SBI China Provident
A member of Softbank Investment Group

By Mail & e-mail

Investment Products Department
Securities & Future Commission
12/F Edinburgh Tower
The Landmark
Central
Hong Kong

7th December 2001

Dear Sir/Madam,

Response to SFC Consultation paper on the "Offering of Hedge Funds"

We at SBI China Provident Capital Management Limited are very pleased to have an opportunity to provide the SFC with our views on the 'Hedge Fund' Industry.

SUMMARY

We summarize our views here and elaborate on them below:

Precursor A Objective of Investment Management Industry

Precursor B Definition of the term 'Hedge Fund'

RECOMMENDATION 1. **Full Public Offering Approach - we are unreservedly and in total support of this position**

RECOMMENDATION 2. **Full Investor Protections via**
- ***a. Full Disclosure***
- ***b. Full licensing and registration of investment product and investment manager***
- ***c. Adequate regulatory review and reporting***
- ***d. Strict disciplining of wayward participants***

RECOMMENDATION 3. **Full Support for Incentive Remuneration Structure for Managers**

DETAILS

Precursor A The Objective of the Investment Management Industry - Is Absolute Returns, no Exceptions

We would respectfully submit that the objective of the Investment Management Industry irrespective of the category of fund is to Maximize Positive Returns for investors with agreed upon levels of risk. Returns must exceed the risk free rate. The higher the return the higher the agreed upon risk. Returns below the risk-free rate by definition would entail a level of agreed upon risk that must by definition be lower than that of the risk-free rate. This is impossible.

Thus investment in equities or equity funds in general will have risk-levels exceeding those investments in money market instruments or funds. Commensurately it would be expected that returns on equities would be higher than returns on money market products. But at all times these returns must exceed returns from investments in the risk-free rate which is positive. (in USA risk free rate depending on maturity is anywhere from 1.75% on the shorter end to 5.35% on the longer end). Failure to do so is a Failure to achieve the Investment Objective and the effect should be seriously studied.

If one agrees with the above statement it is easily understood why all investment products are 'Absolute Return' products with the objective of delivering 'Absolute Returns'. Whether they accomplish this objective or not obviously is a separate topic of discussion.

Therefore, we respectfully caution the inappropriate use of the term 'Absolute Returns' for the misnomer called 'Hedge Funds'.

Precursor B Definition of the term "Hedge Fund"

We believe that the diversity and lack of uniformity amongst this group of product so branded 'Hedge Fund' precludes 'pigeon-holing' them in the same way as 'traditional' products. Thus a strict definition, which is sought after by many, may never come to pass. But just like the generic term 'fruit' is applied to apples and oranges and other such product, so may a generic brand be developed to describe this set of product.

We believe as you do that there are a host of industry participants with different styles and specialties and expertise clumped under this misnomer.

One participant is not in any way representative of another, however all are unfairly tarred with the same broad-brush as if they were representative of one another. Based on Precursor A above, we strongly disagree that the definition of these types of funds are 'Absolute Return' funds as **all** funds are 'Absolute Return' funds. We would offer up the generic brand name for these types of funds as High Return Funds. This would distinguish their returns from the more traditional 'Benchmark' funds or 'Index' funds. We would not however offer the additional generic brand name of 'High Risk' funds, as we would argue that the level of risk is far too varied across the different styles and specialties and furthermore would say that in fact many 'traditional' funds have even higher risk attributes. Keep in mind, the Objective of Reducing Risk and Volatility is common to such 'High Return' funds and is a very positive fact against which to consider the incorrect perception that they are High Risk funds. The Objective of preserving capital and delivering absolute returns, again common to such funds, should be weighed in the same light. These objectives are shared by young and old investors alike, rich and poor investors alike, 'professional' or 'non-professional' investors alike. And to that extent they are thus not exotic nor speculative and in fact are very normal.

Therefore, we respectfully submit that the generic brand name to be used could be 'High Return' funds.

RECOMMENDATION 1. Full Public Offering Approach - we are unreservedly and in total support of this position

The Freedom of Choice

At the heart of the discussion over 'suitability' is this subtle point: It is accepted and championed that all free men and women who have reached the age of majority have the Freedom of Choice. This is a fundamental right of free citizens the world over. If this is the case and these same free citizens freely choose to maximize their economic profit, we would argue that no one should stand in their way to freely invest in a High Return vehicle that reduces risk and volatility whilst delivering absolute returns.

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However, we would add that authorities must put into place Disclosure standards that are sufficient to adequately provide pertinent information and risk disclosures for all potential investors that would enable them to arrive at the most suitable investment decision for themselves.

We would also add that licensing and registration procedures for fund managers as well as the funds themselves needs to be implemented as a regulatory standard to provide adequate protection and monitoring of the funds.

Point 18 the increasing interest to supply 'hedge funds' (by fund managers) and the increasing demand for such funds by the public is not due to volatile stock markets around the world. Rather it is the failure of the traditional suppliers of investment products to deliver a product that meets the specifications of the investing public. We believe that investors everywhere demand a rate of return that is a function of risk appetite but in all cases above the risk free rate (i.e. US-Treasuries in USD or HK Govt paper if it is HKD). This is only logical. The unfortunate dilemma facing us today is that in Asia over a period of more than 5 years, traditional investment products as measured by benchmark funds have returned huge losses. An indication of this can be found in the performance of MSCI the most popular index used by traditional managers here in Asia over the last 5 years MSCI AC Far East Free ex-Japan has returned negative -54% whilst MSCI AC Pacific Free ex-Japan has returned negative -51%. As more than 85% of benchmark funds underperform their benchmarks after fees (the correct measure as investors are interested in net returns back to their own pockets not gross returns that they never see), it is fairly conclusive evidence of the fact that the 'product' is no longer in demand because the 'product specs' are failing.

In its place investors are demanding a 'new' product, the 'High Return' vehicle that will meet their rational investment needs. This applies to all investors who are free to choose and this right must not be taken from them. However every measure should be taken to provide them with adequate disclosure of information to enable them to make and monitor the investments they choose and regulatory procedures put in place to regulate the investment vehicles and investment professionals they have invested in and so protect investors. This brings up the inevitable point which is, if you believe as we do, that the demand for 'new' 'High Return' products will only increase steadily over time, existing regulatory frameworks everywhere must be amended extensively.

With respect to the limited offering approach, we see a number of arguments such as in ***point 15*** where we see the offering of hedge funds (as a result of not fitting into existing regulatory framework) is confined to 'sophisticated investors' as defined by wealth, investment experience and the like. The fatal flaw in this reasoning, unfortunately, is that there are as many 'rich' investors who have no expertise in investments (lets take the example of a musician or an artist) as there are 'poor' investors. Equally there are as many 'poor' investors who know investments as there are rich: example of a registered investment advisors who get paid very frugal salaries by their banking employers would qualify for some forms of government assistance yet they would not be allowed to invest!

We would also go so far as to point out that as mentioned in ***point 27*** (wrt the understanding of a fund product by investors) most investors (i.e. the general public which would be doctors and lawyers and bankers who are not fund managers as well as the lady who sells fruits at the corner store or the taxi driver or the house wife) have very little understanding of 'traditional' fund product.

Yet they are allowed to invest in 'traditional' products! They are allowed to do so presumably because Disclosures and investor protection regulation have been properly put into place. We would argue that they should equally be allowed to invest in 'new' products including 'High Return' funds so long as Disclosure and investor protection is also properly put into place.

Investment experience is equally a flawed measure: we would argue that most who had the relevant investment experience would, by necessity, be full-time, hands on professionals who have

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accumulated their experience over a number of years: consequently very few persons other than the actual managers themselves, would ever qualify!

Equally we fail to see why size of $100 million or any magic number matters (***point 41***). Many authorized funds as a result of their poor performance and fund redemptions fall below $100 million. But if the fund size started at $10 billion for example, this means the performance numbers were dreadful from $10 billion all the way down to $100 million, entailing millions and billions of losses from poor investment performance all the way down to $100 million. We fail to see why such a large fund should have authorized status and a smaller fund of say $50 million which is performing well should be denied the same authorization. What should matter is the ability to deliver returns commensurate with the level of risk investors are willing and prepared to take. We would further propose that large fund sizes might be a detriment to the stability of markets and raise systemic risk (***point 12***) as was the case in 1998. Thus the argument of a certain high minimum fund size as a cut-off is not sensible. Smaller funds would deliver their stated objectives without introducing systemic risk. By removing any size requirements one would make available a large number of small funds who do not have the size to affect markets yet would compete on an equal footing with the large funds on the all important measure of performance. Again the all important caveat would be that the necessary disclosures and investor protection measures be put in place.

RECOMMENDATION 2. Full Investor Protections, via

a. Full Disclosure

As mentioned in ***points 41*** and ***point 51*** should be put into place. Full Disclosure would allow investors to make well-informed investment choices for themselves and also allow regulators the full flow of information to enforce regulations and investor protection.

b. Full licensing and registration of investment product and investment manager

We believe that the manager and the management company need to be registered with the SFC according to internationally recognized standards of the highest quality. This will ensure that industry practitioners have the necessary knowledge and skill set to deliver the products desired (***point 39*** Qualitative Aspects of the fund manager - see licensing). This may also be widened to encompass requirements for certain service providers such as the Fund Administrators, Custodians, Registrar's, Auditors, Legal Counsel, and Prime Broker.

c. Adequate regulatory review and reporting

This cannot be stressed enough, but must be balanced with the need to run a business so as not be so intrusive and restrictive that investment objectives cannot be achieved because of regulatory restrictions and requirements.

d. Strict disciplining of wayward participants

Enforcement without teeth is a recipe for non-enforcement.

RECOMMENDATION 3. Full Support for Incentive Remuneration Structure for Managers

We believe it is in the best interest of the investing public as well as the managers to tie the remuneration of fund managers with the performance of the fund managers through an incentive fee structure.

Point 52 The biggest flaw in existing fee structures of 'traditional' funds is the imposition of management fees irrespective of performance. Thus whilst the average investor in Asia, as measured by MSCI, lost over half his wealth over the last 5 years, 'traditional' fund managers continue to charge management fees. No wonder the well-heard line that fund managers professionally lose you lots of money! Performance Fees we argue are critical to tie the economic benefits of the manager with those of the shareholder or investor. Just as stock options are issued

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to senior executives of listed Companies to incent them to perform so should incentive fees be a normal part of the remuneration structure of the 'High Return' fund industry.

We appreciate the opportunity to submit our views to you during your consultation process and hope it has been useful to you in formulating a better regulatory structure to meet the needs of the investing public. Should you require further information or views from us, please do not hesitate to contact the undersigned on the below numbers.

We look forward to your reply in due course.

Yours Faithfully,

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