

## **Comments on SFC's proposed guidelines on hedge funds for incorporation into the Code on Unit Trusts and Mutual Funds**

### **The Definition for Hedge Funds**

The general wording in Annex I refer to hedge funds as collective investment schemes that differ from traditional funds in their characteristics and their use of a variety of investment strategies. This is generally true and correct. However, we believe this would leave out the essential characteristic that distinguishes a hedge fund from a traditional fund. We suggest the following:

*Hedge funds are investment funds that differ from traditional funds mainly in their absolute return investment objective, which they seek to achieve through a variety of strategies that is based on their managers' skills. In particular, a hedge fund is expected to take calculated risk in areas where its manager possesses the experience and skill sets to manage, while it is allowed (or required) to control or reduce exposure to (hedge) market risks or risk in areas where experience and skill sets of the manager are lacking. Hedge funds are generally expected to use a moderate level of leverage to opportunistically emphasize the "skilled bets" in areas where the funds' manager has an edge.*

### **The Offer of Hedge Funds in Hong Kong**

As the consultation paper has noted, "hedge funds are marketed in Hong Kong mainly on a private basis. The industry lacks transparency and there is little public awareness of the products on offer". We cannot agree more. A growing number of unauthorized hedge funds are being sold in Hong Kong by private placement, the only channel available for such offers. The general public is denied access and there is no protection for those who have access to such funds. This grey area should be brought to the open, with clear guidelines on both how funds should be authorized, and if not authorized, to whom unauthorized funds can be marketed to. **We assume the purpose of establishing an authorization framework for hedge funds is not to restrict distribution of unauthorized hedge funds through private placement channels.**

### **Authorization of Hedge Funds and the Growth of a Home-grown Hedge Fund Management Industry**

The SFC is right to consider, as proposed in Annex I, the experience of the management company's key investment personnel, the company's risk management profile and internal control systems. **We strongly disagree with the proposed criterion of at least US\$100 million of assets under management.** This amount will bar many local fund managers from setting up hedge funds in Hong Kong, which we think is the best way to foster a home-grown hedge fund management industry, and which in turn would serve to educate the public on hedge funds. The experience of hedge fund industry in US and Europe tells us that some of the best and most successful hedge funds started out relatively small, with perhaps US\$20~50 million at start-up. These funds were usually started by talented individuals leaving large buy-side fund management firms or proprietary operations of large institutions. These entrepreneurial individuals gave up high salaried jobs to risk their careers at the cutting edge of investment management. **To impose a US\$100 million limit would**

**only serve to discourage local talents from starting up hedge funds on their own, dimming the hope of creating a local hedge fund industry, the type of industry Hong Kong's "new economy" desperately needs. We believe the size of a fund has little bearing on the fund's risk profile. Rather, it is the qualitative aspects that should be the determinants for fund authorization. These include the calibre of the fund managers, the fund's strategies that should match up with the managers' skill sets, its investment process and risk management systems, its investment terms, which entail the fund's provisions for liquidity, valuation and disclosure/ reporting. We suggest no requirement of minimum assets under management, or a minimum of just US\$10 million.**

### **To Whom Hedge Funds Should be Offered**

**We favour the use of a market segmentation approach by both having a definition for qualified investors and imposing a minimum subscription amount of US\$100,000.**

Given the low penetration of even traditional funds in Hong Kong, hedge funds should not be introduced to the general public without any restrictions. Most of the Hong Kong public has had no exposure to hedge funds, with some harbouring misperceptions through hearsay. It takes time for retail investors to learn about the specialized nature and strategies of various hedge funds. As mentioned above, we believe the best way to educate the public is by fostering a home-grown hedge fund management industry, with professionals offering advice and assistance to the investing public.

Hedge funds and fund-of-hedge-funds should be authorized based on their meeting a number of qualitative and quantitative requirements as discussed above. Their products and/or services should be offered to qualified investors only.

While we agree that a minimum subscription level is a simple and effective way for the purpose of segmentation, we believe it is also necessary to give an official definition for qualified investors, to be known as "sophisticated" or "high net worth" investors, so that the subscription amount is not the only barrier to entry. As the consultation paper has noted, those who cannot afford the minimum amount may pool resources, thus rendering the minimum meaningless. A minimum amount together with a qualitative qualification will help a fund professional to better follow the "know your client" rule.

We favour the term "sophisticated", which suggests experience, and avoids the connotation of "low" net worth for someone not qualifying as "high" net worth. The qualification could require the investor to make signed declarations of his net worth, investing experience and risk appetite etc...

### **Fund-of-Hedge-Funds**

**Fund-of-hedge-fund companies are an important intermediary for introducing hedge funds to the Hong Kong public. As the consultation correctly points out, they "offer a professionally selected basket of ready-made hedge funds to investors". We agree the emphasis in authorization should be "on the due diligence process of the fund-of-hedge-funds manager in selecting and monitoring the underlying funds and clear disclosure of the self-imposed investment parameters in the scheme's**

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constitutive and offering documents". **Under no circumstances should fund-of-hedge-funds be required to have their underlying funds authorized in Hong Kong.** The fund-of-hedge-fund managers should be held accountable for the funds they select for their clients, not Hong Kong's SFC. In fact the authorization of fund-of-hedge-funds will bridge the unavoidable anomaly of having both authorized hedge funds and a grey market of unauthorized private hedge funds.

Although we have suggested bringing the grey market into the open by giving funds the opportunity to be authorized, it is not envisaged that all funds will seek authorization, or that unauthorized funds will become illegal. Unless there is a change in law, it is expected that unauthorized funds will continue to be sold through private placements. The difference, however, is that investors will have the opportunity to choose between authorized and unauthorized funds. Authorized funds will have the advantage of marketing and transparency. However, it does not mean there will be no investor appetite for funds that choose not to be authorized in Hong Kong. **With fund-of-hedge-funds being made a legal venue for entry into unauthorized funds, Hong Kong's investing public will have access to both authorized and unauthorized funds without venturing into a grey area not covered by any investor protection.**

We have stated our preference for a market segmentation approach for the offering of hedge funds. **If in the end a full public offering approach is chosen, we would argue for a two-step approach: initially authorize only fund-of-hedge-funds, with a solid investment process for selecting and allocating to hedge funds and a proper infrastructure for explaining the underlying funds and strategies to investors. Authorization of single fund hedge funds should come later when there is a suitably developed local hedge fund management industry.**

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