Appendix 1

Standards of conduct expected of asset managers considering dubious private fund and discretionary account arrangements or transactions

The senior management[1] of an asset manager should have procedures and controls so that the asset manager could reasonably (i) consider if a proposed private fund or discretionary account arrangement or transaction is dubious and (ii) decide if the asset manager should proceed with the arrangement or transaction. This process should cover the following:

(a) Initial screening

(b) Detailed due diligence

(c) Senior management assessment and decision

(d) Documentation

The senior management should assume responsibility for developing and implementing the procedures and controls in an effective manner. These procedures and controls should be in writing, supplemented by staff training and subject to compliance reviews[2] and internal audits as appropriate.

Where it is necessary to delegate any functions, the senior management should only appoint personnel who are suitably qualified to perform the work and ensure that they are properly supervised.

The asset manager should be familiar with the examples of red flags included in Appendix 2, which are intended to serve as non-exhaustive guidance. It should also observe substance over form throughout the entire process.

(A) Initial screening[3]

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 detailed due diligence.

1. The asset manager should perform an initial screening of each proposed arrangement or transaction which deviates from generally accepted market practices, such as setting up master-feeder fund structures or special purpose vehicles for tax purposes, before:

   (a) accepting a new mandate for a private fund or discretionary account;

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1 Senior management should include, but not be limited to, the Manager-in-Charge (MIC) of Overall Management Oversight, MIC of Key Business Line (ie, asset management), MIC of Compliance and MIC of Anti-Money Laundering and Counter-Terrorist Financing.

2 For example, the asset manager should select mandates and transactions which were not considered dubious for review to assess the reasonableness of the initial screening.

3 For the avoidance of doubt, initial screening should generally not be necessary where the asset manager does not know the identities of the end investors of private funds under its management, for example, where it has appointed another party to distribute private funds and the identities of the end investors are not disclosed to it.

(b) executing an investor-directed or suggested investment transaction for a new or existing private fund or discretionary account under its management; or

(c) accepting the injection of an investment (for example, stocks or bonds) by the investor into a private fund or discretionary account under its management.

2. The asset manager should first assess if there is any reason to suspect that the asset manager is not, or will not be, required or expected to make any investment decisions (apart from mere execution or operational decisions). If there is, then the asset manager should review the details of the proposed arrangement or transaction and ask itself further questions, such as:

(a) Does the fund set up or structure look unduly complex or does it link back to the same investor or small group of investors?

(b) Does the proposed transaction make commercial sense?

(c) Is it logical to make the proposed investment in this way?

(d) Does the proposed transaction involve one or a few investors investing significant amounts in one or a few illiquid stocks or unsecured loans?

(e) Is the proposed transaction part of a series of transactions and, if so, what are the implications of the series of transactions as a whole?

(f) To what extent have the underlying investments been identified or pre-arranged by the investor?

(g) Where a proposed investment does not have a market value, how can the asset manager gauge the reasonableness of the consideration to be paid?

3. If the asset manager is not reasonably satisfied with the answers to any of these questions[4], the proposed arrangement or transaction should be considered dubious. The responsible staff should report the arrangement or transaction and the initial screening result to the MIC of the Key Business Line (ie, asset management) and compliance staff for a decision about whether to proceed.

4. Unless a decision is made not to proceed, the asset manager should log the case and perform enhanced due diligence (please see Section B below).

(B) Detailed due diligence

5. The asset manager should perform enhanced due diligence as follows:

(a) Enhanced due diligence on investors

[4] For example, when the use of derivative instruments for making an investment may generally be a red flag indicator, using them for a fund under the Qualified Domestic Institutional Investor program should not, in most cases, be considered dubious. Similarly, a private equity fund should generally not appear dubious just because its fund or investment structure involves multiple funds or special purpose vehicles.

The asset manager should:

(i) make reasonable efforts, for example, by making enquiries and conducting its own research (such as a public records search), to assess whether the investor in the private fund or discretionary account is related, in any way, to:

- other investors in the same fund or discretionary account;
- the investments made or to be made by the fund or discretionary account, for example, whether the investor is a substantial shareholder, director or affiliate of the investee company;
- the person or entity from which an investment in or by the fund or discretionary account was directly acquired; or
- the borrower under a loan which is an investment of the fund or discretionary account;

(ii) assess whether the amount of funds or assets injected by the investor into the private fund or discretionary account is commensurate with the investor's background and declared net assets; and

(iii) understand the investor's source of funding. For example, if there are indications that funding may be from other parties, this should be a red flag that the investor may not be the beneficial owner.

(b) Enhanced due diligence on investors' instructions

(i) Set up and structures of funds or discretionary accounts

The asset manager should:

- make enquiries with the investor to understand the purpose of setting up the fund or discretionary account, the rationale behind the structure or, where relevant, the reason for channelling money into the fund or discretionary account through multiple or complex layers of arrangements or transactions; and
- assess whether the fund or discretionary account might have been set up for improper purposes, such as concealing beneficial ownership or forming part of a dubious "nominee" or "warehousing" arrangement as referred to in the Circular to intermediaries – Use of "nominees" and "warehousing" arrangements in market and corporate misconduct dated 9 October 2018.

(ii) Transactions directed by investors

The asset manager should:

- 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 or discretionary account's investment mandate;

- 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;

- determine the source of the investments, ie, from where the investments are acquired or are to be acquired, and assess whether this may involve any untoward arrangement or transaction; and

- conduct its own research and exercise independent judgement by assessing whether:

  - the investment is relatively illiquid (for example, a listed equity that is thinly traded or has a high shareholding concentration as identified by the SFC);

  - the investment involves investing in private companies or making sizable unsecured loans to individuals or corporates with obscure backgrounds or poor financial standing; or

  - the investor has suggested a convoluted, risky or expensive way of making the investment.

(C) Senior management review and decision

6. Senior management of the asset manager should exercise due skill, care and diligence in reviewing each proposed arrangement or transaction which was determined to be dubious in the initial screening and take additional steps (such as obtaining professional advice) as needed. Senior management should exercise judgement in determining, among other things, whether:

   (a) the investor has provided a valid explanation (for example, tax efficiencies, capital savings or access to markets) with supporting documentation (such as correspondence with the relevant authority or expert tax advice);

   (b) there remains any reason to suspect that the proposed transaction was illegitimate or improper; and

   (c) there remains any doubt about the investor's source of funding or that transactions are at arm's length.

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

(D) Documentation

8. The asset manager should maintain full documentation covering all aspects of every proposed private fund or discretionary account 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.