Report of the Survey on Hedge Fund Activities of SFC-licensed Managers/Advisors

September 2009

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Executive Summary

Introduction

The Securities and Futures Commission (SFC) conducted its first fact-finding survey on the hedge fund industry in 2006. The survey results, as published in a report issued in October 2006, provide useful information on the structure and profile of the hedge fund activities conducted by the SFC-licensed managers/advisors (collectively known as “hedge fund managers”). Market participants generally regard this as a positive initiative of the SFC to improve the transparency of Hong Kong’s hedge fund industry.

In view of the rapid development of the industry over the past three years, the SFC conducted a similar survey again in 2009, taking the reference date of 31 March 2009 (the Survey). This report summarizes our major findings.

The SFC would also like to take this opportunity to thank all the hedge fund managers for participating in the Survey and the Alternative Investment Management Association Limited (Hong Kong Chapter) for providing valuable comments on the Survey questionnaire.

Major findings

Hong Kong's hedge fund industry registered healthy growth and contained a good mix of local and international hedge fund managers

The number of hedge funds managed by the SFC-licensed hedge fund managers in Hong Kong surged to 542 as at 31 March 2009. This represented a growth for six consecutive years and was almost five times the level in 2004, the earliest year covered in our hedge fund surveys.

The assets under management/advisory (AUM) also registered healthy growth over the past six years. Despite the financial crisis in 2008, the AUM still stood at US$55.3 billion as at 31 March 2009, six times that of 2004.

As at 31 March 2009, about 60% of the SFC-licensed hedge fund managers were locally controlled, with the remaining being controlled from overseas.

The hedge funds mainly adopted Asia Pacific-focused equities long/short and multi-strategies with overseas institutional investors dominated

Equities long/short and multi-strategies remained the most popular investment strategies. For funds that used multi-strategies, the most common underlying strategies included equities long/short, event driven/special situation/merger arbitrage and convertible.

The hedge funds were mainly Asia Pacific-focused. As at 31 March 2009, 59.1% of the total AUM was invested in the Asia Pacific markets. Out of this, only about US$14 billion was invested in the Hong Kong and Mainland China markets.

Investors of the hedge funds were mainly from the Americas and Europe. Hong Kong investors only constituted 1.9% of the investor base. In terms of type of investors, funds of funds dominated and constituted about 40% of the investor base as at 31 March 2009.

Relatively conservative investment approaches were adopted amid financial crisis

As at 31 March 2009, 28.5% of the total AUM of the hedge fund managers was held in cash, deposits or money market instruments, reflecting the conservative investment approach adopted by the hedge fund managers amid the financial crisis.

The leverage of hedge funds generally remained low. As at 31 March 2009, 68.8% of the hedge funds had a leverage of 100% or less.

The percentage of hedge fund managers using more than one prime broker increased from 39.6% in 2006 to 52.5% in 2009, probably reflecting a higher awareness of counterparty risks.

The findings of the Survey will be considered in the SFC's future policy formulation and in monitoring the hedge fund industry.

Definition

There is no formal definition of the term “hedge funds”. For the purpose of this Survey, funds, including managed portfolios that exhibit the following characteristics, are generally regarded as hedge funds.

use of alternative investment strategies, leverage (including leverage embedded in financial instruments such as derivatives), use of derivatives for trading purpose, and/or arbitrage techniques;

pursuit of absolute returns, rather than measuring investment performance relative to a benchmark;

charging of performance-based fees in addition to a management fee based solely on AUM; and/or

For the purpose of identifying the top three hedge funds, the questionnaire requests the hedge fund managers to consider each sub-fund in an umbrella fund as one hedge fund.

Reference date

Information and data were mainly collected at the snapshot of 31 March 2009. Some data as at 31 March 2007 and 2008 were also collected for comparison and trend analysis purposes.

Responses

The SFC identified 231 licensed corporations that were hedge fund managers as at 31 March 2009. Survey questionnaires were sent to these 231 hedge fund managers and 225 replied, representing a response rate of 97.4%. Only a few hedge fund managers did not respond, mainly due to cessation of business.

Out of these 225 hedge fund managers, 16 reported that their hedge funds had not been launched as at 31 March 2009. These hedge fund managers were excluded from our analysis.

The remaining 209 hedge fund managers reported a total of 542 hedge funds under management as at 31 March 2009. Our analysis in this report is based on the information provided by these 209 hedge fund managers.

SFC staff also followed up on certain incomplete information and clarified some information provided by the hedge fund managers during the process.

Scope of the Survey

The findings only represent a snapshot position of Hong Kong's hedge fund industry as at 31 March 2009. This could change rapidly as hedge funds are mobile in their capital allocation and hedge fund managers are flexible in shifting investment strategies.

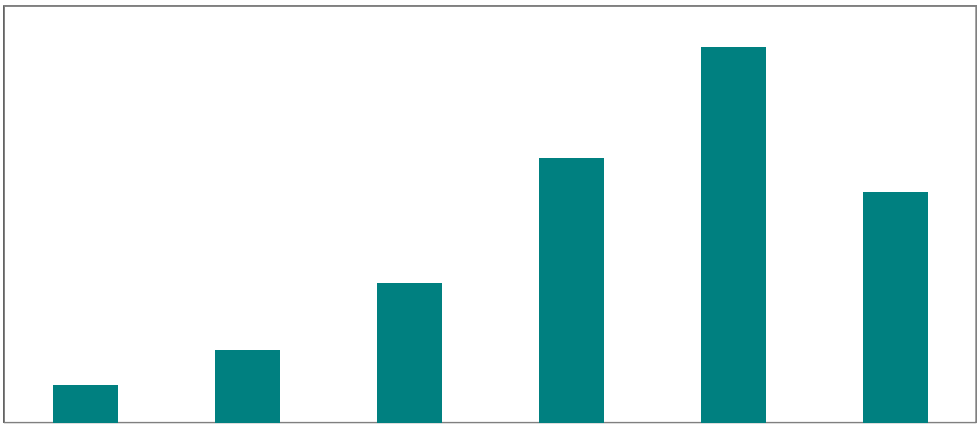
While the results could provide useful information on the general state of affairs of the hedge ome0SysbScostra75 TD0fzng tate l ensed ee fund managers., i sthnu-.2(d pbenot dg5.2(ethat thei)]TJT*.0009 ouestionnair iequestsd ui to teporte eeindger /advsod from oong55.7(tg-.2(iong' n)]TJT*-(Tapbest-effrt)5.6(eba

Major findings

This section summarises our general observations on the 209 hedge fund managers and the top three hedge funds reported by each as at 31 March 2009.

Hong Kong's hedge fund industry registered healthy growth and contained a good mix of local and international hedge fund managers

Healthy growth in number of hedge funds and total AUM



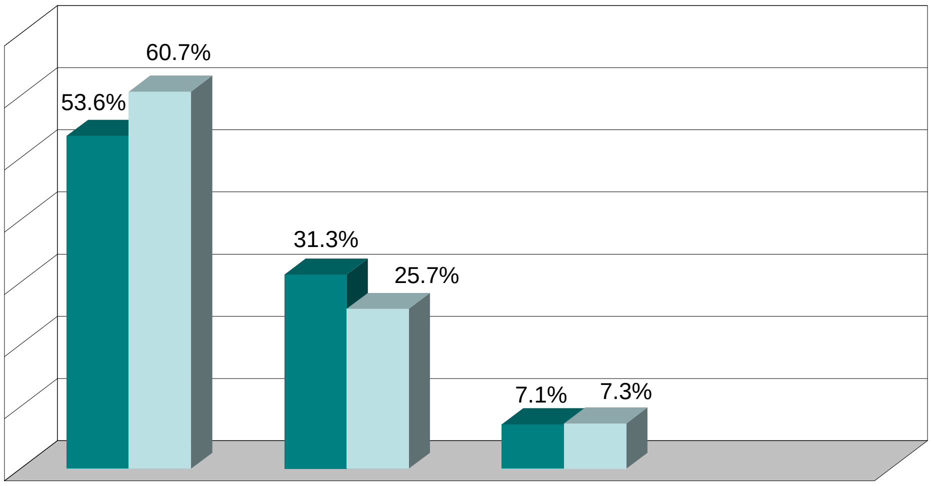
Good mix of local and international hedge fund managers of various sizes

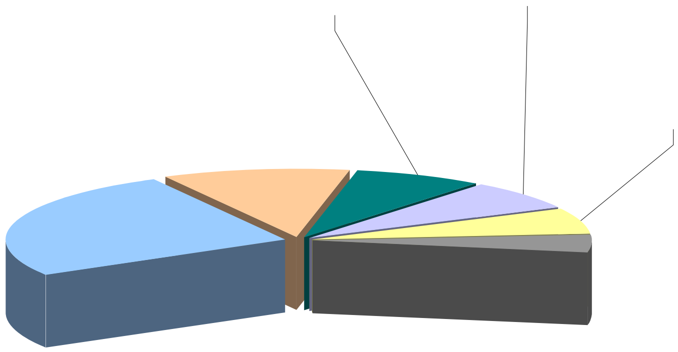
Our industry embraces both local and global players. As at 31 March 2009, about 60% of the SFC-licensed hedge fund managers were locally controlled, with the remaining being controlled from the United States, the United Kingdom, Switzerland, Japan, etc.

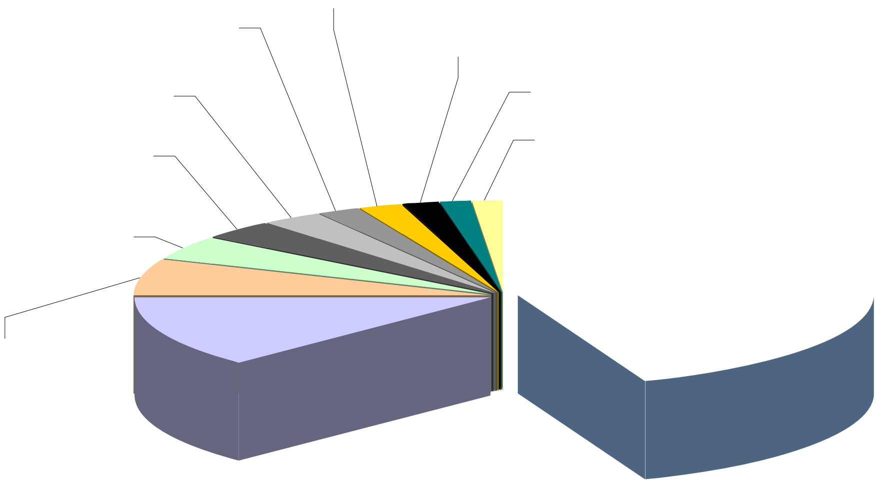
Hong Kong has been a nourishing place for entrepreneurs and is well known for its vibrant start-up of hedge fund business[1]. A number of boutique-sized hedge fund managers were set up in Hong Kong in the past few years. These included some practitioners formerly from large international financial institutions setting up their own hedge fund business and some spin-offs from the existing hedge fund managers.

In addition, we have witnessed an increasing number of overseas hedge fund groups setting up in Hong Kong. Their growing presence in here has brought benefits to the overall development of our hedge fund industry. For example, they bring in experienced investment expertise and help to maintain a larger pool of qualified and trained professionals in Hong Kong.

Apart from different backgrounds, these 209 hedge fund managers also vary in size. The following chart depicts the distribution of AUM of the hedge fund managers at March 2006 and 2009.







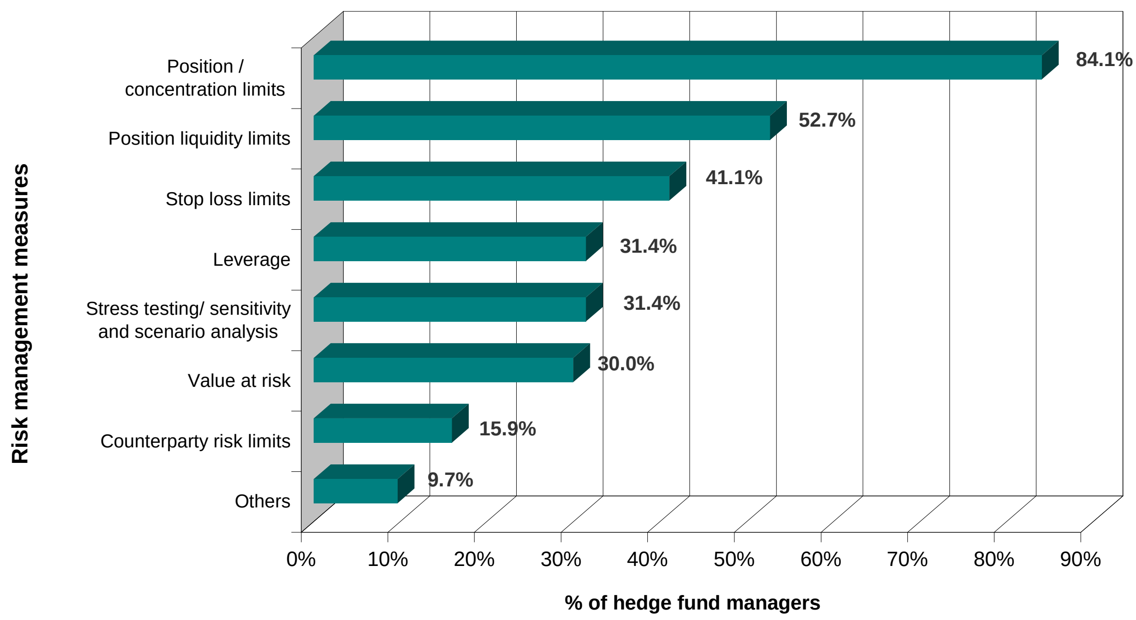
Funds of funds as the bulk of investor base

The major investors of the reported hedge funds were funds of funds (37.6%), followed by high-net-worth individuals/family offices (16.6%), banks/insurance companies/other financial

Various risk management measures

Most (96%) of the hedge fund managers reported that they used at least three measures to monitor the risk of their hedge fund portfolios. Position/concentration limits (84.1%), position liquidity limits (52.7%) and stop loss limits (41.1%) were the most popular measures adopted.

Top 3 risk management measures adopted by hedge fund managers as at 31 March 2009



Increased use of multiple prime brokers

The percentage of the hedge fund managers using more than one prime broker increased from 39.6% in March 2006 to 52.5% in March 2009. On top of some broker-dealers, universal banks have gained popularity in providing prime broking services to the hedge fund managers.

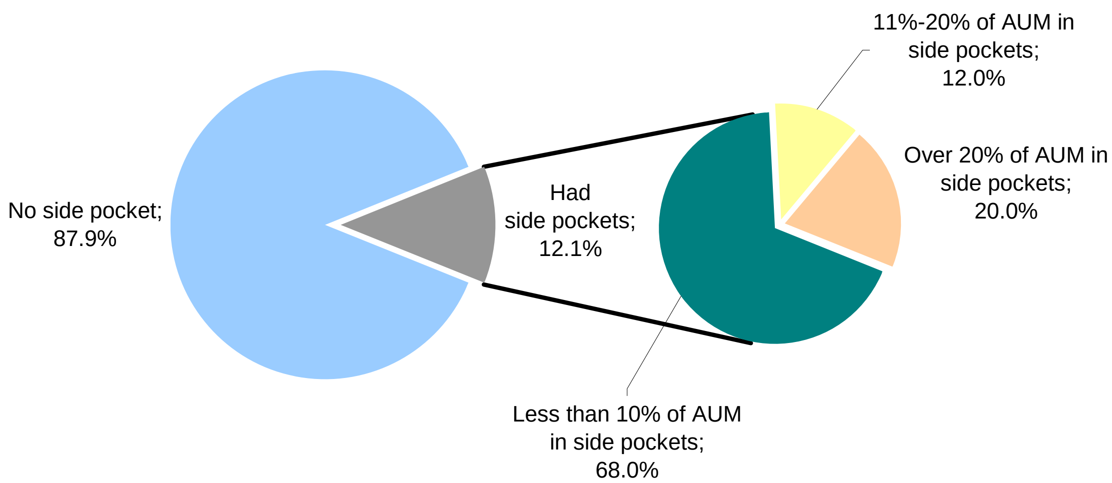
This probably reflected a generally higher awareness of counterparty risks among the hedge fund managers after the collapse of Lehman Brothers in September 2008.

Other findings

Use of side pockets not pervasive

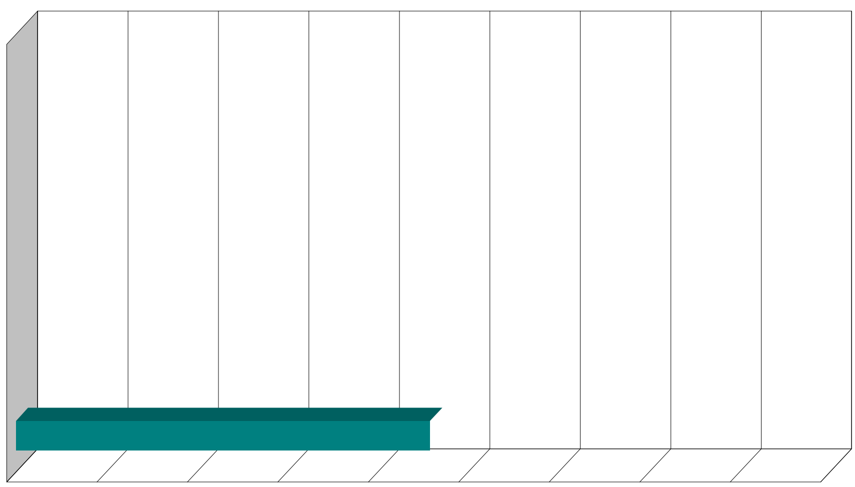
Only 12.1% of the hedge fund managers reported that they had side pockets for illiquid or hard-to-value investments as at 31 March 2009. Most of them put less than 10% of the fund assets into the side pockets.

Use of side pockets by hedge fund managers
as at 31 March 2009



Hedge fund managers with side letter arrangements

About 40% of the hedge fund managers reported that they had side letter arrangements with investors as at 31 March 2009. The most common nature of terms of the side letters included fee rebates, most favoured nation clauses, redemption rights and key man provisions.



SFC’s initiatives for the hedge fund industry

Appendix

Table 1: Breakdown by type of the hedge fund assets managed by the SFC-licensed hedge fund managers

As at 31 March 2009	Assets managed from Hong Kong (US$ billion)	Note