

MBA 2005/6

**REGULATION IN THE
HEDGE FUND INDUSTRY**

by

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**A research report submitted to the Gordon Institute of Business
Science, University of Pretoria, in partial fulfilment of the
requirements for the degree of Master of Business Administration**

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ABSTRACT

The hedge fund industry in South Africa is currently unregulated, which is generally considered a hindrance by hedge fund managers. Some fund managers are under the impression that regulation will bring more credibility to the industry and, in turn, increase investment into this sector. The feeling is that many investors shy away from this unregulated market as there are no procedures in place to ensure that their funds will be properly managed and that, currently, investors have no recourse should the investment be mismanaged.

How one applies the regulation will have profound implications. Due to their global nature, the impact of regulations with regards to both local and foreign hedge funds also needs to be addressed. The implication of regulating the industry needs to be addressed from all aspects, including, for example, cost and industry agility.

Although the South African government has been threatening to regulate the industry since 2001, it has yet to do so. Recently, there has been renewed hope that the government will introduce regulations to the industry; however, some fund managers are skeptical.

DECLARATION

I declare that this research project is my own, unaided work. It is submitted in partial fulfilment of the requirements of the degree of Master of Business Administration for the Gordon Institute of Business Science, University of Pretoria. It has not been submitted before for any degree or examination in any other university.

Jonathan David Betsalel

Date: 14th of November 2006



DEDICATION

I dedicate this thesis to my beautiful daughter

Jessica Michaela

who I love very much.

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LIST OF ABBREVIATIONS

AIC	Association of Collective Investments
AIMA	Alternative Investment Management Association
BESA	Bond Exchange of South Africa
CAL	Capital Allocation Line
CGT	Capital Gains Tax
CIS	Collective Investment Scheme
DIS	Discretionary Investment Advisory
EU	European Union
FOF	Fund of Fund
FSA	Financial Services Authority (UK) or Financial Services Agency (Japan)
FSB	Financial Services Board
JSE	Johannesburg Stock Exchange
LTCM	Long Term Capital Management
SEC	Security and Exchange Commission
SFC	Securities and Future Commission
UK	United Kingdom
US	United States
US\$	United States Dollar
USA	United States of America



CHAPTER 1: THE HEDGE FUND INDUSTRY ENVIRONMENT

1.1. THE SOUTH AFRICAN HEDGE FUND INDUSTRY

The hedge fund industry in South Africa is currently unregulated, which is generally considered a hindrance by hedge fund managers. Some fund managers are under the impression that regulation will bring more credibility to the industry and, in turn, increase investment into this sector. The feeling is that many investors shy away from this unregulated market as there are no procedures in place to ensure that their funds will be properly managed and that, currently, investors have no recourse should the investment be mismanaged. Although a regulated hedge fund industry will have positive implications, the negative effects of regulation must also be addressed. Regulation will not only stifle the current flexibility of the industry, but will challenge the very nature of hedge funds.

1.2. CHALLENGES IN THE HEDGE FUND INDUSTRY

1.2.1. APPLICATION OF REGULATIONS

How one applies the regulations will have profound implications. Hedge Funds World Africa (2005) suggests that the retail investor's need for regulation is very different from the sophisticated investor and, as such, it would be disingenuous to apply a "one size fits all" approach. Due to their global nature, the impact of regulations with regards to both local and foreign hedge funds also needs to be

addressed. There has been increasing exposure of South African investors to offshore hedge funds and, therefore, the Financial Services Board (FSB) should consent to the sale of foreign hedge funds in South Africa (Modise, Nupen, 2004). The implication of regulating the industry needs to be addressed from all aspects, including, for example, cost and industry agility.

A real downside of an unregulated industry can be viewed in Vawda's (Cranston, 2006b) analogy of the method Dion Friedland, founder of the Dion chain, used to promote hedge funds to international investors; he did it in the same way as he would promote a vacuum cleaner, thereby damaging the industry. Despite never being able to regulate all mavericks, regulation would ensure that the hedge fund managers are properly trained and certain industry standards would apply to those involved, and that action could be taken against unscrupulous business practices.

1.2.2. STATUS OF REGULATION IMPLEMENTATION

Although the South African government has been threatening to regulate the industry since 2001, it has yet to do so. Recently, there has been renewed hope that the government will introduce regulations to the industry; however, some fund managers are skeptical.

Stakeholders in the industry realise the need for regulation and that discussion on its introduction into this arena has begun. Despite a joint discussion paper written by the Financial Services Board (FSB), the Alternative Investment

Management Association (AIMA) and the Association of Collective Investments (ACI) on regulating the industry and calling for comment in 2004, there is still no indication of the industry being regulated. As can be seen in 'Figure 1', the hedge fund industry in South Africa is growing at a rapid rate despite its unregulated state.

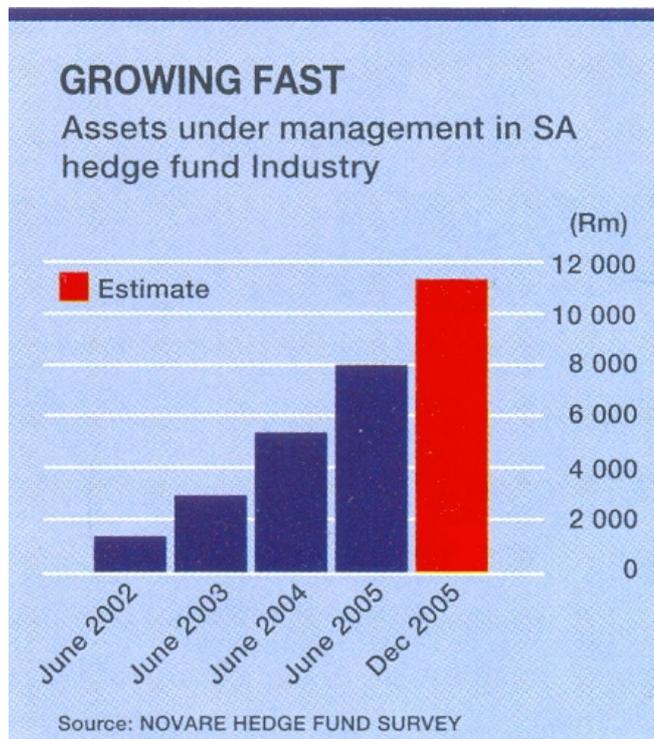
1.2.3. ATTRACTING INVESTMENT

Despite the hedge fund industry requiring greater regulation in order to attract investment from other, more regulated and conservative sectors, Vawda (Cranston, 2006b) indicates that in 2005, there were significant investments by large fund managers such as Telkom (R 500m), Mines Pension Fund (R 350m) and Transnet (R 100m) into this sector. As pension funds allocate more of their investments into this sector, they will require more transparency and greater industry regulation.

How much more the pension fund managers will invest in hedge funds if they are regulated, and what the minimum regulatory requirements they need in place to facilitate this investment, needs to be assessed.

In addition to the vast amounts of funds the pension fund managers would bring to a regulated hedge fund market, greater investment from mainstream investors would also be solicited, enabling the market to target their public clients directly.

Figure 1: Assets under management in the SA hedge fund industry



Source: Financial Mail Supplement (February 10, 2006)

The current unregulated state of the industry, as well as the effectiveness of the industry's self-regulation, needs to be evaluated in order to compare the effects of the implementation of government regulation on said industry.

1.3. BENEFITS AND COSTS OF REGULATION

Regulation has the benefit of protecting the individual investor, but it comes at the cost of constraining and burdening the industry with regulatory red tape and administrative requirements.

In his article ‘Major asset managers take to the play pen’ in the Financial Mail supplement, Cranston (2006a) makes mention that hedge fund managers thrive on taking chances and breaking the rules. In the same article, interviewee Rayhaan Joosub points out that the main obstacle to growth in the hedge fund sector relates to the regulatory requirements in government pension funds.

Although regulation in the hedge fund market will make it easier for pension fund managers to move funds to it, it will stifle the liberal environment that the hedge fund managers currently trade under. Conflicts like these need to be evaluated and weighed up in order to assess the viability of regulating the market.

1.4. ALTERNATIVES TO REGULATION

Despite some of the positive implications of introducing regulations into the industry, there are alternative forms of self-regulation that the industry can and has introduced to self-regulate, making this sector more accessible to the wider investor community.

1.4.1. INTERNAL STRUCTURES

Bruce Cameron (2006) highlights the use of independent managers and fund evaluators by hedge fund managers as being some of the steps being taken by the hedge fund industry to limit the risk to investors. He also points out that the increase in the number of hedge of hedge funds (HoHF) within the industry has

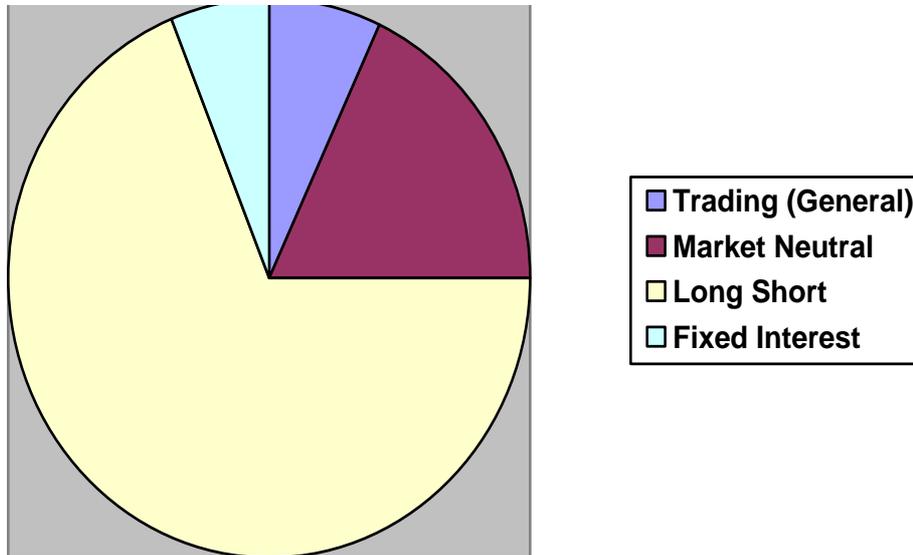
had two advantages, the first being diversified risk due to the different hedging strategies of the fund managers incorporated in the fund; furthermore, it makes the fund accessible to individuals who could not previously afford the very high minimum investment.

1.4.2. HEDGE FUND INDEX

The recently unveiled 'Hedge Fund Index' jointly launched by 'Clade Investment Management (PTY) LTD' (Clade) and the 'Bond Exchange of South Africa' (BESA) is an example of an alternative structure outside of government that can provide a regulatory framework for hedge funds.

In their launch brochure, the exchange purports to represent approximately 62% of the hedge fund industry in South Africa and they expect this number to grow over time. Due to their large representation of the industry, the exchange feels it will act as an accurate benchmark of the industry and be a comprehensive depiction of the performance of all open South African hedge funds.

Figure 2: Exchanges Hedge Fund Strategy Representation



Source:- SA Hedge Fund Index Guide, August 2006

Despite the media attention to the launch of the above index, another such example is the 'Nedgroup SA Hedge Fund Index', which predates the aforementioned.

As Stephen Cranston (2006a) from the Financial Mail quite rightly points out in his article 'Official Recognition at Last', the index excludes Brait's R 4.2bn as well as funds that are not open for new business. Hence Cranston (2006a) concludes that the publication of the index does not bring the introduction of regulation any closer.

On the surface, the viability of indexes being used as a form of regulating the hedge fund industry seems to be feasible; however, it is compromised by excluding closed funds and large players in the market. Besides not being all-inclusive, another consideration is what authority the index has to bring transgressors of their regulations to book.

1.5. REGULATION IN THE INDUSTRY

In order to understand the fundamentals of regulation in the South African hedge fund industry, it is imperative that the perspective of each stakeholder is obtained.

Obtaining these perspectives will assist in gaining a clear understanding of the industry's current state as well as the regulatory options available moving forwards. Issues ranging from establishing what regulations currently exist in the industry to asking whether government regulations would assist in mitigating the current shortfalls of the industry or whether they could be addressed by alternatives such as index listings or administrators, need to be examined.

Comparing the different perspectives of all the stakeholders on the various issues will assist in understanding the best way for industry to move forward in order to benefit the industry as a whole.

CHAPTER 2: LITERATURE REVIEW

2.1. INTRODUCTION

It is against the above backdrop that this research project examines the pros and cons of regulation of the hedge fund industry in the South African context. It is very topical in the industry at present and its implementation will have far-reaching implications for the sector.

Although regulations assist in eradicating conflicts of interest, fraud and general marketing to unsuitable investors, overregulation is considered stifling to an industry that has built its name on the absence of regulations. This extends to its definition, which is noticeably vague.

2.2. A BRIEF HISTORY OF HEDGE FUNDS

The term “hedge” refers to the strategy used by Alfred Winslow Jones back in 1949. Winslow, with his innovation of selling some stocks short and buying others, is attributed with being the founder of hedge funds. Another innovation attributed to Winslow, which is still used today, is the changing of his general partnership into a limited liability partnership in order to avoid the Security and Exchange Commission (SEC).

According to the BESA's Index Guide, Winslow's hedge fund was kept secret until 1966, when his success (85% better returns than his nearest rival for five years) was broken to the public by a newspaper journalist. Within two years of this publication, more than 200 new hedge funds were launched. Since then, the likes of Warren Buffet and George Soros have attracted great attention to the industry.

Another landmark in hedge funds was the introduction of the Long Term Capital Management (LTCM) fund, the brainchild of John Meriwether. Meriwether included two Nobel economics laureates as partners in the fund. According to Ward and Miller (2005), it was orientated around quantitative techniques. Five years after its launch, the fund was worth US\$ 120bn on a capital base of US\$ 4.8bn. In 1998, however, the fund lost 90% of its market capitalisation due to the Russian debt crisis attracting much attention.

In recent years the hedge fund industry has grown in popularity, causing regulators to take note. The SEC's 2003 staff report states that around 6000 to 7000 hedge funds managing around US\$ 600 to US\$ 650 billion in assets trade in the United States alone. This is estimated to exceed US\$ 1 trillion in the next five to ten years.

2.3. DEFINING HEDGE FUNDS

All of the information analysed relating to hedge funds alludes to the premise that hedge funds are indefinable; it hence seems impossible to find a universally accepted definition. Cameron (2004) emphasises that as there is no standard classification system for hedge funds, it is difficult to compare their performances.

Antia (2005) recognises that despite the fact that 'hedge funds' includes 'hedge' in the name, these funds don't necessarily use risk hedging to protect themselves. This is supported by the 'dictionary.com' definition of hedge funds, which describes them as "an investing group usually in the form of a limited partnership that employs speculative techniques in the hope of obtaining large capital deals".

Most readings have attempted to broadly define hedge funds, attempting to encompass their critical elements. When defining hedge funds, Cobbett (2006, p. 11) says, "The primary aim of most hedge funds is to reduce volatility and risk, preserve capital and deliver positive (absolute) returns under all market conditions", and identifies their ability to short securities and to use leverage as their distinctive features. Connor and Woo's (2003) standard definition of a hedge fund as an actively managed, pooled investment vehicle that is open to only a limited group of investors and whose performance is measured in absolute return units is broader than Cobbett's (2006), but not as broad as

Nailana (2004, p.1), who defines them as “a combination of asset classes which do not fit any specific investment structure.”

Despite their broadness, the above definitions attempt to encompass the different strategies available to hedge funds, such as non-directional/market neutral strategies (arbitrage and event-driven strategies) and market trends/direct strategies (Shorting – long and short positions, macro funds and emerging markets). Included is the use of derivatives, high leveraging, concentration and efficient execution of positions.

Prucell and Crowley (1999) also state that hedge funds employ many different and often complex strategies (often a mix of strategies), of which they offer the following examples:-

- Fundamental long/short funds:- Securities that seem mis-priced based on analysis.
- Qualitative long/short funds:- Identifying opportunities by applying statistical analysis to historical data.
- Arbitrage/relative value funds:- Identifying return differentials or mispricing opportunities.
- Macro funds:- The use of forwards to bet on currencies, bond markets, or equity markets of countries based on global macroeconomic events.
- Fund of Funds:- Diversification by investing in a variety of diversified hedge funds.

One of the issues highlighted in the joint discussion paper addressing regulation in South Africa, according to Bouwmeester (2005), is the definition of the term 'hedge fund'. Should the definition be a narrow and exhaustive definition, or should a broad, more flexible approach be adopted?

As previously stated, most of the literature available on hedge funds has difficulty in broadly defining them. Keeping this in mind, it will be a brave and challenging task to attempt to apply a narrow definition to this sector.

2.4. DEFINING REGULATION

Regulation is generally defined as a set of laws and rules that govern the behaviour of private entities. These rules and laws are enforced using incentive programs as well as taxes and subsidies in order to guide behaviour. Despite regulations infringing on the workings of the market, they are often necessary to ensure its efficiency. The aim should be maintaining the balance between business efficiency and social efficiency. To this end, regulators try to preclude mistakes or lessen their impact in a competitive environment.

Regulation comes in many forms, such as general legal/environmental regulation, specific legal regulation, external agency regulation, self-regulation, moral suasion and self-imposed regulation. These may perform the same role, have similar objectives or have similar effects. Forms of regulation need to be

weighed up as to their degree of interference versus the extent of their intended impact.

The scope of the regulation also needs to be evaluated. Examples of scope elements are geographical area, functional activities, ownership, pricing, entry and standards as well as business operations. These elements can be combined with the forms of regulation to create a regulatory matrix.

Goodspeed, Falkena, Morgenrood and Store (1991, p. 65) state that “the general philosophy of the financial markets implies a tacit admission that both the regulatory authorities and the regulated parties have an interest in the institution and maintenance of an efficient and effective system of regulation”.

They list three regulatory objectives of particular relevance:-

1. Ensuring a high level of efficiency in the provision of financial services in the best interest of the entire economy.
2. Securing the stability of the financial system.
3. Protecting the interests of all parties availing themselves of financial services.

Despite the very definition of hedge funds being contrary to regulation, increasing globalisation and the spectacular growth of this sector will continue to increase the pressure on the industry to implement regulation.

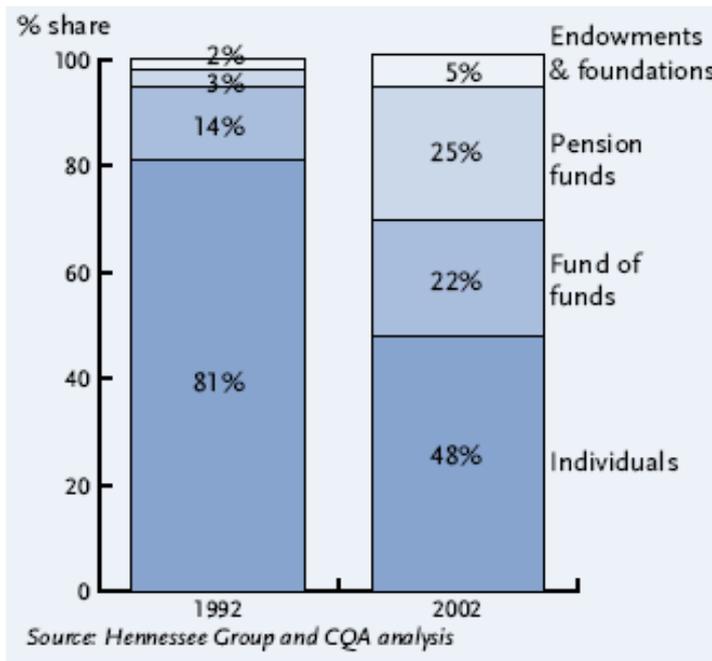
2.5. THE NEED FOR REGULATION

It was stated in the Hedge Fund World Africa (2005) conference transcript that there have been various discussions between industry bodies, representing domestic alternative investment managers and the Financial Services Board, on how domestic and foreign hedge funds may be regulated. This infers that stakeholders in the industry realise the need for regulation and that discussion on its introduction into this arena has begun. Regulation seems imminent in a sector that is synonymous with the opposite.

The hedge fund industry will require greater regulation in order to attract investment away from other, more regulated and conservative sectors. This is confirmed by Bob McDowall (2006), who indicates the need to increase the regulatory requirements for the hedge fund industry so that pension fund and retail investors apportion more of their asset allocation to this sector.

There has been growing demand from the retirement industry, especially as hedge funds are likely to become more institutionalised. Pension funds are demanding more transparency and prefer to invest with more established hedge fund managers to reduce the business risk associated with go-it-alone managers (Wood, 2003a). This perspective almost suggests that pension fund operators would be quite happy with a self-regulated, transparent industry.

Figure 3: Hedge Funds by investor type



Source: International Financial Services

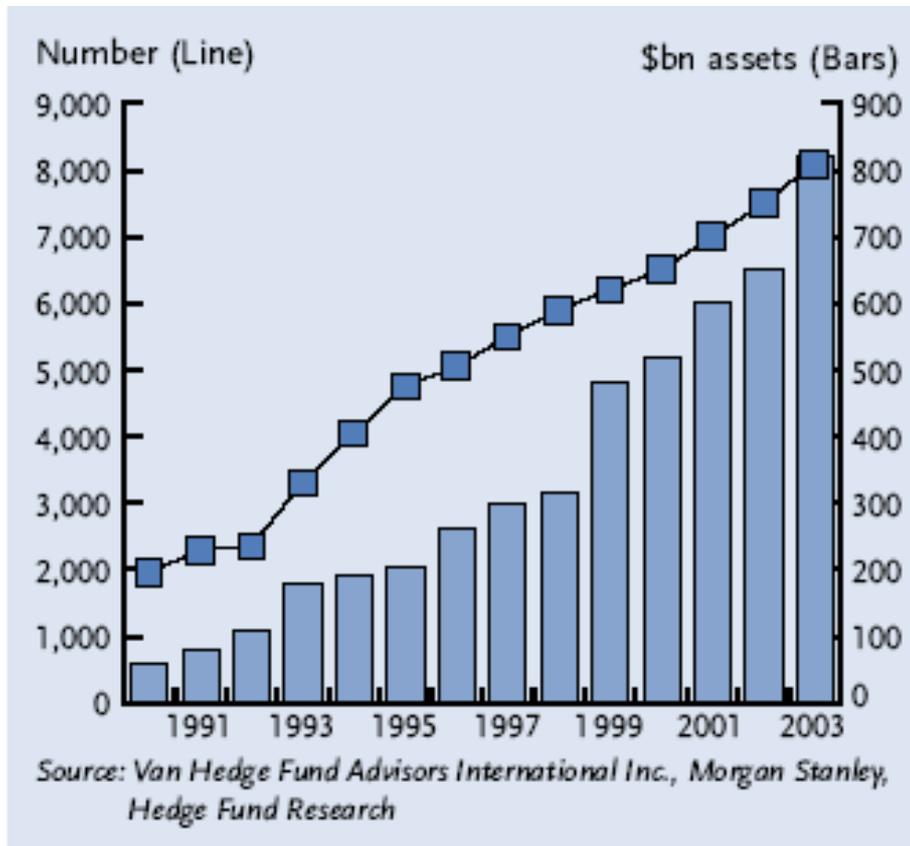
A positive aspect of an unregulated market such as hedge funds, according to Der Hovanesian (2005), is that they are able to cut deals quickly and without the red tape that other institutions such as banks require. Cumbersome regulation would harm this advantage and stifle this type of investment.

Seco (2005) attributes the success of hedge funds to their ability to take both long and short positions, use arbitrage, leverage, buy and sell undervalued/overvalued securities, trade options, bonds, over-the-counter products, virtually any opportunities with substantial gains at a reduced risk or inefficiencies.

The changing investor mix, as can be seen in figure 3 above, is one reason why regulators are watching the sector more closely. Until recently, hedge funds were the exclusive preserve of rich Texans, Arab sheikhs and family offices of the super-wealthy (The Economist 2006). McDowall (2006) makes mention of the increased regulatory need as hedge funds become a more mainstream investment vehicle. Generally, the industry believes that hedge funds are becoming more attractive to the ordinary investor; however, while they are unregulated, they are unable to solicit investments from the general public.

Hedge funds create a direct nexus between unregulated and regulated markets. Potential policy problems arise when excessive speculation in unregulated markets impacts regulated markets (Hanlon, 2002). As the increase in demand for hedge funds grows, the greater the impact these products will have on traditional investment vehicles.

Figure 4: Number and assets under management of hedge funds



Source: International Financial Services

Whether it is because the industry is reaching critical mass, or because an increasing amount of pension fund money is moving towards hedge funds, or that the investor mix is broadening, or because of the impact of unregulated markets on regulated markets, the boiling question is should the industry be regulated, and, if so, by whom and how?

2.6. HEDGE FUNDS RISK

In comparing hedge fund risk to traditional funds, Connor & Woo (2003, p.20) state that for traditional funds, “investors care both about total return (in order to measure the overall risk of their investment) as well as active return (to ensure that the portfolio manager is properly positioned in terms of investors’ allocation of funds across benchmarked types)”. This is in comparison to hedge funds whose “active risk management and total risk measurement are equivalent since the benchmark is risk free cash”. They go on to infer that since both the active risk management and the total risk measurement in hedge funds are equivalent, they could be equated to the active risk measurement of traditional active funds and, more specifically, just the active risk measurement if their theoretical definition of a hedge fund as a “purely active” component of a traditional fund is used.

Connor & Woo (2003, p.21) conclude that “in a well-run hedge fund, the only risks remaining in the portfolio are those that are intimately connected to the fund’s speculative strategy, or those that are impossible or too costly to hedge away”.

Purcell and Croweley’s (1999) view is that hedge fund risk is generally larger and more complex than traditional fund risk, hence hedge funds generally use sophisticated analytical tools to manage the risk, and are generally able to keep the risk within acceptable limits. Lo (2001) concurs, and states that in contrast

to traditional investment vehicles, hedge fund investors expect higher returns in exchange for the corresponding risk they endure.

Purcell and Croweley (1999) view a variety of sources of risk which impact hedge fund portfolios, including market risk, security-specific risk (remaining risk once common risk has been removed), common factor risk (risk factors common among securities), “herd” risk (simultaneous market exit), “Greeks” risk (option risk due to price changing of underlying securities), borrow and counterparty credit risk (lender calling security), credit crunch risk (tightening of credit in the market), operational risk and redemption risk (timing could cause managers to unwind portfolio at an inopportune moment).

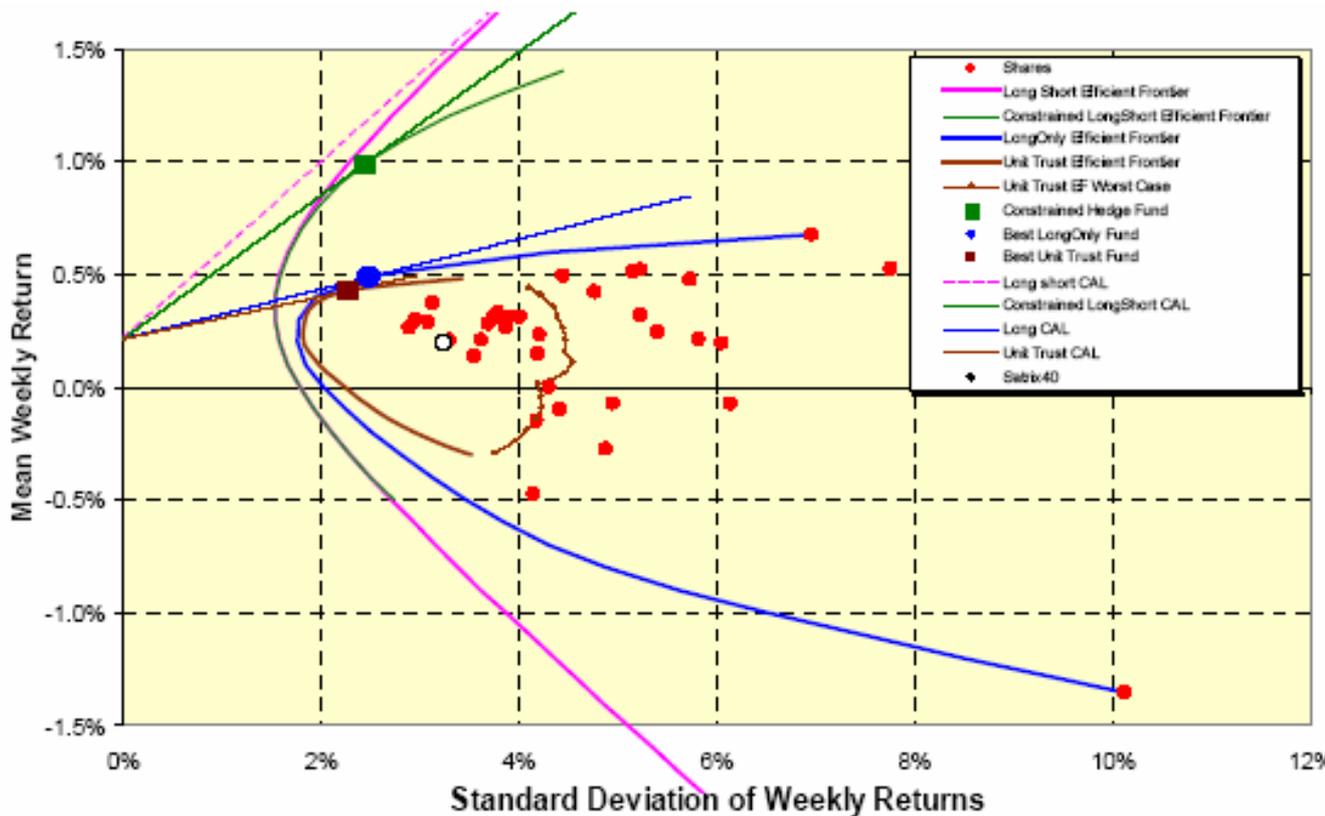
Despite the above-mentioned risk factors, in order for one to get a true reflection of how well hedge funds perform, one must compare their return to the associated risk.

2.7. THE EFFICIENT FRONTIER

Hedge fund patterns of risk, return, and particular correlation is what makes hedge funds attractive to traditional, diversified portfolios, according to Purcell and Crowley (1999). Looking at the efficient frontier of hedge funds and other conventional investment vehicles enables one to compare these investments according to both the risks associated with them and their respective returns. This will also indicate why they are so attractive to traditional portfolio managers.

As can be seen from the graph below, the 'Long Short Efficient Frontier' representing hedge funds (the purple line) displays a lower risk threshold than the other investment instruments, such as the 'Long Only Efficient Frontier' (the blue line) and the 'Unit Trust Efficient Frontier' (the brown line). The graph not only displays the unit trust's lower propensity to risk, but also indicates that there is a greater return with respect to the associated risk.

Figure 5: The efficient frontier



Source: Investment Analysts Journal

The significant improvement, according to Ward and Muller (2005), in the ‘Long Short Efficient Frontier’ (hedge funds) compared to the ‘Long Only Efficient Frontier’ is due to the ‘short position’ constraint being relaxed, essentially expanding the universe of the securities. They further attribute the ‘Long Short Capital Allocation Line’s (CAL)’ (purple dotted line) extension beyond the market portfolio to the permissibility of leveraging. Leveraging allows hedge funds to take advantage of positions with small, fast returns.

Using the ‘Constrained Long Short Efficient Frontier’ (the thick green line) in the above diagram to examine the effects of constraints on the efficient frontier, we find they negatively impact the efficient frontier. According to Charpin and Lacaze (2002, p.738), “by introducing regulation constraints, one limits the use of leverage and consequently the expected returns for a given risk.” It can thus be deduced that an increase in regulation will negatively impact or worsen the efficient frontier.

A contradiction to the above can be found in a recent article in Money Marketing, where Lizelle Stein, manager of Alternative Investments at Nedgroup Investments, says that “unfortunately, operational risk (particularly fraud and poor business management) is higher mainly due to the unregulated nature of the hedge fund industry”.

2.8. CURRENTLY REGULATED MARKETS

Hedge fund markets such as those in the EU and the USA, which are currently going through or have already gone through regulation of the industry, will be briefly examined here in order to expose the global regulatory trend. As deals get larger and buyout fund sizes grow, signs of increased regulation have already surfaced overseas (Flaherty 2006). Flaherty (2006) also confirms that February 1st was the deadline requiring certain hedge fund managers to register in the US.

McDowall (2006), however, regards the more benign UK market as having an advantage over its US counterpart despite admitting that regulation on a growing industry is imminent.

Herewith a brief description of five important hedge fund markets around the world.

2.8.1. UNITED STATES OF AMERICA (USA OR US)

The United States hedge funds are controlled by the Securities and Exchange Commission (SEC). In order for hedge funds to avoid the strict regulation limitations on short selling laid down by the SEC for investment companies, they generally operate as unregistered investment companies. Due to this, these hedge funds may only be offered to 'accredited investors', (individuals with income over US\$ 200 000/month or a net worth of US\$ 1 million and 'qualified

purchasers' (own US\$ 5 million in qualified investments). The funds may have up to 499 investors.

A recent introduction of rules imposed by the SEC in response to the growing hedge fund industry was successfully challenged by the industry in a landmark decision known as Goldstein versus the SEC. The regulations would have brought managers exceeding US\$ 25 million under management or over 15 investors under stricter management. At present, the SEC is still debating what action to take after their loss and the hedge fund industry is still largely unregulated in the US.

2.8.2. UNITED KINGDOM (UK)

According to Frith and Prentice (2002), the Financial Services Authority (FSA) treats hedge funds as unregulated collective investment schemes subject to little or no significant restrictions on what they invest in, or on the leverage that can be placed on the fund's portfolio.

The FSA regulates UK fund managers and advisors, ensuring they use regulatory good practice as well as requiring fund managers to treat their hedge funds as intermediate customers, requiring them to make certain disclosures to the fund. Money laundering must also be disclosed by funds.

Despite the hands-off approach taken by the FSA, the organisation is ready to step in where necessary, taking action against transgressors both domestically and globally.

2.8.3. GERMANY

Hedge funds were only introduced in Germany in January 2004 after the then finance minister Hans Eichel proposed a new law to let them in. Due to regulatory constraints, few funds have taken up the challenge to enter the market.

Retail investors may only be sold fund of fund investments in Germany and the hedge funds included therein must be willing to disclose their portfolio's gains and losses in minute detail. As a result of the high level of regulation in this market, German hedge funds will yield less spectacular returns to their investors, but will also be a more safe investment.

2.8.4. JAPAN

The Japanese regulatory market administered by the Financial Services Agency (FSA) is described by Wells (2005) as not being the friendliest as well as being haphazard. This, he goes on to say, makes establishing an onshore presence both an expensive and burdensome undertaking.

All persons given investment advice are required by Japan's Investment Advisory Business Law to register with the FSA. Investment advisors advising from a foreign base, despite also being required to register with the FSA, are only able to advise other Japanese registered advisors or investment trust firms. Another burden on foreign firms is the required Discretionary Investment Advisory (DIM) registration which brings with it tax implications.

2.8.5. HONG KONG

Hedge funds in Hong Kong targeting investors with less than US\$ 1 million in assets are, since 2002, able to market their products to the masses. Despite not being required to seek approval for their products, they are obliged to register with the Securities and Future Commission (SFC), as well as submit proof of experience and operation manuals and are subjected to periodic on-the-spot audits.

It is evident from the above that different parts of the world have different forms and extremes of regulation. One reason for the lack of regulation in some countries is the ease of moving the funds to greener pastures. Gaber, Gregorion and Ketling (2004, p.2) state that "if hedge funds are forced to come under regulation in the future, it is likely they would relocate offshore, thereby threatening an exodus of billions of dollars out of the USA and into foreign banks in tax havens".

The words of the president of the Federal Reserve Bank of New York, as stated in Beales (2006), that regulators need to work more closely as the world's financial systems become more integrated, could be a solution to the above predicament. Another example is Germany's hopeless attempt to foster a regulated local hedge fund market in an international arena void of regulations.

CHAPTER 3: RESEARCH QUESTIONS

Although there is a large amount of information on hedge funds and the imminent need for regulation in this sector, there seems to be a lack of understanding regarding the actual regulatory requirements of the different stakeholders and the benefits of these regulations for all stakeholders. This exploratory research seeks to address these issues.

Only once all stakeholders' views have been taken into consideration, can the benefits of regulating the industry be deduced. In order to achieve this, the following questions need to be answered.

- What regulatory requirements are there in the hedge fund industry?
- What are the different stakeholders' points of view relating to the regulatory requirements and are there any more requirements from their perspective?

The above research assisted in identifying how the different regulatory requirements affected the industry as a whole and to what extent the different regulations either benefited or hindered the hedge fund market.

The following five questions were used to assist in answering the two main research questions.

Each question was asked in a personalised context to suit each interviewee's individual situation.

Question 1 – Hedge fund industry definition

How would you define a hedge fund industry?

Question 2 – Current regulatory nature of the industry

To what extent is the industry self-regulated and what other measures can be taken in this regard?

Question 3 – Self regulatory trade-offs

What are the shortfalls of hedge funds remaining unregulated?

Question 4 – Regulation of the hedge fund vehicle and managers

What is your view on government (FSB) regulating the hedge fund vehicle and/or managers?

Question 5 – Regulation going forward

What is your view on the future of the hedge fund industry with regards to regulation?

Each interviewee was asked if there was anything that he/she felt was important with regards to the topic, but perhaps was not covered in the questions.

CHAPTER 4: RESEARCH METHODOLOGY

4.1. RESEARCH DESIGN

The research method employed an exploratory research approach. The reason this approach was used is to validate the above research propositions. Another advantage gained by using this approach was that it lends itself to new areas which lack established research findings as indicated by Welman and Kruger, (2005).

In a qualitative study the 'variables' are usually not controlled because it is exactly this freedom and natural development of action and representation that we wish to capture (Henning, 2004). As all stakeholders' points of view had not been identified, it is exactly this freedom that allowed new un-envisaged information to be further explored within the interviews, which, in turn, led to new insights being gained. These new insights were then included in future interviews in order to assess their validity and get further opinions on them.

Confirming the suitability of this method in this type of research, Kumar (2005) likens the qualitative approach to an unstructured, flexible and open methodology, with its main purpose being to describe variation in a phenomenon, situation, issue or the like.

4.2. POPULATION

The population of relevance for this study includes all stakeholders in the hedge fund market.

- FUND MANAGERS

- Market players in the industry, such as fund of fund managers and hedge fund traders and institutions.

- INVESTMENT ADVISORS

- Clients such as portfolio investors, institutional investors and pension fund managers.

- REGULATORY BODIES

- Financial Services Board (FSB), as well as other regulatory boards such as the Alternative Investment Management Association (AIMA).
- Third Party Administrators.
- Exchanges such as the Bond Exchange of South Africa (BESA).

- INDUSTRY WATCHDOGS

- Industry analysts and journalists.

4.3. PROPOSED SAMPLING

A non-probability sampling method was used to conduct the research. This method is said by Kumar (2005) to be used when the number of elements in a population is either unknown or not easily identifiable and where their selection is based on other considerations. Welman (2005) confirms this, adding that it is especially useful in pilot studies.

Combining quota sampling and snowballing, the intention was to do at least 12 interviews of the different stakeholders. Eighteen were actually achieved surpassing this by six. Kumar (2005) indicates that the saturation point of interviewing has been achieved once any new information or data obtained from the interviews is negligible. This method was used to determine if the sampling done was exhaustive enough.

4.4. DATA COLLECTION

The data collection was conducted through in-depth interviews. As it is a more intimate form of data collection, it enables the interviewer to further explore the interviewee's perspective on relevant topics and also allows for deviation from the planned format. This was crucial in ensuring that the self-regulatory nature of the hedge fund industry could be thoroughly assessed and new insights into the regulation of the industry could be revealed.

The primary data was collected during the semi-structured interview from a structured set of five questions posed to the interviewee. Secondary data, emanating from deviations from the format, was also noted. To this effect, each group of the proposed population was asked a similar set of questions appropriate to their circumstances. The questions acted only as a guide and the interview was allowed to flow naturally.

The interviews were conducted either face to face or telephonically, the former being the desired choice; however, due to geographical distance, three interviews were conducted telephonically. All interviews were recorded in a digital format, and have been placed on a single compact diskette in their entirety. The interviews were continuously referred to while researching the above topic. Only those particular excerpts of each interview, which are directly referred to herein, have been transcribed.

4.5. INTERVIEW

The ideal setting for conducting the interview was in a boardroom environment. However, where unavoidable, some interviews were conducted in noisy environments such a coffee shop.

The interviews were initiated with a briefing, setting the scene for the rest of the interview. As there are no mandatory regulations required in the industry at present, the briefing ensured that the interviewee understood on which perspective the interview would be based.

There was no set of questions handed to the candidate before the interview, but the interviews were conducted around the five main questions. The interview was then built around these questions.

The process of asking for the expansion of topics brought up by the interviewee, or clarification of concepts, mentioned by Henning, Van Rensburg, Smit (2004), was also used during the interviews. Some of the conversation was summarised back to the interviewee to ensure that the interpretation was correct. This also led to further clarification in some instances. The interviewee was given the option at the conclusion of the interview to add any insights that he/she felt were overlooked during the interview.

4.6. DATA ANALYSIS

The data collected from all the respondents was analysed, paying attention to specific aspects that are either important to the industry or are of general concern and were assessed to reach a conclusion as to the benefits of regulation in the hedge fund industry.

The data was analysed using content analysis, whereby the main theme is identified from the descriptions given by respondents in answers to questions, as described by Kumar (2005). This method is also identified by Henning, Van Rensburg, Smit (2004, p.127) in which she suggests “the researcher uses comparisons to building and refining categories, to define conceptual similarities

and to discover patterns”. This is precisely the method used in analysing the data collected from the interviews.

Further analysis of the data follows Kumar’s (2005) combinational view of

Chapter 5: Examining verbatim responses and integrating them into the report as either supporting or contradicting the argument.

Chapter 6: Assigning a code to each theme and counting the frequency of its occurrence

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4.7. RESEARCH LIMITATIONS

The following limitations are expected:-

- The stakeholders interviewed were based on availability and not on random sampling. The snowballing method may have led to similar points of view being expressed by respondents.

- As most of the interviews were conducted face to face, a certain personal bias may be attributed by the manner in which the interview was conducted. The interaction quality may also have had an impact.

- There may have be some bias when analysing the data.

- As personal interviews are lengthy, the information given could have deteriorated as the interview progressed.
- Due to personal time constraints, interviews could have been rushed through.
- The interviewer has had no formal training in the interviewing process.

4.8. CANDIDATES

The following is a list of the candidates chosen to be interviewed based on recommendation or the position they hold in the industry. Careful consideration has been given to ensure that all the candidates interviewed are of a high standard and have a genuine interest and impact within the industry. To follow is a list of the candidates interviewed. A brief curriculum vitae of each candidate is included in appendix A.

Table 1: List of respondents

NAME	COMPANY	DESIGNATION
Barrow, Robbert	Financial Services Board (FSB)	Executive Officer, FSB
Boyd, Jurgen	Financial Services Board (FSB)	Head of CIS, FSB
Braudo, Steven	Investment Solutions (IS)	Managing Director
Cuyler, Chris	Kensani Capital	Divisional Director
Gunnion, Stephen	Business Day	Financial Services Editor
Hamilton, Ian	Investment Data Services Group	Chief Executive Officer
Harvey, Lesley	eComply Consultants (Pty) Ltd	Hedge Fund Leader
Hertz, Jonathan	Caveo Fund Solutions	Managing Director
Hoernel, Alfred	T-Cap	Hedge Fund Manager
Katz, Sean	SKLP Capital (Pty) Ltd	Director
Khüm, Steinberg	T-Cap	Hedge Fund Manager
Marx, Jean	T-Cap	Hedge Fund Manager
Petzer, Marilize	Bond Exchange of South Africa	General Manager
Pretorius, Jacques	T-Cap	Hedge Fund Manager
Rae, Matthew	Stenham (London)	Compliance Manager
Runchhod, Shiresh	Bond Exchange of South Africa	Risk Analyst
Shames, Kevin	Alpha Asset Management	Director
Wides, Kevin	Bari International	Hedge Fund Manager

CHAPTER 5: THE RESULTS

5.1. INTRODUCTION

The transcribed interviews are used in this chapter to extract the main issues raised by the respondents pertaining to the hedge fund industry. In order to assist in this regard, frequency tables, corresponding to the five interview questions have been used.

5.2. QUESTION 1:- HEDGE FUND INDUSTRY DEFINITION

Research question 1, 'How would you define a hedge fund industry?' seeks to ascertain how comprehensive the definition of the hedge fund is, as well as identify the key words used to describe the industry. Table 2 shows the key constructs given in response to the above questions.

Table 2: Hedge fund industry definitions

Construct	Frequency Recorded
Removes market risk / market fluctuations	9
Diversification	7
Employs leverage and derivatives	4
Anything other than traditional investment	3

5.2.1. MARKET RISK AND BOUNDARY LIMITATIONS

The above table reveals that, generally, most respondents used similar key words to define the hedge fund industry. ‘Removes market risk’ or ‘averse to market fluctuations’ were the most frequently used terms. This, together with ‘diversification’, was used to describe the generally stable returns expected from the industry.

5.2.2. LEVERAGE, DERIVATIVES AND ARBITRAGE

Less frequently used were technical terms such as ‘leverage’, ‘derivatives’ and ‘arbitrage’, with some of the respondents simply describing the industry as ‘anything other than traditional investments’. Despite the help of these technical terms, Shires Runshhod stresses the difficulty of defining a hedge fund when he says: “It took some time for us to get a broad definition of a hedge fund but in the local context, we would look at an instrument that would go long and short, would have some leverage, and, finally, would not fall under the CIF schemes.”

5.2.3. THE HEDGE FUND

A number of respondents highlighted the fact that the word ‘hedge fund’ has evolved over time and is continuously changing. Rob Barrow went further and described the word ‘hedge fund’ as a misnomer. He said that “one thing they don’t seem to do is hedge, and not in the purest sense of the word.” This is an important point as despite respondents generally agreeing that the word ‘hedge

fund' has changed drastically, only one respondent highlighted the most pertinent disassociation.

Other than the above, Jacques Pretorius describes hedge funds as offering small but consistent returns. This highlights an issue brought up by Jonathan Hertz, when he describes the danger of an increasing number of thinly disguised long only funds acting as hedge funds.

5.2.4. SUMMARY

No respondent came up with a comprehensive definition of a hedge fund and, interestingly, no respondent used the word 'unregulated' in their definition. Most respondents seemed content with a broad definition to describe the industry.

The vastness of the industry seems to lead people to describe it in terms of what it is not, as well as use words that describe the output rather than the industry. The response to this question would indicate that the industry is satisfied with a broad definition.

5.3. QUESTION 2:- REGULATORY NATURE OF THE INDUSTRY

In order to assess the regulatory nature of the hedge fund industry, the following question was asked of each respondent: ‘To what extent is the industry self-regulated and what other measures can be taken in this regard?’. The following list of key constructs measuring the extent of self-regulation in the hedge fund industry were extracted and inserted into Table 3

Table 3: Extent of self-regulation

Construct	Frequency Recorded
Self-regulation exists within the industry	14
Administrator assist in self regulation	12
AIMA contributes to self-regulation	6
FOF contributes to self-regulation	6
Hedge Fund Index is a regulatory tool	6
Reputation is important	5
Prime Broker assist in self-regulation	5
Mandate is a regulatory tool	4
General Law's apply to the industry	4
Performance based compensation	3
Minimum investment limits access	2

5.3.1. SELF-REGULATION

The high number of respondents who indicated that self-regulation exists is a good indication that they seem to be happy with the status quo. Kevin Shames goes so far as to say: “The beauty of the hedge fund industry in an unregulated world is that it works very efficiently from a Darwinian Theory point of view.” He

believes that the hedge funds' unregulated state ensures that the weak DNA is eliminated, allowing the industry to remain cutting-edge. Giving an example of his theory and agreeing with five other respondents, he says: "We as FOF managers go and do a due diligence on him (hedge fund manager) and we say this is exactly the kind of manager we are looking for and throw tons of money at him. Typically, what happens is he will now start glowing (performing better)."

In explaining the self-regulatory nature of the industry, Jean Marx indicates that there are three different parties involved in the transaction, namely the administrator, the prime broker and the fund manager, and they are all looking after their own interests. There are a many checks and balances in place and each party has watches over the other.

5.3.2. THIRD PARTY ADMINISTRATOR

The overwhelming majority of respondents identified the third party administrator as being a critical part of the self-regulatory nature of the industry. Jean Marx believes that not only does the administrator ensure the fund manager complies with his/her mandate by performing due diligences and issuing reports to both the fund manager and his/her clients, but they also handle the money between the investor and the prime broker. This ensures that the hedge fund manager has no physical access to the capital. Alfred Hoernle also attributes the task of the monitoring of exposure limits to counterparty control. What it ultimately boils down to, according to Matthew Rae, is that: "You get the four-eyes check; not only is our back office looking,

but another administrator's office is looking at it as well. In my opinion, that's more than enough."

Despite administrators having a certain amount of industry overview, Rob Barrow questions the fact that one player in the South African hedge fund market is the service provider to 70% of the market. He also questions the power administrators have in terms of bringing transgressors to book.

5.3.3. AIMA, FOF'S AND THE HEDGE FUND INDEX

AIMA, FOFs and Hedge Fund Indexes were not as favourable as Administrators, with half the number of respondents recognising their importance in terms of regulation. Says Steven Braudo: "I also think that if there is a code that just sets out principles in terms of fiduciary responsibility, and there is an industry association, like the Alternative Investment Managers Association, people who run hedge funds should subscribe to it. That would give the client more comfort, knowing that there is something a bit more formal in place." Jean Marx seems to concur with Braudo when he states: "If you are not part of the Alternative Investment Management Association, where they can do a due diligence on you, you actually won't attract capital." Jonathan Hertz believes that we have world-class administrators as well as strong prime brokers with good prime broking skills.

This is disputed by two respondents, with one of them going as far as saying that the Association sometimes seems to drive its own interests. Another concern raised is that AIMA does not have the teeth to take action where and when necessary.

Adding to his previous assertions, Kevin Shames feels the job of an FOF manager is to differentiate between luck and skill. Jacques Pretorius believes that: “FOF guys do a lot of their own due diligence so they push up the level of transparency themselves and it leads to us being more up to date.” Jean Marx says that FOF managers analyse the performance of hedge fund managers in order to identify the best funds in which to invest their clients’ money. Nobody disputed the role of the FOFs within the industry.

Hedge Fund Indexes were also credited with bringing self-regulation to the industry. Despite this, the issue of each individual fund having a different strategy, as well as the selection of hedge funds included in the index not being representative of the entire industry, were raised as potential concerns. Another issue raised was the effect hedge funds joining or leaving would have on the index.

5.3.4. REPUTATION

Despite ‘reputation’ only being mentioned by five respondents, it seems to be a very important self-regulatory tool for the industry, with transgressors suffering dire consequences. Lesley Harvey states that: “The traditional industry and the hedge fund industry are a tiny, close-knit world industry. Everybody knows everybody else and I think there is a bit of a phobia about doing something wrong and getting caught. It is very easy to blotch a copy book, and boy, that will stay with you forever.” Steven Braudo believes that reputation is everything in the investment management industry.

5.3.5. MANDATES, GENERAL LAW AND PERFORMANCE BASED COMPENSATION

Mandates, the law of the land, performance based compensation and minimum investment were all sited as contributors to the self-regulation of the industry.

Sean Katz stresses the importance of having a mandate in place. He says: “You can’t raise money without having a clear mandate. So all the regulation you really require is compliance within your mandate.” Alfred Hoernle addresses the general laws of the land: “There are the laws of the land; we are not going to be fraudulent; we are not going to be remiss of the tax laws; there are many other regulations in the whole market and you don’t need to now bring in new hedge fund specific ones.” In clarifying the concept of performance based compensation, Jean Marx says: “Depending on the kind of structure you have

and the risk profile of the fund, 3% divided by 12 is what you (the client) are paying on a monthly basis. And in a month where you don't perform, the fund manager actually chips in. So he doesn't charge you his performance fees until such a point where he reaches the high water mark again."

Despite only being mentioned by four or less respondents, the above descriptions reaffirm that these issues are important tools in ensuring the market is adequately self-regulated.

5.3.6. MINIMUM INVESTMENT

Rob Barrow gives an interesting analogy of the qualified investor or so-called high net worth individual. He says: "Say someone has R 7 million to invest. You have to ask, what is his/her tolerance for risk? Now, a lot of people in that sort of category are probably individuals who have retired or taken an early package and now have to invest those funds. Their tolerance for risk should be fairly low."

5.3.7. SUMMARY

It seems that most of the respondents agree that the hedge fund industry is generally well self-regulated. Confirming this, industry reporter Steven Gunion is of the opinion that everything the hedge fund industry is doing would appear

to be above board and it is misconception of the industry that leads to speculation.

5.4. QUESTION 3:- SELF-REGULATORY TRADE-OFFS

Despite the industry’s perception that there is adequate self-regulation in the hedge fund industry, there are definite self-regulatory trade-offs. To examine this, the following question was asked: “What are the shortfalls of hedge funds remaining unregulated?” Table 4 lists these tradeoffs, highlighting the shortfalls existing in the industry.

Table 4: Self-regulatory trade-offs

Construct	Frequency Recorded
Transparency is lacking	10
Position Limitations need to be monitored	8
Tax clarity is required	7
Can't target the man in the street	6
Large funds liquidating is a concern	6
Not interested in the man in the street	5
Industry body has no teeth	5
Pension fund money needs addressing	4
Opinions on Advertising and marketing	3

5.4.1. TRANSPARENCY

The most mentioned trade-off was the issue of transparency. This is an interesting outcome, as transparency seems to be an issue no matter on which side of the fence you sit, with the implementation being the real issue.

One of Lesley Harvey's main concerns on this issue is disclosure. She feels strongly that the client needs to be kept up to date and in the loop. She also hopes that at some stage, the South African hedge fund industry will adopt the Global Investment Performance Standards. Agreeing with Lesley, Marilize Petzer says: "There is a reputation of risk, there is a lot of secrecy around it in our market, which I believe is not appropriate. This is a huge international market and we should not fall behind with the international trends." Putting it more bluntly, Stephen Gunnion says: "There obviously have to be rules that these companies adhere to, particularly transparency, and at the moment, there is no transparency around the hedge fund industry."

Despite most of the respondents raising transparency as an issue, a general concern was giving away both position and strategy. Concurring, Kevin Shames says: "Part of the hedge fund process is protection of positions, particularly on the shorting side." This he attributes to the danger of the market getting wind of a hedge fund with a large short position and then closing out this position. Talking about a more regulated product, Ian Hamilton suggests that disclosure is an important issue. Rob Barrow brought up the issue of proper

disclosure of fees and charges. In clarifying his position, Barrow says: “I am not saying that they always have to tell people what shares they are shorting and which they are longing. In fact, that wouldn’t be healthy for the market.”

5.4.2. POSITION LIMITATIONS

Alfred Hoernle raises the severity of this issue by asking: “The only danger is how you control your positions? Are you going to ride out the guy’s capital or not?” When asked what kinds of limitations could be imposed on the industry, Jean Marx said that one of the things that one could limit is gearing. He felt, however, that since the blow-out in long-term capital, the industry has limited itself. Lesley Harvey concurs with this, saying: “Maybe it is just because they are still a little bit nervous, but the managers have not used up their leverage limits, so their limit will say they can go five times but they will only go twice.” Sean Katz believes that if you want to sell a hedge fund, you need to tell investors what your strategy is because that’s what defines your risk.

Despite mixed views on this issue, generally, respondents agree that having no limitations could pose a risk for the industry, and that some disclosure would go a long way in providing reassurance to investors.

5.4.3. TAX

The main tax issues brought up were in respect to the favourable tax allowance granted to the CIS industry, as well as tax clarity for the hedge fund industry. Both Jean Marx and Jacques Pretorius feel there needs to be more clarity on the tax issue. Both believe that the reason hedge funds do not have tax clarity yet is because unit trusts are trying to protect their favourable status. Lesley Harvey brings up the industry's concern: "the unit trust funds aren't subject to tax; it all filters through to the unit holders and to the investors of those funds. When buying or selling securities in the fund, there are no CGT (Capital Gains Tax) implications there it is only applicable when a unit holder sells their units.

Ian Hamilton has a unique perspective on the tax issue. He says that tax laws are limiting foreign companies from investing in South African hedge funds. They face local taxes if they invest in limited partnerships, as well as being limited with regards to interest and paying sin tax if they invest in debenture structures.

5.4.4. THE MAN IN THE STREET AND PENSION FUNDS

There was a split when it came to the issue of attracting the man in the street and procuring more money from pension funds. The split was between those who thought the industry needs more money and those who believed more money would saturate the industry. Jean Marx feels there is a large amount of money looking to join the hedge fund market. However, the market does not

have the capacity or the skills to handle the money. The analogy of too much money chasing too few goods was also extracted from the respondents.

Alfred Hoernle was explicit about how he felt about regulation enabling the industry to attract capital from the innocent investor (man in the street): “What is the purpose of it, to protect the innocent investor? We don’t want the innocent investor. We want the intelligent investor, who is happy to take the risks that we know we are going to be taking.” Taking more of an industry view, Chris Cuyler says that he agrees with the strict regulation placed on traditional funds as they are taking money from the so-called widows, orphans and pensioners. Other respondents agreed with not needing the man in the street as an investor and also acknowledged that the man in the street could use other investment vehicles to enter the hedge fund industry, such as life insurance products.

The same debate surrounds the pension funds. However, respondents generally agreed that the two-and-a-half-percent limit placed on the pension funds is too restrictive. Jonathan Hertz believes that Section 28 of the Pension Fund Act is inappropriate and that more authority should be given to pension fund managers in this regard. Marilize Petzer suggests a solution to this dilemma by using a risk based approach rather than a percentage per asset limitation. She qualifies this by saying: “Then you are basically telling an asset manager whose job it is to manage risk how to invest and maybe his risk is not mitigated because he needs to now follow these guidelines.”

5.4.5. THE INDUSTRY BODY HAS NO TEETH

This issue was raised by some, not wanting to be critical of AIMA, but pointing out that perhaps the body needs more powers to enforce industry protocol. Yet Lesley Harvey doesn't believe this to be an issue. She believes regulation without any teeth is called good governance. Rob Barrow clarifies his position by saying: "The JSE is a self-regulatory body, BESA is a self-regulatory body. In terms of legislation they have to create rules, their rules have to address certain issues, their rules have to be approved by us. They have to apply the rules, they have the right to fine people, to discipline people."

5.4.6. ADVERTISING AND MARKETING

Generally, respondents did not feel that the advertising and marketing restriction on the industry had a negative impact. In describing the typical hedge fund manager, Alfred Hoernle says: "The hedge fund manager is usually not a great marketing person. You are dealing with someone who is quite technical, quite happy in his little office and doesn't really want to be out on the road a huge amount of time." Sean Katz, on the other hand, feels that not being able to go out and market your fund is a hindrance.

5.4.7. SUMMARY

The main downsides of an unregulated market seem to be primarily transparency and the control of positions held by managers. The tax issue, although a contentious one, simply needs clarity. Advertising, pension fund money and attracting the man in the street appear to be issues that could be dealt in ways other than regulating the market.

5.5. QUESTION 4:- REGULATING THE VEHICLE AND MANAGER

In the research process it became apparent that if one were to research regulations in the hedge fund industry, one would have to separate them into the manager and the vehicle. To this effect, the following question was asked: “What is your view on government (FSB) regulating the hedge fund vehicle and/or managers?” The key responses are tabulated below.

Table 5: Regulation drivers

Construct	Frequency Recorded
Regulating the manager	17
Regulating the vehicle	11
Categorise hedge funds	8
Disclosure is an issue	6
Regulate and limit leverage	6
Negatively impact the industry	5
Attract capital to industry	5
Attract offshore investment	5

5.5.1. REGULATING THE MANAGER

Out of all the issues raised in the interviews, this was the only one where the response was unanimous. The general feeling was that this is regulation that is long overdue and that the industry would be better for its implementation. Agreeing Kevin Wides believes there is a misconception as to how well educated some fund managers are.

Jonathan Hertz says of this issue: “I don’t subscribe to it. There is no reason not to regulate; it’s another week of a manager time. If he really wants to run a proper business, he must go through the process of explaining to the FSB that he is qualified to run a hedge fund, and if he doesn’t want to do it, then he shouldn’t be allowed to run a hedge fund.” He also believes that this regulation will be implemented quite soon, and that it will be strictly and well enforced. Kevin Shames also believes that regulation regarding the manager as well as the intermediary will be implemented in South Africa soon. He is relieved that after years of debating this issue, a decision has finally been taken.

Sean Katz points out that by regulating the manager, you are actually, indirectly, regulating the industry. Steven Baudo says: “Let the FSB give a stamp of approval to the managers. Then the managers themselves will actually form part of the industry association, which has a broad range of guidelines that everyone subscribes to. Ultimately, you want to give comfort to the man in the street.”

5.5.2. REGULATING THE VEHICLE

Most of the respondents agreed that a light form of regulation would be acceptable. But some respondents disagreed. For instance, Chris Cuyler says: “I doubt they will ever be able to effectively regulate a hedge fund, because the name will just change; you can’t simply stop people from employing their capital for financial gain.” Alfred Hoernle feels that regulating the industry would send the industry back to traditional trading styles, effectively closing down the industry.

Sean Katz feels that not having regulations is bad for the industry and is amazed that there is no regulation yet. He feels this is due to over-intellectualising the issue. He says: “So all the regulation you really require is compliance within your mandate. If those mandates are sound and fall within the parameters the FSB think are appropriate, why can’t you put in regulation?” However, Steven Braudo says: “There are always new financial instruments that come to the fore and new tools and trading techniques that hedge fund managers want to make use of, so to try to regulate it won’t work. The regulators will always be playing catch-up.”

5.5.3. CATEGORISING HEDGE FUNDS

Following on from regulating the vehicle, respondents also suggested that there should be different categories of hedge funds attracting different regulations. This would enable the FOF managers seeking to solicit business from the pension funds and the man in the street to do so, while leaving the fund manager managing private money alone. Sean Katz divides hedge funds into two categories: the larger institutions, and the smaller funds managing between R 10 and R 30 million. The focus, he says, needs to be on the larger funds. Marilize Petzer agrees with Katz: “I am a bit concerned because then a small hedge fund manager, who runs his own portfolio, mainly his own money or his brother’s money, is probably going to fall into that net. It will probably scare them away more than anything else.”

Despite this, Kevin Shames believes that the FOF managers and intermediaries, and not the hedge fund managers, need to be regulated. He feels that regulating the hedge fund manager would be changing the underlying DNA structure of the market, thus meddling with the Darwinian process. This, however, would not be the case when regulating the FOF.

5.5.4. DISCLOSE, REGULATE AND LIMIT LEVERAGE

The issues of no disclosure, no regulatory limits and no leverage limits were raised as shortfalls of an unregulated market and were suggested as being reasons to regulate the market. They have been adequately discussed under Question 3 in chapter 5.4.

5.5.5. REGULATION WILL NEGATIVELY IMPACT THE INDUSTRY

Some of the respondents felt that regulation would have a negative impact on the very nature of the hedge fund industry, namely its efficiency and creativity. This was, in most cases, directed at over-regulation. Alfred Hoernle says: “The very nature of running your portfolio in this way means that you don’t want a whole lot of rules that are maybe a little technical hovering over you when you actually have to get the market risk out of your portfolio.” Stephen Gunnion feels that “over-regulation that actually tampers with how hedge funds operate would be a problem.” Sean Katz also believes that there is a risk of over-regulation. Ian Hamilton encapsulates the issue quite nicely when he says: “Institutionalisation of hedge funds is an oxymoron.”

5.5.6. ATTRACTING CAPITAL AND OFFSHORE INVESTMENT

Some of the respondents envisaged a regulated industry bringing in local money as well as offshore capital. However, Rob Barrow disputes this, saying there are absolutely no restrictions on investors bringing money into South Africa nor any exchange control restrictions on them taking their money out;

they can come and go as they please without worrying about any capital control issues: As stated in Chapter 4 under the tax issue, Ian Hamilton disagrees.

Another view is that regulation will give foreign investors reassurance and security to invest in hedge funds. Germany, however, seems to be a prime example that refutes this.

5.6. QUESTION 5:- REGULATION GOING FORWARD

In order to understand what the industry felt the future of regulations would be, the following question was asked: “What is your view on the future of the hedge fund industry with regards to regulation?” In order to ensure consistency, views that were expressed by less than four respondents were not tabulated.

Table 6: Regulation going into the future

Construct	Frequency Recorded
Relax exchange controls	6
Eventual regulation	5
Global regulation (follow trends)	4
Public investor education	4

5.6.1. RELAX EXCHANGE CONTROLS

Topping the list of future regulations was relaxing exchange controls to enable hedge funds to trade the wider market. The general feeling is that, with the hedge fund industry doubling in size over the last 18 months and the limited positions open to the industry, the market could become saturated.

Says Steven Braudo: “The only thing in South Africa which is tricky is that our market is small. We need new shares, we need new listings, we need new opportunities for hedge fund managers, and that’s our big risk here. We need a larger capital investment market for the guys to work in.” He also feels that both Trevor Manuel and the government have done a sterling job in relaxing exchange controls and that from a position of strength, they will hopefully implement further relaxation. Sean Katz agrees with Braudo, saying: “In South Africa you have a limited amount of liquidity. Hedge funds need liquidity because there is a lot of gearing.” Jean Marx wants to see exchange controls removed to enable him to trade the world markets.

Ian Hamilton takes a different view. He says: “There are ways and means for fund managers to actually go offshore. I think most of the guys need to learn how to operate in international funds.” He goes on to qualify this by saying: “We are seeing guys now starting to set up separate portfolios offshore, so it gives them access into that market and learning experience in the international arena.”

5.6.2. EVENTUAL REGULATION AND GLOBAL REGULATION

Despite not all being in favour of regulating the industry, some feel that, in time, the industry will become regulated as it becomes larger and attracts systemic risk. Some also feel a disaster like Amaranth in the US could trigger local regulation. Rob Barrow confirms these sentiments: “We are monitoring the growth, and I actually report back to the policy board on a regular basis about where we are on this thing. If it gets to the stage where I become concerned that there could be some sort of systemic issue in our markets, then obviously we would have to take the matter further.” He says it is one thing trying to get hedge funds to provide enough information in order to monitor the systemic risk in the market, and quite another thing trying to regulate it.

Another point is that regulations globally will converge. Lesley Harvey's idea of the Global Investment Performance Standards is indicative of this. The very fact that the South African industry looks at regulatory outcomes in both the US and the UK, and that South Africa is implementing similar regulatory measures locally, further qualifies this point.

5.6.3. PUBLIC INVESTOR EDUCATION

As hedge funds become more popular and fall into the mainstream, less educated investors will be attracted to the industry. To this effect, education material needs to be made available that takes the level of sophistication of the investor into account. Lesley Harvey puts it brilliantly when she says: “What I would love is education, so that people know and understand. The moment

you sell hedge funds, you get the glazed-over look. Really, it's not that difficult and I think if people could understand exactly what it is we're talking about, it would be a whole lot easier, both from a regulatory perspective and, consequently, from a marketing perspective."

5.6.4. OTHER ISSUES RAISED

Other issues raised were the inclusion of multi-strategy funds in South Africa, derivatives being issued off the indices and the increased cost required to run hedge funds should they be regulated.

5.6.5. CONCLUSION

In general, the industry seemed pretty positive about its future, the two major issues being future regulation and the relaxing of exchange controls. The other issues raised did not warrant much concern in the industry.

CHAPTER 6: DISCUSSION OF THE RESULTS

6.1. INTRODUCTION

In this chapter the results obtained through interviews and analysis in the previous chapter are compared to the literary data and discussed in terms of the five research questions.

The key learnings of each subheading are summarised at the end of each section. A tick indicates the source that acknowledges the learning and a cross indicates disagreement. A small tick indicates partial acknowledgement and a small cross indicates partial disagreement.

6.2. DEFINING THE HEDGE FUND INDUSTRY

In defining the hedge fund industry, all the respondents gave very broad and varied definitions, which seems to support Cameron's (2004) point that there does not seem to be a standard classification system for hedge funds. This is further supported by the absence of any definitions given by respondents, but rather by breaking the industry down into the different strategies as attempted by Prucell and Crowley (1999).

What was most often mentioned by respondents when defining a hedge fund is its ability to remove market risk as well as mitigate market fluctuation. These concur with Connor's and Woo's (2003) thinking that performance is measured in absolute returns.

The second key component of Connor's and Woo's (2003) definition, namely that the funds are only open to a limited group of investors, failed to make it onto the respondents' list of definitions.

The second most used term was diversification. This was used as an attempt to describe the myriad strategies employed by the hedge fund industry. This term also seems to highlight a general misconception in the market, namely that hedge funds are generally diversified. Pruce and Croweley (1999) correctly place diversification under fund of funds, as this vehicle invests in a variety of funds. The use of this term could also be an attempt to describe a long/short strategy. Diversification is also a term synonymous with positive returns, mentioned by Cobbett (2006) in his definition of a hedge fund.

The other two terms mentioned by respondents -- 'employs leverage' and 'derivatives' -- are supported by the 'dictionary.com' definition, which mentions 'speculative techniques' as a method employed by hedge funds.

'Anything other than traditional investments' was the least mentioned term on the list. This seems to complement Nailana's (2004, p.1) who defines them as "a combination of asset classes which do not fit any specific investment structure."

Lastly, Antia's (2005) criticism of the term 'hedge fund' to describe the industry was echoed by Rob Barrow. He said: "The word hedge fund is a misnomer, because the one thing they don't seek to do is generally hedge."

Other than disagreeing on the term 'diversification', it would appear that both the literature and the interviews correlate in the terms and phrases used to describe a hedge fund. To this effect they both seem to support a broad definition in defining a hedge fund.

Table 7: Defining the hedge fund industry

Key Learnings	Literature	Interview
Described as a set of strategies	✓	
Diversification		✓
Diversified industry	✓	✓
Removes market risk	✓	✓
Mitigates market fluctuation	✓	✓
Employs leverage	✓	✓
Uses derivatives	✓	✓
Limited group of investors	✓	
Generally broadly defined	✓	✓
The term hedge fund is a misnomer	✓	✓
Not fitting any specific investment structure	✓	✓

6.3. CURRENT REGULATORY NATURE OF THE INDUSTRY

6.3.1. SELF-REGULATORY STAKEHOLDERS

An overwhelming majority, over 75% (14 respondents) of respondents, agreed that self-regulation exists in the hedge fund industry. Furthermore, 65% (12 respondents) regarded the third party administrator as being the custodian of this regulation. This seems to refute the unregulated description of the industry given by Cranston (2006a), in which he makes mention that hedge fund managers thrive on taking chances and breaking rules. This misconception is pointed out by Stephen Gunnion when he says: “I do think that it is unregulated, it is largely unknown and people are quite ignorant of how it works.” Further on in the interview, he clarifies his position: “I think there is a misconception that hedge funds are doing illegal things or getting too creative with defrauding people. I don’t think that is the case.” He thus contradicts Cranston (2006a).

Vawda’s (Cranston, 2006b) point of not being able to control all mavericks in an unregulated industry is supported by the respondents in so far as regulating the manager would ensure that they are properly trained and certified. However, with regards to ensuring proper conduct in the market, respondents seemed to side more with Bruce Cameron’s (2006) view of using administrators and FOFs to self-regulate the industry.

Bruce Cameron's (2006) observation of the use of independent managers and fund evaluators by hedge funds in order to limit the risk to investors seems to be complementary to the respondents' views. Two examples of this are Matthew Rae's 'four eyes check' and Alfred Hoernle's counter party control over exposure limits. Rob Barrow's observation that there is one administrator servicing 70% of the market raises the issue of lack of competition in this sector of the hedge fund industry. This shortcoming seems to be absent from the literature.

Cameron's (2006) assertion that FOF managers have assisted in self regulation, as well as given access to individuals previously excluded is also echoed by the respondents. Kevin Shames and Jacques Marx credit FOF managers with picking the top performers in the industry; Jean Pretorius feels FOF managers increase transparency in the industry by performing due diligences on hedge funds.

Together with FOF managers, respondents listed AIMA and the hedge fund indices as being relatively important to regulation in the industry. Despite some respondents like Steven Braudo and Jean Pretorius stressing the importance of a regulatory body to ensure funds follow the principles set out by the industry, there seems to be a large portion that do not see the association's current role as being that important. The role, however, of an association in an industry that is self-regulated should be extremely important. The fact that AIMA did not feature much in the interviews nor in the literature is an indictment on the

organisation. How can it claim to represent an industry when only 33% of the industry acknowledges its importance in the self-regulatory process?

The role of the hedge fund indices is not considered to be very important. Some respondents agreed with Stephen Cranston's (2006a) issues of the index not being truly representative of the industry as it excludes Brait's R 4.2 billion and funds not open for business. Furthermore, the issue of the effect of funds leaving and joining the index was also raised.

The issue of trading derivatives on the index was seen by the Rob Barrow and Jurgen Boyd as an opportunity for the future. One provider whose literature gives the impression that they are running a derivative product off the index is Clade Investments. Their claim was, however, refuted by one respondent (not from the FSB), who believed that despite Clade claiming to be an investable index, they run a formidable portfolio that mimics the index. In fact, they include other funds not on the hedge fund index to try to outperform the index.

Once again the literature and the interviews appear to agree. The majority of the respondents and most of the literature believe that both the third party administrators and FOF managers play an important part in ensuring the hedge fund industry is well self-regulated. The respondents are, however, sceptical that the hedge fund indices will be of any use with regards to regulation and also question their legitimacy.

6.3.2. REPUTATION

Vawda's (Cranston, 2006b) and Cranston's (2006a) assertion that hedge fund managers would be able to run amok is refuted by the respondents. Both Steven Braudo and Lesley Harvey agree that a blotch in a hedge fund manager's copy book would spell disaster. Kevin Shame's Darwinian theory also suggests that a hedge fund manager not performing would not last long in the industry.

Table 8: The role of self-regulatory stakeholders

Key Learnings	Literature	Interview
Self-regulation is present in the industry		✓
Third party administrators are custodians of regulation	✓	✓
Managers thrive on taking chances & breaking rules	✓	✗
Administrators limit investor risk	✓	✓
One administrator servicing 70% of the industry		✓
FOF managers assist with regulation	✓	✓
View AIMA's role important		✓
Index not seen as a legitimate regulatory tool	✓	✓
Outsider misconception of self-regulation		✓
FOF gives access to individuals previously excluded	✓	✓

6.3.3. SELF-REGULATORY ENABLERS

Although the mandate is a critical enabler in the self-regulatory process, it was only mentioned four times. To Alfred Hoernle, this document is critical, as it is here that you specify to the nth degree what you will and will not do for the client. It is also used by the third party administrator as a template for ensuring that the hedge fund lives up to its pledge. The mandate does not seem to be mentioned in the literature as a critical factor.

The poor scoring in the interviews of the minimum investment requirements being an enabler of self-regulation, could be seen as an agreement by the industry with both McDowall (2006) and The Economist (2006), with regard to the changing investor mix and hedge fund moving into the mainstream.

The literature and interviewees seemingly confirm that the minimum investment criteria previously excluded the unsophisticated investor. This is, however, no longer considered an adequate self-regulatory process. There also appears to be a disconnect with regards to the media and the industry on the importance of the mandate in the industry.

Table 9: The role of self-regulatory enablers

Key Learnings	Literature	Interview
The mandate is a critical enabler		✓
Mandate is a comprehensive list of obligations		✓
Mandates ensure compliance		✓
Minimum investment requirements no longer seen as a regulatory tool	✓	✓
The mix of investors within the industry is changing	✓	✓

6.3.4. SELF-REGULATORY TRADE-OFFS

Agreeing with McDowall (2006), Wood (2003a) acknowledges that transparency in the hedge fund industry needs to be addressed. This seems to be echoed by the industry, with more than half the respondents agreeing. In addressing this issue, both Lesley Harvey and Marilize Pentzer feel that Global Investment Performance Standards and international trends respectively need to be met.

Stephen Gunnion believes there is no transparency in the industry. Rob Barrow and Ian Hamilton also agree that there needs to be more transparency. Kevin Shames, however, as well as other respondents, are under the impression that too much transparency would effectively give away your strategy.

Despite both the literature and the interviewees agreeing that transparency is an issue, the literature seems to place less importance on the transparency exposing the hedge fund's position. The FSB, however, has admitted that despite their position on the need for transparency, they are sensitive to this issue.

Table 10: The role of self-regulatory enablers

Key Learnings	Literature	Interview
Transparency needs to be addressed	✓	✓
Industry needs to follow Global Investment Performance Standards		✓
Industry needs to keep abreast of international trends		✓
Too much transparency is damaging to the industry		✓

6.3.5. TAX

Although passionately raised in the interviews, the issue of tax seems to be absent from the literature. The general concern in the market is whether hedge funds will benefit from the CIS tax incentives. At present, hedge funds speculate as to the best tax structures to use in order to pay as little tax as possible. Both Jacques Pretorius and Jean Marx feel that tax clarity would

bring relief to the industry. Another issue raised by Ian Hamilton is that South African tax laws are not friendly to the foreign investor.

The absence of the tax issue in the hedge fund literature could be a result of the literary world feeling it is more a CIS issue than a hedge fund issue. Nevertheless, it is still remarkable that this issue is not more publicised.

Table 11: The role of self-regulatory enablers

Key Learnings	Literature	Interview
Tax issue high on industry agenda		✓
Hedge fund industry looking for CIS type benefits		✓
Funds applying their own tax avoidance techniques		✓
Taxes not foreign investor friendly		✓

6.4. REGULATION WITHIN THE INDUSTRY

In order to understand the need to regulate the industry, issues placing pressure on the industry, as well as issues from within the industry, need to be weighed up. This allows for a better understanding of the underlying problems and for the formulation of the correct level of action to be taken, where necessary. Here, the need for growth, the requirements for regulation, the impact of regulation and its implementation within the industry, will be examined.

6.4.1. THE MAN IN THE STREET, PENSION FUNDS AND GROWTH

The literature includes both a push (market forcing growth) and a pull (industry wanting growth) perspective to the attraction of more pension fund money and the man in the street to the industry. It all seems to hinge around the industry's hunger for growth and the pressure of the market forces. The respondents' views are, however, mixed on this issue.

From a literary perspective, Rayhaan Joosub and Vawda (Cranston, 2006b) support the perspective of the hedge fund industry being hungry for money and that its insatiability will only be met by soliciting from these new markets. This perspective is supported by both Jonathan Herz and Marilize Petzer. Hertz believes that the Pension Fund Act should be changed to allow for greater investment into the hedge fund industry. Agreeing, Petzer sees the solution in pension funds using a risk based approach to measure their investment into the industry rather than a percentage limitation. Sean Katz also believes soliciting more business from these two sectors will bring welcome revenue to the industry.

The other perspective is that the changing investor mix and growing demand for hedge fund products is a major reason forcing change in the industry. This view is supported by Wood, who says pension funds are demanding more transparency in this sector. The article in the Economist (2006) supports the notion that an increase in interest by the man in the street in hedge funds is a growing issue. Respondent Jean Marx does not believe the market has the

capacity to absorb the inflow and Alfred Hoernle says the industry is not interested in the innocent investor.

Some of the literature takes a two-pronged view. McDowall believes that not only is regulatory change required for pension funds and retail investors to apportion more of their capital to this sector, but also because the industry is becoming a more mainstream investment vehicle. Steven Braudo seems to agree with this point, but he warns that “our market is small. We need new shares, we need new listings, we need new opportunities for hedge fund managers, and that’s our big risk here. We need a larger capital investment market that the guys can work in.”

Although increasing regulation to solicit investments from foreign markets was brought up by three respondents, it did not seem to be an issue in the South African context from a literary perspective. Gregorion and Ketling, however, warn of the industry potentially relocating if markets become over-regulated.

Although there seems to be a serious oversight in the literature with respect to separating the regulatory issues relating to both the manager and the industry, their views appear to support the responses fielded in the interviews. Both the literature and the industry seem to be split between those who feel the industry needs an inflow of capital and those who believe there is enough capital flowing in already. One issue to take note of, however, is the capacity of our local

market to sustain the rapidly expanding hedge fund industry, rather than being able to attract investment to South Africa

Table 12: The role of self-regulatory enablers

Key Learnings	Literature	Interview
The industry is hungry for money	✓	✓
Market pressure forcing regulation		✓
Change pension fund act for greater access		✓
Pension funds to use risk-based approach rather than a percentage-based one		✓
Increased interest by the man in the street	✓	✓
Industry lacks capacity for extra inflows of capital		✓
Innocent investor not sought after by industry		✓
Hedge funds need larger capital investment markets		✓
Soliciting investment from foreign markets		✓
Too stringent regulations forces industry to relocate	✓	
New market industry growth required	✓	x ✓

6.4.2. REGULATING HEDGE FUNDS

When it comes to regulating the industry, the literature is somewhat divided. On the one hand, McDowall (2006), Wood (2003a), Cranston (2006a), Vawda (Cranston, 2006b) and Hanlon see regulation as addressing issues such as increasing investment to the industry, increasing operational control within the industry, as well as the hedge fund industry's impact on other markets. On the other hand, Charpin and Lacaze (2002), Connor and Woo (2003), De Hovanesian and Seco (2005) all agree that regulations would hamper hedge funds by limiting their options, decreasing their efficiencies and increasing their costs.

Except for Cranston (2006a) and Vawda's (Cranston, 2006b) point of the unscrupulous manager, there was a noticeable absence of viewing regulation with respect to the manager and the vehicle. Most of the literature raises the issue of regulation only in respect to the industry. An exception to this, however, is literature directed at the FSA regulations in the UK and the FSB's white paper.

But the industry is quite aware of this distinction, with almost 100% agreeing that the manager needs to be regulated and just under two thirds agreeing with lightly regulating the vehicle.

In respect to the manager being regulated, Kevin Shames believes the decision to regulate the manager is long overdue; Kevin Wides is worried about the skill of some of the managers trading in the industry, and Jonathan Hertz believes if a manager does not want to get regulated, then he should not be allowed to trade. Sean Katz's view is that by regulating the manager, you are regulating the industry.

Although the respondents, in general, believed that lightly regulating the vehicle would be acceptable, they raised similar concerns as the literature in respect to what its impact would be on the options currently available to them in terms of efficiency and costs. Steven Braudo feels that limiting a manager's tools will impact his expected returns. Steinberg Khum agrees, saying regulation stifles

the manager’s creativeness. Alfred Hoernle believes that the last thing one needs hampering you when you need to liquidate your position is regulation; Jean Marx feels regulations ignore the particle costs of its implementation.

Once again the literature and the respondents appear to be in agreement as well as divided on the same issues. They both agree that there is a trade-off between regulation addressing issues such as increasing the investor mix, ensuring control of positions and manager competence against scope, efficiency and cost.

Table 13: The role of self-regulatory enablers

Key Learnings	Literature	Interview
Assists with bringing investment to the industry	✓	✓
Assists in increasing operational control	✓	✓
Minimises the industry’s impact on other markets	✓	
Limits hedge fund options and tools	✓	✓
Impacts expected returns		✓
Decreases hedge fund efficiencies	✓	✓
Leads to an increase in admin and operating costs	✓	✓
Separate industry into manager and vehicle		✓
Regulate the manager	✓	✓
Managers who don't register shouldn't be allowed to trade		✓
By regulating the manager you are regulating the industry		✓
Regulate the vehicle	✓	✓

6.4.3. CATEGORISING HEDGE FUNDS

Just under half of the respondents felt there was a need for hedge funds to be categorised when applying regulations to them. This ranged from Lesley

Harvey suggesting different categories for different sophistications of investors and Sean Katz categorising them into large and small funds, to Kevin Shames believing that the industry should be divided into clients that go directly to the hedge fund and those that need to go through the FOF. Hedge Fund World Africa (2005) seems to agree with Harvey, taking the position that it would be disingenuous for the regulator to apply a one-size-fits-all approach in this regard. Bruce Cameron (2006) appears to agree with Shames in respect to FOFs being used to accommodate previously excluded investors.

Despite the different definitions on how to categorise the industry, the respondents and the literature seem to confirm that it would be welcomed.

Table 14: Categorising hedge funds

Key Learnings	Literature	Interview
There is a need for categorisation	✓	✓
Categorise with respect to client sophistication	✓	✓
Categorise with respect to fund size	✗	✓
Categorise as traditional clients to hedge funds and new investors to FOFs	✓	✓

6.4.4. LEVERAGE

In spite of media reports highlighting the shortfalls in the use of excess leverage in the hedge fund industry when reporting on tragedies such as Amaranth, leverage is generally reported in technical papers as an enabler. Seco attributes the ability of a hedge fund to use leverage as a success factor; Ward and Muller accredit the ability of a hedge fund to take advantage of small and

fast returns to leverage; Charpin and Lacaze (2002) feel that limiting leverage will limit returns.

In contrast to the literature, respondents felt that leverage was one of the factors that needed further regulation. Jacques Pretorius agrees that limitations on gearing could be beneficial to the industry and Alfred Hoernle indicates that how you control your position could pose a problem. Sean Katz feels that if you need to disclose your positions to investors, that is what defines your risk. Despite leverage remaining unregulated, Lesley Harvey believes that managers in South Africa are conservative when it comes to using leverage.

It seems in this instance that the fears of the respondents appear to have been overlooked by the literature. Despite this, the articles on failures in the hedge fund market more than make up for it.

Table 15: The role of self-regulatory enablers

Key Learnings	Literature	Interview
Leverage is a success factor of hedge funds	✓	
Leverage enables hedge funds to take advantage of small fast returns	✓	
Limiting leverage limits returns	✓	x
Limits on leverage are beneficial to hedge funds	x	✓
South African hedge funds are conservative in the use of leverage		✓

6.4.5. SYSTEMIC RISK

Hanlon identifies hedge funds as creating a direct nexus between regulated and unregulated markets. To this effect, when problems arise due to excess speculation in the unregulated market, it impacts the regulated market. As the hedge fund industry grows, its impact on the regulated market increases as well.

Rob Barrow is aware of this issue in the South African context. He defines it as systemic risk, creating a serious abnormality in the performance of the markets, a potential to create contagion. To this effect, he is continuously monitoring the market. If there is a potential for systemic risk, the FSB will need to take action. He goes on to say that despite identifying systemic risk as being a problem, taking action when it is identified is another issue.

Table 16: The role of self-regulatory enablers

Key Learnings	Literature	Interview
Nexus between regulated and unregulated markets	✓	
Impact of potential disaster in unregulated market on regulated market growth as the market grows	✓	
FSB monitoring for contagion		✓
FSB to take action if contagion identified		✓
Not easy to identify or take action when contagion is identified		✓

6.4.6. GOING INTO THE FUTURE

In terms of the hedge fund industry going into the future, respondents identified relaxing of exchange controls as being the most important issue. Steven Braudo identifies current exchange controls as a barrier to growth in the

industry. The potential for disaster, however, in this regard has been highlighted by Rob Barrow as systemic risk. As the industry grows, there is too much money chasing too few goods and, eventually, there are too many traders holding the same position and they are unable to relinquish their position, which could lead to a disaster.

Following on this point, the market feels this will lead to eventual regulation of the vehicle as and when the industry reaches its critical mass.

CHAPTER 7: CONCLUSION AND RECOMMENDATIONS

Two models are used in this section to assist in extracting findings from the combined data set. The first model brings into perspective how regulation affects the industry and identifies what regulation is most appropriate. The model uses the two regulatory variables identified through the research, namely the vehicle and the manager to achieve the conclusion.

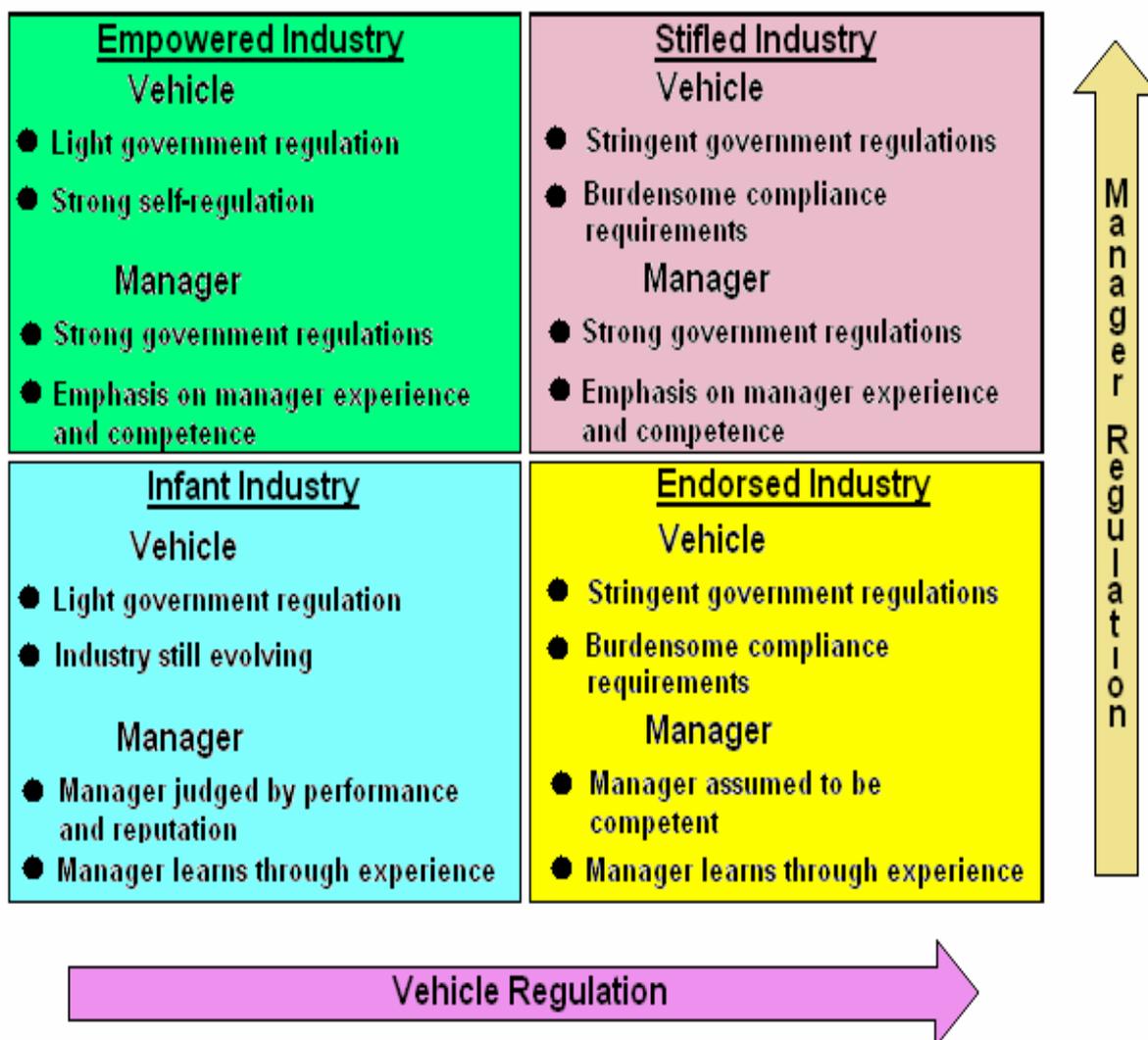
The second model is an integrated depiction of the proposed hedge fund industry structure. It is used to convey recommendations based on the research, identifying all stakeholders, their position as well as their responsibilities within the industry.

Wrapped insurance products and debentures are excluded as they are beyond the scope of this thesis.

7.1. POSITIONING REGULATION

7.1.1. THE HEDGE FUND REGULATORY POSITIONING MODEL

Figure 6: Hedge fund industry regulatory positioning matrix



Source: Jonathan Betsalel (2006)

The above matrix created by the writer separates regulation of the industry into vehicle regulation across the horizontal axis and manager regulation against the vertical axis. The level of regulation increases from left to right and from the bottom up respectively.

Using different combinations of strength with respect to the two variables, the following four quadrants were identified.

7.1.2. QUADRANT 1 (EMPOWERED INDUSTRY)

This quadrant is the most ideal quadrant, with the manager being regulated and the vehicle only lightly regulated. This ensures that the hedge funds are able to trade freely while being managed by trained, skilled managers.

7.1.3. QUADRANT 2 (INFANT INDUSTRY)

This quadrant has both a lightly regulated vehicle and a manager. This is synonymous with an industry in its infancy. As with any new industry, it is risky.

7.1.4. QUADRANT 3 (ENDORSED INDUSTRY)

By instituting strong vehicle regulation, the product is endorsed as safe. However, by only applying light regulations to the manager, the product is almost as risky as quadrant two.

7.1.5. QUADRANT 4 (STIFLED INDUSTRY)

By applying both strong vehicle and managerial regulations, the industry is stifled, which results in the breakdown of the industry, with funds migrating or closing down.

7.1.6. POSITIONING THE SOUTH AFRICAN HEDGE FUND INDUSTRY

The research suggests that the regulation needs to be split into two variables, namely the vehicle and the manager. By varying the degree of regulation imposed on each of these variables, one is able to identify an ideal combination. Based on the research, the ideal combination for the South African hedge fund industry is strong regulation of the manager and light regulation on the hedge fund vehicle. This ensures that the managers driving the vehicle have the experience and are properly qualified, while not restricting the tool or strategies required to achieve success. This is identified in the positioning matrix model below as the empowered industry and, as previously stated, is where the South African hedge fund industry should be positioned.

7.2. THE HEDGE FUND INDUSTRY

This model represents an integrated picture of the regulatory framework constructed using the learnings and information emanating from the data. The model will assist in conveying the conclusions by presenting the most feasible regulatory solution relevant to the current state of the hedge fund industry, while taking cognisance of all the stakeholders' interests.

The diagram is divided up into the five main categories of industry stakeholders, namely the clients, the regulator, the self-regulator, industry watchdogs and investment product providers. The general flow of the diagram is from left to right, and the dotted grey lines indicate alternative choices.

Figure 7: Regulatory diagram for the hedge fund industry

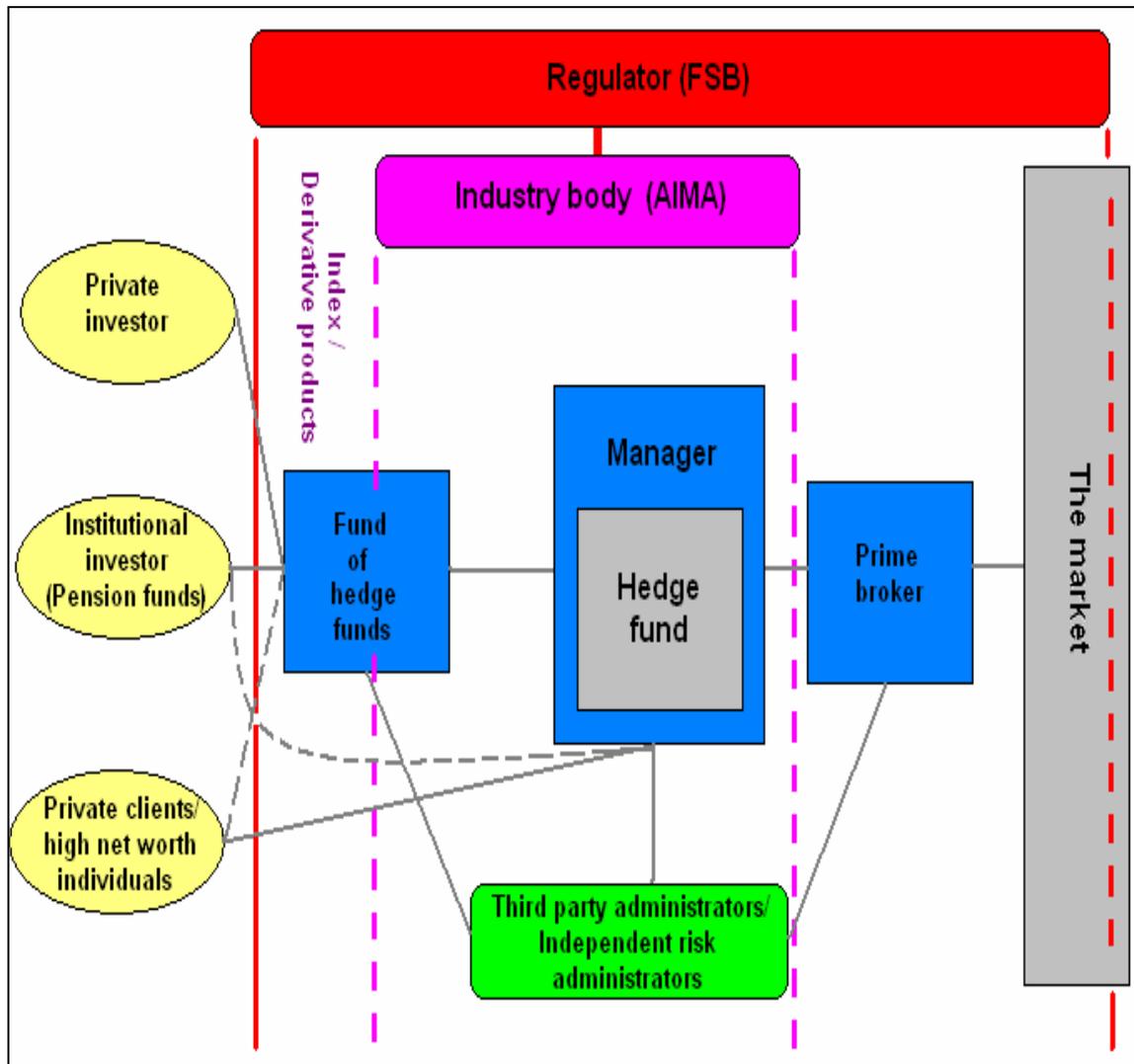


DIAGRAM KEY

Source: Jonathan Betsalel (2006)

- YELLOW** = HEDGE FUND CLIENTS
- BLUE** = INVESTMENT MANAGERS
- RED** = GOVERNMENT REGULATOR
- PURPLE** = SELF-REGULATORY BODIES (INDUSTRY WATCHDOG)
- GREY** = INVESTMENT PRODUCTS

7.2.1. INTRODUCTION

The data indicates three main hedge fund clients, namely the private investor, man on the street or retail investor, the institutional investor or pension fund administrator, and the private client or high net worth individual.

Three main investment specialists have been identified as having a stakeholding in the investment process. They are the fund of fund manager, the hedge fund manager and the prime broker.

Enablers of self-regulation have been identified as the industry body AIMA, the hedge fund indices and third party administrators or independent risk administrators.

(For ease of reference, the diagram is explained in the following sections by using the first term depicted in the diagram.)

7.2.2. HEDGE FUND CLIENTS

The hedge fund clients are depicted outside the regulatory realm and their only contact with the industry is either through the FOF fund or the actual hedge fund managers.

The only clients, other than FOFs and investment institutions that should be able to invest directly in hedge funds, are the private clients.

Pension fund managers are advised to enter the market through an FOF or should be required to be certified. It is recommended that if this procedure is followed, the limit for pension fund investment in the industry should be raised to 5%. According to the data, this should be sufficient for the market to digest.

7.2.3. INVESTMENT MANAGERS

7.2.3.1. FUND OF FUNDS

Within the classification of investment manager, three distinct segments are identified. The first is the FOF. This entity is identified as being the safest and most convenient point of entry to the industry. It is safe as it is a diversified portfolio, and convenient as the FOF is more client-orientated than a hedge fund. FOFs also have the ability to identify a good and reliable portfolio of hedge fund managers.

Due to its status as an intermediary, an FOF should be regulated by the FSB in conjunction with the industry body. Another requirement should be that FOFs are certified as hedge fund managers and understand the relevant trading strategies.

7.2.3.2. HEDGE FUNDS

Due to the data showing a need for greater transparency and regulation on leverage, it is suggested that hedge funds be placed under the industry body as well as the FSB. To avoid stifling the creativity or limiting the options available

to hedge funds, the regulations imposed on the industry need to be light, with the main regulatory responsibility residing with the industry body backed by the FSB.

An administrator would be a requirement for all clients investing directly with a hedge fund. The administrator would be required, under the regulatory guidance of the industry body, to ensure that concise mandates are in place for all these clients, as well as monitoring the hedge funds to ensure they comply with their mandates. A rating of each fund needs to be maintained and transgressors should be brought to the attention of the FSB once their rating reaches an unacceptable level.

7.2.3.3. PRIME BROKER

In order to ensure that hedge fund managers are not burdened with the administration requirements of trading the markets, it is recommended that they employ a prime broker. All money entering the market would go through the prime broker, adding another element of security to the process.

7.2.4. INDEX AND DERIVATIVES

The hedge fund index is a well-intentioned concept, which, if representative of the market, would provide a realistic benchmark for the industry, ensure greater transparency and regulation and provide an opportunity for the man in the street to buy into derivative products. Unfortunately, with closed funds and most private funds being excluded, it will never fulfil its promise.

Another index option is a listing of FOFs. The model suggests, that FOFs should be more tightly regulated by the FSB and should, therefore all meet the minimum standards required by such an index. It could also be a regulatory requirement that the FOF lists with the index. In this regard, this would result in an index fully representative of the industry. As FOFs are diversified, the index would be more stable, so any fund leaving or joining the index would have an insignificant effect. This would encourage the market to issue derivatives off the index, offering the public a secure investment in the hedge fund arena.

7.2.5. CONCLUSION

By setting out the industry in the above manner, it would be ensured that there is enough regulation to provide a secure and reliable product to the industry, with unobtrusive checks and balances to maintain minimum standards.

The above is achieved by regulating the FOF products, while leaving the hedge funds to a self-regulatory process, with both the administrators and prime brokers acting as custodians. This relieves the onerous burden of regulation from both a regulator's and hedge fund manager's perspective, while still providing all the clients with a safe product.

By providing an index of FOFs rather than a hedge fund index, a safer and more stable index is achieved, which also provides derivative opportunities.

7.3. RECOMMENDATIONS FOR FURTHER RESEARCH

The following are recommendations for further research:-

- How effective is the industry body AIMA and does it have the buy-in of the industry stakeholders?
- How comprehensive is the hedge fund mandate and how enforceable is it?
- How effective are administrators and how does the shortage of competition impact its efficiency?
- What are the benefits of a hedge fund index and is it viable?
- How is the investor mix changing, and what are the opportunities?
- How much capacity exists in the market for growth?
- What is the effect of foreign exchange regulation on the hedge fund market and what opportunities exist if they are relaxed?
- Are there benefits to regulating leverage and is it viable?
- How much transparency is viable in the hedge fund industry?
- Should section 28 of the Pension Fund Act be amended to allow administrators more discretion with regards to investing in hedge funds?
- What is the impact of unregulated markets on regulated markets.
- The pros and cons of international hedge funds soliciting business in South Africa?
- An international perspective on hedge fund regulation.
- Compare local hedge fund strategies to international strategies.



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APPENDICES

APPENDIX A: LIST OF RESPONDENTS CURRICULUM VITAE'S

The respondents have all included their own curriculum vitae's.

Robert J G Barrow

Rob Barrow is a chartered accountant and was a partner in the Johannesburg office of Coopers & Lybrand for 16 years. During his professional career he was actively involved in the setting of accounting standards having been involved in the South African Institute of Chartered Accountants Accounting Practices Committee for 7 years, 3 of which he acted as chairman.

In 1992 he moved to the Johannesburg Stock Exchange (JSE) as the Director: Surveillance. Whilst at the JSE he oversaw the development of a comprehensive suite of electronic surveillance systems and was extensively involved in the so-called deregulation of the JSE.

In 1997 he joined the Financial Services Board (FSB) as Deputy Executive Officer responsible for Investment Institutions, which includes regulatory oversight of the South African Exchanges, the Collective Investment Schemes Industry and Insider Trading. He has acted as chairman of the Insider Trading Directorate for the last 5 years.

In July 2005 he was appointed Executive Officer of the FSB.

Jurgen Boyd

Qualifications:

B.Compt and B.Compt (Hons)
Qualified as CA(SA) in 1987

Employment History:

1985 - 1989: Nestlé (Pty Ltd. (management accountant, internal auditor and financial manager - refrigerated products)

1989 - 1992: Robertsons (Pty) Ltd (company accountant)

1992 - 1997: In public practice and founding partner of KMMT Inc. CA(SA)

1997 - 2000: Business consultant and financial director of Rentcorp (Pty) Ltd

2000 To date Financial Services Boar

- i) Head: Collective Investment Schemes Department:
November 2000 - April 2006
- ii) Deputy Executive Officer : Retirement Funds
May 2006 to date

Membership of professional bodies:

1. SAICA
2. ABASA

Other

Alternate Board member Public Accountants and Auditors Board
Chairperson of audit committee of Department of Water Affairs and Forestry

Civic Interests

1. Past Vice President of the Durban branch of ABASA(the Association for the Advancement of Black Accountants in Southern Africa.)
2. Past Chairman of the Ifafa Beach Committee of the Independent Civic and Development Associations (Icada)
3. Past Non-Statutory Member of the Technical Committee of the Pennington Local Government Negotiating Forum
4. Past Member of the Career Guidance Committee of the Kwa Zulu Natal Society of Chartered Accountants.(SAICA)

Steven Braudo

Managing Director Investment Solutions

Qualifications: BEcon. Sc, Bsc (Hons), FIA, CFA

Steven obtained his BEconSc. degree from Wits University in 1992 and qualified as a Fellow of the Institute of Actuaries in 1997. He obtained his CFA Charter in 2000.

Prior to joining Investment Solutions in 1997, he worked at Commercial Union for five years gaining experience in both the Employee Benefits area and the Corporate area.

Steven has been with Investment Solutions since its inception and has been involved in all areas of the business, including operations, marketing as well as being a member of the investment committee.

He has been an Executive Director responsible for operations at Investment Solutions since 1999 and was appointed Managing Director of Investment Solutions with effect from 1 April 2002.

Craig Cuyler

After completing University in 1994 he went to work at the JSE on the fixed Income floor as a Bond Broker/Trader. During the course of the next few years Craig developed his skills as a yield curve market maker, trader and analyst for HSBC (South Africa.) He was then hired as a proprietary trader for African Merchant Bank to trade emerging market and G7 leveraged products. After the delisting of AMB he went on to found a hedge fund for a Swiss based Asset manager through CSFB. Craig remains an active speculator in the financial markets and is involved in private equity, capital raising and advisory work. Craig is a director of Kensani Entertainment which is a division of Kensani Capital.

Stephen Gunnion

Stephen Gunnion has been financial services editor at Business Day since 2004. He was previously economics editor for television and radio news at the SABC and news editor at Summit TV. Stephen studies a Bachelor of Arts degree at Wits University and Unisa and started his career as a radio reporter for Channel Africa, the external arm of the SABC.

Ian Hamilton

Ian is the Chief Executive Officer of the Investment Data Services Group, which he founded in 2003. He has a wealth of expertise and an extensive network in the South African investment market. Ian has also served as a director of the South African Association of Unit Trusts (Now the Association of Collective Investments (ACI)) and is a founder board member and now Chairman of the South African Chapter of Alternative Investment Management Association (AIMA South Africa).

Ian was appointed in June 2001 by the Minister of Finance of South Africa, the Honourable Mr. Trevor Manuel, to the Advisory Board of the South African Financial Services Board. He has been actively involved in the debates surrounding the possible introduction of hedge fund regulations for the Collective Investment Schemes Control Act.

Ian is also Chairman of IDS International, a fund administration company registered and domiciled in Dubai. This company is providing third party administration to the international hedge fund market.

Lesley Harvey

BCom, CA(SA)

Experience

In the late 1980s, while working in the Regulatory Compliance Unit of a large accounting firm in London, Lesley was seconded to the Securities & Investments Board (Now the Financial Services Authority).

On her return to South Africa, she spent six years with Southern Asset Management where she was responsible first for portfolio administration and later as compliance officer. She was also a director of Southern Asset Management. In 1999, she joined NIB Asset Management where she became the Chief Operating Officer.

In 2002, Lesley joined Ernst & Young where she was responsible for non-audit services to investment management clients. She was also responsible for the firm's hedge funds practice.

Lesley joined Tim Howse in eComply Consultants in 2005. eComply provides risk management, compliance, corporate governance and investment performance reporting services to investment managers.

Lesley is an active member of various local and global industry organisations, including AIMA, the Compliance Institute of SA, and the CFA Institute

Jonathan Hertz

BSc FIA, FASSA, CFA

Jonathan held the position of Chief Operating Officer on the board of Peregrine for five years before joining Caveo Fund Solutions as the managing director reporting to the board.

Alfred Hoernle

Alfred is a scientist by training. He did a PhD in Nuclear Physics (Wits 1989) and B.Com (Unisa 1992). Worked with De Beers Industrial Diamonds in synthetic diamond manufacture from 1988 to 2000, then joined Mettle as an interest rate derivative trader. Moved to Securities Investment Bank in 2002, was absorbed into Investec in 2003 and started the Interest Rate Derivative Trading Fund with Steynberg Kuhn in September 2005.

Sean Katz (Director of SKLP Capital (Pty) Ltd)

B Compt (Honours), CA (SA)

Sean Katz completed a B Compt (Honours) from UNISA and qualified as a chartered accountant from Ernst and Young in 1994. He then joined Liberty Asset Management in 1994 where he held the position of senior investment manager. In 1996, Sean joined Peregrine where he held the position of managing director of Peregrine Investments - which controlled Peregrine Strategic Investments and an investment banking business. Sean left Peregrine in November 2002. He established and has been running the SPYGLASS suite of hedge funds since November 2003.

Steynberg Kühn

Steynberg graduated with a B. Com Hons (UP), and is a CFA charterholder. His experience includes, 4 years market risk management experience, 4 years proprietary trading experience trading interest rate derivatives and fixed income. 2 years institutional bond sale experience, 2 years Hedge Fund Management experience. Seynberg started the Interest Rate Derivative Trading Fund with Alfred Hoernle in September 2005.

Marilize Petzer

Marilize holds the position of market development general manager at the Bond Exchange of South Africa.

Jacques Pretorius

B Com Hons (Investment Management) M Com RAU

Jacques was the manager of the Stanlib Asset Managers Quasar Hedge Fund and Head of Quants research at Stanlib Asset Managers. He was the only fund manager on Quasar, since inception in October 2002 to 30th June 2005, during which time the hedge fund had an accumulative return of 106% and the last twelve months net return for the fund was 48.5%. Jacques was the winner of the Old Mutual Symmerty hedge fund award - Market neutral category. At T-Cap, Jacques is an Equity Market Neutral Hedge Fund manager, with a view of launching an Equity long-short in 2006.

Matthew Rae

Worked as an independent compliance consultant for four years with The CCL Partnership in London before joining Stenham in June 2004. Holds the Investment Administration Qualification of The Securities Institute. Matthew currently holds the position of compliance manager at Stenham in London.

Shiresh Runchhod

Shiresh holds the position of risk analyst at the Bond Exchange of South Africa.

Kevin Shames

Kevin qualified as a C.A. (S.A.) and CFA.

Kevin Shames started his career in 1991 as a derivatives trader at Investec Bank in Johannesburg. He left Investec to start Mercury Consolidated Holdings in the inception of South Africa's hedge fund industry, launching the third SA hedge fund in 1999. Kevin simultaneously established and was the President of the Hedge Fund Association (HFA), an industry body to liaise with regulators and the press on hedge fund related matters. In September 2003, the HFA became the South African Chapter of AIMA (The Alternative Investment Management Association), of which Kevin was Chairman for 6 years until Oct 2005.

Apart from managing hedge funds himself, Kevin has managed a HF incubator. In October 2004, he moved to the fund of hedge fund business with Alpha Asset Management, where he heads their South African FoHF business.

Kevin Wides

Graduated from Wits University with a B Com in Economics, Kevin worked a floor bond trader on the South African Bond Market with Irish Mennel Rosenberg from 1994-1995 and then Anderson Wilson from 1995 – 2000.

From 2000 to 2004, Kevin was a director Widespread Treasury Pty Ltd overseeing private fund management. In 2004 Kevin started Bari International, a hedge fund company which includes running a global hedge fund in conjunction with Credit Swiss.