

Hong Kong SFC Fines Fund Managers for Internal Control Failures and Other Breaches

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In the past three months, the SFC has pursued disciplinary proceedings against two fund managers for failures and breaches relating to fund management activities. Licensed intermediaries, and especially holders of type 9 (asset management) licenses and their senior management, should ensure that effective internal controls are in place to properly manage the risks arising from fund management activities.

PICC Asset Management (Hong Kong) Company Limited. On 5 February 2024, the Securities and Futures Commission (“SFC”) reprimanded and fined PICC Asset Management (Hong Kong) Company Limited (“PICC”)¹ HK\$2.8 million over its failure to discharge its duties as the manager of a Cayman-incorporated fund.

The SFC found that PICC failed to properly manage the fund in accordance with its investment strategy, objectives and investment restrictions. Contrary to the fund’s stated objective of capital preservation combined with steady long-term capital appreciation primarily through investments in a diversified portfolio of equity securities, the investigation revealed only one to three stocks in the fund’s portfolio at any given time over a 21-month period,² and highly concentrated positions in two Hong Kong listed stocks during the two-year life span of the fund, one of which was not on PICC’s permitted securities list at the time of investment.³

The SFC also found that PICC did not have adequate internal controls and risk management mechanisms in place to ensure the fund’s adherence to the investment mandate and other internal procedures and requirements, handle noncompliance, and

¹ PICC is licensed to carry on Type 4 (advising on securities) and Type 9 (asset management) regulated activities under the SFO.

² From its inception in May 2018 to January 2020.

³ PICC was found to have breached paragraph 3.1 of the Fund Manager Code of Conduct (“FMCC”).

manage liquidity and concentration risks.⁴ PICC also failed to adequately supervise the investment manager who managed the fund and the associated risks on its behalf.⁵

In reaching the decision to take disciplinary action, the SFC took into account all relevant circumstances including (i) the gravity of the failures; (ii) the deterrent message to the market; (iii) PICC's efforts to enhance its risk management and liquidity controls; and (iv) PICC's otherwise clean disciplinary record.

Ruifeng Securities Limited. The SFC's disciplinary action against PICC came shortly after it, around two months ago on 4 December 2023, reprimanded and fined Ruifeng Securities Limited ("RSL"),⁶ the manager of another Cayman-incorporated Fund, HK\$5.2 million over failures relating to its fund management activities and account opening procedures and suspended the licence of its responsible officer, Fang Zhi, for 10 months for failing to discharge his duties.

As in its investigation of PICC, one of the main issues that the SFC identified was the inadequacy of internal controls. Specifically, the SFC found that RSL failed to take all reasonable steps to identify, prevent, manage and/or monitor actual or potential conflicts of interest, which resulted in the fund investing in senior notes that it had underwritten. RSL also failed to disclose such conflict to the fund's investors and failed to have sufficient risk management measures in place to ensure that the fund was not exposed to excessive risk, and its decisions to invest in certain fixed income products for the fund were reasonable and in the fund's best interests.⁷

Additionally, the investigation revealed that RSL failed to (i) ensure the accuracy of a representation made on behalf of the fund; (ii) make adequate disclosures of information about the fund's investment holdings; and (iii) have acceptable account opening procedures in place.⁸

The SFC considered RSL's management failures to be attributable to Fang Zhi, the responsible officer in charge with RSL's fund management activities and a member of the senior management of RSL, and concluded that Mr Fang has breached GP 9 for failing to act competently and diligently in carrying out the asset management activities

⁴ PICC's failure constitutes a breach of paragraphs 1.2(c), 1.7.1 and 3.14.1(a) of the FMCC.

⁵ PICC has breached General Principle 3 (capabilities), Principle 7 (compliance), paragraph 4.2 (staff supervision), paragraph 4.3 (internal control, financial and operational resources) and paragraph 12.1 (compliance : in general) of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct").

⁶ RSL is licensed to carry on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities under the SFO.

⁷ RSL's conduct constitutes a breach of paragraph 1.5 of the FMCC and paragraph 10.1 of the Code of Conduct.

⁸ RSL has breached GP 2 and paragraph 5.1 of the Code of Conduct, paragraphs 1.2(d), 1.7.1 and 6.2 of the FMCC.

on behalf of RSL and for failing to ensure the maintenance of appropriate standards of conduct and adherence to proper procedures by RSL.

In deciding the sanctions, the SFC took into account all relevant circumstances including (i) RSL's remedial actions; (ii) RSL and Mr Fang's cooperation with the SFC in resolving the SFC's concerns; and (iii) their otherwise clean disciplinary record.

Conclusion. These two SFC disciplinary actions against fund managers demonstrate that intermediaries' misconduct and, in particular, internal control failures, very much remain an enforcement priority of the regulator. This serves as an important reminder to asset managers that having in place adequate internal controls and risk management procedures, as well as properly implementing and monitoring those procedures, are vitally important to avoiding noncompliance and minimising regulatory risk.

In this regard, there are various steps that an asset manager could take to avoid the types of pitfalls highlighted above. For instance:

- Regular reviews and monitoring of the performance of the staff members responsible for investment management should be conducted to ensure that investment strategies and mandates are strictly adhered to, and investment decisions are made in the best interest of clients;
- A register of direct and cross trades should be maintained and reviewed by designated staff members regularly to facilitate identification and prevention of possible conflicts of interest between the firm and its client(s);
- Effective procedures should be put in place to ensure that where actual or apparent conflicts of interest cannot reasonably be avoided, the relevant clients are fully informed of the nature and possible ramifications of such conflicts and are, in all cases, treated fairly; and
- Review policies and procedures on a regular basis and monitor staff members' adherence to such policies and procedures by independent compliance and internal audit functions.

It is also important for directors and senior management of asset managers to bear in mind their obligation under paragraph 14.1 of the Code of Conduct to understand their firms' internal control and risk management procedures, as they are ultimately responsible for the adequacy and effectiveness of those procedures.

At the same time, they should be proactive in identifying and addressing actual or potential noncompliance by being constantly on the lookout for red flags and seeking

reasonable explanations when things “do not feel right”. An inquisitive approach and a curious mindset are crucial to preventing noncompliance or, if that has already taken place, mitigating its effects and exercising damage control.

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