

SFC reprimands and fines two JP Morgan entities HK\$5.6 million for regulatory breaches

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The Securities and Futures Commission (SFC) has reprimanded J.P. Morgan Securities (Asia Pacific) Limited (JPMSAP) and JPMorgan Chase Bank, National Association (JPMCB), and fined them \$3 million and \$2.6 million respectively for regulatory breaches including disclosure failures in research reports and offering offshore listed index options without the required licences (Notes 1 & 2).

The SFC's investigations into the conduct of JPMSAP and JPMCB found the following breaches:

Disclosure of financial interests and market making activities in research reports

- JPMSAP failed to disclose JP Morgan's financial interests in respect of certain listed issuers covered in its research reports. The failure was caused by deficiencies in JP Morgan's global securities position reporting system which failed to include stock borrow and options positions in the calculation of positions in relevant securities. The deficiencies were first identified by JP Morgan in the US in October 2013 and brought to JPMSAP's attention in January 2014. During the sample year 2013, JPMSAP was required to disclose its financial interests of more than 1% in four listed issuers in 33 research reports, but it failed to do so in 30 of these reports (Note 3).
- JPMSAP failed to put in place adequate systems and controls to ensure compliance with the disclosure of financial interests requirements under the Code of Conduct.
- JPMSAP failed to make clear, concise and specific disclosure in the research reports where JP Morgan is a market maker. Instead of clearly specifying whether JP Morgan made a market in the relevant securities, JPMSAP simply included a standard disclosure clause referring investors to the HKEX website to check if JP Morgan was a liquidity provider or market maker for the securities covered (Note 4).

Offering of offshore index options without Type 2 and/or Type 5 registration

- Between 1 April 2003 and 22 July 2015, JPMCB offered certain offshore listed index options to its clients without a Type 2 (dealing in futures contracts) and/or Type 5 (advising on futures contracts) registration (Note 5).

Delay in reporting breaches to the SFC

- JPMSAP and JPMCB did not report the breaches or suspected breaches to the SFC in a timely manner as required under the Code of Conduct. In both instances, JP Morgan self-reported the breaches to the SFC around five months after discovery of the breaches (Note 6).

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

- JPMSAP and JPMCB co-operated with the SFC in resolving the SFC's concerns;
- JP Morgan has taken remedial measures to rectify the deficiencies in its securities position reporting system; and
- JPMCB has stopped offering offshore listed index options to clients.

End

Notes:

1. JPMSAP is a registered institution under the Securities and Futures Ordinance (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.
2. JPMCB 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 9 (asset management) regulated activities.
3. Paragraph 16.5(a) of the Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct) provides that where a firm has any financial interests in relation to an issuer or a new listing applicant the securities in respect of which are reviewed in a research report, and such interests aggregate to an amount equal to or more than 1% of the issuer's market capitalization (or the new listing applicant's issued share capital), the firm should disclose that fact in the research report.

4. Paragraph 16.5(b) of the Code of Conduct requires a firm that makes, or will make, a market in the securities in respect of the issuer or the new listing applicant to disclose that fact in the research report. Paragraph 16.10(a) of the Code of Conduct requires such disclosure to be clear, concise and specific.
5. During the relevant period, JPMCB offered to its clients offshore listed index options that referenced stock indices. The SFC considers that the products were futures contracts for the purpose of the SFO.
6. Under paragraph 12.5 of the Code of Conduct, a licensed corporation or registered institution is required to report to the SFC immediately upon the happening of any material breach, infringement of or non-compliance with any rules, laws, regulations and codes administered or issued by the SFC, or where it suspects any such breach, infringement or non-compliance by itself or persons it employs or appoints to conduct business with clients.

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

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STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has reprimanded J.P. Morgan Securities (Asia Pacific) Limited¹ (**JPMSAP**) and JPMorgan Chase Bank, National Association² (**JPMCB**), and fined them \$3 million and \$2.6 million respectively pursuant to section 196 of the Securities and Futures Ordinance (**SFO**) for regulatory breaches.
2. Following two separate investigations into the conduct of JPMSAP and JPMCB, the disciplinary action is taken in respect of:
 - (a) JPMSAP's failure to make proper and/or adequate disclosure of JP Morgan's financial interests and/or market making activities in the research reports issued by JPMSAP, in breach of paragraphs 16.5(a) and 16.5(b) of the Code of Conduct³, and related internal control deficiencies;
 - (b) JPMCB's offering of certain offshore listed index options that referenced stock indices (**Index Options**) to its clients during the period from 1 April 2003 to 22 July 2015 (**Relevant Period**) without a Type 2 (dealing in futures contracts) and/or Type 5 (advising on futures contracts) registration; and
 - (c) JPMSAP's and JPMCB's failure to report the breaches to the SFC in a timely manner, as required under paragraph 12.5 of the Code of Conduct.

Summary of facts

- (A) *Disclosure of financial interests and market making activities in research reports*
- Failure to disclose JP Morgan's financial interests in research reports*
3. Paragraph 16.5(a) of the Code of Conduct provides that where a firm has any financial interests in relation to an issuer or a new listing applicant the securities in respect of which are reviewed in a research report, and such interests aggregate to an amount equal to or more than 1% of the issuer's market capitalization (or the new listing applicant's issued share capital), the firm should disclose that fact in the research report.
 4. General Principle 7 and paragraph 12.1 of the Code of Conduct require licensed corporations or registered institutions to implement and maintain measures appropriate to ensuring compliance with relevant regulatory requirements.

¹ 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.

² JPMCB 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 9 (asset management) regulated activities.

³ Code of Conduct for Persons Licensed by or Registered with the SFC.

5. An SFC investigation revealed that JPMSAP failed to disclose JP Morgan's financial interests in respect of certain listed issuers covered in its research reports. The failure was caused by deficiencies in JP Morgan's global securities position reporting system which failed to include stock borrow and options positions in the calculation of positions in relevant securities. The deficiencies were first identified by JP Morgan in the US in October 2013 and brought to JPMSAP's attention in January 2014.
6. Despite the SFC's enquiries, it is unclear precisely when JP Morgan's system failed to capture stock borrow and options in its calculation of the firm's financial interests. Given that the macro that failed to include options in the relevant position calculations had been in use since at least 2010, it appears that there might have been deficiencies in JP Morgan's system since at least 2010.
7. During the sample year 2013, JPMSAP was required to disclose its financial interests of more than 1% in four listed issuers in 33 research reports, but it failed to do so in 30 of these reports, in breach of paragraph 16.5(a) of the Code of Conduct.
8. The SFC further found that JPMSAP relied on the systems in the US (which were designed for US disclosure requirements) for ensuring compliance with paragraph 16.5 of the Code of Conduct. The SFC considered that JPMSAP failed to put in place adequate systems and controls to ensure compliance with the disclosure of financial interests requirements under the Code of Conduct, in breach of General Principle 7 and paragraph 12.1 of the Code of Conduct.

Failure to make clear, concise and specific disclosure where the firm is a market maker

9. Paragraph 16.5(b) of the Code of Conduct requires a firm that makes, or will make, a market in the securities in respect of the issuer or the new listing applicant to disclose that fact in the research report.
10. Paragraph 16.10(a) of the Code of Conduct provides that where any matter is required to be disclosed under paragraph 16 of the Code of Conduct, the disclosure should be clear, concise and specific.
11. According to JPMSAP, a standard disclosure clause was included at the end of all its equity research reports, irrespective of whether JP Morgan made a market in the relevant securities or whether the research reports involved securities traded or to be traded in Hong Kong. The clause referred investors to the HKEX website to check if J.P. Morgan Broking (Hong Kong) Limited was a liquidity provider or market maker for the securities covered.
12. The standard disclosure clause did not disclose whether the firm made or would make a market in the securities covered in the research report at all. It merely informed investors the possibility that JP Morgan might be a liquidity provider or market maker in respect of such securities, and that investors could ascertain this fact from the HKEX website. In circumstances where JP Morgan was a market maker in the covered securities, the SFC considered that JPMSAP failed to discharge its obligation to make clear, concise and specific disclosure as required under paragraph 16.5(b) of the Code of Conduct.

(B) Offering of Index Options without a Type 2 and/or Type 5 registration

13. The SFC found that during the Relevant Period, JPMCB offered certain Index Options (which the SFC considers to be futures contracts for the purpose of the SFO) to its clients without a Type 2 (dealing in futures contracts) and/or Type 5 (advising on futures contracts) registration. During an internal compliance review in June 2015, JPMCB obtained preliminary advice from external counsel to the effect that the offering of the Index Options to the clients would require a Type 2 and/or Type 5 registration. JPMCB has ceased to offer the Index Options to its clients since 23 July 2015.

14. JPMCB executed 708 transactions concerning these Index Options for 37 clients involving premium of about US\$90 million during the Relevant Period (169 of these transactions were executed for 24 Hong Kong contracting clients).

(C) Delay in reporting breaches to the SFC

15. Paragraph 12.5 of the Code of Conduct requires licensed corporations or registered institutions to report to the SFC immediately upon the happening of any material breach, infringement of or non-compliance with any rules, laws, regulations and codes administered or issued by the SFC, or where it suspects any such breach, infringement or non-compliance by itself or persons it employs or appoints to conduct business with clients.

16. The SFC investigation showed that:

(a) JP Morgan in the US first identified that stock borrow and options positions were not included in the position reporting system in October 2013, and the issue was brought to JPMSAP's attention in January 2014. However, it was not until 26 March 2014 that JPMSAP made a self-report to the SFC regarding its breach of paragraph 16.5(a) of the Code of Conduct; and

(b) JPMCB discovered that it might have offered Index Options to clients without the relevant licence or registration in June 2015. It took preliminary advice from external counsel to the effect that the matter did not trigger a reporting obligation under paragraph 12.5 of the Code of Conduct. It only reported the matter to the SFC on 26 November 2015.

17. The SFC considered the delay in both instances to be lengthy, and JPMSAP and JPMCB were in breach of paragraph 12.5 of the Code of Conduct for failing to report the breaches, or suspected breaches, to the SFC immediately.

Conclusion

18. Having considered all the circumstances, the SFC is of the opinion that the fitness and properness of JPMSAP and JPMCB as regulated persons has been called into question.

19. In deciding the disciplinary sanctions, the SFC has taken into account that:

(a) JPMSAP and JPMCB co-operated with the SFC in resolving the SFC's concerns;

- (b) JP Morgan has taken remedial measures to rectify the deficiencies in its securities position reporting system; and
- (c) JPMCB has stopped offering offshore listed index options to clients.