(Provisional Translation)

Summary of Hedge Fund Survey Results
and
the Discussion Points

December 2005

Financial Services Agency

CONTENTS

Note: This English report is a translation and extraction of the Japanese original. The original Japanese report has the following sections, which are not translated in English:

IV. Hedge Fund Regulations in Major Securities Markets

2. United States 3. United Kingdom 4. Germany 5. Hong Kong

V. Recent Development around Hedge Fund Regulations

1. International Organization of Securities Commissions 2. Securities Regulators
3. European Union 4. International Monetary Fund 5. Private Sector

Executive Summary

(Introduction)

The hedge fund industry has rapidly developed and regulators have been paying more attention to them and their possible impact on the markets. Based on the recent development of hedge funds, the Financial Services Agency (“FSA”) announced the “Program for Further Financial Reform” in December 2004, with a concrete measure to study issues on hedge funds. The FSA conducted its first fact finding survey on hedge fund activities in Japan in the middle of 2005. This report summarises the survey results and the discussion points.

(Definition of Hedge Funds)

While many hedge funds share characteristics such as: (i) private placement, (ii) sales to high net worth customers, (iii) use of leverage, (iv) high exposure to risks, (v) charge a performance fee, there exists no established definition.

For the purpose of this survey, hedge funds were defined as “funds that (i) use leverage, (ii) charge a performance fee, and (iii) use hedge fund strategies (including funds of hedge funds).”

(Hedge Fund Survey and Results)

The FSA sent the questionnaire to the 1,251 financial institutions regulated by the FSA, including banks, insurance companies, investment trust management companies and investment advisers, etc. (“surveyed companies”). The responses were provided on a voluntary basis.

The questionnaire requested information on hedge funds that: (i) the surveyed companies or their related companies outside Japan established and were involved in their management or sales in the five-year survey period from 1 April 2000 to 31 March 2005, (ii) the surveyed companies sold in the five-year survey period from 1 April 2000 to 31 March 2005, and (iii) the surveyed companies or their consolidated subsidiary companies held as of 31 March 2005.

To capture a wider picture of hedge fund activities in Japan, including how the surveyed companies recognise the hedge funds, the FSA deliberately entrusted the surveyed companies to interpret the definition of hedge funds. The interpretation by the companies might have been diverse. There were instances where funds that did not use leverage nor charge a performance fee but used hedge fund strategies were included in the reply to the questionnaire. Accordingly, accuracy is not the main feature of this survey and the readers of this report are advised to take this into account when analysing the survey results.

In the five-year survey period from 1 April 2000 to 31 March 2005, 57 companies established 735 hedge funds, amounting to ¥2.5 trillion, while 91 companies sold hedge funds with the total amounting to ¥5.9 trillion. In addition, there were 310 companies investing in hedge funds, amounting to ¥6.1 trillion.

Hedge funds have dramatically increased both in number and in amount since FY 2003. Strategies, such as funds of hedge funds, equity market neutral and equity long/short, accounted for about 70% of share, implying that not all the hedge funds use high-risk strategies; however, a more close and careful scrutiny is desirable as to the details of the strategies and their risk profile.

It is said that overseas hedge funds use prime brokers, who provide a range of services relating to securities business, including equity lending, loans collateralised by securities custody of hedge funds assets, etc. Such prime brokers do not seem to exist in the Japanese market, at least at this stage.

The largest share (around 50%) of total hedge funds was found to be sold to financial institutions (such as banks, *shinkin* banks (credit associations) and *shin-yô kumiai* (credit cooperatives), etc.), followed by individuals (16%), to whom sales have remarkably increased in recent years.

60% of hedge funds that the surveyed companies arranged were established in Japan, but only 40% of hedge funds that the surveyed companies sold were established in Japan. This implies that foreign securities companies sold many hedge funds that were established outside Japan by their overseas group companies to domestic Japanese investors.

310 companies, one-quarter of the surveyed companies, were found to be investing in hedge funds. Insurance companies held ¥1.6 trillion; city banks, etc. held ¥1.3 trillion; trust banks held ¥1.2 trillion; regional banks held ¥900 billion and other companies held ¥1.0 trillion.

The results show that the larger investors tend to prefer funds of hedge funds.

(Hedge Fund Regulations in Major Securities Markets)

The current legislation in Japan does not provide for any explicit definition of hedge funds.

(Discussion Points)

Need for Hedge Fund Regulation: As investor protection and market integrity are the important regulatory and supervisory missions for the securities regulators, it has been debated whether the role of the regulators should be focused narrowly on the systemic risks and limited to monitoring of hedge funds only through the regulated financial institutions.

Investor Protection: Some surveyed financial institutions did not consider hedge funds as high risk/high return investment products. As the survey refrained from close scrutiny into investors' individual risk management situation, it might be necessary to address suitability issues, such as (i) how to identify investor risk management capacity; (ii) how their risk management capacity could be improved, and (iii) whether non-professional investors should be segregated from the hedge fund market.

Market Integrity: It might be necessary to monitor closely the hedge fund's own risks, such as control issues, risk management, market abuse (*e.g.* insider trading and manipulation, etc.), fraud, money laundering, conflicts of interest, etc., under the current regime of inspection and supervision.

Stability of Financial System: At this moment, the hedge fund market is relatively limited in Japan, and the transactions involving financial institutions might not be extensive. However, financial institutions are significantly increasing their exposure to hedge funds, accounting already for half of hedge funds sold in the market. In this context, a continued monitoring may be needed as to the transactions of hedge funds with financial institutions.

Others: More discussion is desired as to the definition of hedge funds and the manner to adequately monitor and analyse hedge funds activities. It might also be necessary to discuss establishment of a reporting system to identify and analyse various risks related to hedge funds. In addition, as many hedge funds are established outside Japan as private placement funds, strengthening of international cooperation multilaterally with the IOSCO or bilaterally with other regulators is imperative.

Conclusive Remark: The FSA will further discuss what ought to be the suitable hedge fund regulations in Japan, from the viewpoints of ensuring investor protection and market integrity, with due regard to international developments.

I. Introduction

The hedge fund industry has rapidly developed. The size of the hedge fund market was US$ 324 billion at the beginning of 2000, grew to US$795 billion by the beginning of 2004, and it seems to have reached over US$1 trillion in 2005[1]. As the hedge fund market is growing, regulators have been paying more attention to the credit exposure of hedge funds and their possible impact on the markets. Particularly, the cross-border activities of hedge funds have become more active as a result of the growing market, and further cooperation among securities regulators is considered necessary. In addition, measures and proposals to regulate hedge fund activities and their possible impacts on international financial markets have been discussed among regulators, multinational organisations and the industry.

In December 2004, the Financial Services Agency ("FSA") developed and announced the *"Program for Further Financial Reform – Japan's challenge: Moving toward a Financial Services Nation-"* in order to realise a financial system that is to highly satisfy the users and be well-received internationally. One of the policies in the Program is "further development of a financial system which is internationally open and a financial administration with an international perspective" with a concrete measure to study issues on hedge funds.

Based on the recent development of hedge funds in the international financial markets, the FSA conducted its first fact finding survey of hedge fund activities in Japan in the middle of 2005. This report summarises the survey results and introduces outlines of hedge fund regulations in Japan and other major markets and also presents discussion points on hedge fund regulations in the international fora, as well as in Japan.

[1] Hennessee Group LLC, "Written Testimony of Charles J. Gradante", July 15, 2004; "HENNESSEE RELEASES 8TH ANNUAL HEDGE FUND INVESTOR SURVEY", October 5, 2005

II. Definition of Hedge Funds

1. General Image of Hedge Funds

There is no established definition of hedge funds; however, in general, they are considered as the funds with (i) private placement, (ii) sales to high net worth customers, (iii) use of leverage, (iv) high exposure to risks, (v) charge a performance fee, and (vi) funds manager's own investment in the hedge funds that they manage[2]. The Bank of Japan released the hedge fund report[3] in July 2005, where it chose the following three characteristics for hedge funds; (i) to take highly free investment strategies, (ii) to pursue absolute return, and (iii) to charge a performance fee by portfolio managers.

2. Definition by Regulators

(1) International Organization of Securities Commissions

The International Organization of Securities Commission ("IOSCO"), an international organisation consisting of securities regulators, released a report[4] in February 2003 and stated the characteristics of hedge funds as:

> *"Hedge funds have at least some of the following characteristics: Borrowing and leverage restrictions, which are typically included in CIS regulations, are not applied, and many (but not all) hedge funds use levels of leverage; significant performance fees (often in the form of a percentage of profits) are paid to the manager in addition to an annual management fee; investors are typically permitted to redeem their interests periodically, e.g., quarterly, semi-annually or annually; often significant 'own' funds are invested by manage; derivatives are used, often for speculative purposes, and there is an ability to short sell securities; more diverse risks or complex underlying products are involved"* but, *"it will, at the end of the day, most likely be next to impossible to arrive at a definition of 'hedge funds' that is a) accepted internationally and b) sufficiently precise for 'universal' implementation in laws and statutes regulating CISs."*

(2) Hong Kong

Currently, there are some jurisdictions where hedge funds regulations exist, but they do not necessarily provide for a clear definition on hedge funds. For example, the Securities and Futures Commission of Hong Kong defines hedge funds as follows:

[2] YAMAUCHI, Hideaki, "*Alternative Tôshi Nyumon* (Introduction to Alternative Investment)", Tôyô Keizai Shimpôsha
[3] The Bank of Japan, "*Hedge Fund wo Meguru Saikin no Dôkô* (Recent Trend in Hedge Funds)", BOJ Quarterly Bulletin, July 2005
[4] IOSCO, "Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds", Report of the Technical Committee of IOSCO, February 2003, pp3-4

"The following criteria apply to collective investment schemes that are commonly known as hedge funds (or alternative investment funds or absolute return funds). Hedge funds are generally regarded as non-traditional funds that posses different characteristics and utilize different investment strategies from traditional funds. In considering an application for authorization, the commission will, among other things, consider the following: (i) the choice of class of assets; and (ii) the use of alternative investment strategies such as long/short exposures, leverage and/or hedging and arbitrage techniques.[5]*"*

3. Definition by FSA's Survey

For the purpose of the survey, the FSA chose to define hedge funds as "the funds that (i) use leverage, (ii) charge a performance fee, and (iii) use hedge fund strategies (including funds of hedge funds)", in order to identify widely so-called hedge funds. In addition, we included funds both offered publicly and placed privately, as the publicly offered investment trusts with hedge fund strategies have recently shown a significant increase.

[5] Securities and Futures Commission, "Code of Unit Trusts and Mutual Funds", Chapter 8.7 Hedge Funds

III. Hedge Fund Survey and Results

In May 2005, the FSA conducted its first comprehensive fact finding survey of hedge funds of the financial institutions regulated by the FSA.

1. Procedure of Survey

(1) Hedge Funds to be Reported

In conducting the hedge fund survey, hedge funds were defined as "the funds that (i) use leverage, (ii) charge a performance fee, and (iii) use hedge fund strategies (including funds of hedge funds)." The survey covered publicly offered and privately placed funds.

(2) Target Financial Institutions

The questionnaires were sent to the 1,251 financial institutions, regulated by the FSA, such as banks, insurance companies, securities companies, investment trust management companies and investment advisers (hereinafter "the surveyed companies"). These responses were provided on a voluntary basis.

(3) Survey Period and Survey Items

To capture a wider picture of hedge fund activities, encompassing arrangement/ management of hedge funds, sale to investors and investment in hedge funds, different sets of questions were sent to (i) hedge fund arrangers/managers, (ii) hedge fund distributors, and (iii) investors of hedge funds. The items that appeared in the questionnaire were as follows:

(i) <u>To hedge fund arrangers/managers</u>

Name of fund, form of subscription, strategy, name of manager, country of establishment, terms of fund and amount of establishment of funds which the surveyed companies established or which their related companies outside Japan established, but the surveyed companies themselves are involved in part of management or sales of the hedge funds in the five-year survey period from 1 April 2000 to 31 March 2005

(ii) <u>To hedge fund distributors</u>

Name of fund, form of subscription, strategy, name of manager, country of establishment, terms of fund, date of sales, amount of establishment, and to whom they sold the hedge funds that the surveyed companies sold in the five-year survey period from 1 April 2000 to 31 March 2005

(iii) To investors of hedge funds

Name of fund, form of subscription, strategy, name of manager, country of establishment, terms of fund, date of purchase, amount of purchase, and from whom they purchased the hedge funds that the surveyed companies or their consolidated subsidiary companies held as of 31 March 2005

(4) Interviews

Of the surveyed companies, some ten companies that arranged/sold or invested in a certain amount of hedge funds were selected for further interview on their management process, solicitation policy, investment policy, etc.

2. Points of Note

In this survey, as mentioned above, hedge funds were defined as “the funds that (i) use leverage, (ii) charge a performance fee, and (iii) use hedge fund strategies (including funds of hedge funds)”. However, it is generally difficult to provide a strict definition of hedge funds. To capture a wider picture of hedge fund activities in Japan, including how the surveyed companies recognise the hedge funds, the FSA deliberately entrusted the companies to interpret the definition of hedge funds. Accordingly, the interpretation by the surveyed companies might have been diverse, and there remains room for possible improvement in terms of accuracy of the survey results, if that is the priority. Similar limitations are understood to exist in other survey results conducted by other regulators or private research institutions as well. The readers of this report are advised to take account of this.

The survey did not place any limitation as to types of the vehicles used for a hedge fund; the vehicles may have been diverse, including investment trusts, investment companies, limited partnership, etc.

3. Outline of Survey Results

Responses were received from 1,171 companies out of 1,251 targeted financial institutions. The result of the survey shows that there were 57 companies that established hedge funds, 91 companies that distributed hedge funds during the five-year survey period and 310 companies that held hedge funds as of 31 March 2005.

This survey, which defined hedge funds as “the funds that (i) use leverage, (ii) charge a performance fee, and (iii) use hedge fund strategies (including funds of hedge funds)", illuminated the following points:

- While some investors recognised these types of funds as "hedge funds," others recognised them rather as "alternative investment products," defined as funds that used investment strategies different from those of the traditional investment products and placed accent on seeking an absolute return.
- Many arrangers and distributors also used the term "alternative investment products," rather than "hedge funds."
- The definition (or perception) of hedge funds may be changing with the lapse of time. In the past, leveraged, highly risky hedge funds were preferred and such funds were commonly called "hedge funds"; but recently less risky funds are favoured, and as a result, the common terminology seems to no longer be applicable.

In addition, there were instances where the funds, which did not use leverage nor charge a performance fee[6], but used hedge fund strategies, were included in the response. The readers of this report are also advised to keep this point in mind.

(1) Survey Results for Those Who Arrange/Manage Hedge Funds

a) Outline

57 companies established hedge funds in the five-year survey period from FY 2000 to FY 2004[7] and the total amount of establishment in the survey period was ¥2,509.7 billion[8].

From FY 2000 to FY 2002, there were around a hundred hedge funds established a year; the number more than doubled in FY 2003 and FY 2004. The amount was between ¥250 to ¥300 billion from FY 2000 to FY 2002, but it increased to ¥770 billion in FY 2003 and FY 2004.

[6] In case of domestic publicly offered investment trusts, it seems difficult to charge a performance fee unless setting sub-funds, due to requirement of equal treatment of beneficiary owners, and this has resulted in many funds answering that they do not charge a performance fee in the answer to the questionnaire.
[7] FY stands for fiscal year, which starts on 1 April and ends on 31 March of the following year.
[8] Non-yen denominated funds were converted into Japanese yen, using the average forex rate of the fiscal year. This conversion policy was also applied to the survey results for distributors and investors.

[Table 1] Number and Amount of Hedge Funds Established in Each Fiscal Year

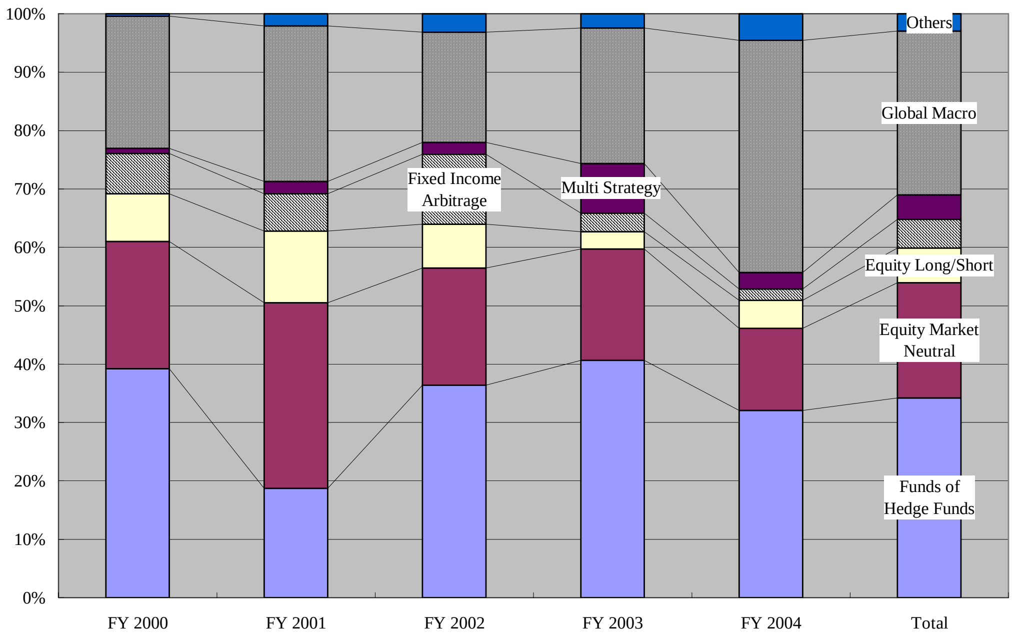
(Unit: ¥ billion for the amount)

Fiscal Year	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	Total
Number of Funds	81	92	129	202	231	735
(Private Placement)	(80)	(86)	(117)	(188)	(208)	(679)
Establishment Amount	247.4	343.1	371.8	770.9	776.6	2,509.7
(Private Placement)	(246.4)	(293.4)	(292.6)	(652.2)	(643.5)	(2,128.1)

b) Hedge Fund Strategies

Chart 1 shows the strategies that the established hedge funds used.

[Chart 1] Hedge Fund Strategies in Each Fiscal Year

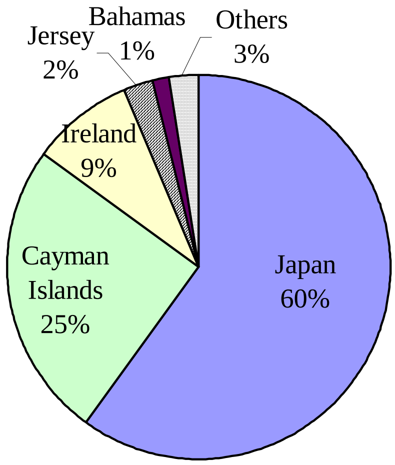


The strategies are classified by funds of hedge funds, equity long/short, equity market neutral, fixed income arbitrage, multi strategy and global macro, which were based on the classification reported by the surveyed companies. In the five-year survey period, funds of hedge funds share of the total amount was 34%; followed by global macro (28%); equity market neutral (20%); equity long/short (6%); fixed income arbitrage (5%); and multi strategy (4%). This result shows that strategies, such as funds of hedge funds, equity market neutral, equity long/short, fixed income arbitrage and multi strategy, totalled about 70% of share, implying that not all the hedge funds use high-risk strategies; however, a more close and careful scrutiny may be desired as to the details of the strategies and their risk profile.

c) Country of Establishment of Hedge Funds

331 hedge funds, amounting to ¥1,508.0 billion or 60% of the total amount were established in Japan; followed by the Cayman Islands, 286 funds, amounting to ¥622.2 billion (25%); Ireland, 19 funds, amounting to ¥220.8 billion (9%); Jersey, 4 funds, amounting to ¥61.8 billion (2%); and Bahamas, 8 funds, amounting to ¥30.8 billion (1%). The reasons for selection of countries outside Japan were reported as cost of establishment; infrastructure, such as lawyers; political stability, etc.

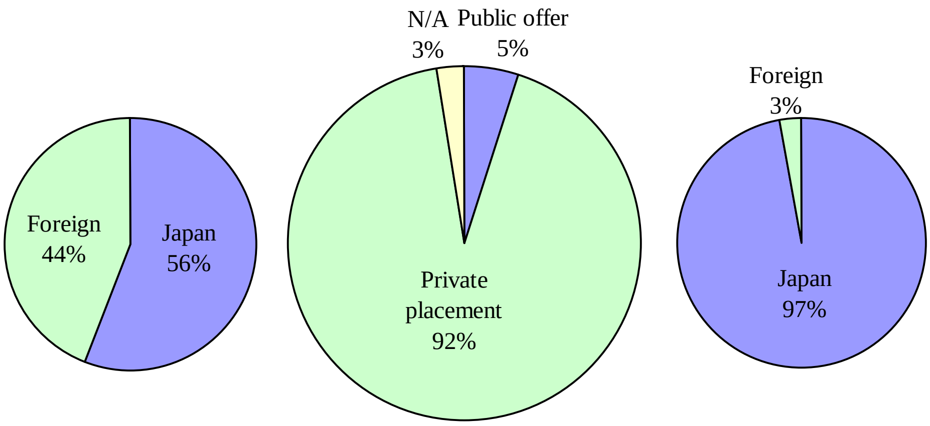
[Chart 2] Countries of Establishment of Hedge Funds



d) Form of Subscription of Hedge Funds

Of the 735 hedge funds established, 679 hedge funds, amounting to ¥2,128.1 billion were private placement. 97% of publicly offered hedge funds and 56% of private placement hedge funds were established in Japan.

[Chart 3] Form of Subscription and Countries of Establishment of Hedge Funds



<Countries of Establishment of Private Placement Funds> <Form of Subscription> <Countries of Establishement of Publicly Offered Funds>

e) Others

(i) <u>Prime Brokers</u>

It is said that overseas hedge funds use prime brokers who provide a range of services relating to securities business, including equity lending, loans collateralised by securities, custody of hedge fund assets, etc.

In case of Japan, a limited number of foreign securities companies provide services of execution, lending or custody of Japanese equities, as a part of global businesses of the group. However, Japanese arrangers/managers, such as investment trust management companies, use trust banks as trustees, and it is said that they do not need the services provided by the prime brokers and the service providers, such as prime brokers in the overseas markets; the prime brokerage does not seem to exist in the Japanese market at least at this stage.

(ii) Selection of Securities Companies / Trustees

Securities companies which execute securities transactions are reportedly selected by criteria, such as execution capacity, commission, lending fee, quality of analyst reports. The selected securities companies are auctioned every time orders are placed. The selected securities companies are periodically reviewed and reselected from the viewpoints mentioned above.

Trust banks, as trustees, are the custodians of securities and calculators of the net asset value ("NAV") and are reportedly selected for the viewpoints of accuracy of their operations. However, the number of trust banks is limited in Japan nowadays, and there does not seem to be significant difference in their operational abilities so that the trustees are not often changed.

(iii) New Money Inflow into Hedge Funds

Large inflows of new money into the same strategy of hedge funds have a big influence on the markets, and this may result in a negative impact on the hedge fund management. The management companies may set the limit to which new money would be accepted to each strategy in order to prevent it from being concentrated into one specific strategy.

(2) Survey Results for Those Who Distribute Hedge Funds

a) Outline

91 companies sold hedge funds for the five-year survey period from FY 2000 to FY 2004, and the total amount of sales in the period was ¥5,879.0 billion.

42 domestic securities companies sold ¥3,391.9 billion (58% of the total amount) worth and 19 foreign securities companies[9] sold ¥1,394.2 billion (24%) worth. 30 other companies (such as banks and insurance companies, etc.) sold ¥1,092.9 billion (18%) worth.

The distribution amount increased drastically from FY 2003, as well as the amount of established hedge funds seen in the previous section. The amount of distribution was between ¥400 billion and ¥700 billion from FY 2000 to FY 2002, but increased to ¥1,879.5 billion in FY2003, about 2.5 times that of the previous fiscal year. In FY 2004, it reached ¥2,113.0 billion.

[Table 2] Distribution Amount of Hedge Funds in Each Fiscal Year

(Unit: ¥ billion)

Fiscal Year	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	Total
Domestic Securities Companies	302.3	408.6	446.1	868.0	1,366.9	3,391.9
Foreign Securities Companies	122.2	135.7	110.7	615.8	409.8	1,394.2
Others	30.1	121.3	209.4	395.8	336.4	1,092.9
Total	454.5	665.6	766.2	1,879.5	2,113.0	5,879.0

b) Investors of Hedge Funds

Chart 4 shows the categories of investors to whom hedge funds were sold by fiscal year. In the five-year survey period, 50% of total hedge funds were sold to financial institutions (such as banks, *shinkin* banks (credit associations) and *shin-yô kumiai* (credit cooperatives), etc., but excluding trust accounts of trust banks); followed by individuals (16%), trust accounts of trust banks, such as pension funds and investment trusts (11%), insurance companies (10%) and corporations (8%).

[9] Foreign securities companies mean securities companies registered with the FSA under the Law Concerning Foreign Securities Firms (Law No. 5 of 1971).

[Chart 4] Distribution Amount of Hedge Funds by Categories of Investors

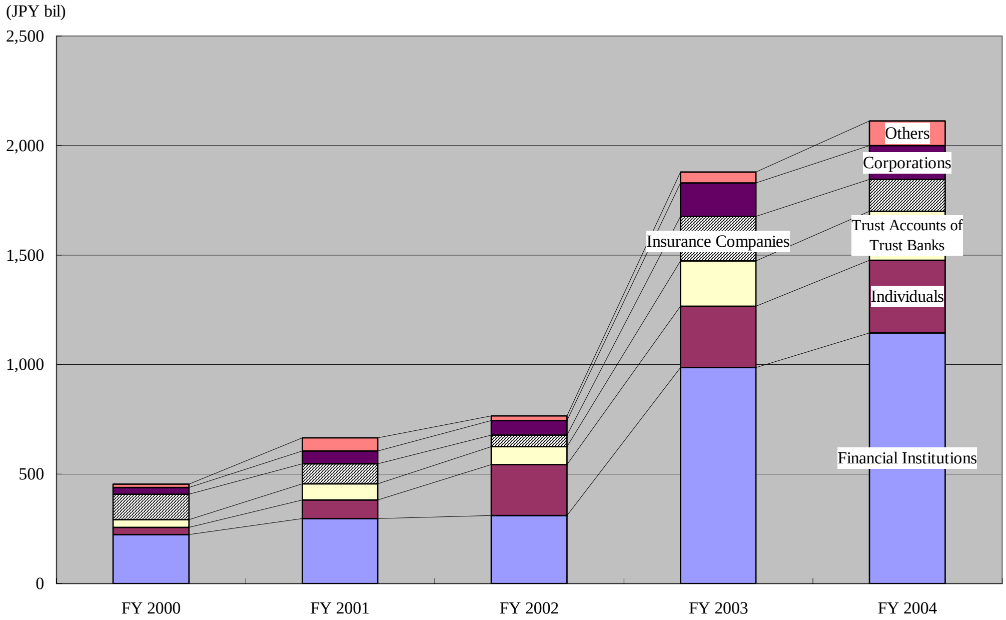
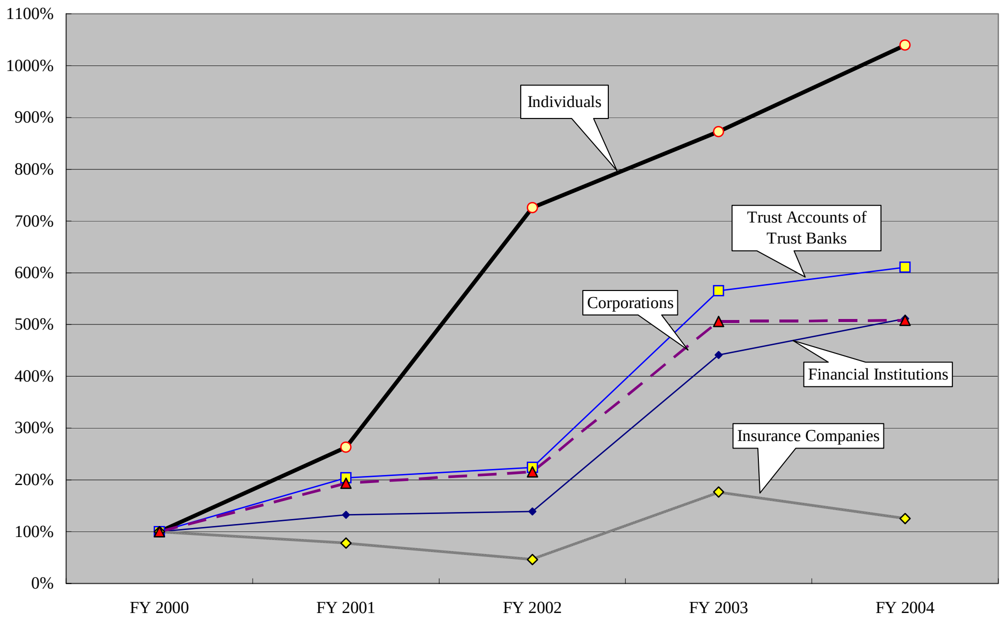


Chart 5 shows how the distribution amount in each category of investors increased in the five-year survey period.

[Chart 5] Increase of Distribution Amount by Category of Investor (FY2000=100)



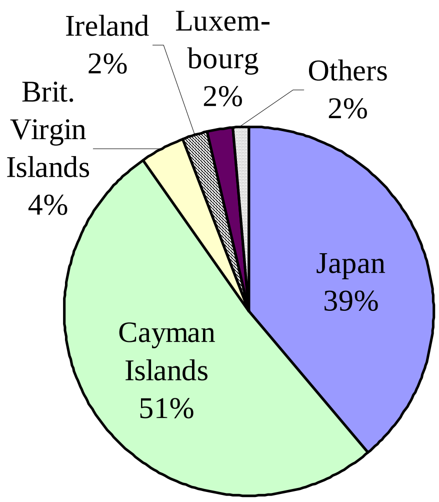
In the past five years, sales to individuals have remarkably increased; the sales amount in FY 2004 was more than 10 times that of FY 2000. The sales amount to the trust accounts of trust banks increased six-fold, and the sales amount to the financial institutions and corporations rose five-fold.

c) Country of Establishment of Hedge Funds

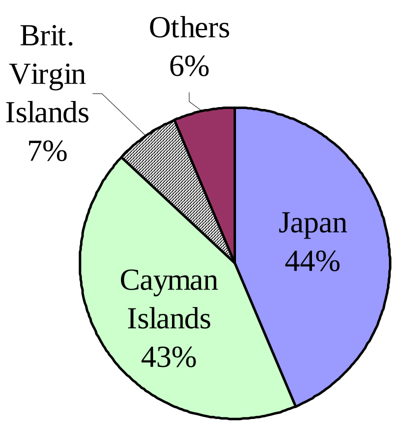
51% of the hedge funds sold in the survey period were established in the Cayman Islands; followed by Japan (39%), the British Virgin Islands (4%), Ireland (2%), and Luxembourg (2%).

Viewed from another angle, 44% of the hedge funds that the domestic securities companies distributed were established in Japan, but 84% of the ones that foreign securities companies distributed were established outside Japan. This could mean that foreign securities companies sold many hedge funds that were established outside Japan by their overseas group companies to domestic Japanese investors.

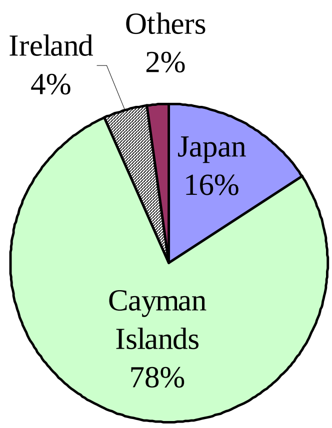
[Chart 6] Countries of Establishment of Hedge Funds Sold



[Chart 7] Countries of Establishment of Hedge Funds by Distributors



Countries of Establishment of Hedge Funds Distributed by Domestic Securities Companies



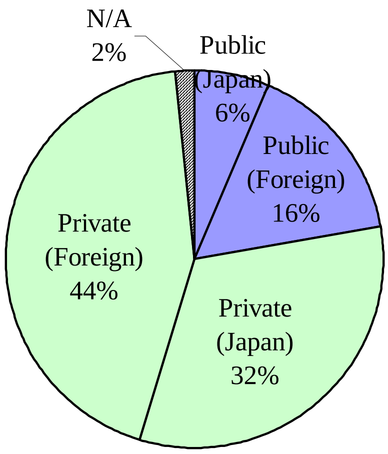
Countries of Establishment of Hedge Funds Distributed by Foreign Securities Companies

d) Form of Subscription

About three-quarters (76%) of the total hedge funds distributed in the survey period were private placement funds, amounting to ¥4,479.2 billion.

In addition, 57% of the private placement hedge funds, amounting to ¥2,568.6 billion (44% of the total distribution amount) were established outside Japan.

[Chart 8] Form of Subscription



e) Solicitation Policy of Hedge Funds

Of the companies that the FSA interviewed, none set any restrictions for sales of hedge funds, such as hedge funds to be separated from other investment products, and sales to the limited investors depending on the category of investors based on the size of assets under custody or investment experience, etc.

There was a company, however, which sold hedge funds in the department that was specialised to sell investment instruments to only high net worth investors, due to recognition of the importance for adequate explanation of hedge fund characteristics, including their risks, and then, when salespersons, who have customers other than high net worth investors, can understand the risks and other characteristics well, sales to all other investors were allowed in the company.

Distribution companies do not establish the solicitation policies which are specialised for hedge funds, but hedge funds are sold in accordance with the principle of suitability as well as other investment trusts. In this process, special points of consideration for hedge funds are as follows: investment strategies, frequency of availability of transactions, calculation method of the NAV and how to provide the NAV, etc. The distribution companies that the FSA interviewed did not categorise the hedge funds as the riskiest funds, but rather as middle risk funds.

f) Selection of Hedge Funds for Sales

Generally, foreign sales companies, which target to Japanese investors, sell the hedge funds which their group companies established, but Japanese sales companies sell not only hedge funds established by their group companies but also ones that are established by the companies outside their group.

There was a company that chose to sell funds that only the management company or trust bank in the same group were involved in the management. This was due to preference for the smooth flow of funds in the case of an emergency where the redemption of the funds or providing the NAV is troublesome, *e.g.* when the market has sharply declined.

Each sales company tries to carefully select hedge funds that they sell. Selection is done by a special department in Japan. Some companies station staff in their overseas office, who are specialised in the selection of hedge funds (some companies establish a research company in a foreign country for selection of hedge funds) or ask other companies within the group, etc., to advise the fund selection.

(3) Survey Results for Those Who Invest in Hedge Funds

a) Outline

310 companies, one-quarter of the surveyed companies, were found to be investing in hedge funds, amounting to ¥6,083.2 billion[10] as of 31 March 2005. Among them, 15 companies held not less than ¥100 billion; 62 companies held not less than ¥10 billion but less than ¥100 billion; 116 companies held not less than ¥1 billion but less than ¥10 billion; and 117 companies held less than ¥1 billion.

As for the situation of hedge funds possession by categories of investors, 30 insurance companies held ¥1,627.4 billion (27% of the total amount); 10 city banks, etc.[11] held ¥1,279.1 billion (21%); 13 trust banks held ¥1,226.3 billion (20%); 86 regional banks held ¥908.7 billion (15%); and other 171 companies held ¥1,041.7 billion (17%).

b) Reasons to Invest in Hedge Funds

According to the surveyed companies whom the FSA interviewed, the prolonged historical low interest rates in Japan and the weak Japanese equity markets encouraged portfolio managers to review their portfolio to make them more profitable. They need to establish a new portfolio that is less correlative to the markets than the ordinary investment products, such as equity or fixed income products, and to pursue absolute return. These

[10] This is based on the amount when purchased.
[11] City banks, etc. include city banks, long-term credit banks and other new types of banks, etc. in this category. This categorisation is based on the “List of licensed (registered) Financial Institutions” by the FSA.

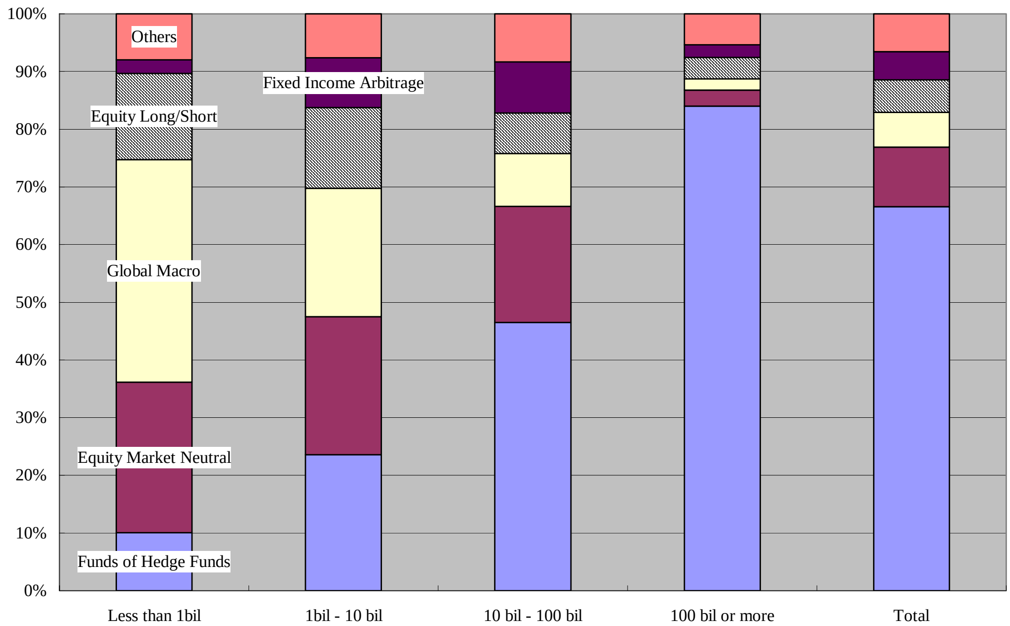
are said to be the reasons for starting to investment in hedge funds.

c) Hedge Fund Strategies

Of total held hedge funds, 67% were funds of hedge funds; followed by equity market neutral (10%), global macro (6%), equity long/short (6%), and fixed income arbitrage (5%).

Chart 9 shows the hedge fund strategies by the size of investment. In the category of investors who held hedge funds equal or more than ¥100 billion, more than 80% of the total amount was funds of hedge funds. However, the less the investors hold, the less they hold funds of hedge funds, and the more they hold equity market neutral, global macro and equity long/short strategies.

[Chart 9] Hedge Fund Strategies by Size of Investment



Investment in funds of hedge funds seems aimed at reducing risk concentration. In order to maximise the effect, investors are alert not to select the same gatekeepers, who choose single hedge funds, or not to concentrate on the same strategies in the funds of hedge funds.

d) Currency of Hedge Funds

61% of the total hedge funds held is denominated in Japanese yen and 38% is in US dollars. The remaining 1% is Euros and British pounds.

The more the investors invest in hedge funds, the more they have ones denominated in US dollars. For example, 53% of the hedge funds that investors who hold equal or more than ¥100 billion are denominated in US dollars, but it is only 19% for investors who hold hedge funds equal or more than ¥10 billion but less than ¥100 billion; it is only 5% for investors who hold hedge funds less than ¥10 billion.

The US dollar denomination is preferred because there is a large selection of hedge funds available in the US dollar hedge fund market than in the Japanese yen market; besides, major gatekeepers who select single hedge funds are usually located in the United States and most of the hedge funds that they select in the funds of hedge funds are denominated in US dollars.

e) Risks of Hedge Fund Investment

Hedge funds have generally been regarded as high risk and high return investment products, but historical data show that the hedge fund risks (standard deviation) were just single digits, while the risks of TOPIX were somewhere around the 10% mark. In fact, some investors recognised hedge funds as middle return investment products with mitigating investment risks.

f) Liquidity of Hedge Funds

Hedge funds have another characteristic, namely, they require time from the notice of redemption to the actual redemption that the investors receive cash. In response to investors' demand, some hedge funds have shortened the period of redemption notice; others ague that a redemption restriction prevents outflow of the funds, which may aid stable management of the hedge funds. There are investors who have the internal investment rule that allows to invest in hedge funds, which have only a certain period of redemption notice (*e.g.* within six months) in order to improve performance under the limited investment conditions.

IV. Hedge Fund Regulations in Major Securities Markets

Current hedge fund regulations in the major securities markets are explained in this chapter.

1. Japan

The current legislation in Japan does not provide for any explicit definition on hedge funds.

Hedge funds are considered as one of the collective investment schemes ("CISs"), *i.e.* a structure providing financial services that specialists invest money, which is collected from investors, in various assets and distribute profits from investment to the investors. The laws to regulate CISs are the Law for Investment Trusts and Investment Companies, the Commodities Fund Law, the Real Estate Fund Law. They regulate sales activities, activities of asset management, the fund itself and formation of vehicles, etc., in total.

The outlines of regulations of investment trusts, among CISs, are explained, in the following three aspects; (i) regulations for establishment of funds, (ii) regulations for fund management, and (iii) sales of funds.

(1) Regulations for Establishment of Funds

a) Form of Subscription

The Securities and Exchange Law ("SEL") defines the term of "public offering of securities" as solicitation of an offer for acquisition of securities to be newly issued, which is made to a large number of persons (excluding qualified institutional investors), and the term of "private placement of securities" which does not fall within the public offering[12].

The Law for Investment Trusts and Investment Companies ("LITIC") defines the term of "public offering" as solicitation of an offer for acquisition of beneficiary securities to be newly issued, which is made to a large number of persons (excluding qualified institutional investors), "private placement to qualified institutional investors" as solicitation made only to the qualified institutional investors, and "private placement to general investors" as solicitation, which does not fall within the public offering and private placement to qualified institutional investors[13].

[12] Paragraph 3, Article 2 of SEL
[13] Paragraphs 13 – 15, Article 2 of LITIC

b) Disclosure Requirements

In order to offer securities publicly, the registration statement of securities, which includes information of securities (such as, name of fund, issue price, term of subscription, etc.), information of funds (purpose of fund, investment policy, investment objects, investment management system, restriction on investment, etc.) and special information (financial conditions of investment trust management companies, etc.), shall be prepared and submitted to the Prime Minister (vested to the Commissioner of the FSA) in advance[14] and the prospectus shall be also prepared[15]. In case of private placement, however, both documents are not required.

c) Investment Advisers

Those who conduct investment advisory business with customers, based on the contract of investment management, shall register at the FSA under the Law Concerning Investment Advisers for Securities ("Investment Advisers Law"), and thus be subject to supervision and inspection by the FSA. However, if those who are judicial persons established by the foreign laws or natural persons domiciled in foreign countries, and conduct investment advisory business in foreign countries, conduct investment advisory business only to the authorised investment advisers in Japan, such registration is not required[16].

Investment advisers who conduct businesses based on the investment discretionary agreement are required to obtain authorisation from the FSA[17].

(2) Regulations for Fund Management

a) Regulation for Short Sale

Short sale is regulated in the SEL[18]. Securities companies shall give an explicit indication whether or not the sale of securities is a short sale in connection with the sale of securities in the exchange securities market provided by the securities exchange[19].

Securities companies shall confirm a person who places an order of securities whether or not the sale of the securities is a short sale, in connection with its acceptance of

[14] Paragraph 1, Article 4 of SEL; Article 10 of Ordinance of Cabinet Office Concerning Disclosure of Specific Securities
[15] Paragraph 1, Article 13 of SEL; Article 15 of Ordinance of Cabinet Office Concerning Disclosure of Specific Securities
[16] Article 4 of Investment Advisers Law; Article 2 of Cabinet Order for Enforcement of Investment Advisers Law
[17] Article 24 of Investment Advisers Law
[18] Section 1, Paragraph 1, Article 162 of SEL
[19] Paragraph 1, Article 26-3 of Cabinet Order for Enforcement of SEL

the order[20] and shall not make any short sale at a price lower than the price of the securities published immediately prior to such a short sale[21].

b) Regulations for Leverage

Regulations for leverage are stipulated in the regulations of Investment Trusts Association of Japan that the total market value of open interest of margin transactions in case of management of publicly offered investment trusts, of equities in case of equity borrowing and of bonds in case of bond borrowing shall be within the total net asset value of the investment trust assets[22].

c) Regulations for Assets

The LITIC and the Regulation for Management of Investment Trusts of Investment Trusts Association ("ITA Management Regulation"), etc. stipulate restrictions of kinds of assets which can be purchased in the investment trusts. Here are the major restrictions in connection with the securities investment trusts and funds of funds:

[Table 3] Restrictions for Securities Investment Trusts

	Public Offer	**Private Placement**
Principle	Not less than 50% of the total net asset value of the trust assets shall be invested by securities[23].	
Scope of equities, etc. in investment trust	Listed equities, etc.[24]	No restriction
Restriction on equity acquisition	More than 50% of the voting right of the equity issued by the same juridical person cannot be obtained[25].	
Restriction on futures transactions, etc.	Total unrealised loss of transactions shall be less than 50% of the total net asset value of the trust assets[26].	No restriction
Scope of funds to be invested	(i) There exist restrictions on foreign funds[27]. (ii) Total amount of funds shall be not more than 5% of the trust assets[28].	Investment in one fund shall be not more than 50% of the total net asset

[20] Paragraph 2, Article 26-3 of Cabinet Order for Enforcement of SEL
[21] Paragraph 1, Article 26-4 of Cabinet Order for Enforcement of SEL
[22] Article 15 of ITA Management Regulation
[23] Article 5 of Cabinet Order for Enforcement of LITIC; Article 3 of ITA Management Regulation
[24] Article 11 of ITA Management Regulation
[25] Article 16 of LITIC; Article 32 of Enforcement Regulation of LITIC
[26] Section 6, Paragraph 1, Article 15 of LITIC; Section 5, Paragraph 1, Article 27 of Enforcement Regulation of LITIC; Article 17 of ITA Management Regulation
[27] Paragraph 1, Article 12 of ITA Management Regulation
[28] Paragraph 2, Article 12 of ITA Management Regulation
[29] Paragraph 3, Article 12 of ITA Management Regulation

	Public Offer	Private Placement
	(iii) Investment by an investment trust management company in one fund shall be not more than 50% of the total net asset value of the funds to be invested[29].	value of the funds to be invested[30].
Scope of securitization products, etc.	Those which market price can be obtained[31].	No restriction
Others	(i) Total market value of open interest of margin transactions, of equities in case of equity borrowing and of bonds in case of bond borrowing and short sale shall be within the net asset value of the investment trust assets[32]. (ii) Funding is limited to the payment of redemption, etc.	No restriction

[Table 4] Funds of Funds[33]

	Public Offer	Private Placement
Scope of funds to be invested	There exist restrictions on foreign investment trusts.	No restriction
Investment in other than funds	There exist restrictions.	No restriction
Scope of real estate funds	There exist restrictions (limited to listed, OTC registered or those which market price is available).	No restriction
Scope of equity index linked funds	There exist restrictions (listed or those which market price is available).	No restriction
Investment restriction	Investment in one fund shall not be more than 50% of the total net asset value of funds of funds (not less than 30% in case of real estate funds).	Investment in one fund shall not be more than 50% of the total net asset value of funds of funds.

(3) Regulation for Sales of Funds

The trust deed of the investment trust shall be filed and delivered to investors in both cases of public offer and private placement[34]. The management report shall also be prepared and delivered in principle[35].

[30] Article 21 of ITA Management Regulation
[31] Article 13 of ITA Management Regulation
[32] Article 15 of ITA Management Regulation
[33] Chapter 3 of ITA Management Regulation
[34] Paragraphs 1 and 2, Article 26 of LITIC
[35] Paragraph 1, Article 33 of LITIC

[Table 5] Disclosure Requirements on Investment Trusts[36]

	Disclosure Document	Public Offer	Private Placement: For Institutional investors	Private Placement: For less than 50 people
Primary Disclosure (Disclosure on Issuance)	Preparing and filing securities registration statement	Necessary	Not necessary	Not necessary
	Preparing and filing prospectus	Necessary	Not necessary	Not necessary
	Preparing, filing and delivering trust deeds	Necessary	Necessary	Necessary
Secondary Disclosure	Preparing and filing securities report	Necessary	Not necessary	Not necessary
	Preparing and filing semi-annual securities report	Necessary	Not necessary	Not necessary
	Preparing, filing and delivering financial report	Necessary	Necessary	Necessary

The investment advisers shall prepare and deliver the statement report of the customers' assets under the investment discretionary agreement at least once in six months to the customers with whom they have an investment discretionary agreement[37].

2. United States[38]

3. United Kingdom

4. Germany

5. Hong Kong

V. Recent Development around Hedge Fund Regulations

1. International Organization of Securities Commissions

2. Securities Regulators

3. European Union

4. International Monetary Fund

5. Private Sector

[36] Chapter 3 of ITA Management Regulation
[37] Paragraph 1, Article 32 of Investment Advisers Law
[38] As mentioned in the contents, hedge fund regulations in other major markets and the recent development around hedge fund regulations, which exist in the original Japanese version, are not translated.

VI. Discussion Points

1. Investors' Protection and Market Integrity

(1) Need for Hedge Fund Regulation

The International Monetary Fund issued a report[39] in September 2004, which contained one chapter on hedge funds, and said "*The primary goal of most official bodies is to better understand hedge fund operations and their potential impact on systemic risk, not necessarily to regulate these funds*". But, investor protection is one of the important regulatory and supervisory missions for the securities regulators, and it has been discussed whether the role of the regulators should be narrowly focused on the systemic risks and limited to monitoring of hedge funds only through the regulated financial institutions. In addition, the Counterparty Risk Management Policy Group II ("CRMPG II"), composed of senior officials from US major financial institutions, chaired by Mr E Gerald Corrigan, also said in a report[40] that "*the Policy Group continues to believe that indirect regulation has considerable merit. … Using the indirect method, regulators would collect and aggregate large exposure data from traditionally regulated institutions and, through those institutions, collect data on hedge fund activity*". But, it has been also discussed whether it is enough to collect hedge fund data only indirectly, in order to review the risk management capacity of those involved in the hedge fund businesses and whether those involved in the hedge fund businesses should be more directly regulated.

Looking at the latest situations in other countries, there are two types of regulations: (i) hedge fund managers or distributors, who arrange or sell hedge funds, to be registered at the authority; or (ii) hedge funds themselves to be registered at the authority, if they are sold to public investors. In this report, the cases in other countries[41] were introduced; the US, the UK and Hong Kong are the former cases, and Germany is the latter case. The current legislation in Japan does not provide for any explicit definition of hedge funds, however, Japan may be categorised as the former case as investment trust management companies, investment advisers as arrangers of funds, and securities companies and banks, etc., as distributors of funds are regulated.

In the viewpoints of investors' protection, some countries introduced hedge fund

[39] International Monetary Fund, "Global Financial Stability Report – Market Developments and Issues", September 2004. pp45-58 "Hedge Fund Industry: Developments and Practices"
[40] Counterparty Risk Management Policy Group II, "Toward Greater Financial Stability: A Private Sector Perspective", July 27, 2005
[41] *cf*. note 38.

regulations, such as: minimum investment amount to hedge funds; in the case of sales to the public investors, a certain restriction to the hedge fund assets; authorisation from the regulatory authority; cooperation between the regulators in the case of cross-border sales of hedge funds, etc. The regulations for the distributors, such as capital requirement, experience of fund managers, are also introduced in some countries.

(2) Investor Protection

Generally, a large minimum investment amount is set for hedge fund investment, since the main target investors are high net worth customers or institutional investors. However, an increasing tendency has been observed regarding hedge funds with moderate size of minimum investment amount to attract wider range of retail investors. The FSA's survey results show that the sales amount to the retail investors increased ten-fold in five years.

In Hong Kong, the Securities and Futures Commission ("SFC") proposed to reduce the minimum investment amount to single hedge funds from US$50,000 equivalent to US$30,000 equivalent, when the SFC reviewed their hedge fund regulations, but the SFC finally decided not to change the minimum investment amount as "*respondents who are in frontline retail sales such as brokers and investment advisers, opposed the lowering of the threshold on the grounds that the investing public are still not familiar with the investment features and risks associated with hedge funds. The SFC has concluded that, on balance, it is not appropriate at this stage to reduce the minimum subscription level of single hedge funds from US$50,000 to US$30,000, having regard to the feed back from practitioners conversant with retail practice*[42]".

On the other hand, in the U.K., public investors cannot buy unregulated collective investment schemes, but they can buy it if they take proper steps. The UK Financial Services Authority ("UK FSA") raised issues of regulatory regime in the Discussion Paper[43] as to whether they should strengthen the regulations or allow providing wider range of investment products.

Some surveyed financial institutions did not consider hedge funds as high risk/high

[42] Securities and Futures Commission, "Consultation Conclusions on Consultation Paper on the Review of Chapter 8.7 of the Code of Unit Trusts and Mutual Funds", September 2005

[43] Financial Services Authority, "Wider range retail investment products: consumer protection in a rapidly changing world", June 2005

return investment products. As the survey refrained from close scrutiny into investors' individual risk management situation, it might be necessary to address suitability issues, such as (i) how to identify investor risk management capacity; (ii) how their risk management capacity could be improved, and (iii) whether non-professional investors should be segregated from the hedge fund market.

(3) Market Integrity

a) Hedge Funds' Own Risks

Securities regulators have strong interest in the market integrity regarding hedge funds. As the hedge fund market has expanded, risks owned by the hedge funds and the prime brokers as the counterparties of the derivative transactions and credit exposure of the hedge funds have also increased, and some regulators strongly recognise the possible significant impacts on the market when the markets become volatile.

In 2004, the UK FSA conducted the survey on prime brokers' activities and published the Discussion Paper[44] in June 2005, where they identified some risks of hedge funds to be examined such as control issues, risk management, market abuse (*e.g.* insider trading and manipulation, etc.), fraud, money laundering, conflicts of interest, etc.

The Discussion Paper also identified a risk of conflicts of interest where "*[u]nlike the situation for collective investment schemes, hedge funds are not required to have independent depositaries or trustees whose role is to ensure that the funds' assets are valued in line with regulatory rules. … This reflects the significant conflict of interest that would in turn determine the amount of performance fees it earned*". The Paper also identified valuation method and its correctness of illiquid assets that hedge funds often invested in illiquid investment products or complicated structured products. This valuation issue should be primarily discussed as a matter of risk management capacity of investors or how hedge fund investors could manage market risks of hedge funds.

As the survey refrained from close scrutiny into investors' individual risk management situations, it might be necessary to monitor closely the hedge funds' risks identified by the UK FSA in the Discussion Paper, such as control issues, risk management, market abuse (*e.g.* insider trading and manipulation, etc.), fraud, money laundering, conflicts of interest, etc., under the current regime of inspection and supervision.

[44] Financial Services Authority, "Hedge funds: A discussion of risk and regulatory engagement", June 2005

b) Discussion Points for Collective Investment Schemes

The IOSCO said in their 2003 report[45] that, "*hedge funds do not give rise to a number of other regulatory issues that are important, such as: short selling; fee structures; whether the use of derivatives by hedge funds could lead to a more relaxed regulation of use of derivatives by traditional funds; the use of benchmarks as a source of information for investors to compare the results of the CISs they invest in; and the methods of distribution and the quality of the advisers. These issues are, however, not limited to hedge funds as a phenomenon, and may warrant broader consideration than just in the hedge funds context*". As the report pointed out, it might be appropriate to discuss the hedge fund issue from a wider perspective.

(4) Stability of Financial System

The CRMPG II expressed their opinions of hedge funds regulations and risk management of the financial institutions in the paper[46], from the viewpoints of addressing risks that seriously impact the whole financial system.

At this moment, the hedge fund market is relatively limited in Japan, and the transactions involving financial institutions might not be extensive. However, financial institutions are significantly increasing their exposure to hedge funds, accounting for half of hedge funds sold in the market. In this context, a continued monitoring under the current regime of inspection and supervision may be needed as to the transactions of hedge funds with financial institutions, specifically the internal control, such as, timely procurement of the NAV of hedge funds; secure execution of the OTC transactions; counterparty risk management; avoidance of conflicts of interest, etc., and study of potential impact on the market stability by transactions of financial institutions, etc.

2. Monitoring Hedge Fund Markets

(1) Definition of Hedge Funds

As mentioned in this report, currently, there is no established definition of hedge funds, and it seems difficult to define them. For the purpose of the survey, hedge funds were defined as "the funds that (i) use leverage, (ii) charge a performance fee, and (iii) use hedge fund strategies (including funds of hedge funds)," but the survey results show that

[45] *cf*. note 4.
[46] *cf*. note 40.

there are a considerable number of funds which do not use leverage or charge a performance fee, but utilise hedge funds strategies. In order to monitor the hedge fund activities more appropriately and effectively, it might be necessary to discuss how to define hedge funds, drawing on discussions at the IOSCO, other regulators or various international fora.

(2) Reporting Hedge Fund Data

It is said that there are very few reliable hedge fund data bases that could show the whole picture of the hedge fund industry. A private data base is widely used in the market in order to grasp the market size and the market trend, but there exist many limitations of its use due to voluntary reporting by hedge fund managers[47].

It might be necessary to introduce periodical reporting to the regulators in order to adequately monitor and analyse hedge fund activities and address the issues based on the analysis as arrangement, distribution and investment in hedge funds, in addition to the general information about the hedge funds to be published. It should also be considered to establish cost effective data collection or reporting and efficient analysis of hedge funds and their risks based on the reporting.

(3) Further Strengthening of International Cooperation

As the survey results show, many hedge funds distributed to the Japanese investors were established outside Japan as private placement funds[48]. Even if the regulations on the funds themselves were introduced in Japan, the regime under the Japanese jurisdiction should have a limit to its enforcement. Actually, the UK FSA regulates hedge fund managers domiciled in their jurisdiction, rather than the hedge funds themselves, which are mostly established outside the UK. From this viewpoint, strengthening of international cooperation multilaterally with the IOSCO or bilaterally with other regulators is imperative.

3. Conclusive Remark

The FSA has raised some discussion points, such as need for hedge fund regulation, investor protection and market integrity, etc. They are based on the information from the first comprehensive survey results conducted on the regulated financial institutions under

[47] The issues of the private hedge fund data base were examined in detail in the report issued by the Bank of Japan. See note 3.
[48] See Chart 8 on page 13.

the FSA and on the latest discussions in the IOSCO or other foreign regulators, etc. It is evident from the survey results that the customer base of the hedge funds has been enlarged and deepened due to market enlargement and a sharp increase of distribution to retail investors. Whereas cross-border activities of hedge funds are also increasing, the IOSCO and foreign regulators are discussing appropriate hedge fund regulations.

Based on the situations, the FSA will further discuss what ought to be suitable for hedge fund regulations in Japan, from the viewpoints of ensuring investors' protection and market integrity, with due regard to international developments.