

SFC reprimands and fines Merrill Lynch Far East Limited & Merrill Lynch (Asia Pacific) Limited \$15 million over internal control failures

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The Securities and Futures Commission (SFC) has resolved its concerns with Merrill Lynch Far East Limited (MLFE) and Merrill Lynch (Asia Pacific) Limited (MLAP) over internal control failures. Under the resolution, the SFC reprimanded and fined them a total of \$15 million for breaches of the Code of Conduct and the Internal Control Guidelines (Notes 1 & 2).

In the last quarter of 2016, the SFC, MLFE and MLAP jointly engaged an independent reviewer to review MLFE's and MLAP's internal controls related to its reporting of Large Open Positions (LOP), electronic trading systems, distribution of research reports involving futures contracts, and disclosure of market making activities in research reports.

The review findings revealed that:

- MLFE failed to ensure compliance with requirements for LOP reporting under the Securities and Futures (Contracts Limits and Reportable Positions) Rules and the Rules of the Hong Kong Futures Exchange in some instances since May 2006 (Note 3);
- in respect of the electronic trading system for trading in futures contracts, MLFE failed to:
 1. put in place formal governance including key policies and procedures when the electronic trading regulations under the Code of Conduct came into effect on 1 January 2014;
 2. effectively manage, adequately supervise and keep proper records on the design, development, deployment and operation of the electronic trading system; and
 3. ensure the integrity and reliability of the electronic trading system, and that the algorithmic trading system and trading algorithms are adequately tested to ensure they operate as designed (Note 4);
- MLAP failed to ensure compliance with the applicable legal requirement to obtain a licence for Type 5 regulated activity before carrying on business in advising on futures contracts between May 2005 and August 2016 (Note 5); and
- MLFE failed to disclose it was a market maker in the relevant securities in research reports distributed to clients between May 2011 and November 2016 (Note 6).

In reaching this resolution, the SFC took into account that MLFE and MLAP:

- self-reported to the SFC the unlicensed activity and non-disclosure of market making activities in its research reports;
- involved their senior management in the liaison with the SFC about the regulatory concerns at an early stage;
- took the initiative to bring this matter to an early conclusion by fully and frankly discussing the regulatory concerns with the SFC;
- undertook a credible review with the SFC to address the regulatory concerns and identify the deficiencies in its internal controls; and
- co-operated with the disciplinary action by resolving the SFC's regulatory concerns.

The SFC also took into consideration MLFE's board of directors have undertaken that the problems unveiled in the review findings concerning the compliance with requirements for LOP reporting will be rectified within 12 months and will not reoccur after 12 months.

The SFC considers MLFE's and MLAP's prompt cooperation has significantly expedited the disciplinary proceedings. Otherwise, similar failures would have resulted in a substantially higher level of fine.

End

Notes:

1. MLFE is licensed under the Securities & Futures Ordinance (SFO) to carry on business in Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 6 (advising on

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

2. Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct) and the Management, Supervision and Internal Controls Guidelines for Persons Licensed by or Registered with the SFC
3. General Principle 2 (diligence), General Principle 3 (capabilities), General Principle 7 (compliance) and paragraph 12.1 of the Code of Conduct require a licensed corporation to act diligently when conducting business activities, employ effectively the resources and procedures needed for the proper performance of its business activities, and to comply with the applicable regulatory requirements. In addition, Internal Control Guidelines requires that key components of the information system design and implementation programme are adequately documented and regularly reviewed for effectiveness.
4. Paragraph 18 of and Schedule 7 to the Code of Conduct set out specific requirements for licensed corporations that conduct electronic trading of futures contracts business.
5. A licensed corporation that distributes research reports involving futures contracts is required to hold a licence for Type 5 (advising on futures contracts) regulated activity. Please see Note 3 above in relation to the requirements under General Principle 7 (compliance) and paragraph 12.1 of the Code of Conduct.
6. Paragraph 16.5(b) of the Code of Conduct requires a firm to disclose in the research report if it makes, or will make, a market in the securities in respect of the issuer or the new listing applicant.

[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 publicly reprimanded and fined Merrill Lynch Far East Limited (**MLFE**) & Merrill Lynch (Asia Pacific) Limited (**MLAP**) a total of \$15 million pursuant to section 194 of the Securities and Futures Ordinance (**SFO**).
2. The disciplinary action is taken according to an agreement pursuant to section 201 of the SFO dated 23 March 2017 in relation to MLFE's and MLAP's internal control failures related to its reporting of Large Open Positions (**LOP**), electronic trading systems, distribution of research reports involving futures contracts, and disclosure of market making activities in research reports.
3. MLFE is licensed under the SFO to carry on business in Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 6 (advising on corporate finance) and Type 7 (providing automated trading services) regulated activities.
4. MLAP is licensed under the SFO to carry on business in Type 1 (dealing in securities), Type 4 (advising on securities) and Type 6 (advising on corporate finance) regulated activities.

Summary of facts

Reporting of Large Open Positions

5. As an Exchange Participant of the Hong Kong Futures Exchange Limited (**HKFE**) and a Stock Options Exchange Participant of the Stock Exchange of Hong Kong (**SEHK**), MLFE is required to comply with the requirements for LOP reporting under the Securities and Futures (Contracts Limits and Reportable Positions) Rules and the Rules of the Hong Kong Futures Exchange, and report the relevant reportable positions for its own account and for any client to the HKFE or SEHK. In May 2006, MLFE launched the LOP Reporting Program, which generates the LOP reports for submission to HKFE and SEHK.
6. In October 2016, the SFC and MLFE jointly engaged an independent reviewer to review MLFE's LOP reporting after instances of inaccurate LOP reports were identified (**LOP Review**).
7. The LOP Review identified a number of issues in relation to the LOP Reporting Program, some of which have existed since its inception in 2006. Most of the identified issues were in connection with program logic and coding errors, and

inadequate record-keeping. In particular, the reviewer found the following deficiencies, which contributed to MLFE's inaccurate LOP reporting:

- (a) poor design of the program, which resulted in incorrect processing of position data and the need for extensive manual processing subsequent to the generation of the interim LOP reports;
 - (b) overall lack of adherence to the IT change management procedures throughout the program development process, with limited to no supporting IT change documentation and audit trails, inadequate system testing to detect program logic issues, and undefined sampling rationale for system testing;
 - (c) the relevant escalation policies and procedures were confined within the operations team and did not include compliance nor specify the nature of issues that should be escalated;
 - (d) manual controls were not effectively designed to review the accuracy of the LOP reporting before submission, and manual reviews and updates made on spreadsheets were prone to human errors;
 - (e) inadequate documentation of processes and controls to ensure compliance with client instructions regarding delegated reporting, and lack of audit trail to support these instructions; and
 - (f) lack of systematic record-keeping.
8. General Principle 2 (diligence), General Principle 3 (capabilities), General Principle 7 (compliance) and paragraph 12.1 of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**) require a licensed corporation to act diligently when conducting business activities, employ effectively the resources and procedures needed for the proper performance of its business activities, and to comply with the applicable regulatory requirements.
 9. In addition, the Management, Supervision and Internal Controls Guidelines for Persons Licensed by or Registered with the SFC (**Internal Control Guidelines**) requires that key components of the information system design and implementation programme are adequately documented and regularly reviewed for effectiveness.
 10. In summary, MLFE's failures to put in place effective systems and controls to ensure compliance with the relevant regulatory reporting requirements lasted for a decade and breached the Code of Conduct and the Internal Control Guidelines.

Electronic and algorithmic trading systems

11. As a licensed corporation that conducts electronic trading of futures contracts, MLFE is required to comply with paragraph 18 of and Schedule 7 to the Code of Conduct, which have been effective since 1 January 2014.
12. In October 2016, the SFC and MLFE jointly engaged an independent reviewer to review MLFE's internal systems and controls in respect of its electronic trading and algorithmic trading systems for futures contracts after an algorithm order placed by

MLFE for execution in HSCEI futures contract caused irregular price movement in the market on 16 May 2016 (**Electronic Trading Review**).

13. The Electronic Trading Review found deficiencies of governance, testing, record-keeping, and risk controls in MLFE's electronic trading system for trading in futures contracts. In particular:
 - (a) the formal bodies in charge of the overall governance of the electronic trading operations were not established until September 2014, and the risk officer responsible for identifying, escalating, and mitigating electronic trading risk was not designated until June 2015;
 - (b) numerous key policies and procedures pursuant to the electronic trading regulatory requirements effective from January 2014 were not put in place until late 2015 or early 2016;
 - (c) a formal risk assessment framework to regularly assess if controls are sufficient in light of changing market conditions is still missing;
 - (d) the kill switches and order cancellation functionalities do not have formal framework governing their uses, and the clients were not formally informed of the order cancellation procedures;
 - (e) regular testing is not performed to ensure reliability of the electronic trading system;
 - (f) the alert monitoring team did not have sufficient resources to handle volume of alerts generated by the electronic trading system;
 - (g) the documentation for the system update, which led to the incident on 16 May 2016, does not contain sufficient details about the rationale and revisions made;
 - (h) the key document recording the risk controls of the algorithmic engine was not established until seven months after the system was implemented in December 2015;
 - (i) the parameters of the risk control limits of algorithmic trading system were set to default levels that did not reflect changes to market conditions, and there was no policy or procedure covering changes in certain risk control limit before August 2016; and
 - (j) the incident on 16 May 2016 was caused by a combination of inadequate testing, deficient alert monitoring and risk control thresholds that were insufficient to prevent market impact.
14. In summary, MLFE's deficiencies breached paragraph 18 of and Schedule 7 to the Code of Conduct, which specifically require licensed corporations that conduct electronic trading of futures contracts to, among others:
 - (a) implement policies, procedures and controls to ensure proper governance and risk management of its electronic trading system;

- (b) effectively manage, adequately supervise and keep proper records on the design, development, deployment and operation of the electronic trading system; and
- (c) ensure the integrity and reliability of the electronic trading system, and that the algorithmic trading system and trading algorithms are adequately tested to ensure they operate as designed.

Distribution of research reports involving futures contracts and non-disclosure of market making activities in research reports

- 15. In December 2016, the SFC, MLAP and MLFE jointly engaged an independent reviewer to review the controls over the issue of research reports on futures contracts and the disclosure of securities market making activities in the research reports (**Research Review**).
- 16. The Research Review found that between May 2005 and August 2016, MLAP published 34,832 research reports, which might contain commentaries on futures contracts, without being licensed in Type 5 (advising on futures contracts) regulated activity.
- 17. The research reports involving futures contracts were distributed through an in-house email platform and portal, and third party information vendors. On average, about 4,429 clients who could access the research reports had mailing address in Hong Kong from 2005 to 2016.
- 18. In summary, MLAP failed to put in place effective controls to ensure compliance with the licensing requirement¹ in breach of General Principle 7 (compliance) and paragraph 12.1 of the Code of Conduct.
- 19. In addition, the Research Review found that MLFE has acted as market maker for stock options in 18 Hong Kong stocks since 2011. From May 2011 to November 2016, 2,704 references were made to the relevant stocks in research reports distributed by MLAP. These research reports failed to disclose MLFE was a market maker in the relevant securities and breached paragraph 16.5(b) of the Code of Conduct.
- 20. Paragraph 16.5(b) of the Code of Conduct requires a firm to disclose in the research report if it makes, or will make, a market in the securities in respect of the issuer or the new listing applicant.

Conclusion

- 21. In coming to the decision to resolve the abovementioned failures concerning MLFE's and MLAP's internal controls, the SFC took into account all relevant circumstances, including that they:
 - (a) self-reported the unlicensed activity and non-disclosure of market making activities in its research reports to the SFC;

¹ section 114 of the SFO provides that no person shall carry on a business in a regulated activity or hold himself out as carrying on a business in a regulated activity unless he is licensed by the SFC

- (b) involved their senior management in the liaison with the SFC about the regulatory concerns at an early stage;
 - (c) took initiative to bring this matter to an early conclusion by fully and frankly discussing the regulatory concerns with the SFC;
 - (d) undertook a credible review with the SFC to address the regulatory concerns and identify the deficiencies in its internal controls; and
 - (e) co-operated with the disciplinary action by resolving the SFC's regulatory concerns.
22. The SFC also took into consideration MLFE's board of directors have undertaken that the problems unveiled in the review findings concerning the compliance with requirements for LOP reporting will be rectified within 12 months and will not reoccur after 12 months.
23. The SFC considers MLFE's and MLAP's prompt cooperation has significantly expedited the disciplinary proceedings. Otherwise, similar failures would have resulted in a substantially higher level of fine.