
STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has taken the following disciplinary action against Fulbright Securities Limited (**Fulbright**):
 - (a) publicly reprimanded Fulbright, pursuant to section 194(1)(b)(iii) of the Securities and Futures Ordinance (**SFO**); and
 - (b) imposed a financial penalty of HK\$3,600,000 on Fulbright, pursuant to section 194(2)(b) of the SFO.
2. The disciplinary action is taken because Fulbright failed to:
 - (a) put in place an effective system and control procedures to detect and prevent short selling¹; and
 - (b) report the short selling incidents to the SFC in a timely manner.

Summary of facts

3. In April 2016, the SFC received a complaint that Fulbright illegally short sold the shares of Ngai Shun Holdings Limited (stock code: 1246) on 8 April 2016.
4. As a result of the complaint, the SFC made preliminary enquiries with Fulbright and found 10 other oversold transactions during the period from January to March 2016. Fulbright explained that the oversold transactions were identified by its Risk Management System, an in-house on-line real time computer system, when those executed transactions exceeded the relevant stocks held by the client at the time of execution.
5. In July 2016, the SFC commenced an investigation into the conduct of Fulbright in relation to short selling.
6. The SFC investigation revealed that during the period from October 2015 to March 2016, there were at least 93 instances of short sales executed by Fulbright. Out of these 93 short sales, 83 were executed via the Multi-Workstation System (**MWS**) and at least 9 were executed via Broker Supplied System (**BSS**).
7. At all material times, Fulbright did not report the short sales to the SFC until the SFC made enquiries or during its investigation.

Breaches and reasons

Failure to prevent and detect short sales

¹ For the purpose of this statement of disciplinary action, the terms “short selling”, “short sales”, or “short sell” orders refer to the selling of a stock which the seller does not own or have the sufficient number of stocks in his or her inventory to sell.

8. As a licensed corporation, Fulbright was under a duty to exercise due skill, care and diligence to ensure it would carry on business in the best interests of its clients and market integrity under General Principle 2 of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**).
9. Fulbright should have internal control procedures and operational capabilities which could reasonably be expected to protect its operations, its clients and other licensed persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions under paragraph 4.3 of the Code of Conduct.
10. Fulbright should establish and maintain appropriate and effective procedures in relation to dealing and related review processes to prevent or detect errors, omissions, fraud and other unauthorized or improper activities under Paragraph 8 of Part VII of the Management, Supervision and Internal Control Guidelines For Persons Licensed by or Registered with the SFC (**Internal Control Guidelines**). Fulbright's management should also ensure that detailed policies and procedures pertaining to authorizations and approvals, as well as the authority of key positions were clearly defined and communicated to and followed by its staff under paragraph 4 of Part I of the Internal Control Guidelines.
11. Short sales or short selling orders may potentially result in illegal short sales in contravention of section 170 of the SFO, which creates a criminal offence for a person to sell securities at or through a recognized stock market unless at the time he sells them (a) he has or, where he is selling as an agent, his principal has; or (b) he believes and has reasonable grounds to believe that he has or, where he is selling as an agent, that his principal has a presently exercisable and unconditional right to vest the securities in the purchaser of them.
12. Fulbright should have therefore implemented adequate systems and controls to prevent and detect short selling.
13. Fulbright's submitted that it had the following policies, procedures and controls for preventing and detecting short sales:
 - (a) Fulbright relied on the integrity of its account executives as licensed representatives of the SFC and assigned dealers to monitor the account executives;
 - (b) Fulbright had a Risk Management System which could monitor and detect short sales after these had been executed;
 - (c) Fulbright had written policies and procedures in place namely, the Compliance Manual and Account Manager's Rules, to prevent and detect unlawful short selling;
 - (d) Fulbright had issued circulars to its staff members, stating its policy that all profits arising from error transactions, including oversold transactions would belong to Fulbright and all losses would be borne by the relevant account or dealer;
 - (e) Fulbright had issued warning letters to the account executives and dealers in relation to short sell orders; and

- (f) Fulbright gradually replaced the MWS terminals with BSS terminals by April 2017 with a view to enhancing its internal controls (the BSS terminals had a built-in mechanism which required the approval from Risk Management Department in order to sell shares that were not recorded on BSS but the MWS terminals did not have this function).
14. Notwithstanding such policies, procedures and controls, 93 short sales were executed by Fulbright during the period from September 2015 to March 2016.
15. At least 9 of the 93 short sales were executed on BSS, notwithstanding the built-in mechanism in BSS terminals described in paragraph 13(f) above. Fulbright's explanation for these short sales suggests that it did not have and/or failed to implement adequate and proper controls to enable it to detect and prevent short selling via BSS.
16. The 83 short sales executed on MWS similarly suggest that the various policies, procedures and controls that were put in place to prevent and detect short sales were either ineffective or not properly implemented:
- (a) Fulbright's reliance on the integrity of its account executives to prevent and detect short sales, and on dealers to monitor account executives, was unsatisfactory. While Fulbright allowed its account executives and dealers to access its portfolio viewing system so they could check their clients' stockholdings on a real time basis, its responsible officer did not know if the account executives and dealers would do so. In any event, the system could not prevent short selling, but only allowed the account executives and dealers to check the stockholdings for reference.
- (b) Fulbright's responsible officer also confirmed that its Risk Management System could not detect a short sell order at the moment the order was sent out, and could only identify a short sell trade *after* it had been executed. As such, the Risk Management System was clearly ineffective in preventing short sales.
- (c) While account executives or dealers were required to provide explanations for oversold transactions in the Error Trade Reports for the designated responsible officer's review, consideration and approval or rejection, it is unclear:
- (i) how the steps taken by Fulbright could effectively prevent and detect short selling. According to Fulbright, when the responsible officer received the Error Trade Reports, he would check whether each transaction appeared to be a genuine oversold transaction by enquiring with the relevant account executive or dealer about the reasons stated in the forms. If he found that the error trades were made owing to negligent handling, he would issue a warning letter; and
- (ii) how the criteria purportedly applied by the designated responsible officer in deciding whether an Error Trade Report should be approved could determine whether a short sale was intentional.

It is not apparent how relying on account executives and dealers to submit Error Trade Reports *after* a short sale had been executed could enable Fulbright to prevent and detect short selling.

- (d) The effectiveness of the warning letters and circulars issued to the account executive and dealers in deterring short sales was also questionable, given there was no substantive and immediate consequence for failure to comply with Fulbright's policies and procedures on short selling.
17. In light of the above, Fulbright did not have or failed to implement adequate and effective internal policies, procedures and controls to enable it to detect and prevent illegal short selling activities by its staff members. In particular, Fulbright failed to implement any effective controls over the account executives and dealers who had access to the MWS terminals, as, unlike the BSS trading system, the MWS trading system could not prevent its users from placing short selling orders when it detected that there were insufficient stocks in the relevant account.

Delay and failure to report to the SFC

18. Fulbright is under a duty to report to the SFC immediately upon, inter alia, any material breach, infringement of or non-compliance with any law, rules, regulations and codes administered or issued by the SFC, or where it suspects any such breach, infringement or non-compliance whether by itself or persons it employs or appoints to conduct business with clients or other licensed persons under paragraph 12.5 of the Code of Conduct.
19. Fulbright did not report to the SFC immediately when it became aware of the short selling incident on 8 April 2016. Instead, Fulbright decided to conduct its own investigation first. On 25 April 2016, the SFC made enquiries with Fulbright about the short selling orders. Only then did Fulbright inform the SFC that it would report to the SFC "within a few days", when it claimed it had been conducting its investigation since 8 April 2016, the day of the short sale in question.
20. Upon our request, Fulbright identified more occasions of short selling activities in a client's account in the first quarter of 2016. A significant number of further short selling incidents were later revealed during the course of the SFC's investigation.
21. It appears that Fulbright must have been aware of these further short selling incidents at the time, or at least shortly after, they occurred, as Error Trade Reports were available for these transactions. However, these short selling incidents were only disclosed to the SFC upon its enquiries or revealed during the course of its investigation. Fulbright had apparently failed to report such short selling incidents to the SFC immediately upon discovering the same.

Conclusion

22. Having considered all the circumstances, the SFC is of the view that Fulbright has breached General Principle 2 (Diligence) and paragraphs 4.3 and 12.5 of the Code of Conduct and paragraph 4 of Part I and paragraph 8 of Part VII of Internal Control Guidelines.
23. In deciding the disciplinary sanction against Fulbright, the SFC has taken into account all the circumstances of this case, including:
- the Disciplinary Fining Guidelines made under section 199(1)(a) of the SFO;
 - adequate and effective internal control systems are fundamental to the fitness and properness of a licensed corporation;

- Fulbright's short selling failures lasted for at least 6 months;
- Fulbright's cooperation in resolving the SFC's concerns and acceptance of the findings and disciplinary action of the SFC;
- Fulbright had taken measures to rectify its internal control deficiencies in relation to the detection and prevention of short selling after the incidents; and
- Fulbright has an otherwise clean disciplinary record.