Hong Kong Securities and Futures Commission (SFC) highlights operating, control and compliance deficiencies in asset management industry

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Abstract

Purpose – *To examine the nine common areas of non-compliance in managing investment funds and discretionary accounts, detailed in a Hong Kong Securities and Futures Commission (SFC) circular dated September 15, 2017, directed at SFC-licensed asset managers.*

Design/methodology/approach – *Discusses a July 2017 circular indicating the SFC's general concerns and analyzing the following nine common areas of non-compliance cited in the September 15, 2017 circular: (1) inappropriate receipt of cash rebates giving rise to apparent conflicts of interests, (2) failure to follow investment-suitability and discretionary account mandates during solicitation, (3) failure to implement liquidity-risk management processes, (4) deficiencies in governance structures and fair-valuation procedures, (5) deficiencies in systems for ensuring best execution, (6) failure to safeguard fair order allocation, (7) inadequate controls for protection of client assets, (8) inadequate systems to comply with investment restrictions, and (9) inadequate safeguards to address market misconduct risk.*

Findings – *The nine examples of non-compliance provide a useful insight into key ''problem areas'' indicated to currently be of particular concern to the SFC.*

Practical implications – *All SFC-licensed asset managers would be well advised to revisit their internal governance structures and operational policies and procedures in order to ensure that they are compliant with applicable standards and requirements.*

Originality/value – *Practical guidance from a lawyer with extensive experience advising investment managers and advisers, fund administrators, trustees and other fund service providers on investment fund-related issues.*

Keywords *Hong Kong, Securities and Futures Commission, Compliance, Asset managers, Internal governance structures, Operational policies and procedures*

Paper type *Technical paper*

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Further to general concerns raised in a circular issued by the Hong Kong Securities and Futures Commission ("SFC") in late July 2017[1], the SFC issued a further circular on September 15, 2017, specifically directed at SFC-licensed asset managers (the "Circular")[2].

The Circular was based on findings from recent routine inspections of 250 licensed corporations. Further, the Circular addressed a number of issues identified as part of the SFC's supervision of licensed asset managers and their management of private funds and discretionary accounts. The Circular provided illustrative examples of non-compliance observed by the SFC.

The examples highlighted by the SFC provide a useful insight into key "problem areas" that are of particular concern to the SFC.

Non-compliance Issue 1: inappropriate receipt of cash rebates giving rise to apparent conflicts of interest

The SFC highlighted the practice of managers receiving and retaining cash rebates from execution brokers.

The SFC considered the retention by managers of broker rebates as a potential or perceived conflict of interest. This is due to the risk that such rebates may incentivize a manager to trade more frequently with the broker than:

- might be consistent with the fund's investment strategy; and/or
- might otherwise be in the best interests of that fund.

The SFC highlighted a situation that it found where rebates had amounted to 7 percent of the net asset value of the relevant fund.

To address the conflicts of interest inherent in cash rebate practices, fund managers should ensure that specific consents have been obtained from their clients[3].

Non-compliance Issue 2: failure to ensure suitability of funds or discretionary account mandates when making solicitations or recommendations of funds under their management or providing discretionary account management services to clients

As part of the amendments to the SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the "Code") adopted in March 2016[4] for licensed corporations, the Code now requires a full investor suitability analysis in respect of all high-net-worth individuals and unsophisticated corporates.

Accordingly, when intermediaries are recommending or soliciting a product to such categories of investors, such intermediaries are required to ensure that the suitability of the recommendation or solicitation for the client is reasonable in all circumstances.

Furthermore, intermediaries are now required to include mandatory wording in client agreements, confirming that:

- where a financial product is solicited or recommended, that financial product must be reasonably suitable for the client having regard to the client's financial situation, investment experience and investment objectives;
- no other provision of the client agreement or any other document signed by the client may derogate from the suitability clause; and
- The requirement for a written client agreement containing the foregoing clause cannot be waived by high-net-worth individuals or unsophisticated corporates.

The SFC cited examples of managers who had inappropriately waived Code requirements. The previous provisions of the Code that permitted the waiver of certain obligations under the Code by investors who are high-net-worth individuals or which are unsophisticated corporates have been removed.

The inclusion of this point in the Circular serves as a reminder to asset managers that the SFC views the suitability requirement as being applicable to asset managers.

Non-compliance Issue 3: failure to put in place a proper liquidity risk management process to ensure that liquidity risks of funds and discretionary accounts under management are adequately addressed

The SFC issued a circular in late 2016 outlining liquidity-risk-management procedure requirements for management companies of SFC-authorized funds.

In the Circular, the SFC reiterated that asset managers managing SFC-authorized funds should ensure that policies and procedures are supported by strong and effective governance and operational capabilities.

In addition, as part of the SFC's ongoing consultation process for the SFC's Fund Manager Code of Conduct ("FMCC")[5], the Circular proposed to enhance the requirements relating to liquidity-risk management for asset managers.

The SFC cited examples of managers who had not exercised due care, skill and diligence in assessing the liquidity profile of certain funds' assets and liabilities. These managers simply relied on information shown on their firms' portfolio management systems and made assessments that did not take into account the historical and expected redemption pattern of a fund or were based on a single quantitative metric or qualitative factor.

Non-compliance Issue 4: deficiencies in setting up a proper governance structure and implementing comprehensive policies and procedures for fair valuation of assets

The Circular serves as a reminder to asset managers of the duty to ensure the proper valuation of fund assets. SFC-licensed asset managers are subject to the general requirement to ensure that fund assets are valued on a regular basis, in accordance with the constitutive documents of the fund and to disclose to investors the basis for the valuation[6].

The Circular highlighted instances in which managers did not have proper governance structures in place and had implemented valuation policies that were deemed to be deficient in light of requirements under the Code and under the SFC's separate circular issued on July 20, 2015[7]. Examples given include:

- for suspended bonds and stocks, no assessment of whether historical values reflect the fair value of such assets;
- a valuation policy lacking appropriate policies to determine whether fair value adjustments are necessary; and
- a valuation policy imposing too high a trigger for escalating fair valuation issues to the internal valuation committee.

Non-compliance Issue 5: deficiencies in systems and controls for ensuring best execution

The SFC noted deficiencies in the systems and controls of some asset managers in relation to best execution.

SFC-licensed fund managers are required to execute client orders on the best available terms, taking into account the relevant market at the time for transactions of the kind and size concerned[8].

Asset managers should put in place adequate systems and controls and should take into account factors such as price, costs, speed, likelihood of execution and settlement, size and nature of the trade, and other relevant considerations.

The SFC highlighted operational deficiencies in terms of allocation of trades by managers:

- to brokers offering the best soft-dollar arrangements;
- other than in accordance with the results of broker evaluation scoring; and
- without specifying a minimum number of quotations required for the transaction.

The SFC generally noted that asset managers should be mindful of potential conflicts of interest arising when directing trades to execution brokers.

Non-compliance Issue 6: failure to safeguard fair order allocation

The SFC also identified deficiencies in fair order allocation arrangements among some asset managers.

The FMCC imposes a requirement on all fund managers to:

- ensure that all client orders are allocated fairly;
- make a record of the intended allocation before a transaction is effected; and
- ensure that an executed transaction is allocated promptly in accordance with the stated intention, except where the revised allocation does not disadvantage a client and the reasons for the re-allocation are clearly documented[9].

The SFC provided examples of asset managers that managed multiple funds and discretionary accounts, and failed to ensure compliance with the requirements of the FMCC, due to:

- failure to maintain the required records;
- failure to demonstrate fair allocation between accounts (in particular, between a house account and a client account); and
- failure to properly match pricing with order input.

The SFC reiterated the need for asset fund managers managing multiple funds to implement proper governance structures, policies and procedures to govern order allocation; maintain clear records of the basis of allocation; and ensure that any deviation from internal policy is clearly documented and subject to senior management review and approval.

Non-compliance Issue 7: inadequate systems and controls in relation to protection of client assets

The SFC observed that, contrary to the duty under the FMCC[10] to ensure that client assets are properly safeguarded, some asset managers had failed to implement adequate systems and controls to properly protect the assets of the funds and discretionary accounts to which they have been entrusted.

The SFC highlighted the following commercial practices as being inadequate to meet the safeguarding requirement imposed under the FMCC:

- appointment of a sole authorized signatory (with no secondary signatory) to effect non-trade transfers of fund assets in and out of brokerage accounts or custodian accounts; and
- failure to demonstrate regular reconciliations of cash and investment holdings with external service providers in order to detect omissions, errors or missing assets.

The SFC reiterated the need for asset managers to implement appropriate and effective controls and procedures in order to protect client assets from potential theft, fraud and other acts of misappropriation, and to ensure the proper safeguarding of assets under their management.

Non-compliance Issue 8: inadequate systems and controls for ensuring compliance with investment restrictions and guidance

The SFC highlighted failures by asset managers to impose proper and adequate systems and controls so as to ensure that investments were compliant with investment restrictions and guidelines. Examples of inadequate practices include:

- ability for a trader to override system-generated violation alerts without proper justification; and
- failure to properly implement automated pre-trade and post-trade investment restrictions checking and, in particular, failure to carry out post-trade investment restrictions checking.

The SFC reiterated the need for asset managers to implement effective systems in order to ensure that all transactions performed with respect to a fund are carried out in accordance with that fund's stated objectives, restrictions and guidelines. The SFC particularly highlighted the need to ensure that automated investment restriction checks are properly verified.

Non-compliance Issue 9: inadequate systems and controls to address the risk of market misconduct

Market misconduct is addressed in Parts XIII and XIV of the Securities and Futures Ordinance ("SFO") and covers the criminal and civil offences of "insider dealing," "false trading," "price rigging," "disclosure of information about prohibited transactions," "disclosure of false or misleading information inducing transactions" and "stock market manipulation[11]." The SFC considers market misconduct offences as particularly grave.

The SFC reiterated the need for asset managers to implement adequate internal systems and controls in order to prohibit and prevent market misconduct.

Such systems and controls would ordinarily be documented in a dedicated chapter in the asset manager's compliance manual, dealing with monitoring, identification, escalation, and, where necessary, investigation and discipline. In addition, the SFC expects that asset managers will ensure that relevant staff receives proper training so that they are familiar with the correct protocols. Examples of inadequate policies and procedures include:

- failure to implement proactive measures to identify irregular trades (notwithstanding the existence of internal policies governing the reporting of insider information); and
- absence of procedures for the appointment and monitoring of external "expert network" firms as part of the research process for securities.

Conclusion

The Circular highlights areas of particular concern to the SFC, and it is in line with the Enforcement Division's objective of signaling to the asset management industry regarding issues about which it is dissatisfied.

In light of the issuance of the Circular, all SFC-licensed asset managers would be well advised to revisit their internal governance structures and operational policies and procedures in order to ensure that these are compliant with applicable standards and requirements.

In particular, SFC-licensed asset managers would be well advised to ensure that their firms do not exhibit any of the deficiencies highlighted in the Circular.

The Circular is also a reminder that the SFC is a vigilant regulator and carefully monitors asset managers in order to ensure compliance with standards imposed by the SFO, the Code, the FMCC and the various circulars, guidelines and FAQs issued by the SFC from time to time.

Notes

1. *Circular to Licensed Corporations Engaged in Asset Management Business: Irregularities and Deficiencies in Managing Private Funds and Discretionary Accounts, available at*: www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=17EC48

2. *Circular to Licensed Corporations Engaged in Asset Management Business: Common Instances of Non-Compliance in Managing Funds and Discretionary Accounts, available at*: www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=17EC57
3. See Section 13.1 of the Code of Conduct for Persons Licensed by or Registered with the SFC (June 2017).
4. As covered comprehensively in the separate client alert, *SFC Publishes Circulars and Updates FAQs on the Triggering of, and Compliance with, Suitability Obligations* (January 2017)*, available at*: www.akingump.com/en/news-insights/sfc-publishes-circulars-and-updates-faqs-on-the-triggering-of.html
5. See SFC *Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency* (November 2016)*, available at*: www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=16CP5
6. See Paras. 5.3 and 5.4 of the SFC Fund Manager Code of Conduct.
7. See SFC *Circular to Management Companies and Trustees/Custodians of SFC-authorized Funds – Relating to Fair Valuation of Fund Assets"* issued on July 20, 2015.
8. See Para. 3.2 of the SFC Fund Manager Code of Conduct.
9. See Para. 3.4 of the SFC Fund Manager Code of Conduct, which addresses order allocation. See also Para. 3.11 of the SFC Fund Manager Code of Conduct, which addresses dealing for house accounts.
10. See Para. 4.1 of the SFC Fund Manager Code of Conduct.
11. See Section 245 of the Hong Kong Securities and Futures Ordinance (Cap. 571).

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