27 October 2008

Circular to All Licensed Corporations Engaged in Hedge Funds Management Business

This circular sets out specific instances of management oversight and information disclosures issues concerning the hedge fund industry that we have noted during our ongoing monitoring and onsite inspections. This circular also sets out the standards of conduct and control procedures generally expected of hedge fund managers[1] licensed in Hong Kong.

Profile of the 8 Hedge Fund Managers Recently Inspected

We have recently completed a theme inspection of 8 locally set up hedge fund managers. These hedge fund managers were generally smaller firms employing between 3 and 30 staff with assets under management ("AUM") ranging between US$5 million and US$800 million. The majority of them adopted equity long/short as their main investment strategy although a few of them adopted other strategies such as global macro and event driven. Use of leverage amongst the funds managed by the 8 hedge fund managers was generally low.

Risk Management and Controls

As hedge fund managers are increasingly adopting complex investment strategies, it is important for them to strengthen and implement proper risk management systems that are commensurate with the complexity of their investment strategies.

It was noted in some cases that the chief investment officer also takes on the role and responsibilities of a risk manager, therefore depriving the business of the important check and balance of an independent risk management officer. While it might not always be practical or cost effective for a small operation to have an independent risk manager, hedge fund managers should implement internal controls that compensate for the lack of a risk manager, wherever possible.

It was noted in one case that the parameters used in a proprietary trading model had not been updated for many years.

Hedge fund managers are strongly reminded to critically review their existing risk management policy and procedures especially under current severe market conditions.

Hedge fund managers are also reminded that under the new Financial Reporting Standards[2], the financial statements prepared for the funds under management are now required to

[1] The term "hedge fund managers" include those fund managers that manage hedge fund assets as well as those that advise hedge funds
[2] International Financial Reporting Standard ("IFRS") / Hong Kong Financial Reporting Standard ("HKFRS") 7-Financial Instruments: Disclosures requirements (effective for entities with annual periods beginning or after 1 January 2007)

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disclose in detail the financial risk management tools used and how these are applied in practice.

Information for Clients

(a) Information provided in newsletters etc.

We noted instances of inaccurate information being disclosed in the newsletters or monthly fact sheets distributed to investors. In one case, the largest stock holding was excluded from the top 5 investments in a newsletter due to oversight. Other cases involved misstatement of gearing ratios and net asset values, though only to a limited extent.

Hedge fund managers should take all reasonable steps to ensure that the data and information disclosed to investors are accurate and not misleading.

(b) Disclosure of side letter arrangements

We noted that some side letters entered into with certain fund investors contain preferential terms. These preferential terms typically include preferential redemption rights and additional transparency (such as providing more information on the larger investment holdings and more frequent or up-to-date disclosure). However, as these side letter arrangements are normally only disclosed to investors upon request, it may thus result in unfair treatment of other investors.

The hedge fund industry recognises the importance of making appropriate disclosure in this regard and one hedge fund industry association has already developed a voluntary industrial code for its members. To ensure fair treatment of investors, we consider it good practice to:

(i) Disclose material terms to all existing and potential investors; and

(ii) Highlight, where applicable, that side letters have been entered into only with investors with significant shareholding or interest.

(c) Disclosure made to ultimate clients

In one case we noted that information with potential conflicts of interest implications provided by the hedge fund adviser to the hedge fund manager (which was related to the hedge fund adviser) was not disclosed to the underlying fund/account investors.

Hedge fund managers are reminded to disclose all information which gives rise to an actual or potential conflict of interest to their ultimate clients and to take all reasonable steps to ensure their fair treatment.

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Side Pockets

We understand that some hedge fund managers are contemplating setting up side pocket arrangements in the future.

(a) Managing the side pockets

Hedge fund managers should critically assess the following factors before they introduce any side pocket arrangement:

(i) Operational capacity and risk management competency in managing side pockets;

(ii) Valuation basis and its appropriateness; and

(iii) Basis and control for transferring investments in and out of side pockets.

(b) Disclosure of side pockets arrangement

Both existing and potential investors should be kept fully informed of the side pocket arrangement so that they can assess the implications. In particular, the offering documents or subsequent memorandum of the relevant fund should clearly disclose:

(i) That the redemption lock-up period for this side pocket would be different from that of the ordinary shares of the same fund; and

(ii) How the hedge fund manager defines and categorises investment products which are to be put into the side pocket and the policies for transferring investments in and out of side pockets.

Operational Efficiency

Some of the hedge fund managers we inspected have grown considerably in terms of size (in terms of AUM, number of funds/managed accounts, opening of new offices) as well as complexity (in terms of investment strategies adopted, markets and product types traded in).

It is important for hedge fund managers to plan ahead and ensure that there are adequate staff resources (including back-up for key day-to-day operations) and the organization structure, reporting lines and systems and controls are commensurate with business needs. Smaller sized hedge fund managers are reminded to put in place proper checks and balances to compensate for their limited resources.

Reporting of Value of Assets under Management in Financial Returns

We noted that some licensed hedge fund managers[3] did not report the value of their managed assets in the financial returns.

[3] including advisers that were delegated with an asset management function

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All licensed hedge fund managers are reminded to report the value of their managed assets in Part B of Form 12 of the financial returns and if necessary, refer to the Circular and the Frequently Asked Questions (FAQs) which was issued by SFC on 10 January 2006[4].

Should you have any queries regarding the contents of this circular, please contact Ms Lorraine Chan at 2842-7751.

Intermediaries Supervision Department
Securities and Futures Commission

End

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[4] The Circular and FAQs could be downloaded from the SFC website under Intermediaries Supervision Related Matters

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