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**Hedge Funds:  
The Regulatory Approach in Hong Kong**

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### **I. Introduction**

The hedge fund guidelines (the “Guidelines”) are set out in the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (the “SFC Handbook”) under the Code on Unit Trusts and Mutual Funds (the “Code”) as Chapter 8.7. The Code sets out the requirements for authorization under the Securities and Futures Ordinance (Cap. 571) (“SFO”) applicable to unlisted hedge funds that are to be offered to the public in Hong Kong. The introduction of the Guidelines was a significant development as hedge funds had previously been marketed in Hong Kong mainly on a private basis. The Code does not have the force of law. Consequently, the Securities and Futures Commission (the “Commission”) has considerable discretion in its implementation on a case by case basis.

The issue of an advertisement or invitation to the public in Hong Kong to invest in an unauthorized hedge fund may be an offence under the Securities and Futures Ordinance. Application for authorization should therefore be lodged with the Commission for consideration where a hedge fund is to be offered to retail investors.

### **II. Hedge Funds**

There is no legal definition of the term “hedge funds”. The SFC Handbook states that hedge funds are generally regarded as non-traditional funds that possess different characteristics and utilize different investment strategies from traditional funds.

In considering a hedge fund’s application for authorization, the Commission will, among other things, consider:

- (i) the choice of asset class; and
- (ii) the use of alternative investment strategies such as long/short exposures, leverage, and/or hedging and arbitrage techniques.

Due to the wide array of schemes that may fall under this category, the Commission will exercise its discretion in imposing additional conditions to each scheme on a case by case basis as appropriate.

### **III. Segmentation Approach**

The Commission has adopted a market segmentation approach of regulation by imposing a minimum subscription amount together with qualitative and disclosure requirements.

The Guidelines identify three different categories of hedge funds, as follows:

- (i) Single hedge funds.
- (ii) Funds of hedge funds (“FoHFs”), where a scheme invests all its non-cash assets in other hedge funds. One of the underlying assumptions of a FoHFs is that it can achieve diversification through investing in a range of funds that employ different investment strategies and/or utilise the skills of different fund managers.
- (iii) Capital guaranteed hedge funds, where a scheme has a capital guarantee feature, it may be authorized as a capital guaranteed hedge fund.<sup>1</sup>

<sup>1</sup> In these cases, the provisions of chapter 8.5 and 8.7 of the SFC Handbook may apply to the scheme where relevant, depending on the nature of the scheme.

The minimum initial subscription amount by an investor for each of the above categories is as follows:

Hedge funds with a 100% capital guarantee feature	No limit
FoHFs	US\$10,000
Single hedge fund	US\$50,000

#### **IV. Qualitative Requirements of Hedge Fund Manager**

In view of the wide range of investment strategies, techniques and instruments employed by hedge funds, the Commission has placed much emphasis on the qualitative requirements of the hedge fund manager.

In addition to the requirements for the authorization of other general collective investment schemes, the Guidelines provide that the Commission, when assessing the suitability of the management company for hedge funds will also consider the following:

- (i) The management company must have the requisite competence, expertise and appropriate risk management and internal control systems. It must also be adequately and suitably staffed in order to properly manage the risks and operational issues in connection with its hedge fund business;
- (ii) the experience of the key investment personnel of the management company and those of the investment adviser (where the latter has been delegated the investment management function) in managing hedge funds;
- (iii) amount of assets under management;
- (iv) the risk management profile and internal control systems of the management company; and
- (v) the investment management operations of the scheme must be based in a jurisdiction with an inspection regime acceptable to the Commission

##### **A. Financial Resources**

The management company must be engaged primarily in the business of fund management and must have sufficient financial resources to conduct its business effectively and meet its liabilities. Specifically, it must have a minimum issued and paid-up capital and capital reserves of HK\$1 million or its equivalent in foreign currency; it must not lend to a material extent and it must maintain at all times a positive net asset position.

##### **B. Assets under Management and Qualification of Managers**

- (i) For manager of single hedge fund:

Minimum US\$100 million assets under management (“AUM”) for the amount of assets that follow hedge fund strategies plus at least 2 key personnel (e.g. investment executives), each with five years’ general experience in hedge funds strategies with at least two years’ specific investment management experience in the same strategy as the proposed hedge fund. While assets under management may include proprietary funds, the Commission will generally look for experience in managing third-party funds.

(ii) For manager of FoHFs:

Minimum US\$100 million AUM for the amount of assets that follow hedge fund strategies plus at least 2 investment executives, each with five years' general experience in hedge funds strategies with at least two years' experience as a FoHFs manager.

(iii) For manager of the underlying funds of FoHFs:

No AUM requirement but the management company of the FoHFs should ensure that:

- each of the key personnel of the management company of an underlying fund possesses at least two years' experience in the relevant hedge fund investment strategy, provided however that up to 10% of the net asset value of the FoHFs may comprise of underlying funds managed by investment personnel with less experience;
- there is an independent trustee/custodian to safe keep the assets of the underlying funds;
- where a FoHFs invests in underlying funds managed by the same management company or its connected persons, all initial charges on such underlying funds are waived;
- neither the management company of the FoHFs nor its connected persons retain a rebate (whether in cash or in kind) on any fees or charges levied by such underlying funds, their management company or any of their connected persons;
- the offering document of the FoHFs clearly discloses the aggregate amount or gives an indicative range of all the fees and charges of the FoHFs and each of its underlying funds; and
- where the FoHFs invests in hedge funds not authorized by the SFC, such fact should be disclosed in the offering document of the FoHFs. A warning must be included to the effect that some or all of the underlying funds of the FoHFs and their fund managers are not subject to the regulation of the Commission and that such funds may not be subject to rules similar to those of the Commission that are designed to protect investors.

### **C. Risk Management Profile and Internal Control System**

High standards have been set by the Commission for the risk management and internal control systems of hedge funds:

(i) For single hedge funds:

The management company must have in place suitable internal controls and risk management systems commensurate with the company's business and risk profile, including a clear risk management policy and written control procedures. The management company should demonstrate that those representatives and agents (including for example, administrators, custodians, brokers, valuation agents) appointed by it possess sufficient know-how and experience in dealing with hedge funds.

(ii) For FoFHs:

The management company for FoFHs should have in place a due diligence process for the selection of the underlying funds and on-going monitoring of their activities. The management company should demonstrate its ability to assess and monitor the performance of the managers of the underlying funds, and the ability to replace the underlying funds whenever necessary to protect the interests of holders. It should submit a plan to explain its due diligence and on-going monitoring processes to the Commission and include a summary of the plan in the offering document of the scheme.

The management company must ensure that its risk management process is able to deal with normal and exceptional circumstances including extreme market conditions. The management company must take all reasonable care in the selection of its distribution agents engaged in the selling of hedge funds and provide all necessary information and training to these agents for the purpose of selling the scheme.

#### **D. Acceptable Inspection Regime**

Under section 5.1 of the Code, every collective investment scheme for which authorization is requested must appoint a management company acceptable to the Commission, except for self-managed schemes.

The manager and any investment adviser to whom it has delegated the investment management responsibility must be appropriately licensed and based in a jurisdiction with an inspection regime acceptable to the Commission. The Commission's list of acceptable inspection regimes for these purposes is reproduced below. This list is not however exhaustive and other jurisdictions may consider other jurisdictions on their merits to be acceptable to the Commission. As a general rule, the Commission looks at the following matters in determining the acceptability of an overseas supervisory authority: (a) the overseas regulatory authority or its delegate carries out inspections of investment management firms within its jurisdiction in a manner generally consistent with the Commission; and (b) the Commission and the overseas regulatory authority have satisfactory procedures for the timely exchange of information regarding investment management firms.

<b>Jurisdiction</b>	<b>Regulatory Authority</b>	<b>Notes</b>
Australia	Australian Securities and Investments Commission (ASIC)	The Fund Manager has to hold either an Australian Financial Services license authorizing it to operate a registered managed investment scheme (MIS), or a dealer's license from ASIC authorizing the fund manager to operate registered MIS of the kind of financial assets.
France	Commission des Operations de Bourse (COB)	Authorized asset management firms
Germany	Bundesanstalt für Finanzdienstleistungsaufsicht (BAFin) (German Federal Financial Supervisory Authority)	Authorized investment management companies for investment fund business
Ireland	Financial Regulator	Authorised to act as an investment manager of Irish domiciled collective investment schemes
Hong Kong	Securities and Futures Commission	Persons licensed by or registered with the Commission for carrying on regulated activities, including asset management

Luxembourg	The Commission de Surveillance de Secteur Financier (CSSF)	Subject to additional audit review as agreed with the CSSF and advised to the SFC
Malaysia	Securities Commission (SC)	Investment management entities or persons that are approved and supervised primarily by the SC to operate, manage or offer to the public one or more collective investment schemes
Taiwan	Financial Supervisory Commission (FSC)	Investment managers permitted and licensed under Article 63 of the Securities Investment Trust and Consulting Act
United Kingdom	Financial Services Authority (FSA)	Persons with permissions from the FSA to carry out regulated activities including management of, advising on, and/or establishing and/or operating collective investment schemes
United States of America	Securities and Exchange Commission (SEC)	Investment advisers registered under the Investment Advisers Act 1940, as amended

## V. Investment and Borrowing Restrictions

If the fund has been structured as a feeder fund (i.e. a scheme that invests all of its assets in a single collective investment scheme):

- the underlying fund will also require to be authorized by the Commission;
- the borrowing of the feeder fund may not exceed 10% of its total net asset value and should be restricted to facilitating redemptions or defraying operating expenses; and
- no increase in the overall total of initial charges, management company's annual fee, or any other costs and charges payable to the management company or any of its connected persons borne by the holders or by the scheme may result, if the schemes in which a scheme invests are managed by the same management company or by a connected person of that company.

A hedge fund is also subject to the following restrictions:

- a fund may not invest in any type of real estate or interests in real estate;
- a fund may not lend, assume, guarantee, endorse or otherwise become directly or contingently liable for or in connection with any obligation or indebtedness of any person without the prior written consent of the trustee/custodian;

- a fund may not acquire any asset which involves the assumption of any liability which is unlimited;
- if any of the fund's investment limits are breached, the management company should take as a priority objective all steps as are necessary within a reasonable period of time to remedy the situation, taking due account of the interest of the holders.<sup>1</sup>

In the case of a FoHFs:

- a FoHFs must invest in at least five underlying funds, and not more than 30% of its total net asset value may be invested in any one underlying fund; and
- a FoHFs may not invest in another FoHFs.

## **VI. Qualifications of Custodian**

The trustee/custodian must be acceptable to the Commission and must be:-

- a bank licensed in Hong Kong; or
- a trust company which is a subsidiary of such a bank; or
- a trust company registered under Part VIII of the Trustee Ordinance; or
- a banking institution or trust company incorporated outside Hong Kong which is acceptable to the Commission.

The trustee/custodian must have a minimum issued and paid-up capital and non-distributable capital reserves of HK\$10 million or its equivalent in foreign currency or may have paid-up capital and non-distributable capital reserves of less than HK\$10 million if it is a wholly-owned subsidiary of a substantial financial institution and:-

- the holding company issues a standing commitment to subscribe sufficient additional capital up to the required amount, if so required by the Commission; or
- the holding company undertakes that it will not let the wholly-owned trustee/custodian default and will not, without prior approval of the Commission, voluntarily dispose of, or permit the disposal or issue of any share capital of the trustee/custodian such that it ceases to be a wholly-owned subsidiary of the holding company.

## **VII. Independence of Trustee/Custodian and Management Company**

The Code requires that the trustee/custodian and the management company must be independent of each other.

If the trustee/custodian and the management company both have the same ultimate holding company, they are deemed to be independent of each other if:-

- they are both subsidiaries of a substantial financial institution;
- neither is a subsidiary of the other;
- there are no common directors; and
- they give an undertaking that they will act independently of each other in their dealings with the fund;

or

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<sup>1</sup> The investment and borrowing restrictions applicable to hedge funds also apply to each sub-fund of an umbrella fund as if each sub-fund were a single scheme.

- the fund is established in a jurisdiction where the trustee/custodian and the management company are required by law to act independently of one another.

### **VIII. Qualifications of Prime Broker**

Where a hedge fund scheme appoints a prime broker, the following shall apply:

- (i) the prime broker must be a substantial financial institution subject to prudential regulatory supervision;
- (ii) where assets of the scheme are charged to the prime broker for financing purposes, such assets must not, at any time, exceed the level of the scheme's indebtedness to the prime broker;
- (iii) the assets charged to the prime broker must remain in a segregated custody account, in the name or held to the order of the trustee/custodian; and
- (iv) the scheme's offering document must disclose the profile of the prime broker and its relationship with the scheme.

### **IX. Disclosure Requirements**

Disclosure is another important element in the regulatory system to protect the investors and the Commission has set out various disclosure requirements to that effect.

#### **A. Liability of Holders Must be Clearly Stated**

The liability of holders must be limited to their investment in the scheme and this should be clearly stated in the offering document. Where the scheme is a sub-fund of an umbrella fund, the scheme will be required to demonstrate to the Commission that there are legally enforceable provisions to ring-fence the scheme assets from the liabilities of other sub-funds.

#### **B. Disclosure Requirements for the Offering Document**

The authorized scheme must issue an up-to-date offering document, which should contain the information necessary for investors to make an informed judgement of the investments proposed to them, including the information listed in Appendix C of the Code. The front cover of the offering document for a hedge fund must display prominently the following warning statements:

- (i) the scheme uses alternative investment strategies and the risks inherent in the scheme are not typically encountered in traditional funds;
- (ii) the scheme undertakes special risks which may lead to substantial or total loss of investment and is not suitable for investors who cannot afford to take on such risks;
- (iii) investors are advised to consider their own financial circumstances and the suitability of the scheme as part of their investment portfolio; and
- (iv) investors are advised to read the offering document and should obtain professional advice before subscribing to the scheme.

The text of the warning statements may be varied but the message should be clear and not disguised. The offering document should also give lucid explanations of the investment strategy of the scheme and the risks inherent in the scheme. For example, explanations should be given on the nature of the scheme; the markets covered; the instruments used; the extent of diversification or concentration of

investments or strategies; the extent and basis of leverage (including the maximum level of leverage); the risk and reward characteristics of the strategy; the circumstances under which the scheme would work best and the circumstances hostile to the performance of the scheme; the risk control mechanism, including the setting of investment and borrowing parameters to control the risks; the terms of the offering; and the responsibilities of each of the relevant parties.

It is the responsibility of the fund manager to produce an easy-to-understand offering document. Technical terms used in the offering document should be clearly explained. Therefore, the offering document should be written in plain language and preferably use a glossary to explain technical terms.

### **C. Product Key Facts Statement (“Product KFS”)**

The Product KFS must contain information that enables investors to easily comprehend the key features and risks of the scheme, and will form part of the Offering Document.

The Product KFS must be clear and concise and must not contain any false or misleading information. As a matter of best practice, the KFS should not be more than 4 pages.

A Product KFS shall carry a prominent warning on the first page to warn investors that the statement is part of the Offering Document and that they should not invest in the product based on the Product KFS alone.

### **Dealing and Valuation of Hedge Funds**

#### **A. Dealing**

There must be at least one regular dealing day per month and the maximum interval between the lodgement of a properly documented redemption request for redemption of units/shares (whether a notice period is required or not) and the payment of redemption money to the holder may not exceed 90 calendar days.

The offering document of the scheme must include a warning to the effect that the redemption price may be affected by the fluctuations in value of the underlying investments during the period between the lodgement of the redemption request and the date when the redemption price is calculated.

#### **B. Valuation of Hedge Funds**

The Commission is mindful that proper valuation on a regular basis is necessary to protect the interests of investors, especially in the context of hedge funds where the underlying investments may be complex instruments and illiquid in nature. The investments of the scheme should be fairly valued on a regular basis in accordance with generally accepted accounting principles and industry’s best practices, applied on a consistent basis.

On the basis of the monthly dealing rule, the Commission considers that valuation would also be required at least on a monthly basis. Full particulars of the valuation frequency, the valuation methods of the scheme’s investments and the identity and qualifications of the valuation agent(s) must be disclosed in the offering document. The Commission also encourages managers to consider, on a voluntary basis, valuation of the investments of the scheme more frequently than the scheme’s dealing frequency.

The offering document of the scheme should include a warning to the effect that some of the underlying investments of the scheme may not be actively traded and there may be uncertainties involved in the valuation of such investments. Potential investors must be warned that under such circumstances, the net asset value of the scheme may be adversely affected.

## **XI Reporting Requirements**

An annual report must be published within four months of the end of the relevant financial year (or within six months of the end of the financial year in the case of FoHFs). The annual report must be audited by the auditor for the scheme. A semi-annual report must be published within two months of the end of the relevant period. In addition, the management company must issue a quarterly narrative report to holders on the scheme activities during the reporting period. The quarterly report should be distributed within one month (or six weeks in the case of FoHFs) of the end of the period it covers.<sup>1</sup>

Quarterly reports must contain the following information regarding the fund: -

- a commentary by the manager describing and explaining the fund's performance during the relevant quarter;
- a discussion by the manager of the market outlook;
- disclosure of changes in the composition of the key investment personnel at the scheme level and their impact on the fund's overall strategy, risk profile or future performance;
- details of any lawsuits that may have a financial impact on the fund during the reporting period;

details of the fund's net asset value and net asset value per share as at the end of the reporting period and the percentage change in net asset value per share since the last reporting period;

- the amount of cash borrowings and other sources of leverage at the scheme level and a summary of how leverage is calculated as at the end of the relevant quarter;
- a disclosure of performance and risk measures of the fund in tabular form;
- the amount of seed money expressed in percentage terms of the fund's net asset value contributed by the manager or its connected persons as at the end of the relevant quarter;
- details of all illiquid holdings; and
- details of the fund's concentrated exposures

## **XII Other Requirements**

### **A. Name of Scheme**

It should be noted that if the name of the scheme indicates a particular objective, geographic region or market, the scheme should utilize at least 70% of its non-cash assets for the purposes of pursuing the objective or geographic region or market.

### **B. Performance Fee**

The "high-on-high" calculation basis applies to performance fees for hedge fund schemes. Therefore, if a performance fee is levied, the fee can only be payable:

- (i) no more frequently than annually; and

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<sup>1</sup> Where the management company wishes to report to holders via monthly reports, there is no need to prepare quarterly reports provided that the same requirements for quarterly reports are complied with in the monthly reports.

- (ii) if the net asset value per unit/share exceeds the net asset value per unit/share on which the performance fee was last calculated and paid (i.e. on a "high-on-high" basis).

Full and clear disclosure of the calculation methodology should be set out in its offering document. For FoHFs, however, the offering document of the scheme must disclose whether a performance fee is levied at both the scheme level and the underlying funds level and it should also summarize the bases of how performance fees are calculated and paid by the underlying funds.

### **XIII Application**

Authorizations of hedge funds are now open for application. The relevant application fees are as follows:

<b><u>Application Fee</u></b>	
Single fund	HK\$20,000
Umbrella fund	HK\$40,000
Sub-fund	HK\$5,000

The application fee should be in the form of a cheque, payable to "Securities & Futures Commission". All application forms of the scheme should state prominently that the scheme is a hedge fund and there are special risks involved with investment in the scheme, and direct investors to read the offering document. A compliance checklist for application for authorization of hedge funds is available on the SFC website.

Upon the granting of authorization by the Commission, an authorization fee and the first annual fee is payable, as follows

<b><u>Authorization Fee</u></b>	
Single fund	HK\$10,000
Umbrella fund	HK\$20,000
Sub-fund	HK\$2,500

  

<b><u>Annual Fee</u></b>	
Single fund	HK\$6,000
Umbrella fund	HK\$7,500
Sub-fund	HK\$4,500

### **XIV Authorisation Procedures**

An applicant for authorization of a hedge fund must submit a completed application form and an information checklist to the Commission.

The application must be accompanied by the following:

- the hedge fund's offering and constitutive documents;
- the latest audited reports (if any) and if more recent, the latest unaudited report;
- a management company profile (if applicable);
- the trustee/custodian's latest audited report (if applicable);
- for non-recognised jurisdiction schemes or new funds, a letter of consent to the appointment from the trustee/custodian;

- the application fee; and
- the letter nominating an individual to be approved by the Commission as an approved person.

## **XV Post Authorisation Compliance Issues**

All funds authorized by the Commission in Hong Kong must ensure full ongoing compliance with all applicable guidelines, codes and other legal and regulatory requirements.

The Code sets out specific post-authorization requirements in relation to the following operational matters: -

- valuation and pricing;
- pricing errors;
- changes to dealing;
- suspension and deferral of dealings;
- transactions with connected persons;
- changes to the fund's offering and constitutive documents;
- notices to investors;
- increases in fees;
- de-authorization
- mergers and terminations;
- reporting requirements; and
- advertising and public announcements in connection with the fund

## **December 2012**

*This note is intended for information purposes only. Specific advice should be sought in relation to any particular situation.*