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The Regulation of Hedge Funds in South Africa

A proposed framework issued by the National
Treasury and Financial Services Board

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1. INTRODUCTION

- 1.1. The purpose of this document is to provide a framework on the proposed regulation of hedge funds. The proposal is to regulate and supervise certain hedge fund structures under the existing Collective Investment Scheme Control Act, 2002 (“the Act”) with the creation of a new and separate category for hedge funds as a collective investment scheme. This can be done through the insertion of a separate chapter in the Act dealing with hedge funds. This will, therefore, require an amendment of the Act.¹
- 1.2. The Act currently regulates diverse types of collective investment schemes namely,
 - 1.2.1. collective investments schemes in securities;
 - 1.2.2. collective investments schemes in property; and
 - 1.2.3. collective investment schemes in participation bonds.
- 1.3. Prior to amendment of the Act, as an interim measure the hedge fund structure will be declared a scheme in accordance with section 63 of the Act; through the promulgation of subordinate legislation. Section 63 of the Act empowers the Minister to declare a specific type of business to be a collective investment scheme to which the Act or any part of the Act applies. The Minister will be requested to issue such a declaration as an interim measure until an amendment to the Act can be effected. Interim measures are proposed in order for South Africa to meet its G20 commitments.
- 1.4. The intention is not to regulate hedge fund financial service providers but to regulate hedge funds as a special collective investment scheme.
- 1.5. In addition to the Act, and the Regulations, the Deed, as defined in the Act, will also provide some form of regulation.

2. POLICY/REGULATORY OBJECTIVES²

- 2.1. Regulatory objectives include:
 - 2.1.1. greater investor protection;
 - 2.1.2. prevention of systemic risk;
 - 2.1.3. the promotion of market integrity; and
 - 2.1.4. transparency.

¹ This may facilitate a separate tax treatment. Tax concerns were previously an obstacle to getting agreement on the regulation of hedge funds. Guidance should be given by National Treasury.

²The above objectives are based on the principles of the International Organisation of Securities Commissions (“IOSCO”). These objectives are achieved through the mandatory registration of hedge fund managers, their portfolios (also known as funds) and comprehensive requirements of disclosure to both the investor and the Registrar as well as the monitoring of levels of leverage and risk. The term hedge fund manager in the context of this document refers to a manager of a collective investment scheme in hedge funds and should not be confused with the category IIA hedge fund financial services provider.

- 2.2. It is proposed that a distinction be made between two types of hedge funds with regard to the regulatory approach, namely restricted and retail funds.
- 2.3. **Restricted Hedge Funds** - These are funds which do not solicit the sale of their participatory interests from the public and are limited in their membership to private arrangements amongst qualified investors. These funds will not be subject to strict regulation. They will be required to register as restricted funds in accordance with the registration requirements determined by the Registrar. They will have to disclose, amongst others, the number of clients, the names of their clients and details of their counterparties. In addition the restricted fund will lodge annual returns to the Registrar for the purpose of assessing levels of leverage.
- 2.4. **Retail Hedge Funds:** The retail category will be regulated more closely by the Registrar, *inter alia*, by prescribing what type of assets may or may not be included in the portfolio and limiting the level of leverage permitted. They will be required to register in terms of the requirements of the Registrar. This category of investments will be available for retail investors, including institutional investors. Additional requirements may entail restrictions on the type of assets included in a portfolio, valuation and liquidity. A minimum investment of between Fifty Thousand Rand (R50 000) and One Hundred Thousand Rand (R100 000) will be prescribed.

3. DEFINITIONS

It is proposed that the following new terms be introduced into the collective investment scheme environment:

- 3.1. **Fund Administrator** means a hedge fund administrator who administers the trading, reconciliations, valuation and pricing for a hedge fund.
- 3.2. **Derivatives**³ a “derivative ” means a financial instrument, or contract, that creates rights and obligations and that derives its value from the price or value, or the value of which may vary depending on a change in the price or value, of some other particular product;
- 3.3. **“Hedge Fund”**⁴ is a collective investment scheme whose portfolio uses any one or more of the following investment strategies:
- (a) leverage;
 - (b) short positions; or

³ Derivatives are financial instruments with values tied to the performance of assets (usually securities or bonds) or to benchmarks (usually interest rates). A plain vanilla derivative instrument is a future - an agreement to buy or sell a specific commodity or financial instrument at a set price on a stipulated date.

⁴The current FAIS definition is as follows: “a portfolio 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 -

(a) leverage; or

(b) net short positions.”

The FAIS Act will require amendment in order to align the definitions.

- (c) *derivative positions for the purposes of enhancing returns or to protect the assets against market exposures.*
- 3.4. **Funds of Hedge Funds** -These are funds which invest in hedge funds. Further a fund of hedge funds can be either a retail fund of hedge funds or a restricted fund of hedge funds, depending on the type of hedge funds in which it invests. A combination will not be permitted.
- 3.5. **Leverage** is the use of financial instruments or borrowed capital to increase the potential return of an investment.⁵
- 3.6. **“Prime broker”** means a bank as defined in the Banks Act, 1990 or an authorised financial services provider offering prime brokerage services which include lending money, acting as counterparty to finance or execute transactions in financial instruments, lending securities for the purpose of short selling, clearing and settlement of trades, operational support facilities and customised technology.
- 3.7. **Qualified Investor**⁶ is any person, including a natural person, who meets at least two of the following criteria:
- 3.7.1. The investor has carried out transactions of a significant size on securities markets at an average frequency of at least 10 per quarter over the previous four quarters,
- 3.7.2. The minimum investment amount of R1 million per portfolio;
- 3.7.3. The investor or his authorised advisor works or has worked for at least one year in the financial sector in a professional capacity which requires knowledge of securities investment.
- 3.8. **“risk management programme”** means a programme established by a manager and agreed to by the trustee, to measure, and adequately cover, the risk to which a portfolio is exposed through the exposure under a transaction in a financial instrument not listed on an exchange

4. LEGAL STRUCTURE

- 4.1. The investment vehicles utilised by hedge funds financial services providers include partnership arrangements (mostly *en comandite* partnerships⁷), trusts, debentures (mainly

⁵Typically, financial leverage takes the form of a loan that is reinvested with the hope of earning a rate of return that is greater than the cost of interest. Therefore, the use of leverage creates the possibility of higher returns for the investor than would otherwise be available. However the potential for significant loss is also greater because, if the investment fails, the investor loses his or her money and also must repay the loan. Thus the use of leverage magnifies the potential for gains *and* losses. Only limited partnerships will be permitted.

⁶ Aside from being identified by the types of investors who invest in them, hedge funds are identified by the investment strategy that they adopt. All strategies will be allowed but proper disclosure to clients will be a requirement. In addition the strategies must be specifically incorporated in the founding documents.

⁷An ***en comandite* partnership** – is a limited partnership similar to a silent partnership, save that the partner *en comandite* limits its liability to its co-partners for the losses of the partnership to an agreed amount, on condition it receives a fixed share of the profits. In the hedge fund environment the silent partners contribute funds but are liable only to the extent of the capital invested in the partnership / scheme.

variable rate) and companies⁸. Most hedge funds are structured as *en commandite* partnerships.⁹

- 4.2. The manager in terms of the Act must be a company registered in terms of Companies legislation, and conform to capital and reserving requirements prescribed in the Act. A manager of a hedge fund will be required to comply with the same requirements as contemplated in section 64 of the Act.

5. REGISTRATION

- 5.1. The managers of all hedge funds i.e. retail, restricted and funds of hedge funds, targeting investors in South Africa will have to be registered with or authorised by the Registrar irrespective of the value of assets of the fund. The same requirements pertaining to fitness and propriety as provided in the Act will apply.

- 5.2. Financial services providers that are currently registered as category IIA financial services providers will be required to procure the registration of collective investment scheme managers for purposes of the hedge funds that they currently manage.

- 5.3. In order to register, the following general information must be provided:

- 5.3.1. a description of the manager seeking registration as well as an organogram indicating the group structure and ownership of the company;
- 5.3.2. a current tax clearance certificate in respect of all of the proposed shareholders (direct and indirect) of the proposed manager;
- 5.3.3. full particulars of the collective investment scheme the manager proposes to carry on and the manner in which it proposes to carry on such scheme;
- 5.3.4. an indication of the manager's existing and proposed client base and an indication of the target market;
- 5.3.5. a business plan on how the marketing of the proposed scheme will be done;
- 5.3.6. the business objectives of the proposed scheme including the intended strategies to achieve these objectives and the different phases of achieving such objectives;
- 5.3.7. the names and physical addresses of the chairperson, directors and managing director of the manager together with their curriculum vitae;

⁸All these structures, referred to above, can be accommodated under the Act provided that the principle of segregation and identification of assets as contained in section 2(2) of the Act is satisfied, that is to say, there must be a clear separation of assets. It must be emphasised that the structure of the hedge fund is separate from the manager thereof.

⁹Notwithstanding that partnerships are a viable structure for hedge funds, hedge funds which intend targeting retirement funds must comply with the requirements of the Registrar of Pension Funds. There is no guarantee that because the agreement will specify that the partner's (the pension fund's) liability will be limited to the value of its contributions, that this necessarily means the pension fund is protected from creditors.

- 5.3.8. fit and proper assessment of all directors;
- 5.3.9. the name of the proposed trustee for the scheme;
- 5.3.10. the name of the proposed prime broker and/or the names of derivatives counterparties;
- 5.3.11. the name of the proposed auditor;
- 5.3.12. the name of the financial services provider that will perform the financial services, as defined in the FAIS Act, in respect of the scheme and confirmation of its authorisation as such;
- 5.3.13. the names and *curriculum vitae* of all managerial staff responsible for the administration;
- 5.3.14. an indication of the pricing structure of the scheme;
- 5.3.15. a copy of the memorandum of incorporation of the manager;
- 5.3.16. a pro-forma copy of the deed, as defined in the Act, and of the supplemental deed in respect of the scheme; and
- 5.3.17. a risk management programme that contains procedures to ensure that all applicable risks pertaining to the hedge fund can be identified, monitored and managed at all times.

6. RISK MANAGEMENT

6.1. PRUDENTIAL REQUIREMENTS

- 6.1.1. The retail hedge fund managers will be subject to prudential regulation that reflects the risks they take, e.g. operational risk, client money, credit counterparty risk. Retail hedge funds will be required to have capital requirements as determined by the registrar under the Act, (refer to section 88 of the Act).
- 6.1.2. Retail hedge fund managers will be required to fund any excess capital requirements ensuring that the investor's liability is limited to the amount of his investment in the fund (i.e. any shortfalls will be required to be paid by the manager). That is to say the investor may not be liable for more than his investment in the fund.

6.2. CONFLICT OF INTEREST

- 6.2.1. All hedge fund managers must have policies and procedures in place to identify, monitor, and manage conflicts of interests; e.g. fee sharing arrangements between the underlying fund and the fund of hedge funds.
- 6.2.2. Full disclosure of any potential conflict of interest will be required.

6.3. VALUATION

- 6.3.1. All hedge fund managers must be required to submit to an independent valuation of assets of the hedge fund.
- 6.3.2. Retail hedge funds must be required to provide daily pricing. This requirement must also be included in the founding document.
- 6.3.3. All listed investments must be priced according to, market prices as per section 44 of the Act, marking to market, and the unlisted investments must be priced according to a methodology approved by the trustee and undertaken by a party approved by the trustee.

6.4. LIQUIDITY

- 6.4.1. Retail hedge funds should have a maximum fourteen (14) day liquidity requirement as an obligation to investors, similar to the provisions for a collective investment scheme in securities as provided at paragraph 2 of Schedule 1 to the Act. This is to be incorporated in the founding documents as well as the subordinate legislation (i.e. an investor should be able to liquidate his investment within 14 days).
- 6.4.2. The founding documents should also include provisions in respect of withdrawals where payments as required cannot be made. This may involve payment consisting of assets of the fund. These will be similar to the provision in respect of collective investment schemes in securities as provided in the Act.

6.5. SEGREGATION¹⁰

- 6.5.1. The assets of the fund should be separate and distinct from the assets of the manager. A trustee or custodian will be appointed to perform this function. A trustee or fiduciary must be appointed to perform the functions prescribed in the Act and to ensure mandate compliance.

¹⁰ The Act provides for segregation and identification of assets in the investors name at section 2(2) quoted below:

“The assets of an investor must be properly protected by application of the principle of segregation and identification.”

This is given effect by the provisions of Part XI of the Act, which deals with the Trustee or Custodian, specifically:

section 68 which addresses the appointment and termination of the trustee or custodian;

Section 69 deals with the qualification and registration of the trustee or custodian;

Section 70 details the duties of the trustee or custodian;

Section 71 details the status of the assets. Section 71 of the Act provides that money or other assets received from investors and the assets of a portfolio are regarded as trust property in terms of the Financial Institutions (Protection of Funds) Act, No 28 of 2001 (FI Act¹¹). The FI Act stipulates that trust property must be held separate from assets belonging to an institution, and must be clearly identified as trust property as being property belonging to a specified principal; and Section 72 deals with the liability of the trustee and custodian in the event of a loss of assets.

- 6.5.2. Section 105 of the Act provides that a manager must open and maintain a separate operational trust account controlled by the trustee or custodian.
- 6.5.3. Any collateral received does not form part of the net asset value of the fund.

6.6. RISK MANAGEMENT PROGRAMME

- 6.6.1. The fund will require a risk management programme which sets out the types of derivatives the fund will use, the risks associated with the derivatives and how those risks will be managed.
- 6.6.2. The risk management programme should provide information on the trading process employed by the investment manager and explain in detail the responsibilities and expertise of the personnel involved in the derivative trading activity of the fund. It should explain clearly the types of derivative instruments used by the fund and their specific purpose. The risk management programme must cover all derivatives to be used.

6.7. LEVERAGE¹¹

- 6.7.1. Hedge funds can create leverage by borrowing funds or by engaging in derivative transactions with counterparties.
- 6.7.2. A manager of a retail hedge fund shall ensure that the fund's total exposure relating to derivative instruments does not exceed the total net value of its portfolio.
- 6.7.3. This effectively means that a fund not applying value at risk can gear to a maximum of one hundred percent (100%) with gross assets being double that of the net assets.
- 6.7.4. The rules for measuring total exposure and leverage differ depending on whether the fund uses simple or complex (termed "sophisticated") investment strategies. A fund that uses non-complex investment strategies will generally measure total exposure and leverage according to the commitment approach. A fund that uses more complex or "sophisticated" strategies will employ an advanced risk measurement methodology. The use of the Value at Risk (VaR) method is recommended. VaR is an estimate of the worst possible loss an investment could realise over a specified period under normal market conditions.
- 6.7.5. Counterparty risk exposure may not exceed twenty percent (20%) of the fund's net asset value.

¹¹ Leverage is an integral component of many hedge fund investment strategies. It can be viewed as a means of potentially increasing an investment's value or return without increasing the capital amount invested. The use of leverage may have a significant impact on investment results because it may enhance investment gains; it may also magnify investment losses. It may also increase the risk caused by holding assets that are illiquid.

- 6.7.6. Absolute VaR or Relative VaR may be applied. Absolute VaR is the VaR of the fund capped as a percentage of the net asset value. A limit on Absolute VaR of twenty percent (20%) of net asset value is proposed. Relative VaR is the VaR of the fund divided by the VaR of a bench mark. Under Relative VaR, VaR is limited to twice the VaR on the benchmark. Relative VaR measures the risk of under-performance relative to a pre-defined benchmark. It is noted that there have been reservations around the use of Absolute VaR as a reliable measure.
- 6.7.7. Leveraging through the use of derivative instruments and physical borrowing will be allowed.

6.8. AUDITOR OF FUND

An auditor must be appointed in accordance with the provisions of the Act.¹²

6.9. APPOINTMENT OF COMPLIANCE OFFICER

All funds should have an appropriately qualified and experienced compliance officer, in accordance with the requirements determined by the Registrar. The compliance officer must also fulfil a risk management function, if not an additional risk management officer must be appointed.

7. TRANSPARENCY AND DISCLOSURE REQUIREMENTS

- 7.1. All hedge funds must provide information to investors including valuation methodology, positions and leverage exposure for purposes of transparency.
- 7.2. Hedge fund managers will be expected to comply with initial and on-going disclosure requirements. Existing disclosure requirements are specified at sections 3 and 100 of the Act, and will therefore be applicable.¹³
- 7.3. The hedge fund manager must prepare a key investor information document (“KIID”). The KIID is intended to be a short document containing key investor information so as to assist retail investors’ understanding of the investment product being offered.
- 7.4. The KIID would be expected to incorporate:
- 7.4.1. the investment policy and objectives: it must describe the main categories of eligible financial instruments, detailing any industrial, geographical or other focus;

¹²Part X at sections 73 -75 of the Act deal with the appointment and approval of auditors.

¹³Section 3 provides that prior to entering into a contract with an investor -

(a) information about the investment objectives of the collective investment scheme, the calculation of the net asset value and dealing prices, charges, risk factors and distribution of income accruals must be disclosed to the investor; and

(b) information that is necessary to enable the investor to make an informed decision must be given to the investor timeously and in a comprehensible manner.

In addition section 100 sets out requirements in respect of the contents of price lists, advertisements, brochures and similar documents.

- 7.4.2. risk and reward indicator: indicating the levels of risk from lowest to highest, together with a narrative explanation of the risk;
- 7.4.3. charges: the charging structure should be presented as clearly as possible to enable investors to consider the impact of all the charges; i.e. the charges should be presented in a table summarising the percentage entry and exit charges, on-going charges and contingent charges; and
- 7.4.4. a past performance presentation: of the performance of the fund over the last ten years. New funds which do not yet have performance data for a complete calendar year should provide a statement explaining that there is insufficient data to provide a useful indication of past performance to investors.
- 7.4.5. all other practical information i.e. name of the trustee, how to obtain further information about the fund, copies of its prospectus, annual reports etc.

REGULATORY REPORTING

- 7.4.6. All hedge fund managers will be required to report monthly, to the Registrar, on the gross assets, net assets, short positions and leveraging in order to monitor systemic risk. They will also be required to identify their credit counterparties.
- 7.4.7. In addition retail hedge funds will be required to report quarterly, on their holdings and exposures, to the Registrar.
- 7.4.8. All funds will be required to submit annual reports to the Registrar.

8. ROLE OF PRIME BROKER AND ADMINISTRATORS

8.1. PRIME BROKERS¹⁴

- 8.1.1. The prime broker typically provides the following services:
 - 8.1.1.1. Execution of transactions and netting operations on behalf of the fund;
 - 8.1.1.2. Transactions relating to margin deposits;
 - 8.1.1.3. Creating credit facilities to finance overdrafts; and/or
 - 8.1.1.4. Securities lending and borrowing or share repurchase transactions.
- 8.1.2. The extent of rehypothecation, that is the re-use of the fund's assets as security, will be limited to a certain percentage of the hedge fund's indebtedness to the prime broker.

¹⁴ The role of the prime broker would be new to the collective investment schemes environment.

- 8.1.3. Prime brokers, who provide funding and other services to hedge funds, should be subject to mandatory registration/regulation and supervision. Only registered banks and approved financial services providers will be allowed to act as prime brokers. They should have appropriate risk management systems and controls in place in order to monitor their counterparty credit risk exposures to hedge funds.
- 8.1.4. A prime broker must not be appointed as a trustee/custodian since prime brokers act as counterparties to the hedge fund. A nominee of a prime broker may be appointed as sub custodian, by the Trustee.
- 8.1.5. A prime broker, who provides funding and other services to hedge funds, will be subject to supervisory oversight (market conduct and prudential regulation).
- 8.1.6. The hedge fund manager must exercise due diligence in the selection and appointment of a prime broker. Criteria will be prescribed.

8.2. ADMINISTRATORS¹⁵

- 8.2.1. The administrator must be separate from the hedge fund manager, and they should avoid a conflict of interest.
- 8.2.2. The administrator must be domiciled in South Africa and should be registered as a financial services provider.
- 8.2.3. In terms of valuation and pricing, where a manager provides input or contributes to a valuation, this must be disclosed to the Trustee.

9. INVESTMENT/TRADING ACTIVITIES FOR RETAIL HEDGE FUNDS

- PERMITTED ASSET CLASSES (ELIGIBLE ASSETS)

9.1. Retail Hedge funds may invest in permitted asset classes (eligible assets) which include:

- 9.1.1. Securities and money market instruments either listed on an exchange or dealt with on a market which is regulated, operates regularly, is recognised and open to the public, including structured financial instruments if they meet the securities criteria.
- 9.1.2. Over the Counter ("OTC") derivatives and participatory interests.

9.2. The following criteria must be met:

- 9.2.1. The potential loss on the investment is limited to the amount paid to acquire it (e.g. one cannot lose more money than one has invested).
- 9.2.2. The liquidity of the instruments or securities must not compromise the ability of the hedge fund to meet its repurchase obligations.

¹⁵ The definition of an administrator for purposes of hedge funds will be incorporated.

- 9.2.3. A reliable valuation for the investment must exist.
- 9.2.4. Appropriate information on the investment must be available.
- 9.2.5. The instrument must be negotiable.
- 9.2.6. The acquisition of the investment must be consistent with the investment policy of the hedge fund.
- 9.3. The risks associated with the investment must be adequately captured by the risk management process of the hedge fund.
- 9.4. A security or money market instrument may embed a derivative, i.e. if it is an instrument which contains a component fulfilling the following criteria¹⁶:
 - 9.4.1. Some or all of the cash flows of the security or the money market instrument (host contract) can be modified according to a variable, and therefore vary in a way similar to stand-alone derivative.
 - 9.4.2. Its economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract.
 - 9.4.3. It has a significant impact on the risk profile and pricing of the transferable security or money market instrument.
- 9.5. For those securities or money market instruments embedding a derivative, the underlying assets of the embedded derivative instrument must consist of eligible assets.
- 9.6. Participatory interests of registered collective investment schemes either closed or open ended.
- 9.7. Financial Indices
 - 9.7.1. To be eligible, financial indices contracts must meet the following criteria:
 - 9.7.1.1. Be sufficiently diversified;
 - 9.7.1.2. Be an adequate benchmark of the market it refers to;

¹⁶The **COMMITTEE OF EUROPEAN SECURITIES REGULATORS' (CESR)** advice on eligible assets for investments of UCITS (March 2007, ref: CESR/07-044b) also includes an "illustrative and non-exhaustive list" of financial instruments that CESR believes could be assumed to embed a derivative. This list comprises the following, all of which could be examples of money market instruments, bonds and other forms of securitised debt embedding a derivative:

- Credit linked notes;
- Structured instruments whose performance is linked to the performance of a bond index;
- Structured instruments whose performance is linked to the performance of a basket of shares with or without active management;
- Structured instruments with a fully guaranteed nominal value whose performance is linked to the performance of a basket of shares, with or without active management;
- Convertible bonds; and
- Exchangeable bonds.

9.7.1.3. Be published in an appropriate manner.

9.7.2. Based on the eligibility criteria mentioned above indices may, amongst others, consist of commodity, metal, real estate and private equity indices.

9.7.3. Exposure to hedge fund indices may also be obtained through the use of performances swaps or total return swaps.

9.8. Financial Derivative Instruments

9.8.1. For FDIs to be eligible as core investments, the underlying asset of the FDI must be an eligible asset (a security, deposit, money market instrument, closed and open-ended CIS fund, financial index, interest, foreign exchange rate or currency). If the acquisition or use of a financial derivative could result in the delivery or the transfer of non-eligible assets, the financial derivative instrument, regardless of its nature, is not eligible.

9.8.2. Over-the-counter (OTC) FDI's must meet the following criteria:

9.8.2.1. The counterparties must be subject to prudential supervision of the South African Reserve Bank, or its international equivalent, or persons regulated by the Registrar of Securities;

9.8.2.2. They must be subject to daily, reliable and verifiable valuation;

9.8.2.3. They must be able to be sold, liquidated or closed by an offsetting transaction at any time at their fair value at the hedge fund's initiative.

9.8.3. Eligible financial derivative instruments include, but are not limited to, futures, options or swaps (interest rate swaps, currency swaps, total returns, credit defaults swap, etc.), forwards and other contracts for differences.

- **NON-PERMITTED ASSET CLASSES**

9.9. Investments either directly (i.e. physical) or indirectly (i.e. through the use of derivatives) are not generally permitted in the following:

9.9.1. Commodities, including precious metals or certificates representing them, where physical delivery of the commodities is possible;

9.9.2. Property / Real Estate; and

9.9.3. Private Equity.

9.10. Non-Financial Indices

9.11. However, with limits, hedge funds may be permitted to gain exposure to the above through financial indices.

10. INVESTMENT PARAMETERS FOR RETAIL HEDGE FUNDS

10.1. Equity Securities¹⁷

Limits similar to those stipulated in Board Notice 80 of 2012 to the Act (“Notice 80”) are suggested. These are:

10.1.1. equity securities issued by any one concern 5%, or a concern with a market capitalisation of R2 billion or more, 10 % of the market value of all the assets comprised in the portfolio, or 120%, whichever is the greater, of that security’s weighting in an index, subject to –

10.1.1.1. a maximum of 20 % of the market value of all the assets comprising the portfolio where the benchmark is the index representing the overall market or exchange;

10.1.1.2. a maximum of 35 % of the market value of all the assets comprising the portfolio where the portfolio tracks or replicates an index, which is not an overall market or exchange index.

10.2. Money Market Instruments, Deposits, Fixed Interest Securities and Government Securities

Categories of Money Market Instruments and Securities	Limits being the maximum percentage of the aggregate market value of the portfolio	
	Per issuer/guarantor as applicable	In aggregate for all issuers/guarantors as applicable
Money market instruments and non-equity securities issued or guaranteed by:		100%
The government of the Republic of South Africa;	100%	100%
Any foreign government which has been assigned a foreign currency sovereign rating not lower than that of the Republic of South Africa;	100%	100%
The South African Reserve Bank.	100%	100%
Money market instruments and non-equity securities issued or guaranteed by a local or foreign bank which forms part of a group (in terms of international accounting standards) of which the holding company is listed on an exchange:		100%

¹⁷The concentration limit per the “5/10/40” rule in UCITS is as follows:

10% net asset value maximum investment in securities/ money market instruments (money market instruments) issued by the same body. Where investments in securities / money market instruments in the same body exceed 5% of net asset value, these cannot cumulatively exceed 40% of net asset value. It is felt that this may be too restrictive for the South African market.

with a market capitalisation for the listed group holding company of more than R 20 billion;	30%	100%
with a market capitalisation for the listed group holding company of between R 2 billion and R 20 billion.	20%	100%
Money market instruments and non-equity securities issued or guaranteed by:		100%
a Public Entity under the Public Finance Management Act,1999 (Act No.1 of 1999);	10%	100%
any local or foreign entity which is listed on an exchange:	10%	100%
Money market instruments and non-equity securities issued or guaranteed by entities not described above	5%	10% (20% under discussion)

10.3. Derivatives

- 10.3.1. Investments through derivatives may be made in assets, in which a hedge fund can invest directly, including financial instruments with the same characteristics of those assets, financial indices, interest rates, foreign exchange (FX) and currencies.
- 10.3.2. 10% NAV maximum exposure to a single OTC derivative counterparty in the case of qualifying credit institutions or 5% NAV in all other cases.
- 10.3.3. **Leverage Limits:** A retail hedge fund will generally measure leverage using the “commitment approach” up to a gross leverage limit of 100% of the fund’s net asset value. Total exposure may therefore not exceed the fund’s net asset value. Leverage being total exposure divided by net asset value.
- 10.3.4. The limits to a maximum level of leverage which a hedge fund may employ as well as the extent of the right of the re-use of collateral or guarantee that could be granted under the leveraging arrangement, should take into account the following aspects;
- 10.3.4.1. The type of a hedge fund;
- 10.3.4.2. Its strategy;
- 10.3.4.3. The sources of its leverage;
- 10.3.4.4. Any other relationship with the financial services institutions, which could pose systemic risk;
- 10.3.4.5. The need to limit the exposure to any one counterparty;
- 10.3.4.6. The extent to which the leverage is collateralised;

10.3.4.7. The asset liability ratio.

10.4. Investments in other Collective Investment Schemes (“CISs”)

- 10.4.1. 20% NAV maximum investment in any one CIS;
- 10.4.2. Investee CIS must limit its own investment in other CISs to 10% of NAV;
- 10.4.3. Due diligence should be conducted, in respect of underlying hedge funds that the fund of funds want to invest in, by funds of hedge funds managers;
- 10.4.4. Due assessment of the suitability of the underlying hedge fund;
- 10.4.5. Due diligence before and during the investment;
- 10.4.6. The legislation will prescribe the criteria for performance of due diligence procedures for the type of hedge funds that may be included for a Fund of Hedge Funds (similar to what is currently provided for Fund of Funds and Feeder Funds in Notice 80).

10.5. Unlisted Securities:

A maximum investment of 10% NAV in unlisted or unregulated securities is permitted.

11. SHORT SELLING

- 11.1. A short sale is the sale of a security that the seller does not own or a sale that is completed by the delivery of a security borrowed by, or for the account of, the seller.
- 11.2. Physical short selling of borrowed securities is a permitted activity. It may also be possible to use derivative instruments to create synthetic short positions. Permitted techniques and instruments should meet the following criteria:
 - 11.2.1. Be economically appropriate and realised in a cost effective manner;
 - 11.2.2. Be entered into for at least one of the following reasons:
 - 11.2.2.1. Risk reduction;
 - 11.2.2.2. Cost reduction;
 - 11.2.2.3. Generation of additional capital or income for the fund, provided that risk levels and diversification remain consistent (e.g. lending);
 - 11.2.2.4. Be captured by the risk management process.
- 11.3. No naked short selling is permitted.