Regulatory Initiatives in Hong Kong:  
Review of the Consultation Paper on Hedge Funds  
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I know that many of you will have read the consultation paper on the offering of hedge funds2, which was released last Friday and I want to take sometime this morning to go through that document. I will give you some of the background thinking that lay behind the proposal. I would also like to invite comments on areas that may cause particular concern or uncertainty.

I would like to explain why the document was produced now. I think it’s important to step back and say something about the regulatory philosophy as it is in Hong Kong. Generally in respect of managing products that are offered to public, the style of regulation in Hong Kong, actually not just in Hong Kong, is very parental and very protective of investors. Like most other jurisdictions, Hong Kong adopts an approach, which says investors who look for pooled management of their funds are probably less sophisticated on average than those who directly invest in equity. So, they need some extra protections. They need some restrictions on the nature of the investments that can be made on their behalf, limitations on the kinds of products that can be invested in on their behalf, additional disclosures of risk, and additional explanation of the type of product. It is not only Hong Kong that does this of course. It’s Europe, the United States and any of the other developed markets. That’s the background against which this consultation paper is prepared. It is important to keep that in mind. In particular, if you come from the hedge fund industry and you have not had as much experience in dealing with authorized products that are offered to the public, your expectations are likely to be frustrated at least in the short-term.

Leading up to the preparation of the paper, we saw an increase in the number of requests that were coming from the industry. People were saying to us: I have got a great product; my lawyers, some of them are sitting in front here, have told me that I can’t get it authorized from the SFC; so I hadn’t bothered to do anything about it.

We found ourselves increasingly saying to these friends: wait a minute. If it is a good product, if it doesn’t involve any particular problems of investor protection, then we ought to be authorizing it. We ought to be allowing it to get out there and to be made available to the public or at least some part of the public in Hong Kong.

So it didn’t take us long to realize that there was something we have missed. At least some reconsideration is required about the way we were authorizing products for public offering.

Given the situations in the equity markets where the traditional long equity funds were becoming most popular, it is curious we had a bifurcation. You had on the one hand people looking for alternative investments, which in some respects were more risky, and on the other hand people moving towards guaranteed funds.

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[1] This speech was delivered at the conference on the Regulation of Hedge Funds in Asia on 31 October 2001 in Hong Kong. Andrew Procter was then Executive Director, Intermediaries & Investment Products, Securities and Futures Commission, Hong Kong. He is now Director, Enforcement, Financial Services Authority, United Kingdom.

We are also concerned that we really knew very little about and still know very little about hedge fund activity in Hong Kong. It is a well-paid sector of the market. That's not to say this is a bad thing. But that doesn't help development of the market. It helps in fact to keep it small. It doesn't help investors gain access to that wider range of products. It doesn't help the regulators do anything about facilitating market development. It doesn't help the regulator do anything about protecting those investors who choose to invest in those kinds of products. And so we were concerned also to make the market itself more transparent.

It was also part of a wider review about regulatory philosophy. I described earlier that Hong Kong has a parental approach to regulation that we share with the Europeans and the Americans in the collective investment area. We were concerned that there was too much focus on that protection. Too much focus on investment restriction, but not enough credit was given to disclosure-based regulation. Not enough confidence was being placed in investors and investors' capacity to make judgments on their own behalf. And, for that matter, not enough confidence was being placed in the intermediaries that we licensed, whom we expected to be able to provide confident advice to those investors.

So we have undertaken a wider review about regulatory philosophy, which will manifest itself in a rewriting of the Code on Unit Trust and Mutual Funds. That's part of an ongoing exercise. In a sense, this project on hedge funds slots into that. It's part of that wider reform consideration. We hope to be able to expose for public comment a revised Code on Unit Trusts and Mutual Funds next year, which will, amongst other things, look at the general issue of investment restrictions.

In that context, we have to recognize that we are a relatively small domestic market. Most of the products that are authorized for public offering in Hong Kong are in fact domiciled somewhere else. So we can't ignore the international practices. But we can at least make sure that we are not getting in the way of market facilitation and market growth. So we undertook a preliminary consultation against that background. As part of that consultation process, we talked to some hedge fund operators. The hedge funds operators said to us that in some respects there should be no change. They were quite happy with the way things were working. In fact, some of the traditional fund operators also said they were quite happy.

Understandably they think there should be no change. But many said things should open up. But they were less clear about the way things should be opened up. They were less clear about the way in which we should make access available to ordinary members of the public. They did, in fact, recognize that there were real and genuine investor protection issues that we had to consider.

We took these issues to our Committee on Unit Trust, which some of you are members of. It is the industry specialist body that authorizes products for public offering, announces new policy and authorizes new investment management groups in Hong Kong. We took comments from them. Again there was a very strong division of views about whether this was the right thing to do and if so, how to do it. We also looked around at overseas experiences but there was not really much experiences of offering these wider range of products to the retail public.

It is basically only Switzerland, which is a little surprising, although I am told that Italy might also do
something along those lines. Generally the Europeans and the Americans had quite tight restrictions on offering to the public these alternative investments that don't fit the traditional investment products.

The consultation paper itself is popularly characterized as the paper about hedge funds. But if you look at it, it does not actually define a hedge fund. It does not proceed from the basis of saying this is the kind of product we are looking at and this is how we are going to deal with it.

In one sense it works by an omission. It says you can deal with your product according to the traditional categories and the traditional categorizations and treatments and investment restrictions and disclosures and so on. But if you do not fit those traditional categories, then have a look at these possibilities for offering to the public. So in that sense it opens up a range of other investments, which at the moment would not meet our criteria. But they may meet our criteria as they are developed as a part of this consultation.

It is not going to be easy, in fact, to decide what kind of products ought to be authorized under these new arrangements. We are certain to get, before very long, some products, which are both a hedge fund and a guaranteed product. We are certain to get not simply a range of products, which fit neatly into categories but a whole lot of hybrids, a whole lot of fund of funds, feeder fund structure and other structures. They would defy easy categorization.

In taking on this project of opening up this market sector, we have also taken on for ourselves a hugely difficult task in finding a way through the investor protection issues. Frankly it is a new territory. We do not have a very sophisticated understanding of the way in which a lot of these products work. We are going to have to acquire a better understanding.

Or we are going to have to lean on the industry such as members of our Committee on Unit Trust to help us through that. But it is not going to be easy. It is not going to be a situation, where we can say, here's some nice neat little boxes, fit yourself into one of those and then you can proceed under this new chapter. It is not going to work like that. We will have to, in that context, change the structure, or at least the balance, of that Committee so that we have greater expertise in these alternative investments.

So far as the objectives of the project were concerned we were not starting out with an assumption that these were dangerous. We were not starting out with an assumption that these products were necessarily riskier than the products we already authorized. In fact we know that because that's not the case in some instances.

The kind of products that might come within these new arrangements would not be riskier than products that have been authorized in the past. They are different. They just do not fit those traditional categories of investment restriction and disclosure and so on. So we wanted to, first of all, without assuming that these things were riskier, widen access to these alternative managed investments. We did, though, need to strike a balance between market development, market facilitation and investor protection.

We know that the industry will come to us and knock on our door and demand an expansion of the range of products that can be offered to the public. Of course, that's what you should do. We have to then step back and say: well, is there a problem? At the moment we don't think there is a problem that cannot be solved by the kind of arrangements and proposals that are in this consultation document. But it will require some changes.
I have talked about one aspect of the regulatory philosophy, the paternal philosophy, which involves investment restrictions. Clearly they will have to be much less, and in some respect almost no emphasis on that as a means of investment protection. Clearly the emphasis will have to be on a much wider range of disclosure and much clearer type of disclosure. Hence there is a complementary project that we have to take upon ourselves to improve the quality of disclosure. Of course we bear some responsibility for that because unlike some other jurisdictions we not only authorize the product offering documents and everything that has been said in them, but also the advertising in respect with them. We were also very concerned to make sure that Hong Kong didn't lose its position as the premier funds management centre in the region.

Frankly, we are very proud of the fact that that's the reputation we have. It's the best place to do business in the funds management industry. It's the clearest, most transparent form of regulation for that industry in this region. It's the most business friendly place in the region. It's the place with the lowest barriers to entry into the region. We don't want to lose any of those advantages. We were very conscious of the fact that others in the region are also looking at these products. We are also being asked by their market practitioners to expand the range of products that could be offered to the public.

But there are some real regulatory concerns. We are concerned that investors will not understand the risks or the cost involved in some of these products. As I have said, frankly, nor will our staff, initially. It's going to be hard work to get on top of it. We are concerned that the principle of diversification, which is the core protection that is available to investors, who put their money into pooled management in the European and the American traditions will not only be eroded but it will be completely removed in most respects.

We are concerned that selling agents may be inexperienced in these new types of products. In fact they will be inexperienced in these new types of products. So we need to find ways of making sure that the advice that is given to investors by selling agents is at least confident. We are concerned that investors will find their money tied up for lengthier periods of time than they had been used to in their previously experienced investment in a managed product.

Actually in some respect that might not be a bad thing. It might encourage them to take a slightly longer-term view of things. Fortunately, in the way the legislation works in Hong Kong, and the way it would work under the proposed composite bill, we have an extremely wide discretion as to the products that we authorize for public offering: virtually unlimited offer to the public if the SFC approves it.

Like in the past that discretion will be used to decide whether a product is appropriate for public offering. In a very transparent way through the Code on Unit Trust and Mutual Funds, we will lay down the kind of things that we will take into account and the kind of circumstances we will be satisfied.

So it means that we can be very clear, very explicit about what we are doing but it also means in fact that we can approve a very wide range of products. We can be extremely flexible. Flexibility will allow us not only to stay ahead of the other markets in the region and internationally but do so in a way that doesn't compromise investor protection.

But there were questions about to whom should these products be offered. I know you will have
read something about this in the press. You would be familiar with the basic debate. Many of you will know also that, for example, in Singapore they adopt this stratification approach for the fairly low level of minimum investment. The theory that lies behind this notion of stratification is a simple but flawed one. It is that if people can afford to invest a certain amount of money they are probably going to be more or less sophisticated. They are probably going to be able to afford to take in the independent advice. And they probably are able to look after themselves.

Obviously that's only partially true. There are plenty of people with plenty of money, who have no sense when it comes to investment. Recognizing this reality, you will find that there is nothing in the consultation paper that says stratification is the answer. What it says is, it may be part of the answer.

But the question is, what is the answer even in terms of stratification? In some respects in some areas of regulation, we deal with that as a question of the net worth of the individual. That's basically the way we do a definition of professionals. But it affects other markets as well. That seems to us to make much less sense in this context. It was rather too complicated a process having regard to the ordinary way in which these products are first discussed and then offered to investors.

So it could make more sense to explore the possibility of a minimum subscription. So we talked to the industry about that in our informal consultations. We talked to our Committee on Unit Trusts about it. They gave a range, which was basically from about (HK$) fifty thousand dollars to one million, which wasn't very helpful. From our perspective, it was pretty clear that at the lower end of the range the arguments of that providing some kind of comfort or protection basically fell away. So long as you got down towards those lower end figures, you may as well forget about stratification.

At the upper end of the range there is a danger that it is a self-defeating exercise. There is a danger that you start out with the propositions that these things are inherently dangerous ventures. They may be complicated and may involve some risks but it may be worth getting them out there. But if you set a minimum subscription in the order of a million dollars, you are basically cutting it off in such a way that you are not really expanding the market tremendously. You are not going to do very much to encourage people to offer those products in Hong Kong, bearing in mind that Hong Kong is, as I have said, a pretty small domestic market.

There is an issue that I think is relevant, although we have not touched on in the consultation paper. I mentioned it so you know that we have an understanding. The issue is that we are competing with other product types. We are competing, for example, with the banking sector. In the banking sector, the definition of a private banking client is coming down fast and far. The kind of products that are being offered to those people are increasingly complicated and sophisticated. They are increasingly unable to afford the risks in some cases because they don't really have very much money to bet against those risks. We have to, on the one hand, recognize that there may be some issues there, but on the other hand also recognize that you are competing with those other product sectors.

There is another issue in respect to stratification. Under the existing opaque arrangements for hedge funds, generally speaking, there is a very high subscription requirement at the outset. That encouraged people to form little syndicates, pool their money and then make an investment in the
hedge funds. Now we would be concerned if in setting a subscription figure of, say half a million dollars, we had ten people who were putting in $50,000. That $50,000 could represent a large proportion of their savings. We have to recognize that it is not simply going to be a case of an individual meeting the subscription requirement.

So, eventually it was clear to us that if there was any stratification it was only going to be one part of the client protection requirement.

The registered persons, as always, would have to be told and they would have to actually live by the maxim that they need to know their client. That is the fundamental maxim of all investments advisors and dealers in Hong Kong and internationally. But it becomes absolutely critical with this kind of product.

We added some extra layers in the consultation document. I think one or two of these extra layers are going to be controversial. I don't think anyone can argue with the proposition that they should understand enough about their clients' circumstances to know whether they should reasonably bear a certain kind of risk, although I doubt that often happens in Hong Kong. But when it came to the extra layers what we have thought was appropriate was what the management company itself should undertake. Its employees and its distribution agents should have enough knowledge to be able to give the advice, assuming they have taken a proper client history.

Now suppose it concerns the management company itself and its employees. Nothing is really very new about that. That's what they ought to do anyway. When it comes to the distribution agent that is new and I think it could be misunderstood and is liable to be misunderstood. It doesn't mean that the management company has to test all the distribution agents. It doesn't mean that the management company is responsible for the distribution agents. It doesn't mean that the management company is liable for a failure on the part of the distribution agents.

But what we have in mind is that they ought to, as management company, at least make sure that their distribution agent's network is reasonably well-educated, is reasonably well informed about the product and if they use an agent, a corporate agent for that, then it is somebody who is confident and credible.

Beyond that, so far as the management companies themselves are concerned, there is a focus on the quality of the management company. Now that's not going to be easy to assess, it is never easy to make judgments at the outset about the quality of anyone you license or approve or authorize. It is going to be even more difficult in this area because it is a new area.

In addition to the normal sorts of requirement that we impose under the Code on Unit Trusts, such as expectations about the company and its directors, we think it is appropriate that the management company had at least five years' experience in the relevant type of investment and that means in this case, something closer to the kind of the product that is being offered. That's actually a traditional requirement, but beyond that we are going to look much harder at the experience of the key investment personnel and their experience in these kinds of products.

Because one thing that has been said to us on a number of occasions is that we ought to be a little concerned about the management companies, because not only are these new types of products being offered more generally but new people are doing it. And
not everyone who is in the hedge fund game now has a lot of experience. Some people don’t have any experience. They are learning along with the SFC and we have to be very cognizant of that as a potential risk area. There is also a concern that the hedge fund manager ought to have a substantial volume of assets under management.

In that context, we are talking about US$100 million and that’s a figure that we have arrived at for consultation purposes based on the discussions that we have had so far. Actually, it’s not a very big figure, frankly, in terms of such a market, although it’s a significant figure for some of the new start-up companies in this area. We think that the management company ought to take proper due diligence on its representatives and agents. We think that should happen anyway but we are going to be particularly focused on that kind of qualitative aspect of the management company.

When it comes to performance fees, many of you will know that under the existing arrangements a performance fee is payable on a high on high basis, i.e., you can only get a fee if the net asset value of units or shares exceeds the net asset value of units or shares when the fee was last paid. Of course, that isn’t the tradition with a lot of hedge funds. That’s not the basis on which performance fees are paid.

We had certainly, in our informal consultation, had some complaints about that as a proposal. In fact I can tell you that in one of the earlier drafts of the paper, that was not going to be the proposal. But on reflection, we thought that was a fair approach. It is certainly a matter upon which we expect widely divergent views and a matter upon which we expect strong comment from the industry.

If you are entitled to a performance fee, then the usual requirements of the Code on Unit Trusts will apply. That is you have got to make very full and clear disclosure about the basis on which you are entitled to that fee. In reading this consultation document, you very often need to go back to the Code on Unit Trusts to see the wider context, in which these things operate. This is a good example. You are not simply entitled to a performance fee without meeting other Code requirements.

In respect of the trustee and custodian, we also thought that they ought to certify certain things to the Commission. I know that this is stepping back to a very parental style of regulation in some respects. But what we are trying to do is to avoid a parental style of regulation, which limits access to the products. We are placing greater emphasis and greater responsibility on those whom we register or approve.

So in this context, we want the trustee or custodian, fee-using custodian in the European context rather than someone who simply holds assets, to certify to us that they have the right kind of control procedures for monitoring the operations of this game. That won’t always be the case under the existing set-up with trustee and custodians. And again it is not going to be easy for us to make that judgment call. They also have to demonstrate that they have some relevant experience and understanding of the product types.

When it comes to investment and borrowing restrictions, you will see here that we have said that some of the existing requirements of the Code should continue to apply. The provisions of chapter 7 relate to feeder funds, and they relate to the fact that you can’t invest in real estates; the need for consent from trustee or custodian to either make loans or act as guarantors, the fact that breaches of investment limits have to be remedied in a reasonable time, and the fact that if a scheme name suggests a certain
geographical market focus, then 70% of its non-cash assets have to be invested in that geographic area or that market.

But otherwise, what we were saying is that the scheme itself should have clearly defined investment and borrowing parameters. But we are not imposing the full range of traditional restrictions, for example, of 10% limits. People have come to us in informal consultation and said, "Can I have a fund of hedge funds" and the answer is "yes."

That is the kind of product that would be able to be authorized under these new arrangements. Now there is a difficulty again in fitting fund of hedge funds into the existing Code arrangements. Essentially going with the very light touches, most of Chapter 8 drops away. Some parts of chapter 8.1 remained, which is to do with unit portfolio management funds. But again it is a pretty light touch in respect of the chapter 8 requirements.

So far as valuation is concerned nothing very radical here. You should value your assets on a regular basis. You should use generally accepted accounting principles and industry practices. You should be consistent in the way you do it. What is more difficult though is what happens in the information about valuations once they are made and disclosed. We do think that the full particulars of the valuation methods themselves should be set out in the constituve documents and summarized in the offering documents.

Dealing days is again an issue that caused us some anxiety in drafting a consultation document. We are very conscious of the industry practice in the hedge funds industry, where there were quarterly dealing days, for example, of six months in some cases, which did not fit with the traditional requirement of a dealing day every month. This is a bit of fudge in some ways, a bit of a compromise. You have to have a regular dealing day every month. But then you can have up to sixty days to make a payment. I am not sure how that would fit with the expectations of the industry and certainly would be interesting to see. You can see that in practice the longest that you have to wait, assuming there is no suspension or redemption, would be about ninety days, so about a quarter.

Now we come to the disclosure issues. There is quite a long list of disclosures that are proposed for the front cover of offering documents. They are also pretty conservative and they are not by any means, fixed in our minds. There may be better or other ways of expressing these disclosures. These include risk disclosure statements. For example, you have to say that it uses alternative investments strategies, that it is not subject to the usual prudential rules on spreading of risk, and that the risk of the fund may not be suitable for everyone. But you might suffer substantial losses and you are advised to read the document. Now, of course, no one is going to read the document so that it makes it very important that we get the risk disclosures right on the front cover and that we get those risk disclosures, built into any advertising as well.

Of course, when I say no one is going to read the document, they are not going read the whole of the document. And we have to recognize that, which is why these risk disclosures are so important. This is why we have as a separate project, a very close watch on what is happening in the UK in the area of providing key information fact sheets. We would like to see whether we can do better at the way we disclose information to investors.

We are also looking very closely at the way in which, the US discloses information about fees. Because I

[3] Chapter 8 of the Code on Unit Trusts and Mutual Funds deals with specialised schemes.
think, frankly we have got some lessons that we can learn from those other jurisdictions in those areas. We particularly encourage the use of a glossary to explain technical terms. We particularly encourage illustration of the way in which the scheme works. We want information about the circumstances in which, this kind of scheme would expect to do very well. We want information about the circumstances that would be hostile to a good performance for this kind of scheme, illustration rather than merely technical description. And so we expect, as we already require in the Code, very clear description of investment strategies.

We expect also that in relating to reporting requirement, advertisements should contain similar kinds of risk warnings. We did not think that, that was enough. We thought that the investors in these funds ought to get some regular feed of information from those who manage their money. I think again, this is going to be somewhat controversial. We think it is important that they get the information. What information they get and how they get it, is something that we need to consider in the light of the consultation responses.

But, obviously, we have to have sensitivity to the fact that the disclosure about the operations of the fund, particularly if it is made only a month after the relevant period end, might contain information about the positions of the funds and the trading strategies of the fund and that might be regarded as sensitive and confidential and we can't obviously expect that kind of detail to be made available to the investors in the fund in a way that would allow it to be leaked to the wider public.

So we need to strike a balance about the kind of information that we think people should get and respecting the integrity of the investment and management process. Of course, that kind of information coming as it does a month after the end of the quarter doesn't tell you what the fund is about to do. But it is some guidance, some useful basis upon which you can make judgments about whether or not the fund is performing to your expectations and whether or not you should stay in the fund.

Not a guarantee of future performance of course, but we, nonetheless, think it's useful information. And although, we do expect some feedback and some comments about the content of that quarterly report, I think it's a reasonable assumption that there will be some kind of quarterly report that has that kind of information going out to investors.

It was pretty obvious to us, as we talked to the industry about the consultation subject, that there were people who are right over here and there are people who are right over there and only the SFC in the middle and that we want to get that out. We want to make it pretty clear how divergent the views were on some of those issues and so this is the first time that the SFC has published a consultation document with the intention of also publishing the consultation responses.

Because of the way in which the privacy legislation works in Hong Kong you can opt out of that. You can say, I don't want you to publish my response but you can say that I have made one or I don't want to publish my response or my name, but we really do hope that people come back and say I am happy if you are to publish this response. I think it's extremely important that we get the views aired publicly and indeed I think it would be valuable if we could get some of the comments in early. So people could comment on comments but I don't expect that to happen as I am sure that the comments
would all come on the last day. Probably, in fact, in this case because they are to be made public, people would be a little reluctant but I certainly hope that even if they come in late, that you do say to us that you are happy for us to make them public. I think that would be in the best interest of a transparent consultation and a consultation that gets us to something like the right result.

Before I finish, I should say that in many respects this consultation and these proposals depend upon wider reforms. I have spoken about the more general review of the Code on Unit Trusts. I think it is clear that the kind of investment strategies that are likely to be undertaken by these kinds of funds also requires a market in which stock borrowing and lending works well, in which short selling arrangements are conducive to this kind of trading strategies that are likely to be adopted, in which the rules of the exchange and the legislation facilitate and promote arbitrage trading. It’s also important that there be clarification of any issues to do with tax treatment of any of these kinds of products.

Now we recognize that - it's not in the paper - there are a number of initiatives that are designed to address each of those points. There is work being done on the stock borrowing and lending rules, the short selling rules, the arbitrage trading arrangements and the area of things like tax treatment and more generally, the incentives to the industry in Hong Kong. We and the Financial Services Bureau have begun a dialogue, a very intensive dialogue I should say, in respect of industry development, which includes the range of issues that are needed to fully complement these proposals. So we do recognize that this, in itself, is not going to solve all the concerns and anxieties of those who would want to promote alternative investment strategies.

Finally, on the timetable, the consultation itself is six weeks. So that closes on the 7th of December, which is one week after I leave the SFC. I would actually, really, quite like to see this one through because it's extremely interesting but it is a week after I leave so it would be for other SFC staff to sort through the responses that we get. The market demand is clearly that we should move quickly. The market pressure and the competitive pressure for Hong Kong is clearly that we should move quickly. We recognize that and we will move quickly to review the consultation responses and to adjust the paper in the light of those responses. I don't think we need to wait for the completion of the wider review of the Code on Unit Trusts. I think that although this fits in as part of that review and although there are some aspects, however, which will nicely complement this review and improve the circumstances for alternative investment managers in Hong Kong. I don't think we should wait for that. I think we can actually get on with this part as a separate and discrete exercise.

So we very much look forward to receiving your comments. We very much hope that you will allow us to publish your comments.

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