



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

Industry briefing: Asset and Wealth Management – Major Requirements and Observations from Inspections

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Introduction

1. Overview of Asset and Wealth Management Industry
2. Some Major Regulatory Requirements applicable to Asset and Wealth Management Activities
3. Observations from Inspections on Firms conducting Asset Management
4. Observations from Inspections on Firms conducting Wealth Management (Discretionary Account Management)

A. Overview of the Fund Management Industry

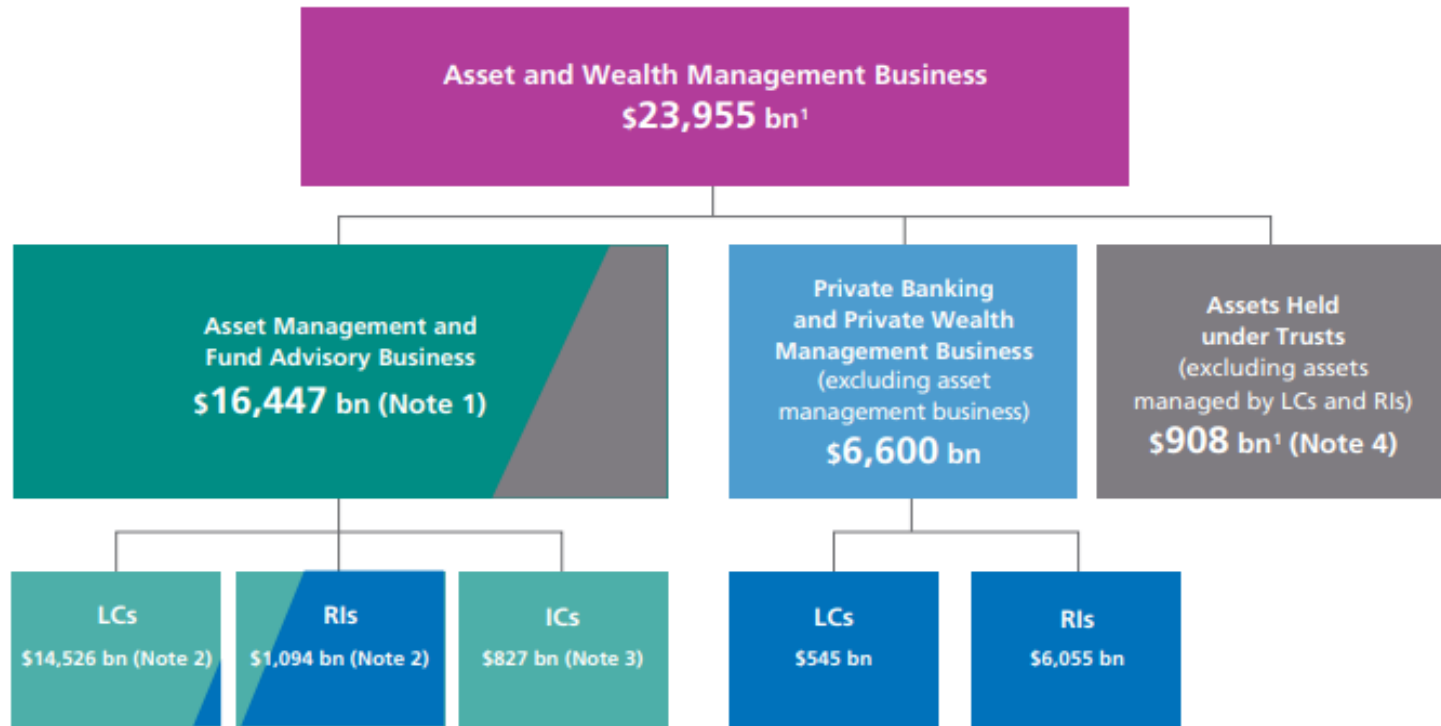


Chart 1: Asset and Wealth Management Business Overview

Notes:

1. The amount of \$16,447 bn includes the assets held under trusts which were managed by LCs and RIs under their asset management business (\$3,425 bn).
2. The amounts of \$14,526 bn and \$1,094 bn include the AUM of the asset management business provided to private banking and private wealth management clients by LCs (\$98 bn) and RIs (\$926 bn) respectively.
3. The amount of \$827 bn represents the AUM of insurance companies excluding those assets which were sub-contracted or delegated to other LCs or RIs in Hong Kong for management.
4. The amount of assets held under trusts was \$4,333 bn¹, out of which \$908 bn¹ represents the assets held under trusts which were not managed by LCs or RIs (assets held under trusts attributable to non-LCs/RIs).

B. Some Major Regulatory Requirements applicable to Asset and Wealth Management Activities

1. Securities and Futures Ordinance and relevant subsidiary legislations
2. Fund Manager Code of Conduct
3. Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission
4. Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission
5. Various circulars and FAQs

Circulars, FAQs relevant to Asset and Wealth Management Activities



<https://www.sfc.hk/web/EN/regulatory-functions/intermediaries/supervision/search-regulations-by-topics/asset-management.html>

- conclusions
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Asset Management

Circulars

FAQs

Thematic Reports

Market infrastructure & trading

Listings & takeovers

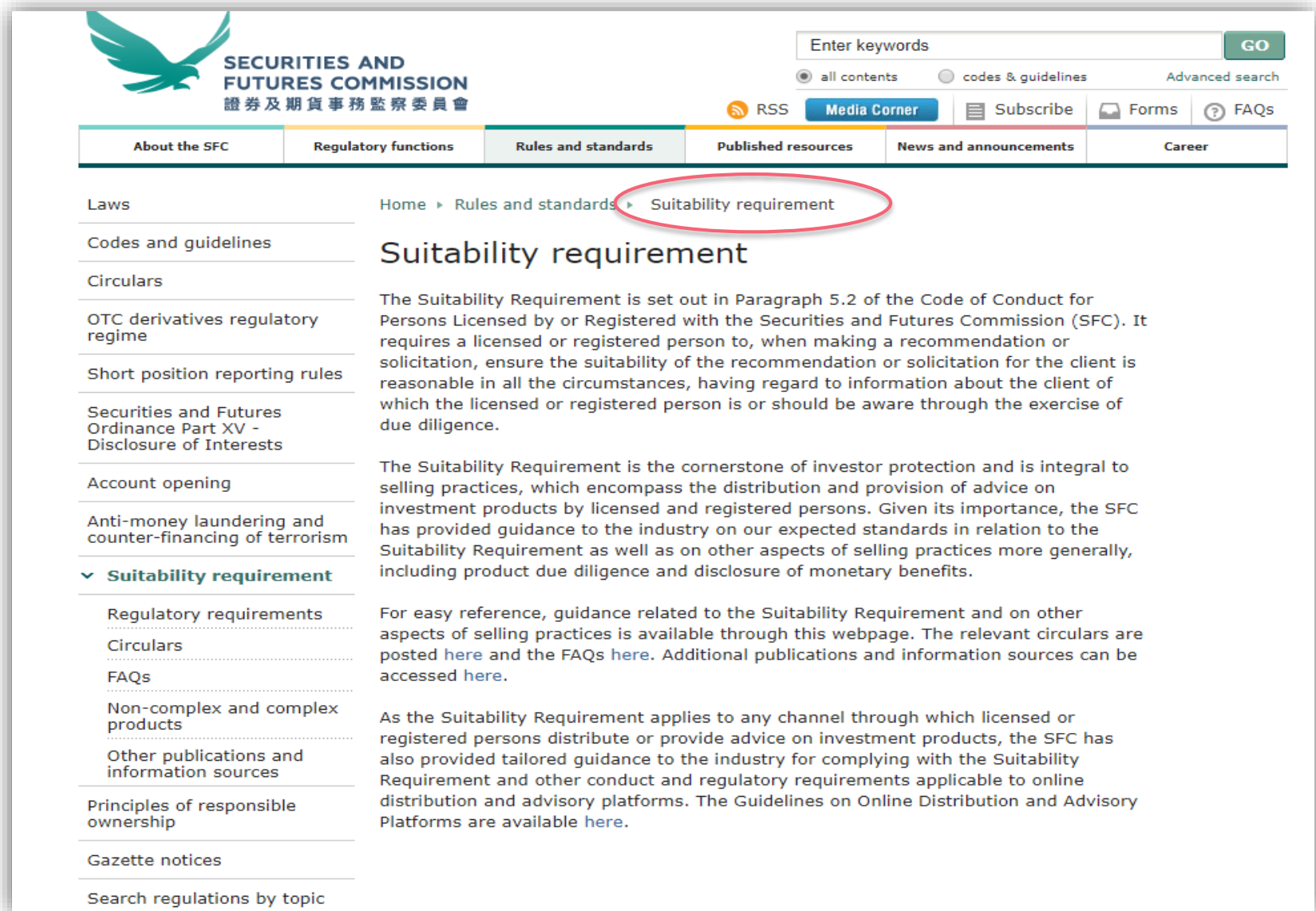
Investment products

Enforcement

Issue Date	Publication
21 Nov 2019	Circular to licensed corporations Dubious private fund and discretionary account arrangements or transactions Appendix 1 Appendix 2
4 Oct 2019	Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets
23 Aug 2019	Circular to licensed corporations Managing the liquidity risk of funds Appendix
24 Apr 2019	HKMA and SFC adopt a coordinated approach to supervise banks and licensed corporations
1 Nov 2018	Circular to intermediaries Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators Annex
3 Aug 2018	Circular to Licensed Corporations Margin Financing Activities Disguised as Investments
30 Oct 2017	SFC notifies the industry of a thematic review on prime services and related equity derivatives activities
15 Sep 2017	Circular to Licensed Corporations Engaged in Asset Management Business Common Instances of Non-Compliance in Managing Funds and Discretionary Accounts Appendix
31 Jul 2017	Circular to Licensed Corporations Engaged in Asset Management Business Irregularities and Deficiencies in Managing Private Funds and Discretionary Accounts
23 Sep 2016	Circular to Intermediaries - Frequently Asked Questions on Client Agreement Requirements Appendix 1
28 May 2010	Circular to Fund Management Companies - Investment in Financial Derivative Instruments for SFC-authorized Funds

Circulars, FAQs relevant to Asset and Wealth Management Activities

<https://www.sfc.hk/web/EN/rules-and-standards/suitability-requirement/>



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Suitability requirement

The Suitability Requirement is set out in Paragraph 5.2 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (SFC). It requires a licensed or registered person to, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for the client is reasonable in all the circumstances, having regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence.

The Suitability Requirement is the cornerstone of investor protection and is integral to selling practices, which encompass the distribution and provision of advice on investment products by licensed and registered persons. Given its importance, the SFC has provided guidance to the industry on our expected standards in relation to the Suitability Requirement as well as on other aspects of selling practices more generally, including product due diligence and disclosure of monetary benefits.

For easy reference, guidance related to the Suitability Requirement and on other aspects of selling practices is available through this webpage. The relevant circulars are posted [here](#) and the FAQs [here](#). Additional publications and information sources can be accessed [here](#).

As the Suitability Requirement applies to any channel through which licensed or registered persons distribute or provide advice on investment products, the SFC has also provided tailored guidance to the industry for complying with the Suitability Requirement and other conduct and regulatory requirements applicable to online distribution and advisory platforms. The Guidelines on Online Distribution and Advisory Platforms are available [here](#).

C. Observations from Inspections on Firms conducting Asset Management

Key Requirements under Fund Manager Code of Conduct (“FMCC”)

- Organisation and Management Structure (e.g. segregation of duties, conflicts of interest, management responsibilities)
- Fund Management (e.g. investment mandate, best execution, transactions with connected persons, risk management)
- Custody of fund assets (e.g. segregated account, use of custodian)
- Operations (e.g. valuation, audit)
- Dealing with the Fund and Fund Investors (e.g. information or representation for investors)

Common Instances of Non-Compliance in Managing Funds and Discretionary Accounts highlighted in the Circular issued on 15 September 2017

- (a) Inappropriate receipt of cash rebates giving rise to apparent conflicts of interest;
- (b) 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;
- (c) 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;
- (d) Deficiencies in setting up a proper governance structure and implementing comprehensive policies and procedures for fair valuation of assets;
- (e) Deficiencies in systems and controls to ensure best execution;
- (f) Failure to ensure fair order allocation;
- (g) Inadequate systems and controls in relation to protection of client assets;
- (h) Inadequate systems and controls for ensuring compliance with investment restrictions and guidance; and
- (i) Inadequate systems and controls to address the risk of market misconduct

Managing liquidity risk of funds

According to paragraphs 3.14.1 to 3.14.3 of the FMCC, a fund manager should :

- establish, implement and maintain appropriate and effective liquidity management policies and procedures to monitor the liquidity risk of the fund, taking into account the investment strategy, liquidity profile, underlying assets and obligations, and redemption policy of the fund;
- regularly assess the liquidity of the assets of a fund;
- regularly assess the liquidity profile of the fund's liabilities;
- regularly conduct assessments of liquidity in different scenarios, including stressed situations, to assess and monitor the liquidity risk of the funds accordingly; and
- disclose the liquidity risks involved in investing in the fund and relevant liquidity management policies to fund investors.
- conduct periodic reviews and update of the liquidity management policies and procedures

Managing liquidity risk of funds (con't)

Circular on Managing the liquidity risk of funds (23 August 2019)

- Surveyed and conducted inspections on fund managers managing SFC-authorized funds to understand liquidity risk management processes and assess compliance with the July 2016 circular* on liquidity risk management as well as their implementation of the relevant FMCC requirements
- Important to note the relevant liquidity risk management requirements under the FMCC apply to all fund managers of SFC-authorized funds as well as non-SFC authorized funds
- August 2019 circular highlights deficiencies or inadequacies noted by the SFC in fund managers' liquidity risk management practices, reminding fund managers to implement robust risk management systems and establish well-documented liquidity risk management policies and procedures for the funds under their management

* Circular on SFC-authorized funds on liquidity risk management (4 July 2016)

Managing liquidity risk of funds - Common Inspection Findings

Assessments of liquidity profiles of fund assets and liabilities

- Bonds issued by government policy banks can be categorised as “assets that can be liquidated within 5 days”, no further assessment was made despite the last traded price of the bond concerned had been stale for over 100 days
- No regular assessment on liquidity profile of funds’ liabilities
- Assumed a fixed percentage of redemption over a certain period of time. No assessment had been conducted by the fund manager to ensure the ongoing validity of these assumptions

Managing liquidity risk of funds - Common Inspection Findings (con't)

Stress testing

- No liquidity stress testing was performed
- Stress testing was based on hypothetical redemption scenarios without taking into account of historical redemption patterns

Governance structure for risk management

- No independent risk management personnel responsible for monitoring the liquidity risk of the funds. Instead, monitoring was performed by the funds' investment managers

Please refer to Appendix of the August 2019 Circular highlighted the deficiencies or inadequacies of some fund managers

Dubious private fund and discretionary account arrangements or transactions

Circular on Dubious private fund and discretionary account arrangements or transactions (21 November 2019) highlights the following:

- Asset managers did not exercise its discretion to make investment decisions for the funds or discretionary accounts under their management but largely followed investors' instructions when structuring private funds or discretionary accounts and effecting transactions
- Many of these arrangements and transactions involved other red flags and together should have led to a reasonable suspicion on the part of asset managers that these might not be legitimate or proper
- Asset managers should not disregard signs of dubious private fund and discretionary account arrangements or transactions, which may facilitate misconduct by their clients or other entities
- Senior management of an asset manager bears the primary responsibility for ensuring the firm's maintenance of appropriate standards of conduct and adherence to proper procedures as well as effective procedures and controls for the asset manager to:
 - (a) consider if a proposed private fund and discretionary account arrangement or transaction is dubious; and
 - (b) decide if the asset manager should proceed with the relevant arrangement or transaction
- This process should cover the following:
 - (a) Initial screening; b) Detailed due diligence; (c) Senior management assessment and decision;
 - (d) Documentation

Dubious private fund and discretionary account arrangements or transactions (con't)

(A) Arrangements or transactions which are unduly complex or lack of commercial rationale

- (i) Investors using structured products and derivatives to channel money into a private fund, disguising one financial institution's lending to another (e.g. investment into a preferential stock issued by a HK listed company or a bond issued by an overseas F.I. via convoluted methods, such as fund-linked notes); and
- (ii) The subsidiary of Asset Manager A setting up a discretionary account with Asset Manager A and then issuing a note linked to the performance of the discretionary account. This note was then subscribed by Asset Manager B for another discretionary account it managed .

Dubious private fund and discretionary account arrangements or transactions (con't)

(B) Arrangements or transactions which may facilitate corporate or market misconduct or breaches of legal or regulatory requirements

- (i) Multiple private funds were set up with the same fund manager which invested all or most of each such fund's assets in a single investment or subscribed to a single initial public offering
- (ii) A private fund subscribed to other multiple private funds all of which made the same investment and together held a sizeable stake in that investment
- (iii) A private fund was set up by a single investor for investing in a single project or providing a loan to a single person or entity
- (iv) A private fund was set up for an investor, but apart from a transfer of shares owned by the investor into the fund, no other transactions, or only minimal transactions, were carried out by the asset manager for the fund
- (v) An investor instructed a fund manager to set up multiple funds which invested in a single stock. But these funds were only subscribed by persons who were related to the investor or with funds provided by the investor
- (vi) The fund investors were connected to the listed stocks in which the fund invested, e.g. the investors were substantial shareholders, directors or affiliates of the listed companies
- (vii) Listed companies (or their subsidiaries or affiliates) invested in different private funds which cross-invested in one another's shares

D. Observations from Inspections on Firms conducting Wealth Management (Discretionary Account Management)

Requirements on Suitability Obligations

- Code of Conduct Requirements
 - Paragraph 5.2 of the Code of Conduct sets out key investor protection obligations of licensed/ registered persons to ensure, when making a recommendation or solicitation, that the suitability of the recommendation or solicitation for the client is reasonable in all circumstances (i.e. the suitability obligations)
- Two Circulars enclosing FAQs to provide further guidance on the existing suitability obligations were issued on 23 December 2016

Applicability of Suitability Obligations to Discretionary Account Management

- **Are suitability obligations applicable when licensed or registered persons provide discretionary account services to their clients?**

Answer to Q2 of the FAQs on Triggering of Suitability Obligations (23 December 2016) states that licensed or registered persons that provide discretionary account services to their clients (which involves the making as well as execution of recommendations) should comply with the suitability obligations under the Code of Conduct supplemented by the relevant FAQs and circulars issued by the SFC from time to time

- **Answer to Q3 of the FAQs on Triggering of Suitability Obligation further provide guidance on how to comply with the suitability obligations for discretionary accounts:**
 - (a) With mandate/ predefined portfolio
 - (b) Without mandate (services provided as ancillary to brokerage services)

Additional requirements applicable to Discretionary Account Managers Applicability of Suitability under Appendix 1 to the FMCC

(a) Client Agreements

Ensure that a written agreement is entered into with a client before any services are provided to or transactions made on behalf of that client with the following minimum contents:

- (i) appointment as the Discretionary Account Manager
- (ii) statement of the client's investment policy and objectives, including asset classes, geographical spread, risk profile of the target portfolio, any limitations or prohibitions on asset classes, markets or instruments (e.g. use of derivatives) and performance benchmark (if any)

In the case where the client has selected a pre-defined model portfolio, the Discretionary Client Agreement should also specify the proportion of the asset classes, markets, and corresponding risk profile of the selected pre-defined model portfolios

Additional requirements applicable to Discretionary Account Managers Applicability of Suitability under Appendix 1 to the FMCC (con't)

(a) Client Agreements (con't)

- (iii) the amount of all fees to be paid by the client, whether to the Discretionary Account Manager or to a connected person with respect to the account, and a description of fees to be paid by the client to third parties, where applicable;
- (iv) any consent from the client where the Discretionary Account Manager intends to receive soft commission or retain cash rebates;
- (v) details of custody arrangements if the Discretionary Account Manager provides custody arrangement by itself or through its associated entity; and
- (vi) details of periodic reporting to be made to client.

Additional requirements applicable to Discretionary Account Managers Applicability of Suitability under Appendix 1 to the FMCC (con't)

(b) Performance Review

Review the performance of each Discretionary Account against any previously agreed benchmark, either in writing to the client or by way of meeting, at least twice a year

(c) Valuation Reports

Provide valuation reports to the client on a monthly basis or at such shorter intervals as provided in the Discretionary Client Agreement. The report should include, as a minimum:

- the date on which the report is made;
- the cash and investment holdings and value of the Discretionary Account on that date including all income received and charges levied against that account;
- movements in the value of the Discretionary Account; and
- any open positions in relation to derivative transactions.

Common Inspection Findings - Discretionary Account Management

▪ Client Agreement

- (A) Some LCs did not enter into written agreements with discretionary clients
- Under Paragraph 6.1 of the Code of Conduct, LC should enter into a written agreement with each client before services are provided to the client
 - Under Appendix 1 to the FMCC, the agreement should, among others, set out the precise terms and conditions under which discretion will be exercised and contain at least such information set out in the section “Minimum Content of Discretionary Client Agreement”. For instance:

“Statement of the client’s investment policy and objectives, including asset classes, geographical spread, risk profile of the target portfolio, any limitations or prohibitions on asset classes, markets or instruments (e.g. use of derivatives) and performance benchmark (if any)

In the case where the client has selected a pre-defined model portfolio, the Discretionary Client Agreement should also specify the proportion of the asset classes, markets, and corresponding risk profile of the selected pre-defined model portfolios.”

Discretionary Account Management

- Common Inspection Findings

- **Client Agreement (con't)**

(B) Some LCs did not make an assessment of the client's attitude towards risk. This is contrary to Answers to Questions 2 and Questions 3 of the Suitability FAQ that a LC should make an assessment of the client's attitude towards risk, his expectations and so on based on the information disclosed by a client

(C) Under Paragraph 6.2 (i) of the Code of Conduct , all licensed/ registered persons must insert the following new clause into client agreements:

“If we [the intermediary] solicit the sale of or recommend any financial product to you [the client], the financial product must be reasonably suitable for you having regard to your financial situation, investment experience and investment objectives. No other provision of this agreement or any other document we may ask you to sign and no statement we may ask you to make derogates from this clause.”

Discretionary Account Management

- Common Inspection Findings

- **Use of leverage**

Under Paragraph 3.12 of the FMCC, LC should disclose:

- (i) the expected maximum level of leverage; and
- (ii) the basis of calculation of leverage which should be reasonable and prudent.

- **Risk management**

Under Paragraph 1.7 & 3.11 of the FMCC, LC should establish and maintain effective policies and procedures as well as a designated risk management function to identify and quantify the risks to which the LC and, if applicable, the funds are exposed.

- **Professional Investor (“PI”)**

LCs are reminded to strictly follow paragraph 15.3B and 15.5 of the Code of Conduct regarding the exempt provisions eligible for individual PI.

Thank you.

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