SECURITIES AND FUTURES COMMISSION

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UBP

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1. Alternative vs Traditional Asset Management

This document is prepared in response to the invitation by the Securities and Futures Commission (SFC) to comment on the proposed guidelines on hedge funds, for incorporation into the Code on Unit Trusts and Mutual Funds (the Code).

Union Bancaire Privée is a privately owned Swiss Bank. We are headquartered in Geneva and detailed information about our organisation can be found on the website www.ubp.ch

UBP currently allocates USD 6 billion of proprietary and clients assets to the hedge fund industry. Our flagship fund of hedge fund, Dinvest Total Return has been approved for public sale in Switzerland.

On the discussion of *What are Hedge Funds*?

We propose that the key distinguishing feature of hedge funds is the style of management. A useful exercise is to compare with Traditional Asset Management.

In contrast with traditional asset management based on the assumption of efficient markets and the perception that outperforming the market over time is impossible without accepting undue risk to capital, alternative asset management presumes that markets are indeed inefficient and offer, therefore, opportunities for increased investment performance without increased risk to capital. Some of the defining characteristics of alternative asset management strategies can be summarised as follows:

- Whereas traditional asset management will focus on building a portfolio of long securities, essentially equities and bonds, alternative asset management will use both long and short positions. In addition, the use of derivatives, both for hedging and speculative purposes, is not limited in alternative asset management strategies.

- In traditional asset management, the use of leverage is only permitted to a limited extent. By contrast, alternative asset management strategies can be highly leveraged.

- A portfolio managed according to traditional asset management principles aims to outperform a benchmark, some form of index, or industry median, following an indexed and/or passive investment approach. Performance, therefore, is measured on a relative basis. Alternative asset management, on the other hand, seeks to capture absolute gains at all times, whether in a rising, static, or falling market, following a dynamic investment approach.

- Traditional asset management strategies generate returns, which are more highly correlated to major market indices than alternative asset management strategies.

In attempting to define Hedge Funds, it may be more important to focus on the different investment styles and strategies rather than the manner in which they are set up and regulated, particularly when our objective is to define the instrument so as to better regulate it.

2. Hedge Fund: Definition

Hedge Funds include a variety of alternative investment strategies. Far from being a homogeneous group, hedge funds cover a wide array of investment styles and strategies. Some adhere to well defined investment disciplines while others are highly opportunistic. Risk profiles and performance attributes, therefore, can vary substantially. The style of some hedge funds may evolve over time to better suit market conditions. Broadly speaking, hedge funds styles and investment strategies include the following:

- **The "Classic" hedge fund strategy is long-short equity.** Managers take both long and short positions on equity markets to construct a portfolio that can generate profits in both rising and falling markets.

- **Macro strategies.** Managers seek to capitalise on regional and global economic changes by taking advantage of broad market opportunities in such areas as currencies, interest rates, stock markets and commodities.

- **Arbitrage or relative value strategies.** These strategies are based on the principle that when a price discrepancy exists between related trading instruments, a relative value position may be established by buying the relatively underpriced instrument and hedging that position by selling short the relatively overpriced instrument. If the relationship between these instruments returns to normal (fairly priced), a profit may be realised. Examples of such strategies include: convertible arbitrage, fixed income arbitrage and capital structure arbitrage.

- **Event-driven strategies.** Managers invest long and short in the securities of companies that are involved in a major corporate event such as a merger, acquisition, bankruptcy, or buyout. Managers will take a position based on their analysis of the probable outcome, and its impact on the company's market valuation.

- **Distressed securities investment strategies**, based on the observation that securities of companies involved in bankruptcy proceedings are frequently undervalued, providing the prospect of greater appreciation in value than the securities of more financially stable issuers. Undervaluation, in relation to real fundamental value, may be the result of several factors, including, the difficulty of financial analysis of a troubled issuer, complex legal difficulties and the lack of available information.

This list is by no means exhaustive and terminology differs significantly depending on the author.

3. On Regulatory Concerns

It is perhaps essential to classify and identify the risks involved and resolve the conundrum that way. In the broadest terms possible, there are two main risks, economic and structural.

Economic risks are associated with volatility in the markets and the skills of the managers. These risks are no different from making any form of investment.

Structural risks are linked to the infrastructure of how the funds are set up and serviced. These risks are addressed by regulating the service providers, such as the fund management company, the auditors, the prime broker, the fund administrator etc.

Ultimately, the objective is to protect investors,

- Stratification implies that investors who can afford to lose do not need or require less protection. It is possible that an investor does not understand the risks involved while another less well off investor understand the risks, is willing to take the risk but is precluded because he is deemed inappropriate from an "ability to lose" perspective.
- "Inexperienced investors + inexperienced managers lead to losses. The last two years have amply demonstrated that experienced investors and managers are equally able to lose a tremendous amount of money.

With reference to Overseas Regulatory Approaches in the consultation paper, Apart from Switzerland, increasingly, hedge funds are authorised for sale to the retail investors, notably, significant changes have occurred in countries like Singapore, Australia and Italy, the United Kingdom and Canada.

Our comments on the Proposed Guidelines are as follows:

The Management Company

(a) i Apart from the requirement of at least five years of experience in the relevant style of investment, it is necessary for the performance track record to be audited; or at least have a verifiable independent source. This reduces the possibility of fraud.

ii' Apart from the minimum amount of US 100 million, a useful check and balance on the manager is to ensure that he/she has a significant portion of his/her personal wealth invested in the pooled fund. This will ensure that the manager's interest is aligned with the investors. Moreover, it will prevent unchecked risk taking.

Minimum Subscription

(d) The issue of minimum initial subscription has taken on mythical proportion of protective powers. If I have to state a number it will be on the lower end of the spectrum HKD 100,000. Why?

– If the minimum is not an issue relative to my net worth, it is irrelevant, if it is and my desire is to invest, the likely outcome is that my portfolio will be forced to be concentrated.

– While the concept appears simple, is it effective? The regulators are aware that pooling of funds by smaller investor may take place. Moreover, with the involvement of selling intermediaries, how realistic is it to check that the minimum initial size per investment is in compliance?

Dealing

(f) Enforcing monthly liquidity on the hedge fund will lead to a skewed set of hedge funds seeking approval in Hong Kong. Depending on the strategies employed by the hedge funds, monthly redemption may not be the optimal way for the fund to be organised.

- The investors should be in the best position to judge whether they need the liquidity. This information must be made available to the investors at the beginning.
- A long redemption period may be more effective in discouraging investors who are not in a position to make the investment.
- Illiquid investment is not necessary a bad investment. Some strategies require longer time horizon to work out.
- Moreover, having a longer period of redemption does not preclude the evaluation of the hedge fund on a monthly basis; or more frequently by an independent source, like a fund administrator for valuation purposes.

(g) Restricting the payment of redemption money to the investors within 60 calendar days is in effect intervening in the management of the fund because:

- The manager will have incentive to hold a higher cash balance than optimal, alternatively he/she may establish a credit facility to meet redemption requests, which will be an added cost to the fund and penalize the other
- investors who do not have this liquidity need.

Performance Fees

(j) Paying a performance fee to the manager creates an alignment of interests with the investors, an appropriate incentive for superior performance and prudent risk management. Importantly, it creates incentive for the manager to seek long-term superior performance. There should not be any difference for hedge funds with a target to achieve absolute returns.

4. Fund of Hedge Funds

That each of the underlying hedge funds in the fund of hedge funds will be authorised individually.

This issue is not directly addressed in Annex 1 but discussed at the conference organised in conjunction with this consultation paper. Operationally, it will not be feasible because the turnover of managers is unpredictable and the timing of allocation by the fund of funds manager determines performance. It is also crucial that the selection of managers is an independent decision.

– The Swiss Banking Commission took the view of regulating the fund of hedge fund manager rather than the underlying funds. The onus is on the FoHF manager to ensure compliance with the due diligence requirements.

Quality of Selling Agents

Another point that was discussed but not addressed directly in Annex 1 refers to the standards and qualifications of selling agents.

- Appropriate training together with accurate and precise risk disclosure documents could mitigate the fears of misunderstanding or erroneous asset allocation.
- In some ways, this is easier to control from a regulatory perspective. And has positive spin-offs as it effectively amounts to skill training for the financial advisors.

Disclosure of information

There has been a lot of discussion of disclosure of information. What information clarifies and what obfuscates?

– In Union Bancaire Privée (UBP), we view our function as one of oversight and not portfolio management. There are key points we cover with every manager, including but not limited to a set of key statistics: assets under management, monthly net performance, market exposure by percentage, performance attribution on sector and on long/short position, top holdings broken down by geographic and sector exposure, use of leverage.

– We aim to understand and anticipate our managers' monthly performance and risk positions through the information we receive on a continuous basis.

– We focus on their corporate infrastructure, internal process, understand their portfolio construction decisions, their analytical work and their risk management controls.

These are yardsticks or checks and balances, which we have developed over the last 20 years to monitor an industry that is not otherwise regulated.

Principal Guaranteed Notes (PGN)

This is not directly addressed in Annex 1, but the regulators anticipate applications by such products for authorisation in Hong Kong.

The objective of a PGN should be to transfer the risks peculiar to hedge funds away from the investor to the issuer/guarantor of the note.

We have outlined the two broad categories of risks as being economic and structural. There is a wide spectrum of products that are called principal guaranteed. The focus should be whether they succeed in reducing the risks identified.

Economic risks - the note should have less volatility than the underlying fund and the maximum downside is limited.

Structural risks - the note should eliminate the structural risks completely. In the event of fraud where the hedge fund is illegitimate. The investor retains 100% of his/her principal. The task of monitoring the operational risks, i.e. insufficient controls in the backoffice of the fund, incorrect calculation of the Net Asset Value or misleading reporting of performance become the responsibility of the guarantor.

To regulate these structures:

- The focus should be on the terms of the guarantee. The guarantee should not contain escape clauses. For example, some hedge funds are allowed to suspend the fund when liquidity dries up in the market. Investors no longer have the option to redeem. The terms of the guarantee should not have a clause allowing it to wind up the fund in such an event.
- The credit risk of the issuer/guarantor. It is important to specify whether the note is a direct obligation of the issuer or that of a special purpose vehicle.

There are two broad categories of Principal Protected Structures. For detailed discussion of how they operate please refer to **Appendix 1**- "Capital Guaranteed Hedge Funds. How do they work?" Essentially, they are the "bond and call structure" or the "leveraged-deleveraged structure".

UBP uses primarily the "bond and call" structure.

Characteristics of UBP's principal guaranteed notes:

- The notes are direct obligations of a double A rated issuer; not a special purpose vehicle. There are no escape clauses where the guarantee does not apply under certain circumstances. In the worst case scenario, the investor gets 100% of his/her principal.
- The participation rate in the performance of the underlying fund is fixed at the launch of the note. It does not vary during the life of the note. There will not be a situation of being "knocked out" where the investor is left holding a zero coupon bond.
- Due to the bond component of the structure, the volatility of the note is reduced. For example, should the underlying fund goes down in value by 10%, the note will still have a value of 94.50. Hence, the note will always have a volatility that is lower than the underlying fund. This is markedly different from structures, which use the "leverage/deleverage" methodology of providing the principal protection. The effect of the latter method is to amplify the volatility of the note.

The intention and the thinking behind the crafting of this product are to address the risks peculiar to hedge funds. This serves as an introductory product for investors who are unfamiliar with hedge funds as an asset class.

5. Conclusion

In the same manner that the SFC proposes that "Hedge Funds would be required to clearly disclose a set of self-imposed investment and borrowing restrictions, including the maximum limit on leverage. Disclosure should be made in the scheme's constitutive and offering documents." The same attitude should apply to other aspect of the operation of hedge funds. It will be more constructive to understand their method of operation, seek a comfortable level of transparency in their operation than to attempt to influence the running of the fund.

Appendix 1:

"Capital Guaranteed Hedge Funds. How do they work?"

Capital Guaranteed Hedge Funds
How do they work?

The recent focus on hedge funds as an alternative asset class has led many investors to consider investing in this area for the first time. One of the forces that has both driven and responded to this development is the available range of new products that enable investors to overcome the traditional obstacles to investing in hedge funds. These obstacles can broadly be described as "economic" - the fear of investing in an unknown asset class and the possibility of losing money, and "regulatory" - internal or external rules that may prevent an institution or individual from investing in an unregulated asset class such as hedge funds.

The single most effective product to overcome such obstacles is the Capital Guaranteed Hedge Fund (or, more often, fund-of-funds). These are funds with a pre-determined maturity - frequently 3 or 5 years - and a guarantee that at maturity the investor will receive at least his initial investment.

These products are often offered in the form of a bond or Note issued by a highly-rated bank or insurance company . The Note will pay no annual coupon, but its value at maturity will be indexed to the performance of a Fund. Purchasing a Capital Guaranteed Note ("CGN"), will often enable institutional investors to bypass internal or external regulations, which would normally prevent them from investing directly in the Fund itself. In combination with the reduced economic risk offered by the capital guarantee (the investor's risk is limited to the interest forgone on the sum invested), these Notes make it possible to overcome both traditional hurdles. As a result, they have proved very popular with both institutional and private investors, and we estimate that over USD 10 bn worth of these Notes have already been distributed worldwide.

Notwithstanding their success, these products have suffered from a lack of transparency, which has made it difficult for investors to compare different structures, and to make informed decisions on which best meets their requirements. The purpose of this article is to describe and compare the two basic structures that underlie most CGNs, in order to assist investors in choosing the structure best suited to their individual needs.

"Bond plus Call" versus "Leverage/Deleverage"

Although in the past, CGNs were issued with a variety of structures, the current market is dominated by two basic forms - the "Bond plus Call" (also known as "fixed participation rate") structure, and the leverage/deleverage ("portfolio insurance" or "CPPI") structure. Although the two structures may appear similar to an investor, they actually work in quite different ways and offer relatively different risk/return profiles. Thus, it is important for an investor to be aware of and understand these differences before making a decision regarding which structure, if any, corresponds best to his particular needs.

The "Bond plus Call"

The easiest structure to understand (and this is certainly one of its benefits) is the Bond plus Call. This is a Note that offers a fixed participation rate in any positive performance of the underlying fund as calculated on the date of the Note's maturity.

For instance, a typical five-year USD-denominated Note currently offers a participation rate of 80%. This means that at maturity the investor would receive his initial investment (e.g., USD 100) plus 80% of the Fund's performance over the five years. Thus, if the underlying Fund had appreciated by 90% over the five-year period, at maturity the investor would receive:

USD 100 plus 80% of USD90 = USD 172

If the performance of the Fund had been negative, the investor would receive just the return of his original investment, i.e. USD 100.

Importantly, the return on the Note is solely dependent on the performance of the Fund over the life of the Note, as calculated at the date of maturity. The path that the fund has taken over the course of the 5 years does not impact the final value of the Note. Thus, even if the value of the fund plunges early in the life of the Note but subsequently recovers strongly to end the 5 years with a positive return, the investor would receive 80% of the final positive performance - he would be unaffected by any drawdowns or volatility that the fund may have experienced over that period (other than the adverse "mark-to-markets" on the value of his Note that he would have experienced).

The "Leverage/Deleverage" Note

The second structure, the leverage/deleverage Note, differs in important aspects from the Bond plus Call in that the value of the Note at maturity depends on the final value of the Fund as well as the course or path which the fund would have taken over the life of the Note.

The mechanics of each Note will differ slightly, but they broadly follow the same basic theme. On the day of investment in the Note, the issuer will calculate the cost of a zero coupon bond with a value at maturity equal to that of the investment (the guaranteed amount, e.g. USD100). For example, on a five-year USD-denominated bond, the zero coupon bond would currently be priced at USD75. The issuer will then subtract the value of the zero coupon bond (USD75) from the value of the investment (USD 100), to calculate the investor's "equity " (USD25). This equity is then multiplied by a pre-agreed "leverage factor", typically 4, to calculate the initial participation, in this case: USD 100 (4 * 25).

The investor is therefore receiving an initial participation rate of 100% - i.e., he will participate in 100% of the performance of the Fund (minus an annual Principal Protection Payment of 1% to 2% made under this structure to the Note issuer).This is clearly preferable to the previous structure, where the investor only received an 80% participation rate (although with no additional Principal Protection Payment). However, with the leverage/deleverage structure, this participation rate will depend on the level of the investor's equity, and this will vary over the life of the Note depending upon the Fund's performance.

Variable Participation Rate

This can work to the investor's advantage: if the Fund rises in value, the investor's equity will also rise and his participation rate may even increase to over 100% (typically, it would be capped at 125% to 150%),which could enable the Note to actually outperform the underlying Fund.

However, the reverse is true if the Fund starts returning negative performance. Lets take the example of a fund that loses 5% of its value in the first month after the Note was issued. This would mean that the investor had lost 5% of the value of his original USD 100 investment in the Fund. His equity, therefore, has fallen from USD 25 to USD 20. The Note issuer will then apply the leverage factor to this new level of equity, to arrive at a new participation rate of 80% (4 * 20). The Note issuer will have to sell some of the investments in the Fund in order to reduce the amount invested to USD 80. The investor has been partially "deleveraged", and his participation rate is now 80%.

This process continues over the life of the Note. In the extreme (but certainly not unknown) case of sustained poor performance by the Fund, the investor may find that he has lost all of his equity. This results in the Note being completely deleveraged, such that the investment in the Fund falls to zero. At this point the Note investor no longer has any exposure to the Fund and, even if the Fund were subsequently to recover and end the five-year period with a positive return, the investor would only receive the return of his principal. The investor has been "stopped-out".

Which is the better structure?

The table on page 4 lists a number of issues to be considered, and compares the two types of Notes. Clearly, each of the structures has its own advantages and disadvantages, and some of these may be decisive for a particular class of investors or Note distributors. However, we think that there are two major points to be aware of and to understand when choosing between the two.

The first is that the risk/return profiles of the two structures are quite different. The leverage/deleverage Note holds out the chance of producing returns equal to, or perhaps even above the Fund itself. Similarly, the volatility of the Note will be equal to or higher than the Fund's. Thus, this product can be viewed as "equity-like" in terms of potential returns, volatility and risks: although here, the investor's risk is that of being "stopped-out" and of not participating in any recovery in the value of the Fund.

On the other hand, the Bond plus Call structure is a more defensive instrument: the return on the Note will always be less than the return on the Fund (unless, of course, the return on the Fund is negative), and the volatility will be lower. However, the investor runs no risk of being stopped out. To a certain extent, this structure may be viewed as more of a "bond-like" investment: less risk, less volatility and a lower potential return. Thus, the first point to bear in mind is that the choice of structure should depend upon the investor's requirements and goals, and the type of investment he is looking for.

The second, and possibly key, factor to consider is that the relative attractiveness of the two structures is ultimately determined by the performance of the Fund itself. If one knew with certainty that the Fund was going to produce consistent positive returns with limited drawdowns, then the leverage/deleverage structure would clearly be preferable. Hence, the choice of structure can only be made by considering the nature of the underlying Fund and quality of the Fund manager.

In essence, the leverage/deleverage structure can work very well, but only if the Fund is well managed: combining the leverage/deleverage structure with a poorly diversified and badly managed fund-of-funds is a sure recipe for disappointment. This can be made worse by the addition of high annual Principal Protection Payments that often come with the leverage/deleverage structure, and which can be a drag on the Fund's performance and may increase the possibility of being deleveraged.

However, with an experienced fund-of-fund manager actively managing a well-diversified pool of high-quality fund managers, and a reasonable fee structure, it would not be unrealistic for an investor to anticipate attractive returns with a leverage/deleverage Note. Here, homework is crucial - the investor should consider closely the nature of the fund that he wishes to have exposure to, and consider whether the proposed CGN structure is appropriate.

In conclusion, there is no single answer to the question of which structure is to be preferred. However, by understanding the Note, and taking the time to understand the underlying Fund and fund manager, the investor should be able to take an informed decision on which one is the most appropriate for him, given his particular risk/return/volatility requirements.

However, one thing is clear: these structures provide an efficient means for many investors to enter an exciting new asset class which would otherwise be inaccessible to them. As such, we should expect to see this area continue to grow, and for structures to be continually refined and hopefully improved. Alternative asset structured products is an evolving area and one where we should expect to see some interesting new developments in the future.

Issue:	Bond Plus Call:	Leverage/Deleverage:
Potential to match or beat fund performance	**No.** Performance will always lag fund	**Yes.** If fund experiences limited drawdowns.
Risk of being "stopped-out"	**No.** Participation Rate is fixed.	**Yes.** Participation Rate will vary depending on performance, and may drop to zero.
Easy to understand	**Yes**	**No.** Difficult for investor to understand Note payoff because it is "path-dependent".
Volatility of Note valuation	Lower than fund.	Similar to fund.
Sensitivity of Note valuation to interest rates	**Yes,** due to bond component of Note	**No.**
Possible Note maturity	Can be 3 years and more	Usually 5 year minimum.
Secondary Market Liquidity	Usually monthly, with early exit fee of 1%	Usually monthly, with early exit fee of up to 5%
Target investor base	Conservative	More aggressive

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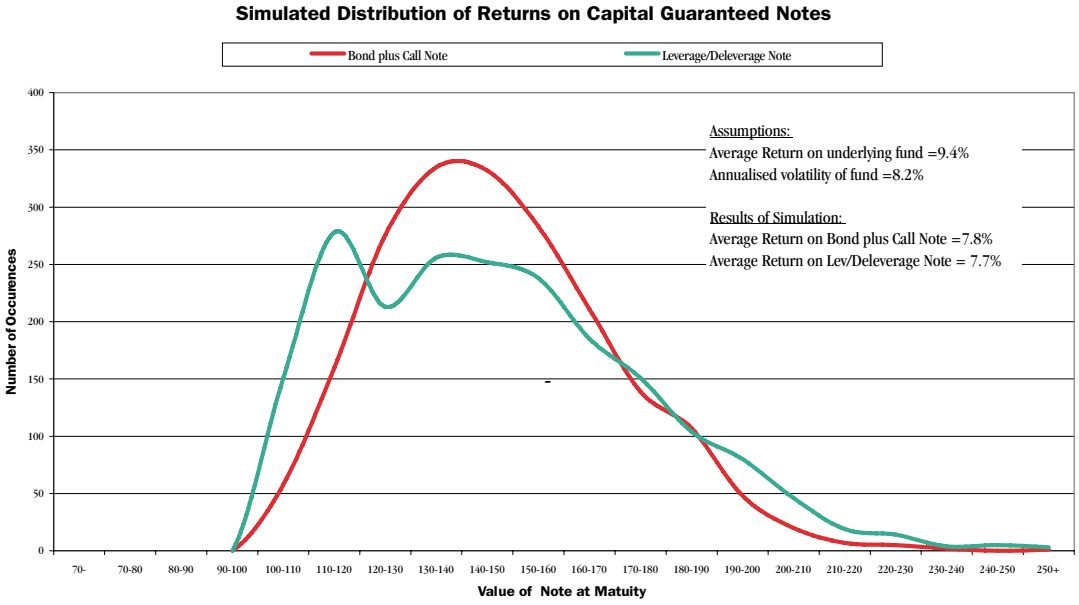
APPENDIX - COMPARISON OF SIMULATED RETURNS ON CAPITAL GUARANTEED NOTES

It is possible to compare the respective theoretical returns on the two types of Notes by running a simulation of their returns based on different Fund performances.

In order to carry this out, a number of assumptions have to be made on, for example, expected fund returns and volatility, the Notes' participation rates, the cost of Principal Protection Payments[1]. These assumptions will clearly effect the result of the simulation, and therefore this simulation should only be used as one factor in comparing the two structures.

The following graph illustrates the results of running 2000 simulations for a fund with assumed returns and volatility equal to those achieved by the HFR fund-of-funds index since January 1997 (9.4% annual return, 8.2% volatility). It compares the returns on a 5-year Bond plus Call Note with an 80% participation rate, with those on a 5-year leverage/deleverage Note with an initial participation rate of 100%.

The respective average returns achieved by the two structures are almost identical at around 7.75%. In some ways we should expect this, if we assume that the market for capital protection is to some extent "efficient".



However, as the graph illustrates, while average returns on the two Notes are almost identical, the distribution of returns is not. The returns on the Bond plus Call structure are concentrated around the average, while the returns on the leverage/deleverage Note are more widely dispersed. Given that most investors will value relative certainty of returns, this would make the Bond plus Call preferable. Combined with the relative simplicity of the Bond plus Call structure, we would assert that given the assumptions used in this simulation, most investors would prefer the Bond plus Call Note.

However, each investor will wish to make his own assumptions about future fund returns and this may lead to different conclusions. For instance, if it is assumed that future returns will be equal to those achieved by the fund-of-funds offered by Union Bancaire Privée (annual return of 14.4%, volatility of 6.1%), then a simulation of returns would produce higher average returns for a leverage/deleverage Note than for a Bond plus Call (13.1% versus 12.1%).

[1] An assumption must also be made on the distribution of monthly fund returns. We assume that monthly returns are normally distributed. In reality, this may not reflect the likely distribution of returns which are likely to have some sort of "fat tails". In addition, fund returns may have other characteristics - such as a tendency to trend or to "gap" - which are also not accounted for by the simulation. Our guess is that these factors are likely, all else equal, to generally reduce the actual returns achieved by the leverage/deleverage Note.

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