



Hong Kong

June 2020

## SFC PUBLICLY REPRIMANDS AND FINES GUOTAI JUNAN HK\$25.2 MILLION

On 22 June 2020, the SFC announced<sup>1</sup> that it has reprimanded and fined Guotai Junan Securities (Hong Kong) Limited (**Guotai Junan**) HK\$25.2 million for internal control failures and regulatory breaches in failing to mitigate risks of money laundering and terrorist financing in relation to third party fund transfers and a listed company's placing activities and failure to detect and late reporting of wash trades. Full details are available in the SFC's statement of disciplinary action<sup>2</sup> on the SFC website. The following is a summary of the key regulatory issues.

### 1. Lack of proper safeguards to mitigate risks of money laundering and terrorist financing in relation to third party fund transfers

The SFC found that Guotai Junan had failed to take reasonable measures to ensure the existence of proper safeguards to mitigate the risks of money laundering and terrorist financing in relation to third party fund transfers.

#### 1.1 Failure to adequately monitor client activities and scrutinise third party deposits and withdrawals

Guotai Junan was found to have breached section 5(1) of Schedule 2 of the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (**AMLO**) and paragraphs 5.1, 5.10 and 5.11 of the Guideline on Anti-Money Laundering and Counter-Terrorist Financing (the **AML Guideline**) in failing to

- <sup>1</sup> <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=20PR58>
- <sup>2</sup> SFC. Statement of Disciplinary Action. Available at: <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/openAppendix?refNo=20PR58&appendix=0>

adequately monitor client activities and scrutinise 15,584 third party deposits / withdrawals worth around HK\$37.5 billion in total between March 2014 and March 2015 and a further 5,406 transactions between July 2015 and June 2016.

#### Activities Raising Suspicion of Breaches of Anti-Money Laundering and Counter-Terrorist Financing Ordinance

The activities in some clients' accounts fell within situations which the AML Guideline and Guotai Junan's internal policies specify as potentially suspicious including:

- frequent transfers of funds to or from unrelated or unverified third parties - 11,501 of the 15,584 third party deposits/withdrawals were allegedly made between "friends" whose relationship was difficult to verify;
- transactions with no apparent legitimate purpose – despite clients being asked to give a reason for third party deposits and withdrawals, the reasons and relationships given often lacked sufficient details to allow Guotai Junan's staff to understand the reason for the fund transfers. Guotai Junan also unquestioningly accepted some deposits where the clients gave no details of the third party depositor and failed to explain why they used their securities accounts to receive deposits;
- cases where the source of funds was unclear or inconsistent with the client's profile. The SFC found instances of deposits from third parties whose

identities were not verified by Guotai Junan where the source of funds was unclear. Other withdrawals and transfers were inconsistent with clients' declared net worth and/or annual incomes;

- iv) unnecessary routing of funds to/from third parties or using accounts as a conduit for transfers. The SFC found that one of the 7 accounts sampled received over HK\$39 million from unverified third parties from 7 to 15 May 2014, an amount which substantially exceeded the client's declared net worth; and
- v) large or unusual cash payments (e.g. on two consecutive trading days, 22 cash deposits totalling over HK\$2 million were made into the account of one of the seven clients sampled by the SFC. Despite Guotai Junan's policy stating that cash funds of over HK\$1,000 would not generally be accepted, large cash deposits exceeding that amount were approved apparently without enquiry.

Despite these red flags, Guotai Junan failed to enquire about the transactions or flag them as suspicious and report them to the legal and compliance department. Guotai Junan only reported suspicious transactions in the account of one of the seven sampled clients to the Joint Financial Intelligence Unit (JFIU). It only identified and reported to the JFIU other suspicious transactions in the 7 client accounts sampled by the SFC after the SFC raised enquiries and 6 months to one year after the relevant transactions took place.

#### Breaches of Anti-money Laundering and Counter-Terrorist Financing Ordinance and AML Guideline

The firm's conduct breached the requirements of Section 5(1) of Schedule 2 to the AMLO and paragraphs 5.1, 5.10 and 5.11 of the AML Guideline which require licensed corporations to continuously monitor their business relationships with clients including:

- i) monitoring clients' activities, including cash and non-cash transactions, to ensure their consistency with the nature of the client's business, risk profile and source of funds;
- ii) identifying transactions that are complex, large or unusual and patterns of transactions with no apparent economic or lawful purpose which

may indicate money laundering and/or terrorist financing;

- iii) making relevant enquiries, examining transactions' background and purpose, and (where appropriate) the circumstances;
- iv) reporting suspicious transactions to the JFIU in a timely manner; and
- v) documenting the findings and outcomes of their examinations in writing to assist the relevant authorities.

#### **1.2 Failure to Effectively Implement AML and CTF Policies and Procedures**

Despite having AML/CFT policies on handling third party deposits and withdrawals, Guotai Junan did not have measures in place to ensure those policies and related procedures were properly and effectively implemented. The following failings were noted:

- i) Suspicious activities in the seven client accounts reviewed by the SFC were not reported to the firm's compliance officer or its money laundering reporting officer as required by the firm's policies. There appeared to be no monitoring by Guotai Junan's senior management of how operations staff assessed whether or not transactions were suspicious. Third party transfers and withdrawal instructions were checked by the Head of Operations on an ad hoc basis only;
- ii) Staff generally failed to comply with the firm's policy requirements to enquire about the reasons for third party transfers and the relationship between clients and transferees, and to document the reasons on the relevant third party fund deposit or instruction form. Guotai Junan did not provide adequate guidance to its staff on the extent of enquiries required to be made as to the reasons for third party transfers and clients' relationships with transferees;
- iii) There were a number of occasions when the reasons for third party withdrawals/deposits, relationships between parties and the identity

of third parties were not documented and these omissions were not identified by the Head of Operations during random reviews;

- iv) The firm's internal policy that third party withdrawal instructions would not be processed unless the client's relationship with the third party and the reasons for the third party receiving the funds were set out in the form, was not implemented in practice; and
- v) Reasons for third party deposits were usually written briefly on deposit slips contrary to the internal policy requirement that operations staff should document reasons for the deposit and the relationship between the client and third party depositor on the firm's Third Party Fund Deposit Instruction.

For the period July 2015 to June 2016, the SFC found that:

- i) of the 4,034 third party deposits between July and December 2015, there was no record of the depositor's identity for 527 third party deposits and the depositors' identify, customer relationship and reason for deposits were missing for at least 13 third party deposits; and
- ii) of the 1,372 third party deposits between January and June 2016, 97 were made through bank transfers or cheques despite internal policy stating that third party deposits made through transfers, remittances or cheques would not be accepted.

Guidance provided in AML/CFT staff training stated that Guotai Junan did not accept "friend" as an explanation for a third party transfer, however this was not reflected in the firm's policies and there were no measures to ensure it was implemented in practice. The SFC also found that operations staff gave conflicting evidence on who approved third party deposits / withdrawals and Guotai Junan's procedures did not require its money laundering reporting officer to play an active role in identifying suspicious transactions, contrary to paragraph 7.21 of the AML Guideline.

The SFC found these failures to breach Section 23 of Schedule 2 to the AMLO and paragraph 2.1 of the AML Guideline which require all reasonable measures to be taken to ensure that proper safeguards exist to mitigate the risks of money laundering and terrorist financing and to prevent contravention

of due diligence and record-keeping requirements under the AMLO. Failure to identify third party deposits, which may potentially be suspicious transactions, was also found to be a breach of paragraph 5.1 of the AML Guideline.

### 1.3 Failure to Put in Place Written Procedures to Identify Third Party Deposits

Guotai Junan failed to put in place written procedures to identify third party deposits (in breach of paragraph 5.1 of the AML Guideline) with Guotai Junan failing to identify that two deposits totalling HK\$38.2 million for a share subscription in December 2015 came from a third party. The firm had no written procedures for the identification of third party deposits until around September 2016. Previously, the firm's policies required third parties' identity to be checked only if third party deposits were identified, although there were no procedures for identifying third party deposits.

Guotai Junan stated that after 1 January 2016, a copy of the cheque would be obtained for a cheque deposit from a high risk customer or if it was over a certain amount to determine if the deposit was from a third party. However, the firm had no written procedures on cheque deposits and remittances until September 2016 and even then it merely required operations staff to ensure that the cheque issuer was the same as the account holder for cheque deposits and that remitters were the same as the account holders for bank transfers.

The SFC found that failure to comply with the relevant provisions of the AMLO and the AML Guideline, breached General Principle 7 and paragraph 12.1 of the Code of Conduct for Persons Licensed by or Registered with the SFC (the **SFC Code of Conduct**) which requires SFC-licensed corporations to comply with, implement and maintain measures appropriate to ensuring compliance with all regulatory requirements applicable to the conduct of their business activities.

## 2. Failures relating to a Listed Company's Placing Activities

Guotai Junan was the sole global coordinator, sole bookrunner and sole lead manager of an application to list on the Main Board of the Hong Kong Stock Exchange (**HKEx**). In January 2016, 21,338,000 shares of the listed company were placed by or through Guotai Junan to 5 placees for a total consideration of HK\$28.2 million. The 5 placees settled their allocations with funds deposited to their Guotai Junan accounts from a third party company.

### 2.1 Failure to Conduct Proper Enquiries and Properly Scrutinise Third Party Deposits

Guotai Junan accepted 5 separate fund transfer instructions for a total of HK\$29,103,610 from a single company on 29 December 2015. Each transfer instruction contained a similar handwritten note instructing Guotai Junan to deposit funds into the accounts of five placees and transfer instructions were not signed by the placees. The transfer instructions explained that the placees had entrusted a friend's company to deposit the funds on their behalf as they could not come to Hong Kong at the relevant time. The SFC found the third party deposits to be unusual and suspicious since:

- i) all five placees applied to open securities accounts with Guotai Junan on the same day;
- ii) details given in their account opening forms for their employment, income and net worth were identical;
- iii) the deposits were made on the same day the accounts were opened and by the same third party; and
- iv) deposit amounts substantially exceeded the annual income and net worth declared by each placee.

Despite the red flags, Guotai Junan accepted the third party deposits and effected the fund transfers in accordance with the transfer instructions without making any enquiries.

### 2.2 Failure to Conduct Proper Enquiries and Properly Scrutinise Placees' Subscriptions

Guotai Junan failed to conduct proper enquiries and sufficient scrutiny on the five placees' subscriptions. The firm's Equity Capital Market (**ECM**) department responsible for handling the five placees' subscription applications did not review the account opening documents or check the source of funds used by the placees to settle their subscriptions. The relevant staff were unaware that the funds for all five subscriptions had been transferred by the same third party.

Despite the red flags raising suspicions as to whether the placees beneficially owned their accounts and were independent of the listed issuer, the SFC found that Guotai Junan did not take reasonable steps to verify the ultimate beneficial owners of the five placees' accounts and their source of funds. It also relied on the placees' declarations of independence from the listed issuer without further enquiries.

It was later found that three of the placees were employed by the listed issuer and were allotted 11% of the shares placed under the international tranche, breaching the 10% limit on the placing shares that can be offered to a new issuer's employees (past or present) under paragraph 7 of Appendix 6 to the Listing Rules (Placing Guidelines for Equity Securities).<sup>3</sup>

The SFC found that such failures breached:

- General Principle 2 of the SFC Code of Conduct – the requirement to act with due skill, care and diligence, in the best interests of clients and the integrity of the market in conducting its business;
- General Principle 3 of the SFC Code of Conduct which requires SFC-licensed corporations to have and effectively employ the resources and procedures necessary to properly perform its business;
- The requirement under paragraph 5.1 of the SFC Code of Conduct to take all reasonable steps to establish the true and full identity of each client;
- Paragraph 4.7.12 of the AML Guideline which requires steps to be taken from time to time to ensure that the client information obtained for the purposes of complying with client due diligence and record-keeping requirements is up-to-date and relevant; and
- paragraphs 5.1, 5.10 and 5.11 of the AML Guideline and section 5(1) of Schedule 2 of the AMLO.

### 2.3 Failure to Detect Wash Trades and Late Reporting

The SFC found that Guotai Junan failed to detect a total of 590 potential wash trades in a timely manner between January 2014 and July 2016. The firm lacked adequate written trade monitoring procedures or guidelines before June 2016. The policies in place before then referred to wash trades but did not contain details on how to detect them. The failures were also attributable to the technical failures of a post-trade transaction pattern monitoring system implemented around December 2014. This post-trade surveillance system experienced technical failures from December 2014 to July 2016 and thus failed to generate alerts of suspicious activities. The system failures came to light on 30 June 2016 and Guotai Junan became aware of 210 potential wash trades, however these

<sup>3</sup> [https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Listing-Rules-Contingency/Main-Board-Listing-Rules/Appendices/appendix\\_6.pdf?la=en](https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Listing-Rules-Contingency/Main-Board-Listing-Rules/Appendices/appendix_6.pdf?la=en)

went unreported until 10 February 2017.

The SFC found such failures to breach General Principles 2, 3 and 7 and paragraphs 12.1, 12.5 and 2.1.1(b) of Schedule 7 to the SFC Code of Conduct. Paragraph 2.1.1(b) requires licensed corporations to have post-trade monitoring to identify manipulative or abusive order instructions and transactions. Guotai Junan also breached Paragraph VII.8 of the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC which requires the management of licensed corporations to establish and maintain effective procedures in relation to dealings and review procedures to prevent or detect errors, omission, fraud and other unauthorised or improper activities.

### **3. SFC Disciplinary Decision**

The SFC found that Guotai Junan had committed misconduct and that its internal control failures and regulatory breaches called into question its fitness and properness to remain a licensed corporation.

In reaching the decision to take disciplinary action, the SFC considered a number of factors including the extent of the AML/CFT failures, the extensive period of non-compliance and the length of time the potential wash trades went undetected. The SFC also considered the requirement for licensed corporations to report misconduct to the SFC immediately upon discovery, the need to send a message in order to deter similar misconduct and the prompt remedial action taken by Guotai Junan.

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