

October 2024

SFC warns deficiencies and misconduct in management of private funds and discretionary accounts



The Securities and Futures Commission (the "**SFC**") issued a [circular](#) on 9 October 2024 setting out various deficiencies and misconduct that it identified while supervising licensed corporations engaged in managing private funds and discretionary accounts, together with specific case examples for practical illustration.

The circular serves as a reminder to licensed corporations engaged in the asset management business of the standard expected of them.

Deficiencies identified

The SFC identified four key areas where deficiencies and substandard conduct arose in the asset management sector, namely: conflicts of interest; risk management and investment within mandate; information for investors; and valuation methodologies.

Conflicts of interest

A significant number of cases identified in the circular relates to the failure by asset managers in preventing and managing potential or actual conflicts of interests arising from their transactions or practices. Examples include: financing manager-related entities using fund assets; providing financing to funds with unjustified fees; allocating trades unfairly; receiving monetary benefits from fund transactions; and failing to act fairly in handling redemption payments.

In response to such cases, the SFC suggested that, in addition to identifying and managing any actual or potential conflicts of interest, asset managers should prevent such conflicts by considering other alternatives if possible. Where material conflicts of interest cannot be prevented, asset managers should critically consider whether it is in the best interest of the fund to conduct such transactions, which should be executed in good faith at arm's length and on normal commercial terms. SFC also advised fund managers to have effective policies and procedures in place to identify, manage, and disclose conflicts of interest.

In addition, specific disclosures about the material interest or conflict should be made to fund investors, and generic disclosure in the fund's constitutive documents may not be sufficient for such purpose. For example, where an asset manager considers using a material portion of the fund's assets to provide loans to its affiliate, it should specifically inform investors of details such as the identity of the counterparty of the loan arrangements (in this case, its affiliate), loan amount, material interests of the asset manager and its affiliate, risks of the material conflicts of interest and the loan, as well as how the conflict will be managed and mitigated through a prescribed monitoring mechanism.

Risk management and investment within mandate

Other cases also showed certain asset managers failing to ensure that transactions were carried out in accordance with the fund's stated investment restrictions or objectives, or that adequate risk management procedures were implemented to appropriately identify, manage and monitor all relevant risks.

While it goes without saying that asset managers should conduct adequate due diligence on proposed investments, the SFC reminded them in the circular that all relevant risks should be considered, especially where the investment may result in significant concentration, liquidity and credit risks, and that any risk assessment should not be mechanistic. Asset managers should also integrate liquidity management in investment decisions, and regularly monitor any liquidity mismatches between the funds' underlying investments and their redemption obligations.

Information for investors

In relation to providing fund investors with adequate information, there were asset managers that failed to make specific disclosures relating to: (a) concentrated positions and significant exposures that subject the fund to significant risk; (b) significant events impacting the funds (e.g. major investment losses, significant defaults in investments); and (c) modified opinion issued by the funds' auditors or material delay in issuing of audited financial statements.

It should be noted that the SFC expects these types of specific disclosures even though they might not be expressly stipulated under the Fund Manager Code of Conduct (the "**FMCC**") or other codes and guidelines issued by the SFC. Asset managers should therefore exercise their judgment to determine whether any particular information should be specifically disclosed to fund investors to discharge their duty under the FMCC to provide fund investors with adequate information to allow them to make informed judgement about their investments into the funds.

Valuation methodologies

The SFC also noted instances where asset managers adopted inappropriate valuation methodologies with an intention to hide investment losses. These cases generally relate to illiquid or non-performing assets, and asset managers are reminded to refer to the guidance under the FMCC in valuing assets that are not actively traded.

Steps to be taken

In light of the SFC's commitment to stepping up its disciplinary actions and imposing stricter penalties for similar or persistent misconduct, this may be an appropriate time for asset managers to review existing practises and consider whether their current policies and procedures need to be tweaked or bolstered. If so, proactive steps are to be taken to ensure compliance with regulatory expectations and mitigate the risk of enforcement actions.

Our team regularly advises asset managers on a wide range of regulatory issues in connection with the establishment and operation of private funds and discretionary accounts. Should you require any legal assistance, please feel free to get in touch.

Contact us



Penelope Shen

Partner

T: +852 3166 6936

E: penelope.shen@shlegal.com



Katherine Liu

Partner, Head of Finance and
Financial Service Regulation

T: +852 2533 2717

E: katherine.liu@shlegal.com



James Wong

Managing Associate

T: +852 3166 6933

E: james.wong@shlegal.com



Brian Ho

Associate

T: +852 2533 2752

E: brian.ho@shlegal.com



Alan Wong

Associate

T: +852 2533 2719

E: alan.wong@shlegal.com



Monica Jia

Associate

T: +852 2533 2795

E: monica.jia@shlegal.com

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