Examples of deficiencies and substandard conduct of asset managers

(I) Conflicts of interest

1) The SFC noted the following cases where asset managers managing private funds had engaged in transactions that gave rise to actual conflicts of interest and could seriously jeopardise the interests of investors.

2) Some asset managers used a material portion of fund assets to provide financing to related entities. They also prioritised the interests of their related entities or key personnel over those of the fund investors.

3) The asset managers only relied on generic and non-specific disclosures in the funds' constitutive documents that the asset managers and their affiliates may have an interest in the investments or transactions of the funds that may conflict with the interest of the fund investors.

Examples A: Use of fund assets to provide financing to related entities

Case A1

- Asset manager A1 managed a fund that invested in loans and used the fund's assets to grant loans to its parent company, which is a listed company in Hong Kong. Despite the parent company's default in repayments and deterioration in financial situation, such as profit warning and auditor's concerns about inadequate cash positions to meet its net current liabilities, the asset manager continued to allow the parent company to draw down additional loans from the fund and did not proactively demand repayment of overdue loans and interests. These loans ultimately accounted for 90% of the fund's assets. As a result, the fund was subsequently suspended for redemption due to insufficient cash.

Case A2

- Asset manager A2 managed several funds and used the funds' assets to provide loans to its connected parties, which included its holding company and affiliate. These loans accounted for a material portion of the funds' assets. Some of these loans were granted with interest rates lower than the prevailing market rates. One of the funds had to borrow a margin loan at a higher interest rate to finance the loan provided to the holding company. Some of these loans were not collateralised or subject to any guarantees.

4) The SFC also noted a case where an asset manager provided financing to funds and failed to justify charging fees higher than normal commercial rates.

Example B: Providing financing to the fund and failing to justify charging fees higher than normal commercial rates
Case B1 • Asset manager B1 extended loans to several private funds under its management and charged interests at higher rates than those charged by other execution brokers on margin loans extended to these funds. The asset manager did not document how it determined these interest rates and was unable to demonstrate that it had taken necessary measures to ensure that the interests charged were not higher than the prevailing commercial rates. It failed to implement appropriate safeguards to avoid, manage and minimise the conflicts of interest arising from the loans. It also did not disclose such conflicts to the investors.

5) The loan transactions in the above cases gave rise to material and actual conflicts of interest. The asset managers had failed to prevent, manage and minimise the conflicts of interest that were self-evident. The asset managers also failed to demonstrate that they had taken appropriate safeguards and measures to ensure fair treatment of fund investors as they prioritised the interests of their related entities or key personnel over those of the fund investors. Additionally, the asset managers failed to make proper disclosures about the material conflicts of interest to the fund investors and did not maintain proper documentation on the management of conflicts of interest. As a result, the SFC considers the above conduct to be breaches of paragraphs 1.5, 3.8.1 and 3.8.2 of the FMCC[1], General Principle 6 and paragraph 10.1 of the Code of Conduct[2] as well as section IV.6 of the Internal Control Guidelines[3].

Identify, prevent and manage actual or potential conflicts of interest

6) Pursuant to paragraph 1.5 of the FMCC, asset managers should implement effective policies and procedures and take all reasonable steps to identify, prevent, manage and monitor any actual or potential conflicts of interest that may arise from transactions during their initial and ongoing due diligence process. Where material conflicts of interest have been identified in the transactions, they should prevent such conflicts by considering other alternatives to the transactions. If there is no other alternative, asset managers should critically consider whether it is in the best interests of the fund to enter into or continue with such transactions.

[1] Fund Manager Code of Conduct (**FMCC**).
[2] Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**).
[3] Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (**Internal Control Guidelines**).

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Ensure fair treatment of fund investors

7) Pursuant to paragraph 1.5 of the FMCC, asset managers should conduct all transactions in good faith at arm's length and in the best interests of the fund on normal commercial terms. Any conflict should be managed and minimised by appropriate safeguards and measures to ensure fair treatment of fund investors. General Principle 6 of the Code of Conduct also stipulates that when conflicts of interest cannot be avoided, a licensed person should ensure that its clients are fairly treated.

Specific disclosures for material interests or conflicts

8) Asset managers are required to properly disclose any material interest or conflict to fund investors pursuant to paragraph 1.5 of the FMCC and paragraph 10.1 of the Code of Conduct.

9) In the case examples, generic and non-specific disclosures in the funds' constitutive documents that the asset managers and their affiliates may have an interest in the investments or transactions of the funds did not amount to proper disclosures to fund investors. Such proper disclosure should include the specific description of the nature and source of conflicts, the material interests of the asset manager and its connected persons, potential risks to the investors as well as steps taken by the asset managers to mitigate the risks.

Documentation on conflicts of interest

10) To demonstrate compliance with paragraph 1.5 of the FMCC and section IV.6 of the Internal Control Guidelines, an asset manager should keep proper records of its assessments and justifications for the investment decision despite the actual or potential conflicts of interest that arise. The documentation should demonstrate how the transaction is fair to the fund investors and in the best interests of the fund, despite the material conflicts of interest. In particular, it should show how the transaction is conducted in good faith, at arm's length and on normal commercial terms. The asset manager should also maintain records on the safeguards and measures that it has taken to ensure fair treatment of investors before entering into the transaction.

Transactions with connected persons

11) Asset managers should not enter into loan transactions with their connected persons on behalf of the funds if those transactions are not carried out on arm's length terms. As stipulated in paragraphs 3.8.1 and 3.8.2 of the FMCC, an asset manager should not, on behalf of a fund:

    i) carry out any transaction with a party which is a connected person unless such transaction is carried out on arm's length terms, consistent with best execution standards, and at a commission rate no higher than customary institutional rates; and

ii) deposit funds with or borrow funds from a connected person unless the interest rate is the same as or better than the prevailing commercial rate of a similar transaction.

12) The SFC has further noted a case where the portfolio manager of an asset manager allocated trades among funds to the detriment of fund investors.

Example C: Unfair allocation of trades
Case C1 • Asset manager C1 did not specify the intended allocation of trades at the point of order placing for two funds under its management. The asset manager subsequently allocated those trades with unrealised profits to a fund where the portfolio manager of the asset manager had a substantial interest and those trades with unrealised losses to another fund over a seven-month period.

13) In the above case, the trade allocations of the asset manager are unacceptable and were a breach of paragraph 3.4 of the FMCC. The asset manager prioritised its interest over those of the investors of another fund. The asset manager failed to demonstrate that all client orders were allocated fairly and promptly.

14) In addition to the regulatory requirements in relation to conflicts of interest discussed above, paragraph 3.4 of the FMCC requires an asset manager to:

i) ensure that all client orders are allocated fairly;

ii) record the intended basis of allocation before a transaction is effected; and

iii) ensure that the executed transaction is allocated promptly in accordance with the stated intention.

15) In some cases, an asset manager or the related company of an asset manager received monetary benefits from transactions entered into on behalf of the funds, which gave rise to concerns about conflicts of interest and further cast doubt on whether the asset managers were acting in the best interests of the funds.

Examples D: Receipt of monetary benefits from the funds' transactions
Case D1 • Asset manager D1 managed a fund with the stated investment objective of achieving capital appreciation through investing in a wide range of instruments. However, the fund only invested in the senior notes issued by a subsidiary of a listed company. The asset manager failed to demonstrate how the associated market, concentration and credit risks were managed. Furthermore, the SFC noted that a group company of the asset manager acted as the financial advisor to the issuer of the senior notes, which was entitled to a fixed fee and a variable fee of 1% based on the subscription amount of the senior notes. The group

company received a total fee of US$1.5 million, a substantial part which was generated from the subscription made by the fund. However, the asset manager failed to demonstrate how the conflict was properly managed and disclosed to the fund investors. The issuer of the senior notes then defaulted in less than a year after the fund made the subscription.

Case D2

- Asset manager D2 acted as a lead manager and joint bookrunner in an offering of senior notes. The asset manager invested in the senior notes on behalf of a fund under its management and received a fee of US$120,000 for underwriting a portion of the notes, which was all purchased by the fund. However, the asset manager failed to demonstrate that it had taken reasonable steps to identify, prevent, manage and minimise the conflict arising from its underwriting activities, as well as disclose the conflict to the fund's investors. The senior notes subsequently went into default.

16) In the above cases, the monetary benefits received by the asset manager and the asset manager's group company caused conflicts with the duties owed by the asset managers to their clients. This is because the asset managers might be incentivised to make the investments on behalf of the funds even when the investments might not be in the funds' best interests. The asset managers also failed to take all reasonable steps to manage the conflicts of interest and provide disclosure to the fund investors on the material interests and conflicts that arose from the receipt of the fees.

17) Pursuant to paragraph 1.5 of the FMCC and paragraph 10.1 of the Code of Conduct, asset managers should conduct transactions in the best interests of the funds. Where an actual or potential conflict arises, the conflict should be managed by appropriate safeguards and measures to ensure fair treatment of fund investors. In the above cases, for example, the asset managers should ensure that investment management activities and other activities (eg, underwriting and financial advisory services) carried out by them or their group companies are handled by separate and independent teams and processes without undue influence. Any material interest or conflict should also be properly disclosed to fund investors. Additionally, proper records regarding the safeguards and measures taken, as well as the assessments and justifications for the investment decision despite the actual or potential conflicts of interest should be maintained.

18) Pursuant to paragraph 2.2(a) of the FMCC, asset managers are not allowed to accept any inducement which is likely to materially conflict with the duties owed to clients. Asset managers should thoroughly assess whether any offer or inducement extended to them or their group companies poses a material conflict with their duties to their clients. If such a conflict is identified, the asset managers should reject such offers or inducements. For example, asset managers should reject gifts, entertainment or money given to staff responsible for making investment decision by potential issuers if such inducement is assessed to pose a material conflict with the duties owed to their funds.

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19) The SFC has noted that some asset managers did not treat all fund investors fairly in handling redemption payments.

Examples E: Failure to act fairly in handling redemption payments
Case E1 • Asset manager E1 managed a fund where a significant portion of fund assets was held in illiquid high-yield bonds. It delayed the redemption payments for certain investors due to liquidity concern while giving priority to other investors, particularly its staff, whose redemption payments were first settled in full. **Case E2** • Asset manager E2 managed a fund that has significant exposure to illiquid high-yield bonds. A responsible officer of the asset manager redeemed his interest in the fund when he became aware of the poor financial condition of the issuer of these bonds, including negative news regarding the issuer. The responsible officer deployed the remaining liquidity of the fund to satisfy his own redemption payment and the redemption of the fund was subsequently suspended for other fund investors. The asset manager failed to provide the investors with timely disclosure of material information that had a significant impact on the value of the fund's assets. It also failed to prevent its responsible officer from front running other investors and benefiting from the information asymmetry.

20) The asset managers above failed to act fairly in handling redemption payments in breach of General Principle 1 of the Code of Conduct. Asset manager E2 also failed to inform fund investors of certain significant events impacting the fund and ensure that key personnel of the fund does not benefit from the information asymmetry.

21) Pursuant to General Principle 1 of the Code of Conduct, asset managers should act honestly, fairly, and in the best interests of its clients. They should also ensure that their clients are fairly treated in accordance with General Principle 6 of the Code of Conduct. When an asset manager is responsible for the overall operation of a fund, it should adopt measures to ensure fair treatment of investors by avoiding conflicts of interest, including when handling redemption payment in accordance with the fund's constitutive documents.

22) Where an asset manager becomes aware of significant events that have a material negative impact on the values of the fund assets (as illustrated in case E2), it should disclose such information as soon as practicable to the fund investors. Asset managers should ensure that the fund price is promptly adjusted to reflect such impact and all fund investors are able to act upon such information before processing any redemption requests for the coming redemption period. Asset managers should ensure that all fund investors are treated fairly without any unjustified preferential treatment due to such information.

23) Asset managers should also consider using appropriate liquidity management tools and exceptional measures to ensure fair treatment of all fund investors.

(II) Risk management and investment within mandate

24) The SFC noted some cases where asset managers failed to implement adequate risk management procedures to appropriately identify, measure, manage and monitor all relevant risks. Some also failed to implement proper investment management processes to conduct adequate due diligence on the proposed investments, to ensure that transactions carried out on behalf of the funds were in accordance with the investment objectives and restrictions of the respective funds. In some cases, this also meant that they took on significant concentration, liquidity and credit risks for their clients.

Examples F: Significant exposure to concentration and liquidity risks in breach of investment restrictions

Case F1

- Asset manager F1 invested more than 40% and 25% of the net asset value (**NAV**) of a fund it managed into two investment funds managed by a third-party asset manager. This breached the investment restriction of the fund that no more than 20% of NAV could be invested into other funds as stipulated in the private placement memorandum.

- Moreover, while the fund itself only had a remaining lock-up period of less than one year, the third-party funds were subject to lock-up periods of three years and seven years respectively, as they mainly invested in bonds issued by a private company or leveraged notes linked to such bonds. As a result, the fund was unable to meet the redemption requests from its investors. The two third-party funds also suffered significant losses due to the default of the private company, which resulted in a substantial loss to asset manager F1's fund investors.

Case F2

- Despite having a significant amount of overdue redemption payables, asset manager F2 continued to invest the assets of a fund into illiquid stocks or private notes that were estimated to take 6 to 18 months to liquidate. This aggravated the fund's liquidity problem and further delayed redemption payments to the investors. The asset manager could not demonstrate that liquidity risk assessments were performed before making these investment decisions and that liquidity risk management was taken into consideration in its investment decisions.

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Examples G: Inadequate credit risk assessment or management and outsize credit risk exposure

Case G1

- Asset manager G1 managed a fund and used most of the fund assets to provide unsecured loans to a private company. The asset manager did not obtain any information about the financial position of the borrower for analysis before entering into the loan arrangements. In addition, despite the private company's delays in settling certain interest payments, the asset manager still renewed those loans and granted new loans to the borrower for another two years. However, the borrower defaulted on the loan repayments after one year and was liquidated. As a result, the fund suffered significant losses and was unable to meet investors' redemption requests.

Case G2

- Asset manager G2 purchased senior notes worth US$35 million issued by a subsidiary of a Mainland listed company which accounted for a material portion of the fund assets. The investment analysis report prepared by the asset manager to support the purchase included only descriptions about the general investment environment of offshore fixed income investments issued by Mainland companies denominated in US dollars. The asset manager did not conduct any analysis on the fundamentals of the issuer of the senior notes or its holding company to assess the relevant risks of such investment. The issuer ultimately defaulted on the notes, incurring significant losses to the fund investors.

Case G3

- The fund managed by asset manager G3 had the investment objective to achieve attractive stable returns with capital preservation. After investing around 20% of the fund assets into a bond, the asset manager invested another 10% of the fund assets into another bond of the same issuer, despite negative news about the issuer's financial viability such as concerns on its liquidity and repayment ability, as well as court orders on demand for payment. The asset manager failed to demonstrate that it had taken into consideration the negative news when it increased the fund's exposure to the bond issuer and how the significant exposure to a single bond issuer was consistent with the stated investment objective of capital preservation.

- In addition, the asset manager had relied on an outdated credit rating report in monitoring and assessing the credit risk of the bonds. Concerns on the issuer's debt repayment ability were raised in the latest available credit rating report when the asset manager increased the bond exposure. Within a month after the further investment, the issuer defaulted on one of the bonds held by the fund. The issuer defaulted on the other bond as well subsequently, resulting in significant losses to the fund investors.

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Example H: Inappropriate investment due diligence
Case H1 • Asset manager H1 managed a discretionary account and invested about 90% of the portfolio assets into the debt and shares of an unlisted company. The asset manager used a product due diligence form to score each investment. The asset manager considered that these investments were appropriate for the discretionary account as the calculated scores exceeded the acceptance thresholds. However, the product diligence form was designed for fund products and the product scores of the above investments were inflated as the form contained items that were irrelevant to the debt and shares of the unlisted company, which led to arbitrary scoring.

25) The asset managers in the above cases failed to ensure that the transactions were carried out on behalf of the funds in accordance with the stated investment restrictions or objectives. They also failed to assess the financial positions of the issuers adequately before making significant investments into these instruments. Besides, they failed to assess the impact of these investments on the diversification and liquidity of the fund portfolios. This exposed their clients to significant concentration, liquidity and credit risks, and ultimately resulted in significant losses to the investors. As a result, the above asset managers failed to comply with paragraphs 3.1, 3.11.1 and 3.14.1 of the FMCC and keep proper records regarding their investment and risk management processes in accordance with paragraph 5.1(a) of the FMCC and section IV.6 of the Internal Control Guidelines.

Proper risk management and investment within mandate

26) As required under paragraph 3.1 of the FMCC, asset managers should ensure that transactions carried out on behalf of the funds and discretionary accounts are in accordance with their stated investment strategy, objectives, restrictions and guidelines, whether in terms of asset class, geographical spread or risk profile, as set out in the respective constitutive and relevant documents. Asset managers should design and implement proper policies and procedures for the investment management process of funds and discretionary accounts, which should include conducting adequate research and due diligence on potential investments.

27) Pursuant to paragraph 3.11.1 of the FMCC, asset managers should also implement adequate risk management procedures (including risk measurements and reporting methodologies) in order to identify, measure, manage and monitor appropriately all relevant risks to which each fund or account is or may be exposed. These include market, liquidity, concentration and credit risks, which may be material for each fund or account that they manage throughout the fund's or account's life cycle. In the above cases, where credit risk is a key risk factor under risk management assessment, Credit Rating Agency (CRA) ratings can appropriately be used as an input to asset managers' internal credit assessment processes. However, any use of CRA ratings should not be mechanistic nor

lessen asset managers' responsibility to ensure that their credit exposures are based on sound risk assessments.

28) Asset managers should also integrate liquidity management in investment decisions according to paragraph 3.14.1 of the FMCC as well as setting concentration limits with respect to the funds' exposures, taking into account the respective liquidity profiles and the funds' liquidity risk policies. Additionally, asset managers should regularly monitor any liquidity mismatches between the funds' underlying investments and their redemption obligations. This can be done using quantitative metrics or qualitative factors in accordance with the suggested risk-management control techniques and procedures listed in Appendix 2 to the FMCC.

Management supervision

29) In situations like the cases above where risk exposures of the funds are significant, the risk assessments should have been reviewed by a qualified and experienced person of the asset manager. This would be consistent with paragraph 1.6(b) of the FMCC, where the senior management of an asset manager is required to maintain clear reporting lines with supervisory and reporting responsibilities assigned to qualified and experienced persons.

Proper record

30) Asset managers should keep proper records of their assessments on the portfolios' risks with respect to the investment objectives of the investment mandates. These records should be commensurate with the nature, size, complexity and risk profile of the firm and the investment strategy adopted by each of the funds and accounts under management as part of their record retention for the purpose of complying with the requirements under paragraph 5.1(a) of the FMCC and section IV.6 of the Internal Control Guidelines.

(III) Information for investors

31) The SFC has also noted some cases where asset managers that are responsible for the overall operation of the funds failed to provide to fund investors material information necessary for them to make informed judgement about their investment into the funds.

Examples I: Failure to disclose concentrated positions and significant exposures of the funds as well as certain significant events to fund investors
Case I1 • Asset manager I1 managed a debt fund and invested HK$100 million, which was about 75% of the fund's NAV, in a loan made to a private company which is the major shareholder of a listed company. It did not make disclosure to the fund investors with respect to the significant exposure of the fund to a loan made to the private company. Despite the fact that the private company subsequently

defaulted on the loan and the loan was valued at cost, the asset manager failed to make specific disclosure about the default to the fund investors.

Case I2

- Asset manager I2 managed a fund with a stop-loss mechanism that requires the fund to secure additional subscriptions from designated investors to maintain the NAV level or to consider rejecting redemption requests when the NAV of the fund drops to certain levels. If the NAV continues to drop, the fund would be liquidated. However, the asset manager notified the fund investors about the triggering of the stop-loss mechanism that required subscription of additional shares only two months after the mechanism had been triggered.

Case I3

- Asset manager I3 managed a fund with quarterly redemption. However, due to the default of a significant loan holding and the difficulty in arriving at a reasonable valuation of the fund, redemption of the fund was suspended. The asset manager notified the fund investors regarding the suspension only six months afterwards.

Example J: Failure to notify investors about the unavailability of financial statements and the auditor's modified opinion

Case J1

- According to the offering memoranda of some funds, the audited financial statements of these funds should be provided to fund investors within six months after the end of the relevant financial year. However, the audited financial statements of these funds were only issued in the seventh month and ninth month after the year-end date respectively, which exceeded the prescribed timeframe. Asset manager J1 failed to notify the fund investors about such delay. The funds' audited financial statements were only provided to the fund investors 11 months after the end of the relevant financial year upon the enquiry of the SFC.

- In addition, the funds' auditor provided modified opinions on the funds' financial statements. The asset manager also failed to inform the investors about such material information in a timely manner.

32) The failure to disclose adequate information on the funds in the above cases is in breach of paragraph 6.2 of the FMCC and adversely affects the fund investors to make an informed judgement about their investments into the funds.

33) When an asset manager is responsible for the overall operation of a fund, according to paragraph 6.2 of the FMCC, it should make adequate disclosure of information (as well as any material changes to the information) on the fund which is necessary for fund investors to be able to make an informed judgment about their investments into the fund.

34) In the above cases, for example, the asset managers should have disclosed the following information, amongst other things, to fund investors promptly:

   i) Concentrated positions of aggregate exposure, which may subject the fund to significant risk and materially affect the value of the fund. For example, position(s) that resulted in a majority of the fund assets being exposed to a single issuer or issuers of the same group, as illustrated in case I1, is considered significant, and warrants disclosure to the fund investors. In this connection, where complex / opaque arrangements are involved or investments are held through other investment vehicles, asset managers should employ a look-through approach in determining the exposure to the issuers.

   ii) Significant events that have had a material adverse impact on the value of the fund assets or the fund's ability to meet its liquidity needs, such as major investment losses, defaults in principal or interest payment in relation to any significant position(s) by counterparties or their related companies (as illustrated in case I1), large redemption requests that result in the majority of the liquid assets of the portfolio being liquidated to meet the redemption requests, or suspension of redemption (as illustrated in case I3), etc.

   iii) Modified opinion on audited financial statements or other material information issued by the fund auditors. Asset managers should promptly inform the fund investors if there is a modified opinion issued by the fund's auditor on these statements (as illustrated in case J1) or if there are material discrepancies in the year-end fund valuation information between the fund's audited financial statements and the information provided to fund investors for the relevant period. This is irrespective of whether the fund's constitutive documents have required the provision of its audited financial statements to fund investors or upon request.

35) Asset managers are also expected to notify fund investors if the stipulated information is not provided to them according to the fund's constitutive documents, with the reasons why the information is not available and the expected time when such information will become available.

36) To demonstrate compliance with paragraph 6.2 of the FMCC, asset managers are also required to keep proper records of the disclosures made to fund investors.

(IV) Valuation methodologies

37) The SFC has noted that some asset managers responsible for the overall operation of the funds failed to evaluate the fund assets or ensure that the valuation policies and procedures adopted are appropriate.

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Examples K: Inappropriate and ineffective valuation policies and procedures
Case K1 • Asset manager K1 valued a defaulted loan at cost for a fund under its management, which accounted for 75% of the fund's NAV. The loan was collateralised by a majority stake in a listed company in Hong Kong. Shares of that company were suspended from trading due to litigation and winding up petitions against the company as well as the delay in the publication of its audited annual result. The company was subsequently delisted. • According to the fund's constitutive documents, the fund's directors have the discretion to determine the valuation methodology for any securities when market prices are not available. Given that the loan was in default and the trading of the shares (the collaterals of the loan) had been suspended, the fund's directors (who are also the responsible officers of the asset manager) decided to value the loan at cost based on the estimated value of the collateralised shares which exceeded the loan principal. The estimated value of the collateralised shares was calculated using closing prices of the shares at different points of time prior to the suspension and weighted by different probabilities that the shares would trade at such prices. However, the asset manager was unable to justify why the shares were expected to trade at those prices, no adjustment was necessary to be made for the impact of the litigation and petition cases, as well as for the prolonged period of suspension of the shares. **Case K2** • Asset manager K2 managed a fund that was heavily invested in high-yield bonds issued by companies and obtained guarantees from the bond issuers or their related parties. According to the guarantees, if the market prices of the bonds fell below specified thresholds, the issuers were required to provide cash deposits to cover the difference between the par value and the market value of the bonds. • The market prices of the bonds had fallen below specified thresholds, but the asset managers failed to take reasonable steps to collect promptly from the guarantors the difference between the bonds' par value and their market value. As a result, the majority of the required cash deposits remained uncollected and some of them had been outstanding for more than two years. However, the asset manager continued to book the full value of these receivables in the NAV computation. The asset manager did not properly assess the likelihood of collecting these long-overdue receivables as some of the bonds had already defaulted, calling into question the ability of the bond issuers or their related parties to pay the cash deposits while they had defaulted on their other payment obligations. The asset manager also failed to identify when the fund's asset should be written down or written off according to the valuation policies and procedures.

38) The asset managers in the above cases adopted inappropriate valuation methodologies with an intention to hide the investment losses of the funds from investors in breach of paragraphs 5.3.1 and 5.3.6 of the FMCC. They failed to ensure that appropriate policies and procedures are established for a proper valuation of fund assets.

39) When an asset manager is responsible for the overall operation of a fund (or has been delegated responsibility for fund valuation), as set out in paragraph 5.3.1 of the FMCC, it should ensure that appropriate policies and procedures are established so that a proper and independent valuation of the fund assets can be performed and valuation methodologies are consistently applied to the valuation of similar types of fund assets.

40) Paragraph 5.3.6 of the FMCC provides guidance to asset managers in discharging their responsibilities above. It sets out the general principles that asset managers should consider when valuing the fund assets, including applicable generally accepted accounting principles, and best industry standards and practices, unless specified methodologies are stated in a fund's constitutive documents. In particular:

    i) The value of unlisted or unquoted securities that are not actively traded should be valued by either: (i) reference to comparable recent third-party transactions, (ii) appraised by suitably qualified person and/or (iii) information from independent sources as stipulated under paragraph 5.3.6(b) of the FMCC.

    ii) For suspended securities, asset managers should maintain procedures to demonstrate that they will actively seek independent confirmation of appropriate price from suitable brokers or market makers, identify when the security should be written down or written off or ascertain whether it will transfer the security to its own account pursuant to paragraph 5.3.6(d) of the FMCC.

41) If a third party is appointed to perform valuation services, asset managers should exercise due skill, care and diligence in the selection of a third-party valuer pursuant to paragraph 5.3.4 of the FMCC:

    i) The asset managers remain responsible for the valuation of a fund's assets notwithstanding the appointment of a third party to perform valuation services.

    ii) The asset managers should ensure that the third-party valuer possesses the appropriate level of knowledge, experience and resources that are commensurate with the investment strategy, size, and complexity of the funds under their management.

    iii) The asset managers should also periodically review the third-party valuer's activities and assess whether the valuation model and assumptions adopted by the third-party valuer continue to be appropriate and effectively implemented.

42) The above is also applicable to discretionary accounts, where asset managers should observe these requirements and the relevant valuation provisions set out in the Discretionary Account Agreement in conducting valuation.