

Report of the Survey on Hedge Funds Managed

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1. Executive summary

Introduction

The Securities and Futures Commission (SFC) recognises the growing importance of hedge funds. In light of the increased hedge fund activities in Hong Kong, the SFC conducted its first fact-finding survey amongst our licensed corporations whose business involved the management of and/or provision of advisory services to hedge funds (the Survey) in June 2006. The purpose of the Survey is to keep the SFC abreast of the hedge fund activities carried out by the SFC licensees in Hong Kong. This report summarizes our major findings.

Definition

There is no formal definition of the term “hedge funds”. For the purpose of this Survey, funds that use alternative investment strategies, pursue absolute returns, charge performance-based fees in addition to a management fee, and have investment mandates that give managers more flexibility to shift strategies are generally regarded as hedge funds.

For the purpose of this Survey, the term “hedge fund managers” include those fund managers that manage hedge fund assets as well as those that advise hedge funds. Also the term “assets under management” (AUM) refers to the value of assets managed and/or advised by such hedge fund managers. Similarly, the term “hedge fund management” refers to the management of and/or provision of advisory services to hedge funds.

The Survey

The Survey questionnaire is divided into two parts. Part A collects general information, such as the AUM, company profile, etc., about the hedge fund managers. Part B collects detailed information, such as the structure, investment strategies, investment geography, portfolio composition, leverage, etc., about the three largest hedge funds (determined by reference to their respective net asset value (NAV)) that were managed by each hedge fund manager as at 31 March 2006.

The SFC sent Survey questionnaires to 197 licensed corporations that, based on market information, managed or advised hedge funds as at 31 March 2006. A total of 186 responses (representing a response rate of 94%) were received, of which 118 respondents confirmed that they engaged in managing and/or giving advice to hedge funds as at that date. They in total managed and/or advised 296 hedge funds.

Scope of the Survey

The Survey results only represented a snapshot position of the hedge fund industry as at 31 March 2006 and this could change rapidly as hedge funds are mobile in their capital distribution and hedge fund managers are flexible in shifting investment strategies.

While the Survey results could provide useful information on the general state of affairs of the hedge fund industry operated by our hedge fund managers, it should be noted that the Survey did not cover hedge funds managed overseas but investing in Hong Kong.

Readers of this report are therefore advised to take note of the above in analyzing the Survey results.

Major findings

A generally simple investment strategy and relatively low leverage was adopted by hedge funds

The following observations are related to the top three hedge funds (determined by reference to their respective NAV) managed by the respondents as at 31 March 2006. A total of 201 hedge funds were reported.

With regard to investment strategies, 34% of the hedge funds reported by the respondents adopted equities long/short strategy, followed by multi-strategies (25%) and fund of hedge funds (20%). For the funds that were using multi-strategies, equities long/short predominated.

Equities were the major asset component in the hedge funds reported, which in aggregate accounted for 53% of total NAV of the hedge funds. Bonds were the second major investment category, followed by investments in other hedge funds, derivatives/structured products, etc.

US\$24.0 billion of the total NAV of the hedge funds reported was invested in Asia Pacific markets as at 31 March 2006, in which US\$4.1 billion was invested in Hong Kong.

40% of the hedge funds reported by the respondents did not use any leverage as at 31 March 2006. Among those which used leverage, majority of them had a leverage of less than 200% of NAV.

Institutional investors formed the bulk of the client base of the hedge funds reported and performance varied among hedge funds

Most of the hedge funds reported that they served and/or targeted institutional investors. They were not widely distributed through external distributors. For example, 74% of the hedge funds reported did not have external distributors. This finding reflected that hedge funds were not common among retail investors. It was further evidenced by the smaller size of the retail hedge funds in Hong Kong (the total net asset size of the 13 retail hedge funds authorized by the SFC was US\$1.15 billion as at the end of March 2006).

Performance varied. 20% of the hedge funds reported an annualized return of more than 20% over the period whereas 16% recorded a loss during the same period.

Regulatory approach

Direct regulation over hedge funds is not practical, if not impossible. This is because many of the hedge funds are domiciled overseas. The SFC therefore does not seek to register, license or authorize private hedge funds. Furthermore, a mandatory disclosure regime is not practicable as overseas domiciled hedge funds may not have representation in Hong Kong. However, these funds are not unregulated. Hedge funds that are using the Hong Kong platform are still subject to the law against fraud, insider dealing and market misconduct.

While private hedge funds are not authorized, hedge funds offered to the public are. With respect to licensing requirements, all hedge fund managers who operate in Hong Kong are required to be licensed regardless of whether the related fund is privately or publicly offered. The regulatory fabric is set out below:

Licensing of hedge fund managers – A hedge fund manager performing asset management/advisory activities in Hong Kong, like any other fund managers or investment advisers, is required to be licensed by the SFC. In this regard, the fund manager should demonstrate that, among other things, it has expertise, financial resources, proper internal controls and risk management systems in order to be licensed. In October 2004, the SFC designated a focus team to handle hedge fund managers' licence applications and to answer enquiries from prospective applicants. Since the establishment of the team, we have processed 54 licence applications from hedge fund managers up to 30 June 2006, of which 44 were approved or approved in principle.

Supervision of intermediaries – The SFC performed a round of theme inspections on a sampling of hedge fund managers in 2005 to review their infrastructure and corporate governance, investment strategies, risk controls, leverage, valuation of investments, resolution of conflicts of interest, etc. We also met with some prime brokers to discuss their risk management controls over hedge funds. Certain issues related to conflicts of interest, valuation of illiquid and exotic/tailor-made financial products, etc. were noted. These issues are by no means unique to Hong Kong. We will continue to monitor international developments in considering our regulatory response to these issues.

Product authorization for hedge funds offered to the public – Hong Kong is one of the first few jurisdictions in the world to allow the sale of hedge funds to the public. The SFC introduced the Hedge Fund Guidelines in May 2002, which were revised in September 2005, to

Selection basis

Based on internal and external market information,

Scope of the Survey

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Readers of this report are therefore advised to take note of the above in analyzing the Survey results.

4. Findings

Part A of the findings relates to some general observations on the hedge fund managers that responded to the Survey as engaging in hedge fund management as at 31 March 2006, whereas Part B relates to findings on the top three hedge funds as reported by each of these hedge fund managers.

PART A: GENERAL OBSERVATIONS

The following summarized our general observations on the 118 hedge fund managers as at 31 March 2006.

Number of hedge fund managers

Number of hedge fund managers increased dramatically

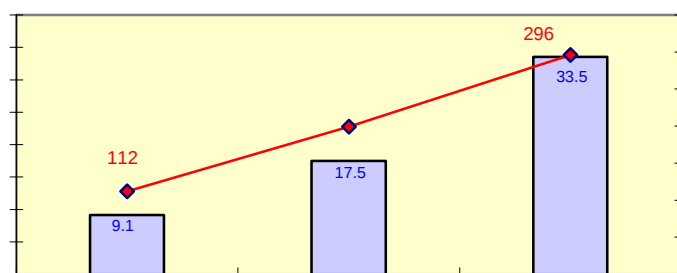
The number of hedge fund managers increased dramatically over the

Analysis on AUM and number of hedge funds

Hedge funds reported by respondents grew significantly both in terms of AUM and number of funds

Total AUM reported by the respondents grew a remarkable 268% to US\$33.5 billion over the period (US\$9.1 billion in March 2004). The total number of hedge funds managed in Hong Kong also surged by 164% from 112 to 296 during the period.

Analysis of total AUM and number of hedge funds (2004-2006)



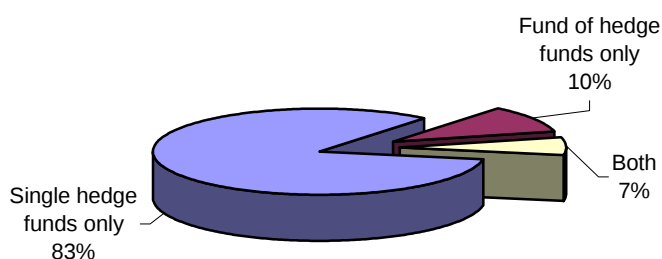


Types of hedge funds

Majority of the respondents managed only single hedge funds

Majority, being 98 out of 118 (83%), of the respondents indicated that they managed only single hedge funds. 12 (10%) respondents managed fund of hedge funds while the remaining 8 (7%) indicated they did both. The following pie chart depicts the types of hedge funds managed by the respondents.

Types of hedge funds managed

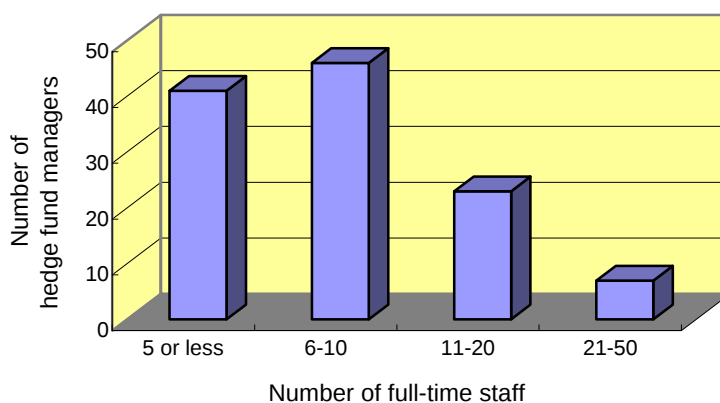


Profile of staff

Various firm size

Total number of full time staff reported by the respondents was 1,053 as at 31 March 2006. 74% of the respondents reported that they had 10 or less staff responsible for various key functions in relation to the operation of hedge funds. On the other hand, about 6% of the respondents had over 20 staff to support their hedge fund business.

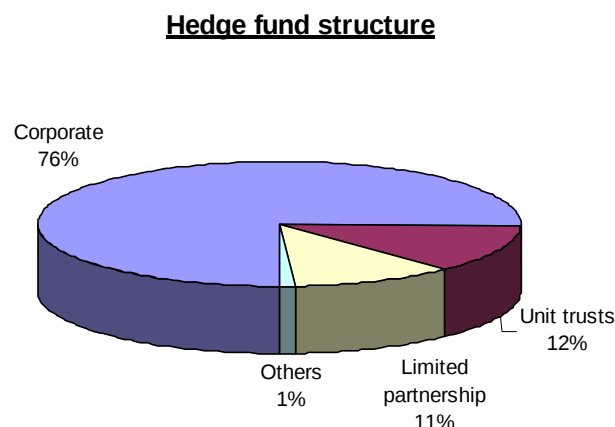
Number of full-time staff engaged in hedge fund activities



Fund structure and place of listing

Most hedge funds reported adopted a corporate structure

Most of the hedge funds reported by the respondents adopted a corporate structure (76%), followed by unit trusts (12%) and limited partnership (11%).



14% of hedge funds were listed

Among the 201 hedge funds, 28 (14%) of them were listed on the exchanges, mainly the Irish Stock Exchange.

Client base and distribution channel

Institutional investors still dominated

Institutional investors have always been the support base for hedge funds. The Survey confirmed this to be the case. The total number of investors investing in the hedge funds reported was around 10,140 as at 31 March 2006, of which majority were institutional investors.

Most of the hedge funds reported (149 or 74%) did not have external distributors. The rest mainly had less than 3 external distributors. This may, to certain extent, due to the non-retail nature of most of the hedge funds reported.

Investment geography

Hedge funds reported invested mainly in Asia Pacific markets

Asia Pacific was most popular among the regions in which the hedge funds invested, constituting about US\$24.0 billion of the total NAV of the hedge funds reported by the respondents as at 31 March 2006. Among this US\$24.0 billion, US\$4.1 billion was invested in the Hong Kong market.

The above coincided with our understanding that many hedge fund houses were set up in Hong Kong (because of its strategic geographical location within the Asia Pacific regions) to invest in the Asia Pacific markets. However, it should be noted that the amounts did not include hedge funds managed overseas but invested in Asia Pacific (including Hong Kong) markets.

Portfolio composition

Equities were the major asset component in the hedge funds reported

The hedge funds reported by the respondents held various classes of assets as at 31 March 2006. Equities were the major component in the

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- b) Valuation of assets. Valuation of assets, especially complex, illiquid and exotic/tailor-made financial products, could be an issue.
- c) Deficiencies in offering docume

about US\$88 million, with the largest fund having about US\$359 million.

In the context of the whole hedge fund universe in Hong Kong, the hedge funds authorized by the SFC for sale to the public would appear to be relatively small in size.

6. Final note

We believe that hedge funds are here to stay and the industry is expected to grow further. It is essential that hedge funds maintain investor confidence if the industry is to enjoy growth. We will continue to monitor hedge fund developments on both local and international fronts, including meeting regularly with major fund managers, prime brokers, administrators, custodians, and other service providers to better understand their hedge fund-related activities and risk controls.

We encourage the hedge fund industry to be more transparent and provide their investors with timely and useful information, including factors contributing to investment returns and portfolio risks. We will strive to work closely with the industry and leading industry bodies to develop the local hedge fund market and to safeguard investor interests, market integrity and the good reputation of Hong Kong's financial market.

As hedge fund activities are not restricted by national borders, cooperation with overseas regulators is of utmost importance. In line with this, we maintain close ties and organise joint initiatives on hedge fund activities with regulators of other major financial markets. In addition, the SFC has been participating actively in the discussions of the Task Force of the IOSCO on hedge fund related issues, such as formulating the good practices for the valuation of the assets of hedge funds. Such cooperation and partnership with other regulators and the industry will be key to a healthy development of the hedge fund industry in Hong Kong.