



Proposed Regulatory Framework for Foreign Member Funds in South Africa

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1. Introduction

- 1.1 South African institutional investors are allowed to invest offshore subject to various foreign investment limits, depending on the type of institutional investor. Retirement funds and the non-market linked business of insurance companies can invest up to 25 percent of their total retail assets and collective investment schemes, asset managers and market-linked business of insurers can invest up to 35 percent their total retail assets. An additional 5 percent is allowed for investments into Africa.
- 1.2 The rationale for this policy is to strike a balance between diversification of investments by institutional investors and to manage (excessive) foreign risk. The challenge, however, with the current institutional investment framework is that all institutional investors of South African origin are subject to a foreign investment limit. This limit makes it difficult and uncompetitive for local fund managers to be used by foreign investors to manage foreign sourced funds using South Africa as a domestic base to invest in Africa and internationally. This is also in the context of SA not having capital controls on non-residents.
- 1.3 To promote SA as an investment management hub for investment into Africa and the rest of the world, the Minister of Finance announced the introduction of another class of investment vehicles, called *foreign member funds* (FMF) during the 2014 Budget (see Box 1)¹. The FMF will be exempted from the applicable macro-prudential foreign exposure limit. Against this background the Financial Services Board (FSB), and the South African Reserve Bank (SARB), in consultation with the National Treasury have developed this framework that sets out the proposed framework for establishing regulation for FMFs in South Africa and to provide guidance on the way forward.

Box 1: 2014 Budget announcement

Foreign member funds

All institutional funds are currently subject to a macro-prudential limit. The National Treasury proposes to introduce “foreign member funds”, which are not subject to the macro-prudential limit. These funds are collective investment schemes and alternative investment funds (including private equity, venture capital and hedge funds), which may source funding from:

- *Non-residents*
- *Domestic institutional funds (subject to their macro-prudential limit)*
- *Individuals (subject to their annual investment limit)*

Foreign member funds must be domiciled, managed and tax compliant in South Africa, and are subject to registration with the Financial Services Board and the Reserve Bank.

These funds will support South Africa as a hub for African fund management.

¹ <http://www.treasury.gov.za/documents/national%20budget/2014/review/Annexure%20W3.pdf>

2. Purpose

- 2.1 A working group consisting of officials from the NT, FSB and SARB has prepared this framework document for the introduction of the FMFs in South Africa. The purpose of the document is to provide a brief outline of the important issues relating to the proposed regulation of FMFs and to invite comments on the preliminary regulatory proposals.
- 2.2 Given that an FMF is a pooled investment vehicle and can easily be accommodated in the regulatory framework established by Collective Investment Scheme Control Act, 2002 (“CISCA”), it is proposed that FMFs be regulated and supervised under CISCA through the creation of a new category of collective investment schemes for FMFs.

3. Policy/Regulatory Objectives

- 3.1 The policy objective of the FMF framework is to enable and encourage foreign investors to use South Africa and its investment management industry as a hub and gateway for investments into Africa and the rest of the world. Secondly, the objective is to also provide a domestically regulated channel for local investors to obtain foreign exposure, subject to the applicable macro-prudential limits. The intention is also to attract foreign capital.
- 3.2 The proposed regulatory framework aims to create a favourable regulatory environment that will facilitate the flow of foreign capital through South Africa and thereby make it seamless and attractive for foreign funds to invest into the rest of Africa (and beyond) through South Africa. Certain restrictions such as the foreign portfolio macro-prudential investment limits will be relaxed for FMFs, making it easier and attractive for foreign funds to be managed from South Africa. An FMF may source funds from non-residents (natural or legal persons, or retail and institutional clients), domestic institutional investors (whose investments in the FMF will remain subject to macro-prudential limits) and individuals (who will remain subject to their annual investment limits).
- 3.3 Regulatory objectives include enhanced investor protection for domestic and foreign investors compared to the relatively limited protection when domestic investors invest directly offshore. The aim is to achieve these objectives through mandatory registration of FMFs with the FSB and adequate supervision, including comprehensive disclosure requirements to both the investor and the regulator.

4. Definition

- 4.1 The following definition for an FMF is proposed:-

“foreign member fund” means a collective investment scheme established and managed in South Africa which:

- (a) invests mainly in foreign assets and securities,

- (b) sells and repurchases participatory interests in a foreign currency, and
 - (c) obtains investments from resident or non-resident investors.
- 4.2 An FMF, is a locally registered collective investment scheme (CIS) managed in South Africa that invests in foreign assets and securities, and that may source funds from non-residents and domestic investors. It will have no foreign exposure limits. Although the FMF must be registered in South Africa, its shareholders and/or promoter may be based in a foreign country. It is proposed nonetheless that as a minimum requirement and for accountability, the managing director of the structure must be resident in South Africa.

5. Other Required Regulations

- 5.1 The following are the proposed regulatory considerations:
- 5.1.1 No limits should apply to the amount of money that an FMF may take outside of South Africa, as is currently imposed by the SARB (exchange control), given that the FMF will be essentially or largely targeting foreign funds and investors
 - 5.1.2 The appropriate tax treatment for the proposed structures, international investor relationships need to be considered with a view to allow for a flow-through of income to non-residents invested in FMF's.
 - 5.1.3 A foreign currency denominated account needs to be allowed for an FMF scheme of domestic origin to reduce the transaction costs, accommodate currency conversion issues and allow for flow-through into targeted offshore investment assets. An FMF scheme of foreign origin (depicted in structure 1) and an FMF utilising existing CIS structures (depicted in structure 2) will qualify to open a foreign currency denominated account for their FMF schemes.
 - 5.1.4 Loop structures that are prohibited under the Exchange Control requirements were considered and FMFs will be permitted to invest back into South Africa without being regarded as loop structures.
 - 5.1.5 Reporting will be required for financial regulation purposes and for monitoring foreign capital flows associated with the FMF. Investments by individuals into the FMF are reportable transactions for the purposes of balance of payments. Local institutional investors' investments into the FMF will be marked-off against their foreign asset allocation in the SARB Quarterly Asset Allocation Report. The current quarterly reporting mechanism for ordinary CIS will be applied to the CIS FMF. SARB Financial Surveillance Department (FSD) and NT will design a reporting template for an FMF to ensure reporting requirements specifically applicable to FMF's (note that CIS's currently also have to report in a required format).

See Annexure A, which provides an illustration of the flow of funds under the FMF framework.

6. Guiding Principles

- 6.1 **South Africa as a platform for investments:** The purpose of FMFs is to provide a facility for international and domestic investment managers to use South Africa as a platform for international investment with foreign and domestic investors. Domestic investors' contributions to the fund will be limited to foreign investment macro-prudential limits allowed under exchange controls.
- 6.2 **Alignment of regulation to international best practice:** In order to attract foreign investments, the relevant regulations should be in line with international best practices. The Directive on Undertakings for Collective Investment in Transferable Securities (UCITS) is the main European framework covering the regulation of collective investment schemes. The Alternative Investment Fund Managers Directive 2011/61/EU ("AIFMD") is a European Union law on the financial regulation of hedge funds, private equity, real estate funds, and other alternative investment fund managers (AIFMs) in the European Union. For the most part, South African collective investment scheme legislation is continually updated to remain in line with UCITS framework. As a member of the International Organisation of Securities Commissions (IOSCO), the FSB constantly aims to embed the IOSCO principles into its regulations like other jurisdictions, including European jurisdictions.
- 6.3 **Encouraging investment into Africa:** Although the initial policy proposal for the establishment of FMFs in South Africa strongly focused on a competitive vehicle for investment into and from the rest of Africa, investment from anywhere in the world and into the rest of the world will be accommodated.
- 6.4 **Accommodating African specific needs:** However, the majority of investment opportunities in the rest of Africa are currently not regarded as UCITS or CISCA compliant pertaining to specifically the criteria for permissible investments. Accordingly, it is proposed that FMF regulations provide for and specifically accommodate African investments and funds that may hold UCITS' non-permissible assets as a separate demarcated type of a CIS portfolio. However where this is utilized, it would create a barrier for the FMF as an available investment for UCITS investment because the FMF will hold UCITS' non-permissible securities.
- 6.5 **Application of foreign investment limits:** FMFs will not require a limit to their foreign investment exposures, unless it is part of the particular portfolio's investment mandate. Investors can be non-residents, whose investments into the South Africa-domiciled FMFs will be unrestricted from a South African regulatory perspective (given that SA does not have capital controls on non-residents), domestic institutional investors (whose investment into the FMF's will remain subject to their permissible foreign exposure macro-prudential limits) and South

African resident individuals (who will remain subject to their annual foreign capital allowance). Non-residents will be able to transfer their foreign currency denominated investments to the FMFs foreign currency accounts or convert Rands to foreign exchange for investment in FMFs. As is currently the case with all foreign investment, South African investors will be required to convert Rand to foreign currency through a local Authorised Dealer if they wish to invest in a FMF that is denominated in a foreign currency.

6.6 **Registration:** All FMFs must be registered as collective investment schemes with the FSB (Registrar of Collective Investment Schemes), based and managed in South Africa and subject to South Africa’s tax laws. An FMF must also be registered with the SARB for reporting and monitoring of cross-border flows.

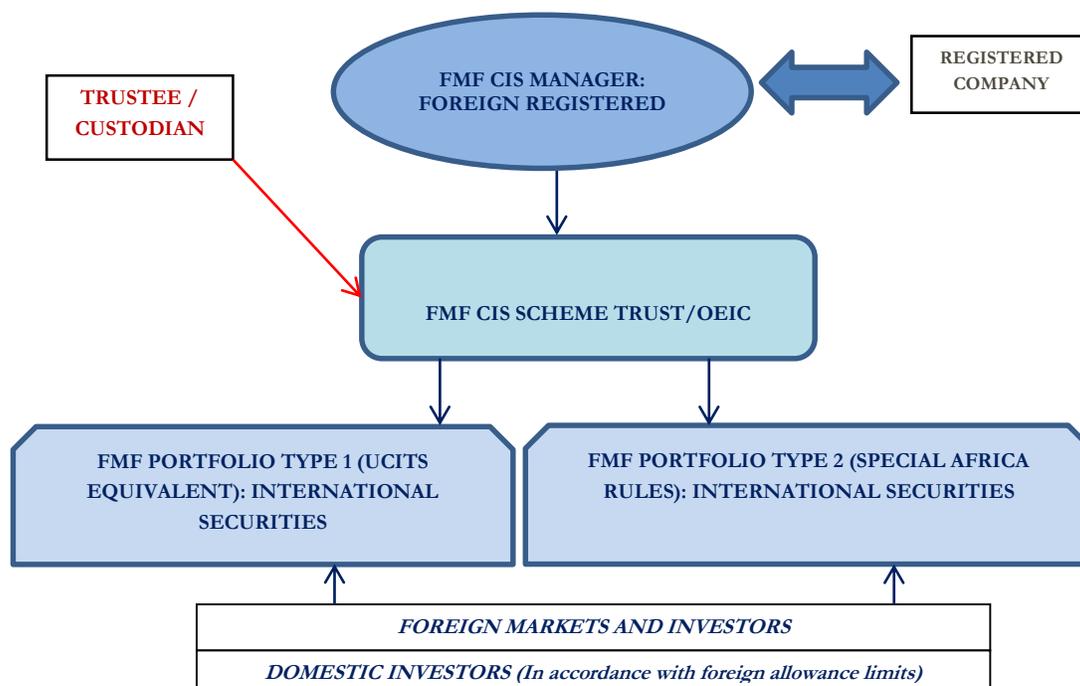
7. Proposed Structures

7.1 Any FMF structure to be implemented needs to provide for a:

- (a) South African registered CIS Manager that has been set up and promoted by a South African company or group of companies, or
- (b) Foreign registered asset manager/CIS manager approved for administration or other promoting financial institution (promoter or owner through shareholding) in an acceptable foreign jurisdiction that wishes to establish an FMF CIS Scheme in South Africa.

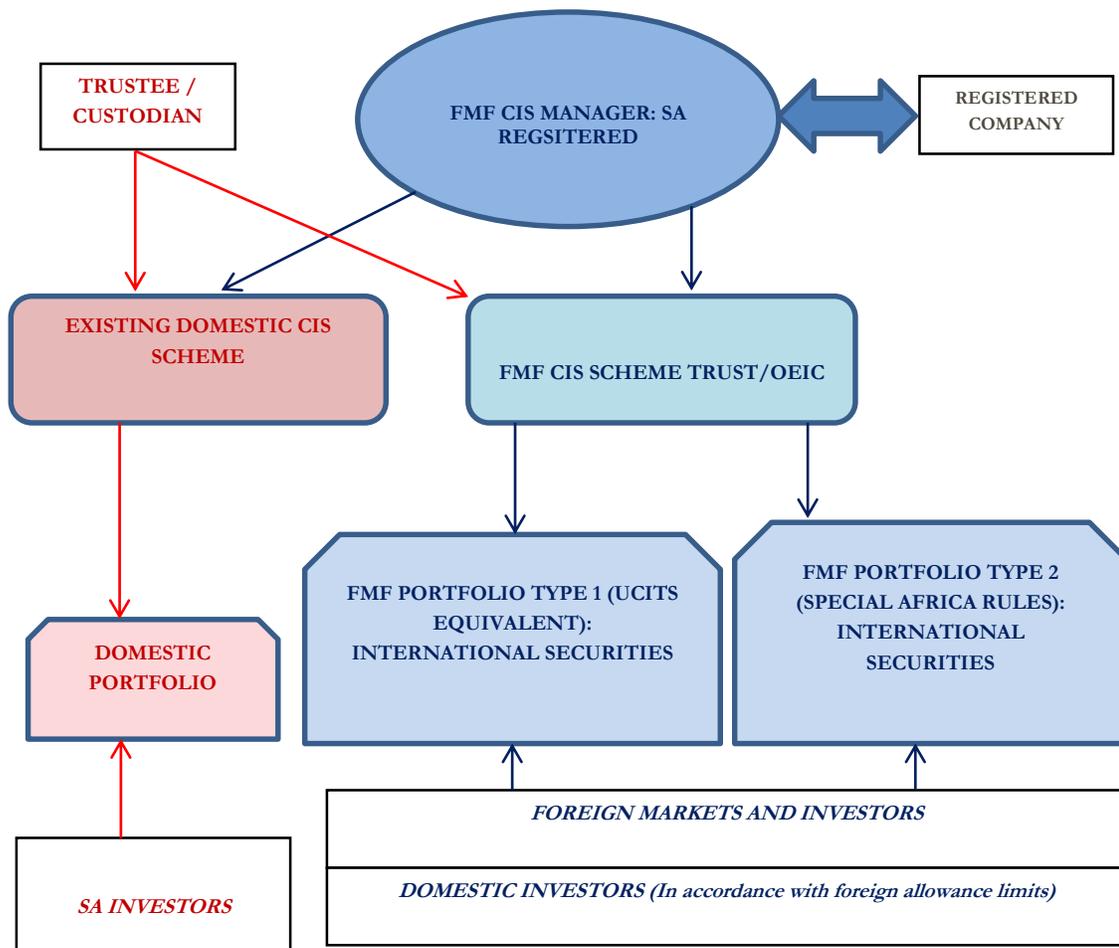
7.2 The following schematics highlight the different possibilities for establishing FMFs according to the two major sources of promoting and establishing an FMF, namely from a foreign or domestic source. The foreign promoter may want to utilise an investment manager from its own jurisdiction. A domestic manager is expected to register an additional FMF scheme.

Structure 1: Foreign registered manager initiated



- 7.3 The first structure (structure 1) envisages a scheme where a foreign CIS manager establishes domestic presence (domestic office) and manages a scheme that targets foreign investors as well as local investors. The foreign CIS manager will be regulated in terms of South African legislation, whilst managing investment portfolios of foreign and local investors. The scheme may be structured as a trust or an open-ended investment company. A trustee/custodian is required to hold assets on behalf of the investors. CIS managers under the FMF framework will have an option to have UCITS and non-UCITS compliant portfolios (Africa focused) depending on their targeted investor markets.
- 7.4 The second structure (structure 2) provides for existing domestic CIS managers to establish and manage FMFs. Under this structure, a separate FMF scheme will be registered and this scheme's portfolio(s) can be administered alongside the existing domestic scheme(s). CIS managers under the FMF framework will have an option to have UCITS and non-UCITS compliant portfolios (Africa focused), depending on their targeted investor markets.

Structure 2: SA registered manager initiated



- 7.5 Whereas the South African structures are based on the traditional collective investment scheme structure (a unit trust), most foreign schemes are corporate based. Accordingly, foreign schemes

may not be conversant with the existing South African (unit trusts) structures and therefore corporate structures, such as open-ended investment companies (OEICs), may have to be utilised and accommodated for the first time².

- 7.6 Consideration will need to be given to whether mirrored existing foreign structures will be permitted to register in SA and how this will be regulated, as it may be a preferred approach for many foreign promoters.
- 7.7 The other elements of the structures as indicated in the diagrams are discussed below.

8. Platform

- 8.1 Certain foreign promoters may wish to utilise some of the existing South African CIS managers' structures to host an FMF portfolio or FMF scheme on their behalf. Consideration will therefore be given to allowing a domestic CIS manager to provide its FMF 'platform' for the hosting of at least one foreign financial institution. It is to be expected in most of these instances that the investment manager would be a foreign registered and regulated investment manager. If necessary, the regulations pertaining to third party portfolios could be amended to provide for this scenario.

9. Empowering Legislation

- 9.1 CISCAs enables the Minister to declare a specific type of business to be a collective investment scheme to which the Act or any part or provision of the Act applies. Due to the potential special tax treatment and arrangements (exemptions, dispensations) for the FMFs that might differ from the other types of schemes, it is preferable that a declaration for a specific category of CIS be made, namely an FMF, which is to be defined and described in the declaration.
- 9.2 The necessary existing regulatory provisions under CISCAs that will be applicable to an FMF will be provided for in the declaration and further necessary regulations will be drafted and promulgated as indicated further herein.
- 9.3 All schemes and portfolios established under the FMF legislation will be captured under the framework for FMFs and it is proposed the words 'Foreign Member Fund' or the abbreviation 'FMF' be used in each registered name for a portfolio.

² Although CISCAs permits CIS's in different forms, regulations must first be put in place to enable implementation where it is different from a unit trust.

10. Overall Regulatory Provisions

10.1 It is proposed that specific regulations for FMF's be drafted in line with the 'Twin Peaks' framework of financial regulation. The FSB will however continue to update the regulatory framework and regulations pertaining to CIS in Securities on a regular basis to ensure comparability to and compliance with international best practices.

Prudential Regulations

10.2 Board Notice 90 of 2014 (BN90) determines the securities and assets that a CIS can invest in, and the limits and conditions under which securities may be included in a CIS portfolio. It is proposed that BN90 be revised to include the most recent developments in the industry and to update the provisions in so far as applicable in accordance with the latest developments under the UCITS and IOSCO.

10.3 Of further particular importance under BN90 is chapter VI that addresses the foreign equity and foreign non-equity securities in which a CIS portfolio may invest. The due diligence requirements provided for in these regulations are sufficient to assure international investors in line with international best practices.

10.4 These proposed amendments should provide for sufficient regulation for all FMF's, excluding those that invest extensively in the rest of Africa.

10.5 While the amended provisions may allow for the inclusion of certain higher quality securities from Africa, it would largely exclude most of Africa's investible securities as they would not currently fall within the due diligence criteria and, for example, the UCITS criteria. It would therefore be necessary to develop a separate set of regulations (within the revised BN90) for the inclusion of securities specific to investment into Africa, as will be discussed under section 11 below.

Disclosures, Advertising and Marketing Regulations

10.6 The Advertising, Marketing and Information Disclosure Requirements for Collective Investment Schemes (BN 92 of 2014) are comparable to similar regulations under UCITS. It is proposed that, as discussed in the section below, portfolios that invest into Africa outside of the UCITS equivalent regulations have a specific descriptor, as well as warnings and disclosures that are relevant to such an investment.

10.7 FMFs must ensure that marketing and advertising material clearly and accurately define and identify their target market, highlighting any distribution restrictions which may or may not be applicable.

Valuation and Pricing Regulations

- 10.8 The valuation of assets should be required to be performed in a similar manner as the regulations under UCITS and CISCA.

Registration and Operational Regulations (Fit and Proper)

- 10.9 All FMFs should be registered with or authorised by the Registrar of Collective Investment Schemes for the purpose of ensuring that the FMF meets all the CISCA requirements. Registration with the Financial Surveillance Department of the SARB will also be required.
- 10.10 Particular consideration needs to be given to FMF managers and schemes to be set up in South Africa from foreign owned and controlled schemes.
- 10.11 Firstly, as these foreign entities are not directly regulated by CISCA, the qualification criteria of applicants for FMFs from foreign jurisdiction must be addressed specifically and clearly. In this instance, the ‘Conditions for Approval’ under the regulations for Conditions in terms of which Foreign Collective Investment Schemes May Solicit Investments in the Republic (Board Notice 257) may be useful.
- 10.12 Secondly, it would be the expectation of the foreign entities that the existing structures in other jurisdictions would be applied in South Africa and accordingly it is proposed that these structures (e.g. OEICs and other corporate based schemes and mutual funds) need to be accommodated in South Africa for FMFs. This would require a clear basis upon which these structures are to be accepted and registered, provided they also comply with relevant South African laws.
- 10.13 There would accordingly also need to be proper guidance with regard to the jurisdictions that would be acceptable, and Chapter V of BN90 would need to be reviewed and updated (also see below the discussion on regulations for investment into Africa).

Capital Requirements Regulations

- 10.14 FMF managers should have similar capital adequacy requirements to those currently under CISCA.

Distribution

- 10.15 Where FMFs delegate any of their functions, the delegated functions may, in applicable circumstances, be subject to all relevant requirements of the Financial Advisory and Intermediary Services Act, 2002 (FAIS Act) in South Africa and CISCA. Where the products are distributed in foreign jurisdictions, the relevant laws of the particular country must be adhered to.

11. Regulations for Investment into Africa

- 11.1 As indicated and motivated earlier in the paper, it would be necessary to establish regulations governing separate types of FMF portfolios that could invest into African investments, securities and assets that would neither normally qualify under CISCA nor other international legislation, so as to differentiate those portfolios from portfolios that are aligned with UCITS legislation.
- 11.2 These type of portfolios, depicted as Type 2 portfolios in the Structure 1 and 2 diagrams, may however not be permitted to invest limitlessly in African investments and securities. Accordingly, specific regulations must be developed to determine the securities and assets that an African FMF may invest in, the manner of such investment and the limits and conditions subject to which securities may be included in a portfolio.
- 11.3 The regulations to be drafted will focus on a due diligence process that would, for example, include:
- (A) The acceptability of the jurisdiction, which could include:
- a. Considerations around political situation, possible political instability.
 - b. Freedom of domestic and international trade, and capital movement.
 - c. Does the jurisdiction have and enforce prevailing laws for the protection of capital markets and investors alike (e.g. similar to the FAIS Act).
 - d. Is the regulatory regime effective in protecting investors?
 - e. Does it have an operating, regulated exchange that provides reliable information on its traded securities?
 - f. In considering the appropriateness of a foreign exchange, the following must be taken into account:
 - i. the overall liquidity of the exchange;
 - ii. whether securities or derivatives may be bought and sold in a reasonable time, at best execution and in adequate amounts; and
 - iii. the procedures and restrictions, if any, on the repatriation of funds to the Republic.
- (B) The acceptability of the issuer:
- a. Capital structure and strength of the issuer.
 - b. Is the instrument issued against a strong balance sheet of the issuer?
 - c. Historic reputation of the issuer.
 - d. Accessible public information on the issuer, including its financial statements.
 - e. Is the issuer audited by independent audits and are the audit results freely available?
- (C) The acceptability of the instrument:
- a. Is the instrument a structured instrument with unknown elements?
 - b. Transparency of the nature and risks related to the instrument.

- c. Is the instrument guaranteed by an acceptable third party?
 - d. Private equity must be in actual equity and not company debt and must be limited in a portfolio.
 - e. Fixed income instruments should only be permitted in listed debt instruments and sovereign debt.
 - f. Depository products that are based on foreign currency, must be held by a bank in the respective country, e.g. interest earned on a fixed deposit in Ghanaian Cedi must be derived from capital held in a bank registered in Ghana.
- 11.4 Chapter V of BN90, however, provides for considerations that must be applied in a due diligence process for selecting appropriate foreign assets and securities. This list needs to be further reviewed specifically to meet the requirements of a wider approach for investment into Africa and be incorporated in the set of regulations for African CIS FMFs. It may essentially imply that the list of issues to be addressed under Chapter V of BN90 be revised for African investment purposes and some additional particular issues be added.
- 11.5 The remaining and relevant provisions of Board Notice 90 pertaining to exposure limits should continue to apply to FMFs targeting the African market.
- 11.6 Derivatives should not be permitted in these portfolios unless they are listed and traded on exchanges that are members of the World Federation of Exchanges (WFE) or the New York Stock Exchange (NYSE) or the London Stock Exchange (LSE). Any use of derivatives would in any event be subject to Chapter V of BN90 and may not be used in a speculative manner, but purely to hedge existing exposures and to assist in efficient portfolio management .
- 11.7 All foreign currency exchange should be done through an authorised dealer as defined by the SARB.

12. Conclusion

- 12.1 Comments are invited from the investment funds industry and other interested stakeholders. The framework document as well as public comments received will guide the drafting of the FMF Regulations.

ANNEXURE A

FIGURE 1: Flow of Funds

