15 September 2017

Circular to Licensed Corporations Engaged in Asset Management Business

Common Instances of Non-Compliance in Managing Funds and Discretionary Accounts

Further to the circular issued on 31 July 2017 which covers a number of potential regulatory concerns identified in the course of our supervision of licensed corporations engaged in managing private funds[1] and discretionary accounts, this circular highlights various other issues noted amongst asset managers in general.

Whilst inspecting asset managers, the SFC identified many instances of non-compliance with relevant provisions of the Fund Manager Code of Conduct, the Code of Conduct[2] and/or the Internal Control Guidelines[3]. These observations were drawn from around 250 recent inspections which covered asset managers forming part of an overseas group of companies (based, in the United States, Europe, and on the Mainland) of varying sizes, as well as local asset managers generally operating on a smaller scale. Different types of issues and deficiencies were identified in a number of these inspections, although some were more common than others. Moreover, some appeared to present more of a problem to smaller operations with weaker governance and resource constraints.

Examples of instances of non-compliance identified are grouped into the following nine areas in the Appendix:

(a) Inappropriate receipt of cash rebates giving rise to apparent conflicts of interest;

(b) 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;

(c) 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;

(d) Deficiencies in setting up a proper governance structure and implementing comprehensive policies and procedures for fair valuation of assets;

(e) Deficiencies in systems and controls to ensure best execution;

(f) Failure to ensure fair order allocation;

(g) Inadequate systems and controls in relation to protection of client assets;

[1] In the circular issued on 31 July 2017, this mainly refers to open-ended private funds whose investors could redeem anytime from the fund in accordance with the fund's dealing frequency set out in the offering document
[2] Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission
[3] Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission

(h) Inadequate systems and controls for ensuring compliance with investment restrictions and guidance; and

(i) Inadequate systems and controls to address the risk of market misconduct.

In addition, during the course of our inspections, some asset managers informed Commission staff that they do not in practice exercise any discretion over asset management; essentially they only provide investment advisory and trade execution services. Asset managers are warned that when they follow instructions from or otherwise assist their clients in setting up dubious arrangements and/or executing suspicious transactions such as those described in our circular of 31 July 2017, they could be potentially implicated in any associated market misconduct or other illicit activities.

Asset managers with discretionary management authority should perform their role responsibly, always with due skill, care and diligence, in the best interests of their clients and the integrity of the market. Asset managers should also be vigilant and report to the Commission[4] any material breach, infringement or non-compliance with the market misconduct provisions of the Securities and Futures Ordinance which they reasonably suspect may have been committed by their clients.

Moreover, asset managers should take note that if they only provide investment advice when executing transactions as directed by their clients, they would not be regarded as conducting asset management activities and as such are not eligible for the incidental exemption for dealing in securities (e.g. distribution of funds and placing orders with brokers for funds under their management).

The SFC urges asset managers to review their existing internal control procedures and operational capabilities, and enhance them as needed so as to ensure that standards of conduct and control procedures meet our expectations as elaborated in the Appendix.

With regard to some of the examples cited in the Appendix, the SFC may take enforcement actions against the relevant parties. The SFC will continue to monitor compliance by asset managers with applicable regulatory requirements and will not hesitate to take action against any asset managers and/or their management, including the relevant Managers-In-Charge of Core Functions, for failure to comply with regulatory requirements, including fitness and properness.

Should you have any queries regarding the contents of this circular, please contact Ms Remy Cheung at 2231 1186.

Intermediaries Supervision Department
Intermediaries Division
Securities and Futures Commission

Enclosure

End

SFO/IS/032/2017

[4] Paragraph 12.5 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

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Examples of Common Instances of Non-Compliance by Asset Managers

(A) Inappropriate receipt of cash rebates giving rise to apparent conflicts of interest

Some asset managers have inappropriately received cash rebates from execution brokers, giving rise to apparent conflicts of interest.

Case 1: Receipt of Cash Rebates
Example 1: Firm A received cash rebates generated from transactions carried out by a fund under its management. Such rebates constituted 7% of the net asset value of the fund. Approximately 80% of these transactions were executed by brokers that offered commission rebates at 85% of their gross commission rates. The exceptionally high stock turnover in the fund suggests that Firm A might have traded more frequently than was consistent with the investment strategy of the fund, for the purpose of generating cash rebates for its own benefit.

Cash rebates inevitably give rise to potential or perceived conflicts of interest. Asset managers should establish and maintain robust conflict of interest management policies and procedures, and take all reasonable steps to ensure fair treatment of all clients.

(B) Failure to ensure suitability of funds and discretionary account mandates

Some asset managers which (i) made solicitations or recommendations of funds under their management to clients, or (ii) provided discretionary account management services to clients in accordance with agreed mandates had failed to ensure that these funds and mandates were suitable for their clients.

Case 2: Recommending funds and providing discretionary account management services
Example 2a: Firm A managed a fund investing in a highly concentrated portfolio with substantial positions in small-mid cap stocks subject to high price volatility and limited liquidity. Firm A had treated individual and corporate investors as Professional Investors (“PIs”) and inappropriately waived certain Code of Conduct requirements (including the suitability obligations) when recommending this fund to these clients. Example 2b: Firm B provided discretionary account management services to clients. However, the investment objective and strategy were either absent from the client agreement or unclear. In addition, Firm B also relied on clients’ self-declaration of their risk profile without using any risk profiling questionnaire to assist the clients to consider their risk tolerance. Certain vulnerable clients were categorised as “Aggressive” based on their self-declaration without making any further enquiry or evaluation. Without a clear investment objective or strategy and proper assessment of the clients’ risk profile, Firm B could not ensure that suitability of the discretionary account mandate for clients was reasonable.

In the above cases, the suitability of the fund and discretionary account mandate might not be reasonable for the client concerned.

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Suitability obligations are the cornerstone of investor protection. Asset managers should always ensure that the fund they recommend to clients, or the discretionary account mandate established for clients, are reasonably suitable for those clients in all circumstances[1]. In addition, asset managers are also reminded that, under the new PI regime that came into effect on 25 March 2016, firms can no longer waive certain Code of Conduct requirements (including but not limited to the suitability obligations) when dealing with (i) individual PIs or (ii) Corporate PIs that cannot satisfy the assessment criteria for corporate PIs[2] or do not agree to be treated as a PI.

(C) Failure to put in place a proper liquidity risk management process

Some asset managers failed to implement a proper liquidity risk management process for the funds or discretionary accounts under their management.

Case 3: Liquidity risk management process
Example 3a: A number of firms considered that liquidity risk management had been integrated in their portfolio construction process and hence it was not necessary to implement a separate liquidity risk assessment. Reliance was solely placed on portfolio managers who would monitor the risks by "eye-balling" the information shown on the portfolio management system, such as the positions and sector exposures of the funds or discretionary accounts. There was no oversight by senior management or risk personnel. This could not be effective because some of these portfolio management systems did not possess risk measurement functions and there was no liquidity risk related information, e.g. the number of days required to liquidate a certain percentage of the portfolio. Example 3b: Firm A managed SFC-authorized funds which primarily invested in fixed income securities. Liquidity assessment reports were generated on a regular basis. However, this liquidity assessment was based on a single metric or factor. For example, a general assumption had been made that assets such as bonds issued by government policy banks should be categorised as "assets that can be liquidated within 5 days". No assessment had been performed by Firm A to substantiate that assumption. In addition, no liquidity assessment had been performed on any other types of assets falling outside the "assets that can be liquidated within 5 days" category. It was unclear how many days would be required to liquidate this portion of the portfolio, which constituted around 50% of the net asset value of the fund. Moreover, Firm A did not perform regular liquidity risk monitoring for discretionary accounts under its management, even though some were heavily concentrated portfolios. Example 3c: When considering the liquidity profile of a fund's liabilities, Firm B assumed a fixed percentage of redemption over a certain period of time for all funds under its management. However, it did not consider the need to assess the investor profile or historical and expected redemption pattern for each individual fund. Furthermore, the fixed redemption percentage assumption was not subject to any regular review to ensure its ongoing validity.

Failure to properly manage liquidity risk could result in an inability to meet redemption or withdrawal requests due to liquidity mismatches.

[1] Paragraph 5.2 of the Code of Conduct, Questions 2 and 3 of the Frequently Asked Questions on Triggering of Suitability Obligations updated on 23 December 2016, and Frequently Asked Questions on Compliance with Suitability Obligations updated on 23 December 2016

[2] Frequently Asked Questions on the assessment of Corporate Professional Investors issued on 22 January 2015

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Asset managers should put in place effective liquidity risk management policies and procedures for funds and discretionary accounts under their management to ensure that liquidity concerns are adequately addressed, taking into account the investment strategy, liquidity profile, underlying redemption obligations and withdrawal policies of the funds and discretionary accounts[3]. In addition, asset managers managing SFC authorized funds should ensure that policies and procedures are supported by strong and effective governance and operational capabilities[4].

(D) Deficiencies in fair valuation of assets

Some asset managers did not put in place a proper governance structure, and valuation policies and procedures to ensure that fund assets that were hard-to-value (such as when there were no current or reliable market prices) were being valued fairly and accurately.

Case 4: Fair valuation of assets
Example 4a: A number of firms valued suspended stocks and bonds based on last traded prices even though the stocks had been suspended for trading and the bond prices had been stale for many months. No assessment had been performed to determine whether such historical prices reflected the fair value of these investments. Example 4b: Firm A solely relied on its portfolio managers to assess whether fair value adjustments would be necessary and there was no policy which set out the triggering threshold for such adjustments. If the portfolio managers decided to make fair value adjustments, approval from the valuation committee would be needed. However, if the portfolio managers decided not to make such adjustments, it was not subject to any independent review. Example 4c: Firm B had a defined process for monitoring stale prices and escalating fair valuation issues to its valuation committee. However, the triggering threshold was set very high (e.g. when suspected stocks constituted a significant percentage of the fund's net asset value) and hence might not be effective. In addition, the threshold was not subject to regular review and so could not take into account changing market conditions.

Proper valuation of assets is critical to investors as this directly impacts subscription and redemption prices of funds, the calculation of fees, risk management and performance reporting.

Where the market price of an asset is not available or where the most recent market price does not reflect its fair value, asset managers should value the asset at a price which is fair and reasonable. Asset managers should set up a proper governance structure and review process, and implement comprehensive valuation policies and procedures to ensure that fund assets are valued fairly and accurately[5].

[3] Please see Paragraph 1.2 of the Fund Manager Code of Conduct and Section VIII Paragraph 6 of the Internal Control Guidelines for general requirements about risk management procedures and policies "Circular to management companies of SFC-authorized funds on liquidity risk management" issued on 4 July 2016 Paragraph 5.3 of Fund Manager Code of Conduct, "Circular to Management Companies and Trustees/Custodians of SFC-authorized Funds - Relating to Fair Valuation of Fund Assets" issued on 20 July 2015

[4] "Circular to management companies of SFC-authorized funds on liquidity risk management" issued on 4 July 2016 Paragraph 5.3 of Fund Manager Code of Conduct, "Circular to Management Companies and Trustees/Custodians of SFC-authorized Funds - Relating to Fair Valuation of Fund Assets" issued on 20 July 2015

[5] Paragraph 5.3 of Fund Manager Code of Conduct, "Circular to Management Companies and Trustees/Custodians of SFC-authorized Funds - Relating to Fair Valuation of Fund Assets" issued on 20 July 2015

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(E) Deficiencies in relation to best execution

Deficiencies were noted in the systems and controls of some asset managers in relation to best execution.

Case 5: Best execution
Example 5a: Firm A performed a regular broker evaluation to ensure best execution whereby votes would be awarded to each broker by designated personnel, including the CEO, CIO, portfolio managers and traders. Allocation of trades to respective brokers in the next quarter would be in line with the broker evaluation. However, Firm A's CEO, who was not involved in day-to-day dealing and operations, was allocated substantially more votes than others who should have more knowledge about the quality of each broker's execution, research and other services. Much of the orders placed by Firm A were directed to brokers offering more attractive soft dollar arrangements. The allocation of votes to the CEO could have biased the selection of brokers and therefore might not be able to ensure best execution as originally intended. Example 5b: Firm B's policy stipulated that a regular broker evaluation was required to help allocate trade orders to approved brokers on a fair and reasonable basis. However, a trader allocated the majority of trades to a broker which had the lowest score amongst other approved brokers in the latest broker evaluation. Example 5c: Dealing policies of a number of firms did not set out the minimum number of quotations required for bond transactions. In addition, some of these firms represented that they performed regular post-trade reviews to ensure best execution. For example, some firms informally reviewed the execution prices of equities transactions to assess if they were largely in line with the VWAP[6], but these reviews were not documented.

Delivering best execution is fundamental to ensure that transactions executed by asset managers are in the best interests of clients.

Asset managers should put in place adequate systems and controls to ensure that client orders are executed on the best available terms, taking into account the relevant market for transactions of the kind and size concerned[7]. Asset managers are also generally expected to consider factors such as prices, costs, speed, likelihood of execution and settlement, size, and the nature of the trade and other relevant considerations. Where asset managers adopted regular broker evaluations as the means to assess best execution, these should be performed in a holistic and unbiased manner, taking into account qualitative and quantitative factors. Asset managers should also be mindful of the potential conflicts of interest that could arise when directing trades to execution brokers.

(F) Failure to ensure fair order allocation

It is common for asset managers to manage multiple funds and discretionary accounts. However, some asset managers failed to ensure fair order allocation.

[6] Volume Weighted Average Price
[7] Paragraph 3.2 of the Fund Manager Code of Conduct

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Case 6: Order allocation
Example 6a: A number of firms placed aggregated orders for multiple funds and discretionary accounts under their management. As they did not maintain the record of intended basis of allocation, when orders were only partially filled, they could not demonstrate that orders had been allocated fairly. Example 6b: Firm A managed a fund for external investors as well as a discretionary account for its group proprietary account ("House Account"). As Firm A did not maintain a record of intended basis of allocation, when orders were placed on an aggregated basis and only partially filled, it could not demonstrate that priority had been given to external investors. Example 6c: Orders for buying the same bond were input into Firm B's order management system ("OMS") by two of its portfolio managers, each on behalf of a fund under their respective management. These orders were aggregated by the trader in order to source for better price quotations from various brokers. Orders were then placed with different brokers and executed at different prices. The best price was allocated to the fund with the earliest input time in the OMS. This could not ensure fair allocation.

Proper governance structures, policies and procedures to govern order allocations for asset managers managing multiple funds and discretionary accounts are essential to ensure that all orders are fairly allocated, and to minimize risk of preferential treatment, especially when aggregated orders involve house accounts.

Moreover, asset managers should always record the intended basis of allocation prior to execution, and ensure that executed transactions are allocated promptly in accordance with this basis. Any deviation from the intended basis of allocation should be clearly documented and subject to senior management review and approval[8].

(G) Inadequate protection of client assets

Some asset managers did not implement adequate systems and controls to protect the assets of the funds and discretionary accounts under their management.

Case 7: Protection of client assets
Example 7a: Funds managed by a number of firms permitted a sole authorized signatory to effect non-trade related transfers of fund assets in and out of brokerage and/or custodian accounts with no compensating controls. Example 7b: A number of firms did not perform or failed to demonstrate the use of regular reconciliations of cash and investment holdings with records issued by the banks and custodians of the funds or discretionary accounts under their management to detect errors, omissions or missing assets.

Asset managers should implement appropriate and effective controls and procedures to protect client assets from potential theft, fraud and other acts of misappropriation, and to ensure that assets under their management are properly safeguarded[9]. In addition, asset

[8] Paragraphs 3.4 and 3.11 of the Fund Manager Code of Conduct
[9] Paragraph 4.1 of the Fund Manager Code of Conduct, Paragraph 4.3 of the Code of Conduct, Section VII Paragraph 9 of the Internal Control Guidelines

managers should perform regular reconciliations of their internal records against those issued by third parties such as banks, execution brokers and custodians[10].

(H) Inadequate investment compliance systems and controls

Some asset managers did not put in place proper and adequate systems and controls to ensure that investments made by the funds and discretionary accounts were compliant with investment restrictions and guidelines of the relevant mandates at all times.

Case 8: Investment compliance
Example 8a: A number of firms primarily use automated pre-trade and post-trade investment restrictions checking. Where investment restrictions and guidelines could not be incorporated into the system, some firms have relied on the investment team to perform pre-trade checking by "eye-balling" and no post-trade investment restrictions check was done. Example 8b: Firm A used a system to perform automated checking of compliance with investment restrictions and guidelines for the funds under its management. However, an incorrect net asset value was used in the system for investment restrictions checks. In addition, violation alerts generated by the system were overridden by the trader without proper justification.

It is fundamental that asset managers ensure that transactions carried out on behalf of funds and discretionary accounts under their management are in accordance with their stated objectives, investment restrictions and guidelines, whether in terms of asset class, geographical spread or risk profile[11]. Asset managers should implement effective systems and controls and be able to demonstrate that transactions are in compliance.

Moreover, when asset managers use automated investment restrictions checks without other compensating controls, it is important to ensure the accuracy of the net asset values to ensure that automated pre-trade and post-trade checks are accurately and effectively performed.

(I) Inadequate systems and controls to address market misconduct

Some asset managers have not implemented any or only have inadequate systems and controls to address potential risk of market misconduct.

Case 9: Market misconduct controls
Example 9a: The compliance manuals of a number of firms have stipulated policies and procedures about material non-public price sensitive information. For example, if an employee suspects that he or she or anyone else was in possession of insider information, he or she must immediately report to the Head of Compliance who would then make a further assessment and consider the need to restrict trading of the relevant stock. Nevertheless, these firms did not implement any proactive measures to identify any irregular trades. In one case, a portfolio manager bought a stock shortly before it was suspended from trading, and subsequently sold it at a substantial profit once it

[10] Paragraph 5.5 of the Fund Manager Code of Conduct, Section VII Paragraph 10 of the Internal Control Guidelines
[11] Paragraph 3.1 of the Fund Manager Code of Conduct

resumed trading. No monitoring had been performed by this firm despite this could be a potential red flag which should warrant closer scrutiny.

Example 9b: As part of its research process, Firm A would engage expert network firms from time to time. However, Firm A did not have any internal policy to govern the engagement of these firms and there were no other controls to address risks posed by such activity.

Market misconduct damages market integrity and undermines confidence in the financial markets.

Asset managers should put in place adequate systems and controls to prohibit and prevent market misconduct. In particular, asset managers should not effect or cause to be effected any transaction based on material non-public price sensitive information, and put in place procedures to ensure that staff are aware of this restriction[12]. When asset managers become aware of any potential red flag that could suggest potential market misconduct[13] by its staff, they should implement follow up action and investigate.

[12] Paragraph 3.3 of the Fund Manager Code of Conduct

[13] Pursuant to Section 245 of the Securities and Futures Ordinance, market misconduct comprises 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, and includes attempting to engage in, or assisting, counselling or procuring another person to engage in, any of the aforementioned conduct

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