

Hong Kong

Regulation

HEDGE FUNDS 2009

Hedge fund managers/advisors

Regulation

Authorization requirements and process

The typical business activities of a hedge fund manager/advisor will likely fall into the scope of regulated activities as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (SFO) of Hong Kong.

There are nine types of regulated activities as defined in Schedule 5 of the SFO:

- Type 1: Dealing in securities
- Type 2: Dealing in futures contracts
- Type 3: Leveraged foreign exchange trading
- Type 4: Advising on securities
- Type 5: Advising on futures contracts
- Type 6: Advising on corporate finance
- Type 7: Providing automated trading services
- Type 8: Securities margin financing
- Type 9: Asset management

In the context of the SFO, securities, in brief, includes shares, debt instruments, unit trusts, or mutual funds, and related derivative products such as, warrants and options. Futures contracts are referring to contracts or options made under the rules or convention of a futures market.

The hedge fund manager/advisor should apply for the appropriate license from the Securities and Futures Commission of Hong Kong (SFC) when carrying out regulated activities in Hong Kong. Usually a hedge fund manager/advisor should apply for a license for carrying out regulated activities type four, five, and nine.

The hedge fund manager/advisor is required to complete relevant application forms, which are available from the SFC Web site. The hedge fund manager/advisor should also provide documents to satisfy the SFC that it has proper business structure, internal control systems and qualified personnel as set out in section 129 of the SFO and the Licensing Information Booklet published by the SFC. Section 8.7 of The Code of Unit Trusts and Mutual Funds (UT Code) established by the SFC has specific requirements for a fund manager and its key personnel which manage SFC-authorized hedge funds.

Individuals conducting the regulated activities for the hedge fund manager/advisor are also required to apply for a license from the SFC under section 120 of the SFO. The SFC, in considering whether a person is fit and proper for the purposes of licensing and registration, usually have regard to the applicant's financial status, educational or other qualifications or experience, reputation, and ability to carry on the regulated activity concerned.

The company should appoint at least two responsible officers to directly supervise the conduct of each regulated activity applied for and should have at least one responsible officer available at all times to supervise the proposed business.

Typical timescale to receive approval

Normally, it will take approximately 15 weeks for the SFC to process a license application for a new industry participant. The time the SFC takes to process an application may vary depending on a number of factors such as the type of service or products the applicant is proposed to provide, quality of information, and supporting documents provided, whether the applicant has previously been registered with the SFC, qualification of responsible officers, the applicant's response over any further information requested during the application period, etc.

The SFC issued a circular in June 2007 to provide practical guidance to overseas fund managers when applying for a license from the SFC and clarify certain key aspects of the licensing requirements for fund managers. The circular also explains the ways the SFC adopted to streamline the process for licensing overseas fund managers.

Regulatory capital requirements

The regulatory capital requirement for a licensed corporation pursuant to the SFO is detailed in Table 1 of Schedule 1 to the Securities and Futures (Financial Resources) Rules (SF(FR)R), a subsidiary legislation of the SFO.

The minimum regulatory capital required for a hedge fund manager/advisor varies depending on the type of regulated activities it is approved to carry on and the licensing conditions attached to its license.

On an ongoing basis, the hedge fund manager/advisor is also required to comply with the minimum liquid capital requirements in the SF(FR)R. Liquid capital is calculated based on the computation basis as set up in Part 4 of the SF(FR)R.

Significant restrictions on marketing to investors

There is a general prohibition on the marketing of non-SFC-authorized hedge funds, regardless of its place of domicile, to the general public in Hong Kong, unless the marketing efforts are made to only professional investors as defined in Part 1 of Schedule 1 to the SFO. The hedge fund manager/advisor should reasonably satisfy himself/herself that the person whom the hedge fund is promoted to has sufficient expertise and investment experience in hedge funds.

If the hedge fund is an SFC-authorized hedge fund, the promotional material of the hedge fund is required to be authorized by the SFC before it is released to the general public. Where the marketing materials are not required to be authorized by the SFC (for example those of a non-SFC-authorized hedge fund presented to professional investors), the hedge fund manager should nonetheless ensure that any representations made and information supplied in such materials are accurate and not misleading and that any performance claims can be verified.

Hedge fund structures

Regulation

Authorization requirements

A hedge fund which is authorized by the SFC is eligible to be offered to the general public in Hong Kong, while an unregulated hedge fund can only be offered to persons who are qualified as professional investors as defined in the SFO.

In order for a hedge fund to be authorized by the SFC, it should meet the conditions and requirement as set out in the UT Code and make an application to the SFC.

A fund manager/advisor of a SFC-authorized hedge fund should be either incorporated in Hong Kong or an overseas company which has established a place of business in Hong Kong and has complied with the provision of Part XI of the Hong Kong Companies Ordinance. However, the investment

management operation of the fund manager or advisor (if the advisor has been delegated the investment management function) of an SFC-authorized hedge fund should be based in a jurisdiction with an inspection regime acceptable to the SFC. At the date of this questionnaire, SFC-approved inspection regime includes:

- Australian Securities and Investments Commission of Australia;
- Commission des Opérations de Bourse of France;
- Bundesanstalt für Finanzdienstleistungsaufsicht of Germany;
- SFC of Hong Kong;
- Central Bank of Ireland;
- La Commission de Surveillance de Secteur Financier of Luxembourg;
- Financial Service Authority of the United Kingdom; and
- Securities and Exchange Commission of United States of America.

However, if the hedge fund manager/advisor intends to carry out investment management/advisory services in Hong Kong, it must apply for the appropriate license(s) from the SFC.

Restrictions on types of investments, concentration levels, and the manner in which hedge funds can invest and/or strategies

An SFC-authorized hedge fund should comply with the conditions and requirements as set out in the UT Code, in particular section 8.7 of the UT Code which is designated to hedge funds.

If the SFC-authorized hedge fund is a single hedge fund (that is, not a fund of hedge funds), there is no strict limitation on the investment direction, types of financial instruments in which the fund will invest, diversification, or concentration of investments or strategies and the extent and basis of leverage. However, these should be clearly defined in the fund's constitutive and offering documents.

In respect of an SFC-authorized fund of hedge funds, the fund must invest in at least five underlying funds, and not more than 30 percent of the fund's total net asset value is invested in any one underlying fund. The fund also cannot invest in another fund of hedge funds.

Rules regarding the publishing of the accounts and prospectuses

The manager of an SFC-authorized hedge fund is required to issue regular reports to its investors at least on a quarterly basis. Reports must be prepared and distributed in accordance with the Appendix H, Guidelines on Hedge Funds Reporting Requirements of the UT Code.

An annual report of an SFC-authorized hedge fund, in which a set of audited financial statements is included, must be filed with the SFC and distributed to its investors within four months of the end of the relevant financial year, except for an SFC-authorized fund of hedge funds where the filing and distribution to investors must be completed within six months of the relevant financial year.

Time-scale of establishment of a hedge fund

The actual time required for processing an application largely depends on the level of compliance of the applicant fund with the UT Code. Processing time also depends on other factors such as, complexity of the fund structure, accuracy, annotation and quality of the fund documentation, and the responsiveness and turn-around time of the applicant on enquiries from the SFC.

Specifically for hedge funds, the SFC will also consider the choice of asset class and the use of alternative investment strategies by the fund.

As a general guide, SFC will take up an application within two working days upon receipt of the application, including application fees. For a reasonably straightforward single fund application, the SFC aims to provide initial comments on the application within seven working days after take-up.

Investors

Regulation

Restrictions on which type of investors can invest in a hedge fund and/or the minimum/maximum number of investors in a hedge fund

There is no restriction on the minimum or maximum number of investors in a hedge fund.

An SFC-authorized hedge fund is open to the general public to subscribe, notwithstanding the minimum level of initial subscription requirement stated in the UT Code. The minimum level of initial subscription by each investor of an SFC-authorized hedge fund should not be less than USD 50,000 equivalent, except for fund of hedge funds, where the minimum initial subscription should

not be less than USD 10,000 equivalent. No minimum subscription level will apply to a hedge fund which provides at least 100 percent capital guarantee.

There is no minimum or maximum subscription level on follow-on investments by investors.

A non-SFC-authorized hedge fund cannot be legally promoted or offered publicly in Hong Kong unless the promotion or offer is open only to professional investors who meet the definition in Part 1 of Schedule 1 to the SFO.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.