



Consultation Paper on a Review of Hedge Fund Guidelines (the “Consultation Paper”)

We summarise our views on the proposed revisions to the Guidelines on Hedge Funds contained in Chapter 8.7 of the Code on Unit Trusts and Mutual Funds. Terms defined in the Consultation Paper shall have the same meanings in this paper.

Broadly, given the growth in the hedge fund and FoHFs markets in Hong Kong, we agree that the Code should be amended to give more protection to the investor and that one way of achieving this aim is to require fuller public disclosure. It would not, however, be beneficial if regulatory action and tighter regulation caused the hedge fund industry to move to jurisdictions with a lighter regulatory touch. We also note that hedge fund managers may be sensitive to increased market transparency if it required revealing their strategies and positions to competitors.

Investors in hedge funds and FoHFs are at risk of significant losses in the event of a fund collapse. This risk should be mitigated by the requirement for due diligence both before any initial investment and on an ongoing basis. Due diligence is however clearly only possible in relation to available data; inadequate or inaccurate disclosure by hedge fund managers clearly restricts the scope of due diligence by investors. We agree that fuller disclosure by managers in offering documents is one way to assist with the due diligence process.

1. Management company - assessment criteria for acceptability - Chapter 8.7(a)(i)

We support the view that all management companies that manage SFC-authorised funds must have sufficient resources and satisfactory corporate governance, competence, expertise, risk management and internal control systems. Whether this experience must include expertise in managing public funds is questionable given that public funds are managed rather differently to hedge funds and FoHFs.

2. Key personnel’s experience - Chapter 8.7(a)(ii)

We welcome the view that the key personnel are not necessarily required to have public funds experience so long as they have other relevant experience, given the

differences in management of hedge funds and FoHFs when compared to public funds.

3. Prime brokers - Note to Chapter 8.7(b)

We support the view that before appointing a prime broker, the management company must conduct thorough due diligence on its suitability and competence and the disclosure obligations in the offering document.

We note the Irish Financial Services Regulatory Authority's amendments to its hedge fund guidelines and submit that there should be no limit on the amount of assets charged to a prime broker as collateral for financing purposes provided full disclosure is made in the offering document and the assets are not exposed to claims of creditors of the prime broker in the event of insolvency.

4. Prohibition of investing in unlimited liability vehicles and disclosure of ring fencing arrangements - Notes to Chapter 8.7(d) and (e) and Chapter 8.7(g)

We welcome the proposal that the liability of investors must be limited to their investment in the fund. The note to Chapter 8.7(d) goes further and suggests that a hedge fund or FoHFs must not invest in unlimited liability vehicles; it would be helpful to clarify if this is the intention (the insertion of the reference in Chapter 8.7(g) to Chapter 7.18 suggests this is the case in relation to FoHFs only).

We support the view that ring-fencing arrangements should be disclosed in the offering document.

5. Disclosure relating to calculation of performance fees - Chapter 8.7(i)

We support the further disclosure requirements relating to performance fees.

6. Proprietary trading by fund of hedge funds - Note to Chapter 8.7(j)

The proposed amendments would mean FoHFs may not carry out proprietary trading through "managed accounts". Managed accounts may, however, in certain cases be more cost efficient than investing through a fund. If full disclosure is required in the offering document, the managed account is managed by an independent manager and appropriate liability safeguards are put in place we submit that FoHFs should be permitted to carry out proprietary trading through managed accounts.

7. Redemption in specie and compulsory redemption - Note to Chapter 8.7(m)

We support the proposal that investor consent is required for a redemption in specie and the requirement to disclose this in the offer document. However we

consider the proposals prescribing when a scheme may effect a compulsory redemption may be unduly restrictive as it would reasonable to be able to have compulsory termination on the occurrence of compulsory termination events clearly set out in the offering document, whether by reference to minimum net asset values or otherwise.

8. Valuation - Chapter 8.7(o) and (p)

We consider that the restrictions in note (a) to 8.7(o) on precise legal relationship (and perhaps also common directorships) may be over zealous in light of the general protections envisaged by notes (b) - (d). The SFC should rather look at the overall safeguards put in place by the manager as envisaged by notes (b) - (d) (and envisaged generally by the suggested holistic approach to assessment). If it is accepted that valuations can be carried out within a group (which subject to due disclosure and due safeguards may be advantageous for cost reasons) then a restriction on precise legal relationships within the group seems over burdensome.

The proposal that investments must be independently and fairly valued on a regular basis in accordance with generally accepted accounting principles (GAAP) and industry's best practice does not seem entirely consistent. GAAP and the hedge fund and FoHFs best practice may differ given the differing nature of hedge funds and FoHFs and the other forms of entities with which GAAP was drafted in mind.

9. Minimum subscription for single hedge funds

The suggestion of lowering of the minimum subscription for a single hedge fund from USD50,000 to USD30,000 to make hedge funds more accessible to retail investors is welcomed and in fact we would support a lower minimum subscription of US\$25,000.

**The Law Society of Hong Kong
Securities Law Committee**

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