



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

**CONSULTATION CONCLUSIONS ON
CONSULTATION PAPER ON THE REVIEW
OF CHAPTER 8.7 OF THE CODE ON UNIT
TRUSTS AND MUTUAL FUNDS**

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Annex I

Marked-up version of the final version of the HF Guidelines.

Annex II

Clean version of the final version of the HF Guidelines.

Annex III

List of respondents to the Consultation Paper

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

Executive Summary

1. The Securities and Futures Commission (“SFC”) issued a Consultation Paper on the Review of Chapter 8.7 of the Code on Unit Trusts and Mutual Funds (“Code”) on 26 May 2005 for a consultation period of four weeks. 11 submissions were received from various market practitioners, legal professionals and industry associations.
2. The Consultation Paper proposed revisions (“Consultation Proposals”) to the Hedge Fund Guidelines under Chapter 8.7 of the Code (“HF Guidelines”). The Consultation Proposals focused on three main areas:
 - (i) To adopt a holistic approach in assessing the acceptability of the management company as a hedge fund manager;
 - (ii) To increase transparency of the management company’s operations through enhanced disclosure in the offering document; and
 - (iii) To consolidate and codify the SFC’s regulatory practices in the application of the HF Guidelines by proposing additional notes to it.
3. The majority of the respondents were supportive of all three main proposals. They supported the SFC’s proposal to take into consideration a management company’s internal controls, risk management process, resources, public funds management experience and corporate governance when assessing whether or not the management company should be authorised as a retail hedge fund manager. Respondents also welcomed the SFC’s clarification on the scope of relevant experience that would be recognized as part of the general experience required of the two key personnel of a hedge fund manager.
4. Respondents agreed with the proposed additional disclosure requirements to provide further investor protection, which include disclosures regarding the relationship between prime brokers and the scheme, the management of conflicts of interest, risk management process, the conduct of a fair and independent valuation and the calculation of performance fees. Some respondents asked the SFC to clarify its regulatory intent regarding the disclosure requirements relating to prime brokers and independent valuation. In view of these comments, the SFC has modified the wording of the relevant sections of the HF Guidelines to better reflect its regulatory intentions regarding these issues.
5. Market practitioners were also supportive of the codification of certain existing SFC regulatory practices through additional notes to the HF Guidelines in relation to compulsory redemption, ring-fencing provisions, equalisation and prohibitions on the use of “managed accounts” by Funds of Hedge Funds (“FoHFs”).

6. Besides the three key areas, the SFC also sought the market's view on the minimum subscription level for single hedge funds and the level of collateralisation to prime brokers.
7. Respondents' views were divided on the minimum subscription threshold issue. Those respondents with a fund industry background welcomed a lowering of the threshold to expand the scope of their hedge fund businesses in the retail sector, while respondents who are in frontline retail sales such as brokers and investment advisers, opposed the lowering of the threshold on the grounds that the investing public are still not familiar with the investment features and risks associated with hedge funds. The SFC has concluded that, on balance, it is not appropriate at this stage to reduce the minimum subscription level of single hedge funds from US\$50,000 to US\$30,000, having regard to the feedback from practitioners conversant with retail practice.
8. Furthermore, the SFC considers that at this stage of market development, it is not appropriate to increase the collateralisation level whereby an SFC-authorized hedge fund may pledge its assets to prime brokers. Therefore, the proposal of relaxing the collateralisation level to beyond 100% will not be adopted. However, the SFC will closely monitor market developments, and may revisit the issues of minimum subscription threshold and collateralisation level in the future.
9. During, and shortly after the close of the consultation period, a number of significant market events in relation to hedge funds and regulatory initiatives took place in various leading financial markets.
10. In June 2005, the hedge funds industry was assailed by news and rumours of the collapse of various hedge funds. Market sources revealed that the liquidation of hedge funds managed by Bailey Coates, Marin Capital and Aman Capital (Singapore) was largely attributed to losses incurred in derivatives trading, in particular, credit derivatives. Some hedge funds had suffered severe losses in the first 6 months of 2005 ranging from 14% to 17 % as seen in the case of GLG Partners in London.¹
11. The Financial Services Authority ("FSA") in the UK released two Discussion Papers in June: "*Hedge Funds – A discussion of risks and regulatory issues*" and "*Wider-range retail investment products – Consumer protection in a rapidly changing world*".
12. In the US, the Counterparty Risk Management Policy Group ("CRMPG") released a report² in July that included a set of initiatives aimed at reducing the risks of systemic financial shocks and limiting the damage of such shocks when

¹ Source: July 8 Issue of the Executive Intelligence Review mentioned that 2 out of the 16 hedge funds of GLG partners suffered losses from January to end of May losing 14.5% to 17.2% respectively.

² "*Toward Greater Financial Stability: A Private Sector Perspective*" issued by the CRMPG on 27 July 2005. CRMPG is a group of senior officials from a number of major financial institutions, led by Gerald Corrigan, Managing Director of Goldman Sachs & Co.

they occur.³ Furthermore, the Managed Funds Association (“MFA”), an industry association for hedge fund managers in the US, released a paper on “Sound Practices for Hedge Fund Managers” in August. The paper provides guiding principles and recommendations to hedge fund managers on how they should act to strengthen their risk management, to satisfy their responsibilities to investors, and to address unexpected market events.

13. All these initiatives provide practical guidance and recommendations on how to better manage the risks involved in the management of hedge funds and how to further enhance the transparency of hedge fund operations.
14. In arriving at the final HF Guidelines, the SFC has taken into account these recent international developments together with the responses received from the Consultation Paper. The SFC has also conducted a number of discussion sessions with respondents to clarify and better understand their submissions.
15. The final version of the HF Guidelines, in marked-up format is set out in **Annex I**. Consequential changes made to the proposed revised HF Guidelines following the close of the Consultation have been highlighted in different shades for easy reference. A clean version of the final version of the HF Guidelines is also set out in **Annex II**. The HF Guidelines will become effective upon publication in the Government Gazette.
16. Apart from the implementation of the revised HF Guidelines, the SFC will continue to closely monitor the market development of hedge funds and the conduct of hedge fund managers. The SFC will also continue its efforts to educate the investing public about the product features and risks associated with investing in hedge funds and other exotic products.

Summary of comments received from the Consultation Paper and SFC’s response to these comments

17. The following is a summary of the key submissions received from the market and our responses to them. Paragraphs 19 to 46 relate to the proposals regarding the assessment of management experience, valuation, disclosure in relation to prime brokerage, conflicts of interest, collateralisation to prime brokers and the minimum subscription level for single hedge funds. Paragraphs 47 to 79 are mainly responses to comments on the proposals to consolidate existing practices of the SFC in regulating SFC-authorized hedge funds.
18. Separately, a summary of those comments, which raised issues on the interpretation or application of the Code provisions relating to both hedge funds and traditional funds authorised for public offering is also provided at the end of this paper. As they cover a scope broader than the topics

³ The report focuses particular attention on risk management, risk monitoring and enhanced transparency in the context of today’s highly complex and tightly interconnected global financial system.

contemplated by the Consultation Proposals, these will be addressed in future reviews of the Code.

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

Public’s comments

19. Almost all of the respondents were supportive of the proposed holistic approach in assessing the eligibility of management companies for managing SFC-authorized hedge funds. The SFC’s general policy direction to assess the overall controls, risk management systems and the sufficiency of resources on a firm-wide basis was regarded as practical and welcomed by the industry.
20. While the general direction is acceptable to the market, some respondents would like to seek clarification from the SFC on the following issues:

Public funds experience: Some respondents would like the SFC to clarify the sort of experience required of the two key personnel in Chapter 8.7(a) because Chapter 5.5(a) of the Code specifically requires that, among others, fund managers of SFC-authorized funds have to demonstrate “public fund experience” and this requirement is cross referred to in the HF Guidelines. Since public funds are predominately long-only mutual funds, respondents observed that their fund managers are likely to have limited experience in managing hedge funds. If the same degree of “public fund experience” as specified in Chapter 5.5(a) were strictly applied on the individual personnel of the management company for an SFC-authorized hedge funds, respondents were concerned that this might result in a mis-matching of experience and expertise.

Risk controls: A couple of respondents commented that the obligation where “the management company must ensure that its risk management process was able to deal with normal and exceptional circumstances” might be too burdensome. Another respondent asked the SFC to clarify how a management company could demonstrate the ability of its risk management process to deal with exceptional circumstances to the SFC’s satisfaction.

SFC’s response

21. In view of the general support for the holistic approach proposed in Chapter 8.7(a)(i), this proposal will be adopted.
22. With respect to the two technical questions posed, our responses are as follows:

Public funds experience: When a hedge fund is authorized by the SFC pursuant to section 104 the Securities and Futures Ordinance, it becomes eligible for public offering. Inevitably, an SFC-authorized fund will interact with the investing public on various fronts including the processing of subscription and redemption requests, issuing of units/shares of the fund, and daily administration of the fund to meet investors’ requests and demands. The SFC believes it is necessary, for purposes of safeguarding investors’ interests,

that the management company is required to possess the necessary resources, competence and expertise to interact with the investing public and is able to administer the public funds properly.

In order to clarify this requirement, Chapter 8.7(a)(ii) has been revised such that the management company will be assessed on whether it has, on a firm-wide basis, sufficient experience and resources to administer public funds.

Risk controls: Recently, there have been a number of surveys and regulatory reviews conducted on the hedge funds industry by international bodies or regulators including those in the UK and the US. These reviews and surveys reveal that the risk management tools of the hedge fund managers were extremely varied in terms of methodologies and metrics used⁴. It is also noted that risk management controls employed by hedge funds are tailored to suit the strategies of individual funds; and that there appear to be few risk metrics that are effective across the entire strategy space.

23. Practitioners group, industry bodies and professional associations in various jurisdictions have also dedicated resources and efforts to identify the spectrum of risks involved in the management of hedge funds. These organisations have also provided practical guidance to hedge fund managers in relation to proper measures for risk controls.⁵ Stress testing is one of the risk metrics to help manage exposures of a hedge fund. The Guide to Sound Practices for Asian Hedge Funds Managers (published by Alternative Investment Management Association (“AIMA”) in December 2004) and the 2005 Sound Practices for Hedge Funds Managers (published by the MFA in August 2005) contain similar recommendations that a risk management process should deal with normal and exceptional conditions. Hedge funds managers are expected to perform stress tests to assess the impact of large market movements and to conduct “scenario analyses”.
24. The SFC believes that the requirement on a management company to ensure its risk control system is able to deal with normal and exceptional circumstances in Chapter 8.7(a)(iv) is in accord with international market standards and best practices in the hedge funds industry.

Key personnel’s experience – Chapter 8.7(a)(ii)

Public’s comments

25. Market practitioners welcomed the SFC’s clarification of the requirements for key personnel in a management company. In general, the expansion of the scope of individual experience recognised for the two key personnel’s experience is regarded as an improvement of the Code.

⁴ Financial Services Authority paper on Hedge Funds: A discussion of risk and regulatory engagement issued in June 2005

⁵ See notes 1 and 2.

26. With respect to the practical application of this requirement, some respondents raised specific comments on the types of experience that would be considered towards the satisfaction of this requirement.

SFC's response

27. Hedge fund management is a fast-evolving industry. However, there are several key principles in assessing the eligibility of key personnel for a hedge fund manager, e.g. the possession of relevant investment management expertise and experience. Investment management experience of key personnel is expected to include actual fund management experience and not just data analyses or research. Consequently, practical field experience gained in managing a hedge fund, using substantially the same strategy as the applicant scheme, remains a key criterion in assessing the acceptability of the key personnel.
28. On the other hand, market practitioners should note that the guidelines laid down in Chapter 8.7 serve as guiding principles to hedge funds for their applications for authorisation. If there are specific circumstances or factors that the applicant would like to bring to the attention of the SFC in considering the acceptability of the key personnel, the applicant and its professional advisers are recommended to consult the SFC at the earliest possible time on whether Chapter 8.7 requirement is complied with.

Independent valuation – Chapter 8.7(o)

Public's comments

29. Respondents were, in principle, supportive of SFC's proposal that assets of hedge funds should be independently and fairly valued.
30. A number of respondents raised the practical question of how independent valuation could be assured and what would be the acceptable measures to achieve independent valuation. While they saw merits in the requirement of a fair and independent valuation of a scheme, their views were diverse on whether the proposal to set out specific restrictions on the legal relationship between the valuation entity and the management company is the best way to achieve this end. Some favoured the view that the common directorship or shareholding between the valuation agent and the management company does not automatically compromise the integrity of the valuation. They observed that in large multinational conglomerates, a valuation agent may still be independent of the management company despite having common directors or being a subsidiary of the other.
31. On the other hand, some respondents believed that independence of the parties engaged in valuation and investment management process is key to investor protection. One respondent even suggested that the SFC consider insisting retail hedge funds to have an independent board of directors with an independent chairman who could oversee the trading and valuation processes,

and ensure that all third party relationships such as prime brokerage, valuation, etc, are truly done on a third party basis.

SFC's response

32. The importance of independent valuation of hedge funds has been highlighted in recent regulatory studies and reviews undertaken in major financial markets. Very often, hedge funds trade and invest in investment instruments that may not have a ready market or a transparent pricing system. It is therefore important that the valuation of the net asset value of the fund, being the basis on which redemption and subscriptions are made, is carried out in a fair and independent manner.
33. Having considered the recent publications released by CRMPG, the FSA and recommendations on best practices for pricing methodologies on hedge funds issued by various industry associations such as MFA and AIMA, the wide spectrum of investment instruments in which a hedge fund may invest and the different business models upon which hedge fund valuation, and investment management are built, the SFC concludes that there are certain core principles commonly accepted as best or recommended practices for conducting valuation for hedge funds. These core principles include the need to conduct a fair and independent valuation for a hedge fund, the need to maintain proper checks and balances in the way valuation is carried out and to ensure proper segregation of the functions of investment management from those of valuation.
34. Accordingly, the SFC has revised the Consultation Proposal on Chapter 8.7(p) by adopting a principles-based approach such that the core principles on valuation are laid down in the revised HF Guidelines, leaving sufficient discretion and flexibility for the scheme and the management company to implement the necessary measures to ensure fair and independent valuation.

Valuation in accordance with general accepted accounting principles – Chapter 8.7(o)

Public's comments

35. Some respondents sought clarification regarding the requirement under Chapter 8.7(o) of the Code requiring funds to be valued in accordance with the generally accepted accounting principles (“GAAP”). They mentioned that there are certain differences between GAAP and the valuation principles normally applied in the fund industry. In addition, respondents submitted that currently, there is no mandatory requirement to adopt a specific set of accounting principles for valuation purposes for traditional funds authorised under Chapter 7 of the Code.

SFC's response

36. The SFC notes the market practitioners' views that the principles and methodologies adopted by hedge funds may vary in light of the regulatory

requirements and jurisdictions in which they are established. In view of this, we conclude that while an SFC-authorized hedge fund should be fairly and independently valued on a regular basis, it would not be appropriate to mandate a particular set of valuation standards and methodologies, having regard to the broad spectrum of investment strategies or investment instruments that a hedge fund may employ or invest respectively. A scheme should, where applicable, disclose any differences between its valuation methodology and the generally accepted accounting principles adopted by the scheme.

37. We believe that no matter which set of valuation methodologies or principles is adopted, it should be applied consistently and, where applicable, the management company should also consider adopting the best industry practices in the valuation of the scheme's assets.

Prime brokers – Note to Chapter 8.7(b) regarding the disclosure of relationship with prime brokers and the level of collateralisation

Public's comments

38. Most respondents supported the proposal to include more detailed disclosure regarding the relationship between prime brokers and SFC-authorized funds in the offering document. However, some took the view that for retail investors, it would be more useful if the focus of such disclosure could be oriented towards the qualification of the prime broker and risk disclosure of any conflicts of interest rather than the detailed contractual/legal relationship and commercial terms between the prime broker and the scheme itself. They also suggested that it would add little value to investor protection if a scheme is further required to disclose the maximum amount of borrowings available to the scheme by the prime broker because the amount of leverage is dependent on a number of factors that fluctuate over time.
39. On the issue of collateralisation to prime brokers, there were diverse views. A number of opinions were expressed on how, on the technical side, the level of collateralisation should be calculated and the level at which the restriction should be set. As there were few local direct examples or experiences on how retail hedge funds' collateralisation level should be set, some respondents suggested that the SFC should consider the experience of overseas jurisdictions when they register hedge funds for professional investors.

SFC's response

40. The SFC agrees with the market's views that it would be more useful to investors if the focus of disclosure of the prime brokerage relationship is placed on whether the prime broker is subject to any regulatory oversight and the disclosure of any conflicts of interest between the prime broker and the scheme itself. Chapter 8.7(b)(iv) is therefore revised accordingly.
41. With respect to the level of collateralisation, the SFC is of the view that a prudent regulatory approach should be taken in the regulation of publicly

offered funds including SFC-authorized hedge funds. There is a wide range of regulatory issues related to the collateralisation of a scheme's assets against the scheme's borrowings from a prime broker: conflicts of interest faced by prime brokers upon foreclosure of the collaterals, and the impact to investors arising out of re-hypothecation of the collaterals by prime brokers. These issues have been the focus of regulatory studies in recent years and we intend to keep these under review in light of the evolving market practice and international regulatory developments.

42. Having balanced the need to maintain basic safeguards for investors, the practitioners' request for a less regulated collateralisation level and against the backdrop of the evolving international developments, the SFC has concluded that the collateralisation level should not be relaxed at this point in time. The SFC will keep in view further market developments and may revisit this issue where appropriate.

Minimum subscription for single hedge funds – Chapter 8.7(c)

Public's comments

43. The views on whether the minimum subscription threshold for single strategy hedge funds should be lowered from US\$50,000 to US\$30,000 are divided. Those respondents with a fund management industry background advocated the lowering of the threshold. These respondents wish to see a further expansion of the scope of hedge fund business into the retail sector.
44. On the other hand, market practitioners who are in frontline sales and interact with retail investors, such as stockbrokers and investment advisers, did not support the proposal to lower the threshold. These practitioners took the view that while there has been growing public awareness of hedge funds, this does not necessarily mean that the public has a good understanding of the hedge fund's product features and the risks associated with investments in hedge funds. These respondents also pointed out that even among intermediaries, a sizeable number of the frontline sales force are still not familiar with the investment risks and features of hedge funds. They feared that this may lead to mis-selling and mis-buying of hedge funds.

SFC's response

45. The SFC notes the concerns expressed by front-line market practitioners that the investing public may not possess the same level of understanding and familiarity with the investment features of hedge funds as they do with traditional funds. Other securities regulators like the FSA have also raised concerns on the general availability of hedge funds to retail investors having regard to the increasing complexity and illiquidity of this type of products;⁶ and various consultations are still being undertaken to assess whether further liberalisation of the retail market for hedge funds should be made.

⁶ FSA's paper: "Wider-range retail investment products – Consumer protection in a rapidly changing world"

46. The SFC concludes that there is merit in maintaining the market segmentation approach by imposing a minimum level of subscription. The SFC also agrees with the view that this is not the appropriate time to lower the threshold as proposed in the Consultation Paper. It follows that for single hedge funds, the minimum level of subscription is maintained at US\$50,000.

Prohibition of investing in unlimited liabilities vehicles - Chapter 8.7 (d) and (g)

Public's comments

47. Respondents, in general, supported the clarification of the application of Chapter 8.7(d) and (g) whereby investors' liability must be limited to their investment in the scheme and that a SFC-authorized FoHFs is prohibited from investing in unlimited liability vehicles. Nevertheless, some respondents commented that whether the scheme invests in unlimited liability vehicles or not has nothing to do with whether investors' liability is limited to their investment in the scheme.
48. Some respondents sought clarification on whether the SFC intends to prohibit investment in derivatives such as options or futures by a single hedge fund. Two respondents further suggested that should it be the SFC's intention, Chapter 7.16 should be mentioned in Chapter 8.7(g).

SFC's response

49. The SFC confirms that it is not the SFC's intention to prohibit investments in futures or options by single hedge funds. By their very nature, single hedge funds are expected to be involved in trading in equities, derivatives and other investment instruments. The SFC requires SFC-authorized hedge funds to implement proper risk management controls and process to reduce their exposures incurred in connection with various trading strategies.
50. The prohibition in Chapter 7.18 is intended to guard against a FoHFs assuming unlimited liabilities through investing in unlimited liability underlying funds, such as those taking the form of unlimited partnerships. Given the scope of investments permitted of single hedge funds and FoHFs has now been clarified, the SFC believes that it is not necessary to revise the current provision in 8.7(g).

Disclosure of ring-fencing arrangements - Chapter 8.7 (e)

Public's comments

51. The majority of responses supported the disclosure of ring-fencing arrangements which limit the liabilities between sub-funds in the umbrella structure. Some respondents were interested to know whether ring-fencing is a common feature in overseas jurisdictions where hedge funds are established.

SFC's response

52. As mentioned in the Consultation Paper, the requirement on an umbrella fund to implement proper ring-fencing arrangements is crucial to the segregation of liabilities between sub-funds within an umbrella structure. This requirement is key to safeguarding the interests of the investing public. It is the obligation of the management company of an SFC-authorized hedge fund to ensure that the relevant safeguards are legally enforceable in accordance with the relevant laws governing the operations of the scheme.
53. In response to the comment on whether ring-fencing is a common feature in other jurisdictions where hedge funds are established, the SFC would like to point out that an increasing number of overseas jurisdictions including those popular domiciles for SFC-authorized funds such as Luxembourg, Cayman Islands, Bermuda, France and recently Ireland have enacted or proposed to enact legislation to allow the establishment of protected cell companies or vehicles. This allows for segregated liability between sub-funds of an umbrella structure and thus ring-fencing of liabilities between sub-funds.
54. The SFC believes that the proposed requirement in Chapter 8.7(e) is reasonable having regard to the need for investor protection. However, in view of the market responses, the SFC has made minor drafting changes such that the fund is only required to make a disclosure regarding the ring-fencing arrangements in its offering document.

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

Public's comments

55. The public generally supports the proposal to codify the existing practice of disclosing whether “equalisation” is adopted or not and its related risks and benefits.
56. Some respondents also took this opportunity to raise other issues in connection with the topic of performance fees, e.g. issues related to the choice of tools to achieve equalisation such as the use of notional class, illustration of the performance fees calculation, as well as the issue of calculating performance fees on a “high-on-high” basis.

SFC's response

57. Given the support from the market, the SFC concludes that it is necessary to disclose to investors whether equalisation of performance fees will be achieved; and whether the amount of performance fees payable by investors would be affected in the absence of equalisation measures.
58. The SFC notes that there are various methodologies to achieve equalisation and we do not intend to prescribe any particular methods or tools in the Code. We believe it would suffice if the relevant methodology is clearly disclosed in the offering document.

59. Separately, we are aware that for unauthorised funds, performance fees may be charged on a basis other than “high on high”, for example, fees may be charged against a benchmark index or at a hurdle rate. However, in the case of SFC-authorized funds, the requirement to charge performance fees on a “high on high” basis has been well observed by both traditional and hedge funds. Since the discussion of the bases for charging performance fees involves a wider scope of review than the current consultation exercise, the SFC intends to consider this issue separately in the overall review of the Code provisions.

Proprietary Trading by FoHFs – Note to Chapter 8.7(j)

Public’s comments

60. The public had diverse views on the proposal to limit the conduct of “proprietary trading” by FoHFs. Some respondents supported the proposal to prohibit proprietary trading by FoHFs, while others suggested that certain types of proprietary trading should be allowed on a case-by-case basis. Despite this divergence of views, most respondents noted the risks of an over-spilling effect occurring when a FoHFs carries out “proprietary trading”.
61. Respondents that advocated proprietary trading by FoHFs believed that FoHFs carrying out proprietary trading through “managed accounts” provide more flexibility to hedge fund managers and are more cost efficient.
62. Some respondents also mentioned that “managed accounts” may be used for the purpose of currency and portfolio hedge and therefore should be allowed as this, in some ways, complements the overall strategy of the FoHFs.

SFC’s response

63. Since SFC-authorized hedge funds are designed for public offering to retail investors, they are expected to have a straightforward product structure and strategy. Investors would expect a FoHFs to select underlying hedge funds with an on-going obligation to monitor their performance. At the same time, the management expertise expected of a FoHFs should be different from that of a single hedge fund.
64. Once a FoHFs manager starts to carry out proprietary trading, the lines become blurred and an investor’s exposure may increase whenever proprietary trading results in a spill-over of the liabilities to the underlying funds invested in by the FoHFs. In an extreme case, a FoHFs manager may carry out a skewed strategy that allocates a substantial amount of the fund’s assets to proprietary trading, hence increasing the volatility of the FoHFs. This runs contrary to the regulatory intent that FoHFs authorised pursuant to the HF Guidelines are meant to achieve diversification through asset allocation into different underlying hedge funds.
65. The SFC has therefore concluded that the proposal to prohibit the conduct of proprietary trading by FoHFs should be adopted. However, the SFC is aware

that some respondents advocated that a reasonable amount of currency hedging activities should be allowed for a FoHFs. As not all FoHFs would need to carry out such activities and even if undertaken, each case would likely involve different considerations, it would not be practicable to lay down a set of uniform requirements for this purpose in the Code.

66. The SFC is prepared to consider on a case-by-case basis whether currency hedging activities should be allowed in the context of a FoHFs, and if allowed, the relevant safeguarding measures including effective ring-fencing provisions that it needs to put in place.

Investment in another FoHFs by FoHFs – Chapter 8.7(j)(ii)

Public's comments

67. One respondent suggested the relaxation of the prohibition contained in Chapter 8.7(j)(ii), namely, an authorised FoHFs is not allowed to invest in another FoHFs. It was suggested that a small proportion of a FoHFs should be allowed to be invested in other FoHFs to further reduce risks.

SFC's response

68. Investment by a FoHFs in another FoHFs not only increases opacity, but also undermines some of the structural safeguards in the HF Guidelines intended for the regulation of FoHFs. With the layered structures of a FoHFs investing into another FoHFs, it is difficult for investors to know if there is double charging of initial charges that are not permitted pursuant to Chapter 8.7(k). The SFC maintains that the restriction stated in Chapter 8.7(j)(ii) should remain.

Redemption in specie and compulsory redemption – Note to Chapter 8.7(m)

Public's comments

69. Some respondents considered the SFC's proposal to require a scheme to obtain an investor's consent before redemption in specie to be reasonable. However, some respondents suggested that it would be preferable not to confine the circumstances under which compulsory redemption may be effected to those set out in the Consultation Proposal. Rather, a broad based description of the principles for compulsory redemption would give more flexibility to the management company in circumstances where continuous holding by an investor would result in prejudice to the remaining investors.

SFC's response

70. The SFC maintains that individual consent must be obtained for redemption in specie. This serves to safeguard the interests of retail investors, who in most cases expect to receive cash on redemption instead of specific securities or other investment instrument. The SFC takes the view that if an individual investor is deemed to have given a blanket consent for redemption in specie,

this is tantamount to putting the investor at risk of having to receive illiquid investments or investments which are difficult to value and realise.

71. With respect to compulsory redemption, the SFC takes into account the market's response that there may be other circumstances where compulsory redemption has to be effected for the overall benefit of the scheme. We have revised the wording in Chapter 8.7(m) so that compulsory redemption may be made if it is for the overall benefit of the scheme. We also provide a non-exhaustive list of examples to facilitate the market's understanding of the application of this requirement.

Disclosure – Conflicts of Interest and Mitigating Measures - Chapter 8.7(t)

Public's comments

72. In response to the requirement of additional disclosure on conflicts of interest, respondents commented that while it is common practice for funds to disclose and describe the potential conflicts of interest they may have with service providers, there is currently no disclosure of mitigation measures that have been or may be taken against such conflicts. Meaningful disclosure in relation to mitigation of conflicts of interests would have to be addressed in the prime brokerage agreement.
73. Respondents also asked the SFC to explain more clearly what is considered to be a conflict of interest, the precise scope of disclosure that would be required and the measures expected by the SFC.

SFC's response

74. As it is the obligation of the management company to comply with the general principle of avoiding and properly managing conflicts of interest, the management company is expected to assess whether in a particular situation, conflicts of interest arise and if so, what would be the proper measure(s) to reduce or manage the conflicts in light of the management company's duty to act in the best interests of the investors of the relevant scheme.
75. The SFC has decided that the detailed scope of disclosure of conflicts should be left to the management company to decide but the general obligation to disclose how conflicts are managed will be maintained in the final version of Chapter 8.7(t).

Insurance linked product prohibitions

Public's comments

76. One respondent suggested that SFC should remove the provision under item (j) of Appendix C of the Code on Investment Linked Assurance Schemes and allow investment linked products to invest in appropriate hedge funds. The respondent believed that such allowance may be beneficial to the investor as

investments in an appropriate hedge fund by investment linked products may help further diversify the investment risk without unduly increasing volatility.

SFC's response

77. The SFC noted there might be commercial reasons for hedge fund managers to make their products more widely available through the network of ILAS products. On the other hand, the retailisation of hedge funds is still at an early stage and it would be prudent to observe the impact of such products to the retail sector for a period of time.
78. At the same time, the SFC is concerned whether ILAS products linked to hedge funds would be able to confer the same level of protection, in terms of structural safeguards and disclosure requirements, that is presently available to SFC-authorized hedge funds. To better understand the situation, the SFC has informally discussed with practitioners familiar with such insurance products and sales practices. They agreed that on a practical level, it may be difficult to ensure that the same kind of safeguards and disclosure requirements imposed on SFC-authorized hedge funds are fully implemented by an ILAS linked to hedge funds.
79. The SFC considers it premature at this stage to consider the expansion of the scope of hedge fund availability via ILAS products. However, we welcome any suggestions from the industry on how to enhance the market development of hedge funds and ILAS products and will conduct a dialogue with practitioners in the insurance industry to exchange our views on this subject.

Other comments

80. The SFC also received several comments regarding other issues that are relevant to both traditional and hedge funds, including the acceptable inspection regime, and the outsourcing of investment management functions. Respondents also provided feedback regarding the SFC's overall regulatory regime on both hedge funds and traditional funds.
81. These issues cover a much wider scope of regulatory consideration than those contemplated in the current consultation exercise. Most of them involve a broad review of the provisions in other parts of the Code for the authorisation of other types of funds, and not just hedge funds. The SFC is grateful for the valuable opinions expressed regarding these issues, and will take them into consideration in its future review of the Code.

Conclusion and implementation of the HF Guidelines

82. The SFC would like to thank all parties who have assisted or made contributions during the consultation process. A list of respondents is provided in **Annex III**.

83. In upholding SFC's principle of "Investors Come First", the SFC will continue its investor education initiatives to educate the investing public on the key investment features and risks in investing in hedge funds. The SFC would also like to reiterate that investors should ensure that they understand their own investment objectives and level of risk tolerance before investing in hedge funds or other alternative investments.
84. At the same time, the SFC, as part of its regulatory functions, will continuously monitor the market development of hedge funds and the conduct of hedge fund managers and intermediaries participating in the distribution of these products, particularly their compliance standards in fund management and selling practices.
85. The HF Guidelines will become effective upon its publication in the Government Gazette which is expected at the end of September 2005.

8.7 Hedge Funds

Foreword

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

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

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

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

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

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

The Management Company

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

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

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

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

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

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

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

A key personnel may satisfy this five years' relevant experience by a combination of both of his specific experience mentioned above and general experience relating to hedge funds. With respect to general experience, the Commission will normally consider the following types of experience acceptable:

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

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

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

For the avoidance of doubt, to the extent that Chapter 5.5(a) requires the key personnel to possess specific public funds experience, this requirement may be satisfied if the management company on a firm-wide basis is able to demonstrate that it possesses the requisite experience and resources to administer public funds.

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

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

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

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

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

Note: The management company ~~should~~ must have in place suitable internal controls and risk management systems

commensurate with the company's business and risk profile, including a clear risk management policy and written control procedures.

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

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

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

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

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

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

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

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

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

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

Prime Broker

- (b) Where a scheme appoints a prime broker, the following shall apply:
- (i) the prime broker must be a substantial financial institution subject to prudential regulatory supervision;
 - (ii) where assets of the scheme are charged to the prime broker for financing purpose, such assets ~~should~~must not, at any time, exceed the level of the scheme's indebtedness to the prime broker;

Note: Where assets of the scheme may be used as collateral or security for financing to be provided by the prime broker, disclosure must be made in the offering document of the risks associated with the collateralisation, for example, foreclosure or re-hypothecation of these assets by the prime broker and any consequential impact to the scheme and its investors.

- (iii) the assets charged to the prime broker must remain in a segregated custody account, in the name or held to the order of the trustee/custodian; and
- (iv) the scheme's offering document ~~should~~must disclose the profile of the prime broker and its relationship with the scheme.

Note: Before a prime broker is appointed by the scheme, the scheme or the management company (as the case may be) must conduct due diligence on the prime broker and be reasonably satisfied with the prime broker's suitability and competence.

Apart from disclosing the profile of the prime broker, the offering document must disclose the role(s) of the prime broker in relation to the hedge fund, whether the prime broker is subject to any regulatory supervision, and if so, a brief description of its licensing status in the relevant jurisdiction. Where appropriate, disclosure of the risks relating to any

conflicts of interest between the prime broker and the scheme has to be made in the offering document.

Minimum Subscription

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

() or the currency equivalent*

Limited Liability

- (d) The liability of holders must be limited to their investment in the scheme and this ~~should~~must be clearly stated in the offering document.
- (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. A brief description of such ring-fencing arrangement must be made in the offering document.

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

Investment and Borrowing Restrictions

- (f) The scheme ~~should~~must have a set of clearly defined investment and borrowing parameters in its constitutive and offering documents. The offering document ~~should~~must clearly explain the types of financial instruments in which the scheme will invest; the extent of diversification or concentration of investments or strategies; the extent and basis of leverage (including the maximum level of leverage); and the related risk implications of the investment and borrowing parameters.
- (g) The core requirements in Chapter 7 will not apply except for 7.12, 7.13, 7.14, 7.17, 7.18 (only applicable to FoHFs), 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~~must utilize at least 70% of its non-cash assets for the purposes of pursuing the objective or geographic region or market.

Performance Fees

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

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

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

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

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

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

Where the scheme does not intend to achieve equalisation of performance fees, its offering document must clearly disclose this fact and how the absence of equalisation may affect the amount of performance fees to be borne by investors.

Fund of Hedge Funds

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

- (j) The FoHFs ~~should~~ must comply with the following:
- (i) a FoHFs must invest in at least five underlying funds, and not more than 30% of its total net asset value may be invested in any one underlying fund; and

Note: One of the underlying assumptions of a FoHFs is that it can achieve diversification through investing in a range

of funds that employ different investment strategies and/or utilise the skills of different fund managers.

Any scheme applying for authorisation as a FoHFs should clearly explain its diversification strategy in the offering document.

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

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

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

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

- (vi) where the FoHFs invests in hedge funds not authorized by the SFC, such fact is disclosed in the offering document of the FoHFs. A warning ~~should~~must be included to the effect that some or all of the underlying funds of the FoHFs and their fund managers are not subject to the regulation of the Commission and that such funds may not be subject to rules similar to those of the Commission that are designed to protect investors.

Dealing

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

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

A scheme may not effect compulsory redemption except where the management company is reasonably satisfied that it is in the overall benefit of the scheme to do so. Examples where the management may effect compulsory redemption include the circumstances where the continuous holding of the scheme's interest by a particular holder will cause the scheme to be in breach of any laws or regulations governing the scheme, or result in adverse financial consequences to the scheme such as tax penalties.

Subject to the foregoing, the offering document must disclose the circumstances under which compulsory redemption may be effected and the length of notice for such redemption.

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

Valuation

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

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

In considering whether the management company is able to demonstrate that a scheme's investments are independently valued, the Commission may take into account a number of factors including the following:

(a) The duties and functions of the party carrying out the valuation (the "valuation agent") is expected to be segregated from those of the party carrying out the investment management function for the scheme e.g. the appointment of an independent administrator. Disclosure of how the segregation is achieved must be made in the offering document;

(b) There should be checks and balances to ensure that the valuation process and policy is consistently followed;

(c) The pricing data should be gathered from reliable sources;

(d) Where necessary, safeguarding measures should be implemented for the valuation to be carried out independently; and

(e) The selection of the valuation agent by the management company is based on due process.

Disclosure must be made of (1) the selection criteria of the valuation agent and the relationship between the management company, its group of companies and the valuation agent; and (2) any limitations and constraints of the valuation policies and methodologies.

The above factors are not exhaustive and the Commission may take into account other relevant factors in assessing the compliance with the independence requirement.

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

Disclosure

- (r) The front cover of the offering document must display prominently the following warning statements:
- (i) the scheme uses alternative investment strategies and the risks inherent in the scheme are not typically encountered in traditional funds;
 - (ii) the scheme undertakes special risks which may lead to substantial or total loss of investment and is not suitable for investors who cannot afford to take on such risks;
 - (iii) investors are advised to consider their own financial circumstances and the suitability of the scheme as part of their investment portfolio; and
 - (iv) investors are advised to read this offering document and should obtain professional advice before subscribing to the scheme.

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

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

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

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

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

(t) The management company must disclose the measures and safeguards put in place for the management of conflicts of interest in relation to the operation of the scheme.

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

Application Form

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

Financial Reports

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

8.7 Hedge Funds

Foreword

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

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

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

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

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

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

The Management Company

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

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

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

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

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

- (a) *In the case of a single hedge fund manager, the Commission will normally consider it acceptable if each of the two key personnel has at least two years' specific investment management experience in the same strategy as that of the scheme.*
- (b) *In the case of a FoHFs manager, the Commission will normally consider it acceptable if each of the two key personnel has at least two years' specific investment management experience as a FoHFs manager.*

A key personnel may satisfy this five years' relevant experience by a combination of both of his specific experience mentioned above and general experience relating to hedge funds. With respect to general experience, the Commission will normally consider the following types of experience acceptable:

- (1) *proprietary trading experience in securities, derivatives or other investment instruments which are of a similar nature to those contemplated by the scheme; or*

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

- (2) *carrying out investment strategies in the context of investment management or securities dealing business in similar nature to the one contemplated for the scheme; or*
- (3) *prior experience in evaluating or selecting hedge funds for investment purposes.*

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

For the avoidance of doubt, to the extent that Chapter 5.5(a) requires the key personnel to possess specific public funds experience, this requirement may be satisfied if the management company on a firm-wide basis is able to demonstrate that it possesses the requisite experience and resources to administer public funds.

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

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

- (iii) amount of assets under management;

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

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

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

It must continuously deploy such necessary resources and be vigilant to ensure that all the relevant risks in

connection with the management of the scheme are properly monitored and controlled in accordance with the investment strategy of the scheme.

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

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

- (a) have in place a due diligence process for the selection of the underlying funds and on-going monitoring of their activities;*
- (b) demonstrate its ability to assess and monitor the performance of the managers of the underlying funds, and the ability to replace the underlying funds whenever necessary to protect the interests of holders; and*
- (c) submit a plan to explain its due diligence and on-going monitoring processes (containing, among others, the frequency of reporting and evaluation of the underlying funds, and measures adopted by the management company to ensure investment and operational risks of the underlying funds are analysed and controlled) and include a summary of the plan in the offering document of the scheme.*

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

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

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

Note: Whilst reference would be made to the list of acceptable inspection regimes set out in Appendix A2, it is noted that the regulation of offshore hedge funds vs. onshore funds may be different in some jurisdictions. The

acceptability of an inspection regime for a scheme may need to be considered on a case-by-case basis.

Prime Broker

- (b) Where a scheme appoints a prime broker, the following shall apply:
- (i) the prime broker must be a substantial financial institution subject to prudential regulatory supervision;
 - (ii) where assets of the scheme are charged to the prime broker for financing purpose, such assets must not, at any time, exceed the level of the scheme's indebtedness to the prime broker;

Note: Where assets of the scheme may be used as collateral or security for financing to be provided by the prime broker, disclosure must be made in the offering document of the risks associated with the collateralisation, for example, foreclosure or re-hypothecation of these assets by the prime broker and any consequential impact to the scheme and its investors.

- (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 must disclose the profile of the prime broker and its relationship with the scheme.

Note: Before a prime broker is appointed by the scheme, the scheme or the management company (as the case may be) must conduct due diligence on the prime broker and be reasonably satisfied with the prime broker's suitability and competence.

Apart from disclosing the profile of the prime broker, the offering document must disclose the role(s) of the prime broker in relation to the hedge fund, whether the prime broker is subject to any regulatory supervision, and if so, a brief description of its licensing status in the relevant jurisdiction. Where appropriate, disclosure of the risks relating to any conflicts of interest between the prime broker and the scheme has to be made in the offering document.

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 must 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. A brief description of such ring-fencing arrangement must be made in the offering document.

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

Investment and Borrowing Restrictions

- (f) The scheme must have a set of clearly defined investment and borrowing parameters in its constitutive and offering documents. The offering document must clearly explain the types of financial instruments in which the scheme will invest; the extent of diversification or concentration of investments or strategies; the extent and basis of leverage (including the maximum level of leverage); and the related risk implications of the investment and borrowing parameters.
- (g) The core requirements in Chapter 7 will not apply except for 7.12, 7.13, 7.14, 7.17, 7.18, 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 must utilize at least 70% of its non-cash assets for the purposes of pursuing the objective or geographic region or market.

Performance Fees

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

Chapter 6.17 does not apply to the underlying funds of a FoHFs. For FoHFs, the offering document of the scheme must disclose whether a performance fee is levied at both the scheme level and the underlying

funds level. It must also summarize the bases of how performance fees are calculated and paid by the underlying funds. Appropriate warnings must be made in the offering document about the possibility of charging performance fees at various levels within a FoHFs and the implications to investors.

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

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

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

Where the scheme does not intend to achieve equalisation of performance fees, its offering document must clearly disclose this fact and how the absence of equalisation may affect the amount of performance fees to be borne by investors.

Fund of Hedge Funds

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

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

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

Any scheme applying for authorisation as a FoHFs should clearly explain its diversification strategy in the offering document.

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

acceptable for a FoHF to carry out proprietary trading directly or through the use of “managed accounts”.

- (ii) a FoHFs may not invest in another FoHFs.
- (k) The management company of the FoHFs must ensure that:
 - (i) each of the key personnel of the management company of an underlying fund possesses at least two years’ experience in the relevant hedge fund investment strategy, provided however that up to 10% of the net asset value of the FoHFs may comprise of underlying funds managed by investment personnel with less experience;
 - (ii) there is an independent trustee/custodian to safe keep the assets of the underlying funds;
 - (iii) where a FoHFs invests in underlying funds managed by the same management company or its connected persons, all initial charges on such underlying funds are waived;
 - (iv) neither the management company of the FoHFs nor its connected persons retain a rebate (whether in cash or in kind) on any fees or charges levied by such underlying funds, their management company or any of their connected persons;
 - (v) the offering document of the FoHFs clearly discloses the aggregate amount or give an indicative range of all the fees and charges of the FoHFs and each of its underlying funds; and
 - (vi) where the FoHFs invests in hedge funds not authorized by the SFC, such fact is disclosed in the offering document of the FoHFs. A warning must be included to the effect that some or all of the underlying funds of the FoHFs and their fund managers are not subject to the regulation of the Commission and that such funds may not be subject to rules similar to those of the Commission that are designed to protect investors.

Dealing

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

Note: A scheme may only effect redemption in specie with the prior consent of individual redeeming holder. The offering document must disclose the possibility of redemption in specie and the

need to obtain prior consent from an individual holder for making such redemption.

A scheme may not effect compulsory redemption except where the management company is reasonably satisfied that it is in the overall benefit of the scheme to do so. Examples where the management may effect compulsory redemption include the circumstances where the continuous holding of the scheme's interest by a particular holder will cause the scheme to be in breach of any laws or regulations governing the scheme, or result in adverse financial consequences to the scheme such as tax penalties.

Subject to the foregoing, the offering document must disclose the circumstances under which compulsory redemption may be effected and the length of notice for such redemption.

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

Valuation

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

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

In considering whether the management company is able to demonstrate that a scheme's investments are independently valued, the Commission may take into account a number of factors including the following:

- (a) *The duties and functions of the party carrying out the valuation (the "valuation agent") is expected to be segregated from those of the party carrying out the investment management function for the scheme e.g. the appointment of an independent administrator. Disclosure of how the segregation is achieved must be made in the offering document;*
- (b) *There should be checks and balances to ensure that the valuation process and policy is consistently followed;*
- (c) *The pricing data should be gathered from reliable sources;*

- (d) *Where necessary, safeguarding measures should be implemented for the valuation to be carried out independently; and*
- (e) *The selection of the valuation agent by the management company is based on due process.*

Disclosure must be made of (1) the selection criteria of the valuation agent and the relationship between the management company, its group of companies and the valuation agent; and (2) any limitations and constraints of the valuation policies and methodologies.

The above factors are not exhaustive and the Commission may take into account other relevant factors in assessing the compliance with the independence requirement.

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

Disclosure

- (r) The front cover of the offering document must display prominently the following warning statements:
 - (i) the scheme uses alternative investment strategies and the risks inherent in the scheme are not typically encountered in traditional funds;
 - (ii) the scheme undertakes special risks which may lead to substantial or total loss of investment and is not suitable for investors who cannot afford to take on such risks;
 - (iii) investors are advised to consider their own financial circumstances and the suitability of the scheme as part of their investment portfolio; and
 - (iv) investors are advised to read this offering document and should obtain professional advice before subscribing to the scheme.

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

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

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

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

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

- (t) The management company must disclose the measures and safeguards put in place for the management of conflicts of interest in relation to the operation of the scheme.
- (u) All advertisements must prominently display the warning statements referred to in 8.7(r) above.

Application Form

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

Financial Reports

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

Annex III – List of respondents to the Consultation Paper

Category A - Commentator has no objection to publication of name and content of submission (in alphabetical order).

- Clifford Chance
- Deacons
- HKSFA
- The Hong Kong Association of Financial Advisors Limited
- Hong Kong Investment Funds Association
- Law Society
- Linklaters (Representing Citigroup Global Markets Asia Limited, Goldman Sachs (Asia) L.L.C., and UBS AG)
- SAIL Advisors Limited
- Stewart Aldcroft/Noble Investments HK Ltd

Category B - Commentator requested submission to be published on a "no-name" basis.

Two submissions