Risk Management Analysis of Chinese Securities Companies Based on the 8.16 Incident of China Everbright Securities Company

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Abstract. Today, securities firms are exposed to a wide range of risks. Therefore, the ability to effectively manage risks has become an important factor, which affects the survival and development of the company. Some securities companies are lagging behind in risk management and internal control, and the resulting risk events have seriously affected the normal development of the company. External institutional supervision and internal risk management are the two main safeguards for securities companies to prevent risks. However, external regulation is often costly and not well targeted. For securities companies, strengthening their own risk management and internal control construction is the fundamental measure. This paper presents a case study and a general study of risk management in Chinese securities firms using a case study approach. The analysis focuses on the occurrence of the 8.16 incident at Everbright Securities and points out the serious deficiencies in the information system, risk reporting system and risk response mechanism, which are important aspects of risk management at Everbright Securities. Based on the problems exposed by Everbright Securities and the general problems of risk management in China's securities companies, this paper proposes three measures to improve risk management in China's securities companies: enhancing information systems, improving risk reporting pathway, building risk response mechanism.

Keywords: 8.16 Incident, Everbright Securities, Risk Management, Internal Control.

1 Introduction

1.1 Research Background

As China's market economy reform progresses, the securities industry plays an important role in the optimal allocation of resources and wealth management, facilitating the transformation of China's economic system. As a major player, securities companies are at the heart of the securities market, and as a result, they combine many kinds of risks. In the event that a securities company becomes insolvent due to improper risk control, it will not only bring difficulties to the company's operation, but will also

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directly affect investors and many counterparties due to the risk transmission effect of the securities market itself, bringing serious negative impact to the entire securities market and financial system.

Risk management is of great importance, both for the securities firms themselves and for the social economy as a whole. After the comprehensive treatment from 2004 to 2007, securities companies were able to release the risks accumulated in the past and entered a new period of development. However, risk management in securities firms still lags behind, and risk events arising from internal control deficiencies occur from time to time [1]. On 16 August 2013, serious problems of Everbright Securities led to severe market fluctuations, causing financial losses to investors and also subjecting Everbright Securities to huge penalties, which seriously affected the company's development. This incident is a wake-up call for our securities companies. While continuously innovating to achieve business development, risk management construction must also be strengthened in parallel. It also provides us with a real-life case study of risk management and internal control in securities companies.

1.2 Research Status

Krishnan (2005) and Doyleetal (2007) found that the size of a company is positively related to the soundness of internal risk, with the larger the company, the more sound the internal risk [2]. Doyleetal and Ashbaugh (2007) also found that the length of time a company has been in existence is also positively related to the soundness of internal risk [3].

In 2009, Ashbaugh found that tighter internal risk improves the quality of accounting information, as lax internal risk can lead to management interference with accounting information, which can lead to falsification [4]. In 2011, James studied the internal risk behavior of ten public companies in the United States and found that an effective internal risk system is one of the best ways to enhance the internal strength of a company.

In 2007, Doyleetal found that the better the financial position of a company, the better the internal risk of the company. Engel's study of privatization of listed companies also found that the implementation of more rigorous internal risk can lead to significant cost increases, especially for smaller companies [5]. In 2013, Dumitrascu and Savulescu analyzed the interrelationship between corporate governance and internal risk, arguing that the two should not be viewed separately, meaning that without effective internal risk, corporate governance is unlikely to work as intended [6].

Doyle and Abbott et al. argue that the likelihood of internal risk deficiencies is negatively related to the soundness of corporate governance mechanisms, and that the more sound the corporate governance mechanism, the less likely it is that internal risk deficiencies will occur [7]. Meanwhile, Li found that the higher the knowledge, experience and competence of the CFO, the better the level of internal risk of the company, and vice versa. However, this may be because the more capable the person, the higher the demands on the company, and good companies like capable employees [8].

Overall, it appears that internal control has evolved through roughly four stages (see Table 1)

Table 1. Historical development of theories related to internal control

Time	Development Stage	Main objectives
Before the 1940s	Internal control phase	Ensuring the authenticity of financial information
1940s to 1970s	Internal control system stage	Fraud prevention
1980s	Internal control structure phase	Helping to achieve set corporate goals
1980s to present	Internal control integration framework phase	Operating objectives, reporting objectives, compliance objectives

Source: Compiled by the author from literature

1.3 Research Contents and Framework

The first part is introduction, which contains the background of the study, the general framework, the significance and limitations of the study. The second part provides a review of the 8.16 incident at Everbright Securities. The third part analyses the deficiencies in the information system, risk communication mechanism and risk response mechanism of Everbright Securities as revealed by the incident. The forth part puts forward suggestions for improving the risk control construction of China's securities firms in terms of information systems, risk reporting channels, and risk emergency response systems based on the outstanding issues exposed in the Everbright Securities incident. The fifth part summarizes the previous article and identifies the shortcomings and limitations of this essay.

1.4 Research Significance and Limitations

Compared with general enterprises, securities companies face more complex risks in their operations. For securities companies, the prevention and handling of risks are directly related to the survival and development of securities companies, and improper risk management can bring serious impact to the operation of securities companies and even lead to the bankruptcy of the company, as well as bring negative impact to the entire financial market. Therefore, the establishment of an effective risk management and internal control system is an important means to enhance risk management capabilities.

There are numerous studies on risk management in securities companies, but many of them focus on risk management methods, and there are fewer studies from the perspective of internal control and corporate governance. Through the case study of the Everbright 8.16 incident, which has certain theoretical and practical significance for improving the risk management of securities companies, this paper analyses the typical problems of securities companies in China from the perspective of corporate governance and internal control. However, there are still many shortcomings in this paper. This paper only provides recommendations on risk management in the domestic securities industry from a qualitative perspective. However, there is a lack of accurate quantitative research and data analysis. Meanwhile, the analysis and discussion in this article is based on the "8.16" case of Everbright Securities, which inevitably has the inherent limitations of a case study and may also be biased. In addition, the analysis of the Everbright Securities case is based on publicly available market information, especially media information, which makes it difficult to avoid the impact of inaccurate media reporting on the study.

2 Case Description

On 16 August 2013, the Strategic Investment Department of Everbright Securities carried out ETF arbitrage trading as planned, and the auditors approved a trading quota of RMB 80 million for the trader before the opening of the trading session. At 9:41 a.m., the trader of the Strategic Trading Department analysed and judged that there was room for arbitrage on 180 ETFs, and then issued the first group of 177 commissioned orders to buy 180 ETF components through the arbitrage strategy order generation system. At 10:13 a.m., the trader issued a second group of 102 orders to buy 180 ETF constituents for a total amount not exceeding RMB1.5 million. At 11:02 a.m., the trader issued a third group of 172 orders to buy 180 ETF constituents for a total amount not exceeding RMB 2 million. Due to a glitch in the trading system, 26082 unanticipated orders were generated by the system and sent to the Exchange in the following 2 seconds [9].

As a result of the operation error, at 11:05 a.m., the SSE Composite Index suddenly rose 5. 96%, with heavyweight stocks such as PetroChina, Sinopec, ICBC and Bank of China all touching the halt, the market was pulled up in a straight line, and market investors speculated that there was a problem with the system. At 11:07 a.m., traders of Everbright Securities noticed an abnormal transaction amount and received a telephone enquiry from the Shanghai Stock Exchange, traders quickly withdrew orders in bulk and terminated the operation of the arbitrage policy order generation system. When the market closed at 11:30 a.m., the turnover amount of Everbright Securities shares was 7.27 billion yuan, and a total of 253 short contracts of stock index futures IFE 1309 were sold for hedging purposes. At 11:32 a.m., the media reported that the self-dealing department of Everbright Securities was suspected of 7 billion insider trading. At 11.59 a.m., the secretary of the board of directors of Everbright Securities denied the rumour and this misleading information was reproduced in major media. After the market opened at 1 p.m., the strategic investment department began to hedge the risk of buying shares in the morning. At 14:25 p.m., Everbright Securities issued an announcement acknowledging that there was a problem with the company's arbitrage system and that internal verification and corresponding disposal work was being carried out.

After the 8.16 incident of Everbright Securities, the Securities Regulatory Commission issued a penalty decision, found that Everbright Securities remedial measures for insider trading, confiscated 84.21 million yuan of illegal income of Everbright Securities, and imposed a fine of 5 times the amount of 520 million yuan. Stopped Everbright Securities from engaging in securities proprietary business and suspended the approval of new business of Everbright Securities [10]. When such bad incidents occur, we should actively find the problems and provide solutions to prevent them from happening again. The 8.16 incident of Everbright Securities reflected three major problems with its risk management that is Deficiencies in information systems, inadequate information communication mechanisms and inadequate risk response mechanisms. Next, this article will analyse each of these three issues and propose solutions to the corresponding problems.

3 Analysis on problems

3.1 Deficiencies in Information Systems

The 8.16 incident of Everbright Securities occurred in the strategic trading department, which at the time applied a high-frequency trading system. The information processing speed of the high-frequency trading system is very fast, which simplifies the transaction processing process and avoids the problem of wasted resources. In order to improve the efficiency of a high-frequency trading system, its software and hardware must be constantly optimized and designed [11].

Although Everbright Securities has built a high-frequency trading system, it has not continuously improved the strategic trading system, which affects the basic functions of the high-frequency trading system. The trading system mainly consists of two functional links: the first functional link is the order generation link; the second functional link is the order execution link. In order to ensure that the work is not leaked, Everbright Securities Corporation designs its own procedures for the system. In addition to the trading system, there were also design issues with the execution system of Everbright Securities Inc. and the two went hand in hand to cause this incident. In the strategic trading system, Everbright Securities entered the order ‘buy individual stock function’ as a ‘buy basket of stocks function’. In the event of an instruction error, a number of problems with the strategy trading process would have arisen. If a normal design session had been used, the trading price would have been limited by the order. However, due to a programming error in the execution system, the order limit for the trade price was missing and the reported order amount in the Everbright Securities Company account could not be displayed. With the order amount not visible, the system was unable to check and verify the credit limit. The problems arising from the execution and communication systems caused this incident to have a deleterious effect on the securities market.

3.2 Inadequate Information Communication Mechanisms

In order to ensure the smooth operation of the working system, Everbright Securities Company needs to achieve the active cooperation of all departments and build a perfect information intercommunication mechanism. In the absence of information communication, the leading department, decision-making department and execution department of Everbright Securities Company are separated from each other [12]. Therefore, information transfer and information feedback are not timely enough, making it easy for problems of abnormal risk management to occur. The lack of information communication was also revealed soon after the emergence of problems at Everbright Securities. After the 8.16 incident, the CSRC monitored the system operation of Everbright Securities Co. and found that there were abnormal transactions at Everbright Securities Co., and then CSRC called to enquire about the actual operation of Everbright Securities Co. In the course of the calls, it was found that many departmental staff were not aware of the working information. They claimed that they were not in the company and did not know the situation. In addition, due to the dissemination of false information by the Chairman's Secretary, the CSRC decided to impose penalties in the final review process.

The lack of information disclosure for Everbright Securities Company was caused by two factors. Firstly, the various departments did not establish their information sharing mechanisms and the liquidity of various information was relatively poor. The trading staff had reported the situation to the competent authorities when there were trading fluctuations in Everbright Securities Company. The competent department analysed the situation and claimed that it would report the main information to the chairman and president, etc. However, in fact, the competent authorities did not report the information, resulting in Everbright Securities Inc. taking a greater operational risk. Secondly, the chairman's secretary did not assume his own responsibility. The Chairman's Secretary played a key role in the operation of the entire Everbright Securities Company. But when risky events arose, he did not acknowledge and address them, but chose to deny the facts. When the chairman's secretary issued a speculative statement, the media reproduced the chairman's secretary's remarks, resulting in turmoil in the securities market [13].

3.3 Inadequate Risk Response Mechanisms

In the day-to-day operations of a company, the risk response mechanism plays a critical role in proposing risk remediation measures and dealing with risks on an emergency basis. The 8.16 incident showed that Everbright Securities did not have the necessary risk response mechanisms in place. Therefore, when a risk issue arises, it is impossible to deal with the incident urgently at the first time. It is noteworthy that not only did Everbright Securities fail to deal with the risks urgently after this vicious incident, but the reasonableness of many of the subsequent remedial measures is questionable. In order to cushion the financial losses arising from this crisis, Everbright Securities Company chose to short sell stock index futures, but there were obvious procedural problems in adopting this approach. Everbright Securities Company adopted an authorization mechanism, and in doing so, it needed to play a joint role of the board of directors, the decision-making department and the proprietary department [14]. With all three departments adopting the policy, the authorization can be completed. However, the decision-making committee and the risk control committee did not play a role in the decision-making process, and only the president led the risk response actions of Everbright Securities Inc.

When Everbright Securities decided to short sell stock index futures to cover its previous losses, it did not make the information public in the first instance, preventing the external market from accessing information about Everbright Securities Inc. in a timely manner. This act was qualified as undisclosed insider information and was suspected of insider trading. Therefore, Everbright Securities Inc. was punished by CSRC. An analysis of the results of its insider trading reveals that the way of trading first and disclosing later did bring a gain of RMB 80 million to Everbright Securities Company, which further solidified the suspicion of Everbright Securities Company's violation of the law. If Everbright Securities had developed an effective risk response mechanism, complied with laws and regulations, and handled risk incidents correctly, it might not have been in this predicament.

4 Suggestions

4.1 Research Background

In order to improve the standard of financial risk management for Everbright Securities, the first step is to strengthen the information system, as deficiencies in the information system were the main cause of the 8.16 incident of Everbright Securities. The network information technology of China continues to develop, and its integration with the securities industry is becoming closer. The application of network information technology in the construction of information systems can improve the efficiency and speed up the processing of information. It is worth noting that although network information technology has many advantages, there are also inevitably many risks. In order to form a reliable information system and improve the service quality of the information system, Everbright Securities Company needs to draw on the experience of securities information systems in foreign developed countries and optimize the allocation of resources in the information technology department [15]. Moreover, information systems are built with certain security risks, such as programming errors, malfunctioning instruction design, etc., which can have an impact on the functioning of the information system. Therefore, Everbright Securities Company must invest more money to assess and prevent possible risks. At the same time, the risk control system of Everbright Securities Company should follow up its work in a timely manner and gradually form the most scientific risk management plan. After the establishment of the information system, each department should be invited to test the information system and be required to submit test reports to ensure that the information system functions well and is resistant to stress. After each department has approved the construction of the information system, Everbright Securities can put the information system into use [16].

4.2 Improving Risk Reporting Pathway

The management of the transmission of risk information at Everbright Securities was confusing, and the relevant risk information was not effectively communicated internally after the incident, resulting in errors in external information disclosure. The problem of unclear risk reporting paths is also common among other securities companies, and the roles of various departments in the transmission of risk information are not clearly defined, resulting in relevant risk information not being transmitted to the corresponding responsible persons in a timely manner, making risk management difficult.

The Code on Comprehensive Risk Management for Securities Firms highlights the necessity to establish a sound risk information communication mechanism to ensure that risk information is passed between relevant departments of the firm in a timely, accurate and complete manner. Securities firms must shape an efficient risk management information transfer process to ensure effective top-down and bottom-up transfer of corporate risk information, without violating confidentiality and firewalls [17]. The business units of a securities firm are the first recipients of risk information, and monitor, check and control the business units accordingly. Risk information from business departments is reported to the risk management headquarters, and the reporting path should be independent of the execution path of business decisions in order to ensure the accuracy and reliability of the information.

4.3 Building Risk Response Mechanism

An analysis of Everbright Securities Company reveals that Everbright Securities Company has not formed a scientific and effective risk contingency mechanism and has encountered a series of obstacles in preventing risks. Apart from Everbright Securities Company, other securities companies in China also have the problem of inadequate risk contingency mechanisms. In the event of a risky incident, the securities companies are less able to respond and have to bear greater financial risks. In order to avoid these problems, Everbright Securities Company should formulate risk plans according to the types of risks and gradually form an effective risk contingency mechanism.

In the process of constructing the risk contingency mechanism, Everbright Securities Company should first determine the conditions for activating the risk contingency mechanism. For Everbright Securities Company, risks can be divided into three categories: the first is a particularly significant risk, the second is a major risk and the third is a serious risk. The first type of risk can cause serious economic losses and may even lead to corporate bankruptcy; the second type of risk causes some economic losses and can have a bad impact on the normal operation of the company. The third type of risk does not cause as much economic loss, but still has an impact on individual earnings and group earnings [18]. The three risks mentioned above have different triggering conditions. Therefore, the corresponding risk plans should also show significant differences.

Furthermore, Everbright Securities should set up a risk response team so that it can solve problems more effectively in the face of risky crises. The tasks to be performed by the risk response team include the following: firstly, it is necessary to identify the various types of risks and decide whether to activate the risk response system. Secondly, a risk response plan needs to be developed based on the severity of the risk, and public disclosure of risk information needs to be made [19]. Thirdly, experienced risk control experts should be hired so that the experts can propose the optimal solution to the crisis, and minimize the financial losses borne by the company.

5 Conclusion

This paper analyses the issues arising from risk management in Chinese securities firms in the context of risk management theory and internal control theory. The paper takes the 8.16 incident of Everbright Securities as the object of study, and analyses the risk management issues that erupted in the incident. At the same time, risk management countermeasures for China's securities industry are improved based on the issues that arise. The conclusions drawn from the study of this paper are as follows.

Firstly, the inadequate risk management system, the confusion of information communication mechanisms and inadequate risk response mechanisms were main factors that contributed to the 8.16 incident of Everbright. Secondly, combining the problems that emerged from the 8.16 incident and the general problems of risk management in the Chinese securities market, there is a need to improve the information system and risk response system, so as to enhance the effectiveness and quality of risk management in the securities industry. Thirdly, in the process of improving the existing problems, Everbright Securities has to consider its own actual situation. Meanwhile, it should take precautions that appropriate to the situation of the company to combat risks, so that it can reduce the chances of them occurring.

The occurrence of the 8.16 incident of Everbright Securities has sounded an alarm for the risk management of securities companies in China. Due to the author's own research level, this paper still has the following shortcomings. First of all, this paper focuses on the qualitative aspects of risk management and lacks quantitative calculations. Therefore, the accuracy of the conclusions drawn in this paper still needs to be further confirmed through quantitative analysis. Furthermore, the most critical aspect of this paper's recommendations on risk management in securities firms is the implementation of the measures. Further research is needed on how to ensure that these measures can be effectively implemented in practice, considering the actual situation of the company.

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