Appendix 2

Red flags for dubious private fund and discretionary account arrangements or transactions

The following examples of red flags in private fund and discretionary account arrangements or transactions were noted in the SFC's supervision of asset managers. These examples are intended to serve as non-exhaustive guidance. Asset managers should be wary of arrangements or transactions which exhibit similar characteristics.

(a) Arrangements or transactions which are unduly complex or lack a commercial rationale

Some arrangements did not appear to have a commercial rationale, were unduly complex or were not the most logical or convenient means to acquire an investment as they would increase costs or counterparty risks. These included:

(i) Investors using structured products and derivatives to channel money into a private fund, disguising one financial institution's lending to another. For example, investment into a preferential stock issued by a Hong Kong listed company or a bond issued by an overseas financial institution via convoluted methods, such as fund-linked notes; and

(ii) The subsidiary of Asset Manager A setting up a discretionary account with Asset Manager A and then issuing a note linked to the performance of the discretionary account. This note was then subscribed by Asset Manager B for another discretionary account it managed.

(b) Arrangements or transactions which may facilitate corporate or market misconduct or breaches of legal or regulatory requirements

Some private funds or discretionary accounts only invested solely or mainly into a single investment, often selected or suggested by the investor. In some of these cases, "nominees" and "warehousing" arrangements were suspected to be involved. In other cases, these arrangements appeared to be used to mask connected party transactions or to circumvent legal or regulatory requirements[1]. For example:

(i) Multiple private funds were set up with the same fund manager which invested all or most of each such fund's assets in a single investment or subscribed to a single initial public offering;

(ii) A private fund subscribed to other multiple private funds all of which made the same investment and together held a sizeable stake in that investment;

(iii) A private fund was set up by a single investor for investing in a single project or providing a loan to a single person or entity;

[1] Including the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited and the Codes on Takeovers and Mergers and Share Buy-backs

(iv) A private fund was set up for an investor, but apart from a transfer of shares owned by the investor into the fund, no other transactions, or only minimal transactions, were carried out by the asset manager for the fund;

(v) An investor instructed a fund manager to set up multiple funds which invested in a single stock, but these funds were only subscribed by persons who were related to the investor or with funds provided by the investor;

(vi) The fund investors were connected to the listed stocks in which the fund invested, for example, the investors were substantial shareholders, directors or affiliates of the listed companies;

(vii) Listed companies (or their subsidiaries or affiliates) invested in different private funds which cross-invested in one another's shares; and

(viii) Some asset managers facilitated the setting up or operation of the arrangements as covered in the Circular to licensed corporations – Margin financing activities disguised as investments dated 3 August 2018.