May 2014

The regulation of hedge funds in terms of the Collective Investment Scheme Control Act 2002 is a step closer. On 10 February 2014 the National Treasury announced that the draft regulations would be published by the end of March. At the time of writing they have not yet been promulgated, but it can be assumed that this is imminent.

The initial framework has been the subject of public comment and as such the draft regulations may be significantly amended from the initial draft.

The draft regulations will now distinguish between retail hedge funds and “qualified investor hedge funds” (qualified investor hedge funds replace the previous concept of the “restricted hedge funds”). The compliance requirements for retail hedge funds will be more onerous than for qualified investor hedge funds in order to protect ordinary South African citizens and provide a more secure environment for institutional investors who have long since lost their appetite for risk. This is particularly true for pension funds, which must now comply with the stringent guidelines of Regulation 28 of the Pension Funds Act that governs investment allocation. Pension and provident funds would conceivably be allowed to invest in both types of hedge funds, subject to any directions the Registrar of Pension Funds may issue.

Both types of hedge funds will initially be required to report on a quarterly and annual basis, despite monthly reporting being called for. This will be discussed further with industry experts.

The governance model to be adopted for both qualified investor and retail hedge funds where an *en commandite* partnership is used will, in all likelihood the general partner’s board of directors (managers of the scheme) to act as the “governing body” of the scheme. An *en commandite* partnership is a limited partnership similar to a silent partnership whereby the *en commandite* partner (the investor) limits its liability to its co-partners (the other investors).

In hedge funds utilising a debenture structure, the investor will be investing directly into a company, which will issue the investor with a debenture. The company in turn invests the funds into a trust where the scheme is housed. The trustees of the trust thus exercise an oversight function similar to that of the “governing body” in the partnership structure.

In both models the scheme itself is governed by the Act, while in addition the hedge fund
managers are regulated in terms of the Financial Advisory and Intermediary Services Act 2002 (FAIS) and the associated CAT IIA license requirements. This may provide fresh challenges to hedge fund managers as the “Twin Peaks” model of financial regulation nears implementation (Financial Services Board on one hand and the Reserve Bank on the other).

There have been further concerns regarding the tax treatment of hedge funds upon their being regulated by the Act, particularly in terms of section 63. These concerns have partially already been dealt with by the Taxation Laws Amendment Bill but certain matters are still under consideration by SARS and the National Treasury. The Bill removes the spectre of double taxation for hedge funds but concerns still exist that trading profits could be taxed within the funds themselves based on the individual investors’ intentions, regardless of whether they invest in a qualified investor or retail hedge fund. Industry experts would like hedge funds to be taxed on a similar basis as collective investment schemes, particularly with regard to receipt of accruals, the levy of capital gains tax (CGT) only on disposals of investors’ interests and a clear inclusion of the flow-through principle with regard to holders of interests.

Even if these regulations are not perfect, they will be a welcome step forward in the growth and maturation of the hedge fund industry. Hedge funds are no longer to be viewed as speculative investments but as a tool to diversify portfolios, balance risk and increase returns, all within a governance structure that aims to enhance transparency and accountability.