Enforcement Action – GEO Limited Fined HK$6.3 Million for Breaching Licensing Conditions and Internal Control Failures (March 2021)

On 23 March 2021, the Securities and Futures Commission ("SFC") announced that it had reprimanded and fined GEO Securities Limited ("GSL") HK$6.3 million over failing to adhere to its licensing conditions as well as other internal control failures related to the sale of unlisted bonds. The action taken against GSL was taken pursuant to section 194 of the Securities and Futures Ordinance ("SFO").

In this regulatory update we will assess the internal control failings of GSL and provide guidance as to how these failings could have been avoided.

Licensing Conditions

GSL currently hold T1 (dealing in securities), T4 (advising on securities) and T9 (asset management) licenses. Under its T9 license, GSL is subject to the licensing condition that it cannot conduct business involving the discretionary management of any collective investment schemes.

From 3 May 2013 to 22 March 2016, GSL was subject to the licensing condition that it shall not hold client assets. In addition, for its T1 regulated activity, GSL could not conduct business other than:

1. communicating offers to effect dealings in securities to a corporation that is licensed by or registered with the SFC for Type 1 regulated activity, in the names of the persons from whom those offers are received; and
2. introducing persons to a corporation that is licensed by or registered with the SFC for Type 1 regulated activity in order that they may affect dealings in securities or make offers to deal in securities.

Breach of Licensing Conditions

Following an inspection by the SFC, it was found that GSL had provided discretionary asset management services to 8 clients in which GSL were remunerated via an annual management fee. The annual management fee was paid to GSL on 1 July 2014 and 15 July 2015. The investigation found that GSL accessed 7 client accounts through remote terminals located at its approved office premise.

Making matters worse, between 28 October 2014 and 16 November 2015, GSL induced 36 clients to subscribe for 6 unlisted bonds that were issued directly by four companies resulting in 43 transactions totaling over HK$108 million. The process involved GSL sending the clients' subscription agreements directly to the issuing company or for GSL's staff to escort clients to the office of the issuers to directly subscribe for the bonds. The critical issue in this is that GSL received payments from the issuers for each bond order successfully placed.

Due Diligence Failures

GSL failed to conduct sufficient due diligence on the bonds it was marketing to its clients. The due diligence that GSL conducted was specifically focused on the default risk of the issuers and failed to effectively evaluate the other critical features of the bonds.

During its inspection, the SFC found that GSL did not have in place any written policies and procedures outlining the due diligence processes. The due diligence performed was insufficiently

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documented which was highlighted in the fact that there was no rational documentation to ensure that the offering of bonds only be made to professional investors.

The failure to conduct sufficient due diligence on the bonds offered to its clients resulted in GSL breaching its suitability obligations under paragraphs 3.4 and 5.2 of the Code of Conduct.

Suitability Failings

When conducting a suitability assessment, a licensed corporation must ensure that it appropriately scrutinizes the self-declared risk tolerance of its clients during the onboarding process. The SFC found that GSL failed to apply any such scrutiny to its clients' self-declarations prior to 2015.

The investigation found that GSL did not apply any scrutiny to the self-declared risk tolerance of clients when they were onboarded because there were no processes, prior to 2015, in place to review the declarations.

GSL lacked policies or procedures outlining the process of evaluating the risk of investment products prior to recommending products to clients. Instead, reliance was placed upon the judgment of Account Executives to decide if a product was appropriate. This unfortunately meant that there was no way in which the financial situation, investment experience, investment objectives and risk tolerance level of clients could be matched accurately with the characteristics and risk profile of the products being recommended.

Compounding matters further, GSL failed to effectively communicate or document the requirement that unlisted bonds should only be marketed to professional investors. GSL informed the SFC that it conveyed this to its Account Executives during internal training sessions. During its inspection the SFC found that attendance at these training sessions was not mandatory and therefore the requirement was not effectively enforced.

These gaps in GSL's policies and procedures meant that the SFC took the view that GSL was in breach of General Principle 2 and paragraphs 3.4, 4.2 and 5.2 of the Code of Conduct.

It is worth noting that during recent SFC routine inspections the SFC has increased its focus on suitability. It is important for licensed corporations offering complex products like bonds, to have in place a detailed due diligence process that clearly identifies the steps to be taken in order to address the suitability obligations appropriately.

Documentation of Investment Advice

When providing investment advice to clients it is important that documentary evidence is kept on file outlining the advice given as well as the justification for providing such advice. GSL were found to have failed to implement sufficient policies and procedures to document or justify the investment advice provided to clients. As a result, GSL's Account Executives were not required to document the justification for their recommendations.

The SFC highlighted that due to the lack of documentary evidence it would be extremely difficult for GSL to effectively monitor and evaluate the recommendations being made by its Account Executives. In the event of a complaint by a client, GSL would have been unable to assess the likelihood that one of its Account Executives had mis-sold an investment product.

The lack of documentary evidence resulted in GSL breaching paragraph VII(3) of, and paragraph 3 of the Appendix to the Internal Control Guidelines through its failure to document the advice it provided to its clients.

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Conflict of Interest Disclosure

Finally, GSL failed to disclose to its clients that it received commission for every successful unlisted bond placement. The SFC emphasizes that this unfairly prevented clients from making an informed decision about the investment and subsequently breached General Principle 5 and paragraph 8.3 of the Code of Conduct.

Disciplinary Action

The SFC firmly believed that GSL's conduct called into question its fitness and properness to carry on regulated activities as GSL was clearly guilty of numerous misconducts. As is always the case, when deciding on a suitable punishment the SFC took into consideration that no losses were suffered as a result of the unlisted bond offerings, and GSL continued to cooperate throughout the full SFC inspection process. In addition, the SFC noted GSL's clean disciplinary record and the fact that GSL engaged external support to address its policies and procedures issues.

How we can help

As an SFC Licensed Corporation you have a number of obligations to the regulator to fulfill on an ongoing basis in addition to your licensing requirements. ComplianceAsia's dedicated ongoing support team can support licensed entities with their daily operations through monitoring and testing to ensure that you adhere to your licensing requirements. Furthermore, you are required to maintain suitable and effective policies and procedures to ensure that can fulfill your fiduciary duty to your clients. 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 ensuring that suitability and documentation procedures are being effectively implemented.

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About ComplianceAsia

ComplianceAsia is the longest established compliance consulting firm in Asia Pacific established in 2003 with 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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