

SFC fines President Securities \$2 million for regulatory breaches in relation to handling Taiwanese clients' accounts

4 Dec 2012

The Securities and Futures Commission (SFC) has issued a public reprimand to President Securities (Hong Kong) Limited (President Securities) and fined it \$2 million for failing to act in the best interests of its clients when accepting subscriptions for a number of Lehman Brothers related structured products by 21 Taiwanese clients in 2008 (Note 1).

An SFC investigation found that the selling process of the products gave rise to a number of regulatory concerns:

- The Taiwanese clients were referred to President Securities by its parent company in Taiwan, President Securities Corporation. They opened accounts with President Securities before they purchased the products, but the account opening process was handled by President Securities Corporation.
- President Securities staff signed as witnesses on the Taiwanese clients' account opening documents when, in fact, they had never met the clients.
- No one from President Securities contacted the Taiwanese clients to verify their identities, explain the account opening documents to them, establish their financial situation, investment experience, and investment objectives, and make risk disclosure to them.
- President Securities did not sufficiently ensure that the Taiwanese clients understood the products and accepted the risks associated with them before accepting their subscriptions for the products. It relied on standard risk disclaimers signed by the Taiwanese clients even though no explanation of the disclaimers had been given to the clients.
- A number of the products prescribed minimum subscription requirements to restrict the categories of investors eligible to invest in them. Since some of the Taiwanese clients' subscriptions amounts did not meet the minimum subscription requirements, President Securities pooled their orders together so as to meet the minimum subscription requirements. However, President Securities did not inform such clients that their orders would be pooled together.

In view of these concerns, President Securities has failed to comply with the regulatory standards in relation to opening client accounts for the Taiwanese clients. Its unquestioning acceptance of the Taiwanese clients' subscriptions for the products and its pooling of client orders that did not meet the minimum subscription requirements reflect that it has failed to act in the best interests of its clients. The SFC considers that President Securities' breaches are prejudicial to the interest of the investing public.

"Once again, we have had to take action against an intermediary over poor internal controls and practice causing loss and damage to customers. Intermediaries must demonstrate they have learned the lessons of the past four years to avoid harsher measures being imposed against them," the SFC's Executive Director of Enforcement, Mr Mark Steward said.

In deciding the disciplinary sanction, the SFC took into account all relevant circumstances of the case which included:

- the SFC had previously issued a warning letter to President Securities about certain aspects of its account opening procedures, in particular its failure to obtain all necessary information about clients before approving the opening of their accounts;
- the manner in which President Securities accepted the Taiwanese clients' subscriptions for the products and pooled together clients orders that did not otherwise meet the minimum subscription requirements reflect a fundamental disregard for the clients' best interests; and
- President Securities agreed to engage an independent audit firm to review its internal control system and account opening procedures.

End

Notes:

1. President Securities is licensed under the Securities and Futures Ordinance to carry on business in Type 1 (dealing in securities), Type 4 (advising on securities), Type 6 (advising on corporate finance) and Type 9 (asset management) regulated activities.
2. Please refer to the [Statement of Disciplinary Action](#) for further details of President Securities' misconduct and the disciplinary action taken against it.

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STATEMENT OF DISCIPLINARY ACTION

1. The Disciplinary Action

1.1. The Securities and Futures Commission (SFC) has taken the following disciplinary action against President Securities (Hong Kong) Limited (President Securities) pursuant to section 194 of the Securities and Futures Ordinance (SFO):

1.1.1. publicly reprimanded President Securities, pursuant to section 194(1)(b)(iii) of the SFO; and

1.1.2. imposed a financial penalty of \$2 million on President Securities, pursuant to section 194(2)(b) of the SFO.

1.2. The disciplinary action relates to President Securities' conduct in selling a number of Lehman Brothers related structured products (the Products) to 21 Taiwanese clients in 2008.

2. Summary of facts

2.1. In August 2009, the SFC received a complaint from two clients of President Securities' regarding the sale of two of the Products to them. The complainants reside in Taiwan and are clients of President Securities Corporation (PSC), President Securities' parent company in Taiwan.

2.2. In light of the complaint, we conducted an investigation into the process through which the Products were sold to the complainants. Our investigation revealed that President Securities has also sold the Products to 19 other clients who reside in Taiwan (the Taiwanese Clients).

2.3. Our investigation findings suggest that President Securities has failed to comply with the regulatory requirements in relation to opening client accounts vis-à-vis the Taiwanese Clients. They also suggest that President Securities has failed to act in the best interests of the Taiwanese Clients' in accepting their subscriptions for the Products.

Account opening

2.4. President Securities' account opening procedures require, amongst other things:

2.4.1. Account opening documents should be executed in the presence of a licensed staff of President Securities. If the account opening documents are not executed in the presence of a licensed staff of President Securities, the signing of the account opening documents and sighting of related identity documents should be certified by one of a number of specified persons, including another licensed person, an affiliate of a licensed person, a Justice of the Peace, or a professional person, etc.

2.4.2. The licensed staff should provide and fully explain the contents of the risk disclosure statements to the clients in a language which the clients understand and invite the clients to read such risk disclosure

statements, ask question and take independent advice. The licensed staff should declare the completion of this procedure by signing the agreement. If a non-face-to-face approach is used in opening the account, the procedures mentioned in this paragraph should be done over the phone before the approval process of the account.

- 2.5. However, the above mentioned account opening procedures were not followed in the opening of the Taiwanese Clients' accounts:
- 2.5.1. The account opening documents were provided to the Taiwanese Clients in Taiwan by their PSC account executives and were completed and signed in Taiwan.
 - 2.5.2. President Securities staffs have signed as witnesses on the account opening documents but they have, in fact, never met the clients.
 - 2.5.3. No one from President Securities has explained the account opening documents to the Taiwanese Clients, nor enquired about their investment objective, investment experience, financial situation and risk tolerance level.
 - 2.5.4. Although President Securities claimed that a member of its staff should have called the Taiwanese Clients to verify their identities, only one of the Taiwanese clients that we have made enquiries with said that a member of President Securities staff did contact him to verify his identity.

Sale of the Products to the Taiwanese Clients

- 2.6. The SFC's investigation revealed that the Products were recommended to the Taiwanese Clients by their PSC account executives.
- 2.7. The Taiwanese Clients were required to sign a number of documents in subscribing for the Products, including:
- 2.7.1. a Subscription Form which contains a declaration to the effect that the client has read the term sheet and risk disclosure statement, and that the client has made an independent decision to make the investment and undertakes to be responsible for all the risks and losses arising therefrom; and
 - 2.7.2. a Client Declaration to the effect that the client has been provided with and read the term sheet, President Securities has warned the client of the risk of the loss of principal, the client understands that losses may arise from the investment, and the client has made an independent decision to make the investment, having fully considered his/her financial situation and the risks associated with the product.
- 2.8. Further, the Subscription Forms require the signature of the client as well as that of a "handler" (經辦). There is a declaration by the "handler" to the effect that s/he has explained the term sheet and risk disclosure statement to the client, confirmed the client's intention to invest and witnessed the client's signature on the Subscription Form.
- 2.9. The sales documents were provided to the Taiwanese Clients by the PSC account executives, but no one explained the sales documents to the clients. The sales documents were signed in Taiwan and then returned to President

Securities by PSC. Upon receiving a client's order from PSC, President Securities simply contacted the relevant counterparty to place the order.

- 2.10. President Securities asserted that the fact that the clients made voluntary declarations that they have made their own independent investment decision demonstrated that it only acted as a broker for the clients.
- 2.11. Although the Client Declaration states that President Securities has warned the client of the risk of the loss of principal, and the "handler's" declaration in the Subscription Form states that the "handler" has explained the terms and conditions and risk disclosure statement to the client, President Securities confirmed that all that was done was that President Securities staff were required to request clients by phone / email to read the relevant term sheets and risk disclosure, instead of explaining the content of the term sheet and the risk disclosure to clients in detail. Clients were then asked to sign the documents to confirm that they understood the terms and the risk involved.

Pooling of clients' orders

- 2.12. A number of the Products contain the following Hong Kong Selling Restriction:

"No offers of the Notes for sale or resale shall be made unless the minimum consideration payable by a prospective investor for the Notes is not less than HK\$500,000 or such other amount prescribed for the time being under Section 4, Part 1 of the Seventeenth Schedule of the Companies Ordinance (Cap. 32 of the Laws of Hong Kong) ("CO"), or its equivalent in another currency, and the warning statement as set out in the Eighteenth Schedule of the CO is stated in the offer document given to such prospective investor upon making the offer of the Notes."
- 2.13. The Hong Kong Selling Restriction reflects one of the safe harbours in relation to the prospectus regime under the CO governing offers of structured products in the form of debentures. The rationale for introducing this safe harbour was that an investor who can afford to take up such offers should be sufficiently knowledgeable to understand the risks involved or should be able to secure professional advice if considered necessary. It was believed that such an investor would not need the protection afforded to a retail investor by a prospectus¹.
- 2.14. Our investigation revealed that 10 of the Taiwanese Clients' orders for the Products were in a sum less than HK\$500,000. President Securities has confirmed that all but one of those orders were pooled with other clients' orders, so that the orders, collectively, satisfied the Hong Kong Selling Restriction. President Securities has also confirmed that it did not inform its clients that their orders would be pooled with that of other clients.

¹ Paragraph 23, Consultation Conclusions on Possible Reforms to Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance (April 2010).

3. Breaches and reasons for action

3.1. Under General Principle 2 of the Code of Conduct², President Securities, as a licensed corporation, has the duty to exercise due skill, care and diligence and to act in the best interests of its clients.

3.2. President Securities is also obliged, under General Principles 4 and 5 of the Code of Conduct respectively, to seek information from its clients about their financial situation, investment experience and investment objectives relevant to the services to be provided and to make adequate disclosure of relevant material information in its dealings with its clients.

3.3. In opening accounts for clients, President Securities is required:

3.3.1. under paragraph 5.1 of the Code of Conduct, to take all reasonable steps to establish the true and full identity of each of its clients, and of each client's financial situation, investment experience and investment objectives; where an account opening procedure other than a face-to-face approach is used, it should be one that satisfactorily ensures the identity of the client;

3.3.2. under paragraph 5.4 of the Code of Conduct, to satisfy itself on reasonable grounds about the identity, address and contact details of the new client; and

3.3.3. under paragraph 6.1 of the Code of Conduct, to properly draw to the client's attention the relevant risks; where an account opening procedure other than a face-to-face approach is used, the covering correspondence should specifically direct the client's attention to the appropriate risk disclosure statements.

3.4. In this case, the evidence shows that President Securities has failed to carry out proper account opening and know-your-clients procedures for PSC clients who were referred by PSC to open accounts with it. As such, President Securities has breached General Principles 2, 4 and 5 and Paragraphs 5.1 and 6.1 of the Code of Conduct.

3.5. With respect to President Securities' acceptance of the Taiwanese Clients' orders for the Products, in the SFC's view, considering:

3.5.1. the Taiwanese Clients were all referred to President Securities with ready instructions to subscribe for the Products, and

3.5.2. it must have, or it at least ought to have, occurred to President Securities that it was inherently unlikely that the 21 Taiwanese Clients, all clients of PSC, would have independently learnt about the Products and approached President Securities for assistance in subscribing for the Products,

President Securities must have known, or at least ought to have known, that PSC had played a role in recommending the Products to the Taiwanese Clients.

3.6. The SFC considers that President Securities has essentially turned a blind eye to the fact that PSC was recommending the Products to its clients who would,

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

in turn, become President Securities' clients if they wanted to subscribe for the Products. In reliance upon declarations that the relevant clients were asked to sign without being given an explanation of what they meant, President Securities claimed that it only acted as a broker for those clients and sought to divest itself of responsibilities vis-à-vis the clients' subscriptions for the Products. In the circumstances, President Securities has failed to act with due care and diligence and in the best interests of the Taiwanese Clients in accepting their subscriptions for the Products and therefore breached General Principle 2 of the Code of Conduct.

3.7. The SFC also considers that President Securities' pooling of client orders that fell short of the minimum consideration requirement imposed by the Hong Kong Selling Restriction was prejudicial to the interests of the affected clients, in that:

3.7.1. President Securities enabled retail investors clients to buy an investment product which should not be available to them, and would not have been available to them but for the pooling of orders by President Securities; and

3.7.2. President Securities did not inform its clients that their orders would be pooled with that of other clients. Had it done so, the affected clients would have had an opportunity to make enquiries as to the reasons for such arrangements, and would have had an opportunity to reconsider whether they would like to proceed with the purchase

Therefore, President Securities has breached General Principles 2 and 5 of the Code of Conduct.

4. Conclusion

Having regard to the nature of President Securities' breaches, particularly its lack of regard for its clients' best interests, as demonstrated by the manner in which it sold the Products to the Taiwanese Clients, including its pooling of client orders to overcome the minimum consideration requirement, the SFC has decided to take the disciplinary action against President Securities as described in paragraph 1.1 above.