The Hong Kong/China Chapter of the Alternative Investment Management Association

Comments on SFC Consultation Paper on The Offering of Hedge Funds

General Comments

1. The authorising of hedge funds is generally viewed positively because it will allow investors access to a broader range of investment opportunities and it may remove some of the current negative perceptions by global investors of Hong Kong's financial system.

2. Many promoters or managers of hedge funds around the world are not likely to be interested in promoting their hedge funds in Hong Kong or seeking authorisation for their hedge funds in Hong Kong. They are not interested in the retail market in Hong Kong or elsewhere, have no administration and client servicing systems to handle retail client activity, prefer to operate without the sorts of regulatory constraints that authorisation would entail, and are essentially non-public funds for a specific client base and have limited investment capacity and scale. The vast majority of hedge funds that seek authorisation are likely to be promoted by traditional retail unit trust managers or distributors with existing Hong Kong operations that are seeking to broaden their product range.

3. We favour the market segmentation approach and specifically recommend both a minimum net worth requirement and a minimum subscription amount. We also favour a lower minimum subscription amount for funds of hedge funds and a higher subscription amount for single manager or single strategy funds. Hedge funds are complicated and it is prudent to discourage the lowest end of the retail market from entering products that they probably will not understand.

4. We support the proposal for increased transparency and disclosure for any fund seeking authorisation. There may be some technical problems with the implementation or enforcement of such transparency and disclosure requirements since different investment strategies and funds often have different investment and risk characteristics that may not be comparable.

5. The proposed guidelines for authorisation establish high standards that very few Hong Kong-based managers are likely to meet.

6. The proposed guidelines do not consider investment capacity issues. The capacity of any particular investment strategy is extremely important to the success and risk of the investment. Capacity is the amount of money that may be invested in a particular strategy or segment of the market OR handled by a particular manager without diluting

performance. The traditional unit trust and mutual fund industry operates on the basis that capacity to invest is unlimited and thus any unit trust or mutual fund can accept an unlimited amount of money. The hedge fund industry is much more concerned with capacity, partly because the investors in hedge funds are more aware of capacity issues and partly because the compensation of the manager is tied more to performance and less to the total size of the hedge fund. The Commission should require some disclosure of the expected maximum investment capacity of the investment strategy, the manager and the fund, as well as a discussion of the circumstances under which the fund may close to new subscriptions once capacity is reached. The SFC should be aware of and facilitate the need for authorised hedge funds to close to new subscribers and even to return monies of existing investors once capacity is reached.

7. We recommend the SFC adopt a more liberal and accommodating authorisation policy for funds of hedge funds. This is because there may be significant risks in single hedge funds or in single investment strategies. These risks can be diversified away by funds of hedge funds. In addition, the manager of funds of hedge funds should have more expertise and be better placed than Hong Kong retail investors to do due diligence on managers of single hedge funds and on alternative investment strategies.

<u>Comments on Specific Proposed Guidelines</u>

A. Definition of Hedge Funds

Many funds that use hedging techniques or that otherwise might be described as a "hedge fund" will not want to explicitly be called a hedge fund or to acknowledge that they are a "hedge fund." This is because labelling a fund as "hedge fund" may attract negative connotations. Many funds may prefer to describe themselves as "alternative" funds, "absolute" funds or "market neutral" funds.

B. The Management Company

The five-year minimum relevant investment management experience is an unnecessary barrier and will in effect eliminate most Hong Kong-based managers regardless of whether they are large or small firms or traditional or alternative managers. The SFC will likely find itself under a great deal of pressure from traditional "long only" equity fund managers to accept previous long only equity management experience as meeting the five year requirement. Such experience is only partly but not wholly relevant. Hedging, long-short strategies and related skills such as borrowing securities and short selling are critical to the success of hedge funds and will not be obtained by managing long only funds. The SFC, instead, should concentrate on ensuring that the manager has the right structure, staff, experience, controls, systems and service providers in place.

The proposed requirement of US$100 million of assets under management "in relation to the underlying investment style proposed for authorisation" will eliminate most Hong

Kong based managers for the immediate future. There is very little management in Hong Kong of hedge fund strategies at the present time, particularly at major traditional asset management firms. Only overseas hedge fund managers (including divisions of large fund management operations) are likely to meet this requirement. This requirement will also eliminate start-up fund management operations. An important characteristic of the hedge fund industry is that the managers often tend to be independent managers who have come out of major firms. This will make it harder for Hong Kong to attract independent fund management firms if that is a wish of the Hong Kong government.

The proposed guidelines will require the hedge fund manager to assume responsibility for the quality of selling agents and the advice such selling agents give to their investors in regards the hedge fund. This appears excessive and potentially opens up confusion over who is really responsible the advice given to the client and for the relationship with the client. Licensed selling agents should be responsible for the products they sell and for the advice they give their clients.

Prime Broker

While the proposed guidelines are laudable on the role of the prime broker, they do not reflect commercial practice. Many prime brokers are not likely to want to meet the guidelines. Since hedge funds generally can not operate without prime brokerage, this is likely to prevent many hedge funds from seeking or obtaining authorisation.

Minimum Subscription

We suggest the SFC adopt different minimum subscription amounts for single funds and for funds of hedge funds, with the former have a higher minimum amount and the latter having a lower minimum amount. Funds of hedge funds should be significantly less risky than single funds, and thus a significantly lower minimum is warranted. We recommend a minimum of HK$1,000,000 for single funds and HK$100,000 for funds of hedge funds.

Performance Fees

We see no logic in requiring performance fees to be paid no more frequently than annually (as required under the current Code and which thus would apply to the proposed guidelines). To fairly value the net assets of a fund with performance fees, any performance fee must be properly calculated and accrued at each valuation point (which would be at least monthly under the proposed guidelines). Once performance fees are accrued and thus could be legally chargeable to the fund's assets (depending on the exact legal structure of the fund), there does not seem to be any particular reason why such fees could not or should not be paid out. Performance fee calculation methods and the accounting and administrative treatment of them are very complex and can lead to abuse of investors. It would be better for the SFC to focus on ensuring that any performance fee arrangement is completely fair and transparent rather than on restricting the payment of any such fees to an annual basis.

Dealing Days

The requirement of at least one dealing day per month is contrary to the current practice of many hedge funds. While it is probably appropriate to require monthly dealing for authorised funds available to the public, this will exclude many funds and many investment strategies that insist on less frequent dealing either for the convenience of the manager or to accommodate the illiquidity of the underlying investment strategy.

Financial Reports

This is not a problem in principle but the SFC must understand that there may be definitional or interpretation problems. Each investment strategy (and possibly each fund) usually has unique characteristics. It may not be possible to standardise the description and disclosure of the important characteristics of individual investment strategies and individual funds.

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