

15 September 2017

## **Circular to Licensed Corporations Engaged in Asset Management Business**

### **Common Instances of Non-Compliance in Managing Funds and Discretionary Accounts**

Further to the [circular](#) issued on 31 July 2017 which covers a number of potential regulatory concerns identified in the course of our supervision of licensed corporations engaged in managing private funds<sup>1</sup> and discretionary accounts, this circular highlights various other issues noted amongst asset managers in general.

Whilst inspecting asset managers, the SFC identified many instances of non-compliance with relevant provisions of the Fund Manager Code of Conduct, the Code of Conduct<sup>2</sup> and/or the Internal Control Guidelines<sup>3</sup>. These observations were drawn from around 250 recent inspections which covered asset managers forming part of an overseas group of companies (based, in the United States, Europe, and on the Mainland) of varying sizes, as well as local asset managers generally operating on a smaller scale. Different types of issues and deficiencies were identified in a number of these inspections, although some were more common than others. Moreover, some appeared to present more of a problem to smaller operations with weaker governance and resource constraints.

Examples of instances of non-compliance identified are grouped into the following nine areas in the Appendix:

- (a) Inappropriate receipt of cash rebates giving rise to apparent conflicts of interest;
- (b) Failure to ensure suitability of funds or discretionary account mandates when making solicitations or recommendations of funds under their management, or providing discretionary account management services, to clients;
- (c) Failure to put in place a proper liquidity risk management process to ensure that liquidity risks of funds and discretionary accounts under management are adequately addressed;
- (d) Deficiencies in setting up a proper governance structure and implementing comprehensive policies and procedures for fair valuation of assets;
- (e) Deficiencies in systems and controls to ensure best execution;
- (f) Failure to ensure fair order allocation;
- (g) Inadequate systems and controls in relation to protection of client assets;

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<sup>1</sup> In the circular issued on 31 July 2017, this mainly refers to open-ended private funds whose investors could redeem anytime from the fund in accordance with the fund's dealing frequency set out in the offering document

<sup>2</sup> Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

<sup>3</sup> Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission



- (h) Inadequate systems and controls for ensuring compliance with investment restrictions and guidance; and
- (i) Inadequate systems and controls to address the risk of market misconduct.

In addition, during the course of our inspections, some asset managers informed Commission staff that they do not in practice exercise any discretion over asset management; essentially they only provide investment advisory and trade execution services. Asset managers are warned that when they follow instructions from or otherwise assist their clients in setting up dubious arrangements and/or executing suspicious transactions such as those described in our circular of 31 July 2017, they could be potentially implicated in any associated market misconduct or other illicit activities.

Asset managers with discretionary management authority should perform their role responsibly, always with due skill, care and diligence, in the best interests of their clients and the integrity of the market. Asset managers should also be vigilant and report to the Commission<sup>4</sup> 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.

Moreover, asset managers should take note that if they only provide investment advice when executing transactions as directed by their clients, they would not be regarded as conducting asset management activities and as such are not eligible for the incidental exemption for dealing in securities (e.g. distribution of funds and placing orders with brokers for funds under their management).

The SFC urges asset managers to review their existing internal control procedures and operational capabilities, and enhance them as needed so as to ensure that standards of conduct and control procedures meet our expectations as elaborated in the Appendix.

With regard to some of the examples cited in the Appendix, the SFC may take enforcement actions against the relevant parties. The SFC will continue to monitor compliance by asset managers with applicable regulatory requirements and will not hesitate to take action against any asset managers and/or their management, including the relevant Managers-In-Charge of Core Functions, for failure to comply with regulatory requirements, including fitness and properness.

Should you have any queries regarding the contents of this circular, please contact Ms Remy Cheung at 2231 1186.

Intermediaries Supervision Department  
Intermediaries Division  
Securities and Futures Commission

Enclosure

End

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<sup>4</sup> Paragraph 12.5 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission