

# Management of Private Funds and Discretionary Accounts

December 2024



The Securities and Futures Commission (“SFC”) issued a circular in October 2024 to highlight deficiencies and substandard conduct identified during its supervision of asset managers engaged in managing private funds and discretionary accounts. In the circular, the SFC also stated its expectations in asset managers with reference to the SFC’s Code of Conduct (“CoC”), Fund Manager Code of Conduct (“FMCC”) and Management, Supervision and Internal Control Guidelines for Persons Licensed by or registered with the Securities and Futures Commission (“Internal Control Guidelines”).

## SFC’s concern

“ The misconduct was egregious and demonstrated a lack of integrity on the part of asset managers involved.

As a result, investor interests were seriously jeopardised, undermining the integrity of Hong Kong asset management market and investor confidence in Hong Kong as an international asset management centre. ”

## SFC’s actions

To combat asset management misconduct, the SFC will

- Commence thematic on-site inspection to detect any material breaches or non-compliance with applicable regulatory requirements among other issues; and
- Step up its disciplinary actions and impose harsher penalties against similar or persistent misconduct.

## Main attributes

## Deficiencies and substandard conduct identified by the SFC

Conflicts of interest	<ul style="list-style-type: none"> <li>• Fail to prevent and manage potential or actual conflict of interests arising from business:             <ul style="list-style-type: none"> <li>• Use of fund assets to provide financing to related entities</li> <li>• Fail to justify higher rates for financing</li> <li>• Unfairly allocation of trades in favour of the asset manager’s key personnel</li> <li>• Receiving monetary benefits from fund’s transactions</li> <li>• Fail to act fairly in handling redemption payments</li> </ul> </li> </ul>
Risk management and investment due diligence	<ul style="list-style-type: none"> <li>• Fail to implement adequate policies and procedures in relation to risk management and investment management</li> <li>• Fail to conduct appropriate investment due diligence in accordance with clients’ investment objectives and restrictions</li> <li>• Fail to assess and address the risks associated with the transactions</li> </ul>
Information for fund investors	<ul style="list-style-type: none"> <li>• Fail to disclose adequate information to fund investors:             <ul style="list-style-type: none"> <li>• Concentrated position and significant exposures of the fund</li> <li>• Significant events impacting the funds</li> <li>• Modified opinion issued by the fund’s auditors or material delay in the audited financial statement</li> </ul> </li> </ul>
Valuation methodologies	<ul style="list-style-type: none"> <li>• Inappropriate valuation methodology adopted with an intention to hide investment losses of the funds from investors</li> </ul>

# SFC's Expectations

<b>Conflicts of Interest</b>	<ul style="list-style-type: none"><li>✓ Asset managers should ensure implementation of controls to identify, prevent, manage and monitor any actual and potential conflicts of interest.</li><li>✓ Asset managers should conduct all transactions at arm's length, and the actions taken should be in the best interests of the fund and its investors.</li><li>✓ Where material interest in the transaction gives rise to conflicts of interest, asset managers should:<ul style="list-style-type: none"><li>✓ prevent such conflicts by considering alternatives;</li><li>✓ manage and minimise the conflicts by appropriate safeguards and measures to ensure the fair treatment of fund investors; and</li><li>✓ Disclose any material interest or conflict to fund investors.</li></ul></li><li>✓ When conducting transactions with connected persons, asset managers should ensure the transactions are conducted at arm's length and ensure fair treatment including in allocation of funds and redemption payments</li><li>✓ Asset managers should maintain proper documentation of controls performed</li></ul>
<b>Risk Management and Investment Due Diligence</b>	<ul style="list-style-type: none"><li>✓ Asset managers should implement adequate risk management procedures in relation to:<ul style="list-style-type: none"><li>• Risk measurements and reporting methodologies for proper identification, measurement, management and monitoring of investment risks including concentration, liquidity and credit risks;</li><li>• Investment due diligence to ensure transactions carried out on behalf of clients are in accordance with the strategy, objectives, restrictions and guidelines stated in the investment mandate;</li></ul></li><li>✓ Management should ensure they conduct adequate reviews to challenge the appropriateness and reasonableness of the risk assessments performed.</li><li>✓ LC are expected to maintain adequate documentation of these assessments.</li></ul>
<b>Information for fund investors and Risk Disclosures</b>	<ul style="list-style-type: none"><li>✓ LC must provide fund investors with adequate information and timely disclosures to allow them to make informed judgment about their investment into the funds. Information including but not limited to the following:<ul style="list-style-type: none"><li>• Concentrated positions and significant exposures;</li><li>• Significant events impacting the fund (e.g., major investment losses, default in payments by counterparties, large requests in fund redemption and suspension of redemption);</li><li>• Material delay in the issuance of audited financial statements; and</li><li>• Issuance of a modified opinion from the auditors.</li></ul></li></ul>
<b>Valuation Methodologies</b>	<ul style="list-style-type: none"><li>✓ LC must establish policies and procedures on the proper and independent valuation of fund assets. In addition, LC are expected to implement controls to ensure the consistent application of fund valuation methodologies for the similar types of assets.</li><li>✓ LC are expected to adopt the following methodologies for unlisted and suspended securities:<ul style="list-style-type: none"><li>• References to be made to comparable third-party transactions when pricing the unlisted security, or to seek for appraisal and valuation of the security from an independent source; and</li><li>• Seek for independent confirmation of the price of the suspended security from brokers and market makers.</li></ul></li><li>✓ When a third party is appointed to perform valuation services, LC would remain responsible for the valuation of the assets. LC should perform adequate due diligence and periodic assessments on the valuer and its work.</li></ul>

# How KPMG can help

## Actionpoints for LCs

1. Observe the expected internal control standards elaborated in the circular;
2. Thoroughly review practices, policies, procedures and internal controls; and
3. Ensure implementation of effective controls specifically on the handling of conflicts of interest, risk management, risk disclosures and fund valuation.

Perform regulatory gap analysis and review on existing policies and procedures against the requirements stipulated in recent circulars issued by the SFC and relevant SFC requirements, namely CoC, FMCC and Internal Control Guidelines.

Perform sample testing to assess the operating effectiveness of controls regarding compliance with SFC requirements.

Provide training on the regulatory updates and market practices in relation to the handling of conflicts of interest, risk management, risk disclosures and fund valuation

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