

**Consultation Conclusions on
the Offering of Hedge Funds**

Securities and Futures Commission
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Part 1 – Consultation Conclusions

Introduction

1. On 26 October 2001, the Securities and Futures Commission (the “SFC”) issued a Consultation Paper on the Offering of Hedge Funds (the “Consultation Paper”). The SFC invited the public to comment on the proposals (the “Hedge Fund Guidelines”), which were aimed at setting the standards and guidelines for the authorization of hedge funds that are offered to the public in Hong Kong.
2. The consultation period ended on 7 December 2001 but late submissions were accepted and considered. The SFC received a total of 36 submissions. Of these, one was a group submission, representing the views of 24 industry practitioners. Two respondents made a second submission after their first. A list of respondents is set out in **Annex 1**.
3. To increase the transparency of the consultation process, the SFC published the names of commentators and the content of their submissions on the SFC website, unless the respondent asked for such information to be withheld.
4. This paper summarises the results of the consultation and describes how the public comments have been taken into account in the final provisions of the Hedge Fund Guidelines. The text of the Hedge Fund Guidelines is set out in **Annex 2**. A marked up version with all the amendments from the consultation draft is also set out in **Annex 3**.
5. The Commission has approved the Hedge Fund Guidelines and these have been formally incorporated into the Code on Unit Trusts and Mutual Funds (the “UT Code”) as Chapter 8.7. The Hedge Fund Guidelines should be read in conjunction with the Consultation Paper and the UT Code. Both documents are available on the SFC website at <http://www.hksfc.org.hk>.
6. The SFC wishes to thank those who have provided their views on the proposals in the Consultation Paper.

General Comments

7. As expected in a consultation of this nature, comments varied considerably by range and depth, with some respondents focussing on the broad principles behind the proposals and others on specific questions raised in the Consultation Paper.
8. Most respondents welcomed the hedge funds initiative and some saw it as an acknowledgement by the SFC of the importance of this asset class as an investment tool.
9. An overwhelming majority of respondents supported the proposal to allow hedge funds to be marketed to the public in Hong Kong. Respondents generally

believed that the formulation of clear Hedge Fund Guidelines would facilitate market development and benefit investors by allowing them access to a broader range of products.

10. Most of the submissions focused on the ground rules for the offering of hedge funds to a wider segment of the public, rather than on whether they should be offered to the public at all.
11. On the other hand, a few respondents felt that it would be premature to offer hedge funds to non-professionals, other than pension funds, insurance companies and high net worth individuals.
12. At the extreme, one hedge fund manager argued that hedge funds were not an appropriate investment class for retail participation. He questioned whether there was genuine retail investor demand for hedge funds and whether the main driving force behind the initiative was the mutual fund industry and its partners rather than the hedge funds industry. He was also concerned that retail investor loss might jeopardize life savings and compel increased regulation of hedge funds, with additional compliance costs to institutional hedge fund managers.

Regulatory Approach

13. The SFC acknowledges that there are certain hedge fund managers who have no interest in offering their products to the public at large whilst there are others who are keen to obtain SFC authorization of their funds. The SFC believes that the industry should be in the best position to judge whether there is any commercial demand for such products.
14. The SFC is mindful of the need to facilitate market development and accommodate product innovation. In doing so, the SFC needs to strike a balance between market development and investor protection. In finalizing the Hedge Fund Guidelines, the SFC has been careful in weighing the benefits to the market as a whole and the protection offered to investors against the costs to industry practitioners. It is acknowledged that certain requirements may differ from existing industry practices and may add to the costs of practitioners. However, the SFC does not consider these as unduly burdensome. Moreover, there is a need to distinguish between existing practices for institutional/professional investors and requirements that are appropriate for retail public investments. Higher standards may be necessary in certain areas to protect the interests of retail investors.
15. The SFC recognizes that product authorization on its own may not achieve the desired level of investor protection. Regulation of the conduct of fund selling agents and investor education are two other important elements to complement the setting of product authorization criteria.
16. Aside from the conduct rules that apply to SFC registrants, the SFC intends to work with industry practitioners to develop a set of guidelines for intermediaries to provide additional guidance on the offering of hedge funds.

17. The SFC acknowledges that investor education is an important part of its functions and is working with the industry to consider strategies for better educating the public on hedge funds. The SFC envisages that educational materials on hedge funds will be released for the investing public to coincide with the authorization of these products.

Part 2 - Consultation Responses to Specific Provisions

Market Segmentation vs. Full Public Offering

18. The SFC proposed two alternative approaches in the Consultation Paper, namely:
 - (a) *a market segmentation approach*, i.e. to allow hedge funds to be offered to a specific segment of the public; and
 - (b) *a full public offering approach*, i.e. to allow hedge funds to be offered to the general public without any restrictions.

Both approaches require full disclosure to potential investors of the risks of investment and selling agents to assess whether the investment is suitable for the investor.

19. *Public Comments:* Some respondents were in favour of a full public offering approach but most opted for a segmentation approach to filter out “unsuitable” investors. Of those who favoured a segmentation approach, many agreed that a full public offering would be appropriate in the longer term. It was suggested that the SFC should adopt a prudent step-by-step approach in allowing retail participation in hedge funds.
20. *SFC’s Response:* The SFC is mindful of the need to strike a balance between market development and investor protection. The SFC recognizes the public demand for wider investment choice and yet is concerned that retail investors must be able to understand complex investment products and their inherent risks. The SFC agrees that segmentation could be a prudent, step-by-step introduction of new complex products to retail investors. As the market matures and investors’ knowledge increases, a general opening up could be considered.

Segmentation methods

21. *Public Comments:* Many of those who advocated a segmentation approach supported the use of a minimum subscription threshold and some considered that this should be used together with a net worth checklist or some qualitative requirements. Those who objected to financial hurdles (whether by means of

minimum subscription levels or minimum net worth) argued that this would have little bearing on investors' ability to understand investment in hedge funds.

22. Vastly divergent views were expressed on the appropriate minimum subscription thresholds. Many respondents proposed different thresholds for various fund categories:

- ◆ Hedge funds with a capital guarantee feature no limit / US\$6,400¹
- ◆ Fund of hedge funds (FoHFs) no limit – US\$50,000²
- ◆ Other hedge funds (depending on level of risks) no limit – US\$250,000³

23. Aside from those who favoured full public offering and hence recommended no limit to entry, other respondents who supported segmentation were generally in favour of a tiering approach. The predominant view was that FoHFs, in general terms, should warrant a lower minimum subscription threshold compared with single hedge funds. The argument was that retail investors should be able to rely on the FoHFs manager to act on their behalf to play the role of “sophisticated investors”. The general opinion was that a competent FoHFs manager would perform its due diligence in manager/strategy selection and construct a diversified portfolio of hedge funds that could help mitigate the adverse impact that investors could face in the event of individual hedge fund failures. With proper diversification, a FoHFs would remove significant “manager risk” of the underlying funds.

24. Some respondents also suggested differentiation of risks between single manager/single strategy, multi-managers/single strategy or multi-managers/multi-strategies hedge funds.

25. On the other hand, some respondents cautioned that too high a threshold for single hedge funds could stifle the development of such funds, some of which utilize simple strategies and are relatively low risk.

26. *SFC's Response:* The SFC is not in a position to assess the investment risks of hedge funds or assign risk ratings to them. Nevertheless, having regard to the reasons put forward by the respondents, the SFC generally agrees with the tiering approach and accepts that, in general, a higher threshold should be set for single hedge funds.

27. The SFC is mindful that a lower minimum subscription threshold for FoHFs may have the undesired effect of denoting FoHFs as lower risk vehicles and single hedge funds as higher risk investments when investment vehicles covering a broad risk-return spectrum may be included in both types of funds. It may not be necessarily true, in every case, that FoHFs are less risky than single hedge funds.

¹ No limit, except for one respondent (suggested HK\$50,000)

² Mostly between US\$10,000 and US\$20,000

³ Mostly between US\$50,000 to US\$100,000

28. In view of the general support for segmentation via minimum subscription thresholds, and in order to strike a balance, the SFC has adopted the following thresholds for the different categories of hedge funds:
- | | |
|--|------------|
| ◆ Hedge funds with a capital guarantee feature | no limit |
| ◆ Fund of hedge funds | US\$10,000 |
| ◆ Single hedge funds | US\$50,000 |
29. The thresholds selected represent the majority view. However, as mentioned in the Consultation Paper, the SFC notes that any threshold limit would be arbitrary. Consequently, the education of intermediaries (fund distributors) and investors in respect of hedge funds is of utmost importance. The setting of an entry threshold should not substitute or displace the education process.
30. The SFC would also consider that classification of funds into different risks categories based on their investment strategies would be difficult to administer in the absence of a clear industry definition of the term “strategy”. There is a wide range of hedge fund strategies and certain strategies would require considerable investment expertise to comprehend. On the basis of the above, the SFC has not adopted different thresholds based on investment strategy.

Foreword

31. *Public Comments:* Some respondents commented that the definition of hedge funds was unclear. It was suggested that the Hedge Fund Guidelines should explicitly describe which types of funds are intended for authorization under this category. A few respondents suggested definitions for adoption in the Hedge Funds Guidelines.

A few respondents also requested further guidance on the offering of unauthorized hedge funds, i.e. to whom unauthorized funds can be marketed.

32. *SFC's Response:* The SFC acknowledges the comments. As pointed out in the Consultation Paper, there is no universal definition for the term “hedge funds”. Hedge funds vary in their characteristics and these need to be examined on a case-by-case basis. The SFC is mindful that flexibility should be provided to accommodate funds that may be similar in substance but differ in fund features. As such, the key considerations that the SFC will have regard to in authorizing products are set out under the Hedge Funds Guidelines. Minor refinements have been made to the text to reflect common terminology of the hedge funds industry. Where the provisions refer to the “scheme”, this means the applicant scheme. Alternative investments other than hedge funds may warrant further examination and additional guidelines. In short, in authorizing hedge funds, the SFC will give due regard to the substance of a proposed application.

The offering of unauthorized funds to the public is prohibited under the current legislation. Practitioners should refer to the exemptions available under the legislation if they wish to offer unauthorized hedge funds.

Entry Requirements for Management Company

33. There is tremendous support for the Hedge Fund Guidelines to set sufficiently high standards to ensure suitability of the fund manager. There is little dispute on the requirements for suitable internal controls and risk management systems and for the fund to be managed in an acceptable inspection regime. There is, however, a very substantial number of comments on the proposed requirements that a fund manager has US\$100m AUM and five years experience as detailed below.

Assets under management

34. Public Comments: Many respondents were unclear whether the AUM threshold applied to a single fund or the total combined assets under management by the firm, and whether the AUM referred to general assets under management or only hedge fund assets managed under a particular strategy. In addition, clarification was sought whether proprietary funds would be counted in the AUM.
35. Support for the AUM requirement was divided. Some respondents were in favour of an AUM threshold and two would even like to see the AUM threshold further increased. On the other hand, others felt that the AUM requirement might be counter-productive. They felt that hedge funds are a product of skill and not size and AUM might not be a suitable measure of experience and integrity. Moreover, it bore little correlation to the risk and return profile of the product. In addition, some said that an excessively high AUM might discourage the development of local talents and expertise in establishing hedge funds.
36. One respondent considered that an AUM requirement based on hedge funds under management was prohibitive for fund companies who had only traditional assets under management. Another respondent was concerned that investors might be “fooled” by traditional long-only managers disguising as hedge fund managers.
37. SFC's Response: The SFC would like to clarify that the AUM requirement is not the sole criterion for determining the eligibility of hedge fund managers. Minimum AUM is in addition to the experience and other qualifying requirements.
38. The SFC considers that the management company should have sufficient resources, including human and technical support, at its disposal in order to maintain the necessary infrastructure for the management of public funds. The SFC has no intention of discriminating against small players. The concern with small fund companies is that they may not have adequate resources or the experience to deal with issues relating to managing a public fund, and investors dealing with them may therefore face greater risks. However, smaller hedge funds should be allowed to grow, and in fact would be able to do so, by making themselves available for investment by FoHFs managers. The managers of

these smaller hedge funds can then be relieved from having to deal directly with retail investors, thus avoiding issues such as providing liquidity for redemption and distribution matters etc., and be in a position to concentrate on the management of the fund.

39. The SFC therefore takes the view that it is necessary to maintain the US\$100m AUM requirement for management companies of hedge funds (both single fund and FoHFs managers). The intention of the SFC is that the minimum US\$100m AUM should be the amount of assets under management that follow hedge fund strategies, although these assets may be invested in more than one strategy. The SFC considers that while proprietary funds may be acceptable for AUM purpose, the SFC will generally look for experience in managing third party funds.

Five-year experience

40. Public Comments: On the five-year experience rule, respondents sought greater clarity in what could be counted as relevant experience and whether the experience should be in a single strategy or different strategies.
41. Some respondents were concerned that a five-year experience requirement would discriminate against small local hedge fund managers. It was cited that there were in fact very few hedge fund managers who would have the required five years experience. Some respondents proposed that the requirement should be reduced to two or three years.
42. Many respondents also sought clarification on whether the qualification requirement applies to the managers of the underlying funds of a FoHFs. They were concerned that the requirement would exclude many qualified hedge fund managers and, in turn, unduly limit the choice of eligible funds to act as underlying funds to a FoHFs.
43. In addition, some FoHFs managers cited that they add value to FoHFs investors by identifying talented new start-up managers who, while not necessarily meeting the experience requirement, are nonetheless “valuable jewels” waiting to be discovered. Hence, some flexibility would be desirable for the FoHFs manager to allocate a small portion of the FoHFs to new start-ups.
44. SFC’s Response: The SFC considers that it is vital for the manager of any collective investment scheme to possess relevant management experience. Investors in such schemes are relying on the expertise of the professional managers to invest on their behalf. Traditional fund managers are required to possess a minimum of five years’ experience. In case of hedge funds where it is often asserted that returns arise from the active management of a skilled manager rather than simply as a consequence of the asset class of the portfolio, there is a strong argument for experienced fund managers who possess the necessary skills. Traditional long-only managers with no experience in managing hedge funds are unlikely to be acceptable. Moreover, the management of the fund should not rely solely on a single individual’s expertise.

45. Nevertheless, the SFC appreciates that there may be good and talented hedge fund managers who may not meet the above AUM and experience requirements. These managers may not wish to offer their funds directly to the public. Given that the FoHFs managers are required to perform due diligence on the selection of the underlying fund managers, the SFC believes that flexibility could be given to allow hedge fund managers with less experience to manage the underlying funds of FoHFs. In this way, retail investors would be able to access the talents of these smaller hedge fund managers, albeit indirectly via FoHFs, with comparatively lower risk than direct investment in such funds.
46. Overall, the SFC believes that new start-up hedge funds may not be suitable for the retail public until such time when the managers have demonstrated their track record. For the time being, the SFC would confine eligible hedge fund managers of authorized funds to proven establishments.
47. Weighing the comments received, the SFC considers the following entry requirements appropriate:
- (i) Single hedge fund manager

Minimum US\$100m AUM for the amount of assets that follow hedge fund strategies *plus* five years' general experience in hedge funds strategies with at least two years' experience in the same strategy as that of the proposed hedge fund.
 - (ii) Fund of hedge funds (FoHFs) manager

Minimum US\$100m AUM for the amount of assets that follow hedge fund strategies *plus* five years' general experience in hedge funds strategies with at least two years' experience as a FoHFs manager. The FoHFs manager is expected to perform due diligence process in selecting and monitoring the underlying funds and their managers.
 - (iii) Managers of the underlying funds of FoHFs

No AUM requirement but at least two years' experience in the relevant investment strategy, provided however that up to 10% of the net asset value of a FoHFs may comprise of underlying funds managed by investment personnel with less experience. The FoHFs manager will need to ensure that the managers of the underlying funds meet these requirements.

Monitoring of distribution agents

48. Public Comments: There were strong views expressed in relation to the proposal for the hedge fund managers to undertake to the SFC that their selling agents possess adequate knowledge of hedge funds for the purpose of explaining the risks involved to an investor and that due diligence will be carried out to

ensure the suitability of the investment to the investor. Many respondents felt that hedge fund managers should not be held accountable for the actions of third party agents since these would be beyond their control.

Some respondents considered that special training or competence test should be imposed on distribution agents. Some respondents also expressed concern that banks, which are primary distributors of funds, are not within the jurisdiction of the SFC. Others suggested that each agent should be directly regulated by the SFC or the Hong Kong Monetary Authority. One respondent suggested that the SFC should require potential investors to pass an exam before they can invest in hedge funds.

49. SFC's Response: It is not the SFC's intention to hold the fund managers accountable for the actions of their distribution agents. Ensuring product suitability to the investor is mainly the responsibility of the distribution agents. However, fund managers have the responsibility of taking reasonable care in the selection of distribution agents and providing adequate information and training to the distribution agents to ensure that they are fully equipped to distribute the products. In this regard, the note to provision (a)(iii) of the Hedge Funds Guidelines has been amended accordingly.
50. As pointed out in the Consultation Paper, it is primarily the responsibility of intermediaries to ensure that investors are properly informed about the risk of investing in a particular product. In general, persons dealing in securities are required to be registered with the SFC. It is a condition of registration that a person must be fit and proper. The SFC expects every registrant to act with due skill, care and diligence and in the best interests of the client. To meet these expectations, a registrant must be competent to advise on the products they recommend. The SFC expects that any registered person offering investments to their clients should adhere to the "know your client" rule to ensure the suitability of the particular product for their clients.
51. With regard to the distribution of funds (and, in general, dealing in securities and provision of investment advice), the Hong Kong Monetary Authority applies to banks that are exempt dealers and their securities staff the same regulatory standards as those applied by the SFC to registered persons. These include the requirements stipulated in the SFC Fit and Proper Criteria and the SFC Code of Conduct for Persons Registered with the SFC.
52. Under the newly enacted Securities and Futures Ordinance (SFO), if banks intend to carry on regulated activities, they have to be registered with the SFC as Registered Institutions (RIs) as well as subject to a number of provisions in the same way as licensed corporations. In particular, the SFO makes it a legal obligation for RIs and their relevant staff to comply with various rules and guidelines issued by the SFC. These include the requirement that the relevant staff of RIs are, and remain, fit and proper in the conduct of regulated activities (which includes the SFC's competency standards). In line with the treatment of licensed persons, RIs and their relevant staff are subject to the same range of disciplinary sanctions for failure to comply with the requisite fit and proper standards, or for acts of misconduct.

Acceptable inspection regime

53. Public Comments: Some respondents requested the SFC to relax the requirement for the investment management activities of a hedge fund to be based in an acceptable inspection regime (AIR) because many hedge funds are managed in offshore jurisdictions. Others considered that this requirement should be strictly enforced to ensure adequate investor protection. A few respondents were under the wrong impression that the AIR requirement relates to the fund domicile. Others would like the SFC to expand the list of AIRs.
54. SFC's Response: The SFC maintains its original proposal in respect of AIR. The AIR requirement is in line with the existing requirement for traditional funds. As many SFC authorized funds are managed outside Hong Kong, it is necessary for the SFC to ensure that such management activities are properly supervised by a competent regulatory authority that is willing to enter into a co-operation agreement with the SFC such that the SFC can rely on the supervision of the overseas authority.
55. The AIR concept does not relate to the fund domicile but the place of actual investment management activities, whether carried out by the management company or its delegates. The AIR requirement is crucial in the regulation of investment funds and should be observed. However, the SFC believes that there is room for a degree of relaxation of this requirement in the case of the underlying funds of FoHFs (see paragraphs 82 to 84).

Certification by Trustee/Custodian

56. Public Comments: Several respondents considered it impractical or expensive to impose the requirement that the trustee/custodian certifies that suitable control procedures are in place for monitoring the scheme. It was pointed out that the prime broker should be the party in the best position to give such a certification but prime brokers would not be prepared to provide it as they do not perform the monitoring function in respect of scheme activities.
57. SFC's Response: The SFC recognizes the practical difficulties cited above and agrees that a paper declaration by the trustee/custodian may not offer additional regulatory comfort in the absence of other safeguards. Accordingly, the proposal for trustee/custodian certification has been deleted in its entirety. Instead, the SFC would focus on whether the trustee/custodian has the necessary experience and resources to fulfill its obligations as set out in Chapter 4.5 of the Code.

Prime Broker

58. Public Comments: Most respondents agreed that there should be special requirements to govern the appointment of prime brokers. In particular, there is general support that the prime broker should be a substantial financial

institution⁴ subject to prudential regulatory supervision and that disclosure should be made in the offering document of the prime broker's relationship with the scheme.

59. However, many respondents (including some prime brokers) pointed out that the prohibition against the pledging of assets in excess of the amount actually borrowed and the requirement for segregation of scheme assets from the prime broker do not reflect current industry practice. In addition, one prime broker believed that segregation of scheme assets in segregated custody accounts would add to the costs of prime brokers in servicing its clients without offering any material increased investor protection. It was also argued that the parties should be allowed to negotiate freely to retain flexibility in determining the appropriate collateral levels.
60. *SFC's Response*: The SFC recognizes that the proposals on the level of collateralisation and separate custody of scheme assets may not reflect current industry practice in respect of managing non-retail funds. However, the SFC considers that there is a need to differentiate retail funds from non-retail funds as investors in the former category may not be in a position to negotiate and protect their own interests.
61. In authorizing hedge funds that are offered to the Hong Kong public, the SFC is mindful that it is important to ensure that the fund assets are properly safeguarded. The requirements conform to international regulatory principles⁵ in seeking to protect the physical and legal integrity of the assets of a collective investment scheme by separation of assets from the assets of the management, its related entities and other schemes, as well as from the custodian itself. The present drafting is in line with similar requirements imposed by overseas regulators⁶ in respect of prime brokers.
62. The SFC recognizes the practical difficulties of imposing the requirements on underlying funds of FoHFs, which may not be authorized by the SFC. The underlying funds will not be required to comply with the provisions on prime brokers. Instead, the SFC will place reliance on the FoHFs to monitor the underlying funds.

Minimum Subscription

63. The discussion on market segmentation via minimum subscription thresholds is set out in paragraphs 21 to 30 above.

⁴ Defined in the Chapter 3.12 of the UT Code as a licensed banking institution authorized under the Banking Ordinance or financial institution with a minimum paid-up capital of HK\$150m or equivalent in foreign currency

⁵ Principle 2 of the IOSCO Principles for the Regulation of Collective Investment Schemes (IOSCO – International Organization of Securities Commissions)

⁶ For example, the Central Bank of Ireland

Limited Liability

64. All respondents who commented on the provision agreed that the liability of holders must be limited to their investment in the scheme. In addition, where there are subfunds belonging to an umbrella structure, there may be a concern that a creditor of any specific subfund may have recourse against the assets of another subfund and that liabilities not met by one subfund may have to be met by other subfunds. To prevent a spill-over of excess liabilities, the SFC has added a provision to require ring-fencing of assets between the scheme and other sub-funds within the umbrella structure.

Dealing

65. *Public Comments:* Respondents generally favoured rules on dealing. A few respondents believed that the dealing frequency was a matter best left to the manager to decide, having regard to the size and the particular strategy of the hedge fund. It was also suggested that investors would be in the best position to determine their liquidity needs and thus clear disclosure would suffice.
66. The majority view was that monthly dealing should be required although some suggested quarterly dealing. Five respondents suggested that flexibility should be given to permit initial lock-up periods of up to one year and advance notice (30-60 days before the dealing day) for redemption, subject to clear disclosure. There were also suggestions that the 60-day redemption period be counted from the relevant dealing day (instead of the date of receipt of a properly documented redemption request).
67. *SFC's Response:* The SFC considers that the original proposal for monthly dealing should be maintained and that redemption proceeds should be paid within a 90-day period, from the date of receipt of a properly documented redemption request (i.e. proper notice received) to the date of actual payment. This rule would give the manager flexibility in deciding on the length of prior notice required and the length of the period for payment of redemption proceeds, provided that the combined time period does not exceed 90 calendar days.
68. The SFC is mindful that infrequent dealing, lock-up periods and advance notice for redemption may represent a significant departure from the generally accepted practices for open-ended public funds. Effectively, even with enhanced disclosure, investors would be denied access to their monies for prolonged periods.
69. However, certain hedge fund strategies do need time to come to fruition and the hedge fund manager may wish to shield the scheme from potentially disruptive redemption activities. It is therefore considered that some relaxation to accommodate advance notice and time for payment of proceeds may be justified. For retail funds, however, lock-up periods are not appropriate unless there are other exit facilities (e.g. trading on an exchange). In addition, the longer the length of the payout period for redemption proceeds, the longer

investors are exposed to price fluctuations of the scheme after the lodgement of a redemption request. It is therefore necessary to insert a warning in the offering document to draw the attention of investors to such risk.

Investment and Borrowing Restrictions

70. *Public Comments:* In general, respondents welcomed and supported a disclosure-based approach in respect of investment and borrowing restrictions. In particular, two respondents pointed out that there was no single standard for defining “leverage” and any self-imposed limit on maximum leverage could be easily circumvented by the creative use of derivatives. It was suggested that the SFC should require disclosure of the types of investment instruments permitted to be traded by the scheme. Two respondents would like relaxation in respect of Chapter 7.12 (underlying fund to a feeder fund must obtain SFC authorization) and Chapter 7.13 (no double-charging of fees where the scheme invests in underlying funds managed by the same management group).
71. *SFC’s Response:* The SFC welcomes the support of the respondents. The disclosure-based approach in the original proposal is now adopted. The SFC has also taken on board suggestions for additional disclosure in the scheme’s offering document in relation to information on types of financial instruments in which the scheme will invest, the extent of diversification and leverage, and the risk implications to investors. The SFC notes that there is no single or universal definition of “leverage” and that it would be undesirable for the SFC to mandate a specific formula for “leverage” for all hedge funds. Instead, management companies would be required to disclose the basis for determining leverage in the offering document. As regards Chapters 7.12 and 7.13, the SFC does not consider relaxation appropriate since the governing principles for safeguarding investors’ interests should also apply to hedge funds in these two areas, as in the case of traditional funds.

Name of Scheme

72. *Public Comments:* One respondent considered that Chapter 7.24 might not be applicable to hedge funds. Chapter 7.24 requires that if the name of a scheme indicates a particular objective, geographical region or market, the scheme should *invest* at least 70% of its non-cash assets in securities and other investments to reflect the particular objective or geographical region or market which the scheme represents. The respondent pointed out that hedge funds might not necessarily “invest” in a particular market but instead could “short” the market of its specific focus.
73. *SFC’s Response:* A new provision (h) has been added to the Hedge Funds Guidelines to take into account the comment on Chapter 7.24.

Performance Fees

74. *Public Comments*: The majority of respondents (including hedge fund managers) are supportive of the proposal for calculation of performance fees on a “high-on-high” or high watermark basis. The “high-on-high” basis is in line with the objective of hedge funds as absolute returns funds. A few respondents, on the other hand, considered that the SFC should not interfere with commercial decisions provided that clear disclosure is made to investors.
75. With respect to the payment frequency of performance fees, a few respondents demanded greater flexibility. The view expressed was that performance fees should be calculated and paid in accordance with the underlying liquidity of the fund and this would mean a quarterly basis for most hedge funds. On the other hand, some respondents felt that hedge funds should not be treated differently from traditional mutual funds that are subject to an annual payment requirement. A few respondents also requested flexibility on the accrual frequency of performance fees.
76. Furthermore, respondents argued that only SFC authorized funds should be subject to the requirement, i.e. where underlying funds of FoHFs are non-SFC authorized funds, they need not follow the “high-on-high” and annual payment basis.
77. *SFC’s Response*: The SFC considers that the original proposal for “high on high” calculation basis and annual payment should be retained for schemes that are authorized for public offer. It is arguable whether fund managers should be paid for their short term performance gains when investment funds are often sold on the basis that these are medium to long term investments. Quarterly payment of performance fees would seem to be inconsistent with a long term investment objective. The annual payment of performance fees would also coincide with the frequency of fund audits, which are often on an annual basis.
78. With respect to the underlying funds of FoHFs, the SFC agrees that it would be difficult for the manager of a FoHFs to demand that the underlying funds follow the SFC’s requirements and this could mean a good investment opportunity foregone if the underlying funds refused to do so. Hence, it would be reasonable to require a single hedge fund or FoHFs, but not the underlying funds of the FoHFs, to follow the requirement. The offering document of the FoHFs will be required to give a summary of the bases of how performance fees are calculated and paid in the underlying funds and at the FoHFs’ level.

Fund-of-Hedge Funds

Authorization of underlying funds

79. *Public comments* : There was a general bias in favour of the authorization of FoHFs. Respondents argued that retail investors should be able to rely on the FoHFs manager to act on their behalf to play the role of “sophisticated investor” in selecting and monitoring the underlying hedge funds and their managers.

Hence, the regulatory focus should be on FoHFs managers rather than the underlying funds. Respondents were generally in favour of some diversification rules on FoHFs.

80. Many respondents sought clarification from the SFC whether each of the underlying funds in the FoHFs would require separate authorization by the SFC. Respondents were concerned that since there were virtually no SFC authorized hedge funds in existence, it would be impossible to set up a FoHFs at the outset. Moreover, as not every highly qualified hedge fund manager would wish to seek SFC authorization, any restriction placed on FoHFs to invest in SFC authorized funds only would circumscribe the choice of highly qualified managers for FoHFs. This would in fact be against the best interests of investors. One respondent suggested that the SFC should follow the example of the Swiss regulator: regulate the FoHFs managers rather than the underlying funds. A majority of the respondents supported this view.
81. On the other hand, two respondents believed that FoHFs should be required to invest a substantial portion of their assets in hedge funds that are SFC authorized. The respondents argued that the necessary investor protection offered by SFC authorization should exist at the underlying fund level. One respondent suggested that the SFC should require the underlying funds of a FoHFs to appoint independent custodians/trustees.
82. SFC's Response: In allowing FoHFs to invest in non-SFC authorized funds, the SFC is mindful that the SFC may have little control over the monitoring of such funds, especially where they are based in offshore jurisdictions or managed by entities that are not subject to acceptable inspection regimes. Nevertheless, the SFC acknowledges the practical difficulties faced by the industry and is prepared to place the monitoring responsibility on the manager of the FoHFs. This approach is in line with the existing practice on traditional mutual funds, which permits a management company to delegate investment management functions to third parties, provided the management company supervises and regularly monitors the competence and performance of the delegates.
83. Therefore, provided that the FoHFs manager satisfies the qualification requirement and is itself based in an acceptable inspection regime, the SFC feels that reliance can be placed on the FoHFs manager to perform suitable due diligence in the selection of the underlying hedge funds and fund managers. The FoHFs manager will be required to submit a compliance plan to the SFC to explain how it proposes to monitor the activities of the underlying fund managers on an on-going basis. The relevant provisions have been amended to reflect this approach.
84. In adopting this approach, the SFC considers it necessary for additional risk disclosure to be made in the offering documents of FoHFs. Adequate risk warnings are required in the FoHFs offering document 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 SFC and that such funds may not be subject to rules similar to those of the SFC that are designed to protect investors.

Qualification requirement of the managers of the underlying funds

85. As discussed in paragraphs 45 to 47 above, the SFC considers that flexibility can be provided to the managers of underlying funds to FoHFs.

Diversification requirement

86. *Public Comments* : Nearly half of those respondents who commented on issues relating to FoHFs suggested that there should be some diversification requirements. Suggestions ranged from four to ten underlying funds and a maximum of 30% to 35% per fund. There were also suggestions regarding diversification in terms of investment styles and number of underlying fund managers. The suggestions were based on the belief that FoHFs are less risky than single hedge funds because of diversification.
87. *SFC's Response* : The SFC notes that the suggestions were based on the belief that FoHFs are less risky than single hedge funds because of diversification. Given that the proposed minimum subscription thresholds for FoHFs (paragraph 28) and the proposed flexibility on the qualification requirements of FoHFs managers and their underlying fund managers (paragraphs 45 to 47) are also based on the assumption that FoHFs would be less risky than single hedge fund because of diversification, the SFC agrees that it would be necessary to build in diversification requirements to support the assumption.
88. In this regard, the SFC has recommended that the usual diversification rule on traditional fund of funds apply, namely, that the FoHFs should invest in at least five underlying funds, with no more than 30% of its total net asset value invested in any one fund.
89. It is, however, considered not necessary to impose concentration limits on the number of underlying fund managers. Any such limits can be easily circumvented by the use of separate subsidiaries to house different hedge funds. Instead, the FoHFs manager should be required to allocate assets to different fund managers and formulate an investment strategy that matches the risk description of the fund. To achieve the desired effect of diversification, the FoHFs manager must explain its diversification strategy in the scheme's offering document. The SFC may raise question where a FoHFs invests solely in underlying funds managed by the same FoHFs manager and/or its connected persons.

Valuation

90. *Public Comments*: A few respondents suggested that, given the nature of hedge funds, there should be independent valuation of the fund's assets on a regular basis. One respondent also suggested that although dealing could be less frequent (e.g. monthly), valuation should be done on a more regular basis (e.g.

weekly), so that fund managers would have the means to check on the portfolio valuation in a timely manner.

Some industry participants have, on an informal basis, expressed concern to the SFC about the costs for independent valuation on a frequent basis. These participants also cited practical difficulties in finding qualified independent valuation agents for illiquid assets that are difficult to value.

91. *SFC's Response:* The calculation of fund price and valuation of fund assets is an important part of any regulatory system because of the direct interest that investors have in the underlying assets of the fund. The SFC is mindful that proper valuation on a regular basis is necessary to protect the interests of investors, especially in the context of hedge funds where the underlying investments may be complex instruments and illiquid in nature. In this regard, it is important for the valuation agent to possess the necessary expertise to perform the valuation function. The SFC considers that it may not be appropriate for the SFC to set out the qualification requirements of valuation agents given that the underlying assets of a hedge fund may cover a very wide variety of instruments each demanding different valuation skills and expertise. Rather, the onus must be on the management company to demonstrate that its valuation agents possess sufficient know-how and experience in dealing with hedge funds (provision (a)(iii) in the Hedge Funds Guidelines)
92. As far as independent valuation is concerned, the SFC acknowledges the practical difficulties cited by industry participants. The SFC recognizes that independent valuation may not necessarily translate to fair valuation unless the party performing the valuation is well qualified, the valuation methodology used is fair, and the valuation process is transparent. The SFC does not wish to rule out qualified valuation agents that are connected to the management company so long as there are suitable internal controls, such as Chinese walls, to achieve the desired "independence". It is the responsibility of the fund management company to ensure that the investments of the scheme is fairly valued in accordance with generally accepted accounting principles and industry's best practices.
93. On the basis of the monthly dealing rule, the SFC considers that valuation would also be required at least on a monthly basis. The SFC also notes that some managers may wish to consider, on a voluntary basis, valuation of the investments of the scheme more frequently than the scheme's dealing frequency. The SFC would encourage such decisions.
94. Apart from disclosing the full particulars of the valuation methods, the offering document should also disclose the identity and qualifications of the valuation agent, and the frequency of valuation.

Disclosure

95. *Public Comments:* Views on the disclosure requirements are diverse. Several respondents would like the SFC to standardize a glossary of terms for use by all

hedge funds that seek authorization in Hong Kong while others do not see the need. A few respondents desire some flexibility in the choice of wording for the risk warnings. One respondent believes additional warnings, apart from the standard price fluctuation and past performance warnings, are superfluous. Another respondent sought clarification with respect to whether details of unauthorized funds could be shown in the offering document of FoHFs.

96. A respondent criticised the warning statements suggested in the Consultation Paper for creating a false impression that all hedge funds are necessarily riskier than traditional funds. In addition, one respondent would like the SFC to set standards on the statistical data on the scheme's performance and standardize the measurements of risks.
97. *SFC's Response:* The SFC has amended the wording of the mandatory disclosures to reflect the above views, where possible. So long as the message is clear and undisguised, there is some room for deviating from the standardized text required. However, the offering documents must be written in plain language. It is the responsibility of the fund manager to produce an easy-to-understand offering document that clearly describes for prospective investors the nature of the product, the nature of the risks, the terms of the offering, and the responsibilities of each of the relevant parties. Technical terms used in the offering document should be clearly explained. The SFC has no intention to prescribe a glossary of terms for hedge funds because it recognizes the need to provide some flexibility for the choice of terms to describe different investment strategies and to cater to the different needs of management companies for marketing purposes. The comment on standardized measurements of risks and performance statistics will need to be considered in the wider context of the entire public funds regime, including those of traditional funds.

Application Form

98. *Public Comments:* One respondent recommended a declaration by the investor to confirm he had subscribed to the scheme in his own right to avoid circumvention of the minimum subscription threshold. In one group submission, it was recommended that the subscriber confirm that the distributor had explained the risks to him and he had considered the risks of investing in the scheme.
99. *SFC's Response:* The SFC understands the concerns that underlie these comments. In particular, the SFC notes that some investors who cannot afford the minimum subscription amount may be encouraged to pool their monies together with others to satisfy the minimum subscription threshold. However, the SFC considers that investor education, proper conduct of selling agents and adequate risk disclosure may be the more appropriate means to deal with issues of pooling and mis-selling.
100. In respect of confirmation by the investor that the distribution agent has explained the risks to him, the SFC intends to work with industry practitioners

to develop a set of guidelines for intermediaries wishing to sell hedge fund products (paragraph 16).

Financial Reporting

101. *Public Comments:* Views were divided between monthly and quarterly reporting. Some respondents considered that consistency and transparency is important when preparing and presenting financial statements, especially in highlighting the underlying risks of the funds. Others, however, said that many managers would object to the timely disclosure of the underlying positions held by the scheme since such information may be commercially sensitive and, if made available publicly, could put them at a competitive disadvantage. In addition, some respondents were concerned that it would be difficult to standardize the description and disclosure of the important characteristics of individual strategies and individual funds.
102. *SFC's Response:* On the whole, the SFC considers it necessary to require a quarterly report to scheme holders to inform them of the activities during the reporting period. The SFC invited specific comments on the content requirements of financial reports in the Consultation Paper. There was, however, little input in this area. The SFC will be conducting more research in this respect and additional guidance notes on the content requirements of hedge funds financial reports will be published in due course.

Others

Capital guaranteed hedge funds

103. *Public Comments:* A few respondents pointed out that hedge funds with a capital guarantee should be authorized as an initial step because they are less risky compared to many other stand-alone hedge funds. A question was raised as to whether such funds would need to comply with both the Guaranteed Fund Guidelines and Hedge Fund Guidelines.
104. *SFC Response:* As stated in the Foreword of the Hedge Fund Guidelines, the application of Chapter 8.5 (Guaranteed Funds) and Chapter 8.7 (Hedge Funds) will depend on the nature of the scheme, and in deciding on the extent of the application of the relevant provisions, each case will have to be considered on its own merits.

Taxation issues of hedge funds

105. One respondent raised issues on the taxation of hedge funds and restrictions on short selling and stock borrowing. These issues are beyond the scope of the consultation and are hence not considered in this paper.

Part 3 - Implementation of the Hedge Funds Guidelines

106. The Hedge Fund Guidelines will become effective on 17 May 2002, the day of publication in the government gazette.
107. Funds seeking authorization as hedge funds will need to comply in full with the relevant provisions in the Hedge Fund Guidelines. The SFC will adopt a pragmatic approach in the implementation of the Hedge Fund Guidelines. In particular, fund management companies are encouraged to discuss any difficulties in complying with the Hedge Fund Guidelines with the SFC. Applicants may also request waivers and file a submission providing the detailed reasons in support of the waiver request.
108. The SFC intends to submit all hedge fund applications to the Committee of Unit Trusts (CUT) for consideration. The membership of the CUT has recently been enlarged to include experts from the hedge fund industry. The CUT, consisting of experts from different sectors of the fund industry, will advise the SFC on the acceptability of hedge funds and other products that fall within the UT Code.
109. Finally, the SFC welcomes further comments from the industry. Given that the industry is moving at a fast pace and new products are constantly evolving, it is the SFC's intention to review the provisions on a regular basis. Where applicable, necessary amendments or further guidance notes will be made or published to ensure a robust yet facilitative regime.

**Securities and Futures Commission
May 2002**

List of Respondents (in alphabetical order)

Category A – Commentator has no objection to publication of name and content of submission

1. Alternative Investment Management Association – The Hong Kong/China Chapter
2. Aquitaine Investment Advisors Ltd
3. Axiom Investment Management Limited
4. Cheetah Investment Management
5. Clifford Chance (first submission)
6. Clifford Chance (second submission)
7. Deacons¹ (group submission)
8. E*TRADE
9. EK Investment Management Limited
10. Financial Control Limited (first submission)
11. Financial Control Limited (second submission)
12. Goldman Sachs (Asia) L.L.C.
13. Hong Kong Investment Funds Association
14. HT Capital Management Limited
15. Investec Asset Management
16. JF Asset Management
17. JPMorgan Partners
18. Lyxor Asset Management and Alternative Investment Team of Societe Generale Paris
19. Man Investment Products
20. Mandatory Provident Fund Schemes Authority
21. Momentum Asia (HK) Limited
22. Morgan Stanley Dean Witter Asia Limited
23. Pegasus Fund Managers Limited
24. Permal Investment Management Services Limited
25. PricewaterhouseCoopers
26. SBI China Provident
27. Union Bancaire Privée
28. Zurich Capital Markets

Category B – Commentator requested submission to be published on a “no-name” basis

Four submissions

Category C – Commentator requested that both name and submission to be withheld from publication

Four submissions

¹ Group submission representing 24 industry participants.

[Important: The following provisions have been incorporated in Chapter 8.7 of the Code on Unit Trusts and Mutual Funds. These should be read in conjunction with other relevant Chapters of the Code. Full text of the Code may be found on the SFC website (www.hksfc.org.hk).]

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)** Apart from the requirements of Chapter 5, the Commission, when assessing the suitability of the management company, will consider the following:
 - (i)** the experience of the key investment personnel of the management company or those of the investment adviser (where the latter has been delegated the investment management function) in managing hedge funds;

Note: The key personnel must be dedicated full-time staff with a demonstrable track record in the management of hedge funds. There should be at least two investment executives, each with five years' general experience in

hedge fund strategies including at least two years' experience in the same strategy as that of the scheme.

Notwithstanding the above, key personnel of a FoHF's manager should each possess five years' general experience in hedge fund strategies including at least two years' experience as a FoHF's manager.

The Commission may require independent substantiation of the management experience and track record of the key personnel.

The experience requirement of the investment personnel of the underlying funds of a FoHF's is set out in the "Fund of Hedge Funds" section below.

- (ii) 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) the risk management profile and internal control systems of the management company; and

Note: The management company should 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.

The management company should 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 FoHF's, the management company should 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 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 submit a plan to explain its due diligence and on-going monitoring processes and include a summary of the plan in the offering document of the scheme.

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) 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 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 disclose the profile of the prime broker and its relationship with the scheme.

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 be clearly stated in the offering document.
- (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.

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 have a set of clearly defined investment and borrowing parameters in its constitutive and offering documents. The offering document should 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, 7.13, 7.14, 7.17, 7.22 and 7.23.

Name of Scheme

- (h) If the name of the scheme indicates a particular objective, geographic region or market, the scheme should 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 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 also summarize the bases of how performance fees are calculated and paid by the underlying funds.

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

Fund of Hedge Funds

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

- (j) The FoHFs should 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
 - (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 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 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.
- (n) The offering document of the scheme should 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 be fairly valued on a regular basis in accordance with generally accepted accounting principles and industry's best practices, applied on a consistent basis.
- (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) must be disclosed in the offering document.
- (q) The offering document of the scheme should 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 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 be clear and not disguised.

- (s) For the purpose of Chapter 6.1, the offering document should 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 control mechanism, including the setting of investment and borrowing parameters to control the risks; the terms of the offering; 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) All advertisements must prominently display the warning statements referred to in (r) above.

Application Form

- (u) All application forms of the scheme should 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) In addition to the requirements of Chapter 11.6, the management company must issue a quarterly narrative report to holders on the scheme activities during the reporting period. The quarterly report should be distributed within one month of the end of the period it covers.

[Important: The following provisions ~~form part~~ have been incorporated in Chapter 8.7 of the Code on Unit Trusts and Mutual Funds, and These should be read in conjunction with other relevant Chapters of the Code. Full text of the Code may be found on the SFC website (www.hksfc.org.hk).]

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:

- (iv) the choice of asset class; and*
- (iv) 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) Apart from the requirements of Chapter 5, the Commission, when assessing the suitability of the management company, will consider the following:
 - (i) the experience of the key investment personnel of the management company or those of the investment adviser (where the latter has been delegated the investment management function) in managing hedge funds;

Note: ~~The relevant investment management experience (at least five years) should be in the same investment types as those proposed for the scheme seeking authorization. Experience in both private and public funds and performance track record may be taken into account.~~

The key personnel must be dedicated full-time staff with a demonstrable track record in the management of hedge funds. There should be at least two investment executives, each with five years' general experience in hedge fund strategies including at least two years' experience in the same strategy as that of the scheme.

Notwithstanding the above, key personnel of a FoHF's manager should each possess five years' general experience in hedge fund strategies including at least two years' experience as a FoHF's manager.

The Commission may require independent substantiation of the management experience and track record of the key personnel.

The experience requirement of the investment personnel of the underlying funds of a FoHF's is set out in the "Fund of Hedge Funds" section below.

- (ii) amount of assets under management;

~~Note: The assets managed may include proprietary funds and/or third party funds on a discretionary basis. The Commission would generally expect more than at least US\$100 million for the total amount of assets under management in relation to the underlying investment style proposed for authorization. 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) the risk management profile and internal control systems of the management company; and

~~Note: The management company should 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.~~

~~The management company should 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 FoHF's fund of hedge funds, the management company should 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 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 investors holders. The management company should submit a plan to explain its due diligence and on-going monitoring processes and include a summary of the plan in the offering document of the scheme.~~

~~The management company must undertake to the Commission that its employees and/or distribution agents engaged in the selling of hedge funds possess adequate knowledge of such funds for the purpose of~~

~~explaining the risks involved to an investor and that due diligence will be carried out to ensure the suitability of the investment for the investor.~~

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) 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 hedge funds may need to be considered on a case-by-case basis.

Certification by Trustee/Custodian

- ~~(b) The trustee/custodian must certify to the Commission that suitable control procedures are in place for monitoring the operations of the scheme. The trustee/custodian must demonstrate that they have the relevant experience in this respect.~~

Prime Broker

- ~~(b.e)~~ 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 fund are charged to the prime broker for financing purpose, such assets should 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) ~~There should be clear disclosure in the~~ the scheme's offering document should disclose the profile of the prime broker and of its relationship with the scheme. ~~prime broker.~~

Minimum Subscription

- ~~(c.d)~~ The minimum level of initial subscription by each investor ~~must be HK\$[] or its equivalent in foreign currency.~~ 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 be clearly stated in the offering document.
- ~~(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.

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

Dealing (modified and moved to sections (l) to (n))

- ~~(f)~~ There must be at least one regular dealing day per month.
- ~~(g)~~ The maximum interval between the receipt of a properly documented request for redemption of units/shares and the payment of redemption money to the holder may not exceed 60 calendar days.

Investment and Borrowing Restrictions

- ~~(f)~~ ~~h~~ The scheme should have a set of clearly defined investment and borrowing parameters ~~(including the maximum level of leverage)~~ in its constitutive and offering documents. The offering document should 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)~~ ~~i~~ The core requirements in Chapter 7 will not apply except for 7.12, 7.13, 7.14, 7.17, 7.22 and 7.23 ~~and 7.24.~~

Name of Scheme

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

Performance Fees

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

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 also summarize the bases of how performance fees are calculated and paid by the underlying funds.

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

Fund of Hedge Funds

Where a scheme invests all its non-cash assets in other hedge funds, the scheme may seek authorization as a fund of hedge funds.

- ~~(k) The scheme should have a set of clearly defined investment and borrowing parameters (including the maximum level of leverage) in its constitutive and offering documents.~~
- ~~(l) The provisions in Chapter 8.1 will not apply except for 8.1(e), 8.1(h) and 8.1(i).~~

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

- (j) The FoHFs should 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
 - (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 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 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~~f~~) There must be at least one regular dealing day per month.
- (m~~g~~) The maximum interval between the ~~receipt~~ 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 ~~60~~90 calendar days.
- (n) The offering document of the scheme should 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~~m~~) The investments of the scheme assets should be fairly valued on a regular basis in accordance with generally accepted accounting principles and industry's best practices, applied on a consistent basis.
- (p~~n~~) Full particulars of the valuation frequency, the valuation methods of the scheme's assets investments and the identity and qualifications of the valuation agent(s) ~~should be~~ disclosed in the ~~constitutive document and summarized in the~~ offering document.
- (q) The offering document of the scheme should 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 warned that under such circumstances, the net asset value of the scheme may be adversely affected.

Disclosure

- (r~~o~~) 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; is not subject to the usual prudential rules on limitation and spreading of risks that apply to 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) ~~Investment in the scheme may lead to substantial losses and~~ investors are advised to consider their own financial circumstances and the suitability of the scheme investment as part of their investment portfolio; and

- (iv) investors are advised to read this offering document and ~~if in doubt~~, should obtain professional advice before subscribing to the scheme.

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

- (s p) For the purpose of Chapter 6.1, the offering document should 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 control mechanism, including the setting of investment and borrowing parameters to control the risks; the terms of the offering; 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 q) All advertisements must prominently display the warning statements referred to in (r e) above.

Application Form

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

Financial Reports

- (v s) In addition to the requirements of Chapter 11.6, the management company must issue a quarterly narrative report ~~should be distributed to holders to provide information on the scheme activities of the fund during the reporting period. Information should include, but not be limited to, the volatility and risk return profile, maximum leverage, fund size, etc., to enable the holder to assess the performance of the fund manager during the period.~~ The quarterly report should be distributed within one month of the end of the period it covers.