Report of the Survey on Hedge Funds Managed by SFC Licensed Managers

(for the Period 31 March 2004 – 31 March 2006)

The Securities and Futures Commission
Hong Kong
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Table of contents

		Page
1.	Executive summary	2
2.	Background	6
3.	Survey methodology and responses	7
4.	Findings	10
	Part A: General observations	10
	Part B: Analysis of top three hedge funds	14
5.	Recent development in the hedge fund industry	19
6.	Final note	22

1. Executive summary

Introduction

The Securities and Futures Commission (SFC) recognises the growing importance of hedge funds. In light of the increased hedge fund activities in Hong Kong, the SFC conducted its first fact-finding survey amongst our licensed corporations whose business involved the management of and/or provision of advisory services to hedge funds (the Survey) in June 2006. The purpose of the Survey is to keep the SFC abreast of the hedge fund activities carried out by the SFC licensees in Hong Kong. This report summarizes our major findings.

Definition

There is no formal definition of the term "hedge funds". For the purpose of this Survey, funds that use alternative investment strategies, pursue absolute returns, charge performance-based fees in addition to a management fee, and have investment mandates that give managers more flexibility to shift strategies are generally regarded as hedge funds.

For the purpose of this Survey, the term "hedge fund managers" include those fund managers that manage hedge fund assets as well as those that advise hedge funds. Also the term "assets under management" (AUM) refers to the value of assets managed and/or advised by such hedge fund managers. Similarly, the term "hedge fund management" refers to the management of and/or provision of advisory services to hedge funds.

The Survey

The Survey questionnaire is divided into two parts. Part A collects general information, such as the AUM, company profile, etc., about the hedge fund managers. Part B collects detailed information, such as the structure, investment strategies, investment geography, portfolio composition, leverage, etc., about the three largest hedge funds (determined by reference to their respective net asset value (NAV)) that were managed by each hedge fund manager as at 31 March 2006.

The SFC sent Survey questionnaires to 197 licensed corporations that, based on market information, managed or advised hedge funds as at 31 March 2006. A total of 186 responses (representing a response rate of 94%) were received, of which 118 respondents confirmed that they engaged in managing and/or giving advice to hedge funds as at that date. They in total managed and/or advised 296 hedge funds.

Scope of the Survey

The Survey results only represented a snapshot position of the hedge fund industry as at 31 March 2006 and this could change rapidly as hedge funds are mobile in their capital distribution and hedge fund managers are flexible in shifting investment strategies.

While the Survey results could provide useful information on the general state of affairs of the hedge fund industry operated by our hedge fund managers, it should be noted that the Survey did not cover hedge funds managed overseas but investing in Hong Kong.

Readers of this report are therefore advised to take note of the above in analyzing the Survey results.

Major findings

Hedge fund industry has been growing significantly in Hong Kong over the past few years

- Significant growth in the number of hedge fund managers and hedge funds and the aggregate AUM during the period from 31 March 2004 to 31 March 2006 (hereinafter refer to as "the period") was noted. As at 31 March 2006, the aggregate AUM of the respondents amounted to US$33.5 billion, representing an increase of 268% over the period.

- The number of larger hedge fund managers increased. 46% of the respondents had an AUM of over US$100 million as at 31 March 2006, compared to 34% as at 31 March 2004.

- The average number of hedge funds managed by each respondent increased by 30% from 2.0 to 2.6 over the period. At the same time, the average AUM per respondent increased by 84% from US$163.0 million to US$299.3 million.

- Our market embraced both international and local hedge fund managers. Among the top 20 hedge fund managers (determined by reference to their respective AUM) as at 31 March 2006, 13 of them (accounting for 72% of the AUM of the top 20 hedge fund managers) were affiliates of hedge fund managers from the US, the UK and Japan, while the rest were local set-ups.

A generally simple investment strategy and relatively low leverage was adopted by hedge funds

The following observations are related to the top three hedge funds (determined by reference to their respective NAV) managed by the respondents as at 31 March 2006. A total of 201 hedge funds were reported.

- With regard to investment strategies, 34% of the hedge funds reported by the respondents adopted equities long/short strategy, followed by multi-strategies (25%) and fund of hedge funds (20%). For the funds that were using multi-strategies, equities long/short predominated.

- Equities were the major asset component in the hedge funds reported, which in aggregate accounted for 53% of total NAV of the hedge funds. Bonds were the second major investment category, followed by investments in other hedge funds, derivatives/structured products, etc.

- US$24.0 billion of the total NAV of the hedge funds reported was invested in Asia Pacific markets as at 31 March 2006, in which US$4.1 billion was invested in Hong Kong.

- 40% of the hedge funds reported by the respondents did not use any leverage as at 31 March 2006. Among those which used leverage, majority of them had a leverage of less than 200% of NAV.

Institutional investors formed the bulk of the client base of the hedge funds reported and performance varied among hedge funds

- Most of the hedge funds reported that they served and/or targeted institutional investors. They were not widely distributed through external distributors. For example, 74% of the hedge funds reported did not have external distributors. This finding reflected that hedge funds were not common among retail investors. It was further evidenced by the smaller size of the retail hedge funds in Hong Kong (the total net asset size of the 13 retail hedge funds authorized by the SFC was US$1.15 billion as at the end of March 2006).

- Performance varied. 20% of the hedge funds reported an annualized return of more than 20% over the period whereas 16% recorded a loss during the same period.

Regulatory approach

Direct regulation over hedge funds is not practical, if not impossible. This is because many of the hedge funds are domiciled overseas. The SFC therefore does not seek to register, license or authorize private hedge funds. Furthermore, a mandatory disclosure regime is not practicable as overseas domiciled hedge funds may not have representation in Hong Kong. However, these funds are not unregulated. Hedge funds that are using the Hong Kong platform are still subject to the law against fraud, insider dealing and market misconduct.

While private hedge funds are not authorized, hedge funds offered to the public are. With respect to licensing requirements, all hedge fund managers who operate in Hong Kong are required to be licensed regardless of whether the related fund is privately or publicly offered. The regulatory fabric is set out below:

- Licensing of hedge fund managers – A hedge fund manager performing asset management/advisory activities in Hong Kong, like any other fund managers or investment advisers, is required to be licensed by the SFC. In this regard, the fund manager should demonstrate that, among other things, it has expertise, financial resources, proper internal controls and risk management systems in order to be licensed. In October 2004, the SFC designated a focus team to handle hedge fund managers' licence applications and to answer enquiries from prospective applicants. Since the establishment of the team, we have processed 54 licence applications from hedge fund managers up to 30 June 2006, of which 44 were approved or approved in principle.

- Supervision of intermediaries – The SFC performed a round of theme inspections on a sampling of hedge fund managers in 2005 to review their infrastructure and corporate governance, investment strategies, risk controls, leverage, valuation of investments, resolution of conflicts of interest, etc. We also met with some prime brokers to discuss their risk management controls over hedge funds. Certain issues related to conflicts of interest, valuation of illiquid and exotic/tailor-made financial products, etc. were noted. These issues are by no means unique to Hong Kong. We will continue to monitor international developments in considering our regulatory response to these issues.

- Product authorization for hedge funds offered to the public – Hong Kong is one of the first few jurisdictions in the world to allow the sale of hedge funds to the public. The SFC introduced the Hedge Fund Guidelines in May 2002, which were revised in September 2005, to facilitate product innovation and investor access to a wider range of investment choices. As at the end of March 2006, there were 13 retail hedge funds authorized by the SFC with a total net asset size of US$1.15 billion. The net asset size was over seven times of that as at the end of December 2002, when the Hedge Fund Guidelines were first issued.

The findings of the Survey will be considered in future policy formulation regarding monitoring of the hedge fund industry by the SFC. We are however mindful that we cannot work on our own to tackle cross border hedge fund issues. To that end, we have been maintaining close dialogue with overseas regulators in respect of hedge fund activities. We have also been participating actively in the discussions of the Task Force of the International Organization of Securities Commissions (IOSCO) on hedge fund related issues. Furthermore, the SFC has also been working closely with leading industry bodies to develop the local hedge fund market and to safeguard investor interests, market integrity and the reputation of Hong Kong's financial market.

2. Background

It was estimated that currently there were about 8,800 hedge funds worldwide, with about US$1.2 trillion of assets[1]. According to market source, there were about 400 Asian-focused hedge funds in 2005 with total AUM of about US$95 billion, up by 337% from 2000.

In Hong Kong, over the past few years, we have been witnessing an increasing number of participants in the hedge fund industry. Our inquiries of some of the hedge fund managers indicate that there is a trend of US/European hedge fund houses seeking ways to set up their presence in Asia. The move is largely due to the managers' desire to increase their asset allocations to the region in order to pursue their Asian focused strategies, as the US and European markets, in which hedge funds have been traditionally active, are becoming saturated.

Apart from global players, Asian home-grown hedge fund managers are also keen to kick off their business in the region. Hong Kong has consistently managed to attract a significant portion of hedge fund start-ups and inflow of funds. In addition, we also noted a trend that existing fund managers are extending their business to hedge fund management.

Against the background of increased hedge fund activities, in June 2006, the SFC conducted its first fact-finding survey amongst our hedge fund

[1] Source: Testimony of the SEC Chairman before the US Senate Committee on Banking, Housing and Urban Affairs concerning the regulation of hedge funds on 25 July 2006.

managers. The purpose of the Survey is to keep the SFC abreast of the state and the latest development of the hedge fund industry in Hong Kong. This report summarizes our major findings.

3. Survey methodology and responses

Definition of hedge funds

For the purpose of circumscribing the Survey so that traditional funds are excluded, it is necessary to define what are hedge funds. However, there is no formal definition of the term "hedge funds" and the distinction between hedge funds and other types of funds, like private equity funds, is usually quite arbitrary. Hedge funds often are characterized as funds that can take on significant leverage and employ complex trading strategies using derivatives or other new financial instruments. Private equity funds are usually not considered as hedge funds, yet they often use significant leverage in their investments. Likewise, more and more traditional asset managers are using derivatives or are investing in structured financial instruments that allow them to take on leverage or establish short positions.

For the purpose of this Survey, funds that exhibit the following characteristics are generally regarded as hedge funds:

- use of alternative investment strategies such as long/short exposures, leverage (including leverage embedded in financial instruments such as derivatives), use of derivatives for trading purpose, and/or arbitrage techniques;

- pursuit of absolute returns, rather than measuring investment performance relative to a benchmark;

- charging performance-based fees in addition to a management fee based solely on AUM; and

- having investment mandates that give managers more flexibility to shift strategies.

For the purpose of this Survey, the term "hedge fund managers" include those fund managers that manage hedge fund assets as well as those that advise on hedge funds. Also the term AUM refers to the value of assets managed and/or advised by such hedge fund managers. Similarly, the term "hedge fund management" refers to the management of and/or provision of advisory services to hedge funds.

Survey design

The Survey's objects are fund managers who, based on market information, managed or advised hedge funds as at 31 March 2006. The Survey questionnaire is divided into two parts. Part A collects general information such as the AUM, company profile, etc., about the hedge fund managers. Part B collects detailed information, such as the structure, investment strategies, investment geography, portfolio composition, leverage, etc., about the three largest hedge funds (determined by reference to their respective NAV) that are managed by each hedge fund manager as at 31 March 2006. For the purpose of identifying the three largest hedge funds, the hedge fund managers are asked to consider each hedge fund at sub-fund level if the hedge fund managed is an umbrella fund.

Most information and data are collected at the snapshot of 31 March 2006, and some data also at the snapshots of 31 March 2004 and 2005 for comparison and trend analysis purposes.

The SFC staff also followed up on certain incomplete information and/or clarified some information provided by the respondents during the process.

Selection basis

Based on internal licensing databases and external market information, the SFC identified 197 fund managers who to our best knowledge, managed or advised hedge funds as at 31 March 2006. Survey questionnaires were sent to these 197 hedge fund managers.

Responses

Replies were received from 186 out of the 197 hedge fund managers, representing a response rate of 94%. Out of these 186 respondents,

- 118 (63%) confirmed that they engaged in managing the assets of and/or giving advice to hedge funds as at 31 March 2006;

- 4 (2%) reported that they were at a start-up stage; and

- the remaining 64 (35%) confirmed that they did not manage and/or advise any hedge funds as at 31 March 2006.

Scope of the Survey

The Survey results only represent a snapshot position of the hedge fund industry as at 31 March 2006. This could change rapidly as hedge funds are mobile in their capital distribution and hedge fund managers are flexible in shifting investment strategies.

While the Survey results could provide useful information on the general state of affairs of the hedge fund industry operated by our hedge fund managers, it should be noted that the Survey did not cover hedge funds managed overseas but investing in Hong Kong.

Readers of this report are therefore advised to take note of the above in analyzing the Survey results.

4. Findings

Part A of the findings relates to some general observations on the hedge fund managers that responded to the Survey as engaging in hedge fund management as at 31 March 2006, whereas Part B relates to findings on the top three hedge funds as reported by each of these hedge fund managers.

PART A: GENERAL OBSERVATIONS

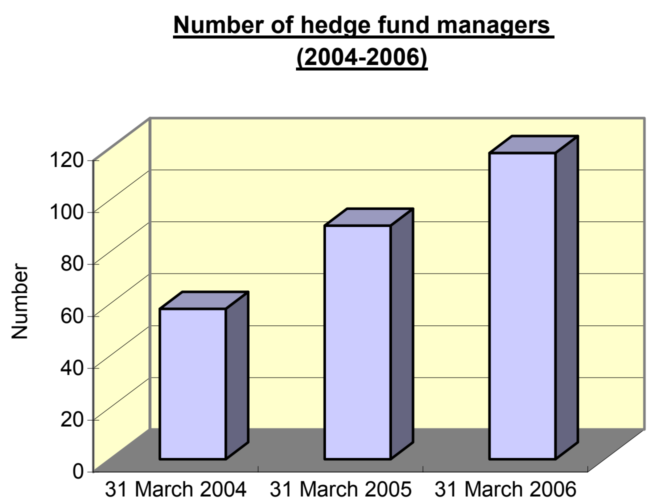
The following summarized our general observations on the 118 hedge fund managers as at 31 March 2006.

Number of hedge fund managers

Number of hedge fund managers increased dramatically

The number of hedge fund managers increased dramatically over the period. As shown in the graph, the number of hedge fund managers literally doubled over the period from March 2004 (58 hedge fund managers) to March 2006 (118 hedge fund managers).

Increasingly, both local and overseas large hedge fund managers are starting up their hedge fund businesses in Hong Kong. Overseas hedge fund managers, especially the larger ones, prefer to set up in Hong Kong as an extension of their business to Asia. Reasons cited by market practitioners include proximity to China and North Asia, larger pool of talents and highly trained professionals, efficient financial and social infrastructure, fair and robust regulatory regime and low and simple tax regime.

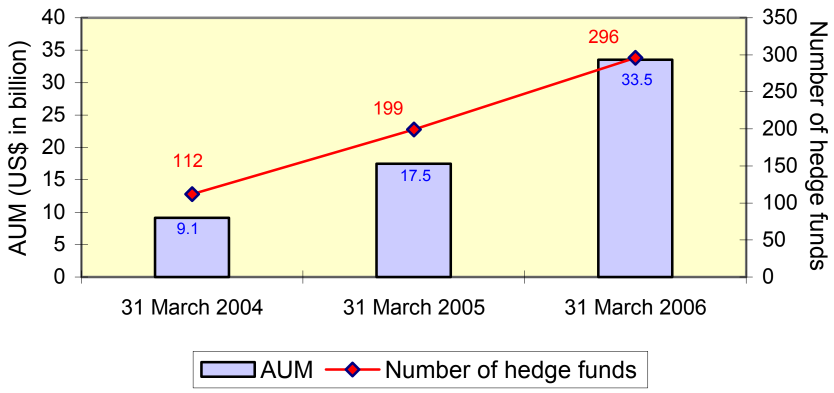


Analysis on AUM and number of hedge funds

Hedge funds reported by respondents grew significantly both in terms of AUM and number of funds

Total AUM reported by the respondents grew a remarkable 268% to US$33.5 billion over the period (US$9.1 billion in March 2004). The total number of hedge funds managed in Hong Kong also surged by 164% from 112 to 296 during the period.

Analysis of total AUM and number of hedge funds (2004-2006)



Hong Kong's success in attracting inflow of funds was also evidenced by figures compiled by a market data collection agency[2].

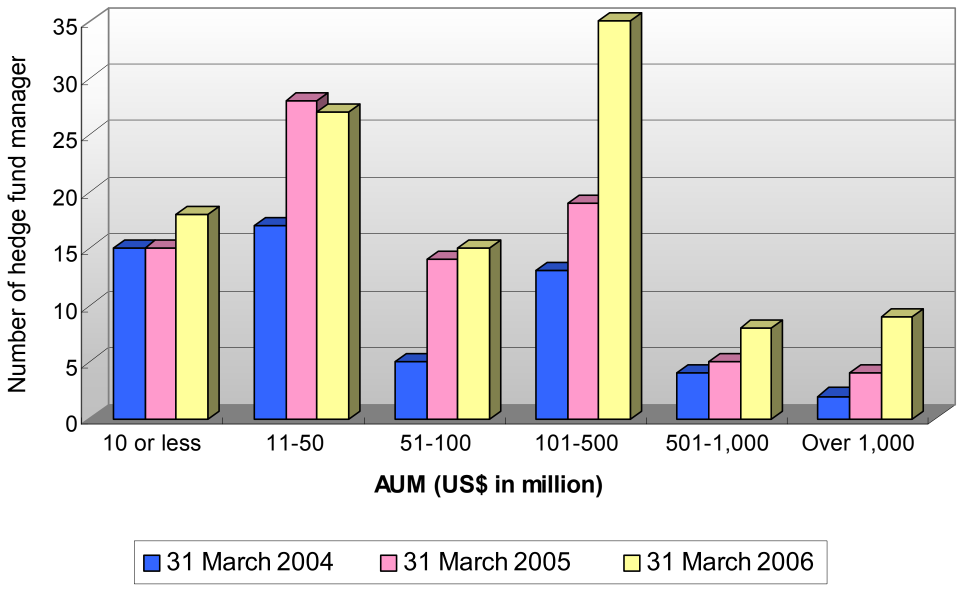
More large hedge fund managers

The hedge fund managers varied in size. While some of the hedge fund managers had an AUM of less than US$10 million, there were large ones with AUM over US$1 billion as at 31 March 2006.

The following bar chart depicts the distribution of the AUM of the respondents over the period. The number of larger hedge fund managers increased. 46% of the respondents had an AUM of over US$100 million as at 31 March 2006, compared to 34% as at 31 March 2004.

[2] According to AsiaHedge, Hong Kong had the largest number of new Asian hedge funds within Asia in 2005, followed by Australia, Singapore and Japan. In respect of the aggregate asset size of these start-ups, Hong Kong also came first, followed by Japan, Australia and Singapore.

AUM per individual hedge fund manager (2004-2006)



Average number of hedge funds managed by respondents and their average AUM

The average number of hedge funds managed by each respondent increased by 30% from 2.0 to 2.6 over the period. At the same time, the average AUM per respondent also increased by 84% from US$163.0 million to US$299.3 million.

	Average number of hedge funds per respondent	Average AUM per respondent (US$ million)
31 March 2006	2.6	299.3
31 March 2005	2.3	205.5
31 March 2004	2.0	163.0

Background of the hedge fund managers

Our market embraced both international and local hedge fund managers

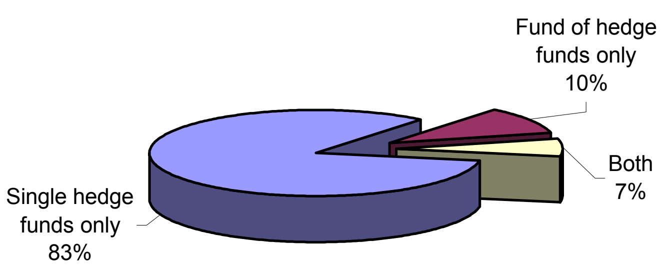
While some hedge fund managers were set up locally, many were the Hong Kong offices of the US and the UK hedge fund groups. Among the top 20 hedge fund managers (determined by reference to their respective AUM) as at 31 March 2006, 13 of them (accounting for 72% of the AUM of the top 20 hedge fund managers) were affiliates of hedge fund managers from the US, the UK and Japan, while the rest were local set-ups.

Types of hedge funds

Majority of the respondents managed only single hedge funds

Majority, being 98 out of 118 (83%), of the respondents indicated that they managed only single hedge funds. 12 (10%) respondents managed fund of hedge funds while the remaining 8 (7%) indicated they did both. The following pie chart depicts the types of hedge funds managed by the respondents.

Types of hedge funds managed

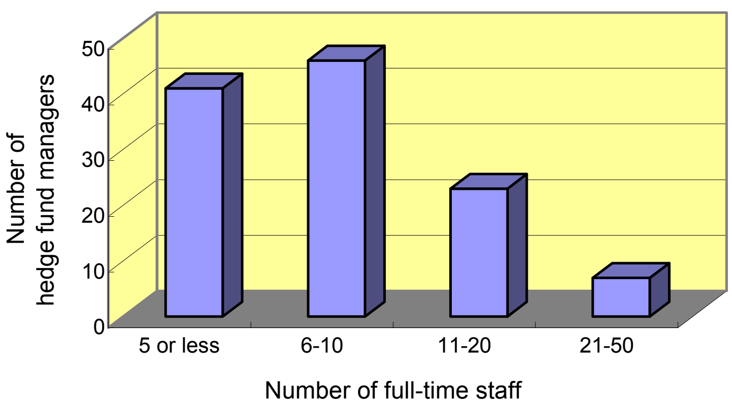


Profile of staff

Various firm size

Total number of full time staff reported by the respondents was 1,053 as at 31 March 2006. 74% of the respondents reported that they had 10 or less staff responsible for various key functions in relation to the operation of hedge funds. On the other hand, about 6% of the respondents had over 20 staff to support their hedge fund business.

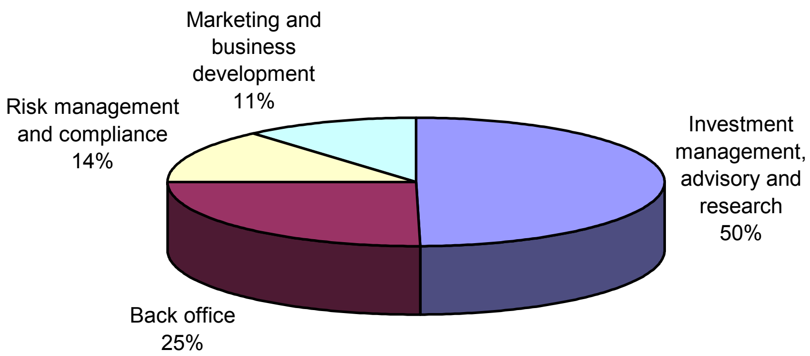
Number of full-time staff engaged in hedge fund activities



Most staff involved in investment management, advisory and research functions

Half of the staff of the respondents were involved in investment management, advisory and research functions, followed by 25% in back office functions, such as settlement, accounting, etc. The rest were mainly involved in risk management and compliance, and marketing and business development.

Percentage of staff by function



PART B: ANALYSIS OF TOP THREE HEDGE FUNDS

Respondents to the Survey were also asked to provide the details of the top three hedge funds (determined by reference to their respective NAV) managed by them as at 31 March 2006. A total of 201 hedge funds were reported by the respondents. The following summarized our observations on these hedge funds.

Inception date

Most hedge funds reported were incepted in 2004/2005

2004 and 2005 were the two most prolific years in terms of the setting up of hedge funds by the respondents. These two years accounted for more than half of the 201 funds incepted.

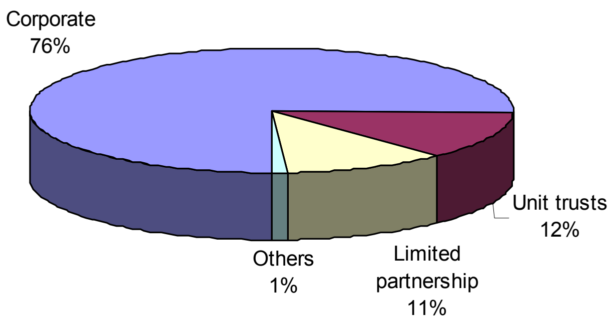
Year of inception	Number of hedge funds	As a percentage of total
2006 (up to March)	6	3%
2005	53	26%
2004	53	26%
2003	31	16%
2002	16	8%
Prior to 2002	42	21%
Total	**201**	**100%**

Fund structure and place of listing

Most hedge funds reported adopted a corporate structure

Most of the hedge funds reported by the respondents adopted a corporate structure (76%), followed by unit trusts (12%) and limited partnership (11%).

Hedge fund structure



14% of hedge funds were listed

Among the 201 hedge funds, 28 (14%) of them were listed on the exchanges, mainly the Irish Stock Exchange.

Client base and distribution channel

Institutional investors still dominated

Institutional investors have always been the support base for hedge funds. The Survey confirmed this to be the case. The total number of investors investing in the hedge funds reported was around 10,140 as at 31 March 2006, of which majority were institutional investors.

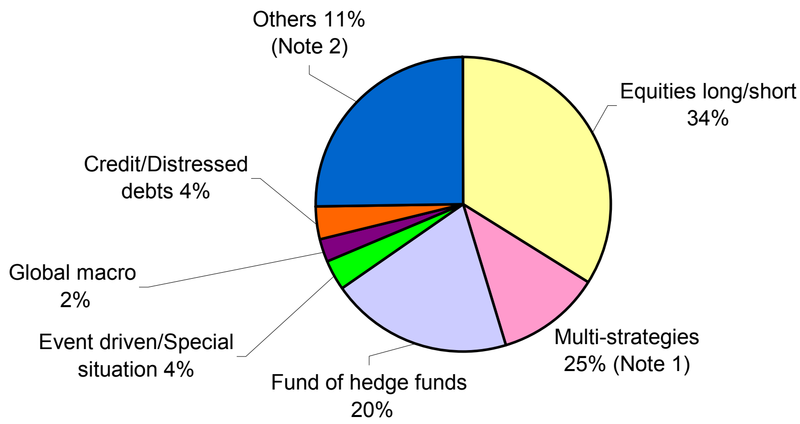
Most of the hedge funds reported (149 or 74%) did not have external distributors. The rest mainly had less than 3 external distributors. This may, to certain extent, due to the non-retail nature of most of the hedge funds reported.

Investment strategies

Equities long/short was the most popular hedge fund strategy

About one third (34%) of the hedge funds reported by the respondents engaged an investment strategy of equities long/short. This was followed by 25% of the hedge funds using multi-strategies and 20% using fund of hedge funds. The other strategies used, including event driven/special situation, global macro, credit/distressed debts, etc., would depend on the availability of opportunities. The following graph depicts the distribution of the hedge fund strategies:

Investment strategies (by number of hedge funds)



Note 1: For the purpose of our analysis, hedge funds that used more than one investment strategy and did not have a single dominant strategy were classified as multi-strategies.

Note 2: Others include fixed income arbitrage, equities market neutral, emerging markets, managed futures, etc.

For the funds that were using multi-strategies, equities long/short predominated.

The above findings were consistent with our discussion with local prime brokers who advised that the majority of hedge funds in Asia were adopting the traditional long/short strategy though there were some hedge funds adopting more complex strategies such as multi-strategies, event driven, credit/distressed debts, etc., for better investment returns.

Investment geography

Hedge funds reported invested mainly in Asia Pacific markets

Asia Pacific was most popular among the regions in which the hedge funds invested, constituting about US$24.0 billion of the total NAV of the hedge funds reported by the respondents as at 31 March 2006. Among this US$24.0 billion, US$4.1 billion was invested in the Hong Kong market.

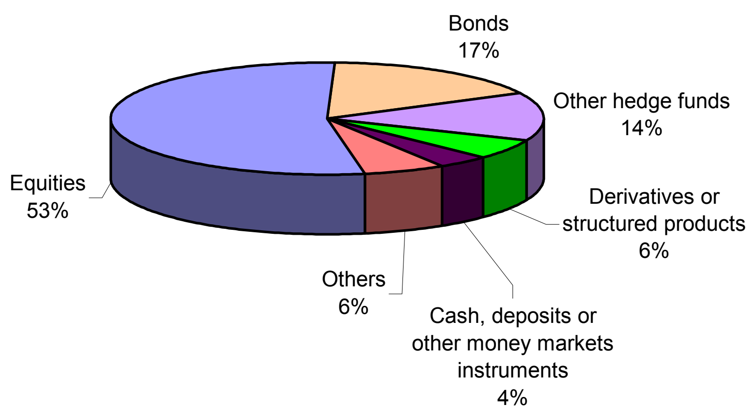
The above coincided with our understanding that many hedge fund houses were set up in Hong Kong (because of its strategic geographical location within the Asia Pacific regions) to invest in the Asia Pacific markets. However, it should be noted that the amounts did not include hedge funds managed overseas but invested in Asia Pacific (including Hong Kong) markets.

Portfolio composition

Equities were the major asset component in the hedge funds reported

The hedge funds reported by the respondents held various classes of assets as at 31 March 2006. Equities were the major component in the hedge funds reported, which in aggregate accounted for 53% of the total NAV of the top three hedge funds reported by the respondents. The other components included bonds, other hedge funds, derivatives/structured products, etc.

Portfolio composition
(as a percentage of total NAV of the hedge funds reported)



Market practitioners explained that most hedge funds in Asia were mainly investing in equity markets as there were not many options of derivatives available in Asia and the margin/collateral requirements were high.

Leverage

The level of leverage was not excessive

There was no unanimous definition of leverage. The hedge funds reported had various calculation methods for leverage. One of the more common leverage calculation methods was [(Long market value + Short market value) / NAV].

81 or 40% of the hedge funds reported did not use any leverage as at 31 March 2006. Among those hedge funds which reported to have leverage, majority (85%) of them had a leverage of less than 200% of NAV as at 31 March 2006.

Valuation

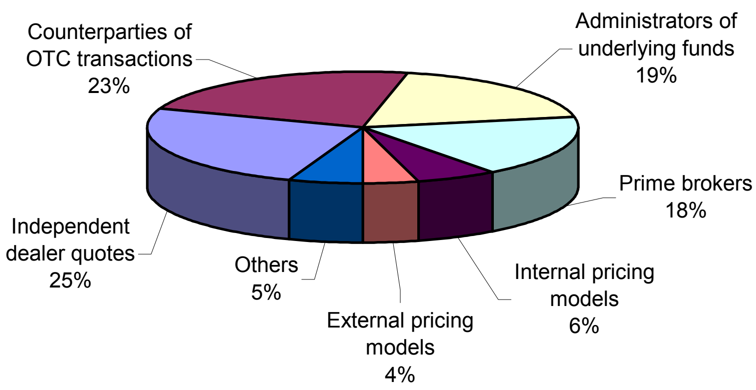
Most hedge funds reported involved the administrators/trustees in NAV calculation

Among the 201 hedge funds reported, most of them (157 or 78%) reported their NAV to investors on monthly basis. 184 (92%) of the hedge funds involved their administrators/trustees to carry out the NAV calculation.

Independent dealer quotes and counterparties of OTC transactions were the most popular price sources for valuation of unlisted instruments

Where market prices were not available, independent dealer quotes and counterparties of OTC transactions were by far the most popular price sources for valuing unlisted instruments for the purpose of computing the NAV of the hedge funds.

Price sources for unlisted instruments for valuation purpose



Annualized return

Most hedge funds reported recorded a positive return but performance varied

The annualized return of the hedge funds over the period varied (see table below). 20% of the hedge funds reported an annualized return of more than 20% over the period. However, 16% of the hedge funds recorded a loss during the same period.

Annualized return	Percentage of hedge funds
Over 50%	3%
Between 21% and 50%	17%
Between 0% and 20%	64%
Negative returns	16%
Total	**100%**

5. Recent development in the hedge fund industry

Growth in the hedge fund industry in the Asia-Pacific region has been impressive in recent years. Hong Kong, as a leading financial hub in the region, continues to attract large global players to establish a presence for their Asian focus strategies. Other than global players, Asian home-grown hedge fund managers are also keen to start up their business in Hong Kong, as well as some existing fund managers, which extend their business to the management of hedge funds.

Direct regulation over hedge funds is not practical, if not impossible. This is because many of the hedge funds are domiciled overseas. The

SFC therefore does not seek to register, license or authorize private hedge funds. Furthermore, a mandatory disclosure regime is not practicable as overseas domiciled hedge funds may not have representation in Hong Kong. However, these funds are not unregulated. Hedge funds that are using the Hong Kong platform are still subject to the law against fraud, insider dealing and market misconduct.

While private hedge funds are not authorized, hedge funds offered to the public are. With respect to licensing requirements, all hedge fund managers who operate in Hong Kong are required to be licensed regardless of whether the related fund is privately or publicly offered. The regulatory fabric is set out below:

- ***Licensing of hedge fund managers***

  Like other fund managers or investment advisers, a hedge fund manager performing asset management or advisory activities in Hong Kong is required to be licensed by the SFC. In this regard, the fund manager should demonstrate that, among other things, it has expertise, financial resources, proper internal controls and risk management systems in order to be licensed.

  In October 2004, the SFC designated a focus team to handle hedge fund managers' licence applications and to answer their enquiries. Since the establishment of the team, we have processed 54 licence applications from hedge fund managers up to 30 June 2006, of which 44 were approved or approved in principle.

- ***Supervision of intermediaries***

  On top of the SFC's regular ongoing supervision of intermediaries, the SFC performed a round of theme inspections in 2005 on a representative sampling of hedge fund managers to review their infrastructure and corporate governance, investment strategies, risk controls, leverage, valuation of investments, resolution of conflicts of interest, etc. We also held a series of in-depth discussions with selected hedge fund managers to obtain a better understanding of fund strategies, leverage levels and use of prime brokers. In addition, we discussed with some prime brokers for the purposes of assessing their exposures to hedge funds and their risk management and controls. The main issues identified were:

  a) Conflicts of interest. Hedge fund managers have been signing "side letters" with substantial investors, giving them preferential treatment over other investors without adequate disclosure.

b) Valuation of assets. Valuation of assets, especially complex, illiquid and exotic/tailor-made financial products, could be an issue.

c) Deficiencies in offering documents. Some of the terms in the offering documents of hedge funds were ambiguous.

These issues are not unique to Hong Kong. We will continue to monitor international developments in this area. The SFC has been maintaining a continuous dialogue with the regulators of other major financial markets, and investment banks, prime brokers, industry bodies/practitioners in Hong Kong to gauge the major regulatory developments, trends in the hedge fund industry and any hedge fund related regulatory issues.

- ***Hedge funds offered to the public***

Hong Kong is one of the first few jurisdictions in the world to allow the sale of hedge funds to the public. The SFC introduced the Hedge Fund Guidelines in May 2002, which were revised in September 2005, to facilitate product innovation and investor access to a wider range of investment choices. The Hedge Fund Guidelines are not applicable to hedge funds that are not offered to the public.

Given their retail nature, SFC-authorized hedge funds are required to comply with specific disclosure requirements and implement structural safeguards in accordance with the Hedge Fund Guidelines. The guidelines place emphasis on the following aspects: (a) hedge fund managers' qualifications; (b) risk management and internal controls and systems of hedge fund managers; (c) information disclosure; and (d) other structural and/or operational safeguards.

One of the regulatory approaches adopted is the "market segmentation" concept. While recognizing the public demand for broader investment choices, the SFC considers that a prudent, step-by-step introduction of new complex products to retail investors is necessary. The Hedge Fund Guidelines establish minimum subscription thresholds for different categories of hedge funds. For example, the minimum subscription threshold for single hedge funds is US$50,000, and US$10,000 for fund of hedge funds.

There were 13 retail hedge funds authorized by the SFC with a total net asset size of US$1.15 billion as at the end of March 2006. The net asset size as at the end of March 2006 was over seven times of that as at the end of December 2002, when the Hedge Fund Guidelines were first issued. The average NAV of our authorized hedge funds was about US$88 million, with the largest fund having about US$359 million.

In the context of the whole hedge fund universe in Hong Kong, the hedge funds authorized by the SFC for sale to the public would appear to be relatively small in size.

6. Final note

We believe that hedge funds are here to stay and the industry is expected to grow further. It is essential that hedge funds maintain investor confidence if the industry is to enjoy growth. We will continue to monitor hedge fund developments on both local and international fronts, including meeting regularly with major fund managers, prime brokers, administrators, custodians, and other service providers to better understand their hedge fund-related activities and risk controls.

We encourage the hedge fund industry to be more transparent and provide their investors with timely and useful information, including factors contributing to investment returns and portfolio risks. We will strive to work closely with the industry and leading industry bodies to develop the local hedge fund market and to safeguard investor interests, market integrity and the good reputation of Hong Kong's financial market.

As hedge fund activities are not restricted by national borders, cooperation with overseas regulators is of utmost importance. In line with this, we maintain close ties and organise joint initiatives on hedge fund activities with regulators of other major financial markets. In addition, the SFC has been participating actively in the discussions of the Task Force of the IOSCO on hedge fund related issues, such as formulating the good practices for the valuation of the assets of hedge funds. Such cooperation and partnership with other regulators and the industry will be key to a healthy development of the hedge fund industry in Hong Kong.