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Hong Kong to "supercharge" scrutiny of private fund managers in key areas

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BIO

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On 23 January 2024, the Securities and Futures Commission (SFC) rolled out its strategic plan governing the regulation of financial markets, signalling a clear and renewed focus on minimising crime and misconduct (including insider dealing), which is part of its top four strategic priorities and regulatory agenda, alongside protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation. The strategic priorities were announced as part of the SFC’s desire to be transparent about its program to enhance capital market regulation and Hong Kong’s competitiveness as an international financial centre. Ms Julia Leung (Chief Executive Officer, SFC), speaking at the recent Regional Securities Regulatory Leadership Symposium in Hong Kong, observed that “the [Asia-Pacific] region will continue to supercharge global growth amidst continued challenges”. The program will run for three years (2024-2026). In this article, we provide a summary of the key elements of the new program, analysis on the areas of regulatory scrutiny and expected standards of conduct and, more generally, commentary on the agenda items of most relevance to private fund managers to better navigate the highly regulated investment funds landscape in Hong Kong.

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SFC Agenda

In summary, under its new strategic regulatory agenda/ program, the SFC has committed to prioritising the following areas:

- **Maintaining fair, orderly and efficient markets:** continue to harness technology, leverage surveillance capabilities and explore new regulatory tools to monitor, detect and investigate market misconduct, and foster closer collaboration with regulatory counterparts in Mainland China, overseas and the Hong Kong police to combat financial crime and reduce investment scams in Hong Kong.

- **Strengthen Hong Kong’s position in global capital markets:** encourage innovation and support its status as an international asset and wealth management hub and global fund-raising centre, expand and enhance mutual market access programmes with Mainland capital markets, and review and enhance Hong Kong’s IPO fund-raising capability as well as market quality and liquidity.

- **Virtual assets and ESG priorities:** advance the regulatory regime for virtual asset trading platforms, whilst embracing tokenisation of traditional products, safeguarding investors. Roll out and expand sustainability disclosure requirements with the IFRS Sustainability Disclosure Standards, stem greenwashing and work with regional and global leaders to bridge the gap in tackling climate change between emerging and developed economies and promote sustainable finance regulation more generally.

- **Enhancing resilience and operational efficiency:** institutionalise operational efficiency by adopting a new organisation-wide IT strategy, introducing artificial intelligence to workflows to better monitor (and, if necessary, intervene earlier to shut down) social platforms with the rise of online scams, and stepping up cyber resilience in light of heightened risks.

The SFC items most immediately relevant to private fund managers include heightened scrutiny of asset managers in several key areas of regulatory concern and the new market sounding rules.

Areas of Regulatory Concern

On 9 October 2024, consistent with its strategic priorities, the SFC announced in a special Circular to asset managers the commencement of a thematic on-site inspection of private fund managers to detect any material breaches or non-compliance with applicable regulatory requirements. The common deficiencies noted by the SFC in the management of private funds or discretionary accounts include:

- **Conflicts of interest:** failure to manage potential or actual conflicts of interest when using fund assets to provide financing to related parties, or providing financing on preferential terms lower than the prevailing market rates (without security or inadequate collateral), or unfairly allocating trades in favour of a manager's key personnel, or receiving monetary benefits from fund transactions arising from underwriting activities, or giving priority to staff redemptions over those of external investors.

- **Risk management:** failure to implement adequate risk management or conduct due diligence to ensure investments are in accordance with a fund's stated investment strategy, objectives, restrictions and guidelines to avoid exposing investors to significant concentration, liquidity or credit risks.

- **Investor disclosures:** failure to make adequate disclosures to investors about concentrated positions or other significant events which impair net asset value or liquidity or delays in issuing or modifications of an auditors opinion involving a fund's audited financial statements (regardless of whether the fund's constitutive documents have required provision of audited financial statements to investors or upon request), which are critical for investors to make informed decisions about their investments.

- **Valuation methodologies:** adopting valuation methodologies to conceal investment losses, especially for funds heavily invested in fixed income products or collateralised loans.

Expected Standards of Conduct

The SFC has urged private fund managers (including their senior management and managers-in-charge) to "*observe substance over form throughout the entire process*" and critically review the areas of concern and strengthen their supervisory and compliance programs, including policies and procedures as well as systems and controls to rectify any deficiencies ahead of its thematic on-site inspections in 2025. When scrutinising these areas, managers are expected to consider the expected standards of conduct in the Fund Managers Code of Conduct (FMCC). This includes:

- the need to identify, prevent and manage actual or potential conflicts that arise from transactions to ensure fair treatment of fund investors. Specifically, managers should avoid prioritising the interests of related parties over those of fund investors and properly evaluate and document objective counterparty/credit/collateral risk assessments. Reliance on generic or non-specific disclosures that managers and their affiliates may have an interest in investments or transactions that may conflict with the interests of investors is likely to be viewed as inadequate where material interest or conflict is involved.

- the need to identify, measure, manage and monitor appropriately all relevant risks to which each is exposed, including assessing the market, diversification, liquidity, concentration and credit risks of investment portfolios throughout the life cycle of the fund. However, the SFC cautioned that the use of credit rating agency ratings should not be "mechanistic nor lessen asset managers' responsibility" to ensure credit exposures are based on robust risk assessments. It also reminded managers of the baseline requirements set out in the FMCC, including the duty to "integrate" liquidity management when making investment decisions.

- the need to make prompt disclosures to fund investors whenever significant events have a material adverse impact on the value of a fund's assets or its ability to meet its liquidity needs, such as major investment losses, defaults in principal or interest for any significant position(s) with counterparties or related parties, large redemption requests that result in the majority of liquid assets being liquidated, or suspensions of redemptions. Further, the SFC also urged managers to adopt a "look-through" approach in determining a fund's exposure to issuers where complex arrangements are involved or investments are held through other investment vehicles.

- the need to obtain independent quotes from suitably qualified third parties when valuing unlisted securities or quotes from brokers or market makers when valuing securities that are not actively traded or have been suspended from trading at their fair value (rather than at cost or last known market price). Specifically, managers are expected to identify when such a security ought to be written down or written off in the valuation of a fund account. However, the SFC noted that managers "remain responsible" for valuation of a fund's assets notwithstanding the appointment of a third-party valuer and need to assess whether the valuation model and assumptions are appropriate.

Market Sounding Practices

On 1 November 2024, the SFC also published its finalised proposals to implement new "market sounding" guidelines, together with practical FAQs (the "Guidelines"), which seek to regulate how sell-side and buy-side firms who participate in market soundings intended to gauge potential investors' interest in possible block trades or private placements can use non-public information obtained during soundings. The final form of the Guidelines, which will take effect on 2 May 2025, cut back on proscriptive rules that would have prohibited trading involving all types of securities based on any non-public information disclosed or received during soundings. Nevertheless, market participants will need to ensure there are effective functional and physical barriers in place to ensure that they do not exploit or unfairly benefit from any confidential information received during soundings (even if not inside information).

- **Type of information and securities in scope:** The Guidelines make it clear that the new rules only apply to (i) confidential information in connection with possible transactions in listed securities regardless of the listing venue or (ii) transactions involving other securities that are likely to materially affect the price of listed securities. In other words, market participants should apply the "confidentiality" test for market soundings involving listed securities and the "price-sensitivity" test for market soundings involving any other securities. Examples of information that would be regarded as "confidential" for market soundings involving securities listed in Hong Kong or elsewhere include (i) the name of the security (or specific information that would allow the recipient to deduce the security), (ii) the identity of the market-sounding beneficiary (e.g. the name of the substantial shareholder disposing of its shares), (iii) the purpose of the transaction (e.g. a sell-down of a substantial shareholder's stake in the security), and (iv) the terms or specifications relating to the transactions (e.g. potential timing, size, pricing, structure and trading method).

- **Restrictions on trading or use of non-public information:** While buy-side firms do not need to automatically restrict trading following mere receipt of non-public information, the SFC has stated that it expects firms to safeguard the confidentiality of market-sounding information and ensure there are effective barriers to prevent inadvertent disclosure, misuse or leakage of confidential information (regardless of whether it is price sensitive or constitutes inside information). The SFC therefore dismissed concerns that the rules create a new form of market misconduct or indirect expansion of the insider dealing regime without statutory backing simply because buy-side firms are required to restrict trading following receipt of confidential information (even if it was not inside information). It stressed that firms can still engage in legitimate trading activities after participating in a market sounding as long as effective information barriers are in place to prevent inadvertent disclosure, misuse or leakage of confidential information.

- **Specific requirements for disclosing persons:** The Guidelines put the burden on sell-side brokers to use standardised scripts (in line with existing best practices) and ensure that any preliminary information provided to the buy-side firm before it agrees to participate is on a "no-name" basis and sufficiently broad, limited, vague and anonymised to ensure that recipients will not be able to deduce the name of the subject security. In addition, the Guidelines require sell-side brokers to maintain a list of internal and external individuals who possess non-public information because of market soundings. It also relaxes the obligation for sell-side brokers to determine whether non-public information disclosed during market soundings has been cleansed. In line with existing market practices, non-public information will cease to be treated as confidential when a buy-side recipient (i) is notified of a change of status of the transaction (e.g. completed, suspended, postponed or cancelled), (ii) given advance notice that the information will become "stale" if no status updates are received within a prescribed time period (e.g. a certain number of hours or days), or (iii) agrees up-front on when the duty of confidentiality will end.

The Way Ahead

Given the increased level of regulatory scrutiny facing private fund managers, fund managers should critically review the areas of concern and strengthen their supervisory and compliance programs, including policies, procedures as well as systems and controls to rectify any deficiencies and ensure compliance. In particular, regulated buy-side managers should adapt their policies and procedures to identify and handle market-sounding information as early as possible in 2025. Overall, it will be difficult to assess the impact of the Circular and the Guidelines, which will require time and experience to answer.

Nevertheless, managers who become aware of any material breach, infringement or non-compliance with any regulatory requirements are under pressure to promptly comply with their self-reporting obligations to the SFC under the Code of Conduct for Persons Licensed by or Registered with the SFC (the "Code of Conduct"). The SFC has warned that it is ready to take enforcement action and impose harsher penalties for similar or persistent misconduct to the key areas of concern identified in the Circular, with no leniency for those who delay in self-reporting, sending a clear message that senior management, including managers in charge of core functions and responsible officers, bear primary responsibility for ensuring appropriate standards of conduct.

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Similarly, the SFC has also stressed that simply because the Guidelines apply to Hong Kong–licensed intermediaries does not mean that persons involved in market soundings who are not SFC-licensed are immune from potential liability. Rather, the SFC cautioned that unregulated persons remain subject to the relevant laws and regulations concerning insider dealing. Whilst the Guidelines do not automatically mandate buy-side managers to restrict trading following receipt of confidential information obtained during the market sounding process, industry associations have expressed concerns that the Guidelines risk having a chilling effect on capital raisings in Hong Kong.

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