

SFC reprimands and fines three JP Morgan entities a sum of \$30 million for regulatory breaches

15 Dec 2015

The Securities and Futures Commission (SFC) has reprimanded J.P. Morgan Broking (Hong Kong) Limited (JPMBHK), J.P. Morgan Securities (Asia Pacific) Limited (JPMSAP) and J.P. Morgan Securities (Far East) Limited (JPMSFE) (collectively “JP Morgan”), and fined them \$15 million, \$12 million and \$3 million respectively for various regulatory breaches and/or internal control failings (Notes 1 to 3).

An SFC investigation revealed that JP Morgan had failed to implement adequate systems and controls in its institutional equities business in Hong Kong to ensure compliance with the rules and regulations applicable to the following areas:

- short selling activities;
- client facilitation and principal trading business; and
- operation of dark liquidity pool trading services.

Short selling activities

Between May 2010 and February 2013, JPMBHK and JPMSAP had incorrectly aggregated the inventory positions controlled by a principal trading desk across two offshore affiliates in determining whether their position in a security is net long or net short. As a consequence, the two firms wrongly conducted over 41,000 uncovered short sale trades as long sale trades (Notes 4 & 5).

Furthermore, contrary to the requirements under the Securities and Futures Ordinance (SFO), 34% of the short selling orders placed by JPMBHK and/or JPMSAP for their principal trading in May 2012 did not have the appropriate “documentary assurance” in place to confirm that the sales were covered when the short sell orders were placed (Note 6).

Client facilitation and principal trading business

A review by the SFC found that, between January 2011 and December 2012, JPMSFE and JPMSAP did not have adequate systems and controls in place to prevent a client facilitation trade being executed without the client’s consent.

The SFC also found that JP Morgan granted seven facilitation traders and 14 principal traders incorrect access rights under its network shared drives and/or order management systems between January and December 2012. As a result, the facilitation and principal traders were able to view client order flow information beyond their defined access rights.

Furthermore, JP Morgan had set up a reporting structure with potential conflicts under which the trading desks responsible for handling agency orders had a reporting line to two senior managers who were also facilitation traders prior to August 2012. However, JP Morgan did not put in place effective systems and controls to guard against potential misuse or abuse of client agency order flow information by the facilitation traders.

Operation of dark liquidity pool trading services

In April 2011, the SFC granted approval to JPMBHK to carry on business in Type 7 (providing automated trading services) regulated activity. During and after the application process, JPMBHK represented to the SFC that its client-facing crossing engine, namely JPMX, was a pure agency-to-agency matching platform.

The SFC however found that numerous principal orders of JP Morgan were incorrectly routed into the agency pool of JPMX for matching between March and July 2012 due to human and systems errors. None of these orders were crossed in JPMX. There were also a number of instances where agency orders were incorrectly routed on two dates in August and December 2012 into a separate, non-client principal pool of JPMX. Some of these agency orders were crossed with principal orders in this separate pool but none of them were executed at a price lower than the prevailing best bid (for sell orders) or higher than the prevailing best ask (for buy orders) price of the Stock Exchange of Hong

Kong Limited.

Many of the above failings were not identified or corrected until the SFC brought them to JP Morgan's attention in the course of a SFC inspection into the business activities of JPMBHK and JPMSFE.

In determining this disciplinary action, the SFC took into account that JP Morgan:

- co-operated with the SFC in resolving the SFC's concerns;
- has taken steps to rectify the concerns raised by the SFC;
- agreed to engage an independent reviewer to conduct a forward-looking review of the internal controls and systems of JP Morgan in respect of the areas mentioned above; and
- has a clean disciplinary record in relation to its regulated activities.

End

Notes:

1. JPMBHK is licensed under the SFO to carry on Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts) and Type 7 (providing automated trading services) regulated activities. JPMBHK is also an Exchange Participant registered with The Stock Exchange of Hong Kong Limited (SEHK).
2. JPMSAP is a registered institution under the SFO to carry on business in Type 1 (dealing in securities), Type 4 (advising on securities), Type 6 (advising on corporate finance) and Type 7 (providing automated trading services) regulated activities.
3. JPMSFE is licensed under the SFO to carry on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 6 (advising on corporate finance) regulated activities.
4. In Hong Kong, "naked" or "uncovered" short selling is prohibited under section 170(1) of the SFO.
5. Under section 8.3 of the Guidance Note on Short Selling Reporting and Stock Lending Record Keeping Requirements published in March 2003, it is acceptable for an organisation to aggregate the positions of its proprietary trading units/books to determine whether its position in a security is net long or net short. However, this is limited to aggregating different trading units/books within the same legal entity. It does not extend to the aggregation of the positions of the trading books held under separate legal entities even if they are within the same group of companies.
6. Pursuant to section 171(2) of the SFO, when passing a short selling order to an agent for execution, the short seller must, at the same time, provide the agent with a "documentary assurance" that: (a) he has a presently exercisable and unconditional right to vest the securities to which the order relates in the purchaser of them; and (b) where the securities have been borrowed to cover the sale, that the lender has the securities available to lend to the seller. Section 171(3) of the SFO also provides that where an Exchange Participant conducts a short selling order as a principal, and if the "cover" for the sale is a borrowing arrangement, the Exchange Participants must have obtained a documentary assurance from the lender that the lender has the securities available to lend to him before conveying the orders to SEHK.

[A copy of the Statement of Disciplinary Action is available on the SFC website](#)

Page last updated : 15 Dec 2015

STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has reprimanded J.P. Morgan Broking (Hong Kong) Limited¹ (**JPMBHK**), J.P. Morgan Securities (Asia Pacific) Limited² (**JPMSAP**) and J.P. Morgan Securities (Far East) Limited³ (**JPMSFE**) (collectively **JP Morgan**), and fined them \$15 million, \$12 million and \$3 million respectively pursuant to section 194 and section 196 of the Securities and Futures Ordinance (**SFO**).
2. The disciplinary action is taken for JP Morgan's regulatory breaches and/or internal control failings in its institutional equities business in Hong Kong with respect to the following areas:
 - (a) short selling activities;
 - (b) client facilitation and principal trading business; and
 - (c) operation of dark liquidity pool trading services.

Summary of facts

(A) Short selling activities

Uncovered short selling

3. Between May 2010 and February 2013, JPMBHK and JPMSAP had incorrectly **aggregated the inventory positions across two offshore affiliates** under an order management system that was used by a principal trading desk to check the securities positions. As a consequence, over 41,000 uncovered short sale trades were wrongly conducted by JPMBHK and/or JPMSAP as long sale trades.
4. In Hong Kong, "naked" or "uncovered" short selling is prohibited. It is an offence under section 170(1) of the SFO for a person to sell securities at or through a recognized stock market unless at the time of the sale, he (or his client, if he is an agent) has a presently exercisable and unconditional right to vest the securities in the purchaser of them, or believes and has reasonable grounds to believe that he (or his client, as the case may be) has such a right.

¹ JPMBHK is licensed under the SFO to carry on Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts) and Type 7 (providing automated trading services) regulated activities.

² JPMSAP is a registered institution under the SFO to carry on business in Type 1 (dealing in securities), Type 4 (advising on securities), Type 6 (advising on corporate finance) and Type 7 (providing automated trading services) regulated activities.

³ JPMSFE is licensed under the SFO to carry on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 6 (advising on corporate finance) regulated activities.

5. For an organization that operates different trading units/books, as stated in section 8.3 of the Guidance Note on Short Selling Reporting and Stock Lending Record Keeping Requirements published in March 2003, it is acceptable for the organization to aggregate the positions of its proprietary trading units/books to determine whether its position in a security is net long or net short. However, this is limited to aggregating different trading units/books within the same legal entity. **It does not extend to the aggregation of the positions of the trading books held under separate legal entities even if they are within the same group of companies.**

Failure to obtain documentary assurance for short selling orders

6. For the period before June 2012, JP Morgan did not have adequate systems and controls in place to ensure compliance with the requirements under section 171 of the SFO.
7. Pursuant to section 171(2) of the SFO, when passing a short selling order to an agent for execution, the short seller must, at the same time, provide the agent with a “documentary assurance” that: (a) he has a presently exercisable and unconditional right to vest the securities to which the order relates in the purchaser of them; and (b) where the securities have been borrowed to cover the sale, that the lender has the securities available to lend to the seller.
8. Section 171(3) of the SFO also provides that where an exchange participant conducts a short selling order as a principal, and if the “cover” for the sale is a borrowing arrangement, the exchange participants must have obtained a documentary assurance from the lender that the lender has the securities available to lend to him before conveying the orders to the Stock Exchange of Hong Kong Limited.
9. A sample review conducted by the SFC revealed that 34% of the short selling orders placed by JPMBHK and/or JPMSAP for its principal trading in May 2012 did not have the appropriate documentary assurance in place when the short selling orders were placed. Specifically, the following irregularities were observed:
 - (a) no documentary assurance was obtained/maintained for some short selling orders;
 - (b) documentary assurance was received after some short selling orders were placed;
 - (c) the borrowed quantity was not specified in some documentary assurance; and/or
 - (d) the borrowed quantity specified in some documentary assurances was insufficient to cover the quantity of the short selling order.

(B) Client facilitation and principal trading business

Failure to obtain clients' consent to facilitation trades

10. Facilitation trading involves brokers and clients executing transactions on a principal-to-principal basis rather than on an agency basis. As the broker is no longer an agent but deals with the client as a principal, conflicts of interest may arise. Therefore, brokers offering facilitation services must have systems in place to identify, manage, and control any conflicts that may arise in providing facilitation services.
11. General Principle 6 of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**) provides that a licensed or registered person should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its clients are fairly treated.
12. Paragraph 10.1 of the Code of Conduct provides that, where a licensed or registered person has a material interest in a transaction with or for a client or a relationship which gives rise to an actual or potential conflict of interest in relation to the transaction, it should neither advise, nor deal in relation to the transaction unless it has disclosed that material interest or conflict to the client and has taken all reasonable steps to ensure fair treatment of the client.
13. According to JP Morgan, its client facilitation business encompassed units and staff across JPMSFE, JPMBHK, JPMSAP and other affiliates. Typically, JPMSAP or an offshore affiliate would have direct interaction with an underlying client and would take client orders. **The client facilitation desk sat within JPMSFE would receive client facilitation orders from JPMSAP and route its Hong Kong orders to JPMBHK.**
14. As a measure to ensure that the client was informed of conflicts of interest that might arise in the facilitation trades, it was a policy of JP Morgan that client consent should be obtained before executing the relevant facilitation trades.
15. However, for the period between January 2011 and December 2012, JP Morgan did not put in place systems or procedures in its institutional equities business in Hong Kong to prevent a client facilitation trade from being executed without client consent. Nor did JP Morgan implement any regular compliance review programs to check if client consent had been obtained prior to executing a facilitation trade.
16. **The SFC found that clients' express consent was not obtained by JPMSFE and/or JPMSAP in 35% of client facilitation trades** reviewed by the SFC.

Visibility of client agency orders incorrectly granted to facilitation/principal traders

17. Regulated persons are expected to implement appropriate systems and controls to restrict access to or visibility of client agency orders by its staff, particularly, facilitation/principal traders, on a strictly need-to-know basis. Where such access is granted, the usage should be closely monitored and

controlled to protect against any potential fraudulent transactions based on confidential knowledge of clients' orders.

18. During the period from January to December 2012, JP Morgan had granted seven facilitation traders and 14 principal traders incorrect access rights under its network shared drives and/or order management systems. As a result, the facilitation and principal traders were able to view certain client order flow information beyond their defined access rights.

Potential conflicts in the reporting structure

19. JP Morgan had set up a reporting structure under which trading desks responsible for handling agency orders had a reporting line to two senior managers who were also facilitation traders prior to August 2012.
20. JP Morgan did not put in place effective systems and controls to guard against potential misuse or abuse of client agency order flow information by the facilitation traders.

(C) Operation of dark liquidity pool trading services

Incorrect mixing of agency orders with principal orders in the crossing engine

21. In April 2011, JPMBHK submitted an application to the SFC for approval to carry on business in Type 7 (providing automated trading services) regulated activity for its provision of crossing engine services in Hong Kong. The SFC granted approval to JPMBHK in February 2012.
22. During and after the application process, JPMBHK represented to the SFC that its client-facing crossing engine, namely JPMX, was a pure agency to agency matching platform.
23. The SFC however found that, as a result of human and systems errors:
 - (a) 2,456 principal orders were incorrectly routed into the agency pool of JPMX for matching between March and July 2012. None of these orders were crossed in JPMX; and
 - (b) 251 agency orders were incorrectly routed on two dates in August and December 2012 into a separate, non-client principal pool of JPMX. **54 of the incorrectly routed agency orders were crossed with principal orders in this separate pool but none of them were executed at a price lower than the prevailing best bid (for sell orders) or higher than the prevailing best ask (for buy orders) of the Stock Exchange of Hong Kong Limited.**

Conclusion

24. Having considered all the circumstances, the SFC is of the opinion that JPMBHK, JPMSAP and JPMSFE are guilty of misconduct and their fitness and properness as a licensed/regulated person has been called into question.

25. A breakdown of the total fine of \$30 million is set out below:
- (a) JPMBHK has been fined a total of \$15 million – \$9 million attributable to the failings in relation to its short selling activities, \$3 million attributable to the failings concerning client facilitation and principal trading activities, and \$3 million attributable to the failings in relation to its operation of dark liquidity pool trading services;
 - (b) JPMSAP has been fined a total of \$12 million – \$9 million attributable to the failings in relation its short selling activities and \$3 million attributable to the failings concerning client facilitation and principal trading activities; and
 - (c) JPMSFE has been fined \$3 million for its failings concerning client facilitation activities.
26. In deciding the disciplinary sanctions, the SFC has taken into account that JP Morgan:
- (a) co-operated with the SFC in resolving the SFC's concerns;
 - (b) has taken steps to rectify the concerns raised by the SFC;
 - (c) agreed to engage an independent reviewer to conduct a forward-looking review of the internal controls and systems of JP Morgan in respect of the three areas mentioned in paragraph 2; and
 - (d) has a clean disciplinary record in relation to its regulated activities.