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Newsletter

Financial Services

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Hong Kong's Court of Appeal rules on advertising case

Scott Carnachan

A recent Court of Final Appeal judgement opens the way for wider advertising of unauthorised collective investment schemes in Hong Kong than has been the industry practice.

Section 103(3)(k) of the Securities and Futures Ordinance (SFO) exempts from the requirement for authorisation under section 103(1) an offer made in respect of interests in collective investment schemes "that are or are intended to be disposed of only to professional investors".

The scope of this exemption was considered by the Court of Final Appeal in its judgment of 20 March 2015 in Securities and Futures Commission v Pacific Sun Advisors Ltd (FACC No. 11 of 2014). In that case, Pacific Sun Advisors Ltd (Pacific Sun) sent an email to various recipients informing them of the launch of the Pacific Sun Greater China Equities Fund (the Fund) and subsequently published information about the Fund on its website. The Fund was not authorised by the Securities and Futures Commission (SFC) under section 103 of the SFO. Pacific Sun stated (and the court accepted) that the Fund was or was intended to be available solely to professional investors and was not available for investment by the general public.

However, this intention was not stated in the emails or in the information posted on the website. The SFC brought an action against Pacific Sun alleging a breach of section 103 of the SFO. The SFC was unsuccessful at the initial hearing, but successful on appeal. Pacific Sun then appealed that decision to the Court of Final Appeal.

The Court of Final Appeal found in favour of Pacific Sun and stated:

i. There is no requirement under the exemption that the advertisements or other materials contain an express statement that the collective investment scheme is intended to be disposed of only to professional investors.

ii. In order for Pacific Sun to rely on the exemption, it needed to show as a matter of fact that the Fund was intended to be disposed of only to professional investors. Whilst it would be helpful for the party seeking to rely on the exemption to include a statement to this effect in advertisements or other materials, that is not sufficient to fall within the exemption.

iii. Accordingly, it is necessary to consider the steps the person seeking to rely on the exemption undertakes to ensure that only persons who are professional investors are permitted to invest in the collective investment scheme. The burden of proving that is the case rests on the person seeking to rely on the exemption (in this case, Pacific Sun).

The SFC stated in its press release that it will study the decision to determine whether there should be any proposal to amend section 103 of the SFO.

March 2015

UK: Clarification of duties of fund managers

Michelle Kirschner, Lora Froud and
Gregory Talbot of Macfarlanes LLP

The UK High Court's decision in SPL Private Finance (PF1) IC Limited and others v Arch Financial Products LLP; SPL Private Finance (PF2) IC Limited and other v Robin Farrell [2014] EWHC 4268 (Comm) demonstrates a fund manager's potential liability when they fail to act in a fund's best interests.

Arch Financial Products LLP (Arch FP) was the investment manager of: (i) two UK incorporated open-ended investment companies (the UK Funds); and (ii) 22 cells within a Guernsey cell company (the Cells) into which the UK Funds invested.

Arch FP committed the Cells to investing in excess of £20m in "Club Easy" student housing investments (the Investment). The Investment indirectly exposed the UK Funds to illiquid assets, an asset class to which the UK Funds should arguably not have been exposed. When the financial crisis hit the Investment was not sufficiently liquid to meet redemption requests in the UK Funds. The value of the Investment was subsequently written down to zero, leading to a significant loss for the Cells and investors in the UK Funds. It was alleged that Arch FP's decision to invest was driven by its own interest in receiving an illegitimate payment of £3m rather than proper consideration of the Investment's merits.

The court held that no reasonable investment manager could possibly have considered that the Investment was in the best interests of the Cells. In reaching this decision, the court considered the following principles that apply to a fund manager when exercising discretionary management powers:

1. duty not to exceed investment mandate – if an investment manager exceeds the authority of its investment mandate when making an investment it will be liable to the fund for losses caused;

2. management powers and duties – unless the parties agree a different level of protection an investment manager has a duty to exercise discretionary powers with due skill and care; and

3. duties of loyalty – an investment manager owes fiduciary duties to the funds it manages, which means that it must give preference to the fund's interests above its own interests. This obligation is reinforced by the duties of an investment manager to avoid conflicts of interest with its funds and not to use its position to make a secret profit.

The court was not persuaded by Arch FP's defence that the £3m payment was disclosed and consented to by the Cells. The "disclosure" defence will succeed only where a fund manager can demonstrate that before entering into a transaction it made full disclosure of material facts and the extent of its own interests.

Robin Farrell, CEO of Arch FP, was also liable for dishonestly assisting Arch FP to breach its fiduciary duties and inducing Arch FP's breaches of contract.

Separately, Arch FP and Robin Farrell have been subject to regulatory sanctions from the Financial Conduct Authority.

Weavering Appeal - Summary

Robert Searle and Kirsten Houghton
of Campbells

The Cayman Islands' Court of Appeal has recently overturned the decision of the Grand Court in Weavering Macro Fixed Income Fund v. Ekstrom & Peterson [2011] 2 CILR 203, in which the trial judge had held a hedge fund's former non-executive directors liable for $111m on the basis they had acted with "wilful neglect and default" in failing to spot that the fund's main "assets" were fictitious swap agreements made with a related counterparty which had no assets to satisfy its liabilities.

The Court of Appeal concluded that although the non-executive directors had acted negligently, there was no evidence to support the judge's findings that they had intended to breach their duties, nor that they had even suspected that they were failing to meet their obligations. The Court of Appeal further found that the judge was wrong to have drawn inferences of wilful default from

the directors' failures to carry out certain functions which the judge took the view should have been carried out by them.

The appeal judgment gives some comfort to current directors that the common exemption provision in a hedge fund's articles of association, excluding liability for conduct falling short of wilful default or neglect, will apply unless any breach of duty is shown clearly to be intentional or reckless (in the sense that the directors had been conscious that they might be acting in breach, but then continued regardless).

The question for the Cayman Islands may now be whether, as in a number of jurisdictions, the inclusion of such provisions in a company's constitutional documents should continue to be permitted given that they make it very difficult for claimants, including liquidators of insolvent funds, to pursue any directors (including executive directors) for any default short of a deliberate or "knowingly reckless" act. In short, unless a director was deliberately dishonest, he will be entitled to his indemnity and claims against him will not be legally viable. However, if he did act deliberately then any D&O insurance is likely to be avoided, and accordingly many such claims will not be commercially viable.

The liquidators of the fund intend to appeal to the Privy Council.

SFC licensing and compliance hints

Rebecca Yip

Does the SFC need to know if a licensed company moves offices? Yes. A licensed company needs to get the SFC's prior approval before moving to new office premises. This includes expanding the office to include a neighbouring unit. This is because records relating to the regulated activities are typically kept, whether in soft or hard form, on the office premises.

Does the SFC need to know if a licensee's company secretary relocates office or if the licensee decides to change company secretary? Depends. If the company secretary only keeps the statutory books and records and does not keep any records relating to the company's regulated business, the SFC will not need to be notified if the company secretary changes address. However, if the address of the company's official registered office changes, this will need to be notified to the SFC.

Deacons provides company secretarial and other corporate support services to numerous SFC licensed companies.

Further information is available on our website: http://www.deacons.com.hk/our-services/by-services/corporate-/-m-and-a/

Does the SFC need to know if a licensed company has set up a new branch in Hong Kong? Yes. A licensed company needs the SFC's prior approval for a new branch. This is because records relating to the regulated activities may be kept at the branch.

AML update for SFC licensed companies

Heather Mak

The requirements relating to customer due diligence (CDD) and record-keeping for financial institutions are set out in Schedule 2 to the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (AMLO).

As an interim provision, the AMLO permits financial institutions to outsource the performance of the CDD measures to specified intermediaries, on the condition that these intermediaries have adequate procedures in place to prevent money laundering and terrorist financing. The government has published a Gazette Notice to extend this provision, which was due to expire on 31 March 2015, for three more years until 31 March 2018.

As a reminder to licensed companies, although the CDD procedures may be outsourced to an eligible intermediary, ultimate responsibility resides with the licenced entity. The licensee needs to be comfortable that all the AML work conducted on its behalf complies with Hong Kong's AML regulatory framework and that records are maintained.

Recent Publications

Hong Kong's Employees' Compensation Levels to Increase

Contracts (Rights of Third Parties) Ordinance or Contract Out of Rights of Third Parties?

Clearing and Settlement Systems (Amendment) Bill 2015: Changes and Implications

Reminder on Annual Report disclosure requirements

Hong Kong's 2015/16 budget offers hope and risk for tax competiveness

Code of Banking Practice Update

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