



## Regulatory Update – SFC Fines and Reprimands Fulbright Securities Limited for Breaches Related to Short Selling (December 2020)

On 23 December 2020, the Securities and Futures Commission (“SFC”) publicly reprimanded and fined Fulbright Securities Limited (“FSL”) HK\$3.6 million for internal control failures relating to the prevention and reporting of short selling. This regulatory update outlines the internal control failures and other key facts relating to this case against FSL.

### Short Selling Breaches

After receiving a complaint, on 8 April 2016 the SFC commenced a preliminary investigation into FSL for overselling shares of Ngai Shun Holdings Limited (stock code: 1246). The preliminary investigation revealed that FSL engaged in 10 oversold transactions from January to March 2016. Following this discovery, the SFC commenced a full investigation into the operations of FSL. The investigation found that FSL engaged in 93 illegal short sales between October 2015 and March 2016 through its two different trading systems.

Out of the 93 short sales placed, 83 were executed using the Multi-Workstation System (MWS) and at least 9 others were executed using the Broker Supplied System (BSS). Brokerage firms such as FSL are required to have in place policies and procedures that prevent and 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).

During the investigation, FSL noted that it had implemented the following controls to prevent and detect short sales:-

- It relied on the integrity of its account executives as licensed representatives of the SFC and assigned dealers to monitor the account executives;
- It had a Risk Management System which could monitor and detect short sales after these had been executed;
- It had written policies and procedures (e.g. the Compliance Manual and Account Manager’s Rules, to prevent and detect unlawful short selling;
- It issued circulars to its staff members, stating its policy that all profits arising from error transactions, including oversold transactions would belong to FIL and all losses would be borne by the relevant account or dealer;
- FSL had issued warning letters to the account executives and dealers in relation to short sell orders; and
- FSL had been gradually replacing the MWS terminals with BSS terminals by April 2017 with a view to enhancing its internal controls as 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.

The SFC was of the view that as the short sales occurred, these controls were ineffective primarily because:-

- Relying on the integrity of its account executives to prevent and detect short sales, and on dealers to monitor account executives, was unsatisfactory;

- Account executives and dealers could access its portfolio viewing system so they could check their clients' stockholdings on a real time basis, but the Responsible Officer did not know if they did so;
- The system could not prevent short selling, but checking of stockholdings for reference;
- The 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;
- Although account executives or dealers were required to provide explanations for oversold transactions in the Error Trade Reports for the Responsible Officer's review, consideration and approval or rejection, this did not prevent or detect short selling; and
- The criteria for the Responsible Officer to determining if an Error Trade Report could be approved did not determine if a short sale was intentional in the first place.

FSL claimed that they relied on post trade execution reporting by account executives to detect and prevent short sales. Any breaches detected as a result of the system, if deemed unintentional, would result in the issuing of a warning letter to the account executive. The SFC made it very clear that it does not believe this type of system can suitably identify and prevent short sale trades from taking place. In particular the SFC does not believe that post trade identification of a short sale is effective to prevent short sales.

## Failure to Report to the SFC

FSL failed to notify the SFC of the short sales as is required for any material breach under paragraph 12.5 of the Code of Conduct. The SFC's investigation found that instead of immediately notifying the SFC as is the required practice, FSL conducted an internal investigation into the short sales that commenced on 8 April 2016.

On 25 April 2016, the SFC contacted FSL regarding the short sales and received a response stating that FSL had commenced an internal investigation on the day of the sale. The SFC enquired about any other short sales that had taken place but FSL did not identify and / or disclose additional short sales until they were identified by the SFC during its investigation.

The investigation found that due to the existence of the error trade reports FSL were not able to fully identify the extent of the short sale breaches. These error reports were not initially disclosed to the SFC following their request.

## Action Taken

The SFC took into consideration the duration and extent of FSL's failures, the fact that FSL cooperated with the SFC during the investigation, the robust action taken by FSL to remediate the SFC's findings relating to internal control deficiencies and FSL's otherwise clean record when deciding to publicly reprimand and fine FSL HK\$3.6 million.

## How we can help

As an SFC Licensed Corporation you have a number of obligations to the regulator to fulfill on an ongoing basis. Included in these obligations is the requirement to prevent and report any breaches such as short selling. Our dedicated team of professionals can help you understand your obligations, create a plan of action, and deliver support to help you and your organisation meet regulatory expectations in the region.



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ComplianceAsia’s dedicated projects team can assist you with reviewing and updating your policies and procedures and sample testing the reporting systems you have in place in relation to detecting and monitoring any short selling activities.

## About ComplianceAsia

ComplianceAsia is the longest established compliance consulting firm in Asia Pacific established in 2003 with key offices in Hong Kong, Shanghai, Singapore, Tokyo and London. We have an unmatched track record of completing complex compliance consulting projects for financial firms in the APAC region.

With over 70 staff, including compliance experts with experience in dealing with the SFC, HKMA, MAS, CSRC, JFSA and Asian exchanges, we provide independent, unbiased advice on Asian financial industry legislation and regulations. Our international client base consists of asset managers, hedge funds, private equity funds, family offices, broker-dealers, insurers, wealth managers and investment banks.

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