

## STATEMENT OF DISCIPLINARY ACTION

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### The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has publicly reprimanded and fined PICC Asset Management (Hong Kong) Company Limited (**PICC**)<sup>1</sup> HK\$2.8 million pursuant to section 194 of the Securities and Futures Ordinance (**SFO**).
2. The disciplinary action is taken in respect of PICC's failure to discharge duties as the manager of a Cayman-incorporated fund (**Fund**) between May 2018 and May 2020 (**Relevant Period**), in that PICC has failed to:
  - (a) properly manage the Fund to ensure that the Fund's investments were in line with its stated investment objective and investment restrictions;
  - (b) implement adequate and effective internal controls to properly manage the risks of the Fund; and
  - (c) adequately supervise the investment manager who managed the Fund on behalf of PICC.

### Summary of Facts

#### A. Background

3. By a Management Agreement dated 17 May 2017 (as supplemented by a Supplemental Management Agreement dated 22 November 2018), PICC was appointed to act as manager of the Fund.
4. S was the investment manager primarily responsible for managing the Fund from the Fund's inception on 2 May 2018 until his departure from PICC on 8 April 2020. The Fund was terminated on 7 May 2020.
5. The net asset value (**NAV**) per share of the Fund dropped from HK\$991.65 as at 28 May 2018 (the month of inception) to HK\$650.42 as at 30 April 2020 (the date of last valuation of the Fund).
6. The SFC received a complaint from a representative of an investor of the Fund, raising concerns about PICC's failure to properly supervise the Fund and its investment manager, S.
7. Following an investigation, the SFC has identified various deficiencies in PICC's management of the Fund as set out in sections A to C below.

#### A. Failure to adhere to the Fund's investment strategy, objectives and investment restrictions

8. Paragraph 3.1 of the Fund Manager Code of Conduct (**FMCC**)<sup>2</sup> provides as follows:

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<sup>1</sup> PICC is licensed to carry on Type 4 (advising on securities) and Type 9 (asset management) regulated activities under the SFO.

<sup>2</sup> Unless otherwise specified, the references to FMCC in this document are to the Third Edition of the FMCC which came into effect on 17 November 2018.

*“Investment within Mandate*

*A Fund Manager should 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, whether in terms of asset class, geographical spread or risk profile, as set out in the respective constitutive and/or relevant documents of the funds managed by the Fund Manager. In this connection, a Fund Manager should have in place effective and properly-implemented procedures and controls.”<sup>3</sup>*

9. Pursuant to the private placing memorandum dated December 2017 and November 2018 applicable to the Fund, the Fund’s investment objective was to achieve capital preservation combined with steady capital appreciation over the long term through primarily investing in a diversified portfolio of equity securities and to enhance investment performance by investing in bonds and other fixed income securities from time to time based on PICC’s assessment of market conditions and available investment opportunities.
10. PICC did not manage the Fund in accordance with the stated investment objective and strategy:
  - (a) The Fund only held one to three stocks at any given point in time during a 21-month period from its inception in May 2018 to January 2020.
  - (b) The Fund held highly concentrated positions in two Hong Kong listed stocks (including Stock X) for a significant period during its two-year life span.
  - (c) It was only in February 2020 that the Fund started to hold a more diversified portfolio of shares.
11. Further, the Fund’s investment in Stock X was contrary to PICC’s internal policies as it was not on PICC’s permitted securities list:
  - (a) Under PICC’s internal policies, an investment manager is only allowed to purchase or sell stocks which are in a stock pool. The stock pool should be approved by the Investment Committee<sup>4</sup>.
  - (b) On 14 September 2018, the Fund purchased 14,880,000 shares in Stock X for a consideration of HK\$18,747,000 (**Purchase**). Stock X was not in the stock pool at the time of purchase:
    - (i) On 14 September 2018, Legal and Compliance Department (**L&C**) received a request from the Third Party Asset Management

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<sup>3</sup> The requirement that Fund Managers should carry out transactions in accordance with clients’ mandates is also provided in paragraph 3.1 of the Second Edition of the FMCC.

<sup>4</sup> The Investment Committee of PICC was responsible for reviewing and approving the “whitelisting” of securities which formed a pool of permitted securities in which individual investment managers were allowed to trade on behalf of their clients. It also performed a supervisory function. Decisions of the Investment Committee were passed to the President’s Office (and to the Executive Committee after mid-February 2020) which had the right to override the decisions made by the Investment Committee.

Department (TPAM)<sup>5</sup> to assign Stock X a permitted trading status in order to participate in a share placement.

- (ii) L&C noted TPAM's urgency to participate in the placement<sup>6</sup> and TPAM's promise that it would get the Investment Committee's approval on or before 28 September 2018, and allowed Stock X to be temporarily assigned a permitted trading status after consulting the Chief Operating Officer of PICC.
- (iii) TPAM did not obtain the Investment Committee's approval to include Stock X in the stock pool by 28 September 2018 as required by L&C.

12. PICC's failure to properly manage the Fund to ensure that the Fund's investments were in line with its stated investment strategy, objectives and investment restrictions constitutes a breach of paragraph 3.1 of the FMCC.

#### **B. Inadequate internal controls to properly manage risks of the Fund**

13. Paragraph 1.2(c) of the FMCC provides that a Fund Manager should maintain satisfactory internal controls and written compliance procedures which address all applicable legal and regulatory requirements.

14. Paragraph 1.7.1 of the FMCC provides that:

*"The Fund Manager should establish and maintain effective policies and procedures as well as a designated risk management function to identify and quantify the risks, whether financial or otherwise, to which the Fund Manager and, if applicable, the funds are exposed. The Fund Manager should take appropriate and timely action to contain and otherwise adequately manage such risks."*

#### **B1. Inadequate internal controls to ensure that the Fund adheres to the investment mandate and manage non-compliance with investment mandate**

15. As set out in section A above, the Fund's investment in Stock X was not in line with the investment restrictions set out in PICC's internal policies at the time.

16. Despite TPAM / S's several requests to add Stock X to the stock pool subsequent to the Purchase, the Investment Committee / the President's Office repeatedly rejected such requests until 6 March 2019, when the President's Office added Stock X to the stock pool *only to allow the stock to be sold*.

17. The evidence shows that:

- (a) S failed as a first line of defence in that he proposed to acquire Stock X which was not within PICC's investment mandate.
- (b) By allowing S to proceed with the Purchase, L&C also failed as a second line of defence.

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<sup>5</sup> TPAM was the business unit within PICC that was involved in the management of the Fund and its investments before December 2019. S was the Deputy Head of TPAM.

<sup>6</sup> It subsequently transpired that the Purchase was made in the secondary market, and not during a placement of the shares.

- (c) The Investment Committee and the President's Office were aware of the Purchase and did not consider Stock X a suitable stock for investment. However, PICC did not have procedures in place as to how and when the Fund should dispose of the stock to ensure that the investors' interests are properly protected, thereby exposing the Fund's investors to risks associated with the Fund's holding of an unsuitable stock. Specifically:
- (i) Although the Investment Committee resolved on 4 October 2018 that Stock X was not a suitable stock to be added to the stock pool due to, among other factors, the lack of liquidity of the stock, it made no decision as to how the Fund should deal with the stock which had already been purchased.
  - (ii) PICC did not have procedures in place as to how shares purchased by the Fund that were not in the stock pool should be treated.
  - (iii) While the President's Office recommended on 8 October 2018 that the Fund dispose of Stock X at a good opportunity as soon as possible, the Fund only sold 2,464,000 of the shares, representing 16.56% of its total investment in the stock, from 18 October 2018 to 4 December 2018.
  - (iv) The President's Office resolved on 13 December 2018 that S might dispose of Stock X at the earliest opportunity, and in the best interests of the Fund's investors, and added Stock X to the stock pool on 6 March 2019 for the purpose of allowing the stock to be sold, but it was only on 7 January 2020 that the Investment Committee resolved that S must sell the Fund's investments in Stock X within 60 trading days.
  - (v) S did not take any action to reduce the Fund's holding in Stock X after 4 December 2018. At the time of his resignation from PICC in April 2020, the Fund still held 83.44% of the stock that it acquired in breach of the investment restrictions.

18. The events in relation to the Fund's purchase and subsequent handling of Stock X show that PICC did not have adequate internal controls to ensure that the Fund adheres to the investment mandate, or procedures to manage non-compliance with the investment mandate. The deficiencies in PICC's controls had led to the Fund holding a stock which should not have been acquired in the first place for 21 months (from September 2018 to May 2020) during its short, two-year life span.

***B2. Inadequate internal controls to manage liquidity risks***

19. Paragraph 3.14.1(a) of the FMCC provides that a Fund Manager should establish, implement and maintain appropriate and effective liquidity management policies and procedures to monitor the liquidity risk of the fund, taking into account the investment strategy, liquidity profile, underlying assets and obligations, and redemption policy of the fund.
20. In the Circular to licensed corporations on managing the liquidity risks of funds published on 23 August 2019, the SFC reminds Fund Managers that they should implement robust risk management systems and establish well-documented liquidity risk management policies and procedures for the funds they manage.

21. PICC failed to establish, implement and maintain appropriate and effective liquidity management policies and procedures to manage the liquidity risk of the Fund:
- (a) Between November 2018<sup>7</sup> and October 2019, PICC did not have detailed procedures for monitoring liquidity risks.
  - (b) Even though L&C started circulating liquidity risk analysis reports of the Fund from July 2019 and the liquidity reports for June 2019 and August 2019 show that 62.5% and 76.79% of the Fund's investment portfolio was invested in illiquid assets (including Stock X), L&C and PICC's senior management did not require S to take any action to address the issue.
  - (c) In November 2019, PICC revised its risk management policy and set out detailed rules for managing liquidity risks, including a framework on how breaches of liquidity limit should be managed. Under the framework, illiquid assets (ie, assets that require more than 30 days to sell) should not exceed 20% of a fund's investment portfolio, and the responsible investment manager should rectify any breaches of the liquidity within one month, failing which L&C should report the matter to the investment manager's supervisor and to the Risk Management Committee.
  - (d) The liquidity risk analysis reports as of 29 November 2019 and 2 December 2019 show that 80.7% and 91.69% of the Fund's portfolio were invested in illiquid assets. Despite this, PICC did not follow the procedures set out in the revised policy and failed to rectify breaches of the liquidity limit from November 2019 to May 2020.

***B3. Inadequate internal controls to manage concentration risks***

22. PICC did not have adequate controls in place to manage the concentration risks of the Fund:
- (a) On 23 April 2018, L&C set up a risk limit (**Concentration Limit**) in a system provided by a third party vendor that the market value of the Fund's holding in a single stock should not exceed 20% of the Fund's total NAV.
  - (b) An alert for breach of the Concentration Limit was only prompted once in the system on 18 September 2018<sup>8</sup>.
  - (c) There were a number of instances from November 2018 to April 2020 when the Fund's holding in Stock X and another stock accounted for more than 20% of the Fund's NAV. However, no alerts for breaches of the Concentration Limit were recorded in the system and the breaches were not rectified before the Fund's termination in May 2020.

***B4. Failure to enforce stop loss procedure***

23. PICC's failure to enforce the risk management policies that it put in place is further evidenced by its failure to enforce its stop loss procedure:

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<sup>7</sup> When the Third Edition of the FMCC came into effect.

<sup>8</sup> According to PICC, this alert was due to a miscalculation of the NAV. The Concentration Limit was not breached on this occasion.

- (a) On 19 March 2020, PICC implemented a stop loss policy which provides, among others, that if a fund's holding in a particular listed stock suffers a loss of more than 50%, the investment manager should arrange for the stock to be sold within three trading days; and if he is not able to do so, he should submit a report to L&C to explain the reason and provide a proposal to address the issue.
- (b) On 25 March 2020, the Fund's holding in Stock X had triggered the threshold for forced sale under the stop loss policy. S should have liquidated the Fund's position in Stock X within three trading days, but he failed to do so.
- (c) On 9 April 2020, after S's departure from PICC, L&C notified the new investment manager by email about the failure to comply with the stop loss policy, and asked him to submit a proposal to the Investment Committee for approval. On 16 April 2020, TPAM submitted a proposal to wind up the Fund. The Fund was terminated on 7 May 2020.

24. PICC's failure to implement adequate and effective internal controls to properly manage the risks of the Fund as set out in section B constitutes a breach of paragraphs 1.2(c), 1.7.1 and 3.14.1(a) of the FMCC.

### **C. Inadequate supervision, systems and controls**

- 25. General Principle 3 (capabilities) of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**) provides that a licensed person should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities.
- 26. Paragraph 4.2 (staff supervision) of the Code of Conduct states that a licensed person should ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf.
- 27. Paragraph 4.3 (internal control, financial and operational resources) of the Code of Conduct also provides that a licensed person should have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients and other licensed or registered persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.
- 28. The SFC's investigation found that while PICC had certain investment guidelines and risk management policies in place during the Relevant Period, it failed to effectively implement these guidelines and policies. Even though PICC's senior management was aware that the Fund's portfolio was concentrated in two stocks (and one of them was not in the stock pool), and that the liquidity and concentration limits were breached, it did not take adequate steps to rectify the situation and reduce the risk exposure of the Fund.
- 29. PICC has breached General Principle 3 (capabilities), paragraph 4.2 (staff supervision) and paragraph 4.3 (internal control, financial and operational resources) of the Code of Conduct by failing to have effective systems and

controls to ensure that the Fund was properly managed, and failing to adequately supervise S's investment activities.

30. The failures set out above also constitute a breach of General Principle 7 (compliance) of the Code of Conduct, which requires licensed persons to comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of clients and the integrity of the market, and paragraph 12.1 (compliance: in general) of the Code of Conduct, which states that a licensed person should comply with, and implement and maintain measures appropriate to ensuring compliance with the law, rules, regulations and codes administered or issued by the SFC.

## **Conclusion**

31. Having considered all the circumstances, the SFC is of the view that PICC is guilty of misconduct.
32. In reaching the decision to take the disciplinary action set out in paragraph 1 above, the SFC has taken into account all relevant circumstances, including:
  - (a) the gravity of PICC's failures to ensure the Fund's adherence to its investment mandate and to properly manage the risks of the Fund could undermine the confidence of the investing public and market integrity;
  - (b) a strong deterrent message to the market that such failures are not acceptable;
  - (c) PICC has taken steps to enhance its risk management and liquidity monitoring controls; and
  - (d) PICC's otherwise clean disciplinary record.