SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

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

- adoption of investment mandates that give managers more flexibility to shift strategies.

For the purpose of this Survey, the term “hedge fund managers” include those fund managers that manage and/or advise hedge fund assets. The term 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, and the term “managed” refers to “managed and/or advised”.

Survey methodology

Survey questionnaire

The Survey questionnaire is divided into two parts. Questions in Part A relate to the general operations of the hedge fund business of the hedge fund manager, while questions in Part B relate to the details of the top three hedge funds (determined by their respective net asset value (NAV)) managed by the hedge fund manager as at 31 March 2009.

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 fund industry operated by the SFC-licensed hedge fund managers, it should be noted that the Survey did not cover hedge funds managed overseas but investing in Hong Kong.

For the purpose of this Survey, if a hedge fund manager provides investment management or advisory services to its group companies on a part of the whole group's hedge fund portfolio, the questionnaire requested it to report the amount of assets managed/advised from Hong Kong on a best-effort basis. Three hedge fund managers reported that they could not split the AUM attributable to their operations in Hong Kong using a reasonable basis and the entire AUM they reported was therefore excluded from our AUM analysis for prudence sake.

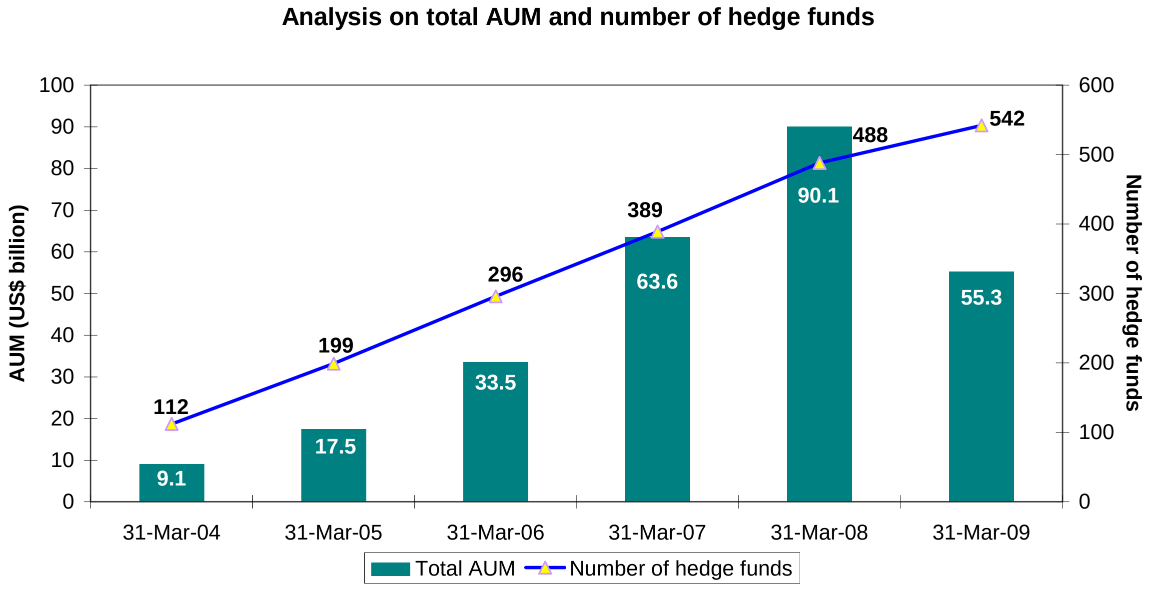
Readers of this report should take note of the above in analyzing the Survey results.

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



The number of hedge funds managed by the SFC-licensed hedge fund managers surged to 542 in 2009, which was almost five times that of 2004, the earliest year covered in our hedge fund surveys.

The total AUM in Hong Kong has registered a healthy growth since 2004, expanding from US$9.1 billion in 2004 to the peak of US$90.1 billion in 2008. It dropped to US$55.3 billion in 2009 in the wake of the global financial crisis. The reduction of AUM was split roughly equally between negative performance and net redemptions.

Table 1 in the Appendix further shows the breakdown by type of the US$55.3 billion assets managed by the hedge fund managers from Hong Kong. Single hedge funds constituted over 80% of the total AUM. In aggregate, the top three hedge funds reported by each hedge fund manager represented about 93% of the total AUM as at 31 March 2009.

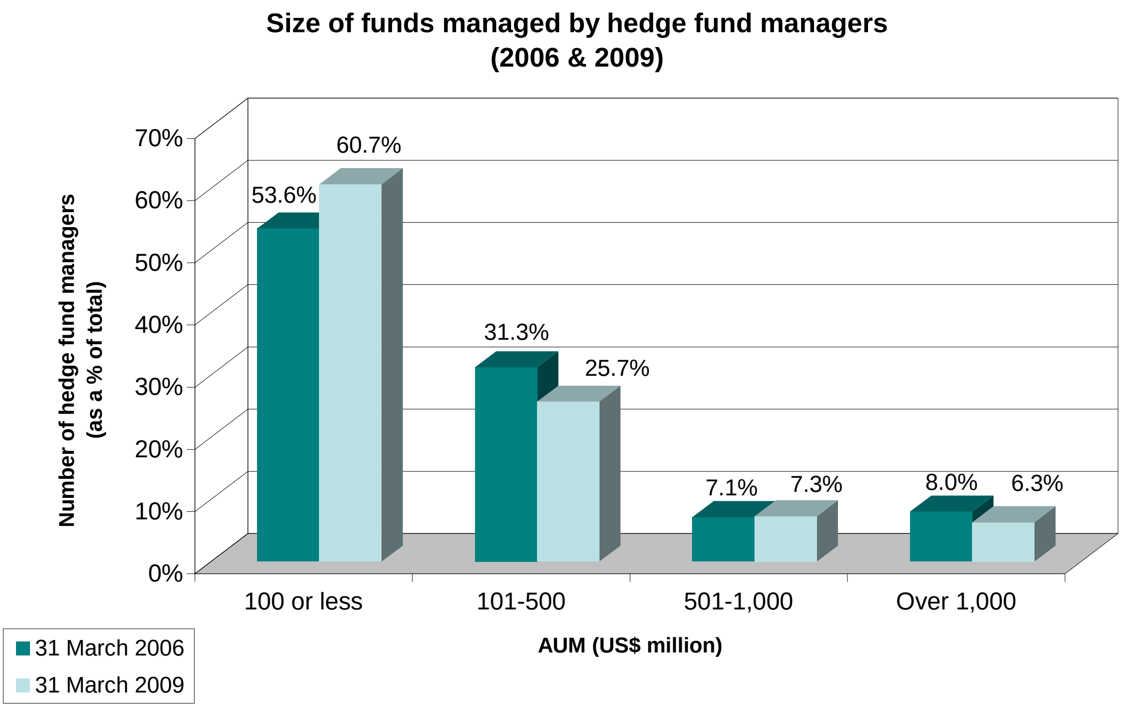
Good mix of local and international hedge fund managers of various sizes

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.



In March 2009, 60.7% of the hedge fund managers had an AUM of US$100 million or less. The increase in the proportion of these smaller hedge fund managers as compared to 2006 was mainly because the hedge fund industry has experienced heavy redemptions and negative performance in the midst of financial crisis in 2008.

[1] According to AsiaHedge, Hong Kong had the largest number of new Asia Pacific hedge funds in 2008 within Asia, followed by Singapore, Australia and Japan. In respect of the aggregate asset size of these start-ups, Hong Kong also came first.

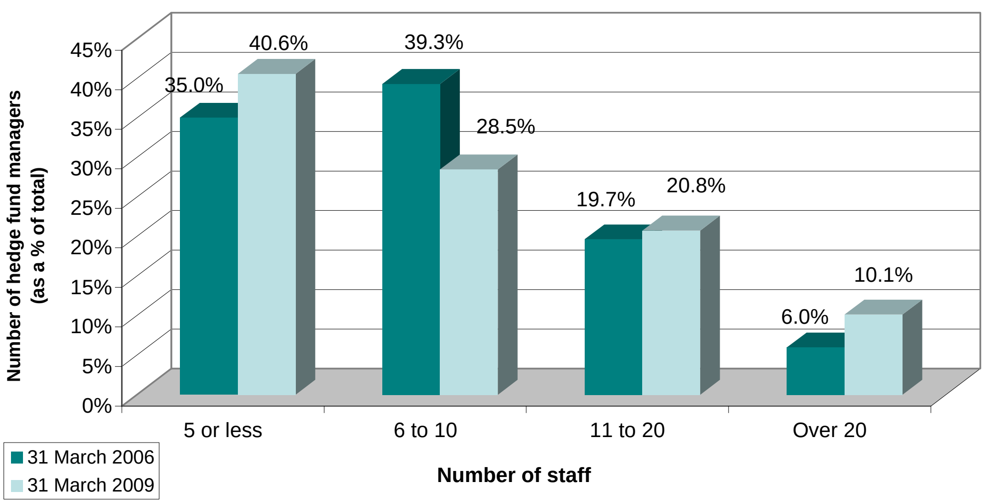
The remaining 39.3% of hedge fund managers managed a much larger size of fund assets. This included a number of the existing hedge fund managers which continued to grow in Hong Kong over the past few years and have built up their infrastructure in Hong Kong to support their operations here.

In addition, it is worth noting that the top 20 hedge fund managers already accounted for about 60% of the total AUM as at 31 March 2009. Please refer to Table 2 in the Appendix for details.

Dramatic increase in number of staff employed in hedge fund industry

In line with the increase in the percentage of small-sized firms, the percentage of hedge fund managers with five or less staff increased to 40.6% at March 2009 from 35% at March 2006, as shown in the following chart.

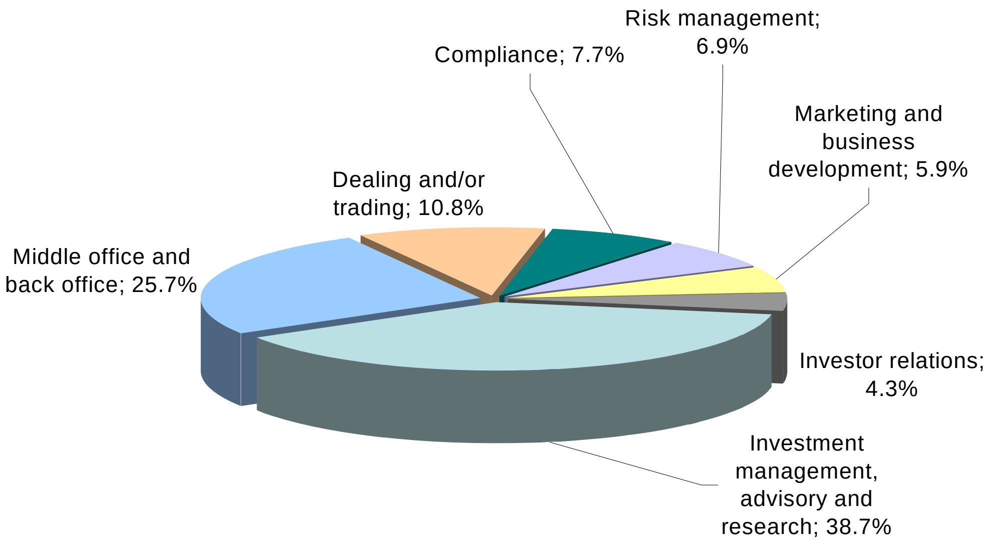
Number of staff engaged in hedge fund activities (2006 & 2009)



On the other hand, the proportion of hedge fund managers with more than 20 staff also increased from 6% to 10.1% during the past 3 years. This was mainly attributable to the expansion of the assets managed by the hedge fund managers during the period.

The 209 hedge fund managers reported a total of 1,967 staff involved in their hedge fund business in Hong Kong, a surge of 86.8% from 1,053 in March 2006. There was no material change in the composition of staff by key functions as compared to March 2006. The majority of staff were involved in the investment management, advisory and research function (38.7%) and the middle office and back office function (25.7%).

Staff by key functions as at 31 March 2009

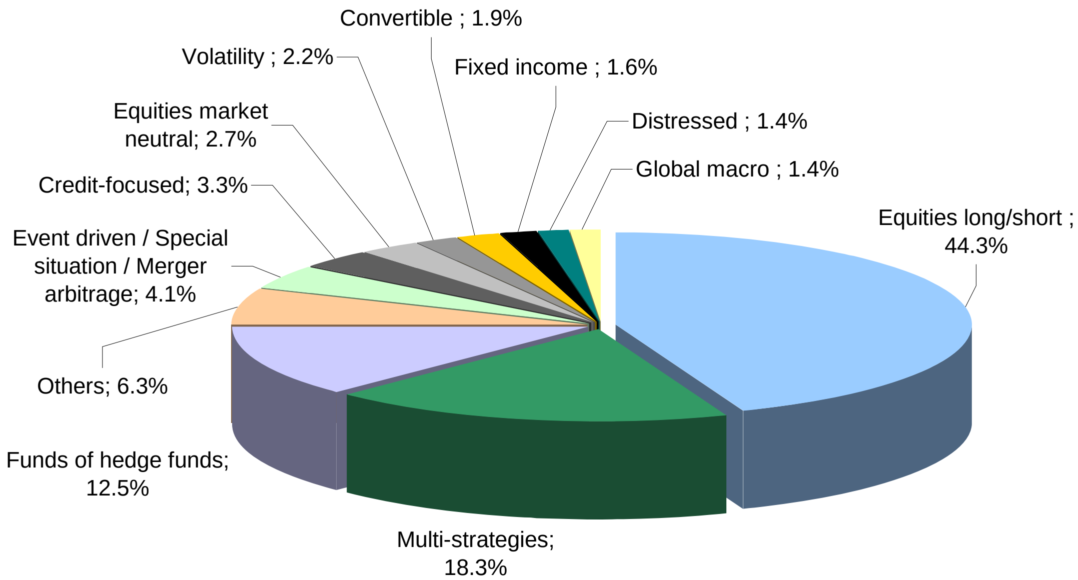


The hedge funds mainly adopted Asia Pacific-focused equities long/short and multi-strategies with overseas institutional investors dominated

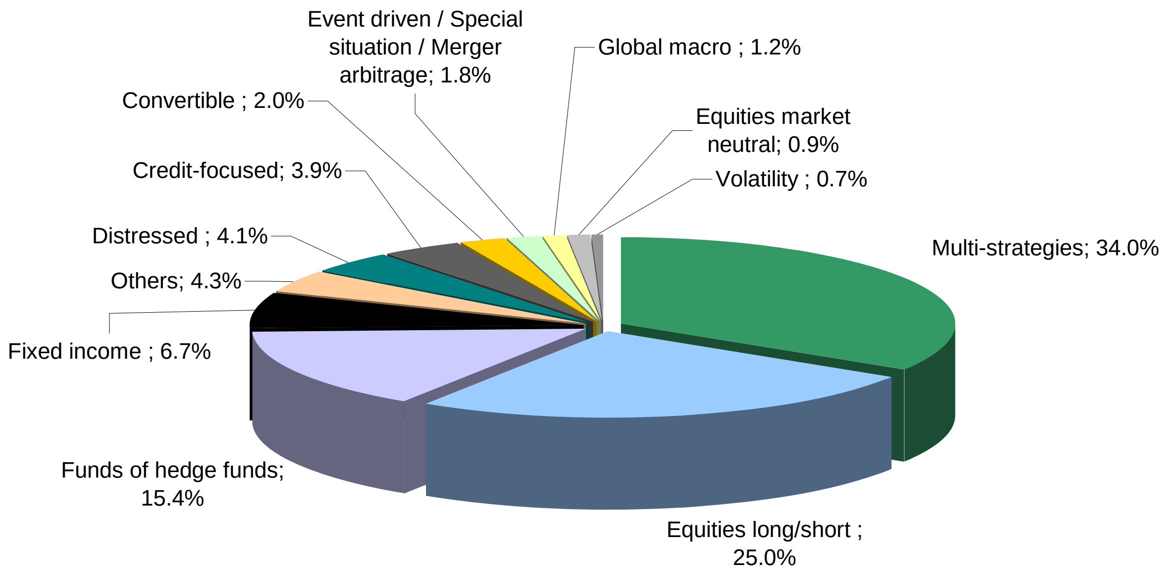
Domination by equities long/short and multi-strategies

The hedge fund managers reported a broad spectrum of investment strategies. As at 31 March 2009, by number as well as NAV of the hedge funds, equities long/short and multi-strategies remained the most popular strategies. For funds that used multi-strategies, the most common underlying strategies included equities long/short, event driven/special situation/merger arbitrage and convertible.

Investment strategies of hedge funds as at 31 March 2009
(as a % of total number of hedge funds reported)



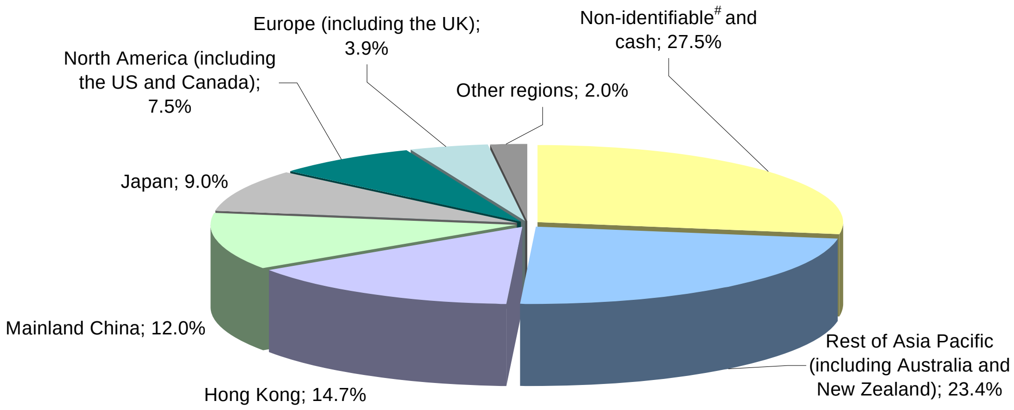
Investment strategies of hedge funds as at 31 March 2009
(as a % of total NAV of hedge funds reported)



Investments mainly Asia Pacific-focused

The hedge funds managed by the SFC-licensed hedge fund managers 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[2] markets.

Breakdown on AUM by geographical areas as at 31 March 2009

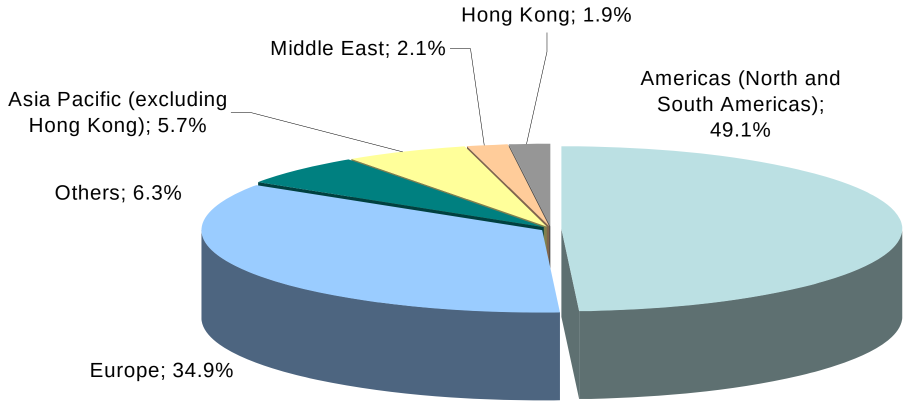


Non-identifiable refers to assets invested in instruments whose ultimate origin in terms of geographical region cannot be clearly determined.

Hedge fund investors mainly from Americas and Europe

In terms of source of investors by location, Americas (49.1%) and Europe (34.9%) dominated. Hong Kong investors only constituted 1.9% of the investor base as at 31 March 2009.

Source of investors by locations as at 31 March 2009

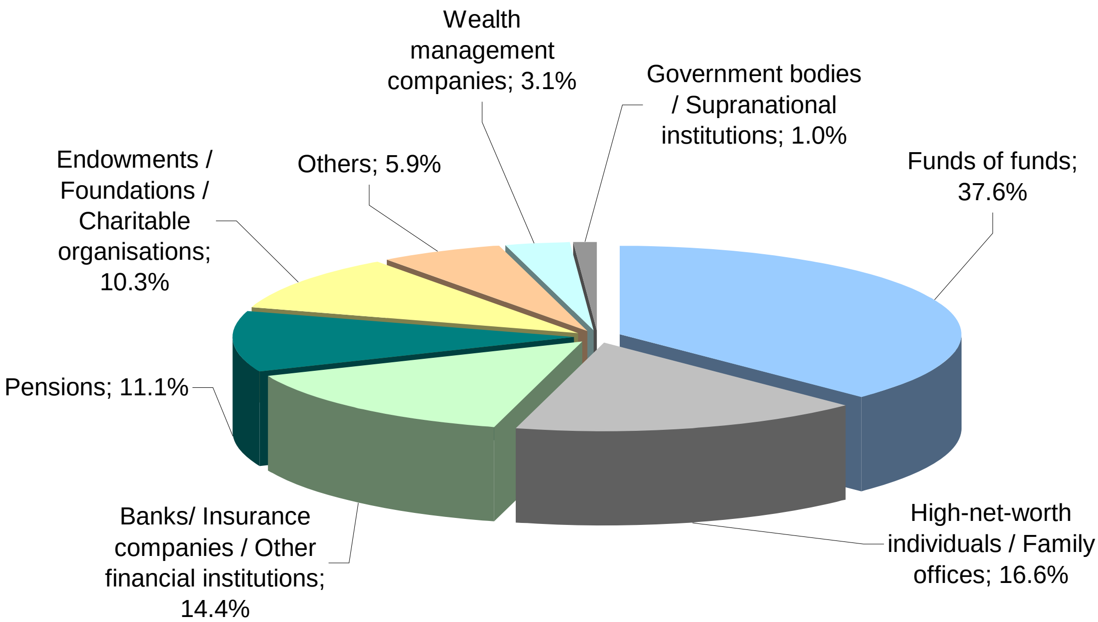


2 Based on our discussion with some hedge fund managers which reported material investments in Mainland China, these investments included A-shares, H-shares, Red Chips, debt financing and investments in private equities in Mainland China, etc.

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 institutions (14.4%), pensions (11.1%) and endowments/foundations/charitable organisations (10.3%), etc.

Source of investors by type
as at 31 March 2009

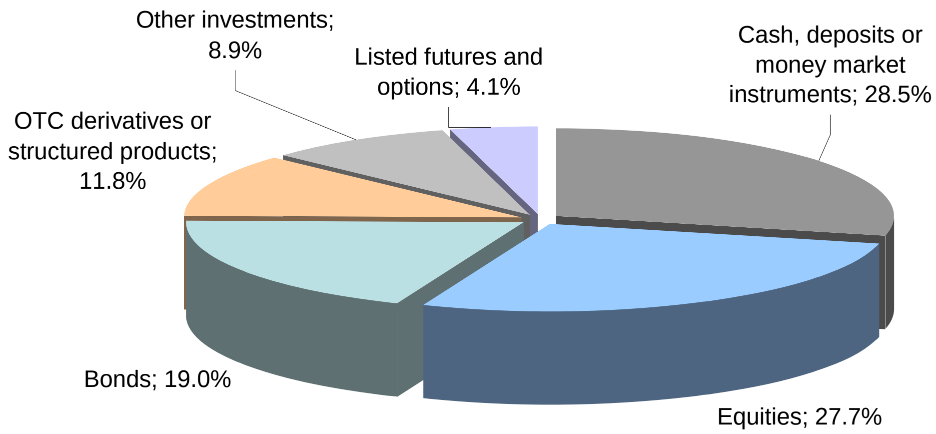


Relatively conservative investment approaches were adopted amid financial crisis

High cash level

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. In our last survey in 2006, this category in aggregate only accounted for 4% of the assets of the hedge funds reported. This probably reflected hedge fund managers' increased awareness of liquidity risk and their adoption of a more conservative investment approach amid the financial crisis.

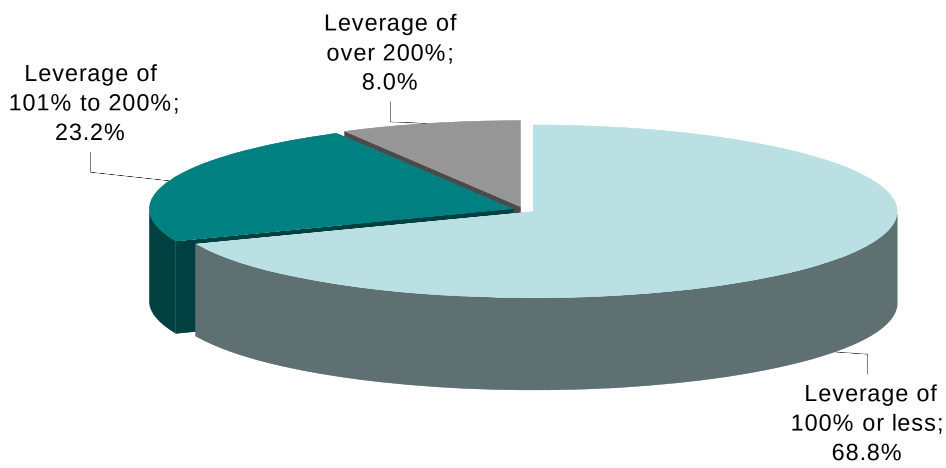
The remaining assets managed by the hedge fund managers were mainly invested in equities (27.7%) and bonds (19%).



Breakdown on AUM by investment components
as at 31 March 2009

Low leverage

The hedge funds generally adopted a low leverage. As shown in the graph below, 68.8% of the hedge funds had a leverage of 100% or less as at 31 March 2009[3].



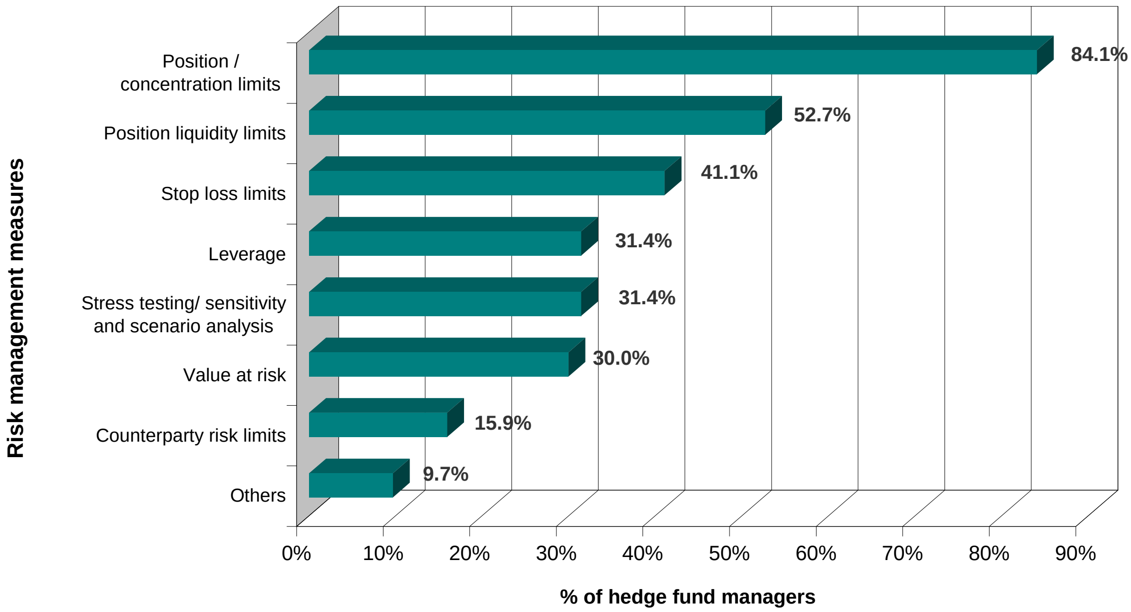
Leverage of hedge funds as at 31 March 2009

3 There is no unanimous definition of leverage. For the purpose of this Survey, the hedge fund managers can use either their own methods or a standardised method, namely [(Market value of long investment portfolio + Absolute market value of short investment portfolio) / NAV of the hedge fund *100%], to calculate the leverage of their hedge funds. It should be noted that this latter method in general does not take into account the leverage embedded in derivative instruments used by hedge funds. About 90% of the hedge funds reported had provided their leverage % calculated by using the latter method, of which 68.8% had a leverage of 100% or less as at 31 March 2009.

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.

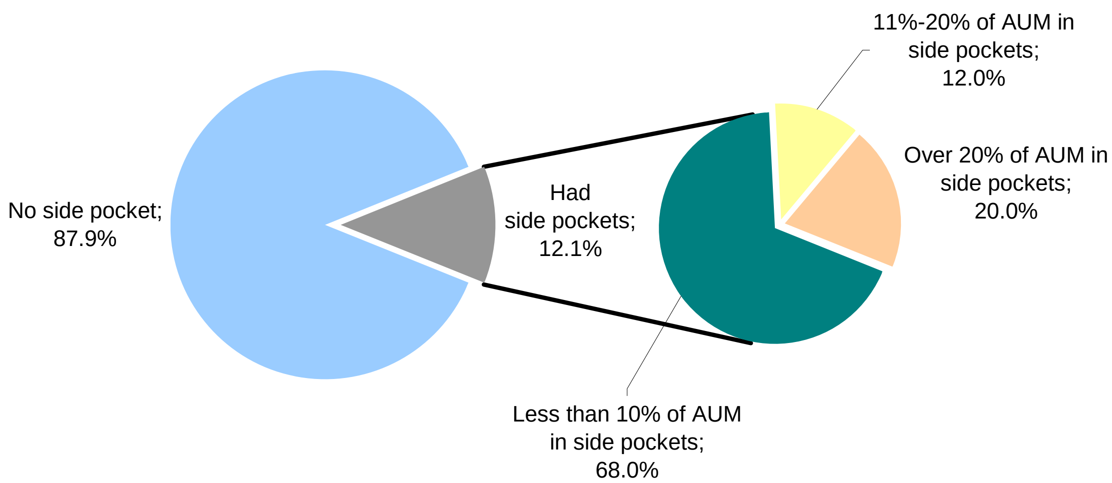
This probably reflected a generally higher awareness of counterparty risks among the hedge fund managers after the collapse of Lehman Brothers in September 2008.

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.

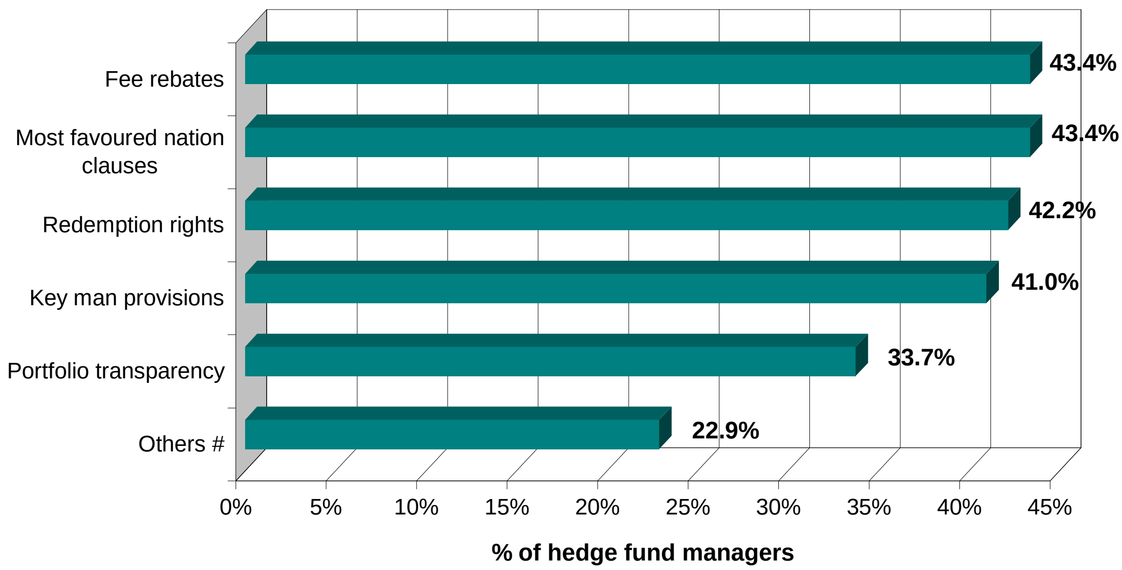
Use of side pockets by hedge fund managers
as at 31 March 2009



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.

Hedge fund managers with side letter arrangements
as at 31 March 2009



Others included terms like concentration limits, capacity agreements and other reporting requirements.

SFC's initiatives for the hedge fund industry

The following summarises our major initiatives in the past three years in response to the growth and the changing landscape of the hedge fund industry in Hong Kong.

Streamlining licensing procedures for hedge fund managers

We streamlined and clarified the licensing procedures for fund managers in June 2007[4]. This has resulted in the simplification of the licensing process for firms which are already licensed or registered as investment managers or advisors in other jurisdictions and which have a good compliance record and serve only professional investors. Our initiatives have been welcomed and well received by market participants. The streamlined procedures have reduced the average processing time for licence applications submitted by hedge fund managers to the SFC by about 40%, from 12 weeks in June 2007 to seven weeks in August 2009. Well-prepared applications are generally processed in four to six weeks.

Providing guidance to industry

We have met with a number of local start-up hedge fund managers to discuss their operations and understand their business profile. The findings were subsequently published[5] to remind the industry the importance of operational controls, such as segregation of duties.

We have also conducted theme inspections on hedge fund managers. Based on the inspection findings, we issued a circular[6] to all licensed hedge fund managers to highlight the standards of conduct and control procedures we generally expected of them. The circular covered major areas like risk management and control procedures, valuation of investments, disclosure to investors, operational efficiency, etc. In particular, we reminded the hedge fund managers to ensure proper disclosure of the material terms of side letters to all existing and potential investors, and to critically assess the basis and control for transferring investments in and out of side pockets and ensure proper disclosure of the side-pocket arrangements to both existing and potential investors.

We also monitor hedge fund industry development through on-going dialogue and meetings with market participants, such as prime brokers and other service providers.

Enforcing regulations to deter misconduct and fraudulent activities

In early 2009, the SFC took prompt regulatory actions on suspected fraudulent activities conducted by a private hedge fund, its related hedge fund manager and other related parties[7].

Maintaining close ties with overseas regulators

As hedge fund activities are not restricted by national borders, cooperation with overseas regulators is of utmost importance. In this regard, the SFC has performed joint inspections with

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4 Details of the SFC's initiatives to streamline the licensing process can be found in the circular "SFC adopts a pragmatic approach to licensing fund managers" issued on 11 June 2007. The circular is available on the SFC website.

5 A summary of findings was published on 27 August 2007 in the SFC Bulletin (Issue No. 42, August 2007). It is available on the SFC website.

6 The circular, which is available on the SFC website, was issued on 27 October 2008.

7 For details, please refer to the SFC's press releases dated 28 April 2009, 19 May 2009, 25 May 2009 and 21 August 2009 in relation to Descartes Investment Management Ltd, Descartes Global Asset Management Ltd, Descartes Finance Ltd and Descartes Athena Fund SPC. The press releases are available on the SFC website.

the Securities and Exchange Commission of the United States on some dually-registered hedge fund managers. We have also participated actively in International Organization of Securities Commissions discussions in setting international standards and good practices for the hedge fund industry.

Conclusion

Hedge funds have been playing an increasingly important role in the financial markets worldwide. Hedge fund managers, like other fund managers, are required to be licensed by the SFC if they carry out asset management or advisory activities in Hong Kong. Once licensed, they are subject to our on-going supervision. In addition, although we do not directly regulate hedge funds unless they are offered to the public, this does not mean that they are unregulated. Hedge funds using the Hong Kong platform are subject to the law against fraud, insider dealing and market misconduct.

The SFC will closely monitor international regulatory developments and review our regulatory regime where appropriate. It is our aim to continue to maintain a balanced regulatory environment to foster the growth of the hedge fund industry while ensuring adequate protection to investors.

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
Total AUM reported by the 209 hedge fund managers	**55.3**	
- Single hedge funds	45.1	1
- Funds of hedge funds	7.8	1
- Managed portfolios	2.4	1
Top three hedge funds reported by each of the 209 hedge fund managers	**51.6**	2
- Hedge funds entirely managed from Hong Kong	33.8	
- Hedge funds partially managed from Hong Kong	17.8	3

Note 1: Single hedge funds represented 81.6% of the total AUM, followed by funds of hedge funds (14.1%) and managed portfolios (4.3%).

Note 2: The top three hedge funds reported by the 209 hedge fund managers constituted 93.3% of the total AUM.

Note 3: This refers to hedge funds that were managed both from Hong Kong and outside of Hong Kong. These hedge funds reported a total fund size of US$180.5 billion, among which, US$17.8 billion or 9.9% was reported to be managed from Hong Kong.

Table 2: Stratification of the SFC-licensed hedge fund managers by size of AUM

Hedge fund managers ranked by AUM as at 31 March 2009	AUM (US$ billion)	% of total AUM
Top 1 to 20	32.7	59.1%
21 to 50	13.2	23.9%
51 to 100	7.0	12.7%
101 to 209	2.4	4.3%
Total	**55.3**	**100.0%**