## Aoba Newsletter – Hong Kong

**Aoba Business Consulting Limited**
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# Latest SFC Compliance Issues to Intermediaries

## [Background]

Since the launch of Shanghai-Hong Kong Stock Connect in year 2014, the number of intermediaries and licensed individuals in Hong Kong increased significantly. As of 30th September, 2017, over half of the intermediaries are registered for Type 9 regulated activity (i.e. asset management). Also, the numerical increase in number of individuals licensed for asset management is the largest for the past five years among all other regulated activities.

In view of the Hong Kong's position as a leading global asset management centre, the Securities and Futures Commission ("the SFC") focuses in supervising intermediaries with higher emphasis on front-loaded regulation and real-time supervision. Since a number of regulatory concerns is identified during the course of its inspection, therefore, the SFC has issued the first edition of "*SFC Compliance Bulletin: Intermediaries"* in December 2017 to highlight the importance of managing conflicts of interests and details of which are summarised as below.

## [Highlights]

*[Issue observed: Inadequate risk management]*

An instance is discovered for a private fund manager with inappropriate risk management policies to address concentration and liquidity risks. Certain private funds that managed by a fund manager are invested heavily in concentrated positions in illiquid stocks.

*[SFC requirements]*

Asset managers should have effective risk management policies and procedures in place so as to identify and manage the risks to which their funds may be exposed. Any undue concentration of illiquid or interconnected stocks of the funds managed should be considered. In particular, the liquidity risk of funds should be properly managed in order to ensure those investors' redemption requests under the funds' offering documents can be met.

*[Issue observed: Unfair treatment]*

When a fund is unable to meet margin calls on leveraged stock trading, an asset manager obtained loans with terms that are unfair to the lending funds' investors from other funds that it managed. Unfairness is identified as the lending funds are also in need of cash to meet their own outstanding redemption requests and the loans that made to borrowing funds are without securities or collaterals. The lending funds are further disadvantaged given the interest rate charged to the borrowing funds are lower than the market rate that usually charged for securities margin financing. Separately, a party related to the asset manager made a loan to the borrowing funds with an extremely high one-off financing charge.

*[SFC requirements]*

According to the General Principle 1 of the "Code of Conduct for Persons Licensed by or Registered with the SFC" ("Code of Conduct"), asset manager should act honestly, fairly, and in the best interests of its clients and the integrity of the market when conducting its business activities. An asset manager should also maintain the proper internal control procedures in order to protect its operations and its clients arising from dishonest act and professional misconduct. Failure to act in the best interests of clients and integrity of the market is a very serious matter and directly impair its fitness and properness for being a licensed or registered person.

*[Issue observed: Inappropriate receipt of high cash rebates]*

Fund manager is discovered to receive unusually large cash rebates from transactions executed by funds under its management. Under an inspection, an approximately 80% of the fund’s transactions can offer commission rebates up to 85% of their gross commission rates. Such exceptionally high stock turnover may suggest that the trades made by the fund manager are excessive. Its sole purpose may be interpreted to derive unusually high rebates for its own benefit at the expense of clients’ interests.

*[SFC requirements]*

In accordance with the General Principle 6 of the Code of Conduct, a licensed or registered person should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its clients are fairly treated. Given cash rebates are perceived to give rise to actual or potential conflicts of interests, asset manager should have a strong conflict of interest management policy and procedure in place and should take all reasonable steps to ensure fair treatment of all its clients.

*[Issue observed: Placing commission with lower yields]*

During the course of distributing bonds for a listed client, a licensed corporation placed three different clients the bonds on the same date and at the same price but with different annual coupon payments. Being the placing agent, the licensed corporation earned commission income of 20%, 23.75% and 30% of the principal amount for the bond selling with coupon rates of 6%, 5.25% and 4% respectively. No appropriate advice is provided to separate clients to explain why the lower yields of 5.25% or even 4% are fair and no proper disclosure is made to clients for the material conflict of interest that the licensed corporation has in respect of the commission income.

*[SFC requirements]*

By reference to Paragraph 10.1 of the Code of Conduct, where a licensed or registered person has a material interest in a transaction with or for a client or a relationship which gives rise to an actual or potential conflict of interest in relation to the transaction, it should neither advise, nor deal in relation to the transaction unless it has disclosed that material interest or conflict to the client and has taken all reasonable steps to ensure fair treatment of the client.

*[Issue observed: Sale of in-house products and improper order execution]*

Upon selling structured products to clients, certain intermediaries only select "in-house" products that are issued by its own related entities as counterparties with no adequate disclosure to clients. Even though intermediaries are required to obtain quotes from different market participants for client's order execution, still it is found that no sufficient quotes are obtained from external market participants. Furthermore, certain of client orders are even not executed at better prevailing prices.

*[SFC requirements]*

Pursuant to Paragraph 3.2 of the Code of Conduct, a licensed or registered person when acting for or with clients should execute client orders on the best available terms. Intermediaries should implement proper controls and monitoring to ensure compliance with their established policies and procedures, including the compare of quotes from external counterparties. In case no relevant external quote is available, the fact should still be appropriately disclosed to clients. Any material interest in a transaction with or for a client or a relationship which gives rise to an actual or potential conflict of interest should be properly disclosed to clients as required under Paragraph 10.1 of the Code of Conduct.

*[Issue observed: Improper product due diligence]*

An instance is found for an intermediary with no adequate controls in place to assess the conflicts of interests in selling in-house products. In the meantime, it solely relied on its affiliated entities to perform product due diligence on certain third-party managed funds without further independent assessment.

*[SFC requirements]*

Intermediaries should have the full understanding on all its in-house products before recommending their products to clients. In case product due diligence is performed by affiliated entities, adequate policies and procedures must still be in place to ensure independent assessment is conducted without bias. Also, the concerned assessment should properly be performed by considering if there are any actual or potential conflicts of interest and how the conflicts be identified and addressed. Approval from senior management should also be obtained for proper documentation purpose.

*[Issue observed: Selling process with different rates and charges]*

An intermediary made solicitations of a specific class of certain in-house products to clients but not disclosing to the clients that they were entitled to invest in other classes of products in which lower fees and charges could be applied. Clients were eventually required to pay higher fees and charges.

*[SFC requirements]*

Intermediaries should implement proper policies and procedures to ensure their solicitations or recommendations to clients are reasonable in all circumstances having regard to all relevant available information about the clients. Intermediaries should properly comply with Paragraph 2.2 of the Code of Conduct by ensuring all charges, mark-ups, or fees affecting a client should be fair and reasonable in the circumstances, and be characterized by good faith in the course of dealing or advising concerning a client.

*[Issue observed: Discretionary portfolio management ("DPM")]*

Certain investment portfolios of DPM are found to be made up of substantial investments in in-house products. No proper monitoring tools or controls are in place to ensure the overall risk exposure matched with the investment strategies and risk expectations agreed with clients.

*[SFC requirements]*

For discretionary management models, intermediaries should ensure the selection of in-house or third-party products to match with the investment strategies and risk expectations agreed with clients. Robust policies and procedures should be in place so as to demonstrate in a sufficiently clear manner that careful consideration has been made to all investment products, including both the in-house products and third-party products after taking into account the client's all reasonable circumstances.

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## About Aoba & Hopkins Group:

The Aoba & Hopkins Group consists of CPA firms and full service consulting firms located in Hong Kong, Guangzhou and Beijing that have been providing quality and efficient professional services to our valued clients aboard and at home since 1989.

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