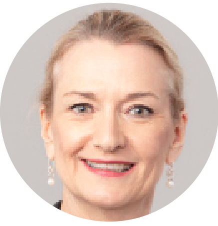
HONG KONG HEDGE FUND MANAGERS: OBSERVATIONS ON REGULATORY COMPLIANCE



Jane McBride
Partner
Deacons
jane.mcbride@deacons.com

Connie Chan
Licensing, Compliance and Regulatory Executive
Deacons
connie.chan@deacons.com

In recent years we have seen an increase in the Securities and Futures Commission (SFC) conducting on-site inspections of SFC licensed corporations. In 2019 alone, the SFC conducted 350 on-site inspections, a rise of 19.8% from the previous year.

One regulatory focus of note is senior management accountability, and statistics demonstrate that the SFC has little hesitation in holding individuals accountable for non-compliance.

In this article, we share six common compliance deficiencies observed during our recent mock audits of hedge fund clients. These audits were conducted to help clients prepare for an SFC inspection. In sharing our observations, we encourage firms to conduct a gap analysis between these deficiencies and their own operations.

FMCC and Code of Conduct

While conducting these mock audits, we identified a number of instances of non-compliance with relevant provisions of the SFC's Fund Manager Code of Conduct (FMCC) and the Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct). The FMCC is applicable to all fund managers, including those involved in the management of authorized and unauthorized collective investment schemes. While the FMCC and Code of Conduct do not have the force of law, a breach is likely to have an adverse effect on the SFC's view of the defaulting entity or individual's fitness and properness to hold an SFC licence and may result in disciplinary action.

Observation 1: Insufficient measures in recording MNPI

A portfolio manager may become privy to material non-public information (MNPI) when conducting due diligence on listed companies. While perhaps only a few fund managers set out to deliberately breach insider trading laws, a fund manager may nevertheless end up on the wrong side of an investigation due to the lack of robust compliance procedures to prevent the misuse of MNPI.

Our mock audits revealed that:

• while hedge fund managers sometimes obtain MNPI about listed companies through frequent contact with the management of these companies, smaller hedge funds in particular do not maintain a central system to record and store attendance notes of telephone calls, interactions and meetings with these companies; and

• some hedge fund managers do not regularly review electronic communications between their employees and third parties from listed companies to detect any potential misuse of MNPI.

The FMCC requires firms to establish, maintain and enforce policies and procedures to prevent market misconduct and insider trading. We recommend that firms take a more proactive approach in managing MNPI risks. At a minimum, a firm should have a central electronic recording system of MNPI, which must be periodically reviewed against the firm's trading activities and personal trading activities of its employees.

Observation 2: Lack of measures to demonstrate appropriate use of soft dollars

Over the years, we have seen best execution and soft dollar arrangements being a common topic in SFC inspections and enquiries. Following MiFID II in January 2018, and the SFC's own report on the thematic review on best execution published in the same period which saw many firms directing orders to brokers offering more attractive soft dollar arrangements, we expect the SFC to pay even more attention to firms' controls in this area.

The Hong Kong regulator permits the use of soft dollar arrangements; but the FMCC puts the onus on the licensed firm to ensure that such arrangements will not adversely affect the firm's ability to deliver best execution.

Our mock audits revealed that:

• some hedge fund managers do not have policies and procedures in place to evaluate broker performance and the use of soft dollars provided by brokers; and
• of the firms with policies and procedures in place, some do not periodically evaluate their use of soft dollar arrangements, or are unable to demonstrate that they perform such an evaluation.

While a fund manager may consider all relevant factors in its broker selection exercise, without proper policies and procedures and records documenting broker evaluations, it will be difficult to convince the SFC that broker selection is not primarily based on soft dollar inducements.

Observation 3: Failure to maintain records of suitability assessments

Suitability remains at the top of the SFC's agenda, it being named a priority in both its current and previous annual reports going back several years. Under paragraph 5.2 of the Code of Conduct, licensed firms must determine whether a product they are selling is a complex product. If a product is a complex product, the licensed firm cannot sell it to an individual investor, whether a professional or not, unless the licensed firm is satisfied that the product is suitable for the investor.

In 2018 and 2019, we saw the SFC take three notable disciplinary actions against licensed firms for deficient selling practices. In total the firms were fined HK$24.6 million. Given that the SFC has repeatedly communicated its concerns on this topic, it has limited patience where firms continue to fall short.

Our mock audits revealed that:

• some firms do not keep proper records explaining why the funds they manage are suitable for their investors, having considered their needs and circumstances; and
• some firms have not kept sufficient documents in relation to identification and risk assessments of investors.
Firms need to implement safeguarding systems to demonstrate suitability, and to automate and streamline that documentation so that investor information, interactions with investors, product due diligence, risk profiling assessments and professional investor assessments are recorded and regularly updated. Adequate record keeping is the best way, and in many cases the only way for a firm to demonstrate compliance.

Observation 4: Lack of records to show eligibility verification of CPIs

Certain investor related protections set out in paragraph 15 of the Code of Conduct, including the suitability assessment, can be waived for corporate professional investors (CPIs). However this waiver is not automatic; a licensed firm must conduct a formal assessment to verify that the investor is a CPI. The assessment criteria is set out in paragraph 15.3A of the Code of Conduct. It is principles-based and the SFC's FAQs assessment of Corporate Professional Investors includes a non-exhaustive list of factors to consider when performing the assessment.

Our mock audits revealed that while all firms performed CPI assessments, some hedge fund managers do not keep sufficient records. When the SFC conducts an inspection, its officers will ask for an audit trail of enquiries made and information obtained as part of the CPI assessment. In the absence of sufficient documents, it will be difficult to demonstrate to the SFC that the CPI assessment has been properly conducted.

Observation 5: Lack of records to support investment rationale

As part of the investment decision

making process, portfolio managers often meet with potential target companies to obtain business updates.

Our mock audits revealed that during or after these meetings, it is common practice for a portfolio manager to take personal notes.

However, some hedge funds do not maintain a central system to collect, record and store these notes. These personal meeting notes form an important part of the documentary evidence substantiating investment decisions and during routine inspections, the SFC will often ask for such evidence.

Observation 6: Insufficient monitoring of personal trading activities

The SFC actively pursues breaches of internal control failures. In fact, of the total fines of over HK$413.3 million imposed by the SFC in the final quarter of 2019, HK$408.8 million resulted from disciplinary actions concerning internal control weaknesses. A number of these actions resulted from failures to put in place adequate systems and controls to detect and prevent illegal activities, including short selling and cross trades by employees using their personal trading accounts.

The FMCC requires fund managers to establish appropriate policies and procedures governing personal account dealing (PAD).

Our mock audits revealed that:

- some firms do not strictly follow their own PAD policies and procedures. For example, employee personal account statements are not periodically reviewed to ensure that trades have been pre-cleared as required; and
- listed securities flagged for MNPI are not always placed on a restricted trading list.

We recommend that hedge fund managers actively monitor personal account trading activities to ensure compliance with the firm's PAD policy.
The SFC will not hesitate to discipline senior management for such failures. In mid-2019 the SFC suspended the licences of two senior management staff for a period of six months for failing to adequately supervise and implement effective controls in relation to personal trading activities.

Conclusion

We recommend hedge fund managers to review their policies and procedures, with an eye toward what the SFC would look for during an inspection. There is no bright line test as of how much effort is sufficient, but erring on the side of caution, particularly in areas that the SFC has highlighted in its thematic inspections and enforcement actions should help to narrow the expectation gap and reduce non-compliance risks.