

9 October 2024

## Circular to licensed corporations engaged in asset management business

### Deficiencies and substandard conduct noted in the management of private funds and discretionary accounts

1. The Securities and Futures Commission (SFC) has identified various deficiencies and substandard conduct during the course of its supervision of licensed corporations engaged in managing private funds and discretionary accounts (asset managers). These deficiencies and substandard conduct pose significant risks to the assets under their management, and are in breach of their obligations under the SFC's Code of Conduct<sup>1</sup>, FMCC<sup>2</sup> and Internal Control Guidelines<sup>3</sup>.
2. In many cases, the misconduct was egregious and demonstrated a lack of integrity on the part of asset managers involved. As a result, investor interests were seriously jeopardised, undermining the integrity of our market and investor confidence in Hong Kong as an international asset management centre.
3. Concerns due to breaches of regulatory requirements identified by the SFC are summarised below. Case examples that gave rise to these concerns are set out in the Appendix. To address the concerns identified in the case examples, this circular outlines and reminds asset managers of their existing obligations when managing unauthorised collective investment schemes (private funds) and discretionary accounts. For the purpose of this circular, the existing obligations are applicable to conduct related to managing private funds, discretionary accounts in the form of an investment mandate or a pre-defined model portfolio unless otherwise stated.

### Senior management responsibilities and potential regulatory action

4. The board and senior management of asset managers, including the Managers-In-Charge of Core Functions and Responsible Officers, bear primary responsibility for ensuring the maintenance of appropriate standards of conduct. They are expected to critically review the areas of concern discussed in this circular (including the Appendix) and give priority to strengthening their supervisory and compliance programmes, including their policies, procedures as well as systems and controls to ensure compliance with all applicable regulatory requirements. Where practicable, an independent and objective audit should be conducted on the asset manager's compliance with the existing obligations discussed in this circular. Should an asset manager become aware of any material breach, infringement or non-compliance with any regulatory requirements in its review, it should report to the SFC immediately, while providing particulars of the breach as well as relevant information and documents as required under paragraph 12.5 of the Code of Conduct. The asset manager's initiative to self-report any breaches of regulatory requirements identified will be taken

<sup>1</sup> Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**).

<sup>2</sup> Fund Manager Code of Conduct (**FMCC**).

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

into consideration during the process of determining any potential disciplinary action against it by the SFC.

5. The SFC is determined to combat asset management misconduct. To this end, it will commence a thematic on-site inspection of asset managers managing private funds to detect any material breaches or non-compliance with applicable regulatory requirements among other issues. The SFC will not hesitate to take decisive action against these asset managers and their management, including relevant Managers-In-Charge and Responsible Officers, for their misconduct in asset management activities and failure to discharge their supervisory duties.
6. To protect investor interests and maintain market integrity, the SFC has always been vigilant in detecting misconduct and monitoring emerging risks within the asset management industry, particularly, with respect to the management of private funds and discretionary accounts<sup>4</sup>. The SFC has issued a number of circulars<sup>5</sup> in recent years, highlighting the deficiencies observed during our supervision of asset managers and providing guidance on how to strengthen their internal controls and risk management processes accordingly. Nevertheless, misconduct has persisted in the asset management industry. Following this circular, the SFC will step up its disciplinary actions and impose harsher penalties against similar or persistent misconduct to send a strong deterrent message to preserve the integrity of our market and instil confidence in the investing public.

## Regulatory concerns and existing obligations

### (I) *Conflicts of interest*

7. Some asset managers failed to prevent and manage potential or actual conflicts of interests arising from their transactions or practices, such as:
  - (a) using fund assets to provide financing to related entities (Examples A);
  - (b) providing financing to funds and failing to justify charging fees higher than prevailing commercial rates (Example B);
  - (c) unfairly allocating trades in favour of the asset manager's key personnel (Example C);
  - (d) receiving monetary benefits from the funds' transactions (Examples D); and
  - (e) failing to act fairly in handling redemption payments to fund investors by giving priority to redemptions from its staff over those of other clients (Examples E).
8. The transactions or practices concerned have seriously jeopardised the interests of investors and, in most cases, resulted in their substantial losses. The issue was particularly disconcerting when the conflicts of interest on the part of the asset

<sup>4</sup> See the SFC's press releases dated [20 June 2024](#), [5 February 2024](#), [4 December 2023](#), [30 January 2023](#) and [27 June 2022](#) for its enforcement actions against asset managers and their personnel in recent years.

<sup>5</sup> See the SFC's circulars dated [21 November 2019](#), [23 August 2019](#), [24 April 2019](#), [9 October 2018](#), [3 August 2018](#), [15 September 2017](#), [31 July 2017](#) and [27 October 2008](#) issued by the Intermediaries Supervision Department.

managers were apparent. For instance, the continuous extensions of loans to loss-making related entities that could not fulfil repayment obligations had exposed the funds to significant credit risks and resulted in significant losses for the investors.

9. Pursuant to paragraph 1.5 of the FMCC, the SFC reminds asset managers of their duty to take all reasonable steps to identify, prevent, manage and monitor any actual or potential conflicts of interest. These steps should be documented as appropriate, and the asset managers are expected to demonstrate effective implementation of these steps upon the SFC's request.
10. Where material interest in the transactions gives rise to conflicts of interest, asset managers should prevent such conflicts by considering other alternatives.
  - For example, an asset manager should consider other counterparties when contemplating any financing arrangement for the fund from itself or its affiliates. To act in the best interest of the fund, the asset manager should conduct thorough and objective assessments of all financing sources available and proceed with the best available option.
11. Where material conflicts of interest cannot be prevented, asset managers should critically consider whether it is in the best interest of the fund to conduct such transactions. The asset managers should also ensure that all transactions are conducted in good faith at arm's length and on normal commercial terms. After complying with the above requirements, asset managers should further manage and minimise the conflicts by appropriate safeguards and measures to ensure the fair treatment of fund investors as required under paragraph 1.5 of the FMCC.
12. Pursuant to paragraph 10.1 of the Code of Conduct and paragraph 1.5 of the FMCC, specific disclosures about the material interest or conflict should be made to fund investors. Such disclosures should include specific description of the nature and source of conflicts, material interests of the asset manager and its connected persons, potential risks to investors as well as the steps taken by the asset manager to mitigate the risks. As such, generic and non-specific conflicts of interest disclosures in the fund's constitutive documents would not amount to proper disclosure where material interest or conflict is involved.
  - For example, where an asset manager considers using a material portion of the fund's assets to provide loans to its affiliate, generic disclosure in the fund's constitutive documents to the effect that there may arise future instances where the interests of the fund conflict with interests of the asset manager and its affiliate would not suffice. Rather, the asset manager should make specific disclosure to fund investors prior to the transaction about the loan arrangements, including details such as the counterparty of the loan arrangements which is its affiliate, the loan amount, material interests of the asset manager and its affiliate, risks of the material conflicts of interest and the loan, as well as how the conflicts will be managed and mitigated through a prescribed monitoring mechanism.
13. In addition to the above, asset managers should conduct transactions with connected persons at arm's length, fairly allocate client orders and reject any offers or inducements extended to them or their group companies which may pose a material

conflict with their duties owed to clients, as required under paragraphs 3.8.1, 3.8.2, 3.4 and 2.2(a) of the FMCC.

14. Asset managers should also maintain proper documentation of their management of conflicts of interest to demonstrate compliance with paragraph 1.5 of the FMCC and section IV.6 of the Internal Control Guidelines.

**(II) Risk management and investment within mandate**

15. Some asset managers failed to implement adequate risk management procedures or conduct appropriate investment due diligence to ensure that transactions carried out on behalf of clients were in accordance with their investment objectives and restrictions (Examples F). Additionally, they did not adequately address the risks associated with the transactions (Examples G and H). As a result, these failures exposed the investors to significant concentration, liquidity and credit risks, leading to substantial losses due to defaults by the issuers or borrowers.
16. Pursuant to paragraphs 3.1 and 3.11.1 of the FMCC, asset managers are expected to implement adequate risk management procedures to identify, measure, manage and monitor appropriately all risks to which the fund or account is or may be exposed, and ensure investment is made in accordance with their investment objectives, restrictions and risk profiles. Asset managers should also maintain effective record retention policies and keep proper records of their risk assessments to demonstrate compliance with all relevant legal and regulatory requirements in accordance with paragraph 5.1(a) of the FMCC and section IV.6 of the Internal Control Guidelines.

**(III) Information for investors**

17. The SFC has noted instances where asset managers failed to provide fund investors with adequate information, such as disclosures about:
  - (a) concentrated positions and significant exposures that subject the fund to significant risk, such as the majority of the fund's assets being exposed to a single issuer or issuers of the same group (Case I1);
  - (b) significant events impacting the funds such as major investment losses, significant defaults in investments with substantial adverse impact on the funds' net asset value or the funds' ability to meet their liquidity needs (Cases I2 and I3); and
  - (c) modified opinion issued by the funds' auditors or material delay in issuing of audited financial statements (Case J1).
18. As required under paragraph 6.2 of the FMCC, the SFC reminds asset managers responsible for the overall operation of the funds under their management that they have a responsibility to provide fund investors with adequate information on the funds to allow them to make informed judgement about their investments into the funds.



#### **(IV) Valuation methodologies**

19. The SFC has noted instances where the asset managers adopted inappropriate valuation methodologies with an intention to hide investment losses of the funds under their management from investors.
  - For example, some asset managers valued their investments at cost but failed to justify why no adjustments were needed when the issuers and guarantors of those investments had defaulted on the payments for their debts (Examples K).
20. The SFC reminds asset managers responsible for the overall operation of the funds under their management that they have a responsibility to ensure the valuation policies and procedures adopted by the funds are appropriate, pursuant to paragraph 5.3.1 of the FMCC. In particular, asset managers should make reference to paragraph 5.3.6 of the FMCC in valuing securities that are not actively traded or have been suspended from trading (for listed securities), unless specified methodologies are stated in the funds' constitutive documents.
21. The SFC will continue to supervise asset managers' compliance with applicable requirements through offsite monitoring, on-site inspections and thematic reviews focused on the management of private funds and discretionary accounts.
22. Should you have any questions regarding the contents of this circular, please contact Ms Kammy Kwok at 2231 1455 or your case officer.

Intermediaries Supervision Department  
Intermediaries Division  
Securities and Futures Commission

Enclosure

End

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