

SFC Circular to licensed corporations

July 2024

Expected standards and examples of deficiencies relating to Financial Resources management and compliance with the Securities and Futures (Financial Resources) Rules



Background

The Securities and Futures Commission (SFC) has issued a circular outlining minimum expected standards for licensed corporations (LCs) to enhance the governance and internal control standards needed to monitor financial resources and comply with the Securities and Futures (Financial Resources) Rules (FRR). This follows observations of inadequate practices and internal control deficiencies that have led to declines in excess liquid capital (ELC) and breaches of liquid capital requirements. The SFC expects LCs to meet these standards, taking into account of the size, business model and needs of each LC to ensure they remain fit and proper to operate within the industry.

Key existing requirements

Under the FRR, LCs must always maintain liquid capital above their required levels. Additionally, LCs must immediately notify the SFC and cease regulated activities if they cannot maintain or ascertain their required financial resources. Internal controls should be robust to ensure compliance, and senior management must establish effective policies and procedures. LCs are required to designate responsible officers (ROs) or Managers-In-Charge (MICs) to oversee financial resources adequacy and FRR compliance.

Summary of the expected standards

The circular emphasizes the need for:

Governance and oversight:

- ▶ LCs must ensure senior management, including at least one RO or MIC (most likely MIC of Finance and Accounting), to be responsible for financial resources and FRR compliance in particular:
 - ▶ The oversight of calculating, monitoring and reporting of liquid capital
 - ▶ Implementing appropriate policies and internal controls e.g., setting up alerts on material drops in ELC
 - ▶ Identifying any FRR compliance failure and conducting prompt remediation
 - ▶ Ensuring personnel involved in liquid capital calculation and reporting must be competent and qualified
 - ▶ Ensuring the accuracy and verification of FRR returns which must be signed by the RO or an SFC approved officer

Internal controls:

- ▶ Implement effective controls to ensure FRR compliance by maintaining:
 - ▶ Sound accounting policies for month-end and year-end closing procedures and for proper recognition of revenues, accruals and provisions
 - ▶ Maker and checker of mechanisms for liquid capital assessment
 - ▶ Appropriate ongoing liquid capital monitoring procedures
 - ▶ Regular liquid capital projections to ensure a sufficient liquid capital buffer
 - ▶ An effective liquidity management framework for identifying and resolving thin ELC situations
 - ▶ Oversight and clear delineation of any outsourced accounting and FRR compliance functions
 - ▶ Procedures for ensuring compliance with all relevant notification requirements

Incident report and remedial measures

- ▶ A detailed incident report (available on SFC website) reflecting the details of the inability to maintain the required liquid capital and remedial actions should be submitted to the SFC within three weeks from the date of first identifying such deficit

Procedures during financial distress situation

- ▶ LCs encountering financial difficulties should comply with the relevant SFC requirements pertaining to disruptions

- ▶ An LC which has ceased business operation is still subject to all FRR requirements and, must ensure to wind down its regulated business in an orderly manner including notifying its clients as soon as practicable

Next steps

The SFC has elaborated in this Circular the importance for LCs in Hong Kong to maintain financial resources adequacy at all times. Their concerns stem from recent internal control deficiencies observed from the market and as a result issued minimum standards which serve as a reminder to LCs to enhance their existing controls. In addition to these standards the SFC has highlighted some examples of cases and situations whereby certain LCs have failed to comply with the FRR. The SFC may take regulatory actions when necessary if LCs and their senior management are found to have failed to meet these standards.

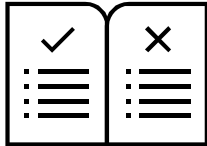
Therefore, LCs should:

- ▶ Review their existing internal controls and accounting policies relating to FRR compliance against these expected standards
- ▶ Improve governance practices to safeguard against abrupt financial declines including setting alerts and escalation procedures and conducting regular projections
- ▶ Ensure that senior management have effective management oversight to address deficiencies in liquid capital monitoring
- ▶ Ensure that personnel responsible for calculating and monitoring liquid capital and preparing financial returns are competent and qualified
- ▶ Conduct regular communications with any outsourced service providers
- ▶ Review the examples of observed deficiencies in FRR compliance

Key questions to avoid common pitfalls in financial resources rules compliance

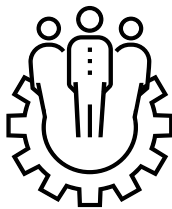
Effective controls

► Policies



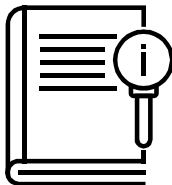
Have you implemented adequate controls to monitor liquid capital positions and to detect and prevent breaches?

► Senior management



Are senior management demonstrating adequate oversight of FRR compliance? Are liquid capital positions verified before reporting to the SFC?

► FRR knowledge



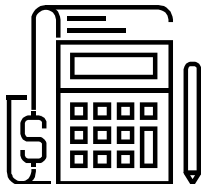
Do those responsible for FRR compliance have the relevant training and knowledge? Have you conducted any spot checks to detect any FRR computational errors? Have you maintained adequate records? How do you ensure all appropriate accruals are properly accounted for in your ongoing liquid capital monitoring.

► Service providers



Do you monitor and conduct regular communications with external service providers and accounting firms to ensure FRR compliance?

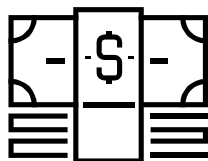
Accounting practices



Do you adopt proper accounting practices based on generally accepted accounting principles? Are all relevant expenses and provisions accurately estimated and included before year-end closing?

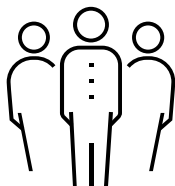
Assets and liabilities

► Cash



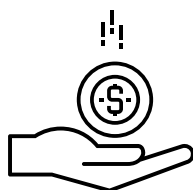
Are house monies held with brokers, non-authorized financial institutions or banks incorporated outside the prescribed countries mistakenly included in liquid assets?

► Proprietary positions



- Are accurate haircuts and corresponding concentration charges applied to proprietary investments?
- Are downgraded bonds properly assessed to be considered as liquid assets?
- Are off-exchange traded derivative contracts accurately valued as part of liquid capital computation taking into account of any mark-to-market losses while disregarding any associated margins deposited with counterparties?
- Are unauthorized funds excluded from liquid assets as required by the FRR?

► Amounts receivable



Are all amounts receivable including those from dealers and clients properly assessed for the purpose of inclusion as liquid assets under FRR requirements e.g., illiquid collateral?

► Amounts payable to clients and other liabilities



Have you ensured that all ranking liabilities have been accounted for including client money deposited with brokers or banks outside the prescribed countries and intercompany payables?

► Shareholders' funding



Have you accurately classified shareholders' funding as capital or ranking liabilities as evidenced by proper documentation maintained for FRR compliance?

► No set-off



Are set offs between assets and liabilities properly assessed under the FRR especially for inter-group balances and correctly reported in FRR returns?

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