

Investment Products Department  
The Securities and Futures Commission  
8/F Chater House  
8 Connaught Road Central  
Hong Kong

30 June 2005

Dear Sir,

**Consultation Paper on Revisions to the Hedge Fund Guidelines**

We set out below our comments to the SFC's Consultation Paper on Revisions to the Hedge Fund Guidelines. We would like our name not to be mentioned in the SFC's publication of the responses.

We are very happy that SFC is taking action to clarify and, in some circumstances, relax the requirements needed to authorize a hedge fund in Hong Kong. The "holistic" approach would appear to be appropriate given the diversity in hedge fund managers, operators and types of hedge funds.

**8.7(a)(iv)**

The relaxation and clarification of what is admissible as part of the 5 year relevant experience is very helpful. We agree that experience is of utmost importance. However, we feel it is unduly restrictive that only experience gained in Acceptable Inspection Regimes ("AIRs") is acceptable for SFC purposes. A number of hedge fund managers are based in countries not in AIRs. We recommend that, consistent with the holistic approach taken with respect to other parts of the Code, the SFC focus on the internal controls, risk management process, sufficiency of human and technical resources, public funds management experience and good corporate governance of hedge fund managers and waive the requirement for a hedge fund manager to be based in AIR countries (a local representative regime could be considered as a compromise). The SFC should not restrict the authorisation of hedge funds purely because of where the hedge fund manager operates, especially when the other factors mentioned above meet the SFC's requirements.

**8.7(a)(iii)**

The use of risk management systems is very much dependent upon the human factor when making decisions. Risk management systems should be robust enough to deal not only with normal circumstances but also "exceptional circumstances. We would be appreciative if the SFC could clarify how a management company could demonstrate the ability of its risk management process to deal with exceptional circumstances to the SFC's satisfaction.

### **8.7(m)**

The compulsory redemption provisions are not broad enough to cover instances where a redemption event has been triggered (e.g. something akin to target redemption note) or where NAV of the hedge fund has fallen below a level where the manager would be able to invest effectively or where running costs have become detrimental to ongoing performance. There should be some provision allowing the hedge fund directors to redeem in the event that they consider this to be in the best interests of shareholders.

### **8.7(o)**

We agree with the SFC's position that the integrity of valuation agents must be maintained. However, we strongly disagree with the proposition that integrity is automatically compromised if the valuation agent has directors or shareholders in common with the management company. In large multinational financial services conglomerates, a valuation agent may still be independent of the management company despite having common directors or being a subsidiary of the other. The impact of implementing the proposed definition of independence may be to prevent or discourage large, reputable hedge funds from entering the HK market.

We recommend that the SFC not set in stone the prohibition on a subsidiary relationship or directorships in common and instead take a holistic approach to require the management company to provide clear evidence that the valuation agent is independent of the management company. For example, the existence of a SAS70 report should bolster a valuation company's claim to competence and independence.

### **Other matters**

Insurance linked product prohibitions: Currently, insurance linked products cannot be invested in a hedge fund even though that specific hedge fund may be authorized by the SFC (prohibited by item (j) of Appendix C in the Code on Investment Linked Assurance Schemes). We feel that an investment in an appropriate hedge fund may be able to help an investor diversify the investment risk more without unduly increasing volatility. As such, allowing investment linked products to be invested in appropriate hedge funds may benefit the investor.

We understand that the SFC is concerned that investors are able to invest into hedge funds via insurance linked products without needing to meet the minimum subscription requirements.

We recommend that, as investments in hedge funds have the potential to reduce volatility of an investment portfolio, the SFC permit insurance linked products to be invested in hedge funds but place the responsibility of meeting minimum subscriptions, not only for hedge funds but for mutual funds and any other investment products, on the insurance companies.

As a final comment, we think the willingness of the SFC to engage in a public consultation exercise is to be commended. We also welcome a more holistic approach to assessing the acceptability of the management company. However, we would say the SFC must seize the initiative to apply flexibility where flexibility makes sense and where it is in the clear interest of Hong Kong investors.

Please feel free to contact me should you wish to discuss our response in further detail.

Yours sincerely,