STATEMENT OF DISCIPLINARY ACTION

The disciplinary action

1. The Securities and Futures Commission (**SFC**) has publicly reprimanded and fined China Industrial Securities International Asset Management Limited (**CISIAM**)[1] HK$6.8 million pursuant to section 194 of the SFO.

2. The SFC found that, while acting as the fund manager of a private fund (**Fund**) between August 2019 and September 2020 (**Relevant Period**), CISIAM:

   (a) failed to identify, assess and address red flags in questionable arrangements related to the Fund;

   (b) acted on investor instructions without conducting adequate due diligence on the Fund's investments;

   (c) did not ensure the Fund's investments complied with its stated investment restrictions and were aligned with its investment objective; and

   (d) failed to implement effective measures to identify, manage and monitor the risks to which the Fund was exposed.

3. The relevant regulatory requirements and expected standards are set out in the **Appendix**.

Summary of facts

A. Background

4. On or around 5 September 2019, CISIAM established the Fund for Tahoe Life Insurance Company Limited (**Tahoe Life**), an authorized insurer in Hong Kong, with an investment amount of US$50 million[2].

5. At the request of the then Chief Investment Officer (**CIO**) of Tahoe Life, CISIAM executed the following investments on behalf of the Fund:

   (a) On 12 September 2019, the Fund invested US$26 million in a structured note (**SN1**) issued by a financial institution. SN1 was entirely linked to the performance of senior notes (**Tahoe Notes**)[3] issued by a wholly owned subsidiary of Tahoe Group Co., Ltd. (**Tahoe Group**, a company related to Tahoe Life) and guaranteed by Tahoe Group. Tahoe Group, formerly listed on the Shenzhen Stock Exchange, was primarily engaged in residential and commercial real estate development in the Mainland.

   (b) Also on 12 September 2019, the Fund purchased a US$20 million structured note (**SN2**) issued by another financial institution. SN2 was

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[1] CISIAM has been licensed under the Securities and Futures Ordinance (**SFO**) to carry on Type 4 (advising on securities) and Type 9 (asset management) regulated activities since 27 April 2012 and Type 5 (advising on futures contracts) regulated activity since 3 June 2013.

[2] Tahoe Life was the sole investor in the Fund.

[3] The Tahoe Notes had a one-year term.

linked to the performance of four reference assets, with the Tahoe Notes comprising 90% of their total face value.

(c) On or about 23 December 2019, the Fund subscribed to a private fund (**Fund 2**)[4] managed by another asset management company in the amount of US$50 million. As part of this subscription, the Fund transferred SN1 and SN2 (collectively, the **Structured Notes**), valued at US$46.3 million, to Fund 2 as non-cash consideration, with the remaining balance of approximately US$3.7 million paid in cash.

6. From around early 2020, market reports emerged regarding Tahoe Group's deteriorating financial position, raising significant concerns about its ability to meet its debt obligations.

7. On 6 July 2020, Tahoe Group announced a default on a RMB1.5 billion onshore bond. This default triggered the cross-default clause in the Tahoe Notes. Consequently, SN1 and SN2 were redeemed before maturity or unwound in August and September 2020 respectively, and the underlying Tahoe Notes were delivered to Fund 2.

8. As of 31 December 2021, the Fund's net asset value (**NAV**) had fallen to US$21,557,135.50, representing a decline of approximately 57% from Tahoe Life's initial investment of US$50 million. This was mainly due to the reduced market value of Fund 2, resulting from the substantial reduction in the value of the Tahoe Notes.

9. In January 2022, CISIAM, on behalf of the Fund, took delivery of the Tahoe Notes from Fund 2, and the Fund continued to hold them as of 24 April 2023.

B. Failure to identify, assess and address red flags in questionable arrangements and perform due diligence

10. The investment arrangements proposed by Tahoe Life's CIO exhibited clear red flags:

(a) The CIO chose to have the Fund gain exposure to the Tahoe Notes through the Structured Notes, rather than having Tahoe Life invest directly in the Tahoe Notes. This structure was unnecessary complex and lacked a clear commercial rationale, particularly given that the Tahoe Notes were issued by Tahoe Life's related company and accounted for over 90% of the Fund's NAV. It also introduced additional costs and increased counterparty risks, raising further concerns about transparency and the underlying purpose of the arrangement.

(b) The subsequent subscription to Fund 2, involving the transfer of the Structured Notes as a substantial part of the consideration, further complicated the investment structure and added another layer of complexity.

(c) Collectively, these arrangements reduced transparency and gave rise to concerns about the potential concealment of asset movements or connected party transactions, as well as possible attempts to circumvent regulatory requirements.

[4] The Fund was the sole investor in Fund 2.

11. Despite these red flags, CISIAM took no appropriate steps to identify, assess, or address them.

12. Instead, CISIAM simply followed the CIO's instructions without conducting adequate due diligence or exercising independent investment discretion. The two research reports prepared by CISIAM's analysts, which purportedly set out the basis for the investments, contained no analysis of the Tahoe Notes. Furthermore, neither report addressed any of the red flags identified above. The fund manager responsible for managing the Fund also confirmed that neither he nor his team conducted any substantive due diligence on the Structured Notes or the Tahoe Notes, as the investment decisions were made by the investor.

13. These failures amount to a serious breach of CISIAM's duty to act with due skill, care and diligence, in the best interests of its clients and the integrity of the market, in contravention of GP 2 of the Code of Conduct. They also demonstrate CISIAM's failure to implement effective risk management policies and procedures, and to properly identify and manage risks to which the firm and / or the Fund were exposed, in breach of paragraphs 1.2(d) and 3.11.1 of the FMCC and section VIII of the Internal Control Guidelines.

C. Failure to ensure the Fund's investments were consistent with its stated investment restrictions and investment objective, and to implement effective risk management measures

14. According to the Fund's placing memorandum:

    (a) The principal investment objective of the Fund is to seek steady interest income through investing primarily in investment grade fixed income products and monetary instrument.

    (b) The Fund is subject to the following investment restrictions:

        (i) no more than 30% of the latest available gross asset value (**GAV**) of the Fund may be invested in debt securities issued by any single issuer (**30% Limit**); and

        (ii) the Fund shall not invest in any assets that is below investment grade. If the relevant fixed income asset does not itself have a credit rating, reference may be made to the credit rating of the issuer or guarantor of such asset.

15. The investments executed by CISIAM for the Fund were inconsistent with its stated investment objective and restrictions, and exposed the Fund to significant concentration and credit risks:

    (a) The Fund's investments in SN1 and SN2 represented 52% and 40% of its GAV, respectively, which breached the 30% Limit.

    (b) As the performance of the Structured Notes was wholly or substantially linked to the Tahoe Notes, the Fund was exposed to significant concentration and credit risks in a single underlying asset.

    (c) The subsequent subscription to Fund 2 did not mitigate these risks, as the Structured Notes continued to account for over 88% of Fund 2's net asset value as of 30 June 2020, and the investment in Fund 2 constituted almost 100% of the Fund's GAV.

(d) Although the Structured Notes were issued by financial institutions rated investment grade, the Fund's actual economic exposure was ultimately to the performance of the Tahoe Notes, which, along with their issuer and guarantor, were either unrated or below investment grade. This undermined the Fund's investment objective to generate interest income primarily from investment-grade fixed income products and resulted in a risk profile inconsistent with the Fund's stated objective.

16. It is evident that CISIAM has failed to:

(a) ensure that investments made on behalf of the Fund complied with its stated investment restrictions and were aligned with its investment objective; and

(b) maintain effective measures to identify, manage and monitor the risks to which the Fund was exposed, including substantial credit and concentration risks associated with the Tahoe Notes.

17. These failures constitute breaches of: (a) GP 2 of the Code of Conduct; (b) paragraphs 1.2(d), 3.1, 3.11.1 of the FMCC; and (c) section VIII of the Internal Control Guidelines.

Conclusion

18. In the circumstances, the SFC is of the opinion that CISIAM is guilty of misconduct.

19. In arriving at the sanctions set out at paragraph 1 above, the SFC has taken into account all relevant considerations including the following:

(a) CISIAM's failures could potentially facilitate misconduct or other improper activities by its clients or other entities, thereby undermining public confidence and compromising the integrity of the market;

(b) CISIAM received management fees of approximately HK$1.9 million from the Fund in respect of the Relevant Period;

(c) CISIAM's remedial actions, including updates to its policies and procedures for risk management and handling dubious investment arrangements, and compliance training sessions for its officers and employees;

(d) CISIAM's cooperation with the SFC in resolving the SFC's concerns; and

(e) CISIAM's otherwise clean disciplinary record.

Appendix

Relevant regulatory requirements and expected standards

*Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**)*

1. General Principle (**GP**) 2 of the Code of Conduct requires a licensed corporation to act with due skill, care and diligence, in the best interests of its clients and the integrity of the market in conducting its business activities.

*Fund Manager Code of Conduct (third edition, November 2018) (**FMCC**)*

2. Paragraph 1.2(d) of the FMCC requires a fund manager to maintain satisfactory risk management governance structure and procedures commensurate with the nature, size, complexity and risk profile of the firm and the investment strategy adopted by each of the funds under its management.

3. Paragraph 3.1 of the FMCC requires a fund manager to ensure that transactions carried out on behalf of each fund are in accordance with the fund's stated investment strategy, objectives, investment restrictions and guidelines, as set out in the respective constitutive and / or relevant documents of the funds managed by the fund manager.

4. Paragraph 3.11.1 of the FMCC provides that a fund manager should implement adequate risk management procedures (including risk measurements and reporting methodologies) in order to identify, measure, manage and monitor appropriately all risks: (a) relevant to each investment strategy; and (b) to which each fund is or may be exposed, such as market, liquidity and counterparty risks, and other risks, including operational risks, which may be material for each fund it manages taking into account the nature, scale and complexity of its business and of the investment strategy of each of the funds it manages.

5. A note to paragraph 3.11.1 of the FMCC further explains that, where appropriate, measures to manage risks of a fund may include: (a) identifying and managing potential risks of a fund throughout the fund life cycle; (b) ensuring that the risk profile of the fund is consistent with the nature, size, portfolio structure and investment strategies, restrictions and objectives of the fund as provided and represented to fund investors in the constitutive and/or relevant documents; and (c) ensuring ongoing and proper identification, measurement, management and monitoring of risks associated with each investment of the fund and their overall effects on the fund's portfolio (including via the use of suitable stress testing procedures).

*Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (**Internal Control Guidelines**)*

6. Section VIII of the Internal Control Guidelines requires licensed corporations to establish and maintain effective policies and procedures to ensure the proper management of risks to which the firm and, if applicable, its clients are exposed, particularly with regard to their identification and quantification, whether financial or otherwise, and the provision of timely and adequate information to management to enable it to take appropriate and timely action to contain and otherwise adequately manage such risks.

*Circular to licensed corporations – Dubious private fund and discretionary account arrangements or transactions issued on 21 November 2019 (**SFC Circular**)*

7. Appendix 1 to the SFC Circular provides that:

   (a) The senior management of an asset manager should have procedures and controls so that the asset manager could reasonably (i) consider if a proposed private fund arrangement or transaction is dubious and (ii) decide if the asset manager should proceed with the arrangement or transaction.

   (b) Once an initial screening determines that a proposed arrangement or transaction is dubious, the asset manager should not proceed without prior written approval from the senior management with the reasons clearly stated, after having conducted enhanced due diligence.

   (c) For enhanced due diligence, the asset manager should, among others:

      (i) make reasonable efforts, for example, by making enquiries and conducting its own research to assess whether the investor in the private fund is related to the investments made or to be made by the fund;

      (ii) take a cautious approach when an investor directs or suggests that the asset manager effects a specific transaction, purchase a particular investment or use structured products or derivatives to make an investment, even if the investment is within the private fund's investment mandate;

      (iii) make enquiries with the investor to understand the purpose of setting up the fund, the rationale behind the structure or, where relevant, the reason for channelling money into the fund through multiple or complex layers of arrangements or transactions;

      (iv) make enquiries to determine whether the investor has set up similar arrangements with or made similar investments through other asset managers or brokers, and assess whether all these arrangements, when viewed in their totality, appear suspicious; and

      (v) conduct its own research and exercise independent judgement by assessing whether the investor has suggested a convoluted, risky or expensive way of making the investment.

   (d) Senior management should only decide to proceed with the arrangement or transaction if it is satisfied that its concerns have been sufficiently addressed.

   (e) The asset manager should maintain full documentation covering all aspects of every proposed private fund arrangement or transaction which was determined to be dubious in the initial screening. This should include: (i) a log of all such arrangements and transactions; (ii) details of the initial screening and enhanced due diligence as well as any additional steps taken by the senior management, with the corresponding results; and (iii) the senior management's review and decision, with its stated reasons for approval.

8. Appendix 2 to the SFC Circular provides examples of red flags for dubious private fund arrangements or transactions, including (among others):

   (a) Arrangements that 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.

   (b) Private funds investing solely or mainly into a single investment, often selected or suggested by the investor, and arrangements that appeared to be used to mask connected party transactions or to circumvent legal or regulatory requirements.