Financial Resource Management and FRR Compliance: Guidance for Licensed Corporations

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Background

The Securities and Futures Commission ("**SFC**") recently issued a circular ("**Circular**") emphasising the importance of robust governance and internal control standards for licensed corporations ("**LCs**"), in particular, in relation to the adequacy of an LC's financial resources.

The SFC identified examples of undesirable financial practices including:

- inadequate or ineffective controls over liquid capital monitoring;
- failure to make proper accruals or accounting provisions,
- incorrect treatment of certain assets or liabilities for liquid capital computation,

  all of which may result in abrupt deficiencies in excess liquid capital and breaches of liquid capital requirement under the FRR (see Appendix A to the Circular for further details). These shortcomings are mainly attributable to ineffective management oversight and the failure to engage competent and qualified personnel for calculating and monitoring liquid capital, as well as preparing and reviewing financial returns ("**FRR returns**").

In this News Flash, we summarise the SFC's expectations in respect of the governance, management oversight, and other internal control standards of LCs for monitoring the adequacy of financial resources and compliance with the Securities and Futures (Financial Resources) Rules ("**FRR**").

Expected Standards for LCs and their Senior Management

LCs are required to maintain liquid capital at or above the required level at all times. They are expected to employ necessary resources and procedures for the proper performance of their business activities, including maintaining sufficient liquid capital. If an LC is unable to maintain or ascertain its required financial resources, it must immediately cease all regulated activities and inform the SFC in writing, unless granted permission by the SFC.

Inadequate internal controls may lead to abrupt interruptions in regulated activities, potentially harming clients' interests and exposing the LC to risks such as theft, fraud, and professional misconduct. LCs must have adequate internal controls over FRR compliance. An LC's ongoing fitness and properness to remain licensed is directly affected by its FRR compliance, and the fitness and properness of the LC's senior management may also be questioned if such non-compliance is attributable to inadequate governance or internal control standards. Therefore, the SFC expects LCs and their senior management to employ and enforce effective policies, procedures and internal controls, to ensure that the LC has sufficient liquid capital, complies with all FRR requirements, and maintain sufficient resources to operate its business as a going concern.

Governance

The Circular specified that responsible officers ("**ROs**") and Managers-In-Charge of Core Functions ("**MICs**") of an LC are accountable for managing business risks and ensuring FRR compliance. They must ensure that the LC complies with relevant legal and regulatory requirements, including managing its financial resources and ensuring its compliance with the FRR. An LC must designate at least 1 RO or MIC to oversee the adequacy of financial resources and FRR compliance. These individuals are responsible for overseeing the calculation, monitoring and reporting of liquid capital, setting up and enforcing policies and procedures regarding financial resources adequacy and FRR compliance, as well as identifying issues and implementing remedial measures in case of any FRR compliance failure.

If a designated RO or MIC delegates or outsources the task of calculating, monitoring or reporting liquid capital, the RO/MIC must ensure such delegates are competent and possess the relevant qualification, knowledge and experience. Importantly, the LC remains responsible for the compliance with the FRR despite the outsourcing of such tasks.

Furthermore, the FRR returns of an LC must be signed by its RO or officer approved by the SFC (the "**Signer**"). The Signer must certify that the information provided in the FRR return is true and correct to the best of his/her knowledge in the declaration form of the FRR return. The SFC expects the Signer to have verified the liquid capital computation against relevant records, conducted necessary inquiries, and assessed whether the LC's systems and procedures can produce reliable, up-to-date and accurate financial information.

Internal Control

LCs are expected to implement effective controls for FRR compliance, including:

(a) sound accounting policies and procedures;

(b) a "maker and checker" mechanism for the calculation, monitoring and reporting of liquid capital;

(c) effective processes for ongoing liquid capital monitoring;

(d) regular liquid capital projections;

(e) liquidity management framework for handling thin excess liquid capital situations;

(f) procedures to ensure compliance with all relevant notification requirements; and

(g) clear allocation of scope, roles and responsibilities between the LC and any external service providers regarding outsourced accounting and FRR compliance functions.

The frequency of liquid capital monitoring should align with the LC's operational complexity. FRR compliance controls should also ensure proper segregation of duties.

Incident Report and Financial Distress Situation

If an LC has failed to maintain the minimum required liquid capital, it must submit an incident report (as set out in Appendix B to the Circular) to the SFC within 3 weeks of identifying the deficit, detailing the issue, its causes, and any remedial steps to redress the inability. LCs that cease to carry on regulated activities should promptly inform their clients of the same as soon as practicable.

LCs facing financial difficulties must act in accordance with the "Dealing With Disruptions Circular" and fulfil all regulatory obligations until licence revocation. It is important to note that an LC which has ceased business operation is still subject to all FRR requirements, and it should ensure sufficient resources for an orderly wind-down process and the return of client assets.

What this means for LCs

This Circular identifies various examples of observed internal control deficiencies in FRR compliance and sets out the SFC's expectations regarding the governance and internal control standards of LCs, including the designation of RO(s) or MIC(s) for overseeing the financial resources and FRR compliance. This serves as a clear mandate for LCs to review and enhance their internal control systems to ensure the adequacy of financial resources and the ongoing compliance with the FRR.

The Circular also provides a timely and important reminder that FRR adequacy and compliance go to the core of an LC's "fitness and properness" to be and remain regulated – and is thus something not to be taken lightly.

Let's talk

For a deeper discussion of how this impacts your business, please contact us.

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