November 2, 2001

Securities and Futures Commission
12/F., Edinburgh Tower,
The Landmark
15 Queen's Road Central
Hong Kong

Dear Sir/Madam,

RE: Response to the consultation paper on the offering of hedge funds

[redacted] is a registered Investment Advisor with the Hong Kong Securities and Futures Commission.

With respect to the consultation paper issued on 26th October 2001, we applaud the Commission on your highly pragmatic approach in the attempt to strike the balance between investor protection and maintaining flexibility to the hedge fund managers.

Overall, we agree with the Commission on the use of the segmentation approach in offering this new asset class to the higher net worth echelon investors in Hong Kong. However, we recommend the Commission to consider offering certain types of hedge funds structures first, namely, fund of hedge funds. Hedge funds strategies are highly diverse with over 20 different strategies currently and with new strategies being introduced constantly. While some strategies would be relatively easy to understand, certain strategies are considered more complex and would require considerable effort to comprehend, even by investment professionals. While each strategy has its own merit, we feel that at the initial stage, it is impractical to expect retail investors to fully appreciate the merits and risks relating to each hedge fund strategy. Obviously we do not recommend, nor do we expect the Commission to take on the burden of approving individual investment strategy. The solution, we believe, is the initial approval of fund of hedge funds. A fund of hedge funds manager, through its expertise in the selection of managers as well as the constructions of diversified portfolios, can help retail investors to manage and to diversify investment risks effectively. It also allows investors to gain exposure to a much larger investment universe with much smaller investment amounts. Therefore, compared to single manager hedge funds, funds of hedge funds offer an additional layer of protection to investors and can effectively help retail investors to guard against investment risks, and more importantly, mortality risk of hedge funds in general. Offering fund of hedge funds in phase one might therefore be a prudent approach to introduce this new asset class to the public.

The following are our comments on specific proposed guidelines raised in your paper:

The Management Company

- Proposed requirement of US$100 million of assets under management is reasonable. However, to ensure relevance, we recommend that only assets managed with alternative strategies (individual strategies or fund of hedge funds) should be counted.
- The majority of offshore hedge funds are domiciled in Cayman Islands. We would recommend the Code to incorporate Cayman Islands (at least with respect to hedge funds) as an acceptable inspection regime to maximize choices to investors.

Minimum Subscription

- Fund of Hedge Funds: HK$50K
- Single Manager Fund: HK$100K
- Guaranteed Hedge Fund or Guaranteed Fund of Hedge Funds: no imposed minimum as it should be considered as the same as any guaranteed funds currently offered in the market. The maximum downside of these guaranteed investments is already contained by default.

Dealing

- Minimum of having quarterly dealing dates – performance of many less liquid strategies such as Distressed Debt will be significantly impacted should there be forced redemptions during volatile market conditions. Having too frequent a redemption window might work against the clients' best interests. However, valuations should be done on a monthly basis.

- Along the same argument, the maximum interval between the DEALING DATE and the payment of redemption proceeds should be around 60 days. Also, it is general practice for hedge funds in other jurisdictions to allow a redemption notice period between 30-60 days prior to the dealing dates. This should allow the fund managers to have sufficient flexibility to obtain best execution to unwind less liquid trades and to minimize performance impact to existing investors in the funds.

Fund of Hedge Funds

- The underlying hedge funds should not be required to be authorized by the SFC as this would significantly limit the investible universe of the manager and would contravene the Commission's stated objective of requiring the management company to *"demonstrate its ability to assess and monitor the performance of the underlying funds and <u>the ability to replace the underlying funds whenever necessary to protect the interests of investors</u>."* (From our experience, many highly qualified hedge fund managers DO NOT have the intention to register with the SFC or any other jurisdictions for various reasons.)

Financial Reporting

- We believe having a quarterly narrative report would be beneficial to retail investors. However, the content of the reports will be different depending on the style of hedge funds. For example, a single strategy fund may wish to describe the factors affecting the performance of that particular strategy; a fund of hedge funds, given its diverse holdings of individual hedge funds (normally between 15-30), should only be required to provide information and comments at the fund of funds level.

[redacted] is supportive of the Commission's initiative and we would be delighted to have the opportunity to discuss with the Commission further on the subject.

We would also respectfully request that our comments be published on a no-name basis.

Sincerely,

[redacted]