

## FINANCIAL CONTROL LIMITED

Unit 712, Yu To Sang Building, 37 Queen's Road,  
Central, Hong Kong

Tel : (852) 2591-5923/2147-9609 Fax : (852) 2591-6903/2147-9610

Web Site : [www.financialcontrollimited.com](http://www.financialcontrollimited.com) E-mail: [help@financialcontrollimited.com](mailto:help@financialcontrollimited.com)

30 September 2002

Ms. Tina So  
Director  
Investment Products Division  
Securities and Futures Commission  
12/F Edinburgh Tower  
The Landmark  
Central  
Hong Kong

Dear Ms. So,

FCL is a private consulting firm incorporated in Hong Kong offering services to family investment offices, hedge funds, fund of hedge funds, investment banks and other financial institutions in areas such as asset allocation, investment analysis and due diligence, risk management, portfolio re-valuation, system search and implementation, operations strategy, and training.

It is our pleasure to submit the following responses to the September 2002 "Consultation Paper on Hedge Funds Reporting Requirements".

We support the SFC's valiant efforts to address hedge fund reporting requirements; however we believe that certain critical issues unique to hedge funds have not been adequately explored or discussed in this paper. These include:

**The Bigger Picture:** It is our view that hedge funds cannot be regarded as a mere extension or subset of traditional funds, and therefore the final reporting requirements deserve more than just adopting existing guidelines with slight modifications/added requirements. They should be a new set of policies and reporting requirements that address the explicit business nature of hedge funds, and call for comparable disclosures in terms of content and transparency between individual funds and FoHF's. Unlike 'traditional funds' where most investment decisions are made on individual assets with upside potential, hedge funds employ strategies that often involve a combination of positions such as arbitrage and pair trading. Therefore, requiring hedge funds to disclose individual top-ten positions can be irrelevant and misleading – this can exaggerate exposures relative to the overall portfolio. Reporting requirements should focus on aggregated risk/return statistics that are in line with the objectives set out in the prospectus, for example by asset class, sector and market, or other 'group' categories,

although managers should be given an alternative to report all individual positions and not just the top ten.

Terms such as exposure and position must be further defined so that they are clear to all parties when preparing and analysing reported figures. In other words, investors must be able to understand if a particular set of figures represent market values or notional amounts or market risks. Whether a fund chooses to report all of its individual positions or aggregate risk, figures should include details that allow investors to better understand what would happen if the markets were to move in a particular direction or the assumptions behind the risk measurements. If aggregate risk figures are not reported, then in the case of options or warrants for example, figures reported would include the underlying notional amounts, strike prices, expiry dates, current market values, and other relevant descriptions of the instruments. In the case of futures, figures reported would include futures notional, underlying market, etc. If risk aggregated exposures are reported instead, such figures would inherently include the effects of notional amounts, leverage, optionality, etc. without having to disclose closely-guarded positions.

**Derivatives' Disclosure:** It is common practice for hedge fund managers to include derivatives in their portfolios for different purposes, from hedging certain risks to leveraging risk-to-NAV ratio, yet there is no reference to these products in the paper. Disclaimers by fund managers stating that 'the fund may contain futures and options, or other derivatives' are not adequate without further qualifying (i) the purpose for using derivatives, such as to neutralize a particular risk (eg. FX exposures), skewing the risk profile, arbitrage strategies, derivatives trading/speculation, etc., and (ii) the expected extent of derivatives' usage or notional amount of derivatives. Further to the items noted in the paper, the SFC should require fund managers to disclose all outstanding notional position amounts on all the derivatives, classified as either hedging/arbitrage or trading/speculation, listed by market and categorized as fixed income, equity, currency, commodities, etc. Further related information such as mark-to-market value and potential market risk should also be included.

**Currency Exposure:** This is generally a by-product from investing in various markets regardless of the instruments used. Therefore the SFC should be encouraging fund managers to disclose any currency exposures and state whether they are active players in currency trading or if the portfolio is maintained currency neutral at all times.

**Investment Portfolio:** It is unclear how any hedge fund portfolio could be treated and classified as an investment portfolio. There is no doubt that this is strictly a trading book and thus all reporting requirements need to be specified with this in mind. The word 'investment' should be removed, and the requirements under the current 'investment portfolio' revised to take into account the various instruments used by fund managers.

**Risk Measurement:** A qualitative summary of the steps taken in controlling risk and/or ex-post 'standard deviations' on historical portfolio returns are not deemed adequate in assessing current portfolio risk. The SFC should encourage disclosure of more appropriate risk measures such as VaR as suggested in B11(c) or some form of

standardized stress testing and scenario analysis that will give the investor a better indication of future potential risk. Warnings as stated under the “Appendix – Monthly Returns and Summary Data” are not sufficient.

Standardization: If the SFC wishes to standardize the disclosed information across all funds, further to the required data, it should also spell out the methodology or formula to be used for each of the calculations in order to avoid ambiguity.

### **Paragraph Comments**

Paragraph 18 – It would be in the best public’s interest for the SFC to disclose the names of the ‘various members of the hedge funds community’ to maintain full transparency.

Paragraph 20 – As not all positions are considered illiquid, the second sentence should be amended as follows: Due to the *sometimes* illiquid nature of their ....

Paragraph 25 – Should be revised as follows:

The SFC does not wish to preclude or discourage existing hedge funds that do not *currently* apply IAS from seeking authorization and offering their investments to Hong Kong retail investors, *but going forward, IAS should be adopted starting with the next set of financial statements.*

Paragraph 27 – We strongly agree that IAS should be mandatory for SFC authorised hedge funds.

Paragraph 32~34 – It is unlikely that any hedge fund will provide full disclosure of individual holdings for reasons stated in the paper, therefore the SFC should focus on what it considers ‘reasonable and adequate’ in meeting minimum disclosures. As discussed above, reporting the top ten individual positions may not be helpful because (i) they provide little added insight into the portfolio composition (ii) other smaller positions could be carrying a higher market risk (iii) they could be of little use to the individual investor in judging a fund’s performance or suitability, and (iv) they may be totally or partially offset by other positions that are not included in the top ten positions reported. While an individual position may represent a large percentage of NAV, many strategies comprise two or more positions where the combined risk exposure is far less than each of the individual risks. Therefore looking at a limited number of individual positions may make no sense. Instead, we believe that a hedge fund manager should either report all of its positions or aggregate risk across a wide range of asset classes/groups such as interest rates, currencies, equities, commodities, sectors, countries, etc. Furthermore, hedge funds should also report a breakdown between total position values that are marked-to-market based on available market prices and those that are marked with ‘estimated’ prices using a fair value calculation in order to provide an indication of portfolio liquidity.

Paragraph 40 – We agree that disclosures should be standardized across the board; however the SFC should also provide the methodology or formulae for calculating these statistics to ensure consistency across funds.

Paragraphs 45~47 - If one or more of the underlying funds have annual reporting dates different from the FoHF's annual reporting date, will a scope limitation in the audit opinion be acceptable or will the SFC require underlying funds to have audit procedures performed in order to preclude such scope limitations? We would of course recommend the latter.

Annex 1 A7 – In the case of full position disclosure, forwards, futures, and other derivatives notionals, and delta-equivalent values for all positions with optionality should also be disclosed as a percentage of NAV, separately for long and short derivative positions (i.e., no netting of offsetting derivatives notionals or delta-equivalent values). See also paragraph 32-34 above for further comments.

Annex 1 A7(1) – should be revised as follows:

*Risk* exposures for the scheme ...

Annex 1 A8(a) – Disclosing the ‘maximum levels’ of assets during the year with each broker, although theoretically a good idea, would impose a high reporting burden on each manager. We feel that it is adequate for managers to simply report the names of each broker used during the reporting period, and the types of instruments traded (and currently outstanding in the case of OTC derivatives) with each broker.

Annex 1 B11(a) – For FoHF's, the disclosure should include the breakdown of the quarterly return attributable to each strategy and underlying fund, and the percentage of NAV allocated to each strategy.

Annex 1 B11(b) – Leverage – How should leverage be defined in the context of hedge funds, and what distinction is made between cash leverage and risk leverage? This is a critical issue as it can provide a good indication of how risky the fund is, and furthermore, the methodology used should not be left to the discretion of the manager. (Note: Items following ‘Portfolio Review’ need to be re-lettered)

Annex 1 B11(f) – Same as other comments above

Annex 1 B11(g) – Additional FoHF disclosures should include:

- The percentage allocation to each underlying fund and the name of each fund
- The percentage range of management and performance fees of underlying funds
- The total actual management and performance fees paid to underlying funds
- Whether the FoHF and/or its manager received any management fee or performance fee rebates from underlying funds

Annex 1 B 11 new item (h) – The manager should explain its currency hedging policies: i.e., whether currency exposure arising from portfolio investments is typically hedged and if so to what extent

Annex 1 C 12 (a) – Subscription and redemption disclosure should be mandatory, not voluntary

Annex 1 C 12 new item (d) – Intra-period leverage should also be disclosed (highest, lowest, mean), and it should be mandatory, not voluntary. Leverage should include gross long and short positions separately, and include derivatives as described in the comments above for Annex 1 A7

Appendix Monthly Return and Summary Data – Benchmark data for several common market benchmarks (e.g., MSCI, S&P, Libor, high-yield, CSFB/Tremont, etc.,) that the manager believes are somewhat related should also be provided, including commentary on why the fund/FoHF out/under-performed such benchmarks. Correlation figures to such benchmarks should also be provided, qualified with the period covered and the frequency of data used. (Notes 1, 2 and 3 have no reference on the table)

Appendix – Monthly NAV and GNAV (before performance fees but after management fees) figures should also be provided

We welcome further discussion with the SFC in implementing any of the above recommendations, or in a public forum where different views can be heard, reconciled, and compromises reached.

Warm Regards,

Robert Jones and Benjamin Vella  
Directors