



Hong Kong

December 2019

SFC GUIDANCE ON DISCLOSURE BY HKEX-LISTED COMPANIES AND TO LICENSED FUND MANAGERS ON DUBIOUS PRIVATE FUNDS

On 21 November 2019, the Securities and Futures Commission (**SFC**) issued a Statement on the Disclosure of Actual Controllers or Beneficial Owners of Counterparties to a Transaction¹ and a Circular to Licensed Corporations regarding Dubious Private Fund and Discretionary Account Arrangements or Transactions.²

The statement reminds companies listed on the Hong Kong Stock Exchange (**HKEx**) of the need to properly disclose the identities of the counterparties to corporate transactions in announcements, shareholders' circulars and other documents relating to the transaction. The circular provides guidance for Hong Kong-licensed asset managers considering transactions or arrangements for private funds and discretionary accounts, which the SFC have found to be increasingly dubious. It singles out special purpose vehicles as being used to conceal ownership as part of wider schemes to engage in misconduct.

The latest guidance is part of the SFC's continued efforts to combat market misconduct by SFC-licensed intermediaries. The SFC notes that it will use its powers under the Securities and Futures (Stock Market Listing) Rules (**SMLR**) to intervene where HKEx-listed companies do not disclose the information necessary for shareholders to make an informed assessment. It also states that it will not hesitate to take

regulatory action against asset managers who fail to detect dubious arrangements or facilitate improper conduct due to inadequacies in their controls.

The SFC Statement on Disclosure of Actual Controllers or Beneficial Owners of Transaction Counterparties

The SFC's Statement on the Disclosure of Actual Controllers or Beneficial Owners of Counterparties to a Transaction³ (**Statement**) expresses concerns about HKEx-listed companies publishing materially false, incomplete or misleading information regarding their counterparties in corporate transactions and reminds them of their disclosure obligations.

Where listed companies acquire or dispose of interests in target companies, form joint ventures with a target company or inject capital into a target business, the identities of the actual controllers of the counterparties may be important information for shareholders in making an informed assessment.

The SFC noted that announcements of certain corporate transactions fail to disclose the identities of listed companies' counterparties in the transactions, even where it appeared necessary for investors to make an informed assessment of the company's activities. In some cases, for instance, circular or meaningless definitions of the counterparties were given. In

1 SFC. "Statement on the Disclosure of Actual Controllers or Beneficial Owners of Counterparties to a Transaction". 21 November 2019. At https://www.sfc.hk/web/EN/files/ER/Statment_UBO_EN.PDF

2 SFC. "Circular to Licensed Corporations regarding Dubious Private Fund and Discretionary Account Arrangements or Transactions". 21 November 2019. At <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/openFile?refNo=19EC68>

3 <https://www.sfc.hk/web/EN/news-and-announcements/policy-statements-and-announcements/statement-on-the-disclosure-of-actual-controllers-or-beneficial-owners.html>

other cases, only the names of the entities consummating the transaction are disclosed without identifying their beneficial or controlling entities.

According to the Circular, before adopting such an approach, an HKEx-listed company must be reasonably satisfied that disclosure of the actual controllers or beneficial owners is not necessary for the investing public to make an informed assessment of the company and its activities. If their identity is required for an informed assessment, non-disclosure may mean that the document in question contains materially incomplete information. In serious cases, the SFC will intervene using its powers under the SMLR.

There is also concern that special purpose entities are being misused to engage in illicit activities and market misconduct, and to avoid laws, rules and regulations. The SFC issued a Circular to Intermediaries regarding the Use of “Nominees” and “Warehousing” Arrangements in Market and Corporate Misconduct⁴ in October 2018 regarding the use of ‘nominee’ and ‘warehousing’ arrangements to facilitate market and corporate conduct.

Examples of where the identity of actual controllers or beneficial owners of transaction counterparties is material

The SFC’s statement sets out the following non-exhaustive examples of circumstances where the identities of the actual controllers or beneficial owners of a counterparty may be required.

Acquisitions, disposals, capital injections, and formation of joint ventures

In cases where HKEx-listed companies acquire or dispose of interests in target companies, form joint ventures or inject capital into target businesses, the identities of the actual controllers or beneficial owners of the counterparties may be important in enabling investors to make an informed assessment of the company’s activities. This may, for example, inform investors as to the background, resources or strategy of parties with whom the company is entering into a long-term business relationship.

⁴ SFC. “Circular to intermediaries – Use of ‘nominees’ and ‘warehousing’ arrangements in market and corporate misconduct”. 9 October 2018. At <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=18EC73>

Money lending

The SFC has also highlighted that a number of HKEx-listed companies are increasingly engaging in money lending as part of their business. Where the amount lent is material and the borrower is a privately held entity which is not generally known to the market, disclosure of the identity of the borrower’s controllers or beneficial owners and their background and financial standing may be necessary to enable the investing public to make an informed assessment of the company’s activities.

Issues of shares, convertible bonds and options

The HKEx Listing Rules sometimes require disclosure of the identities of persons acquiring the securities of HKEx-listed companies.

For instance, on a private placement of new shares or issue of convertible bonds, the listed company must disclose the names of the allottees if there are fewer than six allottees. There have been some cases where the disclosure was limited to the names of corporate vehicles used to consummate the transaction without disclosure of the controllers or beneficial owners.

HKEx-listed companies are also required to announce the grant of a stock option as soon as possible. The SFC notes that many announcements simply state that stock options were granted to unnamed ‘eligible participants’, which given the broad definition ‘eligible participants’ often adopted, does not give investors the information necessary to make an informed assessment.

The SFC notes that it may use its powers to require further information or to object to the listing of securities, where it appears that the listing application does not provide all the information necessary to allow an investor to make an informed assessment of the company and its activities as required by section 3 of the SMLR.

Private funds and similar arrangements

The SFC finally notes that some HKEx-listed companies use private fund structures to engage in proprietary transactions, including investments, acquisitions, share buybacks and lending and gives the following examples:

- i) the listed company was the sole investor in, or provided the vast majority of the capital for, a private fund;
- ii) the listed company was one of a handful of investors in a private fund which invested exclusively in one company or a single investment (e.g. a loan to an individual);
- iii) the listed company subscribed to numerous private funds managed by different persons, but each fund invested all or the majority of their capital in the same investment and, together, the funds held 100% of that investment;
- iv) the listed company subscribed to a private fund which in turn, through multiple tiers of other private funds, invested in a wholly-owned subsidiary of the listed company; and
- v) the listed company disposed of an asset to a private fund that was in turn majority-owned by the listed company itself.

In some cases, the private fund is managed by the listed company itself or its connected person and there is no commercial rationale for the transaction or the transaction is extremely convoluted. Transactions of this type raise concerns that the reasons for entering into them have not been fully disclosed.

The SFC reminds listed companies not to use private fund structures, discretionary accounts or complex arrangements with a view to obfuscating the nature of the transaction and its risk, avoiding or contravening laws, rules or regulations. The SFC may direct a suspension in dealings of the listed company's securities where it believes that the disclosure made in any relevant document is materially false, misleading or incomplete or if it considers it to be in the interest of the investing public.

The SFC Circular to Licensed Corporations – Dubious Private Fund and Discretionary Account Arrangements or Transactions

The SFC's Circular to licensed corporations – Dubious private fund and discretionary account arrangements or transactions⁵ (SFC Circular) provides guidance to licensed asset managers on (i) considering whether a proposed private fund and

⁵ <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/openFile?refNo=19EC68>

discretionary account arrangement or transaction is dubious, and (ii) deciding if they should proceed with the proposed arrangement or transaction that they consider dubious.

SFC-licensed asset managers are warned not to disregard signs of dubious private fund and discretionary account arrangements or transactions which could facilitate the following types of market misconduct by their clients or other entities:

- i) avoiding or contravening any of the market misconduct provisions or disclosure obligations of Parts XIII, XIV, XIVA or XV of the Securities and Futures Ordinance (SFO), or other laws, rules and regulations including the Codes on Takeovers and Mergers and Share Buy-backs and the HKEx Listing Rules;
- ii) conducting unlicensed regulated activities in breach of the SFO; or
- iii) involvement in fraud or other serious misconduct or illicit activities.

The SFC Circular reminds licensed corporations that disregarding dubious arrangements or transactions may constitute failure on the part of the asset manager to act honestly, fairly or with due skill, care or diligence, in the best interests of its clients or the integrity of the market as required by General Principles 1 and 2 of the SFC Code of Conduct for Persons Licensed by or Registered with the SFC. Failure to report suspicious client transactions can also amount to a breach of paragraph 12.5(f) of the Code of Conduct.

Moreover, asset managers may also be in breach of the Guideline on Anti-Money Laundering and Counter-Financing of Terrorism⁶ by failing to (a) conduct customer due diligence measures to identify the identity of the client or beneficial owner, (b) obtain information about the purpose and nature of the business relationship established, (c) adopt a risk-based approach in determining the extent of customer due diligence measures and ongoing monitoring so that preventative or mitigating measures are commensurate to the identified risks, (d) comply with special requirements in a situation which by its

⁶ SFC. "Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations)". November 2018. At [https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidelines/guideline-on-anti-money-laundering-and-counter-financing-of-terrorism-\(for-licensed-corporations\)/guideline-on-anti-money-laundering-and-counter-financing-of-terrorism-\(for-licensed-corporations\).pdf](https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidelines/guideline-on-anti-money-laundering-and-counter-financing-of-terrorism-(for-licensed-corporations)/guideline-on-anti-money-laundering-and-counter-financing-of-terrorism-(for-licensed-corporations).pdf)

nature may present a high risk of money laundering of terrorist financing, or (e) report suspicious transactions to the Joint Financial Intelligence Unit.

Failures or breaches of these regulations will call into question whether the asset manager remains fit to be licensed.

The SFC Circular also appends Standards of Conduct expected of asset managers considering dubious private fund and discretionary account arrangements or transactions⁷ (Appendix 1) and Red Flags for dubious private fund and discretionary account arrangements or transactions⁸ (Appendix 2).

SFC's Expected Standards of Conduct for Licensed Intermediaries

The senior management of an SFC-licensed intermediary has primary responsibility for maintaining appropriate standards of conduct and ensuring adherence to proper procedures.⁹ Accordingly, an asset manager's senior management is responsible for ensuring that effective procedures and controls are in place to enable the asset manager to:

- i) consider whether a proposed private fund and discretionary account arrangement or transaction is dubious; and
- ii) decide if the asset manager should proceed with the relevant arrangement or transaction.

The process for assessing whether a transaction is dubious and whether to proceed should comprise an initial screening, detailed due diligence, senior management assessment and documentation.

Initial screening

Once an initial screening determines that a proposed transaction is dubious, asset managers should not proceed without prior written approval from senior management which clearly states the reasons for approval.

⁷ <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/openAppendix?refNo=19EC68&appendix=0>

⁸ <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/openAppendix?refNo=19EC68&appendix=1>

⁹ General principle 9 (Responsibility of senior management) of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

Asset managers should be familiar with the red flags set out in Appendix 2¹⁰ to the SFC Circular, although these are not exhaustive and are subject to change. Asset managers should avoid a box-ticking approach and should instead:

- i) perform an initial screening of each proposed transaction which deviates from market practice such as setting up a master-feeder fund structure or special purpose vehicles for tax purposes, using derivative instruments for making an investment for a fund under the Qualified Domestic Institutional Investor program and having multiple funds or special purpose vehicles in private equity funds; and
- ii) assess whether there is any reason to suspect that the asset manager is not, or will not be, required or expected to make any investment decisions. If there is, asset managers should consider the arrangement or transaction to be dubious unless these reasons can be addressed. Examples of the types of questions asset managers should ask when reviewing the details of proposed transactions are given in Paragraph 2 of Appendix 1¹¹ to the SFC Circular.

Detailed due diligence

All transactions which were considered dubious at the initial screening should be logged and subject to detailed evaluation. Asset managers should conduct enhanced due diligence on the investor, the set up and the structure of the fund and discretionary account and transactions directed by the investor. The asset manager should then escalate the proposed transaction and its due diligence to senior management for review.

Senior management review and decision

Senior management should exercise due skill, care and diligence in reviewing each proposed arrangement or transaction which was considered dubious at initial screening. Additional steps should be taken as needed. In particular, senior management should critically assess any remaining

¹⁰ <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/openAppendix?refNo=19EC68&appendix=1>

¹¹ <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/openAppendix?refNo=19EC68&appendix=0>

doubts about the investor's explanations, sources of funding and whether the transaction is at arm's length. Senior management should only decide to proceed if it is satisfied that the suspicions have been sufficiently addressed.

Documentation

The asset manager should maintain full documentation covering all aspects of every proposed private fund or discretionary account arrangement or transaction which was considered dubious at initial screening. If asset managers fail to detect dubious arrangements or transactions or they facilitate illegal or improper conduct due to inadequacies in their procedures and controls, the SFC would not hesitate to take regulatory action against them and their senior management.

CHARLTONS

Boutique Transactional Law Firm of the Year 2017

Asian Legal Business Awards

This newsletter is for information purposes only.

Its contents do not constitute legal advice and it should not be regarded as a substitute for detailed advice in individual cases.

Transmission of this information is not intended to create and receipt does not constitute a lawyer-client relationship between Charltons and the user or browser.

Charltons is not responsible for any third party content which can be accessed through the website.

If you do not wish to receive this newsletter please let us know by emailing us at unsubscribe@charltonslaw.com

Hong Kong Office

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

Tel: + (852) 2905 7888

Fax: + (852) 2854 9596

www.charltonslaw.com