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Monetary Authority of Singapore

GUIDELINES FOR RETAIL HEDGE FUNDS

EXECUTIVE SUMMARY

Guidelines for retail hedge funds were first introduced in June 2001 in response to interest expressed by the financial industry. The potentially higher risks of hedge funds make them more appropriate for investors who are able to bear such risks. As such, a minimum subscription of S\$100,000 on their offer was required.

2 We are now seeking comment on the proposed revised guidelines for retail hedge funds which will replace the existing Appendix 4 in the Code on Collective Investment Schemes. The proposed guidelines will differentiate between single hedge funds, fund-of-hedge-funds and capital protected or capital guaranteed hedge funds.

3 The key features of the proposed guidelines include enhancing the disclosure requirements for prospectuses and marketing materials, providing for redemptions at least once every quarter, requirements as to risk management and controls, limiting the liability of investors to their investment in the hedge fund and new minimum subscription requirements.

4 Comments on the proposed guidelines may be submitted to hedgefunds@mas.gov.sg by 3 September 2002.

Note: Explanatory notes and illustrations pertaining to the guidelines are denoted in *italics*.

Code on Collective Investment Schemes

Appendix 4: Hedge Funds

Definition

There are different characteristics and investment strategies that define hedge funds. In general, a hedge fund seeks to deliver an “absolute” return independent of the directional move of equity, fixed income or cash markets. In considering whether a fund falls within these Guidelines, the Authority would look at, among others, the following:

- a) strategies that use leverage, short selling, arbitrage, derivatives; and
- b) investment in non-mainstream asset classes i.e. investments other than listed equities, bonds and cash.

Disclosure

2 Where a hedge fund is approved under this Appendix, the cover page of a hedge fund prospectus should clearly state that:

- a) this scheme complies with Appendix 4 of the Code on Collective Investment Schemes (“Code”) which sets out guidelines for hedge funds. Unlike those for traditional funds, Appendix 4 does not incorporate investment guidelines;
- b) an investment in the scheme carries risks of a different nature from traditional schemes which are “long only” funds investing in listed securities. The scheme may not be suitable for persons who are averse to such risks;
- c) investors **may lose all or a large part of their investment** in the scheme;
- d) an investment in the scheme is not intended to be a complete investment programme for any investor and prospective investors should carefully consider whether an investment in the scheme is suitable for them in the light of their own circumstances, financial resources and entire investment programme; and

- e) investors may only redeem their units once every calendar quarter and it could take a further 95 days for redemption proceeds to be paid following the acceptance of such a request.

3 The investment objective, risks inherent in the scheme and the material differences between the scheme which is the subject of the prospectus and a “traditional” fund should be disclosed clearly and in language that is easily understood.

Some examples of material differences (list is not exhaustive) that should be highlighted, where applicable:

- a) some of the underlying investments may not be actively traded and there may be uncertainties involved in the valuation of such investments;*
- b) compared to traditional schemes, relatively little information on how the scheme and underlying schemes are managed will be available;*
- c) there is limited liquidity as redemption requests are only accepted quarterly and proceeds are paid 95 days after a request has been accepted;*
- d) the redemption price may be affected by fluctuations in value of the underlying investments from the time a redemption request is submitted and the date the redemption price is determined; and*
- e) most of the underlying hedge funds are not regulated.*

4 All marketing material should state items 2(b), (c) and (d) and make reference to the other inherent risks of investing in the scheme.

A. SINGLE HEDGE FUNDS

Minimum Subscription Requirement

Single hedge funds should be offered with a minimum initial subscription of S\$100,000 per investor.

Manager

2 The manager of a single hedge fund should have expertise in managing such schemes. Where investment decisions are outsourced to a sub-manager or adviser, the sub-manager or adviser should have expertise in managing such schemes.

3 *In assessing expertise, the Authority would consider the professional experience, qualifications, assets under management and performance history of the manager or its sub-manager or adviser.*

4 The manager should have at least 2 executives who each have at least 5 years of experience in the management of hedge funds.

Investment in Another Scheme

5 A Singapore single hedge fund may invest in another single hedge fund which is not a feeder fund.

Risk Management and Monitoring Procedures and Internal Controls

6 The manager of a hedge fund should have in place proper risk management and monitoring procedures and internal controls. These should be set out in the prospectus, together with a statement from the manager that in their view, the procedures and controls are adequate.

7 *The Authority will require senior management of a hedge fund manager to certify annually that the procedures and controls for monitoring the management and risk of the fund are as set out in the prospectus.*

Borrowings

8 A single hedge fund may be leveraged up to the extent disclosed in the prospectus.

Dealing

9 There must be at least one regular dealing day per quarter. In addition, redemption proceeds must be paid to the end investor within 95 days from the dealing day the redemption request is accepted.

Limited Liability

10 The liability of investors must be limited to their investment in the scheme. For this purpose, the constitutive documents of the scheme should contain a provision limiting the liability of investors to their investment in the scheme. This should also be clearly disclosed in the prospectus.

B. FUND OF HEDGE FUNDS (“FoHF”)

An FoHF is a portfolio in which a professional manager will allocate capital across a range of hedge funds, which in turn may invest in a wide range of investment markets using differing techniques. The manager will be responsible for deciding which investment strategies should be invested in as well as selection of the most appropriate hedge funds for the chosen strategy.

Minimum Subscription Requirement

2 An FoHF should be offered with a minimum initial subscription of S\$20,000 per investor.

Diversification

3 An FoHF should have diversification as one of its key objectives. The manager should have in place strategies to achieve adequate diversification and ensure that the fund is so diversified at all times. (Such information should be set out in the prospectus.)

4 *In submitting an application to the Authority for a FoHF, the manager should set out the:*

- (a) method of diversification or intended diversification (in the case of new schemes) e.g. by investing in various strategies or investment styles;*
- (b) objective criteria which the manager would adhere to in ensuring that diversification is achieved e.g. not more than x% will be invested in any one strategy or investment style; and*
- (c) for existing funds, past data demonstrating the said diversification.*

5 An FoHF should be diversified across at least 15 hedge fund managers.

Manager

6 The manager of a FoHF should have expertise in managing such schemes. Where investment decisions are outsourced to a sub-manager or adviser, the sub-manager or adviser should have expertise in managing such schemes.

7 *In assessing expertise, the Authority would consider the professional experience, qualifications, assets under management and performance history of the manager or its sub-manager or adviser.*

8 The manager of a FoHF should have at least 2 executives who each have at least 5 years of experience in the management of hedge funds, of which at least 3 years must be in the management of an FoHF.

Investment in Another Scheme

9 A Singapore FoHF may invest in another FoHF which should only invest directly in other hedge funds and not through another FoHF or a feeder fund.

Risk Management and Monitoring Procedures and Internal Controls

10 The manager of a hedge fund should have in place proper risk management and monitoring procedures and internal controls. In particular, for an FoHF, the manager must have a proper due diligence process for the selection of the underlying managers and funds and ongoing monitoring of the manager's management of the funds. These should be set out in the prospectus, together with a statement from the manager that in their view, the procedures, processes and controls are adequate.

11 *The Authority will require senior management of a hedge fund manager to certify annually that the procedures and controls for monitoring the management and risk of the fund are as set out in the prospectus. Where a Singapore FoHF invests in other FoHFs, the manager of the underlying FoHF must also submit such certification.*

Borrowings

12 The underlying funds of an FoHF may be leveraged up to the extent disclosed in the prospectus. An FoHF may borrow only for the purposes of meeting redemptions and short-term (not more than 3 months) bridging requirements. Aggregate borrowings for such purposes should not exceed 25% of the deposited property of the FoHF at the time the borrowing is incurred.

Dealing

13 There must be at least one regular dealing day per quarter. In addition, redemption proceeds must be paid to the end investor within 95 days from the dealing day the redemption request is accepted.

Limited Liability

14 The liability of investors must be limited to their investment in the scheme. For this purpose, the constitutive documents of the scheme should contain a provision limiting the liability of investors to their investment in the scheme. This should also be clearly disclosed in the prospectus.

C. CAPITAL PROTECTED OR CAPITAL GUARANTEED SINGLE HEDGE FUNDS AND FOHF

The requirements for single hedge funds and FoHF in Parts A and B respectively apply to such funds which are capital protected or capital guaranteed.

2 *However, capital guaranteed and certain capital protected hedge funds are less risky in that the initial capital invested will normally be returned to investors at maturity of the scheme. Hence, the minimum subscription requirement for single hedge funds and FoHF may be waived where certain criteria are met.*

3 Protection covering at least **100% (less front end charges)** of subscriptions is required for the minimum subscription requirement of \$100,000 (single hedge funds) or \$20,000 (FoHF) to be waived.

Capital Protected Hedge Funds

4 Capital protection should be afforded to an investor by way of fixed income instruments where:

- a) not more than one-third of the deposited property of the scheme may be invested or placed with:
 - i) an issuer which is a corporation, government, government agency or supranational that has a minimum long-term issuer rating of A by Fitch Inc, A by Moody's or A by Standard and Poor's (including such sub-categories or gradations therein); or
 - ii) a financial institution with a minimum individual rating of B by Fitch Inc, a financial strength rating of B by Moody's or a long-term issuer rating of AA by Standard and Poor's; or
- b) up to 100% of the deposited property of the scheme may be invested with an issuer if the issuer is, or the issue has the benefit of a guarantee from, either a government, government agency, or supranational that has a minimum long-term issuer rating of AA by Fitch Inc, Aa by Moody's or AA by Standard and Poor's (including such sub-categories or gradations therein).

5 The proportion to be invested in fixed income instruments must at maturity return the capital invested less front-end loads (if any).

Capital Guaranteed Hedge Funds

6 A third party guarantee may be used to ensure that capital is returned to an investor at a specified date. Where there is a third party guarantor which meets the requirements for capital guaranteed funds set out in Appendix 5 of the Code on Collective Investment Schemes, the applicable minimum subscription may be waived. Under Appendix 5, the guarantor must have:

- a) in the case of a financial institution, an individual rating of at least B by Fitch Inc, a financial strength rating of at least B by Moody's or a long-term issuer rating of at least AA by Standard and Poor's; or
- b) in all other cases, a long-term credit rating of AAA by Fitch Inc, Aaa by Moody's or AAA by Standard and Poor's.