national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

FSB

EXPLANATORY MEMORANDUM

ON THE DRAFT

REGULATIONS FOR HEDGE FUNDS IN SOUTH AFRICA

16 April 2014

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1. Background

1.1 History of hedge funds

A hedge fund is a pooled investment vehicle administered by a professional investment management firm, and can be structured as a limited partnership, company or trust.

The first hedge fund was established in the USA in 1949 by Alfred Winslow Jones, using his money and other investors' funds. His investment strategy entailed the use of two strategies to achieve an absolute return,[1] *viz.* leveraging and shorting securities. These two strategies still, to a large extent, define a hedge fund. Jones later required performance fees from investors to manage their investments.

Globally and for a long period, hedge funds have been operating in an unregulated space, both at manager and product level, and have generally been regarded as complex and exotic investment vehicles that are only available to High Net Worth Individuals and institutional investors.

The size of the global hedge funds industry, in terms of assets under management, funds and managers has grown significantly since 1949, with assets worth approximately US$ 2.6 trillion (R 22 trillion) and 14 700 funds managed by approximately 6500 managers in 2013.

1.2 Hedge Funds in South Africa

The hedge funds industry in South Africa is relatively small, with assets under management of approximately R 46 billion (US$ 4.6 billion) in 2013 (compared to the Collective Investment Schemes' assets under management of R 1.5 trillion in 2013), with approximately 107 funds managed by 55 managers. This relatively small size of the South African industry and its potential to grow, has also informed the nature and extent of the proposed regulatory framework.

South Africa has been unique, compared to its peers, since it has always regulated hedge funds at manager level (but not at a product or fund level) through the Financial Advisory and Intermediary Services Act, No. 37 of 2002 ("the FAIS Act").[2] In terms of FAIS, registered and approved hedge fund managers are issued with a Category IIA licence that authorises them to operate as discretionary Financial Services Providers ("FSPs") managing hedge fund portfolios.

[1] Absolute return strategy seeks to achieve a positive return on investment regardless of whether markets are rising or falling.

[2] Regulation at manager level generally means that all managers of hedge funds are required to register, in terms of the FAIS Act, with the Financial Services Board, to verify their fit and properness.

1.3 The Global Financial Crisis

The Global Financial Crisis ("GFC") of 2008, which was triggered by the collapse of the subprime mortgage market in the USA, caused major global disruptions in financial markets and economies. The crisis resulted in a major shift in how financial institutions are regulated and supervised. The nature and role of "shadow banking" also came under the spotlight (see below) and led to the call for the expansion and extension of regulations to cover private pools of funds and alternative investment vehicles like hedge funds.

Although it seems to be acknowledged that hedge funds did not cause the GFC, the role of hedge funds as major investors, especially using loans from banks (i.e. leveraging), contributed to the systemic risk and GFC.[3] The global scale and depth of the GFC required global coordination to reach a global solution.

1.4 The G-20 and regulation of hedge funds

At the peak of the GFC, the G-20 assumed the role of being the premier policy coordination forum, bringing together economies from both developed and emerging economies. The regulation of hedge funds is part of the 2009 G-20 Pittsburgh Leaders Declaration which highlighted the need to regulate privately pooled funds, including hedge funds. The G-20 considered it imperative to regulate what is termed "shadow banking", which entails banking activities by non-banking financial institutions which are not regulated (extensively) like banks, or unregulated financial activities by regulated financial entities . Hedge funds activities have been identified as "shadow banking".[4]

1.5 The process to regulate hedge funds in South Africa

South Africa remains a member of the G-20, and therefore committed to its decisions and processes. As part of the above-mentioned G-20 process, the National Treasury ("Treasury") and Financial Services Board ("FSB") released, on 13 September 2012, a proposed framework for the regulation of hedge funds in South Africa, for public comment. Extensive and useful comments were received from industry bodies and the public, and were carefully considered by the Treasury and FSB. A response document was then released on the 10th of February 2014, and is available on the Treasury and FSB websites. Industry participants and bodies were subsequently invited to provide input during the drafting process of the hedge funds regulations, which are released for public comment with this Explanatory Memorandum.

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[3] The primary cause of the GFC was the collapse of the subprime mortgage market in the USA due to their lack of performance. This collapse was in turn caused by imprudent mortgage lending to individuals who were not creditworthy and the subsequent default by many of those creditors. The secondary causal and chain reaction was arguably triggered by the collapse of Lehman Brothers, as a major counterparty to various investors.

[4] Other "shadow banks" include, for example, money market funds, securitisation vehicles, and private equity funds.

2. The Regulations for Hedge Funds

The regulations for hedge funds ("the Regulations") will be effected through the existing Collective Investment Schemes Control Act ("CISCA"), as a scheme declared by the Minister of Finance in terms of section 63 of CISCA. The declaration will also include those provisions of CISCA that will be applicable to hedge funds. These draft Regulations are issued by the Registrar of Collective Investment Schemes, as enabled and empowered by CISCA.

2.1 Definition and regulatory objectives

Hedge funds are distinct from traditional Collective Investment Schemes as they employ leverage (either in physical form or synthetically through the use of derivatives) and short selling. Their unique nature, therefore, necessitates a relatively unique approach to their regulation.

The draft Regulations define a hedge fund as a Collective Investment Scheme which uses any strategy or takes any position which could result in the portfolio incurring losses greater than its aggregate market value at any point in time, and which strategies or positions include but are not limited to leverage or net short positions.[5]

Hedge funds tend to be perceived as and can actually be risky alternative investment funds since they tend to be:

- More complex than traditional long only funds
- Exposed to credit counterparty risk
- Less transparent
- Associated with higher fees
- Less liquid
- Disappointing in strong upward trending ("bull") markets

The proposed tiered draft Regulations for hedge funds seek to address many of the above concerns. Despite the identified perceived or actual risks, hedge funds can be prudently used by investors to enhance diversification, reduce volatility, improve returns and tend to have low correlations to other traditional assets. Hedge funds are therefore designed not to outperform all market conditions, but are designed to protect portfolios on the downside and preserve capital and tend to perform *relatively* better than the market during "bear" markets, largely because of their hedging strategies.

The risk of loss to investors, especially in South Africa, is also limited by the requirement that investors in hedge funds cannot lose more than the capital invested into the fund.[6] Hedge funds are therefore legally structured to limit the loss and liability of investors. Further, to protect pension fund investors, Regulation 28 sets a 10 percent limit for exposure towards hedge funds.

[5] This definition is also used in Regulation 28 of the Pension Funds Act, which regulates investments by pension funds.
[6] This principle is also enshrined in Regulation 28 of the Pension Funds Act.

The duty and responsibility lies with the investors, especially institutional investors, to first understand the role and risk hedge funds present and can play in their portfolios. Investors must undertake a thorough due diligence of the hedge fund managers (including interrogating the advice given by qualified financial advisers) before they consider investing in hedge funds.

These draft Regulations are meant to provide further protection to investors and the financial system and the development and deepening of South Africa's financial markets, without unreasonably or excessively constraining the business of hedge funds.

The overriding aim of these draft Regulations, therefore, is to ensure that hedge funds operate in a regulated space, with the following anticipated and associated outcomes and benefits:

- Development of financial markets to cater for different investor risk appetites
- Enhanced investor protection and confidence
- Systemic risk monitoring and management
- Enhanced integrity of the industry
- Enhanced reporting, disclosure and transparency to the regulator and investor

2.2 Types of hedge funds

Two types of hedge funds are envisaged, *viz.* a Retail Investor Hedge Fund ("RIHF") and a Qualified Investor Hedge Fund ("QIHF"). The RIHF will be allowed to solicit investments from all investors, while the QIHF will only solicit and accept investments from a restricted pool of qualified investors. A *qualified investor* is defined in the draft Regulations and includes natural and legal persons meeting the minimum requirements, including institutional investors like pension funds, insurance companies and asset managers.

The RIHFs will be subject to more stringent prudential and risk management requirements than the QIHFs to provide the highest investor protection given their retail focus, while the regulation on QIHFs will largely be an increased focus on risk management and to facilitate reporting and transparency to the investor and regulator, thereby facilitating better monitoring of (systemic) risk, and in turn, investor protection through enhanced disclosure requirements.

2.3 Hedge Fund Structures and Governance Arrangements [7]

i. **RIHF**: The RIHF structure will be similar to the current CIS in securities framework. A person, who seeks to register a RIHF will have to set up a company, which company, once approved, will operate as a CIS manager and be subject to appropriate prudential requirements and a strict requirement

[7] Refer to Annexure.

for a trustee to perform **daily** fiduciary oversight over the hedge fund The trustee will have to be independent of the manager, as envisaged under CISCA.

There is no requirement for the appointment of an independent fund administrator in the retail space, consistent with the current CISCA framework, but the trustee is required to provide daily oversight of all pricing and valuations. Fund administration is the function of the CIS manager, and could be outsourced to an (external) administrator. Managers can also use administrators within their groups, subject to regular external verification of their valuations, which will be done by trustees. However, the RIHF manager is encouraged to appoint an independent fund administrator.

ii. **QIHF**: The draft Regulations do not require a QIHF manager to be set up as a company (this is only a requirement in the retail space, in line with current CISCA requirements). The CIS managers will have discretion to determine structures (which must be either a partnership, trust or company)[8] that are operationally sound or viable to them. However, the structure of the QIHF shall provide for a "governing body", with majority independent members, responsible for exercising fiduciary oversight of the (investment and risk management) functions of the registered CIS manager. The QIHF can either appoint a trustee or an independent administrator to perform the relevant prescribed functions as set out in section 70 of CISCA, and to provide daily oversight.

Where an independent administrator is appointed, it is the duty of the CIS manager to ensure that the appointed fund administrator has adequate systems in place as well as functional capacity to perform the relevant duties.

2.4 Distinction between a CIS Manager and FAIS Category IIA Manager

The "manager" here refers to the CIS (hedge fund) manager[9] and not the Category IIA FSP. The Category IIA FSP is regulated and licensed in terms of the FAIS Act, while the CIS (hedge fund) manager will be registered and regulated in terms of CISCA. Technically speaking, it is the CIS manager that will lodge an application to register a CIS (hedge fund), and not the Category IIA FSP (investment/portfolio manager) since the latter is not regulated under CISCA (the Act under which the hedge funds will be declared as a CIS business).[10]

[8] See attached Annexure 'A' on structures.

[9] See paragraph 1 – definitions encapsulating all CISCA definitions and a manager is defined in CISCA as a person authorised in terms of that Act to administer a collective investment scheme. Administration of a fund includes all the functions necessary for operating a fund.

[10] Since currently most hedge funds are operating as QIHFs, and only as Category IIA licensees, it *effectively* means that it will be these Category IIA investment managers who will apply to be CIS managers (in addition to being Category IIA managers). For a (CIS) manager managing only a QIHF, it means registering under CISCA that relevant structure (company, trust or limited partnership). For a CIS

The current Category IIA FSP who intend to register existing portfolios as CIS funds under a CIS manager (after the declaration) will be required to lodge an application for a CIS manager licence and will thus fall within the regulatory ambit of CISCA. If the intention of the CIS manager is to *solely* manage CIS hedge fund portfolios, then the Cat IIA licence will not be necessary.

The principles of administration contained in the draft Regulations seek to guide the CIS manager (who must register under CISCA) in terms of the manner in which the fund should be administered. The CIS manager should administer the fund in a manner that is fair, transparent and in the best interest of investors. The CIS manager of a QIHF may only invite or permit qualified investors to invest in the portfolio and must take reasonable steps to verify that all investors are qualified. Further steps should be taken by the CIS manager to ensure that investors' liability is limited to their capital invested.

2.5 Prudential requirements applicable to both RIHFs and QIHFs

Both types of hedge fund managers will be subject to prudential requirements meant to ensure that the manager has and maintains sufficient capital reserves to meet redemptions and other operational needs. Prudential requirements will include professional indemnity cover (to cover for risks associated with the actions of the manager) and fidelity cover (to cover risks associated with the actions of the employees of the manager). These prudential requirements are important to ensure investor protection and business continuity of the CIS hedge fund manager.

2.6 Leverage

Leverage involves the use of financial instruments, including derivative instruments, short positions and borrowed capital to increase exposure beyond the capital employed. South African hedge fund managers seem to be conservative when it comes to leveraging their portfolios, compared to their foreign counterparts.

Both RIHFs and QIHFs will be allowed to use leveraging. The managers of QIHFs will be allowed to set their own maximum leverage levels for each underlying portfolio of the QIHF but the leverage levels must be disclosed to the regulator at registration and investors prior to entering into a transaction. This approach is informed by the strength of regulation of South African banks and their strong balance sheets, and the current relatively conservative approach of local hedge fund managers in using debt. However, such internally set limit shall be regularly disclosed to the Registrar and investors, both prospective and existing.

The maximum leverage limits may only be changed with the approval of investors and the Registrar. Further, the Registrar will have the normal powers and discretion to interrogate and object to leverage limits that may not be appropriate, after discussion with the CIS (hedge fund) manager. This discretion is part of the robust regulatory

manager intending to (also) manage a RIHF, it means having and registering a (management) company as currently prescribed by CISCA.

approach promoted by the global standard setting body, *viz.* the Financial Stability Board.

In relation to the RIHFs, two approaches will be allowed; the first one, called the "commitment approach", will allow leveraging of only up to 200 percent total exposure to the market.[11] Given that not all funds can meet the 200% total exposure limit (for example fixed income funds), the use of Value at Risk (VaR) as a measure is acceptable, provided that the maximum monthly VaR of each portfolio is limited to 20%, and such portfolios being subjected to other risk measures such as stress testing, liquidity testing, scenario analysis etc.

These two approaches on leveraging enable a RIHF to still operate like a typical hedge fund, notwithstanding overall strict regulation, and commensurate protection of retail investors in RIHF given their associated risk.

2.7 Counterparty exposure risk

The draft Regulations seek to limit the fund's Over-The-Counter (OTC) derivatives exposure to *single* counterparties other than banks to 30 percent of the net-asset value of the portfolio. Hedge funds can have 100 percent of the net-asset value of the portfolio in OTC derivative exposure to a *single* counterparty, where the counterparty is a bank. The effective regulation of banks and the presence of their balance sheets has informed this differentiated approach. However, it should also be indicated that the OTC markets, globally and locally, are currently undergoing review and improved regulations. Once such OTC (or other relevant) regulations are promulgated by the Minister of Finance based on the standards set by the Financial Stability Board, these Regulations will be concomitantly reviewed to ensure alignment and therefore avoid regulatory arbitrage. Funds are however encouraged to manage their counterparty exposure through the use of collateral.

2.8 Portfolio valuation

This is the periodic valuation of the hedge fund portfolio which must be performed in accordance with appropriate procedures, policies and methodologies used to value different types of assets constituting the portfolio. For the RIHF, the trustee will validate the portfolio valuation, while in the instance of the QIHF the independent administrator (where the QIHF elects not to appoint a trustee) will perform the valuation. Where the QIHF appoints a trustee the trustee will validate the valuation. Portfolio valuation remains the responsibility and function of the manager, as part of its administration functions.

2.9 Disclosure requirements to investors and the Registrar

Proper and extensive disclosure to investors has, since the aftermath of the GFC, become one of the key global regulatory objectives. This objective is particularly critical

[11] This means that a RIHF can borrow up to half of its total exposure, under the "commitment approach".

for the hedge funds industry which still suffers from some negative perception, especially globally.

Proper disclosure empowers investors and enhances their confidence, which in turn can support financial market growth and development as investors are comfortable investing in regulated products. The required disclosures in terms of the Regulations are meant to keep investors informed and enable prospective investors to make informed decisions before they commit their money to an investment. Full disclosure on, inter alia, strategies, fund performance, fees, total expense ratios, leverage levels, and portfolio composition would provide investors with information to assist them in making an informed decision before they invest, and during the life of their investments. Proper disclosure can also enhance competition as investors are able to exercise informed choices.[12] Regular reporting to the Registrar enables pro-active supervision and early remedial action at both levels of the financial institution and system. This enhances market integrity, manages potential systemic risk and enhances investor confidence in the system.

2.10 Trustee & custodian

In accordance with CISCA the trustee, who acts on behalf of investors, performs critical *daily* fiduciary oversight on the investment management and administration functions of the CIS manager. A custodian is responsible for the safe-keeping of the assets of the portfolio. Both the trustee and the custodian are appointed in terms of CISCA and their functions are prescribed under section 70 of CISCA. The trustee can also serve as a custodian. There is a strict requirement in terms of the draft Regulations for all RIHFs to appoint a trustee approved by the Registrar. The trustee or the independent administrator (in the case of a QIHF) will also be required to report to the Registrar should material breaches be identified.

2.11 Liquidity risk management

The manager should ensure that the fund has sufficient liquidity to meet its repurchase obligations, in accordance with the repurchase policies. The portfolio should be stress-tested for its ability to withstand possible increases in investor redemptions, and illiquidity of the underlying assets of the fund. It is primarily the manager’s duty to ensure that liquidity risk is adequately managed. A tiered approach has also been adopted, with traditional CISs having a 14-calendar-day, RIHFs a 30 calendar-day, and QIHFs a 90 calendar-day liquidity requirement, which periods include the redemption notice period.

[12] This disclosure will be in line with the Treating Customers Fairly initiative of the Financial Services Board.

2.12 Prime broker

The prime broker fulfils several critical functions and roles for a hedge fund. Most hedge funds, locally and globally, use prime brokers to facilitate their investment transactions. One of the critical roles they play is to be a counterparty to hedge funds by providing them with leverage or lending them securities (for short selling).

Given the central role played by prime brokers, the Regulations require the CIS (hedge fund) manager to be satisfied with the prime broker's functional and operational capabilities before they appoint them. The CIS (hedge fund) manager may appoint or use a prime broker and a custodian from the same banking group, subject to clear functional separation between the prime broker and custodian. Where the prime broker is also the custodian, there must be clear legal and physical segregation of such prime broker's assets from the investors' assets.

In this instance the prime broker will be required to hold the assets of the fund in a statutorily approved nominee company.

Authorised users who are equity members of the JSE and who adhere to the JSE's daily capital requirements and oversight will also be eligible to be appointed as prime brokers on condition the assets of the fund held are segregated from the balance sheet of the authorised user

2.13 Permitted asset classes

Securities, participatory interests in other funds (with some qualifications), and OTC derivatives will all be allowed in the RIHF portfolio. The instruments or investments should be in line with the fund's investment mandate or policy and should be valued reliably. The RIHF should not include instruments that would negatively impact on its liquidity or redemption obligations. In this regard, RIHFs are not allowed to include in their portfolios instruments that involve physical delivery of commodities, investments in private equities and physical property. However, they may invest in instruments or derivatives that create exposure to these assets but resulting in only cash delivery (settlement). Instruments based on financial indices may be included subject to conditions prescribed in the draft Regulations. QIHF will not have prescribed investment restrictions, given that they are targeting qualified investors who ought to understand the risk-return profiles of such types of hedge funds better than a retail investor, but they must however still adhere to the funds liquidity requirements.

QIHFs may invest in any other form of approved CIS's participatory interests, whilst RIHFs may only invest in the participatory interests of RIHFs. Any hedge fund that is structured as a hedge fund investing in other hedge funds may not invest in other hedge funds that also invest in other hedge funds (e.g. colloquially stated: funds of hedge funds may not invest in funds of hedge funds).

2.14 Derivative instruments

Both types of hedge funds are allowed to use or invest in derivative instruments. Derivative contracts, however, can only be entered into with one or more of the prescribed counterparties. Before derivatives can be included in the portfolios, the Regulations require that the derivative instruments be able to be valued reliably. The proposed OTC derivatives regulations, as enabled by the Financial Markets Act, will apply once in force. Funds must at all times be aware of the credit counterparty risk associated with OTC derivatives and take the necessary steps to mitigate and manage this risk.

2.15 Collateral

Both RIHFs and QIHFs are allowed to post and receive collateral, subject to the prescriptions of the collateral contracts entered into by the counterparties. It is the manager's duty to ensure that the collateral received is sound and appropriate to the fund's credit-exposure management strategies. Re-hypothecation of collateral received and posted is also permitted by the Regulations, subject to the relevant legal agreements. However, such re-hypothecation should only happen after approval from the trustee or Governing Body, whichever is applicable.

3. Taxation of hedge funds

Hedge funds will be declared as Collective Investment Schemes in terms of section 63 of CISCA. This means investors in hedge fund portfolios and the normal Collective Investment Schemes structures will have the same tax treatment. The hedge fund portfolio will be tax-exempt and tax will flow through to investors (taxation in the hands of investors). This tax treatment is the same for investors in both RIHFs and QIHFs.

A holder of a participatory interest in a hedge fund Collective Investment Scheme, whether a RIHF or QIHF, will also be allowed to treat gains and losses from the disposal of their participatory interest as a capital gain or capital loss if the participatory interest was held for a period of at least three years, as is the case with traditional Collective Investment Schemes. In other cases, the nature of the disposal will be based on judicial precedent (see the recently assented to Taxation Laws Amendment Act, No. 31 of 2013).

4. Transitional period

It is envisaged that a transitional period of 12 months will be provided from the time of promulgation of the Regulations. This transitional period will enable stakeholders to submit applications for registration as CIS managers, adjust their respective portfolios as necessary, and attend to all other necessary matters to ensure compliance with the Regulations and the Act.

End.