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Date: 27 September 2002

By Hand

The Securities & Futures Commission

12th Floor, Edinburgh Tower

The Landmark, 15 Queen's Road Central

Hong Kong

Attn: Investment Products Department

28 SEP 2002

Dear Sirs

Re: Consultation Paper on Hedge Funds Reporting Guidelines

In response to your captioned consultation paper, we set out below our comments for your consideration.

1. Appropriate Accounting Standards: para. 20-27

The Guidelines proposes the adoption of International Accounting Standards (IAS) to provide standard measurement and presentation basis for the preparation of hedge funds financial reports, regardless of the domicile of the hedge funds and their management companies. The proposal is to promote consistency, comparability and transparency of hedge funds financial information. IAS 39 and IAS 32 are quoted in the consultation paper as a support to the proposal.

Comments:

- IAS are well drafted. However, there are some issues subject to practicability debate.
- IAS 32 suggests that 'classification (of liabilities and equity) reflect substance, not form'.

Sometimes, the interpretation of substance is different from person to person, particularly for hedge funds whose strategies are always tailor-made.

- IAS 32 requires 'split accounting' for compound financial instruments (such as convertible securities).

The requirement may show a clearer picture to investors. Yet, if those compound financial instruments are hedge-mixed with other securities e.g. convertible arbitrage, split accounting may offer little value of reference. The requirement will also increase the workload of the hedge fund.

- IAS 32 stipulates that 'offsetting on the balance sheet is permitted ONLY IF the holder of the financial instrument CAN LEGALLY SETTLE on a net basis'.

Parties in any derivative contracts (popular hedging tools) doubtless hold contractual relationship legally enforceably. This makes the offsetting restriction meaningless. The real problem is essentially the failure of either party to perform in case of, say, a market crash. If emphasis is placed on 'legal rights on net basis settlement' and 'legal rights' is interpreted too rigidly, many hedge funds will not be able to meet the requirement if hedging activities are done off-exchange and involve different parties under various contracts.

- IAS 32 requires the disclosure of 'fair values of financial instruments'.

'Fair value' is not easy to determine. It may be worked out with relevant reputable and popular formulas. However, as we all know, formula-derived fair values are of little significance if the liquidity is thin. Many long-dated contracts of the hedge funds are these items.

- Under IAS 39, all financial assets and financial liabilities are recognized on the balance sheet, *including all derivatives*. They are initially measured at cost, which is the *fair value* of whatever was paid or received to acquire the financial asset or liability.

The provision encounters the same problem in 'fair value' mentioned above. Hedge funds may not accept that off-balance-sheet derivative items should be recognized in the balance sheet.

- Hedge accounting is permitted under IAS 39 in certain circumstances, *provided* that the hedging relationship is clearly defined, measurable, and *actually effective*.

It's good to stipulate that hedging relationship should be clearly defined and measurable. However, *who could say which strategy is not actually effective?* Even though a hedging strategy fails once in a particular situation, it does not mean that its underlying logic and strength is not actually effective in many presumed market situations.

- Under IAS 39, hedge accounting is permitted *only if* an enterprise designates a *specific hedging instrument as a hedge* of a change in value or cash flow *of a specific hedged item*, rather than as a hedge of an overall net balance sheet position.

The 'specific-to-specific' hedge requirement seems lacking practical sense as well. This will preclude the hedge fund managers from many sensible options in structuring their strategies.

Recommendations:

- In view of the above practical deficiencies of the IAS, it seems **undesirable** to require SFC authorized hedge funds to adopt IAS on a **mandatory basis**.
- Notwithstanding the above, consistency in measurement and presentation for the underlying financial instruments should always be required to allow meaningful comparisons to be made between different hedge funds. Any **good and practically viable provisions in the IAS could be adopted on a selective basis**.
- More ideally, the local bodies in the accounting profession could render help in making specific accounting standards, incorporating all practical considerations, for the above purpose.

2. Adequacy of alternative disclosures: para. 28-34

The Guidelines provide two examples of minimum acceptable disclosures in lieu of full position transparency – the hedge fund's exposures by categories, and the hedge fund's top ten positions.

Comments:

- The requirement for the disclosure of the exposures for the scheme (expressed in percentage terms of net asset value of the scheme) categorized by asset class, geographical region, industry, strategy, or some other basis that the management company considers the most appropriate, taking into account the objective and strategy of the scheme is very reasonable. However, the requirement for detailed disclosure of strategy may discourage good hedge funds from coming to our market. There are other risk areas requiring more disclosure

practically.

- The requirement for the disclosure of the positions in absolute terms is good information to investors. However, it is also good information to the hedge fund's competitors and to those who seek chances for copying effective strategies. Top ten positions do not appear to be a great number for a particular portfolio. Yet, looking at this with the 'weighting' effects, the top ten positions may represent 70% or even more weights of the entire portfolio. Together with other disclosures, in-field professionals may easily sketch the strategy and magic behind the fund as well as its current position. Hedge funds may have serious concern about this.

Recommendations:

- To deal with the concern of the business secrets, the SFC should allow hedge funds to give **general, and not specific and detailed, descriptions about their strategies.**
- **Leverage risk** is practically more eminent for certain strategies, especially when high-risk strategies use high leverage. Illiquid instruments used for leverage purpose will augment the risk further. Thus, **more detailed disclosure** in this area should be required.
- Instead of top ten positions, **top five positions or positions amounting aggregately not exceeding 30%** of the net asset value of the scheme, whichever is the lower, should **be disclosed.**

3. Appropriateness of disclosures required for quarterly reports (para. 37-43)

Comments:

- The Guidelines requires both a Management Commentary (in narrative form) as well as a Portfolio Review (with key quantitative information). These are the parameters that the SFC feels would be directly relevant to retail investors.

Agreed.

- For ease of comparison by investors of different hedge funds, the Guidelines proposes the disclosure of a number of performance and risk measures in standardised format. These include actual monthly returns, annualized returns, annualized standard deviation, Sharpe ratio, highest and lowest NAV per unit/share and maximum drawdowns for the last three individual calendar years and since launch.

Agreed.

- Where quarterly reports are intended for distribution to non-holders (i.e. persons who are not existing fund investors), it is proposed that they must be accompanied by the fund prospectuses. This is to facilitate investors to interpret the information set out in the quarterly reports in the proper context.

Agreed.

- The SFC reserves the right to require disclosure of the full position of the scheme for the purposes of carrying out its regulatory functions. Such disclosures to the SFC will be subject to the Commission's preservation of secrecy provisions.

Agreed. This is reasonable and necessary. The secrecy provisions should be able to offer good protection to the interest of the fund and its investors.

Recommendations:

- The proposed disclosures of performance and risk measures e.g. annualised returns, Sharpe ratio, maximum drawdowns, etc are reasonable and essentially in line with the requirement in major overseas markets. However, **value-at-risk (VaR) and its confidence level** is very important information for risk assessment. Though the SFC encourages hedge funds to disclose VaR in the Portfolio Review, it is better to make it **mandatory**.
- Illiquid holdings are also where the main risk lies in many hedge funds. Apart from the information of the valuation method and the valuing agent, the **size of such illiquid holdings** should be **mandatorily disclosed**.
- Quite a number of hedge funds were discovered, usually after their failure, to have drifted from their original strategies for which investors handed in their money for the fund's management. To avoid such **style-drift risk**, hedge funds should make a **declaration in all reports** that there are no style-drifts during the reporting period.
- The investment personnel is a very important element in the success of any hedge funds. The **key investment personnel** should be specifically described in the prospectus. Any change in the composition of the key investment personnel should be **immediately notified to the SFC and made known** to the investors in writing or other effective communication means.

4. Reasonableness of the timeframe for reporting to holders: para. 45-47

Comments:

- The proposed filing deadline for annual reports is four months after end of scheme financial year (except for fund-of-hedge-funds, in which case, the deadline is six months).

The timeframe is reasonable.

- The proposed filing deadline for semi-annual reports is two months after the relevant reporting period.

The timeframe is reasonable.

- The proposed filing deadline for quarterly reports is one month after the relevant reporting period.

The deadline is a bit aggressive.

Recommendations:

- The filing deadline for quarterly reports should be one and a half months (and two months for fund-of-hedge-funds).
- For any funds or fund-of-hedge-funds that have special difficulties in meeting any of the above deadlines, the SFC should consider **granting extension on case by case basis** if applications are made with reasonable justifications.

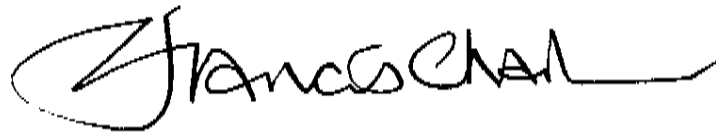
Other Recommendations:

- We understand that the SFC will launch programmes to educate the general investors in the retail market the risk of hedge funds. However, hedge fund products are essentially not easy for retail investors to master. The **intermediaries** selling hedge fund products as agents will thus **assume a very important role in safeguarding the interest of such investors**. It is proposed that **more stringent requirement be set for these selling agents**. Although the Hedge Fund Guidelines issued by the SFC in May stipulates that the selling agents be given 'adequate training', there are no details in overseeing the provision of such training, its relevance, depth and width, and the 'level of adequacy'. Whilst the SFC is not in a position to be the 'trainer', it should set up a monitoring system for regular as well as random checking. Any registered person who is going to sell hedge fund products should first lodge with the SFC a proof of their respective

training. On-the-job training should not be allowed to replace such a requirement. Banks and securities houses should also keep such a register for their staff engaged in selling hedge fund products.

We hope you will find our comments helpful to your further consideration of the proposed guidelines.

Yours faithfully

A handwritten signature in black ink, appearing to read "Francis Chan". The signature is fluid and cursive, with a large initial "F" and a long horizontal stroke at the end.

Francis Chan
President
The Hong Kong Association of Financial Advisors