

SFAT Affirms SFC Decision to Fine Investment Advisor and Suspend the Licence of Its Responsible Officer

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The Securities and Futures Appeals Tribunal (“Tribunal”) recently handed down its determination on an application for review brought by Cardinalasia, a company licenced to carry on Type 4 (advising on securities) and Type 9 (asset management) regulated activities, and Edward Lee, the sole shareholder and responsible officer of Cardinalasia, to set aside the findings of culpability made by the SFC against them in respect of certain loan arrangements and cross trades, and to challenge the reasonableness of the sanctions imposed.

Background

Between about April 2014 and June 2015, Yeung Chun Wai (“Anthony Yeung”) set up five investment funds (“Funds”) for the purpose of investing in small and medium enterprise (“SME”) stocks. Each Fund was incorporated as a Cayman Islands exempted company limited by shares and Anthony Yeung sat on each of their boards of directors. Each Fund appointed Quantum China Asset Management Limited (“QCAML”), solely owned by Anthony Yeung, as its manager. Pursuant to the management agreements, the manager had the power to delegate all or part of its powers.

By way of investment advisory agreements, QCAML appointed Cardinalasia as Principal Investment Adviser of each Fund, a position which Cardinalasia held from about August 2014 to October 2017. Under the investment advisory agreements, Cardinalasia effectively assumed all the responsibilities of the manager under each management agreement, which included not just proffering investment advice, but also giving advice concerning the use of monies.

As Principal Investment Adviser of the Funds, Cardinalasia, through Edward Lee, was involved in two incidents which came under scrutiny by the SFC: (a) a series of loan arrangements entered into between the Funds when some of the Funds were experiencing severe liquidity problems; and (b) a series of cross trades entered into between the Funds for the purpose of rebalancing their investment portfolios.

The “internal” loan arrangements

In 2015, the SME market fell, causing a number of the Funds to suffer a liquidity squeeze. Therefore, between January 2015 and June 2016, seven “internal” loan arrangements were set up to enable those Funds under the most severe financial stress to borrow from those under less stress. Edward Lee was aware of all of these arrangements, and was actively involved in most of them, by having discussions with Anthony Yeung regarding the arrangements and signing the relevant payment instructions.

As licenced persons, both Cardinalasia and Edward Lee were required under the Code of Conduct for Persons licenced by or registered with the Securities and Futures Commission (“Code of Conduct”) to (among other things):

- (a) conduct their licenced business activities in a manner that is honest, fair, in the best interests of their clients and in accordance with the integrity of the market;
- (b) ensure that client positions in the market or assets held are adequately safeguarded; and
- (c) seek to avoid conflicts of interest and, if conflicts cannot be avoided, ensure that their clients are fairly treated.

However, in the context of the loan arrangements, Cardinalasia and Edward Lee failed to address the conflict of interest between the lending Funds and the borrowing Funds by identifying an alternative way to raise money, or if that were not possible, by taking steps to ensure that the interests of the lending Funds were adequately protected.

Edward Lee argued that there was no conflict of interest between the lending Funds and the borrowing Funds, as the constituent investments of the Funds were highly similar, meaning that if one of the Funds were to be forcibly liquidated, there would be a substantial negative impact on the value of the investments of the other Funds, so it was in fact also in the interest of the lending Funds to bail out the borrowing Funds.

The Tribunal, however, noted that it must have been evident to Edward Lee at an early stage that he ran a real risk of facing a conflict of interest, which should have prompted him to maintain a proper paper trail to protect the integrity of his dealings. The complete lack of documentation evidencing the alleged thinking therefore indicated that it merely represented an attempt by Edward Lee to rationalise matters after the event.

In any event, the Tribunal was satisfied that even if the loan arrangements were in the interests of all the Funds, Cardinalasia and Edward Lee were still in breach of the Code of Conduct by failing to adequately protect the interests of the lending Funds under the loan arrangements. In particular, the Tribunal noted that:

- (a) the loans were not backed by any form of collateral, security or guarantee;
- (b) the loan agreements did not contain any requirement for the borrowing Funds to make repayment within a specified period of time;
- (c) the interest rate for six of the loans was 2% p.a., which was far lower than the interest rate charged by other parties (including Anthony Yeung) who had lent money to the Funds, whilst no interest at all was charged in respect of the remaining loan; and
- (d) one of the lending Funds was forced to borrow from a third fund just one day after granting loans to the borrowing Funds, which showed that the lending Fund was in fact not in a financial position to extend the loans to the borrowing Funds in the first place.

Ultimately, the lending Funds suffered huge losses as a result of the loan arrangements. None of the loans were fully repaid. In fact, the lending Funds received no repayment at all in respect of five of the seven loans.

The cross trades

In about November 2015, a rebalancing of the Fund portfolios took place, which involved 14 pairs of cross trades being conducted between the Funds, all at 20% discount pursuant to the advice of Edward Lee.

Similar to the loan arrangements, Cardinalasia and Edward Lee were under a duty to take steps to ensure that the cross trades were fair to, and in the best interests of, both the buying and the selling Funds. This required an assessment of the value of the assets of each Fund and the advantages or disadvantages of the acquisition or disposal of those assets.

However, Edward Lee considered that the cross trades fell outside of his scope of duties. The evidence showed that he recommended the 20% discount “off-the-cuff” without reference to the relevant market and financial data. In fact, Edward Lee accepted that he had not conducted any independent assessment of the cross trades to determine whether they were in the interests of the participating Funds.

In the circumstances, Cardinalasia and Edward Lee failed to meet their obligations as investment advisor to give the Funds considered advice regarding the cross trades.

The Determination

In view of the above, the Tribunal dismissed the application to review the SFC's findings on culpability.

On the issue of sanctions, the Tribunal imposed an even heavier sanction on Edward Lee than the SFC did, suspending his licence for a period of nine months—two months more than what the SFC had considered was sufficient. Cardinalasia received the same sanction: a public reprimand and a fine of HK\$1.5 million.

Significance

This decision is a useful reminder to licenced persons on a number of important issues:

- (a) An investment advisor's duties and responsibilities are usually defined by the terms of the investment advisory agreement. Accordingly, although such agreements are frequently standard legal templates, it is nevertheless important for investment advisors to properly review the agreements to ensure the terms set out clearly and accurately what is expected of them. By directly assuming all the responsibilities of the manager, which are usually broad and extensive in nature, the investment advisor risks taking on obligations that it never intended to.
- (b) A licenced firm is frequently appointed as investment advisor to a number of funds which have the same, or substantially the same, management personnel. However, the investment advisor should always remember that the funds are independent bodies with their own investors, and it is the primary obligation of the management of each fund to protect the best interests of its own investors at all times. In the circumstances, the investment advisor should always be alive to the possibility of conflict of interest arising between the funds, and seek to avoid such conflict whenever possible. Where this is not possible, the investment advisor should ensure all the funds are fairly treated and no fund's interests are favoured over or to the detriment of the interests of the other funds.

- (c) All licenced firms, particularly those operating in circumstances where conflicts of interest frequently arise, should ensure that they always document and record their actions and decisions and the underlying rationale. Quite apart from the obligations under the Code of Conduct and other applicable regulations to maintain proper documentation, the existence (or non-existence) of such documentation will be crucial should any dispute arise in the future over whether the licenced firm has complied with its duties and obligations. Where a court or tribunal considers that certain contemporaneous documentation is likely to have existed, but a party does not produce such documentation (notwithstanding it should be within his power to do so) and seeks to rely on oral evidence instead, adverse inferences may be drawn against that party.

In addition, licenced persons should also bear in mind that applications to the Tribunal for review are not appeals, and are instead heard *de novo*. This means that the Tribunal may increase the sanction that has been imposed. Decisions to make an application for review should therefore not be made lightly, and should only be made after careful consideration, with external counsel's input where necessary.

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