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Investment Management Alert

August 17, 2017

Key Points

- The Commission has identified a number of regulatory concerns with respect to private funds and discretionary accounts, in particular, funds with concentrated, illiquid and interconnected investments.
- The Commission has reminded asset managers and their senior management to maintain appropriate standards of conduct and to strengthen their supervisory and compliance policies and procedures.
- The Commission has reminded asset managers that failure to act in the best interests of clients impacts their fitness and properness to hold a licence.

SFC (the "Commission") Expresses Concern over Irregularities in Asset Management Activities

Irregularities Identified by the Commission Relating to Investments in Listed Companies

On 31 July 2017, the Commission published a circular to asset managers in respect of irregularities identified in private funds and discretionary accounts (the "Circular"). The Commission has become aware of instances in which asset managers have engaged in practices of which the nature and commercial substance were questionable. The Commission highlighted the following practices that raised regulatory concerns:

- asset managers acting solely on the directions of clients without exercising investment discretion where the clients are discretionary account holders with sizeable concentrated stock positions in their accounts;
- related party using bought and sold notes to acquire or dispose of shares in listed company[1];
- fund investors or discretionary account holders being related parties (e.g., substantial shareholders, directors or affiliates) of listed companies in which the funds or discretionary accounts invest; and
- a director of an asset manager who is contemporaneously a director or chief executive officer of listed companies in which funds under the management of the asset manager are invested.

Acting in the Best Interests of the Integrity of the Market

In light of the above findings, the Commission warned asset managers not to turn a blind eye to dubious arrangements and transactions proposed by clients. Asset managers should act with due skill, care and diligence when conducting their business activities. They should perform proper client due diligence, exercise their professional judgment to critically examine proposed arrangements and transactions, and employ appropriate measures to avoid being implicated in any market misconduct or other illicit activities.

Avoidance of Conflicts of Interest

Conflicts of interest concerns may arise if the directors or affiliates of listed companies who may be in possession of material nonpublic, price-sensitive information are perceived to have acted upon such information in making investments. Asset managers should therefore exercise due care when investing in listed stocks to which fund investors, discretionary account holders, directors or key personnel of the fund are related.

The Commission highlighted one case in which a fund was unable to meet margin calls, and loans were arranged from a manager’s other funds. In the same case, a party related to the asset manager made a loan to the fund with an extremely high one-off borrowing charge.

In another case, a fund investor related to an asset manager was allowed to redeem before a negative adjustment was applied to the fund, therefore minimizing the losses assumed by the related-party investor.

Risk Relating to Concentrated Portfolios

The Commission has taken notice of certain funds and discretionary accounts that are invested heavily in concentrated positions in illiquid stocks and/or stocks issued by a network of smaller interconnected listed companies (“interconnected stocks”). In the absence of proper risk management policies to address concentration and liquidity risks, these concentrated portfolios run the risk of suffering amplified losses should the prices of the underlying investments drop. Where the investments are leveraged, any adverse consequences brought about by a price drop would be further aggravated.

Risk Management

Asset managers should maintain proper and effective risk management policies and procedures to identify and manage the risks to which each fund or discretionary account is, or may be, exposed. In particular, the Commission reminded asset managers to manage the liquidity risk of funds under their management to ensure that investors’ redemption requests could be met and to consider whether it is appropriate for their funds or discretionary accounts to have an undue concentration of illiquid or interconnected stocks.

Responsibilities of Asset Managers and Their Senior Management

Senior management[2] is reminded of its obligations to, among others, act in the best interests of its clients and the integrity of the market, act fairly and avoid conflicts of interest, and properly manage risks associated with the business of the firm. The Commission urged asset managers to enhance their supervisory and compliance policies, taking into account the areas of concern set out in the Circular.

Pursuant to paragraph 12.5 of the Code of Conduct for Persons Licensed by or Registered with the Commission, an asset manager must report to the Commission any material breach, infringement or noncompliance of market misconduct provisions set out in the Securities and Futures Ordinance that it reasonably suspects may have been committed by its client.

With the introduction of the new Managers-In-Charge regime which came into effect on 18 April 2017, senior management, including unlicensed Managers-In-Charge, will be held responsible if the asset manager fails to adhere to proper procedures and appropriate standards of conduct. Under Part IX of the Securities and Futures Ordinance, the Commission may exercise disciplinary powers to sanction a regulated person if the person is, or was at any time, guilty of misconduct or is considered not fit and proper to be, or remain, the same type of regulated person.

Conclusion

The Circular is indicative of the Commission's continued and active efforts in supervising licensed market participants and serves as a cautionary reminder that the Commission will take action against asset managers and their senior management for practices that compromise the interests of investors and the integrity of the market.

The full text of the Circular can be accessed via the link below:

http://www.sfc.hk/edistributionWeb/gateway/EN/circular/openFile?refNo=17EC48

Contact Information

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[1] For example, a substantial shareholder of a listed company sells shares of the listed company to a fund managed by an asset manager by bought and sold notes, and subsequently invests in the fund through a discretionary account.

[2] The senior management of a licensed corporation includes, among others:

- directors of the corporation
- responsible officers of the corporation, and
- Managers-In-Charge.