



Regulatory Update – SFC Fines UBS AG and UBS Securities Asia Limited HK\$11.55 million for regulatory breaches (August 2021)

On 3 August 2021, the Securities and Futures Commission (“SFC”) announced that it has reprimanded and fined UBS AG and UBS Securities Asia Limited (“UBSSAL”) (collectively “UBS”) HK\$9.8 million and HK\$1.75 million respectively over numerous regulatory breaches.

In this regulatory update we will address the various internal control breaches that have ultimately resulted in UBS receiving this fine.

SFC Investigation

The SFC were made aware of various internal control and system issues at UBS between September 2018 and November 2020 following self-reports made by UBS and referrals of findings from the Hong Kong Monetary Authority (“HKMA”). The SFC commenced its own investigation into the affairs of UBS and found a number of additional failings.

UBS AG were found to have failed to comply with:

- a) The requirements of the Securities and Futures (Client Securities) Rules (“CSR”) and the Securities and Futures (Contract Notes, Statements of Accounts and Receipts Rules in relation to its securities pooled lending service) (“CNR”);
- b) The telephone recording requirements under paragraph 3.9(b) of the Code of Conduct;
- c) The know your client (“KYC”) requirement under paragraph 5.1A of the Code of Conduct in assessing clients’ derivatives knowledge; and
- d) The product risk disclosure and KYC requirements under General Principle (“GP”) 5 and paragraph 5.3 of the Code of Conduct in the sale of a structured note to clients.

Investment Suitability – Assessing a Clients’ Derivatives Knowledge

A licensed corporation when assessing a clients’ derivatives knowledge, is expected to comply with:

- a) Paragraph 5.1A of the Code of Conduct which requires a licensed corporation, as part of its KYC procedures, must assess its clients’ knowledge of derivatives and characterize the client based on that knowledge.
- b) FAQs issued by SFC on 3 June 2011 which requires a licensed corporation when they are assessing the derivatives knowledge of a client to make appropriate enquiries of or gather relevant information about the client during the KYC process so as to enable them to make the assessment instead of relying merely on the clients’ declaration that he/she has knowledge of derivatives. A proper audit trail must be maintained to demonstrate that this assessment has been completed.

In July 2020, UBS AG reported to the SFC and the HKMA that it may not have gathered the relevant information about its clients’ knowledge of derivatives and as a result they may have breached paragraph 5.1A of the Code of Conduct.

Back before 2018, UBS AG required its staff to obtain trading evidence from clients who declared that they had conducted five or more derivatives trades in the past three years. This practice was discontinued in 2018 due to UBS AG identifying that they had actually misinterpreted the 23 December 2016 [FAQ](#) issued by the SFC.

As a result of this misunderstanding, from 2 January 2018 to 17 June 2020, UBS AG failed to follow the applicable regulatory guidelines relating to the assessment of clients' derivatives knowledge by failing to obtain trading evidence from 858 clients who declared that they had conducted five or more derivative trades in the past three years. Out of the 858 clients, 380 had the prerequisite derivatives trading experience.

This is a strict interpretation by the SFC of its FAQ as the FAQ itself seems to imply that firms could either make enquiries of its clients and rely on their statements OR collect evidence. It seems that the SFC is requiring firms to have evidence to prove the previous derivative trading experience of clients.

Obligation to Disclosure Financial Interests when producing Research Reports

Under paragraph 16.5(a) of the Code of Conduct, a licensed corporation is required to disclose in its research reports the financial interests they have in relation to an issuer or a new listing applicant if the interests aggregate to equal to or more than 1% of the issuer's market capitalization (or 1% of the new listing applicant's issued share capital). The SFC found that from May 2004 to May 2018, UBS failed to make proper disclosures of its financial interests in some Hong Kong listed companies covered in its research reports. The failure was apparently due to multiple data feed logistic errors in a legacy data source used by UBS for tracking shareholding positions.

Following its internal review, UBS noted that the failure of the legacy data source affected 80 (6.43%) of the research reports issued by UBSSAL and 125 (14.59%) of the research reports issued by UBS AG during the sample period of September 2017 to May 2018. Ultimately these failures resulted in UBS directly breaching the following areas of the Code of Conduct:

- 1) GP 2 – which requires a licensed or registered person to act with due skill, care and diligence, in the best interests of its clients and the integrity of the market.
- 2) Paragraph 4.3 – which requires a licensed or registered person to have internal control procedures which can be reasonably expected to protect its operations and its clients from financial loss arising from professional misconduct or omissions.
- 3) GP 7 and paragraph 12.1 – which requires a licensed or registered person to comply with and implement and maintain measures appropriate to ensure compliance with relevant regulatory requirements.

CSR and CNR Obligations

The SFC found that between November 2012 and February 2019, UBS AG failed to diligently supervise its client advisors and implement sufficient controls to ensure that only Professional Investor ("PI") clients were subscribed to its securities pooled lending service ("SPL"). This failure resulted in 2,236 non-PI clients being subscribed to the SPL service in which 91 clients entered into 913 SPL transactions with UBS AG.

UBS AG wrongly assumed that these clients were in fact PIs, and as such failed to obtain valid standing authorities from and issue contract notes to these investors for the SPL transactions. This action was a direct breach of sections 4 and 7 of the CSR and section 5 of the CNR.

According to the SFC, the conduct of UBS AG fell well below the standards expected under GP2, GP7, and paragraphs 4.3 and 12.1 of the Code of Conduct.

We wish to remind licensed corporations in Hong Kong that under Section 4 of the CSR any standing authorities given by a client to the intermediary must be renewed every 12 months unless

the client is a PI. Clients that are PIs must be informed on an annual basis that they continue to be treated as a PI.

Telephone Recording Requirements

The HKMA investigation found that from August 2017 to June 2019, UBS AG failed to record client order instructions that they have received through the telephone which is a direct breach of paragraph 3.9 of the Code of Conduct.

From August to December 2017, the order instructions placed through eight overflow lines for 2,006 transactions executed for 364 clients were not recorded. This was due to an omission in the voice recording setting during the migration of UBS AG's telephone system to a new system. The team responsible for the change wrongfully assumed the recording lines would automatically start recording after the migration but this actually failed to happen.

From November 2018 to January 2019, the order instructions placed through a telephone line for 20 transactions executed for five clients were not recorded. This error occurred when a voice line was transferred from a client advisor to a newly joined advisor but was not re-activated following the transfer.

From 13 to 17 June 2019, order instructions placed through 26 telephone lines for 96 transactions executed for 51 clients were not recorded. This was a result of human error in the course of transitioning UBS AG's telephone system from Skype for business soft phones to Cisco desk phones which produced a break in the voice recording systems.

These repetitive errors suggested that UBS AG failed to have in place effective internal controls to ensure proper functioning of their voice recording system in order to comply with the telephone recording requirement, which was a breach of GP2, GP7 and paragraphs 4.3 and 12.1 of the Code of Conduct.

Investment Suitability – Product Risk Disclosures

In May 2020, UBS AG reported to the SFC and HKMA that it failed to disclose to its clients the “stop loss event” feature of a structured note (“Note”) issued by an issuer before trade execution. This affected 15 client accounts involving the sale of 12 Notes between October and February 2020 for a total notional amount of about US\$12 million. The failure to disclose the stop loss feature was a breach of GP5 of the Code of Conduct which requires adequate disclosures that are made to clients of relevant material information.

This failure was down to the omission of the stop loss event feature in the additional product sheet that was prepared by UBS AG's Structured Product Sales Team in Singapore (“SP Team”). The SP Team member who prepared the additional product sheet was not aware of the stop loss event feature. This was only identified when another SP Team member reviewed the draft additional product sheet and noticed the feature was not referenced. The reviewer did not raise this issue as he did not believe the stop loss event feature was significant compared to something like the issuer's default risk.

The issue was only then discovered following the receipt of a client complaint in April 2020. The failures resulted in UBS AG breaching GP5 and paragraph 5.3 of the Code of Conduct by failing to disclose to clients the risks associated with the stop loss event feature in the Notes and assure itself that the clients understood such risks before trade execution. UBS AG also breached GP2, GP7, and paragraphs 4.3 and 12.1 of the Code of Conduct by failing to put in place proper systems and procedures to ensure all material product information in relation to the Notes was disclosed.

How we can help

ComplianceAsia's dedicated projects team can assist you with internal control policy reviewing of issues like voice and data recording, and updating your internal policies and procedures relating to Investment Suitability obligations. In addition, we can provide training to the individuals directly responsible for Clients Suitability Assessment to ensure that they are aware of and have a clear understanding of the obligations to report.

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