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The 9 Compliance Deficiencies That Asset Managers Need To Know

A discussion on a recent circular issued by the SFC which listed out 9 common instances of non-compliance in managing funds and discretionary accounts.

Background

On 15 September 2017, the SFC issued a circular which highlighted 9 instances of non-compliance amongst asset managers with relevant provisions of the Fund Manager Code of Conduct ("FMCC"), the Code of Conduct and the Internal Control Guidelines.

According to the SFC, these observations were drawn from around 250 recent inspections which covered asset managers forming part of an overseas group of companies (based, in the United States, Europe, and on the Mainland) of varying sizes, as well as local asset managers generally operating on a smaller scale.

This article aims to delve into the implications of each of the 9 instances of non-compliance as below:

(1) Inappropriate receipt of cash rebates giving rise to apparent conflicts of interest

Some asset managers have inappropriately received cash rebates from execution brokers, giving rise to apparent conflicts of interest. For example, it was found that a firm traded more frequently than was consistent with the investment strategy of the fund for the purpose of generating cash rebates for its own benefit. As cash rebates inevitably give rise to potential or perceived conflicts of interest, asset managers should establish and maintain robust conflict of interest management policies and procedures, and take all reasonable steps to ensure fair treatment of all clients.

In fact, Paragraph 10.12 of the Code on Unit Trusts and Mutual Funds clearly states that neither the management company nor any of its connected persons may retain cash or other rebates

from a broker or dealer in consideration of directing transactions in scheme property to the broker or dealer. However, there are exceptions where goods and services (soft dollars) may be retained if following criteria are satisfied:

(a) the goods or services are of demonstrable benefit to the holders;

(b) transaction execution is consistent with best execution standards and brokerage rates are not in excess of customary institutional full-service brokerage rates;

(c) adequate prior disclosure is made in the scheme's offering document the terms of which the holder has consented to; and

(d) periodic disclosure is made in the scheme's annual report in the form of a statement describing the manager's soft dollar practices, including a description of the goods and services received by the manager.

(2) Failure to ensure suitability of funds or discretionary account mandates when making solicitations or recommendations of funds under their management, or providing discretionary account management services, to clients

The SFC inspection revealed that some asset managers, which made solicitations or recommendations of funds under their management to clients, or provided discretionary account management services to clients in accordance with agreed mandates, had failed to ensure that these funds and mandates were suitable for their clients. For example, a firm inappropriately treated individual and corporate investors as Professional Investors and waived certain requirements as set out in the Code of Conduct when recommending the fund to them. Also, it was found that a firm relied on clients' self-declaration of risk profile without using any risk profiling questionnaire to assist clients to consider their risk tolerance. Investment objective and strategy were either absent from the client agreement or unclear as well.

The SFC has emphasized the importance of suitability obligations, which are the cornerstone of investor protection. Asset managers should always ensure that the fund they recommend to clients, or the discretionary account mandate established for clients, are reasonably suitable for those clients in all circumstances.

In addition, asset managers are reminded that, under the new Professional Investors ("PI") regime that came into effect on 25 March 2016, firms can no longer waive certain Code of Conduct requirements (including but not limited to the suitability obligations) when dealing with (i) individual PIs or (ii) Corporate PIs that cannot satisfy the assessment criteria for corporate PIs or do not agree to be treated as a PI.

(3) Failure to put in place a proper liquidity risk management process to ensure that liquidity risks of funds and discretionary accounts under management are adequately addressed

A lack of proper liquidity risk management may lead to the licensed corporation's failure to satisfy redemption or withdrawal requests. Therefore, the SFC expects asset managers to handle liquidity risk carefully. The SFC does not accept that an ordinary portfolio construction process would justify the non-performance of a separate liquidity risk assessment. There should be oversight by senior management or risk personnel with proper documentation of the relevant data and ratios monitored. Liquidity risk assessment should be conducted regularly especially for heavily concentrated portfolios.

As mentioned, the purpose of conducting liquidity risk assessment is to ensure the company's ability to meet redemption and withdrawal requests. Therefore, proper liquidity risk management should also include assessments of the investor profile or historical and expected redemption pattern for each individual fund so that the redemption percentage may be reasonably and logically assumed. This assumption should be regularly reviewed to ensure its ongoing validity. The relevant assumption deduction process shall also be properly recorded and maintained. The SFC does not agree with firms that simply use a fixed redemption percentage assumption for all funds without proper assessment with supporting data.

(4) Deficiencies in setting up a proper governance structure and implementing comprehensive policies and procedures for fair valuation of assets

Since the valuation of fund assets directly impacts subscription and redemption prices of funds, licensed corporations should have in place proper governance structures and comprehensive policies and procedures to value the assets fairly, reasonably and accurately.

During its inspections, the SFC observed that a number of firms have failed to handle valuation of suspended securities properly. These firms have recorded the suspended stocks and bonds at historical prices despite that the prices had been stale for months due to suspension. Assessment should be performed to determine such historical prices can fairly and accurately reflect its fair value and the value should be written down when necessary.

Having in place valuation assessments is merely one of the steps in a set of comprehensive policies and procedures. Triggering thresholds should be set to assess whether fair value adjustments would be necessary. These thresholds should not be ineffective in the sense that they are too high or unreasonable such that they are triggered only in the rarest events. Regular reviews by the senior management should be conducted to ensure that the thresholds can meet changing market conditions. The adjustments or non-adjustments of the values of securities that triggered the thresholds should also be approved by a valuation committee and not determined solely by the portfolio managers.

(5) Deficiencies in systems and controls to ensure best execution

According to Paragraph 3.2 of the SFC FMCC, asset managers should execute client orders on the best available terms, taking into account the relevant market at the time for transactions of the kind and size concerned.

As such, asset managers are expected to put in place adequate systems and controls to ensure best execution, considering factors such as prices, costs, speed, likelihood of execution and settlement, size and nature of the trade. One of the most common measure used in the industry is conducting regular broker review while some firms also compare execution prices of equities transactions with Volume Weighted Average Price ("VWAP"). In both cases, asset managers should document such reviews properly and taking into account the review result in deciding whether to continue with their existing broker selection. In respect of broker reviews, asset managers should be reminded that votes within the firm should be allocated fairly and should cover those who are involved in day-to-day dealing and operations. The review should also be performed in a holistic and unbiased manner, taking into account qualitative and quantitative factors.

Asset managers should be mindful of the potential conflicts of interest that could arise when directing trades to execution brokers. For instance, the attractiveness of soft dollar arrangements offered by a broker should not be the sole factor in broker selection.

(6) Failure to ensure fair order allocation

The SFC has also placed concerns on the asset managers to ensure a fair allocation among the funds and discretionary accounts managed. For instance, some asset managers do not keep the record of the allocation basis so that they cannot prove the orders were allocated fairly for the partially filled orders. Another example for failure to meet the fair allocation requirements as set by the SFC is related to the allocation between the funds, discretionary accounts and proprietary portfolios.

From Paragraph 3.4 of the SFC FMCC, asset managers should ensure that all client orders are allocated fairly and make a record of the intended basis of allocation before a trade is made. They should also ensure that an executed transaction is allocated promptly in accordance with the stated intention, except where the revised allocation does not disadvantage a client and the reasons for the re-allocation are clearly documented.

From Paragraph 3.11 (a) of the FMCC, asset managers should give priority to satisfying a client order as well.

So how should we determine the fairness of trade allocation? Perhaps there are no universal rules to determine this. The key is the consistency of the application of trade allocation policies and rules of the Company.

In order to comply with the requirements in Paragraphs 3.4 and 3.11 (a) of the FMCC, we recommend asset managers should undertake the processes below.

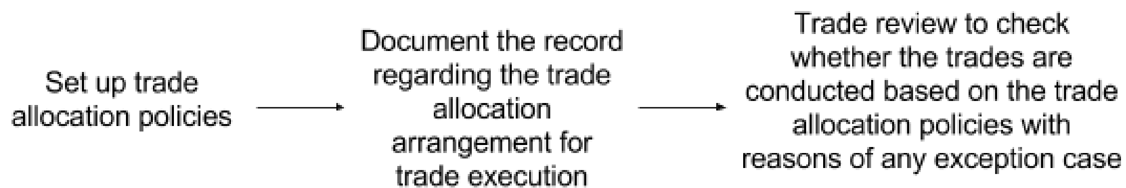

Fig. 1: Procedures to ensure fair allocation requirements are met

For proprietary portfolios, asset managers shall avoid adopting same investment strategies with any of the discretionary accounts or funds they are currently managing so as to ensure the best interests of clients are always met. In particular, when Paragraph 3.11 (a) of the FMCC stresses the orders for the funds and discretionary accounts should be always filled before the proprietary portfolio, this means the proprietary portfolio will always be under disadvantaged. This offers grounds to asset managers to avoid same positions in the proprietary portfolios and clients' portfolios.

(7) Inadequate systems and controls in relation to protection of client assets;

Paragraph 4.1 of the FMCC provides that asset managers should ensure that the assets entrusted to them properly safeguarded. It is important for asset managers to implement adequate systems and controls to safeguard the assets of the fund or discretionary accounts under their management from potential theft, fraud and any potential misappropriation.

On top of this, pursuant to Paragraph 5.5 of the FMCC, asset managers should arrange regular reconciliations of the corporation's internal records against those issued by third parties e.g. clearing houses, banks, custodians, counterparties and executing brokers, to identify and rectify any errors, omissions or misplacement of assets.

Allowing one authorized signatory to effect non-trade related transfers of fund assets in and out of brokerage or failing to carry out regular reconciliation are common deficiencies of asset management firms and is an example of not having passable controls in safeguarding client assets. Such deficiencies may increase the risk for client assets stolen, fraud and causing unnecessary losses to both the clients and the firm.

For the wellbeing of both clients and the asset management firms, an asset manager should by all means to implement effective controls and procedures to protect client assets.

(8) Inadequate systems and controls for ensuring compliance with investment restrictions and guidance; and

Paragraph 3.1 of the FMCC states that asset managers should ensure that transactions carried out on behalf of a client are in accordance with the portfolio's stated objectives, investment restrictions and guidelines, whether in terms of asset class, geographical spread or risk profile.

In view of this, asset managers are expected to implement effective systems and controls to ensure that the transactions are in compliant with the investment guidelines and mandates, meaning that practices, such as using eye-balling method to do pre-trade checking is not advisable.

Further, for asset managers who use automated investment restrictions checks without other compensating controls should be aware of the accuracy of the net asset values all the time to ensure the automated pre-trade and post-trade checks process can be performed accurately and effectively.

(9) Inadequate systems and controls to address the risk of market misconduct.

The SFC has also raised concerns on asset managers who failed to identify any market misconduct activities occurred. The SFC has also criticised them for their insufficient controls or policies to mitigate the risk of market misconduct.

While the chance of carrying out market misconduct activities may seem relatively low for some asset managers, the SFC has also addressed 2 common areas they should beware of, namely the monitoring of suspicious transactions and the use of expert network. Asset managers should regularly review the trading pattern and the setting in the system to ensure the system is capable of generating red flag signals for detecting suspicious trades. Expert network may also be an important source of information to some asset managers. Yet, to prevent being involved in any market misconduct behavior by chance, we recommend asset managers to seek other alternatives.

Asset managers should stay vigilant on utilizing the expert network and any abnormal investment made. If these happen, corresponding record should be kept in order to support the investment rationale and to justify no market misconduct is involved. Once in doubt, the asset managers should escalate the issue to the board or if necessary, the regulators. Prevent using any expert network service is an ideal measure to mitigate the market misconduct risk as well.

Conclusion

The SFC has made it clear that they may take enforcement actions against any asset managers and/or their management, including the relevant Manager-In-Charge of Core Functions, for failure to comply with the applicable regulatory requirements, including fitness and properness and the above examples of deficiencies.

Accordingly, asset managers should review their existing internal control procedures and operational capabilities, and enhance them as needed so as to ensure that standards of conduct and control procedures meet the SFC's expectations stemming from the 9 common instances of non-compliance as listed above.

If you have any further questions regarding this issue of CP insights or have any topic you would like us to cover, please submit your response here https://goo.gl/forms/gDLVThTmxGvMl4r12.

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