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# Amendments To The Hedge Fund Guidelines Effective 30 September 2005

## Introduction

Amendments to the Hedge Fund Guidelines (the "Guidelines") in Chapter 8.7 of the Code on Unit Trusts and Mutual Funds came into effect on 30 September 2005. A marked-up version of the revised Guidelines is set out at Annex I of the SFC's Consultation Conclusions on Consultation Paper on the Review of Chapter 8.7 of the Code on Unit Trusts and Mutual Funds which are available on the [SFC's website](http://www.sfc.hk).

The purpose of this note is to summarise the principal revisions to the Guidelines.

## 1. Management Company - Assessment Criteria For Acceptability - Chapter 8.7(A)(i)

Previously, the assessment of a management company's acceptability was focused primarily on the individual experience of its investment personnel. The revised Guidelines adopt a broader approach in assessing the acceptability of a management company as a retail hedge fund manager. Accordingly, a management company's internal controls, risk management process, resources, public funds management experience and corporate governance will also be considered in determining its acceptability.

## 2. Key Personnel's Experience - Chapter 8.7(A)(ii)

Under the revised Guidelines, the core requirement is that the management company must have 2 key personnel who each have 5 years' relevant experience. Of those 5 years' relevant experience, a key personnel must have at least 2 years' specific experience in the management of hedge funds.

The revised Guidelines include a non-exhaustive list of the types of general experience that will be recognised for the purposes of the "5 years' relevant experience" requirement. These include proprietary trading experience in securities, derivatives or other investment instruments similar in nature to those contemplated by the scheme, carrying out investment strategies in the context of investment management or securities dealing business similar in nature to that contemplated for the scheme, and prior experience in evaluating or selecting hedge funds for investment purposes. General experience acquired through academic research, sales or marketing or back-office administration of hedge funds will not however be recognised. A note also clarifies that the years of specific experience in the management of hedge funds will count towards the 5 years' relevant experience.

The revised Guidelines also clarify that to the extent that Chapter 5.5(a) requires key personnel to have specific public funds experience, this requirement will be met if the management company can demonstrate on a firm-wide basis that it possesses the experience and resources to administer public funds.

## 3. Prime Brokers - Note to Chapter 8.7(b) regarding the disclosure of relationship with prime brokers and the level of collateralisation

The revised Guidelines require additional disclosure to be made in the offering document as to:

1. the associated risks where assets of the scheme are used as collateral or security for financing to be provided by the prime broker and the possible consequences for the scheme and its investors;
2. the role of the prime broker in relation to the hedge fund and whether it is subject to any regulatory supervision and if so, a description of its licensing status in the relevant jurisdiction; and
3. any conflicts of interest between the prime broker and the scheme.

The SFC has decided not to proceed with a relaxation of the restriction on the collateralisation level of SFC-authorised hedge funds, which was raised in the May Consultation Paper. Accordingly, Chapter 8.7(b) continues to restrict the level of collateralisation by stating that *"where assets of the scheme are charged to the prime broker for financing purpose, such assets must not, at any time, exceed the level of the scheme's indebtedness to the prime broker".*

## 4. Disclosure Of Ring Fencing Arrangements - Chapter 8.7(e)

The Guidelines already require the demonstration of a ring-fencing structure in the case of sub-funds within an umbrella structure. The revised Guidelines require a brief description of the ring-fencing arrangement to be included in the offering document.

## 5. Prohibition On Investing In Unlimited Liability Vehicles - Chapter 8.7(G)

Chapter 8.7(g) has been amended to clarify that investment in unlimited liability vehicles is prohibited.

## 6. Disclosure Relating To Calculation Of Performance Fees - Chapter 8.7(I)

The Guidelines have been revised to codify the practice of requiring retail hedge funds to disclose whether the concept of "equalisation" is adopted or not in their calculation of performance fees. If it is, the offering document must disclose the mechanisms adopted to achieve equalisation. If "equalisation" is not adopted, this must be stated in the offering document together with a statement as to how this may affect the amount of performance fees to be borne by investors.

## 7. Proprietary Trading By FoHFs - Note To Chapter 8.7(J)

A new note to Chapter 8.7(j) codifies the prohibition on the conduct of proprietary trading by FoHFs either directly or through managed accounts. The Consultation Conclusions state however that the SFC is prepared to consider on a case-by-case basis whether currency hedging activities should be allowed for a FoHFs, and if allowed, the relevant safeguarding measures including effective ring-fencing provisions that it needs to put in place.

## 8. Redemption In Specie And Compulsory Redemption - Note To Chapter 8.7(m)

A note has been added to reflect the SFC's practice regarding redemption in specie and compulsory redemption.

The Guidelines now provide that redemption in specie may only be made with the prior consent of the individual redeeming holder. Offering documents must also disclose the possibility of redemption in specie and the need to obtain the individual holder's prior consent.

Compulsory redemption is permitted if the management company is reasonably satisfied that it is for the overall benefit of the scheme. The Note includes a non-exhaustive list of circumstances where compulsory redemption will be permitted. These include where the continued holding of the scheme's interest by a particular holder will cause the scheme to be in breach of any relevant laws or regulations, or result in adverse financial consequences for the scheme such as tax penalties. The Guidelines also require that offering documents disclose the circumstances under which compulsory redemption may be effected and the period of notice for such redemption.

## 9. Independent Valuation - Note to Chapter 8.7(o) and Note 8.7(p)

The revised Guidelines require valuation of a SFC authorised scheme to be both fairly and independently carried out. The note sets out a non-exhaustive list of factors the SFC will take into account in determining the independence of the valuation. These include the segregation of the functions and duties of the valuation agent from those of the party carrying out the scheme's investment management function.

The Guidelines also require the offering document to disclose the experience of the valuation agent in evaluating hedge fund assets, the selection criteria of the valuation agent and the relationship of the agent with the scheme's management company or its group of companies and, where applicable, with the prime broker.

## 10. Minimum Subscription For Single Hedge Funds - Chapter 8.7(c)

The SFC has decided not to reduce the minimum subscription threshold for single strategy hedge funds to US$30,000 as was proposed in the Consultation Paper. The threshold remains at US$50,000.

## 11. Disclosure - Note to Chapter 8.7(s) and Chapter 8.7(t)

The offering document is now required to include disclosure on the on-going monitoring of the scheme's investment and asset allocation process and the performance of the scheme and the on-going monitoring of the standards of services provided by the key service providers (e.g. prime brokers and administrators).

Chapter 8.7(t) further requires the disclosure of the measures and safeguards put in place for the management of conflicts of interest in relation to the operation of the scheme.

*This note is intended as a summary of the revisions to the Hedge Fund Guidelines. Specific advice should be sought in relation to any particular situation.*

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