prevent contravention of any client due diligence and record keeping requirements under the AMLO. To ensure compliance with this requirement, the LC should:
    - (i) establish and implement adequate and appropriate internal anti-money laundering (**AML**) and counter-financing of terrorism (**CFT**) policies, procedures and controls pursuant to paragraph 2.2 of the AML Guideline; and
    - (ii) assess the risks of any new products and services (especially those that may lead to misuse of technological developments or facilitate anonymity in ML/TF schemes) before they are introduced and ensure appropriate additional measures and controls are implemented to mitigate and manage the associated ML/TF risks pursuant to paragraph 2.3 of the AML Guideline.
  - (e) Section 5(1)(a) of Schedule 2 to the AMLO and paragraphs 4.7.12 and 5.1(a) of the AML Guideline, which require an LC to review from time

to time client information to ensure that they are up-to-date and relevant when a significant transaction is to take place or a material change occurs in the way the client's account is operated.

- (f) Section 5(1)(b) of Schedule 2 to the AMLO and paragraph 5.1(b) of the AML Guideline, which require an LC to continuously monitor its business relationship with the clients by monitoring their activities to ensure that they are consistent with its knowledge of the clients and the clients' nature of business, risk profile and source of funds.
- (g) Section 5(1)(c) of Schedule 2 to the AMLO and paragraphs 5.1(c), 5.10 and 5.11 of the AML Guideline, which require an LC to identify transactions that are complex, large or unusual or patterns of transactions that have no apparent economic or lawful purpose, make relevant enquiries to examine the background and purpose of the transactions, document the enquiries made (and their results), and report the findings to the Joint Financial Intelligence Unit where there is any suspicion of ML/TF. Pursuant to paragraph 7.11 of the AML Guideline, where a transaction is inconsistent in amount, origin, destination, or type with a client's known, legitimate business or personal activities, the transaction should be considered as unusual and the LC should be put on alert<sup>5</sup>.

## Conclusion

- 18. Having considered all relevant circumstances, the SFC is of the opinion that SCCL is guilty of misconduct and its fitness and properness to carry on regulated activities have been called into question.
- 19. In deciding the disciplinary sanction set out in paragraph 1 above, the SFC has taken into account all of the circumstances, including:
  - (a) SCCL's failures to diligently monitor its clients' activities and put in place adequate and effective AML/CFT systems and controls are serious as they could undermine public confidence in, and damage the integrity of, the market;
  - (b) a strong deterrent message needs to be sent to the market that such failures are not acceptable;
  - (c) SCCL has taken remedial measures to enhance its internal systems and controls;
  - (d) SCCL cooperated with the SFC in resolving the SFC's concerns; and
  - (e) SCCL's otherwise clean disciplinary record.

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<sup>5</sup> Examples of situations that might give rise to suspicion are given in paragraphs 7.14 and 7.39 of the AML Guideline, such as (a) transactions or instructions which have no apparent legitimate purpose and/or appear not to have a commercial rationale; (b) buying and selling of securities/futures with no discernible purpose or where the nature, size or frequency of the transactions appears unusual; and (c) the entry of matching buys and sells in particular securities or futures or leveraged foreign exchange contracts (wash trading), creating the illusion of trading. Such wash trading does not result in a bona fide market position, and might provide "cover" for a money launderer.