

## STATEMENT OF DISCIPLINARY ACTION

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### The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has publicly reprimanded China Everbright Securities (HK) Limited (**CESHK**) and fined it HK\$2.5 million pursuant to section 194 of the Securities and Futures Ordinance.
2. The disciplinary action is taken because CESHK has pledged client securities for financial accommodation provided to CESHK without the clients' valid authority and in breach of:
  - (a) General Principle 8 and paragraph 11.1(a) of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**); and
  - (b) sections 7, 8 and 10 of the Securities and Futures (Client Securities) Rules (**CSR**).

### Summary of Facts

3. CESHK obtains a standing authority from its clients at the time when they open an account which authorizes CESHK to:
  - (a) deposit their securities collateral with an authorized financial institution as collateral for financial accommodation provided to CESHK; and
  - (b) deposit their securities collateral with a recognized clearing house as collateral for the discharge and satisfaction of CESHK's clearing and settlement obligations and liabilities.
4. On 20 August 2018, CESHK made a self-report to the SFC regarding its failure to renew its clients' standing authority which expired on 31 March 2018 (**Incident**).
5. In light of CESHK's self-report, the SFC conducted an investigation and found that, during the period from 1 April 2018 to 19 August 2018 (**Relevant Period**):
  - (a) CESHK continued to rely on the standing authority given by around 6,841 clients (**Affected Clients**) which had expired on 31 March 2018 to pledge their securities with three banks in Hong Kong (**Relevant Financial Institutions**) as collateral for financial accommodation provided to CESHK; and
  - (b) the aggregate market value of the securities pledged by CESHK amounted from around HK\$189 million to HK\$1,214 million, which included securities belonging to the Affected Clients and the securities belonging to clients whose standing authority remained valid (**Unaffected Clients**).
6. When asked to explain the circumstances leading to the Incident, CESHK informed the SFC that:

- (a) Starting from late 2017, China Everbright Securities International Group (of which CESHK is a member) and Everbright Sun Hung Kai Group (**EBSHK Group**) were going through an amalgamation.
  - (b) In late February 2018, the Compliance Department of the EBSHK Group (**EBSHK Compliance**) was instructed to take over CESHK's compliance function.
  - (c) At CESHK, the standing authority renewal exercise was handled by its compliance team in or around March every year. At EBSHK, the same process was handled by its operations team in or around August every year.
  - (d) It was not highlighted to EBSHK Compliance that the standing authority of CESHK's clients should be handled by the compliance team.
  - (e) In mid-August 2018, when EBSHK Group began the process of renewing the standing authority of its clients, it discovered that CESHK had not delivered standing authority renewal notices to its clients at least 14 days before 31 March 2018 in respect of standing authority that had expired on 31 March 2018 pursuant to section 4(3) of the CSR.
7. On 20 August 2018, CESHK repaid the total outstanding loan balances under the secured banking facilities with the Relevant Financial Institutions and redeemed all pledged client securities.

### **Regulatory Requirements**

8. General Principle 8 and paragraph 11.1(a) of the Code of Conduct provide that:
- “GP8. Client assets***
- A licensed or registered person should ensure that client assets are promptly and properly accounted for and adequately safeguarded.”*
- “11.1 Handling of client assets***
- (a) *A licensed or registered person should, in the handling of client transactions and client assets, act to ensure that client assets are accounted for properly and promptly. Where the licensed or registered person or a third party on behalf of the licensed or registered person is in possession or control of client positions or assets, the licensed or registered person should ensure that client positions or assets are adequately safeguarded.”*
9. Section 6 of the CSR provides that an intermediary may deal with client securities or securities collateral of the intermediary that it receives or holds in accordance with, among other things, a standing authority (subject to certain exceptions).
10. Section 4(1) of the CSR provides that a standing authority is a written notice that, among other things:

- (a) is given to an intermediary to authorize it to deal with client securities or securities collateral from time to time received or held on behalf of the client in one or more specified ways; and
  - (b) unless the client giving the standing authority is a professional investor, specifies a period not exceeding 12 months during which it is valid.
- 11. Under section 4(3) of the CSR, a standing authority which is not revoked prior to its expiry:
  - (a) may be renewed for one or more periods not exceeding 12 months, if the client of the intermediary who gave it is not a professional investor; and
  - (b) the standing authority shall be deemed to have been renewed if at least 14 days prior to its expiry, the intermediary gives a written notice to the client reminding the client of its impending expiry and informing the client that unless the client objects, the standing authority will be renewed upon expiry upon the same terms and conditions as specified in the standing authority.
- 12. Sections 7 and 8 of the CSR prescribe the permissible forms of dealing with client securities or securities collateral received or held by the intermediary in relation to dealing in securities and providing securities margin financing, provided there is clients' standing authority. Among other things, sections 7 and 8 of the CSR allow an intermediary licensed for:
  - (a) dealing in securities and providing financial accommodation to clients; or
  - (b) securities margin financing,to deposit the client securities or securities collateral with an authorized financial institution as collateral for financial accommodation provided to the intermediary.
- 13. Section 10 of the CSR provides that an intermediary must take reasonable steps to ensure that client securities and securities collateral are not deposited, transferred, lent, pledged, repledged or otherwise dealt with except as provided in the CSR.

#### **Breaches and Reasons for Action**

- 14. By continuing to pledge the client securities with the Relevant Financial Institutions in the absence of clients' valid standing authority, CESHK has used clients' securities as collateral for financial accommodation provided to CESHK without clients' authorization and in breach of the regulatory requirements set out in paragraph 2 above.
- 15. Safe custody of client assets is a fundamental obligation of licensed corporations. Any transgression of this obligation, even if clients' funds/securities were subsequently returned to the client trust account, cannot be tolerated.
- 16. While the takeover of CESHK's compliance function by EBSHK Compliance might have contributed to CESHK's failure to renew its clients' standing authority, that does not exonerate CESHK from liability or lessen the seriousness of its failure.

17. Before allowing EBSHK Compliance to take over its compliance function, CESHK should have ensured that EBSHK Compliance was familiar with its operation and internal control procedures, so that it would be in the position to ensure the compliance with all applicable legal and regulatory requirements by CESHK.

## Conclusion

18. The SFC has decided to take the disciplinary action against CESHK as described in paragraph 1 above, after taking into account all relevant considerations, including:
  - (a) during the Relevant Period, CESHK has pledged client securities for financial accommodation provided to it without its clients' valid consent or authority;
  - (b) the value of the client securities pledged by CESHK amounted from around HK\$189 million to HK\$1,214 million, including the securities of the Affected Clients and the Unaffected Clients;
  - (c) the total financial accommodation obtained by CESHK from the Relevant Financial Institutions amounted from around HK\$100 million to HK\$490 million, i.e. around 9% to 51% of the market value of the client securities pledged by CESHK;
  - (d) the incident was mainly caused by the corporate restructure undertaken by CESHK and the miscommunication between CESHK's former and current compliance team members and there is no evidence of systemic failure on the part of CESHK;
  - (e) CESHK self-reported its breach to the SFC and redeemed all client securities upon discovering its breach;
  - (f) there is no evidence of client loss as a result of CESHK's regulatory breach; and

CESHK co-operated with the SFC in resolving its concerns and accepting the SFC's findings and disciplinary action.