

**A CONSULTATION PAPER ON
THE OFFERING OF HEDGE FUNDS**

The Securities and Futures Commission invites market participants and interested parties to submit written comments on the proposals discussed in this consultation document or to comment on related matters that might have a significant impact upon the proposals **no later than 7 December 2001**. Any person wishing to comment on the proposed changes should provide details of any organization whose views they represent. In addition, persons suggesting alternative approaches are encouraged to submit proposed text to amend the Code.

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

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

Written comments may be sent

By mail to: Investment Products Department
 Securities and Futures Commission
 12/F Edinburgh Tower
 The Landmark
 Central
 Hong Kong

By fax to: (852) 2877 0318

By on-line submission: <http://www.hksfc.org.hk>

By e-mail to: ip@hksfc.org.hk

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

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

Investment Products Department
Securities and Futures Commission
Hong Kong

October 2001

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¹ Personal Data means personal data as defined in the Personal Data (Privacy) Ordinance, Cap 486 (“PDPO”)

The Data Privacy Officer
The Securities and Futures Commission
12/F, Edinburgh Tower
The Landmark
15 Queen's Road
Central
Hong Kong

A copy of the Privacy Policy Statement adopted by the SFC is available upon request.

A CONSULTATION PAPER ON THE OFFERING OF HEDGE FUNDS

INTRODUCTION

1. The Securities and Futures Commission (SFC) invites comments on the proposed guidelines on hedge funds, for incorporation into the Code on Unit Trusts and Mutual Funds (the Code).

BACKGROUND

2. The SFC has been receiving requests from industry practitioners to authorize hedge funds for public offering in Hong Kong. In view of the increasing interest in hedge funds, the SFC considers it necessary to provide clearer guidance on the offering of such funds. This consultation paper discusses the issues involved in the authorization of hedge funds and proposes a set of criteria for the authorization of such funds.
3. The SFC will take into account the results of the consultation before publishing the guidelines in its final form. The proposed provisions may be found in **Annex 1** and these should be read in conjunction with the Code.

REGULATORY APPROACH

4. In drafting the provisions, the SFC has taken into consideration the following:
 - ◆ The need to facilitate market development and accommodate product innovation
 - ◆ The need to strike a balance between market development and investor protection
 - ◆ Experience and regulatory approaches in overseas jurisdictions

DISCUSSION

What are Hedge Funds?

5. There is no legal definition of the term “hedge funds”. There are however various industry definitions or descriptions of the term. Examples include:

“Hedge funds are private partnerships wherein the manager or general partner has a significant personal stake in the fund and is free to operate in a variety of markets and to utilize investments and strategies with variable long/short exposures and degrees of leverage.”²

² “Fundamentals of Hedge Fund Investing – a Professional Investor’s Guide” by William J. Cremend

“A pooled investment vehicle that is privately organized, administered by a professional investment management firm (referred therein as a “hedge fund manager”), and is not widely available to the public.”³

“Highly leveraged institutions ...are subject to little or no direct regulatory oversight because a significant percentage operate through offshore financial centres, are generally subject to very limited disclosure requirements and are not subject to rating by credit rating agencies, and often take on significant leverage ...”⁴

6. The term “hedge fund” is used to describe a wide range of investment vehicles, which can vary substantially in terms of size, strategy, business model and organizational structure, among other characteristics.
7. The largest market for hedge funds is the USA, where the concept was first introduced some fifty years ago. Whilst most publicly offered funds in the US exist in the forms of mutual funds or unit investment trusts, traditionally, hedge funds in the US appeared in the form of limited partnership to avoid registration requirements and are offered privately to a small circle of high net worth investors. However, it is not the legal form and structure which generally distinguishes a hedge fund from other collective investments but rather its investment strategies.
8. Hedge funds have also registered substantial growth in Europe in recent years. According to industry statistics, the number of hedge funds in the Asian region is rapidly growing although they account for less than 1% of assets under management worldwide. Hedge funds are marketed in Hong Kong mainly on a private basis. The industry lacks transparency and there is little public awareness of the products on offer.
9. In an important regard, these proposals and the developments in other jurisdictions mark a departure from the generally accepted ideas about hedge funds. In particular, under these proposals, there would be greater public access to these products.

Regulatory Concerns

10. The stated objective of many hedge funds is to reduce volatility and risk, while attempting to preserve capital and deliver absolute returns under different market conditions. Hedge funds may use a variety of financial instruments and hedging techniques to reduce risk and enhance returns. Over time, the term “hedge fund” has become a misnomer because not every so-called hedge fund employs hedging techniques.
11. The diversity of investment strategies and employment of different investment instruments and techniques means that hedge funds may vary enormously in terms of volatility and return. Hedge funds are often seen as exotic and

³ “Hedge Funds, Leverage and the Lessons of Long-Term Capital Management” – report by the U.S. President’s Working Group on Financial Markets

⁴ Highly Leveraged Institutions - paper by the Basel Committee

speculative vehicles suitable only for those with a hefty appetite for risk and who are able to understand the risks involved.

12. The opaque nature of hedge fund operations is also a cause of concern. International regulators are concerned with the systemic risks they may pose to the markets where their activities take place. They could threaten the solvency of their counter-parties and may have a potentially destabilizing effect on a particular market or the global financial market during a market event or upon a default situation. This is especially the case where the funds are large, highly leveraged and have highly concentrated positions. Subsequent to the collapse of LTCM, the Basel Committee of bank supervisors has recommended measures to enhance the ways that banks control and monitor their lending to hedge funds. Similarly, the Group of Seven and the Financial Stability Forum have provided for a sharing of information and detection of pressures in financial markets that could have a snowball effect.

Overseas Regulatory Approaches

13. Hedge funds are generally structured to minimize the effects of regulation and taxation on their chosen strategies. They are often set up in offshore jurisdictions where regulations may be less restrictive and for tax reasons.
14. Offering of hedge funds to small retail investors appears to be restricted in most overseas jurisdictions⁵. The reasons for such restrictions are not always clear but generally we understand that due to the special nature of hedge funds, they cannot fit into the existing regulatory framework for traditional funds⁶ in many jurisdictions and hence are not permitted to be marketed to the retail public.
15. In many overseas jurisdictions, the absence of specific rules means that hedge funds are often registered as “excluded” or “exempted” funds subject to fewer regulatory requirements than would apply to those traditional funds that are offered to the general retail public. The offering of these hedge funds are confined to specific categories of investors such as professionals, sophisticated or accredited investors. The criteria used for defining such investors include investment experience, net worth, suitability and minimum subscription level. A comparison table may be found in **Annex 2**.
16. Despite that the hedge funds may be “offshore”, hedge fund managers are still required to be licensed or registered in these overseas jurisdictions in respect of their fund management activities carried out in these jurisdictions.

Recent Developments

17. In the past, hedge fund managers did not see the need for obtaining authorization of their funds to gain access to the general public. There was

⁵ Except Switzerland which allows hedge funds to be offered to the retail public

⁶ In particular, the investments and borrowing restrictions and reporting requirements normally imposed on traditional funds

little retail demand for these products and managers were generally satisfied with distribution to their restricted high net worth client base only.

18. However, in the past year or so, there has been an increasing interest amongst fund managers in promoting their hedge funds as the volatile stock markets around the world have given impetus to investor demand. It is not uncommon to find institutional clients and pension funds including hedge funds as part of their investment portfolio. Investors appear to be looking out for a wider range of investment choices and alternatives to traditional products.
19. Market practitioners have called for the relaxation of rules to allow hedge funds to be offered to retail investors. Some fund managers have argued that, subject to meeting certain standards, members of the public who are capable of looking after their own interests should not be deprived of alternative investment opportunities to traditional products.
20. Against that, some market commentators have expressed concerns about a “hedge fund bubble” and have argued that the combination of inexperienced investors and inexperienced fund managers will lead to losses.
21. In view of these market developments, the SFC has conducted a number of discussions and informal consultation sessions with some industry practitioners. Some practitioners are of the view that hedge funds should be made available to all members of the public while others have reservations whether these products are suitable for everyone. Some firmly believe that hedge funds should be better reserved for professionals only in the strictest sense.
22. According to a recent survey conducted by the Hong Kong Investment Funds Association, 60% of its members are in favour of relaxing the investment restrictions under the Code to facilitate authorization of hedge funds. 14% support the relaxation if the funds have a high minimum threshold for subscription, and authorization being granted under a separate category. There are 12% who feel that investors are not ready for hedge funds and the remaining 14% are indifferent.

The Proposed Approach

23. In deciding the regulatory approach, the SFC is mindful that it should strike a balance between market development and investor protection.
24. Apart from examining the regulatory approaches in overseas jurisdictions, the SFC has also conducted informal discussions with some industry practitioners who have different views on the way in which hedge funds should be regulated.
25. Some practitioners are of the view that hedge funds should only be offered to professional or sophisticated investors. Some advocate the use of a segmentation approach. Others believe that hedge funds should be allowed to be offered to the general public without any restrictions. Nevertheless, all

agree that whatever approach is adopted, there should be full disclosure of information to investors.

26. Having regard to the views of market practitioners, the SFC considers that there may be *two alternative approaches* :
 - (a) **A market segmentation approach**, i.e. to allow hedge funds to be offered to a specific segment of the public. This can be achieved by using a “net worth” test or by imposing a minimum subscription amount.
 - (b) **A full public offering approach**, i.e. to allow hedge funds to be offered to the general public without any restrictions.
27. Like many market practitioners and overseas regulators, the SFC is wary of the ability of ordinary retail investors to understand these specialized funds which may vary enormously in their investment strategies, risk profiles, volatility and returns. It is important that those investors who are offered such funds are capable of understanding the nature of the product and the risks involved, or are able to employ the service of professionals to assist them in making an investment decision. The SFC is aware that investors who can afford the investment may not necessarily be capable of understanding hedge funds.
28. Although a “net worth” test may be one of the ways to divide the market, this may in practice, in the absence of any prior client knowledge, be reduced to a paper declaration by the investor, which would be neither reliable nor satisfactory as a means to investor protection. On the other hand, a minimum subscription level could be a simple and effective way for the purpose of segmentation.
29. Commentators, however, disagree on the appropriate level for the minimum subscription figure. Moreover, there are concerns that a high minimum may unintentionally force investors to put in more money than they would otherwise desire. Some investors who cannot afford the minimum amount may be encouraged to pool their money together with others for investment. Those who agree with setting a minimum subscription level have different views as to what should be the appropriate figure. The general view is that the figure should be set at a high level in order to achieve the desired result of segmentation.
30. Despite the divergent views, it is generally agreed that any figure would just serve as a benchmark. There is consensus that the most important investor protection issue to consider is how the funds are being sold. Concerns have been expressed about the qualifications and knowledge of the selling agents in hedge fund products and general conduct of sales issues. In general, persons dealing in securities are required to be registered with the SFC, unless they are exempt. It is a condition of registration that a person must be fit and proper. The SFC expects that a registrant will act with due skill, care and diligence and in the best interests of the client. To meet those expectations, a registrant must be competent to advise on the products they recommend. The SFC expects that any registered person offering investments to their clients should

also adhere to the “know your client” rule to ensure the suitability of the product for their clients.

31. It is primarily the responsibility of intermediaries to ensure that investors are properly informed about the risk of investing in a particular product. The SFC acknowledges that investor education is an important part of its functions and it will also be necessary for the SFC and the industry to consider strategies for better educating the public on hedge funds generally.
32. The full public offering approach, on the other hand, may be seen as a departure from current international practice, as described in paragraph 15. Nevertheless, the SFC recognizes the demand for alternative investments and is mindful that full public offering should be the trend in the long term.
33. Although segmentation may not satisfy the desire of some practitioners to see a more general opening up, it could be seen as a prudent, step-by-step introduction of new investment concepts, bearing in mind that such rule can be further relaxed as the market matures and investors’ knowledge increases.
34. In view of the divergence of views, the SFC would like to invite specific comments on the two alternative approaches. In particular, where commentators are in favour of the segmentation approach using a minimum subscription level, they are encouraged to propose a minimum subscription amount.

Proposed Guidelines

35. The proposed guidelines on hedge funds are set out in **Annex 1**.

General Code Requirements

36. The proposed provisions should be read in conjunction with the Code as the general code requirements will also apply to hedge funds, unless otherwise specified. Interested parties may refer to the SFC website (www.hksfc.org.hk) for the full text of the Code.

Definition of Hedge Funds

37. As mentioned in paragraph 5 above, there is no universal definition for the term “hedge fund”. Hedge funds vary in their characteristics and these need to be examined on a case by case basis. As such, the present drafting only refers to the key considerations of the SFC in authorizing products under the hedge funds guidelines.
38. Alternative investments other than hedge funds may warrant further examination and additional guidelines.

The Management Company

39. In view of the wide range of investment strategies, techniques and instruments employed by hedge funds, the SFC considers that it should place emphasis on the qualitative aspects of the fund manager. Apart from the usual assessment criteria as set out in Chapter 5 of the Code, we propose some specific additional areas in which the SFC would seek information when considering the acceptability of a fund manager for hedge funds.
40. In examining the relevant experience of the key investment personnel, the SFC is prepared to consider management experience in private funds, noting that the number of public hedge funds is limited.
41. The proposed requirement of US\$100 million of assets under management is the result of preliminary informal consultation with industry practitioners.
42. In view of the complex investment strategies employed by many hedge funds, it is important that there are suitable risk management systems and internal controls in place. In particular, the hedge fund manager must have in place a due diligence process for the appointment of its representatives and agents (e.g. administrator, custodian, prime broker, valuation agent). The objective is to ensure that parties dealing with the hedge fund possess the know-how and experience to manage the risks of the fund. In the case of a manager of a fund of hedge funds, a due diligence process should be in place for the selection of the underlying funds and monitoring the performance of the underlying fund managers.
43. In addition, many commentators have expressed concern about the standards and qualifications of selling agents. Given the complexity of hedge fund products, it is felt that the fund management company should have due diligence procedures in place to ensure that investors are properly informed of the risks involved in the investment. Generally, this will require competent sales staff, actual disclosure and an acknowledgement by the client that an explanation has been given. An undertaking from the fund manager in this regard is hence considered necessary.
44. The concept of an acceptable inspection regime (AIR) is set out in Chapter 5.1 of the Code. This concept provides the flexibility to accommodate fund managers, albeit not present in Hong Kong, whose investment management activities are supervised by an overseas regulator that is acceptable to the SFC. The essence of the requirement is that the management activities of the fund manager in relation to the fund are subject to adequate regulation in an AIR. In the context of hedge funds, it may be necessary to consider the acceptability of an inspection regime on a case by case basis because of the different regulatory treatment of offshore versus onshore hedge funds in some jurisdictions.

Certification by trustee/custodian

45. Such certification is also required for futures and options funds. The objective is to ensure that the trustee or custodian has the necessary experience and resources to fulfill its obligations as set out in Chapter 4.5 of the Code.

Prime broker

46. A hedge fund may utilize the services of a prime broker⁷ and such services may include the provision of clearing, custody, margin financing, reporting and stock lending services. In view of the different functions that a prime broker may undertake in its dealings with the fund, it is important to ensure that the fund's assets are safeguarded from undue counter-party risks.

Minimum subscription

47. The discussion on market segmentation is set out in paragraphs 23 to 34 above.

Dealing

48. It is expected that there should be at least one dealing day per month. This is to ensure that there is periodic valuation (at least monthly) of the scheme assets. In addition, it could serve as a safeguard to prevent a highly illiquid investment strategy.
49. In recognition of the fact that certain hedge fund strategies take time to come into fruition and in order to prevent sub-optimal portfolio management (e.g. unwinding positions at distress prices), allowance would be given to the manager to pay out redemption proceeds to the investor within 60 calendar days.

Investment and Borrowing Restrictions

50. It is recognized that the investment and borrowing parameters set out in Chapter 7 of the Code are originally designed for traditional products and hence may not be suitable for non-traditional and innovative products like hedge funds. Quantitative investment restrictions may stifle the investment operations of such funds. Flexibility is therefore provided to allow hedge funds to derogate from the Chapter 7 requirements.
51. Rather than imposing detailed guidelines or a prescriptive list of investment and borrowing parameters, the SFC proposes to follow largely a "disclosure" approach in regulating the investment aspects of hedge funds. Hedge funds would be required to clearly disclose a set of self-imposed investment and borrowing restrictions, including the maximum limit on leverage. Disclosure should be made in the scheme's constitutive and offering documents.

⁷ A prime broker must be a substantial financial institution – definition of substantial financial institution may be found in the Chapter 3.12 of the Code on Unit Trusts and Mutual Funds

Performance Fees

52. It is recognized that performance or incentive fees are a common feature of hedge funds. Some practitioners have suggested that the current Code requirement of “high-on-high” and “annual payment” may not be appropriate for hedge funds that seek absolute returns. The SFC is interested in receiving comments on this particular issue.

Fund-of-Hedge-Funds

53. A fund-of-hedge-funds is a fund that invests all its non-cash assets into other hedge funds. Such funds appear to be increasingly popular as they offer a professionally selected basket of ready-made hedge funds to investors.
54. Adopting the same reasoning as in paragraph 50 above, it is proposed that a fund-of-hedge-fund may derogate from some of the prescribed restrictions set out in Chapter 8.1 of the Code. The emphasis would instead be on the due diligence process of the fund-of-hedge-funds manager in selecting and monitoring the underlying funds and clear disclosure of the self-imposed investment parameters in the scheme’s constitutive and offering documents.

Valuation

55. As in the case of any other funds, full particulars of the valuation methods for the scheme’s assets should be disclosed in the constitutive document and summarized in the offering document of the scheme.

Disclosure

56. It is important that full and clear information is provided to investors for them to understand the product and the risks involved in order to make an informed decision. The SFC will be looking for explanations in plain language and the use of a glossary of technical terms is highly encouraged.
57. Certain warning statements would be made mandatory in the offering document as well as all advertising materials and application forms.

Reporting requirement

58. It is often argued that total transparency may undermine the existence of hedge funds. By disclosing their full portfolio positions, the unique investment strategies of hedge funds could be easily replicated and the investment opportunities identified by the hedge fund manager foregone.
59. On the other hand, it is believed that given the often complex and sometimes opaque investment strategies of hedge funds, investors may not be able to understand the activities undertaken by the fund manager by reading the financial reports. It is felt that a narrative report would help investors to better understand the activities of the fund manager and such report should be issued on a more frequent basis than semi-annually or annually.

60. The SFC is particularly interested in receiving comments on the content of the financial reports for hedge funds.

CONCLUSION

61. As a first step, it is felt that a market segmentation concept and a qualitative and disclosure approach would be appropriate for hedge funds offered to the public. Over time, it is envisaged that it may be possible for the segmentation approach to be further relaxed as the market matures and investors' knowledge of such funds increases. The Commission has also recognized that the possibility of moving directly to an approach based on disclosure and without segmentation. We have an open mind on the issue and await comments in this consultation process.

[Important : The following provisions form part of the Code on Unit Trusts and Mutual Funds and should be read in conjunction with the Code. Full text of the Code may be found on the SFC website (www.hksfc.org.hk).]

Hedge Funds

The following criteria apply to collective investment schemes that are commonly known as hedge 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 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.

Unless otherwise specified, the provisions in other Chapters of the Code shall apply.

The Management Company

- (a)** Apart from the requirements of Chapter 5, the Commission, when assessing the suitability of the management company, will consider the following:
 - (i)** The experience of the key investment personnel of the management company in managing hedge funds;

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

- (ii)** Amount of assets under management;

Note: The assets managed may include proprietary funds and/or third party funds on a discretionary basis. The Commission would generally expect more than US\$100 million assets under management in relation to the underlying investment style proposed for authorization.

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

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

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

In the case of the management of a fund of hedge funds, the management company should have in place a due diligence process for the selection of the underlying funds. The management company should demonstrate its ability to assess and monitor the performance of the managers of the underlying funds and the ability to replace the underlying funds whenever necessary to protect the interests of investors.

The management company must undertake to the Commission that its employees and/or distribution agents engaged in the selling of hedge funds possess adequate knowledge of such funds for the purpose of explaining the risks involved to an investor and that due diligence will be carried out to ensure the suitability of the investment for the investor.

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

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

Certification by Trustee/Custodian

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

Prime broker

- (c) 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;

Annex 1

- (ii) Where assets of the fund are charged to the prime broker for financing purpose, such assets should not, at any time, exceed the level of the scheme's indebtedness to the prime broker;
- (iii) The assets charged to the prime broker must remain in a segregated custody account, in the name or held to the order of the trustee/custodian; and
- (iv) There should be clear disclosure in the scheme's offering document of its relationship with the prime broker.

Minimum Subscription

- (d) The minimum level of initial subscription by each investor must be HK\$[] or its equivalent in foreign currency.

Limited Liability

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

Dealing

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

Investment and Borrowing Restrictions

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

Performance Fees

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

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

Fund of Hedge Funds

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

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

Valuation

- (m) The scheme assets should be valued on a regular basis in accordance with generally accepted accounting principles and industry practices, applied on a consistent basis.
- (n) Full particulars of the valuation methods of the scheme's assets should be disclosed in the constitutive document and summarized in the offering document.

Disclosure

- (o) The front cover of the offering document must display prominently the following warning statements:
 - (i) The scheme uses alternative investment strategies and is not subject to the usual prudential rules on limitation and spreading of risks that apply to traditional funds;
 - (ii) The scheme undertakes special risks and is not suitable for investors who cannot afford to take on such risks;
 - (iii) Investment in the scheme may lead to substantial losses and investors are advised to consider the suitability of the investment as part of their investment portfolio; and
 - (iv) Investors are advised to read this offering document and if in doubt, should obtain professional advice before subscribing to the scheme.
- (p) For the purpose of Chapter 6.1, the offering document should give lucid explanations of the investment strategy of the scheme and the risks inherent in the scheme.

Note : For example, explanations should be given on the 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; and the risk control mechanism, including the setting of investment and borrowing parameters to control the risks.

The Commission specifically encourages the use of a glossary to explain technical terms.

- (q) All advertisements must prominently display the warning statements referred to in (o) above.

Application Form

- (r) All application forms of the scheme should state that there are special risks involved with investment in the scheme and should direct investors to read the offering document.

Financial reports

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

Comparison table for the “qualified investor” requirements applicable to hedge funds

	US	UK	Dublin	Guernsey	Isle of Man	Luxembourg	Singapore
<i>Any regulatory restrictions on the offering of hedge funds to the public?</i>	✓ Registration of securities under the Securities Act and of the fund under the Investment Company Act if offers are made to the public.	✓ The FS Act prohibits the offer or promotion of unregulated CIS to the UK public. ⁸	✓	✓	✓	✓	✓
<i>Any “qualified investors” exemption?</i>	✓	✓	✓	✓	✓	✓	✓
<i>Asset or wealth test and minimum subscription for “Qualified investors”</i>	✓ (only asset test) “Qualified Purchasers” (unlimited in number): if there is no public offering, and all the interests are held by Qualified Purchasers ⁹ , the fund is not required to be registered as an investment company.	Not applicable.	✓ Qualifying or Super Fund: <u>Individual Asset</u> 1.25 million Euro worth of net asset. <u>Institution</u> : either it owns or invests on a discretionary basis of at least 25 million Euro or of which all the beneficial owners are qualifying investors. <u>Minimum investment</u> : 250,000 Euro	✓ Category “Q” of PIF ¹⁰ . <u>Asset</u> : £ 500,000 No min. investment.	✓ <i>Professional investor fund</i> <u>Asset</u> : US\$ 1 million <u>Min. subscribe</u> : US \$100,000	Not applicable.	✓ (only minimum subscription) Minimum: S\$ 100,000

⁸ Section 76(1) of the Financial Services Act 1986.

⁹ The categories of “Qualified Purchasers” under the Investment Company Act are:

- (a) natural person who owns not less than US\$ 5 million of investments;
- (b) family company owning not less than US\$ 5 million of investments;
- (c) any person, either as principal or as agent for other Qualified Purchasers, who owns and invests on a discretionary basis of not less than US \$25 million in investments;
- (d) any trust not formed specifically for the purpose of acquiring securities under offer, and whose assets are contributed by Qualified Purchasers of (a), (b) or (c).
- (e) Most QIBs under Rule 144A with two exceptions. These are: (1) dealers. In order to be qualified purchaser, a dealer has to own and invest on a discretionary basis US\$25 million of investments; and (2) 401(k) self-directed employee benefits plan unless each of the participants is a “qualified purchaser”.

¹⁰ PIF: professional investor funds

Comparison table for the “qualified investor” requirements applicable to hedge funds

	US	UK	Dublin	Guernsey	Isle of Man	Luxembourg	Singapore
			<i>PIF:</i> professional investors with a minimum subscription of 125,000 Euro.				
<i>Qualitative experience test</i>	Not applicable (see note 2(e)).	Relevant. Hedge funds, being unregulated CIS ¹¹ , may be offered to the following categories of investors: ¹² <ul style="list-style-type: none"> • “professional investors”¹³ • A current participant of the CIS or one who has participated in an unregulated CIS in the past 30 months. • An established client or a newly accepted client for whom reasonable steps have been taken to ensure that the unregulated scheme is suitable. • Non-private customer (as defined in the SIB Rules). 			Relevant. <i>Experienced investor</i> ¹⁴ - no need for asset test or minimum subscription	Main criterion: “institutional investor”. ¹⁵	

¹¹ The 9 types of funds that may be authorised under the SIB Rules are: securities fund, money market fund, futures and options fund, geared futures and options fund, property fund, warrant fund, feeder fund, fund of funds and umbrella fund.

¹² These exceptions are contained in The Financial Services (Promotion of Unregulated Schemes) Regulations 1991.

¹³ Professional investors are persons whose ordinary course of business involves the acquisition and disposal of property of the same kind as the property or a substantial part of the property to which the unregulated CIS relates.

¹⁴ Experienced investor is a person who, in relation to any experienced investors fund, is sufficiently experienced to understand the risks associated with an investment in that fund. This exemption is aimed at skilled global investors and offers flexibility to both traditional and alternative fund managers.

¹⁵ Institutional investors comprise the following categories: (1) domestic or overseas investment funds even if holders are not institutional investors; (2) bank or other professional of the financial sector (domestic or overseas) managing client’s monies on a discretionary basis; and (3) holding company that holds substantial financial interests even if its shareholders are not institutional investors.

Comparison table for the “qualified investor” requirements applicable to hedge funds

	US	UK	Dublin	Guernsey	Isle of Man	Luxembourg	Singapore
<i>Any requirement for investor to provide wealth certification?</i>	No. The fund manager needs only have a reasonable belief that the investor is a qualified purchaser based on the investor’s representations. ¹⁶	No, but the intermediaries have to take reasonable steps ¹⁷ to ensure that investment in the scheme is suitable in the case of an established client or a newly accepted client.	Yes. Qualifying investors must certify in writing to the fund that they meet the minimum criteria and that they are aware of the risk involved in the proposed investment.	Not ascertained.	Not ascertained.	Not ascertained.	Not applicable.

¹⁶ The investor’s status must be assessed each time the investor acquires securities of the fund, unless subsequent acquisitions are made pursuant to a binding agreement requiring installment or periodic capital calls.

¹⁷ For ascertaining suitability of the products for a client, intermediaries would have to seek information about the client’s circumstances and investment objectives.