

## Hedge funds disclosure - have your say

The SFC wants to know what all market practitioners and investors think about proposed rules aimed at making hedge funds more transparent

In these bearish times, investors may become more interested in putting their money into hedge funds. But hedge funds can be complex, and so investors need to have enough information to make informed investment decisions. Encouraging disclosure also means that more people become aware of the hedge fund market.

In May 2002, the SFC released the Hedge Funds Guidelines, which together with the Code on Unit Trusts and Mutual Funds require hedge funds to send their investors annual audited reports, semi-annual and quarterly reports.

Now the SFC wants to let market participants and investors comment on the recently released proposals for Hedge Funds Reporting Guidelines. The SFC referred to industry best practice and held informal discussions with interested parties in drafting the guidelines. But the SFC feels it needs to consult the investing public to come up with an appropriate set of disclosure guidelines.

Alexa Lam, SFC Executive Director of Intermediaries and Investment Products, said: "These proposals are designed to promote informed investment choices and encourage greater market transparency. We are asking for views from different market sectors and from the

public to help us establish the most useful and meaningful disclosures for investors without jeopardizing hedge funds' strategies."

To help the public understand the new product, the SFC has published feature articles on hedge funds and a new investor leaflet called "How Much Do You Know About Hedge Funds?" (see article below). Ms Tina So, SFC's Director of Investment Products, has also issued an open letter to investors explaining the proposed Hedge Funds Reporting Guidelines.

Highlights of the proposals are:

- Standardized accounting approach  
The guidelines propose to use International Accounting Standards in hedge fund accounting and valuation.
- Alternative disclosure  
The guidelines suggest two alternatives to full disclosure of a fund's individual holdings: (a) exposure in terms of type of assets, geography or strategies; (b) top 10 positions in annual and semi-annual reports, and top five positions in quarterly reports.

*(continued on page 2)*

## Reform goes on

The SFC will continue to implement reform measures necessary to make Hong Kong competitive, as recommended by the report on the penny stocks incident.

The report of the independent Panel of Inquiry on the Penny Stocks Incident was released by the Financial Secretary on 10 September. The report made conclusions about the incident and proposed the way forward.

The SFC fully agrees with the Panel's conclusions and recommendations that we must press ahead with reform measures and look forward. We will make sure that the market and the public are engaged as early as possible to identify the key issues and build consensus.

We will work closely with the Administration, Hong Kong Exchanges and Clearing Limited, and other relevant parties on efforts to improve the quality of the securities market in Hong Kong.

SFC Chairman Mr Andrew Sheng said: "The Panel's report has clearly set out the facts. The SFC and I personally feel deeply about the incident and its effects on the public. We will be on guard to avoid the recurrence of similar incidents in the future."

The SFC thanks the Panel for having given it the opportunity to explain the issues and present the facts on the incident.

The report is available on the Government website at [www.info.gov.hk/info/pennystock-e.htm](http://www.info.gov.hk/info/pennystock-e.htm).

### CONTENTS

- Hedge funds disclosure - have your say P.1
- Understanding hedge funds P.1
- Reform goes on P.1
- Licensed to deal P.2
- Training aids P.2
- Stronger links with the CCB P.3
- Behind bars P.3
- It's good to talk P.3
- Adjusting the tap P.4
- SFO updates P.4

## Understanding hedge funds

Make sure you understand hedge funds before investing

Hedge funds will be offered to the general public during the last quarter of 2002. Is this good news, because hedge funds guard against risks so are "sure-win" products? Or is it bad news, given that hedge fund managers are merely speculators who sparked the 1997 Asian financial crisis? Well, neither is right.

### What is a hedge fund?

Hedge funds are a type of collective investment schemes that pool investors' monies to be managed by a third-party manager with a common investment objective. While there is no universal definition of "hedge fund", these funds generally adopt a flexible investment style - they may take both long and short positions, use leverage, invest widely in derivatives, and employ

active trading techniques. Hedge funds therefore vary enormously in their investment returns, risk profiles and investment strategies.

Although hedge funds are often marketed as all weather funds that will perform well under different market conditions, they are not "sure-win" products. Some strategies work well in certain circumstances but poorly in others. That is why before investing in



To find out more, also read the above leaflet (accessible on the SFC website)

*(continued on page 4)*

LICENSING UPDATE

## Licensed to deal

The majority of exempt dealers and exempt investment advisers (non authorised institutions) will apply for licences under the new regime

Under the new Securities and Futures Ordinance, exempt dealers and exempt investment advisers, those not being authorised institutions, like any other intermediaries and exempt persons will have to re-apply to the SFC for licences to operate regulated activities. They have to do it before the end of the two-year transitional period.

To ensure better licensing services to the intermediaries, the SFC has recently released a survey on those exempt dealers and exempt investment advisers to find out whether they intend to apply for licences and, if so, which type of regulated activities they plan to carry out.

In March 2002, the SFC sent 74 questionnaires to those exempt persons, who are primarily trustee companies and bank subsidiaries that deal in securities or offer investment advice. Of the 52 respondents, 37 were exempt dealers and 18 were exempt investment advisers (three were both).

### Survey highlights

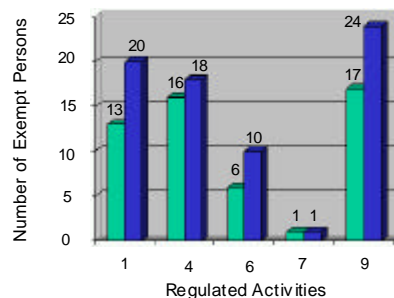
- 32 respondents indicated their intention to apply to become licensed corporations. Nine respondents said they would not apply for a licence and the remaining 11 respondents had not decided.
- Among the 37 exempt dealers, 25 decided to apply for a licence under the new regime.
- For the 18 exempt investment advisers, 10 said they would apply to become licensed corporations.
- Among the respondents who would apply for a licence, nine would operate one regulated activity, 11 would carry on two regulated

(continued from page 1)

### Hedge funds disclosure - have your say

- Quarterly reporting  
Quarterly reports will give investors a regular snapshot of the funds' changing risk profile. The quarterly report should include the fund's borrowings, illiquid holdings, portfolio exposure details, and information on fund performance and volatility.
- Specific management commentaries  
Fund managers should give their opinions in the form of a narrative in quarterly reports.
- Information on performance and risks  
The SFC proposes standardizing the presentation of statistics to help investors make more effective comparisons between funds. Statistical data should include a glossary of technical terms and highlighted data on monthly returns over the past three years or since the fund was launched.

activities and six would carry on three. One exempt person wishes to operate four regulated activities. The others had not decided. Please refer to the diagram for the types of regulated activities the respondents intend to operate.



#### Footnote

The left bar stands for the number of exempt persons which intend to operate the regulated activities under the new regime. The right bar stands for the number under the current regime.

The different types of regulated activities are explained below:

- Type 1 - Dealing in securities
- Type 4 - Advising on securities
- Type 6 - Advising on corporate finance
- Type 7 - Providing automated trading services
- Type 9 - Asset management

- Respondents employed 697 representatives and 79 persons to supervise their regulated business. Most of them are already registered with the SFC under the current regime.

A copy of the full survey report is available on the SFC website at [www.hksec.org.hk/eng/bills/html/sfo/ed\\_ei\\_survey\\_2002.htm](http://www.hksec.org.hk/eng/bills/html/sfo/ed_ei_survey_2002.htm).

Provided respondents consent, the SFC will post comments on its website to allow an informed debate. The consultation will end on 30 September 2002, and after this a consultation conclusions document will be released.

The open letter and the investor leaflet are accessible on the SFC website at [www.hksec.org.hk](http://www.hksec.org.hk). Other feature articles can be found on the SFC-operated Electronic Investor Resources Centre at [www.hkeirc.org](http://www.hkeirc.org).

The Consultation Paper on Hedge Funds Reporting Guidelines can be found on the SFC website at [www.hksec.org.hk/eng/bills/html/consultation.htm](http://www.hksec.org.hk/eng/bills/html/consultation.htm).

## Training aids

The SFC has recognised new industry qualifications and professional institutions that deliver post-licensing training

An important part of the SFC's role is to make sure that market practitioners are suitably qualified to deal with investors and other market participants. While education and practical experience are important considerations for a licence approval, so are qualifications. The SFC is pleased to announce that two qualifications have recently been added to its list of recognised industry qualifications. These are the internationally renowned Chartered Financial Analysts (CFA) designation and the Leveraged Foreign Exchange examination programmes to be offered by the Vocational Training Council's Financial Services Development Centre.

### Keeping up

Rapid changes in financial markets and products mean it's not enough for practitioners to demonstrate their initial competence - they have to keep up with new market developments. This is why the SFC has imposed the Continuous Professional Training (CPT) requirements since 2001. Licensees have to complete a minimum of five CPT hours per calendar year, building on their technical knowledge and professional expertise, in order to keep their licences.

The SFC has recently approved four more recognised institutions that can provide CPT, bringing the total number of recognised institutions to 12. The four new institutions are:

- Hong Kong Investment Funds Association
- Department of Accountancy of the Hong Kong Polytechnic University
- School of Professional Education and Executive Development of the Hong Kong Polytechnic University
- School of Continuing Education of the Hong Kong Baptist University.

### Corporate training

When CPT was first introduced, the SFC wanted to make sure that licensed firms' internal training was of a high enough standard and relevance to give practitioners the updates they needed. As a result, for the past year the SFC had asked corporate licensees to let it know about their internal training sessions and send in the training materials. After monitoring this for a year, the SFC is now satisfied with the standard of training, and has decided to drop this requirement.

However, licensees still need to keep their training and attendance records and report on their CPT compliance in the Annual Returns they make to the SFC.

The full lists of recognised industry qualifications and recognised institutions are accessible on the SFC website at [www.hksec.org.hk/eng/licensing/html/requirements.htm](http://www.hksec.org.hk/eng/licensing/html/requirements.htm).

ENFORCEMENT

## Stronger links with the CCB

Sharing expertise helps in the battle against market misconduct

Corporate crime often weaves through a complex maze of transactions and spreads its tentacles across many companies, deals and bank accounts. Getting to the bottom of these crimes needs a great deal of patience and expertise, and most important of all co-operation between different regulators and law enforcement agencies.

The SFC and the Hong Kong Police's Commercial Crime Bureau (CCB) are almost in contact daily, and in the past have successfully worked together on matters ranging from corporate fraud and theft by brokerage staff to boiler room fraud and market manipulation cases.

To strengthen this co-operation, from 9 September 2002 the CCB has seconded two officers to SFC's Enforcement Division for a three-month period.

The secondments, together with shared training courses, will help in the exchange of experience and expertise between the two bodies. This type of secondment may become regular.

Mr Alan Linning, SFC Executive Director of Enforcement, said: "We have always enjoyed an excellent working relationship with the Police in general and the CCB in particular. There is good rapport between us at both the management and the operational level, and this has led to some excellent results, such as the convictions for

manipulating Gay Giano shares\*."

### Clamping down

Corporate misgovernance is one of SFC's enforcement priorities this year (see the July issue of the SFC Alert). Since April 2002, the Commission has initiated four major investigations under Section 29A and three under Section 33 of the Securities and Futures Commission Ordinance. All of these cases involve suspected corporate misconduct. Where there is clear suspicion of criminal conduct, the SFC refers the case to the CCB.

The SFC cannot often reveal details of targets under investigation or comment on the progress of cases due to a secrecy provision in the law.

This makes sure that people under investigation get a fair hearing. It also prevents any premature market reaction. But the SFC will make appropriate announcements when investigations are concluded and it is taking formal action, or where some form of public sanction is imposed.

"The message is - we are on the alert for suspicious corporate activity. In co-operation with our law enforcement colleagues, we will not hesitate to take the strongest action against those who try to undermine Hong Kong's reputation as an international financial center," Mr Linning said.

\* See the August issue of the SFC Alert for details.

"The message is - we are on the alert for suspicious corporate activity."

## Behind bars

A cross-border boiler room scam operator finds that financial crime doesn't pay

International co-operation between the Financial Services Authority and the Police in the UK, and the SFC has led to the successful prosecution of a cross-border fraudster. Graham Hammond, former chairman of FCS Fund Management, was jailed for eight years at Norwich Crown Court in the UK on 16 August 2002 for operating a £10 million high yield investment fraud.

FCS had its headquarters in Hong Kong and sales offices in Norwich and Dubai. Two of the company's funds did not have a custodian or issue valuation reports. Investors of the two funds, who were in the UK, Europe and the Middle East, were asked to send their money to an offshore account that was purported to be a custody account. But, in fact, the account was directly and solely controlled by Hammond.

By creating false statements of account which were printed in Hong Kong, Hammond duped investors into thinking that their money had gone into genuine investments. He used the offshore cash to pay for his lavish lifestyle. He opened a

club in Bangkok and was a regular at casinos and stayed at luxury hotels.

### The net closes

In September 2000, following a referral from the UK's Financial Services Authority, the SFC started investigating FCS's operations, as the company was suspected of having operated in Hong Kong without an SFC licence. The SFC then referred the case and its initial findings to the CCB and we worked closely together on it. Meanwhile, Hammond surrendered himself to the Serious Fraud Office in London.

On 25 May 2002, Hammond pleaded guilty to 20 counts of furnishing false information. Recently, the Norfolk Constabulary wrote to acknowledge the assistance of the SFC Enforcement Division colleagues.

*To protect themselves, investors should only deal with SFC licenced intermediaries. The lists of licenced dealers and authorized funds are accessible on the SFC website at [www.hksfc.org.hk/eng/licensing/html/requirements.htm](http://www.hksfc.org.hk/eng/licensing/html/requirements.htm).*

## It's good to talk

Meetings with market practitioners provide useful two-way feedback on regulatory issues

As part of its outreach initiatives, SFC executives have met with more than 200 executives of broker firms over the last month. These contacts gave both sides the chance to talk about subjects including ideas on helping Hong Kong's securities and futures market develop, improving market turnover, helping intermediaries with their compliance and how to trim compliance costs.

Some brokers have been the victims of fraudsters posing as walk-in clients or from their employees' fraudulent activities. During these contacts, the SFC took the opportunity to remind brokers to be cautious with new clients and to strengthen their internal control measures. The SFC also encouraged the brokers to report any suspected fraud. Similar advice has been issued to all intermediaries pointing out how fraudsters could target them.

The SFC has many ways of communicating with industry participants, something the SFC sees as vital in developing a fair and orderly market. Other channels include:

### Clarifying regulatory requirements

Information on modifications of certain SFC's requirements and frequently asked questions on new regulations are posted on our website, enabling market practitioners to refer to them easily.

### Keeping the industry up-to-date

The SFC holds regular seminars, complemented by information circulars, to keep the industry informed of changes to and new developments in relevant rules and regulations.

### Making industry friendly rules

When the SFC is considering the need for material changes to regulations, it collects views through working groups to ensure that concerns and issues are addressed at an early stage.

The opinions gathered help the SFC review its policy position and prepare a paper for public consultation. After considering the public's views, the SFC prepares a conclusions document setting out our final proposed regulations for legislative approval.

### Feedback is crucial

The SFC is determined to work closely with the industry to improve regulation of the securities and futures market. However, we cannot achieve results without invaluable industry input. If market intermediaries have any difficulty in complying with any relevant rules and regulations, or if they become aware of any suspected market malpractices and fraudulent activity, they are strongly encouraged to contact the SFC so as to resolve the issues as early as possible.

INVESTOR FOCUS

# Adjusting the tap

A liquidity provider provides quotes for a warrant. To find out how this works, read on ...

In a move to improve market liquidity, from 10 December 2001 a derivative warrant issuer has to appoint a liquidity provider (or market maker) for every new issue.

A liquidity provider provides liquidity from 10:05am until the close of trading each day. Its quotes must comply with the requirements in the listing document: the maximum spread, the minimum lot size (the Stock Exchange requires at least 10 board lots), and the maximum response time (if a quote request is adopted).

The liquidity provider can (a) respond to requests for quotes (quote request) or (b) continuously input bids and offers into the system (continuous quote).

## Finding quotes

First you need to find out which type of liquidity providing mechanism your warrant uses. If this is "quote request" and you find the liquidity provider hasn't given any quotes, you can ask your brokerage to call for a quote. If the liquidity provider uses the "continuous quote" method, it will input bids and asks to the system continuously.

Although liquidity providers have to provide quotes, they don't have to take up all the outstanding orders in the market. They can

provide quotes at any price they think is fair provided they comply with the requirements. So if their quote doesn't match an order, the order won't be executed.

Sometimes the issuer can stop providing liquidity in the derivatives warrants. The exact conditions are set out in the listing document and may vary among issues. Here are a few examples:

- the warrant or the underlying share is suspended from trading;
- over a specified period, such as five business days, before the warrant expires;
- technical or operational problems affect the liquidity provider's ability to provide liquidity;
- if the price of the underlying share is very volatile within a short time period;
- the fair value of the warrant falls below the minimum price of HK\$0.01 that the system can accept;
- market conditions make it impracticable to source a hedge or to unwind a hedge;
- if insufficient warrants are available to be offered by the liquidity provider, it may choose to quote a bid price only but may not take up the outstanding orders.

For more information, please refer to the series of articles called "Understanding Warrants" at [www.hkeirc.org](http://www.hkeirc.org).

(continued from page 1)

## Understanding hedge funds

a hedge fund, you should always find out about its strategies and whether these suit your needs.

### Fund-of-hedge-funds

A fund-of-hedge-funds (FoHF) invests exclusively in other hedge funds. The manager invests in a variety of "baby" funds to improve the FoHF's risk and return profile. A FoHF charges two layers of fees - one at the parent level and one at the baby funds level.

### Holes in the hedge

"Hedge fund" does not necessarily mean that a fund is hedged! The net position of a hedge fund is never totally neutral because of the fund's risk exposure to individual securities. Plus hedge funds often actively take on risks to aim for higher returns.

Unless a hedge fund has a guarantee attached to it, nobody can give any assurance about its performance. Even then, investors should check the level of guarantee provided. Remember, risk and reward go hand in hand. Investing in hedge funds could lead to substantial capital loss. Check the manager's background and experience, and the product features in the offer document. Compare different products and see which one best fits your needs.

### Getting your money

Some research shows that investing in hedge funds can diversify a portfolio. In other words, investors could increase their portfolio's overall returns without increasing risks in the same proportion. However, you should consider your own financial circumstances.

Some hedge funds can only be dealt in once a month, and it may take longer - up to 90 days - to get the sale proceeds after a redemption request than it does with a traditional fund. So think carefully about your future liquidity needs.

### Some DOs and DO NOTs

- Hedge funds for public sale must be authorized by the SFC. But, SFC approval is not a seal of recommendation. DO make sure you read the offer documents.
- DO ask questions if you do not understand.
- DO NOT sign anything that you don't understand.
- DO NOT pool your monies with other people just to meet the minimum subscription amount.

For more details, please visit the SFC-operated Electronic Investor Resources Centre (eIRC) at [www.hkeirc.org](http://www.hkeirc.org).

# SFO updates

## LegCo Subcommittee meetings

The LegCo Subcommittee on draft subsidiary legislation to be made under the Securities and Futures Ordinance is holding meetings in the week of 16 September 2002 to consider the last 10 items of subsidiary legislation required for commencement of the Ordinance.

## Consultations and Conclusions

The SFC has completed consultation on all subsidiary legislation required at this stage. We issued five consultation conclusions over the last month and the remaining conclusions papers will be issued shortly. All documents are available under the SFO section of our website.

### Consultation Conclusions on the following have been issued since 15 August 2002:

	Issue Date
S&F* (Insurance) Rules	13 September
S&F (Offences and Penalties) Regulations	13 September
S&F (Intermediary Information) Rules**	13 September
S&F (Miscellaneous) Rules	12 September
S&F Ordinance (Amendment of Schedule 8) Order	12 September

\*S&F stands for Securities and Futures

\*\*To be known as the S&F (Licensing and Regulations) (Information) Rules

Securities and Futures Commission

12/F Edinburgh Tower, The Landmark, 15 Queen's Road Central, Hong Kong