The **first hedge fund was established in the USA in 1949** by Alfred Winslow Jones employing two investment strategies to achieve an absolute return, viz. *leveraging* and *shorting securities*

- strategies still predominantly employed today

- The **size** of the global hedge funds industry has grown significantly since 1949
  - AUM of approximately US$ 2.6 trillion (R 22 trillion) and 14 700 funds managed in 2013

- A hedge fund is a **pooled investment vehicle** administered by a professional investment manager and are largely structured as a limited partnership (*en commandite*) or trust

- Globally hedge funds have been **operating in an unregulated space** both at manager and product/fund level
  - South Africa a slight exception, with managers regulated from 2007 in terms of FAIS Act
  - They were previously regarded as investment vehicles only available to High Net Worth Individuals and certain institutional investors
Hedge funds did not cause the Global Financial Crisis (GFC), but contributed through investing in Mortgaged Backed Securities (MBS) and borrowing from banks.

The GFC resulted in a major shift in how financial institutions are regulated and supervised.

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 nature and role of “shadow banking” also came under the spotlight.

- “Shadow banking” entails unregulated financial activities by regulated financial entities OR banking activities undertaken by unregulated financial entities.
- G-20 considered it imperative to regulate shadow banking.
- Hedge funds activities (some) have been identified as part of “shadow banking.”

The 2009 G-20 Pittsburgh Leaders Declaration highlighted the need to expand and extend regulations to cover shadow banking, privately pooled investments and alternative investment funds – including hedge funds and OTC Derivatives.
The hedge funds industry in South Africa is relatively small, approximately R46 billion (US$ 4.6 billion) in Assets Under Management (compared to R1.5 trillion for traditional CIS) and approximately 107 funds managed by 55 managers.

Industry has potential to grow, hence the need to bring it within the regulated space.

As part of South Africa’s commitment to G-20 decisions and processes, the National Treasury (“Treasury”) and Financial Services Board (“FSB”), on 13 September 2012, released for public comment, a proposed framework for regulating hedge funds in South Africa.

Extensive comments were received from industry bodies and the public, and were considered by the Treasury and FSB in drafting the regulations.

A response document was then released on 10 February 2014.

Industry participants and bodies were invited to provide inputs during the regulations drafting process and relevant international frameworks were consulted (eg AiFMD and UCITS).

The draft regulations were released for public comment on 16 April 2014, together with the relevant Explanatory Memorandum.
REGULATORY OBJECTIVES

- Hedge funds are perceived to be and can actually be risky alternative investment vehicles because:
  - More complex than traditional long only funds
  - Can include leveraging
  - Exposed to credit counterparty risk
  - Less transparent
  - Associated with high fees
  - Less liquid

- The overriding aim and benefits of the draft Regulations:
  - 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 investors
The regulations for hedge funds (“the Regulations”) will be effected through the existing Collective Investment Schemes Control Act No. 45 of 2002 (“CISCA”) as a scheme declared by the Minister of Finance in terms of section 63 of the Act.

While hedge funds will be regulated in terms of CISCA, it is acknowledged that they are distinct from traditional Collective Investment Schemes as they employ leverage (either by borrowing, shorting securities or derivatives) AND therefore, their unique nature necessitates a relatively unique regulatory approach and provisions.

- Tiered system of regulation
  - Retail Investor Hedge Fund (“RIHF”) and Qualified Investor Hedge Fund (“QIHF”)
  - The RIHFs will be subject to more stringent (prudential) requirements than the QIHFs to ultimately provide the highest investor protection
  - Regulations on QIHFs will focus on disclosure, risk management, reporting and transparency
  - Both will have minimum consumer protection provisions; eg segregation of assets
The “Manager” in this context refers to the CIS (hedge fund) manager and not the Category IIA Financial Services Provider which is regulated and licensed in terms of the FAIS Act.

The CIS (hedge fund) manager is/will be registered and regulated in terms of CISCA and it is the “Manager” that will lodge an application to register a CIS (hedge fund), and not the Category IIA FSP (investment/portfolio manager).

If the intention of the CIS manager is to solely manage CIS hedge fund portfolios, then the Cat IIA licence will not be necessary. If intention is to manage also segregated portfolios, then Cat IIA licence required also.
Segregation of assets CRITICAL and to be required for both RIHF and QIHF

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/Depository** is responsible for the **safe-keeping** of the assets of the portfolio.

All RIHFs must appoint a trustee approved by the Registrar and QIHFs must have an independent administrator if they do not have trustees.

Valuation is the process of estimating what a portfolio is worth (Net Asset Value) and is usually performed through valuation of financial assets (stocks, options, bonds, derivatives etc.) or liabilities.

For the RIHF, the **trustee will validate the portfolio valuation**, while in the case 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.
Prudential requirements refer to provisions, regulations, norms or other types of enforceable standards as they relate to ensuring capital adequacy (establishing minimum amount of capital to be held), restricting potential risk, establishment of limits on risk exposures to institutions (counterparty credit exposure limits)

Both RIHFs and QIHFs 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).

Prudential requirements are important to ensure investor protection and business continuity of the CIS hedge fund manager and the fund.
Liquidity risk refers to the *probability of loss arising from a situation where there may not be enough cash and/or cash equivalents to meet the needs of fund investors* due to the fact that *illiquid assets* may not be sold at the desired time (if there are no immediate buyers).

- The manager should ensure that the fund has sufficient liquidity to meet its *repurchase obligations*, in accordance with the repurchase policies of the fund.
- A tiered approach to regulation has also been adopted, with traditional CISs having a **14-days**, RIHF a **1 calendar-month**, and QIF a **three calendar-months** liquidity requirement, which periods include the redemption notice period.
Leverage involves the use of financial instruments, including derivative instruments, short positions and borrowed capital to increase exposure beyond the capital employed.

Both RIHFs and QIHFs will be allowed to use leveraging as a strategy

- RIHFs will have a statutory limit
- QIHFs will set their own maximum leverage levels but must disclose to the regulator at registration and investors prior to investing
  - The maximum leverage limits may only be changed with the approval of investors and the Registrar
- The Registrar will have the powers and discretion to interrogate and object to leverage limits that may be deemed inappropriate, after discussion with the CIS (hedge fund) manager
The prime broker fulfils several critical functions for a hedge fund. One of the critical roles is to be a *counterparty* to hedge funds by providing them with leverage or securities lending (for short selling).

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 brokerage and custodian operations*

- Where the prime broker is also the custodian, there must be clear legal and physical segregation of such prime broker’s assets from the funds/investors’ assets.
- In this instance the prime broker will be required to hold the assets of the hedge fund in a statutorily approved nominee company.

Authorised users who are *equity members* of the JSE adhere to the JSE’s daily capital requirements and oversight, and can be appointed as prime brokers on condition that the assets of the hedge fund are segregated from the balance sheet of the authorised user.
Declaration of hedge funds as a CIS will enable the **same tax treatment** as with other CIS.

The hedge fund portfolio will **not** be taxed on amounts distributed to investors within 12 months of accrual (receipt in the case of interest) as with traditional CIS - **taxation will be in the hands of investors**, irrespective of whether investor is Retail or Qualified.

- Capital gains on underlying financial instruments will not be taxed in the CIS or investors – the only capital gains to be taxed is when investors dispose of their participatory interests.
- Investors (QIHF or RIHF) will also be allowed to treat gains and losses from the disposal of their participatory interest as of **capital nature if the participatory interest was held for a period of at least three years**.
- **This tax treatment is the same for investors** in both RIHFs and QIHFs.

Treasury in current discussions with SARS to consider the tax treatment of **structure conversions**.
Regulated products provide confidence to investors
CIS are transparent and convenient way to save for the long term
Two types of products cater for different risk appetites
  - Remember, losses only up to invested capital and not beyond
Enhanced disclosure means you know what you are getting yourself into and can hold fund manager accountable
Enhanced disclosure means Supervisor is better abled to protect you
Liquidity requirements facilitate orderly but required redemptions
Better management of systemic risk
  - Financial crisis impose a major cost on entire society!
IMPLICATIONS FOR FUNDS

- Regulation at fund level for the first time
- Enhanced disclosure and risk control measures will mean better protection but could mean higher admin costs
  - But benefits of disclosure could outweigh higher admin costs
- Existing structures (partnerships, trusts, debentures) will be accommodated.
- Funds could be required to change structures depending on business
  - Eg focus on QIHF means having an independent administrator or trustee
  - Eg focus on RIHF means converting fully to the current Trust structure with trustee and management company
- Two tiered-regulatory regime very accommodating
- Transitional period of 12 months to be provided from the time of promulgation of the Regulations to enable registration and compliance
- Capital requirements to cover largely operational risk
Thank you