SFC reprimands and fines North Sea Securities Limited $700,000

26 Jan 2017

The Securities and Futures Commission (SFC) has reprimanded North Sea Securities Limited (North Sea) and fined it $700,000 for failing to put in place proper controls to monitor and supervise employee dealings, in breach of the Code of Conduct (Notes 1 & 2).

The SFC found that from 4 to 27 December 2013, there were 25 cross trades between four accounts belonging to or controlled by two North Sea employees, for the purpose of delaying the settlement of their personal trades (Notes 3 & 4).

At the material time, North Sea had no written policy on employee dealings to, among other things, specify the conditions under which employees may deal for their own accounts and require employees to identify all related accounts and report them to the senior management. North Sea also did not adequately supervise and/or review employee dealings and cross trades. Therefore, North Sea was unable to identify accounts in which its employees held beneficial interests and monitor dealings in such accounts (Note 5).

Monitoring employee dealings is important for the detection and prevention of possible irregularities and/or market misconduct. The absence of any controls on employee dealings has not only facilitated North Sea's employees to conduct personal trades in client accounts, but also impeded the ability of North Sea to ensure the integrity of the market.

In determining the sanction, the SFC took into account that:

- North Sea co-operated with the SFC in resolving the SFC's concerns;
- there is no evidence that any client of North Sea has suffered any loss;
- North Sea agreed to engage an independent firm of reviewers to conduct review of its internal controls on employee dealings and on the supervision of staff in their trading activities; and
- North Sea has no previous disciplinary record with the SFC.

End

Notes:

1. North Sea is licensed under the Securities and Futures Ordinance (SFO) to carry on Type 1 (dealing in securities) regulated activity.
2. Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission
3. North Sea allowed their staff and clients to trade stocks on cash account basis, i.e. they could opt to settle the full amount of a purchase on T+2 or sell the stock and settle the loss (if any). However, by executing the cross trades in question, North Sea's employees could hold onto their positions for a longer period of time by only incurring transactional cost and any losses on each T+2 without having to settle the full amount of the purchase costs.
4. The cross trades in question did not, however, constitute market misconduct under the SFO.
5. Paragraph 12.2 of the Code of Conduct requires licensed corporations to implement procedures and policies on employee trading and to actively monitor the trading activities in their employees' accounts and their related accounts.

A copy of the Statement of Disciplinary Action is available on the SFC website

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STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has publicly reprimanded North Sea Securities Limited (**North Sea**) and fined it $700,000 pursuant to section 194 of the Securities and Futures Ordinance.

2. The disciplinary action is taken because North Sea has failed to put in place proper controls to monitor and supervise employee dealings.

Summary of facts

3. During its regular market surveillance, the Hong Kong Exchanges and Clearing Limited (**SEHK**) found that North Sea had conducted a number of unusual cross trades in a warrant NMCSA50@EC1402A (**DW25848**) during the period from 11 to 30 December 2013.

4. Upon receipt of SEHK's referral, the SFC conducted an investigation into the activities of North Sea. The SFC found that, on divers days between 4 and 27 December 2013, there were 25 cross trades between four accounts of North Sea in three warrants and four stocks.

5. The four accounts[1] belonged to or were controlled by two employees of North Sea (the **Employees**). The cross trades were conducted in these accounts for the purpose of delaying the settlement of their personal trades. The cross trades in question did not, however, constitute market misconduct under the Securities and Futures Ordinance:

   - The Employees invested in a number of warrants and stocks in December 2013 but the price of such warrants/stocks continued to fall.

   - Instead of settling the transactions on T+2, the Employees transferred their positions to other accounts by way of cross trades. By so doing, they could hold on to the positions for a longer period by only paying the difference between the purchase price (of the original transactions) and the sale price (of the cross trades), without having to settle the full amount of the transactions. This settlement arrangement was allowed by North Sea.

   - After Employee A transferred the position to an account controlled by Employee B, Employee B would try to offload the position to the market at a profit and account the profit to Employee A. If Employee B could not offload the position at a profit, Employee A would ask Employee B to transfer the position back to him by cross trades. Likewise, Employee A would do the same for Employee B after Employee B transferred his position to an account controlled by Employee A.

[1] Four accounts, i.e. one employee account and three client accounts which the Employees have been authorised by the relevant clients to operate.

Internal Control and Supervisory Failures

6. During the relevant period, North Sea allowed their staff and clients to trade stocks on cash account basis, i.e. they could opt to settle the full amount of a purchase on T+2 or sell the stock and settle the loss (if any). At the material time, North Sea had no written manual, guidelines, policy or procedure on employee dealings to, among other things, specify the conditions under which employees may deal for their own accounts and require employees to identify all related accounts and report them to senior management.

7. One of North Sea's responsible officers also confirmed that North Sea did not have any written regulations or procedures regarding employee dealing at the material time. Employees did not need to seek pre-approval before conducting personal trades, but they would submit a dealing ticket to the responsible officer upon completion of each transaction for monitoring purposes.

8. However, the checking of the dealing tickets in relation to the cross trades by North Sea has clearly failed to (a) identify that they were in fact personal trades belonging to the Employees; and (b) flag the cross trades for management attention despite their frequency and unusual pattern.

9. Monitoring employee dealings is important for the detection and prevention of possible irregularities and/or fraudulent activities, such as market manipulation, front running or other market misconduct. The absence of any controls on employee dealings has allowed the Employees to conduct personal trades in client accounts without being detected, which impeded the ability of North Sea to act in the best interests of market integrity.

10. Further, the fact that the responsible officers of North Sea approved the dealing tickets in relation to each of the 25 cross trades conducted between an employee account and three client clients controlled by the Employees during the period from 4 and 27 December 2013 without raising any concerns about them suggest that the management supervision of North Sea's business activities was not adequate.

11. Even if the first few cross trades did not arouse North Sea's suspicion, the subsequent similar incidents should have – particularly considering all four accounts involved either belonged to or were operated by the Employees. Had North Sea supervised the Employees diligently, it would likely have detected the unusual cross trades or at least instigated inquiries about them.

Breaches and reasons

12. As a licensed corporation, North Sea has a duty:

- under General Principle 2 of the Code of Conduct[2], to exercise due skill, care and diligence and to act in the best interests of its clients;

- under General Principle 3 of the Code of Conduct to have and employ effectively the resources and procedures which are needed for the proper performance of its business activities;

[2] Code of Conduct for Persons Licensed by or Registered with the SFC.

- under paragraph 4.2 of the Code of Conduct to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf;

- under paragraph 4.3 of the Code of Conduct, to have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients and other licensed or registered persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions; and

- under paragraph 12.2 of the Code of Conduct, to implement procedures and policies on employee trading and to actively monitor the trading activities in their employees' accounts and their related accounts.

13. In this case, North Sea, has breached:

    - General Principle 3, paragraph 4.3 and 12.2 of the Code of Conduct in failing to have in place and implement proper internal control procedures in relation to the regulation and monitoring of employee dealings; and

    - General 2 and paragraph 4.2 in failing to adequately supervise and/or review employee dealings and cross trades.

Conclusion

14. Having considered all the circumstances, the SFC is of the view that North Sea's fitness and properness as a licensed corporation has been called into question.

15. In deciding the disciplinary sanction, the SFC has had regard to the SFC Disciplinary Fining Guidelines and taken into account all relevant circumstances, including:

    - adequate internal procedures and controls are fundamental to the fitness and properness of a licensed corporation;

    - North Sea has failed to properly supervise the Employees and approved the repeated cross trades between the accounts controlled by the Employees without raising any concerns about the cross trades;

    - there is no evidence that any client of North Sea has suffered any loss;

    - North Sea co-operated with the SFC in resolving the SFC's concerns;

    - North Sea agreed to engage an independent firm of reviewers to conduct review of its internal controls on employee dealings and the supervision of staff in their trading activities; and

    - North Sea has no previous disciplinary record.