SFC reprimands and fines HSBC Investment Funds (Hong Kong) Limited and HSBC Global Asset Management (Hong Kong) Limited HK$3.5 million for regulatory breaches over funds’ cash management

7 Apr 2020

The Securities and Futures Commission (SFC) has reprimanded and fined HSBC Investment Funds (Hong Kong) Limited (HIFL) and HSBC Global Asset Management (Hong Kong) Limited (HGAML) HK$3.5 million for breaches of regulatory requirements in relation to cash management for SFC-authorized funds (Notes 1 & 2).

The SFC’s investigation found that some of the 53 funds managed and/or advised by HIFL and HGAML between 2010 and 2016 maintained cash deposits with connected entities, namely, The Hongkong and Shanghai Banking Corporation Limited and/or its affiliates. The funds’ cash deposits were placed in interest-bearing accounts of the connected entities but mostly did not receive any interest.

An independent review revealed that prior to January 2015, HIFL and HGAML had no procedures in place to ensure that the funds’ cash deposited with their connected entities received interest at a rate not lower than the prevailing commercial rate (Notes 3 & 4). The review also found that whilst HIFL and HGAML had an established process to monitor the funds’ cash balances on a daily basis, such process was not documented in any policies and procedures and was performed for only 10 of the 53 funds.

The SFC considers that HIFL’s and HGAML’s internal controls and procedures on cash management of the funds at the material time were inadequate and they failed to manage and minimise the conflicting interests between their connected entities and the funds’ investors.

In deciding the sanctions, the SFC took into account all the circumstances, including that HIFL and HGAML:

- agreed to make a voluntary payment of US$433,257 to the affected funds, representing the financial impact arising from their failures;
- engaged an independent reviewer to conduct the review and took remedial actions to strengthen their internal systems and controls;
- undertook to provide the SFC with a report prepared by an independent reviewer within nine months confirming that all identified concerns have been properly rectified;
- cooperated with the SFC in resolving its concerns and have no previous disciplinary record with the SFC.

End

Notes:

1. HIFL is licensed under the Securities and Futures Ordinance (SFO) to carry on Type 1 (dealing in securities), Type 4 (advising on securities), Type 5 (advising on futures contracts) and Type 9 (asset management) regulated activities.
2. HGAML is licensed under the SFO to carry on Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts) and Type 9 (asset management) regulated activities.
3. In July 2019, the SFC, HIFL and HGAML jointly engaged an independent reviewer to review HIFL’s and HGAML’s cash management process in relation to a total of 53 SFC-authorized funds managed and/or advised by HIFL and/or HGAML between 1 January 2010 and 31 December 2016.
4. Under paragraph 10.10 of the Code on Unit Trusts and Mutual Funds (the versions effective between 1 April 2003 and 31 December 2018) and paragraph 3.9 of the Fund Manager Code of Conduct (first and second editions), a fund manager should not deposit cash forming part of the fund’s assets with a connected person unless interest is received on the deposit at a rate not lower than the prevailing commercial rate for a deposit of that size and term.

A copy of the Statement of Disciplinary Action is available on the SFC website

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STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has reprimanded HSBC Investment Funds (Hong Kong) Limited (**HIFL**)[1] and HSBC Global Asset Management (Hong Kong) Limited (**HGAML**)[2] and fined them HK$3,500,000 collectively pursuant to section 194 of the Securities and Futures Ordinance (**SFO**).

2. The disciplinary action is taken in respect of HIFL's and HGAML's failure to comply with regulatory requirements in relation to cash management for SFC-authorized funds, in particular, their failure to ensure the funds' cash deposited with their connected persons received interest at a rate not lower than the prevailing commercial rate for a deposit of that size and term between 2010 and 2016 (**Relevant Period**).

Summary of facts

Regulatory requirements

3. Paragraph 1.2(c) of the Fund Manager Code of Conduct requires a fund manager to maintain satisfactory internal controls and written compliance procedures which address all applicable regulatory requirements.

4. In respect of transactions with connected persons:

   (a) Paragraph 10.10 of the Code on Unit Trusts and Mutual Funds (**UT Code**)[3] requires that if cash forming part of the scheme's assets is deposited with the trustee/custodian, the management company, the investment adviser or with any connected person of these companies (being an institution licensed to accept deposits), interest must be received on the deposit at a rate not lower than the prevailing commercial rate for a deposit of that size and term.

   (b) Paragraph 3.9 of the Fund Manager Code of Conduct[4] requires that a fund manager should not deposit funds on behalf of a client with a connected person unless interest is received at a rate not lower than the prevailing commercial rate for a deposit of that size and term.

5. Further:

   (a) General Principle 4 of the Overarching Principles Section of the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products

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[1] HIFL is licensed under the SFO to carry on Type 1 (dealing in securities), Type 4 (advising on securities), Type 5 (advising on futures contracts) and Type 9 (asset management) regulated activities.

[2] HGAML is licensed under the SFO to carry on Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts) and Type 9 (asset management) regulated activities.

[3] The versions effective between 1 April 2003 and 31 December 2018.

[4] The first and second editions of the Fund Manager Code of Conduct.

(**Products Handbook**) provides that Product Providers[5], counterparties and service providers shall avoid being placed in a conflicts of interest position that may undermine the interests of the investors of the relevant product.

(b) Paragraph 4.2 of the Overarching Principles Section of the Products Handbook provides that the Product Provider shall avoid situations where conflicts of interest may arise including any actual or potential conflicts that may arise between different parties in respect of a product. Where such a conflict cannot be avoided, and provided that investors' interests can be sufficiently protected, the conflict shall be managed and minimized by appropriate safeguards, measures and product structure and these measures and safeguards shall be properly disclosed to investors.

The SFC's concerns

6. During the Relevant Period, HIFL and HGAML managed and/or advised 53 SFC-authorized funds (**Funds**).

7. The SFC's investigation revealed that some of the Funds maintained cash deposits in "instant access cash accounts" (**IAC Accounts**)[6] at The Hongkong and Shanghai Banking Corporation Limited (**HSBC**) and/or its affiliates, which fall within the definition of "connected persons" for the purpose of the UT Code. Although the IAC Accounts were interest-bearing accounts, most of the deposits did not receive any interest during the Relevant Period.

8. In July 2019, HIFL, HGAML and the SFC jointly engaged an independent reviewer to review HIFL's and HGAML's internal systems and controls in relation to their cash management process (**Review**).

9. The Review noted that HIFL and HGAML had an established process to manage cash on a day-to-day requirements basis during the Relevant Period. Specifically, HIFL and HGAML prepared a daily cash balance report to identify cash balances over 3% of a fund's net asset value (**NAV**). The threshold of 3% was set to act as a monitoring trigger to enable HIFL and HGAML to consider taking appropriate action, where necessary, to ensure actual cash levels in the IAC Accounts do not exceed 5%. However:

(a) While the daily cash balance reports were circulated to the portfolio managers and the chief investment officer, there was limited documentation to indicate the follow-up and considerations made to transfer or not transfer such cash and earn potentially better market returns.

(b) The extent of the control was limited as it was only performed for only 10 of the 53 Funds.

(c) The daily monitoring control on cash balance was not documented in any policies and procedures.

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[5] "Product providers" in the Products Handbook includes the management company of a unit trust.

[6] According to HIFL and HGAML, the IAC accounts were used to hold operational cash to satisfy the Funds' cash needs for daily trading, overdraft avoidance, settlements and redemptions, etc.

10. In August 2016, HIFL and HGAML further introduced a weekly monitoring control to monitor cash levels using a 2% NAV threshold. The threshold of 2% was also set to act as a monitoring trigger to enable HIFL and HGAML to consider taking appropriate action, where necessary, to ensure actual cash levels do not exceed 5% of NAV. However, the control did not cover all 53 Funds (including Funds whose investment function had been delegated/sub-delegated to other HSBC overseas fund managers). In addition, there was limited documentation to indicate the follow-up and considerations made to transfer or not transfer such cash and earn potentially better market returns.

11. The Review found that, prior to January 2015, HIFL and HGAML did not have any procedures in place to compare the IAC Accounts interest rates (**Instant Access Rates**) against the interest rates offered by other banks to ensure that the cash deposited with their connected persons received interest at a rate not lower than the prevailing commercial rate.

12. Whilst a monthly monitoring control (i.e. checking the Instant Access Rates against the rates obtained from 3 unconnected custodian banks) was introduced in December 2015, the Review identified that:

    (a) The monthly comparison was only applied to HKD[7] and USD[8] deposit rates at the time when the control was implemented. The control was further extended to cash denominated in CNH[9] and EUR[10] in March and June 2016 respectively.

    (b) The monthly monitoring control was not complete as it did not cover all HSBC connected custodians.

    (c) HIFL and HGAML had not been able to obtain a sufficient number of quotations from 3 unconnected custodian banks for some currencies. Where insufficient quotes were obtained, no additional analysis was performed to supplement the comparison. For identified deviations from the prevailing commercial rate, there was no documentation of justification or subsequent action to address the deviation.

13. The SFC is of the view that, in managing and/or advising the Funds during the Relevant Period, HIFL and HGAML have failed to:

    (a) ensure that the Funds’ cash deposited with their connected persons received interest at a rate not lower than the prevailing commercial rate for a deposit of that size and term;

    (b) implement and maintain satisfactory internal controls and written compliance procedures on fund cash management; and

    (c) minimize and manage the conflicting interests between the Funds’ investors and their connected persons.

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[7] HKD refers to Hong Kong Dollar.

[8] USD refers to United States Dollar.

[9] CNH refers to the offshore renminbi rate.

[10] EUR refers to Euro.

14. HIFL’s and HGAML’s failures constitute a breach of paragraph 10.10 of the UT Code, paragraphs 1.2(c) and 3.9 of the Fund Manager Code of Conduct, and General Principle 4 and paragraph 4.2 of the Overarching Principles Section of the Products Handbook.

Conclusion

15. Having considered all relevant circumstances, the SFC is of the opinion that it is in the interest of the investing public and in the public interest to resolve the above concerns with HIFL and HGAML, and take the disciplinary action set out in paragraph 1.

16. In deciding the disciplinary sanctions, the SFC has taken into account that HIFL and HGAML:

    (a) agreed to make a voluntary payment of US$433,257 to the affected Funds, representing the financial impact arising from their failures;

    (b) engaged an independent reviewer to conduct the Review and took remedial actions to strengthen their internal systems and controls;

    (c) undertook to provide the SFC with a report prepared by an independent reviewer within nine months confirming that all identified concerns are properly rectified;

    (d) cooperated with the SFC in resolving its concerns; and

    (e) have no previous disciplinary record with the SFC.