

**Consultation Conclusions on  
The Hedge Funds Reporting Requirements**

Securities and Futures Commission  
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## Part 1 - Consultation Conclusions

### Introduction

1. On 5 September 2002, the Securities and Futures Commission (SFC) issued a Consultation Paper on Hedge Funds Reporting Requirements (Consultation Paper). The SFC invited the public to comment on the proposals (Hedge Funds Reporting Requirements), which provide further guidance to management companies of authorized hedge funds regarding their on-going reporting obligations to holders.
2. The consultation period ended on the 30 September 2002 and the SFC received a total of 18 submissions. The diversity of the profile of the respondents to the consultation is a reflection of Hong Kong's status as an international financial centre and the interest from the market in the subject matter. Respondents included international and local fund managers, industry associations, hedge fund consultants, consumer rights advocate, and representatives from the legal and accounting professions. A list of respondents is set out in **Annex 1**.
3. To increase the transparency of the consultation process, the SFC has 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 Funds Reporting Requirements. The text of the Hedge Funds Reporting Requirements is set out in **Annex 2**. A marked up version of all the amendments from the consultation draft is also set out in **Annex 3**.
5. The Commission has approved the Hedge Funds Reporting Requirements and these will supplement the Guidelines on Hedge Funds in Chapter 8.7 of the Code on Unit Trusts and Mutual Funds (the Code).
6. The SFC wishes to thank those who have provided their views on the proposals in the Consultation Paper.

### General Comments

7. Comments varied considerably in range and depth, with some respondents focussing on the broad principles behind the proposals and others on specific issues raised in the Consultation Paper.
8. Most respondents supported the initiatives taken by the SFC to enhance the transparency of hedge funds offered to the retail public. However, there was little consensus on how this could be achieved.

9. There were respondents who welcomed the additional disclosures and had no difficulty in complying with the proposals. Other respondents expressed concern that the required disclosures might expose them to business risks from competitors as they view that some of the proposed disclosures are proprietary information. They were also mindful of the costs and time involved in obtaining all the necessary information for the reports.
10. The polarisation of the responses has made drawing the conclusions a fine balancing act between investor protection and market development.

## Regulatory Approach

11. The purpose of the Hedge Funds Reporting Requirements is to enhance the transparency of hedge funds for retail investors. The demand for transparency in investment portfolios is a growing global trend. International financial institutions, regulators and professional accounting bodies are all working towards appropriate disclosure and better corporate governance.
12. The SFC recognizes the general concern over the potential complexity of investment strategies and diversity of management approaches of hedge funds. In order to ensure proper protection of retail investor interests and promote public confidence, we believe it is important that *timely, meaningful and useful information* would be provided to investors so that they can make informed investment decisions.
13. Due to the wide variety of strategies adopted by hedge funds, the Hedge Funds Reporting Requirements is unlikely to be a set of “one size fits all” standards. Often, professional judgement is involved in considering what is appropriate and informative to investors, taking into account the specific objective and strategy of the scheme in each case.
14. The Hedge Funds Reporting Requirements are not intended to be exhaustive. They are designed to provide a framework of minimum disclosures only. The SFC strongly advocates clear and fair disclosure. We believe that management companies are in the best position to consider what are the additional information that may be necessary for investors to understand the investment strategy and the risks inherent in their specific hedge funds.
15. In drafting the Hedge Funds Reporting Requirements, the SFC notes that there is a contention between hedge funds as retail products versus hedge funds for the professionals or high net worth individuals. However, we recognize that 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 foster investor confidence in retail hedge funds.
16. The SFC is mindful of the need to facilitate market development and accommodate product innovation. In doing so, we need to strike a balance between market development and investor protection. In finalizing the Hedge

Funds Reporting Requirements, 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.

17. The SFC recognizes the disclosure regime is an evolving concept. We will monitor international market trends and industry practices to ensure that the Hedge Funds Reporting Requirements are up-to-date.
18. Lastly, the SFC recognizes that investor education is an important element to help investors make informed decisions based on useful information. The SFC will continue to work with the industry to educate investors on hedge funds and other complex products.

## Part 2 - Consultation Responses to Specific Provisions

### Appropriate Accounting Standards

19. *Public Comments:* A few respondents supported the mandatory adoption of International Accounting Standards (IAS). In particular, one respondent stated that the adoption of two specific IAS standards: IAS 32 (disclosure and presentation requirements in relation to financial instruments) and IAS 39 (valuation and methodologies) are essential.
20. However, many respondents were concerned that adopting the IAS standard would preclude many hedge funds especially U.S. hedge funds from seeking authorization in Hong Kong. These respondents indicated that other accounting standards (especially the U.S. accepted accounting principles) should also be acceptable in the reports. Some respondents proposed that the SFC could require additional disclosure to address the discrepancies between the IAS and the other accounting standards. One respondent also pointed out that the SFC does not mandate the adoption of any specific accounting standard in the financial reports of other investment products authorized in Hong Kong. Another respondent expressed doubts about the practical application of IAS 32 and IAS 39 to hedge funds. In respect of fund of hedge funds (FoHFs), a respondent questioned the effectiveness of adopting IAS at the scheme level while the underlying funds may or may not apply IAS in their reports.
21. *SFC's Response:* While the SFC regards IAS as the global emerging accounting standard, we recognize that there is no market consensus of what would be the most appropriate accounting standard. While we wish to provide the market with a more standardized framework, the international nature of the investment fund industry in Hong Kong requires us to be pragmatic and sensitive to global trends. We do not intend to preclude quality hedge funds that have not adopted IAS from seeking authorization, and thus deprive Hong Kong investors of a wider choice of investments. Having regard to the comments, the SFC believes that it may be premature to introduce IAS as the standard, and thus will not for the time being, mandate the use of IAS in the financial reports of hedge funds.

The original provision has been deleted from the Hedge Funds Reporting Requirements. That said, adoption of IAS remains the recommended accounting best practice.

## Timeframe for Filing and Distribution of Reports to Holders

22. *Public Comments*: Respondents agreed with the proposed timeframes except for the filing deadlines in respect of semi-annual and quarterly reports of FoHFs. Many respondents expressed concern that FoHFs faced practical difficulties in adhering to the one-month deadline for quarterly reports due to the need to compile data from underlying funds and prepare the reports in English and Chinese. This is especially the case for FoHFs with underlying funds that adopt complex investment strategies. The suggested timeframes for quarterly reports of FoHFs ranged from six weeks to two months but the majority of respondents were in favour of the six week timeframe. There were also a few suggestions for extending the reporting deadline for semi-annual reports of FoHFs as well.
23. *SFC's Response*: In view of the positive support, the SFC has largely retained the original proposal in respect of reporting deadlines, modified however to relax the reporting deadline for quarterly reports of FoHFs. We acknowledge the practical difficulties that FoHFs may encounter in preparing the scheme reports. Our response was to relax the normal filing timeframe for annual reports of FoHFs from four months in the original proposal to six months. In addition, the SFC has accepted the suggestion to extend the timeframe required for FoHFs to file and distribute quarterly reports to holders from one month to six weeks after the end of the reporting period. The relevant provision has been amended accordingly.
24. With respect to the reporting deadline for semi-annual reports of FoHFs, the SFC maintains the original proposal. The SFC takes the view that the timeliness this requirement imposes is necessary for the protection of investors' interests, and hence the SFC considers it necessary and not unduly burdensome to retain the two-month deadline in respect of semi-annual reports.

## Compliance with Appendix E of the Code – Alternative Disclosures in Lieu of Full Position Transparency in Semi-Annual and Annual Reports

### **General**

25. *Public Comments*: All respondents welcomed the SFC's flexibility in allowing alternative disclosures in lieu of full position transparency, given the nature of hedge funds.
26. With respect to the minimum acceptable alternative disclosures, respondents supported the proposed disclosure of scheme exposures by various categories. However, there were divergent views with respect to the proposal for disclosure

of the top ten positions of the scheme. Respondents felt that the top ten positions would give investors little further insight, and would also expose the hedge fund to unnecessary business risks from competitors especially when large short positions are revealed. A few respondents argued that the disclosure of top positions would not be reflective of a hedge fund's performance as they only provide a snap shot of the hedge fund's portfolio.

27. It was suggested that in order to mitigate the business risks, top ten positions could be disclosed but without including the associated names of the underlying funds in the case of FoHFs nor the underlying assets in the case of single hedge funds. Alternatively, investors may obtain more information from hedge funds upon signing a confidentiality letter, or hedge funds should be allowed to choose other appropriate methods of disclosure provided that they are consistently used.
28. All respondents (except one) had no objection to compliance with Appendix E of the Code, ie. those requirements that are currently applicable to the financial reports of traditional funds. That dissenting respondent viewed that hedge funds cannot be regarded as a mere extension or subset of traditional funds and, therefore, there should be a new set of reporting requirements that address hedge funds explicitly (rather than the adoption of existing guidelines with modifications or added requirements).
29. Some respondents would also like to see a different set of disclosure requirements for FoHFs vis-à-vis single hedge funds.
30. *SFC's Response*: The SFC needs to strike a balance between the investors' right to know the key investments of the scheme and the potential business risks that the scheme may face. The SFC encourages full disclosure of individual holdings of the scheme. Yet, the SFC is prepared to be flexible in this area to address any practical difficulties in order not to jeopardize the scheme's position. The alternative disclosures in the Hedge Funds Reporting Requirements are specifically tailor-made for hedge funds.
31. In the case where the management company is satisfied that full disclosure of scheme holdings may be unduly burdensome or would jeopardize the position of scheme investors, the proposal is that the management company may adopt alternative disclosures that it considers the most appropriate and informative, taking into account the objective and strategy of the hedge fund.
32. The SFC will maintain the requirement for exposures of the scheme to be disclosed, and we wish to clarify that exposures include exposures to cash and cash equivalent holdings both in respect of single hedge funds and FoHFs.
33. The SFC agrees that the disclosure of the top positions may not be totally reflective of a hedge fund's performance. However, in the absence of full portfolio transparency, the SFC considers that this information, even if limited, is useful to investors in assessing the profile of the hedge fund, especially if such top positions were monitored on a periodic basis.

34. The SFC considers the disclosure of the names of the top underlying funds and positions to be relevant. This basic information is necessary for investors to assess the investment profiles of the hedge funds. Without the associated names, the value of the disclosed information on the top funds and positions will be diminished.
35. As for the suggestion that those investors wanting additional disclosure could individually request information from the hedge fund upon the signing of a confidentiality letter, the SFC believes this, as a private agreement between the two parties, is outside our control. Therefore, we do not accept this proposal as it is beyond our regulatory remit to enforce.
36. Separate provisions for FoHFs and single hedge funds have been added to the Hedge Funds Reporting Requirements to give greater clarity to the provisions applicable to each type of funds.

### **Fund of Hedge Funds**

37. Public Comments: Some respondents would like clarification on the required disclosure for FoHFs: whether it pertains to underlying positions held by the underlying funds, or to the underlying funds held by the FoHFs. Furthermore, there were concerns regarding the proposal that FoHFs publicize their top ten underlying funds. The objection is that the top ten underlying funds would comprise a large portion of the scheme, the disclosure of which would most likely pose significant business risks to the FoHFs.
38. SFC's Response: The SFC would like to clarify that there is no intention to require disclosure of the underlying positions held by the underlying funds. As regards disclosure of the underlying funds held by the FoHFs, the SFC notes the argument that the top ten underlying funds may represent a significant proportion of the FoHFs' portfolio and that the release of such current information might lead to business risks from competitors. On this basis, the SFC is prepared to relax the original proposal to provide that only details relating to the *top five underlying funds* held by the FoHFs need to be disclosed, and only in the semi-annual and annual reports. And to supplement this revised provision, the number of underlying funds and number of underlying fund managers included in the FoHFs as at the end of the reporting period must be disclosed. Specifically, where the FoHFs is a multi-strategy FoHFs, it is required to disclose the number of underlying funds and underlying fund managers under each strategy in addition.
39. The SFC understands some FoHFs may still view the top five underlying funds as proprietary information. Yet, the SFC believes such information is useful to investors. Investors that have a direct interest in the underlying assets of the fund and holders of a FoHFs should be able to identify at least key constituents of the investment portfolio of the FoHFs on a periodic basis. In addition, given the timeframe for the filing of semi-annual and annual reports of a FoHFs is two months and six months after the reporting dates respectively, the SFC expects that the sensitivity of the disclosures would be considerably reduced.



40. *Public Comments:* A few respondents were concerned about the possible lack of standardized data from the underlying funds of multi-strategy FoHFs. One respondent also queried whether additional audit procedures needed to be carried out on underlying funds of FoHFs if their reporting dates differed from that of the FoHFs.
41. *SFC's Response:* The SFC would like to stress that it should be the responsibility of the manager of a FoHFs to perform ongoing due diligence in monitoring the underlying funds on a regular basis. Therefore, the SFC feels that the burden of validation lies with the FoHFs to ensure that all its underlying hedge funds provide proper, appropriate and accurate valuations and information in order to help the FoHFs to comply with the reporting requirements in all the reports.

### **Single Hedge Funds**

42. *SFC's Response:* The SFC is mindful of the need to strike a balance between adequate and relevant disclosure, and the burden on fund managers and implications to the fund. The SFC acknowledges the concerns of business risks arising from disclosure of the current top positions of a single hedge fund. Yet, the SFC regards such information as useful to investors. Investors that have a direct interest in the underlying assets of the fund and holders of a single hedge fund should be able to identify key constituents of the investment portfolio of the scheme on a periodic basis, especially since full position transparency is not mandated. In addition, given that the timeframe for the filing of semi-annual and annual reports of a single hedge fund is two months and four months after the reporting dates respectively, the SFC expects that the sensitivity of the disclosures would be considerably reduced.
43. Having regard to the comments, the SFC has relaxed the provisions to require single hedge funds to disclose the names and amounts invested in its top five long and top five short positions on a gross basis as of the reporting dates, and only in its semi annual and annual reports. To supplement this provision and to give investors an overview of the long and short positions of the scheme, the SFC requires single hedge funds to disclose the aggregated gross long and short positions held by the scheme as of the reporting dates in the semi-annual and annual reports.
44. The SFC strongly advocates that in addition to the required minimum alternative disclosures, more information should be disclosed by the hedge funds if such information is deemed appropriate and informative to holders, in light of the objectives and strategies of the schemes.

## Risk Measures

45. *Public Comments:* A few respondents expressed concern over the different types of risks that may exist in hedge funds. Some of the respondents indicated that the proposed requisite risk measures in the quarterly, semi-annual and annual reports may not fully reflect the risk profiles of the schemes.
46. One respondent commented that the top positions might not fully reflect the major risk exposures of the hedge funds especially when some of these positions could be related as in “pair trading” or some of these positions could be offset by other smaller positions which would mean that their combined risk profile is lower than their individual risks. There were also comments that the size of a position may not be fully indicative of the amount of the associated risks.
47. Some respondents also suggested that there should be additional mandatory risk measures especially in the quarterly reports. One respondent’s gave relatively detailed and technical comments recommending additional risk indicators with particular reference to derivatives. Various proposals were made with a view to addressing liquidity risks, market risks and currency risks. These included proposals for mandatory disclosure of VaR (value at risk), aggregated risk/return statistics, stress tests, notional amounts of different types of derivatives and delta equivalent amounts of options along with the assumptions behind these risk measurements. This respondent also recommended that the purpose and extent of usage of derivatives (if any) should be qualified and an account of various financial instruments used by the hedge fund manager would be warranted.
48. *SFC’s Response:* The SFC is mindful that the disclosure of the scheme’s exposures, even if combined with disclosures of the top underlying funds in respect of FoHFs and top underlying positions in respect of single hedge funds, may not fully reflect the risk exposures of the hedge funds. Yet, the SFC is not in a position to assign risk ratings to them. Indeed, there is no consensus on a set of universally accepted risk measures in the current global risk disclosure framework involving derivatives. A recent survey carried out by the Alternative Investment Management Association (AIMA) indicated an absence of common risks measures employed by a large majority of hedge funds.
49. Hedge funds employ various risk measures and there are no standardized risk management parameters. Some risk measures may be pertinent to specific strategies but they may not be relevant to other hedge funds strategies. There are many different opinions from the industry regarding the most appropriate risk measures to take even for the same investment strategy. Risk measures are also highly technical and the same risk measure may have many different calculation bases and interpretations.
50. The SFC has considered mandating the disclosure of one of the more commonly used risk measures such as VaR but we note that this requirement may be unduly burdensome for some hedge funds which do not currently employ VaR as a risk management tool. In addition, there are industry concerns about the limitations of VaR: it lacks a uniform calculation basis; it is unable to highlight tail end risks; it may not be applicable to all investment strategies; and VaR at

the parent fund's level may not reflect the individual risks borne by its underlying funds. In addition, the VaR for various hedge funds may not be comparable due to different calculation basis and investors may also find VaR difficult to interpret.

51. While the SFC encourages enhanced disclosure of risks, we are not in a position to endorse a particular set of risk measurements that is not commonly acceptable at present to the industry for all types of hedge fund strategies. The SFC takes the view that management companies are in the best position to consider what are the most relevant information that should be disclosed for investors to understand the investment strategy and the associated risks of their investments. In light of this, the SFC strongly recommends that each individual hedge fund, in addition to the required risk measures, discloses other appropriate performance and risk indicators that best illustrate its risk profile accompanied by the relevant calculation basis and definitions. The SFC encourages the disclosure of VaR and/or other risk measures on a voluntary basis if it is deemed appropriate by the management company.

## Definitions of Financial Terms

52. Public Comments: Several respondents requested exact definitions and the calculation methodologies of the financial terms to be used in the reports. One respondent also recommended that the reports must be accompanied by a glossary and a reader's guide. Some respondents asked for further clarification on how the top positions are valued.
53. In addition, most of the respondents who had made comments in respect of the required disclosure of leverage sought clarification on the SFC's definition of "leverage" in the context of hedge funds. Their main concern was the distinction between different sources of leverage (ie. cash leverage and other forms of leverage) and how these are taken into account in calculating leverage. One respondent also commented that it would be difficult for FoHFs to aggregate leverage at both the parent fund's level and the underlying funds level, given that not all underlying funds will provide details of leverage and there is a lack of standard presentation of leverage.
54. SFC's Response: The SFC acknowledges these comments. Yet, the SFC is not in a position to mandate an exhaustive set of financial terms and their calculation bases, given the lack of universal definitions.
55. The SFC is mindful that management companies should be given a certain amount of discretion to exercise their professional judgement to appropriately define the choice of terms and their calculation methodologies. As such, to the fullest extent possible, the SFC has provided some standard definitions for certain parameters to be used in the reports to facilitate a common disclosure platform. Management companies are required to state the calculation bases and definitions for *all* the financial terms being used.

56. That said, the SFC has no intention to mandate a separate glossary of financial terms (ie. management companies would have the flexibility to decide whether to include an explanation of the calculation basis and definition alongside the financial term used, or to have such disclosures set out in a separate glossary). The SFC regards appending a separate glossary of financial terms to the reports as a useful voluntary industry practice. Going forward, the SFC welcomes the adaptation of an industry-led set of standards for the Hedge Funds Reporting Requirements, so that reasonable comparability, consistency and standardization can be achieved.
57. The SFC agrees that the definition of leverage is very wide especially in the context of hedge funds due to the vast array of investment strategies that can be utilised. The uses of leverage and sources of leverage may also be different for each hedge fund depending on the specific investment strategy that it employs.
58. The SFC recognises that there is no industry consensus in defining leverage in a way that comprehensively includes all the available types of leverage. We further note that the levels of leverage disclosed are not comparable due to the different sources of leverage. Moreover, the extent of leverage does not equate to the risks inherent in the fund.
59. In light of this, we have modified the proposal for the disclosure of leverage. The SFC takes the view that information regarding the size of cash loans taken out by a hedge fund at the end of each quarterly period is a simple, but useful piece of information to give investors an indication of the indebtedness of the scheme. Therefore, the relevant provision has been amended to include cash borrowings in addition to disclosure of other forms of leverage on a self-reported calculation basis.
60. For FoHFs, disclosure of cash borrowings and the other forms of leverage only apply to the FoHFs level.
61. To clarify the issue of valuation, the SFC expects the scheme's positions to be fairly valued, based on generally accepted accounting principles and industry best practices, and applied on a consistent basis.

## Prime Brokers

62. Public Comments: One respondent commented that disclosing the maximum levels of scheme assets held with each prime broker during the year would be unduly burdensome. Another respondent sought clarification on whether the disclosure of the details regarding the prime brokers during the financial year would be applicable to FoHFs.
63. SFC's Response: SFC acknowledges these practical difficulties. As information on prime brokers appointed by the hedge funds are already disclosed in the offering documents, the original provision for additional disclosure in the semi-annual and annual reports has been deleted in its entirety.

## Performance Fees Disclosure in Annual Reports

64. *Public Comments:* There was a suggestion that the percentage of performance fees that has been distributed to employees should be disclosed. The rationale given was that it shows how the employees are being remunerated according to their performance. One respondent also sought clarification on the required performance fees disclosure for FoHFs.
65. *SFC's Response:* The SFC maintains its original proposal. The remuneration of individuals in connection with the scheme is private information. The SFC takes the view that the performance fees borne by the scheme would have already reflected part of the costs of investment for scheme investors.
66. The SFC wishes to clarify that, for FoHFs, only performance fees charged at the scheme level need to be disclosed. It was never the intention of the SFC to require disclosure of actual performance fees paid at the underlying funds level. An explanatory note to the provision has been added. Although the offering document of the FoHFs would have disclosed the entitlement criteria (ie. the calculation basis and payment frequency) of any performance fees borne by the FoHFs, the actual amount of such fees being borne by the FoHFs would not be known until after the fact. Thus, we require disclosure of the actual amount of performance fees incurred at the FoHFs level during the financial year and their calculation basis in the annual report.
67. The SFC supports voluntary additional disclosure regarding performance fees being borne by underlying funds of FoHFs by the management companies if deemed appropriate and beneficial to holders.

## Disclosures Required for Quarterly Reports

### **General**

68. *Public Comments:* Most respondents agreed to the provision for regular quarterly reporting to investors. A few respondents have even volunteered to produce monthly reports to investors. There were however many comments from the respondents on the contents of the quarterly reports. The section under "Portfolio Review" attracted the most comments.
69. *SFC's Response:* The SFC is pleased to note that the industry recognizes the need to keep investors informed via periodic reporting. We are appreciative of the comments made regarding the content requirements of the quarterly reports and have made new provisions in some areas to take account of the relevant concerns voiced by the public.

## **Distribution of Quarterly Reports**

70. *Public Comments*: With respect to the requirement for the first quarterly report to obtain a “no objection” letter from the SFC before it is issued to investors in Hong Kong, one respondent suggested that the SFC should consider issuing the “no objection letter” prior to the authorization of the scheme to ensure a smooth post authorisation procedure.
71. *SFC’s Response*: The SFC places high priority towards ensuring a smooth post authorization procedure. To facilitate the vetting procedures, the SFC may upon request from the management company, review and provide comments on the format of the first quarterly report of each scheme before the scheme is authorized. The “no objection” letter will only be issued after the scheme is authorized.
72. *Public Comments*: One respondent suggested that it might be more appropriate for the SFC to require updated explanatory notes to be attached to the quarterly reports for non-holders (ie. new investors) of the scheme as the existing prospectus may be out of date.
73. *SFC’s Response*: The proper place for updates of scheme information is the scheme’s offering document. Under the Code (Chapter 6.1), authorized schemes must issue an up-to-date offering document, which should contain the information necessary for investors to be able to make an informed judgement of the investment proposed to them. As such, the management company is obliged to update the scheme offering document on a regular basis or as soon as there are any material changes.
74. *Public Comments*: Some respondents argued that producing reports in Chinese was too burdensome and that more time would be required for translations. A query was raised regarding whether a Chinese version of the quarterly report would be required where a waiver has already been granted under Chapter 6.2 (requirement to produce a Chinese offering document) of the Code.
75. *SFC’s Response*: The SFC would like to stress the importance of adhering to the dual-language requirement, as non-English speaking investors would not understand quarterly reports in the English language. However, where a waiver has already been granted under Chapter 6.2 of the Code (in the limited circumstances that justify relief from producing a Chinese offering document), there is no need to produce the quarterly reports in Chinese.

## **Contents of the Quarterly Reports**

76. *Public Comments*: One respondent questioned whether the word “should” which was used under the “Contents of quarterly reports” section meant that the required disclosure was not mandatory.

77. *SFC's Response:* The SFC has amended the wording in the requirement so that the quarterly reports “must” contain the following information to clarify that the disclosures are mandatory. In addition, since the accuracy of the disclosures in the quarterly reports is paramount, the SFC has added a new provision to require that the directors and/or the management company of the scheme must accept full responsibility for the accuracy of all the information contained in the reports.

#### ***Management Commentary - Performance Review***

78. *Public Comments:* One respondent recommended that disclosure is needed if there has been any significant change in the strategy and/or performance drivers for the fund that would constitute a significant style drift from the original objectives of the scheme outlined at its inception.
79. *SFC's Response:* The SFC agrees that any style drifts in the scheme during the reporting period should be highlighted in the performance review section of the quarterly reports. The SFC has amended the provision accordingly.

#### ***Management Commentary - Changes in Key Investment Personnel***

80. *Public Comments:* One respondent commented that information regarding any changes in personnel in the underlying funds of FoHFs is irrelevant to investors while the key personnel changes at the FoHFs level is relevant information to investors.
81. *SFC's Response:* The SFC would like to clarify that the current provision already requires that only changes in the composition of key investment personnel at the parent fund's level need to be disclosed for FoHFs.

#### ***Management Commentary - Lawsuits***

82. *Public Comments:* One respondent suggested that hedge funds should disclose any lawsuits against them during the quarterly reporting period.
83. *SFC's Response:* The SFC agrees that details of any lawsuits that may have a financial impact on a scheme during the reporting period should be disclosed as this constitutes material information for investors. A new provision has been added to take account of this.

#### ***Portfolio Review - General***

84. *Public Comments:* One respondent queried the basis for capturing and calculating data in the quarterly reports. Another respondent sought clarification on whether the dates of quarterly reporting should follow the quarter ends of the scheme year or whether they should correspond to the quarter ends of the calendar year (ie. March 31, June 30, Sept 30 and Dec 31).

85. *SFC's Response:* As regards the basis for capturing data in the quarterly reports, reference should be made to the specific provision in the Hedge Funds Reporting Requirements and the management company must state the calculation basis and the assumptions for each financial disclosure. The SFC would allow the management company to use either the scheme financial year or the calendar year as the basis of the quarterly reports so long as there are no gaps in the reporting periods and the reports are distributed to holders at regular intervals according to the stipulated filing deadlines.

***Portfolio Review - Fund size and NAV per share***

86. *Public Comments:* One respondent suggested that FoHFs should include the breakdown of the quarterly return attributable to each strategy and underlying fund, and the percentage of NAV allocated to each strategy.
87. *SFC's Response:* The SFC feels that similar disclosure requirements have already covered this aspect under the explanatory note to the "Performance Review" section of the Hedge Funds Reporting Guidelines.

***Portfolio Review - Leverage***

88. Please refer to the section on "Definitions of Financial Terms".

***Portfolio Review - Performance and Risk Measures***

89. *Public Comments:* There were divergent views on the relevance of some of the performance and risk indicators in the proposal under the Appendix Table. One respondent regarded the Sharpe ratio and standard deviation measures were the most significant and appropriate. Another respondent claimed that the Sharpe ratio could be misleading to investors because it did not measure the downside risk of the fund. He proposed that the Sortino ratio would be a more appropriate risk measure.
90. Another respondent appeared to be concerned with investors' interpretation of the performance and risk measures. He recommended proper explanation of the Sharpe ratio and standard deviations parameters in the quarterly reports, including a highlight of their usage, limitations, and calculation bases.
91. Several respondents felt that the assumption of a "zero risk free rate" in calculating the Sharpe ratio was unrealistic and misleading. One respondent cited specific circumstances under which the assumption of a zero risk-free rate in calculating the Sharpe ratio would mislead investors. On the other hand, some respondents recognized the advantages of using a "zero risk free rate" in calculating the Sharpe ratio.
92. Some respondents also suggested that hedge fund managers be allowed to add additional measures for risk adjusted returns if necessary.



93. On other items in the Appendix Table, one respondent also suggested that an additional parameter, namely, "Time to Recovery" (ie. the time that was needed by the fund to offset the loss that constituted the Maximum Drawdown) should also be disclosed.
94. *SFC's Response:* The SFC maintains the initial disclosure requirements as set out in the Appendix Table as the minimum required disclosures for hedge funds in the quarterly reports. The SFC is mindful that these requirements are by no means exhaustive and comprehensive in highlighting all the relevant risk and performance indicators for each hedge fund. We strongly recommend that each individual hedge fund disclose additional measures that best illustrate its risk and performance profile accompanied by the relevant calculation basis and definitions.
95. The management company is encouraged to disclose other appropriate performance and risk measures, taking into account the objective and strategy of the scheme (eg. VaR, alpha, Sortino ratios, additional Sharpe ratios using alternative risk free rates other than zero, aggregated risk/return statistics, full position disclosure of derivatives and their basis of calculation, time to recovery periods, % of down months, % of up months, delta equivalent of option positions etc.). Where these parameters are used in the reports, the management company must provide the calculation basis and definition of each performance and risk measure.
96. As regards the calculation basis for Sharpe ratio, the SFC notes that the relevant "risk free rate" for each investor may vary widely and it would be impossible for the SFC to cater to each individual's circumstances. Thus, the SFC maintains the assumption of a zero risk free rate for the calculation of the Sharpe ratio in order to provide a consistent, simple and comparable methodology for investors. Its limitations are noted, but it does not outweigh its usefulness. Again, management companies may provide additional variations of the Sharpe ratio based on other calculation methodologies if deemed to be appropriate for investors. Management companies may also explain the limitations of each risk measure/ underlying assumption in the quarterly reports.

#### ***Portfolio Review - Amount of Seed Money***

97. *Public Comments:* One respondent recommended that as an alternative to stating exact amounts of seed money, it was suggested that disclosure would only be required if the amount breached a pre-determined benchmark level by the said parties.
98. *SFC's Response:* The SFC maintains that the disclosure of seed money contributed by the management company or its connected persons at the end of each quarter is useful information to the holders, as it indicates the level of committed investments by the administration of the fund. As the size of each hedge fund can vary greatly, we accept that relative values instead of absolute dollar amounts will be more relevant to investors especially over an extended period of time. The original proposal has been amended to require disclosure of

seed money in percentage terms of a hedge fund's NAV instead of the absolute amounts at the end of each quarter.

### ***Portfolio Review - Illiquid Holdings***

99. *Public Comments*: Most respondents agreed that details of illiquid holdings must be disclosed since these holdings may pose significant risks especially within concentrations of illiquid strategies. However, most of the respondents were concerned with the definition of "illiquid" as different managers have different views especially on over-the-counter (OTC) products. There were also some queries about FoHFs, whose underlying funds may not provide details of illiquid holdings thus making it difficult to construct a composite measure.
100. *SFC's Response*: The SFC acknowledges the comments and notes the support of most respondents. The SFC takes the view that information regarding illiquid holdings may partly reflect the potential short term liquidity needs of a hedge fund and will provide investors with a view of its valuation risks. In order to ensure consistency and comparability of the disclosure on illiquid holdings, the SFC has set out the definition of "illiquid holdings" to be those assets for which there are no readily available market values to be transacted between knowledgeable and willing parties at an arm's length transaction, or with no registered turnover in the last thirty days prior to and including the reporting date. This description is by no means a definitive classification, but is deliberately defined in broad terms for the purpose of simplicity and uniformity.
101. Furthermore, in response to the respondents' desire to have separate disclosure requirements for single hedge funds and FoHFs, the SFC has differentiated the reporting requirements of illiquid holdings for each quarter between FoHFs and the other types of hedge funds.
102. In respect of FoHFs, a separate provision requires disclosure of names and acquisition costs of any suspended underlying funds during each quarter plus the latest status report of such funds as at the reporting date. For a FoHFs, the main investment assets are its underlying funds. Therefore, if an underlying fund of a FoHFs is suspended, it then becomes an "illiquid" investment holding for the FoHFs. Implicit in the requirement for a status report, the management company is invited to provide the latest news regarding the suspensions (ie. whether the underlying funds remain suspended or suspensions have been uplifted) and provide the reasons for such suspended funds.
103. In respect of single hedge funds, a separate provision requires disclosure of illiquid holdings (as defined above) as at the end of the reporting period. Such disclosures would need to differentiate between illiquid positions in derivatives and non-derivatives in light of the liquidity concerns of OTC derivatives.

### ***Portfolio Review - Concentrated Exposures***

104. Public Comments: One respondent suggested that only exposures exceeding a certain percentage benchmark of NAV warrant disclosure to investors. Respondents also reiterated concerns regarding the disclosure of top positions of the scheme in the quarterly reports. These concerns were substantially the same as those they had expressed in respect of similar disclosure requirements in the semi-annual and annual reports. Respondents also noted the timing for release of the quarterly reports meant that the disclosures contained therein are more likely to expose them to business risks from competitors as they view that some of the proposed disclosures are proprietary information. On the other hand, one respondent suggested that in addition to the proposed disclosure, maximum and minimum long, short and net exposures and their calculation methodologies be disclosed as well.
105. SFC's Response: The SFC recognises that any benchmark for triggering disclosure will be arbitrary and may be difficult to administer. Please see the section on "Compliance with Appendix E of the Code - Alternative Disclosures in Lieu of Full Position Transparency in Semi-Annual and Annual Reports" for our overall views regarding alternative disclosures.
106. The SFC maintains the requirement for exposures of the scheme to be disclosed, and we wish to clarify that exposures include exposures to cash and cash equivalent holdings both in respect of single hedge funds and FoHFs. Separate provisions in respect of single hedge funds and FoHFs are inserted for greater clarity.
107. The SFC notes that information in the quarterly reports may be considered as more strategically sensitive compared to information contained in the semi-annual and annual reports. Having regard to the shorter reporting deadlines for quarterly reports (ie. one month and six weeks for single hedge funds and FoHFs respectively) vis-à-vis the deadlines for semi-annual and annual reports (ie. four months and six months for annual reports of single hedge funds and FoHFs respectively) and in light of respondents' concerns, the proposal for disclosure of the top five positions of the scheme is deleted.
108. To supplement the revised provision, where the scheme is a FoHFs, the number of underlying funds and number of underlying fund managers included in the FoHFs as at the end of the reporting period must be disclosed. Specifically, where the FoHFs is a multi-strategy FoHFs, it is required to additionally disclose the number of underlying funds and underlying fund managers under each strategy. Where the scheme is a single hedge fund, we require disclosure of the aggregated gross long and short positions held by the scheme as of the reporting dates, to give investors an overview of the long and short positions of the scheme. Management companies must also provide the calculation methodologies used.

***Portfolio Review - Additional Disclosures for FoHFs***

109. *Public Comments*: Some respondents were concerned that the liquidity profile of the underlying funds could be misinterpreted as a schedule for redemption payouts, and that this was misleading as factors such as exit penalties, redemption refusals and the availability of borrowings could all affect the FoHF's ability to meet redemption requests.
110. In respect of the "percentage closed" disclosure, respondents believed that there was a need to distinguish between funds that were closed to new investors versus funds that were closed to current investors. A few respondents also noted that the managers of underlying funds are not obliged to report to the FoHFs if their funds have reached capacity. Such knowledge may only come to light upon making a specific enquiry to the underlying fund manager. As such, disclosure of the percentage closed figure may be unduly burdensome.
111. As for appropriate disclosures regarding underlying funds, additional information recommended by one respondent include the percentage allocation to each underlying fund and the name of each fund; the percentage range of management and performance fees of underlying funds; the total actual management and performance fees paid to underlying funds and whether the FoHFs and/or its manager received any management fee or performance fee rebates from its underlying funds.
112. One respondent also suggested that the size of holdings by the single largest investor (by percentage of the fund's capital) be disclosed since the stability of a fund may depend on whether this investor remains a shareholder. However, another respondent commented that "liquidity profile" and "percentage closed" are very sensitive and proprietary information for FoHFs.
113. *SFC's Response*: The SFC appreciates all comments received on the additional disclosure requirements for FoHFs. The SFC has studied these concerns and agrees that the "liquidity profile" of the holdings of a FoHFs may have its inherent limitations. The SFC also concedes that the "percentage closed" figure for a FoHFs pertaining to its underlying funds is unduly burdensome to compile given that the information may not be readily available to the FoHFs. Furthermore, a "closed" fund can be re-opened at anytime. Accordingly, both provisions have been deleted.
114. The SFC has moved and expanded the provision on disclosure of the number of underlying fund managers under the section on "Concentrated Exposures".
115. The SFC appreciates the suggestions received for additional disclosures for FoHFs in the quarterly reports with particular reference to fees. However, the indicative range of fees charged by the underlying funds of FoHFs is already disclosed in the scheme's offering documents. The actual fees incurred as at the reporting date may not be readily ascertainable due to complicated payment procedures and entitlement of fees. The SFC also wishes to clarify that the Guidelines on Hedge Funds specifically prohibits the retention of rebates on any

fees or charges levied by the underlying funds by the management company and its connected persons.

116. Lastly, as regards the suggested disclosure on the holdings of the largest investor, the SFC views this as proprietary information for a FoHFs which may also not be meaningful for investors since all investors may choose to redeem their investments at any time for various reasons. The SFC considers that the disclosure of seed money held by management to be more useful to investors.

## Recommended Practices

### **Inflows and Outflows of Money, Intraproduct Holdings and Risk Measures**

117. *Public Comments:* All respondents who commented on “Inflows and Outflows of Money” had very divergent views. One respondent stated that these recommended practices should be made mandatory. Another respondent claimed that this information was too sensitive and would rather not make it publicly available. Yet another respondent recommended other additional disclosures such as requiring the management company to comment on the reasons for the inflows and outflows of money, and also the maximum capacity sustainable by the scheme before it reaches the point where the money balance could affect the fund’s performance.
118. Respondents sought clarification on the recommended basis for the highest, median and lowest values for “Intraproduct Holdings and Risk Measures” and whether these values are based on daily marked-to-market values or at each reporting period end. It was also suggested that intraproduct leverage should be disclosed on a mandatory basis in absolute terms and should include derivatives whereby notional amounts and delta equivalent values are shown.
119. *SFC’s Response:* The SFC appreciates the comments made by the respondents on recommended practices. Having regard to the significantly divergent views expressed by the respondents, and on the basis that the recommended practices are voluntary disclosures, the SFC has deleted the section in its entirety. The SFC reiterates that the management company is in the best position to consider what is the most relevant information that should be further disclosed to investors to help them understand the investment strategy and associated risks of their schemes.
120. The SFC has set out the minimum required amount of information to be disclosed by hedge funds to investors. The SFC recognizes that these minimum disclosure requirements are by no means exhaustive and we strongly encourage additional disclosure by each individual hedge fund if it is deemed appropriate and informative to investors, taking into account the objectives and strategies of the scheme.

## Others

121. *Public Comments:* One respondent suggested that data for several common market benchmarks (e.g., MSCI, S&P, LIBOR, CSFB/Tremont indices etc.), which the management company believes are relevant to the scheme, should also be provided in the quarterly reports, including a commentary on why the scheme out-performed/under-performed such benchmarks.
122. *SFC's Response:* The SFC is not in a position to endorse any particular benchmark. We note that some hedge funds do not measure themselves against specific benchmarks. Furthermore, the relevance of each benchmark to the scheme may differ on a case-by-case basis. The general principle we hold to is fair representation and comparison between "like with like". Thus, the SFC views the disclosure of any benchmarks in the scheme reports as voluntary information only.

## Part 3 - Implementation of the Hedge Funds Reporting Requirements

123. The Hedge Funds Reporting Requirements will become effective upon publication in the government gazette.
124. Funds seeking authorization as hedge funds will need to comply in full with the relevant provisions in the Hedge Fund Guidelines and the Hedge Funds Reporting Requirements. The SFC will adopt a pragmatic approach in the implementation of these requirements. In particular, fund management companies are encouraged to discuss any difficulties in complying with the Hedge Funds Reporting Requirements with the SFC. Applicants may also request waivers and file a submission providing detailed reasons in support of the waiver request.
125. Finally, the SFC welcomes further comments from the industry. Given the newness of hedge funds as public investment vehicles and that the hedge funds industry is evolving and moving at a fast pace, the SFC intends to review the provisions on a regular basis. Where applicable, necessary amendments or further guidance will be made or published to ensure a robust yet facilitative regime.

**List of Respondents (in alphabetical order)**

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

1. ACCA Hong Kong
2. Alternative Investment Management Association: The Hong Kong/China Chapter
3. Consumer Council
4. Deacons
5. Financial Control Limited
6. JF Asset Management
7. Quadriga Asset Management Ltd.
8. Schroders
9. SHK
10. Simmons & Simmons
11. Societe Generale, Investment Banking Division and Lyxor Asset Management
12. The Hong Kong Association of Financial Advisors Limited
13. The Law Society of Hong Kong

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

Two submissions

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

One submission

**Category D – Commentator requested its name to be published but submission to be withheld from publication**

1. Baring Asset Management
2. Zurich Capital Markets Hong Kong Limited

## Guidelines On Hedge Funds Reporting Requirements

### Introduction

*The Securities and Futures Commission (the Commission) has published the Guidelines on Hedge Funds Reporting Requirements (the Guidelines). The Guidelines sets out the minimum amount of information that is required to be disclosed in regular reporting to holders. The Commission advocates additional information to be disclosed if it is deemed to be appropriate and informative to holders, taking into account the objective and strategy of the scheme.*

1. Pursuant to Chapters 5.17 and 11.6 of the Code on Unit Trusts and Mutual Funds (the Code), authorized schemes are required to publish at least two reports in respect of each financial year, of which the annual report must be audited by the auditor for the scheme. Pursuant to Chapter 8.7(v) of the Code, authorized hedge funds are also required to publish quarterly reports for holders. The following scheme reports should be distributed to holders and filed with the Commission within the stipulated timeframe:

<u>Nature of reports</u>	<u>No. of reports for each scheme financial year</u>	<u>Timeframe for filing and distribution to holders</u>
Annual report	One	Within four months of the end of the relevant financial year, except for funds of hedge funds (FoHFs) where the timeframe for filing and distribution to holders is within six months of the end of the relevant financial year.
Semi-annual report	One	Within two months of the end of the relevant period
Quarterly reports	Four	Within one month of the end of the relevant period, except for FoHFs where the timeframe for filing and distribution to holders is within six weeks of the end of the relevant period.

*Note: Where the management company wishes to report to holders via monthly reports, there is no need to prepare quarterly reports provided that the same requirements for quarterly reports are complied with in the monthly reports.*

2. These Guidelines aims to provide further guidance to management companies regarding the on-going reporting requirements of authorized hedge funds. *The Commission reserves the right to require additional disclosure to be made.*



3. For the ease of understanding by holders, where technical terms are used in the scheme reports, the management company is specifically encouraged to include a glossary to explain their meaning and their implications to investors. Where financial terms are used in the scheme reports, the management company must provide their calculation bases, definitions, and any underlying assumptions.
4. Where the provisions refer to the scheme, this means the authorized hedge fund.

## **A. Contents of Financial Reports**

### ***Requirements Applicable to Both Annual and Semi-Annual Reports***

5. Annual and semi-annual reports of the scheme must contain the information as required by Appendix E of the Code, with the exceptions as provided in paragraph 6.
6. The Commission encourages full disclosure of individual holdings of the scheme. Where the management company is satisfied that full disclosure of such information may be unduly burdensome, it may adopt alternative disclosures in lieu of the disclosure as required in the Investment Portfolio subsection of Appendix E of the Code. In that case, the management company must choose the most appropriate and informative illustration of the scheme's holdings/exposures at the end of the relevant period, taking into account the objective and strategy of the scheme.

*Note: The following will be regarded as minimum disclosures acceptable to the Commission. The Commission reserves the right to require disclosure of the full position of the scheme for the purposes of carrying out its regulatory functions. Such disclosures to the Commission will be subject to the Commission's preservation of secrecy provisions.*

*With respect to any scheme that is a FoHFs, the management company should disclose:*

- a. *Exposures (including cash and cash equivalent holdings\*) for the scheme at the scheme level as of the reporting date (expressed in percentage terms of net asset value of the scheme) categorized by geographical region, industry, strategy, or some other basis that the management company considers the most appropriate, taking into account the objective and strategy of the scheme;*
- b. *The names and percentage values (based on net asset value of the scheme) of the top five underlying funds held by the scheme as of the reporting date;*
- c. *The number of underlying funds and the number of underlying fund managers included in the scheme as of the reporting date; and*
- d. *(Where the scheme is a multi-strategy FoHFs) disclosure of the number of underlying funds and underlying fund managers under each hedge fund strategy.*

*With respect to other schemes, the management company should disclose:*

- a. *Exposures (including cash and cash equivalent holdings\*) for the scheme as of the reporting date (expressed in percentage terms of net asset value of the scheme) categorized by asset class, geographical region, industry, strategy, or some other basis that the management company considers the most appropriate, taking into account the objective and strategy of the scheme;*
- b. *The names and amounts of the top five long positions and top five short positions held by the scheme on a gross basis as of the reporting date; and*
- c. *The aggregated gross long and short positions held by the scheme as of the reporting date (expressed in percentage terms of the net asset value of the scheme);*

\* *“Cash equivalent holdings” are defined as those assets with a maturity of less than one year and which are readily transactable in an arm’s length transaction between willing and knowledgeable parties.*

## **Requirements Specific to Annual Reports**

7. Where performance fees were borne by the scheme during the financial year, the annual reports of the scheme must contain the amount of such performance fees payable at the scheme level expressed as a percentage of average net asset value of the scheme as at the end of the financial year and the calculation basis.

*Note (1): A nil statement is required if no performance fees were borne by the scheme during the financial year.*

*(2): Where the scheme is a FoHFs, only performance fees at the FoHFs’ level need to be disclosed.*

## **B. Quarterly Reports**

### ***Distribution of Quarterly Reports***

8. The Commission requires that quarterly reports be distributed to holders to keep them informed of the scheme activities on a timely basis.
9. Quarterly reports are required to be filed with the SFC and distributed to holders within the stipulated timeframe under paragraph 1 of these Guidelines.

*Note: Given the newness of these Guidelines to the market, measures would be taken to familiarise the management company with the reporting requirements and the disclosure standard expected of these reports. The first quarterly report of each scheme must obtain a “no objection” letter from the Commission before it is issued to persons in Hong Kong. In order to facilitate the vetting procedures, upon request from the management company, Commission staff may review and provide comments on the format of the first quarterly report of each scheme before its contents are ready.*

10. Quarterly reports may not be distributed to non-holders unless accompanied by the offering document of the scheme.

### **Contents of Quarterly Reports**

11. Quarterly reports must be provided in the English and Chinese languages, and must contain the following information regarding the scheme.

#### *Management Commentary*

12. A statement to the effect that the directors of the scheme and/or the management company accept responsibility for the information contained in the quarterly reports as being accurate as at the date of publication.

(a) Performance review

A commentary by the management company that describes and explains the key factors impacting upon the scheme's financial performance and any style drifts in the scheme during the reporting period.

*Note: Where the scheme is a FoHFs, the management company is expected to explain what has driven performance in terms of different strategies.*

(b) Market outlook

A discussion of the management company's expectation of the primary risk factors to which the scheme is exposed to, and the outlook of the development of these factors as they relate to the scheme.

(c) Changes in key investment personnel

A discussion on the changes in composition of the key investment personnel (if any) at the scheme level and their impact on the scheme's overall strategy, risk profile or future performance.

(d) Lawsuits

Details of any lawsuits that may have a financial impact on the scheme during the reporting period.

#### *Portfolio Review*

(e) Fund size and NAV per unit/share

The scheme's total net asset value, net asset value per unit/share as at the end of the reporting period, and the percentage change in net asset value per unit/share since the last reporting period.

(f) Cash borrowings and other sources of leverage

The amount of cash borrowings and other sources of leverage at the scheme level and a summary of how leverage is calculated as at the end of the reporting period.

*Note: The management company is expected to choose the most appropriate and informative illustration of the scheme's leverage, consistent with disclosures in the scheme's offering document, taking into account the objective and strategy of the scheme. Where the scheme is a FoHFs, disclosure is only required at the FoHFs' level.*

(g) Performance and risk measures

Disclosure of performance and risk measures of the scheme in tabular form. A sample format with the required parameters and time frames is set out in the **Appendix** to these Guidelines.

The management company is encouraged to disclose other appropriate performance and risk measures, taking into account the objective and strategy of the scheme (eg. Value at Risk (VaR), Alpha, Sortino ratio, additional Sharpe ratios using alternative risk free rates other than zero, aggregated risk/return statistics, full position disclosure of derivatives and their basis of calculation, time to recovery periods, % of down months, % of up months, delta equivalent of option positions etc.).

The management company must provide the calculation basis, definition and any underlying assumptions of each performance and risk measure either alongside the performance and risk measure or in a separate glossary.

(h) Amount of seed money

Disclosure of the amount of seed money expressed in percentage terms of the net asset value of the scheme contributed by the management company or its connected persons as at the end of the reporting period.

(i) Illiquid holdings

With respect to any scheme that is a FoHFs, the management company must disclose:

- (i) The name(s) of any underlying fund(s) suspended during the reporting period;
- (ii) The acquisition cost of such underlying funds; and
- (iii) The latest status of such underlying funds as at the end of the reporting period.

With respect to other schemes, the management company must disclose the name(s) and acquisition costs of all illiquid holdings\* held by the scheme as at the end of the reporting period, categorized by:

- (i) Derivatives; and
- (ii) Non-derivatives.

\* *“Illiquid holdings” are defined as assets for which there are no readily available market values to be transacted between knowledgeable and willing parties in an arm’s length transaction, or with no registered turnover in the last 30 days prior to and including the reporting date.*

(j) Concentrated exposures

With respect to any scheme that is a FoHFs, the management company should disclose:

- (i) Exposures (including cash and cash equivalent holdings) for the scheme at the scheme level as of the reporting date (expressed in percentage terms of net asset value of the scheme) categorized by geographical region, industry, strategy, or some other basis that the management company considers the most appropriate, taking into account the objective and strategy of the scheme;
- (ii) The number of underlying funds and the number of underlying fund managers included in the scheme as of the reporting date; and
- (iii) (Where the scheme is a multi-strategy FoHFs) disclosure of the number of underlying funds and underlying fund managers under each hedge fund strategy.

With respect to other schemes, the management company should disclose:

- (i) Exposures (including cash and cash equivalent holdings) for the scheme as of the reporting date (expressed in percentage terms of net asset value of the scheme) categorized by asset class, geographical region, industry, strategy, or some other basis that the management company considers the most appropriate, taking into account the objective and strategy of the scheme; and
- (ii) The aggregated gross long and short positions held by the scheme as of the reporting date (expressed in percentage terms of the net asset value of the scheme).

*Note (1): “Cash equivalent holdings” are defined as those assets with a maturity of less than one year and which are readily transactable in an arm’s length transaction between willing and knowledgeable parties.*

*(2): The Commission reserves the right to require disclosure of the full position of the scheme for the purposes of carrying out its regulatory functions. Such disclosures to the Commission will be subject to the Commission’s preservation of secrecy provisions.*

## Appendix

### **Information to be Disclosed under Section B.12(g) of the Guidelines on Hedge Funds Reporting Requirements**

#### Actual Monthly Returns in the Last Three Calendar Years (net of all fees and charges)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD Actual
Year (T-2)													
Year (T-1)													
Year T													

#### Summary Data

	Year T <sup>3</sup> (annualised year to date)	Year (T -1)	Year (T - 2)	Since Launch <sup>4</sup> [specify launch date]
<b>Performance Statistics</b>				
Annual Return				
Annualized Standard Deviation <sup>5</sup>				
Sharpe Ratio <sup>6</sup>				
<b>Fund Statistics</b>				
Highest NAV per unit/share				
Lowest NAV per unit/share				
Maximum drawdown <sup>7</sup>				

*[Display prominent warning statements to the effect that: “Investment involves risk, please see the offering document for further details. Past performance figures shown are not indicative of future performance.”]*

#### **Notes:**

- (1) Calculations must be net of all fees and charges borne by the scheme, with the calculation basis clearly stated.
- (2) As per paragraph 3 of the Guidelines, the management company should include a glossary of technical terms to explain their meaning and implications to investors (e.g. the higher the number, the riskier the scheme etc.).
- (3) “Year T” denotes the current scheme financial year.
- (4) Statistics since launch can only be shown if the scheme has been in existence for one year or longer.
- (5) “Annualized standard deviation” is defined as the square root of the squared deviations of the actual returns from the simple average return based on the dealing days of the scheme, divided by the number of observations, shown on an annualised basis.
- (6) “Sharpe ratio” is defined as annual return divided by the annualised standard deviation.  
*Note: For the sake of simplicity, a zero risk free rate is adopted in the calculation for “Sharpe Ratio”*
- (7) “Maximum drawdown” is the maximum amount of loss from an equity high until a new equity high, expressed as a percentage of the previous equity high.

## Guidelines On Hedge Funds Reporting Requirements

### Introduction

*The Securities and Futures Commission (the Commission) has published the Guidelines on Hedge Funds Reporting Requirements (the Guidelines). The Guidelines sets out the minimum amount of information that is required to be disclosed in regular reporting to holders. The Commission advocates additional information to be disclosed if it is deemed to be appropriate and informative to holders, taking into account the objective and strategy of the scheme.*

1. Pursuant to Chapters 5.17 and 11.6 of the Code on Unit Trusts and Mutual Funds (the Code), authorized schemes are required to publish at least two reports in respect of each financial year, of which the annual report must be audited by the auditor for the scheme. Pursuant to Chapter 8.7(v) of the Code, authorized hedge funds are also required to publish quarterly reports for holders. The following scheme reports should be distributed to holders and filed with the Commission within the stipulated timeframe:

<u>Nature of reports</u>	<u>No. of reports for each scheme financial year</u>	<u>Timeframe for filing and distribution to holders</u>
Annual report	One	Within four months of the end of the relevant financial year, {except for funds of hedge funds (FoHFs) where the timeframe for filing and distribution to holders is within six months of the end of the relevant financial year.}
Semi-annual report	One	Within two months of the end of the relevant period
Quarterly reports	Four	Within one month of the end of the relevant period, <u>except for FoHFs where the timeframe for filing and distribution to holders is within six weeks of the end of the relevant period.</u>

*Note: Where the management company wishes to report to holders via monthly reports, there is no need to prepare quarterly reports provided that the same requirements for quarterly reports are complied with in the monthly reports.*

2. These Guidelines aims to provide further guidance to management companies regarding the on-going reporting requirements of authorized hedge funds. *The Commission reserves the right to require additional disclosure to be made.*

3. For the ease of understanding by holders, where technical terms are used in the scheme reports, the management company ~~should~~ is specifically encouraged to include a glossary to explain their meaning and their implications to investors. Where financial terms are used in the scheme reports, the management company must provide their calculation bases, definitions, and any underlying assumptions.
4. Where the provisions refer to the scheme, this means the authorized hedge fund.

## **A. Contents of Financial Reports**

### **Requirements Applicable to Both Annual and Semi-Annual Reports**

- ~~5. Annual and semi annual reports of the scheme must be prepared in accordance with International Accounting Standards (IAS) as promulgated from time to time by the International Account Standards Board.~~

*Note: ~~Where the Scheme is an existing fund that adopts a different accounting standard from IAS and the financial year end for its annual report (or the end of the reporting period for its semi annual report, if more recent) falls on a date within four months from the effective date of these Guidelines, the scheme is not required to prepare such report in accordance with IAS until the next reporting period provided that it discloses and explains differences of accounting practice between IAS and the accounting standard adopted by the scheme, and include a statement of the financial effect of any such material differences.~~*

5. ~~6.~~ Annual and semi-annual reports of the scheme must contain the information as required by Appendix E of the Code, with the exceptions as provided in paragraph ~~6~~ 7.
6. ~~7.~~ The Commission encourages full disclosure of individual holdings of the scheme. Where the management company is satisfied that full disclosure of such information may be unduly burdensome, it may adopt alternative disclosures in lieu of the disclosure as required in the Investment Portfolio subsection of Appendix E of the Code. In that case, the management company must choose the most appropriate and informative illustration of the scheme's holdings/exposures at the end of the relevant period, taking into account the objective and strategy of the scheme.

*{Note: The following will be regarded as minimum disclosures acceptable to the Commission. The Commission reserves the right to require disclosure of the full position of the scheme for the purposes of carrying out its regulatory functions. Such disclosures to the Commission will be subject to the Commission's preservation of secrecy provisions.*

With respect to any scheme that is a FoHFs, the management company should disclose:

- a. (1) Exposures (including cash and cash equivalent holdings\*) for the scheme at the scheme level as of the reporting date (expressed in percentage terms of net



asset value of the scheme) categorized by ~~asset class~~, geographical region, industry, strategy, or some other basis that the management company considers the most appropriate, taking into account the objective and strategy of the scheme;

~~(2) Top ten position of the scheme in absolute terms (ie. Counting both the long and short positions of the scheme).~~

- b. The names and percentage values (based on net asset value of the scheme) of the top five underlying funds held by the scheme as of the reporting date;
- c. The number of underlying funds and the number of underlying fund managers included in the scheme as of the reporting date; and
- d. (Where the scheme is a multi-strategy FoHFs) disclosure of the number of underlying funds and underlying fund managers under each hedge fund strategy.

With respect to other schemes, the management company should disclose:

- a. Exposures (including cash and cash equivalent holdings\*) for the scheme as of the reporting date (expressed in percentage terms of net asset value of the scheme) categorized by asset class, geographical region, industry, strategy, or some other basis that the management company considers the most appropriate, taking into account the objective and strategy of the scheme;
- b. The names and amounts of the top five long positions and top five short positions held by the scheme on a gross basis as of the reporting date; and
- c. The aggregated gross long and short positions held by the scheme as of the reporting date (expressed in percentage terms of the net asset value of the scheme);

\* “Cash equivalent holdings” are defined as those assets with a maturity of less than one year and which are readily transactable in an arm’s length transaction between willing and knowledgeable parties.

## **Requirements Specific to Annual Reports**

~~8. Annual reports of the scheme must contain the following information:~~

- ~~(a) Where the scheme appointed prime broker(s) during the financial year, the name(s) of the prime broker(s), the amount of the scheme’s assets held with the prime broker(s) as at the end of the financial year, and their respective maximum levels during the financial year; and~~

7. (b) Where performance fees were borne by the scheme during the financial year, the annual reports of the scheme must contain the amount of such performance fees payable at the scheme level expressed as a percentage of average net asset value of the scheme as at the end of the financial year and the calculation basis.

*Note (1): A nil statement is required if no performance fees were borne by the scheme during the financial year.*

*(2): Where the scheme is a FoHFs, only performance fees at the FoHFs' level need to be disclosed.*

## **B. Quarterly Reports**

### ***Distribution of Quarterly Reports***

8. The Commission requires that quarterly reports be distributed to holders to keep them informed of the scheme activities on a timely basis.
9. Quarterly reports are required to be filed with the SFC and distributed to holders within the stipulated timeframe under paragraph 1 of these Guidelines.

*Note: Given the newness of these Guidelines to the market, measures would be taken to familiarise the management company with the reporting requirements and the disclosure standard expected of these reports. The first quarterly report of each scheme must obtain a "no objection" letter from the Commission before it is issued to persons in Hong Kong. In order to facilitate the vetting procedures, upon request from the management company, Commission staff may review and provide comments on the format of the first quarterly report of each scheme before its contents are ready.*

10. Quarterly reports may not be distributed to non-holders unless accompanied by the offering document of the scheme.

### ***Contents of Quarterly Reports***

11. Quarterly reports must be provided in the English and Chinese languages, and must ~~should~~ contain the following information regarding the scheme.

### ***Management Commentary***

12. A statement to the effect that the directors of the scheme and/or the management company accept responsibility for the information contained in the quarterly reports as being accurate as at the date of publication.

(a) Performance review

A commentary by the management company that describes and explains the key factors impacting upon the scheme's financial performance and any style drifts in the scheme during the reporting period.

*Note: Where the scheme is a FoHFs, the management company is expected to explain what has driven performance in terms of different strategies.*

(b) Market outlook

A discussion of the management company's expectation of the primary risk factors to which the scheme is exposed to, and the outlook of the development of these factors as they relate to the scheme.

(c) Changes in key investment personnel

A discussion on the changes in composition of the key investment personnel (if any) at the scheme level and their impact on the scheme's overall strategy, risk profile or future performance.

(d) Lawsuits

Details of any lawsuits that may have a financial impact on the scheme during the reporting period.

### *Portfolio Review*

(e)(a) Fund size and NAV per unit/share

The scheme's total net asset value, net asset value per unit/share as at the end of the reporting period, and the percentage change in net asset value per unit/share since the last reporting period.

(b) ~~Leverage~~

(f) Cash borrowings and other sources of leverage

The amount of cash borrowings and other sources of leverage at the scheme level and a summary of how leverage is calculated as at the end of the reporting period.

*Note: The management company is expected to choose the most appropriate and informative illustration of the scheme's leverage, ~~at the end of the relevant period,~~ consistent with disclosures in the scheme's offering document, taking into account the objective and strategy of the scheme. Where the scheme is a FoHFs, disclosure is only required at the FoHFs' level.*

(g)(e) Performance and risk measures

{Disclosure of performance and risk measures of the scheme in tabular form. A sample format with the required parameters and time frames is set out in the **Appendix** to these Guidelines.}

The management company is encouraged to disclose other appropriate performance and risk measures, taking into account the objective and strategy of the scheme (eg. Value at Risk (VaR), Alpha, Sortino ratio, additional Sharpe ratios using alternative risk free rates other than zero, aggregated risk/return statistics, full position disclosure of derivatives and their basis of calculation, time to recovery periods, % of down months, % of up months, delta equivalent of option

positions etc.).

The management company must provide the calculation basis, definition and any underlying assumptions of each performance and risk measure either alongside the performance and risk measure or in a separate glossary.

(h)(d) Amount of seed money

Disclosure of the amount of seed money expressed in percentage terms of the net asset value of the scheme contributed by the management company or its connected persons as at the end of the reporting period.

(i)(e) Illiquid holdings

~~Disclosure of any scheme holdings as at the end of the reporting period for which there is no readily available market value, how the value of these holdings are ascertained, and by whom.~~

~~Note: For the purposes of presentation, such illiquid holdings should be classified into different categories, eg. Securities and derivatives.~~

With respect to any scheme that is a FoHFs, the management company must disclose:

- (i) The name(s) of any underlying fund(s) suspended during the reporting period;
- (ii) The acquisition cost of such underlying funds; and
- (iii) The latest status of such underlying funds as at the end of the reporting period.

With respect to other schemes, the management company must disclose the name(s) and acquisition costs of all illiquid holdings\* held by the scheme as at the end of the reporting period, categorized by:

- (i) Derivatives; and
- (ii) Non-derivatives.

\* “Illiquid holdings” are defined as assets for which there are no readily available market values to be transacted between knowledgeable and willing parties in an arm’s length transaction, or with no registered turnover in the last 30 days prior to and including the reporting date.

(j)(f) Concentrated exposures

With respect to any scheme that is a FoHFs, the management company should disclose:

- (i) Exposures (including cash and cash equivalent holdings) for the scheme at the scheme level as of the reporting date (expressed in percentage terms of net asset value of the scheme) categorized by asset class geographical region, industry, strategy, or some other basis that the management company

considers the most appropriate ~~and informative~~, taking into account the objective and strategy of the scheme ~~and the top five positions of the scheme in absolute terms (ie. Counting both long and short positions of the scheme)~~;

- (ii) The number of underlying funds and the number of underlying fund managers included in the scheme as of the reporting date; and
- (iii) (Where the scheme is a multi-strategy FoHFs) disclosure of the number of underlying funds and underlying fund managers under each hedge fund strategy.

With respect to other schemes, the management company should disclose:

- (i) Exposures (including cash and cash equivalent holdings) for the scheme as of the reporting date (expressed in percentage terms of net asset value of the scheme) categorized by asset class, geographical region, industry, strategy, or some other basis that the management company considers the most appropriate, taking into account the objective and strategy of the scheme; and
- (ii) The aggregated gross long and short positions held by the scheme as of the reporting date (expressed in percentage terms of the net asset value of the scheme).

*Note (1): “Cash equivalent holdings” are defined as those assets with a maturity of less than one year and which are readily transactable in an arm’s length transaction between willing and knowledgeable parties.*

*(2): The Commission reserves the right to require disclosure of the full position of the scheme for the purposes of carrying out its regulatory functions. Such disclosures to the Commission will be subject to the Commission’s preservation of secrecy provisions.*

~~(g) Additional disclosures for FoHFs~~

~~Where the scheme is a FoHFs, the management company should include:~~

- ~~(i) A liquidity profile of the holdings of the FoHFs as at the end of the reporting period. A sample format with the required parameters is set out as follows;~~

<b>Liquidity Profile of Holdings of [the FoHFs] as at [date]</b>	<b>%</b>
Holdings with less than 30 days to cash	[ ]
Holdings with 30 to 59 days to cash	[ ]
Holdings with 60 to 89 days to cash	[ ]
Holdings with 90 to 179 days to cash	[ ]
Holdings with 180 or more days to cash	[ ]
Total scheme net asset value	100%

- (ii) A “percentage closed” figure for the FoHFs (defined as the percentage of the FoHFs’ capital dollars invested in underlying funds that would be closed to further subscriptions by the FoHFs as at the end of the reporting period divided by total capital dollars across all underlying funds); and

*Note: “Percentage closed” gives an indication of the FoHFs’ investment in underlying funds that have reached their full capacity with reference to the FoHFs, and whether new subscriptions into the FoHFs are likely to face diluted allocations. It is recognized that funds closed may re-open in future and vice versa, and thus the figure is disclosed as an indication only.*

- (iii) The number of underlying funds and number of underlying fund managers included in the FoHFs as at the end of the reporting period.

### **C. Recommended Practices**

12. In addition to the minimum disclosure requirements, the Commission encourages inclusion of the following voluntary disclosures in the scheme’s reports:

- (a) Information on inflows and outflows of money

Disclosure of total subscriptions and redemptions of the scheme during the relevant period.

- (b) Information on intraperiod holdings

Disclosure of intraperiod investment activities in terms of the highest, median and lowest holdings of the portfolio categorized by asset classes, geographical region, industry, strategy, or some other basis that the management company considers the most appropriate, taking into account the objective and strategy of the scheme.

- (c) Information on intraperiod risk measures

Risk measures, including its definition adopted by the management company in preparing the scheme report, of the relevant portfolio in terms of the highest, median and lowest values over the reporting interval and at period end.

## Appendix

### Information to be Disclosed under Section B.12(g) of the Guidelines on Hedge Funds Reporting Requirements

#### Actual Monthly Returns in the Last Three Calendar Years (net of all fees and charges)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD Actual
Year (T-2)													
Year (T-1)													
Year T													

#### Summary Data

	Year T <sup>3</sup> ( <u>annualised</u> year to date)	Year (T -1)	Year (T - 2)	Since Launch <sup>4</sup> [specify launch date]
<b>Performance Statistics</b>				
Annual Return				
Annualized Standard Deviation <sup>5</sup>				
Sharpe Ratio <sup>6</sup>				
<b>Fund Statistics</b>				
Highest NAV per unit/share				
Lowest NAV per unit/share				
Maximum drawdown <sup>7</sup>				

[Display prominent warning statements to the effect that: **“Investment involves risk, please see the offering document for further details. Past performance figures shown are not indicative of future performance.”**]

#### **Notes:**

- (1) Calculations must be net of all fees and charges borne by the scheme, with the calculation basis clearly stated.
- (2) ~~(3)~~As per paragraph 3 of the Guidelines, the management company should include a glossary of technical terms to explain their meaning and implications to investors (e.g. the higher the number, the riskier the scheme etc.).
- (3) ~~(2)~~“Year T” denotes the current scheme financial year.
- (4) Statistics since launch can only be shown if the scheme has been in existence for one year or longer.
- (5) “Annualized standard deviation” is defined as the square root of the squared deviations of the actual returns from the simple average return based on the dealing days of the scheme, divided by the number of observations, shown on an annualised basis.
- (6) “Sharpe ratio” is defined as annual return divided by the annualised standard deviation.  
*Note: For the sake of simplicity, a zero risk free rate is adopted in the calculation for “Sharpe Ratio”*
- (7) “Maximum drawdown” is the maximum amount of loss from an equity high until a new equity high, expressed as a percentage of the previous equity high.