PRESS RELEASE

THE REGULATION OF HEDGE FUNDS IN SOUTH AFRICA

Update and the Release of the Comments and Response Document by the National Treasury and Financial Services Board

Background

In 2012, South Africa, as a committed member of the G20, embarked on a process to enhance and expand the scope of regulation and oversight over hedge funds, following the Global Financial Crisis in 2008. This process culminated in the release, on 13 September 2012, of the National Treasury ("Treasury") and Financial Services Board ("FSB") proposed framework for regulating hedge funds in South Africa.

The framework proposes that the regulatory framework for hedge funds be effected through the existing Collective Investment Schemes Control Act, No. 45 of 2002 ("CISCA"), as a declared scheme by the Minister of Finance in terms of section 63 of CISCA.

National Treasury and the FSB asked for public comments on the proposed framework by 15 November 2012 and received extensive and valuable comments from 21 industry bodies, regulatory bodies and other interested parties, as detailed in the attached **Annexure A**. Engagements were also held with some of the industry bodies. The Treasury and the FSB are grateful for these engagements and comments, and have considered them carefully.

The Public Comments and Our Responses

Treasury and FSB hereby release preliminary responses to the public comments as set out in **Annexure A**. The comments largely welcome the proposed regulatory framework. Further details will be provided for in the draft Regulations. A few key common themes were identified from the comments, and are summarised below, including also our responses.

- ***The Distinction between Retail and Restricted Hedge Funds***

  A concern was raised regarding the distinction between Retail and Restricted Hedge Funds. It is now proposed that Restricted Hedge Funds be renamed Qualified Investor Hedge Funds ("QIHF"), to accurately reflect their nature and the commensurate regulation. Retail Hedge Funds are envisaged to comply with stricter regulation to ensure commensurate protection of ordinary investors, while the Restricted (Qualified Investor) Hedge Funds will target qualified investors, with commensurate and proportionate regulation, and focus on systemic risk reporting, monitoring and adequate disclosure to investors.

- ***Definition of a Hedge Fund***

Concerns were expressed that the definition in the proposed framework differs from the one under legislation promulgated under the Financial Advisory and Intermediary Services Act, No. 37 of 2002, and that this could lead to anomalies and inconsistent approaches. Treasury and FSB prefer the definition in the FAIS legislation for the hedge funds declaration and Regulations.

- ***Allowed Legal and Operational Structures for Hedge Funds***

Concerns were raised on how existing hedge fund structures would be accommodated in the new dispensation. Existing hedge funds will be accommodated in the Retail Hedge Funds (RHF) structure or/and QIHF structure. Both the QIHF and RHF will have to register their respective current and proposed structures with the FSB, in terms of the declaration under CISCA. The RHF structure will be similar to the current structure for Collective Investment Schemes in Securities, which requires a CIS Manager and a trustee to establish a scheme. An existing hedge fund structure will be able to convert into a RHF, provided it complies with the requirements of the Regulations for a RHF.

The QIHF will also be required to register as a CIS Manager and will be able to register any current structure (partnership, company or trust). A QIFH will also be required to have a Governing Body to ensure proper accountability; for example, where the hedge fund is structured as a partnership, the board of directors of the general partner would constitute the governing body. A QIHF manager intending to <u>also</u> undertake retail hedge fund business will need to establish a scheme with a trustee, as contemplated under CISCA. A diagram and further details on the structures are provided in **Annexure B**.

- ***Ancillary Issues***
  1. **Valuation:** Treasury and FSB remain of the view that the valuation of hedge funds should be done only by independent third-party (i.e. separate from the group) valuators.
  2. **Liquidity:** A tiered approach to liquidity requirements is recommended, with proposed 14, 30 and 90 day requirements for vanilla CISs, RHFs and QIHFs, respectively.
  3. **Separation of Assets:** There should also be legal and physical separation of assets between the prime broker and custodian, to enhance investor protection and financial stability. Only prime brokers regulated by the SA Reserve Bank and/or JSE Securities Exchange will be endorsed.
  4. **Leverage:** As part of commensurate tiered regulation, QIHFs will be required to set their own leverage limit and to disclose this to investors, while there will be regulatory set appropriate leverage limits for RHFs. A

higher industry soft upper limit will also be considered to enable systemic risk monitoring.

v. **Pricing:** Lastly, the pricing frequency of hedge funds' assets will be dependent on the trading frequency of the fund.

Process going forward

The public comments have laid a good foundation for the drafting of the Regulations. A drafting panel constituted by the FSB, Treasury, experts and relevant industry associations will prepare a draft of the Regulations, to be issued in the first quarter of 2014 for public comments. The final Regulations, with the relevant CISCA Ministerial declaration, are envisaged to be finalised by the second quarter of the year. The Regulations will take into consideration the relative size of the industry in South Africa, the current trends in the local industry and the type of hedge funds operated. A transitional period for implementation will also be considered.

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