

31 July 2017

Circular to Licensed Corporations Engaged in Asset Management Business

Irregularities and Deficiencies in Managing Private Funds and Discretionary Accounts

The Securities and Futures Commission (SFC) has identified a number of potential regulatory concerns during the course of its supervision of licensed corporations engaged in managing private funds¹ and discretionary accounts (“asset managers”). In a number of cases, private funds and discretionary accounts with concentrated, illiquid and interconnected investments were found to have irregular features.

The SFC expects the board and other senior management (including the Managers-In-Charge of Core Functions) of all asset managers to maintain adequate oversight of their firm’s business activities. In particular, they should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct, including but not limited to acting fairly and in the best interests of their clients and the integrity of the market, as well as for ensuring adherence to proper procedures and the maintenance of proper risk management measures. They should review the areas of concern discussed below and give priority to strengthening their supervisory and compliance programmes to ensure compliance with all applicable regulatory requirements.

The SFC will continue to closely supervise asset managers and will not hesitate to take action against any licensed corporations and their management, including the relevant Managers-In-Charge, for failure to comply with regulatory requirements.

Acting in the best interests of the integrity of the market

The SFC noted a number of irregular features in some private funds and discretionary accounts with concentrated, illiquid and interconnected investments:

- (i) discretionary account holders having sizeable concentrated stock positions in their accounts and asset managers acting solely at the direction of their clients without exercising investment discretion;
- (ii) related-party acquisition or disposal of listed company shares by bought and sold notes, such as, a substantial shareholder of a listed company selling the company’s shares to a fund managed by an asset manager by bought and sold notes, and the substantial shareholder in turn investing in the fund through a discretionary account;
- (iii) fund investors or discretionary account holders being related (eg, as a substantial shareholder, director or affiliate) to the listed companies invested by the funds or the discretionary accounts; and

¹ In this circular, private funds mainly refers to open-ended private funds whose investors could redeem from the fund anytime in accordance with the fund’s dealing frequency set out in the offering document.



- (iv) a director of an asset manager was also a director or chief executive officer of listed companies in which funds under the management of the asset manager were invested.

The nature and commercial substance of the above practices are questionable and may conceal the shareholding of the fund investors or discretionary account holders in the listed companies. The SFC warns that asset managers should not turn a blind eye to dubious arrangements and transactions proposed by their clients. They should critically examine arrangements and transactions, including performing proper client due diligence, and take appropriate steps to avoid being implicated in any market misconduct or other illicit activities.

Reporting to the SFC

Asset managers are also reminded to report to the SFC² any material breach, infringement or non-compliance with the market misconduct provisions of the Securities and Futures Ordinance which they reasonably suspect may have been committed by their clients.

Conflicts of interest

Directors or affiliates of listed companies may be privy to material non-public, price-sensitive information which may give rise to potential conflicts of interest. Accordingly, asset managers should exercise due care when investing in stocks related to their fund investors, discretionary account holders, directors or their own key personnel who might be perceived to have acted upon such information.

Risk management

During the course of our supervision, the SFC identified funds and discretionary accounts invested heavily in concentrated positions in illiquid stocks and/or stocks issued by a network of smaller interconnected listed companies (“interconnected stocks”).

In particular, the holdings of some asset managers’ funds and discretionary accounts accounted for nearly 5% or more of the issued shares of certain listed companies. In such concentrated portfolios, losses would be amplified should there be a price drop in the underlying investments. Moreover, these asset managers did not have appropriate and effective risk management policies to address such concentration and liquidity risks. The negative impact of a drop in the price of the illiquid stocks would be exacerbated by the use of leverage.

The SFC reminds asset managers to have in place and to maintain effective risk management policies and procedures to identify and manage the risks to which each fund or discretionary account is or may be exposed. In particular, asset managers should manage the liquidity risk of funds under their management to ensure that they are able to meet investors’ redemption requests in accordance with the terms set out in the funds’ offering documents. Asset managers should also consider if their funds or discretionary accounts should have an undue concentration of illiquid or interconnected stocks.

² Paragraph 12.5 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission



Acting fairly and avoiding conflicts of interest

In one case, when a fund was unable to meet margin calls on leveraged stock trading, loans were arranged to be made from the asset manager's other funds. Investors in the lending funds could be disadvantaged, especially if the lending funds also needed cash to meet outstanding redemption requests and the ability of the borrowing fund to repay uncollateralised loans was questionable. In the same case, a party related to the asset manager made a loan to the borrowing fund with an extremely high one-off financing charge.

In another case, a fund investor related to an asset manager was given preferential treatment and allowed to redeem his holdings before negative adjustment was applied to the fund, thereby minimising his own investment losses.

Reminder

Asset managers are reminded that failure to act in the best interests of their clients and the integrity of the market is a very serious matter and directly impugns their fitness and properness.

Should you have any queries regarding the contents of this circular, please contact Ms Seine Luk at 2231 1696.

Intermediaries Supervision Department
Intermediaries Division
Securities and Futures Commission

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