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FUTURES COMMISSION
證券及期貨事務監察委員會

Consultation Paper on the Review of Chapter 8.7 of the Code on Unit Trusts and Mutual Funds

Hong Kong
26 May 2005

CONSULTATION PAPER ON THE REVIEW OF CHAPTER 8.7 OF THE CODE ON UNIT TRUSTS AND MUTUAL FUNDS (GUIDELINES ON HEDGE FUNDS)

The Securities and Futures Commission (“Commission”) invites market participants and interested parties to submit written comments on the proposals discussed in this consultation paper or to comment on related matters that might have a significant impact upon the proposals **no later than 30 June 2005**. Any person wishing to submit comments on behalf of any organization should provide details of the organization whose views they represent.

Please note that the names of the commentators and the contents of their submissions may be published on the Commission website and in other documents to be published by the Commission. In this connection, please read the Personal Information Collection Statement attached to this consultation paper.

You may not wish your name to be published by the Commission. If this is the case, please state that you wish your name to be withheld from publication when you make your submission.

Written comments may be sent

By mail to: Investment Products Department
The Securities and Futures Commission
8/F Chater House
8 Connaught Road Central
Hong Kong

By fax to: (852) 2877 0318

By on-line submission: <http://www.sfc.hk>
(Please enter into the subsection “Consultation Papers & Conclusions” under the section “Speeches, Publications & Consultations” on the website <http://www.sfc.hk>)

By e-mail to: ipconsult@sfc.hk

For further information, please contact the Investment Products Department at (852) 2840 9259.

Additional copies of the consultation paper may be obtained from the above address of the Commission. A copy of this paper can also be found on the Commission website at <http://www.sfc.hk>.

Investment Products Department
Securities and Futures Commission
Hong Kong

26 May 2005

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Consultation Paper on the Review of Chapter 8.7 of the Code on Unit Trusts and Mutual Funds (Guidelines on Hedge Funds)

Introduction

1. The Securities and Futures Commission (the “SFC”) invites comments on the proposed revisions in relation to the Guidelines on Hedge Funds (the “HF Guidelines”) contained in Chapter 8.7 of the Code on Unit Trusts and Mutual Funds (the “Code”).

Executive Summary

2. Since the HF Guidelines became effective in May 2002, the SFC has authorised 13 retail hedge funds. The SFC considers that this is an appropriate time to review the existing requirements for authorisation of hedge funds, having regard to the considerable experience built up in the past 3 years, the recent rapid market development of the hedge funds industry, in particular, in the Asian region, and the market practitioners’ feedback to some of the provisions of the HF Guidelines.
3. Towards the end of 2004, the SFC undertook an internal review of the hedge funds authorisation process and the application of the requirements of the HF Guidelines. A total of 13 hedge funds (of which 5 are single hedge funds and 8 are funds of hedge funds (“FoHFs”)) have been authorised by the SFC under the HF Guidelines. The SFC noted that some hedge funds that were unsuccessful in their applications for authorisation failed to meet the basic requirements in the HF Guidelines, such as the requirements of requisite experience and qualification of key personnel of hedge funds managers. A few unsuccessful applications are hedge funds that were already established solely for institutional investors before applying to the SFC for authorisation, which had no intention to conduct reorganisation to comply with the HF Guidelines.
4. The internal review also shows that hedge funds management companies sometimes take a rather different model for their business operations and risk management from that of traditional long-only fund management companies. Given the complexity of investment strategies and related potential volatility, and investors’ concerns about the liquidity of the underlying assets of hedge funds, some hedge fund managers may maximise their internal group expertise to oversee specific operational functions like risk analyses or derivatives trading. Having regard to the nature of hedge funds industry, it is increasingly difficult to consider hedge funds a homogeneous fund type.
5. In light of the diverse range of investment strategies adopted by hedge funds and different business structures of hedge funds managers, the SFC has adopted a principle-based framework for the authorisation of retail hedge funds under the HF Guidelines. However, some market practitioners expressed that, occasionally, they encountered difficulties in applying the principles in the context of specific hedge fund applications.

6. The SFC decided to review the HF Guidelines with an aim to clarify our existing practices in the authorisation of hedge funds and provide additional guidance to market practitioners on how certain rules are applied in practice. The SFC also intends to enhance the disclosure standards of hedge funds by proposing various disclosure requirements to increase the transparency of the management companies in their risk monitoring, due diligence process and other related operational aspects.
7. The SFC seeks the views of the public on three key aspects of the HF Guidelines. First, instead of placing a heavier focus on the individual experience of investment personnel as the HF Guidelines presently are, the SFC proposes to take a holistic approach in assessing the acceptability of the management company. Management companies that have proper internal controls, risk management process, sufficient human and technical resources, public funds management experience and good corporate governance will be considered acceptable for the purpose of managing retail hedge funds. On this basis, the SFC would like to clarify the requirement on the individual investment experience of the two key personnel so that each key personnel is required to demonstrate he has at least 2 years' specific hedge fund management experience out of the 5 years' relevant experience. Also, the SFC is prepared to accept that the 5 years' relevant experience can be made up of a wider combination of hedge funds related experience and to assess the requirement of public funds management experience on a firm-wide basis.
8. Second, the SFC proposes to increase the transparency of the operations of the management company by way of enhanced disclosure in the offering document. New provisions requiring the disclosure of on-going monitoring process of underlying funds by a FoHFs, the relationship with prime brokers and the independence of valuation agents are proposed in the Draft Revised HF Guidelines.
9. Third, the SFC proposes to review the minimum subscription level for single hedge funds and the level of collateralisation to prime brokers. We propose that the minimum subscription level for single hedge funds, currently set at US\$50,000, be lowered to US\$30,000 in consideration of the increasing awareness of investors about hedge funds and the checks and balances contained in the Draft Revised HF Guidelines for enhancing the transparency of SFC-authorized hedge funds. The SFC also takes this opportunity to consult the public on whether there is a need to review the current restriction imposed on a SFC-authorized hedge fund's collateralisation level to its prime brokers in view of the latest overseas regulatory development.
10. Apart from the above, the SFC also fine-tunes the existing provisions of the HF Guidelines to reiterate the importance of the management company's internal systems, resources and risk management processes; and proposes additional notes to codify the SFC's regulatory practices in the application of the HF Guidelines. Key provisions for which additional notes are inserted include compulsory redemption, ring-fencing provisions, equalisation and prohibitions on the use of "managed accounts". The SFC believes that these additional notes help increase the transparency in our administration of the HF Guidelines.

11. The consultation period for the Draft Revised HF Guidelines will end on 30 June 2005. A copy of the Draft Revised HF Guidelines with the proposed revisions marked up is attached in **Annex I** to this paper.

Background

Authorised Hedge Funds in Hong Kong

12. The number of retail hedge funds applying for authorisation by the SFC has grown steadily. As of 31 March 2005, there were a total of 13 authorised hedge funds in Hong Kong. The aggregate net asset size of these funds has also grown significantly from US\$160 million at the end of 2002, to US\$405 million at the end of 2003, and to about US\$1.2 billion at the end of year 2004, achieving a more than 7 times increase in asset size from 2002 to 2004. The majority of the authorised hedge funds had a fund size of less than US\$100 million each, while the biggest fund amounted to more than US\$500 million, as of the end of 2004.
13. Out of the 13 authorised hedge funds, six are managed by Hong Kong managers licensed by the SFC, covering about 70% (US\$830 million) of the total asset under management of all authorised hedge funds.
14. In terms of fund structure, eight are FoHFs with an aggregate net asset value (NAV) of about US\$320 million (27% of all authorised hedge funds). The remaining five single hedge funds have a total NAV of about US\$850 million (73% of all authorised hedge funds).
15. In respect of investment strategy, all except one FoHFs follow a multi-strategy investment objective. For the five single hedge funds, four follow macro investment style, while the remaining one adopts a combination of equity long/short and market neutral strategies.

Processing Time

16. The processing time for hedge funds applications depends largely on the complexity of the product, the completeness of documents submitted and the extent of compliance with the HF Guidelines.
17. According to our internal review, the reasons for unsuccessful hedge funds applications are mainly: the inability to demonstrate compliance with the basic requirements in the HF Guidelines (such as the requirements of requisite experience and qualification of key personnel of hedge funds managers) and the failure to meet the disclosure requirements in the HF Guidelines.
18. On the other hand, hedge funds that were in full compliance with the HF Guidelines and able to submit proper documentation along with their applications did not experience any delay in authorisation.

Investor Protection Comes First

19. In processing the hedge funds applications, the SFC upholds the principle of “Investors Come First”. Retail hedge funds intending to access the general public should possess basic structures that would help reduce non-investment or operational risks. However, it is generally accepted that no regulatory systems can assure investors of zero failures in their investments or prevent the occurrence of frauds. Investors should therefore ensure that they understand their own investment needs and risks appetite, as well as the expertise and profile of fund managers before investing into hedge funds or other alternative investments.

Regulatory Approach

20. This consultation paper focuses on three key areas for the revision of the HF Guidelines:

- (a) *Holistic approach in the application of the assessment criteria for the acceptability of the management company*

The Code requires a management company that manages a SFC-authorized hedge fund to have two key personnel, each possessing 5 years’ general experience in hedge fund strategies including at least 2 years’ experience in the same strategy as that of the scheme. In our soft consultation with the industry, market practitioners advised us that it would be useful if further clarification can be made on the scope of experience that would be recognised in satisfying this requirement. The SFC therefore proposes to clarify the types of experience that would be considered acceptable as general hedge fund experience and how the years of experience should be counted in the Draft Revised HF Guidelines.

- (b) *Emphasis on the competence and resourcefulness of the management company*

The hedge funds business is a skill and resource intensive industry. In this rapidly evolving industry where different kinds of highly complicated investment strategies and techniques are employed to achieve returns and to suit different clients’ needs, the level of risk control and management systems, as well as infrastructural support of a hedge fund manager have to be enhanced in tandem. In view of the intensive demand on skilled specialists, sophisticated management of risks and overall infrastructural support, the SFC reiterates in the Draft Revised HF Guidelines the importance of the management company’s internal systems, resources and risk management processes.

- (c) *Enhanced disclosure*

In general, the SFC intends to promote greater transparency in the way hedge funds are managed. In the Draft Revised HF Guidelines, we propose additional disclosure be made in the areas of hedge fund

operations, risk management process, calculation of performance fees and the roles and relationship of prime brokers with hedge funds.

21. In order to achieve the objectives of providing further guidance to the market on the application of the authorisation requirements and to enhance the disclosure standards, the SFC proposes that the current HF Guidelines be revised by inserting practical notes to reflect our existing practices.
22. An important aspect of promoting financial literacy among the investing community is by way of investor education. The SFC will continue to educate investors on the selection of investment advisers and the need to gain better understanding of various products and their features such as hedge funds. At the same time, the SFC expects to see more industry initiatives to carry out investor education in order to promote the understanding of new or unconventional investment products.

Proposed revisions

23. Paragraphs 25 to 31 contain proposals that serve to expand the category of investment experience recognised for the purpose of general hedge funds experience and to reiterate the importance of the overall acceptability of the management company in managing retail hedge funds.
24. Paragraphs 32 to 51 contain proposals for the codification of existing regulatory practice and the enhancement of disclosure standards of the hedge funds offering document.

Management company – assessment criteria for acceptability - Chapter 8.7(a)(i)

25. There are two key proposals in relation to the general criteria for acceptability of a management company for SFC-authorized hedge funds. The SFC believes that where increasingly complex business models and investment strategies are being adopted in the management of hedge funds, it is important that only fund management companies having sufficient resources and the requisite competence, expertise and risk management and internal control systems be allowed to offer retail hedge funds in Hong Kong. Unlike funds that are marketed exclusively to institutional and professional investors, retail hedge funds interface with a much larger population of investors, very often with different risk appetite from, and less product knowledge than, that of institutional and professional investors.
26. The Code requires all management companies that manage SFC-authorized funds to meet the acceptability criteria in Chapter 5. However, in the case of hedge funds, some of the acceptability criteria in Chapter 5 may not be practicable. For example, Chapter 5.5(a) requires the two key personnel of a management company to possess public funds management experience. Since most hedge funds are originated in the institutional sector, their key personnel are less likely to be retail-oriented and hence this requirement may pose practical difficulties to hedge funds managers. In view of this, we propose that instead of requiring the key personnel to demonstrate that they have public

funds experience as in Chapter 5.5(a), we are prepared to take a holistic approach and consider on a firm-wide basis, whether the management company is able to demonstrate that it has the 5 years' experience and sufficient resources in managing public funds.

27. Also, good corporate governance and proper risk management of a management company is as crucial as the skills and expertise of the key investment personnel it can procure. The SFC therefore reiterates in the Draft Revised HF Guidelines that the management company has to demonstrate that on a corporate level, in addition to the key personnel requirements, its business structure, resources and risk management systems are able to meet certain basic requirements such as adequacy of human and organisational resources in the light of its hedge funds businesses.

Key Personnel's Experience – Chapter 8.7(a)(ii)

28. In the soft consultation with the market, market practitioners advised us that it would be useful if further clarification can be made on the scope of experience that would be recognised in the requirement set out in Chapter 8.7(a)(ii). Chapter 8.7(a)(ii) states that a management company must possess at least two key personnel, each having a 5 years' general experience in hedge fund strategies including at least 2 years' experience in the same strategy as that of the scheme. However, some market practitioners were not certain about the sort of general experience that would be recognised under this requirement and the way the 5 years' experience is counted.
29. With a view to clarifying the application of this requirement, we propose to revise Chapter 8.7(a)(ii) in two main ways. First, the core requirement is that the management company must be able to demonstrate that it has two key personnel each possessing 5 years' relevant experience. However, it is intended that out of these 5 years' relevant experience, a key personnel must have at least two years' specific experience in the management of hedge funds. Appropriate wording has been included as Notes to Chapter 8.7(a)(ii) to clarify this intent.
30. Second, the SFC proposes to give flexibility to individual key personnel in meeting the requirement of the "5 years' relevant experience". Apart from the 2 years' minimum specific experience requirement, the SFC proposes to recognise a wider range of hedge funds related experience as "relevant experience" for meeting the 5 years' relevant experience test such as proprietary trading experience, securities dealings or funds selection experience. For the avoidance of doubt, the years of specific experience in the management of hedge funds of a key personnel will be correspondingly counted towards the "5 years' relevant experience".
31. Management of hedge funds very often involves relatively complex functions and different skill sets from those of traditional long-only fund managers. We are therefore mindful of the need to adopt a practical approach in assessing the acceptability of the two key personnel's general experience and in recognising a wider range of experience in this context. To facilitate the understanding of the market, the Draft Revised HF Guidelines provide, in a non-exhaustive manner,

examples of the types of general experience that will be normally regarded as acceptable. We also set out, by way of examples, experience that is usually regarded as irrelevant for the purpose of meeting this test.

Prime Brokers - Note to Chapter 8.7(b)

32. Prime brokers very often provide a variety of services to hedge fund managers including clearing, custody, brokerage, margin financing, reporting and stock lending etc. It is important that hedge fund managers thoroughly understand the roles of prime brokers and conduct adequate due diligence on how their services will be delivered and their contractual obligations before appointing them.
33. The SFC proposes that additional disclosure be made in the offering document in respect of the relationship between prime brokers and the management company, the maximum amount of financing to be provided by prime brokers (where practicable), and potential areas of conflicts and mitigating measures. Disclosure must also be made as to the circumstances under which assets pledged to prime brokers may be foreclosed where assets of a scheme are pledged to prime brokers as security for financing.

Prohibition of investing in unlimited liabilities vehicles and disclosure of ring fencing arrangements –Notes to Chapter 8.7(d) and (e) and Chapter 8.7(g)

34. Where a hedge fund is a sub-fund in an umbrella fund structure and there is no enforceable ring-fencing structure between each sub-fund, the incurrence of liabilities by one sub-fund may have to be set off by assets of other sub-funds under the same umbrella structure. This, in short, constitutes a liability “spillover” from one sub-fund to another. Given the amount of leverage activities a hedge fund may undertake, the HF Guidelines already require the demonstration of a ring-fencing structure in the case of sub-funds within an umbrella structure. It is proposed the ring-fencing arrangements be disclosed in the offering document.
35. We also take this opportunity to clarify in Chapter 8.7(g) that a SFC-authorized FoHFs, is prohibited from investing in unlimited liability vehicles.

Disclosure relating to calculation of performance fees – Chapter 8.7(i)

36. The Code requires that performance fees may only be charged on an annual basis and must meet the “high water mark” test. Where there are active subscriptions and redemptions in a hedge fund that also charges performance fees, some hedge fund managers may wish to employ the concept of “equalisation” in order to apportion the fees to investors that subscribe and redeem at different points of time.
37. On a theoretical level, the concept of “equalisation” may have its own appeal. However, it is generally accepted that there are practical difficulties in trying to implement this concept. Either the use of “notional class” for different investors entering on different dates or the use of complex methods in calculating the accrual of performance fees at each NAV calculation is

recognised as imperfect solutions for achieving equality among investors¹. Besides, there is still neither universal acceptance of this practice in the fund industry nor unified definition for this concept. It is possible that the administrative costs and burden that the hedge fund managers may have to undertake to implement the concept of “equalisation” may outweigh the benefits to investors.

38. Having considered the practical implications of adopting the concept of “equalisation”, we do not propose to mandate retail hedge fund managers to implement measures for “equalisation” in the calculation of performance fees. However, it has been the practice of the SFC to request retail hedge funds to disclose whether the concept of “equalisation” is adopted or not in their calculation of performance fees; if so, details of the mechanisms adopted to achieve “equalisation”, and if not, the financial advantages or disadvantages to investors. We propose to codify this current practice in the Revised HF Guidelines for the sake of transparency.

Proprietary Trading by Fund of Hedge Funds – Note to Chapter 8.7(j)

39. As stated in the HF Guidelines, a FoHFs is expected to be designed to achieve diversification through investing in various underlying funds. It follows that a FoHFs is not anticipated to carry out direct or proprietary trading. Sometimes, a FoHFs may wish to use “managed accounts” to carry out direct or proprietary trading.
40. Direct proprietary trading by FoHFs at the scheme level may affect the overall risk profile and investment objectives of the FoHFs and, in some cases, result in a spillover of liabilities to the scheme as a whole. In view of these potential risks to investors in a FoHFs, the use of “managed accounts” or direct proprietary trading is not allowed in general. This prohibition is proposed to be codified as a note to Chapter 8.7(j).

Redemption in Specie and Compulsory Redemption – Note to Chapter 8.7(m)

41. Additional notes are proposed to reflect the existing practice of the SFC in addressing issues relating to redemption in specie and compulsory redemption.
42. If redemption in specie is effected, the redeeming holder will only get the specific assets of a single hedge fund, or units/shares of a hedge fund in the context of a FoHFs. The SFC believes that for better investor protection, redemption in specie may only be made with the prior consent of the individual redeeming holder.
43. In the case of compulsory redemption, the SFC believes it is appropriate that a hedge fund may only unilaterally demand a holder to redeem in limited circumstances, for example, where the continuous holding would constitute a breach of law or any contravention of rules to which the hedge fund is subject.

¹ IOSCO’s Final Report on Elements of International Regulatory Standards on Fees and Expenses on Investment Funds (November, 2004)

Valuation – Chapter 8.7(o) and (p)

44. One of the key concerns investors have about hedge funds is the reliability of the valuation conducted on the assets held by a hedge fund. Very often, hedge funds may invest in relatively illiquid assets which do not have a ready and open market. Experience and competence of a valuation agent is therefore of paramount importance to ensure that the right methodologies are adopted for evaluating the assets held by a hedge fund. To ensure transparency and to provide better safeguards to investors, we propose that all hedge funds should, in addition to the disclosure of the identity of the valuation agent, disclose the experience and selection criteria of the valuation agent and its relationship with the management company.
45. Another issue that concerns investors is whether valuation is carried out in an impartial and objective manner. In the existing provisions of the HF Guidelines, the scheme is required to be fairly valued in accordance with generally accepted accounting principles.
46. At the same time, we recognise that in large financial conglomerates, valuation agents may be affiliated to the management company due to corporate relationships. Despite such relationship, a valuation agent may still be able to carry out valuation in an independent manner through proper segregation of internal reporting lines and management decisions procedures within the conglomerate.
47. On balance, we believe independent valuation helps strengthen protection to investors in hedge funds and therefore we propose that valuation of a SFC authorised scheme has to be both fairly and independently carried out. We also clarify in the Draft Revised HF Guidelines that the valuation agent will not be regarded as independent in either of these situations: the valuation agent is a subsidiary of the management company or vice-versa; or there is common directorship between the two. Other than these two situations, if a valuation agent is related to the management company by virtue of a corporate relationship with the management company, it may still be deemed as independent provided that the management company ensures there are proper measures in place such that the valuation can be carried out independently of the management company.

Miscellaneous

48. Chapter 8.7(g) is revised to clarify the scope of application of Chapter 7.13 and Chapter 8.7(k)(iii) to reflect existing regulatory practices.
49. In addition, we propose to revise various provisions in the HF Guidelines to enhance the disclosure standards of the offering documents of hedge funds and to iron out possible internal inconsistencies between various Chapters. Detailed disclosure is now proposed to enhance transparency in the on-going monitoring of the scheme's investment and asset allocation process and the services provided by key service providers. In the case of a single hedge fund,

disclosure is also required of the key obligations of prime brokers for which they are contracted and the way conflicts of interest are mitigated. Additional disclosure of the risk management and internal control mechanism is also proposed.

50. The SFC also takes this opportunity to amend certain wording in the HF Guidelines to ensure consistency with the rest of the Code. Accordingly, the word “should” has been replaced by “must” where appropriate.
51. Finally, the SFC will further communicate with the industry on the practical application of the disclosure requirements in the Guidelines on Hedge Funds Reporting Requirements contained in Appendix H of the Code. For example, in the “performance review” section of a quarterly report, we expect fund managers to explain the strategies adopted and the allocation of the assets as described in the report, and the reasons for any substantial holdings in a particular strategy and/or asset class (including cash and cash equivalents). The SFC will keep a continuous dialogue with market practitioners on various practical issues arising from the implementation of the Code with a view to enhancing the overall transparency of SFC-authorized hedge funds.

Proposals to revise the minimum subscription level for single hedge funds and the level of collateralisation to prime brokers

Minimum subscription for single hedge funds

52. The SFC has conducted soft consultation with the industry on ways to improve the current retail hedge funds regulatory regime. Some practitioners suggested the lowering of the minimum subscription level of US\$50,000 for single hedge funds. The argument in support of this downward revision is three-fold.
53. First, investment risks cannot be reduced or eliminated by setting a higher threshold. A better way to deal with investors’ awareness of the risks embedded in an investment product is by way of investor education and proper advice given by competent investment advisers. Second, by holding a higher threshold, investors are in fact invited to concentrate their risks in one single hedge fund rather than diversifying them through investing in various single hedge funds. Third, hedge fund managers will be more willing to launch their single hedge funds products to the market if the threshold is revised downwards. At the moment, only one Hong Kong licensed fund manager has offered to retail investors single hedge funds and it is difficult in such circumstances to arouse sufficient interests both on the side of investors and fund distributors to consider this fund type.
54. On the other hand, there is counter-argument that, hedge fund is a relatively new type of product to the Hong Kong market, and investors are less familiar with them as compared with long-only traditional funds. Proponents of this argument saw the merit in maintaining the minimum subscription at the current level.

55. In view of the experience built up in the past 3 years in the authorisation of retail hedge funds and the growing awareness of the public in hedge funds and other non-traditional investment products, the SFC believes it is an appropriate time to review the minimum subscription level for single hedge funds. However, the complexity of the investment strategies of hedge funds, their risk profiles and the overall awareness of investors are factors suggesting that a complete removal of the threshold may not be in the overall benefits of retail investors.
56. As the Hong Kong market is already one of the leading jurisdictions in opening up to retail hedge funds, there are very few examples in other leading finance centres that we can draw a direct comparison on the appropriate level for the minimum subscription threshold. We have therefore considered information from the industry. Market sources reveal that it is rather common to see a minimum subscription amount of US\$25,000 to 35,000 for private single hedge funds. Minimum subscription amount in some cases can help hedge fund managers and their distribution agents differentiate individual investors' risk appetite.
57. Having considered the market practice and the need to maintain the threshold for product differentiation, we propose to revise downwards the minimum subscription level for single hedge funds from US\$50,000 to US\$30,000. While proposing to lower the threshold, the obligation on the management company to ensure there are sufficient safeguards against mis-selling is not lessened. Under the HF Guidelines, the management company is required to select its distribution agents for SFC-authorized hedge funds carefully and to provide sufficient training to these agents for the purpose of selling this type of products.

Prime Broker and Level of Collateralisation

58. Chapter 8.7(b)(ii) restricts the level of collateralisation of an SFC-authorized hedge fund by stating that *"the amount of assets charged to prime broker by the fund cannot exceed the fund's indebtedness to the prime broker."* The current requirement is based on a similar provision in the rules governing certain categories of funds authorised by the Irish Financial Services Regulatory Authority ("IFSRA")².
59. The SFC in its consultation conclusions paper on the HF Guidelines released in May 2002 explained that the restriction on collateralisation serves to ensure that there is proper segregation of assets, which is in line with international regulatory principles³.

² Two categories of IFSRA-authorized funds may be permitted to engage in financing and collateral arrangements with a prime broker. These are Professional Investor Funds ("PIF") and Qualifying Investor Funds ("QIF"). Pursuant to the IFSRA's existing rules in relation to prime brokers (set out in Guidance Note 2/00), a PIF and a QIF may pass assets of the fund to a prime broker, which the prime broker may pledge, lend, re-hypothecate or otherwise utilise for its own purposes provided, inter alia, that the assets so passed shall not exceed the level of the funds indebtedness to the prime broker.

³ Principle 2 of IOSCO Principles for the Regulation of Collective Investment Schemes.

60. The SFC notes that IFRSA has recently issued a public consultation paper on its hedge funds regulations that contains, among others, a proposal to revise the level of collateralisation to prime broker. IFSRA proposed that any assets charged to prime broker by a PIF should not exceed 140% of the amount of the fund's indebtedness to the prime broker. In the case of a QIF, no limit will be imposed on the level of collateralisation provided that that extent should be disclosed in the fund's offering document.
61. In view of the proposal from IFSRA, we consider it appropriate to take this opportunity to consult the public on whether there is a need to review the current restriction imposed on the collateralisation level of SFC-authorized hedge funds.

Conclusion

62. One of the key competitive advantages of hedge fund managers in a fast-moving industry is their ability to innovate and develop new product features. It is noted that hedge funds take on increasingly complex structures. In view of the pace the industry is developing, it is not expected that the Draft Revised HF Guidelines would be able to exhaustively contemplate all possible product features for hedge funds. However, the SFC maintains an open stance towards innovative product features and welcomes hedge fund managers to consult with us at the early stage of product development for clarification of the application of the HF Guidelines.
63. The proposals in the Draft Revised HF Guidelines represent the minimum standards of a retail hedge fund. We are aware that some international industry associations have already started to release specific practical guidelines on the standards of due diligence to be carried out on the selection of service providers or underlying hedge funds, risk management process and enhanced disclosure. These industry's specific guidelines may, to a certain extent, complement the application of the basic principles governing retail hedge funds in the Code. We welcome any comments from the public and the industry on the proposals made in this paper and other suggestions in relation to the regulatory framework for retail hedge funds in Hong Kong.

8.7 Hedge Funds

Foreword

The following criteria apply to collective investment schemes that are commonly known as hedge funds (or alternative investment funds or absolute return funds). Hedge funds are generally regarded as non-traditional funds that possess different characteristics and utilize different investment strategies from traditional funds. In considering an application for authorization, the Commission will, among other things, consider the following:

- (i) the choice of asset class; and*
- (ii) the use of alternative investment strategies such as long/short exposures, leverage, and/or hedging and arbitrage techniques.*

Due to the wide array of schemes that may fall under this category, the Commission will exercise its discretion in imposing additional conditions to each scheme on a case-by-case basis as appropriate.

Where a scheme invests all its non-cash assets in other hedge funds, it may be authorized as a fund of hedge funds (FoHFs).

Where a scheme has a capital guarantee feature, it may be authorized as a capital guaranteed hedge fund. In this case, provisions of Chapters 8.5 and 8.7 may apply to the scheme where relevant, depending on the nature of the scheme.

Unless otherwise specified, the provisions in other Chapters of the Code shall apply. Where the provisions refer to the scheme, this means the applicant scheme.

The Management Company

- (a) The management company of a scheme must satisfy the requirements set out in Chapter 5 unless otherwise specified in this Chapter. ~~Apart from the requirements of Chapter 5,~~ For the avoidance of doubt, the Commission ~~, when assessing the acceptability~~ suitability of the management company, will consider, among others, the, the following factors when assessing the acceptability of the management company:*
 - (i) The management company must have the requisite competence, expertise and appropriate risk management and internal controls systems. It must also be adequately and suitably staffed in order to properly manage the risks and operational issues in connection with its hedge funds business;*

~~(ii)~~ the experience of the key investment personnel of the management company and ~~or~~ those of the investment adviser (where the latter has been delegated the investment management function) in managing hedge funds;

Note: *The key personnel of the management company of either a single hedge fund¹ or a FoHFs must be dedicated full-time staff with a demonstrable track record in the management of hedge funds.*

The Commission will take into account various factors in assessing the acceptability of the key personnel for a scheme. These factors may vary from a single hedge fund to a FoHFs having regard to the different strategies and operational differences of these funds.

There must be at least two key personnel in the management company each having at least 5 years' relevant experience. The management company must demonstrate that out of these 5 years' relevant experience, the two key personnel must each have at least 2 years' specific experience:

(a) In the case of a single hedge fund manager, ~~There should be at least two key personnel, investment executives, each with five years' general experience in hedge fund strategies including at least~~ the Commission will normally consider it acceptable if each of the two key personnel has at least two years' specific investment management experience in the same strategy as that of the scheme.

(b) In the case of a FoHFs manager, ~~Notwithstanding the above, its two key personnel of a FoHFs manager must should each possess five years' general experience in hedge fund strategies including at least~~ the Commission will normally consider it acceptable if each of the two key personnel has at least two years' specific investment management experience as a FoHFs manager.

A key personnel may satisfy this 5 years' relevant experience by a combination of both of his specific experience mentioned above and general experience relating to hedge funds. With respect to general

¹ "Single hedge fund" in the context of Chapter 8.7 means hedge funds that are not in the form of FoHFs.

experience, the Commission will normally consider the following types of experience acceptable:

- (1) proprietary trading experience in securities, derivatives or other investment instruments which are of a similar nature to those contemplated by the scheme; or
- (2) carrying out investment strategies in the context of investment management or securities dealing business in similar nature to the one contemplated for the scheme; or
- (3) prior experience in evaluating or selecting hedge funds for investment purposes.

However, general experience acquired through academic research, sales or marketing or back-office administration of hedge funds is unlikely to be considered acceptable for meeting the requirement in Chapter 8.7(a).

For the avoidance of doubt, the requirement in Chapter 5.5(a) that the key personnel must possess public funds experience does not apply to the two key personnel stated in this Note. However, the management company on a firm-wide basis must have sufficient experience in managing public funds as required by Chapter 5.5(a).

The Commission may require independent substantiation of the management experience (including public funds management experience) and track record of the key personnel, the management company and the group companies (where appropriate).

The experience requirement of the investment personnel of the underlying funds of a FoHFs is set out in the “Fund of Hedge Funds” section below.

~~(ii)~~(iii) amount of assets under management;

Note: The Commission would generally expect at least US\$100 million for the total amount of assets under management that follow hedge fund strategies. While assets under management may include proprietary funds, the Commission will generally look for experience in managing third-party funds.

~~(iii)~~(iv) the risk management profile and internal control systems of the management company; and

Note: The management company ~~should~~must have in place suitable internal controls and risk management systems commensurate with the company's business and risk profile, including a clear risk management policy and written control procedures.

It must continuously deploy such necessary resources and be vigilant to ensure that all the relevant risks in connection with the management of the scheme are properly monitored and controlled in accordance with the investment strategy of the scheme.

The management company ~~should~~must demonstrate that those representatives and agents (including for example, administrators, custodian, brokers, valuation agents) appointed by it possess sufficient know-how and experience in dealing with hedge funds.

In the case of the management of a FoHFs, the management company ~~should~~must:

(a) ~~have~~ in place a due diligence process for the selection of the underlying funds and on-going monitoring of their activities; ~~The management company should~~

(b) demonstrate its ability to assess and monitor the performance of the managers of the underlying funds, and the ability to replace the underlying funds whenever necessary to protect the interests of holders; ~~The management company should~~

(c) submit a plan to explain its due diligence and on-going monitoring processes (containing, among others, the frequency of reporting and evaluation of the underlying funds, and measures adopted by the management company to ensure investment and operational risks of the underlying funds are analysed and controlled) and include a summary of the plan in the offering document of the scheme

The management company must ensure that its risk management process is able to deal with normal and exceptional circumstances including extreme market conditions.

The management company must take all reasonable care in the selection of its distribution agents engaged in the selling of hedge funds and provide all necessary information and training to these agents for the purpose of selling the scheme.

~~(iv)~~(v) the investment management operations of the scheme must be based in a jurisdiction with an inspection regime acceptable to the Commission.

Note: Whilst reference would be made to the list of acceptable inspection regimes set out in Appendix A2, it is noted that the regulation of offshore hedge funds vs. onshore funds may be different in some jurisdictions. The acceptability of an inspection regime for a scheme may need to be considered on a case-by-case basis.

Prime Broker

- (b) Where a scheme appoints a prime broker, the following shall apply:
- (i) the prime broker must be a substantial financial institution subject to prudential regulatory supervision;
 - (ii) where assets of the scheme are charged to the prime broker for financing purpose, such assets ~~should~~must not, at any time, exceed the level of the scheme's indebtedness to the prime broker;
 - (iii) the assets charged to the prime broker must remain in a segregated custody account, in the name or held to the order of the trustee/custodian; and
 - (iv) the scheme's offering document ~~should~~must disclose the profile of the prime broker and its relationship with the scheme.

Note: Before appointing a prime broker, the management company must conduct a thorough due diligence on its suitability and competence.

Apart from disclosing the profile of the prime broker, the offering document must disclose the role(s) and contracted obligations of the prime broker in relation to the hedge fund and its assets, its experience in prime brokerage, areas of potential or actual conflicts of interest (whether in its role as a prime broker or other corollary capacities) vis-à-vis the scheme.

Where assets may be pledged to the prime broker, the management company must disclose in the offering document the maximum amount of borrowings available to the scheme by the prime broker (where practicable) and the risks and circumstances in which the assets may be foreclosed by the

prime broker and the consequential impact to the fund and its investors.

Minimum Subscription

- (c) The minimum level of initial subscription by each investor in a scheme must not be less than US\$50,000*, except for FoHFs, where the minimum initial subscription must not be less than US\$10,000*. No minimum subscription level will apply to a scheme which provides at least 100% capital guarantee.

(or the currency equivalent*

Limited Liability

- (d) The liability of holders must be limited to their investment in the scheme and this ~~should~~must be clearly stated in the offering document.

Note: According to the basic principles in Chapter 8.7(d), the scheme must not invest in unlimited liability vehicles and this also applies to investments made by a FoHFs in its underlying funds.

- (e) Where the scheme is a sub-fund of an umbrella fund, the scheme will be required to demonstrate to the Commission that there are legally enforceable provisions to ring-fence the scheme assets from the liabilities of other sub-funds. Disclosure of such ring-fencing arrangement must be made in the offering document.

Note: The Commission may require an independent legal opinion or regulatory confirmation regarding the enforceability of the ring-fencing provisions.

Investment and Borrowing Restrictions

- (f) The scheme ~~should~~must have a set of clearly defined investment and borrowing parameters in its constitutive and offering documents. The offering document ~~should~~must clearly explain the types of financial instruments in which the scheme will invest; the extent of diversification or concentration of investments or strategies; the extent and basis of leverage (including the maximum level of leverage); and the related risk implications of the investment and borrowing parameters.
- (g) The core requirements in Chapter 7 will not apply except for 7.12, 7.13², 7.14, 7.17, 7.18 (only applicable to FoHFs), 7.22 and 7.23.

² For the avoidance of doubt, Chapter 7.13 is relevant only to single hedge funds. Accordingly, FoHFs need only comply with Chapter 8.7(k)(iii).

Name of Scheme

- (h) If the name of the scheme indicates a particular objective, geographic region or market, the scheme ~~should~~must utilize at least 70% of its non-cash assets for the purposes of pursuing the objective or geographic region or market.

Performance Fees

- (i) If a performance fee is levied, the scheme must comply with Chapter 6.17. Full and clear disclosure of the calculation methodology ~~should~~must be set out in its offering document.

Chapter 6.17 does not apply to the underlying funds of a FoHFs. For FoHFs, the offering document of the scheme must disclose whether a performance fee is levied at both the scheme level and the underlying funds level. It ~~should~~must also summarize the bases of how performance fees are calculated and paid by the underlying funds. Appropriate warnings must be made in the offering document about the possibility of charging performance fees at various levels within a FoHFs and the implications to investors.-

Note: ~~The Commission may require illustrative examples to be given in the offering document to demonstrate the charging method where this is considered appropriate.~~

The Commission notes that various methodologies may be used for the charging and accrual of performance fees based on the basic principle in Chapter 6.17.

The Commission may require illustrative examples to be given in the offering document to demonstrate the charging method where it considers appropriate.

Where a scheme intends to achieve equalisation for the calculation of performance fees, its offering document must disclose the mechanisms adopted to achieve equalisation.

Where the scheme does not intend to achieve equalisation of performance fees, its offering document must clearly disclose this fact and any possible financial implications in the absence of equalisation in the calculation of performance fees.

Fund of Hedge Funds

8.1. *The following provisions apply to FoHFs in lieu of the provisions of Chapter*

- (j) The FoHFs ~~should~~must comply with the following:

- (i) a FoHFs must invest in at least five underlying funds, and not more than 30% of its total net asset value may be invested in any one underlying fund; and

Note: One of the underlying assumptions of a FoHFs is that it can achieve diversification through investing in a range of funds that employ different investment strategies and/or utilise the skills of different fund managers.

A FoHFs authorised pursuant to the Code is expected to achieve investment return through the performance of its underlying funds rather than direct investments in securities, futures, options, derivatives, currency or other investments through proprietary trading or “managed accounts”. It is therefore generally not acceptable for a FoHF to carry out proprietary trading directly or through the use of “managed accounts”.

- (ii) a FoHFs may not invest in another FoHFs.

~~*Note: One of the underlying assumptions of a FoHFs is that it can achieve diversification through investing in a range of funds that employ different investment strategies and/or utilise the skills of different fund managers. Any scheme applying for authorization as a FoHFs should clearly explain its diversification strategy in the offering document.*~~

- (k) The management company of the FoHFs ~~should~~must ensure that:

- (i) each of the key personnel of the management company of an underlying fund possesses at least two years’ experience in the relevant hedge fund investment strategy, provided however that up to 10% of the net asset value of the FoHFs may comprise of underlying funds managed by investment personnel with less experience;
- (ii) there is an independent trustee/custodian to safe keep the assets of the underlying funds;
- (iii) where a FoHFs invests in underlying funds managed by the same management company or its connected persons, all initial charges on such underlying funds are waived;
- (iv) neither the management company of the FoHFs nor its connected persons retain a rebate (whether in cash or in kind) on any fees or charges levied by such underlying funds, their management company or any of their connected persons;

- (v) the offering document of the FoHFs clearly discloses the aggregate amount or give an indicative range of all the fees and charges of the FoHFs and each of its underlying funds; and
- (vi) where the FoHFs invests in hedge funds not authorized by the SFC, such fact is disclosed in the offering document of the FoHFs. A warning ~~should~~must be included to the effect that some or all of the underlying funds of the FoHFs and their fund managers are not subject to the regulation of the Commission and that such funds may not be subject to rules similar to those of the Commission that are designed to protect investors.

Dealing

- (l) There must be at least one regular dealing day per month.
- (m) The maximum interval between the lodgement of a properly documented redemption request for redemption of units/shares (whether a notice period is required or not) and the payment of redemption money to the holder may not exceed 90 calendar days.

Note: A scheme may only effect redemption in specie with the prior consent of individual redeeming holder. The offering document must disclose the possibility of redemption in specie and the need to obtain prior consent from individual holder for making such redemption.

A scheme may not effect compulsory redemption except in the case where the continuous holding of the scheme's interest by a particular holder will cause the scheme to be in breach of any laws or regulations governing the scheme or resulting in adverse financial consequences to the scheme such as tax penalties. Subject to the foregoing, the offering document must disclose the circumstances under which compulsory redemption may be effected and the length of notice for such redemption.

- (n) The offering document of the scheme ~~should~~must include a warning to the effect that the redemption price may be affected by the fluctuations in value of the underlying investments during the period between the lodgement of the redemption request and the date when the redemption price is calculated.

Valuation

- (o) The investments of the scheme ~~should~~must be independently and fairly valued on a regular basis in accordance with generally accepted accounting principles and industry's best practices, applied on a consistent basis.

Note: It is incumbent upon the management company to demonstrate that the scheme will be independently and fairly valued.

Where the valuation agent is connected to the management company as a member within a group of companies, the Commission may consider whether the management company is able to demonstrate that the valuation agent is sufficiently independent having regard to the specific circumstances under which the parties are related and the compliance with the following conditions:

- (a) the valuation agent and the management company must be separate legal entities and neither of them is a subsidiary of the other, or has common directorship with each other;
- (b) there are adequate safeguarding measures for the valuation to be carried out independently;
- (c) the selection of the valuation agent by the management company is based on due process; and
- (d) disclosure is made of the selection criteria of the valuation agent and the relationship between the management company, its group of companies and the valuation agent.

- (p) Full particulars of the valuation frequency, the valuation methods of the scheme's investments, ~~and~~ the identity and qualifications of the valuation agent(s), the experience of the valuation agent(s) in evaluating hedge fund assets and the relationship of the agent(s) with the scheme's management company or its group of companies and, where applicable, with the prime broker must be disclosed in the offering document.
- (q) The offering document of the scheme ~~should~~must include a warning to the effect that some of the underlying investments of the scheme may not be actively traded and there may be uncertainties involved in the valuation of such investments. Potential investors ~~should be~~must be warned that under such circumstances, the net asset value of the scheme may be adversely affected.

Disclosure

- (r) The front cover of the offering document must display prominently the following warning statements:
 - (i) the scheme uses alternative investment strategies and the risks inherent in the scheme are not typically encountered in traditional funds;
 - (ii) the scheme undertakes special risks which may lead to substantial or total loss of investment and is not suitable for investors who cannot afford to take on such risks;

- (iii) investors are advised to consider their own financial circumstances and the suitability of the scheme as part of their investment portfolio; and
- (iv) investors are advised to read this offering document and should obtain professional advice before subscribing to the scheme.

Note: The text of the warning statements may be varied but the message ~~should~~must be clear and not disguised.

- (s) For the purpose of Chapter 6.1, the offering document ~~should~~must disclose all relevant matters relating to the investment operations and risk management aspects of the scheme and give lucid explanations of the investment strategy of the scheme and the risks inherent in the scheme.

Note: For example, explanations should be given on the nature of the scheme; the markets covered; the instruments used; the risk and reward characteristics of the strategy; the circumstances under which the scheme would work best and the circumstances hostile to the performance of the scheme; the risk management and internal control mechanism, including the setting of investment and borrowing parameters to control the risks; the terms of the offering; the on-going monitoring of the scheme's investment and asset allocation process and the performance of the scheme; the on-going monitoring of the standards of the services provided by key service providers, for example, prime brokers and administrators and the replacement process of these service providers and the responsibilities of each of the relevant parties.

The offering document should be written in plain language. The Commission specifically encourages the use of a glossary to explain technical terms.

Details of unauthorized funds must not be shown in the offering document. Where names of such funds are mentioned, these must be clearly marked as unauthorized and not available to Hong Kong residents.

- (t) A scheme must also disclose measures undertaken to reduce or mitigate potential conflicts of interest arising out of the key operational aspects of the scheme.

Note: The offering document must clearly identify the operational aspects and commercial arrangements entered into with various parties involved in the management and administration of the scheme including the management company, its agents,

the prime broker (where applicable) and other key service providers to the scheme. It must also identify possible areas of conflicts in relation to these relationships and measures adopted or proposed to be adopted for reduction or mitigation of such of these conflicts.

~~(t)~~(u) All advertisements must prominently display the warning statements referred to in 8.7(r) above.

Application Form

~~(u)~~(v) All application forms of the scheme ~~should~~must state prominently that the scheme is a hedge fund and there are special risks involved with investment in the scheme, and direct investors to read the offering document.

Financial Reports

~~(v)~~(w) The management company must issue regular reports to holders on the scheme activities at least on a quarterly basis. Reports ~~should~~must be prepared and distributed in accordance with the Guidelines on Hedge Funds Reporting Requirements [see Appendix H].