Retail participation in hedge funds: Assessing South African hedge fund regulation

P Steenkamp

orcid.org/0000-0002-3644-9446

Thesis submitted in fulfilment for the requirements for the degree Doctor of Philosophy in Risk Management at the North-West University

Promotor: Prof GW van Vuuren
Co-promotor: Dr M Botha

Graduation: May 2019
Student number: 11994487
ACKNOWLEDGEMENT

For the ones…

This study was so much more than just an academic endeavour, whilst at its inception the purpose was merely that. To every person involved over the extent of the completion of this thesis, the ones whom provided love, support and friendship, the ones who enabled me to experience this journey to the fullest extent, the ones influencing crucial junctures hereof and the ones that provided inspiration. Thank you.

Some had more influence than others. The highest of all the many attributes qualifying a promotor when guiding any research endeavour, in my experience, is belief. Without this trust and confidence in me this study would not have been possible. Gary, I commend you for this.

My family. Ermie, Ruhann, Kylin, Alise. Thank you for loving me.

For the One…

Creator meum Salvator meus Vita mea.
PREFACE

This thesis was completed in fulfilment of the requirements for the degree of Philosophiae Doctor at North-West University, Potchefstroom Campus, under the supervision of Prof Gary van Vuuren and Dr Marius Botha.

The work described in this thesis was carried out by the author whilst in the employment of the North-West University. This study represents the original work of the author. This study has not been submitted in any form to another university. The work of others and data supplied by service providers have been duly acknowledged in the text.

The outcome of this thesis and the contributions it makes to the existing body of knowledge are summarised in Chapter 7, which also sets out future research opportunities. This study aimed to assess retail hedge fund regulation in South Africa to international good practice within the demarcated context.

PHILIP STEENKAMP
23 JANUARY 2019
ABSTRACT

Hedge funds have been regulated more closely since the financial crisis of 2007-2009. This crisis prompted emotive debates amongst financial industry representatives, lawmakers and regulators to identify and evaluate gaps in the international financial architecture. Hedge funds, as an alternative type of investment, function within a highly complex financial system and through intricate investment strategies that require due oversight. The financial crisis exposed regulatory fault lines which, amongst the major contributors, included hedge funds. Hedge funds did not necessarily cause the crisis, but they did contribute to the severity thereof. Self-regulation within markets was absent and contributed, together with other factors, to global efforts to progressively coordinate regulatory efforts. The regulation of this type of alternative investment thus became more comprehensive.

The global investment industry is experiencing a movement towards retailisation, which is not a recent trend. Non-qualified investors or retail investors invest in hedge funds as one of the investment structures available within the range of alternative investment opportunities. The protection of retail investors is a major element of financial regulation and needs to be affirmed, re-affirmed and re-visited. Continued assessment is required to ensure safeguarding within the dynamic, constantly changing and increasingly intricate global financial market system and complex investment landscape.

In the latter half of 2015, hedge funds were designated as Collective Investment Schemes in South Africa. This study pursued the question of whether the enactment of legislative changes affecting hedge fund investment in South Africa measures up to international good practice. This interdisciplinary study more specifically aimed to assess whether retail investment in hedge funds in South Africa incorporates and adheres to international good practice in this regard. The research involved a comparative legal assessment of the global regulatory environment from an investor protection focus. Good practice regarding regulatory standards relevant to retail investment in hedge funds was identified from reports issued by the International Organisation of Securities Commissions (IOSCO), and an examination of the country jurisdictions with the most assets under management (the United States of America and United Kingdom) was conducted. As a political and economic union, the European Union’s (EU) legislative provisions for hedge fund regulation influence all regions within the union and other major investment markets. Therefore, regulation regarding hedge funds in the EU was deemed important and included for the purposes of the study.
From the good practices identified, a premise was established from which an assessment was performed of the regulatory landscape of retail hedge fund investment in South Africa and a benchmarking of local regulation to international good practice.

Findings indicated that excessive regulation would disadvantage retail consumers. It removes flexibility and variety in the basket of available investment opportunities and services that are accessible in less regulated markets. Overregulation in one jurisdiction might lead to disinvestment from a tighter regulated market to less regulated ones resulting in regulatory arbitrage. On the other hand, underproduction or a lack of an effective regulatory framework exposes retail consumers to exploitation and would likely expose retail investors who find themselves in an alternative investment environment. Regulatory balance within a specific jurisdiction requires a sound approach and can be attained by combining the regulatory tools available in that jurisdiction, whether through direct or indirect measures. Economic circumstances must also be considered. For example, international best practice evolved from the integrated and sophisticated financial nature of the global financial architecture and, of course, risk.

The current study endorses the structural reforms to the South African financial system, as well as the inclusion of hedge funds as collective investment schemes in accordance with the Collective Investment Schemes Control Act of 2002. This legal and regulatory framework provides a sound regulatory structure which measures up to international good practice on retail investor protection in hedge funds. The regulatory environment for hedge funds has seen a transference of assets into retail investor hedge funds, which can be ascribed to investor confidence growing as a result of this very same regulation. Unfortunately, risk cannot be removed entirely from investments, and such risks are never stagnant. Thus, given the nature of hedge fund investment, South Africa’s hedge fund regulatory framework requires continuous assessment. This should be done to determine the effect and impact of new direct regulation, and possible overregulation, which may turn out to become a barrier to growth within the market.

Key words:

Alternative investment, hedge funds, European Union, financial crisis, financial regulation, financial reform, regulation, retail funds, retail investment, qualified investor fund, IOSCO, securities regulation, South Africa, United Kingdom, United States of America.
Sedert die finansiële krisis van 2007-2009 word verskansingsfondse meer noukeurig gereguleer. Hierdie krisis het hewige debat aangespoor tussen verteenwoordigers, wetgewers en reguleerders in die finansiële bedryf in 'n poging om gapings in die internasionale finansiële argitektuur te identifiseer en te evalueer. As 'n alternatiewe tipe belegging funksioneer verskansingsfondse binne 'n hoog komplekse finansiële stelsel en so deur middel van ingewikkelde beleggingstrategieë wat die nodige toesig vereis. Die finansiële krisis het verskuwingslyne ten opsigte van reguleringsontbloeot, waarvan verskansingsfondse een van die grootste bydraers blyk te wees. Verskansingsfondse het nie noodwendig die krisis veroorsaak nie, maar het wel tot die hewigheid daarvan bygedra. Geen selfregulerings het binne markte plaasgevind nie, wat saam met ander faktore gelei het tot wêreldwye pogings om regulerings in te koördineer. Die regulerings van hierdie tipe alternatiewe belegging het dus meer omvattend geword.

Die globale beleggingsbedryf ondervind tans 'n beweging na verkleinhandeling wat op sigself nie 'n nuwe tendens is nie. Ongekwalificeerde beleggers of kleinhandelbeleggers belê in verskansingsfondse as een van die beleggingstrukture wat binne die reeks van alternatiewe beleggingsgeleenthede beskikbaar is. Die beskerming vir kleinhandelbeleggers is 'n belangrike element van finansiële regulerings en moet bevestig, herbevestig en herbesoek word. Voortdurende assessering is nodig om hierdie beskerming te verseker binne die dinamiese globale finansiële markstelsel en beleggingslandskap wat konstant verander en toeneem in kompleksiteit.

In die laaste helfte van 2015 is verskansingsfondse in Suid-Afrika tot Kollektiewe Beleggingske- mas verklaar. Hierdie studie poog om te bepaal of die verordening van wetsveranderinge wat op verskansingsfondsbeleggings in Suid-Afrika betrekking het aan internasionale goeie praktyk vol- doen. Hierdie interdissiplinêre studie beoog meer spesifiek om te evalueer of kleinhandelbelegging in verskansingsfondse in Suid-Afrika internasionale goeie praktyk inkorporeer en dit navol. Die navorsing behels 'n vergelykende regsassessering van die globale regulerende omgewing vanuit 'n beleggersbeskermingsfokus. Goeie praktyk ten opsigte van regulerende standaarde vir kleinhandelbelegging in verskansingsfondse is uit verslae van IOSCO (International Organisation of Securities Commissions) geïdentifiseer, en 'n ondersoek na die jurisdicties met die meeste bates onder bestuur (die VSA en Verenigde Koninkryk) is uitgevoer.
As politieke en ekonomiese unie, oefen die Europese Unie (EU) se wetlike bepalings vir verskansingsfondsregulasies ’n invloed uit op alle streke binne die unie, asook op ander vername beleggingsmarkte. Dus is die regulering van verskansingsfondse in die EU as belangrik beskou en vir die doeleindes van die studie ingesluit.

Die goeie prakties wat geïdentifiseer is, het die basis gevorm vir die assessering van die regulerings landskap van kleinhandel-verskansingsfondsbelegging in Suid-Afrika, asook vir die vasstelling of plaaslike regulering dieselfde peil as internasionale goeie praktiek handhaaf.

Die bevindinge het getoon dat oormatige regulering tot nadeel van kleinhandelverbruikers kan wees. Dit verwyder soepelheid en verskeidenheid uit die mandjie van beskikbare beleggingsgeleenthede en -dienste waartoe minder gereguleerde markte toegang bied. Oormatige regulering in een jurisdiksie kan lei tot disinvestering in ’n streng gereguleerde mark na een wat minder gereguleer word, wat weer tot regulerende arbitrage kan lei. Aan die ander kant kan onderproduksie of die gebrek aan ’n doeltreffende regulerende raamwerk die kleinhandelverbruiker aan uitbuiting blootstel en kleinhandelbeleggers wat hulleself in ’n alternatiewe beleggingsomgewing bevind, ontbloot.

Balans ten opsigte van regulering binne ’n spesifieke jurisdiksie vereis ’n grondige benadering. So ’n benadering kan verkry word deur die reguleringsinstrumente wat in daardie jurisdiksie beskikbaar is, te combineer, hetsy deur direkte of indirekte maatreëls. Ekonomiese omstandighede moet ook in ag geneem word, byvoorbeeld internasionale beste praktiek gevorm weens die geïntegreerde en gesofistikeerde finansiële aard van die globale finansiële argitektuur, en risiko natuurlik.

Die huidige studie onderskryf die strukturele hervormings van die Suid-Afrikaanse finansiële stelsel, asook die insluiting van verskansingsfondse as kollektiewe beleggingskemas ingevolge die Wet op die Beheer van Kollektiewe Beleggingskemas van 2002. Hierdie wetlike en regulerende raamwerk verskaf ’n grondige regulerende struktuur wat voldoen aan internasionale goeie praktiek ten opsigte van beskerming vir kleinhandelbeleggers in verskansingsfondse. In die regulerende omgewing vir verskansingsfondse het ’n oordrag van bates na kleinhandelbelegger-verskansingsfondsplaasgevind. Dit kan toegeskryf word aan die feit dat beleggersvertroue begin groei het weens hierdie einste regulasie. Risiko kan egter nooit heeltemal uit beleggings verwyder word nie, en risiko is nooit stagnant nie.
Dus, weens die aard van verskansingsfondsebelegging, word voortdurende assessering van Suid-Afrika se regulerende raamwerk vir verskansingsfondse vereis. Die doel hiervan is om die uitwerking en impak van nuwe direkte regulering te bepaal, asook moontlike oormatige regulering, wat ’n struikelblok tot groei binne die mark kan wees.

Sleuteltermé

Alternatiewe belegging, verskansingsfonds, Europese Unie, finansiële krisis, finansiële reguler- ing, finansiële hervorming, regulering, kleinhandelfonds, kleinhandelbelegging, gekwalifiseerde belegger-fonds, IOSCO, effekteregulering, Suid-Afrika, Verenigde Koninkryk, VSA.
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<td>ACS</td>
<td>Authorised Contractual Scheme</td>
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<tr>
<td>AIF</td>
<td>Alternative Investment Fund</td>
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<tr>
<td>AIFM</td>
<td>Alternative Investment Fund Managers</td>
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<td>AIFMD</td>
<td>Alternative Investment Fund Managers Directive</td>
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<td>AIM</td>
<td>Alternative Investment Market</td>
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<td>AIMA</td>
<td>Alternative Investment Management Association</td>
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<td>AMC</td>
<td>Asset Management Committee</td>
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<td>AMCP</td>
<td>Asset Managers Committee Principles</td>
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<td>AUT</td>
<td>Authorised Unit Trust</td>
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<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
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<td>BIS</td>
<td>Bank of International Settlements</td>
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<tr>
<td>CESR</td>
<td>Committee of European Securities Regulators</td>
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<td>CIS</td>
<td>Collective Investment Scheme</td>
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<td>CISCA</td>
<td>Collective Investment Schemes Control Act of 2002</td>
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<tr>
<td>CFTC</td>
<td>Commodity Futures Trading Commission (United States)</td>
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<td>CMU</td>
<td>Capital Market Union</td>
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<tr>
<td>COLL</td>
<td>Collective Investment Schemes Sourcebook</td>
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<td>DFA</td>
<td>Dodd-Frank Act</td>
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<td>EBA</td>
<td>European Banking Authority</td>
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<td>EC</td>
<td>European Commission</td>
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<td>EEA</td>
<td>European Economic Area</td>
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<td>EFAMA</td>
<td>European Fund and Asset Management Association</td>
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<td>EMIR</td>
<td>European Market Infrastructure Regulation</td>
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<td>ERISA</td>
<td>Employee Retirement Income Security Act of 1974</td>
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<td>ESAs</td>
<td>European Supervisory Authorities</td>
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<td>ESFS</td>
<td>European System of Financial Supervisors</td>
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<td>ESRB</td>
<td>European Systematic Risk Board</td>
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<td>ESRC</td>
<td>European Systemic Risk Council</td>
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<td>ESMA</td>
<td>European Securities and Markets Authority</td>
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<td>ETFs</td>
<td>Exchange Traded Funds</td>
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<td>EU</td>
<td>European Union</td>
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<td>EuSEF</td>
<td>European Social Entrepreneurship Funds</td>
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<td>EuVE-CA</td>
<td>European Venture Capital Funds</td>
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<td>FAIFS</td>
<td>Funds of Alternative Investment Funds</td>
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<td>FAIS</td>
<td>Financial Advisory and Intermediary Services Act of 2002</td>
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<td>FATF</td>
<td>Financial Action Task Force</td>
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<td>FINRA</td>
<td>Financial Industry Regulatory Authority</td>
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<td>FCIA</td>
<td>Financial Conduct Authority</td>
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<td>FCIC</td>
<td>Financial Crisis Inquiry Commission</td>
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<td>FG</td>
<td>Fiduciary Guide</td>
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<td>FPC</td>
<td>Financial Policy Committee</td>
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<td>FRSC</td>
<td>Financial Reform Steering Committee</td>
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<td>FSA</td>
<td>Financial Sector Authority</td>
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<td>FSB</td>
<td>Financial Stability Board</td>
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<td>Abbreviation</td>
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<tr>
<td>FSBSA</td>
<td>Financial Services Board South Africa</td>
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<td>FSCA</td>
<td>Financial Sector Conduct Authority</td>
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<td>FSF</td>
<td>Financial Stability Forum</td>
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<td>FSMA</td>
<td>Financial Services and Markets Act of 2000</td>
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<td>FSOC</td>
<td>Financial Stability Oversight Council</td>
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<tr>
<td>FSP</td>
<td>Financial Services Provider</td>
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<td>FSRA</td>
<td>Financial Services Regulation Act</td>
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<td>GAO</td>
<td>Government Accountability Office (United States)</td>
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<td>GFA</td>
<td>Global Financial Architecture</td>
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<td>HFTA</td>
<td>Hedge Fund Transparency Act of 2009</td>
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<td>HLI</td>
<td>Highly Leveraged Institution</td>
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<tr>
<td>IA</td>
<td>Investment Association</td>
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<td>IAA</td>
<td>Investment Advisors Act of 1940</td>
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<tr>
<td>IADI</td>
<td>International Association of Deposit Insurance</td>
</tr>
<tr>
<td>IAIS</td>
<td>International Association of Insurance Supervisors</td>
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<td>IASB</td>
<td>International Accounting Standards Board</td>
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<td>IC</td>
<td>Investor Committee</td>
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<td>ICA</td>
<td>Investment Company Act of 1940</td>
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<td>ICFP</td>
<td>Investor Committee Fiduciary Principles</td>
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<td>ICIP</td>
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<tr>
<td>ICVC</td>
<td>Authorised Investment Company with Variable Capital</td>
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<td>IFAC</td>
<td>International Federation of Accountants</td>
</tr>
<tr>
<td>IG</td>
<td>Investor’s Guide</td>
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<td>Acronym</td>
<td>Full Form</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IOSCO</td>
<td>International Organisation of Securities Commissions</td>
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<tr>
<td>JSE</td>
<td>Johannesburg Stock Exchange</td>
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<tr>
<td>KID</td>
<td>Key Information Document</td>
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<tr>
<td>KIID</td>
<td>Key Investor Information Document</td>
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<tr>
<td>LSE</td>
<td>London Stock Exchange</td>
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<tr>
<td>LTCM</td>
<td>Long Term Capital Management</td>
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<td>MFFS</td>
<td>Multilateral Trading Facilities</td>
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<tr>
<td>MiFID</td>
<td>Markets in Financial Instruments Directive</td>
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<tr>
<td>MiFIR</td>
<td>Markets in Financial Instruments Regulation</td>
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<tr>
<td>MMFs</td>
<td>Money Market Funds</td>
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<tr>
<td>MTFs</td>
<td>Multinational Trading Facilities</td>
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<tr>
<td>NURS</td>
<td>Non-UCITS Retail Funds</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<tr>
<td>OEIC</td>
<td>Open Ended Investment Company</td>
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<tr>
<td>OFR</td>
<td>Office of Financial Research</td>
</tr>
<tr>
<td>OpR</td>
<td>Operational Risk</td>
</tr>
<tr>
<td>OTC</td>
<td>Over-the-counter</td>
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<tr>
<td>PA</td>
<td>Partnership Act of 1890 (US)</td>
</tr>
<tr>
<td>PEPP</td>
<td>Pan-European Personal Pension’s Product</td>
</tr>
<tr>
<td>PRA</td>
<td>Prudential Regulation Authority</td>
</tr>
<tr>
<td>PRIIP</td>
<td>Packaged Retail Insurance-Based Investment Product</td>
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<tr>
<td>PWG</td>
<td>President’s Working Group</td>
</tr>
<tr>
<td>Acronym</td>
<td>Description</td>
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<tr>
<td>QI</td>
<td>Qualified Investor</td>
</tr>
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<td>QIHF</td>
<td>Qualified Investor Hedge Fund</td>
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<tr>
<td>QIS</td>
<td>Qualified Investment Scheme</td>
</tr>
<tr>
<td>RAO</td>
<td>Regulated Activities Order</td>
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<tr>
<td>REITS</td>
<td>Retail Estate Investment Trusts</td>
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<tr>
<td>RIHF</td>
<td>Retail Investor Hedge Fund</td>
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<tr>
<td>SEA</td>
<td>Securities Exchange Act of 1934</td>
</tr>
<tr>
<td>SEC</td>
<td>Security and Exchange Commission</td>
</tr>
<tr>
<td>SRO</td>
<td>Self-Regulatory Organisation</td>
</tr>
<tr>
<td>SSA</td>
<td>Securities Services Act of 1933</td>
</tr>
<tr>
<td>SSM</td>
<td>Single Supervisory Mechanism</td>
</tr>
<tr>
<td>SUP</td>
<td>Supervisory manual of the FCA’s Handbook of rules and guidance</td>
</tr>
<tr>
<td>SYSC</td>
<td>Senior Management Arrangements, Systems and Controls sourcebook of the FCA’s Handbook of rules and guidance</td>
</tr>
<tr>
<td>UCIS</td>
<td>Unregulated Collective Investment Scheme</td>
</tr>
<tr>
<td>UCITS</td>
<td>Undertakings for Collective Investment in Transferable Securities</td>
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<tr>
<td>UK</td>
<td>United Kingdom</td>
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<td>US</td>
<td>United States</td>
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<tr>
<td>UUT</td>
<td>Unauthorised Unit Trust</td>
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<tr>
<td>WEF</td>
<td>World Economic Forum</td>
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CHAPTER 1 INTRODUCTION

1.1 Background and motivation

1.1.1 Global advancement towards financial market reforms and regulation

The global financial system is constantly evolving and, consequently, stirs ongoing debate about what should be regulated and how such regulation should occur (Davies & Green, 2008:2-3). In this evolutionary process, financial systems function as complex networks in which firms interact through markets (directly or indirectly) within a distinct legal framework or set of legal rules (Anabtawi & Schwarcz, 2013:76). A system is regarded “law related” when law forms an integral component of the system. Law is regarded innate to any financial system, as its removal would alter the system’s operational behaviour (LoPucki, 1997:82). The elements of a financial system, as a law-related system, can be identified, from a functional approach, as firms, markets and legal rules (Anabtawi & Schwarcz, 2013:83-85). The importance of legal rules as a component of this functional approach is emphasised, as both financial firms and financial markets operate within the context of various bodies of regulation which govern the allocation, provision and deployment of financial capital. Broadly formulated, a financial system can be regarded as “legally constructed” (Pistor, 2013:315-317).

Owing to the fragmented spread of regulations across various administrative authorities, four basic types of regulations can be identified: (i) market integrity (or market conduct) regulations, (ii) competition regulations, (iii) prudential regulations, and (iv) consumer protection regulations (Anabtawi & Schwarcz, 2013:83-85). These types of financial regulations establish law as an integral element of the financial system (Pistor, 2013:325).

The international dimension of financial regulation is no longer regarded as having a marginal influence on any domestic regulatory regime; it is regarded as the most dominant question in financial markets today (Davies & Green, 2008:5-6). The 2008 financial crisis (hereafter “financial crisis” or “crisis”) and subsequent worldwide recession left the global financial milieu, and financial reform, in disarray. Globalised capital markets, changes in channels of financial intermediation and changes to the global financial architecture (GFA) after the crisis have revived discussions on international financial regulation. Developments such as these pose many challenges to financial regulation (Cannata & Quagliariello, 2009; McBarnet, 2010).

An understanding of the growing interdependencies of markets within a global financial system is required to ensure the ability to deal with consequences, whether intended or unintended (Davies
The crisis spurred emotive debates amongst financial industry representatives, lawmakers and regulators on the gaps in the GFA that had been exposed by the crisis (Pagliari, 2012:45). A further issue of contention was how these gaps should be addressed. Should public regulators intervene, or should private sector participants be given first opportunity to correct mistakes? (Pagliari, 2012:45; Stoll-Davey, 2008).

The crisis demonstrated the extent of interconnectivity amongst economies. Since its origin in the banking sector, the crisis has precipitated a shrinking of demand for goods and services across the world. This had the same negative impact on manufacturing and commodity producers as on the financial sector itself. The sense of a shared fate led commentators to incorporate the dialogue relating to globalisation directly into their analyses of the causes of and responses to the crisis. The characterisation of the crisis as “global” contributed largely to the renewed reform of the GFA that generated, amongst others, the reform of international institutions such as the G20 (Morgan, 2011:588). The cause of the crisis might be attributed to many factors. Some of these include government policies and a macro-economic environment conducive to reckless behaviour on the part of financial institutions and consumers. A process of “legal engineering” that is understood to be cleverly conceptualised legal frameworks that allows room the existence of complex financial instruments, were also blamed (McBarnet, 2010). According to Financial Crisis Inquiry Commission (FCIC, 2011:xviii-xix), failures in financial regulation, supervision, corporate governance and risk management all played an important part in the crisis. Helleiner (2011:568) also regards regulatory mistakes and global imbalances as two of the key causes thereof.

With regard to addressing these failures, Naudé (2011:2) asserts that global financial regulation and supervision are two key dimensions of the GFA that need urgent reform. Falkena et al. (2001:iii) also regard financial regulation as core to maintaining effective financial markets, institutions and financial service providers. It is evident that the crisis posed challenges to financial regulation. As a result, financial systems are regulated and supervised more stringently in the aftermath of the crisis than any other system worldwide (particularly in the light of the potential severity of the systemic risks posed and the importance of consumer protection) (Cannata & Quagliariello, 2009; Elson, 2010:17). Experience has shown that regulation strongly impacts the size, structure and efficiency of a financial system; the business operations of financial markets and institutions; and competitive conditions overall and amongst subsectors of the system (Falkena et al., 2001:v; Stoll-Davey, 2008). Porter (2005) argues that global finance and its governance have become extensively institutionalised and well established in transnational governance regimes. Public authorities are constantly faced with ever-changing global markets which, in a sense, have forced them to rely on hybrid blends of dispersed public and private regulation. This has occurred mostly through international forums or organisations such as the Financial
Stability Board (FSB) (previously the Financial Stability Forum [FSF]) or the Organisation for Economic Co-operation and Development (OECD) (Lutton, 2011:37; Porter, 2009).

In November 2008 the leaders of the G20 countries called for an extended membership to the then FSF to strengthen its effectiveness as a mechanism for national authorities, standard-setting bodies and international financial institutions with the ultimate aim of addressing vulnerabilities and developing and implementing strict regulatory, supervisory and related policies in the interest of financial stability (FSB, 2014). During its summit in November 2008, the G20 leadership focused primarily on the strengthening of financial regulation. This resulted in an agreement on a 47-point action plan for curbing deteriorating financial market conditions and the improvement of financial regulation throughout membership country jurisdictions (G20, 2008). The root causes of the financial crisis were identified as the inadequate appreciation of risk and the lack of exercise of due diligence in the search for higher yields following a period of strong global growth, increased capital flows and prolonged stability. At the same time, unsound risk management practices, weak underwriting standards, increased complex financial products and consequent excessive leveraged positions had combined to create vulnerabilities within the global financial system (G20, 2008). Also, policy makers, supervisors and regulators, even in advanced countries, had not adequately appreciate the slow accumulation of risk within financial markets or kept abreast with financial innovation against the backdrop of the possible systemic ramifications of domestic regulatory actions (G20, 2008).

Agreement was reached that a broader policy response was required, and parties committed themselves towards implementing policies that are consistent with common reform principles, which included (G20, 2008):
- strengthening transparency and accountability;
- enhancing sound regulation;
- promoting integrity in financial markets;
- reinforcing international cooperation; and
- reforming international financial institutions.

In April 2009, the FSB was established as the successor to the FSF in accordance with the policy response voiced six months earlier by the G20 (2008). The FSF had united national authorities responsible for financial stability in significant international financial centres (treasuries, central banks and supervisory agencies), as well as sector-specific international groupings of regulators and supervisors tasked with the development of standards and codes of good practice (FSF, 2006). Also included were committees of central bank experts tasked with market infrastructure and functioning, along with international financial institutions (responsible for the surveillance of
domestic and international financial systems, including monitoring and fostering implementation of standards) (Cannata & Quagliariello, 2009; G20, 2014).

At the second heads of state G20 summit, hosted in London in April 2009, leaders agreed that major failures in financial regulation and supervision were fundamental causes of the financial crisis and that a stronger, more resilient, globally consistent supervisory and regulatory framework should be developed for a future financial system.

On 24 and 25 September 2009, the third meeting of the heads of state of the G20 was held in Pittsburgh, with the purpose of discussing financial markets and the world economy at that time (G20, 2014). The nature and role of shadow banking were highlighted as unregulated financial activities by regulated financial entities or banking-related activities undertaken by unregulated financial entities (Bakk-Simon et al., 2012; Makhubela, 2014:3-4). Certain hedge fund activities were also included as activities forming part of shadow banking. The subsequent G20 declaration highlighted the need for the expansion of regulations pertaining to shadow banking, privately pooled investments, alternative investment funds (which included hedge funds) and the use of over-the-counter (OTC) derivatives (EC, 2018; Bakk-Simon et al., 2012; G20, 2009a).

The weakness of a pre-crisis “light touch approach” towards financial regulation led the way to creating minimum international standards and greater coordination amongst national regulators at G20 level. It raised questions concerning the adequacy of financial regulation, an important component of GFA reform (Naudé, 2011:2), as well as concerning the oversight and supervision of a consolidated system of exchanges, integrated financial markets and specifically whether private equity and hedge funds had created threats to financial stability and the integrity of traded markets. These questions the system failed to address, according to Davies and Green (2008:11-12).

Against this background, the focus is henceforth on hedge funds.

1.1.2 Hedge funds and their role in the crisis

Together with the re-assessment of the robustness of the entire global financial system, the regulation of hedge funds has gained prominence post the crisis. Hedge funds have become favoured by many institutional and private and investors since the early 2000s. At its peak during the latter half of 2008, the hedge fund market had more than USD2tn in assets under management, according to industry estimates (Cumming & Dai, 2010:830; Stoll-Davey, 2008).

As an effective channel of non-bank intermediation, hedge funds’ increased popularity has led to a record level of capital invested in the global hedge fund industry, totalling more than USD2.6tn
in 2013 (Prequin, 2014:25). Net capital inflows for the industry at the end of 2015 were recorded reaching USD71.5bn (Prequin, 2016a). This took the global hedge fund industry to managing nearly USD3.2tn (Prequin, 2016b).

Changes to international hedge fund regulation were supported by stakeholders as far back as the collapse of Long Term Capital Management (LTCM) in 1998 (Edwards, 1999). The crisis did not undermine the support for industry-driven codes of good practice and market-based regulatory reforms emanating therefrom (Pagliari, 2012:57). At the outset of the crisis, European leaders, including the German government as most vocal about direct regulation of such investment vehicles, supported self-regulatory initiatives drafted by a group of London-based hedge funds (Hedge Fund Working Group, 2009). US federal regulatory agencies took it upon themselves to create two advisory groups, consisting of investors and hedge fund managers respectively, with the mandate of creating private sector-driven principles of good practice (Pagliari, 2012:58).

However, due to the hedge fund industry’s lukewarm reception of self-regulatory principles during and post the G20 Washington and London summits, industry-driven initiatives were not successful in deflecting more stringent regulation. At the London summit, G20 leaders agreed that hedge funds and their managers would have to be registered and be required to disclose appropriate information continuously to regulators and supervisors to stifle the build-up of systemic risk posed individually or collectively (Brown, Green & Hand, 2012; G20, Leaders’ statement: Pittsburgh Summit, 2009b).

### 1.1.2.1 Defining hedge funds

Providing a precise definition of “hedge funds” is an elusive exercise, because many funds have adopted qualities of the management of a classic hedge fund model, for instance, fee structures and discretionary trading mandates. Furthermore, attempts to formulate precise definitions always bring to fore inescapable borderline issues (Eichengreen, Mathieson & Sharma, 1998). Therefore, hedge funds can be best defined by viewing them in the context of their regulatory environment (Brown & Goetzmann, 2001:4), which means they can be described as by-products of regulatory exemptions. In this way, hedge funds are defined by reference to what they were not (De Brouwer, 2001; Nabilou, 2014:22).

Hedge funds have been referred to as eclectic investment pools, typically organised as private partnerships and often located offshore for tax and regulatory reasons (Eichengreen & Mathieson, 1999). Strömqvist (2009:87) sees “hedge funds” as a collective term for different types of investment funds. She describes hedge funds, in general, as funds with absolute return targets for
financially sophisticated investors, of which some funds employ hedging strategies to protect investor funds, whereas others do not (Brown & Goetzmann, 2001:4; Brown et al., 2001; EC, 2018; Strömqvist, 2009:87). Bookstaber (1997:102) also experienced problems providing an exact definition. According to him, hedge funds encompass a wide range of investment strategies minus traditional funds and investment strategies.

Providing a precise definition of hedge funds is complicated by the fact that other investors engage in similar practices. Individual and institutional investors buy stocks on margin (Eichengreen et al., 1998). Commercial banks utilise leverage in the sense that a fractional reserve banking system can be viewed as a group of leveraged financial institutions whose total assets and liabilities are several times their capital. The proprietary trading desks of investment banks buy and sell derivatives, take positions and alter their portfolios in the same way as hedge funds (Brown et al., 2001; Eichengreen & Mathieson, 1999; Nabilou, 2014).

The US President’s Working Group on Financial Markets (1999) (PWG) defines a hedge fund as a pooled investment vehicle that is privately organised and administered by a professional investment manager and not widely available to the public.¹ According to Brentani (2004), there are two important aspects of hedge funds. The first is that they aim to generate absolute positive returns by taking risk and not returns relative to a predetermined index. Furthermore, they try to control losses and avoid negative compounding of capital. Garbaravicius and Dierick (2005) define hedge funds as unregulated or loosely regulated funds which can freely employ various active investment strategies to achieve positive absolute returns. The lack of clarity on agreement of the term “hedge fund”, its diverse trading spectrum and its general non-availability of an accepted definition leave only its characteristics to indicate its classification.

Hedge funds are characterised by the employment of aggressive trading strategies that allow for positive market returns in all market conditions, as well as high fee structures (Fung & Hsieh, 1999:314). This usually addresses principal-agent issues by aligning the interests of managers with those of investors. Hedge funds are typically opaque with very little disclosure beyond their trading strategy to investors and prime brokers. They are also highly levered institutions, but not uniquely so (King & Maier, 2009:284-285). They typically leverage their positions by margining positions using short sales (Fung & Hsieh, 1999:314). The characteristics which distinctly separate hedge funds from mutual funds, or any other fund for that matter, are their flexible and dynamic investment strategies, flexible regulatory frameworks, high levels of leverage and absolute

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¹ The PWG was established for purposes of enhancing the effectiveness, orderliness, efficiency and competitiveness of US financial markets and to maintain investor confidence (United States, 1988).
return targets, expensive fee structures, as well as minimum investment limits and redemption periods (Strömqvist, 2009:87).

Initial proposals for defining the term “hedge fund” in South Africa, captured in a joint discussion paper, referred to funds that utilise some form of short asset exposures or short selling to reduce risk or volatility, preserve capital and enhance returns (Bouwmeester, 2005:27). Furthermore, these funds use some sort of leverage of which the gross exposure of underlying assets exceeds the amount of capital in the fund, and the manager of the fund charges a fee based on performance of the fund relative to an absolute return benchmark (Bouwmeester, 2005:31). In terms of the Explanatory Memorandum on the Draft Regulations for Hedge Funds in South Africa, published by the National Treasury of South Africa on 16 April 2014, the most distinct component of hedge funds relative to other collective investment schemes (CISs) is the use of leverage (National Treasury, 2012b; National Treasury, 2014:4-5). These draft regulations define a “hedge fund” as a CIS which uses any strategy or takes any position that could result in the portfolio incurring losses greater than its aggregate market value at any point in time, and of which the strategies and/or positions include, but are not limited to, leverage or net short positions (National Treasury, 2012b; National Treasury, 2014:5).

The structure of hedge funds differs amongst international jurisdictions. In the US, hedge funds are set up in the form of a limited partnership whereby investors are regarded as limited partners and hedge fund managers as general partners in most foreign international jurisdictions (Fung & Hsieh, 1999:310; Makhubela, 2014:1). As general partners, hedge fund managers invest significant portions of their own wealth into such a partnership to align their own economic interests with those of their partners.

Hedge funds have remained accessible to a limited audience due to high minimum-entry requirements and restrictions on withdrawals that allow them to remain mostly unregistered. This has left managers free to pursue investment strategies that would not have been regarded as prudent for other investment funds such as mutual funds.

Hedge fund strategies are facilitated by various parties. The typical parties involved in the operation of a hedge fund, according to Cumming, Imad'Eddine, et al. (2012:1008), are illustrated in Figure 1-1.
The typical parties appointed to operate a hedge fund are the administrator, the registrar or transfer agent, the custodian and the prime broker. A hedge fund’s board of directors has a fiduciary duty to investors to ensure that all parties involved carry out their responsibilities diligently (Cumming & Dai, 2010:830; National Treasury, 2012b). Hedge fund managers are assisted by various professional advisors, including tax, legal and audit specialists, amongst others. Administrators assist fund managers in providing fund administrative accounting services that include record keeping, independent evaluations of investments and meeting disclosure requirements. These duties can, however, be performed internally by the hedge fund manager. The execution of investments and the implementation of actual financing arrangements are done by the prime broker, which can be either a bank or securities firm. These firms or prime brokers can also become fund managers. Custodians fulfil the important role of maintaining custody over managed fund assets (Cumming, Imad’Eddine, et al., 2012:1008).
1.1.2.2 The role of hedge funds in the financial crisis

The latter half of the 21st century saw financial markets increasingly trade beyond international borders, more so than ever before (Davies & Green, 2008:7; Obstfield & Taylor, 2002). This has kept increasing, alongside channels of intermediation. Whilst most business flowed through bank balance sheets, a limited number of investment funds or insurance companies provided a wider range of investment vehicles which evolved mostly due to the unpredictable increase in private wealth. The most prominent of these were private equity and hedge funds, funded by high-net-worth investors and organised in an informal way, and have, until recently, gone largely unregulated (Davies & Green, 2008:8).

Since the early 1990s, a dramatic increase in financial innovation has been seen globally. Combined with a largely unregulated industry, like that of hedge funds, risks related to financial systems increased as well. Financial globalisation further led to greater investments and trade across borders by financial institutions and investors. Although increased cross-border trade and investment, by financial institutions especially, led to the reducing of frictions to trade, as well as greater trade across markets with increased risk sharing and market liquidity, the impact of shocks originating in one market was quickly transmission to other markets. Financial assets increased in complexity and resulted in greater information asymmetry, causing uncertainty about the creditworthiness of counterparties. Owing to deregulation, unregulated actors expanded in key markets which, in turn, caused a lowering in credit standards and, subsequently, weaker monitoring by financial intermediaries because of competitive dynamics and poor incentives. This can be seen clearly when the effects of the crisis are evaluated (King & Maier, 2009:287). The increased development of new financial instruments, therefore, makes the transfer of large-scale complex risks easier in general. Global financial markets have developed even further to incorporate the growing dominance of a small number of institutions with enormous balance sheets, such as hedge funds.

The contribution of hedge funds to the dire impact of the crisis experienced by global markets has so far been substantiated in various fora, most importantly, the FSB and G20. The role that hedge funds played in causing the crisis was profound and undeniable. At the very least, hedge funds contributed to the systemic magnitude of the crisis (Brown, Green & Hand, 2012).

According to Lysandrou (2012:225), two arguments are central to hedge funds’ line of defence concerning their contribution to the cause of the crisis. The first is that they were not the creators of the toxic securities which fell at the epicentre of the crisis. In other words, they did not provide the non-performing mortgages, neither did they repackage these securities by bundling them together as collateral for other securities. Ratings of these structured securities were provided by
rating agencies and their distribution was mediated through banks. The second argument asserts that they were not the only buyers of high yielding, subprime-backed securities. Other parties, including European and Asian banks, pension and mutual funds, as well as insurance companies, were also seduced into purchasing their fair share (Lysandrou, 2012:226; Shadab, 2008b). The defence strategy, according to Lysandrou (2012), is thus that hedge funds made themselves as invisible as possible by disassociating with subprime products and disappearing amongst their buyers.

This strategy worked, as major banks were left with most of the blame. The rapid growth of hedge funds and their high leverage posed potential risks to the broader economy, but they were not blamed in the US for reckless trading practices nor as contributors to the crisis (Lysandrou, 2012:226). This line of argument positions hedge funds as causal role players in the crisis. Whether hedge funds are viewed as direct contributors to the crisis or whether their special role as intermediaries is considered, the pivotal part they play in financial markets, as well as their systemic influence, is undeniable and focuses attention on the importance of regulating such influential financial market “role players” (Brown, Green & Hand, 2012). The regulation of hedge funds was, therefore, unavoidable in the global economic restructuring following the financial crisis.

1.1.3 The regulation of hedge funds in South Africa

In the aftermath of the crisis, South Africa agreed to the minimum international standards and greater coordination amongst national regulators at a G20 level (G20, 2008:1). In April 2009, the first set of international plans for the regulation of hedge funds was agreed upon: Regulation and oversight would be extended to all systemically important financial institutions, instruments and markets, including hedge funds (G20, 2009a:4).

This represented a departure from the initial stance where hedge funds explicitly rejected international regulation due to disagreements between governments that opposed regulatory expansion of international regulatory authority and governments that sought agreement both on regulation of funds and their managers. International coordination in matters relating to the systemic risks posed by hedge funds was also sought (Fioretos, 2010:696-697).

What is, however, of importance is that the content of international hedge fund regulations not be attributed narrowly to the financial crisis. Global reform on finance, and specifically the GFA, is regarded as one of the most critical challenges for achieving globally coordinated finance (Naudé, 2011:1). Deregulation, economic and political dominance of the financial sector by the 2000s,
together with a dramatic growth in the volume of international trade and finance on the back of increased globalisation were the trends which gave context to the financial crisis (Naudé, 2011:1).

South Africa’s commitment to the implementation of higher global financial standards is highlighted through its participation in multilateral institutions and fora such as the IMF, G20, FSB and the Basel Committee on Banking Supervision (BCBS). South Africa committed itself to implementing higher standards of financial regulation in an attempt to make the financial sector safer and better (FRSC, 2013:1). This resulted in the Cabinet’s adoption of proposed financial reforms in 2011. The main objective of these proposals was the development of institutions to deal with system-wide macro-prudential risks (FRSC, 2013:3).

The National Treasury, together with the FSB, as primary market conduct regulator in South Africa, proposed a framework for the regulation of hedge funds in South Africa in 2012 (National Treasury, 2012b). The purpose of the proposed framework was to regulate and supervise hedge fund structures under the existing Collective Investment Schemes Control Act of 2002 (CISCA) by creating a separate category of CIS for hedge funds. The intention was thus to regulate hedge fund structure rather than hedge fund service providers. Furthermore, these objectives had to be aligned with the International Organisation of Securities Commissions (IOSCO). Thus, it became mandatory for hedge fund managers and their portfolios to adhere to comprehensive disclosure requirements to both a registrar and investors. In addition to disclosure requirements, high levels of leverage and risk taking needed to be monitored. Managers of financial service providers are regulated under the Financial Advisory and Intermediary Services Act of 2002 (FAIS). Combined, these proposals (together with current requirements in terms of FAIS administered under the Financial Services Board South Africa [FSBSA]) created the regulatory framework to which hedge funds and managers thereof must adhere (South Africa, 2002b).

New proposals in terms of CISCA introduced two separate categories of hedge funds available to investors, namely Qualified Investor Hedge Funds (QIHFs) and Retail Investor Hedge Funds (RIHFs). QIHFs are prohibited from soliciting participatory interest from the public and are limited in their membership to private arrangements amongst qualified investors. RIHFs, on the other hand, are regulated more closely with strict prescriptions to types of assets and leverage, amongst others. These funds are open to investments from both retail investors and institutional investors (South Africa, 2002a; FSB, 2014:6; National Treasury, 2012b).

This new regulatory administration effectively opened up hedge fund investment to a retail sector and, consequently, ushered in a new dispensation of investment opportunities and possible growth. However, it also created a high-risk investment environment in for retail investors. The obvious questions to be answered, not all necessarily so by this thesis, include whether legislative
reforms would be sufficient to protect investors from exposure to such volatile and high-risk investments and whether retail investors, who (through the enactment of these proposals) gain greater opportunity to invest directly into hedge funds, have sufficient protection when doing so.

Hedge funds are inherently high-risk investment vehicles, originally designed for smaller groups of sophisticated investors who invest large amounts of money and are familiar with the risks associated with the typical investment strategies and financial instruments employed by these funds. Retail investors, as the “man on the street”, who are mostly unfamiliar with such investment strategies, are more vulnerable to misleading practices and/or unnecessary exposures that could adversely affect their investment. Institutional investors necessarily absorb losses more easily than retail investors because of professional and informed managers and oversight, which is usually backed by sufficient liquidity to manage out a possible disastrous investment. Institutional investors are, therefore, afforded a luxury not necessarily available to retail investors.

According to Novare’s South African hedge fund survey, assets under management reached a new high in 2014 with hedge fund assets surpassing R50bn and the largest single-manager hedge fund assets surpassing R5bn (Novare Investments, 2014:2). With regard to total assets under management, these figures reflect an increase of more than R10bn from 2013 (Novare Investments, 2013). This substantial increase can be attributed to a combination of a strong positive performance from managers and net flows into the country (Novare Investments, 2014:3).

Funds of hedge funds remained the largest allocators of capital to the local hedge fund industry, but with a noticeable decrease from 63% in 2013 to 61.8% in 2014 (Novare Investments, 2014:10). However, a marked increase was seen from direct pension fund investments (1.5%) and life funds (0.5%), albeit from offshore investors. This substantiates the sentiment by participants that the anticipated regulation of the hedge fund industry is expected to stimulate growth in assets of retail investors which have, until 2016, not been able to access the industry. More recently, the South African hedge fund industry has experienced a decline in assets under management to approximately R62.2bn. This will be discussed in greater detail in Chapter 6.

Clearly, it is important that investors in hedge funds, as a function of financial regulation in general, be provided with ample protection, aside from regulatory oversight, as a means to managing the possible occurrence of systemic and/or other adverse economic impacts (Brown, Green & Hand, 2012).

This emphasises the necessity of sufficiently regulating hedge funds in a coordinated global effort. Contextualising regulatory advances requires insight into the global picture and of jurisdictions influencing these advances. For this purpose, this study will commence with a discussion on
global developments concerning the subject and, specifically, the country jurisdictions influencing the regulation of the financial system as demarcated. Equally important, retail investments in hedge funds should be regulated more onerously, not only to provide protection to the retail investor, but also to create certainty of how such investments should be managed and dealt with from a regulator’s perspective for purposes of legal certainty and effective regulatory oversight.

1.2 Problem statement

The importance of hedge fund regulation post-crisis is undisputed. Because of changes in the GFA, of which financial regulation was identified to be an important driver, focus on the reform of hedge fund regulation in South Africa has grown substantially. The impact and effectiveness of legislation affecting hedge funds will most certainly have an impact on investors.

Ideally, investors should not only have access to all investment products, but also have the right to decide for themselves which products to buy or which product/risk combinations would suit them best (Edwards, 2006:1-3). They would make investment decisions according to current and expected financial income streams, portfolio of assets and obligations, and their own tolerances for risk. Asset managers, for their part, would then provide various investment products that would satisfy the needs of all investors. Thus, investors would solely be responsible for their own miscalculations and/or decisions relating to their investments. Obviously, the real world complicates this ideal setting considerably. Not all investors have the same information or financial know-how to evaluate the information they obtain. In addition, vendors of investment products are not all honest or forthright in their dealings with investors. Vendors in any event will have a better understanding of their own products than do consumers, and they might have an economic incentive not to communicate all available information to consumers credibly, if at all (Edwards, 2006:3).

Not all retail investors fully comprehend world complexities that would, amongst others, involve information asymmetries, conflicts of interest and disparate investor capabilities, normally understood by many well-equipped or financially sophisticated investors (Edwards, 2006:4). One of the most common solutions is the intermediation of investment advisors who represent investor interests and provide advice on appropriate investments. These professional investment advisors are expected to know more about investment products being offered to their investor clients and, consequently, be able to protect their clients’ interests. An alternative to investors would be to invest their funds with professional fund managers that would make appropriate investment decisions on their behalf (Edwards, 2006:4).

However, market intermediaries are not likely to eradicate the disparities between investor sophistication and information asymmetries. They might well create additional problems due to their
limited knowledge, compared with that of product developers, and regard their own financial interests as more important than the long-term well-being of their clients. Holding advisors and fund managers liable for inappropriate investment decisions or advice clearly falls short of any reliable solution for this problem. In reality, governments and regulators decide on how market complexities should be dealt with, as well as how proactive intervention should be balanced to protect investors against the cost of doing nothing. Some might even argue that it is governments themselves whose decisions are driven by political power rather than by social welfare (Edwards, 2006:4-6).

The difficulty of quantifying these contending considerations resulted in different countries’ reaching different conclusions as to how best to balance these competing interests (Edwards, 2006:5). In almost all countries, however, the favourable resolution seemed that of regulation, which would, at the very least, protect some, if not most, investors. Most countries made a judgement call that the potential benefit of regulation outweighs associated potential cost (Edwards, 2006:6). Therefore, investor protection will always be integral to retail investment markets in most countries. This study examined how investor protection regulation related to retail investors in hedge funds measures up to international good practice principles.

One of the essential pillars of why substantive and effective financial regulation is an imperative is the protection of the investor. Regarding retail investor hedge funds (RIHFs) in South Africa, the problem is that, if their structure is not properly aligned with developments in international retail-market regulatory principles and not well developed, properly enforced and closely guarded, the retail investor with no specific investment exposure or knowledge concerning highly complex investment-related activities would stand exposed.

Because of the augmented retailisation of investment products globally, retail investors have become exposed, and in certain ways subjugated, to increasingly complex investment strategies and investment opportunities which could lead to their exploitation, as they surely have in the past. Retail investors in hedge funds clearly need adequate protection within the envisaged and recently reformed regulatory framework for hedge funds in South Africa. This thesis, therefore, assessed whether investors in retail hedge funds in South Africa are adequately protected within the enacted regulatory framework for hedge funds compared with international financial regulatory reforms and good practice influencing the industry.

1.3 Research questions

From the problem statement, the following research questions emerged:
i. How does the framework for the regulation of retail hedge funds in South Africa compare with international standards and good practice regarding the regulation of hedge funds and retail investor protection in such funds?

ii. Do the enacted hedge fund regulatory reforms introduced in South Africa sufficiently protect the retail investor in hedge funds?

iii. Can additional good practice be identified regarding the regulation of retail hedge funds within the existing international financial architecture and respective demarcated jurisdictions? If so, how can such additions be adequately incorporated given the existing international good practice framework established in this thesis?

1.4 Research objectives

The main objective of this study was to empirically assess whether investors in retail hedge funds in South Africa are adequately protected within the enacted hedge fund regulatory framework. This assessment was conducted by the benchmarking, or comparison, of domestic regulatory good practices and/or principles to international hedge fund regulatory reforms and developments similarly so identified, within an increasingly complex and advanced financial industry.

The following secondary objectives were formulated to address the main objective of this study:

i. To determine whether legal scientific research methodology can be used as a valid research method within the risk management domain;

ii. to identify, from academic literature, legislation, proposed legislation and directives and guidelines issued by international regulatory or supervisory bodies, standards and good practices or principles regarding the regulation of hedge funds and/or the regulation of retail hedge funds specifically, should any regulation explicitly make provision therefore;

iii. to identify, from academic literature, legislation, proposed legislation and directives and guidelines applicable within the respective demarcated country jurisdictions, standards and good practices or principles regarding the regulation of hedge funds and/or the regulation of retail hedge funds specifically, should any regulation explicitly make provision therefore;

iv. to identify, from academic literature, legislation, proposed legislation and directives and guidelines applicable within South Africa, standards and good practices or principles regarding the regulation of hedge funds and/or the regulation of retail hedge funds specifically, should any regulation explicitly make provision therefore, and to provide an overview on the development of hedge fund regulation in South Africa; and

v. to assess the regulatory reform and new legislative requirements imposed on retail hedge funds in South Africa compared with international standards and good practices (determined in the literature and regulatory overview) to establish whether current provisions in fact conform to or substantially measure up to international good practice.
1.5 Contribution

The study uniquely contributes to the body of knowledge in relation to hedge fund regulation and research methodology in risk management by:
- providing validation for the use of legal scientific research methodology and specifically that of the legal comparative method within the risk management sphere as part of research design and methodology (Chapter 1);
- evaluating the regulation of retail hedge funds or qualified investor funds by examining South Africa’s newly enacted legislative requirements and regulatory reform on retail hedge funds known as QIHFs (Chapter 6);
- benchmarking the South African regulatory requirements for QIHFs against international standards on retail participation in similar legal fund structures and good practice, with specific reference to developments within the international soft law landscape (Chapter 7). The focus is on the key standard setter for securities regulation, the IOSCO policies pertaining to the protection of investment in hedge funds, as well as international agreed practice for hedge fund regulation;
- providing a review of hedge fund regulation with a focus on retail or qualified investment within the US (Chapter 3); and
- providing a review of EU and UK hedge fund regulation with a focus on retail or qualified investment in these jurisdictions (Chapters 4 and 5).

The overall contribution of the study highlights the importance of investor protection in country jurisdictions within an increasingly innovative and growing global financial marketplace and investment landscape; this more so having regard to one of the main aims, which is to provide access to retail investors. It remains vital to continuously measure investor protection actions against the dominant international and local regulatory landscapes.

1.6 Demarcation

The scope of legislation and/or regulation applicable to hedge funds, specifically the impact of such legislation on retail investment in hedge funds, is wide ranging. It encompasses a body of information which, due to its scale, necessitates a different way of assessment than a single disciplinary evaluation, such as from a legal normative approach which only attempts to analyse and compare detailed provisos of regulation. This study is interdisciplinary in nature and incorporates legal, risk management and economic-related influences. The scope of the study did not allow for an in-depth evaluation of legal subject matter. Instead, the study endeavoured to provide a principle view or overview of the relevant literature. Summaries of legislative provisions or regulatory
requirements will be provided in table format where relevant to assist in navigating the scope of information provided.

Given the extensive impact of general consumer-related legislation on the financial sector and the hedge fund industry in particular, this study did not include such legislative provisos in its scope. Furthermore, the impact, whether directly or indirectly, of policy, regulation or legislation that governs external parties to hedge fund structures (such as prime brokerage, custodians or counterparties) was also not purposefully considered. The study focused on the two essential and universal components of hedge fund legal structures that are applied in all countries selected for this legal comparative study. The demarcation of the study is divided into two parts. The first part relates to the selection of country jurisdictions, the second to the two primary components related to hedge fund legal structures influenced by regulation. Both are set out below.

1.6.1 Demarcation relating to the selection of country jurisdictions

The study was demarcated in relation to jurisdictions to be analysed as part of the legal comparison as follows:

i. The emphasis of this study is on the regulation of hedge funds and the concrete distinction drawn between hedge funds which are more closely regulated to protect the retail investor in hedge funds. The study aimed to identify international standards and good practice for hedge funds regulated explicitly as such through designated international regulatory organisations by which members agree to develop and adhere to financial regulatory principles, as well as within the demarcated jurisdictions. This includes principles or good practice applicable to hedge funds regulated in a stricter manner that would in effect resemble additional retail investor protection, indirectly contributing thereto and consequently fall within the ambit thereof.

ii. International standards and good practice for the regulation of retail hedge funds were identified from: (i) academic literature; (ii) the guidelines of the FSB as agreed to by the G20 member countries; (iii) IOSCO principles for the regulation of hedge funds; and (iv) any applicable legislation and/or regulations enacted within the US and UK, which have the first and second largest amount of hedge fund assets under management respectively. Together, funds registered in these two countries currently hold 89.7% of the worldwide hedge fund assets under management (Preqin, 2014). Regarding the UK, focus was also placed on the regulatory measures employed by EU members which, on their part, influence the regulatory measures enacted within the UK.

iii. The underlying legal system and approaches applicable to the regulation of hedge funds in the US, UK and EU were considered. They differ from those of South Africa in certain instances. However, English law has had, and still has, an influence on South African law
through its incorporation during the latter part of the 1700s and subsequent development within the multi-layered legal system, which has also been influenced by Roman-Dutch law. The American legal system can also be regarded as multi-layered with division between federal and state law. This entire legal system rests on legal principles found in traditional English common law, although it is superseded by both the American Constitution and statutory law. The demarcated countries and regions were furthermore chosen not only because of their significant size and the geographical concentration of funds and managers, but also because, as a result thereof, their ability to influence the regulation of hedge funds globally. The US and the EU (including the UK) have relatively differing views on hedge fund regulation, namely whether to approach them directly through government intervention or indirectly through the reliance on counterparties to check the risk behaviour of hedge funds. These approaches provide a counterfactual platform from which to address potential risks within the hedge fund industry.

iv. This study did not attempt to discuss the respective legal systems in detail or draw any direct comparison between pieces of legislation, as these are not directly comparable in every respect. International legal principles do, however, have an impact on different legal systems. Consequently, definite regulatory principles can be identified from any such legislation, guidelines and directives, which was the main aim in identifying international standards and good practice. Good practice principles were identified to provide guidance as to regulating retail or any such similar hedge fund. The identified regulatory guidance might include good practice across jurisdictions regulating hedge funds on a more stringent basis in terms of its similarities in legal structure, risk and reporting measures and any other clear caveats which prompt stricter regulatory requirements than the so-called classic hedge fund structure. The approach towards hedge fund regulation in the demarcated legal systems can furthermore be evaluated based on the membership of the respective jurisdictions to international financial regulatory bodies such as IOSCO and their influence within the international financial community.

1.6.2 Demarcation relating to hedge fund legal structures

The fundamental relationship amongst all hedge fund legal structures within the selected jurisdictions stated in 1.6.1 may be that of a company, trust, partnership and CIS, or a combination of these structures. As stated in 1.5, internationally, regulators lean towards regulating the hedge fund structure, i.e. the hedge fund, the manager or both. This is also the case in South Africa. For purposes of this study, the regulatory approach to retail hedge funds was premised on regulation or legislation which speaks directly to these structural attributes. These components of hedge
fund structures are significant, as they have the greatest effect on the decision making and responsibility regarding the management of investment, further supporting the rationale for the demarcation.

1.7 Research design

This study aimed to combine the discipline of legal scholarship with an empirical approach predominantly followed within the social sciences. In studies positioned in the social sciences, the existing approaches are, in most instances, directly stated in the theoretical framework (Taekema, 2018). The theoretical framework provides the conceptual basis for the study and contextualises the study. This means that the theory refers to a coherent body of knowledge that is founded on existing empirical research and systematically provides insight into existing research. The framework would, as a result, justify the research question by indicating how the gaps in the research would be addressed. In social sciences this framework supports a research question that requires an answer aimed at advancing explanations for the question. The explanations are, in effect, investigations conducted through empirical work (Taekema, 2018). Social sciences pay more attention to the incorporation of this research structure compared with legal research.

Legal scholarship is often embedded in a normative assessment of law in the form of a summary of the current state of positive law. This summary is made by combining primary sources, such as legislation or precedent established through case law, and referencing recent journal articles or handbook sources. Law can also be studied as a legal phenomenon. In this case, the intention is to study the law of the state or condition of society; such a study is socio-legal in nature (Christiani, 2016). These types of studies which form part of the broader legal scholarship discipline aim at assessing factors which influence the social reality of law without losing their essence as a form of legal research. They endeavour to criticise and/or explain legal constructs or to construct new theory in this process and are also referred to as “doctrinal” and “non-doctrinal” legal research (Christiani, 2016). Hutchinson and Duncan (2012) argue that, in some ways, in contrast to social sciences and the predominant empirical research approach followed, legal scholars do not refer to previous research methodology in their current research, instead relying on the fact that these methodologies are implicit in previous writings. Empirical work in legal research is different than in the social sciences in that it does not always allow for the gathering of data about social reality. Theory and empirical research complement each other (Taekema, 2018). Theory generates a research problem and a possible solution, which can be tested empirically.

For the purposes of this study, empirical legal research should be understood to fall under the broad heading of “empirical”, but not to be synonymous with “statistical” or “factual”. It involves the study by means of direct methods more so than by consulting secondary sources, institutions, rules or procedures found in law. Direct methods are used to understand how law operates and its influence because of its action.
Research questions in legal research furthermore complicate matters in that they could differ significantly from other form of research. Legal empirical research attempts not only to answer descriptive and explanatory questions but goes further to evaluate normative questions. Thus, a framework different from those used in the social sciences is required, one which not only explains why law is what it is, but one which provides arguments for evaluating whether law is good or bad (Taekema, 2018).

For purposes of this study, it was critical to use methodology embedded within legal scholarship due to the nature of the assessment to be conducted and its normative substance. The topic combined a doctrinal approach with a socio-legal empirical research question that requires the incorporation of a risk management theoretical perspective. This incorporation results in both legal and economic factors impacting this research. The method selected for the research can be positioned within the ambit of social sciences and the field of risk management specifically.

The study included both doctrinal (normative) and non-doctrinal (theoretical framework) elements in that it assessed the regulation of a specific area of law, namely hedge funds, by following a normative approach, because such an approach specifically contributes where standards for evaluation are to be provided. The non-doctrinal approach to legal research allows for the construction of a broader research ambit which, in the current study, was the inclusion of a risk management approach. This construction thus allows for determining whether the legal research method can be applied to this research endeavour, and if so, whether the identified method would be well suited. The next section provides the validation of the legal comparative method selected by the author for this interdisciplinary study and its positioning within the risk management field.

1.7.1 Design: Validating the legal comparative method within the risk management domain

Risk is an inherent part of financial systems independently, as well as collectively. It exerts itself in different forms. In doing so, it presents actors within individual systems, or actors as a collective, with challenges with regard to its proper functioning. Financial institutions regard risk as the inherent potential for losses or fluctuations in future income, lingering within the periphery of business conducted, and which are triggered by ongoing trends or specific events (HKIB, 2013:4). Others define it as the essence of free enterprise in liberal economies (Carrel, 2013:1).

One of the types or subsets of risk is Operational Risk (OpR). This form of risk stems from business operations and failures in operational processes. Financial losses from this type of risk can arise from diverse sources, for instance, failures within a company’s back office, rogue trading practices, regulatory breaches (which may stem for legislative change) or even so-called Acts of
Traditionally viewed as a function of a specific section of a financial institution, the pre-eminence of OpR has increased significantly. With its inclusion in guidelines for capital adequacy by the BCBS in 1999, financial institutions have dedicated more resources and tools to address OpR (BCBS, 1999a; Yokoi-Arai, 2003:105).

### 1.7.1.1 Operational Risk

To propose the inclusion of the legal comparative research method in the ambit of risk management, requires clear definition of the key components of this research setting, together with background to the inclusion of legal risk within OpR.

At inception Basel II indicated how challenging it would be to manage OpR for purposes of determining adequate capital cover to manage this risk type within banks (BCBS, 2002; BIS, 2002; Smit, 2008:50). It developed a risk-sensitive framework that contained a wider range of new options to measure operational and credit risk. Basel II was regarded as innovative due to its creation of a new capital framework which went further than simply grouping several innovative financial instruments within its scope (BCBS, 2002; BCBS, 2001:6). It brought the calculation of capital requirements methodology more closely in line with advances in risk management at that time (BCBS, 2002; De Beer, 2002:217). Another vital contribution through the Basel accord was that it moved capital regulation towards a more process-oriented direction, away from a common metric for setting capital requirements (BCBS, 2001b; BCBS, 2001:6; Smit, 2008:57). This resulted in a greater reliance on internal risk management measurement and control systems (BCBS, 1999a; BCBS, 1999b; Smit, 2008:57-58). Basel II comprises three pillars, namely minimum capital requirements, supervisory review and market discipline.

For purposes of this thesis, the first pillar was deemed important, as this was where the Basel Committee chose to broaden the focus to include OpR. The inclusion of OpR within the Basel accord links the selected legal comparative research method to risk management by including “legal risk” in its assessment criteria for OpR (BCBS, 2002; BIS, 2002; Cannata & Quagliariello, 2009).

OpR is defined as “the risk of losses resulting from inadequate systems, controls or human error” (Leach et al., 1993). Basel II redefined OpR to be understood as the risk of sustaining losses due to failed internal processes, people and systems or from external events (BCBS, 2001a:3; BIS, 2002; BCBS, 2005:142; BCBS, 2011). The definition includes legal risk, but excludes strategic and reputational risk, and was arguably the most influential description of what constitutes legal risk (BIS, 2002; BCBS, 2005:142; Mahler, 2007:4). The explicit inclusion of legal risk as a component of OpR opened the door for the utilisation of the legal comparative study research method.
in this study. Its inclusion for this purpose, though, hinges on what is understood by the term “legal risk” and whether the above-mentioned research method is suited to the existing framework (BCBS, 2001a; BCBS, 2001b; BCBS, 2005). Furthermore, should the definition of “legal risk” not be sufficient for the inclusion of the stated legal research methodology, does the possibility exist for expanding the existing definition to provide for a suitable inclusion thereof? Thus, the argument is not whether the definition of OpR should, for the purpose of the study, be expanded or reviewed within the bank OpR realm, but whether it is possible to employ the legal comparative research method in the risk management sphere as a valid qualitative research method.³

1.7.1.2 The concept “legal risk” and its inclusion in the definition of OpR

Like the focus on risk management in different disciplines, such as enterprise risk management and banking, focus has been placed on legal risk management since 2000 (BCBS, 2001a; BCBS, 2001b; BCBS, 2005; Mahler, 2007:3).⁴

The definition of “legal risk” include the following attributes:
- the expenses of litigation to a company (Johnson & Swanson, 2007);
- the risk of financial and reputational loss that may result from a lack of awareness or the misunderstanding of ambiguity in or reckless indifference to the way regulation applies to a firm (Tsui, 2013); and
- the cost and loss of income suffered because of legal uncertainty, multiplied by the possibility of the individual event or legal environment (Whalley, 2014).

The above definition refers to attributes pertaining to both firm level and the broader legislative or legal environment which exert influence on risk management in general. In a broader sense, legal risk arises from a failure to adhere to existing statutory or regulatory obligations. Changes in law can, therefore, include legislation or legislative changes which, in turn, might be wrought according to influences of international soft law principles being transposed into national legal systems. (This will be set out later in the thesis in the context of hedge fund regulation.) These changed would furthermore incorporate, as a matter of consequence, any regulation flowing from such legislation duly transposed and given the example.

³ The aim and ambit of this thesis did not allow for an in-depth analysis at this point, as this was not the focus. However, the inclusion of the legal comparative research method within the scope of qualitative research is evident from the variety of approaches and methods applicable to qualitative research methodology, to name one. Qualitative research is not based on unified theoretical and methodological concepts, but on subjective viewpoints, the establishment of interactions and the structures of the social field, and the latent meaning of practices. See Flick (2014) for further discussion. See also Denzin and Lincoln (2011); Silverman (2013) and Saldana (2013). For purposes of this thesis, qualitative legal research simply refers to non-numerical research in contrast to quantitative numerical research (Dobson & Johns, 2007:16).

⁴ See also Keskitalo (2000); Wahlgren (2003); Trzaskowski (2005a); Trzaskowski (2005b) and McCormick (2006).
McCormick (2004) defines “legal risk” as the risk of loss to an institution primarily caused by:

i. The influence of a defective transaction;

ii. a legal claim instituted or an equivalent event resulting in the liability for an institution or other loss;

iii. the failure to take measures to protect assets owned by an institution such as intellectual property disputes; and

iv. changes in law.

The above definition’s first three attributes argue towards the institution or firm accentuating the effect at firm level. The last attribute highlights the broader context of changes in law which, in the sheer extent of their possible influence, would include legislative or regulatory practice or developments, whether existing or not. McCormick (2009) reiterated this argument by stating that:

“Legal risks are a part of the spectrum of risks that are inherent in the operations of banks and other financial institutions, affecting the lives of the people who work there and customers of all kinds who put their trust in them as well as, in more extreme cases, the financial system itself.”

Wide definitions of OpR cause problems because they overlap with other risks that financial institutions face such as market and model risk. On the other hand, a narrowly defined definition of OpR, as opposed to a broader, inclusive definition, might not suffice (Yokoi-Arai, 2003:108). The inability to formulate an overall definition that would find application within every possible permutation of its understanding should not disallow a broad definition. When using the employment of OpR within the bank sector as a point of argument, it is accepted that the definition adopted by financial institutions would depend on the risk profile of each institution (BCBS, 2011). Therefore, allowing the definition of OpR to be adapted to a firm level within a broadly defined scope, creates the possibility for its further expansion. Within such a broadened understanding of what legal risk can include, it should be acknowledged that, the influence of legislation, regulation and/or any amendment thereto within the scope of OpR would not be unattainable.

It might also be argued that, by not defining exactly what should be understood as legal risk, the term is intended to be interpreted within its broadest sense. A narrowly constructed definition of OpR would not serve the development of the understanding of possible risks which might influence not only banks, but financial institutions in general.

5 “Model risk” incorporates the risk of losses emanating from the inappropriate use of modelling techniques for non-vanilla and highly structured transactions. See FBC (2001:6) for further discussion on the topic.
For purposes of this thesis, the author argues the importance of regulation, and specifically financial regulation which impacts financial institutions and investors alike. Through maintaining a reasonable level of OpR, financial institutions are able to enjoy confidence in markets, and the financial system will benefit as a consequence (Yokoi-Arai, 2003:105).

Because OpR, in accordance with its broader definition, aims to manage risks associated with the operational behaviour of financial institutions and human error, it is maintained that OpR does not only positively influence broader systemic risks contained within the financial system, but has a filtering effect, rendering a contribution to investor protection as a further direct, or at the very least, indirect result. An example is where human error fail to properly ascertain the consequence of non-adherence to existing or new legislative or regulatory influences. Yokoi-Arai (2003) addresses OpR primarily for purposes of prudential regulation. Nonetheless, as one of the fundamental pillars of financial regulation, investor protection from a market conduct perspective should be included within the ambit of OpR. This is based on the eventual outcome of broader financial system failure or institutional failure, namely that when operational risks materialise as one of many possible repercussions, investors will be disadvantaged as a result. For example, it is clear that OpR influenced the duration and severity of the 2008 financial crisis (De Jongh et al., 2013). The financial crisis not only resulted in a global financial system failure, from a regulatory perspective, but led to financial losses endured by investors (De Jongh et al., 2013). In this regard, hedge funds had a significant role to play, as set out later in the thesis.

The financial crisis became a true representation of a financial system consisting of market participants that heavily relied on inter-participant funding for day to day affairs. Major global investors ended up investing long and funding short for various and specific reasons, and in doing so, created a dependency on leveraged finance beyond any point of return (Carrel, 2010:235). As a result, the global economy inherited the financial structure of a hedge fund. More so than ever before, the nature of risk, and its definitions, changed (Carrel, 2010:235). As a consequence of the financial crisis, regulators were afforded an inimitable opportunity to correct distortions within the financial system and shape a new future based thereon. With regard to the regulatory future of financial systems, the main challenge would not only be to address existing imbalances to prevent future crises, but to anticipate and identify further possible future concerns in the process (Carrel, 2010:255-256).

In the previous section, it was reasoned and established that legal risk falls within the scope of OpR, and that a definition of legal risk should not be regarded as prescriptive. As a natural consequence, the legal research methodology should be able to form part of research endeavours within the scope of risk management, or at least within the ambit of OpR as a defined subset of risk (McCormick, 2006). In this thesis, it is maintained that regulation is essential for investor
protection, as well as for the protection of the global integrated financial system. The legal comparative research method was, therefore, selected and used to identify international investor protection principles applicable to the regulation of retail participants in hedge funds as part of the assessment of the South African retail hedge fund industry. The following section will discuss in detail the approach followed to identify a legal research method, after which the identified method will be discoursed.

1.7.2 Research method: A legal comparative endeavour

When conducting legal research, one is mostly confronted with a vast number of concepts which do not always surface in the legal sphere itself. The contrary to this *locus* is also true, especially when distinct research fields are integrated from a research perspective. The most predominant research methods within legal science and legal research consist of a mixture between scientific methods in the more technical sense and a broader approach to simultaneously provide a systematic yet holistic view of different research methods which could find application within the practice of legal sciences (Venter *et al.*, 1990:54).

The diverse methods that can be followed by representatives from various research traditions require a focus on the different technical research techniques within a mixed approach. For a legal positivist, methods of empirical verification and induction are much more important than abstract deductive methods. Technically, all legal scientists share at least certain methods, skills and techniques to ensure that any differences in approach concerning the scientific discussion allow for the exchange of knowledge and expertise (Venter *et al.*, 1990:54).

Legal research is basically categorised as doctrinal and non-doctrinal research. Doctrinal research is defined as theoretical research which asks what the law is in a specified area. The doctrinal researcher seeks to collect data and analyse them together with primary sources of law. This is usually done from a historical perspective and may also include secondary sources such as journal articles or other commentaries on legislation (Dobinson & Johns, 2007:17). Non-doctrinal research is defined as all other legal research that can be grouped into one of three categories: problem-, policy- and law reform-based research. This categorisation is not mutually exclusive and identifies a framework for an assessment of what a specific type of research is about (Dobinson & Johns, 2007:19).

Based on Epstein and King’s (2002:69) contention, the author accepts that both qualitative and quantitative research are regarded as empirical research. They assert that empirical research is based upon “observations” of the world, which include data or words is simply another term used for gathering “facts” about the world. These facts may be derived from historical or contemporary
sources, or based on legislation or case law, or be the outcomes of secondary archival research, or primary data collection. Attributes of data collected in one of these ways render them precise or vague, relatively certain or uncertain, directly observed or indirect proxies. Data can be anthropological, sociological, interpretive, political, economic or legal in nature, to name a few. If these facts resemble the world, they can be regarded as data, and as long as research involves data that can be observed or desired, it is empirical (Epstein & King, 2002:69). Although broad, this definition allows for an expansion of what might be included within the ambit of doctrinal research (Dobinson & Johns, 2007:19). Although Epstein and King (2002:3) state with qualification that pure theoretical research is not empirical, the author agrees with Dobinson and John’s (2007) view that labelling it as such would be meaningless, especially where the objective would be to consider legal research from a “best” or “good” practice perspective.

Both categories distinguished above could form part of a large-scale research project. In this thesis, the existing law within a particular area, namely the regulation of hedge funds within an internationally demarcated context, as well as within the local jurisdiction of South Africa, was identified, consistent with the doctrinal method. When considering current influences on or problems affecting the law or legal position related to retail investment in hedge funds in South Africa and highlighting, based on identified good practice investor protection principles together with policy underpinning such existing law, possible flaws could be identified. Should this, as a consequence, lead to proposed changes to the law, it would fall within the ambit of the subcategories of non-doctrinal research, namely law reform. Therefore, by its very nature, the research conducted in the current study was inferential, aiming to provide some level of explanation for the existence of such laws or influences that contributed to their enactment. Consequently, this study included both doctrinal and non-doctrinal research to some extent. Below the discussion continues by defining the methods employed in a legal research endeavour.

1.7.2.1 The concept “method” and its importance in the legal context

The term “method” originates from the Greek word *hodos* which roughly translates to “way of doing”. Scientific “methods” can be defined as purposeful and planned human ways of doing (or human actions) by which reality can be understood and explained (Venter *et al*., 1990:55). The methods used within the legal research context can be divided into three categories, namely methods on a primary, secondary and tertiary level. These levels will be elaborated on briefly.
1.7.2.1.1 Primary category

On a primary level, researchers select an approach to their field of research based on several philosophical factors. This choice provides a primary direction and contextualisation to the research (Venter et al., 1990:59). Examples include (Venter et al., 1990:59; 61-69):
- the “natural law” method;
- the legal positivistic method;
- the “pure” method;
- the "historical" method;
- the dialectic-materialistic method;
- the realistic method;
- critical legal studies; and
- the transcendental-critical method.

1.7.2.1.2 Secondary category

On a secondary level, the researcher moves closer to “method” as a legal technique. “Technique” can be viewed as a “species” of method but is more straightforward than the first category and dependent on the interaction between human skill and the primary methods mentioned above. Thus, technique is a human way of doing of which regular human activities or skills (“reëlmatige menslike vaardighede”) form the basis. Humans naturally possess certain fundamental skills or techniques which vary only in their ability to implement such skills or techniques. Therefore, all humans rely on the same skills and the boundaries created thereby when “doing”. “Method” on a secondary level, therefore, refers to techniques that assist in determining the context for the application of other, more specialised research techniques that would provide even greater context and direction (Venter et al., 1990:59).

The following are legal scientific examples of secondary-level techniques which are applied in combination with other, more specialised research techniques (Venter et al., 1990:60, 69-71):
- the dialectic method;
- the legal comparative method;
- the legal historical research method.

1.7.2.1.3 Tertiary category

In the tertiary sense, research methods employed only in a specific limited context are applied. In this regard two primary categories are found, namely the “knowledge acquiring” technique and
the "knowledge structuring" technique. Knowledge is acquired through identification and discernment. Three techniques are relevant here (Du Plessis, 1978:527; Raath, 1984:226; Stoker, 1967:239-241; Venter et al., 1990:60):
- proclamatory identification (e.g., sensory observation and “diafanerose”);
- inter-subjective identification (e.g., definition, deduction and induction, including analysis and synthesis); and
- distinction (e.g., classification and division).

The knowledge structuring technique is a combination of more specific techniques which aim to structure existing knowledge into a manageable format. Thus, the legal scientist needs to combine the research activities already present at the primary research phase, which may not have been so clearly portrayed at this knowledge acquisition phase and is only now more clearly observable (Venter et al., 1990:60). Relevant techniques are evidentiary methods, critique, and hypothesis and theory creation (Venter et al., 1990:72-80).

1.7.2.1.4 Application to this study

The legal research techniques explained above form a foundation from which legal research can be conducted effectively. As stated earlier, legal researchers are influenced by various legal research traditions and, consequently, rely on different methods or techniques to conduct their research. By creating room for conducting research through a mixed approach in legal method, researchers can select an approach to the research and identify the most suitable, single technique or combination thereof. Then, through knowledge acquisition and/or structuring, the research techniques can be combined in a specific context.

Within the context of this thesis, the primary research technique employed led to the identification of the relevant field of study which falls within the ambit of financial regulation. The specific topic identified within the broad scope of financial regulation was the regulation of hedge funds, and particularly the regulation thereof from a retail investment perspective. The secondary approach selected as the predominant method was that of a legal comparative study, because it best allowed for the proper discussion and evaluation of the research topic to contribute to the body of knowledge. This more so when the research objectives are taken into consideration, namely identifying international regulatory good practice principles and determining how South African regulation of retail investment in hedge funds measures up to these good practices.

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These methods are respectively referred to in the original source as the "kennisverwerwings- en kennisordeningsstegnieke".
The discussion on the main legal scientific research method employed in this study, the legal comparative study, will now commence.

1.7.3 The legal comparative study

In a globalised world with its increase in communication and alignment of legal approaches, the importance of comparing national law with foreign law to develop national legal systems cannot be underestimated. The fact that the law serves as a system which gives structure and provides order for the life of communities implies that certain aspects thereof will overlap and be relevant in all communities (Yntema, 1978:163-166; Zweigert & Puttfarken, 1978:1). Legal comparison delves into the universality of law, which is crucial for expanding the vision of jurists and the development of law as a science (Venter et al., 1990:207-208).

The result of this process, namely the systematic comparison of a specific research area in law, provides new insight and knowledge. Furthermore, legal comparison exposes connections between different elements, free from value judgements. This systematic comparison inherently causes that system-related limitations on the number of factors or elements required for the study are not required or at issue (Venter et al., 1990:209). In this way, the researcher is assisted in selecting the elements of research by considering all practical aspects, including the outcome envisaged with the research (Constantinesco, 1972).

Of extreme importance though, is what is understood by the term “state” and its designation in relation to comparativism. To understand legal practice and the overall study of the law, a solid conception of statehood is vital, one which assumes the existence and authority of the state as generator and guarantor of legal norms (Venter, 2010:11). The concept of a state is furthermore of value when attempting to understand international law and the direction it is taking, having influence on economic and social intercourse, political science and international relations, to name a few (Venter, 2010:11). This is relevant especially to the current study with its aim to compare elements of soft law existing within a neutrally agreed transnational platform whereby country members can be principally bound to adhere to universally agreed practices. These practices enable, to a certain extent, the creation of universally applied good practice that may be transposed into national country jurisdictions depending on their choice (Venter, 2010:13-14). Owing to the overwhelming effects of the global economy, national states have been forced to enter transnational domains which are populated not only by states, but also by private entities.

Politics and policy making are increasingly being conducted at an international level where international organisations play significant roles. This clearly established network of global governance reaches beyond the control of individual states and profoundly influences the exertion of
national law in an international context (Venter, 2010:13-14). This study, therefore, required as part of its legal comparison, to have regard to international soft law influences, like those of the G20 and IOSCO. Furthermore, these global influences together with the legislative and/or regulatory rules applicable in each jurisdiction or such rules transposed thereto as demarcated for this study, gives cause and substance to the assessment of the South African hedge fund regulatory industry.

1.7.3.1 The foundation and character of legal comparison

The general process of comparing sets of information or concepts is indispensable for the acquisition of knowledge and for purposes of creating science (Venter et al., 1990:208). Yntema (1978) goes further, asserting that, without applying the comparative method, no body of knowledge concerning the facts within the corporeal world or any facts enclosed in social life can take rank as a science (Yntema, 1978:175). Schnitzer (1973) defines “legal comparison” as juristic enterprise architecture with direct links to different national legal systems and their subdivisions that are aligned with their core objective of the legal comparative method. This method further provides the requisite methodological framework for knowledge creation within the context of this study (Schnitzer, 1973:67). Schnitzer (1961) refers to the function of stating law within time and space as the ideographic task of legal comparison.

The nomothetic function being fulfilled as the legal comparison process investigates law in its causal context and provides an explanation thereof (Venter et al., 1990:211).

The result of this process is aimed at providing new thought categories concerning law, based on the connections that have been determined to exist among elements of the research in addition to providing solutions to specific problems. The legal comparative method goes further to express these findings meaningfully within the broader international legal context. The legal comparison method is, therefore, a unique and systematic legal scientific work method which is applied to come to new insight on similarities and differences amongst legal systems (Venter et al., 1990:213).

1.7.3.2 The purpose of employing the legal comparison method

As meaningfully noted by Martha Minow in 2010, “[n]eglecting ... comparative law could vitiate the vitality, nimbleness, and effectiveness of [national] law or simply leave us without the best

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7 See also Mastronardi (2007:227).
8 For further discussion, see Wagner (1962:518) and Constantinesco (1972:67-68, 282).
9 See also Wagner (1962:517).
tools and insights as we design and run institutions, pass legislation, and work to govern ourselves”. Overall, the way in which a user of the legal comparison method is enriched, both as jurist and human, is regarded to be the main objective thereof. This method allows for objective comparison together with an increased understanding of the local legal system. It assists in drawing more objective and crisp conclusions, both on strong and weak aspects captured within the local legal system (Venter et al., 1990:214). Moreover, it helps the local legal jurisdiction to be better understood and allows for future legal reform to be executed and incorporated meaningfully. Legal comparison contributes to the study of law itself and, through its comparative process, leads to conclusions concerning the role, styles and techniques through which it finds shape in different communities. Its results not only factors in on stringent legal rules but has an effect on overall scientific meaning (Venter et al., 1990:215).

Legal comparison has utility in specific fields and includes the gaining of increased knowledge of the local legal system or how such a system should be reformed. This applies even more so when the foreign legal system employed exerts influence on the local legal jurisdiction or did so in the past. For this thesis, the demarcated jurisdictions were and still are influential with regard to present-day legal reform, especially in the global financial context. Historically, they have also influenced the development of the South African legal system during times of colonisation and thereafter. Other examples include timeous preparation for changes in other social systems, the carrying of the legal culture into the international legal sphere, formation of knowledge and understanding of foreign legal systems, unification of law11 and, very importantly, for finding satisfactory solutions for concrete problems (Venter et al., 1990:216-217).

1.7.3.3 The phased approach to legal comparison analysis

According to Venter et al. (1990:219), an approach to a legal comparative study should broadly consist of three interconnected yet distinctive phases. The first relevant element (of each individual legal system) needs to be investigated with the aim of obtaining enough information regarding the content of every legal system which forms the basis of the ensuing comparative legal research. In the second phase, the researcher should analyse each respective element against its unique legal and communal background. The purpose hereof is to determine what the respective legislative rules or legal requirements consist of, each within its respective foreign legal systems. In the third phase the researcher considers connections between the respective systems within

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10 For further discussion, see Wagner (1962:523); Constantinesco (1972:337-368); Keyman (1977:46-47); and Zwiegert and Puttfarken (1978:2).
11 This to create greater international harmonisation. See Constantinesco (1972:368-370).
the demarcated study, aiming to synthesise the content to attain the outcome envisaged with the research (Constantinesco, 1972:141-143; Venter et al., 1990:219-220).

1.7.4 Summary: Integrating different research methods through legal comparison

The research method of this study included a literature review based on the legal comparison of identified and demarcated jurisdictions from which criteria for the evaluation of the regulation of retail hedge funds in South Africa were identified. These criteria, referred to as “international standards and good practice”, were explained and demarcated in Chapter 1.6 (Brummer, 2015). Based on these criteria, a regulatory assessment framework of international good practice was formulated applicable to retail hedge funds in South Africa. The evaluation criteria identified in the literature were then used to evaluate the regulation of retail hedge funds in South Africa. This evaluation resulted in a conclusion as to whether retail hedge funds in South Africa are adequate to protect the retail investor and certain recommendations towards possible additions or improvements to the proposed regulations.

The research, therefore, utilised several distinct methods, which included a legal comparative study, historical research, interpretation of statutory tools, teleological methodology, as well as deductive and analytical methods. The integration of these methods is based on legal comparison.

1.8 Thesis outline

Table 1-1: Chapter outline and description

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Description</th>
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<tbody>
<tr>
<td>1</td>
<td>Introduction</td>
<td>Introduction to the problem, research questions, research objectives and contribution of this study.</td>
</tr>
<tr>
<td>2</td>
<td>Transnational hedge fund regulation</td>
<td>The regulation of hedge funds – identifying and assessing international evaluation criteria for retail or “retail type” hedge funds from an investor protection perspective. This chapter identifies what retail or “retail type” hedge funds are and attempts to define a scope within which a hedge fund can be identified as “retail” where no explicit mention is made, or designation exists within current regulatory frameworks in general. This set of regulatory principles or good practices for retail hedge funds will be utilised as benchmarking mechanism or best practice framework against which current developments within the regulation of the defined “retail” fund will be measured and evaluated. The good practice framework will be created from and by reviewing recent academic literature, international legislative principles or standards for hedge funds, as well as regulations on retail hedge funds of the countries in accordance with the demarcation stated.</td>
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<tr>
<td>Chapter</td>
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<td>3</td>
<td>Hedge fund regulation in the US: An investor protection perspective</td>
<td>The regulation of hedge funds – identifying and assessing international evaluation criteria for retail or “retail type” hedge funds from an investor protection perspective. This chapter identifies what retail or “retail type” hedge funds are and attempts to define a scope within which a hedge fund can be identified as “retail” where no explicit mention is made or designation exists within current regulatory frameworks in general. This set of regulatory principles or good practices for retail hedge funds will be utilised as benchmarking mechanism or best practice framework against which current developments within the regulation of the defined “retail” fund will be measured and evaluated. The good practice framework will be created from and by reviewing recent academic literature, international legislative principles or standards for hedge funds, as well as regulations on retail hedge funds of the countries in accordance with the demarcation stated.</td>
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<td>4</td>
<td>Hedge fund regulation in the European Union: An investor protection perspective</td>
<td>The regulation of hedge funds – identifying and assessing international evaluation criteria for retail or “retail type” hedge funds from an investor protection perspective. This chapter identifies what retail or “retail type” hedge funds are and attempts to define a scope within which a hedge fund can be identified as “retail” where no explicit mention is made, or designation exists within current regulatory frameworks in general. This set of regulatory principles or good practices for retail hedge funds will be utilised as benchmarking mechanism or best practice framework against which current developments within the regulation of the defined “retail” fund will be measured and evaluated. The good practice framework will be created from and by reviewing recent academic literature, international legislative principles or standards for hedge funds, as well as regulations on retail hedge funds of the countries in accordance with the demarcation stated.</td>
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<td>5</td>
<td>Hedge fund regulation in the United Kingdom: An investor protection perspective</td>
<td>The regulation of hedge funds – identifying and assessing international evaluation criteria for retail or “retail type” hedge funds from an investor protection perspective. This chapter identifies what retail or “retail type” hedge funds are and attempts to define a scope within which a hedge fund can be identified as “retail” where no explicit mention is made, or designation exists within current regulatory frameworks in general. This set of regulatory principles or good practices for retail hedge funds will be utilised as benchmarking mechanism or best practice framework against which current developments within the regulation of the defined “retail” fund will be measured and evaluated. The good practice framework will be created from and by reviewing recent academic literature, international legislative principles or standards for hedge funds, as well as regulations on retail hedge funds of the countries in accordance with the demarcation stated.</td>
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<td>6</td>
<td>The rising edifice of hedge fund regulation in South Africa</td>
<td>This chapter will first provide a concise description of the onset of financial regulatory reform, its objectives and main features in South Africa as an introduction to the changed financial regulatory landscape. Secondly, the regulation of hedge funds, and retail hedge funds specifically as CISs within the proposed reform framework for the South African financial sector, will be discussed in detail.</td>
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The objective of this chapter is to evaluate the legal reforms, set out in the previous chapter, which pertain to the South African hedge fund industry against the international good practice determined for retail hedge fund regulation in Chapter 2 together with additions, if any, from Chapters 3-5. Possible strengths and weaknesses contained within proposed legislative reforms pertaining to retail hedge funds will be highlighted. This chapter will also conclude the thesis and highlight the key findings after evaluating hedge fund regulation in South Africa, with a focus on the protection of retail investors. This chapter will attempt to make proposals towards addressing any weaknesses within the current South African hedge fund legislative ambit. The implications of key findings and recommendations will be highlighted.

Figure 1-2 is used throughout the thesis to frame the discussion in each chapter and provide structure.

**Figure 1-2: Schematic of thesis progression**

From Figure 1-2, the discussion commences with the position of transnational hedge fund regulation. In Chapter 2 an overview is given of international investor protection principles relating to hedge funds. Consideration of the architecture, structural design and status of international financial law is provided, after which financial systems and market regulation will be elaborated on.

The discussion then turns to the international regulation of hedge funds. Following this, international coordination of financial and securities reforms will be discussed towards the development
of regulatory principles for hedge funds. Relevant investor protection good practice will be identified, which forms the initial list of practices used as part of this legal comparative study. Chapter 3 examines the US financial regulatory framework for hedge funds with a similar aim of determining how retail investors in hedge funds are protected. Chapter 4 sets out good practice from the EU legislative framework for hedge funds in the build up to Chapter 5, in which the UK regulatory position as influenced by the transposed regulatory provisions from the EU is discussed. Chapter 6 explores the South African hedge fund regulatory structure since the implementation of the Twin Peaks structural reform process, with the aim to build towards hedge fund regulation and retail investor protection specifically therein. In Chapters 3 to 6 the list of investor protection practices identified in Chapter 2 are particularised and augmented. Chapter 7 summarises and concludes the study with the comparison of the identified international good practices in Chapters 2 to 6 to the enacted regulatory framework and practice identified in South Africa as part of the assessment as to whether they adhere to international good practices.
CHAPTER 2 TRANSNATIONAL HEDGE FUND REGULATION

2.1 Introduction

During his tenure as chief economist at the World Bank – in the course of the Asian crisis – Joseph Stiglitz compared the international financial system to a road which, after too many accidents, raised more doubts about the road design than the drivers involved (Stiglitz, 1998). This analogy was later adopted by Mervin King during his address to the Bank of England as Deputy Governor. In a speech about the reformation of the international financial system and the impact of the Asian crisis, he compared global financial markets with aeroplanes, stating that “travel is faster and, on the whole, safer, but crashes, when they do occur, are more spectacular” (King, 1999:2). With this comment he aligned these analogies in an unintended prophecy. He stated that, whatever the form of preferred travel, one thing was clear, namely that passengers suffered from severe travel sickness (King, 1999:2). Given the turmoil experienced in the international financial system since 2008, he could not have imagined the catastrophe that lay ahead.

Views on financial regulation differ somewhat. Comments range from obscure to arcane, and frequently regulation is seen as private sector bureaucracy. This is due to a lack of thorough understanding. What is important, is the fact that such a system is central to maintaining effective financial markets, institutions, financial service providers and, consequently, financial systems (Falkena et al., 2001:iii). Arguments to substantiate its importance include the aftermath of collapses in banking systems worldwide (such as South East Asia, which occurred in the late 20th century) to current global financial turmoil experienced since the 2008 crisis took effect. Understanding the importance of financial regulation requires an understanding of the structural design of international financial law. Figure 1-2 shows the progression of this thesis and introduces the discussion on the structural design of international financial law for purposes of this thesis.

2.1.1 Architecture of international financial law

Whilst international financial law is still developing compared with other fields of international law, the need for financial market regulation is not new (Brummer, 2015:6). It is determined by a specific combination of economic governance factors. International laws are not created through international organisations, which have somewhat of an ambiguous legal status. This “soft” law has no formal legal status and does not impose formal legal obligations. Therefore, international financial law takes the form of, amongst others, “best” or “good” practices or rules created to promote wide-ranging regulatory observation (Brummer, 2015:120; Zaring, 2006:294).
These practices often concern discrete issues such as optimal rules regarding disclosures or capital adequacy. These practices are promulgated usually by coalitions of regional bodies or even organisations of private actors approved by national authorities. By definition, international financial law lacks the formality associated with “hard” law which takes the form of international treaties (Brooks & Wohlforth, 2009:51; Brummer, 2015:128).

Figure 2-1 below illustrates a simplistic portrayal of the GFA. At its core the international regulatory system hosts the G20 and the FSB representing the largest economic powers which exert the most influence (Zaring, 2006:281). Having an approximate 90% of representation of global financial market actors, the regulation within distinct financial sectors based upon agreed objectives are determined through these “agenda setters”. Formal guidance through measures focused on market participants is mostly undertaken by institutions which function within areas of the financial sector. These institutions are referred to as “sectoral standard setters” and include bodies such as IOSCO. These standard setting bodies provide an increased focus on standards for a specific sector in contrast to broader policy objectives articulated at an agenda-setting level. The standards might, consequently, be incorporated into local jurisdictions through domestic law making or for purposes of supervisory oversight (Brummer, 2015:70).

Adherence to standards in a determined financial sector can be monitored through various mechanisms which include peer reviews conducted by members of the standard-setting bodies. This monitoring function in the system falls predominantly to the World Bank and International Monetary Fund (IMF) (Brummer, 2015:70).
International regulatory processes demonstrate an inter-institutional logic whereby national regulators exert local expertise at the domestic level and then contribute to establishing global standards through their participation on an international level. The above portrayal of the GFA lacks detail on the involvement of the respective domestic regulatory organisations, as well as the work done by the World Bank and IMF (Brummer, 2015:71). Its purpose is to illustrate how efforts are functionally divided amongst respective participants, enabling them to inform regulatory functions and activities on a global scale (Brummer, 2015:71).

2.1.2 Financial system and market regulation

Financial systems are regulated and supervised more copiously than any other global system. A principal reason for this is systemic risk and the importance of consumer protection. Experience has shown that regulation strongly impacts the size, structure and efficiency of a financial system,
the business operations of financial markets and institutions, and competitiveness among sub-
sectors of the system (Falkena et al., 2001:v).\textsuperscript{12}

The impact of financial regulation can be categorised as “malign” or “benevolent”. The categori-
sation depends on how clearly the objectives for regulation have been defined and what the im-
pact of subsequent regulatory arrangements have been on these objectives. Certain regulatory
structures might have a greater impact on [OR make a greater contribution to] ultimate structures
than others. Some structures are inefficient due to the unwarranted costs they impose on regu-
lated institutions which become counterproductive as a result. Ideally, the outcome envisaged
would be to seek structures, institutions and mechanisms that would function optimally to achieve
explicit regulatory objectives whilst minimising costs (Falkena et al., 2001:v). This necessitates
effective supervisory and enforcement mechanisms to formally ensure that regulatory objectives
are achieved, not disregarding the importance of a proper cost/benefit analysis and its impact on
the economy.

One of the pivotal questions is whether financial markets should be regulated and what the broad
objectives of such financial regulation should be. Financial markets increasingly trade beyond
international borders, more so than ever before. Highly integrated capital markets, identified by
substantial capital flows amongst developing countries pre-World War I, fell sharply in the subse-
quent 50 years. Capital markets have, however, increasingly emerged with a transactional shift
mostly towards rich-trading-with-the-rich. This created a process whereby finance became more
diversified rather than being viewed as development finance (Obstfield & Taylor, 2002; Davies &
Green, 2008:7). The flow of finance across borders has increased, together with channels of in-
termediation. Whilst most business flowed through bank balance sheets, a limited range of in-
vestment funds or insurance companies provided a wider range of investment vehicles which
evolved mostly due to the unpredictable increase in private wealth. The most prominent of these
were private equity and hedge funds, both of which are funded by high-net-worth investors and
organised informally. Until recently, both have existed largely unregulated (Davies & Green,
2008:8). Since the late 1990s, a dramatic increase in financial innovation within an increasingly
globalised world has been experienced.

Combining this with a largely unregulated industry like that of hedge funds, risks related to finan-
cial systems have increased. Financial globalisation has led to greater investments and trade

\textsuperscript{12} Since the 1980s, the South African financial system has experienced structural changes, particular in the bank-
ing sector. These changes, mostly driven by international financial system adjustments, have created major
challenges to regulators who have had to keep up and constantly adapt. Changes within the financial regulatory
system included, amongst others, the transfer of banking supervision responsibilities from the then Department
of Finance (currently National Treasury) to the South African Reserve Bank in 1987 and the establishment of
the FSBSA in 1989.
across borders by financial institutions and investors. Although this has led to the reduction of trade friction, as well as greater trade across markets with increased risk sharing and market liquidity, the impact of shocks originating in one market has increased the speed of transmission to others (Davies & Green, 2008:8-9). Financial innovation has also increased financial asset complexity. This has resulted in increased information asymmetry, leading to uncertainty about the creditworthiness of counterparties. Increased market-driven changes necessitate expedient responses from regulators, in particular in a world where financial institutions are constantly delving into a wider range of products and becoming more active through developing new products (Calomiris & Litan, 2000:283).

Deregulation has allowed unregulated actors to expand in key markets, effectively leading to a lowering of credit standards and, consequently, weaker monitoring by financial intermediaries because of competitive dynamics and poor incentives. This was observed clearly when the effects of the financial crisis were evaluated (King & Maier, 2009:287). International financial regulation can be described as the process of authorising, regulating and supervising financial institutions through available regulatory mechanisms. The simplest answer to why financial markets should be regulated is that they are heavily contested terrains, particularly with regard to the intellect required to navigate their unique complexities.

For this reason, the increased development of new financial instruments makes the transfer of large-scale complex risks easier in general. Global financial markets have developed even further to incorporate the growing dominance of a small number of institutions with enormous balance sheets. Investment banks have dominated major markets in corporate and sovereign debt and equity (Davies & Green, 2008:9). This increased concentration experienced within the global financial industry resulted in a multipolar global economy where economic activity is no longer dominated by the US and Europe (EU) but has spread more consistently throughout the world. This has caused fundamental changes to the GFA, as well as the real economy, but without proper alignment (Davies & Green, 2008:9; Quaglia, 2013:17) (see also Elson, 2010; Morgan, 2011 and Naudé, 2011).

Participant responses to the IOSCO Market Risks Survey conducted in 2015 amplify the importance of financial market regulation (IOSCO, 2015). In response to a question on which areas are the most important to explore for maintaining the financial stability of their respective jurisdictions, participants indicated regulation to be first and foremost (IOSCO, 2015:14). Figure 2-2 illustrates the five main responses with regard to areas of concern to financial stability.
Figure 2-2: Frequency of responses regarding areas of risk or concern to financial stability

Detailed responses regarding regulation and risks transmitted through securities markets showed that most respondents viewed risks to the financial system either as being transmitted through securities markets or amplified by these (IOSCO, 2015:17). Importantly, risks viewed as sourced from securities markets included retail financial products. Figure 2-3 provides a view of how respondents saw risks being transmitted though securities markets.
Figure 2-3: Risk categories and whether they are transmitted through, amplified by or sourced from securities markets

Figure 2-3 highlights the importance of regulation within financial markets and portrays the importance and growth in concern over retail investment products and the global trend towards retailisation of financial products and services (such as in the hedge fund industry). Retail financial products are illustrated here, in the view of respondents, to reportedly being sourced from financial markets close to 45%. Hence, retail financial products and their international development support the drive towards protecting retail investment and retail investors through sufficient and effective regulation.

Structural regulatory reforms of the South African financial sector (and specifically that of hedge funds) are covered in Chapter 6. The structural economic and financial reforms enacted in South Africa support and substantiate regulatory mechanisms implemented for hedge fund regulation and the direct regulation of retail hedge fund investments.

The economic rationale behind this view is that financial market activity creates externalities which cannot easily be addressed by private sector role players and, consequently, requires the involvement of governments or regulatory authorities. Thus, a definitive symbiotic relationship exists between the private sector and regulators in their combined pursuit of regulatory balance. Defining
private sector externalities and the interventions they justify for private sector role players is, however, constantly debated. The ever-opposing market participant and regulator have not reached consensus on the degree of financial regulation required for the private sector (Davies & Green, 2008:13).

One of the general views held before the financial crisis regarding financial market regulation was summarised as “overcontrolled” (King & Maier, 2009:291-292). This view was supported by Greenspan (2007) who argued that regulation implemented after a financial crisis must be fine-tuned. The current (post-crisis) view on regulation, by contrast, rules in favour of stricter regulation due to the regulatory void left because of years of de-regulation, specifically in the US (King & Maier, 2009:292). The objectives of financial regulation are important, because they dictate not only why countries regulate financial markets, but also which guidelines such regulatory reforms can (or should be) developed, updated or implemented. Regulation imposes a high cost on financial institutions and markets, intensifying the burden on the end user. Excessive regulation could also damage the efficient functioning of financial markets and dilute their economic utility.

The end result concerning financial regulation is about achieving a balance between risk taking and the financial soundness of a system. For example, although hedge funds have outperformed regulated CISs, retail investors have typically not been able to access them directly, mainly due to the higher risk associated with them (Davies & Green, 2008:30-31). Thus, the question is that, with increased access for retail investors to this type of investment vehicle, how should they be protected given the inherent risks involved in alternative strategies employed by hedge funds?

The following general objectives regarding international financial regulation serve as an outline for the development of national frameworks:

i. the setting of prudential standards;
ii. regulating conduct of business; and
iii. maintaining and promoting financial stability.

However, the argument for a uniform approach to international financial regulation is not accepted universally because different countries have different views or levels of tolerance for market instability and institutional failure. Countries could also have the view that a more relaxed regulatory environment might attract more international business and be reluctant to subscribe to international standards that could curb regulatory agility. Governments ultimately determine their views on regulation which is largely guided by institutional memory. An ongoing tug of war exists between increased regulation and regulatory liberalisation which hinges on individual national governments and their current views on market stability (Davies & Green, 2008:30-31).
The regulation of the hedge fund industry is very different from the regulation of the markets in
which they operate. The general financial regulatory solutions that may be used for hedge funds
are limited due to the complexity of investment strategies and models (King & Maier, 2009:292).
Since the financial crisis, questions concerning the adequacy of financial regulation (an important
component of GFA reform) have flared up again. Some of the pertinent questions relate to the
oversight and supervision of a consolidated system of exchanges, integrated financial markets
and whether private equity and hedge funds have created threats to financial stability and to the
integrity of traded markets. These questions had not been addressed by the FRS before the crisis
(Davies & Green, 2008:11-12). The next section focuses on international hedge fund regulation,
as well as the structural financial system reforms and direct hedge fund regulation currently being
enacted in South Africa.

2.2 International regulation of hedge funds

Attempts to regulate hedge funds are not new. Significant shifts in regulatory oversight have oc-
curred over periods of time due to large hedge fund failures (Fioretos, 2010; Helleiner & Pagliari,
2010; Lee, 2015; Robotti, 2006; Spalter, 2007; Van Berkel, 2008). Together with the re-assess-
ment of the robustness of the entire global financial system, hedge fund regulation has gained
pre-eminence post crisis. Hedge funds have become favoured by many institutional and private
investors since early 2000. At its peak during the latter half of 2008, the hedge fund market was
estimated to have more than USD2.5tn in assets under management (Cumming & Dai, 2010:830).
As an effective channel of non-bank intermediation, its increased popularity has led to a record
level of capital invested in the global hedge fund industry in 2013 (Preqin, 2014:25).

The year 2015 proved to be a challenging year for hedge funds on a global level. Net capital
inflows for the industry were recorded reaching USD71.5bn, taking the global hedge fund industry
to managing nearly USD3.2tn (Preqin, 2016b). The size of the global hedge fund industry in itself
is sufficient reason for its regulation. Changes to international hedge fund regulations have been
supported by stakeholders as far back as 1998, following the collapse of LTCM. The combination
of excessive leverage and other trading operations, resulted in the loss of an approximate

The US government, determined to control such potential events through regulation, proposed
increased self-regulatory intervention measures to the dismay of critics, who pointed out the fail-
ure of such measures in the case of LTCM (Edwards, 1999; Stoneham, 1999:388). Others like
Paredes (2006:983-986) argued that hedge fund malfeasance should be kept in perspective with
regard to abuses which have characterised the industry. Therefore, general hedge fund behaviour
should not be judged accordingly: The entire industry cannot be collectively held to account as
such (Athanassiou, 2012:51; Chincarini, 2012:51). According to Buller and Lindstrom (2013:392), it is puzzling that hedge funds which were identified as not having been directly responsible for the 2008 crisis have become the target of increased regulation. Others, however, argue that, had it not been for hedge funds’ intermediary position between investors and banks, between yield seekers and suppliers of yield bearing securities, the proportions of the supply of the securities would not have reached the level it did (Lysandrou, 2012). The alternative investment industry is much more concentrated geographically than banking or other financial services, especially in the EU and UK.\(^{13}\) In this case British supervision maintained sufficient global competitiveness and did so for the entire EU financial sector (House of Lords, 2010:16-17; Lutton, 2008).

The crisis did not undermine the support for industry-driven codes of good practices and market-based regulatory reforms emanating therefrom (Pagliari, 2012:57). European leaders at the outset of the crisis, including the German government, were the most vocal with regard to the direct regulation of such investment vehicles. They supported self-regulatory initiatives drafted by a group of London-based hedge funds referred to as the Hedge Fund Working Group (Pagliari, 2012).

US federal regulatory agencies took it upon themselves to create two advisory groups consisting of investors and hedge fund managers respectively. They were given the mandate of creating private sector-driven principles of good practices (Pagliari, 2012:58), but because of a lukewarm reception of self-regulatory principles taken by the hedge fund industry,\(^{14}\) industry-driven initiatives were not successful in deflecting more stringent regulation. In April 2009, G20 leaders agreed that hedge funds and their managers must be registered and would be required to disclose appropriate information to regulators and supervisors on an ongoing basis. This was instituted to stifle the build-up of systemic risk posed individually or collectively (Brown, Green & Hand, 2012; G20:2009a; Horsfield-Bradbury, 2008:5-6).

Danielsson, Taylor and Zigrand (2005:523) endeavoured to identify key economic reasons for and against regulating hedge funds to identify the optimal form of regulation. Arguments in favour of regulating hedge funds focus on both financial stability and consumer protection. With an increasing expansion in client base to include regulated institutions such as pension funds and small investors, regulation is inevitable. Danielsson et al. (2005:523) argued that consumer protection cannot be the most compelling reason for favouring the regulation of hedge funds due to the regulation of ancillary institutions such as pension funds that indirectly serves as a form of

\(^{13}\) 80\% of European hedge funds and 60\% of private equity firms are in London.

\(^{14}\) During and post the G20 Washington and London summits.
regulation to hedge funds. However, the pervasive presence of consumer protection as a fundamental building block of why something like financial regulation exists cannot be denied. It forms part of the ultimate objective of financial regulation which can be described as the attainment of a high degree of economic efficiency and consumer protection within an economy (Falkena et al., 2001).

The argument for regulation based on systemic importance is valid and echoed in the aftermath of the crisis (Brown, Green & Hand, 2012). However, the consistent drive towards providing access to hedge funds highlights the fact that retail investors will increasingly be provided access to hedge funds. The IMF (2007a:56) reiterated that the increasing use of hedge fund investment techniques employed by mainstream CISs will lead to the increased retailisation of hedge funds.

Hedge fund-like products are also increasingly being made available to retail investors, exposing the retail investors to the same risks and investment complexity (Shadab, 2008a:251; WEF, 2015). Regulatory concerns relating to investor protection and market integrity (particularly in the context of retail investments in hedge funds) were identified to be of concern amongst jurisdictions where retail participation was possible (IMF, 2007a:58). The rise of retail investors, and non-high-net-worth individuals in particular, is projected to become a key source of capital that will characterise the alternative investment landscape in the near future (WEF, 2015:23). Social factors such as the rising number of pensioners and their need to boost returns from pension savings have been identified as already having a substantial impact on the enlarged retail investor demand for alternative assets. Regulatory changes in the financial services and investment sector have made the pursuit of retail investor capital attractive to investment managers and allowed for the easing of restrictions usually associated with retail investor protection. Retailisation is likely to lead to large inflows of capital into alternative investments over the next decade, significantly affecting the competitive landscape (WEF, 2015:23). One of the key drivers of this process was identified by the World Economic Forum (WEF) as demographic shifts and structural changes to economies in the aftermath of the most recent financial downturns (WEF, 2015).

Regulation is typically called for under circumstances where the private decisions of firms result in significant net costs to third parties (Danielsson et al., 2005:524). The fraudulent management of hedge funds and insufficient regulatory adherence (or its possible negative systemic impact) could impose a social cost whilst providing a positive social benefit such as efficient and liquid markets. This will create the simultaneous existence of positive and negative externalities. Implementing traditional regulatory techniques, such as activity restrictions and disclosures, may lead to the limitation of positive social benefits, which in turn would strengthen the argument against the regulation of hedge funds (Danielsson et al., 2005:524).
Challenges facing the industry include the adverse impact of new, and often unclear, regulation. Of many key drivers for the hedge fund industry, 53% of managers cited regulations: volatility and uncertainty in financial markets came a distant second at 42% (Preqin, 2015). This explains the lingering uncertainty experienced by managers regarding more complex regulations that dominate the industry. These concerns are also evident in the EU, as 57% of managers indicated that the Alternative Investment Fund Managers Directive (AIFMD) will impact the industry negatively. In addition, almost 30% of managers reported that, due to regulatory changes brought on by the new directive, they would not market in the EU (Preqin, 2015).

The crisis has led to a substantive refocus on changes that must be made in the regulation of hedge funds. This has sparked the impetus for major global reforms (IOSCO, 2016; Lysandrou, 2012). The principal aim of this study concerned the regulation of hedge funds, in particular, the tangible distinction drawn among the different hedge funds which are more closely regulated) to protect the retail hedge fund investor.

To portray the present reforms underway in South Africa, similar legislative developments and/or existing hedge fund regulatory market structures will be assessed against GFA reforms post the financial crisis agreed to by G20 member states. All three countries demarcated for this study, the US, UK and South Africa, are members (IOSCO, 2016).

The interconnectedness of financial markets, investment funding, and financial and investment management activities remains important, especially in the case of specialised alternative investment vehicles such as hedge funds. A regulatory representation on two of the countries with the largest assets under management alone will not suffice. Other jurisdictions have concomitantly been affected by the regulatory revival. However, discussing all jurisdictions and the impact on (or contribution to) the creation of international good practice regulatory principles falls outside the ambit of this thesis. Hence, the demarcation of regulatory principles agreed to by signatories of the most important international bodies responsible for coordinating applicable regulation provides a clear international regulatory stance regarding good practice. In itself it will provide clear measures against which the South African legislative realm can be evaluated in ensuing chapters.

A discussion follows on the studies and reports undertaken by IOSCO as the relevant international sectoral standard setter relating to hedge funds and the risks posed by them. IOSCO is the association of organisations regulating the world’s security and futures markets, and principles agreed to by members provide the foundation of most of the approaches taken by country jurisdictions towards hedge fund regulation (IOSCO, 2016).

15 Membership of more than 100 countries and representing more than 95% of global securities markets.
2.3 International coordination of financial and securities reforms: IOSCO

“The regulation, supervision and oversight of hedge funds are complex, and the intended purpose of any industry reaction must be clear. The motivation for attending to regulatory concerns or financial stability and investor protection concerns, differ and should consequently add to the desired reaction from the industry and enhance the required level of clarity to all industry partakers.” (IMF, 2007a:58)

This excerpt describes the regulatory environment for hedge funds during a period of enormous global financial instability. It also highlights, however, that any action taken subsequently would have to be clear and enhance the existing state of regulation. In November 2008, IOSCO established the Task Force on Unregulated Companies in support of G20 initiatives to reduce risk involved in unregulated entities and to develop an appropriate regulatory approach where needed (IOSCO, 2015:4). Focus was initially placed on hedge funds which highlighted the G20’s concerns at that time. This resulted in the publication of a consultation report which described the operating environment of hedge funds and associated regulatory risks (IOSCO, 2009a). It reviewed and illustrated work and recommendations issued by IOSCO and other international organisations and provided preliminary recommendations of principles to mitigate associated risks (IOSCO, 2009a).

This section discusses and provides insight into the build-up towards the creation of high-level regulatory principles underlying international developments in the regulation of hedge funds. The build-up of regulation aimed at the protection of retail investors undertaken by IOSCO as early as May 2002 (IOSCO, 2003) will also be provided, as this regulation has either not been reviewed or amended since initial consultation. The high-level regulatory principles identified after evaluating relevant IOSCO hedge fund related reports will be measured against current regulatory practices within the demarcated country jurisdictions. These principles will be augmented with the aim of generating a current set of good practice principles applicable to regulating retail hedge funds in general, and South Africa, specifically. The application of the good practice principles then follows by examining whether these principles are or have been embedded within the legislative and regulatory framework for South African retail hedge funds.

IOSCO – as the internationally recognised body striving towards reforming the global regulatory reform agenda – works closely with other important bodies such as the G20, the FSB and global securities regulators. IOSCO develops and implements not only a standardised approach to securities regulation, but seeks to promote adherence to such standards developed (IOSCO, 2016). IOSCO strives to (IOSCO, 2015):
- cooperate in developing, implementing and promoting adherence to internationally recognised and consistent standards of regulation, oversight and enforcement to protect investors, maintain efficient, transparent and fair markets, as well as seeking to address systemic risks;
- enhance investor protection and promote confidence in the integrity of markets. It seeks to do this through strengthened information exchange and cooperation in enforcement against misconduct, as well as the supervision of market intermediaries and markets themselves; and
- facilitate large-scale information exchanges on a global and regional level to assist market development, strengthen market infrastructure and implement appropriate regulation.

To determine a standard for good practice principles, one needs to take into account developments through IOSCO which affect hedge funds especially, as this organisation has such a rare, direct focus on investor protection. This part of the study explores the agreed regulatory principles identified through the relevant working groups of IOSCO affecting retail hedge fund investment. Following this, a more in-depth venture into the US and UK hedge fund regulatory space will be undertaken to identify principles applicable to retail investor protection in these jurisdictions. Finally, a set of principles will be specified against which the South African hedge fund regulatory developments will be assessed.

2.3.1 International development of regulatory principles for hedge funds: IOSCO

The following discussion sets out regulatory developments according to the dates on which the relevant influential reports were published by IOSCO.

Figure 2-4 illustrates the regulatory reform timeline for hedge funds incorporating the G20 and IOSCO recommendations for securities reform that also have bearing on hedge funds.
The following discussions refer to the above reports applicable to hedge fund regulation, as well as to aspects directly influencing retail participation or associative direct or indirect regulatory principles applicable to investor protection embodied in the specific technical reports. For this thesis, however, the most pertinent reports are highlighted and discussed.

2.3.2 IOSCO report on regulatory and investor protection issues arising from the participation by retail investors in funds-of-hedge-funds

Most research undertaken regarding the hedge fund industry commenced with the collapse of LTCM in 1998, so too was the report initiated by the IOSCO Technical Committee through its Standing Committee on Investment Management (hereafter “SC5”) in May 2002 (IOSCO, 2003). The purpose was to investigate regulatory issues which might arise from retail investor participation in hedge funds (IOSCO, 2003).

Even prior to this report, the then FSF (now the FSB) had endorsed recommendations to address concerns highlighted by Highly Leveraged Institutions (HLIs) following the Asian crisis and LTCM debacle (FSF, 2006; Hampton & Christensen, 2002). During the course of the assessment, “fresh concerns” were raised by some members who indicated new industry developments. One of the

Source: Author’s representation of IOSCO (2015)

Figure 2-4: G20 / IOSCO recommendations timeline
aspects highlighted was the marketing of hedge fund-related products to retail investors. An example of this was the issuing of bonds by banks in which the interest or repayable amount depends on a valuation of a portfolio of hedge funds (FSF, 2006; Hampton & Christensen, 2002:9).

Increased participation of retail investors in hedge funds and fund-of-hedge-funds raised regulatory concerns especially related to investor protection. The terms “retail participation”, “retail investor” and “retail investment” may vary by jurisdiction, but it is accepted that these terms refer to investors who would normally otherwise not be regarded as “professional”, “qualified” or “sophisticated” (Hampton & Christensen, 2002:3).

This report identified the following issues regarding hedge funds which have an impact on “retail” participation:
- Can hedge funds be sufficiently identified to enable specific regulation?
- Are hedge funds inherently riskier to retail investors than normal funds, and if so, is this a bad thing?
- Should hedge funds, if not directly available to retail investors, be open indirectly through fund-of-hedge-funds?
- Should hedge funds and fund-of-hedge-funds be subject to the same rules as more traditional CISs?
- Is there a need for special supervision and authorisation requirements where retail participation is involved, taking into account investment strategy, expertise required for management, management information, technology and appropriate internal controls?
- Should additional disclosure requirements be placed on hedge funds to make their risk profiles and strategies more comprehensible to retail investors?
- Do regulators have enough in-house expertise to effectively authorise and supervise complex hedge funds?

Launching a project to address these issues seemed a useful solution because retail investors had to gain greater understanding of risks in investing in hedge funds. It became evident that the regulatory approach, which consisted mainly of non-participation by retail investors, needed to be tested and the extent to which derivatives could be utilised in CISs re-assessed.

2.3.2.1 Regulatory regimes for hedge funds

Most jurisdictions consider hedge funds to be CISs, although not a normal-type CIS which is open-ended and primarily invests in listed securities whilst employing derivatives conservatively (IOSCO, 2003). HLIs were identified as institutions which are significant traders for their own
account in financial instruments and which display some combination of taking on significant leverage, subject to little or no direct prudential regulation as well as to very limited disclosure requirements (IOSCO, 1999). This description, however, lacked focus as the emphasis was placed on a small subset of funds which posed potential market instability. Also, other CISs (i.e., not only hedge funds) also trade in financial instruments for their own account. A further consideration was that hedge funds did not employ much leverage.

The approach adopted to identify hedge funds ultimately resorted to the fundamental characteristics of and investment strategies employed by institutions referring to themselves as “hedge funds”. It remains almost impossible to arrive at a sufficiently precise and internationally accepted definition of the term “hedge fund” for purposes of regulating CISs (IOSCO, 2003:5).

The report also stated that, whilst not directly impacting financial stability, the marketing of these hedge fund-type products raised questions from an investor protection stance about the extent to which retail investors are knowledgeable about products and associated risks, as well as their belief that these products are suitably regulated (IOSCO, 2003:3). This resulted in some FSF members’ issuing consumer alerts and further highlighting the need to include hedge fund like products in future legislative changes (IOSCO, 2003:5-6).

2.3.2.2 The approach adopted relating to investor protection issues

The following observations were made regarding the regulatory implications that hedge funds’ entrance into the retail market had on investor protection (IOSCO, 2003:6):
- not being able to precisely define “hedge funds” makes it extremely difficult to arrive at a legally sound description for regulatory purposes;
- adequate investor assessment of investment propositions, including suitability of hedge funds for investor needs, is of primary concern;
- the usefulness and role of investment vehicles in capital markets are left to markets to decide;
- the notion that hedge funds carry more risk inherently and that they should not be available to non-qualified retail investors, alongside the issue of systemic risks and exposure, are the two major issues regarding hedge funds;
- regulators are more concerned with funds-of-hedge-funds than with hedge funds themselves, as the former are the primary attraction for retail investment in this sector.

The conclusion was that individual national governments and regulators should determine whether or not hedge funds are suitable for sale in their retail markets (IOSCO, 2003:6-7). Where
jurisdictions allowed for the marketing of hedge funds or funds-of-hedge-funds to the retail public, regulators were encouraged to consider the following:

- explore whether principles embodied in CIS regulation are relevant to hedge funds or funds or funds-of-hedge-funds, as the existence thereof may provide a sufficient enough framework for investor protection;
- disclosure of information in an understandable format that would enable retail investors to grasp the risks associated with a specific investment that the framework provided by IOSCO on CISs would be appropriate for the regulation of hedge funds.
- Except for certain principles, primarily principles 7 and 8 which relate to asset pricing and valuation and investment and borrowing limitations, it is argued that these principles would be a sufficient framework;
- Another document prepared by IOSCO’s then Working Party 5 was also deemed relevant, although it was drafted with a traditional fund “mind-set”. Especially its application of informed decision making and understanding of potential rewards and associated risks together with risk disclosure supported its applicability to the hedge fund industry (IOSCO, 1996).

With regard to the disclosure of risks, the discussion paper highlighted the following issues (set out in Table 2-1) either unique to hedge funds or magnified by hedge funds (IOSCO, 2003:7-8).

Table 2-1:  Risk disclosures either unique to hedge funds or amplified through hedge funds

<table>
<thead>
<tr>
<th>Disclosure issue</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund strategy and disclosure of risks</td>
<td>Hedge funds employ diverse strategies which investors are unfamiliar with. These strategies must be clearly explained, and the fundamental underlying investment approach stated clearly. This does not mean that insight into a unique strategy would be given, even though this is commonly the reason provided by fund managers for having an opaque approach to reporting of information in general. Managers need not provide insight into which choices will be executed to make a strategy work, but investment aims, policy and risks should be provided, as with CISs.</td>
</tr>
<tr>
<td>Target performance / prospective financial information</td>
<td>Evaluating hedge fund performance against other traditional funds is hard for retail investors. Thus, the target performance of hedge fund managers should be provided to allow some sort of room for evaluation.</td>
</tr>
<tr>
<td>Fees and charges</td>
<td>Several fees, normally a performance and management fee, are charged by hedge funds. These must be disclosed.</td>
</tr>
<tr>
<td>Past performance</td>
<td>Timely information on fund performance must be readily available as hedge fund performances are less likely to be correlated to general market movements.</td>
</tr>
<tr>
<td>Lock-up periods / liquidity</td>
<td>The effect of lock-up periods should be clearly communicated and stated together with investments in illiquid assets that influence access to funds.</td>
</tr>
<tr>
<td>Valuation</td>
<td>Other than for some strategies being illiquid, some securities may be hard to value. Therefore, investments in illiquid securities must be communicated clearly together with the basis for valuing a portfolio, as well as the risks associated therewith.</td>
</tr>
</tbody>
</table>
The foregoing discussion holds that any regulator has two basic choices when evaluating whether hedge funds should be given access to the retail investment environment vis-à-vis a traditional approach. The hedge funds themselves may be authorised or not. Authorisation would involve a regulator’s being satisfied that adequate disclosures of investment policies and risks associated have been made, amongst other important considerations. The offering of hedge funds may, on the other hand, be restricted when required levels of disclosure cannot be provided by unwilling managers where there is insufficient backing from formal legislation (IOSCO, 2003:9).

2.3.2.3 Summary: Possible regulatory responses relating to retail investor protection

In the light of the discussion on the report, and considering the framework of any given CIS framework in any specific jurisdiction, the following responses by regulators relating to retail investor protection were found to be available:

- a blanket prohibition or direct or indirect retail investment in hedge funds;
- allowing limited indirect retail investment through professional fund managers;
- imposing additional experience and/or competency requirements on fund managers;
- heightened or more in-depth requirements for due diligence processes applied in general, especially fund-of-hedge-funds;
- limiting direct investment to more sophisticated investors through minimum subscription levels;
- additional requirements on the disclosure of risks and investment strategies followed by hedge funds;
- getting investors to sign acknowledgement warnings or disclaimers;
- placing greater emphasis on the proficiency of sellers of hedge fund products; and
- placing greater emphasis on internal managerial control processes, including valuation procedures.

The fact remains, however, that regulators will be challenged continuously due to the innovative and ever morphing nature of hedge funds. This leaves only one aspect that was not addressed fully in this report: the adequacy of the regulator to regulate retail investment in hedge funds and how this would foster and affect investor protection even in a properly constituted regulatory framework provided within any global jurisdiction.

In February 2005, the IOSCO Technical Committee mandated its SC5 to update the 2003 IOSCO Report (IOSCO, 2006). This was done to take account of regulatory reforms affecting hedge funds within the respective member jurisdictions which resulted in the final report being published in 2006. This report is discussed in the next section.

2.3.3 IOSCO Final Report: The regulatory environment for hedge funds

In March 2005, data concerning retail participation in hedge funds were accumulated through questionnaires. The main areas addressed in the questionnaires were strategies, definitions, registration, disclosure, advertising, disclosure, reporting, examination and disciplinary actions. The responses to the survey can be found in the IOSCO (2006) report.

Four significant conclusions were drawn from this survey:
- none of the responding member jurisdictions had adopted a formal legal definition of the term “hedge fund”;
- hedge fund advisors were at that point regulated under most respondents;
- few jurisdictions reported significant “retailisation” of hedge funds, although some anticipated that this would change in future; and
- incidents of fraud were found in some jurisdictions.

Noteworthy was that several jurisdictions stated that their regulatory regimes were new and lacked proper data to examine different components including fraud committed through hedge funds (IOSCO, 2006:3).

Many permutations of the regulation of hedge funds had existed at that point, including the regulation of fund manager, funds themselves, the distribution of hedge funds and/or the information they provided to customers or regulators regarding fund finances. Not all aspects of this report will be discussed in detail. Only aspects regarding changes or renewed approaches to hedge fund regulation in general (or specifically related to retail hedge funds) will be highlighted.
2.3.3.1 General regulatory approaches

From the responses, at least three approaches to hedge fund regulation taken at that stage could be identified (IOSCO, 2006:6). Most jurisdictions applied their respective regulatory approaches based on the definition of hedge funds and certain characteristics of hedge funds (which included retail participation and investment strategies). The Technical Committee grouped the vehicles according to the regulatory approach of the regulators to compare and analyse the information of hedge funds more effectively, which is discussed below. Other aspects will also be commented upon, including (but not limited to) the governance of hedge fund advisors, advertising and disclosure requirements applicable to retail hedge fund investment.

General regulatory approaches to hedge funds:

i. *Registered or authorised CIS engaging in hedge fund-like strategies*
   - Most jurisdictions allowed for registered or authorised CIS to engage in hedge fund-like strategies. Some jurisdictions did not have a formal definition of hedge funds or categories of special investment funds. Investment limitations imposed on these funds also differed amongst jurisdictions.
   - Jurisdictions were found to have differing approaches concerning retail participation in CIS. Ireland offered only funds-of-hedge-funds to retail investors, whilst in Jersey hedge funds were prohibited to be marketed to the general public, like the South African stance until recently. Other jurisdictions imposed minimum thresholds or subscriptions or net worth requirements relating to retail participation in a hedge fund (IOSCO, 2006:7).

ii. *Limited hedge fund oversight by regulators*
   During 2006 only two jurisdictions submitted to limited oversight by regulators which did not include registration or authorisation of funds by such regulators. In jurisdictions where this approach was followed, hedge funds were not subject to investment limitations associated with ordinary CISs. In Australia, for instance, limitations were imposed on offerings to retail investors, whereas France imposed minimum subscription thresholds and net worth or professional advice requirements on these types of funds (IOSCO, 2006:7).

iii. *No registration or regulation of hedge funds*
   Certain jurisdictions, such as the UK, offered private hedge funds that were not to be subject to registration or regulation by regulators. In such instances managers or advisors were authorised and regulated, and limitations were placed on public offerings or direct restrictions on retail participation. Consequently, these jurisdictions approached regulation from an indirect stance and not direct regulation (IOSCO, 2006:7).
2.3.3.2 Regulatory approaches to hedge fund advisors

Regulatory oversight of advisors in member jurisdictions was an area of concern with 17 out of 20 members, with the remaining three member states indicating such oversight is imminent. Several jurisdictions also indicated the need for special requirements on competency-related aspects, such as functioning and duties, proficiency, reviews and appropriate levels of expertise and experience were in some way required in different jurisdictions.

2.3.3.3 Sales through intermediaries

Intermediaries selling hedge funds were regulated in general, although no hedge fund-specific requirements were applicable to them. In certain jurisdictions additional proficiency requirements were set (IOSCO, 2006:8).

2.3.3.4 Advertising

Advertising of hedge funds was regulated or prohibited in general, as was the case in the UK. This was consistent with the general approach to CISs. Varied approaches, however, existed. Licenced or authorised hedge funds were permitted to advertise in certain jurisdictions, such as the Netherlands and Hong Kong. In Germany, public marketing in the case of funds-of-hedge-funds were restricted, whilst any marketing by single hedge funds was prohibited. Other jurisdictions permitted the listing of hedge funds on securities exchanges (subject to listing requirements or market rules). This was done even though hedge funds were not available to retail investors in many of these jurisdictions (IOSCO, 2006:8).

2.3.3.5 Retail hedge fund disclosure

Minimum requirements regarding disclosure to clients were required by law in most jurisdictions. Eleven out of 20 respondents indicated that heightened disclosure requirements accompanied retail hedge fund offerings. These included specific warnings in sales prospectuses and certain types of CISs that engage in hedge fund-like strategies (IOSCO, 2006:8).

2.3.3.6 Retail hedge fund reporting requirements

Regulated reporting was required to be provided for regulated hedge funds annually or semi-annually. Performance reports were usually also required to be filed with regulators (IOSCO, 2006:9).
2.3.3.7 Examination and enforcement

Although the required reporting was done and, in some jurisdictions, detailed information on the valuation of funds and daily positions was provided, enforcement actions and complaints against hedge funds were not high. Data were difficult to compare due to differences in concept and varying regulatory treatment indifferent jurisdictions (IOSCO, 2006:9).

2.3.3.8 Summary

Consistent with prior work, common investor protection principles for hedge funds focused on the following needs:
- the principles must be clear and concise;
- effective disclosure of hedge fund features must include aspects such as fund manager experience, internal controls, performance, risks and fees, disclosures, etc;
- principles regarding valuation and related matters can be developed based on the assumption that unit pricing errors could impact investor interests in funds.

In 2009, the Technical Committee was mandated to provide insight into hedge fund regulation. The report emanating from its research and industry interactions set out principles as guideline for regulators and industry alike concerning the broader approach to regulating hedge funds. The relevant content of this report is discussed below.

2.3.4 Technical Committee of the IOSCO Consultation Final Report: Hedge funds oversight

The report produced by IOSCO focuses on hedge fund oversight in general and not specifically on aspects of retail regulation. However, it speaks directly to principles that may be added to the regulatory guidelines identified within the 2003 Report.

In November 2008, the Technical Committee established the Task Force on Unregulated Financial Entities to support initiatives by the G20 for purposes of restoring global growth and to pioneer much needed reforms in the world’s financial systems subsequent to the financial crisis. The G20 expressed interest in hedge funds as a subcategory of unregulated financial entities, albeit that the principles identified were applicable to other market participant entities or those who control large pools of capital. The purposes of the Consultation Report included describing the operating environment of hedge funds and the definition of associated risks, the review and illustration of the work and recommendations issued by IOSCO and other international organisations and regulators within this area of expertise and the identification of principles and actions that could be recommended to mitigate risks identified (IOSCO, 2009b:3).
Then, as is still the situation in many jurisdictions, there was no single, universal definition of the term “hedge fund”. In the Final Report, previous work undertaken by IOSCO, which had considered the characteristics of and strategies employed by hedge fund-like entities, was used during the consultation process to ascertain the parameters of what would constitute a “hedge fund” for repurposes of the consultation report. This resulted in investment schemes which displayed some of the following characteristics being regarded as “hedge funds” (IOSCO, 2009a):

- the non-application of borrowing and leverage restrictions;
- the payment of performance fees additional to an annual management fee;
- allowing investors to periodically redeem their interests;
- significant investment of own manager\(^{16}\) funds;
- the use of derivatives for speculative purposes, as well as the ability to short sell securities; and
- the involvement of complex underlying products and more diverse risks.

Even with the above-mentioned characteristics hedge funds are still difficult to define given their legal and business structures, not only across different jurisdictions, but even within a single one.

The Consultation Report was provided as input to the G20 summit held in April 2009, after which the Final Report was published with recommendations on high level principles on hedge fund regulation. The regimes that dictate the regulation of hedge funds are mostly a combination of direct regulation or authorisation, together with the monitoring of either hedge funds themselves or fund managers, or both (IOSCO, 2009a:8). In addition, the indirect regulation through counterparties such as banks should be included. Owing to the inconsistent approaches followed by different regulators, six principles were established to provide a broader ambit and allow a consistent approach throughout different jurisdictions (in support of other primary considerations such as investor protection). These principles are given below.

### 2.3.4.1 High level principles on the regulation of hedge funds

The following six high level principles were recommended and accepted by the Technical Committee:

i. mandatory registration for managers and/or advisors and/or hedge funds themselves;

ii. hedge fund managers or advisors required to register should furthermore be subject to on-going regulatory requirements which relate to:
   - operational or organisational standards;
   - conduct of business rules including conflict of interest;

---

\(^{16}\) The term “hedge fund manager” or “manager” here refers to the entity which establishes the investment profile and strategies for the hedge fund and which makes investment decisions on its behalf.
- investor disclosure; and
- prudential regulation.

iii. banks and prime brokers which provide funding to hedge funds must be compelled to adhere to registration and supervision;
iv. hedge fund managers and prime brokers should provide relevant regulators with information for systemic risk purposes;
v. regulators should encourage the development, implementation and convergence of good industry practices; and
vi. regulators should be given the authority to cooperate with one another where appropriate and share information so that global oversight of funds and managers alike can be facilitated. This would also assist with the identification of systemic risks, market integrity and other risks emerging from the activities or exposures of hedge funds. This view should incorporate the management of risks across borders (IOSCO, 2009b:3).

2.3.4.2 The impact of identified high level principles on hedge fund regulation

The Consultation Report touched on regulatory issues with regard to hedge funds, as well as ongoing concerns that included investor protection and market integrity, ongoing monitoring and the investigation of cross-border activity issues. The influence that hedge funds had on amplifying the effects of the financial crisis was also recognised. Global action was required, and questions as to how effective the existing regulatory standards and domestic regimes were and how well they were implemented in practice, burdened the Technical Committee and regulators alike (IOSCO, 2009b:7). In addition, industry-led initiatives were questioned regarding their ability to develop codes of good practice and whether such standards coupled with official sector recommendations could be effective. This was necessary due to different standards of adoption by fund managers and the low level of the standards themselves. Furthermore, there was no unified set of industry standards covering a range of issues applicable to hedge funds, and the enforceability of current standards differed amongst jurisdictions since hedge funds are highly mobile. The strong need for collective global action and application was evident (IOSCO, 2009b:7).

What is important, is that IOSCO realised that recommendations on hedge fund regulation could never be delivered in isolation and had to have support from banking standards setters, in this instance the BCBS, as well as other regulators. Regulatory resources, expertise and improved information sharing amongst regulators were also pivotal (IOSCO, 2009b:8). Hedge funds have systemic relevance and, therefore, should be regulated. It was recognised that, although institutional or otherwise sophisticated investors primarily form the target for hedge fund investment, retail investment has been gaining momentum, and this momentum would become a challenge that deserves attention.
In conclusion, the outcome once again emphasised that a balanced mixture of direct and indirect regulatory responses was desired, whether the focus was to regulate hedge funds or their managers and advisors. The report furthermore confirmed that the principle of proportionality should be followed based on a risk-based or -oriented approach that would be consistent with G20 recommendations.

2.3.5 Implementation and monitoring of recommendations post the financial crisis

Under the FSB’s Coordination Framework for Implementation Monitoring, the status of recommendations made by the G20 and the FSB post the financial crisis must be reported on by FSB jurisdictions annually. Some of these recommendations relate to securities markets, of which IOSCO is the global standard setting body. One of the identified reform areas analysed by IOSCO is hedge funds (IOSCO, 2016). With most jurisdictions advancing towards full implementation of reforms regarding the self-reporting requirement, all jurisdictions which permit hedge funds reported implementation of the G20 and IOSCO recommendations regarding registration, oversight and disclosure. Almost all jurisdictions have implemented recommendations on international information and enhancing country risk management (IOSCO, 2016). The advancement towards full implementation seems to be progressing steadily and is yet to be completed.

2.4 Summary

Prior to the financial crisis, fact-finding research on the regulation of hedge funds was initiated by several international regulatory forums. After the Asian crisis and the collapse of LTCM, policy documents issued by the BCBS (1999a; 1999b), IOSCO (1999), and subsequently the FSF, which was updated in 2007 when the first signs of the financial crisis emerged, were implemented. Along with the review done in the US by the PWG (1999), these documented efforts concluded that hedge funds should be regulated indirectly. The existing self-regulatory principles were, in fact, strengthened (Lee, 2015; Quaglia, 2011:670).

Two different policy approaches could be clearly distinguished from discussions following in international forums after the financial crisis. The first, in favour of direct regulation, was sponsored by Germany and France, whereas the second, championed by the UK and US, resisted regulation (Fioretos, 2010). It was only during preparations for the April 2009 G20 summit when several European countries, led by France and Germany, called for hedge fund regulation and proposed that hedge funds be regulated in a similar way to banks (Quaglia, 2011:670). In contrast, the UK and US position favoured greater disclosure instead of registration to increase transparency and, in this way, assist investors in making informed investment decisions.
However, it became clear that the financial crisis and its effects on global financial markets revived the drive towards formal direct regulatory interventions. Drawing from the indirect, direct or combined regulatory approaches, the following table highlights the most relevant regulatory principles condensing good practice identified through the IOSCO structure and extracted from the discussion. The table serves as a foundation for the review and potential inclusion of measures or principles to be identified from the demarcated international jurisdictions later in this thesis.

Table 2-2 below will, together with any supplemental information gathered from the demarcated jurisdictional assessment, present the framework against which the South African retail hedge fund regulatory approach can be benchmarked.

Table 2-2: Identified IOSCO investor protection principles

<table>
<thead>
<tr>
<th>IOSCO principle identifier</th>
<th>IOSCO principle</th>
<th>IOSCO principle content description</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>GP1</td>
<td>Registration</td>
<td>Mandatory registration for managers and/or advisors and/or hedge funds themselves.</td>
<td>Standards of conduct, the prevention of and dealing with possible and real conflicts of interest. The types of information, the way they are displayed and understood by investors are important regarding disclosure. The enablement for investors to understand risks associated with this type of investment. Prudential regulation over prime brokers and fund managers in relation to, amongst others, their interaction with regulators.</td>
</tr>
<tr>
<td>GP2</td>
<td>Ongoing regulatory oversight measures</td>
<td>Hedge fund managers or advisors required to register should furthermore be subject to ongoing regulatory requirements which relate to: - operational or organisational standards; - conduct of business rules, including conflict of interest; - investor disclosure; and - prudential regulation.</td>
<td>Standards of conduct, the prevention of and dealing with possible and real conflicts of interest. The types of information, the way they are displayed and understood by investors are important regarding disclosure. The enablement for investors to understand risks associated with this type of investment. Prudential regulation over prime brokers and fund managers in relation to, amongst others, their interaction with regulators.</td>
</tr>
<tr>
<td>GP3</td>
<td>Third-party registration and supervision</td>
<td>Banks and prime brokers which provide funding to hedge funds must be compelled to adhere to registration and supervision.</td>
<td>The supervisory and oversight requirements relate to further indirect regulation that has bearing on hedge funds through entities other than regulation affecting funds or managers.</td>
</tr>
<tr>
<td>GP4</td>
<td>Information</td>
<td>Hedge fund managers and prime brokers should provide relevant regulators with information for systemic risk purposes.</td>
<td>Improved information sharing remains a pivotal issue with regard to effective regulation. The provision of information pertinent to the monitoring of curbing systemic risk should be sufficient to encapsulate information or data that can contribute to overall investor protection.</td>
</tr>
<tr>
<td>GP5</td>
<td>Industry practice development</td>
<td>Regulators should encourage the development, implementation and convergence of good industry practices.</td>
<td></td>
</tr>
<tr>
<td>GP6</td>
<td>Global oversight and cross-border risk management</td>
<td>Regulators should be given the authority to cooperate with one another, where appropriate, and share information so that global oversight of funds and managers alike may be facilitated.</td>
<td>This should be done to assist with the identification of systemic risks, market integrity and other risks emerging from the activities or exposures of hedge funds. This view should incorporate the management of risks across borders.</td>
</tr>
<tr>
<td>IOSCO principle identifier</td>
<td>IOSCO principle</td>
<td>IOSCO principle content description</td>
<td>Comments</td>
</tr>
<tr>
<td>---------------------------</td>
<td>----------------</td>
<td>------------------------------------</td>
<td>----------</td>
</tr>
<tr>
<td>GP7</td>
<td>Hedge fund Definition</td>
<td>The ability to precisely define “hedge funds” is required to arrive at a legally sound description for regulatory purposes.</td>
<td>This definition would be aligned with jurisdictional requirements such as being classified as a collective investment scheme. In most jurisdictions hedge funds are defined in accordance with their characteristics.</td>
</tr>
<tr>
<td>GP8</td>
<td>Investment position assessment</td>
<td>Adequate investor assessment of investment propositions, including suitability of hedge funds for investor needs.</td>
<td>This would include the adequacy of specific strategies towards investor needs.</td>
</tr>
<tr>
<td>GP9</td>
<td>Investment Vehicles</td>
<td>The usefulness and role of investment vehicles in capital markets are left to markets to decide.</td>
<td></td>
</tr>
<tr>
<td>GP10</td>
<td>Inherent risk</td>
<td>The two major issues regarding hedge funds are the notion that hedge funds carry more risk inherently and should not be available to non-qualified retail investors, alongside the issue of systemic risks and exposure.</td>
<td></td>
</tr>
</tbody>
</table>

Source: Author’s representation

In the next chapter, the discussion now turns to the first of two countries which hold the largest assets under management, the US, and its rendition of and approach to hedge fund regulation. Thereafter, in Chapter 4 the regulatory framework and premise for hedge funds in the UK will be provided, which include an overview and background of EU regulation and its influence on both these jurisdictions. From the discussion in Chapter 3, investor protection good practices will be identified and supplemented if possible or where feasible. The selected set of good practices will then be utilised for discussing and assessing the South African retail hedge fund industry in Chapter 7. Chapter 3, thus, sets out the layout of the US regulatory structure in general, after which the regulatory framework for hedge funds in the US is discussed. A discussion follows on the market structures determining investment in hedge funds and all applicable legislation. This chapter concludes with summarising the identified investor protection good practices drawn from the respective subsections.
CHAPTER 3 HEDGE FUND REGULATION IN THE US: AN INVESTOR PROTECTION PERSPECTIVE

3.1 Introduction

Most of the regulatory developments regarding hedge funds post crisis were premised on trans-nationally agreed standards, as discussed in the previous chapter. The guidance given by the IOSCO structures created a transnational framework with uniform principles that member states could follow in this complex, challenging and ever-changing environment of hedge fund regulation. This chapter continues, as per Figure 3.1, with the aim of extracting good practices from the US hedge fund regulatory environment. It also aims to determine existing investor protection principles that will be employed in this study to benchmark regulatory principles enacted within South Africa for retail investor hedge funds.

Figure 3-1: Schematic of thesis progression: Phase 1, Chapter 3

The discussion in this chapter offers an overview of the broader US regulatory structure and current developments within the broader US financial sector towards the regulation of hedge funds. This will provide insight towards identifying the regulatory good practice principles employed within this jurisdiction. (In further chapters the background to UK and EU regulation will be given.) In the sections below, the US regulatory structure is discussed, followed by the regulatory framework for hedge fund regulation. Thereafter an overview will be given of the market structure that
determines investment in hedge funds, together with legislation impacting hedge funds. Finally, retail investor protection good practice will be discussed.

3.2 The US financial regulatory structure

The US regulatory structure, like many other international jurisdictions, came under scrutiny during the 2008 financial crisis. In February 2016, the US Government Accountability Office (GAO) provided a report to Congressional Requesters giving an overview of the complex and fragmented state of financial regulation in the US (United States, 2016). Over the last 150 years the US financial regulatory structure has evolved not only in response to financial crises, but to keep pace with the developments in financial markets and products. One of the main findings in the report was that the structure of the financial regulatory system has contributed towards growth and stability in the US economy, whilst simultaneously creating challenges to effective oversight due to fragmentation and overlap on regulators’ oversight activities. This finding correlates with the approach followed in South Africa which aims not only to address policy or regulatory rules, but to also re-evaluate the entire financial regulatory structure to draw cohesion and alignment between regulation and regulatory oversight (United States, 2016).

The financial crisis highlighted a lack of agency or related mechanism responsible for monitoring and addressing risks across the US financial system. In response, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (hereafter “DFA”) attempted to address this gap in systemic risk oversight by placing the responsibility on several financial regulators and other agencies (DFA, 2010). This was done by establishing the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR). However, these efforts were viewed as insufficient and limited (United States, 2016). The US regulatory structure has evolved in various sectors over time. Figures 3-2 and 3-3 illustrate the historical development of the US financial regulatory structure from 1863 until 2015.
Figure 3-2: Development of US financial regulatory structure (1863-2015) [part 1]
Prior to the 1930s, various state regulatory bodies and the exchanges themselves oversaw the securities markets. The Securities Exchange Act of 1934 (SEA) established the Securities and Exchange Commission (SEC) to regulate securities markets and have oversight of security exchanges, broker dealers, etc. (United States, 2016:106). Securities markets and broker dealers that accept and execute customer orders in these markets are furthermore regulated by self-regulatory organisations (SROs) which include securities exchanges and the Financial Industry Regulatory Authority and are funded by industry contributors. SROs govern their members and require examinations related to market integrity and investor protection, whilst the SEC registers and provides oversight for investment companies and advisors, approves rules for market participants, and conducts examinations of broker dealers and mutual funds (United States, 2016:107). The DFA expanded the regulatory oversight of the SEC by including hedge funds and private equity funds within its purview. Investment advisors to these funds are now required to register with the SEC and are consequently subject to examinations (United States, 2016:107).
The current primary regulators in the US financial regulatory structure and their oversight responsibilities are illustrated in Figure 3-4 below.

**Figure 3-4: US financial regulatory structure, 2016**

The primary regulatory structure is complicated. Figure 3-4 does not show all possible regulatory connections nor any additional agencies involved in regulating financial markets within the US. The following section will focus on the regulation of hedge funds.

### 3.3 The regulatory framework for hedge funds in the US

#### 3.3.1 Introduction and industry overview

The first significant demarcation of hedge funds separating them from the rest of the investment world occurred in the US. This distinction was mostly as a result of the 1929 stock market crash. In 1940 it was illegal for investment companies to short sell or leverage (Bourne & Edwards, 2012:110). Companies that did short sell or leverage without being required to register as investment companies were consequently not subject to limitations imposed by legislation on their practices. The result of operating outside the definition of an “investment company” was that hedge funds were only regulated indirectly and not required to disclose any expert practices in much detail (Bourne & Edwards, 2012:110).
The ability to operate outside this regulatory or constricting ambit, however, came with certain restrictions, including a ban from advertising and obtaining investments from sophisticated investors only (Hardie & MacKenzie, 2007; Sierra-Yanez, 2011:13). Owing to the development of large stakes in their domestic unregulated financial system, investment and commercial banking sectors contributed immensely towards the rapid growth of the hedge fund industry since the 1990s (Fioretos, 2010). This was like the situation in the UK and led to a distinctive divide as to how hedge fund regulation developed internationally. Elsewhere, and more so in Germany and France, the financial services sectors were less cohesive, and commercial banks willingly accepted direct regulation of hedge funds as a means of competing with the UK and US. These countries also identified a gap in the market for less risky “retail” products such as funds-of-hedge-funds (Bourne & Edwards, 2012:111).

Although post financial crisis literature, regulation and policy recommendations have been growing at a tremendous pace, numerous challenges remain for systemic risk prevention and investor protection alike (Lee, 2015). The hedge fund industry has been reshaped with the inception of the DFA, rendering it within the perimeters of regulation. This exercise is, however, still incomplete. As the world is settling to its current and expected market situation, changes and opportunities for markets will arise, including hedge funds, which will again pose challenges to the financial system and their effect on investors (Lee, 2015).

According to the SEC hedge funds include any private fund that possess any of three common characteristics: a performance fee that takes market value into account instead of realised gains only, the use of high leverage, or the use of short selling (SEC, 2011a; SEC, 2011b). Hedge funds are distinct from the traditional investments in ways which include but is not limited to the existence of the investment vehicle, extended investment mandates, limited investment authority of funds etc. (MFA, 2003; MFA, 2005). Owing to the differentiation of hedge funds from the traditional asset management industry, its importance as a source for new investment management ideas and strategies, as well as its confinement to the realm of the “sophisticated” investor, hedge funds’ defining features within the US can be contrasted to traditional investment product characteristics as illustrated in Table 3-1.\textsuperscript{17}

\textsuperscript{17} See also Wyman (2005).
Table 3-1: Defining features of hedge funds contrasted to traditional products within the US

<table>
<thead>
<tr>
<th><strong>Hedge funds</strong></th>
<th><strong>Traditional products</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Long/short investment strategies</td>
<td>Long only investments</td>
</tr>
<tr>
<td>Use of leverage</td>
<td>Limited or prohibited use of leverage</td>
</tr>
<tr>
<td>High performance fee structure</td>
<td>Lower ad valorem fee structure</td>
</tr>
<tr>
<td>Co-investment by fund manager</td>
<td>Co-investment not encouraged</td>
</tr>
<tr>
<td>Use of derivatives</td>
<td>Restricted use of derivatives</td>
</tr>
<tr>
<td>Broad investment scope</td>
<td>Limited investment scope</td>
</tr>
<tr>
<td>Extensive cash allocations</td>
<td>Required to stay fully invested</td>
</tr>
<tr>
<td>Objective: generation of absolute return</td>
<td>Objective: generation of relative return</td>
</tr>
<tr>
<td>Investor access regulated, product lightly regulated</td>
<td>Frequently extensively regulated</td>
</tr>
</tbody>
</table>

Source: US Hedge Fund Features (Investor’s Committee, 2009)

Hedge funds provide a wide variety of investment strategies and exposure to risks not typically available to traditional investment classes or vehicles (Investor’s Committee, 2009:10). As mentioned earlier, the type of investment vehicle seems to be the most accurate way to define hedge funds. In the US a hedge fund is regarded as a pooled investment vehicle that meets the following criteria in general (Investor’s Committee, 2009:10):

- it is privately offered and not marketed to the public in general;
- it is limited to high-net-worth individuals and institutions;
- it is not registered as an investment company in terms of section 40 of the Investment Company Act of 1940 (ICA);
- asset management is executed through a professional investment management firm that shares in performance-related gains in such firm; and
- restricted or limited investor redemption rights exist. 

Hedge fund regulation in the US should be considered as several fragmentary exemptions from various investor protection laws rather than a thoughtfully-crafted regulatory scheme. Neither government authorisation of hedge funds nor hedge funds’ ability to show how they trade specific mandatory disclosure requirements for hedge fund advisors to investors, is required. However, to gain such exemptions, hedge funds have to fall within clear investor-related restriction criteria regarding wealth and income-threshold prerequisites before becoming eligible to invest in hedge

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18 See also private fund reporting requirements in SEC (2011a) and SEC (2011b).
funds (Edwards, 2006:7). Figure 3-5, compiled by the Milken Institute, depicts the relevant regulator for the respective sectors within the US financial system of which the SEC is clearly the most prominent regarding hedge fund regulation.

The US is regarded as the most popular on-shore investment location, with nearly two thirds of global on-shore hedge funds, as well as the leading centre for the location of fund management (Rivière, 2011:271). The US is home to more hedge fund managers, institutional investors and hedge fund capital than any other country in the world. The industry is one of the most vital components of the global hedge fund community, accounting for an approximate 72% of global assets representing almost USD3.1tn (Preqin, 2016a). Figure 3-6 illustrates active US-based hedge fund managers together with institutional investors by state.
So urce: Preqin (2016a)

Figure 3-6: Active US-based hedge fund managers and institutional investors by state

The US has at least one institutional investor per state that actively invests in hedge funds and only five states that do not have a hedge fund manager (Preqin, 2016a). The two largest hedge fund managers in the world are located in Connecticut, with the State of New York representing one third of global hedge fund assets under management. Institutional investors have committed well over USD50bn collectively to this asset class (Preqin, 2016a).

The regulated state of hedge funds is captured in exemptions under four acts and could, as part of a pre-existing regulated state at this juncture, be regarded as common knowledge. The first act is the Securities Services Act of 1933\(^\text{19}\) (SSA). The second act is the SEA\(^\text{20}\) under which companies that raise capital from the public and have their securities widely traded are subject to extensive registration, as well as enhanced disclosure and reporting requirements. The third act is the ICA\(^\text{21}\). The fourth act is the Investment Advisors Act of 1940\(^\text{22}\) (IAA), which subject investment companies and advisors to extensive registration, as well as enhanced disclosure and reporting requirements. Pools of capital, which are publicly traded and commonly referred to as “mutual funds”, are open to retail and non-retail investors and therefore required to comply with the four

\(^{19}\) 15 USC. § 77a-77aa (2005).
\(^{20}\) 15 USC. § 78a-78nn (2007).
\(^{21}\) 15 USC. § 80a-1-80a-64 (2007).
\(^{22}\) 15 USC. § 80b-1-80b-21 (2007).
federal securities laws (Shadab, 2008a:251; Sierra-Yanez, 2011:13). Each of these pieces of legislation contains provisions regarding registration exemptions, as well as limited disclosure requirements, and this is according to which hedge funds are characteristically structured and operate.

3.3.2 Overview of the market structure determining investment in hedge funds in the US

In the US, hedge funds have, to an extent, been separated unwittingly in distinct classes, namely that of “retail” and “wholesale” hedge funds. These classes are separated by wealth threshold requirements captured in various pieces of legislation. The legal threshold levels of wealth and income determine whether an investor is regarded as “retail” or an “investor”. Though not specific to hedge funds, these wealth and income-level thresholds were created for broader investor protection to determine first the disclosure obligations applicable to insurers when it comes to public and private securities and secondly the scope of mutual fund regulation (Donaldson, 2003; Edwards, 2006:7-8). When considering the regulation of investment funds, specifically that of retail and non-retail, the US market comprises two layers which preclude retail investors from gaining access to hedge funds.

Securities in one tier of investment funds are open to all investors who can afford to purchase their shares, whilst funds in the other tier is available for purchase only by qualifying investors (which include individuals) (Martin, 2012; Shadab, 2008a:252). Hedge funds as investment pools are potentially subject to various legal restrictions and regulations unless so organised that they would be exempted them from these regulations, and specifically from the SSA, the ICA and the IAA.

The growth of hedge fund assets under management resulted directly in a significant amount of power and influence within capital markets. This proved to be an important rationale of the SEC for taking regulatory action against the hedge fund industry post the financial crisis. In addition, the lack of reliable data and meaningful information concerning the hedge fund industry, together with increased “retailisation”, strongly supported the SEC’s endeavours to regulate the industry more copiously (Martin, 2012; Sierra-Yanez, 2011:13).

In the wake of the financial crisis, regulators aimed to reform the hedge fund industry by means of the Hedge Fund Transparency Act of 2009.23

23 Hereafter referred to as the “HFTA” or “the Bill”. The HFTA, although introduced to the US Senate in 2009, was never enacted. Consequently, its status never reached that of formal enacted legislation, but remains only that of a bill introduced to the US Senate. The HFTA is referred to in this thesis, because it was one of the foremost direct attempts to regulate not only advisors in accordance with the IAA, but funds themselves.
The HFTA proposed the amendment of the following three securities laws, namely the ICA, SSA and SEA, as well as the Internal Revenue Code (HFTA, 2009). In doing so, the amendments converted exceptions to the definition of an “investment company” into exemptions from mandatory registration as one. The HFTA would primarily have affected the following aspects (Alan & Overy LLP, 2009; HFTA, 2009):

i. An investment company with assets, or assets under management, of at least USD50m would have been exempted from ordinary registration and filing requirements with the SEC. However, it will only be possible if that company (1) registers with the SEC; (2) files a specific electronic form, available publicly, providing information concerning ownership structure, investors, primary accountant and broker, and current assets value; (3) maintains financial records as the SEC may require; and (4) cooperates with any information request or examination by the SEC;

ii. It furthermore determined that any investment company that meets such exemption requirements is to establish an anti-money laundering programme, according to rules prescribed by the Secretary of the Treasury;

iii. Exempted investment companies would have been required to use risk-based due diligence policies, procedures and controls reasonably designed to ascertain the identity of, and evaluate, any foreign person who supplies funds, or plans to supply funds, to be invested with the investment company’s advice or assistance; and

iv. Exempted investment companies would have had to comply with the same requirements as other financial institutions for making available records requested by a federal regulator within prescribed time frames.

The HFTA, as an attempt to formally regulate the hedge fund industry, would have had an enormous impact, from a cost perspective and under increased regulatory scrutiny. Some argued that the disclosure regime forwarded by the Bill would have led to the disclosure of proprietary hedge fund strategies to competitors, as well as availing privileged client information to the public. This more so for non-US investors who particularly cherish client privilege (PaulHastings LLP, 2009).

The HFTA would also have had an impact on structured product issuers’ reliance on the ICA section 3(c)(1) or 3(c)(7) exemptions, as no mechanism was provided for limiting the effect thereof to issuers only falling within a specified definition of “hedge fund” (Alan & Overy LLP, 2009). Product issuers within the US capital markets would have found themselves to have structured their deals in accordance with the regulatory exemptions provided for within the US products market only to have them closed upon enactment of the Bill. Nonetheless, a properly revised Bill that had regard to all necessary stakeholder input could have resulted in a clear set of direct legislative provisions.
The HFTA was proposed with the aim to restructure the hedge fund regulatory landscape, that is, to change or alter hedge fund registration requirements, financial and performance reporting requirements and monitoring options for purposes of oversight of hedge fund activities. However, the Bill stalled in the first stages of introduction. Its further aim to remove ambiguities regarding the interpretation and role of an investment company was consequently also not realised (Gerber, Vance & Pasteur, 2009:11). After the unsuccessful proposal of the HFTA, further attempts were made to propose similar legislation, which also proved futile. Therefore, the legislative position with regard to hedge funds remained based on the legislation stated in 3.3.1 hereof.

The different legislative provisions captured in these acts will be discussed accordingly to elucidate the regulatory regime applicable to US hedge funds. A discussion also follows on the more recent addition of the DFA, owing to the financial crisis and specifically in its relation to hedge fund regulatory reform within the US.

3.3.2.1 The Security Services Act of 1933

The SSA purposes to promote efficient capital formation, whilst ensuring that firms which seek to obtain public capital provide full disclosure and fair practice (Coffee, Seligman & sale, 2007:88). Section 5 of the SSA disallows offering to sell or selling unregistered securities as defined by the SSA without the delivery of a prospectus which outlines certain required information concerning the issuer. Hedge funds, often structured as limited partnerships, limited-liability corporate partnerships or other legal entities, fall within the SSA’s definition of “security” that requires registration (Sami, 2009:275).

The private offering exemption in section 4(2) is mostly relied upon by hedge funds as a means of avoiding regulatory oversight under the SSA for purposes of prospectus delivery requirements. This is, however, limited to situations where offerees have access to information afforded by registration under section 5 of the SSA. Hedge fund managers curtail the impracticality of providing investors with the same disclosures by relying on Rule 506 of Regulation D for an exemption. Rule 506 determines to provide a private offering exemption where an issuer has no more than 35 purchasers, who are not defined as “accredited investors”, and does not advertise publicly.24 Hedge funds are usually exempt from registering with the SEC in terms of section 5 of the SSA if they sell mainly to accredited investors, have less than the 35-purchaser threshold limit for non-

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24 Citing 17 C.F.R. § 230.501(a) (2006)). *Accredited investor* is defined as: (i) Individuals who have a net worth, or joint worth with their spouse, above USD1mn, or have income above USD0.2mn in the last two years (or joint income with their spouse above USD0.3mn) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, officers or general partners of the hedge fund or its general partner; and (ii) certain institutional investors, including banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations; partnerships; limited liability companies and business trusts with more than USDSmn in assets.
accredited investors and do not solicit investment in the public domain. Furthermore, what makes Rule 506 so attractive is that it requires no monetary limit to the fund.

3.3.2.2 The Securities and Exchange Act of 1934

In terms of the SEA a dealer in securities or any person engaged in the business of buying and selling securities for their own account must register with the SEC. Hedge funds, therefore, fall under the regulatory scope of the SEA because they qualify as “dealers” in securities or persons who buy and sell securities for their own account. The SSA further qualifies registration under the act through section 12(g) which requires a dealer whose assets are held by more than 500 people and has an asset value greater than USD1mn by the end of its most current financial year, to register. Hedge funds can, therefore, avoid registration by ensuring that no more than 499 investors invest in their funds.

3.3.2.3 The Investment Company Act of 1940

Investment companies or companies that invest in pooled funds of small investors are required to register with the SEC under the ICA and are consequently subject to regulation. Virtually every hedge fund would fall under the purview of this requirement, because they either constitute investment companies or companies that pool investment funds. Sections 3(c)(1) and 3(c)(7), however, provide hedge funds with two separate exemptions from registration under the act (Sami, 2009:274). Section 3(c)(1) exempts any issuer whose outstanding securities are beneficially owned by not more than 100 persons and which does not make public offering to investors or potential investors of its securities.

According to the investor ownership requirement, each individual investor is a beneficial owner, unless it is an investment entity that owns a minimum of 10% of the hedge fund’s voting securities. For purposes of ownership, a hedge fund would be required to look through the investing entity and count each beneficial owner of such entity as an owner, should the entity be deemed an investment entity. Section 3(c)(7) contains the following exemption:

“[any] issuer, the outstanding securities of which are owned exclusively by persons who, at the time of the acquisition of such securities, and which is not making and does not at that time propose to make a public offering of securities”.25

25 ICA, section 3(c)(7).
A “qualified purchaser” is defined by the ICA as any person who owns at least USD5mn in investments.\textsuperscript{26}

The validation for this is that refined investors, who have access to or possess knowledge of pervasive risks associated with this investment type and have the financial means to engross losses from risky investments, are not in need of protection provided by securities laws (Sami, 2009:275). Consequently, a hedge fund would qualify for exemption in terms hereof if it only sells securities to qualified investors and does not make, or propose to make, public offerings.

3.3.2.4 The Investment Advisers Act of 1940

The IAA regulates investment advisor practice and conduct, and requires investment advisors to register with the SEC, including complying with any regulations promulgated by it. The IAA provides protection for investors relying on the advice of investment advisors, whilst simultaneously feeding the SEC with important information from investment advisors.

An “investment advisor” is defined in section 2(a)(11) as any person who engages in advising others directly or indirectly as to the value of securities, the advisability of investing in, purchasing or selling securities, for compensation. Or, furthermore, who for compensation, as part of regular business, issues or promulgates any analyses or report concerning securities. On face value, hedge funds seem to fall squarely within the ambit of this definition, as they advise on a host of opportunities, investments and strategies accompanying such. The act, however, provides for a so called \textit{de minimus} exemption through Rule 203(b). This exemption states that any investment advisor who, during the preceding 12 months, has had fewer than 15 clients and who neither holds himself out in general to the public as an investment advisor nor acts as an investment advisor to an investment company or a so-called business development company, need not register as an investment advisor. Hence, if a hedge fund has not had more than 14 clients in the preceding 12 months and refrained from holding itself out as an investment advisor, it did not need to register as an investment advisor under the IAA (Sierra-Yanez, 2011:13).

It is important to note that, prior to 2004 hedge funds were not obligated to “look through” each fund and count the number of investors in each fund of collective investments. Each fund, therefore, counted as one client, irrespective of the number of investors involved.\textsuperscript{27} Changes towards the regulation of hedge funds commenced in 2004 when the SEC passed a rule (referred to as the Hedge Fund Rule) under the IAA section 203(b) exemption and, in doing so, rendered the

\textsuperscript{26} This section provides for more than one alternative definition for “qualified purchaser”, of which the one provided in the text here is the most important for purposes of this thesis.

\textsuperscript{27} Investment Advisers Act, at R. 203(b)(3) [15 USC. § 80b-3(b)(3)].
majority of hedge funds subject to SEC registration and regulation (Sami, 2009:281). This was, however, short lived, as the Court for Appeals in the District of Columbia Circuit, in the Goldstein v SEC matter (US, 2006), struck down the Hedge Fund Rule as “arbitrary” (FRBSF, 2007). The SEC elected not to appeal, because the appeal was unanimously struck down on multiple grounds by a three-judge panel of the US Court of Appeals for the District of Columbia Circuit (SEC, 2006; United States, 2006). As a result, both sophisticated and unsophisticated investors will be impacted, as hedge funds have become major influences in financial markets and should not be regulated “lightly” (Hall, 2008:226-227).

3.3.2.5 The Dodd-Frank Act (DFA, 2010)

The US government responded to the financial crisis by enacting the DFA. Despite the substantially increased regulatory burden envisaged by it, the DFA was signed into law on 21 July 2010. Regarded as a piecemeal approach to protect many vested interests rather than an overhaul of fundamental design challenges the US financial system faced at that time, the DFA deals with a wide range of topics affecting from banks to insurers. It singles out key actors, provides standards and reporting requirements and creates monitoring bodies with the goal of intercepting future financial instabilities before they get out of hand (Smith & Muniz-Fraticelli, 2013:618). The DFA expands government oversight of the US financial system by both increasing the number and scope of classes that would be bound by regulation. One of the newest classes to be brought under the scope of the SEC’s regulatory purview is hedge funds (Smith & Muniz-Fraticelli, 2013:619). Private fund advisors managing in excess of USD100mn, municipal financial advisors and investment brokers are furthermore required to register with the SEC. Not only specific parties are covered by the DFA, but also subjects falling within the broader financial regulation scope, is included in the DFA. These subjects include collateralised debt obligations, securities collateralised by them and/or any similar instruments. Also, the number of individuals that can invest subject to federal regulation is limited. For instance, investment advisors managing USD100mn or more will be subject to federal regulation, whereas investments of less than USD100mn will require states to regulate the investment advisors themselves.

As legislation attempts to set new standards by which regulated groups must abide, the DFA creates oversight agencies that undertake this task. Examples of these are the FSOC, the independent Bureau of Consumer Financial Protection within the US Federal Reserve which focuses
on consumer protection (Smith & Muniz-Fraticelli, 2013:619-20). The DFA thus attempts to foster higher standards of stability and consumer protection by which financial and other relevant actors are held accountable.

Although it focuses largely on monitoring the extent to which institutions contribute to systemic risk, the DFA depicts its broader purpose as the following:

“... to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail’, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.” (Martin, 2012:87)

“Systemic risk” usually refers to the risk associated with a widespread breakdown of a financial system, typically caused by one event, and occurring often as a series of interconnected defaults amongst financial institutions within a short space of time (Martin, 2012:87). The DFA has targeted hedge funds due to their potential to contribute towards a systemic risk event, specifically more so where investment banks are involved due to the symbiotic relationship hedge funds have with them. Consequently, the focus on systemic risk monitoring has placed less of a focus on investor protection (Martin, 2012:88).

Many issues concerning investor protection have been left unresolved, as some researchers have pointed to the inapplicability of investor protection due to the restrictions placed on its availability to non-sophisticated investors. This is illustrated in the following figure which gives an overview of the extent of rulemaking processes in terms of the DFA as at July 2016. The vertical axis in Figure 3-7 below depicts the respective categories of rules considered, and the horizontal axis states the number of rules either imposed or not, and when not imposed, whether such rules have been proposed to be finalised or not.

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29 DFA, sections 1011-1013.
30 Hedge funds are regulated under section IV of the Dodd-Frank Act. The formal name of section IV is the "Private Fund Investment Advisers Registration Act of 2010". § 401, 124 stated at 1570 (codified at 15 USC. 80b-20 (2006 & Supp. IV 2011)).
31 Articles focusing on systemic risk prevention include Brown, Goetzmann & Park (2012); King and Maier (2009); Gordon and Müller (2011); Rivière (2011); Billio, Getmansky & Pelizzon, (2010).
The lack of consumer-related rulemaking causes constraints when it comes to implementing DFA regulatory measures that apply to consumer protection in general. This lack of consumer-related rulemaking, combined with the deadlines missed on implementing the number of required rulemakings regarding derivative instruments restricts faith in the implementation of measures that will protect retail investors. A lack of stated deadlines for measures related to investor protection and securities laws that should be implemented also contribute to the lack of faith that measures protecting retail investors in hedge funds available through the DFA will be employed.

Paredes (2006:990) argues that neither the need for accurate information nor its protection from possible abuses justifies overregulation. His argument stems from the fact that the SEC never intervened to protect what he refers to as “well heeled” investors or institutions to protect them. Instead, market discipline was available as a means of protection (Paredes, 2006:990). Whether additional or stringent regulatory protection measures as would apply to banks and other financial intermediaries should be required for hedge funds needs still to be definitively determined. Investors cannot sufficiently be protected by raising financial requirements for investing in hedge funds and increased disclosure and requesting counterparty creditors (i.e. banks, other lending institu-
tions) to assist with managing risks (Hall, 2008:222; Martin, 2012). Although it would restrict unsophisticated investors from buying directly into hedge funds, raised financial requirements would not, according to Hall (2008:222-223), address the exposure of all parties, which include fund-of-hedge-fund investors or beneficiaries of endowments and pension funds. Moreover, it would not bolster investor confidence or correct information asymmetries. Hall (2008:223-224) argues that the analgesic proposals for US investor protection must be closer aligned with international good practice to be effective and should apply equally to all investment products with similar risks.

This shift in focus away from investor protection is also attributed to the restrictions applicable to investors which are premised on financial net worth as a “financial barrier to entry”. This more “traditional perspective” on investor protection is based on the proposition that hedge fund investors, due to their “sophistication”, need no additional protection, as they are able to assess risks associated with alternative investments such as hedge funds for themselves. Investors in hedge funds are thus presumed to be able to “fend for themselves”.32

Table 3-2 represents additional regulations for hedge funds that took effect on 1 July 2011.

Table 3-2: Major proposals on hedge fund regulation enacted by the DFA

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<tr>
<td>1. Elimination of 15-client rule and hedge funds should register regardless of the number of clients. Section 203(b)(1) of the IAA and section 203(b)(3) (DFA Section 403).</td>
<td>Section 203(b)(1) contains the intrastate advisor’s exemption, which states that advisors providing advice to private funds may not rely on this exemption. The definition of “private funds” under the DFA includes an investment fund that would be an investment company in terms of section 3 of the ICA, but for exemptions in terms of the ICA under section 3(c)(1) and 3(c)(7) which are used by hedge funds. The fewer than 15 client’s exemption in section 203(b)(3) usually relied upon by hedge funds (together with other requirements) now only applies to foreign private advisors. By totalling investors in private funds with the number of clients, the DFA overrules the Goldstein v SEC decision. This will force hedge fund registration due to the “look-through principle” and, in this way, do away with having individual funds as clients.</td>
<td>Fund</td>
<td>Will increase registration unless hedge funds move offshore or convert to family offices.</td>
</tr>
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</table>

32 See SEC v. Ralston Purina Co. (1953) where the Supreme Court stated that a public offering excludes, effectively, sophisticated investors, and excluded registration under federal securities regulation. Id. See furthermore, e.g., Gibson (2000:713); Paredes (2006:975, 990) where it is asserted that investor protection principles should not be expanded to hedge fund investors.
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<tr>
<td>2. Treatment of mid-sized investment advisors. Increase in minimum number of assets under management to be exempt to USD100mn (DFA section 410).</td>
<td>This will result in less registrations of the number of hedge funds with the SEC. Smaller funds may have to register within the state they are situated.</td>
<td>Advisor</td>
<td>Should reduce SEC administrative costs, but may put a slightly larger burden on states.</td>
</tr>
<tr>
<td>3. Advisor to maintain detailed records for each hedge fund (DFA section 404). The record keeping and reporting requirements for registered investment advisors in terms of section 204 of the IAA authorise the SEC to require a registered investment advisor to maintain necessary or appropriate records of public interest for the protection of investors or for the assessment of systemic risk.</td>
<td>Records include: 1) Amounts if assets under management; 2) use of leverage including off-balance sheet; 3) counterparty credit risk exposure; 4) trading and investment positions; 5) valuation policies and practices; 6) types of assets held; 7) side arrangements or side letters; 8) trading practices; 9) other necessary information so deemed by the SEC or FSOC.</td>
<td>Advisor</td>
<td>This may lead to a more thorough understanding of risks, but not all leverage is the same. Expert interpretation would be required, which is not always the same.</td>
</tr>
<tr>
<td>4. The SEC can conduct periodic inspections of advisors when deemed appropriate for purposes of systemic risk and may also request additional records for this purpose (DFA section 404) in terms of section 204(b) of the IAA.</td>
<td>Hedge funds have never been subject to compulsory disclosure in the normal course of business due to the collective confidential nature thereof. However, subject to confidentiality, such information may be disclosed to regulatory bodies, any government agency or Congress, or be subject to a court order.</td>
<td>Advisor</td>
<td>Might not be as effective because other case studies, like Lehman Brothers, were registered with the SEC and had Federal and SEC officials in the firms monitoring compliance. This did not impact the severity of their bankruptcy.</td>
</tr>
<tr>
<td>5. Pursuit of information on systemic risk is sufficiently vague that it could imply the disclosure of private fund investor names, as well as other private highly confidential details of hedge funds (DFA section 404). Amendment of section 204(b) of the IAA. SEC still subject to stricter confidentiality requirements in terms of section 210(b) of the IAA.</td>
<td>The act refers in general to a “fund”, but this vagueness could lead to clients’ names being disclosed.</td>
<td>Advisor</td>
<td>Revealing investor information would not be beneficial towards reducing major risks. It could serve other purposes, like money laundering and/or conflicts of interest. This may result in hedge funds moving offshore entirely. The focus, however, remains on systemic risk data collection.</td>
</tr>
<tr>
<td>6. At least an annual disclosure of vote cast with regard to US public companies and a monthly report on aggregate amount of short sales.</td>
<td></td>
<td>Advisor</td>
<td>Would not help with major issues. The act is not concerned with conflicts of interest.</td>
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<tr>
<td>Modification</td>
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<td>7. Verification of client assets by independent public accountants (DFA section 223)</td>
<td>Additional regulations include: 1) risk-based capital requirements; 2) content capital requirements; 3) risk management requirements; 4) liquidity requirements; 5) credit exposure and other reporting requirements; 6) limits on short-term debt including margin; 7) semi-annual stress tests; 8) “living will” plans in case of liquidations; 9) restrictions on investments in banks and other financial companies; 10) separation of banking activities from other activities; 11) other prudential standards deemed appropriate by the Federal Reserve.</td>
<td>Fund</td>
<td>Would not help with major issues but might assist in hedge fund fraud cases.</td>
</tr>
<tr>
<td>8. Large hedge funds qualifying as “significant non-bank financial firms” will be subject to Federal Reserve oversight like banks and bank holdings companies.</td>
<td></td>
<td>Fund</td>
<td>This will place an enormous burden on large hedge funds. There is very little advantage in being a bank holding company, and these companies will be put at a disadvantage. Some of these proposals have already been implemented and may put additional controls on hedge funds, depending on the criteria.</td>
</tr>
<tr>
<td>9. Any firm with assets greater than USD10bn will be compelled to perform annual stress tests and report to the Federal Reserve (DFA section 165).</td>
<td></td>
<td>Fund</td>
<td>Not a large cost on hedge funds, but the usefulness thereof has not yet been established. Most hedge funds that collapsed in 2008 had maintained regular stress tests, but still had not performed a sufficiently large test to have predicted what eventually occurred.</td>
</tr>
<tr>
<td>10. The Volker Rule prohibits banks from investing in or sponsoring hedge funds.</td>
<td></td>
<td>Fund</td>
<td>May be useful in removing hidden risks within banks and protect banks and investors from inside hedge fund collapses and subsequent bailouts.</td>
</tr>
<tr>
<td>11. Major Swap Participants are obligated to register with the Commodity Futures Trading Commission (CFTC) (DFA section 721) through the amendment of section 1(a) of the Commodity Exchange Act.</td>
<td>This includes trade position limits, trade reporting obligations, capital and conduct requirements, mandatory central clearing of certain swaps, etc. Major Swap Participants i) maintain major positions in swaps in any category; ii) engage in swaps that create substantial counterparty exposure that could affect the financial system adversely; iii) are a highly leveraged financial entity, not subject to US bank capital requirements, and maintain a substantial position in swaps.</td>
<td>Fund</td>
<td>Many hedge funds that deal in Swaps, deal in futures as well and are probably registered already with the CFTC. Not a large burden, with little effect on major issues.</td>
</tr>
</tbody>
</table>
12. Other items include:
a) altering the definition of “high net worth” to remove home value;
b) periodic reviews of the definition of “accredited investor”;
c) inflation indexing of qualified client threshold;
d) the initiation of various government studies that may result in additional rules in future.

The alternative definitions reduce the pool of investors somewhat but do not affect existing investors.

Indexing investor thresholds makes sense, but in the context of investor protection for purposes of future crises, its relevance must be questioned.

Source: Chincarini (2012:56-59)

Most of the DFA regulatory changes captured in Table 3.2 affect large hedge funds based on their systemic impact. Noticeably, thresholds pertaining to required registration of hedge funds were lowered effectively, resulting in less hedge funds having to register at a federal level. Although hedge fund advisors are required to keep some important clients’ information and regulatory agencies are allowed to access this information subject to court order, there is still no compulsory requirement to disclose such information on a continued basis.

Amid professed fears that client confidential information or other investment-related information could find its way into public domain, one would suspect that providing confidential disclosure of important information on a quarterly or bi-annual basis would make sense from an investor protection perspective, or at the very least for systemic oversight. What is interesting, however, is the validation of fund assets through public accountants, which may prove to provide some assurance to investors on an objective verification of fund assets. Alteration to definitions like “high net worth” or “accredited investor” would increase the reach of retail investor exclusion from participation in hedge funds without affecting current investors. More so, if the current international trend towards retailisation continues, it might only cause investment arbitrage by retail investors effectively not having too much of an impact on their protection in the long run. It is not yet clear what the overall fundamental impact of these changes will be in the long run for the protection of retail investment in hedge funds directly. The discussion now continues on investor protection measures in terms of the DFA and whether these measures could effectively be drawn from to provide protection specifically to hedge fund investors.

When examining the general protection measures or retail specific investor protection measures under the DFA, one would have expected greater incorporation given the extended focus on sys-
temic risk monitoring under the DFA. Existing investor protection under securities legislation generally seeks to protect investors by providing them with tools to make appropriate investment decisions (Martin, 2012:105-106). These laws generally protect through deterring investment advisors from fraudulent activities, providing investors with more information and greater transparency for decision-making purposes, and providing regulators with more information for greater efficiency in their compliance monitoring and the detection of fraudulent activities, amongst others (Martin, 2012:106). 33

Through its restricted application to sophisticated investors, the DFA’s traditional stance towards investor protection is evident. Some limitations in the DFA with regard to investor protection stem from the limited effect of the Advisers Act registration. This limited effect can be ascribed to ineffective disclosure and record-keeping requirements placed on the activities of funds, as well the fact that smaller funds escape regulatory oversight when based in the US and managing less than USD150mn, amongst others Martin (2012). Also, hedge fund advisors with less than USD150mn in assets under management within the US will not be required to register under the Advisers Act, which in turn deprives investors of the same protection. Although they would need to provide information or data regarding systemic risk to the SEC, the precise way in which they will be regulated is still not clear (Martin, 2012; Scannell, 2010). Advisors with less than USD100mn under management would not qualify for federal registration and need only register to be regulated within their respective states. However, doubt has been cast on the efficiency of state regulation. As most hedge funds are smaller, they fall within the restriction requirements and are exempted from federal registration. This leaves much to be desired with regard to investor protection, as many state regulators do not have the required expertise or experience, reducing the likelihood of detecting fraudulent behaviour (Martin, 2012; Scannell, 2010).

Martin (2012:86) argues that there are many investor protection issues not dealt with by the DFA, of which six are highlighted below:

- An inability to properly assess risk. This assumes that investor protection principles should not be expanded, since "sophisticated" investors spend between two and six months approximately performing due diligence on hedge funds to make an informed decision (Paredes, 2006). Information obtained through the due diligence process will be available if the disclosure requirements apply where hedge funds are registered. Underlying financial instruments traded by hedge funds are complex and trading strategies are dynamic, making

33 See DFA, § 77q which makes it unlawful to use fraud or deceit in the sale of securities; see also id. §§ 77k, 771. This section holds a person civilly liable for giving false information when registering statements and prospectuses; furthermore, section §§ 77j, 77e lists the requirements for a prospectus and also prohibits use of any means of interstate commerce in the absence of conformity with requirements pertaining thereto; Also, section §§ 77g, 77aa lists the disclosure requirements for registration statements.
it difficult even for seasoned investors to assess corresponding risks against certain strategies (Martin, 2012:87).

- **Limitations on transparency.** Under US Companies legislation, mutual funds are required to provide prospectuses to all investors, whereas most hedge funds are not required to provide extensive disclosures to investors (SEC, 2003). Some hedge funds provide additional disclosures due to investor demand, but this occurs intermittently and varies between funds with regard to the level and degree of the disclosure (MacSweeney, 2009; Schmerken, 2013). Owing to a limited transparency requirement for small hedge funds, smaller investors are left to themselves to obtain investment information.

- **Inadequacy of comparing hedge funds.** Mandatory disclosure regimes or similar reporting requirements provide regulators with tools to protect investors. One of the important benefits is that investors are afforded the ability to compare financial and risk data amongst various firms (Hannes, 2004). However, there is no standardised mechanism for hedge fund managers to assess risk or calculate valuations, rendering hedge fund comparisons extremely difficult. In addition, there is no information disclosure regime or mechanism that forces hedge funds to report the relevant information. This inability to accurately assess this risk is enhanced because of the advertisement prohibition applicable to hedge fund managers which forbids them from providing information voluntarily to the public.

- **Absence of a standard valuation mechanism.** Valuation is done to determine the value of assets of a fund at a certain point in time. There is a very real motive for managers to inflate valuations of their funds, as this directly impacts their bonuses which are founded on the performance of the fund (Oz, 2009). Hedge funds often trade in illiquid assets which do not have standardised or available market quotes. Hedge funds, therefore, design their own valuation policies. These are disclosed to investors, but do not often reflect sufficient detail that would allow the effective evaluation thereof. In many instances hedge fund managers have discretion to deviate from valuation policies, and in such cases, disclosures are rendered even more ineffective (Sklar, 2009). Despite numerous efforts within the hedge fund industry, the DFA does not address this important issue (Martin, 2012).

- **Deficient standardised risk management practices.** The risks involved across several investment portfolios and the need to be able to compare them run parallel to the necessity to accurately evaluate returns in each individual portfolio (Horwitz, 2004). Hedge fund risk can be spread over several components, which are usually evaluated. These overall components are volatility, leverage, liquidity and diversification, but should not be exclusively limited thereto (Martin, 2012). Several models can be used to measure these components and there is no standardised method to measure these risks or to report them uniformly (Pearson & Pearson, 2007). Therefore, with regard to investors’ ability to assess risk over
the wide array of possible exposures, the DFA lacks consistency and dilutes the ability to properly assess them.

- Information asymmetries creating quality uncertainty within the market. Because of the investor protection issues discussed above, information asymmetries occur between investors and advisors, usually when individuals within a specific market buy goods or services without knowledge of their true inherent quality – also referred to as a “market for lemons” (Akerlof, 1970:488; Martin, 2012). The consequence is that there is no clear differentiation between low- or high-quality goods, and the purchaser pays the same premium for both, without knowing the value that he will receive in return. Higher-quality goods can, therefore, be pushed out, as they are not duly rewarded for their superior quality (Akerlof, 1970:489).

In the hedge fund industry, the lack of standardised valuation and risk reporting mechanisms makes it difficult for investors to know the true value of their investments. Whether a hedge fund manager is talented or not, or the strategy employed is profitable or not, the price for investment may be the same. Because hedge funds are normally evaluated by returns, short-term success, based mostly on speculation and not on a long-term investment plan, can be equally rewarded. This is due to the difficulty of differentiating between managers’ talent and inability to uniformly evaluate risk and/or calculate value.

Concern has been raised as to whether the DFA actually enhances, as its overall purpose, the efficiency and stability of the US financial system. Evidently, the DFA does not do much to address pertinent issues relating to investor protection pointed out herein. Furthermore, reforms with the aim to organise regulation and supervision to reduce regulatory failure do not exist (Barth, Prabha & Wihlborg, 2014), whilst the interconnectedness and dependency of participants within a financial marketplace are assumed. The argument that a “sophistication” criterion is sufficient to protect all participants in the hedge fund market, as they exclude “non-sophisticated” participants, thus rendering it as the premise on which investor protection overall is founded, is noticeably lacking. Bearing in mind that investor protection is a privilege afforded to all investors, should but one sophisticated participant take undue risk, consequent losses are easily transmitted to other market participants such as retail investors and the general public (Martin, 2012). This study, however, does not allow for an elaborate expansion on the investor protection shortfalls of US based regulatory oversight.

The following section provides extracts from investor protection principles applicable to the domain of US hedge funds. Once identified, the principles will be grouped and designated for evaluation against retail investor protection good practice identified in the previous chapter.
3.4 Investor protection good practices identified from the US hedge fund regulatory environment

The US fundamentally follows a closed, exclusionary approach to the protection of retail investors that do not fulfil the criteria, which are mainly premised on net worth or other equivalent indicators of financial sophistication (Martin, 2012; Shadab, 2008a:252). US securities laws do not directly limit the ability of individual investors to invest in hedge funds. This is evident from the various exceptions in the respective sets of legislation discussed in this thesis, including the exclusion in terms of the ICA sections 3(c)(1) and 3(c)(7) based on the definitions of a “private investment company” and a “public offering”, and the eligibility criteria for a “qualified purchaser” of securities. Hedge funds, consequently, receive most of their funds from a limited number of wealthy investors to qualify for certain mandatory disclosure rules and other laws restricting their conduct.

Retail involvement is restricted through these exceptions and they establish a two-tiered market, i.e. qualifying investors and non-qualifying investors (Shadab, 2008a:251). Thus, non-wealthy investors are indirectly not permitted to invest in hedge funds. By contrast, other jurisdictions have successfully permitted retail investors to invest in hedge funds based on a more direct inclusionary approach, of which South Africa is one. Since 2008, the SEC has expressed interest in broadening access to investment strategies, although it seems not to have retracted its exclusionary approach thus far.

3.4.1 President’s Working Group on Financial Markets: developing good practices for the hedge fund industry

The PWG released its final report on the development of good industry practices on 15 January 2009. The report was compiled by its mandated Asset Management Committee (AMC) to identify and circumscribe good practices related to the US hedge fund industry post the 2008 financial crisis. The call to develop good practices at that time was based primarily on reducing systemic risk whilst simultaneously fostering investor protection (AMC, 2009). The AMC called on hedge funds to adopt comprehensive good practices in all aspects of their business. These critical areas included disclosure, valuation of assets, business operations, risk management, compliance and conflicts of interest (AMC, 2009:i).

The practices recommended in this report were regarded as far-reaching and would exceed industry-wide standards. Greater responsibility was required from managers. Overall hedge fund reporting requirements developed as a result of increased regulatory burdens placed on fund managers to the extent of creating for the first-time separate investor’s reports in addition to the
existing good practices report (AMC, 2009:ii). As opposed to direct regulation, the AMC recommendations underscored the need for hedge funds themselves, together with market participants, to evaluate its businesses and to implement strong practices to manage its businesses. The AMC’s view was that, irrespective of any short-term outcome of this interaction within the industry, it would foster investor protection and play a critical role in reducing systemic risk (AMC, 2009).

Parallel to the AMC, the PWG formed an Investor Committee (IC) which also released a good practice report with the aim to enable investors themselves to assess hedge fund investments. This resulted in the development of the Fiduciary Guide (FG) and the Investor’s Guide (IG). The FG provides recommendations to individuals on how to evaluate the appropriateness of hedge funds as a component of an investment portfolio. Included in the term “fiduciary” are investment managers, consultants, banks and plan trustees (Investor’s Committee, 2009:12). The first responsibility of fiduciaries is to determine the attractiveness and suitability of hedge funds for an institution and how their inclusion within a portfolio would advance the client’s needs and objectives. Fiduciaries are under no obligation to include hedge funds in an investment programme.

The IG allows those charged with the administration and execution of the fund itself, having taken fiduciary considerations into account, to deem whether hedge fund investment would be an option for inclusion into an investment portfolio (Investor’s Committee, 2009:3). The term “investor” is narrowly defined within the IG. It refers to internal and external employees responsible for the establishment and management of an investment programme. The IG furthermore elaborates on certain elements addressed by the FG. The reason for this is mostly to highlight the separate roles and responsibilities of investors, distinct from those of fiduciaries (Investor’s Committee, 2009:17).

The AMC regulations correspond with guidelines issued by the IC. These regulations identified good practices in respect of the administration and management of hedge funds that incorporate disclosure, risk management and valuation systems. The AMC drew on advice from professional associations, institutional investors and financial services professionals to obtain as much input from the industry (Investor’s Committee, 2009:3-4). With the issue of the PWG report in 2009 both managers and investors came together for purposes of fostering investor protection and achieving the goal of realising a reduction in systemic risk.

### 3.4.2 Investor protection principles identified from the PWG reports

The good practice identified in this chapter was extracted from the PWG subcommittee reports. The respective categories were grouped into one collective US principle identifier that formed part of the overall analysis. The structure of principles identified in Annexure A holds reference to both
investor protection principles and good practice principles as mentioned within the PWG reports specifically. The definition of the concept “good practice principles” in the US gives detailed actions on how to execute investor protection principles. It is not within the scope of this study to discuss or correlate individual good practices between respective country jurisdictions. However, they will be mentioned and taken into consideration because they provide structure and give content to the evaluation. The principles that have been identified in Annexure A offer a consolidated list of US hedge fund investor protection principles provided by the PWG.

The principle descriptors for the PWG categorisation are referenced as follows:
- AMCP, which refers to principles identified from the AMC of the PWG or other relevant principles that could be incorporated from the legislation discussed in this chapter;
- ICFP, which refers to fiduciary principles identified from the Investor Committee of the PWG or other relevant principles that could be incorporated from the legislation content discussed in this chapter;
- ICIP, which refers to principles identified from the Investor Committee of the PWG or other relevant principles that could be incorporated from the legislation content discussed in this chapter. The principles identified here are those that are applied after the fiduciary principles for establishing the adequacy of hedge funds within an investment portfolio have been assessed. They describe good practices and guidelines for investment professionals who administers hedge fund investment programmes (Investor’s Committee, 2009:17).

An additional itemisation is included in the overall principle descriptors designated in Annexure A. This itemisation, together with its content description, is designated as good practices (GP) and is supplied to bring clarity and context to the reader. The PWG process was followed to itemise its applicable principles. Based on this process, an overall US principle will be identified for consideration together with the IOSCO principle identified in the previous chapter as well as those identified in the chapters to follow.

3.4.3 Extracting a set of US hedge fund investor protection principles

To provide a clear and comprehensive summary of applied US investor protection principles, the various sets of information discussed in this chapter will be considered and consolidated if necessary and where possible. Principles will be identified from the discussion on the US legislative position, which includes existing legislation, industry practice, self-regulatory bodies’ recommendations and reports. Where at all possible, the good practices identified will be grouped for a more concise representation of their contents.
Where applicable, the principles will be grouped to enable and support their assessment. Owing to the fragmented nature of US legislative provisions governing the regulation of hedge funds, the principles will be categorised according to its principle identifier, the principle itself, the source, and a description of its content. Where applicable, comment on the principle content will be provided. In each case, cross-references will be made to the discussion in the chapter.

In the light of the discussion of principles and good practices related to the PWG reports within Annexure A, the process now requires the consolidation and categorisation of investor protection principles relevant to hedge funds into general US principles. Table 3-3 depicts the investor protection principles identified and consolidated from the PWG reports. The approach to grouping the principles is to detect and correlate content description across the different types of principles extracted from the PWG reports as a first step. The principles identified from the AMC and IC reports are then connected and captured according to content description or characteristics.

Table 3-3: Identified and consolidated investor protection principles from the ACM and IC PWG reports

<table>
<thead>
<tr>
<th>Principle identified</th>
<th>Origin</th>
<th>Description and reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disclosure</td>
<td>ACMP</td>
<td></td>
</tr>
<tr>
<td>Valuation</td>
<td>ACMP</td>
<td></td>
</tr>
<tr>
<td>Risk Management, Due Diligence and Manager Selection</td>
<td>ACMP</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ICIP</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ICFP</td>
<td></td>
</tr>
<tr>
<td>Business Operations and Trading</td>
<td>ACMP</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ICFP</td>
<td></td>
</tr>
<tr>
<td>Compliance, Conflicts of Interest and Business Practices</td>
<td>ACMP</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ICIP</td>
<td></td>
</tr>
<tr>
<td>Legal and Regulatory</td>
<td>ICIP</td>
<td></td>
</tr>
<tr>
<td>Disclosure and Reporting</td>
<td>AMCP</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ICIP</td>
<td></td>
</tr>
<tr>
<td>Valuation and Liquidity</td>
<td>AMCP</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ICFP</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ICIP</td>
<td></td>
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</tbody>
</table>

See Annexure A

In the previous chapter, 11 of the most relevant regulatory good practice principles were extracted from the literature and represented together with a description of their broader content. The main US investor protection principles relating to hedge funds identified based on the approach in Annexure A which was consolidated in Table 3-3 above will be provided in Table 3.4. The legislative and regulatory content discussion throughout this chapter is also consolidated and rendered therein. It provides for the US principle identifier, the principle, the source and a description and links the respective principles as far as practically possible with indications, where applicable, to their adequacy for hedge fund investor protection.
**Table 3-4:** Identified US investor protection principles

<table>
<thead>
<tr>
<th>US principle identifier</th>
<th>US principle</th>
<th>Source</th>
<th>US principle content description</th>
<th>Comments on adequacy in relation to investor protection</th>
<th>Principle content reference to chapter</th>
</tr>
</thead>
<tbody>
<tr>
<td>USP1</td>
<td>Registration for managers and/or investment companies</td>
<td>ICA IAA</td>
<td>Mandatory registration for managers and/or investment companies subject to exclusions.</td>
<td>This requirement is subject to a multitude of exclusions, which effectively negate this requirement. Being an indirect form of regulation, it restricts retail protection because it excludes the incorporation of retail participation rather than provide directly for inclusion. Nevertheless, it provides for the registration of managers and/or investment companies, where applicable, for hedge funds in general.</td>
<td>Section 3.2.2.1-3.2.2.5.</td>
</tr>
<tr>
<td>USP2</td>
<td>Ongoing regulatory oversight measures</td>
<td>ICA IAA</td>
<td>Ongoing regulatory oversight is provided for hedge funds qualifying for registration under the respective sets of legislation discussed in this chapter.</td>
<td>This part is provided for within legislation, the AMC and the IC reports respectively. There are shortfalls, for example, with relation to investor information which is hampered due to registration requirement arbitrage. Furthermore, cognisance should be taken of the definition of “investor” for purposes of this reference. It does not provide for what is understood to be retail investors but, instead, the responsible person for deciding about the hedge fund portfolio and who makes the investments.</td>
<td>See discussion in Sections 3.2 and 3.3. See also Annexure A.</td>
</tr>
<tr>
<td>USP3</td>
<td>Third-party services provision, registration and supervision</td>
<td>IAA</td>
<td>Third-party supervision and registration are provided for entities which render prime brokerage services, compliance, legal and audit related services.</td>
<td>These parties are subject to the Basel restrictions and more burdensome requirements under the EU and UK regulatory regimes (dealt with in following chapters) should US hedge funds require approval to manage funds in those jurisdictions. The US position placed larger focus on the ability of the third party to perform designated functions and of the “investor” to monitor its performance for domestic funds. It includes aspects such as marketing and valuation of assets. An example would be the adherence to private placement regulations and the so-called pay-to-play-rule in accordance with the IAA.</td>
<td>See discussion in Sections 3.2 and 3.3.</td>
</tr>
<tr>
<td>USP4</td>
<td>Information disclosure</td>
<td>IAA ICA SEA DFA AMC ICI ICF</td>
<td>Information obtained from hedge fund managers and any third-party service provider. This requirement also includes information to be provided or disclosed within industry norm intervals that enable decision making for investors. Investors should furthermore understand information disclosed sufficiently for risk management purposes and the evaluation of portfolio valuations by fund or third parties.</td>
<td>Subject to registration, information must be reported where hedge funds are concerned.</td>
<td>See discussion in Sections 3.2 and 3.3. This is also extensively discussed in Annexure A with specific reference to the ACM and ICI.</td>
</tr>
<tr>
<td>US principle identifier</td>
<td>US principle</td>
<td>Source</td>
<td>US principle content description</td>
<td>Comments on adequacy in relation to investor protection</td>
<td>Principle content reference to chapter</td>
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<td>---------------------------------------</td>
</tr>
<tr>
<td>USP5</td>
<td>Industry practice development</td>
<td>IAA AMC IC</td>
<td>Development and implementation of good industry practices exist, but provide for strict qualification criteria for investment in hedge funds.</td>
<td>The AMC, together with the IC, established good industry practices protecting fund managers and, per definition, “investors” which refers to people making the investments or who determine the composition of an investment portfolio. It does not provide for retail investor protection directly, because the indirect approach, namely to include only qualifying investors subject to all legislative and regulatory requirements discussed in this thesis excludes direct retail or “non”-qualifying investors. However, many of the good practices discussed would cater for both instances, but their application does not fall within the scope of this thesis. Included within industry practice are effective and accurate valuation methodology, manager selection, cognisance of portfolio level dynamics, as well as the management of fees, conflicts of interest and liquidity, to highlight a few. It furthermore includes important factors such as understanding trading strategy and business operations that will also find application in terms of risk management.</td>
<td>See discussion in Sections 3.2 and 3.3. See also Annexure A for full discussion on AMC and IC reports on good practices.</td>
</tr>
<tr>
<td>USP5</td>
<td>Global oversight and cross-border risk management</td>
<td>AMC ICF ICI</td>
<td>Regulatory cooperation through international soft law structures,</td>
<td>Hedge funds are subject to trading reporting and record-keeping requirements like other investors in publicly traded securities. Hedge funds are furthermore subject to many additional restrictions and regulations, including a limit on the number and type of investors that each fund may have. Regulators include the SEC. For funds operating within the US, possible further regulatory bodies would include the CFTC, advisors registered as Commodity Pool Operators (CPO) and Commodity Pool Advisors (CPA). Where hedge funds invest in markets regulated by the CFTC, they would also incur regulation subject to the requirements contained within the Commodity Exchange Act. Both the CFTC and SEC are ordinary members of IOSCO. Should hedge funds gain more access to investors in other jurisdictions, adherence to the specific regulatory domicile will also be required and could possibly be more substantial in nature. Most additional or strenuous requirements, of which reporting and disclosure mostly form part, will specifically find application in relation to retail investment.</td>
<td>See discussion in Sections 3.1, 3.2 and 3.3.</td>
</tr>
<tr>
<td>USP6</td>
<td>Hedge fund conceptualisation and definition</td>
<td>AMC</td>
<td>Hedge funds are defined and are identifiable for purposes of their regulation domestically and transnationally.</td>
<td>Hedge funds are defined within the domestic US context, as done in most other transnational jurisdictions, according to key features or characteristics. This definition, although not all encompassing and precise, is legally sound and creates certainty to what would constitute a hedge fund for regulatory purposes. For purposes of retail investment, applicable legislative exclusions are based upon this definition.</td>
<td>See the discussion in Section 3.2.1.</td>
</tr>
<tr>
<td>US principle identifier</td>
<td>US principle content description</td>
<td>Comments on adequacy in relation to investor protection</td>
<td>Principle content reference to chapter</td>
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<tr>
<td>USP7</td>
<td>The US follows an exclusionary approach to the protection of retail investors that do not fulfil the criteria for investment in hedge funds.</td>
<td>The premise for exclusion is based on net worth or other equivalent indicators of financial sophistication.</td>
<td>See the discussion in Section 3.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>USP8</td>
<td>Investment vehicles are governed under existing legislative provisions.</td>
<td>Private investment companies are regulated in terms of the ICA. Possible other legal structures were highlighted earlier in this chapter.</td>
<td>See the discussion in Section 3.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>USP9</td>
<td>Risk management and awareness are of high importance and extensively considered. Many good practice principles in relation to internal risk management, third-party risk management, as well as compliance and conflict of interest management, are prescribed.</td>
<td>Fund managers should have the ability to determine the overall risk of the fund always. Frameworks should be adopted which include risks that must be measured, monitored and managed within the established risk profile of the manager. This should include third-party and counter-party risk as well.</td>
<td>See the discussion on principles and good practices summarised in Tables 3-3 and A-1 pertaining to both the AMC and IC reports.</td>
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<td></td>
</tr>
</tbody>
</table>

Source: Compiled by author
3.5 Summary

Prior to global regulatory reforms regarding hedge funds after the 2008 financial crisis, hedge funds could trade in any security or financial instrument in any market in the world. In terms of US legislation, they could trade as exempted investment pools. Derivatives could be employed by investment managers to any extent without restrictions on short-selling or leverage. Hedge funds could hold concentrated positions in any security with no restrictions, set their own redemption policies and utilise any fee structure, or the most productive one for manager or advisors (Edwards, 2006). Extensive disclosures to investors were also not mandatory. This has left the contractual relationship between hedge funds and investors as the primary, yet indirect, regulatory tool, coupled with market discipline through counterparties, creditors and investors, that restricted hedge fund activities (Edwards, 2006).

Since the regulatory changes in both the global and US landscape, times have changed. The market activities of every US-based hedge fund are subject to commodities and securities laws. Furthermore, the amount of indirect regulation through service providers such as prime brokers is also extensive (MFA, 2005:6). The regulation of the global interconnected financial landscape has also changed the way financial and capital markets function, given new laws implemented within the UK, the EU, Asia and elsewhere (MFA, 2003; MFA, 2005). These reforms have brought about an extended regulatory landscape that has carried with it some belief that alternative investment vehicles are safer and that they fulfil an important function in world markets.

Two of the most important factors for the protection of investors are sufficient and effective regulation, and the coordination of regulatory efforts across jurisdictions. The US approach towards regulating hedge funds and principles provided for the protection of investors therein was captured in the broad discussion in this chapter and summarised in Table 3-4.

Chapter 4 explores the regulation of hedge funds in EU countries and the UK. The goal of this endeavour is to determine the efforts and outcomes reached within these jurisdictions towards regulating retail investment in hedge funds.
CHAPTER 4 HEDGE FUND REGULATION IN THE EUROPEAN UNION:
AN INVESTOR PROTECTION PERSPECTIVE

4.1 Introduction

This chapter builds on the previous two chapters which explored the transnational regulation of hedge funds and the regulation of hedge funds in the US. Principles relevant to the regulation of hedge fund investment, specifically with the aim to protect investors, were identified, grouped (where possible) and discoursed. This chapter, still part of the first phase of this study, turns (as per Figure 4-1) towards the regulatory development and current regulatory structure applicable to hedge funds within the EU. Like Chapters 2 and 3, the aim is to provide an overview of the existing regulatory structure and identify principles relevant to the regulation of hedge funds and specifically those that apply to investor protection. As a further contribution towards the identification of relevant principles for hedge fund regulation, and those related to retail investment in particular, this chapter provides the final selection of principles that will be employed to benchmark the South African regulation of retail hedge funds.

Figure 4-1: Schematic of thesis progression: Phase 1, Chapter 4

One of the most important strategies for creating a single market for financial services in the European Economic Area (EEA) was the development of the European investment fund industry (EC, 2005; Europlace, 2015; Mcvea, 2012:141). Overall, the investment management industry acts as a conduit between investments and investors. Retail investments provide investors with
access to professionally managed and diversified investments on affordable terms. There is an ever-increasing necessity for citizens to take responsibility for their long-term investment needs due to an ever-increasing number of people and an ever-increasing life-span. These points all make arguments for access to alternative investments, which might contain higher risk for retail investors, but provide opportunities for higher yields (Mcvea, 2012:142-143).

Research on hedge fund regulation confirms the lack of regulation and coordination of regulatory approaches by the jurisdictions leading the industry, including the US and UK, prior to the 2008 financial crisis (Fagetan, 2012:3). Increased regulatory coordination between EU countries and the US is a requirement for protecting investors. Investor protection and prudential regulation are immensely important financial stability instruments in the hands of lawmakers and should be employed to not only achieve proper regulatory coordination amongst jurisdictions, but to simplify the financial regulatory system (Fagetan, 2012:3).

Mcvea (2012:145) splits the EU investment fund sector in two parts: a harmonised sector directed at unsophisticated or retail investors, based on the Undertakings for Collective Investment in Transferable Securities Directives (UCITS) framework, and a non-harmonised sector mainly directed at sophisticated investors. This distinction is, however, not clear-cut. In the UK, some non-harmonised products are geared towards the retail market, for example, non-UCITS schemes and investment trust companies that invest in other companies and are regarded suitable for the retail market (Mcvea, 2012:145). With the EU’s strong focus on the harmonisation of the UCITS and Alternative Investment Fund Management Directive (AIFMD) regimes, significant market changes are gradually blurring the lines between traditional retail investment products and products employing hedge fund-like investment attributes (such as the use of derivatives and leverage).

This chapter studies the more recent developments relating to regulatory integration within the EU from an investor protection perspective relevant to hedge funds. This will be achieved through a composite review of current harmonised rules relevant to hedge funds. The Markets in Financial Instruments Directive (MiFID) will be reviewed as part of this study especially due to the implementation of its second iteration on 3 January 2018. Its impact on the hedge fund industry cannot be determined or reviewed in its entirety because of the short period of time since its implementation. However, existing good practice principles captured therein will be taken into consideration.

In addition to the three primary sources referenced above, mention will be made to other influential regulatory developments within the European framework which advance the protection of retail investments and could contribute towards identifying regulatory principles that would assist the evaluation of the South African retail hedge fund regulatory environment.
The evaluation of the primary sources of harmonised rules applicable to hedge funds will contribute towards examining the most recent advancements of regulatory integration relating to investor protection within the EU (as governed by the directives stated above). It will furthermore lay a foundation for examining the directives with a focus on investor protection regulation in relation to hedge funds from a retail participation stance. The aim remains to identify or confirm the implementation of good practice principles, or at least their use by regulatory bodies in fashioning these protection measures. The overall discussion in this chapter will, therefore, provide insight into the dynamics of the financial regulatory arrangement within the broader European framework.

Following the discussion on the EU, attention will shift towards the more recent changes to the UK financial regulatory structure, together with the position on hedge fund regulation and regulating retail investment therein. This discussion will refer to the required transposition of EU law in accordance with the directives, together with the current position of the UK after its formal decision to leave the EU after the 2016 Brexit referendum.

This chapter will first provide background and an overview of the industry, after which a concise layout of the EU hedge fund market, its product features and regulatory structure will be given. Attention will then shift to the UCITS and AIFM directives in their respective application to hedge funds, together with the developments regarding MiFID. The chapter concludes with the selection of investor protection principles to be used for purposes of the analysis of study within the South African context in Chapter 7 (as illustrated in Figure 4-1).

4.2 The EU financial regulatory structure

Supervisory convergence within a healthy financial sector was deemed critical for a European economy functioning in a global competitive market. The Lamfalussy process, which commenced in 2001, aimed to create an efficient mechanism whereby financial supervisory convergence in the EU could establish a community able to provide a rapid and flexible response to developments in financial markets (De Visscher, Maiscocc & Varone, 2008). The Lamfalussy process and its impact on hedge funds in the EU will be discussed in 4.4.2.

This brief introduction to the EU financial regulatory structure aims (as captured in Figure 4-2) to show the link of this structure with the international regulatory institutions, discussed in Chapter 2. The structure shows where EU legislators, the European Systemic Risk Board (ESRB) and the European System of Financial Supervision (ESFS) joined to establish a Single Supervisory Mechanism (SSM) through the five-stage legislative process established therefore to develop EU financial services law in accordance with internationally agreed principles.
Figure 4-2: EU system of financial supervision in a global financial supervisory context

A first-level framework directive is passed by the European Council and European Parliament. Such a directive is scrutinised during this process on a technical level and supplemented through secondary legislation developed by the European Commission (EC) and the European Supervisory Authorities (ESAs) (EU, 2009; EU, 2010). Figure 4-3 highlights the European system of financial supervision post the 2008 financial crisis from a macro- and micro prudential supervisory perspective. The impact of this structure, emanating from the 2009 De Larosière Report in the context of hedge funds will be elaborated on in 4.4.
4.3 Regulating hedge funds in the European Union

4.3.1 Background and industry overview

Hedge funds have played an important role in the expansion of capital markets and growth worldwide due to their strong appetite for eclectic strategies and asset classes. In the UK, hedge funds have stimulated corporate activity, facilitated the restructuring of failed companies, and financed the development of emerging sectors, amongst others (Hankova & Lhabitant, 2012:63). They are seen to represent investment vehicles with the extensive trading flexibility that allows for the execution of highly sophisticated investment strategies to deliver absolute returns for investors, regardless of fluctuating financial markets (Fagetan, 2012:23).

However, in Continental Europe hedge funds were viewed differently. They were the recipients of targeted political blame due to their increased roles in financial markets, especially after the financial crisis, with calls all over Europe for their increased control or regulation, and at worst, their
closure (Hankova & Lhabitant, 2012:63). Since the 1990s, hedge funds have been gaining political prominence alongside their explosion in growth in terms of assets under management. This allowed hedge funds to account for more than 50% of the daily trading volumes on equity markets (Quaglia, 2011:665). The important question, however, is: Why did the EU decide to regulate hedge funds, specifically hedge fund managers?

Answers to this question predominantly state that EU rules provide a framework for national regulatory changes in member states (Zimmermann, 2010). The EU, as one of the largest global jurisdictions, is increasingly active in shaping global financial rules in international fora (Mügge, 2011) and was highly involved with the US policy debate on this subject (Helleiner, Pagliari & Zimmerman, 2010; Quaglia, 2011:667). Furthermore, any potential rulemaking by the EU carries with it considerable potential extraterritorial effects. Reasons as to why the EU decided to regulate hedge fund managers after the financial crisis are primarily attributed to pressure applied by G20 members, EU representatives, and national leaders of European countries (Quaglia, 2011:666-667). These bodies insisted on issuing statements concerning the regulation of all systemically important institutions.

The question whether hedge funds were the cause of and/or contributed greatly towards the financial crisis and its devastating effects on the global economy falls outside the scope of this thesis. Those arguing for their innocence feel that they were (and are) unnecessarily burdened by the regulatory onslaught (Brunnermeier et al., 2009), whereas the opposing constituency argues that hedge funds only amplified the effects of the crisis caused primarily by other role players (Quaglia, 2011:666). Furthermore, the evaluation of or the attribution of whether such regulation is or should be directly or indirectly structured is also not the aim of this study. The focus of this study is on the regulation of retail investment in relation to hedge funds (which requires a broader discussion than selected aspects of hedge fund regulation) and the impact of developed global good practice in this regard within the South African retail hedge fund landscape. Hence, the discussion will move towards this focus.

Traditionally, hedge funds were not interested in retail investors due to a very real mismatch between important features of any investment engagement involving retail investment, namely transparency, complexity, and scale of fee structures, and minimum financial entry requirements (Dardanelli, 2011:467).34 The sheer number of investors and the financial burden associated with enhanced reporting requirements, for instance, do not match the general light structures and relatively limited human resources of hedge fund managers (Dardanelli, 2011:467). This explains why hedge funds have proved popular with sophisticated, wealthy investors in search of absolute

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34 “Retail investor” refers to clients who are neither sophisticated investors nor high-net-worth individuals.
returns and who can afford to lose money. This has mostly been the overarching justification for indirect regulation by restricting retail activity in this way (Dardanelli, 2011:467-468). The case “in equity”, however, has been made in that hedge funds have become direct targets for retail investment due to better returns and expanded investment opportunities, requiring that such investment strategies be made available to smaller investors (Dardanelli, 2011:468).

Regulators in different jurisdictions have since been looking for ways to open hedge funds to the retail investment sector. The chosen conduit was mostly through funds-of-hedge funds, resulting in favourable collective investment regulations being made available by the European legislator (Dardanelli, 2011:467-468). In 2016, the debate on retail financial services was brought to the fore with the EC’s launch of its Green Paper on Retail Financial Services (EFAMA, 2016b). The heart of this project, which aimed to establish a Capital Market Union (CMU), was centred in investor’s interests. One of its focus areas included the promotion of financial literacy, product comparison and effective investor decision making (MiFID II and Packaged Retail Insurance-based Investment Products [PRIIPs]) (EFAMA, 2016b). Another priority was the facilitation of cross-border distribution of retail financial services, which includes investment funds. The CMU also aimed to create a single market for personal pensions and the development of a Pan-European personal pension’s product (PEPP) in line with the objectives of the CMU Action Plan.

One of the key tools to achieve its purpose of enhanced investor protection is the Key Information Document (KID). Like MiFID II, the fund sponsor will be required to present information in a clear, precise and timely manner to investors in order for the agreement to be binding. Furthermore, the information must be published on the website of the manager, making the requirement even more stringent than the Key Investor Information Document (KIID) required in terms of UCITS V (Williams, 2016).

By December 2019, UCITS funds already complying with KIID requirements will need to have implemented PRIIPs obligations. KIID goes much further than requiring manager earnings, the price of the funds etc., as required in terms of UCITS. Regulators will want additional information from other market participants to show their price of liquidity, transaction costs, etc. Whether insurance products can provide all the detailed information required in terms of PRIIPs if the underlying UCITS are not ready to provide them, remains to be seen (Williams, 2016). However, much work is still required before PRIIPs can be implemented. At this point, it seems that product manufacturers will have a limited timeframe to incorporate PRIIPs in the final technical rules being made available and the essential guide being published by the regulator. Therefore, this thesis mentions, but does not elaborate on PRIIPs, mostly due to the early stages of implementation of this regulation which falls outside the scope.
Moloney (2014:222) argues that the EU has a rather troubled history of intervention in retail financial markets, with retail interests being brushed aside for either national interests or their use as political cover. Currently, the EU market is challenged by rooted industry incentive structures and the behavioural vulnerabilities of retail investors which pose challenges for the adoption of effective regulation. There are many arguments for the harmonisation of investor protection within the EU and this process of harmonisation has been identified through the increased adoption of new directives and rules that would enable a more harmonised approach thereto (Charter et al., 2010; Moloney, 2002; 2010; Synovate Ltd, 2011). The new developments with UCITS, MiFID and the retail market toolbox under MiFIR have made significant leaps with regard to distribution regulation, disclosure and product intervention (European Parliament, 2014; Moloney, 2014:223-224). The available and largely more robust regulatory tools, in contrast to previous more dominant disclosure tools, enable an auxiliary interventionist approach to regulation within an EU retail market characterised by industry, market and investor differences. The successful enablement of such an institutional architecture will largely depend on effective financial market governance, together with sound architecture that supports rule-making and supervision (Moloney, 2014:225).

The overview of the European hedge fund market, its product features and regulatory framework will now commence.

4.3.2 EU hedge fund market, product features and regulatory structure

The US approach to hedge fund regulation allows for setting default rules and giving sophisticated investors and hedge fund managers the flexibility to either set their own contracts or to opt out. This approach differs from that of the EU which sets mandatory rules with overarching requirements (Dardanelli, 2011:463; Hankova & Lhabitant, 2012:81). Standardised sets of regulation might provide greater certainty in general, but do not exactly provide the flexibility and, consequently, a safeguard against the possibility of overregulation, as with onshore US hedge funds.

European regulators, however, attempted to adopt strict regulation or, put differently, restrict the sale of interest in hedge funds, without the concession of any real alternative (Hankova & Lhabitant, 2012:80-81). The addition of individual sets of rules governing hedge funds in each European country did not make the regulatory landscape for hedge funds any less complicated. European countries maintained their individual regulation, which left fund managers with different sets of regulators, legal systems, official languages, tax codes and supervisors and, although less tangible, cultural barriers (Hankova & Lhabitant, 2012:81).

The complexity of cross-border distributions is not only costly, but results in very low activity. The financial crisis and the resulting calls for reform spearheaded by the European Parliament and
national governments resulted in the creation of rules that, if so adopted, could have led to the suffocation of hedge funds and private equity (Hankova & Lhabitant, 2012:81). The AIFMD introduced for the first time a harmonised set of rules governing the authorisation and supervision of AIFM in European countries. It applied to all AIFM established in the EU and managing Alternative Investment Funds (AIFs), irrespective of whether they are established inside or outside the EU, whether the AIFMD manages AIFs directly or by delegation, whether AIFs belong to open- or closed-ended types, or whatever the structure of AIFMD might be (Dardanelli, 2011:463; Hankova & Lhabitant, 2012:81-82).

This chapter discusses product features of hedge funds within the EU, together with UCITS and MiFID. An overview of alternative investments and their regulation by the AIFMD as part of including non-UCITS or non-harmonised funds into its fold will also be expanded on. The chapter explores the rationales for allowing investors wider access to alternative investment products. It also endeavours to describe and critically assess, to some extent, the regulatory landscape that has led to the liberalisation of retail investor access to alternative investment strategies and investment products with increased sophistication. Thereafter, principles will be extracted from the discussion for purposes of compiling a list of retail-related protection measures or principles that will form part of the good practice principles framework to benchmark the South African retail hedge fund investment regulatory space.

4.3.3 Hedge funds: Product features within the EU

4.3.3.1 Definition

The concept “hedge fund” in the European context does not always imply homogenous financial products (EFAMA, 2005:5). Some legal systems provide for the concept “investment vehicle” that allows freedom for investment managers to operate “without restrictions” together with a counterbalance through bans on offerings to the public. In other legal systems, the term “hedge fund” refers to a set of investment instruments which may be offered to the public, however at the cost of a drastically restricted managerial discretion when it comes to determining the type of investment (EFAMA, 2005:5). In addition, certain funds are partially classified by UCITS as hedge funds by referring to them as “collective investments” (EFAMA, 2005:5).

4.3.3.2 Legal form, nature and type

Most legal systems of EU member states govern hedge funds in similar ways. Hedge funds are defined as “collective investment undertakings” which separates them from other types of financial instruments. Through UCITS, they are also structured with the same structural form as a
contractual form, statutory form or trust. These forms can be set up either as single funds or funds-of-hedge-funds (EFAMA, 2005:5).

4.3.3.3 Investment object and policy

EU member states recognise that hedge funds allow for advanced management techniques, including derivatives, short selling, etc. However, where public or retail investment is allowed, the discretionary powers of managers are narrower and may vary amongst member states (EFAMA, 2005).

4.3.3.4 Investing in hedge funds

Not all member states impose qualitative requirements on hedge fund investors or impose minimum subscriptions for the purchase of units in hedge funds (EFAMA, 2005).

4.3.3.5 Hedge fund distribution

The distribution of hedge funds to the public is permitted in most member countries only where the hedge fund manager’s freedom to determine the content of the investment is restricted in some way or form. Based on this and other distinctions, the European community follows a harmonised approach in terms of the UCITS and AIFM directives. These directives will be discussed in greater detail in 4.4 and 4.5 respectively (EFAMA, 2005).

4.3.3.6 Reporting to investors

Member states surveyed in 2005 by the European Fund and Asset Management Association (EFAMA) indicated that more detailed information was required than the information generally requisite for typical asset management products. The information needed was similar than that required in terms of the UCITS directives, but with increased disclosure on the risks associated with hedge funds and the strategies adopted by the hedge fund manager (EFAMA, 2005).

4.3.3.7 Management company characteristics

Collective investment undertakings are required to appoint a management company in all member states (EFAMA, 2005).

4.3.3.8 Depository and prime brokerage

Based on the requirements in terms of UCITS, a custodian for the fund’s assets is required to ensure that investor’s assets are kept separate. This is not a common approach in terms of US and offshore funds, where separation is not guaranteed. Members recognise the use of prime
brokerage, and only in some member states are certain qualities or requirements pre-determined for a prime broker to assume this function. These requirements include the nature of the collateral that may be provided against any credits extended by a prime broker (EFAMA, 2005).

4.3.3.9 Cross-border hedge fund products

As a pre-cursor to the cross-border regulatory framework under UCITS and the AIFMD, member states allowed hedge funds to enter their jurisdiction subject to conditions which included marketing restrictions and local private placement requirements. This was, however, not ideal, as local regulatory requirements were either stricter than basic private placement rules for instance or vague, for example, the definition of “private placement”. This term could refer to the “institutional” nature of the investor or whether a limited number of investors can invest in a specific fund. The cross-border approach, through the UCITS and AIFMD regimes, has endeavoured to bring greater harmonisation to cross-border investment in hedge funds (EFAMA, 2005).

Hedge funds as alternative investments are not directly regulated through European legislation, but service providers within the hedge fund industry are subject to regulation in accordance with several European directives, which will be elaborated on below.

4.3.4 Alternative investments and retail investors

The concept “alternative investment” can best be described with relation to its attitude towards risk rather than its distinctness as an asset class. Access to investment strategies associated with such investments was something largely secured for sophisticated investors. Sophisticated investors are expected to be acquainted with the risk inherent to alternative investments and, consequently, should be able to decide the extent to which they would employ wealth in such investments and accept associated losses incurred, should any such losses materialise (Mcvea, 2012:141).

Domestic and EU regulators have, however, facilitated retail investor access to a wider range of investments and sophisticated investment strategies by means of onshore investment vehicles. The rationales for this point of view range from greater investment diversification to the importance of consumer choice. The inclusive approach towards hedge fund investment has been advanced by the EC since 2005 with its Alternative Investment Expert Group. The purpose of this group is to advance recommendations towards freeing up investor access, in specifically retail investment, by removing what it views as unproductive, inefficient and unjustified legal and regulatory impediments, as well as barriers to the free provision of services amongst member states (EC, 2006b).
This drive towards the liberalisation of alternative investments and providing access to retail investors in hedge funds or hedge fund-like strategies within the EU context is important to this study, because it provides the fundamental reasoning upon which enacted policy measures have been structured. As the discussion of the relevant policy and legislative measures within the EU, and thereafter the UK, unfolds, it will allow for the extraction of good practice principles for the framework to be presented in this chapter.

The policy strategy of providing wider retail access to alternative investment funds forms part of the creation of a single market for financial services within the EEA. This is focal to the EC, and the European investment fund industry forms an integral part of the establishment of such a market (United Kingdom, 2009). The investment management industry is effectively a conduit between capital available for investment and those who need investment (United Kingdom, 2009). Various reasons can be specified for providing access to alternative investments and hedge funds. They include an aging population that must take responsibility for their long-term financial needs to simply providing access to professionally managed investments that are well diversified and affordably priced (United Kingdom, 2009). Central to the EC’s policy in this environment has been the EU UCITS directive. This directive has created a harmonised framework that has proven durable and successful over time. Its fifth iteration has already come into operation and had to have been transposed into law within European member states as from 18 March 2016 (FCA, 2016b).

4.4 An overview of the UCITS directives

4.4.1 Introduction

UCITS were established in 1985 to answer the need for standardisation rules with regard to the authorisation, supervision, structure and activities for CISs in the European Communities (as they were known then) (Hankova & Lhabitant, 2012:68). Since initial inception, UCITS have undergone several developments due to progress in financial markets. The effect of registration in one EU country enabled a UCITS fund to freely market across the EU, including to retail investors. UCITS account for approximately 75% of all collective investments by small investors in Europe (EC, 2016). Owing to the “harsher” treatment of offshore funds, specifically relating to taxation within many jurisdictions in the EU, many European hedge fund managers have launched UCITS-compliant funds, also referred to as “Newcits” (Hankova & Lhabitant, 2012:68; PWC, 2010; Sender, 2012). For purposes of this discussion, brief reference will be made to the term “Newcits”, as the use of this term seemed to have constructed a legal subcategory of product that was incorrectly identified as being different from UCITS (EFAMA, 2011).
“Newcits” funds were viewed as a response by managers to investor demand as a result of the financial crisis and the declining effect thereof on Europe’s assets under management (PWC, 2010; PWC, 2015; Sender, 2012). This resulted in extensive growth in this market, which also raised concerns regarding the entrance of new fund managers and the fact that new managers might not have the financial strength to support the fund in times of trouble or to clearly differentiate between institutional and retail investors (PWC, 2015). The extensive growth in product innovation, especially since the inception of the amendment to UCITS III in 2001 which allowed for the employment of financial derivative instruments, raised the vigilance of regulators with regard to the balance between product development and threats to investor protection (CESR, 2006; CESR, 2007; EFAMA, 2011; PWC, 2015; UCITS, 2009). Although UCITS imposed rules which limit investor freedom, managers still can package more complex strategies within the “Newcits” structures, contrary to the UCITS principle that investors should understand what they are investing in. With the migration of hedge funds onshore, EU regulators hoped that managers would eventually offer the AIFMD regime for more complex and highly leveraged funds (PWC, 2010). However, it seems that regulators’ ever-increasing inclusionary approach, with its aim to bring more products within their regulatory ambit, is viewed by most managers and investors as bringing opportunity rather than limitation (CESR, 2006; CESR, 2007; PWC, 2015).

UCITS have become a brand for institutional and retail investors alike. They offer investor protection and greater transparency (Cumming, Imad’Eddine, et al., 2012:261; Zervens, 2014:12). UCITS were developed with the intention of providing increased investor protection and transparency, whilst facilitating cross-border distribution of funds within the EU (Cumming, Imad’Eddine, et al., 2012:261). Their inception created the first harmonised European regime for open-ended retail funds and gave the framework for the distribution of such funds on a cross-border basis within the EEA through simple registration (Zervens, 2014:12). Regulatory fragmentation has had its impact on cross-border sales of investment funds to retail investors (Cumming, Imad’Eddine, et al., 2012: 263).

Economies of scale cannot compete with US average fund sizes. This scale contributes to reducing nontrivial costs. Under the UCITS regime, a fund domiciled in one of the EU countries only needs to go through a simplified registration process at the national regulator of another EU country to obtain the right to distribute units in that country.35 UCITS I, adopted in 1985, was the first set of EU rules to allow open-ended funds investing in transferable securities to be subject to harmonised regulations throughout Europe (Cumming, Imad’Eddine, et al., 2012:263; UCITS I, 1984). From this, unfortunately, member states created obstacles to UCITS I to limit the ability of

35 This is also referred to as the notification procedure for fund unit distribution.
a fund to distribute cross-border (UCITS I, 1984). UCITS II ambitiously attempted to curtail this problem, but to no avail. No agreement could be reached amongst member states and UCITS II was not implemented (Cumming, Imad’Eddine, et al., 2012:263).

The third iteration of UCITS made way for alternative investment funds to be formed under the European regulated structure. It broadened the existing types of eligible assets under the scheme to include the use of options and futures and, in doing so, allowed hedge fund managers to mimic existing hedge fund strategies under a liquid, transparent and regulated format (Preqin, 2013:2). When cross-border distributions within the EU opened, an approximate EUR5tn were invested in collective investments throughout Europe by 2005, of which close to 70% were UCITS funds (Cumming, Dai, Hass et al., 2012).

“UCITS” collectively represents a group of directives that regulate the functioning of CISs in the EU without restriction because of a single authorisation provided by a member state. The aim of the UCITS I Directive was to integrate investment funds into the EEA so that investors would benefit and asset managers would be able to take advantage of this expanded market (UCITS I, 1984).36 One priority was to enable previously authorised funds within an EU member state to be distributed to other EU member states; thus, the birth of the “product passport”. The regulation of investment services would be dominated by the regulatory passport within the field of securities regulation. This was done by utilising the UCITS I Directive as a model (EC, 2007; Fagetan, 2012:83).

The concepts of “harmonised rules”, “national supervision” and “mutual recognition” were the main persuasive influences determining the structure for financial governance within the EU. Very importantly, the concepts of harmonisation and mutual recognition were underpinned by the single passport and home country control (Fratangelo, 2003; Wymeersch, 2005:987). The existing requirements to implement EC norms and transnational exchanges uniformly were motivation for cross-border shared actions to prevent the undertaking from breaking away from prudential supervision. This was a repercussion of similar norms being established at an EU level (Zanoni, 2002:880; Fratangelo, 2003:9).

UCITS cross-border marketing was impeded due to different marketing standards in the EU member states. Restrictions on the definition of investments, in turn, restricted marketing ability under UCITS (EC, 2007). In the 1990s new proposals were released which corrected harmonisation

rules and effectively leading to the draft UCITS II, although too ambitious and ultimately not accepted by the Council of Ministers (ESMA, 2016; Hertig & Lee, 2003:359; Zanoni, 2002). In July 1998 the EU released a recommendation comprising two parts, namely a product and a service provider recommendation, as a means to rectify UCITS I. In December 2001 UCITS III was adopted and consisted of the following two directives (ESMA, 2016; Fagetan, 2012:83; UCITS III, 2009):


The Management Directive offered the “European passport” to fund corporations, allowing them the ability to perform freely within the EU. In addition, the concept of a simplified prospectus was introduced to make transnational sales of UCITS across Europe less strenuous. Both of these additions expanded processes that had been permitted previously (Hertig & Lee, 2003:349).

The main purpose of UCITS was the implementation of management company access conditions, operating controls and prudential safeguards.37 Even more so, UCITS III was designed to improve investor protection through the regulation of management companies engaged in the management of UCITS as investment entities (Fagetan, 2012:85; Stefanini et al., 2010:11; UCITS III, 2009). The Product Directive, on the other hand, aimed to remove transnational limitations to enable the exchange of collective investment funds. This was done by enabling these funds to invest in a larger system of financial tools. Therefore, it became possible for products like hedge funds to obtain pan-European passports by adopting UCITS III as part of EU regulations. The availability of this passport enhanced the retail distribution of hedge funds and other similar products significantly (CESR, 2006; EC, 2007; Moloney, 2008:883).

With its aim of promoting free movement of CISs, UCITS III enables easier CIS inter-EU member trade in units. This forms part of the directive’s free-movement structure and facilitates freedom of establishment (UCITS III, 2009). Depending on the corporate format, UCITS can be established as investment companies or unit trusts. “Unit trusts” as regulated by the directive are not limited to trust structures. The directive includes contractual arrangements. Examples hereof are so-called common funds or *fonds commun de placement* which fall under the umbrella of unit trusts. The defining feature of a unit trust in this context is that the common fund or the trust is managed by a management company. Three individual entities are regarded unit trusts in terms of the directive (UCITS III, 2009):

37 Article 47, section 2.
- the capital rose from unit holders;
- the management company administering the trust’s assets and marketing the trust; and
- the depositary which has custody over the trust’s assets.

The directive fosters extended inter-relations amongst securities markets through granting the regulatory passports under UCITS. As stated, it enables cross-border trade in units without additional regulations, only being subject to local marketing rules. This, in turn, is subject to member state approval as per requirements of the directive (Fagetan, 2012:84; UCITS III, 2009).

4.4.2 Development and implementation of the UCITS Directives

The European regulatory integration process unfolded in several phases. The process commenced with the single market phase in 2001, followed by a harmonisation process and a subsequent shift towards a collective reliance on mutual recognition (Fagetan 2012:79; Kudrna, 2009:4). In this thesis, mention is made only of two important phases for purposes of an overview and a summary of the relevant regulatory policy context together with the most important directives. Consideration in this context is given to the Lamfalussy process and De Larosiére Report only (EU, 2009; EU, 2010).

The EU accumulated enough experience over time to realise that the speed at which financial markets change and the standard decision-making processes would be a major obstacle to regulatory integration. This led to the introduction of the Lamfalussy process, together with co-decision and comitology procedures, to produce better regulation, faster.38 The EU initially focused on the adoption of directives that captured regulatory rules, but the Lamfalussy process brought to the fore the need for supervision (Fagetan, 2012:79). This rare case of institutional innovation resulted in the furthest that regulatory integration could advance, namely where directives specify the regulatory rules that have to be adopted. This subsequently led to the following component that had to be addressed, which is supervision (Kudrna, 2009:5).

Throughout the Lamfalussy process, several assessments regarding the adoption of securities regulation were issued. The regulation of securities markets and practices was done to ensure timely adjustments, faster conversion and better cooperation (Recine & Teixeira, 2009:5). The Lamfalussy Committee introduced a four-tiered governance system through which the distinction between the legislation framework and its enforcing rules was clearly set together with reallocated responsibility for each rule.

38 The term “comitology” refers to set procedures through which the EC exercises the implementing powers conferred on it by the EU legislator. This is done in conjunction with the assistance of representative committees from different EU countries.
Better communication regarding financial regulations was introduced between the EU and national bodies by including old and new regulatory and supervisory bodies in the process. The process was not only confined to securities but extended its reach to the banking and insurance sector after its initial implementation in 2001 (Recine & Teixeira, 2009:5). The Lamfalussy process resulted in a new European framework for the single financial market in 2003 and the consistent enforcement of EU regulations in all EU member states. The current organisational regulatory framework is based on this process and would not require any abilities transfer or treaty alteration (Fagetan, 2012:81).

In 2009 the regulatory reform of the European financial supervisory framework commenced as part of a review and recommendation process undertaken by the EC (Garicano & Lastra, 2010:605). Two pillars were introduced, i.e., the European Systemic Risk Council (ESRC) and the European System of Financial Supervisors (ESFS) (EU, 2009). Figure 4-3 illustrates the post-financial crisis macro- and micro-prudential regulatory supervisory structures and their interaction as envisaged by the De Larosiére Report (EU, 2009).

This macro- and micro-prudential supervisory structure was designed to address previous weaknesses on both a micro- and macro-prudential level by creating a single new rulebook and improving coordination amongst national supervisors. This raised the quality of supervision amongst member states and promoted the convergence of supervisory outcomes (FCA, 2011). With regard to prudential regulation, the approach is still a decentralised monitoring system combined with prior regulatory harmonisation-related mutual recognition. The Lamfalussy process represented a definitive drive towards assuring effective and active operation of the EU’s securities sector (FCA, 2011).

The UCITS, as a group of European directives, purposed that CISs function within the EU without restriction by way of member state authorisation. Further secondary regulatory requirements that limit independent processes of hedge funds were also introduced to protect local asset managers (Moloney, 2006:1).

4.4.3 The regulation of hedge funds and the allure of UCITS hedge fund wrappers

4.4.3.1 Regulating hedge funds and UCITS

The UCITS Directive provided a universal regulatory context allowing harmonised open-ended CISs to pursue business freely within the EU, including the marketing of shares and units. Even more so, CISs were enabled to do so through a single authorisation process by a home member state’s regulatory authority (Fagetan, 2012:85; UCITS III, 2009). However, the desired effect of the “product passport” was deleteriously affected by divergent interpretation and implementation.
by the addressees of its provisions. This was exacerbated by the lack of a unified marketing regime, restrictions on the types of assets UCITS were able to invest within member states, and tax regimes for retail funds (Fagetan, 2012:85). Unsurprisingly, these provisions subdued the establishment of a coherent single market for designated asset management products.39

However, with the approval of UCITS III in 2002, many shortcomings could finally be addressed. UCITS III not only allowed for the extension of the scale of eligible UCITS investments, including funds marketed across borders, but also gave approval for the creation of the “single passport” which afforded management companies the opportunity to expand activities to other EU countries (UCITS III, 2009).40

Since the adoption of UCITS III in Europe, the trend towards enhanced convergence of mutual and hedge funds has become increasingly pronounced (Alternative Investment Expert Group, 2006). Hedge funds continue to be excluded from the harmonised funds framework, notwithstanding a number of factors, namely an increase in the list of UCITS investments, the combination of individual strategic mechanisms pursued by alternative investment vehicles under the UCITS folder, existing theoretical similarities between UCITS and non-harmonised funds and, importantly, the gradual convergence of investment strategies between these (Fagetan, 2012:85). The existing version of UCITS II effectively prevents the establishment of onshore UCITS-compliant hedge fund-type vehicles because of a restriction on genuine short positions (Fagetan, 2012:85; UCITS III, 2009).41

Consequently, the UCITS framework could influence European hedge funds due its evolution, or, effectively, the “institutionalisation” of investments in onshore hedge funds. Regulatory changes brought an indirect widening of the UCITS funds’ investment discretion is, affording UCITS fund managers the ability to employ derivatives and, as an indirect result, leverage. In this way they are enabled to offer retail investors partial benefits, which are normally associated with sophisticated portfolio diversification delivered through funds-of-hedge-funds investment, and the promise of higher returns usually as a result of recourse to the use of derivatives (Fagetan, 2012:86).

39 The movement towards the implementation of UCITS III was based upon the Commission proposal by the European Parliament and Council Directive.
41 The revised UCITS Directive allows for the creation of “synthetic” short equity positions, thereby permitting funds to run short derivative positions on equities but with the requirement that these be cash-settled. A UCITS manager must, to create such positions, buy a put option on a security and hold cash on cover (instead of holding the specific underlying security). As an alternative, the manager will have to make use of an equity swap. A UCITS fund manager could effectively replicate a long/short strategy, with the result causing an increased leveraged position in the fund on the long side (this does not remove the relevant transaction costs). Article 19(1)(g).
An EC report found that the effect of hedge funds on the classic asset market extends beyond the mere demand-side substitution effect (EC, 2006b). This encouraged traditional asset managers to adapt their business models in accordance with the hedge fund archetype (EC, 2006b:46). The wide definition of “eligible assets”, combined with Article 2 of the product directive, provided for the opportunity to insert additional hedge fund features within the revised UCITS framework (EC, 2006a). The report furthermore highlighted ways to indirectly distribute non-harmonised products, such as hedge funds, within the EU as eligible EU assets (EC, 2006a; EFAMA, 2011; Fagetan, 2012:87).

The definition of “eligible assets” was one of the contentious issues in UCITS III and led to the establishment of a commission and the adoption of a directive that could address the weakness related to the revised harmonised funds’ framework (Fagetan, 2012:87). The then Committee of European Securities Regulators (CESR) (currently the European Banking Authority [EBA]) examined whether credit derivatives should be included under the UCITS framework and specifically looked at the possible inclusion of Hedge Fund Indices (HFIs). Despite recognising “index tracking” as a legitimate investment management option under UCITS, the Product Directive still reserved the matter on the issue of the ineligibility as UCITS-compliant “financial indices” (CESR, 2006:185).

The inclusion of HFIs in the ambit of eligible assets in terms of UCITS would have the effect of any non-approved offshore hedge fund being distributed to retail investors through a UCITS structure, if such a fund belonged to an HFI (Fagetan, 2012:87). This would effectively challenge the use of the UCITS structure. The matter was elaborated on in a further CSIR paper. However, a feedback statement afterwards stated that HFIs would only qualify as eligible assets should they fulfil the common criteria specified by article 9 of the EC Directive 2007/16 (CESR, 2007:045). The common criteria include secondary requirements concerning information disclosure and index methodology. Expansion of the current position has to bear on the investment policies of harmonised funds, as well as on the broader acceptability of the onshore hedge fund industry.

4.4.3.2 UCITS hedge fund wrappers

UCITS-structured hedge funds are widespread across Europe with managers, banks and funds-of-hedge-funds all utilising them. The 2008 financial crisis led not only to investors seeking alternatives to the more traditional pooled model for hedge fund investment, but also to fund managers launching directive-compliant vehicles. The UCITS sector in the hedge fund industry has grown extensively with regard to fund structures on offer (Preqlin, 2013:4-5).

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The lure of the UCITS wrapper was especially so for institutional- and retail investors opting for smaller investment sizes and stricter regulation. Attractive regulatory components such as increased transparency and disclosure on investments, with attractive liquidity terms (fortnightly, for example) and limited leverage, are important to investors and one of the key reasons why they invest in such funds (Preqin, 2013:4). On the other hand, for the very same reasons, sophisticated investors by large do not favour alternative UCITS funds due to reduced strategy diversification and a combination of reduced investment options, restricted leverage and other regulatory requirements. The hedge fund alternative fund represents a small sample in the broader offshore hedge fund universe (Preqin, 2013:4). Figure 4-4 illustrates the assets under management position of UCITS funds within Europe for the periods between 2008 and 2016. Totalling an amount of USD288.6bn, the percentage of changes to assets under management remained relatively consistent from 2011 up to the beginning of 2016 (Eurekahedge, 2016).

![UCITS HEDGE FUNDS AUM (2008 – 2016 YTD)](image)

**Figure 4-4:** UCITS hedge fund change of year-on-year assets under management (2008-2016 YTD)

New inflows into UCITS and AIFs totalled EUR62bn in October 2016 compared with the EUR51bn in September 2016, as illustrated in Figure 4-5 (EFAMA, 2016a).
UCITS alone registered net inflows of EUR47bn increasing inflows between September and October 2016 of EUR17bn (EFAMA, 2016a).

The share of net assets by UCITS type shows equity funds, with the largest stake at 36% followed by bond funds at 28%. Money market funds share 14% of the total net assets per UCITS type (EFAMA, 2016a).

4.4.4 UCITS IV

UCITS IV is a major step towards achieving a single market for financial products. The asset management industry could be impacted in a similar fashion comparable to when MiFID was implemented that resulted in changes to investment credit institutions and broker dealers (Dejmek, 2009). As an international brand, UCITS is renowned for its reliability and adjustability, yet is regarded as suboptimal when its market size is measured against the US Mutual Fund market (EFAMA, 2016a). The new measures in the UCITS IV Directive enables the free operation of asset managers within the EU based on the single authorisation received from an EU member state. In doing so, it increases investor protection, as well as flexibility within the European fund industry, and have an impact on administrative bureaucracy and the total associated cost burden (EFAMA, 2016a; Fagetan, 2012:88; Mcvea, 2012:143). The objectives and topics of UCITS IV are illustrated in Figure 4-6.

Source: Eurekahedge (2016)

**Figure 4-5: Net sales of UCITS and AIF**

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Figure 4-6: UCITS IV objectives and topics

The five essential measures favour fund mergers and master-feeder structures on the one hand and, on the other hand, allow for centralised fund management throughout Europe (Fagetan, 2012:89). It furthermore decreases the time available to fund managers to inform regulators of new products developed by them.

UCITS IV supports asset managers to reshape fund strategies, by means of not only cost reductions, but also opportunities to establish new businesses through cross-border fund distribution and the leveraging of the UCITS vehicle for renewed investment strategies. The directive creates a framework for cross-border and domestic mergers between UCITS funds irrespective of the types of funds or legal structures they were established in.

UCITS IV gathered every measure in the provisions of the directive under debate and, in doing so, not only reinforced the competitiveness of the European hedge fund industry, but also the dauntless move towards the single financial market for Europe. The directive’s key concept can be summarised as a focus on the transnational distribution of funds and activities. Through the enablement of cross-border fund distribution, the directive, amongst others, include outcomes

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43 BNP Paribas Securities Services (2010).
that ensure higher protection to the investor (Cumming, Dai, Hass et al., 2012). The short prospectus was for instance replaced with the requirement to provide key investor information. This harmonises the information that should be provided to investors across jurisdictions. Additional information may also be required to be presented to investors where umbrella funds are made use of or the UCITS has one or more share classes, to name two examples.

4.4.5 UCITS V

UCITS V was a critical step in harmonising the EU regulatory regimes, in this instance the AIFMD and UCITS V specifically. Changes to the UCITS regime provided even further protection measures for retail investors and aimed predominantly to address three main areas of fund governance (Deloitte, 2016b; Preqin, 2013:9):

- The depositary or custodian function was harmonised to ensure consistency across all EU states. This included depositary eligibility, duties, responsibilities and liabilities. The rules for when safekeeping duties are delegated was also defined in this directive;
- The introduction of manager compensation rules or remuneration policies that affects both management and investment companies managing UCITS. Key members of UCITS managerial staff are subject to such remuneration policies; and
- The harmonisation of minimum administrative sanctions for the breach of main investor protection sanctions across the EU.

The amended rules, also referred to as Delegated Level 2 Regulations, applied only from 13 October 2016 and as a supplement to the Level 1 UCITS V provisions. This regulatory supplement set out detailed guidelines on tasks of depositaries and specified which entities may act as such. It furthermore clarified the task of depositaries, which include those involving financial instruments that may be held in custody and other financial instruments such as derivatives (FCA, 2016d; Deloitte, 2016b; Jones, 2015). Its main aim was to deliver an increased level of protection to investors and improve confidence in UCITS.

The regulatory supplement envisioned that EU regulators responsible for the supervision of UCITS funds and managers have a common minimum set of powers to their avail for investigating infringements of national jurisdictions, which transposed UCITS into their respective legislative structures, and for sanctioning any breaches where necessary (FCA, 2016d). The UCITS Regulations required a self-managed UCITS and UCITS management companies to update relevant fund information and documentation to comply with the new regulations. A remuneration policy must be adopted for certain staff members, and increased financial disclosures are required in the fund documentation. Their annual prospectus, report and KID must contain remuneration related information (Deloitte, 2016b; FCA, 2016d).
Remuneration is a cause for concern to many managers. Whether under UCITS or the AIFMD, portfolio managers, including the subdelegated management function, fall within the ambit of the remuneration policy under these directives. This implies, for example, that a subdelegated US manager will have to comply therewith (Williams, 2016). Remuneration in this context would include all forms of benefit or payment paid by an AIFM to Code Staff in respect of services rendered.\(^4\) The effect of this remuneration policy is that part of the “managers’” remuneration must be reinvested into the fund. This is due to a branched approach that comprises a fixed and variable component (Williams, 2016). The fixed component is paid directly to the Code Staff member. In terms of the requirements for the variable component, between 40% and 60% thereof must be deferred for three to five years. Fifty per cent of the variable component are to be paid in shares or units to the fund, which is equivalent to ownership interest. This aims to increase investor protection, because the investor can see that the management company (AIFM) is paid with the instrument they are selling to the investors (Williams, 2016). Should the performance of the fund be subdued, or a loss be incurred, the remuneration applied to the management company will be reduced also. This applies to both the AIFMD and UCITS V (Williams, 2016). This approach furthermore aligns the interests of investors and the management company and contributes towards retaining key staff within the management company (FCA, 2016d).

4.4.6 UCITS VI

In July 2012 the EC released a working document which outlined further ideas on how the UCITS Directive could be improved. This paper became known as UCITS VI.

In the same month and year, the legislative proposal for the UCITS V Directive was published. The reason the Commission’s consultation on UCITS VI was published was to address areas of concern on eight specific topics raised for discussion not addressed under UCITS V (UCITS Consultation Document, 2012).

These topics in the UCITS consultation document (EU, 2012) are:

- “Eligible assets and the use of derivatives: evaluation of the current practices in UCITS portfolio management and assessment of certain fund investment policies;
- Efficient portfolio management techniques: assessment of current rules regarding certain types of transactions and management of collateral;
- OTC derivatives: treatment of OTC derivatives cleared through central counterparties, assessment of the current framework regarding operational risk and conflicts of interest, frequency of calculation of counterparty risk exposure;

\(^4\) Code Staff include senior management, risk management and anyone with a control function, such as persons heading compliance, tax, accounting and legal affairs.
Extraordinary liquidity management: assessment of the potential need for uniform guidance in dealing with liquidity issues;

Depositary passport: assessment of whether or not to introduce a cross border passport for the performance of the depositary functions set out in the UCITS Directive;

Money market funds: assessment of the potential need to strengthen the resilience of the MMF market to prevent investor runs and systemic risks;

Long term investments: assessment of the potential need for measures to promote long term investments and of the possible form of such measures (including investments in social entrepreneurship);

Improvements to the UCITS VI framework: assessment of whether or not the rules concerning the management company passport, master feeder structures, fund mergers and notification procedures might require improvements.”

The consultation was, to a certain extent, triggered by an international regulatory focus on securities lending and repos, OTC derivatives and liquidity, and systemic issues relating to Exchange Traded Funds (ETFs) and Money Market Funds (MMFs) (KPMG, 2015). Currently, in 2018, there is no indication whether the UCITS VI legislative proposal will be published. Many of the pressing issues identified in the proposal have been, or are in process of being, dealt with through other measures. But the focus remains on member states’ correctly implementing current UCITS V measures and it seems unlikely that a single legislative proposal covering all the topic of the UCITS VI consultation will be issued by the EC (Jones, 2015; KPMG, 2015).

The importance of the UCITS framework as an essential part of the European regulatory integration process remains undisputed. The development of “Newcits” funds, providing non-EU hedge fund managers entrance into the regulated European market, showed that the retailisation within the hedge fund market was actively being pursued. The following section shifts the focus onto the directive covering managers of alternative investment schemes designed for advanced investors which include private equity funds and hedge funds.

4.5 An overview of the Alternative Investment Fund Managers Directive (AIFMD)

4.5.1 Introduction

At the end of 2008, amidst calls for the regulation of hedge funds by the European Parliament, concerns were expressed by the Commission on Hedge Funds and Private Equity (“the Commission”) on, amongst others, the valuation of illiquid and complex financial instruments, risk management standards and leverage (Dardanelli, 2011:474). Based on public consultation, and specifically that of the High-Level Conference on Private Equity and Hedge Funds in February 2009
in Brussels, many issues were raised, including the role of hedge funds in the emergence of the 2008 crisis (ESMA, 2016). Though the conclusion was that hedge funds did not play a major role in this regard, calls were raised for regulatory transparency in relation to hedge funds within the financial system (Möllers, Harrer & Krüger, 2012). On 30 April 2009, the Commission issued the “Proposal for a Directive on Alternative Investment Fund Managers” (Buller & Lindstrom, 2013:391; ESMA, 2016; House of Lords, 2009).

The AIFMD proposal was set to deal with “macro-prudential risks”, which include bank exposures to the hedge fund industry and risk concentration whilst providing oversight on a “micro-prudential level”, which include market integrity and investor protection specifically (AIFM, 2011; Dardanelli, 2011:474). The directive established common requirements governing the authorisation and supervision on AIFM to provide a coherent approach to the management of associated risks and their impact on investors and markets within the EU (AIFM, 2011). The fact that the AIFMD was approved during the financial crisis sheds valuable light on hedge fund rules within the European market. The directive had an impact on investor protection within the hedge fund industry directly (Buller & Lindstrom, 2013:396; Möllers et al., 2012). The US and EU, although different with regard to their basic underlying objectives for securities regulation, both envisage investor protection and the management of systemic risk concerns. The EU highlights a third objective, namely the establishment of a single European market through its supervisory framework, the AIFMD. Throughout most directives regarding EU securities regulation, investor protection can easily be traced as the protruding reason for the establishment of a single market for the regulation of financial products (EC, 2011; Nabilou, 2014:287).

In many instances, the AIFM draws on rules already captured within the UCITS Directive. Some of these rules include a common European authorisation, minimum capital requirements for management companies, and the introduction of depositaries (Möllers et al., 2012:88). Moreover, the AIFM, like UCITS, covers all entities that are focused on collectively investing capital of many investors. Alternative Investment Funds (AIFs) are more broadly defined in terms of prescriptions applicable to the raising investment capital and the type of investment that may be executed. An AIF need not allow the cashing in of capital contributions nor allow anytime withdrawals. UCITS entities gather their capital from the broad public to invest in securities and other solvent financial means according to the principles of risk distribution (Möllers et al., 2012:89-90).

The AIFMD includes in its scope all AIF managers registered within the EU, regardless of whether the fund is headquartered in the EU. It furthermore finds application in funds that are managed or

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45 This according to UCITS, article 7(1), which is identical with the ones according to AIFM directive 2011/61 that relate to minimum capital requirements. See also article 6(2), which includes the additional requirements for portfolios exceeding EUR250m.
The directive defines an AIF as follows:

“[A]ny collective investment undertaking, including investment compartments thereof, which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors and which does not require authorisation pursuant to the UCITS Directive.”
AIFs, for purposes of the directive, include open- and closed-ended funds, as well as listed and unlisted vehicles. In this way, AIFs include a broad range of “vehicles” that are regarded as funds, for instance non-UCITS investment funds wherever established (AIFMD, 2011; Athanassiou, 2011:242). The extended definition means to include institutional vehicles that did not fit the perimeter of EU financial regulation previously, amongst which hedge funds, collective investment schemes, and real estate funds can be included. The scope of the directive should, however, be limited to entities managing AIFs as a regular business, regardless of their type, legal format or whether or not they are listed (AIFMD, 2011; AIMA, 2014:4; Fagetan, 2012:103-104; Möllers et al., 2012:89-90).

The AIFMD, and specifically article 3(a) thereof, defines an “AIF” as any collective investment scheme that requires no authorisation in relation to compliance with the UCITS Directive. There are, however, certain exceptions to the definition which curtail its width (AIFMD, 2011; Nabilou, 2014:295):
- The AIFMD does not apply to collective investment schemes regulated under the UCITS directive, EU credit institutions, pension funds, life assurance or reinsurance companies or sovereign wealth funds;\(^{46}\)
- The AIFMD does not apply to an AIFM that is located in the EU that does not offer management services to an AIF located or marketed within the EU;\(^ {47}\)
- The AIFMD excludes holding companies, supranational institutions, national central banks, national and regional local governments, employee participation or saving schemes, and securitisation special purpose vehicles.\(^ {48}\)

These exceptions do not imply that affected CISs would fall outside the ambit of regulation within their own states. An example hereof is that the definition of an AIF differs from the definition of a CIS in the UK. Although some aspects contained in the different definitions overlap, the possibility remains that the AIFMD scope could include venture capital trusts and investment companies not covered by UK regulation (Christofilou, 2013; Möllers et al., 2012:89-90).

The directive is marked with EEA relevance, meaning that adoption under the EEA agreement has the same legal effect in non-EU countries within the EEA as it currently has in EU member states (AIFMD I, 2011:2-3). On a European level, further guidelines were released in August 2013 by the European Securities and Markets Authority (ESMA), which provided key guidance on concepts in the definition of AIFMD (ESMA, 2013:4).\(^ {49}\) These guidelines gave clarity on collective

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\(^{46}\) Article 2, section 2(c)–(g).

\(^{47}\) Article 2, section 2(b).

\(^{48}\) Articles 18 and 36.

\(^{49}\) Article 4, section 1(a).
investment undertaking criteria, pooling - and other criteria, the raising of capital, the number of investors capital is raised from and defining “investment policy” (Christofilou, 2013; Nabilou, 2014:295).

An AIFM is responsible for ensuring compliance with the directive and that an AIF is managed accordingly. It is defined as an entity that, at a minimum, provides portfolio and risk management services to one or more AIF as its regular business, irrespective of the AIFs location or legal form. The AIFM may either be an external manager appointed by or on behalf of an AIF, or the AIF itself. Thus, a delegate managing assets should not be an AIFM (AIFMD, 2011).

4.5.3 Purpose and implementation

The AIFMD was published officially on 1 July 2011 and came into force on 21 July 2011. On 8 June 2011, it was signed into law on behalf of the European Parliament and European Council. Member states had until 22 July 2013 to transpose the provisions into national law. Unlike the UCITS regime, the AIFMD is fund based and focuses on regulating the AIFM.

The AIFMD implements harmonised requirements for financial intermediaries involved in the management of AIFs in the EU and aims to regulate major risk sources within the alternative investment value chain. This is done by guaranteeing that AIFMs are authorised and undergo continuous and periodic governance in addition to vigorous regulatory standards governing key service providers, including depositaries and administrators (AIFMD, 2011; Fagetan, 2012:103). In addition, it seeks to attain and/or guarantee (AIFMD, 2011:1):
- the improvement of transparency of not only AIFMs but also managed funds themselves;
- that all governing bodies comply with appropriate governance standards and benefit from robust risk, liquidity and conflict of interest management systems;
- the enablement of AIFMs to market funds to professional investors throughout the EU subject to compliance with applicable regulatory standards.

For AIMFs to manage or market an AIF within the EU, authorisation from their EU home member state is compulsory. AIFs are directed at managing the manager of the fund and not the fund itself.

The AIFMD requires the AIFM to be authorised to perform both the portfolio and risk management for the AIF, giving motivation for the requirement for authorisation merely by the performance of either of these activities. This means that there may be a requirement for more than one AIFM within one entity, either necessitating the on-take of more responsibility by current managers or

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50 Article 4, sections 1 and 2.
restructuring to offset management responsibility to another entity (Christofilou, 2013). The directive enhances investor protection through forced compliance with appropriate governance standards, improved transparency, and increased marketing ability. The possible over stringent nature of blanket regulatory principles is offset by a lighter-touch regime for smaller managers (AIFDM, 2011:3).

A de minimus exemption exists for managers who directly or indirectly manage AIF portfolios that hold at least EUR100m of “integral” assets or an amount exceeding EUR500m. The exemption applies provided that the portfolios under management are not leveraged and that investors have no exercisable right for a period of five years following the date of initial investment in each AIF (AIFMD I, 2011; Möllers et al., 2012:89-90). Importantly, an AIFM must provide assurance to its competent authorities that it is able to observe the basic requests of the directive. One pre-condition for authorisation is that an AIFM should provide officials with detailed information on, amongst others, features of the AIFs the company intends to trade, all adjustments for the delegation of management functions, appraisal, safekeeping of portfolio assets and ownership details. When granted authorisation, the AIFM is enabled to not only administer management activities to AIFs in member states, but also to market the securities of AIFs under management to professional investors within the EU (Van Eechoud et al., 2010).

Once authorisation has been granted under the directive, the following substantive requirements must be observed, amongst others (Awrey, 2011:2):

- conduct of business, governance and risk management;
- third-party safekeeping and appraisal; and
- open, periodical and event-driven disclosure to investors, competent official bodies and some third-party stakeholders.

The directive empowers the EC, and if necessary, EU member states, to act to restrict the use of leverage by AIFs. However, the directive is not without its controversies. The AIFMD for instance enables enforcement of a uniform regulatory regime on a varied range of AIFs (Athanassiou, 2010:10). One of the primary objectives at the G20 Pittsburgh summit was offering transparency as part of its drive towards the establishment of a new GFA. With the AIFMD regulating both authorisation and advertisement of funds located both inside and outside the EU is troublesome. The ability for non-EU AIFMs to obtain authorisation seems reduced by this double approach.

51 Article 3, section 2.
52 Article 5.
53 Article 6, section (1); article 34, sections (1)–(3). Furthermore, as defined in Annexure II of MiFID; article 2, section 1. The AIFMD permits EU states to “allow the marketing of securities of AIFs to retail investors in their territory and, for that purpose, to impose requirements on AIFMs and/or AIF” stricter than those imposed by the directive.
Limitations imposed on third-party funds and administrators are another cause for concern in that these limitations imposed might be found to impede the principle of investor choice. This principle was prominent at the G20 London summit where regulators and supervisors demanded a reduction in regulatory arbitrage whilst improving investment (Fagetan, 2012:107).

The regulatory framework of the AIFMD is somewhat confusing due to limitations in its scope, which is aimed primarily at funds marketing and the offering of AIFM services only to professional investors. A more compelling reason for regulation in this area would likely be financial stability, according to Fagetan (2012:114). It can be argued that these regulatory pursuits are mutually exclusive and, consequently, reduce the chances of the directive fulfilling any of these noble pursuits. (Athanassiou, 2010:10; Dardanelli, 2011:475). Athanassiou (2010) argues that a fundamental focus on protecting investors would require a revision of those disclosure rules that are not tailored to the needs of professional investors, but to those of retail investors. The directive includes, as requirements on transparency, yearly requirements, disclosure to investors and reporting to competent authorities.54

Given the background of the financial crisis and the consequent need to draft and implement proper regulation, rushing the process can have dire effects, instead of achieving intended purposes, such as investor protection. A great deal of transposition into national laws has taken place to date in the EU. Whether this has been achieved in the UK context, will be elaborated on in Chapter 5 of this thesis.

It is, however, clear that the AIFMD contributes towards diminishing systemic risks and the use of leverage. Moreover, it enhances the integrity and efficiency of the sector and promotes increased supervision and transparency. But most importantly, it improves investor protection (Dardanelli, 2011:475; Fagetan, 2012:108; Nabilou, 2014).

4.5.4 Requirements for business conduct, governance and risk management

The AIFMD mandates several uniform care and loyalty duties on AIFMs, which include:

- acting honestly and fairly and with due skill, care and diligence when conducting activities;
- acting in the best interest of any AIF, its managers and its investors, as well as the integrity of the market; and
- ensuring that all AIF investors are treated fairly and that there is no preferential treatment of investors.55

54 Articles 22–24; article 43.
55 Article 9, section (1)(a)–(c).
An AIFM is required to take acceptable actions to identify possible conflicts of interest. Then, once identified, the manager must keep and operate institutional and administrative adjustments to end any negative effect they could have on the interests of any AIF or its investors (Möllers et al., 2012). According to article 10 of the AIFMD, “conflict” includes any possible conflict between an AIFM and managers, employees and persons able to exercise direct or indirect control and AIF investors. When employing the purposive approach to interpreting this article, due consideration should be given to the possible realisation of damage where it concerns preventing conflicts of interest and there cannot with reasonable confidence be expected that investors interests will be protected. This due consideration could fall short of the adverse effect of standards captured within the same article (Fagetan, 2012:109). Effectively, this means that, an AIFM must disclose to AIF investors when it has identified material conflicts of interest within its operations or determined that its conflict arrangements will not have the power to protect investor interests from adverse effects with reasonable confidence. It seems that the legislative drafting might have fallen short in this instance.

The directive requires the adoption of an overarching risk management system that supervises and measures overall risks introduced to the AIF under management as a consequence of investment strategies employed (AIFMD, 2011). It requires:
- the implementation of a continuous due diligence process that is not only appropriate, but highly detailed;
- the implementation of stress testing procedures that accurately identify, measure and monitor risks;
- compatibility between risk profiles of individual AIFs and their size, structures, objectives and investment strategies; and
- the implementation of proper risk management procedures where an AIF is engaged in short selling. In addition, EU member states must guarantee that an AIFM has procedures in place that provide access to securities or financial instruments on the date it should deliver them pursuant to any short selling arrangement.

The directive furthermore requires an AIFM to implement a liquidity management system and conduct stress tests both under normal and exceptional market conditions. In addition, portfolio and risk management functions, together with any review processes, should be separated from the AIFM operating environment (AIFMD, 2011; Nabilou, 2014:290). Payment policies should

56 Article 10.
57 Article 11, section 2.
58 Article 11, section 3(a)–(c).
59 Article 11, section 4.
60 Article 11, section 4.
61 Article 12, sections 1 and 2.
also encourage and be compatible with sound risk management purposes. This amplifies the distinct risk management focus throughout the AIFMD, which is not stated directly in the directive, but is consistent with the EU’s position on remuneration within financial institutions (ESMA, 2016). The AIFMD also institutes simple incipient and evolving capital requirements and is required to keep its own funds to a minimum of EUR125 000. Should an AIF’s aggregate portfolio exceed EUR250m, an extra amount calculated at 0.02% of the total amount surpassing this threshold of the portfolio value must be set aside. These capital requirements comply with similar requirements in governing banks and investment companies (Fagetan, 2012:109; Nabilou, 2014:290-294).

The broad nature of these requirements does not directly address the diverse amount of investment strategies, models and types of conflicts of interest or risks typically encountered in connection with different species of AIF. It is still too early to tell how these requirements would impact the daily practices and conduct of AIFMs.

4.5.5 Third-party valuation and safekeeping requirements

Article 16 determines that an AIFM must appoint an independent third party to value its issued securities as well as the portfolio assets managed by an AIF. This valuation must take place annually and also each time the securities of the AIF are traded. A depository should also be appointed for purposes of receiving subscription proceeds from AIF investors and depositing such proceeds into segregated accounts as well as the safekeeping of AIF portfolio assets. The appointed depository must be a registered credit institution in the EU and is obligated to act freely and only on behalf of investors. It will be responsible to AIF investors for damages or failures to fulfil its obligations required by the Directive (AIFMD, 2011; Athanassiou, 2011).

4.5.6 Disclosure under the AIFMD

The main purpose of disclosure requirements is to increase the transparency of AIF activities to investors, certain stakeholder constituencies and competent authorities. In this regard, the directive requires a series of initial, event-driven and periodic disclosures (Fagetan, 2012:110). It is noteworthy here that Article 20(1) of the directive determines the disclosure of descriptions of permitted assets and techniques and their related risks, plus any investment restrictions together

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62 The AIFMD remuneration guidelines were issued in 2013. Article 13, section 2 contains the requirement for the development of guidelines on sound remuneration policies set out under Annexure II of the AIFMD.
63 Article 14.
64 Article 37 furthermore determines that third-party valuators domiciled outside the EU jurisdiction are subject to regulatory standards equivalent to standards applicable within the EU.
65 Article 16, section 1.
66 Article 17, section 1 (a)–(c).
67 Article 17, sections 1, 2, 3 and 5.
with the circumstances under which an AIF may use leverage. With regard to leverage, Article 20(1) includes the types and sources of permitted leverage, as discussed below (Möllers et al., 2012).

Under MiFID, investment firms are required to provide descriptions of the relevant AIF’s objectives and investment strategy, valuation and redemption policies, custody, valuation, administration and risk management activities, as well as investment taxes, charges and costs. Transparency requirements go further to include yearly audited reports, together with annual reports, to be submitted to empowered officials from the home EU country of the AIF (AIMFD, 2011). Periodic disclosure to both investors and competent officials must be made with respect to the special arrangements percentage of AIF portfolio assets emerging from their illiquid type and every new liquidity management settlements, taking into account the existing risk profile of each AIF and the risk management system employed by the AIFM.

The AIFM is required under the directive to provide empowered officials with aggregated data in accordance with certain characteristics. It must not only observe the main targets and tools of AIF trade, but should observe and report fundamental vulnerabilities and substantial risk concentration.

Reporting should, moreover, include the main forms of assets that AIFs are invested in, together with short-sale strategies if so employed. The directive was adapted by the EC to clarify the nature and frequency of periodic disclosures specifically targeted at investors in relation to different AIF types (ESMA, 2018; Fagetan, 2012:111). The directive imposes event-driven and periodic disclosure obligations on AIFMDs related to the acquiring of controlling interests in a company, domiciled within the EU, employing more than 250 persons, with an annual turnover exceeding EUR50m and a balance sheet more than EUR43m. This requirement applies to both listed and unlisted companies, and includes the conclusion of an agreement enabling such an acquisition.

When acquiring any controlled interest in a target company, which would be regarded as such when the AIFMD holds either separately or in total 30% of its voting rights, the AIFMD would be compelled to offer certain prescribed data to the corporation, shareholders and employees (Athanassiou, 2011).

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68 Article 20, section 1.
69 Article 19, sections 1–3 read together with article 21, section 3(a).
70 Article 20, section 2; article 21, section 2.
71 Article 21, section 1.
72 Article 21, section 2(d)–(e).
73 Articles 26–29.
74 Ibid.
The AIFM would then need to provide yearly disclosure with regard to controlling interests in any entity.\textsuperscript{75} The report should \textit{inter alia} include information on the AIFM’s financial and operation affairs, any financial risks associated with its capital structure, employee recruitment, turnover and termination, as well as significant divestment in assets (Möllers \textit{et al.}, 2012; Nabilou, 2014:288-290).\textsuperscript{76}

\subsection*{4.5.7 Leverage requirements}

Where the integrity of the financial system or security matter is considered imperative, the EC is empowered by the directive to establish leverage requirements for AIFs. Leverage, according to the directive, represents any method whereby an AIF is increasingly exposed to an investment by an AIFM whether through borrowing cash or securities, leverage embedded in derivative positions, or through any other means.\textsuperscript{77} National officials are also empowered to prevent the use of leverage by AIFMs and AIFs in very exceptional situations. An AIFM must be evaluated every four months should any of the AIFs it manages utilise high levels of leverage on a systematic and continued basis (Van Eenoo \textit{et al.}, 2010; Nabilou, 2014).\textsuperscript{78}

This evaluation entails a test as to whether, if merged, leverage from overall elements exceeds it amounts of capital in two out of the past four quarters.\textsuperscript{79} When transgression of this threshold has been detected, the manager must make prescribed disclosures to fund investors and properly qualified officials in its EU residence countries.\textsuperscript{80} This is over and above the regular information breakdown between leverage from borrowed cash or securities and that information embedded in financial derivatives which must regularly be provided to competent authorities. This information that must be provided includes the five main sources of borrowed cash or securities for each AIF, together with the amounts of leverage received (Fagetan, 2012:113).

In conclusion, the AIFMD has introduced a uniform regulatory regime for alternative investment funds after it came into force in 2013. It prevents a race to the bottom on the one end, but the balance between investor protection and functionality remains in question (Möllers \textit{et al.}, 2012:104-105). The directive is quite confusing and its impact yet to be fully determined. From an economic perspective, the regulatory instruments introduced by this directive will have a negative impact on compliance costs, which in turn will affect returns for investors (Christofilou, 2013). Its coordination with other directives, such as UCITS and MiFID, is extremely important to prevent

\begin{itemize}
\item \textsuperscript{75} Article 27 and 28. The nature of the information would depend on whether the company is listed or not.
\item \textsuperscript{76} Article 29.
\item \textsuperscript{77} Article 3, section 1. The Directive provides that the EC, when contemplating to implement limits, may consider aspects such as the type of AIF, investment strategy and source of leverage. See also article 25, section (3).
\item \textsuperscript{78} Article 22.
\item \textsuperscript{79} Article 22, section (4).
\item \textsuperscript{80} Article 24, section (1).
\end{itemize}
information overload and competitive disadvantage. ESMA, which was introduced as regulatory agency in 2011, is important as it has been and is continuing to define the framework of the AIFM’s provisions. As data have been reported since inception ESMA will also be able to monitor transparency requirements more efficiently and clearly (Christofilou, 2013; Möllers et al., 2012:105). The AIFMD has become a seal of quality in the market and some of its investor protection requirements influence other areas such a private equity funds which do not fit the size requirement in terms of the AIFMD and might need to orient themselves to avoid hindrances in placement (Möllers et al., 2012:106).

4.6 MiFID: an overview and framework

4.6.1 Introduction

The EU established a comprehensive regulatory regime for the organised execution of investor transactions by stock markets and other trading systems and investment firms. Through this process, it created a single authorisation for investment firms, enabling them to do business anywhere in the EU with less bureaucracy and increased investor protection (EC MiFID, 2016; Janin, 2007). The EU adopted MiFID, in accordance with the Financial Services Action Plan, to strengthen the community legislative framework for investment services and regulated markets, and specifically to further the objectives of investor protection and the safeguarding of market integrity by establishing harmonised governing requirements for authorised intermediary activities. In addition, MiFID aims to promote fair, transparent, efficient and integrated financial markets. The MiFID, as the first directive within the financial services industry and also referred to as “Lamfalussy-formatted”, commenced in 2004, clearing the way for several thoroughly implemented directives or regulations (Fagetan, 2012:113).

Accomplishing a single uniform financial market and financial stability overall, whilst simultaneously maintaining a higher level of financial supervision at a national level, remains a difficult task (Schoenmaker, 2009). Being the earliest of the directives to be implemented with a focus on financial markets, the MiFID cleared the way for several directives and regulations to follow (Fagetan, 2012: 112). The MiFID was amongst the primary European directives which emerged from the Lamfalussy process and could be the most all-embracing directive to result from the approach thus far (Lastra, 2003:212). Management companies managing UCITS funds were impacted significantly by MiFID (Penn, 2007:155). It seems that only certain articles apply to management firms regulated by UCITS, as they cannot find application in the management of collective portfolios (Fagetan, 2012:117). Instead, only investment services provided by UCITS management companies is affected thereby, and specifically individual portfolio management and non-core services, in accordance with article 5(3) of the UCITS Directive (Janin, 2007:90).
The application of the UCITS Directive is constrained in that it cannot be applied to management companies dealing only with non-UCITS funds. The potential application of the MiFID, however, might be in its entirety, except for its non-UCITS fund management activities, as these are neither addressed in the UCITS Directives nor the MiFID and would, consequently, be monitored on a national level only (Fagetan, 2012:117; Penn, 2007:155).

For purposes of this thesis, the discussion on MiFID will focus primarily on the more recent developments concerning the agreement reached on the texts for the recast MiFID II and Markets in Financial Instruments Regulation (MiFIR) by the European Commission, Parliament and Council. These two primary pieces of legislation came into effect on 3 July 2016 and member states were required to adopt and publish law, regulations and administrative provisions necessary to comply with the directive (European Parliament, 2014; Christian & Cronin, 2016). Members were also required to apply the transposed laws, regulations or provisions by 3 January 2018, in accordance with the extension promulgated in agreement with EU Regulations in June 2016 which was initially set for 3 January 2017 (European Parliament, 2014; Henderson, 2014; FCA, 2016b).\(^{81}\)

These primary pieces of legislation represent the response to the ECs review of the MiFID which governs firms that provide investment services and products in the EU. MiFID II expanded the scope by looking at commodity derivatives in particular, along with additional investor protections. It also increased requirements related to the trading of financial instruments (European Parliament, 2014; Henderson, 2014; FCA, 2016b). Fund management has had its share of European regulation through UCITS and the AIFMD.\(^{82}\) Since the implementation of MiFID II on 12 June 2014, it has become an additional competitive force to deal with within the EU. As a dense, far-reaching and multi-faceted directive, MiFID II covers wide areas of capital markets ranging from trading venues to the distribution of financial products (Christian & Cronin, 2016).

### 4.6.2 MiFID II: objectives and core measures

Since its inception in September 2007, the MiFID has been the foundation of capital market regulation in Europe. Not all benefits were, however, fed down to end investors as envisaged. Consequently, MiFID II aimed to address the shortfalls, based on, amongst others, lessons learnt from the financial crisis (Deloitte, 2016a; Ernst & Young, 2014:5). The MiFID regulated firms that provide services to clients which are linked to “financial instruments”, broadly defined as units in

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\(^{81}\) Article 93, section 1. See also EU (2016:175/2).

\(^{82}\) The MiFID replaced the Investment Services Directive (ISD 93/22/EEC).
CISs and derivatives. The firms, and the venues where these instruments are traded, fall within the reach of this regulation (EC, 2016a; FCA, 2016b).

Figure 4-8 provides an overview of key focus areas and core measures of MiFID II.

Source: Author’s representation based on Ernst & Young (2014)

Figure 4-8: MiFID II objectives and core measures

MiFID II and MiFIR replace the initial directive MiFID I.\(^3\) They provide an updated harmonised legal framework that would govern requirements applicable to investment firms, regulated marketing, data reporting service providers, as well as third-country firms providing investment-related activities or services within the EU (Christian & Cronin, 2016; European Parliament, 2014; EU, 2016). It introduces significant structural changes to EU financial markets which will impact all asset managers. In many ways, much of the anticipated reforms will increase costs plus the complexity of trading, resulting in a possible reduction of fixed income market liquidity. This

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\(^3\) EU Regulation, 600/2014.
against the backdrop of one the intended outcomes, namely to improve transparency (Christian & Cronin, 2016; ESMA, 2014a).

As attempts to deal with the consequences of the financial crisis continue globally, from an economic perspective, regulatory efforts still aspire to curb the future re-occurrence of such a crisis. The European regulatory agenda purposed to create what it refers to as the “single regulatory rule book” for financial services in Europe. Political agendas recast MiFID in lengthy level 2 provisions on the form of technical standards and delegated acts (EC, 2016a; ESMA, 2014a). Key aspects affected by MiFID II include products, distribution, markets, investment research, transaction reporting, costs and pricing and operation models. Therefore, it has an impact on operations, conduct and governance of EU investment firms’ strategy and regulated markets to name a few (Deloitte, 2016a). Estimating exactly what the impact of the implementation of MiFID II will be on hedge funds is not possible at this time, but that it will impact retail investment in hedge funds is certain. The following section will look at some aspects that will influence retail investment in hedge funds and, consequently, retail investor protection therein.

4.6.3 MiFID and the regulation of hedge funds

The MiFID I passport primarily made provision for the following:
- investment advice;
- the operation of multilateral trading facilities (MTFs);
- trading platforms like electronic communication networks; and
- the provision of investment services on commodity and credit derivatives.

The wider objective of MiFID I not only aimed toward the abolition of the “concentration rule” but the inclusion of many organisations within its ambit of governance have had a noticeable effect (Fagetan, 2012:121; Penn, 2007:155). The management industry had to undergo more significant changes as a result of the implementation of the MiFID I (Fagetan, 2012:121).

The impact of MiFID I on unregulated or non-harmonised vehicles and products raised important questions. The first would be the significance thereof for the promotion and distribution of non-harmonised products transnationally. Contrary to the UCITS Directives dealing only with harmonised funds, MiFID I concerned itself also with units in collective investment undertakings without considering whether they are harmonised or not (Fagetan, 2012:120). The introduction of MiFID I left the European asset management industry with two impressions. The first is that non-harmonised products could benefit from novel, EU broad distribution potentiality, and the second that this could be done free from compliance with national regulations related to either manager or products. Several market associations and stakeholders diverted from MiFID in that they created
an indirect path with regard to marketing non-harmonised products within the EU. The belief existed amongst Member States that this approach would have a negative impact and harm the overall effect of the MiFID (Assogestioni, 2006). The predominant view of Member States, however, was that guarantees and protection measures built into the harmonised funds system would not necessarily be dismissed by the framework for hedge funds or non-harmonised funds (Christian & Cronin, 2016; Fagetan, 2012:121).

The following part of this discussion will demonstrate the potential impact of MiFID II in relation to hedge fund managers. Thereafter, the possible primary and secondary impacts of MiFID II in relation to retail investors and/or investment will be provided, as far as practicable.

4.6.4 MiFID II: Potential impact in relation to hedge fund asset managers

Table 4-1 depicts five key reform areas in terms of MiFID II which in general apply to asset managers.
Table 4-1: Key reform areas in relation to asset managers in terms of MiFID II

<table>
<thead>
<tr>
<th>Key reform area</th>
<th>MiFID II recital</th>
<th>MiFID II Article</th>
<th>MiFIR recital</th>
<th>MiFIR article</th>
<th>Description of affected reform area</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Internal organisation and governance</td>
<td>R52, R57 and R71</td>
<td>A16</td>
<td></td>
<td></td>
<td>Affects internal organisational and governance requirements, including, for new product, approvals, information security, recording telephone conversations and electronic communications and custody of client assets.</td>
</tr>
<tr>
<td>2. Market structure</td>
<td>R13, R14; R59-R68; R112; R125-131</td>
<td>A4(1)(22); 4(1)(23); A17; A18(1); A18(5) A49; A50; A57; A58; A69(2)(J),(O),(P) R7-R9; R28; R30;R31; R37-R40</td>
<td></td>
<td></td>
<td>- Regarding the introduction of organised trading facilities (OTFs) and multi-lateral trading facilities; - Future trading rules for equity instruments; - Commodity derivative position limits and reporting; - Proposals aimed; - To promote competition by mandating open access; - To the central counterparties (CCPs), trading venues, and benchmarks; - Future requirements for trading venues, circuit breakers, and electronic trading, which include trading halts, market making, and synchronisation of business clocks; - More restrictive regime for high-frequency and algorithmic trading.</td>
</tr>
<tr>
<td>3. Market transparency</td>
<td>R117-R119</td>
<td>A64-A65</td>
<td></td>
<td></td>
<td>Future pre- and post-trade transparency requirements, including, for pre-trade transparency requirements, publication of post-trade information and a European consolidated tape.</td>
</tr>
<tr>
<td>4. Investor protection</td>
<td>R70-R106</td>
<td>A24-A30</td>
<td></td>
<td></td>
<td>Proposals for investor protection include some in respect to: - inducements, independent advice and suitability; appropriateness, tied agents, best execution; and - enhanced client disclosure obligations.</td>
</tr>
<tr>
<td>5. Reporting and market oversight</td>
<td></td>
<td>A66</td>
<td>R32-R36</td>
<td>A24-A27</td>
<td>Increased regulatory requirements with regard to reporting and record keeping. Refer also to 3 hereof for relevance to reporting and market oversight.</td>
</tr>
</tbody>
</table>

Source: Adapted from MiFID II (European Parliament, 2014) and Christian & Cronin (2016)
The five key reform areas identified above emphasises area of reform that have an impact on asset managers in general. Both the direct and indirect reform areas effectively contribute towards investor protection. The underlying regulatory tone seems to recede towards increased transparency and overall availability of information, enabling a greater understanding of the investment risk that accompanies the asset management space. MiFID II will in addition impact on retail investment in general of which brief mention will be made within the following section.

### 4.6.5 MiFID II: Some impacts on retail investment

Regarding investment advice, the distinction in terms of the impact of the advice given will be based on the concept “independent” and what it entails. The sufficiency of the range of suppliers’ product advice to clients will need to be considered, with discretionary investment advice regarded as *de facto* independent (Deloitte, 2016a). It will furthermore impact inducements received by financial advisors from product providers (FCA, 2016d). For advisors to claim independence, the requirements state that they must first prove independence. This could result in advisors’ opting to be non-independent and, in doing so, offer a limited number of products from a limited number of product manufacturers (ESMA, 2014b). In this way, less change might be induced than anticipated. Furthermore, the marketing of cross-border products and services to European clients by non-EU asset managers could be affected. In some instances, an EU MiFID-compliant subsidiary might need to be established with the required permission to manage the portfolio of a client within that EU country where the client resides. Third-country firms might be required to establish local branches to obtain authorisation to deliver services to EU retail and/or professional clients (Christian & Cronin, 2016; ESMA, 2014a).

On the one end, MiFID II leaves EU investors with the option to self-advise, with options limited to non-complex products. Complex products are deemed to be too risky for both retail and professional clients. Regarding the EU investment fund industry’s existing UCITS fund requirements and ESMA technical advice, all AIFs are deemed complex, thus requiring retail clients to obtain professional advice before investing and adding to the cost of investment (Deloitte, 2016a). This inadvertently makes the decision on behalf of investors regarding their ability to understand financial products and confuses complexity with risk. Firms providing investment advice are required to make suitability checks which, amongst others, determine the knowledge and experience of clients within the investment arena, their financial situation, their ability to absorb losses, as well as their investment objectives. Both retail and professional investors are excluded from investing in complex financial instruments. This definition practically then excludes all structured UCITS and all non-UCITS funds, as they are deemed complex (ESMA, 2014a; ESMA, 2014b).
This blanket incorporation of non-UCITS funds as complex financial instruments has moved many investment fund managers to convert pre-existing non-UCITS funds which target retail investors into UCITS funds. Consequently, investors who are comfortable with execution only are driven into costly structured products which seem counter-intuitive (Deloitte, 2016a; ESMA, 2014a).

The previous sections provided the overall representation and discussion of the existing legislative framework applicable to the regulation of hedge funds within the EU which included the respective EU directives. Now attention shifts to the consolidation and categorisation of investor protection principles relevant to hedge funds into general EU principles. The approach to grouping the principles will be to detect and correlate content description and characteristics across the different types of principles extracted from the respective sets of legislation discussed. These will, as in previous chapters, be identified.

4.7 Summary: Investor protection principles identified from the EU hedge fund regulatory environment

Earlier discussion in this chapter focused on the development of investment regulation through the UCITS, MiFID and AIFMD schemes with the aim to determine the positioning or application of these regulatory frameworks to hedge funds. After ascertaining the applicable regulatory provisions to hedge funds within the EU, with the aim to identify investor protection-related principles for purposes of this comparative study, a list of principles will now be identified and extracted. The application of the UCITS framework, as argued earlier, affords harmonised open-ended CISs the ability to freely pursue business within the EU, including the marketing of shares and units. The approval of the UCITS III meant that many shortcomings could be addressed. UCITS III not only allowed for the extension of the scale of eligible UCITS investments, but also included the cross-border marketing of funds under a single passport, expanding activities across EU countries.

Hedge funds continue to be excluded from the harmonised funds framework. The indirect widening of the UCITS funds' investment discretion, due to regulatory changes bringing it into the reach of UCITS fund managers, gives them the ability to employ derivatives which, in turn, allows for leverage. Retail investors are, therefore, offered partial benefits normally associated with sophisticated portfolio diversification delivered through funds-of-hedge-funds investing. They promise of higher returns as a result of recourse to the use of derivatives. The wide definition of “eligible assets”, combined with article 2 of the Product Directive, provided the opportunity to insert additional hedge fund features within the revised UCITS framework and highlighted ways on how to indirectly distribute non-harmonised products such as hedge funds within the EU as eligible EU assets.
UCITS-structured hedge funds are widespread across Europe especially for institutional investors and retail opting for smaller investment sizes and stricter regulation. Attractive regulatory components like increased transparency and disclosure on investments, with attractive liquidity terms (fortnightly, for example) and limited leverage are important to investors and one of the key reasons why they invest in such funds. It should, however, be remembered that, for the very same reasons sophisticated investors by large do not favour alternative UCITS funds due to reduced strategy diversification and a combination of reduced investment options, restricted leverage and other regulatory requirements associated therewith. The hedge fund alternative UCITS fund represents only a sample in the broader offshore hedge fund industry.

Bearing this in mind together with the inception of the AIFMD, many of the principles which find application to hedge funds will predominantly be extracted from the AIFMD directly. The drive towards the alignment between financial regulatory frameworks also seems to drive hedge fund managers towards voluntary listing under the AIFMD. MiFID aims to strengthen the community legislative framework for investment services and regulated markets, furthering the objectives of investor protection and the safeguarding of market integrity. It establishes a coherent governing framework for authorised intermediary activities which aim to promote fair, transparent, efficient financial markets that are sufficiently integrated. MiFID II together with MiFIR provide an updated harmonised legal framework that govern requirements applicable to investment firms, regulated marketing, data reporting service providers, as well as third-country firms providing investment-related activities or services within the EU. Significant structural changes to EU financial markets are introduced. These will impact all asset managers, with the anticipated reforms increasing costs, as well as the complexity of trading. Nevertheless, investor protection principles, such as transparency and increased liquidity requirements for market participants are addressed in the AIFMD and will be highlighted below.

The previous chapter provided the key US investor protection principles relating to hedge funds. Table 4-2 contains principles extracted from the literature discussed within this chapter. It sets out the EU principle identifier, the principle, the source and a description. Where relevant, general commentary on hedge fund investor protection is made should such comments be indispensable. Chapter 5 investigates the UK hedge fund regulatory milieu.
Table 4-2: Identified EU investor protection principles

<table>
<thead>
<tr>
<th>EU principle identifier</th>
<th>EU principle</th>
<th>Source</th>
<th>EU principle content description</th>
<th>Principle content reference to chapter</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUP1</td>
<td>Registration for managers and/or investment companies</td>
<td>AIFMD Chapter I and Chapter II</td>
<td>Article 1 stipulates rules for authorisation, ongoing operation and transparency for AIFM managers within the EU. Article 3 caters for registration under exemptions allowed for under the AIFMD. Article 6 of the AIFMD requires authorisation for the management of an AIF by an AIFM. Article 7 determines that member states must require AIFMs to apply for authorisation from the competent authority of the home member state and provides information to the authorities which includes the underlying type of underlying funds if the AIF is a fund of funds, the AIFM's policy with regard to the use of leverage and the risk profiles and/or other characteristics of the AIF, etc.</td>
<td>Section 4.4; Section 4.5</td>
</tr>
<tr>
<td>EUP2</td>
<td>Marketing</td>
<td>AIFMD Chapter VI</td>
<td>Marketing within the home member state of the AIFM is allowed, subject to home member state supervision. When compliant with article 31 of the AIFMD, an EU AIFM may market units or shares of any EU AIF it manages to professional investors of the home member state of the AIFM. An AIFM may also market in other member states in accordance with Article 32. There are a number of provisions that need not be transposed as they apply directly within the member states, and where marketing takes place through a passport of a non-EU AIF managed by an EU AIFM, third-country provisions will apply in accordance with Article 35 of the AIFMD.</td>
<td>Section 4.3; Section 4.4; Section 4.5; Section 4.6</td>
</tr>
<tr>
<td>EUP3</td>
<td>Ongoing regulatory oversight measures</td>
<td>AIFMD Chapter I and Chapter IV</td>
<td>ESMA is the designated oversight authority within the EU, together with the home authority of each member state. Annual reporting is required upon request to investors and must be provided to authorities within the member state. Disclosure of investment strategies, objective of the AIF, change procedures relating to investment by the AIF and descriptions of the main legal implications of contractual relationship between the AIF and investors must be disclosed, amongst other information, according to Articles 22 and 23 of the AIFMD. Article 24 states the reporting obligations to competent authorities, and Chapter V holds the provisions regarding the management of specific AIFMs, for example, a leveraged AIF, and any ancillary information requirements, supervisory cooperation necessities or limits to leverage (Article 25).</td>
<td>Section 4.3; Section 4.4; Section 4.5; Section 4.6</td>
</tr>
<tr>
<td>EUP4</td>
<td>Third-party services provision, registration and supervision</td>
<td>AIFMD</td>
<td>Article 20 of the AIFMD deals with the delegation of tasks of an AIF to third parties. Competent home member state authorities must be notified, and an AIF would need to be able to show that: - it can justify delegating the entire delegation structure for objective reasons; - the delegate can dispose sufficient resources to effectively conduct business and is of good standing and sufficiently experienced; - where risk or portfolio management functions are delegated, such must be subject to supervision and the home member state authority prior approval obtained; - when risk or portfolio management is conferred under a third-country undertaking, cooperation between home member state competent authority and the supervisory authority of the undertaking must be confirmed; - effectiveness of supervision must be prevented, and an AIF should at all times act in the best interest of the investor; - AIFMs must be able to demonstrate that the delegate is qualified and able to undertake the functions in question and that selection was made with due care. AIFMs’ liability towards investors and the AIF will not be affected as a result of delegation. Worth noting is that prime brokers are providing solutions for UCITS that utilise long-short strategies. It is referred to as “synthetic prime brokerage” products. UCITS does not permit the taking of direct uncovered short positions or the borrowing of</td>
<td>Section 4.4; Section 4.5</td>
</tr>
<tr>
<td>EU principle identifier</td>
<td>EU principle</td>
<td>Source</td>
<td>EU principle content description</td>
<td>Principle content reference to chapter</td>
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<tr>
<td>EUP5</td>
<td>Information disclosure</td>
<td>AIFMD</td>
<td>Section 8 of the AIFMD requires member states to comply with all conditions set by the directive. Article 7(2) to obtain authorisation information on the persons conducting the business of the AIFM must be provided together with the identities of shareholders or members directly or indirectly involved, whether natural or legal persons, who have qualified holdings. The amount of holding must also be provided, amongst other required information. Information in relation to depositaries must also be regulated in terms of such contracts to allow the depositary to provide its services in accordance with Article 21 and the remainder of Section 4. In accordance with transparency requirements captured in Chapter IV, annual reports that include financial information should be provided to regulators and investors (Article 22). Information should also be provided directly to investors covered in section 23 of the AIFMD.</td>
<td>Section 4.3; Section 4.4; Section 4.5; Section 4.6</td>
</tr>
<tr>
<td>EUP6</td>
<td>Industry practice development</td>
<td>AIFMD UCITS</td>
<td>Development and implementation of good industry practices exist and provide for direct retail investment subject to stringent leverage, liquidity, marketing and other rules in accordance with the AIFMD.</td>
<td>Section 4.3; Section 4.4; Section 4.5; Section 4.6</td>
</tr>
<tr>
<td>EUP7</td>
<td>Global oversight and cross-border risk management</td>
<td>AIFMD</td>
<td>The AIFMD aims for the establishment of common requirements governing the authorisation and supervision of AIFMs. This is done so as to provide a coordinated approach to any risks related to the management and/or functioning of AIFMs within the EEA and their resulting impact on markets and investors within the EU. By providing for an internal market for AIFMs, together with a stringent regulatory and supervisory framework, a uniform set of rules are established for all activities of AIFMs within the EU. An example of this is Article 43 that determines cross-border marketing of AIFs to retail investors, irrespective of whether they are EU or non-EU AIFs. Articles 44–46 of the AIFMD state the requirements for established competent authorities within member states and their powers, etc. (Article 66)</td>
<td>Section 4.4; Section 4.5</td>
</tr>
<tr>
<td>EUP8</td>
<td>Hedge fund conceptualisation and definition</td>
<td>AIFMD</td>
<td>The definition of an AIF classifies hedge funds amongst other fund types such as venture capital funds, as CISs are not covered by the UCITS regulatory regime (Article 4). AIFs are widely defined as CISs that undertake to raise capital from a wide range of investors with the aim to invest the funds in accordance with a defined investment policy for the benefit of the investors and do not require approval under Article 5 of UCITS.</td>
<td>Section 4.3; Section 4.4; Section 4.5</td>
</tr>
<tr>
<td>EUP9</td>
<td>Investment qualification criteria</td>
<td>AIFMD UCITS</td>
<td>To enable investment through retail or qualified investors, registration and adherence to the AIFMD must take place where the intended manager or fund qualify as such. The provisions include the regulation of risk management incentives, capital requirements, liquidity requirements, provisions regarding investment securitisation positions, rules regarding remuneration and rules for valuation, to name a few. (Articles 43, 64–65, 66)</td>
<td>Section 4.4; section 4.5</td>
</tr>
<tr>
<td>EUP10</td>
<td>Investment vehicles</td>
<td>UCITS</td>
<td>Investment vehicles or structures are governed under existing legislative provisions within member states qualifying as legal structures that may be utilised as CISs.</td>
<td>Section 4.3; Section 4.4</td>
</tr>
<tr>
<td>EU principle identifier</td>
<td>EU principle</td>
<td>Source</td>
<td>EU principle content description</td>
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<td></td>
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<tr>
<td>EUP11</td>
<td>Risk manage-ment</td>
<td>AIFMD Chapter III</td>
<td>General requirements on effective risk management are captured within the AIFMD, and risk taking which is inconsistent with existing risk profiles, instruments of incorporation or rules in relation to AIFs managed is discouraged. Articles 13 and 15 capture rules in relation to the separation of risk management functions from that of portfolio management. Articles 16, 17 and 18 address liquidity management, investment in securitisation positions and the proper and consistent management of AIF asset valuations respectively. Appropriate human and technical resources should always be available. Home member states within the EU must ensure that the AIFM has sound administrative and accounting procedures, as well as control and safeguard arrangements for electronic data management. Amongst others, transactions involving an AIF must be able to be reconstructed according origin, nature, time and place when affected. Where risk or portfolio management functions are delegated, it must only be conferred to undertakings authorised and registered for such purpose, subject to supervision, and, if required, approval be obtained from the competent authority within the member state in accordance with article 20 concerning delegated functions. (See also Article 66.)</td>
<td></td>
</tr>
</tbody>
</table>

Source: Compiled by Author
CHAPTER 5 REGULATING HEDGE FUNDS IN THE UK

5.1 Introduction

This chapter provides the regulatory structure, framework and, as far as practicably possible, the most recent developments regarding the regulation of hedge funds within the UK. This approach will contribute towards the identification of principles enacted within the UK which contribute towards retail investor protection as it relates to hedge funds directly. Figure 5-1 assists with illustrating the progression of the study. This chapter forms part of Phase 1 and explains the final selection of good practices that will be employed to benchmark the South African regulation of retail hedge funds. These will be compared with a set of international good practice principles identified throughout this thesis.

![Figure 5-1: Schematic of thesis progression: Phase 1, Chapter 5](source: Author’s own representation)

In July 2010 Her Majesty’s Treasury (“the Treasury” or “Treasury”) presented to UK Parliament a discussion document on a proposed new approach to financial regulation in the aftermath of the 2008 financial crisis. This proposal for regulatory reform was based on the failure of the UK regulatory framework at that point in time to absorb and comprehensively withstand the financial sector crisis which overshadowed the entire globe (HM Treasury, 2010). To avert a total banking sector collapse the UK Government had to part-nationalise two of the largest banks in the world whilst simultaneously introducing financial sector interventions which cost billions of pounds.
The UK “tri-partite” regulatory system comprised three authorities – the Bank of England, the FSA and the Treasury – which, as a collective, was responsible for financial stability (HM Treasury, 2010). The UK regulatory framework failed in several critical ways which highlighted its inability to recognise and respond to ongoing problems within the system. The failures were mostly attributed to inherent weaknesses within the tri-partite regulatory system which placed the responsibility for all financial regulation in the hands of a monolithic financial regulator expected to deal with issues ranging from safety and soundness to customer practices. The regulators were furthermore responsible for overseeing services pertinent to the largest global investment bank, as well as the smallest high-street financial advisor (HM Treasury, 2010). The Bank of England was given nominal responsibility, which included the responsibility for financial stability, but without the necessary mechanisms or tools to effectively carry out its function. Treasury had the role of maintaining an overall legal and institutional financial system framework without the accompanying responsibility of dealing with a crisis. This placed tens of billions of pounds worth of public funds at risk (HM Treasury, 2010).

Fundamentally there existed no single oversight authority which monitored the system as a whole. This was described by Lord Turner, the Chairman of the FSA, as “underlap”, referring to a phenomenon where gaps within the UK regulatory system were exposed because of failures in macro-prudential risk analysis and risk mitigation strategies. On a micro-level, compliance with rules and directives was based on a tick-box approach at the expense of in-depth and strategic risk analysis (HM Treasury, 2010). The proposal for reforming the tri-partite model, in addition to dealing with operational deficiencies in the system, had to address several fundamental issues. These included macro-prudential regulation, the prudential regulation of individual firms, and consumer protection and markets regulation. For this study, brief mention will be made of consumer protection reforms and market regulation. To this end, the regulation of market conduct, which includes the conduct of firms towards retail investors and customers, as well as the conduct of participants in wholesale financial markets, would be carried out by a specialist, dedicated body with focused and clear statutory objectives and regulatory functions (HM Treasury, 2010).

It was asserted in Chapter 2 that regulation strongly impacts the size, structure and efficiency of a financial system. The importance of regulation, especially after a substantial crisis as experienced since 2008, necessitated the review of the structure of the UK financial system. To this effect the discussion will focus on the structural changes implemented following the passing of the Financial Services Act of 2012 which came into existence on 13 April of 2013. These structural reforms had a direct impact on the regulation of hedge funds in that they created new regulatory agencies responsible for prudential and market conduct regulation, amongst others (CII, 2013;
HM Treasury, 2011a). An overview of the UK government’s approach to financial regulation will be provided, including the roles and accountabilities of this system (HM Treasury, 2011a).

This overview is also important due to the influence of regulatory advancements within the EU and UK on South African legislation. Like the process followed by the UK government, the South African government conducted a review of the structure of the South African financial system in 2010. This process led to formal regulatory structural changes transposed into South African law in 2015. These reforms will be elaborated on in Chapter 6 of this thesis as a precursor to the development of a regulatory framework for hedge funds and retail investor hedge funds in South Africa. Following this overview of the UK government financial regulatory approach, the focus will shift towards the UK asset management industry from a retail investment perspective as a passage towards discussing the regulation of hedge funds within the UK. This discussion will provide the premise on which a determination can be made as to whether any additional good practice principles can be incorporated into the framework established thus far in this thesis.

The discussion is dually influenced. The first is the so-called Brexit referendum held in July 2016 in which the British public voted in favour of exiting the EU, to the shock and dismay of many. This discussion cannot deviate to speculations on the possible outcome of the Brexit process, as it is not the focus of this study. Furthermore, there is much uncertainty regarding the exact structure and outcome an exit in terms of article 50 of the Lisbon Treaty might entail. What is certain, however, is that, in terms of article 50 of the Lisbon Treaty, a member state, if determined to withdraw from the EU based on its own constitutional requirements, will be required to give notice of such intentions and enter into a withdrawal agreement with the EC to this effect. Treaties applicable to any such member state will cease to apply from the date of entry into force of a withdrawal agreement or failing that, two years after formal notification of intention to withdraw have been provided to the Commission (European Parliament, 2016). The second influence is that the UK is no longer a member of the EU. Formal notice in terms of article 50 of the Lisbon Treaty was delivered to the President of the European Parliament on 29 March 2017. This means that the two-year period, which is provided for negotiating the break-away by the UK from the EU, has commenced. What the exact outcome will be is uncertain and ongoing (November 2018).

These influences therefore do not disaffirm the necessity of the evaluation of this chapter on the regulation of hedge funds in relation to the UK. Whatever the outcome, hedge funds wanting to remain or enter the EU market will have to adhere to the harmonised set of regulation already assented to by the UK as a member of the EU for the time being; more so when their focus is on the European retail investor market. Therefore, questions on the Brexit process as it relates to hedge funds in general might be highlighted for purposes of their fundamental influence on the UK investment space in particular if or when they come to the fore. The exit process is fluid, hence
the existing legal position will be accepted for purposes of the comparison of international good practice principles on the regulation of retail investment in hedge funds.

5.2 The UK financial regulatory structure

When commencing the restructuring of the financial system, the UK government primarily aimed to strengthen the system at a fundamental level by promoting the role of judgement and expertise of its diverse role players (HM Treasury, 2011b). After an extensive consultation process and much refinement three new regulators were established:

- The Financial Policy Committee (FPC) was established within the Bank of England as macro-prudential regulator to monitor and respond to systemic risk;
- The Prudential Regulation Authority (PRA) was established as prudential regulator as a subsidiary of the Bank of England;
- A market conduct regulator, the Financial Conduct Authority (FCA), was established and given the responsibility to ensure that business across services and markets is conducted in a way which promotes the interests of all participants and users (CII, 2013; FCA, 2013b; HM Treasury, 2011a); and
- Her Majesty’s Treasury that has overall responsibility for the UK’s financial system, the institutional structure of financial regulation and its accompanying governing legislation on a domestic and international level (CII, 2013; FCA, 2013b; HM Treasury, 2011a).

Figure 5-2 depicts the Financial Conduct Authority Business Plan illustrating the UK financial regulatory structure.
The FCA is the conduct regulator for approximately 56 000 financial services firms and financial markets within the UK and the prudential regulator for over 24 000 of these firms. To attain its main objective, namely to ensure that markets work well, it has three operational objectives: to protect consumers, to protect financial markets and to promote competition (FCA, 2016c; FCA, 2017a).

The FCA regulates the following sectors (FCA, 2017a):
- standards of conduct within the retail and certain wholesale markets;
- the supervision of trading infrastructures which underpin the above markets;

Source: Adapted from FCA (2013b).

**Figure 5-2: UK financial regulatory structure**
- the prudential regulation of firms not regulated under the PRA;\textsuperscript{84} and
- the functions of the UK Listing Authority.

The FCA supervises hedge fund managers within the UK. It collects data from hedge funds and hedge fund managers which inform its supervisory activities, ensuring thereby that it is enabled to promote market integrity and its efficiency (FCA, 2015).\textsuperscript{85} It regards hedge funds as a category of AIF. AIFs are classified as funds which invest in a wide variety of global assets that include commodities and property. Therefore, hedge funds have the freedom to invest in a wide variety of strategies within different asset classes. It can range from the management of very concentrated portfolios to the pursuit of complex trading strategies which are characterised by high levels of turnover or leverage (FCA, 2015). The following section will provide an overview of the UK asset management sector, especially retail investor participation, after which the UK hedge fund industry will be discussed with a subsequent section stating the current regulatory framework for hedge funds within the UK.

5.3 UK asset management industry: A retail perspective

To understand the term “retail investor” for purposes of the discussion on retail participation within the UK, the definition provided by the FCA will be used (FCA, 2013a). A “retail investor” is defined as a person who invests in their capacity as a retail client. A “retail client” is stated to be a client who is neither a professional client nor an eligible counterparty. The latter refers to institutional clients and individuals who invest by way of business. Distinction is drawn between several types of retail clients: sophisticated investors, high-net worth individuals and so-called ordinary retail investors. This distinction is illustrated in Table 5-1.

\textsuperscript{84} The PRA is responsible for the prudential regulation of approximately 1 700 banks, building societies, credit unions, insurers and major investment firms.

\textsuperscript{85} The FCA works closely with the UK Financial Policy Committee (FPC), the FSB and IOSCO.
### Table 5-1: FSA definition of retail investors

<table>
<thead>
<tr>
<th>Retail Investor(s)</th>
<th>Definition</th>
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<tbody>
<tr>
<td>(i) Sophisticated investor(s)</td>
<td>These are retail clients who meet the criteria for categorisation as sophisticated investors under any of the sophisticated investor exemptions. Such clients have extensive investment experience and knowledge or complex instruments who are better able to understand and evaluate the risk and potential rewards of unusual, complex or illiquid investments.</td>
</tr>
<tr>
<td>(ii) High-net worth individual(s)</td>
<td>These are retail clients who meet the criteria for categorisation as high-net-worth individuals under any of the high-net-worth investor exemptions. Amongst the criteria is the requirement to earn an annual income of more than GBP100 000 or to have investable net assets of more than GBP250 000. This criterion is subject to review on a continued basis.</td>
</tr>
<tr>
<td>(iii) Ordinary retail investor(s)</td>
<td>In the FCA Policy Statement the term “ordinary retail investor” is used to refer to retail clients who are neither sophisticated investors nor high-net-worth individuals. These investors are of ordinary means. They have limited or no experience and make up most of the retail market in the UK. Such investors face difficulty understanding the terms and features of complex financial products. They are at risk where non-mainstream pooled investments are inappropriately promoted as good investments and they do not grasp the workings and effects of such investments.</td>
</tr>
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Source: FCA (2013a); author’s representation.

For the purposes of this chapter the term “retail investor” will be used in the discussion that follow having regard to the fact that the definition resembles the one proposed by the FCA.

It is estimated that approximately GBP6.9tn of assets are managed within the UK. A further breakdown of this figure shows GBP2.7tn of assets managed for overseas clients and around GBP3tn managed on behalf of UK investors and other institutional investors. An amount more than GBP1tn is managed on behalf of retail investors (FCA, 2016a:29). The asset management industry is heavily intermediated with increased retailisation through investment platforms. Institutional investors as the largest client type account for approximately 80% of assets under management. Retail investment accounts for 18.6% of assets under management (FCA, 2016a:29). Although labelled “institutional”, the end beneficiaries of many institutional investments are individuals. Retail investors are allowed to invest in asset management services through product “wrappers”. Significant numbers of retail investors access management services through pensions, with an estimated 15 million policy holders with individual personal pensions at life insurers at the end of 2015 (IA, 2016). Investors are furthermore enabled to access funds or products outside “wrappers” directly or indirectly through available investment platforms, or they could simply obtain advice from financial advisors who can assist with the design and implementation of investment decisions (IA, 2016).

According to FCA data, the number of authorised asset management firms within the UK stood at 1 840 at the end of 2016. In a span of four years, between 2011 and 2015, authorised and active management firms increased by 750 new entrants (FCA, 2016a:35-36). Asset management firms range from small to large international companies. They may take different legal forms,
including partnerships and limited or unlimited companies. Some of these offer asset management services, whilst others are part of groups that offer related investment services, consulting or access to trading platforms. Regarding products and investments, asset managers may offer a wide variety of products such as insurance or pension administration services (FCA, 2016a:35). Slightly more assets are managed in segregated mandates within the UK than pooled investment funds; the former calculated at 58.2% and the latter 41.8% (IA, 2016). Pooled funds are established in various forms, which include a company, a trust (authorised unit trusts [AUTs]), partnerships or charities. Pooled funds can be managed in various regulatory structures of which UCITS compliant funds would be one example (FCA, 2016a:36). Not all funds are authorised by the FCA, rendering them to be known as unauthorised investment vehicles. Examples of these are Investment Trusts and Unregulated Collective Investment Schemes (UCISs). Pooled funds can also be established in terms of the AIFMD and, in doing so, focus regulation on the manager rather than the fund itself.

Many fund managers of pooled fund structures delegate fund management to a MiFID investment manager in their own group or to an outside third party. This effectively brings a large portion of pooled funds within the ambit of MiFID conduct rules (FCA, 2016a:36; FCA, 2017b). Authorised funds in the UK are one of the main conduits through which retail customers in the UK invest. Unauthorised investment vehicles are also employed by retail investors to a lesser extent (FCA, 2016a:36). The structure of regulated CISs has a depositary with oversight responsibility over the fund manager. Depositaries are required for most UCITS or AIFMD funds. The fund trustee is the depositary in the case of an AUT. The fund operator or manager on its part has oversight over its delegates which, amongst others, include ancillary service providers (FCA, 2016a:37; FCA, 2017b). The fund operator usually oversees the establishment of a fund. This establishment process includes the securing of investment managers, the depository and the custodian. The manager is also responsible for the preparation of the application for approval with the FCA. Once this process has been completed, the fund operator will manage the fund, either directly or indirectly via delegation, documentation and/or accounting services (FCA, 2016a:37).

Firms specialise in certain asset classes (equity and property), investment strategies (active or partly active asset management products) or by types of investor (retail or institutional clients). The number of firms authorised in the UK to sell their services to non-UK, European investors in terms of a passport under an EU directive during 2016 was 244. A total of 139 firms possess approved inbound passports, enabling them to sell their services from other EEA jurisdictions into

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86 UCIS operators have neither obtained FCA authorisation or recognised scheme status nor applied for such authorisation or status. UCISs may furthermore not promote themselves to the public, including through advised sales, unless exempted.
the UK (FCA, 2016a:35-36). These approved inbound passports are for undertakings in CISs, as well as funds registered under the AIFMD as shown by FCA internal data on 27 July 2016. However, more recent aggregate statistics have been made available by the FCA on 20 September 2016 through the UK House of Commons Treasury Committee. In a letter published by the Chief Executive of the FCA, Andrew Bailey, dated 17 August 2016, figures were provided on UK firms currently holding single-market passports under EU directives to establish or provide branches elsewhere within the EU (Robson, 2016). The letter contains figures for both inbound and outbound passports granted under nine EU directives, which include AIFMD, UCITS, Solvency II and others. On an aggregate level there are 5 476 authorised firms in the UK holding outbound passports and 8 008 firms holding inbound passports, with 336 421 passports held in total by UK firms for multiple business activities in EU member states (Robson, 2016).

There are two predominant broad categories of investment, namely pooled investments and segregated mandates. In pooled investments, client money is aggregated together and invested in one portfolio. With segregated mandates, a client has an individual investment portfolio. Funds are subject to fund rules which may implement UCITS or AIFMD within in the UK or other covered areas, and discretionary investments are subject to MiFID conduct rules (FCA, 2016a:36; FCA, 2017b). As the fifth largest fund domicile centre in Europe, the UK serves as domicile for approximately 12% of the European fund market. The domicile of a fund in this context is important, as UCITS and the AIFMD require the depository to be domiciled within the same jurisdiction as the fund. A fund can be administered within a different jurisdiction than its domicile. Although not the largest fund domicile in Europe, the UK is the second largest asset management sector in the world, and 37% of assets under management in Europe is managed within its borders (FCA, 2016a:37).

Most UK retail investors access investment products through intermediaries which include financial advisors, online platforms or “fund supermarkets”. The two main platform types can be divided firstly into those which target businesses (financial advisors), pension schemes and fund management services, referred to as B2B. The second type targets retail investors that offer execution services for investors who manage their own investments, referred to as D2C (FCA, 2016a:42). Online platforms and fund supermarkets have become increasingly popular, so much so that almost three million customers make use of them to hold assets or invest. Currently, 80% of new

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87 Platforms are online services utilised by both consumers and intermediaries. Through them, investors can access a different range of products from different asset managers and manage them in one account. The term “platforms” is often used to describe both fund supermarkets and wrap platforms. They do, however, differ in that wrap platforms allow for wider direct access to products like equities, where fund supermarkets only offer funds.
retail investment business is done through platforms either directly by clients or through investment advisors (FCA, 2013b; IA, 2016; Platforum, 2015). As a consequence, they have become very important within this market.

The following section provides an overview of the hedge fund industry. The overview will provide insight into the regulatory framework for hedge funds in the UK, as well as its regulation within the structure of the UK retail market. The discussion will contribute towards identifying any additional principles which can be used for retail investor protection purposes. Any such principles which can contribute towards the final set of good practice principles will be employed to benchmark the South African retail hedge fund universe.

5.4 Regulating hedge funds within the structure of the retail funds market

5.4.1 Overview

The UK hedge fund industry has an approximate GBP335bn of assets under management with an estimated 500 management firms. Direct, highly skilled employment is estimated at approximately 10 000 persons directly employed in the hedge fund sector, with a further 30 000 estimated indirect jobs generated by the industry (AIMA, 2017).

To position the discussion of UK hedge fund regulation, especially one which emphasises retail investment and retail investor protection, a brief introduction is provided of the structuring of UK retail funds market.

The basic distinction drawn between the types of retail funds that can be registered in the UK is whether they are open ended or closed ended. The open-ended fund structure is an investment vehicle which is generally appropriate for investment vehicles that emphasise investment in assets with an established trading market. These structures are mostly free from restrictions on transferability and can, therefore, be readily marked to market and the portfolio rebalanced to accommodate investor contributions or redemptions (Davis et al., 2016). Closed-ended fund structures differ from open-ended structures in several significant ways. Closed-ended funds are mostly allocated for investments that are not able to be marked to market and have substantial restrictions on transferability for periods of time (Davis et al., 2016; FCA Authorised and recognised funds, 2016).

From the perspective of retail funds, an open-ended retail fund can be established in the UK in the ways illustrated in Figure 5-3. Funds may be established either as UCITS or non-UCITS retail funds (NURS). These funds can furthermore be established as authorised investment companies...
with variable capital (ICVC), which are also known as open-ended investment companies (OEIC’s), an AUT or an authorised contractual scheme (ACS) (FCA, 2017a; Gilliatt & Pitt, 2016).

![Respective UCITS and Non-UCITS UK Retail Fund Structures](image)

Source: Author’s representation.

**Figure 5-3: UCITS and non-UCITS UK retail fund structures**

These funds are distributed either via third-party distributors or directly by managers. Distribution can also take place through independent financial advisors and online facilities which may offer investment advice but specialise in the sale of products without providing advice (Davis et al., 2016). Close-ended retail fund structures are companies mainly listed on the London Stock Exchange’s (LSE) Main Market and are known as investment trusts. Most of these investment funds are now in corporate form. The LSE’s Main Market requires the issue of a prospectus under Directive 2003/71/EC (EU Prospectus Directive) which regulates the offering of securities to the public or admitted to trading (Gilliatt & Pitt, 2016). The funds listed on the Main Market may be marketed to retail investors (Davis et al., 2016). These funds can be formed under special tax regimes for real estate investment trusts (REITS) or venture capital trusts. A further option for closed-ended investment companies would be to list on the LSE’s Alternative Investment Market (AIM) or its Specialist Fund Market (Gilliatt & Pitt, 2016). As an exchange-regulated market, the AIM is not regulated under EU direction which limits offers to institutional investment and, consequently, focuses on professional or institutional investors. This is mostly less expensive and can
be executed quickly, as adherence to the EU Prospectus Directive is not a requirement (Davis et al., 2016).

Following the UK implementation of the AIFMD, the clear majority of investment trusts and other listed investment companies are now classified as AIFs. Therefore, although these funds are regarded as retail funds within the UK and they are able to market to retail investors within the EU, they are subject to EU regulation through the AIFD. NURS are similarly classified as AIFs. The distribution of closed-ended funds is like that of open-ended funds, although closed-ended funds have been more commonly promoted directly by funds sponsors and specialist brokers in investment trusts (Davis et al., 2016; Gilliatt & Pitt, 2016).

### 5.4.2 Key statutes, regulations and rules governing retail funds

Open-ended retail funds are governed by the Financial Services and Markets Act of 2000 (FSMA). Various statutory instruments formed under FSMA and FCA rules, especially those of the Collective Investment Schemes Sourcebook (COLL), finds application. Retail fund managers are subject to rules relating to insider dealing and market abuse, money laundering, and short selling and derivatives (Davis et al., 2016; FCA, 2004; FCA, 2017b; Gilliatt & Pitt, 2016). Closed-ended funds are mostly classified as AIFs in accordance with the AIFMD, thereby subjecting the managers of such AIFs when established within the UK to the AIFMD. Closed-ended funds listed on the LSE’s Main Market are subject to the FCA’s listing rules. Both open-ended funds and closed-ended funds are subject to the oversight of the FCA (FCA Authorised and recognised funds, 2016).

Funds listed on the AIM or Specialised Fund Market are governed by the rules of those markets and do not fall within the oversight of the FCA (Gilliatt & Pitt, 2016). However, when their managers are established within the UK, the managers will fall within the oversight of the FCA rules and its supervision (FCA, 2004; FCA, 2017b; Davis et al., 2016). Every open-ended retail fund, as well as the marketing thereof, must be authorised by the FCA. The FCA may authorise or recognise the marketing of any fund established within a foreign jurisdiction subject to certain conditions (Gilliatt & Pitt, 2016). Most of the funds recognised by the FCA are UCITS funds marketed within the EU and UK under the current passporting process.

The establishment of most closed-ended retail funds is not subject to FCA authorisation, although the listing of a closed-ended fund on the LSE’s Main Market requires UK listing authority approval, which is the FCA. Funds listed on the AIM do not require FCA approval but should have an independent advisor to act as nominated advisor to observe and assure compliance with AIM rules to the LSE on behalf of the fund (Gilliatt & Pitt, 2016; FCA, 2004; FCA, 2017b).
5.4.3 Marketing retail funds

Any person who wishes to market retail funds within the UK is required to be an authorised person due to the marketing activities that resort under the FCA-regulated activity (Gilliatt & Pitt, 2016; FCA, 2017b). Non-UK residents performing marketing-related activities, but not from a personal place of business in the UK, are exempt from obtaining authorisation from the FCA, subject to certain requirements. These include compliance with rules on financial promotion (Gilliatt & Pitt, 2016; FCA, 2017b). Authorised EU UCITS funds or listed closed-ended funds may be marketed to any party, whilst other types of funds may be marketed to certain types of investors, including certified high-net-worth individuals or “professional investors” in accordance with the MiFID prescriptions (FCA, 2017b). The marketing may occur through private placement or be based on the UCITS passport. Upon inception of MiFID II, complex UCITS were also subject to an appropriateness test captured in article 25(3) and (4). This test requires a firm to obtain information regarding its clients' knowledge and experience to determine the appropriateness of its envisaged products and services (MiFID II).

5.4.4 Managers and operators of retail funds

Managers of a UK UCITS fund established as an AUT should be a registered body corporate in terms of UK law or any other EEA state. The manager should be independent from the trustee of any AUT. Any OEIC established within the UK has an authorised corporate director as manager (Gilliatt & Pitt, 2016; FCA, 2017b). Such an OEIC may also be established in any other EEA state and will be subject to the same requirements for managers as within the UK. UK UCITS funds are required to be regulated by the FCA to perform any regulated activity related to the management of a UCITS fund. The manager of a UK UCITS fund can also be established within any other EU state which operates under the UCITS management passport (Gilliatt & Pitt, 2016). The trustee or depository of a UK UCITS fund must be authorised by the FCA to act as depository or trustee of a UCITS. Managers are also required to meet the most recent eligibility requirements under UCITS V as implemented within the UK. A transitional period has been provided for non-bank depositaries, running until 18 March 2018. The manager of any NURS will only be allowed to perform any regulated activity associated with AIFs if so registered appropriately (Gilliatt & Pitt, 2016). With regard to closed-ended funds, managers will also only be allowed to perform any regulated activity managing an AIF if registered with the FCA. There is an alternative to this position, however, namely when the fund itself is a ‘self-managed’ AIF. There is no requirement to appoint a manager to any UK-established, closed-ended retail fund (Gilliatt & Pitt, 2016; FCA, 2017b).
5.4.5 Asset portfolios

Open-ended retail funds are required to appoint trustees in the instance of utilising an AUT and a depository for OEICs or ACSs. Trustees or depositaries are required to perform oversight and hold assets on behalf of such open-ended retail funds. They should function independently from any managers and be housed within the UK or, alternatively, be established in any other state holding at least a business address in the UK (Gilliatt & Pitt, 2016). Closed-ended retail funds are mostly classified as AIFs under the AIFMD. If the fund is established and managed within the EEA, a depository must be appointed subject to the AIFMD. Any closed-ended fund not required to appoint any depository under the AIFMD will, in practice, appoint a custodian third party which will hold its assets for purposes of settlement (Gilliatt & Pitt, 2016; FCA, 2017b).

5.4.6 Retail fund legal structures

Most retail funds will be established as UCITS funds. In the UK open-ended retail funds are sometimes structured as NURS, which are non-UCITS funds approved by the FCA for distribution to retail investors. Both can be structured as OEICs, AUTs or ACSs. Figure 5-4 illustrates the basic legal structure and its fundamental characteristic for purposes of structuring open-ended retail funds within the UK (Gilliatt & Pitt, 2016; FCA, 2017b).
These funds may also be established with underlying subfunds ring-fenced from attracting liability from any other subfund. Noticeably, OEICs are most familiar to European investors with ACSs intended to act as master funds into which UCITS funds can combine assets to form economies of scale. ACSs are designed to be issued to professional investors falling within the meaning thereof as contained within the MiFID, or large investors qualifying as such and investing more than GBP1m (Gilliatt & Pitt, 2016). Closed-ended funds, as stated earlier, mostly take the form of listed companies. They also differ from open-ended funds due to fewer investment and borrowing restrictions, strict adherence to investment policy without too much focus on liquidity of underlying assets and a continuous pool of capital to invest from a management perspective (Gilliatt & Pitt, 2016; FCA, 2017b).

5.4.7 Investment and borrowing restrictions

The borrowing powers of open-ended UCITS retail funds are explained in the FCA COLL sourcebook which sets out investment limits and permitted investments for UCITS in the UK. Figure 5-5
below illustrates permitted investment in respective asset classes for UK UCITS funds together with spread and concentration requirements for investments therein.

Source: Author’s representation from FCA COLL sourcebook

**Figure 5-5:** UCITS UK: Asset class investment, spread and concentration requirements

NURS have broader investment powers and may invest in investments that UCITS funds are not permitted to invest in. In addition to the asset classes mentioned in the above figure, NURS may invest in asset classes depicted as follows in Figure 5-6.
NURS that qualify as FAIF are permitted to invest in AIFs. Worth noting is that NURS are subject to restrictions like those of UCITS funds, but not as limited (Gilliatt & Pitt, 2016; FCA, 2017b). Closed-ended retail funds are not subject to restrictions on investment or borrowing, although their published investment policy should cover risk diversification, asset allocation and gearing pre-required for listing on the LSE.

Source: Author's representation from FCA COLL sourcebook

**Figure 5-6: NURS UK: Asset class investment, spread and concentration requirements**

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5.4.8 Restrictions on retail funds

5.4.8.1 Issue and redemption of interests

Open-ended retail funds are required to offer issue and redemption of shares or units on each dealing day, with at least two dealing days scheduled every month. Retail funds can, as a consequence, limit the number of units in issue or such units issued for a particular month (Gilliatt & Pitt, 2016; FCA, 2017b). Where retail funds cater for daily dealing days, redemptions could be suspended until the following valuation point, should redemption requests exceed 10%. When in the interest of unit holders, and under exceptional circumstances, dealing in open-ended retail funds may be suspended, but notice has to be given to the FCA. Such restrictions are, however, rarely applied in practice, as this would cause serious damage to investor goodwill and, therefore, counter the expectation that interests are easily redeemable. NURS may impose limited redemption arrangements when they are, for example, FAIFs (Gilliatt & Pitt, 2016; FCA, 2017b). Listed closed-ended retail funds are traded on the exchange where they are listed. The funds are, therefore, allowed to operate any repurchases of their shares.

5.4.8.2 Rights to transfer or assign interests to third parties

Concerning open-ended retail funds, managers can impose restrictions on shareholders or unit-holders to ensure that the investors who desire to obtain such units are eligible. Other than this, shares or units in open-ended retail funds are freely transferable. Closed-ended funds such as investment trusts shares are freely traded on the relevant exchange. Non-restricted transferability of shares or units will, as a pre-requisite for listing, usually be required to be freely transferable (Gilliatt & Pitt, 2016; FCA, 2017b).

5.4.9 Reporting requirements

Open-ended retail funds are required to report and account to investors on a bi-annual basis. Managers are required to provide short reports for all holders which should include investment activity and performance, amongst others. Long reports need to be made available to investors and must include the accounts and reports of the auditor, manager and trustee or depository.

The latest iteration of UCITS broadly aligned the UCITS and AIFM directives with regard to rules on manager remuneration, the depositary’s role and liability in general. It afforded additional protection to the UCITS retail investor base (Gilliatt & Pitt, 2016; FCA, 2017b). EU-wide rules on sanctions and penalties for breaches were implemented and took effect in March 2016, with the transitional period expiring in March 2018 to allow managers to implement new depository requirements. Currently, there are no new reform proposals for regulating open-ended nor closed-
ended retail funds. In January 2018 MiFID II took effect and impacts product manufacturers’ re-
sponsibilities, as well as fund distribution. These general reforms also impact firms with regard to
their implementation and require them to address the appropriateness test when distributing
structured UCITS.

5.5 **The regulatory framework for hedge funds within the UK: Financial Services and
Markets Act 2000 (FSMA)**

Asset management activities are mainly governed by the FSMA together with other instruments
captured within the FSMA. The regulatory objectives of this act are market confidence, public
awareness, the protection of consumers and the reduction of financial crime (FSMA, 2000). It
regulates the provision of financial services, as well as investment, through the concept of regu-
lated activities that may be carried out only by people who are duly authorised or exempted from
such required authorisation through a specific exemption (Dickson, 2016:432). Regulated activi-
ties specified in terms of the FSMA include (FSMA, 2000; AIFMR, 2013):
- dealing in investments as principal or agent;
- arranging deals in investments;
- managing investments;
- establishing, operating and winding up a CIS;
- managing an AIF;
- managing a UCITS; and
- providing advice on investments.\(^8\)

Many investment managers and certain fund legal structures are required to obtain FCA authori-
sation, as the activities carried out by them fall within the FSMA definition of regulated activities.
CISs are defined very broadly by the FSMA. These regulatory asset management structures form
an integral part of the regulatory system in the UK. Investment within these vehicles exclude the
daily management or control of property management. Arrangements within a CIS must include
the collective management of investor contributions of which returns are to be paid out of income
generated therefrom to participants. A further possible arrangement could be that any property
can be managed in whole or in part on behalf of the operator of the scheme, who is understood
to mean a person or entity responsible for the management of a scheme in accordance with
section 235 of the FSMA. Table 5-2 provides a general overview of the legal structures in the UK
regulatory environment available for investment.

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\(^8\) See Section 22 of the FSMA together with the AIFMR introduced during July 2013.
Table 5-2: Common asset management structures within the UK

<table>
<thead>
<tr>
<th>Legal concept definition and origin</th>
<th>Legal structure</th>
<th>FSMA scheme and/or other authorisation requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unit trusts and authorised unit trusts (AUTs)</strong></td>
<td>Unit trusts are the original form of open-ended funds in the UK. This English common law structure determines that the trustee holds the legal title of property on behalf of the beneficiary investors which have a beneficial interest in the trust assets.</td>
<td>The structure mostly consists of a financial institution which is able to offer trust services. A separate fund manager is required to formulate and implement the unit trust investment strategy, together with the trustee.</td>
</tr>
<tr>
<td><strong>Open-ended investment companies (OEICs)</strong></td>
<td>The OEIC structure effectively permits a company structure to have variable capital. Capital maintenance rules were introduced preventing companies from being open-ended investment structures.</td>
<td>The structure of an OEIC is like that of an AUT. However, the OEIC holds the beneficial interest in the investment portfolio. The appointment is required of a depository that holds legal title over the assets of the OEIC. Before OEICs, closed-ended investment trusts were a form of body corporate that was used for purposes of collective investment. Investors' position is like that of shareholders in a traditional limited company.</td>
</tr>
<tr>
<td>Legal concept definition and origin</td>
<td>Legal structure</td>
<td>FSMA scheme and/or other authorisation requirements</td>
</tr>
<tr>
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</tr>
<tr>
<td><strong>Authorised contractual schemes (ACSs)</strong></td>
<td>ACSs can take the structure of co-ownership schemes or limited partnership schemes in accordance with section 235A of the FSMA. Co-ownership schemes requires a contractual deed entered into between an operator and depositary that does not constitute a body corporate, a partnership or a limited partnership. Assets should be held by the depositary or to the order thereof, and the property must be beneficially owned by participants as tenants in common or, where provision is made for pooling of assets, that each part thereof is held by participants as tenants in common. A partnership scheme is required to be a limited partnership with one general partner at any time and one limited partner at formation who is a person nominated by the general partner. There must be an accepted deed which prohibits pooling in relation to separate parts of the property. The property must be subject to the scheme held by or to the order of a person or to a person directly appointed by the depositary, with limited partners participating in the scheme. A scheme should furthermore determine that when a partner exits, the partnership is not dissolved.</td>
<td>An ACS may be authorised by the FCA in accordance with the stipulations in section 261D (1) and 261E of the FSMA. It should furthermore adhere to the applicable COLL rules. The general restrictions on promotion of CISs do not apply to ACSs, but retail investors are protected indirectly by requiring a GBP1m or more investment contribution to participate.</td>
</tr>
<tr>
<td><strong>UCITS schemes</strong></td>
<td>A UCITS scheme must comply with certain criteria. It should take the structure of an AUT, ACS or OEIC. Its sole objective must be to manage collective investment in transferable securities as stated in COLL 5.2.7, including shares, debentures, alternative finance investment bonds, to name a few. Should the title to any of these not be transferrable or non-transferrable without third-party consent, a UCITS scheme would not constitute securities within the required definition. It could also include other permitted financial instruments which are founded on the principle of risk spreading as captured in COLL 5.2.6A.</td>
<td>UCITS schemes should comply with obligations applicable to UCITS (COLL 1.2.2 and COLL 3.2.8) together with investment and borrowing power rules under COLL 5.2 to COLL 5.5. This more stringent regulatory compliance regime includes the benefit of cross-border passporting that allows for marketing activities between EEA. The rules for recognised overseas schemes in COLL 9 and section 264 of the FSMA are included and determine that the FCA be notified of a funds authorisation under UCITS in the member state, after which the UCITS scheme will have the right to commence marketing units in the UK immediately. UK rules on UCITS management company passports, either in the EEA or the UK, are captured in COLL 12.</td>
</tr>
</tbody>
</table>

In June 2013 the regulations for Collective Investments in Transferable Securities came into force (UK, 2013). These regulations provide for ACSs. Previously, only OEICs and AUTs were options subject to FCA approval. ACSs are transparent collective investment vehicles attributing gains directly to investors.
<table>
<thead>
<tr>
<th>Legal concept definition and origin</th>
<th>Legal structure</th>
<th>FSMA scheme and/or other authorisation requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-UCITS retail schemes (NURS)</strong></td>
<td>NURS do not constitute a separate open-ended type structure, but are AUTs, OEICs and ACSs that do not comply with the criteria stated within the UCITS regime. They are, therefore, regulated less stringently within the UK than UCITS. They do not qualify for EU cross-border passporting and are limited, amongst others, to investing no more than 35% in any other regulated scheme, which is a higher allowed level of investment than that of UCITS. Investors are nevertheless protected through minimum requirements that must be met to be able for a NURS to invest in a CIS. This, however, excludes a feeder NURS.</td>
<td>A NURS must comply with certain criteria. It should take the structure of an AUT, ACS or OEIC. Investment and borrowing powers are restricted in accordance with COLL 5.6.</td>
</tr>
<tr>
<td><strong>Funds of alternative investment funds (FAIFs)</strong></td>
<td>COLL 5.7 determines how FAIFs that are NURS are operated. Some of these rules incorporate general rules under COLL 5.6. The regulation of FAIFs is more relaxed than that applying to NURS with increased flexibility in respect of investment powers.</td>
<td>FAIFs are permitted to invest in all of the assets of a CIS, as long as such a CIS spreads its investment risk and does not itself invest in more than 15% in the value of the assets of the CIS as per COLL 5.7.2 and COLL 5.7.7. Such a CIS invested in by a FAIF needs not itself be subject to the rules governing NURS in UCITS. A FAIF fund manager, however, must do proper due diligence of any CIS invested in per COLL 5.7.9.</td>
</tr>
<tr>
<td><strong>Qualified investor schemes (QISs)</strong></td>
<td>QISs are not specific legal forms of investment. QISs are authorised CISs that may be marketed only to specific qualified investors, and not to retail investors. Fund managers are required to take reasonable care that units within a QIS are only sold to qualifying persons as stated in COLL 5.7.1.</td>
<td>QISs are regulated less stringently than UCITS or NURS due to their not being tailored for retail investment. They have greater flexibility and borrowing powers. QIS investment assets must be permitted investments under the QIS constitution and marketing prospectus, but can have a wide variety of assets including debentures, shares, real estate, bonds, option and contracts for difference. Reasonable risk spreading is also a requirement according to COLL 8.4.1-4.</td>
</tr>
<tr>
<td>Legal concept definition and origin</td>
<td>Legal structure</td>
<td>FSMA scheme and/or other authorisation requirements</td>
</tr>
<tr>
<td>-----------------------------------</td>
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</tr>
<tr>
<td><strong>Investment structure type: Closed-ended investment vehicles</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Investment trusts</strong></td>
<td>The term &quot;investment trusts&quot; is a misnomer, as these investment vehicles are not trusts. They are public companies listed on a stock exchange. The Companies Act of 2006 (CA) finds application and there exists no separate legal regime governing this type of structure, such as OEICs etc. They do, however, for taxation purposes constitute a valid trust and are dealt with accordingly.</td>
<td>Unlike open-ended funds, the shares in an investment trust may trade at a discount or premium to the net asset value of the company's underlying assets. This is subject to the relevant exchange’s liquidity and supply and demand factors.</td>
</tr>
<tr>
<td><strong>Limited partnerships</strong></td>
<td>These structures are formed in terms of the Partnership Act of 1890 (PA) and registered in accordance with the Limited Partnership Act of 1907 (LPA). They consist of one or more general partners who are liable for all the debt and obligations of the partnership. They also have limited partners whose liability is limited to the amount of capital contributed to the investment. Responsibility for day-to-day operations lies with the general partner and, would limited partners involve themselves</td>
<td>Limited partnerships have flexible governance arrangements, with division of responsibilities among general and limited partners. The law on partnerships is also flexible and does not require a written partnership agreement to be entered into for its legal establishment.</td>
</tr>
</tbody>
</table>

In addition to stipulations in the CA, investment trusts are subject to the listing rules which form part of the FCA Handbook and so published by the FCA in its capacity as the UK Listing Authority. Chapter 15 specifically finds application. In addition to the listing requirements, it is stipulated that investment trusts invest in assets and manage such assets in a way that enables the spreading of risk. Also, the investment trust board of directors must act independently from the investment manager. Investments must be made in accordance with a published investment policy, which requires shareholder approval for any changes made to it. These structures do not require direct approval in accordance with the FSMA, but since the AIFMD came into force, FCA approval is needed by managers of investment trusts to operate or, in certain instances, register with the FCA. Because the delegation of the management of the investment to a separate manager is required, authorisation under the AIFMD will need to be obtained. Where the investment trust is internally managed, it would be required to obtain authorisation under the AIFMD. In terms of the CISs Order SI 2001/1062, investment trusts do not qualify as CISs and section 238 of the FSMA does not apply. Section 76 of the FSMA, however, stipulates regulated activities, of which shares in an investment trust form part and it therefore falls within the general restrictions on financial promotion.

Under section 235 of the FSMA, investment funds operating as limited partnerships are regarded as CISs due to the pooling of investment assets whereby investors do not obtain daily control over the management of such assets. Limited partnerships will likely fall under the AIFMD which in the event that it does would determine that the fund manager requires authorisation from the FCA for the regulated activity for the establishment, operation or winding up of the CIS or for the regulated activity of managing an AIF.
<table>
<thead>
<tr>
<th>Legal concept definition and origin</th>
<th>Legal structure</th>
<th>FSMA scheme and/or other authorisation requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>with these affairs, they would lose their limited liability and be treated as a general partner. Under English law limited partnerships do not have separate legal personality and can, as a result, not hold property in their own name.</td>
<td>These structures are incorporated through the Registrar of Companies in accordance with section 3 of the LLPA.</td>
<td>Authorisation will be required under the LLPA. An investment fund incorporated as an LLP may constitute a CIS in terms of section 235 of the FSMA. This will be so in cases where investors do not have control over the management of the LLP.</td>
</tr>
<tr>
<td>Limited liability partnerships</td>
<td>These structures were created through the Limited Liability Partnerships Act of 2000 (LLPA). These entities are bodies corporate with legal personality, coupled with organisational flexibility and limited liability for members.</td>
<td></td>
</tr>
</tbody>
</table>

### Investment structure type: Alternative investment funds (AIF)

The UK implemented the AIFMD through the Alternative Investment Fund Managers Regulations of 2013 (SI 2013/1773) together with changes to the FCA rules. This created an additional category of investment fund. An AIF is a collective investment undertaking which raises capital from investors with the aim to invest the funds according to a defined investment policy for the benefit of the investors. It is furthermore not a UCITS scheme. Like UCITS schemes though, it does not create a separate type of investment vehicle, but constitutes an additional layer of regulation that finds application to managers of investment funds who meet the requirements of the definition.

An AIF can be either closed- or open-ended and be constituted in any legal form, including in terms of a contract through the establishment of a trust or through a statute. Given its broad definition, many categories of investment funds will fall within its scope including QISs, NURS and hedge funds. Should the fund not constitute an AIF, the manager would be regulated in terms of the AIFMD. The impact on managers is greater than would be the case on a fund level. A manager is defined as a legal person whose business it is to manage one or more AIF. The manager could be external, or the AIF can be managed internally.

AIFs are authorised in terms of Part 4A of the FSMA to carry on any regulated activity of managing an AIF. Obligations that must be adhered to include the following: an initial capital requirement, an AIF may be managed only by a single AIFM, persons dealing with the AIFM must be of good repute and have experience, and members of an AIFM must take prudent management into account. AIFMs must furthermore comply with other requirements, including organisational and prudential requirements. Strict transparency and disclosure requirements also relate to investors, including annual reporting.
As highlighted in Table 5-2 certain investment vehicles and/or their managers require FCA authorisation to carry on business, as most of them engage in what is understood as regulated activities which include investment advice, investment management or dealing and promoting regulated activities. The FSMA encloses a basic injunction on unauthorised persons acting in the course of business from inviting, inducing or communicating with people to engage in investment activity (Dickson, 2016:433). The following part of this chapter will provide an overview of the market structure that determines investment in hedge funds within the UK.

5.6 An overview of the market structure determining investment in hedge funds within the UK

5.6.1 Structure of the hedge funds market

Hedge fund managers established within the UK must be authorised as investment fund managers in accordance with the AIFMD. An exception is small managers who fall within the sub-threshold exemption, namely that the total fund assets under management must be less than EUR100m (Gilliatt & Pitt, 2016).

In terms of the AIFMD, managers are subject to regulatory reporting requirements with regard to a vast majority of data on their positions and exposures. The AIFMD furthermore requires derivatives reporting on OTC derivatives, central counterparties and trade repositories (EMIR). Managers are required to report short positions on short selling and certain aspects of credit default swaps (EU, 2012). Securities financing transactions within the EU are also to be reported on (European Parliament, 2015). Requirements that relate to OTC and exchange traded derivatives in accordance with EMIR also find application to managers, together with the newly enacted rules under the MiFID that was introduced on 3 January 2018, as discussed in the previous chapter. The use of derivatives is allowed in terms of UCITS in certain strategies that would similarly be employed by hedge funds. Such funds can execute long or short position within a UCITS fund that would otherwise be prohibited (Gilliatt & Pitt, 2016).

5.6.2 Risk and conduct management and transparency requirements in terms of AIFMD

Since the inception of the AIFMD, managers of hedge funds have been subject to special requirements to the extent that the assets under management threshold has been surpassed (FCA, 2018b). The FCA FUND sourcebook contains rules on risk, conduct and transparency. It places requirements on individuals who fulfil control requirements, valuation, delegation, liquidity, reporting and disclosure, to name a few (FCA, 2018b). The enactment of MiFID II will bring hedge fund
managers within the scope thereof if they fall within the definition of “investment firms”. The implementation of the AIFMD, however, has the effect that a firm that only conducts fund management is excluded from the definition of “an investment firm” and, as such, compliance with MiFID is not required (FCA, 2018b). Non-retail fund managers must have regard to rules applicable within the fund domicile.

5.6.3 Insider dealing, market abuse and money laundering

Mention should be made of requirements concerning insider dealing, market abuse and money laundering applicable to hedge fund managers who carry on business within the UK. There are requirements in accordance with the FSMA, FSA rules on market conduct and regulation, as well as rules on insider trading contained within the Criminal Justice Act of 1993 (Gilliatt & Pitt, 2016). Anti-money laundering regulations apply to hedge fund managers.

5.6.4 Regulatory framework and authority

The FCA is the regulatory authority within the UK and is responsible for the authorisation of managers of hedge funds. Managers are subject to UK law to implement the AIFMD, as well as indirect applications of the AIFMD, which requires the appointment of a depositary, amongst others. Many managers of hedge funds fall within the definition of an “investment firm”, requiring their compliance with MiFID (FCA, 2018b). There may also be non-retail funds which qualify as either European Venture Capital Funds (EuVE-CA) or European Social Entrepreneurship Funds (EuSEF) (FCA, 2018b; Gillian & Pitt, 2016). This designation is available in particular to subthreshold UK AIFMs enabling marketing to professional investors with an EU passport without AIFM full authorisation. QISs may also be established with the FCA and marketed to professional investors. This, however, still constitutes an AIF under the AIFMD.

5.6.5 Short selling and derivatives regulations

Hedge funds are subject to European regulation on short selling and must disclose to the relevant regulator net short positions that exceed certain thresholds. The short positions reported on should relate to EU sovereign debt and equities traded on any EU trading venue (Gilliatt & Pitt, 2016)

5.6.6 Marketing and investment restrictions

Hedge funds, whether onshore or offshore, may only be marketed to professional investors (including investors who qualify to be treated as such) who qualify as such according to the ascribed
meaning contained in MiFID. Under the pre-existing financial promotion system, onshore and offshore hedge fund managers within the UK are allowed to market to a number of other types of private and institutional investors. There are no restrictions on local investors who wish to invest in hedge funds, but for marketing certain restrictions are stated (Gilliatt & Pitt, 2016).

5.6.7 Assets portfolio

The AIFM requires asset holding and protection to be dealt with by a depository duly appointed by the EU manager of an EU hedge fund. The AIFM introduced rules with regard to the liability of depositaries and or sub custodian. Depositaries are also subject to the FCA CASS sourcebook, which prescribes professional standards of care and diligence (FCA, 2018a; Gillian & Pitt, 2016). EU managers of non-EU hedge funds that are not marketed within the EU need not appoint depositaries. Where non-EU funds are marketed within the EU by an EU manager, the “depository-light” requirements find application, and one or more entities must be appointed to perform depository functions. The non-EU funds, therefore, do not need to comply with the full depository regime subject to article 21 of the AIFMD, whereby a single depository is required to perform all three core depository functions which, in principle, include the safe-keeping of assets, cash flow monitoring and the oversight of subscriptions, valuations, redemptions, compliance with laws and regulations, investment restrictions and leverage. The depository takes on strict liability in terms of the full regime, according to which it has to take on the losses for financial instruments.

5.6.8 Disclosure requirements

In terms of the AIFMD, managers are required to prepare annual reports for every single AIF managed and marketed within the EU. Financial information should be disclosed periodically before investment is made by investors.

5.6.9 Key requirements applicable to operators of hedge funds

Managers are subject to AIFM Directive Level 2 requirements, together with the FCA FUND sourcebook on financial conduct irrespective of fund location (FCA, 2018b; Gillian & Pitt, 2016).

5.6.10 Restrictions on hedge funds

Fund documents are a primary source of restriction on redemption by an investor. Minimum requirements as to redemption frequency do not appear in the AIFMD. Rights to transfer or assign interests to third parties may be subject to restrictions in accordance with fund offering documents.
(Moran et al., 2018). Hedge funds within the UK are subject to the AIFMD and MiFID and marketing may be done only to qualifying professional investors. If marketing is done in accordance with the AIFMD or the private placement regime, the FCA should be notified for purposes of private placements and authorisation obtained if in terms of a marketing passport according to the AIFMD requirements (FCA, 2018b; Gillian & Pitt, 2016).

With MiFID II, which took effect on 3 January 2018, the further purpose envisaged by the regulator was that the AIFMD become aligned with MiFID. The fact that the UK is in the process of negotiating a settlement as part of its exit from the EU, UK AIFMs could become non-EU AIFMs, effectively revoking their status. The UK would likely wish to retain the benefits of the AIFMD for local AIFMs, as well as UCITS funds. Exit negotiations are currently still in progress and the impact of the final decision will in due course be felt in the UK hedge fund landscape. There are, however, some deductions to be made at this stage, which will be stated briefly in the ensuing discussion.

5.7 Brexit: Possible implications for hedge funds

The exit from the EU by the UK will have various direct and indirect consequences on the alternative management industry (AIMA, 2017). These hold risks and opportunities yet to be fully grasped and understood. Currently, there are many unanswered questions, for example (AIMA, 2017):

- whether the third-country passport regime will be available for UK AIFMs and non-EU AIFs under AIFMD;
- whether UCITS fund management responsibilities would still be able to be subdelegated to a London-based investment manager;
- whether the EC would have a continued willingness to allow equivalence under EMIR to UK Central Counterparties (CCPs);
- whether the EC would have a continued willingness to allow equivalence under MiFIR to UK trading venues;
- whether equivalence would remain available under MiFIR to enable UK investment firms to deliver MiFID services. The delivery of such services on a cross-border basis to professional clients and eligible counterparties in the EU is also a topic that has not been finalised;
- what the effect of Brexit will be on existing financial services projects and files, for example, the Capital Markets Union (CMU) initiative;
- whether the UK will strive for the repeal of some aspects of the EU Short Selling Regulation; and
the degree to which the UK regulatory regime would possibly diverge from the EU whilst maintaining unconstrained access to EU markets via equivalence.

There is most definitely going to be a regulatory impact on direct UK/EU cross-border business. However, it seems that Brexit might just continue to provide the UK government with increased control over its policy-making and domestic regulatory regime. In a speech delivered on 17 January 2017 at Lancaster House, London, Prime Minister Theresa May set out a plan for Britain which included 12 priorities the UK government will employ to negotiate Brexit. One of these priorities is to take new opportunities within the global economy through the negotiation of beneficial free-trade agreements with different countries, of which the success is yet to be determined (Asthana, Steward & Elgot, 2017; Niblet, 2016). Hedge funds fulfil a central economic function within Europe due to their contribution to British economic growth, amongst others. This can be ascribed to the UK’s financial expertise, the strength of its asset management industry, the scope of its financial services skills base and its recognised regulatory environment (AIMA, 2017).

An astounding 85% of the Europe’s hedge fund assets are managed within the UK, as shown in Figure 5-7 below (AIMA, 2017:2).

![Hedge Fund Industry Size Comparison](image)

* Excluding UK.


**Figure 5-7:** Size of the hedge fund industry in the EU

Approximately 62% of EU-based hedge fund managers who took part in this Preqin survey are headquartered in the UK. With regard to institutional investment in hedge funds housed within the EU, approximately 54% is based in the UK. With regard to the size of the hedge fund industry, the EU manages approximately USD136.5bn to the UK, at the prevailing EU-USD exchange rate. This implies that the UK hedge fund industry is more than double the size of the EU’s industry (Preqin, 2017). The Preqin Global Hedge Fund report for 2017 surveyed over 500 hedge fund
managers and 300 institutional investors active in hedge funds at various points during 2016 to assess and gauge the impact of the Brexit referendum. Other than the fact that more than 70% of respondents were caught off-guard by the outcome of the referendum, there has been a changing sentiment towards the hedge fund industry within the UK, as illustrated in Figure 5-8.

The report, which captured investor views of investments into hedge funds, clearly highlighted the uncertainty about increased future investment, especially from EU managers. However, most managers seemed to expect very little or no change regarding investment, with a smaller percentage of managers indicating a reduction in investment over the indicated period (Preqin, 2017). Sentiment within the UK hedge fund industry currently seems to be that most UK-based hedge fund managers are not planning on moving operations from the UK; however, this remains but an indication of their intent. Hedge fund managers who participated in the survey indicated a view on the impact of Brexit on the performance of funds which seems to have levelled off and become more positive, especially over the second half of 2016 (Preqin, 2017). Brexit's true effect on investment regulation, and specifically retail investment in hedge funds, will be evident only as its consequences unfold during the legislative process to be followed in terms of the Lisbon Treaty and UK legislative obligations.
5.8 Summary: Investor protection principles identified from the UK hedge fund regulatory environment

Table 5-3 provides the principles extracted from Chapter 4. Owing to the fact that the UK is still forming part of the EU and that Brexit negotiations are still underway (November 2018), these principles remain relevant and their application accordingly appropriate. After ascertaining the applicable regulatory provisions to hedge funds in the EU, Chapter 5 will be approached in a comparable manner. Due to the inextricable application of EU regulations related to AIFs within the UK as a member state the framework applied in Chapter 4 will be used and the transpositions of EU law related to hedge funds indicated.

The AIFMD was transposed into UK law during 2013 and established an EU-wide harmonised agenda monitoring and overseeing risks posed by investment funds and their managers. Table 5-3 illustrates the correlating principles between those identified from the previous chapter and this chapter. It furthermore illustrates the transposition of the regulatory principles within the UK through either legislation or the FCA handbook sources.

This chapter investigated the UK hedge fund regulatory milieu and established the regulatory environment in the possible post-Brexit environment. The next chapter provides the requisite background to financial regulation within the South African context.
Table 5-3: Identified EU investor protection principles impacting the UK because of its existing inclusion within the single market

<table>
<thead>
<tr>
<th>EU principle identifier</th>
<th>EU principle</th>
<th>Source</th>
<th>EU principle content description</th>
<th>Transposition into UK through either legislation or the FCA rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUP1</td>
<td>Registration for managers and/or investment companies</td>
<td>AIFMD Chapter I and Chapter II</td>
<td>Article 1 stipulates rules for authorisation and ongoing operation and transparency for AIFM managers within the EU. Article 3 pertains to registration under exemptions allowed for under the AIFMD. Article 6 of the AIFMD requires authorisation for the management of an AIF by an AIFM. Article 7 determines that member states must require AIFMs to apply for authorisation from the competent authority of the home member state and provide information to the authorities, including the type of underlying funds if the AIF is a fund of funds, the AIFMs policy with regard to the use of leverage, and the risk profiles and/or other characteristics of the AIF, to name some.</td>
<td>Legislation: Section 19 of the FMSA. Regulation 2 of the AIFMR; Section 195A (12) FSMA; Articles 51ZC and 51ZF of RAO together with Regulations 11 and 21 of the AIFMR. Regulations 15 and 16 of the AIFMR. FCA rules: FUND 1.4.2R–1.1.4R; FUND 399R; SUP 15.3.1 and 15.3.27R</td>
</tr>
</tbody>
</table>
| EUP2                    | Marketing | AIFMD Chapter VI | Marketing within the home member state of the AIFM is allowed subject to home member state supervision. EU AIFMs may market units or shares of any EU AIF they manage to professional investors of the home member state of the AIFM when compliant with Article 31 of the AIFMD. An AIFM may also market in other member states in accordance with Article 32. There is a number of provisions that need not be transposed as they apply directly within the member states, and where marketing takes place through a passport of a non-EU AIF managed by an EU AIFM, third-country provisions will apply in accordance with Article 35 of the AIFMD. | - Article 31 transposition: Regulation 46 determining marketing activities to only professional investors together with regulations 50, 54 and 55 of the AIFMR and secondary amendments to legislation at paragraphs 5 and 19 Sch. of the AIFMR.  
- Article 32 transposition: Regulations 49 and 57(1) of AIFMR and amendments to secondary legislation at paragraphs 5 and 19 Sch. 2 of the AIFMR. Also paragraphs 20C(2)(5)(b) of the FSMA together with FCA rules published under this section. Regulation 46 of AIFMR also applies, together with Regulation 17A of the EPRR.  
- Article 33 transposition in terms of regulations 29 and 33 of the AIFMR.  
FCA source-book glossary; FUND 3.2.6R; SUP 13.5.2R(6) and SUP 13 Annex 8 BR. |
<table>
<thead>
<tr>
<th>EU principle identifier</th>
<th>EU principle</th>
<th>Source</th>
<th>EU principle content description</th>
<th>Transposition into UK through either legislation or the FCA rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUP3</td>
<td>Ongoing regulatory oversight measures</td>
<td>AIFMD Chapter I and Chapter IV</td>
<td>ESMA is the designated oversight authority within the EU, together with the home authority of each member state. Annual reporting is required upon request to investors and must be provided to authorities within the member state. Disclosure of investment strategies, the objective of the AIF, change procedures relating to investment by the AIF and descriptions of the main legal implications of contractual relationship between the AIF and investors must, amongst other information, be disclosed according to articles 22 and 23 of the AIFMD. Article 24 stipulates the reporting obligations to competent authorities, and Chapter V holds provisions regarding the management of specific AIFMs, for example, a leveraged AIF, and any ancillary information requirements, supervisory cooperation necessities or limits to leverage (Article 25).</td>
<td>Regulation 59(2)(b) and (3)(a) AIFMR.; Section 165 FSMA as extended through regulation (71(1) of the AIFMR; Regulation 66;67(1)-(3); Section 1B of the FSMA and regulations 68(1)-(6) of the AIFMR.</td>
</tr>
<tr>
<td>EUP4</td>
<td>Third-party services provision, registration and supervision</td>
<td>AIFMD</td>
<td>Article 20 of the AIFMD deals with the delegation of tasks of an AIF to third parties. Competent home member state authorities must be notified and an AIF would need to show that: - it can justify delegating the entire delegation structure for objective reasons; - the delegate can dispose sufficient resources to effectively conduct business and is of good standing and sufficiently experienced; - where risk or portfolio management functions are delegated, these must be subject to supervision and prior approval from the home member state authority; - when risk or portfolio management is conferred under a third-country undertaking, cooperation between the home member state’s competent authority and the supervisory authority of the undertaking must be confirmed; - their effectiveness of supervision and an AIF should at all times act in the best interest of the investor; - that the AIFM delegate is qualified and able to undertake the functions in question and that selection was made with due care. AIFMs’ liability towards investors and the AIF will not be affected as a result of delegation.</td>
<td>Sections 55L and 166 of the FMSA; Regulation 24 of the AIFMR; Regulations 26-32 of the AIFMR. Regulation 67(4) of the AIFMR.</td>
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<td>EU principle identifier</td>
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<tr>
<td>EUP5</td>
<td>Information disclosure</td>
<td>AIFMD</td>
<td>Section 8 of the AIFMD requires member states to comply with all conditions set by the directive. Article 7(2) with regard to obtaining authorisation information on the persons conducting the business of the AIFM must be provided together with the identities of shareholders or members directly or indirectly involved, whether natural or legal persons, who have qualified holdings. The amount of holding must also be provided, amongst other important required information. Information on relation to depositaries must be regulated in terms of such contracts to allow the depositary to provide its services in accordance with Article 21 and the remainder of Section 4. In accordance with transparency requirements captured in Chapter IV annual reports including financial information should also be provided to regulators and investors (Article 22). Information should be provided directly to investors covered in section 23 of the AIFMD. The information should include descriptions of investment strategies, the objectives of the AIFMs, the types of assets involved, etc. Article 24 states the requirements for information disclosure obligations to competent authorities.</td>
<td>Regulations 59(2)(b), 59(3)(a) and 66 of the AIFMR. Section 165 of the FSMA. FUND 3.2.2R–FUND 3.2.6R FUND 3.3.2R–FUND 3.3.6R</td>
</tr>
<tr>
<td>EUP6</td>
<td>Industry practice development</td>
<td>AIFMD  ucits</td>
<td>Development and implementation of good industry practices exist and provide for direct retail investment subject to stringent leverage, liquidity, marketing and other rules in accordance with the AIFMD. (Articles 3, 4, 5, 15, 16 of the AIFMD)</td>
<td>Regulation 9(1)(a)-(b) and (2) of the AIFMR. Regulation 2(2)(a) of the AIFMR. FCA sourcebook glossary. FUND 3.7.2R–3.7.7R regarding risk and liquidity management in terms of FUND 3.6.2R–FUND 3.6.3R.</td>
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<tr>
<td><strong>EUP7</strong></td>
<td>Global oversight and cross-border risk management</td>
<td>AIFMD</td>
<td>The AIFMD aims for the establishment of common requirements governing the authorisation and supervision of AIFMs. This is done so as to provide a coordinated approach to any risks related to the management and/or functioning of AIFMs within the EEA and their resulting impact on markets and investors within the EU. By providing for an internal market for AIFMs, together with a stringent regulatory and supervisory framework, a uniform set of rules are established for all activities of AIFMs within the EU. An example of this is Article 43 which determines cross-border marketing of AIFs to retail investors, irrespective of whether they are EU or non-EU AIFs. Articles 44-46 of the AIFMD provide requirements for established competent authorities within member states and their powers, etc. (Article 66.)</td>
<td>No specific transposition is required for instance with regards to Article 43 except for providing information to the Commission and ESMA. Member States may impose stricter requirements on the AIFM or and AIF where marketed to professional investors that will only be applicable to those established within its borders. Regulation 46 AIFMR and selected amendments to section 277 and 277A of the FSMA. With regards to competent authorities the AIFMR in general will find application. In terms of risk management Regulation 4(2) of the AIFMR and Article 51ZC of RAO also applies.</td>
</tr>
<tr>
<td><strong>EUP8</strong></td>
<td>Hedge fund conceptualisation and definition</td>
<td>AIFMD</td>
<td>The definition of an AIF classifies hedge funds, amongst other fund types such as venture capital funds, as CISs not covered by the UCITS regulatory regime (article 4). AIFs are widely defined as CISs that undertake to raise capital from a wide range of investors with the aim to invest the funds in accordance with a defined investment policy for the benefit of the investors. AIFSs do not require approval under article 5 of UCITS.</td>
<td>Regulations 2, 3 and 4(1) of the AIFMR.</td>
</tr>
<tr>
<td><strong>EUP9</strong></td>
<td>Investment qualification criteria</td>
<td>AIFMD UCITS</td>
<td>To enable investment through retail or qualified investors, registration and adherence to the AIFMD must take place where the intended manager or fund qualify as such. The provisions include the regulation of risk management incentives, capital requirements, liquidity requirements, provisions regarding investment securitisation positions, rules regarding remuneration, rules for valuation, to name a few. (Articles 43, 64-65, 66.)</td>
<td>Regulation 1 AIFMR.</td>
</tr>
<tr>
<td><strong>EUP10</strong></td>
<td>Investment vehicles</td>
<td>UCITS AIFMD</td>
<td>Investment vehicles or structures are governed under existing legislative provisions within member states qualifying as legal structures which may be utilised as CISs.</td>
<td>FSMA. See 5.6.1 of this chapter for detail.</td>
</tr>
<tr>
<td>EU principle identifier</td>
<td>EU principle</td>
<td>Source</td>
<td>EU principle content description</td>
<td>Transposition into UK through either legislation or the FCA rules</td>
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<tr>
<td>EUP11</td>
<td>Risk management</td>
<td>AIFMD Chapter III</td>
<td>General requirements for effective risk management are captured within the AIFMD, and risk taking that is inconsistent with existing risk profiles, instruments of incorporation or rules in relation to AIFs managed is discouraged. Articles 13 and 15 capture rules in relation to the separation of risk management functions from those of portfolio management. Articles 16, 17 and 18 address liquidity management, investment in securitisation positions and the proper and consistent management of AIF asset valuations respectively. Appropriate human and technical resources should always be available. Home member states within the EU must ensure that the AIFM has sound administrative and accounting procedures, as well as control and safeguard arrangements for electronic data management. Amongst others, transactions involving an AIF must be able to be reconstructed according origin, nature, time and place when affected. Where risk or portfolio management functions are delegated, it must only be conferred to undertakings authorised and registered for such purpose, subject to supervision, and, if required, approval be obtained from the competent authority within the member state in accordance with article 20 concerning delegated functions. (See also Article 66.)</td>
<td>Article 4(2) of the AIFMR. Article 26 of the AIFMR relating to required approval for the delegation of functions by full-scope AIFMs. Article 51ZC regarding the performance of risk management by a person who manages an AIF.</td>
</tr>
</tbody>
</table>

Source: Author’s representation based on AIFMD, AIFMR and the applicable FCA sourcebook
CHAPTER 6 THE RISING EDIFICE FOR THE REGULATION OF HEDGE FUNDS IN SOUTH AFRICA

6.1 Introduction

This chapter provides the background to financial regulation in the South African context. This context, together with similar settings, was elaborated on in the previous chapters. The ensuing arguments serve as the foundation for the discussion on the regulation of hedge funds and how more recent developments within the South African hedge fund regulatory landscape measure in respect to international good practice. The discussion progresses from the restructuring of the South African financial regulatory architecture, which influenced the new regulatory structure for hedge funds in the country directly, towards how retail funds are regulated and whether the investor protection measures or principles adequately align with or resemble international good practice in this respect. Figure 6-1 illustrates the progression of the study towards determining applicable regulatory principles for the final benchmarking exercise in Chapter 7.

Source: Author’s representation.

Figure 6-1: Schematic thesis progression: Phase 2, Chapter 6

Changes to the structural underpinning and layout of the South African financial sector due to the Twin Peaks reform process, together with specific developments in the regulation of hedge funds subsequent to the financial crisis, have propelled the regulation of this category of alternative
investment formally into the focus of domestic regulators. They have also given rise to an encapsulating approach which incorporates both direct and indirect measures regulating financial instruments and institutions.

This chapter commences with a brief discussion of developments in the South African financial sector and its regulation towards the implementation of the Twin Peaks structural reform process. Thereafter, the regulation of hedge funds will be set out. The regulation of retail investment in hedge funds as the primary focus of this study will then be assessed and retail investor protection principles identified. These principles will be benchmarked against international good practices documented from the global securities standard setting body in Chapter 2, together with any relevant good practices identified from the jurisdictions discussed as per the stated demarcation of the study.

During the latter half of the twentieth century, the South African economy was characterised by vigorous enterprise within its financial sector. This transformed a relative dormant colonial sector in the 1950s to a modern, multi-faceted financial sector in the early 1990s. With the development of Discount Houses, Merchant Banks and Union Acceptance in the late 1950s, it became clear that the pace of innovation and development within the South African financial sector was escalating. The rapid economic growth of the gold standard during this period increased the importance of monetary policy and provided a proper foundation for the bustling growth of the Johannesburg Stock Exchange (JSE) during the decades to follow. The impact on the financial sector during this period was threefold: the evolution of the money market, the transformation of the capital market, and the development of a wide variety of financial institutions built around leasing, factoring, instalment credit and industrial finance (Jones, 1992:1).

Of all the vast ranging changes which occurred, commercial banks bore the brunt. This was due to the growth of large conglomerate financial holding companies based on the foundations laid by old corporate imperial banks (Jones, 1992:1). The expansion of financial institutions was a phenomenon reaching far wider than just the borders of South Africa. The South African financial structure was modelled on and mirrored that of the British, rather than that of the US or Germany during this developmental period. From the late 1950s and early 1960s the world economy did not just expand on a substantial scale but became more complex and volatile as flows of so-called hot money grew much larger. These flows of money further responded much more rapidly to changes in interest rates, as well as fears of currency devaluation or expected revaluation on currencies (Jones, 1992:2).

In comparison with the US and Europe, the South African economy was far less complex and underdeveloped and not a “free economy” as its Western counterparts. Exchange controls were
applied to residents since 1950 and to non-residents since 1961. Government intervention was passive in all sectors within the economy. By international standards, South Africa’s economy, largely subsistent and semi-subsistent in nature, acted as a rein on development. The importance of South Africa to the rest of the world was largely based on the extent of its gold reserves and the fact that it supplied most of the world’s new gold supplies during the 1950s (Jones, 1992:2). South African gold was used as collateral to secure international economic acceptance. Gold was utilised to underwrite the balance of payments and removed constraints on imports. Before the 1980s South Africa lethargically followed international trends when it came to regulation and regulators rarely considered trends beyond their own jurisdictional scope. Capital ratios were determined simplistically using ratios of capital to total assets. Derivatives and off-balance sheet activities were unregulated.

Consolidated supervision and financial sector components were regarded as separate national entities and, consequently, separately regulated (Botha & Makina, 2011:32; Falkena et al., 2001). Differently put, an institutional approach was followed, with supervisory cooperation at an international level only a suggested inkling (Cooke, 1999:27; Falkena et al., 2001). In addition, political isolation contributed towards a further shift from international good practices. Between 1965 and 1980 the South African financial sector was heavily regulated and only after the establishment of the De Kock Commission in 1987 did deregulation start to take effect. Authorities realised that institutional regulation had resulted in overregulation within the banking sector to the extent that it became inefficient and uncompetitive (Botha & Makina, 2011:32). Functional regulation and risk-weighted equity rules were proposed and implemented through the Banking Act of 1990 based on first-world criteria and principles. This regulatory structure, which focused on risk management, became partially integrated in both the central bank regulation of the banking sector and the regulatory approach of the non-bank financial sector. In 1993 the government-sponsored Melamet Commission recommended the adoption of a unified regulatory approach that was in line with developments in many European countries with a similar financial system. Since then the structure of the South African financial system has remained functionally and partially integrated until this day (Botha & Makina, 2011:32). International assessment of the South African financial system and its regulation has been occurring regularly as part of the country’s involvement in multilateral institutions including the FSB and the IMF (IMF, 2014; IMF, 2015).

Suggested areas of reform have included inter-agency coordination, regulatory structural adjustments and the regulation of OTC derivatives markets (FSB, 2013; IMF, 2015). These areas of reform have impacted on the structure finally implemented through the Twin Peaks reform process. The South African financial structure and newly enacted reforms will be elucidated within the following subsections. A financial sector forms part of a country’s core support of its real
economy. It also introduces risk and specifically so when taking factors such as the pace of innovation, complexity and specialisation into account (National Treasury Policy Document, 2011). The 2008 financial crisis highlighted these risk attributes, and many years after the fact financial stability is still an outcome to be continually aspired to. Attention will be paid briefly to structural financial reform in South Africa and its current stance about the broader financial sector reforms post the 2008 crisis. This discussion will form the foundation towards the formal incorporation of hedge funds within the South African regulatory landscape. Focus will then shift to South African regulation of retail hedge funds and its governance of retail investments therein for purposes of assessment against the international good practices identified throughout this study.

6.2 South African financial sector regulatory reform: A safer financial sector to serve South Africa better

Since 2011, South Africa’s financial sector has undergone much scrutiny (FSRA, 2017; National Treasury Policy Document, 2011) through international supra-national country or system evaluations, as well as internal evaluation by means of implemented sectoral reform processes. The financial services sector in South Africa is well developed, much like that of advanced economies. Regulatory matters are regarded important to warrant the attention of authorities both nationally and internationally (Botha & Makina, 2011:31). South Africa is a member of the G20, the Bank of International Settlements (BIS) and has one seat on the FSB which coordinates regulation at an international level. The global 2008 financial crisis showed that the soundness of a country’s financial sector has direct influence on the soundness of its economy and that of other economies. Although South Africa’s financial institutions were buoyant in facing the financial crisis, the crisis still impacted the country’s economy negatively. It should, at this point, be stated that broader investor protection measures within the South African legal landscape are captured in several pieces of legislation and accompanying regulations; however, this study does not intend to incorporate all legislative provisions in this regard. This chapter focuses on the legislation which directly impacts hedge funds regulation, and that of retail hedge fund investment in specific, to keep the discussion within the demarcated framework.

The discussion on financial sector reform in South Africa first focuses on the policy and legislative build-up towards the continuous restructuring of the financial sector post the financial crisis and secondly on the regulation of hedge funds and retail hedge funds in particular. After the South African position on retail hedge fund regulation has been portrayed, the regulatory practice vis à vis international good practice will be indicated.

A country’s financial service sector forms the core of its economy. Financial services not only make daily transacting possible, but channel savings aspirations and retirement requirements and
provide insurance for personal disaster (National Treasury Policy Document, 2011:1). The National Treasury Policy Document, *A safer financial sector to serve South Africa better* (hereinafter “policy document” or “the policy document”), initiated the financial sector reform process. This document was published in February 2011 as the proposed framework from where restructuring would commence. Policy changes targeted four objectives in the new framework under consideration, namely financial stability, consumer protection and market conduct, expanding access through financial inclusion, and the combat of financial crime, as depicted in Table 6-1 (National Treasury Policy Document, 2011:4).

**Table 6-1:** Holistic approach to financial sector structural reform in South Africa

<table>
<thead>
<tr>
<th>Financial stability</th>
<th>Consumer protection</th>
<th>Access to financial institutions</th>
<th>Combating financial crime</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Reserve Bank to lead</td>
<td>• FSB and National Credit Regulator to lead</td>
<td>• Treasury to lead</td>
<td>• Enforcement agencies to lead</td>
</tr>
<tr>
<td>• Establish a Financial Stability Oversight Committee</td>
<td>• New market conduct regulator for banking services in the FSB</td>
<td>• Further support to co-operative and dedicated banks, including Postbank</td>
<td>• Investigating and prosecuting abuse</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Treasury to introduce a micro-insurance framework</td>
<td>• Continued work with international partners</td>
</tr>
</tbody>
</table>

Council of Financial Regulators ensures coordination where necessary


The principal approach taken by National Treasury was to bring a series of regulatory and legislative vicissitudes shifting towards a Twin Peaks model for financial regulation that would enable a safer and tougher prudential and market conduct framework. The process transitioned from the policy document to concept legislation and the more recent publication of the Financial Sector Regulation Bill of 2015 in October 2015. The Financial Sector Regulation Act was assented to on 21 August 2017, introducing the restructured regulatory approach. The importance of this legislation is that it directly influences how hedge funds in South Africa are governed under CISCA. IOSCO’s Technical Committee recognised that, to support G20 initiatives on global financial reform, it was necessary to have as much as possible support amongst different regulators in sharing information and expertise established. Recommendations on hedge fund regulation globally, or in specific jurisdictions, could not be delivered on in isolation (IOSCO, 2009b:8).

The financial crisis furthermore emphasised that, what may have seemed to be well-supervised financial institutions with appearances of being robust and having good risk management practices, in fact possessed risks which had gone unobserved for some time and wreaked havoc when they materialised (Claessens & Kodres, 2014:10). This perspective, therefore, makes the ongoing structural reforms within the South African financial sector relevant to this thesis. The offered
international good practices identified in accordance with the demarcation, together with the IOSCO principles on investor protection agreed to by member states highlighted within Chapter 2, will be used to evaluate and benchmark recent legislative and regulatory reforms pertaining to hedge funds in South Africa.

6.3 **Principles guiding financial market change within the South African financial sector regulatory reform process**

The 2008 financial crisis forced governments to reconsider their approach towards financial sector regulation. Focus was renewed to manage risk on a system-wide basis across an entire financial sector as a result of the 2008 financial crisis, and labelled a macro-prudential approach. A micro-prudential supervisory approach was initially seen to be sufficient, supervising mostly the prudential soundness of individual financial groups or institutions. The 2008 financial crisis simply highlighted that a narrow focus on individual firms may not reveal the build-up of macro-economic risks (National Treasury Policy Document, 2011:12). One key lessons learnt was that a holistic view of financial sector regulation should be undertaken. Furthermore, a “light touch” approach by way of self-regulation seemed to have lost credibility in the aftermath of the financial crisis. The requirement to support prudential regulation with effective regulation of market conduct was found to be essential to protect investors and reduce systemic risk (National Treasury Policy Document, 2011:12). It was highlighted that the global community should cooperate to determine sustainable solutions, and the importance of swift action in addressing regulatory issues was reiterated. These lessons contributed to a rethinking of the principles applied in regulating a complex and sophisticated financial sector (National Treasury, 2011:13). G20 leaders agreed that the regulatory scope should be extended to include private pools of capital, such as hedge funds. This initiated the focus on regulating previously unregulated entities or financial activities of which private pools of capital such as hedge funds formed part. The following governing principles proposed by South Africa’s National Treasury were part of the reform of its financial sector regulatory system. These selected principles in Table 6-2 guide the proposed reforms and are the most relevant for purposes of financial markets and accompanying regulatory reforms.

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89 Defined in the context as “the analysis of macroeconomic trends and how they interact with prudential soundness and stability of financial firms and the financial system”. 184
<table>
<thead>
<tr>
<th>Principle</th>
<th>Description</th>
<th>Content</th>
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<tr>
<td>1</td>
<td>Financial service providers must be appropriately regulated and/or licenced.</td>
<td>This principle deals with market entry and determines that it must be subject to an appropriate licensing or registration process, depending on the type of financial services provided. This, holds that all providers of a financial service should operate within the defined regulatory perimeter.</td>
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<tr>
<td>2</td>
<td>Regulation and supervision must be executed in a transparent manner.</td>
<td>Regarding appropriateness, regulation and supervision should be risk-based. The nature, scale and complexity of risks present in a regulated entity and the system should be in proportion.</td>
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<tr>
<td>3</td>
<td>The quality of supervision must be sufficiently powerful, interfering and effective.</td>
<td>The ability to supervise hinges on appropriate resources, authority, organisation and constructive working relationships with other agencies. For supervisors to act, they must have a clear and unambiguous mandate and operational independence. Furthermore, they should have accountability, a relationship with industry that avoids regulatory interment, and skilled staff at their disposal.</td>
</tr>
<tr>
<td>4</td>
<td>Policy and legislation are set by government and the legislature, providing the operational framework for regulators.</td>
<td>It is required that the executive should set a clear and transparent policy framework to be approved by parliament. Policy, though not determined by regulators, must be clearly demarcated to enable regulators to determine the supervisory framework.</td>
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<td>5a</td>
<td>Regulators must operate objectively with integrity and be operationally independent but must also be accountable for their actions and performance.</td>
<td>The framework in which regulators operate should be free from fear or favour based on entrenched operational independence</td>
</tr>
<tr>
<td>6</td>
<td>Regulations should be of universally applicability and comprehensive in scope to reduce regulatory arbitrage.</td>
<td>Individual institutions, or classes of institutions, should not indiscriminately be exempted from regulation and supervision.</td>
</tr>
<tr>
<td>7</td>
<td>The legislative framework should allow for a lead regulator for every financial institution that is regulated by a multiple set of financial regulators.</td>
<td>Where regulators are involved, the aim must be to coordinate supervisory activities. Financial institutions are usually regulated under more than one regulator. Regulators should be obligated to coordinate their activities in a formal manner through legislation or memoranda of understanding. The main regulator must ensure proper coordination and effective consultation amongst different regulators. It should take care to not accidentally or purposefully undermine other regulators.</td>
</tr>
<tr>
<td>8</td>
<td>Regulatory arbitrage must be avoided through effective coordination amongst the responsible ministries.</td>
<td>Financial institutions are in many instances regulated by legislation transcending different ministries within government. The respective ministers responsible for the administration of their legislation should allow for effective coordination to prevent regulatory arbitrage.</td>
</tr>
<tr>
<td>11</td>
<td>Market conduct oversight must be sufficiently strong to complement prudential regulation.</td>
<td>Market conduct oversight should be robust enough to complement prudential regulation.</td>
</tr>
<tr>
<td>15</td>
<td>Principles identified should reflect international standards.</td>
<td>This policy statement went so far as to confirm that, to the extent that any contradictions or inconsistencies in the above principles exist amongst local jurisdictional legislative or regulatory requirements, the international standards must apply.</td>
</tr>
</tbody>
</table>

Source: National Treasury (2011)
The good practices identified above would guide South African authorities to evaluate their current financial sector structure and overall approach to financial regulation. This approach to regulating the financial system as a whole will now be discussed.

6.4 The approach to the restructuring of the South African financial system

Given the need to strengthen and prioritise the market conduct supervision and powers, as well as prudential regulation, South Africa opted to explore the Twin Peaks approach. Initially, South Africa’s regulatory system was broadly modelled on systems in former British colonies such as Australia and Canada, but particularly the UK which originally adopted a single-regulator model (FRRSC, 2013; National Treasury Policy Document, 2011:28). The Twin Peaks model recognises different sets of skills needed for the prudential and market conduct oversight which is required within a unique financial system (IMF, 2014; IMF, 2015). The difference in philosophy and regulatory perspective between the two pillars of the Twin Peaks model is that the task of the prudential regulator is to maintain safety and soundness of financial institutions or funds whilst simultaneously ensuring that the solvency of these institutions or funds are maintained. The market conduct regulator, on the other hand, considers the customer (National Treasury Policy Document, 2011:28).

This philosophical and regulatory dissimilarity may conflict or even overlap at times, and the increased difficulty of separating these two perspectives in financial markets, pension funds and securities is acknowledged widely. This approach due to the obvious split between prudential and business conduct regulation, including that it is designed to capture the benefits of the integrated approach whilst addressing conflicts between prudential and conduct regulation, was deemed the best approach to financial regulation within the South African framework (National Treasury Policy Document, 2011:29). The structural reconstitution of the financial sector was also one of the areas for regulatory enhancement identified by the IMF during their 2014 Financial Sector Assessment Programme on securities regulation on South Africa (IMF, 2015). The Twin Peaks model represents the optimal means of ensuring transparency, market integrity and consumer protection. By implementing this model in South Africa, with its history of neglecting market conduct regulation, having a dedicated regulator in this regard, substantiates the approach to having an equally important oversight function as that of prudential regulation. The Twin Peaks approach creates more checks and balances than a single regulator and prevents the establishment of an authoritative decision-making body with an overly enhanced influence. The possibility of overlaps and duplication of work remains, but the ability is created to manage the occurrence thereof through formal conflict regulation bodies to ensure the least amount of disruption for both regulators and market participants (National Treasury Policy Document, 2011:29).
Under the regulatory dispensation prior to the initiation of the Twin Peaks restructuring process, the regulatory landscape was set out as reflected in Figure 6-2.

Figure 6-2: South African regulatory landscape prior to the Twin Peaks process

On 22 August 2017 the FSRA was enacted\(^\text{90}\) and the Twin Peaks model officially became the model of financial regulation adopted in South Africa. The FSRA’s stated purpose was the achievement of a stable South African financial system that supports sustainable growth and functions in the interest of financial customers. This supervisory framework established aims to work in conjunction with other financial sector laws to promote financial stability, the safety and soundness of financial institutions and to ensure the protection and fair treatment of financial customers.

In terms of the proposed regulatory structure in accordance with the changes envisaged through the implementation of the FSRA, the Twin Peaks model can be illustrated in contrast to the preceding structure as shown in Figures 6-3 and 6-4 as follows:

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\(^{90}\) The FSRA was published in the South African Government Gazette 41060, resulting in its enactment.
Figure 6-3: Financial regulatory framework divided between prudential and market conduct regulation prior to the FRSA

Source: Author's representation

Figure 6-4: Twin Peaks financial regulatory framework divided between prudential and market conduct regulation

The structural changes to the South African financial sector, as illustrated in Figures 6-3 and 6-4, envisioned the promotion of increased cooperation between regulators whilst establishing a foundation for effective and firm regulation. Hedge funds, in accordance with their designation under
CISCA, falls under the FCSA that is the designated authority. The FCSA IS responsible for their regulatory supervision, including, but not limited to, adherence to prescribed prudential, conduct or joint standards prescribed by the FSRA and/or CISCA (South Africa, 2002a). Both the FSCA and the PA came into operation on 1 April 2018, making the transition to the Twin Peaks model official (National Treasury, 2018). The following section of this chapter will turn towards the regulation of hedge funds and specifically that of retail hedge funds.

6.5 The rising edifice of hedge fund regulation in South Africa: Regulating retail hedge funds

In the latter half of 2012, National Treasury and the FSBSA published a joint proposal on hedge fund regulation (National Treasury, 2012b; National Treasury, 2012a). The proposal aimed to regulate and supervise hedge fund structures under CISCA through the insertion of a separate chapter in the act dealing with hedge funds. This proposal meant the amendment of this act, along with some issues regarding the facilitation of how the accompanying tax treatment would be structured, which had proven to be an obstacle during previous attempts to regulate hedge funds (National Treasury Policy Document, 2011:3; National Treasury, 2012b; National Treasury, 2012a). As the act regulates different types of CISs, hedge funds were brought within the ambit thereof through the promulgation of subordinate legislation in accordance with section 63 of this act.

On 25 February 2015 the Minister of Finance declared the business of a hedge fund as that of a CIS. In terms of this declaration, the business of a hedge fund was defined to be an arrangement in pursuance of which members of the public would be invited and permitted to invest money or other assets and which uses any strategy or takes any position that may result in such an arrangement incurring losses greater than its aggregate market value at any point in time. This definition included positions or strategies like leverage or net short positions, but is not limited to such (South Africa, 2015b).

The South African hedge fund industry experienced exponential growth in total assets under management between 2002 and 2016, as illustrated in Figure 6-5. In 2002, hedge fund industry assets were only R1.4bn, but grew to R68.6bn in 2016 (Novare Investments, 2017). It is worth noting that, since 2011, when formal discussions on financial sector regulatory reform commenced, total hedge fund assets under management in South Africa have almost doubled from an approximate R33.5bn in 2011 to R62n in 2015.

The increased asset allocation cannot be attributed to regulatory certainty, as this was a period during which the required extent of the regulation of hedge funds was assessed and extensively debated. Regulatory clarity because of such extensive market engagement countered much of
the uncertainty and could suggest that regulatory “certainty”, or rather the expectation thereof, necessarily contributed to hedge fund industry asset allocation in general. Although managers of hedge funds were regulated under FAIS, the uniformity between the hedge fund industry and the unit trust industry, as well as the introduction of additional risk management, reporting and supervisory requirements through CISCA, was significant (South Africa, 2002b; Novare Investments, 2016). Much of the asset increase during the period can be attributed to a combination of strong positive performance from managers, as well as net inflows into the industry (Novare Investments, 2014; Novare Investments, 2015; Novare Investments 2016).

Figure 6-5 illustrates hedge fund industry assets under management in South Africa between the periods 2002 and 2017. Increases in hedge fund asset allocation were furthermore directly attributable to a steady upsurge in investment by retail investors who added hedge fund strategies to their portfolios. This underscores arguments set out in earlier chapters that the drive towards retailisation of alternative investments like hedge funds requires regulators to actively pursue the reasonable regulation of such investments. Between 2016 and 2017, however, hedge fund assets decreased by approximately 9.1%. This decline could be attributed to in-house consolidation of product offerings by managers, inadequate performance or outflows due to global and/or local market conditions (Novare Investments, 2017).

Source: Novare Investments (2017)

Figure 6-5: South African hedge fund industry assets under management, 2002-2017

When the new regulation came into effect, the industry experienced much uncertainty, with a few trends emerging such as investors’ changing mandates and moving capital offshore, the consolidation of smaller hedge funds, and some funds not classifying themselves as hedge funds anymore. Hard fund closures increased from 15.9% to 19.5%, contributing to the decline between 2016 and 2017. According to Novare Investments (2017), this illustrates major hedge fund asset
managers’ intent to not dilute returns and to focus on satisfying return expectations of existing investors.

Figure 6-6 illustrates the hedge fund assets under management and net flows on the left axis and the year-on-year growth rate of assets on the right axis. The impact of new funds and fund closures was not significant regarding industry growth, whilst the economic climate can be regarded as the main catalyst for meagre fund performance over the last few years.

Source: Novare Investments (2017)

**Figure 6-6:** South African growth in assets under management in hedge funds, 2010-2017

Most of South Africa’s largest financial service providers offer hedge fund products counter to the belief that only boutique or niche investment houses primarily house hedge fund offerings. Figure 6-7 illustrates that most hedge fund assets are managed by financial firms that have in excess of R2bn worth of total assets under management (Novare Investments, 2017).
The drop in total assets under management between 2016 and 2017 has furthermore led to an almost 18% increase in concentration within the South African hedge fund industry when observing the top 10 largest hedge funds. Figure 6-8 illustrates this concentration over the past three years.

Since the inception of the new regulatory regime for hedge funds in South Africa, RIHFs have fared well given their formal inception at the end of 2015. About 30% of industry assets have been allocated to retail investment in hedge funds based on the regulation (Novare Investments, 2017:19). Figure 6-9 illustrates the allocation of assets amongst schemes within the South African hedge fund industry, indicating that some managers have opted not to launch new funds post the enactment of the new regulatory context.
6.6 The build-up towards legislating and regulating hedge funds in South Africa: Defining hedge funds

Regulation related to hedge funds has been present for some time in South Africa. Fund managers were regulated under FAIS which has been controlling the rendering of financial services since 2007 (National Treasury, 2012a; National Treasury, 2012b; South Africa, 2002b). Under FAIS the requirements in relation to hedge funds were that all fund managers have to be approved by the FSBSA as Category II Discretionary FSPs. Hedge fund managers in South Africa were required to become licensed and regulated by FSBSA in accordance with FAIS and its regulations. The regulations determined that, where any discretionary financial services are to be provided, which included hedge funds, the Category IIA license would be mandatory with the designation “hedge funds FSP” (National Treasury, 2012b; National Treasury, 2014:4). With the designation of hedge funds as CIS by the Minister of Finance during 2015, the requirements for registering as a CIS manager were changed. The declaration of hedge funds as CIS inaugurated the formal and direct regulation of this type of collective investment fund vehicle within South Africa (South Africa, 2015a). The commencement of hedge funds as an investment structure or option can be traced back several years to 1998 when the first single hedge fund manager was established in South Africa. Figure 6-10 illustrates the timeline of the regulatory development of hedge funds in South Africa.
In part as a result of hedge funds being designated as CISs, National Treasury and the FSBSA provided a definition of “hedge funds” for purposes of regulation by looking at its business activity. It is well known that the term “hedge fund” differs amongst countries and jurisdictions. In South Africa, initial proposals to define the term referred to funds that utilise some form of short asset exposures or short selling to reduce risk or volatility, preserve capital and enhance returns as hedge funds (Bouwmeester, 2005:27). Further proposals referred to funds that use some sort of leverage which holds that the gross exposure of underlying assets exceeds the amount of capital in the fund. Reference was also made to the fact that, in these funds, the manager of the fund charges a fee based on performance of the fund relative to an absolute return benchmark (Bouwmeester, 2005:31).

In terms of the Explanatory Memorandum on the Draft Regulations for Hedge Funds in South Africa published by the National Treasury, the most distinct component of hedge funds relative to other CISs is the use of leverage (National Treasury, 2012a; National Treasury, 2012b; National Treasury, 2014:4-5). In this document hedge funds are defined as CISs which use any strategy or take any position which could result in the portfolio incurring losses greater than its aggregate market value at any point in time, and whose strategies and/or positions include, but are not limited to, leverage or net short positions (National Treasury, 2014:5). This definition varies from the initial definition published in Government Notice 141, with only the removal of the reference to the invitation of the public to invest in such funds. This component is, however, incorporated through the inclusion of a specific type of hedge fund, namely the retail investment hedge fund.
which will be discussed in greater detail as the study progresses. Since April 2015, South Africa has established a comprehensive legal framework for regulating hedge funds of which industry statistics seem to indicate industry growth with assets under management reaching R5.1bn marking the 12 months to 31 December 2015, ending the year with assets of approximately R62bn (Asisa, 2018:1). The steady growth in assets is attributed to mostly allowing retirement funds to invest limited portions of their assets into hedge funds since 2011 (Asisa, 2018:1). Now that clear regulation is in place, this growth trend is expected to continue based heavily on investor access which was previously not possible. There is some concentration of fund assets at the moment with 70% of industry assets managed by only two hedge funds which were the first to register under the new regulatory auspices (Asisa, 2018:1).

As early as 2004 discussions commenced between industry bodies and regulators concerning the regulation of hedge funds. The domestic hedge fund industry was growing and consisted mainly of high-net-worth individuals and, in the case of offshore investment, institutional investors such as investment managers and pension funds (FSCA, 2004:6). Hedge funds at that stage were believed to have become a permanent addition to the South African fund management market. The FSBSA then considered how to accommodate hedge funds within the prevailing regulatory framework applying to investment managers and CISs, as well as the market conduct of product providers and financial intermediaries. The South African hedge fund market was, and still is, divided into two primary categories. The first provides access to offshore funds for South African citizens and institutions, and the second to domestic hedge funds investing in the local financial markets (FSCA, 2004:9). The industry utilised several different structures, including companies, trusts and limited liability partnerships, to provide investment products for mainly high-net-worth individuals. South Africa at that stage had no enabling legislation under which hedge funds as investment vehicle could be housed. In March 2003 the requisite framework would come into being.

CISCA provided the framework for the introduction of collective investment products and, together with FAIS, the FSBSA was given the ability to set minimum requirements for investment managers and, consequently, the theoretical framework for regulating hedge funds in South Africa (South Africa, 2002b; FSCA, 2004:9). In considering the regulatory framework, the FSBSA kept with the same regulatory principles employed in other areas regulated by them. The principles included (FSCA, 2004:10):
- preventing regulatory arbitrage amongst different financial sectors;
- creating a balance between innovation and the protection of new and existing investor interests;
- guarding against systemic instabilities;
ensuring disclosure of potential risks to new investors in the marketing of such products;
and ensuring fair treatment of retail investors.

The important aspect to consider at that time was whether managers, product structures, as well as the marketing and sales process, had to be regulated. Industry role players, as well as regulators, had laid the foundation for regulatory advancement towards the regulation of hedge funds in South Africa even before the financial crisis in 2008. This cohesive effort set the tone for existing legislative and regulatory provisions and formed the framework for how hedge funds and managers operate in South Africa. As stated earlier in this chapter, the designation of hedge funds as CIS brought about a different regulatory structure requiring different registration processes. This will now be outlined, and the most recent requirements discussed in the section to follow.

6.7 The incorporation of hedge fund schemes in South Africa

Hedge funds are incorporated and administered under the office of the Registrar of Collective Investment Schemes in accordance with CISCA. Owing to the legislative transition period provided for in CISCA, the office of the Registrar of CIS had most applicants fall into either one of two categories. CIS managers which pre-existed before hedge funds being declared CIS and who wished to operate as hedge fund managers, or, new managers that are required to register as such for the first time (FSBSA Application for Approval to Operate a CIS in Hedge Funds Process Outline, 2016). This process is illustrated in Figure 6-11.

![Figure 6-11: Approval process for the operation of hedge funds in South Africa](source)

Source: FSBSA Application for Approval to Operate a CIS in Hedge Funds Process Outline (2016).

“Managers” for purposes of this chapter refers to a CIS scheme manager and not an asset manager unless so specified.
The transition period allowed for the formal registration of hedge funds in terms of the enacted legislation. At the onset of this period, existing CIS managers, as illustrated in process A above, had the option of either utilising the current CIS licence to register a new scheme in hedge funds or lodge an application to register a new manager in accordance with section 42 of CISCA. In reaching their decision, managers had to decide whether they intend to register a hedge fund scheme as a QIHF or an RIHF. Managers also had the option to register one or both available schemes and/or multiples of each type of scheme. If the latter option to register a new manager was selected, the application defaulted to that of a new manager applying to register as such for the first time. However, the period allocated for the transposition to or configuration of existing funds has passed and now new managers or funds wanting to operate as hedge funds are subject to the requirements for hedge funds in terms of CISCA and must follow the relevant process. Figure 6-12 illustrates the possible CIS structure that can be adopted by a hedge fund when registering under CISCA.

Figure 6-12: Hedge funds adopting a CIS structure

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92 QIHFs, for purposes of the study, are distinguished from RIHFs primarily by the type of investor allowed to invest in the fund. A qualified investor is defined within the act to mean a person who invests a minimum of R1m per hedge fund investment and has a demonstrable knowledge and experience in financial and business matters which would enable such an investor to assess the merits of his or her investment and the risks associated thereto. A qualified investor could also mean a person who invests R1m per hedge fund and who has appointed a financial services provider who has demonstrable knowledge and experience to advise the investor regarding the merits and risks of a hedge fund investment.
As stipulated in the regulations, portfolios may only use an investment scheme trust arrangement or an *en commandite* partnership as legal structures. The approval and registration process requires approval in both instances. With more than 90% of industry participants having transitioned to the regulated space, most funds have been structured as CIS trusts whilst certain larger asset managers have opted to structure in limited liability partnerships in accordance with CISCA (Novare Investments, 2017:19). The section to follow will provide a detailed analysis of the provisions in accordance with CISCA.

6.8 **CISCA: Requirements for hedge funds deemed as collective investment schemes in South Africa**

CISCA contains restrictions prohibiting the use of certain OTC instruments, short selling and leverage. This has allowed limited exposure to derivative instruments for example. Owing to the restrictions placed on collective investments through CISCA, as well as the expanded mandates conferring broad investment powers on fund managers to pursue their alternative strategies, most hedge funds chose, and still choose, to operate outside the regulated environment provided for by CISCA.

The regulations for hedge funds promulgated in terms of CISCA aim to provide protection for investors, to assist and monitor systemic risk build-up within this market, and to promote the integrity, transparency and development of the hedge fund industry and the financial market in general. Initially, the proposed definition published in the government notice stated that hedge funds are to be defined as portfolios that use strategies or take in any position that might result in losses being incurred which could be greater than their aggregate market value, at any point in time. The definition furthermore included strategies and positions such as leverage and net short positions without limiting them to these options. A similar definition is found in Regulation 28 of the Pension Funds Act, which regulates investments by pension funds (National Treasury, 2014:4). This definition, formulated in accordance with the declaration of hedge funds as CIS in South Africa, is still accepted as the main definition of ‘hedge funds’ in South Africa (South Africa, 2015b).

The provisions enacted under CISCA determine that a hedge fund falls within the sphere of a collective investment scheme in securities (CISS). A CISS is defined as a scheme which may take whatever form (including OEICs) in which the public is permitted to invest money or assets in a portfolio. These provisions furthermore determine that such investment in a CISS requires two or more investors to contribute money or assets to and hold participatory interest in a portfolio of the scheme. This could be executed through the ownership of shares, units or any other form
of participatory interest. In addition, investors may only share risk in proportion to their participatory interest or any other basis agreed to in the deed (South Africa, 2002a).

In addition to the need for understanding what hedge funds are within the South African context, defined concepts in CISCA that include what is understood to be “members of the public”, “participatory interest” and “investor” should also be described to understand the regulatory setting that impacts retail investment in hedge funds.

CISCA regards “members of the public” to be not only individuals, but also sections of the public, clients, employees or even ex-employees of the person issuing an invitation to acquire participatory interest in a portfolio, as well as any financial institution regulated by any law. This is a broad definition and includes an extensive understanding of what is meant by “members of the public” for purposes of the ability to invest, to understand reporting requirements, and to market funds, amongst others. Participatory interest is defined by the act to include any interest or divided share thereof or unit or part thereof which may be acquired by an investor in a portfolio. Any such unit or interest would be included in the definition, whether its value varies or remains stable. Investors are regarded as holders of these interests within the borders of the Republic of South Africa (South Africa, 2002a). These concepts underpin the approach to how a CIS should be administered in general, including that it must be governed in the best interest of investors and the industry by the honest and fair employment of skill, care and diligence. They furthermore offer clarity when dealing with the respective types of hedge funds that can be registered and general or additional required precepts associated with retail funds in particular (South Africa, 2002a). Key concepts captured within CISCA and which apply to hedge fund managers and hedge funds themselves will be stated in the discussion to follow. It should be noted at this stage that, with the commencement of the FSRA, sections within CISCA were amended and/or repealed in totality. Where applicable, the impact of these changes will also be stated as part of the overall discussion. The amendments through the FSRA to CISCA established coherence on the topic of hedge funds as part of the larger financial sector regulatory landscape and its regulatory oversight structure by including it as a specific financial sector law under the FRSA. The FRSA’s aim was to achieve a stable financial system that supports balanced and sustainable growth within South Africa whilst working in the interests of financial customers. The Financial Sector Conduct Authority (FSCA) now fulfils the functions of the Registrar of CIS and, through the incorporation of the FSRA, additional standards were introduced which apply to a CIS.

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93 See Section 7 of the FSRA.
Any prescribed matter may include a prudential, conduct or joint standard introduced which may find application to a CIS.\textsuperscript{94} An example is the introduction of concepts such as the “supervisory on-site investigations” to CISs.

Furthermore, what is understood to be an “inspection” in terms of CISCA, carries the meaning of an investigation in terms of the FSRA.\textsuperscript{95} This coherence, amongst other examples of interaction between these acts, aims to foster collaboration and cooperation amongst industry regulators, as discussed earlier, regarding the recently established financial sector structure in South Africa.\textsuperscript{96}

From here, the discourse includes the type of hedge funds, service providers, reporting requirements, applicable asset class distinctions and investment parameters that influence the regulation of retail hedge fund offerings. Table 6-3 contains a portrayal of the general sections of CISCA that impact hedge fund regulation. These sections pertain to general duties in relation to the principles for the administration of hedge funds, provisions relating to hedge fund managers, requirements for the administration of hedge funds, powers of the “registrar”, and information disclosure.

\textsuperscript{94} See Section 1A of the FSRA.
\textsuperscript{95} See Section 129(1) of the FSRA.
\textsuperscript{96} See Section 76 of the FSRA for detail on cooperation and collaboration amongst financial sector regulators and the South African Reserve Bank.
Table 6-3:  CISCA provisions applicable to hedge funds in South Africa

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<tr>
<td>2</td>
<td>Principles for administration of a CIS</td>
<td>A CIS is required to be administered by a manager. Its administration must be done on a fair basis with the required skill, care and diligence and with investor interest, as well as the interest of the broader CIS industry, in mind. Investor assets must be properly protected through application of the principles of segregation of assets and clear identification.</td>
<td>Sections 1A and 7 of the FSRA</td>
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<tr>
<td>3</td>
<td>Disclosure of information</td>
<td>Before parties enter into transactions, the following information must be disclosed to investors: information about the investment objectives of the CIS, the calculation of the net asset value and dealing prices, charges, risk factors, and distribution of income accruals must be disclosed to the investor. Information that is necessary to enable the investor to make an informed decision must be given to the investor in time and in a comprehensible manner to enable proper decision making and risk appreciation.</td>
<td>Chapter 9 of the FRSA enables any authority under the FRSA or any other financial sector law to request information for compliance or in instances of contraventions by a supervised entity.</td>
</tr>
<tr>
<td>4</td>
<td>Duties of a manager</td>
<td>Managers should avoid conflict between the interests of the manager and the interests of an investor. The manager must disclose the interests of its directors and management to the investors and maintain adequate financial resources to meet its commitments and to manage the risks to which its CIS is exposed. Managers should also a) organise and control the CIS in a responsible manner; (b) keep proper records; (c) employ adequately trained staff and ensure that they are properly supervised; (d) have well defined compliance procedures; (e) maintain an open and co-operative relationship with the office of the registrar and must promptly inform that office about anything that might reasonably be expected to be disclosed to such office; and (f) promote investor education, either directly or through initiatives undertaken by an association. A manager would be able to, with the written approval of the registrar, delegate any function listed in the definition of “administration” to any person (in this section referred to as the “delegated person”). Actions or omissions by a delegate are regarded as those of the manager, and the registrar has the same influence over such a person as if he or she were the manager. Where a manager delegated any function listed in the definition of “administration” to any person without the prior approval of the registrar before the commencement of section 209 of the Financial Services Laws General Amendment Act, 2013, that delegation must be regarded as having been made for a period of six months, reckoned from the date of such commencement, during which period the manager must apply for approval, and after the expiration of that six-month period, the deemed period will expire.</td>
<td>Financial Services Laws General Amendment Act, 2013</td>
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## Collective Investment Schemes Control Act, 45 of 2002
### Regulating hedge funds

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<td>5</td>
<td>Requirements for administration of a CIS</td>
<td>Persons may not perform any act or enter into any agreement or transaction for the purpose of administering a CIS, unless such person is registered as a manager by the registrar or is an authorised agent; or is exempted from the provisions CISCA by the registrar by notice on the official website. The provisions of this act do not apply to the rendering of securities services by any “authorised user”, “clearing member”, “licensed central securities depository”, “licensed clearing house”, “licensed exchange” or “participant” as defined in section 1 of the Financial Markets Act, 2012, to the extent that the rendering of those services are specifically supervised under this act.</td>
<td>Financial Markets Act, 2012</td>
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<td>15-22</td>
<td>Powers of registrar [FSCA]</td>
<td>The Registrar of CIS has extensive powers in accordance with CISCA. These powers include that, after an investigation, and if it is within the best interest of investors, application may be made to a high court for the winding-up of a manager or a CIS. A curator may be appointed in terms of the Financial Institutions Protection of Funds Act, 28 of 2001. The registrar may require the appointment of additional trustees, instruct managers to wind-up, withdraw from the administration of a CIS or amalgamate with another portfolio. Failure to comply may constitute an offence, resulting in a fine or imprisonment or both.</td>
<td>Establishment of the FSCA in accordance with section 56 of the FRSA. Financial Institutions Protection of Funds Act, 28 of 2001.</td>
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<td>Sections 85, 91-96 and section 105 of CISCA</td>
<td>In instances where failure of a CIS is expected, or its failure is imminent, the registrar may require information from the manager and proposals as to the course of action to ensure financial soundness. This requirement means any requirement in terms of sections 85, 91-96 and 105 or any other requirement in terms of this act or other prudential standard, conduct standard or joint standard in accordance with the FRSA.</td>
<td>FRSA</td>
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<td>Section 16 of CISCA</td>
<td>The registrar may, subject to due process prescribed within section 16(2) of CISCA, cancel or suspend the registration of a manager where, amongst others, CISCA was not complied with, or where, upon finalisation of an investigation, the business of the CIS is deemed unsatisfactory or undesired or not in the best interest of investors.</td>
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<td>Section 17 of CISCA</td>
<td>Objection to information based on any good and/or sufficient reason made available to investors may be made by the registrar, requiring a manager to refrain from publishing and distributing any relevant documents.</td>
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<td>Section 18 of CISCA</td>
<td>Fines may be imposed by the registrar in cases of failure by any manager or third party to submit reports or any documentation or information subject to proper notice.</td>
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<td>Section 19 of CISCA</td>
<td>Managers may be directed by the registrar to audit financial records, statements or accounts within a specified timeframe.</td>
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<td>Section 22 of CISCA</td>
<td>The registrar is able to exempt a manager or any category of persons from any provision of CISCA on any conditions so determined when it is in public interest.</td>
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### Collective Investment Schemes Control Act, 45 of 2002

#### Regulating hedge funds

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<td></td>
<td>Collective Investment Schemes in Securities: provisions applicable to CIS in hedge funds as declared CIS</td>
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<td>Section 63 of CISCA</td>
<td>Declared CISs are schemes other than those in participation bonds, securities or property in accordance with section 63 of CISCA.</td>
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<td>Section 64 of CISCA</td>
<td>The FSCA, recently established in accordance with section 56 of the FSRA has the authority to declare a specific type of business a CIS. It may define the business activities, specify matters to be included within the deed of the declared CIS, and issue different notices for different types of CIS so declared.</td>
<td>Hedge funds as declared CIS in terms of section 63 of CISCA.</td>
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<td>Section 41 of CISCA</td>
<td>The provisions in this section apply, to the extent possible, to CIS in hedge funds, together with the necessary changes to be read in the respective sections.</td>
<td>The provisions of sections 41 to 43, 45 and 46 respectively apply to CIS in securities and are applicable to CIS in hedge funds.</td>
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<td>Section 42 of CISCA</td>
<td>This section concerns restrictions on the administration of CIS in hedge funds. A company must register as a manager of a CIS in terms of section 42 and may not act as an authorised agent to administer any CIS scheme in securities. Companies which qualify are companies registered in accordance with the Companies Act 71 of 2008 and with the capital reserves in terms of section 88 available for employment in the CIS. A contravention of this section is deemed an offence in terms of CISCA.</td>
<td>Section 88 of CISCA stipulates that the registrar may determine the liquidity requirement of a CIS to be maintained based on risks or other matters associated with the CIS.</td>
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<td>Section 43 of CISCA</td>
<td>The procedure for registration as a manager in terms of CISCA requires applications to be lodged to the registrar for determination together with the applicable fee. The registrar will proceed with registration based on the content of the deed, the qualification of the respective directors, trustees, management, custodians or auditors, and whether they qualify as such in accordance with the requirements in CISCA.</td>
<td>The requirements in terms of the determination on the requirements for hedge funds published under BN 52 Government Gazette 38540 of 6 March 2015 as amended by BN 70 in Government Gazette 38626 of 1 April 2015 should also be read with the prescriptions in CISCA.</td>
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<td>Section description</td>
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<tr>
<td>Section 45 of CISCA</td>
<td>A manager may invest in foreign securities or assets of a portfolio of a CIS in equity or non-equity securities. Such a foreign entity should, however, comply with the following: With regard to non-equity securities, it is required that issuers be located in a country that has a foreign currency sovereign rating, and that such issuer has a long-term issuer credit rating on the international scale endorsed by a rating agency, of which the ratings and rating agency must be determined by the registrar in South Africa. It is furthermore provided that, if the country or the issuer has been rated by more than one agency, the lower of the ratings will apply. Also, where non-equity securities are concerned, the manager has applied the due diligence guidelines for issuers determined by the registrar to such securities in process of consideration. Where equity securities are traded on an exchange that has been granted full membership by the World Federation of Exchanges, a manager may invest in such foreign equities. Where a manager has applied the due diligence guidelines determined by the registrar, equity securities listed on an exchange to which the manager has applied such due principles may also be traded.</td>
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<td>Section 46 of CISCA</td>
<td>The registrar has the ability to determine the way in which, the limits and conditions subject to which securities or classes of securities could be included within a portfolio. The registrar may furthermore determine different ways, limits and conditions for individual securities, or classes of securities, or different portfolios in relation to a CIS in hedge funds.</td>
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In addition to the respective sections of CISCA stated in Table 6-3, specific requirements were promulgated in terms of the Determination on the Requirements on Hedge Funds. These requirements related to the respective hedge funds structures will be stated briefly below.

6.9 Regulatory framework in accordance with the Determination on the Requirements on Hedge Funds in South Africa

The objective of the Determination on the Requirements on Hedge Funds, which was made in accordance with CISCA, has several aims that include investor protection, a focus on systemic risk, the promotion of financial market improvement, and the enhancement of transparency whilst simultaneously promoting integrity within the hedge fund industry. Certain general provisions within the regulations apply equally to both types of hedge funds and will be displayed first in Table 6.4. Others apply to QIHFs and RIHFs respectively and will be clustered as such. These requirements are incorporated in the discussion that follows.

Certain general requirements find application to all types of hedge funds. These requirements are summarised in Table 6-4.
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<td>18</td>
<td>Platforms and hosting arrangements</td>
<td>“(1) A manager may establish a scheme as a platform for purposes of creating or hosting different portfolios which are administered independently of each other and managed by different FSPs. (2) A manager, in establishing a platform - (a) must comply with the principle of segregation and identification; (b) must ensure that the assets included in each portfolio on its platform are properly protected from creditor claims; (c) may not permit the assets of one portfolio to be used to meet the liabilities of any other portfolio of the scheme; and (d) must ensure that the name of each portfolio on its platform bears the name of the manager and that of the relevant FSP.”</td>
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<td>19</td>
<td>Fund administration</td>
<td>“(1) A manager must conduct proper due diligence when appointing a fund administrator and must ensure that its fund administrator- (a) is an FSP; (b) is a juristic person; (c) is domiciled in the Republic; (d) has the requisite experience, knowledge and capital; and (e) has adequate internal controls and systems to ensure proper administration of the portfolio. (2) Despite the provisions of subparagraph (1), where the assets of the portfolio are held in a foreign country, the manager may appoint a fund administrator regulated by an appropriate supervisory authority and subject to on-going supervision by that supervisory authority, to perform the functions of a fund administrator. (3) Where the manager itself performs the fund administration services, the registrar may request an independent verification of the appropriateness of the administration system and capabilities.”</td>
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<td>20</td>
<td>Prime broker</td>
<td>“(1) A manager may only appoint a prime broker, that is- (a) an authorised user that has been admitted as an equity member under the exchange rules defined in the Financial Markets Act, 2012; or (b) a bank. (2) A manager must act with due skill, care and diligence when appointing a prime broker, and only appoint a prime broker that- (a) is financially sound at all times; and (b) has the necessary organisational structure appropriate for the services to be provided to the portfolio. (3) A manager must ensure that it is conversant with all counterparty and prime broker legal agreements, including re-hypothecation arrangements.”</td>
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<td>21</td>
<td>Counterparties</td>
<td>“(1) A hedge fund may only invest in derivative instruments where the counterparty is- (a) the South African Government; (b) a bank; (c) a long-term insurer registered or deemed to be registered as a long-term insurer under the Long-term Insurance Act; (d) a short-term insurer registered or deemed to be registered as a short-term insurer under the Short-term Insurance Act; (e) a clearing house; or (f) an authorised user; (g) a person outside the Republic who is registered, licensed, recognised, approved or otherwise authorised to render services or conduct the business of a bank or a business referred to in paragraphs (b) to (f) by a foreign regulator with functions similar to those of the registrar, the Registrar of Banks, the Registrar of Financial Services Providers or the Registrar of Long-term or Short-term Insurance. (2) A manager must conduct appropriate stress-testing to assess counterparty exposure and the impact of a change in the risk profile of the counterparty on financing and collateral requirements.”</td>
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<td>22</td>
<td>Valuation and pricing</td>
<td>&quot;(1) A manager must establish, maintain, enforce and document a policy which outlines the procedures and methodologies for the valuation of the assets held in or used by each portfolio. (2) A manager must ensure that the valuation methodology is consistently applied according to the valuation policy. (3) The valuation policy must: (a) be reviewed periodically to ensure continued appropriateness; (b) provide for the obligations, roles and responsibilities of all parties involved in the valuation process, including, where applicable, the fund administrators; (c) provide for all listed securities to be priced according to market prices as contemplated in section 44 of CISCA, and unlisted securities to be priced according to a generally recognised methodology approved by the custodian, or where applicable, by the fund administrator; (d) in the case of a retail hedge fund: - (i) provide for pricing that is at least equal to the purchase and repurchase date; (ii) ensure that daily valuation is conducted, and that a requirement to provide daily valuation is included in the founding document; (e) in the case of a QI fund, ensure that - (i) pricing takes place at least equal to the purchase or repurchase dates of the relevant portfolio, whichever is more frequent; and (ii) valuation is performed monthly; (f) ensure that an appropriate level of independent review is undertaken for each valuation and in particular any valuation that is influenced by the manager or the hedge fund FSP; (g) describe the process for handling and documenting instances where the manager has disagreed with the valuations or established a contrary price, including providing for the review by an independent party; (h) provide for initial due diligence investigations performed by a person, other than a manager, of any person that is appointed to perform valuation services; (i) ensure that the valuation methodology is transparent and available to investors; and 0) when using models for valuations, ensure- (i) that the model is included in the valuation policy; (ii) that the valuation procedures and policies indicate the main features of the model; and (iii) that the model is subject to independent validation, by a person who- (aa) was not involved in the process of developing the model; and (bb) has adequate competence and experience in the valuation of assets using such models.&quot;</td>
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<td>23</td>
<td>Remuneration and reward policy</td>
<td>“A manager must have a remuneration and reward policy that ensures- (a) the interest of the investors are aligned with those of the manager; and (b) sound and prudent risk management and risk-taking which is consistent with the relevant risk profile of the portfolio.”</td>
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<tr>
<td>24</td>
<td>Risk management, risk management policy and risk manager</td>
<td>“ (1) A manager must establish, document, maintain, and enforce a risk management policy, which must provide for the management of operational risk, business risk, liquidity risk, and credit-counterparty risk, appropriate to the nature, scale and complexity of its business, and for- (a) the measures, techniques and procedures which must be employed to measure and manage risks, including risk measurement techniques to carry out stress tests, back tests and scenario analysis appropriate to each portfolio’s investment strategy, taking into account the different risk profiles that may apply to each portfolio; (b) appropriate and timely corrective actions, where stress tests and scenario analysis reveal particular vulnerability to a given set of circumstances; (c) the frequency with which stress tests and scenario analyses must be conducted depending on the nature of the portfolio, the investment strategy, liquidity profile, type of investor and repurchase policy of the portfolio; (d) independent performance of the risk management function, including details of the allocation of responsibilities within the manager for risk management and operating procedures; (e) risk management to be performed on a daily basis; (f) appropriate internal control mechanisms to avoid or mitigate operational failures, including professional liability risks; and (g) procedures to ensure- (i) on-going monitoring of the total value of the assets under management; and (ii) adjustments to the amount of coverage for professional liability risks following any significant change in assets under management. (2) A manager must review the risk management policy when necessary, but at least annually. (3) A manager must establish a risk function separate from its investment management function and fund administration function, which function must- (a) determine the risk management policy of the hedge fund; (b) conduct active risk measuring; (c) perform risk monitoring and reporting; and (d) ensure, on a daily basis, that the risk limits are complied with.”</td>
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"A manager must take reasonable steps to ensure the best possible execution result for a transaction, taking into account price, costs, speed, likelihood of execution and settlement, the nature and size of the order and any other consideration relevant to the execution of the order."

"(1) A manager may engage in physical short selling and derivatives creating short positions. (2) Naked short selling, which in this context means the selling of a security without being in possession of the security or ensuring that it can be borrowed, is not allowed."

"Despite the requirements determined by the registrar under Board Notice 92 of 2014 published in Government Gazette No 37895 of 8 August 2014, the provisions apply in respect of the disclosure and reporting of information to investors by a hedge fund."

"The following information must be provided to a potential investor before investing in a portfolio - (a) the name of the hedge fund and of the manager stated clearly and unambiguously; (b) the name of the portfolio; (c) the date of establishment of the portfolio; (d) a list of all portfolios in the hedge fund; (e) names of the members of the board of the manager; (f) the legal structure of the portfolio; (g) accounting and distribution dates of the portfolio; (h) a description of the investment strategy and objectives of the portfolio and all associated risks; (i) a description of the procedures by which the portfolio may change its investment strategy or investment policy, or both; (j) whether the portfolio invests in underlying funds; (k) a description of the types of assets in which the portfolio may invest; (l) any investment restrictions applicable to the portfolio; (m) the circumstances in which the portfolio may use leverage, the types and sources of leverage permitted and the associated risks, any restrictions on the use of leverage and any collateral and asset re-use arrangements, and the maximum level of leverage which the portfolio is entitled to use; (n) where applicable, the identity of the hedge fund's depository, custodian, fund administrator, prime broker, auditor, hedge fund FSP and any other service provider and a description of their duties; (o) where applicable, a description of any material arrangements of the manager with a prime broker or other counterparty, including - (i) the manner in which conflicts of interest are managed; (ii) any provision in the contract with the custodian and depository on the possibility of transfer and re-hypothecation of assets; and (iii) the level of counterparty exposure; and (iv) the methodology of calculating counterparty exposure; (p) a description of any delegated administration function and of any safe-keeping function delegated by the depository, identification of the delegated person and any conflicts of interest that may arise from such delegations; (q) a description of the portfolio's valuation and pricing methodologies; (r) a description of the liquidity risk management of the portfolio, including - (i) the manner in which conflicting interests are managed; (ii) any provision in the contract with the custodian and depository on the possibility of transfer and re-hypothecation of assets; and (iii) the level of counterparty exposure; and (iv) the methodology of calculating counterparty exposure; (s) any gating, side pocket or repurchase restrictions that may exist in the portfolio and how those restrictions may be triggered; (t) any special repurchase arrangement or rights of some investors; (u) a description of all fees, charges and expenses and the maximum amount thereof which is borne directly by investors; (v) a description of all charges paid by the portfolio; (w) a description of how the manager ensures fair treatment of investors; (x) whenever an investor receives preferential treatment or has the right to receive preferential treatment, including ring-fencing arrangements - (i) a description of that preferential treatment; (ii) the type of investors who may receive such preferential treatment; and (iii) where relevant, those investors' legal or economic relationship with the manager or the portfolio; (y) the latest annual report referred to in section 90 of the Act; (z) the procedure and conditions for the issue and sale of participatory interests of a portfolio; (A) the latest net asset value of the portfolio and the latest price of the participatory interests of the portfolio; and (B) a description of how and when the quarterly reporting under subparagraph (2) will be provided. A manager must disclose to the investor quarterly, within 30 days after the end of each calendar quarter - (a) the sources of leverage, including the type, the value and the providers of leverage; (b) the exposure limit or value-at-risk permitted in the founding document and mandate; (c) highest exposure or value at risk applied during the reporting period; (d) the exposure or value-at-risk as at the quarter-end; (e) the extent to which assets are encumbered or re-hypothecated; (f) the methodology for conducting stress-testing; (g) a report on the portfolio's counterparty exposure; (h) the latest total expense ratio applicable to the portfolio; and (i) any changes to the liquidity risk profile of the portfolio."
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Applicable paragraph 27(3) of the South African Collective Investment Schemes Act (CISCA) requires managers of hedge funds to disclose to investors, at least quarterly, the following minimum information:

- **(a)** the name of the portfolio invested in, together with the series or class of participatory interests invested in;
- **(b)** the net asset value and participatory interest price multiplied by the number of notional participatory interests held in the portfolio;
- **(c)** where applicable, equalisation credit and debit or series invested in;
- **(d)** monthly return;
- **(e)** transactions of assets bought and sold;
- **(f)** subscriptions (new investments) and number of participatory interests;
- **(g)** repurchases and number of participatory interests;
- **(h)** a breakdown of net profit or loss for the period, including (i) realised gain or loss; (ii) unrealised gain or loss; (iii) dividends and dividend expenses; (iv) manufactured dividends; (v) interest earned and interest incurred; (vi) management fees; (vii) performance fees; (viii) trading expenses in aggregate; including (i) brokerage costs; (ii) scrip borrowing fees; and (iii) transaction fees; (j) other expenses in aggregate, including (i) accounting fees; (ii) administration fees; (iii) audit fees; (iv) bank charges; (v) custodian or depository fee; (vi) exit fees payable for involuntarily premature dis-investment of assets; and (vii) other transaction fees.

A manager has to, in respect of the hedge fund and each portfolio, prepare an annual report for each financial year which report have to include the financial statements in terms of section 90(1) of CISCA together with details of any activities that had a material impact on the business of the manager, the hedge fund, and the portfolios during the financial year. Any material changes in the information listed in paragraph 27(3) during the financial year have also to be reported. Managers need also to inform investors of the availability of financial information.

Managers are required to, within 30 days after the end of each calendar quarter, furnish to the registrar, in respect of each portfolio of the hedge fund that it manages, electronically or otherwise, a report containing:

- **(a)** a full list of all gross and net assets in the relevant portfolio, including all long and short positions, reflecting the market value of each asset and exposure included in that portfolio, with the value of each of those assets expressed as (i) a percentage of the total value of assets in the portfolio concerned; (ii) a percentage of the total amount of assets of that class issued by the entity in which the investment is held.
- **(b)** the exposure or value-at-risk limits permitted under the portfolio mandate and the exposure or value-at-risk applied during the reporting period, and the exposure or value-at-risk as at the quarter-end;
- **(c)** the method of calculating exposure or value-at-risk and showing how limits have been complied with, including: (i) the sources of leverage, including the type, the amount and the providers of leverage; (ii) level of collateralisation and the re-hypothecation of assets; (iii) level of counterparty exposure; (iv) the capability of the internal control systems for derivatives; (v) the number of new investors; and (vi) the current risk profile of the portfolio and the systems employed by the manager to manage risks, including market, liquidity, counterparty, derivatives, operational and other risks;
- **(d)** a list of all the portfolios that the manager administers.

Managers should furthermore:

- **(a)** not later than 90 days after the close of its financial year, provide the registrar a copy of the hedge fund's audited financial statements and the annual report referred to in paragraph 28; and
- **(b)** on or before a date specified by the registrar, lodge with the registrar such further information and explanations as the registrar may request. Managers are also required to inform the registrar without delay of any change in the liquidity risk profile of a portfolio.

Source: Relevant sections of CISCA (South Africa, 2002)
These general requirements apply in respect to all types of hedge funds. There are, however, certain specific requirements that relate to the respective types of hedge funds themselves.

6.9.1 Qualified Investor Hedge Funds (QIHFs)

Table 6-5 summarises specific regulatory requirements for QIHFs. These requirements pertain to duties ascribed to the managers of such funds together with the responsibility of the managers in relation to the administration of, amongst others, risk in relation to leverage, liquidity and repurchases.
Table 6-5: Determination of the requirements for hedge funds in accordance with CISCA: Qualified Investor Hedge Funds

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<td>3</td>
<td>Duties specific to a manager of a QI fund</td>
<td>“A manager of a QI fund: (a) is allowed only to invite or permit qualified investors to invest in a QI fund; (b) and need to ensure that only qualified investors, who have provided a declaration of their eligibility, are included in the QI fund. (c) A manager furthermore has to employ a structure that limits the liability of an investor to give effect to the principle that an investor will not suffer a loss in excess of the value of its investment or contractual commitment in the QI fund. (d) The fund manager must appoint either: (i) a custodian as contemplated in section 68 of CISCA; or (ii) an independent fund administrator to perform the functions set out in section 70(1) to (3) of CISCA. (e) Where an independent fund administrator has been appointed the manager has to appoint a separate depository for safekeeping of the assets. (f) Where a custodian is appointed, a manager may appoint a separate depository for safekeeping of the assets. (g) Assets to be included may comprise of assets as set out in the founding documents in the QI fund, provided that the following principles are adhered to: (i) the liquidity of securities may not compromise the liquidity terms of the portfolio; (ii) securities based on the value of commodities may be traded, provided that (aa) the security is listed on an exchange; (bb) specific disclosure is made to investors of the nature and extent of the exposure to physical delivery; (cc) the liquidity terms of the QI fund are not compromised; and (dd) the position is closed out before physical delivery is required; (iii) securities must be subject to reliable valuation by the manager and must be negotiable and transferable; (h) may only delegate the management of the assets of the portfolio to a hedge fund FSP.”</td>
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<td>4</td>
<td>Leverage</td>
<td>“(1) A manager of a QI fund is required to: (a) set the level of exposure or value at risk or each portfolio of the QI fund; (b) provide for the limit referred to at subparagraph (1)(a) in the mandate and the founding documents of a portfolio of the QI fund; and (c) inform the registrar of the limits referred to in subparagraph (1)(a). (2) A manager may not change the limits set in accordance with subparagraph (1) without approval of the investors and the registrar.”</td>
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<td>5</td>
<td>Liquidity and Repurchases</td>
<td>“A manager of a QI fund must: (a) have an appropriate framework to measure and manage the liquidity risk of each portfolio against its repurchase obligations; (b) implement and maintain a repurchase policy, which policy must provide for (i) a level of liquidity for the relevant portfolio of the QI fund that would enable the manager to repurchase participatory interests within three calendar months of receipt of an investor instruction to repurchase; (ii) the circumstances under which the manager may suspend the repurchase of participatory interests, provided that suspension must be in accordance with the provisions of the Notice of Suspension of Repurchase of Participatory Interests by Manager of CIS in Securities prescribed by the registrar under section 114(3)(f) of the Act; (c) apply liquidity stress testing providing for (i) increased investor repurchases; (ii) shortage of liquidity of the underlying assets of the portfolio; and (iii) an analysis of the period of time required to meet repurchase requests in the simulated stress scenarios.”</td>
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Source: Relevant sections of CISCA (South Africa, 2002)
6.9.2 Retail Investor Hedge Funds (RIHFs)

Table 6-6 summarises specific or increased regulatory requirements attributable to RIHFs and/or managers thereof. These requirements relate to liquidity and repurchases, fees, counterparty exposures, permitted asset classes, short selling and risk management, to name but a few. The requirements regulate the administration of a RIHF in greater detail, over and above the prescribed registration and other general requirements under CISCA.

An example of the increased regulatory requirement to retail funds is the requirement that QIHFs be able to repurchase participatory interests within three months of receipt of an investor instruction, whereas RIHFs must do so within one month. RIHFs must furthermore report any repurchases to the registrar. Participatory interest of investors in RIHFs must be maintained unless exceptional circumstances require their suspension. Investor interests must be taken into consideration by managers when assessing whether to suspend or not. These requirements, although clearly requiring the position of the investor to be always held, are somewhat vague and require every individual set of circumstances to dictate whether they were adhered to.
Table 6-6: Determination on the requirements for hedge funds in accordance with CISCA: Retail Investor Hedge Funds

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| 6                    | Liquidity and repurchases | "(1) A manager may borrow up to ten percent of the value of a portfolio for liquidity purposes in respect of the repurchase of participatory interests. (2) A manager may not encumber any assets of a portfolio, except for investment purposes. (3) A manager must have an appropriate framework to measure and manage the liquidity risk of each portfolio against its repurchase obligations. (4) A manager must implement and maintain a repurchase policy. The policy must provide for: (a) a level of liquidity for each portfolio that would enable the manager to repurchase participatory interests within one calendar month of receipt of an investor instruction to repurchase; (b) subject to subparagraph (5), the circumstances under which the manager may suspend repurchase of participatory interests. (5) A manager may only suspend the repurchase of participatory interests: (a) in exceptional circumstances and when in the interest of investors; and (b) in accordance with the Notice of Suspension of Repurchase of Participatory Interests by Manager of CIS in Securities prescribed by the registrar under section 114(3)(f) of CISCA. (6) A manager must inform the registrar of any suspension of the repurchase of participatory interests without delay. (7) Where the inclusion of a derivative results in an immediate or future commitment for a portfolio, the following liquidity requirements apply: (a) for a derivative that may require settlement in cash, the portfolio must at all times hold sufficient assets in liquid form to effect the required settlement; and (b) for a derivative that requires physical settlement, the portfolio must hold the physical asset or hold sufficient assets in liquid form to cover the full payment obligation for the physical asset. (8) A manager must conduct a self-assessment exercise of each portfolio to determine its adequate exposure calculation (value at risk or commitment approach)."
| 7                    | Fees        | A manager should specify in its founding documents the maximum level of all fees charged by the manager to the retail hedge fund and provide investors with reasonable notice of any increase in the fees. This period should not be less than three months. |
| 8                    | Counterparty exposure | "(1) A manager must (a) limit the counterparty exposure of a portfolio to the net asset value of the portfolio per one counterparty subject to Annexure A to the Hedge Fund Regulations; (b) may only net the counterparty exposure with the same counterparty and in the same portfolio, provided that the manager is able to legally enforce netting arrangements with that counterparty. (2) When calculating counterparty exposure, a manager must take into account: (a) any initial or variation margin posted to, and held by, a counterparty; (b) the verifiable market value of the derivative, including any excess collateral; (c) any net exposure to a counterparty generated through a securities lending or repurchase agreement; and (d) counterparty exposures created through the reinvestment of collateral."
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| 9                    | Collateral  | "(1) A retail hedge fund is allowed to post to or to receive collateral from its counterparties to manage its counterparty exposure and circumstances where counterparty limits have been breached.  
(2) A manager must ensure that collateral arrangements satisfy the following rules and principles:  
(a) Legal Agreements: Collateral arrangements must be governed by appropriate global master collateral agreements.  
(b) Liquidity: Collateral must be sufficiently liquid to ensure that it can be converted to cash within seven days in a default event at a price that is close to its presale valuation.  
(c) Valuations: Collateral must be capable of being valued on a daily basis and must be marked-to-market daily taking into account any haircuts on noncash collateral, where applicable.  
(d) Issuer credit quality: Creditworthiness of the issuer of the collateral must be taken into account and relevant haircuts must be applied to take into account issuer default risk.  
(e) Legal rights: A manager must ensure that the collateral obligation is legally enforceable and that the collateral will be available to a portfolio without recourse to a counterparty, in the event of a default by the counterparty.  
(f) Concentration risks: A manager must take into account the concentration risks to a single issuer in a portfolio.  
(g) Relatedness: A manager may not accept securities issued by the counterparty as collateral.  
(h) Cash collateral: A manager must appropriately manage the reinvestment risk of cash collateral." |
| 10                   | Permitted assets and securities | "(1) A manager may only include investments in other retail hedge funds or in collective investment schemes in securities in accordance with the limits set out in Table 5 of Annexure A of the Hedge Fund Regulations in a portfolio.  
(2) A manager may only include securities in a portfolio as set out in the founding document, provided that the following principles are adhered to and subject to the exposure limits set out in Annexure A:  
(a) to the Hedge Fund Regulations where the securities are listed, the securities must be dealt with on an exchange; or on a market which is regulated, operates regularly, is recognised and open to the public;  
(b) a security based on the value of a commodity must comply with paragraph 3(g)(ii) and settled prior to its maturity so as not to require physical delivery of any commodity;  
(c) a reliable valuation for the security must exist; and  
(d) the liquidity of instruments must not compromise the liquidity terms of the portfolio." |
| 11                   | Non-permitted asset classes | A manager may not include the following in a portfolio: investments in immovable property, a portfolio of a QI fund and a private equity fund. |
| 12                   | Derivatives | "(1) When a manager includes derivatives in a portfolio, the manager must:  
(a) ensure that the exposure does not exceed the net asset value of that portfolio, provided that when a transferable security or money market instrument contains an embedded derivative, the exposure created by that derivative must be taken into account when exposure is calculated;  
(b) be satisfied that an over-the-counter derivative can be valued with reasonable accuracy and on a reliable and consistent basis;  
(c) ensure that the derivative can be sold, liquidated or closed out by an offsetting transaction, at market value at any time, at the manager's initiative;  
(d) ensure that the fund administrator can value the derivatives instruments independently, where applicable;  
(e) ensure that the underlying assets of the derivative are taken into consideration in determining the resulting exposure;  
(f) not permit the position exposure to the underlying assets of derivatives (including embedded derivatives in transferable securities, money market instruments or investment funds) when combined with positions resulting from direct investments, to exceed the investment limits or counterparty limits;" |
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<td>(g) ensure that the derivative does not result in the delivery of a security that is not permitted under this Notice.</td>
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<td>A manager must ensure that the portfolio:</td>
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<td>(a) is at all times capable of meeting its payment and delivery obligations for cash settled derivatives by holding assets in liquid form which are sufficient to cover the obligations; and</td>
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<td>(b) establishes and maintains risk management processes which monitor derivative positions so that they are adequately covered in accordance with these requirements.</td>
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<td>13</td>
<td>Financial Indices</td>
<td><em>(1) For a security to be classified as an index security, the security must replicate a financial index that is: (a) sufficiently diversified; (b) an adequate benchmark of the market to which it refers; (c) published in an appropriate manner and be readily accessible; and (d) compiled and calculated independently from the manager, the retail hedge fund and the issuer of the security. (2) Indices may, based on the eligibility criteria set out in subparagraph (1), consist of amongst others, commodity, metal, real estate and private equity.</em></td>
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<td>14</td>
<td>Exposure</td>
<td>*(1) A manager may only include securities and assets in a portfolio in accordance with the limits set out in Annexure A to this Notice. (2) A manager may create leverage in a portfolio by borrowing funds, using short positions or by engaging in derivative transactions with counterparties. (3) A manager may calculate the portfolio's total exposure and leverage by either (a) the value-at-risk approach; or (b) the commitment approach. (4) A manager must be able to demonstrate that the risk assessment methodology it uses for a portfolio is appropriate for that portfolio and there must be consistency in the choice of approach used. (5) A manager using the commitment approach when calculating exposure must ensure that a portfolio's total exposure to the market does not exceed 200 per cent of the total net asset value of the portfolio. (6) (a) When calculating the exposure using the value-at-risk approach, all the positions of the portfolio must be considered. (b) A manager must always set the maximum value-at-risk limit according to a portfolio's defined risk profile. (c) A manager must ensure that the value-at-risk model (i) is appropriate for the relevant portfolio or portfolios of the retail hedge fund and takes into account the investment strategy being pursued and the types and complexity of the securities and money market instruments used; (ii) takes into account the general market risks; (iii) is supported by appropriate back testing and stress testing of the portfolio that allows for, inter alia, a comparison to expected loss, and where (aa) a one day change in portfolio value exceeds the related one day value at risk measure, the model must be adjusted; and (bb) the event described in subparagraph (aa) occurs more than four times in the most recent 250 business days, the manager must without delay report this to the registrar, who may take measures and apply stricter criteria for the use of value at risk. (7) (a) When using the commitment approach in a portfolio, all derivatives must be converted into the effective exposure of an equivalent position in the underlying asset of the derivative contract. (b) Where the commitment approach is used, a manager must apply this approach to all derivative positions, whether used as part of the portfolio's general investment policy, for purposes of risk reduction or for the purposes of efficient portfolio management. (c) Where the commitment approach is used, a manager may consider hedging and netting arrangements, provided they fulfil the criteria relating to the commitment approach. (d) Hedging arrangements must (i) ensure that there is a verifiable reduction of risk; (ii) relate to the same or similar asset class; (iii) be efficient in stressed market conditions. (e) Netting arrangements (i) may only include those derivative trades which offset the risks linked to other trades on the same underlying asset, leaving no material residual risk; (ii) must be effected within specific maturity segments in respect of interest rate securities.</td>
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<td>(8)</td>
<td>When calculating exposure of a security that contains exposure to another security, a manager must separate the security into its individual underlying exposure components.</td>
<td></td>
</tr>
</tbody>
</table>

| 15 | Monthly reporting to the registrar | "A manager must in respect of each portfolio, on a monthly basis, within 14 days of the end of the month, furnish the registrar electronically or otherwise, with-
(a) all long and short positions in the portfolio reflecting the market value and the effective exposure, and the value of each of these positions expressed (i) as a percentage of the total value of assets in the portfolio concerned; and (ii) where possible, as a percentage of the total amount of assets of that class issued by the entity in which the investment is held, and indicating which of such assets cannot be liquidated prior to the next redemption date;
(b) exposure or value-at-risk limits permitted in the founding documents of the portfolio;
(c) exposure or value-at-risk applied during the reporting period;
(d) the level of counterparty exposure; and
(e) the capability of the internal systems of control for derivatives." |

| 16 | Permitted structures | "(1) A manager may only establish a scheme using the following structures for its hedge fund
(a) a collective investment scheme trust arrangement as contemplated in the Act; or
(b) an en commandite partnership.
(2) Despite subparagraph (1), a manager of a retail hedge fund, must regardless of which structure it uses for its hedge fund, appoint a custodian as contemplated in Part IX of the Act and may appoint a separate depository for safekeeping of assets." |

| 17 | Collateral | A manager may only use assets which are included in a portfolio as collateral. |

| 18 | Platforms and hosting arrangements | "(1) A manager may establish a scheme as a platform for purposes of creating or hosting different portfolios which are administered independently of each other and managed by different FSPs.
(2) A manager, in establishing a platform
(a) must comply with the principle of segregation and identification;
(b) must ensure that the assets included in each portfolio on its platform are properly protected from creditor claims;
(c) may not permit the assets of one portfolio to be used to meet the liabilities of any other portfolio of the scheme; and
(d) must ensure that the name of each portfolio on its platform bears the name of the manager and that of the relevant FSP." |

| 19 | Fund administration | "(1) A manager is required to conduct proper due diligence when appointing a fund administrator and must ensure that its fund administrator:
(a) is an FSP;
(b) is a juristic person;
(c) is domiciled in the Republic;
(d) has the requisite experience, knowledge and capital; and
(e) has adequate internal controls and systems to ensure proper administration of the portfolio.
(2) Despite the provisions of subparagraph (1), where the assets of the portfolio are held in a foreign country, the manager may appoint a fund administrator regulated by an appropriate supervisory authority and subject to on-going supervision by that supervisory authority, to perform the functions of a fund administrator.
(3) Where the manager itself performs the fund administration services, the registrar may request an independent verification of the appropriate-ness of the administration system and capabilities." |
<table>
<thead>
<tr>
<th>Applicable paragraph</th>
<th>Description</th>
<th>Content overview</th>
</tr>
</thead>
<tbody>
<tr>
<td>20</td>
<td>Prime broker</td>
<td>“(1) A manager may only appoint a prime broker, that is (a) an authorised user that has been admitted as an equity member under the exchange rules defined in the Financial Markets Act; or (b) a bank. (2) A manager must act with due skill, care and diligence when appointing a prime broker, and only appoint a prime broker that (a) is always financially sound; and (b) has the necessary organisational structure appropriate for the services to be provided to the portfolio. (3) A manager must ensure that it is conversant with all counterparty and prime broker legal agreements, including re-hypothecation arrangements.”</td>
</tr>
<tr>
<td>21</td>
<td>Counterparties</td>
<td>“(1) A hedge fund may only invest in derivative instruments where the counterparty is: (a) the South African Government; (b) a bank; (c) a long-term insurer registered or deemed to be registered as a long-term insurer under the Long-term Insurance Act; (d) a short-term insurer registered or deemed to be registered as a short-term insurer under the Short-term Insurance Act; (e) a clearing house; or (f) an authorised user; (g) a person outside the Republic who is registered, licensed, recognised, approved or otherwise authorised to render services or conduct the business of a bank or a business referred to in paragraphs (b) to (f) by a foreign regulator with functions similar to those of the registrar, the Registrar of Banks, the Registrar of Financial Services Providers or the Registrar of Long-term or Short-term Insurance. (2) A manager must conduct appropriate stress-testing to assess counterparty exposure and the impact of a change in the risk profile of the counterparty on financing and collateral requirements.”</td>
</tr>
<tr>
<td>22</td>
<td>Valuation and pricing</td>
<td>“(1) A manager must establish, maintain, enforce and document a policy which outlines the procedures and methodologies for the valuation of the assets held in or used by each portfolio. (2) A manager must ensure that the valuation methodology is consistently applied according to the valuation policy. (3) The valuation policy must: (a) be reviewed periodically to ensure continued appropriateness; (b) provide for the obligations, roles and responsibilities of all parties involved in the valuation process, including, where applicable, the fund administrators; (c) provide for all listed securities to be priced according to market prices as contemplated in section 44 of CISCA, and unlisted securities to be priced according to a generally recognised methodology approved by the custodian, or where applicable, by the fund administrator; (d) in the case of a retail hedge fund, (i) provide for pricing that is at least equal to the purchase and repurchase date; (ii) ensure that daily valuation is conducted, and that a requirement to provide daily valuation is included in the founding document; (e) in the case of a QI fund, it must be ensured that - (i) pricing takes place at least equal to the purchase or repurchase dates of the relevant portfolio, whichever is more frequent; and (ii) valuation is performed monthly; (f) ensure that an appropriate level of independent review is undertaken for each valuation and in particular any valuation that is influenced by the manager or the hedge fund FSP; (g) describe the process for handling and documenting instances where the manager has disagreed with the valuations or established a contrary price, including providing for the review by an independent party; (h) provide for initial due diligence investigations performed by a person, other than a manager, of any person that is appointed to perform valuation services; (i) ensure that the valuation methodology is transparent and available to investors; and”</td>
</tr>
<tr>
<td>Applicable paragraph</td>
<td>Description</td>
<td>Content overview</td>
</tr>
<tr>
<td>----------------------</td>
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</tr>
<tr>
<td>(j) when using models for valuations, ensure (i) that the model is included in the valuation policy; (ii) that the valuation procedures and policies indicate the main features of the model; and (iii) that the model is subject to independent validation, by a person who (aa) was not involved in the process of developing the model; and (bb) has adequate competence and experience in the valuation of assets using such models. “</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>Remuneration and reward policy</td>
<td>A manager must have a remuneration and reward policy that ensures that investor and manager interests are aligned. Furthermore, the manager must ensure that risk taking is consistent with the risk profile of the portfolio. This would include prudent risk management of such a portfolio.</td>
</tr>
<tr>
<td>“(1) A manager must establish, document, maintain, and enforce a risk management policy, which must provide for the management of operational risk, business risk, liquidity risk, and credit-counterparty risk, appropriate to the nature, scale and complexity of its business, and for (a) the measures, techniques and procedures which must be employed to measure and manage risks, including risk measurement techniques to carry out stress tests, back tests and scenario analysis appropriate to each portfolio's investment strategy, taking into account the different risk profiles that may apply to each portfolio; (b) appropriate and timely corrective actions, where stress tests and scenario analysis reveal particular vulnerability to a given set of circumstances; (c) the frequency with which stress tests and scenario analyses must be conducted depending on the nature of the portfolio, the investment strategy, liquidity profile, type of investor and repurchase policy of the portfolio; (d) independent performance of the risk management function, including details of the allocation of responsibilities within the manager for risk management and operating procedures; (e) risk management to be performed on a daily basis; (f) appropriate internal control mechanisms to avoid or mitigate operational failures, including professional liability risks; and (g) procedures to ensure (i) on-going monitoring of the total value of the assets under management; and (ii) adjustments to the amount of coverage for professional liability risks following any significant change in assets under management. (2) A manager must review the risk management policy when necessary, but at least annually. (3) A manager must establish a risk function separate from its investment management function and fund administration function, which function must (a) determine the risk management policy of the hedge fund; (b) conduct active risk measuring; (c) perform risk monitoring and reporting; and (d) ensure, on a daily basis, that the risk limits are complied with.”</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Risk management, risk management policy and risk manager</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>Execution</td>
<td>A manager must take reasonable steps to ensure the best possible execution result for a transaction, taking into account price, costs, speed, likelihood of execution and settlement, the nature and size of the order and any other consideration relevant to the execution of the order.</td>
</tr>
<tr>
<td>26</td>
<td>Short selling</td>
<td>A manager may engage in physical short selling and derivatives creating short positions. The selling of a security without being in possession of the security or ensuring that it can be borrowed is not allowed. This is referred to as “naked short selling.”</td>
</tr>
<tr>
<td>Applicable paragraph</td>
<td>Description</td>
<td>Content overview</td>
</tr>
<tr>
<td>----------------------</td>
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</tr>
<tr>
<td>27 Disclosure and reporting to investors</td>
<td>*(1) Despite the requirements determined by the registrar under Board Notice 92 of 2014 published in Government Gazette No 37895 of 8 August 2014, the provisions of this paragraph apply in respect of the disclosure and reporting of information to investors by a hedge fund. *(2) A manager must provide the following information to a potential investor before investing in a portfolio: (a) the name of the hedge fund and of the manager stated clearly and unambiguously; (b) the name of the portfolio; (c) the date of establishment of the portfolio; (d) a list of all portfolios in the hedge fund; (e) names of the members of the board of the manager; (f) the legal structure of the portfolio; (g) accounting and distribution dates of the portfolio; (h) a description of the investment strategy and objectives of the portfolio and all associated risks; (i) a description of the procedures by which the portfolio may change its investment strategy or investment policy, or both; (j) whether the portfolio invests in underlying funds; (k) a description of the types of assets in which the portfolio may invest; (l) any investment restrictions applicable to the portfolio; (m) the circumstances in which the portfolio may use leverage, the types and sources of leverage permitted and the associated risks, any restrictions on the use of leverage and any collateral and asset re-use arrangements, and the maximum level of leverage which the portfolio is entitled to use; (n) where applicable, the identity of the hedge fund's depository, custodian, fund administrator, prime broker, auditor, hedge fund FSP and any other service provider and a description of their duties; (o) where applicable, a description of any material arrangements of the manager with a prime broker or other counterparty, including—(i) the manner in which conflicts of interest are managed; (ii) any provision in the contract with the custodian and depository on the possibility of transfer and re-hypothecation of assets; and (iii) the level of counterparty exposure; and (iv) the methodology of calculating counterparty exposure; (p) a description of any delegated administration function and of any safe-keeping function delegated by the depository, identification of the delegated person and any conflicts of interest that may arise from such delegations; (q) a description of the portfolio's valuation and pricing methodologies; (r) a description of the liquidity risk management of the portfolio, including the repurchase rights both in normal and in exceptional circumstances; (s) any gating, side pocket or repurchase restrictions that may exist in the portfolio and how those restrictions may be triggered; (t) any special repurchase arrangement or rights of some investors; (u) a description of all fees, charges and expenses and the maximum amount thereof which is borne directly by investors; (v) a description of all charges paid by the portfolio; (w) a description of how the manager ensures fair treatment of investors; (x) whenever an investor receives preferential treatment or has the right to receive preferential treatment, including ring-fencing arrangements—(i) a description of that preferential treatment; (ii) the type of investors who may receive such preferential treatment; and (iii) where relevant, those investors' legal or economic relationship with the manager or the portfolio; (y) the latest annual report referred to in section 90 of the Act; (2) the procedure and conditions for the issue and sale of participatory interests of a portfolio; (A) the latest net asset value of the portfolio and the latest price of the participatory interests of the portfolio; and</td>
<td></td>
</tr>
<tr>
<td>Applicable paragraph</td>
<td>Description</td>
<td>Content overview</td>
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</tr>
<tr>
<td>(B)</td>
<td>a description of how and when the quarterly reporting under subparagraph (2) will be provided.</td>
<td></td>
</tr>
<tr>
<td>(3)</td>
<td>A manager must disclose to the investor quarterly, within 30 days after the end of each calendar quarter-</td>
<td>(a) the sources of leverage, including the type, the value and the providers of leverage; (b) the exposure limit or value-at-risk permitted in the founding document and mandate; (c) highest exposure or value at risk applied during the reporting period; (d) the exposure or value-at-risk as at the quarter-end; (e) the extent to which assets are encumbered or re-hypothecated; (f) the methodology for conducting stress-testing; (g) a report on the portfolio’s counterparty exposure; (h) the latest total expense ratio applicable to the portfolio; and (i) any changes to the liquidity risk profile of the portfolio.</td>
</tr>
<tr>
<td>(4)</td>
<td>A manager must disclose to an investor by way of an investor statement at least quarterly, the following minimum information</td>
<td>(a) the name of the portfolio invested in, together with the series or class of participatory interests invested in; (b) the net asset value and participatory interest price multiplied by the number of notional participatory interests held in the portfolio; (c) where applicable, equalisation credit and debit or series invested in; (d) monthly return; (e) transactions of assets bought and sold; (f) subscriptions (new investments) and number of participatory interests; (g) repurchases and number of participatory interests; (h) a breakdown of net profit or loss for the period, including: (i) realised gain or loss; (ii) unrealised gain or loss; (iii) dividends and dividend expenses; (iv) manufactured dividends; (v) interest earned and interest incurred; (vi) management fees; (vii) performance fees; (i) trading expenses in aggregate; including: (i) brokerage costs; (ii) scrip borrowing fees; and (iii) transaction fees; (j) other expenses in aggregate, including: (i) accounting fees; (ii) administration fees; (iii) audit fees; (iv) bank charges; (v) custodian or depository fee; (vi) exit fees payable for involuntarily premature dis-investment of assets; and (vii) other transaction fees.”</td>
</tr>
<tr>
<td>Applicable paragraph</td>
<td>Description</td>
<td>Content overview</td>
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<tr>
<td>----------------------</td>
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<td>-----------------</td>
</tr>
<tr>
<td>29 Quarterly reporting to registrar</td>
<td>*(1) A manager must within 30 days after the end of each calendar quarter, furnish to the registrar, in respect of each portfolio of the hedge fund that it manages, electronically or otherwise, a report containing&lt;br&gt;(a) a full list of all gross and net assets in the relevant portfolio, including all long and short positions, reflecting the market value of each asset and exposure included in that portfolio, with the value of each of those assets expressed as: (i) a percentage of the total value of assets in the portfolio concerned; (ii) a percentage of the total amount of assets of that class issued by the entity in which the investment is held,&lt;br&gt;(b) the exposure or value-at-risk limits permitted under the portfolio mandate and the exposure or value-at-risk applied during the reporting period, and the exposure or value-at-risk as at the quarter-end;&lt;br&gt;(c) the method of calculating exposure or value-at-risk and showing how limits have been complied with, including: (i) the sources of leverage, including the type, the amount and the providers of leverage; (ii) level of collateralisation and the re-hypothecation of assets; (iii) level of counterparty exposure; (iv) the capability of the internal control systems for derivatives; (v) the number of new investors; and (vi) the current risk profile of the portfolio and the systems employed by the manager to manage risks, including market, liquidity, counterparty, derivatives, operational and other risks;&lt;br&gt;(d) a list of all the portfolios that the manager administers.&lt;br&gt;(2) A manager is required to not later than 90 days after the close of its financial year, provide the registrar a copy of the hedge fund’s audited financial statements and the annual report referred to in paragraph 28 and on or before a date specified by the registrar, lodge with the registrar such further information and explanations as the registrar may request.&lt;br&gt;(3) A manager must inform the registrar without delay of any change in the liquidity risk profile of a portfolio.”</td>
<td></td>
</tr>
</tbody>
</table>

Source: Relevant sections of CISCA (South Africa, 2002)
In addition to the requirements stated in Table 6-6, certain requirements are specifically provided for in relation to interest rate instruments. Some securities can be traded in terms of CISCA with direct prescription as to the total exposures thereon. The determination on hedge funds allows for investment in relation to bonds and debentures, as well as listed futures amongst others, as set out in Table 6-7.
### Table 6-7: Determination on the Requirements for Hedge Funds in accordance with CISCA: Retail Hedge Funds Permitted Interest Rate Securities

<table>
<thead>
<tr>
<th>Description</th>
<th>Retail hedge funds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Permitted interest rate securities</strong></td>
<td>“The following are permitted as interest rate securities or interest rate trades: bonds and debentures; notes (unsecured/secured with or without other option rights); Islamic bonds or instruments; repurchase transactions; listed futures; listed options, warrants or index certificates; unlisted forex swaps (spot/forward); unlisted interest rate swaps; Unlisted Forward Rate Agreements; unlisted interest rate options (including swaptions, caps, floors, caplets and floorlets); instruments based on assets/baskets returns; Exchange Traded Funds or Notes based on other permitted interest rate securities or interest rate trades; trade bill, trade note; treasury bill; promissory note; parastatal bill; negotiable certificate of deposit; Land Bank bill; asset with a branch of a foreign bank; banker's acceptance; bridging bonds; commercial paper; deposit”</td>
</tr>
<tr>
<td><strong>Exposure limits</strong></td>
<td>“(1) A manager may include the following interest rate securities, whether listed on an exchange or not, in a portfolio in the following manner: (a) any money market instrument and repurchase transaction, provided that the market value of such interest rate securities does not exceed the percentage/s, specified in Table 3 below, with netting of issuer/borrower/counterparty risk applied; (b) bonds, debentures, debenture stock and debenture bonds, notes, whether or not they have inherent option rights or are convertible, provided that the applicable market value or exposure of such interest rate securities does not exceed the determined percentage/s with netting of issuer/borrower/counterparty risk; (c) credit derivatives, provided that the market value of such interest rate securities does not exceed the percentage/s on a look through basis, specified in Table 3 below, with netting of issuer/borrower/counterparty risk. (2) Interest rate derivatives may be used, provided that the portfolio exposure or value-at-risk complies with the limits set out in this Notice. (3) Market risk: A manager may select one of the exposure limits specified in Table 3 below. A portfolio has to stipulate upfront in the investment policy which approach it will employ to measure exposure. (4) The calculation of commitment must be based on an exact conversion of the financial derivative position into the market value of an equivalent position in the underlying asset of that derivative. (5) The commitment calculation of each financial derivative position should be converted to the base currency of the hedge fund using the ruling spot exchange rate. (6) Where any currency derivative has two legs that are not in the base currency of the portfolio, both legs must be taken into account in the commitment calculation. (7)(a) OTC counterparty exposure in the case of derivatives that involves collateral movements requires an ISDA agreement &amp; CSA. (b) Counterparty exposure on interest rate derivatives is measured as the present value of the derivative (e.g. on, but not limited to, interest rate swaps, forward rate agreements, swaptions, caps and floors). (8) Netting to be applied under the commitment approach. The following steps must be taken by a manager when calculating total exposure using the commitment approach: (a) Calculate the commitment of each individual derivative (as well as any embedded derivatives and leverage linked to efficient portfolio management (EPM) techniques). (b) Identify netting and hedging arrangements. For each netting or hedging arrangement, calculate a net commitment as follows: (i) commitment is equal to the sum of the commitments of the individual financial derivative instruments (including embedded derivatives) after derivative netting; (ii) if the netting or hedging arrangement involves security positions, the market value of security positions can be used to offset commitment; (iii) the value of the resulting calculation is equal to net commitment. (c) Total exposure is then equal to the sum of: (i) the value of the commitment of each individual derivative not involved in netting or hedging arrangements; and (ii) the value of each net commitment after the netting or hedging arrangements as described above.”</td>
</tr>
</tbody>
</table>

Source: Relevant sections of CISCA (South Africa, 2002)
The regulations require that non-equity securities issued or guaranteed by different parties be limited in relation to the nominal asset value of the fund where RIHFs are concerned. These limits are stated in Table 6-8.

**Table 6-8**: Determination on the Requirements for Hedge Funds in accordance with CISCA: RIHF limits in relation to the categories of securities to be invested in

<table>
<thead>
<tr>
<th>Item/Subitem</th>
<th>Categories of securities</th>
<th>Limits being the NAV of the portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>“Non-equity securities issued or guaranteed by:”</td>
<td>200%</td>
</tr>
<tr>
<td>1.1</td>
<td>the government of the Republic of South Africa;</td>
<td>200%</td>
</tr>
<tr>
<td>1.2</td>
<td>any foreign government which has been assigned a foreign currency sovereign rating not lower than that of the Republic of South Africa;</td>
<td>100%</td>
</tr>
<tr>
<td>1.3</td>
<td>The South African Reserve Bank</td>
<td>100%</td>
</tr>
<tr>
<td>2</td>
<td>Non-equity securities issued or guaranteed by a local or foreign bank and repurchase transactions entered into with 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:</td>
<td>100%</td>
</tr>
<tr>
<td>2.1</td>
<td>with a market capitalisation for the listed group holding company of more than R20bn.</td>
<td>100%</td>
</tr>
<tr>
<td>2.2</td>
<td>with a market capitalisation for the listed group holding company of between R2bn and R20bn.</td>
<td>20%</td>
</tr>
<tr>
<td>3</td>
<td>Non-equity securities issued or guaranteed by an authorised user, other than a bank, and repurchase transactions entered into with an authorised user, other than a bank.</td>
<td>30%</td>
</tr>
<tr>
<td>4</td>
<td>Non-equity securities issued or guaranteed by:</td>
<td>100%</td>
</tr>
<tr>
<td>4.1</td>
<td>a public entity under the Public Finance Management Act, 1999 (Act No. 1 of 1999); and</td>
<td>10%</td>
</tr>
<tr>
<td>4.2</td>
<td>any local or foreign entity which is listed on an exchange, including foreign companies, foreign public entities, foreign local authorities and foreign development institutions</td>
<td>10%</td>
</tr>
<tr>
<td>5</td>
<td>Non-equity securities issued or guaranteed by entities not described above where such security is:</td>
<td>25%</td>
</tr>
<tr>
<td>5.1</td>
<td>listed and traded on an exchange</td>
<td>5%</td>
</tr>
<tr>
<td>5.2</td>
<td>not listed on an exchange, including, participatory interests in participation bonds</td>
<td>5%</td>
</tr>
</tbody>
</table>

Source: Relevant sections of CISCA (South Africa, 2002)
The exposure limits captured in Table 6-9 provide restrictions per security, as well as limits to excess security exposures. Aggregate exposure to a counterparty must not exceed 30%. Limits were also introduced to aggregate exposure to commodities, other metals and gold, having regard to CISCA’s required limits on physical delivery. Parameters were set to exposures to prime brokerages and/or their holdings companies that are listed on an exchange with a market cap above R20bn. These parameters typically force managers to be aware of third-party risks and how they would influence RIHF.

Table 6-9: Determination on the Requirements for Hedge Funds in accordance with CISCA: RIHF exposure limits

<table>
<thead>
<tr>
<th>Description</th>
<th>Retail hedge funds</th>
</tr>
</thead>
</table>
| Exposure limits | • “10% per security or 30% per security as long as the aggregate excess exposure above 10% is limited to 40% of the net asset value of the portfolio;  
  • the aggregate (transferable equity securities, money market instruments, or deposits) exposure per counterparty must be less than or equal to 30%;  
  • a maximum 20% in aggregate in securities based on the value of gold, other metals, and commodities if the securities are listed on an exchange (in accordance with Board Notice 90 of 2014) and as long as physical delivery is limited subject to paragraph 10(2)(b);  
  • a maximum of 20% in unlisted transferable equity securities as long as these securities are negotiable, can be independently valued, and do not compromise the ability of the portfolio to meet its liquidity terms;  
  • maximum of 10% in any other securities or assets;  
  • a maximum of 100% to an authorised user that is an equity member in its capacity as prime broker and where such exposure does not include any exposure to securities issued by the authorised user; [Item added by BN 70 of 1 April 2015.]  
  • a maximum of 100% to a local or foreign bank in their capacities as prime brokers, where such bank or its holding company is listed on a stock exchange and has a market capitalisation of more than R20 billion. [Item added by BN 70 of 1 April 2015].” |

Source: Relevant sections of CISCA (South Africa, 2002)

The regulations furthermore capture limits to market and total exposure on portfolios to be calculated by using either the commitment approach or value-at-risk approach as total exposure measure. The former requires that a specific portfolio’s total market exposure not exceed 200% of the total net asset value of the portfolio. The latter approach uses daily historical data that must be calculated daily, to determine with a 99% confidence level that the potential loss over the following month will not exceed 20% of the portfolio’s net asset value (Statutes and Regulations, 2016).

The Hedge Fund Regulations determine also that, with regard to investing in other portfolios, such investment by an RIHF may not exceed 75% of the market value of the RIHF itself. With regard to investments in fund-of-funds, a RIHF is allowed to invest subject to the fund-of-funds consisting of other portfolios which are domiciled and regulated outside South Africa and that such a fund is not invested in another fund-of-funds or feeder fund. When investment in a feeder fund is desired,
the feeder fund should have at least 85% of its value invested outside South Africa. All investments are subject to proper due diligence by the fund manager before and during the investment period. Such due diligence must be performed on the underlying hedge funds in which the investment is made or is intended to be made (Statutes and Regulations, 2016).

The previous section provided all regulatory requirements to which hedge funds and RIHFs are subject directly in accordance with CISCA. The section to follow provides a framework to which the good practices identified throughout this chapter can be linked to those stated in the chapter build-up.

**6.10 Identifying regulatory good practice on retail investment in hedge funds in South Africa**

The discussion on financial sector reform in this thesis commenced with a focus on the policy and legislative build-up towards the continuing restructuring of the South African financial sector post the financial crisis. The regulation of hedge funds and retail hedge funds in South Africa specifically, has become one of the cutting-edge regulatory frameworks for the regulation of hedge funds globally. The previous chapter provided the key UK investor protection principles relating to hedge funds. Table 6-10 contains principles extracted from the literature discussed in this chapter. It sets out the requisite principle identifier, the principle, the source and a description of the content. Once again, general commentary on hedge fund investor protection will be made should such comments be indispensable, and cross-referencing to other legislation or tables will be included where relevant.
Table 6-10: Identified investor protection good practice with regard to retail investment in hedge funds in South Africa

<table>
<thead>
<tr>
<th>SA principle identifier</th>
<th>SA principle</th>
<th>SA principle content description</th>
<th>Applicable legislation or regulation assented to in terms thereof</th>
<th>Chapter cross reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>SAP1</td>
<td>Registration for managers and/or investment companies</td>
<td>A CIS must be managed by a manager that needs to be registered as such. The administration must be done with required skill, care and diligence and should be executed fairly. There are restrictions on companies allowed to register. These companies must comply not only with the requirements of CISCA, but also with other legislative prescriptions in relation to good corporate governance and compliance in general with the Companies Act, 71 of 2008. Fund administration is subject to proper due diligence and a fund administrator must be appointed subject to strict requirements, including that it must be a registered FSP with adequate experience, skills and knowledge plus enough capital to perform its function effectively. Prime brokers may also be appointed in accordance with CISCA. Derivative instruments may only be employed subject to counterparties’ being South African, a bank and a clearing house, to name but a few requirements. Hedge fund portfolios are also required to register in terms of CISCA. This is an added layer of regulation directly applicable to the fund itself.</td>
<td>Sections 2, 4, 5 of CISCA; Sections 41, 42 and 43 of CISCA; Companies Act, 71 of 2008.</td>
<td>BN 52, Government Gazette 38540 of 6 March 2015 as amended by BN 70 in GG 38626 of 1 April 2015: Determination on requirements of hedge funds at paragraph 19 and 20. See Determination on requirements of hedge funds at paragraph 21 with regards to counterparties.</td>
</tr>
<tr>
<td>SAP2</td>
<td>Ongoing regulatory oversight measures</td>
<td>Ongoing oversight will mainly be deployed through the regulator, the FSCA, with which a hedge fund has been registered. The registrar has extensive oversight and powers to intervene timeously should there be concerns about liquidity, etc. In addition, the registrar may determine the way in which limits or conditions are introduced on which securities or classes of securities may be included in a portfolio. It is also required that an annual report be included within the financial statements of the hedge fund and each portfolio in accordance with section 90 of CISCA. Quarterly reporting to the registrar is another requirement. With regard to RIHFs, monthly reporting is mandatory for each portfolio.</td>
<td>Sections 15-22 and 28 of CISCA. See also sections 85, 90-96 and 105 of CISCA. Also FRSA.</td>
<td>BN 52, Government Gazette 38540 of 6 March 2015 as amended by BN 70 in GG 38626 of 1 April 2015: See Determination on requirements of hedge funds at paragraph 15 with regard to reporting requirements to the registrar.</td>
</tr>
<tr>
<td>SA principle identifier</td>
<td>SA principle content description</td>
<td>Applicable legislation or regulation assented to in terms thereof</td>
<td>Chapter cross reference</td>
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<tr>
<td>SAP3</td>
<td>Third-party services provision, registration and supervision</td>
<td>When establishing a scheme, the platforms and accompanying portfolios to be used must adhere to the principle of segregation. Such platforms and/or portfolios, which may be separately administered, may be run by different financial services providers. Hedge funds are also required to report to the registrar on a quarterly basis.</td>
<td>Sections 20 and 28 of CISCA.</td>
<td>Table 6-1; Table 6-2</td>
</tr>
<tr>
<td>SAP4</td>
<td>Information disclosure</td>
<td>Disclosure of information is demanded before investment, not only information such as the type of investment or strategy, but also the information necessary for an investor to make an informed decision and allowing time to comprehend the risks associated with the investment. The appointment of a prime broker is made subject to strict requirements and is compulsory in respect to RIHF. Section 27 of CISCA prescribes that information be available to potential investors and to be reported on quarterly. The quarterly reports include aspects such as the methodology for conducting stress testing, the most recent total expense ratio applicable to the portfolio, etc. Specific disclosure requirements in relation to fees are essential.</td>
<td>Section 3 of CISCA; Chapter 9 of FRSA.</td>
<td>Table 6-3</td>
</tr>
<tr>
<td>SAP5</td>
<td>Industry practice development</td>
<td>Good industry practices exist and have been developed since the designation of hedge funds as CISs. They specifically provide for direct retail investment subject to stringent leverage, liquidity, marketing and other rules in accordance with CISCA and the Determination on Requirements of Hedge Funds.</td>
<td>BN 52, Government Gazette 38540 of 6 March 2015 as amended by BN 70 in GG 38626 of 1 April 2015: Determination on requirements of hedge funds paragraphs 6-29.</td>
<td>Table 6-4</td>
</tr>
<tr>
<td>SA principle identifier</td>
<td>SA principle content description</td>
<td>Applicable legislation or regulation assented to in terms thereof</td>
<td>Chapter cross reference</td>
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<td>SAP6</td>
<td>CISCA established a common set of governing rules regarding the authorisation and supervision of hedge funds. This set of rules provides for a coordinated approach to any risks involved in the management and functioning of hedge funds in South Africa. Owing to the aligned approach taken towards those areas requiring regulation and South Africa’s being part of an international framework which aims to regulate hedge funds in a coordinated and a risk-based way, it can be argued that, from a good practice stance there is global influence and oversight in regard thereto. Furthermore, risk management practice and cross-border investment require risk management practice to be at a standard that would, at the very least, adhere to the jurisdictional requirements of the country or economic area where such an investment is made. An example would be UCITS in relation to which specific passporting requirements must be complied with, etc.</td>
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<td></td>
<td>See also section 45 of CISCA in relation to investment in foreign securities and associated requirements. Part VIII of CISCA has specific requirements regarding foreign CISs carrying business in South Africa to which the principle of reciprocity would apply which recognises extra jurisdictional law with regard to supervisory or regulatory action taken by that authority – this subject to certain requirements in terms of section 66 of CISCA. These are examples for purposes of cross-border risk management and a global approach to oversight by regulators. There are also memoranda of understanding between and/or amongst regulators within different country jurisdictions determining interaction across jurisdictions.</td>
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<tr>
<td></td>
<td>BN 52, Government Gazette 38540 of 6 March 2015 as amended by BN 70 in GG 38626 of 1 April 2015.</td>
<td>Table 6-1; Table 6-4</td>
<td></td>
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</tr>
<tr>
<td>SAP7</td>
<td>Hedge funds are clearly distinguished and defined in accordance with legislation. Distinction is clearly drawn between different types of funds.</td>
<td></td>
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<tr>
<td></td>
<td>CISCA.</td>
<td>BN 52, Government Gazette 38540 of 6 March 2015 as amended by BN 70 in GG 38626 of 1 April 2015.</td>
<td>Table 6-3; Table 6-4</td>
<td></td>
</tr>
<tr>
<td>SAP8</td>
<td>To enable investment through retail or qualified investors, registration and adherence to CISCA are required where the existing or intended manager or fund qualify as such. The provisions include the regulation of risk management incentives, capital requirements, liquidity requirements, provisions regarding investment securitisation positions, rules regarding remuneration, rules for valuation, etc. Exposure to securities and assets are strictly regulated for RIHFs, and the use of leverage is allowed, but subject to strict risk assessment.</td>
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<tr>
<td></td>
<td>Sections 22, 25 and 26 of CISCA.</td>
<td>BN 52, Government Gazette 38540 of 6 March 2015 as amended by BN 70 in GG 38626 of 1 April 2015: See Determination on Requirements of Hedge Funds in paragraph 14.</td>
<td>Table 6-3</td>
<td></td>
</tr>
<tr>
<td>SA principle identifier</td>
<td>SA principle</td>
<td>SA principle content description</td>
<td>Applicable legislation or regulation assented to in terms thereof</td>
<td>Chapter cross reference</td>
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<tr>
<td>SAP9</td>
<td>Investment vehicles</td>
<td>Portfolios are allowed only to make use of an investment scheme trust arrangement or an <em>en commandite</em> partnership as legal structures. Legal structures provided are substantially regulated. RIHFs must, in addition, appoint a custodian as contemplated in part IX of CISCA and may also appoint a separate depository for safe keeping of assets.</td>
<td>Sections 68-72 of CISCA.</td>
<td>See subsection 6.7</td>
</tr>
<tr>
<td>SAP10</td>
<td>Risk management and counterparty exposure</td>
<td>Strict requirements apply to managers in relation to internal risk management procedures. They are compelled to strict due diligence before investment in derivative instruments availed by counterparties. Stress testing must continuously be done to determine counterparty exposure and the impact that the possible change in risk profile of such counterparty may have on the risk indicators attributable to the manager. Strict requirements are prescribed in relation to liquidity and repurchases, which include the inability to encumber assets for other reasons than investment purposes and the ability or requirements for managers to be able to measure and manage liquidity risk in every respective portfolio against repurchase obligations. Counterparty exposure must be limited to the NAV of each portfolio per one counterparty subject. RIHFs are allowed to post or receive collateral to and from counterparties where counterparty limits have been breached. This must be done in accordance with strict principles and rules, including legal agreements, issuer credit quality and valuations, to name a few.</td>
<td>Sections 4 and 41 of CISCA; sections 18-29 of CISCA.</td>
<td>Table 6-1; Table 6-2; Table 6-4 in relation to counterparty exposure limits</td>
</tr>
</tbody>
</table>

Source: Author’s representation
6.11 Summary

South Africa is one of the first countries in the world, if not the first, to regulate hedge fund products directly and to the degree that it has been doing. The provisions incorporated solely under CISCA are different from those of other regimes such as UCITS in that their application is exclusive even though the UCITS regime is wide-ranging.

The objectives of financial regulation are important, as stated in Chapter 2. Regulatory cost implications on financial institutions and markets intensify the financial burden on the end user. Excessive regulation could also damage the efficient functioning of financial markets, diluting their economic utility. The end result concerning financial regulation is argued to be the achievement of balance between risk taking and the financial soundness of a system. For example, although hedge funds have outperformed regulated CISs in the past, retail investors did not typically gain access to them directly, mainly due to the risk associated with such investments. The general objectives of international financial regulation require the setting of prudential standards, regulating business conduct and maintaining and promoting financial stability. These objectives serve as guidance for the development of national financial regulatory frameworks. South Africa integrated all these objectives during its financial structural reform process, as well as incorporated hedge funds into the primary regulatory domain through their declaration as CISs.

Countries have different views or levels of tolerance for market instability and institutional failure and, therefore, construct financial regulation to suit to their circumstances. This could impact uniformity and cooperation across jurisdictions. South Africa has, however, incorporated most, if not all, practices in this regard and in certain areas to greater degrees. The extent to which South Africa has legislated and regulated hedge funds is foreseen to affect growth in the industry in the short term due to transition pains into the legislated environment. For this very reason, many existing funds chose not to enter the regulated hedge fund environment, as stated in Chapter 6.

In Chapter 2 it was argued that a more relaxed regulatory environment could attract more international business and, therefore, create a reluctance to subscribe to international standards which could lead to inhibited regulatory agility. This type of environment has contributed to regulatory arbitrage in the past. However, global conformity through international bodies such as IOSCO continues to create uniform regulatory approaches or practice, as with hedge funds, which might not lead to a race to the bottom in regulatory terms, but to adoption for purposes of participation. Governments, ultimately, determine their views on regulation which is guided largely by institutional memory.
A never-ending tug of war exists between increased regulation and regulatory liberalisation. It hinges on individual national governments and their existing views on market stability at the time. Investor protection, on the one end, can be a direct influence in the consideration on whether to increase regulation as is the case with retail investment in hedge funds in South Africa. However, indirectly, other influences also require attention when consideration is given to regulation and may become significant in a trade-off for inflows within an industry and the need for regulation. With regard to assets under management, South Africa is a minor player compared with the global hedge fund industry. In spite of this, the approach to regulation and the enormous weight of influence exerted by investor protection as a consideration in establishing regulatory and policy outcomes in South Africa have seen the establishment of an intensive regulatory environment for hedge funds. This stricter regulatory environment has seen a sizable distribution of assets under management allocated to RIHFs, which indicates increased interest on the retail investment end. Consequently, the argument can be forwarded that regulatory certainty has started to provide some sort of a level of confidence and that the general stigma in respect to risk and the overall “alternative” nature of hedge funds may be dissipating, at least to a small extent. Standardised sets of regulation, as argued earlier in this thesis, may provide greater certainty in general, but does not exactly provide the flexibility and the consequent safeguard against the possibility of overregulation.

Overproduction of regulation may disadvantage retail consumers by denying flexibility and variety in the basket of available investment opportunities and services accessible in less regulated markets. A further effect thereof might be disinvestment within a stricter regulatory landscape and the shift thereof to less regulated markets, resulting in regulatory arbitrage. Underproduction of regulation, on the other end, exposes retail consumers to exploitation. Therefore, finding regulatory balance within a specific jurisdiction would require a combination of regulatory tools available to be implemented, whether directly or indirectly, having regard to economic circumstances, international best practice due to the integrated and sophisticated financial architecture globally and, of course, risk.

The regulation of the hedge fund industry is very different from regulating the markets in which hedge funds operate. The general financial regulatory solutions that may be used for hedge funds are limited due to the complexity of investment strategies and models. Since the financial crisis, questions concerning the adequacy of financial regulation have become pertinent, especially with regard to the oversight and supervision of a consolidated system of exchanges, integrated financial markets and whether private equity and hedge funds have created threats to financial stability and the integrity of traded markets.
These questions were not addressed by the financial regulatory system at that point but have extensively been addressed through the entire scope of regulatory reform processes in South Africa and will hopefully be continuously re-visited to establish adequacy and effectiveness as the impact of these new laws and regulations will become evident over time.
CHAPTER 7 SUMMARY, CONCLUSIONS AND RECOMMENDATIONS: ASSESSING SOUTH AFRICAN HEDGE FUND RETAIL INVESTOR PROTECTION

7.1 Introduction: Revisiting the problem statement and objectives

This study assessed retail hedge fund regulation in South Africa vis-à-vis international good practice. The importance of hedge fund regulation after the 2008 global financial crisis was evaluated in Chapter 1. Financial regulation was identified as an important driver of the GFA landscape; thus, hedge fund regulation reform in South Africa was assessed with investor protection as a key facet. The impact on investor protection as one of the fundamental reasons for regulation was also highlighted in Chapter 1. The combination of increased financial sector innovation coupled with momentum towards retailisation (or access to financial investment products for retail investors) emphasised the importance of continued investor protection.

In Chapter 1 it was asserted that investors should always have access to all investment products, as well as the right to decide for themselves which products to purchase or which product-risk combinations would suit them best. This would allow for investment decisions to be tailored according to current and expected financial income streams, portfolio of assets and obligations, and their own tolerances for risk. Asset managers would then provide various investment products that would satisfy the needs of most investors. Consequently, investors would be solely responsible for their own profits, miscalculations and decisions relating to their investments. Real-world complexities disrupt this ideal setting considerably, necessitating intervention by governments and regulators. Intervention in financial markets, due to their interconnectivity, requires not only domestic regulatory solutions, but also cross-jurisdictional regulatory cooperation (and alignment of these).

Not all investors have the same information or financial nous to evaluate the information they receive. Difficulties arise when retail investors do not have the ability to comprehend risks associated with such investment, for example, information asymmetries, conflicts of interest and disparate investor capabilities. These risks may be better understood by better-equipped or financially sophisticated investors. The ensuing argument purports that, where the evolution of and innovation in international retail markets (due to the intricate function of financial systems and markets worldwide) are not properly aligned, constantly established, suitably enforced and closely safeguarded, the retail investor becomes excessively exposed to risks associated with “alternative investment” products, as in this case, hedge funds. This lack of investment exposure and associated lack of understanding (or accurate knowledge) regarding complex investment related
activities – usually employed within hedge fund strategies – could arguably be one of the main reasons for concern over retail access to such investments.

It was proposed in Chapter 1 that retail investors in hedge funds require adequate protection within the regulatory framework recently purposed in South Africa. The main objective of this study was, therefore, to empirically assess whether investors in retail hedge funds in South Africa are adequately protected within the enacted regulatory framework. For this purpose, domestic regulatory good practices and/or principles were identified and benchmarked to or compared with international hedge fund regulatory reforms and developments, similarly so identified, within an increasingly complex and advanced financial industry.

To achieve the main objective, the following secondary objectives were formulated:

i. to determine whether legal scientific research methodology can be used as a valid research method within the risk management domain;

ii. to identify from academic literature, legislation, proposed legislation and directives and guidelines issued by international regulatory or supervisory bodies, standards and good practices or principles regarding the regulation of hedge funds and/or the regulation of retail hedge funds specifically, should any regulation explicitly make provision therefore;

iii. to identify from academic literature, legislation, proposed legislation and directives and guidelines applicable within the respective demarcated country jurisdictions, standards and good practices or principles regarding the regulation of hedge funds and/or the regulation of retail hedge funds specifically, should any regulation explicitly make provision therefore;

iv. to identify from academic literature, legislation, proposed legislation and directives and guidelines applicable within South Africa, standards and good practices or principles regarding the regulation of hedge funds and/or the regulation of retail hedge funds specifically, should any regulation explicitly make provision therefore, and to provide an overview on the development of hedge fund regulation in South Africa; and

v. to assess the regulatory reform and new legislative requirements imposed on retail hedge funds in South Africa compared with international standards and good practices (determined in the literature and regulatory overview) to establish whether current provisions in fact conform to or substantially measure up compared with international good practice.

7.2 Chapter overview

Throughout this thesis, Figure 7-1 was used to frame the discussion within each chapter, provide direction and indicate the progression of the study.
This thesis linked the regulation of hedge funds within the jurisdictions of the US, EU, UK and South Africa as set out in Chapters 1 to 6 illustrated above. It provided a portrayal of the progress achieved on regulatory reform post the financial crisis of 2008 within the international jurisdictions for purposes of benchmarking South African regulatory developments in this regard. The focus stayed on retail investor protection whilst empirical analysis was performed to extract from direct legal regulation those principles or good practice that would have an impact on investor protection. The research highlighted the significance of these major jurisdictions (US and UK specifically) and the influence of their preferences on the regulation of the industry before the financial crisis. These powers mostly advocated for the superiority of market discipline and self-regulatory mechanisms. The financial crisis precipitated alterations in domestic policies of these countries, leading to changes in international rules.

Awareness created by the politicisation of the financial fallout of the crisis and the amount of taxpayer money required in the form of bailouts, provided the platform for regulators and policy-makers to act. The complicit role of hedge funds in the crisis was advanced and accepted. This led to not only defensive regulations, but to constructive improvements in the industry and attempts to reinstall trust and confidence.

Owing to the magnitude and the interdisciplinary nature of this legal comparative study, the information discussed in each chapter was, in many cases, summarised in table format. This approach was found to be the most effective technique to consider the material meaningfully. In this way,
the legislative and/or regulatory provisions that were examined could be highlighted. The objectives of this study were thus predominantly consolidated in this format.

Chapter 2 shifted the focus towards transnational hedge fund regulation. Views on financial regulation differ somewhat, but the fact remains that such a system is central to maintaining effective financial markets, institutions, financial service providers and, consequently, financial systems. Several arguments were laid out to validate its importance, including collapses in banking systems to the global financial turmoil experienced since the 2008 financial crisis. Chapter 2 also provided a structural design of international financial law, as it applies to this thesis, reiterating the importance thereof as an underpin to financial regulation. Attempts to regulate hedge funds have been made over several years, and much of the significant shifts in regulatory oversight can be ascribed to large hedge fund failures. Together with the re-assessment of the robustness of the entire global financial system since the 2008 crisis, hedge fund regulation has gained prominence.

The valid argument for regulation based on systemic importance has been echoing in the aftermath of the crisis. The consistent drive towards providing access to hedge funds highlights the fact that retail investors will be provided access to hedge funds on an increasing basis. The IMF reiterated that the increasing use of hedge fund investment techniques by mainstream CISs will lead to the increased retailisation of hedge funds. Retail investors are also increasingly gaining access to alternative, hedge fund-like products, exposing them to the same risks and investment complexities. Regulatory concerns relating to investor protection and market integrity (particularly in the context of retail investments in hedge funds) were identified to be of concern amongst jurisdictions where retail participation is possible. A discussion then followed on the studies and reports undertaken by IOSCO as the relevant international sectoral standard setter relating to hedge funds (and the risks posed by them). This association of organisations regulating the world’s security and futures markets principally provides the jurisdictional approaches followed by most countries towards hedge fund regulation and establishes the basis for any cross-jurisdictional assessment.

General regulatory approaches to hedge funds were identified in Section 2.3, namely the registration or authorisation of CISs engaging in hedge fund-like strategies, or jurisdictions that limit hedge fund oversight by regulators and jurisdictions where no registration or regulation of hedge funds is required. Two different policy approaches were highlighted from deliberations following the 2008 financial crisis: Some jurisdictions favoured direct regulation, whilst other drove an indirect approach to regulation (Section 2.3). It was only during preparations for the April 2009 G20 summit that several European countries, led by France and Germany, called for hedge fund regulation and proposed that hedge funds be regulated in a similar way to banks. The 2008 financial
crisis and its effects on global financial markets revived the drive towards formal direct regulatory interventions. Based on the indirect, direct or combined regulatory approaches, the most relevant regulatory principles, which best reflect good practice (as identified through the IOSCO structure), were highlighted in Table 2-2. This laid the foundation for the review and potential inclusion of further practices or principles identified from the demarcated international jurisdictions examined in Chapters 3 and 4.

Chapter 3 commenced with the US. Investor protection good practices were identified (through a similar process followed in Chapter 2) to be supplemented if needed. This chapter established the layout of the US regulatory structure, after which the regulatory framework for hedge funds within the US was discussed. A discussion on the market structures determining investment in hedge funds followed, together with a portrayal of all applicable legislation. The chapter concluded with a summary of the identified investor protection good practices in the US context as a further contribution towards the identification of relevant principles for hedge fund regulation and those related to retail investment in particular. Chapter 3, like Chapters 2 and 4, contributed to the final selection of principles that were employed to benchmark the South African regulation of retail hedge funds.

Chapter 4 focused on the development of investment regulation through the UCITS, MiFID and AIFMD schemes with the aim to determine the positioning or application of these respective regulatory frameworks to hedge funds. The application of the UCITS framework, as argued earlier, allowed for harmonised, open-ended CISs to freely pursue business within the EU and included the marketing of shares and units. The approval of the UCITS III addressed many shortcomings. It not only allowed for the extension of the scale of eligible UCITS investments, but also the cross-border marketing of funds under a single passport, which expanded activities across EU countries. However, hedge funds continued to be excluded from the harmonised funds framework. The indirect widening of the UCITS funds’ investment discretion due to regulatory changes bringing it into the reach of UCITS fund managers, gives them the ability to employ derivatives and, consequently, allows for the employment of leverage. Retail investors, therefore, have access to partial benefits normally associated with sophisticated portfolio diversification delivered through funds-of-hedge-funds investing. These types of funds give an expected higher return because of recourse to the use of derivatives.

Most of the principles related to hedge funds and assessed as part of this thesis were extracted from the AIFMD directly. It became evident that the drive towards the alignment between financial regulatory frameworks (such as UCITS and the AIFMD) also seemed to be steering hedge fund managers towards voluntary listing under the AIFMD. The chapter ended by extracting the final
selection of principles with regard to EU legislative provisions to be employed to benchmark the South African regulation of retail hedge funds.

The importance of regulation, as emphasised throughout the thesis, necessitated the UK financial system post the 2008 crisis to review its financial system and its regulation. With this in mind, the discussion in Chapter 5 commenced with a focus on the structural changes implemented following the enactment of the Financial Services Act of 2012. These structural reforms impacted hedge fund regulation in that they created new regulatory agencies responsible for prudential and market conduct regulation. An overview of the UK government’s approach to financial regulation was provided, including the roles and accountabilities within this financial system. This overview was furthermore important due to the influence of regulatory advancements within the EU and UK on South African legislation. Similar processes were followed by the South African government and enabled it to review the structure of the South African financial system during 2010. This process led to financial sector regulatory and structural changes being transposed into law in South Africa in 2015. The overview of the UK government financial regulatory approach was followed by a portrayal of the UK asset management industry from a retail investment perspective to lay the foundation for the discussion of hedge fund regulation in the UK. This discussion established a premise on which a determination could be made as to whether any additional good practice principles could be incorporated into the framework already identified within the prior three chapters.

The previous discussions culminated in Chapter 6 with the assessment of the South African financial sector regulatory and structural reforms, introduced mostly in response to the financial crisis. This assessment was approached like the other chapters in this thesis by providing the required background to financial regulation, the purposes of and progress made with regard to the restructuring of the financial sector regulatory architecture, set in motion by the Twin Peaks process up to the formal declaration of hedge funds as CIS. The regulation of RIHFs explicitly provided for in CISCA through the RIHF structure was explained in detail. Principles or good practice extracted from international good practice provided for through IOSCO, as well as good practice principles identified from the jurisdictions demarcated in the thesis, guided the rendition of the good practice principles incorporated in South Africa, as per Table 6-10.

7.3 An assessment of South African regulation of retail hedge funds in relation to identified international good practice principles

Given the extent of the literature and other related sources considered, and to determine a set of good practices agreed to internationally by different legal jurisdictions with different approaches to the regulation of retail investment in hedge funds, some comments are warranted.
- International associations or bodies such as the G20 and IOSCO play an important role in the cross-jurisdictional cooperation amongst members (see Section 2.3) of an ever expanding, intricate and complex GFA. Since the first ramifications of hedge fund failures were felt and as the effects of the 2008 financial crisis began to surface, regulators responded by providing a range of actions to protect investments in hedge funds. Such responses ranged from blanket prohibitions on retail investment to indirect limitations such as qualification requirements in the form of minimum investment amounts. Additional requirements, like those of existing financial intermediaries (such as banks) which include the regulation of associated third parties, the structure (in this case, the fund itself, as well as the manager involved), were implemented in most jurisdictions which form part of IOSCO membership. All three the identified basic types of regulation, including market integrity or market conduct, prudential and consumer regulation, were addressed substantially.

- As a result of the commitments agreed to by G20 members after the 2008 financial crisis, reform principles were addressed regarding hedge funds, encompassing transparency and accountability, sound regulation, the promotion of integrity and the reinforcement of international cooperation.

- The global drive for the transition from sector-driven principles of financial regulation to stricter regulatory frameworks influencing individual markets or entire financial market structures is evident and clearly so where it involves retail access to investment in general. These frameworks have accordingly increased in rigour or towards more complex investments (see Section 2.3). This shift has become known as retailisation or “de-institutionalisation”. It substantiates this principle of access to investments for all investors and necessitates a continued investor protection focused research.

- Consolidated tables of regulatory good practices identified through Chapters 2-6 provide a standard foundation of investor protection good practices which were identified from more recent regulatory enhancements globally, and which apply to retail investor protection in hedge funds. These good practices are catered for by the demarcated jurisdictions. The approach to protecting retail investors in hedge funds differs across the respective jurisdictions. For example, direct retail investment in hedge funds is precluded entirely through investor qualification criteria employed in the US, whereas provision for direct retail investment in hedge funds has been made in South Africa through CISCA. However, South Africa has simultaneously restricted blanket access to complex and higher risk investments where, for instance, the strategy involves complex derivatives and falls within what is regulated as QIHFs.

- Hedge fund regulation is influenced by several factors, of which the historical development of the financial and regulatory system, the size of market and the market structure are but a few. Regulating the hedge fund industry is very different from regulating the markets in
which hedge funds operate. General financial regulatory solutions that may be used for hedge funds are limited. This limitation stems from the complexity of investment strategies and models.

Table 7-1 provides a consolidated view of the core good practices identified from Chapters 2 to 6.
Table 7-1: South African retail hedge fund regulation mapped against good practice principles identified from Chapter 2 to Chapter 6

<table>
<thead>
<tr>
<th>Good practice principles identified</th>
<th>Good practice principle description</th>
<th>United States of America</th>
<th>European Union / United Kingdom</th>
<th>South Africa</th>
<th>Assessment of South African regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registration</td>
<td>Mandatory registration for managers and/or investment companies are required subject to exclusions. The exclusions either relate to managers or disqualify retail investors from investing in hedge funds. This is an indirect disqualification which, given the global shift towards retailisation, might sooner or later require a positive approach towards providing a regulatory framework.</td>
<td>Authorisation of ongoing operation and transparency of AIFM managers within the EU are required, subject to exemptions allowed for under the AIFMD. The AIFMD requires authorisation for the management of an AIF by an AIFM. Member states must require AIFMs to apply for authorisation from the competent authority of the home member state.</td>
<td>A CIS must be managed by a manager that needs to be registered as such. The administration must be done with required skill, care and diligence and should be executed fairly. There are restrictions on companies allowed to register. These companies must comply not only with the requirements of CISCA, but also with other legislative prescriptions in relation to good corporate governance and compliance in general with the Companies Act, 71 of 2008. Fund administration is subject to proper due diligence and a fund administrator must be appointed subject to strict requirements, including that it must be a registered FSP with adequate experience, skills and knowledge plus enough capital to perform its function effectively.</td>
<td>South African regulation in line with international good practice. South Africa exceeds the minimum standard by requiring that both manager and fund must register.</td>
<td></td>
</tr>
<tr>
<td>Ongoing regulatory oversight measures</td>
<td>Hedge fund managers or advisors must be required to register and should be subject to ongoing regulatory requirements pertaining to operational/organisational standards; conduct of business rules, including conflict of interest; investor disclosure; and prudential regulation.</td>
<td>Ongoing regulatory oversight is provided for hedge funds qualifying for registration under the respective sets of legislation.</td>
<td>Designated oversight authority is required within the EU, together with the home authority of each member state, of which the UK still forms part.</td>
<td>Ongoing oversight will mainly be deployed through the regulator, the FSCA, with which a hedge fund has been registered. The registrar has extensive oversight and powers to intervene timeously should there be concerns about liquidity, etc. In addition, the registrar may determine the way in which limits or conditions to securities or classes of securities that may be included in a portfolio. It is also required that an annual report be included within the financial statements of the hedge fund and each portfolio in accordance with section 90 of CISCA. Quarterly reporting to the registrar is another requirement. With regard to RI-HFs, monthly reporting is mandatory for each portfolio.</td>
<td>South African regulation is in line with international good practice.</td>
</tr>
<tr>
<td>Good practice principles identified</td>
<td>Good practice principle description</td>
<td>United States of America</td>
<td>European Union / United Kingdom</td>
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<tr>
<td>Third-party services provision, registration and supervision</td>
<td>Banks and prime brokers which provide funding to hedge funds must be compelled to adhere to registration and supervision.</td>
<td>Third-party supervision and registration are available to entities which provide prime brokerage services, compliance, legal and audit-related services.</td>
<td>The AIFMD deals with the delegation of tasks of an AIF to third parties. Competent home member state authorities must be notified and an AIF must be able to indicate: - justification for delegating the entire structure objectively; - having sufficient resources to effectively conduct business, alongside required experience and good standing; - that Delegated risk and portfolio management are subject to prior approval obtained from home member state and subject to regulatory oversight; - that where third parties are conferred with responsibility for risk or portfolio management under a third-country undertaking, cooperation between home member state and a competent authority and the supervisory authority of the undertaking must be established; - that the effectiveness of supervision must be ensured and the best interest of the investor should be the focus of an AIF at all times; - Delegates must be qualified and able to undertake the functions of an AIFM, and the selection must be made with due care. Delegation does not affect liability towards investors. AIFMs remain liable.</td>
<td>South African Banks as prime brokers are required to register in accordance with local banking legislation, which adheres to Basel requirements. When establishing a scheme, platforms and accompanying portfolios to be used must adhere to the principle of segregation. Such platforms and/or portfolios, which may be separately administered, may be run by different financial services providers. Hedge funds are also required to report to the registrar on a quarterly basis.</td>
<td>South African regulation is in line with international good practice. Banks and other third-party service providers are regulated strictly under Basel and local banking legislation.</td>
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<tr>
<td>Good practice principles identified</td>
<td>Good practice principle description</td>
<td>United States of America</td>
<td>European Union / United Kingdom</td>
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<td>Information, disclosure and marketing</td>
<td>Hedge fund managers and prime brokers should provide relevant regulators with information for systemic risk purposes.</td>
<td>Information obtained from hedge fund managers and any third-party service provider must be available for disclosure. This requirement includes information to be provided or disclosed within industry norm intervals to enable decision making for investors. Investors should furthermore understand the disclosed information sufficiently for risk management purposes and the evaluation of portfolio valuations by fund or third parties.</td>
<td>The AIFMD requires member states to comply with all conditions set by the directive. Article 7(2) to obtain authorisation information on the persons conducting the business of the AIFM must be provided together with the identities of shareholders or members directly or indirectly involved, whether natural or legal persons, who have qualified holdings. The amount of holding must also be provided, amongst other required information. Information in relation to depositaries must also be regulated in terms of such contracts to allow the depositary to provide its services. In accordance with transparency requirements captured in Chapter IV, annual reports that include financial information should also be provided to regulators and investors. Information should also be provided directly to investors. The information should include description of investment strategies, the objectives of the AIFMs and the types of assets involved, etc. Requirements exist for information disclosure obligations to competent authorities. Annual reporting is required upon request to investors and must be provided to authorities within the member state. Disclosure of investment strategies, the objective of the AIF, change procedures relating to investment by the AIF and descriptions of the main legal implications of contractual relationship between the AIF and investors. Disclosure of information is demanded before investment, not only information such as the type of investment or strategy, but also the information necessary for an investor to make an informed decision and allowing time to comprehend the risks associated with the investment. The appointment of a prime broker is made subject to strict requirements and is compulsory in respect to RIHF. Information must be available to potential investors and be reported on quarterly. Quarterly reports must include information such as the methodology for conducting stress testing, the most recent total expense ratio applicable to the portfolio, etc. Specific disclosure requirements in relation to fees are necessary.</td>
<td>Disclosure of information is demanded before investment, not only information such as the type of investment or strategy, but also the information necessary for an investor to make an informed decision and allowing time to comprehend the risks associated with the investment. The appointment of a prime broker is made subject to strict requirements and is compulsory in respect to RIHF. Information must be available to potential investors and be reported on quarterly. Quarterly reports must include information such as the methodology for conducting stress testing, the most recent total expense ratio applicable to the portfolio, etc. Specific disclosure requirements in relation to fees are necessary.</td>
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South African regulation is in line with international good practice.
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<tr>
<th>Good practice principles identified</th>
<th>Good practice principle description</th>
<th>United States of America</th>
<th>European Union / United Kingdom</th>
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<th>Assessment of South African regulation</th>
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</thead>
<tbody>
<tr>
<td>Good practice identified</td>
<td>must, amongst other information, be disclosed. Reporting obligations to competent authorities must be adhered to, and further provisions determine adherence as an example, to the management of a leveraged AIF, and any ancillary information requirements, supervisory cooperation necessities or limits to leverage. Marketing within the home member state of the AIFM is allowed, subject to home member state supervision. EU AIFMs may market units or shares of any EU AIF it manages to professional investors of the home member state of the AIFM. An AIFM may also market in other member states. There are a number of provisions that need not be transposed, as they apply directly within the member states, and where marketing takes place through a passport of a non-EU AIF managed by an EU AIFM, third-country provisions will apply. Good industry practices exist and have been developed since the designation of hedge funds as CISs. They specifically provide for direct retail investment subject to stringent leverage, liquidity, marketing and other rules in accordance with the CISCA and the Determination on Requirements of Hedge Funds.</td>
<td></td>
<td></td>
<td></td>
<td>South African regulation is in line with international good practice.</td>
</tr>
<tr>
<td>Good practice principle identified</td>
<td>Regulators should encourage the development, implementation and convergence of good industry practices. Development and implementation of good industry practices exist, but provide for strict qualification criteria for investment in hedge funds.</td>
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<td>Industry practice development</td>
<td>Industry practice development</td>
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<th>Good practice principles identified</th>
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<th>European Union / United Kingdom</th>
<th>South Africa</th>
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<tr>
<td>Global oversight and cross-border risk management</td>
<td>Regulators should be given the authority to co-operate with one another, where appropriate, and share information so that global oversight of funds and managers alike can be facilitated.</td>
<td>Regulatory cooperation exist through international soft law structures.</td>
<td>The AIFMD aims for the establishment of common requirements governing the authorisation and supervision of AIFMs. This is done so as to provide a coordinated approach to any risks related to the management and/or functioning of AIFMs within the EEA and their resulting impact on markets and investors within the EU. By providing for an internal market for AIFMs, together with a stringent regulatory and supervisory framework, a uniform set of rules are established for all activities of AIFMs within the EU. An example of this is Article 43 that determines cross-border marketing of AIFs to retail investors irrespective of whether they are EU- or Non-EU AIFs. Articles 44–46 of the AIFMD state requirements for established competent authorities within member states and their powers, etc.</td>
<td>CISCA established a common set of governing rules regarding the authorisation and supervision of hedge funds. This set of rules provides for a coordinated approach to any risks involved in the management and functioning of hedge funds in South Africa. Owing to the aligned approach taken towards those areas requiring regulation and South Africa’s being part of an international framework which aims to regulate hedge funds in a coordinated and risk-based way, it can be argued that, from a good practice stance there is global influence and oversight in regard thereto. Furthermore, risk management practice and cross-border investment require risk management practice to be at a standard that would, at the very least, adhere to the jurisdictional requirements of the country or economic area where such an investment is made. An example would be UCITS in relation to which specific passporting requirements must be complied with, etc.</td>
<td>South African regulation is in line with international good practice.</td>
</tr>
<tr>
<td>Hedge fund conceptualisation and definition</td>
<td>The ability to precisely define “hedge funds” is required to arrive at a legally sound description of the term for regulatory purposes.</td>
<td>Hedge funds are defined and are identifiable for purposes of their regulation domestically, as well as for transnational regulatory purposes.</td>
<td>The definition of an AIF classifies hedge funds amongst other fund types such as venture capital funds, as CISs are not covered by the UCITS regulatory regime. AIFs are widely defined as CISs that undertake to raise capital from a wide range of investors with the aim to invest the funds in accordance with a defined investment policy for the benefit of the investors and do not require approval under Article 5 of UCITS.</td>
<td>Hedge funds are clearly distinguished and defined in accordance with legislation. Distinction is clearly drawn between different types of funds.</td>
<td>South African regulation is in line with international good practice.</td>
</tr>
<tr>
<td>Investment qualification</td>
<td>Adequate investor assessment of invest-</td>
<td>The US follows an indirect approach to the protection</td>
<td>To enable investment through retail or qualified investors, registration and adherence to the AIFMD must</td>
<td>To enable investment through retail or qualified investors, registration and adher-</td>
<td>South African regulation is in line with</td>
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<thead>
<tr>
<th>Good practice principles identified</th>
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<th>European Union / United Kingdom</th>
<th>South Africa</th>
<th>Assessment of South African regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>criteria/position assessment</td>
<td>Investment propositions including suitability of hedge funds for investor needs.</td>
<td>of retail investors by excluding investors who do not fulfil the qualifying criteria for investment in hedge funds.</td>
<td>take place where the intended manager or fund qualify as such. The provisions include the regulation of risk management incentives, capital requirements, liquidity requirements, provisions regarding investment securitisation positions, rules regarding remuneration and rules for valuation, to name a few.</td>
<td>reference to CISCA are required where the existing or intended manager or fund qualify as such. The provisions include the regulation of risk management incentives, capital requirements, liquidity requirements, provisions regarding investment securitisation positions, rules regarding remuneration, rules for valuation, etc. Exposure to securities and assets are strictly regulated for RIHFs, and the use of leverage is allowed, but subject to strict risk assessment.</td>
<td>international good practice.</td>
</tr>
<tr>
<td>Investment Vehicles</td>
<td>The usefulness and role of investment vehicles in capital markets are left to markets to decide.</td>
<td>Investment vehicles or structures are governed under existing legislative provisions.</td>
<td>Investment vehicles or structures are governed under existing legislative provisions within member states qualifying as legal structures that may be utilised as CISs.</td>
<td>Portfolios are allowed only to make use of an investment scheme trust arrangement or an en commandite partnership as legal structures. Legal structures provided are substantially regulated. RIHFs must, in addition, appoint a custodian as contemplated in part IX of CISCA and may also appoint a separate depository for safe keeping of assets.</td>
<td>South African regulation is in line with international good practice.</td>
</tr>
<tr>
<td>Inherent risk and risk management</td>
<td>The notion that hedge funds carry more risk inherently and should not be available to non-qualified retail investors, alongside the issue of systemic risks and exposure, are the two major issues identified regarding hedge funds.</td>
<td>Risk management and awareness are of high importance and extensively considered. Many good practice principles in relation to internal risk management, third-party risk management, as well as compliance and conflict of interest management are prescribed.</td>
<td>General requirements on effective risk management are captured within the AIFMD, and risk taking which is inconsistent with existing risk profiles, instruments of incorporation or rules in relation to AIFs managed is discouraged. Articles 13 and 15 capture rules in relation to the separation of risk management functions from that of portfolio management. Articles 16, 17 and 18 address liquidity management, investment in securitisation positions and the proper and consistent management of AIF asset valuations respectively. Appropriate human and technical resources should always be available. Home member states within the EU must ensure that the strict requirements apply to managers in relation to internal risk management procedures. They are compelled to strict due diligence before investment in derivative instruments availed by counterparties. Stress testing must continuously be done to determine counterparty exposure and the impact that the possible change in risk profile of such counterparty may have on the risk indicators attributable to the manager. Strict requirements are prescribed in relation to liquidity and repurchases, which include the inability to encumber assets for other reasons than investment purposes and the ability or requirements for managers to be able to measure and manage liquidity risk in every respective portfolio against repurchase obligations. Counterparty exposure must be limited to the NAV of each portfolio</td>
<td>Strict requirements are prescribed in relation to liquidity and repurchases, which include the inability to encumber assets for other reasons than investment purposes and the ability or requirements for managers to be able to measure and manage liquidity risk in every respective portfolio against repurchase obligations. Counterparty exposure must be limited to the NAV of each portfolio</td>
<td>South African regulation is in line with international good practice.</td>
</tr>
<tr>
<td>Good practice principles identified</td>
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<tr>
<td>AIFM has sound administrative and accounting procedures, as well as control and safeguard arrangements for electronic data management. Amongst others, transactions involving an AIF must be able to be reconstructed according origin, nature, time and place when affected. Where risk or portfolio management functions are delegated, it must only be conferred to undertakings authorised and registered for such purpose, subject to supervision, and, if required, approval be obtained from the competent authority within the member state in accordance with article 20 concerning delegated functions.</td>
<td>per one counterparty subject. RIHF are allowed to post or receive collateral to and from counterparties where counterparty limits have been breached. This must be done in accordance with strict principles and rules, including legal agreements, issuer credit quality and valuations, to name a few.</td>
<td></td>
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</table>

Source: Author’s representation
From the assessment in Table 7-1 and the extended discussion in Chapter 6, the following conclusions are drawn regarding the regulation of South African hedge funds:

i. South African hedge fund regulation meets, and in some areas exceeds, the international minimum best practice standards identified throughout this study;

ii. The direct approach to regulating retail hedge funds stems from the historical development of the hedge fund market in South Africa and is incorporated into existing legislation by its designation of hedge funds as CISs. The CIS designation was not only done to establish a well-regulated CIS framework that could address global regulatory concerns because of the 2008 financial crisis, but also because collective investment type scheme structures are recognised globally;

iii. Retail hedge fund structures are regulated, as well as the management companies that form part of these structures. Regulating both the fund structure and the manager can be viewed as overregulating the industry in as much as weight can be attributed to the size of the market, its size and influence as in and how it relates to the larger global country jurisdictions in relation to the regulation employed. Furthermore, overregulation may result in unforeseen consequences and negatively affect growth with regard to asset inflows due to regulatory arbitrage.

iv. The strict South African retail hedge fund regulatory environment has, however, seen a sizable distribution of assets under management allocated to RIHFs. This indicates an increased interest on the retail investment end. Regulatory certainty could be one reason for this interest. Another reason could be that, by providing certainty, market confidence has increased and that the general stigma regarding risk and the overall “alternative” nature of hedge funds might be dissipating.

v. Given the drive towards retailisation of investments (including alternative investments such as hedge funds), the establishment of a clear, well-regulated framework for access to these investments is important. This is where South African retail hedge fund regulatory positioning establishes the hedge fund market as a well-regulated market. Sound preparation for investment inflows should, amongst other economic and market influences, make WEF predictions on increased expansion into the retail market a reality.
7.4 Contribution

The contributions of this study, as highlighted in Chapter 1, are:

- Overall, the importance of investor protection in country jurisdictions that are part of an increasingly innovative and growing global financial marketplace and investment landscape cannot be understated. The regulatory environment for hedge funds has seen a transfer-ence of assets into retail investment in hedge funds. Aims to provide access for retail invest-ors to alternative type investments emphasise the need for investor protection practices that are balanced in their aim to provide protection whilst not stifling innovation and growth. The measurement of investor protection actions against the dominant yet comparable in-ternational and local regulatory landscapes remains vital. In this regard, the current study contributes to the general body of knowledge by providing a retail perspective on access to complex alternative investments such as hedge funds. This perspective sets out the global soft law landscape of the US, EU, UK and South African markets combined. The retail investor protection good practices from these jurisdictions were shown in Tables 2-2, 3-4, 4-2 and 5-3 respectively and consolidated in Table 7-1. The South African regulatory framework for retail hedge fund investment protection good practice stated in Table 6-10 was assessed according to the consolidated good practices. The research confirmed that structural reforms to the South African financial system, together with the inclusion of hedge funds as CISs in accordance with CISCA, provide a sound good practice framework and adhere to international good practice on retail investor protection in hedge funds.

- The validation for the use of legal scientific research methods, and specifically the legal comparative method within the risk management sphere as part of the research design and methodology for this thesis, contributes to the development of a multidisciplinary research methodology, as argued in Section 1.7.

- This study evaluated retail hedge fund investment regulation in South Africa in accordance with changes to the South African financial regulatory structure after the implementation of the FSRA and the declaration of hedge funds as CISs in accordance with CISCA.

- This study assessed the evaluation of retail hedge fund regulation and good practices identified relative to international good practice. This was done by benchmarking or comparing the South African regulatory landscape for retail investor protection in hedge funds with international good practice on retail investor protection, having regard to international securities regulation and good practice identified from the demarcated country jurisdictions in Chapters 2 to 5.
This study contributes to the research field by highlighting recent developments within the budding body of literature on the regulation of hedge funds, especially with the focus on retail access thereto, together with providing detailed research on the evolution of hedge funds within the demarcated country jurisdictions. Analysis of the ongoing reforms within these financial jurisdictions, which arguably wield the most influence on the development of financial regulation, supports the continuous concern regarding investor protection and security in complex and highly innovative financial markets globally.

7.5 Assessment of objectives reached and some final remarks

The objectives of this study were reached. Table 7-2 summarises the objectives and the parts of the thesis which addressed these objectives.

Table 7-2: Thesis objectives

<table>
<thead>
<tr>
<th>Content description</th>
<th>Cross-reference</th>
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<tbody>
<tr>
<td><strong>Primary objective</strong></td>
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<tr>
<td>To determine whether investors in retail hedge funds in South Africa are adequately protected within the enacted regulatory framework benchmarked relative to international regulatory good practices.</td>
<td>Throughout and specifically in Chapter 7.</td>
</tr>
<tr>
<td><strong>Secondary objectives</strong></td>
<td></td>
</tr>
<tr>
<td>To determine whether legal scientific research methodology can be used as a valid research method within the risk management domain.</td>
<td>Sections 1.7.1 to 1.7.4.</td>
</tr>
<tr>
<td>To identify from academic literature, legislation, proposed legislation and directives and guidelines issued by international regulatory bodies, standards and good practices regarding the regulation of hedge funds and/or the regulation of retail hedge funds specifically should any regulation explicitly make provision therefore. Such good practices identified stem from the extracted practices of the international association of securities regulators, IOSCO and the country jurisdictions identified within the demarcation of this study.</td>
<td>Chapter 1, Chapter 2, Chapter 3, Chapter 4, Chapter 5.</td>
</tr>
<tr>
<td>To provide an overview on the development of hedge fund regulation in South Africa.</td>
<td>Chapter 6.</td>
</tr>
<tr>
<td>To assess the regulatory reform and new legislative requirements imposed on retail hedge funds in South Africa compared to international standards and good practices (determined in the literature and regulatory overview) to establish whether current provisions in fact conform to international good practice.</td>
<td>Chapter 6 and Chapter 7.</td>
</tr>
</tbody>
</table>

Source: Composed by author

To determine whether the primary objective was reached, the research questions stated in Chapter 1 must be answered:
i. **How does the framework for the regulation of retail hedge funds in South Africa compare with international standards and good practice with regard to the regulation of hedge funds and retail investor protection in such funds?**

The regulatory framework for hedge fund regulation, based on the identified good practices, conforms to international good practice. Through CISCA, not only are hedge fund managers regulated, but also hedge funds directly. CISCA provides for fundamental requirements such as registration and reporting to both investors and regulators but requires more strenuous compliance prescriptions for retail investment in relation to the use of derivative instruments, liquidity and repurchases, counterparty and portfolio exposure, to name but a few. This research question was thoroughly addressed in Chapter 6.

ii. **Do the enacted hedge fund regulatory reforms introduced in South Africa sufficiently protect the retail investor in hedge funds?**

The direct provision for investment in hedge funds, as stated in Chapter 6, and retail investment therein specifically, provides investors with access to this alternative type of investment. This is in line with international shifts towards retailisation of the global investment landscape in as far as the regulatory landscape can provide such access.

iii. **Can additional good practice be identified regarding the regulation of retail hedge funds within the existing international financial architecture and respective demarcated jurisdictions? If so, how can such additions be adequately addressed given the existing international good practice framework established in this thesis?**

No overall additions regarding good practice can be added at this point. The good practices identified in this thesis have been developed with the frame of the global financial system and existing architecture in mind. They are influenced by the largest market jurisdictions, namely the US, EU and UK. These markets determine primarily the policy direction and good practices that would structure the international hedge fund regulatory framework. Therefore, where shifts or changes in the GFA and the international hedge fund market occur, review of good practices may be required.

Based on these findings, it can be concluded that shifts in the GFA and structures of financial systems globally have led to changes to the South African financial regulatory landscape in the wake of the 2008 financial crisis. This global debate deployed a set of repercussions that would structure an international framework for the regulation of hedge funds and reinvigorate a drive towards investor protection. South Africa was, in a sense, ahead at least regarding the practice of regulating FSPs. Since the declaration of hedge funds as CISs, retail hedge fund investors...
have been sufficiently protected, assessed against international good practice. This confirms that the primary research objective of this study was achieved.

The research endorses the structural reforms to the South African financial system, together with the inclusion of hedge funds as CISs in accordance with CISCA. It was further established that South Africa possesses a sound financial good practice regulatory framework that measures well to international good practice on retail investor protection in hedge funds.

7.6 Suggestions for future study

Now that it has been established, based on the assessment of regulation in this study, that retail investors in hedge funds in South Africa are adequately protected, the following recommendations for further study can be made:

- Financial regulation should be reviewed and/or reformed regularly, especially given the speed at which innovation is occurring within this dynamic sector. Rules at any point in time would not necessarily apply to new technologies which could, for example, become incompatible with international financial regulation approaches overnight. In the EU regulatory approaches are regularly scrutinised and evaluated, for example, through the public consultations on the bank capital requirements regulation. Consultations furthermore attempt to determine the collective impact of financial regulation within the EU. The US Financial Choice Act was proposed by the House of Representatives in 2017. Although it represents an altered approach to regulation, this act has been viewed as a step backwards to previous approaches instead of improving the existing regulatory structure within the US. Some experts aver that the US response to the financial crisis, consolidated within the DFA, increased regulatory burdens for financial firms by adding considerable complexity to the resolution process of failing banks and restricted access to debt for households. One aim of the Financial Choice Act is to provide regulatory relief for a subset of banks which, in accordance with the intent of this act, would be smaller and systemically insignificant. This indicates a process of deregulation and re-regulation only a decade after the financial crisis. However, could this type of approach to the hedge fund market be a viable option? Given the size and systemic influence of hedge funds, could a lighter regulatory approach be proposed that would ease the regulatory compliance burden and stimulate investment simultaneously? Would this approach reinforce the existing risks to the financial system and other smaller developing markets?

- The regulatory complexity and strict direct regulatory requirements weigh heavily on market flexibility and innovation. Hedge funds have, however, traditionally been viewed as market
makers, providing value irrespective of market conditions and providers of market liquidity. These attributes offer market value, especially in circumstances where a diversified approach to investment strategy is required. This has been overshadowed in recent years by the exploitation of market opportunities to the detriment of global and local market investors. The overall increased marketability of hedge funds in South Africa, due to stricter regulation, is positioning them as a potential key role player within the South African savings industry. Institutional money flowing into hedge funds will imply greater exposure for investors through such investment, but possibly also increased returns. Future research could address the question of how hedge funds strategies could enhance risk-related returns for institutional investment in South Africa as an investment option.

Regulatory environments vary with regulatory cycles. They are not passive and static. Misconceptions such as that a market will take care of itself at the top of a financial cycle, which is the most dangerous point, or the ironic faith in strict direct regulation when a market is at the bottom of a financial cycle, give cause to look at the possibility of creating cycle-proof regulation in specific markets. Creating regulatory stability through a cycle would require comprehensive, contingent and cost-effective regulations. Regulation which apply comprehensively, for instance, to all financial institutions, would be less likely to cause a shift of financial activities to less regulated markets. The question to be asked then is: What types of contingent regulations could be available to markets that would have the biggest impact on the private sector when they are likely to do harm whilst having a lesser impact the remainder of the time? Would the possibility of prescribing the raising of contingent capital during good financial cycles at a cheaper cost with easier access be a solution that could help create financial soundness for possible cyclical downturns?
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Alternative Investments Fund Directive. see AIDF.


Asset Managers’ Committee. see AMC.

Association of the Luxembourg Fund Industry. see ALFI.


Bank for International Settlements. see BIS.


Basel Committee on Banking Supervision. see BSBS.


Chartered Insurance Institute. *see* CII.


CMS Cameron McKenna Nabarro Olswang LLP. see CMS.


Collective Investment Schemes Control Act see CISCA.
Committee of European Securities Regulators. see CESR.


Department of National Treasury. *see* South Africa. National Treasury.

DFA *see* Dodd-Frank Act.


Dodd-Frank Act *see* US (United States).


European Commission. see EC.

European Economic Community. see EEC.

European Funds and Asset Manager Association. see EFAMA.


European Securities and Markets Authority. see ESMA.

European Union. see EU.

European Union Commission. see EUC.


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Financial Conduct Authority. see FCA.

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Financial Stability Board. see FSB.

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Financial Services Board see. FSCA (Financial Sector Conduct Authority).


FSRA see South Africa. Financial Sector Regulation Act.


House of Lords see United Kingdom. House of Lords.


International Monetary Fund. see IMF.

International Organisation of Securities Commissions. see IOSCO.


Italian Association of Savings and Managers see Assogestoni.


Managed Funds Association. see MFA.


PriceWaterhouseCoopers. see PWC.


PWG see United States. National Archives and Records Administration. President’s Working Group.


Undertakings for Collective Investment in Transferable Securities. see UCITS.


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World Economic Forum. see WEF.


# ANNEXURE A

Table A-1: PWG categorised good practice identification and description

<table>
<thead>
<tr>
<th>Categorised good practice identifier</th>
<th>Good practice</th>
<th>Principle content description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMCP1</td>
<td>Disclosure</td>
<td>Disclosure is required due to the need for material information to redeem investments or make an investment. The required information will differ, as the structure of the fund or strategies employed by the fund differ. The required disclosure regime mirrors the approach followed within the US public company domain, which fundamentally argues the necessity to provide investors with information at the time of making the investment and updates throughout the lifetime of the investment. Information to be provided includes: - providing a private placement memorandum, - annual audited financial statements (accurately and independently verified), - periodic performance information, - investor communications, and - timely information on significant events that will have bearing on an investment. Information should be provided at least on a quarterly basis. In information reports, performance information should be qualitatively discussed in addition to quantitative data. Disclosure policy should include a manager’s view on disclosure to counterparties which needs to be determined as soon as the relationship is established. All exchanges are subject to confidentiality.</td>
</tr>
<tr>
<td>AMCP2</td>
<td>Valuation</td>
<td>Recommendations include the development of consistent policies outlining appropriate controls for segregation of responsibilities between portfolio managers and parties responsible for valuation. Valuation on fund investments does not raise the same issues. For certain investments, market price information is readily available, but other investments are illiquid with a limited or non-existent market, rendering valuations extremely complex. Governance mechanisms that include the establishment of a valuation committee will monitor a manager’s compliance with the fund valuation policy. Where third-party administrators are employed to monitor valuations they, on their part, could be monitored by the valuation committee. Managers may be involved in circumstances where the valuation of an asset is of such difficulty that the knowledge of the manager is required to value an asset.</td>
</tr>
<tr>
<td>AMCP3</td>
<td>Risk management</td>
<td>Owing to the nature of risk, a manager is required to determine the overall risk of the fund. Managers should adopt a wide-ranging framework to measure, monitor and manage risk within a purposefully established risk profile. The profile should include risks identified, the measure of principle categories, policies and procedures which determine monitoring and measurement criteria, and robust monitoring processes, together with knowledgeable employees. Risks involved where hedge funds deal with counterparties should be borne in mind, specifically because many of the counterparties are liquidity providers. Counterparty failure will be seriously detrimental to funds; therefore, creditworthiness of these parties are important.</td>
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<tr>
<td>AMCP4</td>
<td>Trading and business operations</td>
<td>A comprehensive framework for trading and business operations is paramount. The framework should include segregation of functions, infrastructure types for selected investments, effective management of fund operations and accounting, together with processes for the documentation of relationships with counterparties. Third-party service providers should be appropriately employed to provide strong protection for investors. Managers should designate at least a senior employee to take responsibility for oversight and provide adequate resources in support of this function.</td>
</tr>
<tr>
<td>AMCP5</td>
<td>Compliance, conflicts and business practices</td>
<td>A proposed framework to be adopted by a manager should include a written compliance manual incorporating a code of ethics. This should make provision for dealing with conflicts of interest and a clear employee education and training programme. The Chief Compliance Officer, who will be responsible for ensuring discipline and sanctions for non-adherence, should be appointed and needs to review the framework at least annually.</td>
</tr>
</tbody>
</table>

**Investor Committee Fiduciary Principles**

<table>
<thead>
<tr>
<th>ICFP1</th>
<th>Temperament</th>
<th>Does the organisation have the temperament to invest in innovative strategies? Does the organisation have sufficient institutional fortitude to abide by strategic allocations in the face of short-term volatility?</th>
</tr>
</thead>
<tbody>
<tr>
<td>ICFP2</td>
<td>Manager selection</td>
<td>Are the staff component and qualified with necessary investment skill? Do they have the ability to manage and monitor new hedge fund investments and/or existing investments effectively? If not internally, are there other intermediaries to be engaged to assist investment strategy evaluation and implementation?</td>
</tr>
<tr>
<td>ICFP3</td>
<td>Portfolio level dynamics</td>
<td>Is the way in which hedge fund portfolio returns are generated understood? Are return assumptions reasonable, given the market context? Is the risk of the overall portfolio completely understood, as well as the split between idiosyncratic risks or systematic risks associated with particular investments?</td>
</tr>
<tr>
<td>ICFP4</td>
<td>Liquidity match</td>
<td>Is the liquidity of a hedge fund portfolio consistent with organisational needs?</td>
</tr>
<tr>
<td>ICFP5</td>
<td>Conflicts of interest</td>
<td>Have potential, apparent or actual conflicts of interest arising from the hedge fund programme been identified and addressed?</td>
</tr>
<tr>
<td>ICFP6</td>
<td>Fees</td>
<td>Are fees reasonable within the market context? If existing levels of realised return are taken into account, what percentage of gross return goes to the manager versus the investor?</td>
</tr>
<tr>
<td>ICFP7</td>
<td>Citizenship</td>
<td>Evaluate the corporate citizenship of hedge funds within the portfolio and ensure that the fiduciary is comfortable with its practices.</td>
</tr>
<tr>
<td>ICFP8</td>
<td>Risk management</td>
<td>As part of assessing risk, fiduciaries should observe the nature of difficulty of investment, having regard to complexity liquidity, strategies, etc. Understanding the difference between risk and uncertainty is required. Selection and monitoring of investments require resources and continued support from professionals. Understanding the impact of effort and costs is required before investment, even when engaging third parties for investment support. Third parties should be monitored, and their capability determined continuously to ensure appropriateness of investments.</td>
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<tr>
<td><strong>Investment Committee Investment Principle</strong></td>
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<tr>
<td><strong>ICIP1: Due diligence</strong></td>
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<tr>
<td><strong>GP1</strong></td>
<td>Process</td>
<td>Understanding the investment process employed by the manager is vital. It is important how a manager invests and which financial instruments are employed to achieve a competitive advantage whilst proving the ability to perform consistently relative to the industry.</td>
</tr>
<tr>
<td><strong>GP1</strong></td>
<td>Performance</td>
<td>Historical performance with explanations for exceptionally poor or strong returns should be provided. Previous track records at other funds will add to this due diligence step. Has leverage been employed in past funds and to what success? Experience, performance record and fund size also provide further insight.</td>
</tr>
<tr>
<td><strong>GP1</strong></td>
<td>Personnel</td>
<td>Conduct through intensive due diligence on marketplace, reputation, experience and background of hedge fund managers and key persons. Employ as broad a range of employees or resources as possible including industry contacts, references, etc.</td>
</tr>
<tr>
<td><strong>GP1</strong></td>
<td>Risk management</td>
<td>It is important to understand how a manager perceives risk and manage such risks. The risk extends beyond market risks to liquidity, counterparty, operational and other risks. Risks not properly managed affect investment returns. Contingency and business continuity plans decrease significant business interruption.</td>
</tr>
<tr>
<td><strong>GP1</strong></td>
<td>Third parties</td>
<td>Which third parties are employed and who are the funds’ material trading counterparties that provide fund support, expertise and stability. There is also the possibility that contractual or structural relationships may give rise to conflicts.</td>
</tr>
<tr>
<td><strong>GP1</strong></td>
<td>Structure</td>
<td>The type of legal structure addresses investor or manager liability and also gives information on the type of management firm, whether large or boutique.</td>
</tr>
<tr>
<td><strong>GP1</strong></td>
<td>Domicile</td>
<td>Fund domicile influences legal, regulatory and tax regimes. Jurisdictional requirements in relation to legal, regulatory and tax regimes influence liability and requirements for the pursuit of legal claims.</td>
</tr>
<tr>
<td><strong>GP1</strong></td>
<td>Legal matters and terms</td>
<td>Aspects such as taxation, fees, liquidity, limitations on investments and leverage effectively influence investment and investor rights. A due diligence process should always include the way in which regulation influences a fund’s performance and strategy.</td>
</tr>
<tr>
<td><strong>GP1</strong></td>
<td>Compliance</td>
<td>The management of risk and regulatory compliance policies should be contained in fund documents. What responses are provided for when it comes to breaches of compliance or risk management policies? Is there a person involved who carries the responsibility for ensuring compliance, such as a Chief Compliance Officer?</td>
</tr>
<tr>
<td><strong>GP1</strong></td>
<td>Business management</td>
<td>Obtain information on the manager’s governance and compensation structures, the nature and breadth of ownership of the manager, client concentration and the stability of the client base.</td>
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|-------------------------------------|------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------
| GP1                                 | Investment performance             | Understand historical performance and the manager’s ability to operate the fund successfully in fluctuating market environments.                                                                                                                                                                                                                                                                                  |
| GP1                                 | Style and integrity                | This refers to the hedge fund’s ability to maintain investment styles which the investor initially evaluated and selected as part of the fund portfolio. Any changes in the investment style could influence the characteristics of the fund and investments therein, including financial instruments employed, the correlation between the funds targeted and market factors, etc. Continuous risk monitoring and reporting should be done. |
| GP1                                 | Model use                          | Many funds utilise qualitative modeling extensively and in a variety of ways. Qualitative modeling can be used to make investment decisions and identify risks. They could also be employed to determine a quantitative strategy which would direct the fund’s investment process.                                                                                                                                   |
| ICIP2: Risk management              |                                    |                                                                                                                                                                                                                                                                                                                                                                                                                  |
| GP2                                 | Investor risk management programmes | Investor risk management programmes speak to the incorporation of controls to protect the integrity of information used in hedge funds for purposes of evaluation and monitoring. The size of the fund, its complexity, portfolio structure, monitoring and risk oversight are elements to be taken in consideration for this purpose. Formal written policies and supervisory procedures should be developed to meet programme objectives. Policies and procedures should also be reviewed periodically. Comprehensive and professional internal and external risk management, measurement and compliance functions should also be developed. These programmes should be independent from the manager selection process, as well as the process through which investment performance would be evaluated. Where investors are not satisfied with information provided, third-party expertise should be consulted to administer risk management programmes. |

97 The reference to “investor” in this section carries the same meaning as that attributed to it in the IR report. This refers to the responsible person for making investments and determining the fund portfolio.
<table>
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<tr>
<td>GP2</td>
<td>Hedge fund programmes</td>
<td>Fund managers should employ the risk management framework with key features which include an oversight function to determine risk relevant to investment style and type plus policies to ascertain risk parameters and adjustments thereto, including stress testing, effectiveness verification, and reporting and communication procedures and protocols for when a breach occurs. Risk models should test risk systems regularly, and risk managers should understand a fund’s trading strategies and related risks. A direct line of report to senior management must be established. Risk management employees must risk data, metrics, sources of risk and exposures to markets quantitatively and qualitatively on an ongoing basis. Investors, on their part, must understand the manager’s risk management philosophy and process together, with markets and trading strategies actively being employed. They should determine whether the manager has an independent risk management compliance function. Investors should review and understand policies and procedures to determine their effectiveness and obtain enough information on internal risk management practices, metrics and risk calculation for their investment purposes. Before investing, the investor should determine whether the reports by managers adequately address the disclosure needs and risk parameters of the investor. This clearly qualifies possible investors to fall within the legal exclusionary requirements stated earlier in Chapter 3.</td>
</tr>
<tr>
<td>GP2</td>
<td>Investment risk</td>
<td>Here reference is made to systematic risk which is market related, and idiosyncratic risk which is not. The onus is on investors to assess a fund’s key investment risks in the light of its objectives and strategies. They must be comfortable that the manager adequately monitors investment risks within prescribed risk parameters. Investors should evaluate the different risk components in a hedge fund investment and determine their own willingness to accept such risks. These include market and market-related risks (equity, interest rate, currency, credit, etc.) and other investment risks (basis, common holder risks, event risk, counterparty, asset/liability matching risk, etc.). Investors should gain comfort that the type and degree of risk which a hedge fund assumes is constant with the fund’s risk profile and that of the investor. They should independently analyse data disclosed by the manager to understand material risks involved. They should understand the relative impact on the fund’s performance and evaluate the extent to which a fund is susceptible to the respective types of risk.</td>
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<tr>
<td><strong>GP2</strong></td>
<td>Liquidity and leverage risk</td>
<td>Investors should understand liquidity and leverage in relation to hedge funds, including the impact of redemptions, asset liquidation, etc. Liquidity term should be appropriate to prevent significant loss in the instance that rushes may occur. Investors should be well versed with the fund manager’s definition of leverage in combination with the strategies and instruments employed to generate the levered exposure. They should also understand accounting and economic leverage limits used within a portfolio based on either Value at Risk, capital exposures or other similar measures. The way in which a manager would reduce existing leverage when limits are exceeded is also of importance, with a clear outlining of the frequency of liquidity stress testing and scenario analyses. Liquidity risk implicit to fund assets should also be well understood, as well as in relation to the funds underlying asset liquidity and redemption policy. It would assist to determine whether those terms are fair and reasonable in the light of the investor’s objectives. Investors should recognise when fund redemptions can be suspended, as well as the measures that managers could employ to mitigate the risk of suspensions.</td>
</tr>
<tr>
<td><strong>GP2</strong></td>
<td>Measurement of market risks and controls</td>
<td>Risk measurement help investors to understand quantifiable market risks and recognise when acceptable risk limits are being exceeded. Managers are required to employ multiple risk measures which describe risks in several dimensions, though not to the detriment of good judgement. Investors should understand risk metric employed by a fund manager and require that stress testing is done on a regular basis.</td>
</tr>
<tr>
<td><strong>GP2</strong></td>
<td>Management of risk limits</td>
<td>Hedge fund managers should have procedures in place to enable appropriate response if risk limit guidelines are exceeded. Investors should be comfortable with the manager’s decision-making policies and procedures for when limits are exceeded. The standard investment process should be independent from the decision-making authority of the fund. Policies and procedures must provide for timely notification to investors and be responsive to risk limit breaches.</td>
</tr>
<tr>
<td><strong>GP2</strong></td>
<td>Compliance</td>
<td>A hedge fund must have a robust compliance function which is independently managed to mitigate conflicts. Manuals should be reviewed on a continued basis and the investor is required to verify compliance functions of hedge funds.</td>
</tr>
<tr>
<td><strong>GP2</strong></td>
<td>Operational and business risks</td>
<td>Operational risk in hedge funds is often greater than that of traditional fund managers due to, amongst other, higher transaction volumes, leverage, financial incentives and potential leaner staffing in startup operations. Investors should be comfortable that operational functions are independent from portfolio management. This would be to minimise potential conflicts of interest. Investors need to be comfortable with the manager’s processes, confirmation and controls related to trade reporting and other transactions. Back- and middle-office functions of hedge funds must be able to adequately address transaction and trading volumes. Not only must investors understand this, but they should grasp and evaluate trade error policy to determine whether financial responsibility for errors has been assigned appropriately.</td>
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<tr>
<td>GP2</td>
<td>Prime broker and other counterparties</td>
<td>Prime brokers should be sufficiently enabled and sophisticated to avail resources and expertise to manage fund assets. Investors should be aware of a prime broker’s material credit or trading counterparties of the hedge fund. They should also understand the fund manager’s process for analysing and diversifying prime broker and counterparty risk. Investors are required not only to understand with whom the manager trades, but also what the manager’s credit risk towards counterparties entails and how it is managed. Investors should also understand OTC trades and exposures, as well as how the financing arrangements of the fund is managed.</td>
</tr>
<tr>
<td>GP2</td>
<td>Fraud and other crime</td>
<td>Investors are required to confirm that the manager maintains required procedures and controls to protect against fraudulent conduct. These should include, but not be limited to, anti-money laundering procedures, proper segregation of duties and functions and direct communication from an independent administrator. Investors should also confirm that fund assets are held separate from the fund manager and that the compliance function operates independently with proper additional internal control functions.</td>
</tr>
<tr>
<td>GP2</td>
<td>Information technology and business recovery</td>
<td>Managers should ensure that robust business recovery and information plans are appropriate for the business and are tested regularly. This should be verified by investors to ensure that the fund is able to operate during unexpected events which affect business operations.</td>
</tr>
<tr>
<td>GP2</td>
<td>Conflict of interest</td>
<td>The main provision for determining conflicts of interest is reliant on the terms provided for in investment agreements entered into between investors and managers. Conflicts can arise when multiple funds compete for investment opportunities, some accounts are favoured over others, or managers are paid performance fees which depend on such investments. To understand as much of all possible conflicts, investors should understand the scope of advisor activities, types of funds and accounts advised by the manager, whether these funds share investment allocations, etc. They should confirm whether an appropriate conflict-of-interest policy is in place.</td>
</tr>
<tr>
<td>GP2</td>
<td>Other service providers</td>
<td>Other administrators than prime brokers also assist hedge funds in safeguarding investors’ assets and to ensure accurate financial reporting. Capable and experienced auditing firms should be employed to provide independent and reputable service to the fund. Administrators should have the required capacity, resources, technology and expertise to deal with fund accounting and transfer agency services. They should furthermore provide independent mark-to-market pricing, except in circumstances where information is insufficient and inputs from the manager or another third party is required. Investors should monitor the appointment of such service providers and whether they are independent, have sufficient experience and are able to perform their roles effectively.</td>
</tr>
<tr>
<td>GP2</td>
<td>Fund governance</td>
<td>Hedge fund governing bodies differ depending on, amongst others, the type of business entity used and the jurisdiction in which the fund is established. Investors should, no matter what the structure, focus on substance over form. Attention should be paid towards governance mechanisms that truly protect investors. Hedge fund structures should be understood irrespective of the jurisdiction.</td>
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<tr>
<td><strong>GP3</strong></td>
<td>Investment structures</td>
<td>Structures are governed in accordance with the ICA. Hedge funds as private investment companies and the legal position regarding other possible legal structures have been discussed extensively in Chapter 3.</td>
</tr>
<tr>
<td><strong>GP3</strong></td>
<td>Domicile of hedge funds and investments</td>
<td>Investors should confirm that the hedge funds they have invested in prepare financial statements in accordance with accepted accounting standards such as GAAP and IFRS and that such statements are audited by a reputable firm irrespective of its domicile. Investors should grasp the nature, extent and stability of the legal system in the jurisdiction in which the fund is being operated to vindicate their legal rights as a fund investor, should this be required. In addition, investors need to verify manager expertise and the degree of risk faced by the fund from potential tax, legal or regulatory changes.</td>
</tr>
<tr>
<td><strong>GP3</strong></td>
<td>Terms of hedge fund investors</td>
<td>These terms are captured within hedge fund governing documents. These include a prospectus, a subscription agreement, constitutional document (limited partnership agreement or articles of incorporation) and the investor advisory contracts between the fund and its manager. Other contracts might also be included. Individual rights and obligations towards funds, managers, investors and other parties should be distinguished. The investor needs to assess the terms stated in the governing documents and it is fair having insight into the investment freedom offered the manager, management and performance fee calculation, redemption terms, the suspension of redemptions, fund expenses and the use of side pockets. Furthermore, sight must be had to general risk factors, policies regarding NAV calculation, the scope of manager’s liability, tax implications and indemnification provisions. Investors should be aware of how fund terms may be changed or varied. They should obtain sound legal advice.</td>
</tr>
<tr>
<td><strong>GP3</strong></td>
<td>Fiduciary duties</td>
<td>Investors should determine whether the manager would qualify as an ERISA fiduciary which would need to be registered under the IAA. If not, it may be prudent for investors to require a similar duty of care and loyalty to be imposed on the manager, as well as prohibitions against self-dealing provided for by ERISA. Investors should consult with legal counsel who are experts within this area of law.</td>
</tr>
<tr>
<td><strong>GP3</strong></td>
<td>Registration with regulators</td>
<td>US hedge fund managers need to register with the SEC. Such voluntary registration affords investors protection, including fiduciary protection, enforceable within the US federal courts, but which may not be available when investing with unregistered managers. Fund managers may also voluntarily register as broker-dealers with FINRA or as commodities dealers with the CFTC. Investors should always determine the registration status of managers and request explanations if they are not registered. If registration is required, investors should confirm registration. They can also obtain information from the regulatory bodies as part of their due diligence.</td>
</tr>
<tr>
<td><strong>GP3</strong></td>
<td>Rights of other investors / side letters</td>
<td>Material terms should be made available to all investors so that investors can follow up regularly on fund information to monitor investment. Should variation exist, the investor should determine the impact thereof on the fund’s risk and returns.</td>
</tr>
<tr>
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<tr>
<td><strong>ICIP4: Valuation</strong></td>
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<tr>
<td>GP4</td>
<td>Valuation policy</td>
<td>An integrated valuation framework must be established to provide consistent and clear valuations of the investment positions of the fund by the manager.</td>
</tr>
<tr>
<td>GP4</td>
<td>Governance of the valuation process</td>
<td>This requires the establishment of an effective governance system, such as an evaluation committee. This committee should include senior management. It should create a policy for determining investment in a fund's portfolio. Its function may include the development of methods and sources used for valuing different classes of investment positions, approving or reviewing classifications of fund assets, reviewing qualitative or quantitative information for consistency and the appropriateness thereof, and approving final valuations for the fund’s portfolio, including reviewing third-party administrator reconciliations. Policy should be reviewed regularly, but not less than annually.</td>
</tr>
<tr>
<td>GP4</td>
<td>Valuation methodologies</td>
<td>Elements of the policy that a manager should consider adopting include identifying the internal and external parties involved in the fund evaluation process, alongside a clear description of their roles that, amongst others, describe oversight and monitoring. Methodologies should complement types of investments. It should be adopted together with new investments and be consistently applied afterwards. Price sources for different types of investments and their respective uses must be included. Internal documentation procedures must support this process, including valuations for side pockets, exceptions, etc.</td>
</tr>
<tr>
<td>GP4</td>
<td>Valuation controls</td>
<td>Appropriate internal documentation procedures must support the valuation of individual assets. This should be maintained by the manager. It must be done in accordance with policy established by the valuations committee or similar governance structure including discussion with the independent auditor. These procedures should include guidance on price feeds, input models, broker quotes and other information from third-party valuation service providers. It must be clearly communicated to investors when investments are difficult to evaluate, and internal valuations must be done to provide information thereof to investors.</td>
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<td><strong>ICIP5: Fees and expenses</strong></td>
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<tr>
<td>ICIP5</td>
<td>Fees and expenses</td>
<td>Investors should develop a philosophy regarding the payment of fees and expenses for all contracted investment services. This should include total fees and expenses relative to returns sought and risks taken by the strategy. The liquidity offered by the investment manager and the appropriate sharing ratio acceptable to the investor of alpha generated by the manager must be taken into account.</td>
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<td><strong>ICIP6: Disclosure and reporting</strong></td>
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<tr>
<td>GP6</td>
<td>Reporting and transparency</td>
<td>A disclosure framework providing material information to investors must be developed and frequently disseminated to investors with the aim to provide detail concerning the investments. Detail concerning financial and risk information, as well as potential conflicts of interest, must be provided to allow investors to make informed decisions on investments and appropriately monitor and manage the risks associated with exposure to the fund. The types of information include private placement memoranda, audited financial statements, performance information, investor communications, guidelines on potential conflicts of interest and the qualifications of investors within a fund, to name a few. A lack of transparency may lead to unexpected risk exposures. Investors should, therefore, seek sufficient transparency and disclosures to monitor material risks in the fund. An investor should be able to verify from reports received from the manager whether the strategy is followed, changes in assets under management have occurred, material management issues are dealt with, etc.</td>
</tr>
<tr>
<td>GP6</td>
<td>Performance and risk reporting</td>
<td>This includes information quantitatively stated, together with a qualitative discussion thereof describing the performance of the fund and types of investments within a portfolio such as financial statements, estimated fund performance excluding items relevant to calculating the NAV of a fund, the fund’s NAV and so forth. In addition, given the nature of risks within a portfolio, managers should provide investors with risk reports detailing information on the funds risk profile. This includes the assets under management, decision-making processes regarding asset types, liquidity, total fund volatility and residual risk measures, geography and leverage employed.</td>
</tr>
<tr>
<td>GP6</td>
<td>Funds of hedge funds performance measurement</td>
<td>Investors should require managers to employ appropriate practices to determine portfolio valuation. They should furthermore be aware of fees charged by the respective funds themselves and also understand the drivers of risk and returns within the respective funds.</td>
</tr>
<tr>
<td>GP6</td>
<td>Aggregate portfolio performance measurement</td>
<td>The aggregate return, attribution measures and risk must be determinable by the investors. In other words, the information provided must enable investors to monthly calculate the aggregate return, attribution measures and risk, given their performance measurement philosophy.</td>
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<tr>
<td></td>
<td>Taxation</td>
<td><strong>ICIP7: Taxation</strong></td>
</tr>
<tr>
<td>ICIP7</td>
<td>Taxation</td>
<td>Any investment due diligence would be incomplete without a proper impact analysis of taxation on the investment fund’s returns. Hedge fund disclosures should highlight the impact of tax considerations on fund returns.</td>
</tr>
</tbody>
</table>

Source: Author’s representation of good practices extracted from the AMC Report and the IC Report