SFC Compliance Bulletin: Intermediaries

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This newsletter provides guidance to licensed corporations, registered institutions and other market practitioners on the SFC's regulatory and supervisory priorities.

Welcome to the new series

This is the first edition of the *SFC Compliance Bulletin: Intermediaries*, a new publication to provide guidance to intermediaries[1] and market practitioners on the SFC's regulatory and supervisory priorities.

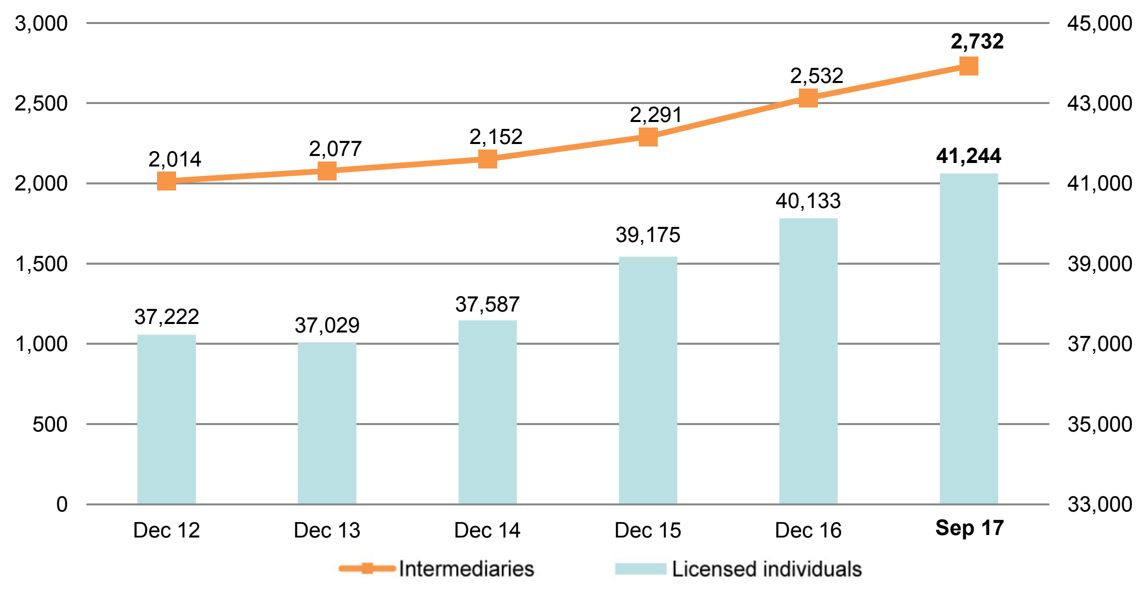
This edition starts with an overview of industry demographics, followed by four supervisory cases which highlight the importance of managing conflicts of interest in selling practices and asset management. Intermediaries should take note of the nature of these conflicts and take all necessary measures to avoid similar egregious conduct.

Fast-changing industry landscape

The past few years saw strong growth in the number of intermediaries and licensed individuals. In particular, a notably sharp rise was recorded after the launch of Shanghai-Hong Kong Stock Connect in 2014. The number of intermediaries and licensed individuals respectively increased at an annual compound growth rate of about 7% and 2% since 2012, reaching record highs of 2,732 and 41,244 as of 30 September 2017.

Hong Kong's position as a leading global asset management centre is reflected in the rise in the number of intermediaries and licensed individuals for Type 9 regulated activity (asset management).

Number of intermediaries and licensed individuals



[1] Licensed corporations or registered institutions.

The number of asset management intermediaries surpassed the number of intermediaries licensed or registered for securities dealing in early 2014 and it has since increased faster than that for other regulated activities. As of 30 September 2017, there were 1,472 asset management intermediaries, making up 54% of all intermediaries. They engaged in a wide range of activities including managing public and private funds and discretionary accounts.

Meanwhile, the number of individuals licensed for asset management reached 10,252 as of 30 September 2017, up 3,575 or 54% from the end of 2012. This was the largest numerical increase amongst all ten types of regulated activity.

In response to changes in the industry landscape, the SFC repositioned the way in which it supervises intermediaries by placing more emphasis on front-loaded regulation and real-time supervision. For example, thematic reviews tackle specific risks as they emerge, whilst early public notifications of the SFC's inspection priorities promote awareness of emerging issues and risks.

Conflicts of interest

In the SFC's supervision of licensed corporations (LCs) as well as in joint thematic reviews with the Hong Kong Monetary Authority (HKMA) which covered registered institutions (RIs), instances of failure to properly manage conflicts of interest in selling practices and asset management were noted. Under General Principle 6 and paragraph 10.1 of the Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct), intermediaries should try to avoid conflicts of interest. When they cannot be avoided, they should be disclosed and all reasonable steps taken to ensure clients are treated fairly.

Conflicts of interest can arise in many situations and in different forms when intermediaries stand to benefit at the expense of their clients. Firms must identify and address situations when such conflicts may occur, eg, when a firm distributes its "in-house" products or charges different commission rates for the same product; or when a fund manager enters into connected transactions or receives cash rebates generated from transactions made by a fund under its management.

Firms should have clear, detailed policies and procedures to manage conflicts of interest and review them regularly to ensure they are relevant and effective.

The SFC will continue to focus on conflicts issues in its supervisory work. The SFC will not hesitate to take action against LCs and their senior management for failing to properly handle conflicts of interest, or otherwise failing to act honestly, fairly, and in the best interests of their clients.

General Principle 6 of the Code of Conduct states that a licensed or registered person should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its clients are fairly treated.

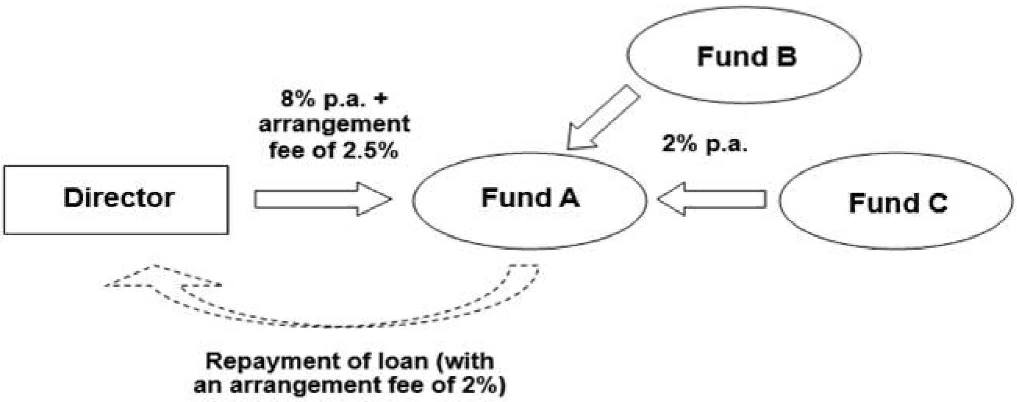
Conflicts in managing private funds

During an inspection of a manager of private funds, the SFC found that it did not have appropriate risk management policies to address concentration and liquidity risks. The funds invested heavily in concentrated positions in illiquid stocks. These funds faced a liquidity problem when the prices of these shares dropped significantly.

To meet margin calls, the fund manager arranged loans between different funds under its management, the terms of which were unfair to the lending funds' investors.

For example, some of the lending funds had outstanding redemption requests or margin loans payable to execution brokers, but the fund manager nevertheless arranged loans from these funds. As the borrowing funds did not provide any collateral or guarantees, the lending funds were exposed to default risks. The lending funds were further disadvantaged because the interest rate of 2% p.a. charged on the loans was much lower than the market rate of at least 8% p.a. charged for securities margin financing.

Separately, the SFC also found that loans from a fund director to one of the funds with a liquidity problem were arranged under more favourable terms. One of these loans, subject to a one-off arrangement fee of about 2%, was repaid after a fortnight even though the borrowing fund had other loans outstanding. Another loan was subject to a higher one-off arrangement fee of 2.5% and an interest rate of 8% p.a.



Conflicts in rebates

An SFC inspection found that a fund manager received unusually large cash rebates from the transactions made by a fund under its management. Approximately 80% of the fund's transactions were directed to execution brokers which rebated as much as 85% of their commissions. The fund manager failed to explain why the majority of trades were directed to execution brokers offering high rebates.

The SFC was concerned that the exceptionally high stock turnover in the fund suggested the fund manager might have traded more frequently than needed as a means to generate cash rebates for its own benefit.

Conflicts in selling practices

During an inspection, it was noted that an LC, in the course of distributing unlisted bonds as placing agent for a Hong Kong-listed company, placed to three retail clients a bond which was issued on the same date and at the same price but at different annual coupon rates. The LC earned a placing commission of 30% of the principal amount for selling the bond with a coupon rate of 4%. This decreased to 23.75% and 20% respectively where the coupon rate increased to 5.25% and 6%. The lower the coupon rate, the higher the placing commission earned by the LC. This arrangement clearly presented material conflicts of interest.

More specifically, the LC failed to demonstrate that it had taken reasonable measures to ensure fair treatment of clients (eg, providing appropriate advice as to whether the lower coupon rates of 4% and 5.25% were a fair yield in the circumstances), and had not disclosed material conflicts of interest (including the inverse relationship between the coupon rate and the placing commission earned by the LC) to help clients decide whether to invest in the bond.

Paragraph 10.1 of the Code of Conduct

Disclosure and fair treatment

Where a licensed or registered person has a material interest in a transaction with or for a client or a relationship which gives rise to an actual or potential conflict of interest in relation to the transaction, it should neither advise, nor deal in relation to the transaction unless it has disclosed that material interest or conflict to the client and has taken all reasonable steps to ensure fair treatment of the client.

Conflicts in selling "in-house" products

Some large financial institutions in Hong Kong conduct business through different RIs and LCs which carry out agency and product manufacturer roles. For instance, LCs may act as the manufacturer of investment products which are distributed to end-clients by the RIs within the same group.

The HKMA and the SFC conducted joint thematic reviews of selected large financial institutions focusing on the potential conflicts of interest arising from the sale of "in-house" products. We found that some RIs mainly selected structured products issued by related entities, such as LCs within the group, for sale to clients without a rigorous mechanism to compare quotes from external counterparties. Not only was there insufficient disclosure to clients of these arrangements, in some cases client orders were not executed at the best prevailing price.

In addition, product due diligence policies and procedures of one RI were noted not to cover the assessment of conflicts of interest in the sale of "in-house" products. The RI also relied on its affiliated LC to perform product due diligence on third-party managed funds without conducting any independent assessment. As the LC managed its own public funds at the same time, this arrangement clearly presented material conflicts of interest.

Furthermore, an LC applied lower fees and charges to some "in-house" products if the transaction amount exceeded a threshold. However, the RI, when soliciting clients to invest in these products, did not disclose that they were entitled to these lower fees and charges even when the transaction amount exceeded that threshold.

As a discretionary account manager, an RI invested substantially (over 90% of portfolio size) in "in-house" products manufactured by an LC within the same group. Again, no robust monitoring tools or controls were in place to ensure that the selection of "in-house" products matched the investment strategies and risk expectations agreed with clients.

Supervisory outcome

In response to the SFC's concerns, the intermediaries in these cases took action to rectify failures, including ceasing unsatisfactory practices, undertaking to engage an independent firm to conduct a review of their compliance systems and controls and enhancing policies and procedures.

The SFC is also investigating aspects of improper conduct and, where appropriate, will take enforcement action against the intermediaries and Managers-In-Charge concerned.

Intermediaries and their senior management are reminded to pay close attention to the circulars issued by the SFC on 31 July, 15 September and 24 November 2017 which reiterate that they are responsible for maintaining appropriate standards of conduct and robust policies and procedures to manage conflicts of interest and take all reasonable steps to ensure fair treatment of their clients. The SFC will not tolerate intermediaries treating clients unfairly or benefiting at the expense of clients' interests.

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