

21 November 2019

Circular to licensed corporations

Dubious private fund and discretionary account arrangements or transactions

This circular provides guidance to assist asset managers¹ in (i) considering if a proposed private fund and discretionary account arrangement or transaction is dubious and (ii) deciding if they should proceed with a proposed arrangement or transaction that has been considered dubious.

In a Statement on the Disclosure of Actual Controllers or Beneficial Owners of Counterparties to a Transaction, also issued by the Securities and Futures Commission (SFC) today, listed issuers are reminded that they should not employ private fund structures, discretionary accounts or similar arrangements with a view to avoid or to contravene laws, rules or regulations.

Background

The SFC has identified a number of dubious arrangements and transactions involving private funds or discretionary accounts in its supervision of asset managers². In these cases, asset managers did not act in the manner which would normally be expected of a conventional investment manager in exercising its discretion to make investment decisions for the funds or discretionary accounts under their management. They largely followed investors' instructions when structuring private funds or discretionary accounts and effecting transactions. Many of these arrangements and transactions involved other red flags and together should have led to a reasonable suspicion on the part of asset managers that these might not be legitimate or proper.

Asset managers should not disregard signs of dubious private fund and discretionary account arrangements or transactions, which may facilitate the following types of misconduct by their clients or other entities:

- (a) avoiding or contravening any of the market misconduct provisions or disclosure obligations set out in Part XIII, Part XIV, Part XIVA or Part XV of the Securities and Futures Ordinance (SFO) or other laws, rules and regulations, such as the Codes on Takeovers and Mergers and Share Buy-backs and the Listing Rules³;

¹ This circular does not apply to licensed corporations which provide discretionary account services as an ancillary part of their brokerage services for clients without any formal investment mandates agreed with, or management fees charged to, clients.

² These arrangements and transactions were previously referred to in the following circulars:

- [HKMA and SFC adopt a coordinated approach to supervise banks and licensed corporations, 24 April 2019.](#)
- [Circular to intermediaries – Use of “nominees” and “warehousing” arrangements in market and corporate misconduct, 9 October 2018.](#)
- [Circular to licensed corporations – Margin financing activities disguised as investments, 3 August 2018.](#)
- [Circular to licensed corporations engaged in asset management business – Irregularities and deficiencies in managing private funds and discretionary accounts, 31 July 2017.](#)

³ The Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (Listing Rules)

- (b) conducting unlicensed regulated activities; or
- (c) involvement in fraud or other serious misconduct or illicit activities.

In disregarding dubious arrangements or transactions, an asset manager may have failed to act honestly, fairly or with due skill, care or diligence, in the best interests of its clients or the integrity of the market in accordance with General Principles 1 and 2 under the Code of Conduct⁴. Failure to report suspicious client transactions may also amount to a breach of paragraph 12.5(f) of the Code of Conduct.

In addition, an asset manager may also be in breach of paragraphs 3.2, 4.1.4, 4.9 or 7.23 of the AML Guideline⁵ by failing to:

- (a) conduct customer due diligence (CDD) measures to verify the identity of the client or beneficial owner;
- (b) obtain information about the purpose and intended nature of the business relationship it has established;
- (c) adopt a risk-based approach in determining the extent of CDD measures and ongoing monitoring so that preventive or mitigating measures are commensurate to the risks identified;
- (d) comply with special requirements in a situation which by its nature may present a high risk of money laundering or terrorist financing; or
- (e) report suspicious transactions to the JFIU⁶.

These failures or breaches will call into question whether the asset manager remains fit and proper to be licensed.

Expected standards of conduct

The senior management of a licensed firm bears the primary responsibility for ensuring the firm's maintenance of appropriate standards of conduct and adherence to proper procedures⁷. As such, the senior management⁸ of an asset manager should ensure that there are effective procedures and controls for the asset manager to (i) consider if a proposed private fund and discretionary account arrangement or transaction is dubious and (ii) decide if the asset manager should proceed with the relevant arrangement or transaction. This process should cover the following:

- (a) Initial screening
- (b) Detailed due diligence

⁴ Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct)

⁵ Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations) (AML Guideline)

⁶ Joint Financial Intelligence Unit (JFIU)

⁷ General principle 9 (Responsibility of senior management) of the Code of Conduct

⁸ Senior management should include, but not be limited to, the Manager-in-Charge (MIC) of Overall Management Oversight, MIC of Key Business Line (ie, asset management), MIC of Compliance and MIC of Anti-Money Laundering and Counter-Terrorist Financing

- (c) Senior management assessment and decision
- (d) Documentation

Asset managers should observe substance over form throughout the entire process. For more details about the expected standard of conduct, please refer to Appendix 1.

(a) Initial screening⁹

Once an initial screening determines that a proposed arrangement or transaction is dubious, asset managers should not proceed without prior written approval from senior management with the reasons clearly stated.

Asset managers should be familiar with the red flags included in Appendix 2 and be able to recognise them. However, as they are non-exhaustive and practices evolve over time to avoid regulatory scrutiny, asset managers should not adopt a box-ticking approach. Instead, they should:

- (i) perform an initial screening of each proposed arrangement or transaction which appears to deviate from generally accepted market practices, such as setting up master-feeder fund structures or special purpose vehicles for tax purposes, using derivative instruments for making an investment for a fund under the Qualified Domestic Institutional Investor program and having multiple funds or special purpose vehicles in private equity funds; and
- (ii) assess if there is any reason to suspect that the asset manager is not, or will not be, required or expected to make any investment decisions (apart from mere execution or operational decisions), and if there is, look more closely at the details and consider the proposed arrangement or transaction to be dubious unless these reasons can be addressed. See paragraph 2 in Appendix 1 for examples of the types of questions asset managers should ask when reviewing the details of proposed arrangements and transactions.

(b) Detailed due diligence

All proposed arrangements or transactions which were considered dubious at the initial screening should be logged and subject to detailed evaluation. Asset managers should conduct enhanced due diligence on the investor, the set up and structure of the fund and discretionary account and transactions directed by the investor. The asset manager should then escalate the proposed arrangement or transaction and its due diligence report to senior management for review and a decision.

(c) Senior management review and decision

Senior management should exercise due skill, care and diligence in reviewing each proposed arrangement or transaction which was considered dubious at initial screening.

⁹ For the avoidance of doubt, initial screening should generally not be necessary where asset managers do not know the identity of the end investors of private funds under their management, for example, where they have appointed another party to distribute these private funds to end investors and the identity of these end investors is not disclosed to asset managers.



Additional steps should be taken as needed. In particular, senior management should critically assess if it has any remaining doubts about the investor's explanations, the investor's sources of funding and whether the transaction is at arm's length. Senior management should only decide to proceed if it is satisfied that the suspicions (for example, of misconduct) have been sufficiently addressed.

(d) Documentation

The asset manager should maintain full documentation covering all aspects of every proposed private fund or discretionary account arrangement or transaction which was considered dubious in the initial screening.

If asset managers fail to detect dubious arrangements or transactions or they facilitate illegal or improper conduct due to inadequacies in their procedures and controls, the SFC would not hesitate to take regulatory action against them and their senior management.

Should you have any questions regarding the contents of this circular, please contact your case officers.

Intermediaries Supervision Department
Intermediaries Division
Securities and Futures Commission

Enclosure

End

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