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The impact of regulation on the hedge fund industry in South Africa

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ABSTRACT

Since the onset of the global financial crisis, there have been calls to regulate those parts of the financial system that were previously either unregulated or lightly regulated. These proposals are being put forward as part of an international drive to bring parts of the financial sector within the ambit of regulation, with the overarching aim of protecting investors from bearing the brunt of regulatory failures, as was experienced in the 2007/2008 global financial crisis. The purpose of this study was to explore the impact of proposed regulation on the South African Hedge Fund industry.

The focus of this research study was limited specifically to regulation in the Hedge Fund industry, although there are also proposals to strengthen regulations in other parts of the financial system. Qualitative research was conducted through a combination of face-to-face and telephonic interviews with stakeholders in the Hedge Fund industry.

The research found that the proposed regulation would result in growth in the hedge fund industry by virtue of giving more credibility to the industry, thereby increasing the consumer base. The research also revealed that regulation would negatively impact the functioning of hedge funds and the quality of regulation in the industry was found to be good.

KEYWORDS

Hedge Funds, systemic risk, regulation.

DECLARATION

I declare that this research project is my own work. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration at the Gordon Institute of Business Science, University of Pretoria. It has not been submitted before for any degree or examination in any other University. I further declare that I have obtained the necessary authorisation and consent to carry out this research.

Yolanda Vatsha **7 November 2012**

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LIST OF ABBREVIATIONS

ASISA - Association for Savings and Investment in South Africa

FSB - Financial Services Board

G20 - Group of 20

IOSCO - International Organisation of Securities Commissions

SBP- Small Business Project

UCITS - Undertakings for Collective Investment in Transferable Securities

US - United States

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CHAPTER 1: INTRODUCTION TO RESEARCH PROBLEM

1.1 Introduction

Since the beginning of the global financial crisis in 2007, various views have existed as to what caused the global financial crisis. The common theme that emerged is that of under-regulation in the securities markets (Nichols, Hendrickson & Griffith, 2011). A theory that is central to this debate is the theory of regulation. A reason often cited in favour of regulation is that regulation is aimed at addressing a market failure (Canova, 2009) and Hedge funds have become a focal point of securities regulation since the global financial crisis.

The global regulatory reform agenda that was proposed at the Group of 20 (G20) summit in April 2009 included the proposal to regulate systemically important hedge funds (van Eechoud, Hamersma, Sieling & Young, 2010). The call to regulate what was a previously unregulated industry, culminated from the view that hedge funds pose a systemic risk to the financial system (Financial Stability Board, 2009). Another reason why Hedge funds have become a focal point of securities regulation is due to the 1998 near-collapse of the US' Long-Term Capital Management Hedge fund, as well as the 2006 collapse of the Amaranth Hedge fund. These events have elevated the debate on the tighter regulation of Hedge funds (van Berkel, 2008).

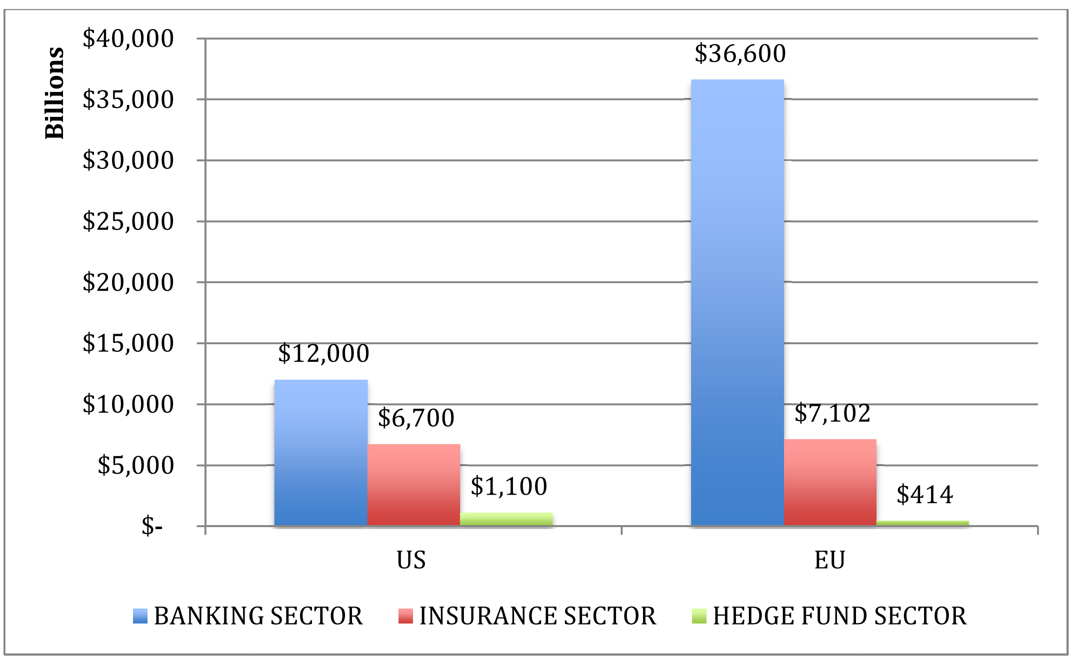
The South African financial system is the conduit for economic transactions and is critical for supporting economic growth in the country. In order to keep the financial sector competitive, South African regulatory authorities have, to a large extent, aligned domestic regulatory practices to global best practice (National Treasury, 2011). According to National Treasury (2011), the South African government has committed to: creating a strong regulatory framework, effective supervision through co-ordination, crisis resolution, oversight on systemic institutions and undertaking regular assessments of the regulatory system.

The purpose of this report is to explore the impact of regulation on the Hedge Fund industry in South Africa - specifically how regulation will impact on growth in the industry, the possible cost implications and the unintended consequences that will arise from regulation.

1.1.1 Hedge fund statistics

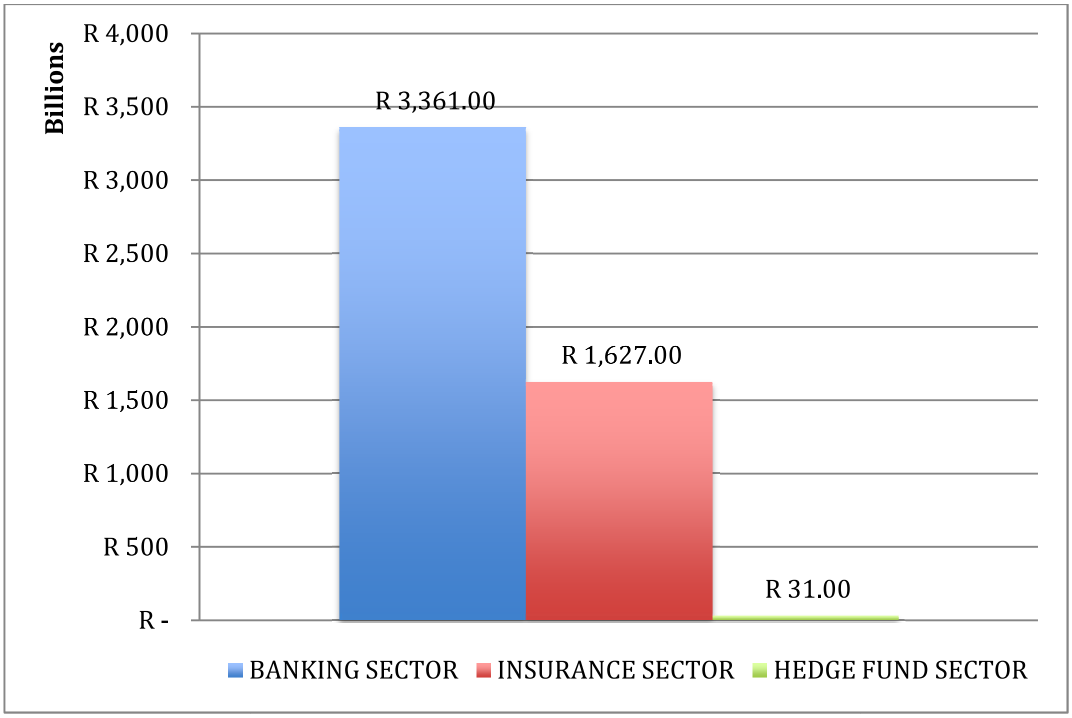
Hedge funds both globally and domestically have witnessed rapid growth (KPMG 2011; Novare, 2011). It is estimated that as at 30 April 2012, the global Hedge Fund industry had $2.13 trillion assets under management (Reuters, 2012). According to the Novare (2011) survey on Hedge funds, Hedge fund assets in South Africa grew from R2 billion in 2002 to R31.5 billion in 2011. The rapid growth of Hedge funds globally has resulted in a renewed focus to regulate these funds, which were previously self-regulating or lightly regulated (van Berkel, 2008). Although the size of the Hedge fund industry is small in comparison to commercial banks, investment banks, mutual banks and pension funds, the major concerns that have been raised relate largely to the interconnectedness of Hedge Funds with other parts of the financial sector (Doyran, 2009). Figure 1 and Figure 2 below illustrate the size of the Hedge fund industry relative to commercial banks and insurance companies globally and domestically.

FIGURE 1: GLOBAL FINANCIAL SECTOR OVERVIEW



Source: Federal Reserve Bank (2012), European Central Bank (2012)

FIGURE 2: DOMESTIC FINANCIAL SECTOR OVERVIEW



Source: SARB (2012), Financial Services Board (2012) and Novare (2011)

1.1.2 Impact of international regulation on South Africa

Financial globalisation is a term that stems from the phenomenon of globalisation. According to Kose (2009), the most recent form of globalisation began in the mid-1980s due to significant increases in cross-border financial flows between economies through liberalisation of capital controls. Although promoters of globalisation believe that financial globalisation has had a positive effect on the global financial system (Kose, 2009), it can also be argued that it has caused significant damage to the financial systems of many countries through the second round effects of the global financial crisis (National Treasury, 2011).

Financial globalisation has also resulted in the phenomena of "international regulation". The term "international regulation" is comprised of four pillars, which, according to Taylor and Arner (2009), are:

⇒ Global consensus on key elements of sound financial systems;

⇒ Design of sound principles and practices by international regulatory authorities;

⇒ Incentives for acceptance of sound supervisory systems; and

⇒ Promotion of the adoption and implementation of sound principles and practices by international multilateral institutions.

The proposed regulation of Hedge funds is the latest in the international drive to bring securities regulation into the ambit of regulation. Some of the proposals from international regulatory agencies include: mandatory registration of hedge fund managers, subjecting hedge fund managers to appropriate regulatory requirements, mandatory registration and supervision of prime brokers, provision of systemic risk data, regulators to encourage implementation and convergence of industry good practices and co-operation of regulators.

Efforts to regulate the Hedge fund industry in South Africa have been in the pipeline for a number of years. Studies by Betsalel (2006), Mutingwende (2008) and Khalaki (2009) show that although there has been talk about regulating this industry, not much has been done until recently. According to the Business Day (1 August, 2012), a Hedge fund task team recommended that two models of regulation be created for the South African environment. The Business Day (1 Aug, 2012) stated that the lighter regulatory version would restrict investment powers and the heavier version would allow for unlimited investment powers but with heavy disclosure. The problem with any proposed regulation is that although the regulator aims to encourage competition in the industry by regulating it, the downside for business is the compliance costs.

In South Africa, the Financial Services Board (FSB) regulates Hedge funds and all Hedge fund managers are required to register with the FSB. Currently Hedge funds are not regulated, however with the new Hedge fund reporting guidelines being proposed by the International Organization of Securities Commissions (IOSCO), the industry is set for some changes. It can be argued that if Hedge funds in developed economies pose a threat to the financial system, then regulatory oversight on them should be increased, however it can also be argued that should they not pose systemic risk, then perhaps they should be allowed to operate as they currently do.

1.2 Research motivation

1.2.1 Purpose of the research

This study is aimed at answering the question: How will regulation impact the Hedge fund industry?

In investigating the impact of regulation, the study will explore the impact on factors such as: growth, costs and innovation, and based on the findings, will propose a model for the introduction of regulation.

According to Statistics South Africa (2011), the financial sector makes up 10.5% of GDP in South Africa. Although on 30 June 2012 the Hedge fund industry assets under management amounted to R31.5 billion (Novare, 2011), the industry has grown steadily in the past few years and it is expected that the relaxation of Regulation 28 limits will further enhance growth in this industry (Hedgeweek, 2012). However, with the proposed regulations and additional regulatory burden this growth could be thwarted, innovation stifled and change the way that hedge funds function.

1.2.2 Research scope

By virtue of membership and participation in international regulatory associations such as the Financial Stability Board and the G20, developing countries that are members of these organisations may be disadvantaged by having to comply with regulatory standards, some of which may not be suitable for the type of economies they operate in. Some of the disadvantages that emerging financial markets face when adopting international regulatory standards includes: hampering growth in the industry, restricting competition, creating additional barriers to entry and stifling innovation.

The financial sector is a key industry in the South African economy and the scope of this research was limited to assessing the impact of regulation on the South African Hedge fund industry and not the entire financial sector. The impact was assessed through an exploratory study, which identified themes from literature and followed up the themes with interviews. These interviews were conducted with key personnel in

Hedge fund management companies and with the regulatory agencies, industry bodies, risk managers, compliance officers and independent experts in the Hedge fund industry.

CHAPTER 2: LITERATURE REVIEW

2. Hedge funds

2.1 Introduction of Hedge funds

Alfred Winslow Jones founded the earliest publicised Hedge Fund in 1949 (AW Jones & Co, 2012). It is said that Jones referred to his fund as a "Hedged Fund" because of his strategy of combining the two techniques of buying stocks with leverage and selling short other stocks (AW Jones & Co, 2012). According to Fung and Hsieh (1999) in Mitra (2009), Hedge funds became well known after an article appeared in a 1966 edition of Fortune. The popularity of hedge funds was due to their outperformance of Mutual Funds. Subsequent to that, a number of Hedge Funds emerged largely due to the unregulated state of that industry. The industry has since grown to an estimated $2.5 trillion in global assets under management (KPMG, 2011).

2.2 Definition of Hedge Funds

It is essential to state upfront that there is no commonly accepted definition of a Hedge fund, and a vast array of definitions emerged from the literature reviewed. Bianchi and Drew (2010, p. 8) summed this challenge up by saying that "Hedge Funds are extremely difficult to define in a clear and cogent manner". A number of definitions were found in the literature across a number of jurisdictions and authors. These definitions will be discussed in this section.

The European Central Bank (2012) defines a Hedge Fund as "an unregulated or loosely regulated fund that can freely use various active investment strategies to achieve absolute returns". The Investment Company Act defines a Hedge Fund as "an entity that holds a large pool of securities and perhaps other assets". Shadab (2007, p. 36) defines a Hedge Fund as "a private investment vehicle that is less regulated than traditional investment companies". Another definition by Yeoh (2007, p. 223) is that Hedge Funds are in general "unregulated pooled investment vehicles". Kambhu, Schuermann and Stiroh (2007, p. 2) also defined Hedge Funds as "largely unregulated, private pools of capital". Frumkin and Vandegrift (2009, p. 243) defined Hedge Funds as "an actively managed investment pool that does not advertise and is privately organised to be exempt from the Securities Acts of 1933 and 1934".

The key themes that emerged from the aforementioned definitions are those of pooled investment, loose regulation and unique investment strategies. One of the reasons that there is no commonly accepted definition of Hedge Funds is because of their unregulated status and the fact that the investment strategies they employ have become complex and no longer follow the simple "hedging" strategy that they were first known for (Mitra, 2009,p. 3).

Due to the lack of a universally accepted definition of a Hedge Fund and for the purposes of this paper, it can be resolved that a Hedge Fund in the South African context is a pooled investment that uses a combination of investment strategies to achieve returns in a lightly regulated regulatory environment.

2.2.1 What do Hedge Funds do?

According to Stulz (2007), Hedge Funds are in the business of taking advantage of arbitrage opportunities. Stulz (2007) went on to explain that arbitrage takes place when there are price discrepancies between securities and that once Hedge Funds identify an asset that is mispriced, they hedge their position such that when the mispricing is corrected the fund benefits from that correction.

Kaiser (2008) defined the business of Hedge funds as investment instruments, which identify and profit from incorrectly valued securities by applying different investment strategies, or securities that earn non-common, risk premiums. Kaiser (2008) also articulated that hedge fund managers use investment strategies to generate profit from misvalued instruments ('arbitrage'), when in essence advantage is being taken of temporary price discrepancies in fundamental values.

Wiethuechter (2010) remarked that modern day Hedge Funds have changed from hedging to leveraging and the concept of "hedging" is no longer central to these

Regulatory practices in the US and Europe have allowed hedge funds more flexibility with regards to their investments and the lack of regulation has allowed hedge fund managers to make use of derivative instruments. The use of leveraging boosts Hedge Fund performances by means of the leverage effect of derivatives. Hedge Funds mostly rely on the same investment principles, but their risk structure and strategy are diverse. These diverse investment strategies are changing even more rapidly than market conditions.

Yeoh (2007) made the observation that Hedge Funds generate profits by borrowing from investment banks to make profitable bets in the financial markets. In short, Hedge Funds accept capital from investors to exploit market price inefficiencies and achieve high returns with minimum risks. Due to the popularity of these funds, they also use derivatives, futures and options to hedge against market risk, but in practice they may try to make higher returns by speculating on such derivatives or other related financial instruments.

The literature is consistent about the business of Hedge Funds; it is evident that the plain vanilla strategy employed by Alfred Winslow Jones is no longer being used as Hedge Funds have found other ways to exploit market inefficiencies. The use of derivatives has resulted in more complex Hedge Fund strategies, which is why it has become necessary to regulate these funds. In the United Kingdom, Hedge Funds are faced with “heavier” regulation than in other jurisdictions (Falkenar & Gerty 2009). It can therefore be concluded that different jurisdictions face different challenges with regards to Hedge Funds and how they employ their investment strategies. How they regulate these funds will depend on the amount of risk they are perceived to pose to the financial system.

2.3 Economic growth and globalisation

Globalisation is a widely used term that is defined by the World Trade Organization as “the increased interconnectedness and interdependence of people and countries that is made possible by the opening of borders to facilitate the flow of goods/ services and the policy regimes that facilitate or promote such flows.” (World Trade Organization, 2012).

One of the advocates of globalisation, Stiglitz (2002), asked the question that if globalisation is a force that has brought good to the world, why then has it become so controversial? Stiglitz (2002) stated that globalisation has spurred the economic growth of countries through international trade, which has had a positive knock-on effect on the welfare of the citizens of those countries. Villaverde and Maza (2011) found that globalisation has had a positive effect on economic and social globalisation, which in turn positively affects the income rate of growth. Villaverde and Maza (2011) also highlighted the positive influence of globalisation on economic growth and found in their study that it is much higher than previously thought.

Nayyar (2006) explained that there have been three periods of globalisation. The first period was from 1870 to 1914 where goods where traded with little government intervention. The second period was between 1950 and 1970 when trade barriers which emanated from the World Wars were dismantled, which led to the last period - globalisation (also known as financial liberalisation) - which began in the mid 1980s. Nayyar (2006) found that during these periods, economic growth was not rapid and economic convergence did not take place.

The literature on globalisation is divergent. One school of thought emphasises that without globalisation many countries would have remained isolated and experienced little economic growth, while the second school of thought says that globalisation has introduced a new dimension of exclusion due to skewed income distribution. There is no doubt that globalisation brings with it many benefits and advances economies as well as nations. The downside of globalisation, however, is that it seems it is a case of the rich countries getting richer and the poor countries getting poorer. South Africa has benefited from being able to trade in international markets, however there has also been a backlash in that the country has advanced in certain areas but if globalisation is so good, why is it that in South Africa the income gap is widening? The World Bank statistics show that South Africa’s Gini Index was 63.1 in 2009 (World Bank, 2012).

Globalisation has also resulted in financial and economic integration of the South African financial system into the rest of the world.

2.4 Financial regulation

According to Canova (2009), from the 1929 stock market crash until the banking crisis of 1933, financial markets were largely unregulated and unsupervised and government had no obligation to stimulate the economy. Canova (2009) continued to say that it was not until 1944 when Abba Lerner, a Keynesian economist, wrote *The Economics of Control: Principles of Welfare Economics*, a book which sought to provide a more detailed theoretical framework for market regulation and public finance in accordance with Keynes' observations. The debate on regulation ensued and what followed were periods of regulation followed by deregulation. This section will explore the definition of financial regulation. Jalilian, Kirkpatrick and Parker (2006) put forward that "the case for economic regulation is based on the existence of a significant market failure resulting from economies of scale and scope in production, from information imperfections in market transactions".

The term regulation has been defined by Stigler (1971) as 'the exercise of coercive government power'. Essentially, it is instructing people to behave in a certain way and punishing them if they do not comply (Stigler, 1971). Stigler was the father of the Economic Theory of Regulation, which is captured in the aforementioned definition. Other definitions of regulation, which have been captured in literature, include one by Ayres and Braithwaite (1992) cited in Smith (2004), which defined regulation as the "so-called command and control approach".

In their study on Public Regulation, Joskow and Noll (1981) stated that qualitative regulation attempts to address market failures. Their study found that the normative theory that regulation increases welfare was unfounded, as many times regulation does not increase economic welfare. In their study, Joskow and Noll (1981) also reviewed the literature on regulation and found that theories of regulation from Stigler (1971) and Spann and Erickson (1970) had conceptual and empirical problems and that the theories lacked full scientific status.

The themes that emerge about financial regulation demonstrate that the main reason for such regulation is to address a market failure in order to promote economic prosperity. Government or regulatory authorities usually impose regulation and organisations are expected to comply. The objectives of regulation will be explained in the next section.

2.4.1 Objectives of financial regulation

Literature on the objectives of regulation show consensus. The three objectives of regulation are to protect customers against monopolistic competition, to provide smaller (retail) clients with protection and to ensure systemic stability (Goodhart, Hartmann, Llewellyn, Rogers-Suárez & Weisbrod, 1998). The objectives have remained similar over time, although the wording has been somewhat modified. Falkena, Bamber, Llewellyn and Store (2001) explained that the overarching principle of regulation is to achieve economic efficiency and consumer protection. These principles filter down to the three objectives of securing systemic stability in the economy, ensuring institutional safety and soundness and promoting consumer protection.

More recently, the objectives for financial regulation have become four-fold, i.e. consumer protection; ensuring financial soundness of financial institutions; promoting fairness, efficiency and transparency in the securities markets; and promoting a stable financial system (Botha & Makina, 2011). Botha and Makina (2011) derived these objectives largely from the objectives of regulation that were articulated by the Minister of Finance in the 2011 policy document “A safer financial sector to serve South Africa better” (2011). In this policy document, the stated objectives are four-fold - to achieve financial stability; consumer protection and market conduct; expanding access through financial inclusion; and combating financial crime.

In the policy document “A safer financial sector to serve South Africa Better” (National Treasury, 2011) the Minister of Finance articulated the aims of regulating the financial sector as the safeguarding of confidence in the financial system; ensuring that financial services providers are licensed; promoting market conduct; and prosecuting cases of market misconduct, thereby protecting the consumer and maintaining the safety and soundness of financial institutions by enforcing applicable laws.

Although financial regulators do impose laws on the financial sector, the process has become more consultative. A case in point is that of the recommendations that have stemmed from the Financial Stability Board on Exchange Traded Funds. The Financial Stability Board has proposed a number of principles to regulate Exchange Traded Funds and given the relevant stakeholders the opportunity to comment on these principles. This is one example where lawmakers have followed a consultative process versus a command and control approach. The question is, have South African regulators been able to achieve these objectives, and if so, will the adoption of additional regulatory measures enhance the soundness in the financial system or will it be detrimental to the financial system?

2.5 Risk

The definition of risk is one that is widely disputed and defined in literature (Holton, 2004). The concept of risk must always be taken into consideration when dealing with the search for yield, as there can be no yields if risks are not taken. Kritzman and Rich (2002) articulated this in their paper which found that investors usually measure risk as the probability of a loss that they will make at the end of their investment horizons, not taking into consideration that there is a risk of loss throughout the investment period.

Miller (1977) described risk as where the future is unknown but the probability distribution of possible futures in known. Another definition of risk is discussed in a study by Kaplan and Garrick (1981), who found that risk has three parts to it: relative risk, relativity of risk and acceptability of risk. Their study concludes that all three parts of risk should be considered during decision-making.

A more recent definition of risk was captured by Holton (2004), who defined risk as the exposure to a proposition that is uncertain. Holton (2004) derived the definition after reviewing several other definitions in literature, but concluded by saying that the definition presented is at best just a general definition. This short review of literature on risk leads to a more micro definition of risk - systemic risk -, which will be defined in the section below.

2.5.1 Systemic risk

Systemic risk is a term that is widely defined in literature. There are several definitions of systemic risk with each placing emphasis on a particular area of systemic risk. According to the International Monetary Fund (2009), most countries do not have a formal definition of systemic risk, however there are a number of definitions that have emerged over time, some very similar in nature. A definition from the Financial Stability Board (FSB, 2010) proposed that systemic risk is "a risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy".

A more comprehensive definition of systemic risk is from the Group of Ten (2001), who proposed that systemic financial risk is the risk that an extraordinary event will cause a loss of confidence in a substantial part of the financial system, which is serious enough to have significant unfavourable effects on the real economy. The Group of Ten (2001) also mentioned that these extraordinary systemic risks could occur suddenly or build up over time due to a lack of policy responses. This definition highlights three key areas - the risk to the financial system, spill overs into other institutions and the disruption of the payment system. A number of other definitions found in the literature cover one or more of these key areas.

According to Chan, Getmansky, Haas and Lo (2007, p. 235), the term 'systemic risk' is used to describe the possibility of a series of correlated defaults among financial institutions caused by a major event that occurs in the financial system. Another definition of systemic risk is articulated in Brown, Hwang, In and Kim (2011) as "the risk or probability of collapse of an entire financial system, as opposed to the risk associated with any individual entity, group, or component of a system" (Kaufman, 2000, p. 70).

In a note on measuring systemic risk, the European Central Bank (2009) outlined three approaches that can potentially be utilised to assess the build-up of systemic risk. The three suggested approaches include monitoring financial soundness indicators such as macroeconomic indicators; monitoring individual institutions to identify which institutions are likely to come under pressure; and assessing systemic linkages between financial institutions. The IMF paper also proposed four systemic risk assessment methods to assess inter-linkages between financial firms (IMF, 2009). These approaches include the network approach, the co-risk model, the distress dependence matrix, and the default intensity model

Understanding the systemic risk posed by Hedge Funds on the financial system has now become a priority for policy-makers since the global financial crisis demonstrated that the financial system could collapse due to contagion. In order to address the systemic risk concern, IOSCO compiled a list of proposed requirements for Hedge Funds. The information that may in future be required from Hedge Fund managers will be used for supervisory purposes and to determine systemic risk. The categories of information that will be required include:

⇒ General firm/advisor and fund information, including net asset value of total fund assets, net asset value of total strategy assets, and predominant investment strategy.

⇒ Performance and investor information for each qualifying fund, including net asset value of fund assets by investor types.

⇒ Market and Product Exposure for strategy assets for each qualifying fund, and details of the material positions in various asset classes split by: Securities, Derivatives, Tangible Assets and Collective Investment Undertakings

⇒ Geographical focus with details of the regional investment focus.

⇒ Turnover/ number of transactions value of turnover in each asset class over the reporting period.

⇒ Trading and clearing estimated percentage of securities traded, derivatives traded, information on primary Clearing Counter Parties.

⇒ Leverage and risk value of borrowings, amount of unencumbered cash and various risk measures used by hedge fund managers.

⇒ Liquidity risk including details of portfolio, investor and financing liquidity.

⇒ Counterparty risk with details of primary counterparties in terms of net counterparty credit exposure.

⇒ Other information on concentration (e.g. principal markets in which trading can represent a significant proportion of overall daily volume, top ten positions as a % of gross market value).

The above-mentioned requirements will increase reporting requirements for Hedge Funds, but it is envisaged that these requirements will enhance transparency in the Hedge Fund industry and will afford regulatory authorities increased oversight on any possible systemic issues that may arise.

According to Bianchi and Drew (2010), the reason for the renewed focus on Hedge Fund regulation is to minimise the probability of Hedge Fund failures resulting in financial contagion that would lead to the collapse of the financial system. Bianchi and Drew (2010) mentioned that the near-collapse of the LTCM Hedge Fund in 1997 was what concerned policy-makers, however the circumstances relating to LTCM were not due to exposure to the banking sector, but were as a result of a different set of circumstances.

Khambu, Schuermann and Stiroh (2007) proposed that there are several ways in which Hedge Funds can pose systemic risk to the financial system. These mechanisms can be through counterparty risk due to the link between commercial banks and Hedge Funds; disruption of broad financial market activity; and shock events in the Hedge Fund industry, which results in reduced liquidity.

The opaque definition of systemic risk has far-reaching implications for regulation in the Hedge Fund industry. Firstly, regulators may have to define exactly what they mean by the term "systemic risk" in Hedge Funds. Secondly, regulators will need to determine which Hedge Funds are systemically important and increase oversight on these. Finally, regulatory authorities need to be cognisant of the fact that increased regulation could lead to regulatory arbitrage, whereby Hedge Funds move into less regulated jurisdictions.

Consensus in the literature suggests that systemic risk can be caused by a shock event, which has the potential to disrupt the financial system as a whole. An important factor in defining systemic risk for the South African Hedge Fund industry would be to determine the interconnectedness of Hedge Funds to the banking sector, and to determine whether the Hedge Fund industry could cause any shocks to the financial sector through the above-mentioned transmission mechanism.

2.6 Measures for assessing regulatory quality

The Organization for Economic Co-operation and Development (OECD) has a defined set of principles of good regulation (OECD, 2005). These principles are aimed at improving the quality of government regulation, and include: clearly identified policy goals; a sound legal basis; benefits that justify costs, minimise costs and market distortions; promoting innovation and clear, simple, practical goal-based approaches for users. The principles for financial regulation are closely aligned to those that will be highlighted below. It is therefore important that regulators take cognisance of these factors when proposing regulation and that regulation does not destroy the industry.

One of the ways to measure if the objectives of financial regulation are being achieved is to assess if the principles of regulation are being applied when formulating regulatory policies. According to Falkena, Bamber, Llewellyn and Store (2001), these principles include efficiency related principles, stability related principles, conflict-conciliatory principles, regulatory structure principles and general principles. Falkena et al. (2001) go on to expand on these principles.

According to Falkena et al. (2001), efficiency related principles are aimed at promoting efficiency in the provision of financial services, including the promotion of competition amongst financial sector participants. Stability related principles are aimed at contributing to the stability of the financial sector, in other words risk management in the financial sector must be assessed correctly in order to mitigate it. Conflict-conciliatory concepts are aimed at resolving conflicts between the objectives of regulation. The principle related to regulatory structure relates to whether there should be different regulators for the different sectors or a single regulator for the financial sector. Finally, general principles relate largely to the costs of regulatory arrangements and how these costs must be distributed equitably.

In their paper, Jalilian et al*.* (2006) agreed that the outcome of a regulatory system must be benchmarked against effectiveness and efficiency. They say that efficient regulation achieves social welfare goals at minimum economic costs. That is, the cost of directly administering the regulatory system and the compliance costs of regulations that are borne by organisations.

Parker (2002) argued that a well-functioning regulatory system is one that has three pillars, namely: accountability, transparency and consistency. The framework that Parker (2002) used to measure the quality of regulation requires that regulators be accountable for the consequences of their actions and to ensure that proper consultation occurs. Parker (2002) went on to build on the second pillar - transparency - meaning that regulatory decisions must be reached in a way that is disclosed to all interested stakeholders. Finally, Parker (2002) articulated the third process of consistency by saying that inconsistent regulatory decisions undermine public confidence in a regulatory system. Parker's (2002) three-fold model suggests that markets will perform well if the state can provide a robust regulatory base.

The one perspective that is lacking in this section is that of the emerging trend of international regulation, where regulation is being recommended to regulatory authorities, leaving them with little option but to adapt their regulatory frameworks in order to comply - sometimes to the detriment of domestic industries as the regulators feel compelled to align regulatory frameworks hurriedly. This reactive stance is captured by Goodhart (2011), who stated that the current enhancement and reform of financial regulation is aimed at countering the actions of role players in the financial system that were oblivious to the fact that their actions would affect others as severely as they did.

2.7 The cost benefit of regulation

According to the World Bank (2001) (cited in Botha & Makina, 2011, p. 29), "when financial systems are left to themselves they are found to be prone to spells of instability and contagion". It can be concluded that the regulatory interventions would to a large extend mitigate these episodes, therefore the first direct consequences of regulation are to create stability and promote efficiency in the financial markets. The argument about regulation and efficiency leads to another critical component of regulatory interventions - the cost-benefit analysis.

According to Mulherin (2007), measurement of costs and benefits of regulation is a challenging task for economic analysis, especially when you take into consideration the two economic theories of regulation, which stem from Stigler (1971) and Posner (1971). Mulherin (2007) went on to say that the measuring costs and benefits can be made difficult by the imprecision of data and regulatory changes taking place when there are confounding events occurring. Therefore measuring the cost and benefits of regulation becomes critical when regulators decide on the implementation of new regulatory standards.

In an occasional paper by the Financial Services Authority (1999), the cost–benefit of financial regulation was said to be a useful tool in regulatory decision-making and that regulators who do not perform a cost-benefit analysis when formulating policy run the risk of creating unintended inefficiencies within the industry they intend to regulate. The FSA (1999) recommended a cost-effective way of conducting cost-benefit analyses. Their recommendations include: a dedicated team of specialists that deal with the cost-benefit of any new regulation; a simplified comparison of the cost-benefit of each of the regulatory options at the disposal of the regulator; and choosing the option that is likely to yield the greatest excess of benefits over costs. However even with the simplified model there are still challenges in using cost-benefit analysis, due to the lack of data on compliance costs that regulated entities incur. The FSA (1999) broke down the cost of regulation into six components:

⇒ Direct costs – the costs that the regulator has to incur in designing, monitoring and enforcing regulations.
⇒ Compliance costs – those costs that the regulated entities have to incur in complying with the increased regulatory burden.
⇒ Quantity of goods sold or brought to market – those costs that are incurred in bringing a product to market. The increased cost of compliance on regulated entities has a direct impact on the products/service they bring to market, as the price will factor in the costs of compliance.
⇒ Quality of goods offered – the intention of financial regulation is aimed at improving the quality of products/services that are delivered to consumers.
⇒ Variety of products/services offered - regulatory authorities can play a role in influencing the costs of products/services.
⇒ Efficiency of competition – regulation plays a role in how competitive the industry is based on the regulatory requirements to enter into that industry.

The direct costs of regulation as highlighted above raise a challenge, which is, if regulation is aimed at ensuring the efficiency of the financial sector and spurring economic growth, how does the additional reporting burden and costs achieve this? Although regulation is necessary in the financial sector, regulators need to consider that the cost of compliance may result in some businesses going bankrupt. One of the most negative consequences of regulation is that of cost of compliance.

The current proposed international regulatory reform that South African financial services firms, such as banking, insurance, securities and pension funds have to comply with, will have far-reaching consequences in terms of costs. A Small Business Project (SBP) report released in 2005 surveyed 1794 businesses in South Africa and found that the cost of complying with regulations were the equivalent of 6.5% of GDP.

It is therefore a challenging task for regulators to have at their disposal perfect information on the above-mentioned costs, however formulating legislation in consultation with industry can improve the process and may result in more efficient financial market products/ services.

2.8 The unintended consequences of regulation

The enforcement of financial regulation on firms can sometimes have undesired consequences, as it can trigger financial institutions to find ways to circumvent the new regulations. A major unintended consequence of regulation is regulatory arbitrage. According to Alexander and Sharpe (1990) in Shleifer and Vishny (1997), the term arbitrage refers to the "'simultaneous purchase and sale of the same, or essentially similar, security in two different markets for advantageously different prices". Frantz and Instefjord (2012, p. 2) presented a more general definition of regulatory arbitrage, which is, "rent seeking through exploiting regulatory loopholes, often closely associated with financial regulation where firms simply relocate their business from a strong regulatory regime to a weaker one". Regulatory arbitrage is therefore a phenomenon that regulators have been aware of for decades and, some say, the excessive risk-taking, which took place prior to the global financial crisis, was as a result of regulatory arbitrage (Levine, 2011).

According to de Larosière (2011), regulators need to consider the unintended consequences of any regulations proposed. In his paper, de Larosière (2011) dealt with some of the unintended consequences of the new wave of financial regulations. One of the consequences foreseen is that of the transfer of certain operations to a shadow banking system, which is outside the scope of regulation. Although not defined in the de Larosière (2011) paper, shadow banking is a term used to describe a financial system which performs the same functions as traditional banking, but in a more unregulated space (Gorton, Metrick, Shleifer & Tarullo, 2010). The Financial Stability Board (2011) defined shadow banking as "credit intermediation involving entities and activities outside the regular banking system." The shadow banking system includes investment banks, money-market mutual funds and hedge funds. Regulatory efforts to limit shadow-banking activities have been proposed by the Financial Stability Board (2011). One of these initiatives is the reporting requirements that will be imposed on the Hedge Fund sector in future.

The new wave of global regulation that has gripped the financial sector is aimed at addressing the gaps in the regulatory framework through the identification of global systemically important institutions; uniform standards of regulation for financial instruments; information sharing amongst regulators; and a macro-prudential approach to regulation (Financial Stability Board, 2009). Hirsh (2011) captured this by mentioning that "as a result of this global wave of regulation, the world is now faced with a host of new legislation and regulations within the financial services industry, dealing with credit rating agencies, Hedge Funds, previously unregulated financial activities such as over-the-counter derivatives, and more enhanced consumer protection measures – most of which are based on international norms and standards."

An important theme that arises here is that although there was regulation prior to the global financial crisis, the crisis still happened. How will the current regulatory reform prevent another one from happening? Why is it that some self-regulating industries are now being subjected to regulation and are regulators learning from their mistakes or will this new wave of reform be the breeding ground for another crisis?

2.9 Literature review conclusion

A number of themes have been covered in this paper, therefore this section will conclude on the key issues that emerged from the literature. The literature review was aimed at introducing some definitions as well as reviewing literature on the effects of financial integration, financial regulation and the unintended consequences of regulation.

What emerged from the definition of Hedge Funds was that although there is no single universally accepted definition in the literature, common phrases that emerge from the definitions included, "pools of capital", "using different investment strategies" and "loosely regulated". Since the global financial crisis, there has been a renewed focus on regulating Hedge Funds due to the possible systemic risk they may pose to the financial system (Bianchi & Drew, 2010). A secondary aim of this paper was to determine whether Hedge Funds pose a systemic risk to the South African financial system and what would be the most suitable regulatory regime for these funds.

The financial integration of the global financial system has resulted in the interconnectedness of the financial system, which has led to financial globalisation. Once again, the literature is ambiguous on the effects of globalisation and financial integration on economies, especially emerging market economies, and evidence from the recent global financial crisis demonstrates how the financial system of one country can cause significant instability to the global financial system (Nichols, Hendrickson & Griffith, 2011).

According to Charles Goodhart (2011), financial regulation is normally reactive and introduced in order to prevent the factors deemed to have caused the previous crisis from happening again. The previous wave of financial regulation that took place after the 1997-1998 Asian crisis (Fischer, 2003) demonstrated that the existence of regulation does not equate to financial system stability, and at times can lead to regulatory arbitrage and what is now known as the “shadow financial system”. The rise of the “shadow financial system” was covered as part of the unintended consequences of regulation. The shadow financial system is a quasi-financial system that operates outside the net of regulation and poses a danger to the entire financial system, as the extent of these activities is unknown due to the fact that the size of the system cannot be accurately measured.

Systemic risk is another term that is widely defined in literature (Kaufman, 2000; IMF, 2009; Chan, Getmansky, Haas & Lo, 2007; Brown, Hwang, In & Kim, 2011). According to the definition, systemic risk can cause an entire financial system to collapse. The fact that the Hedge Fund industry has become interlinked with the banking sector and other financial institutions has caused concern amongst regulatory authorities, hence regulatory authorities are placing more focus on this risk.

Finally, the literature surveyed the measures for assessing regulatory quality and the cost/benefit of regulation. A number of authors in this section expressed views on how to measure regulatory quality. What emerged from the literature was that financial regulation should be effective and efficient and these measures should achieve the objectives of the intended regulation.

The cost and benefit of regulation has been fiercely debated, with regulators imposing more regulation in order to attain the objectives of regulation. These are to create stability and promote efficiency in the financial system (World Bank, 2001), however businesses have to bear the brunt of complying with the new regulations whilst trying to achieve their profit objectives. This section gave a brief outline of the steps regulators can carry out to achieve accurate cost-benefit analyses of their regulatory efforts.

In summary, financial regulation has been in existence for hundreds of years, but the fact that financial crises have transpired despite regulatory interventions indicates that fragilities in the financial system can manifest in ways that can sometimes only be seen when the financial system collapses.

CHAPTER 3: RESEARCH QUESTIONS

A number of government white papers as well as academic papers have divergent views on Hedge fund regulation. Some papers favour regulation of Hedge funds, whilst others favour self-regulation. However, recently the key theme of systemic risk has emerged as an issue as regulators have realised the possible impact that these funds may have on the financial system due to their interconnectedness with the banking sector. This exploratory research seeks to address the following research questions:

RESEARCH QUESTION: 1

Has regulation encouraged or impeded growth in the Hedge fund industry?

RESEARCH QUESTION: 2

Are the objectives of regulation being achieved by the current regulation and how is the quality of regulation?

RESEARCH QUESTION: 3

How will compliance with the new legislation impact the functioning of hedge funds?

CHAPTER 4: RESEARCH METHODOLOGY

This chapter will outline the design and methodology that was used for this research. According to Saunders and Lewis (2012), a number of strategies can be used to answer research questions, and often these strategies can be used in conjunction with each other. The strategies used in this research were combined in order to address the research questions posed in Chapter 3.

4.1 Design

The research method that was used for this study was qualitative and exploratory in nature. According to Saunders and Lewis (2012, p. 110), exploratory research is about discovering information which is not well understood by the researcher". They indicated that exploratory research involves searching academic literature and interviewing experts on the subject matter. The Internet was used to look up information, which then assisted in identifying the relevant academic literature on the research topic. Saunders and Lewis (2012, p. 110) also stated that exploratory studies "aim to seek new insights, ask new questions and assess topics in a new light". This was particularly relevant to this study as there are numerous papers on this particular topic, however this research aimed to seek new insights.

The exploratory research design was chosen for this particular study because an understanding of the relevant literature on the subject matter was necessary. It was important to gain an in-depth knowledge of the changes in the current regulatory framework, understand the rationale behind the international regulatory reform, and contextualise this to the South African financial sector.

The methodology that was chosen lent itself to expert and in-depth interviews. Through the literature review, a number of themes emerged which were then utilised to compile an interview schedule, taking into consideration the aims of the research. The purpose of conducting the interviews was to validate some of the key issues, which emerged from the literature review, as well as to gain new insights into the topic.

Interviews with participants were recorded with permission from each interviewee where possible. The interview recordings will be stored in at least two locations for back-up purposes and will be retained for a period of ten years.

4.2 Unit of analysis

The intention of this research was to extract the opinions of the regulator as well as those who would be affected by the proposed Hedge fund regulations. Therefore the unit of analysis was the outcomes of regulation in the Hedge fund industry.

4.3 Population of relevance

The population of relevance were experts in the regulatory environment and Hedge fund industry participants. These experts were identified based on their experience in the fund industry.

FUND MANAGERS

⇒ Alternative investment fund managers who were in the hedge fund industry were identified.

REGULATORY BODIES

⇒ The Financial Services Board, which regulates hedge fund managers.

⇒ The Johannesburg Stock Exchange.

INDUSTRY ANALYSTS/ EXPERTS

⇒ Analysts from publications such as Hedge News Africa, FA News and Hedge Fund Academy.

INDUSTRY ASSOCIATION

⇒ Association for Savings and Investment in South Africa

COMPLIANCE OFFICERS

⇒ Experts who provide compliance services to hedge fund management companies.

4.4 Sampling method and size

According to Saunders and Lewis (2012), non-probability sampling techniques are used when there is no complete list of the population which rules out the possibility of random sampling. Saunders and Lewis (2012) also stated that purposive sampling is a type of non-probability sampling in which the researcher uses their judgement to select the sample based on certain reasons. Purposive sampling is also deemed best to use when a small sample is involved and is useful when collecting qualitative data (Saunders & Lewis, 2012). Due to the nature of this research, the sample selected was small due to the research covering a specialised field, therefore purposive sampling was used.

The interviews were conducted with experts in the financial services sector and in the regulatory environment. These experts were identified from a list of alternative investment fund managers, which was accessed through a Financial Services Board list of supervised entities. The aim was to interview a minimum of five respondents and a maximum of ten respondents, depending on availability of respondents in the alternative investment industry. Ultimately, 17 respondents were interviewed.

4.5 Data collection process

The first phase of the research involved searching for information such as government white papers and industry reviews on the research topic. The information was collected and collated into different themes and then synthesised. The results of the synthesis were then used to construct the questions, which were used to validate the themes.

Questionnaires are a method used to gather data using the same set of questions to elicit answers from respondents (Saunders & Lewis, 2012). Due to this study being exploratory and qualitative in nature, it was necessary to use an interview schedule to gather responses. The data were collected through face-to-face interviews and where there were constraints such as distance or unforeseen unavailability of a respondent, a telephonic interview was conducted. This method was used in order to solicit responses from respondents about the same issue.

The face-to-face interview is a two-way process initiated by the interviewer to obtain information from a respondent. One of the advantages of face-to-face interviews is the depth of information that can be extracted from the respondent (Cooper & Schindler, 2003). This research utilised face-to-face interviews or telephonic interviews with the selected sample of respondents.

4.6 Data collection instrument

The data collection instrument that was utilised was constructed from information and data sourced from the Financial Services Board, National Treasury, industry publications, Government white papers from other countries, and other electronic media sources. The first phase informed the questions that would be asked in the second phase of the research. The aim of the first phase was to identify the themes and type of information that was required to meet the objectives of the research.

The second phase of data collection involved the use of an interview schedule. The interview schedule was comprised of a number of questions that were influenced by the outcomes of phase one in order to meet the objectives of the research paper. Saunders and Lewis (2012) mentioned that questions could be the same as others researchers' questions, adapted from research questions of others, or original. The researcher used original questions in order to address a different perspective on the topic. Another reason for using new questions was that the questions asked were aimed at addressing recent legislation.

Saunders and Lewis (2012) articulated that open-ended questions can be used when the interviewer wants a detailed response to their question or when the interviewer wants to get the respondent's primary thoughts at the time. Due to the nature of this research, it was necessary to have a few open-ended questions and because of the use of content analysis it was useful to identify themes that emerged from the open-ended questions.

Important elements in questionnaire design are that the questions should be designed in such a way that they collect the data necessary to meet the research objectives, sufficient respondents must be interviewed to meet the research objectives, and the questions should be understood and interpreted by the respondents in the way the researcher intended (Saunders & Lewis, 2012). When designing the interview schedule the author attempted to make the questions as closely aligned to the objectives of the research as possible.

4.7 Data analysis approach

According to Babbie and Mouton (2001), content analysis involves using quantitative techniques to analyse qualitative data by examining words and phrases that are common amongst the respondents, so as to categorise, code and tabulate meanings. This allows the researcher the latitude to draw inference from the phrases. Babbie and Mouton (2001) mentioned that there are two types of content analysis, that is: conceptual analysis and relational analysis.

This study used the method that was found to be most suitable for the desired outcomes of the research. It used content analysis to extract themes, which were found to have an impact on regulation. The study utilised this particular method over others in order to understand certain themes, which were related to the research aims.

4.8 Research limitations

Some of the research limitations that arose included:

⇒ A number of Hedge Fund Managers were domiciled in Cape Town, therefore telephonic interviews were conducted with the respondents, and the lack of face-to-face contact may have resulted in the respondents not providing as much information as they would in a face-to-face interview.

⇒ Interviewer bias may have influenced the quality of data collected.

⇒ Response error due to social distance between interviewer and respondent.

⇒ The study focused on a particular industry, even though the research could be applicable to other industries in the financial sector.

⇒ The results depended on how much information the respondents were willing to share.

⇒ There was also the possibility that respondents would not have give their honest views considering that this research would be available in the public domain. This would be a concern particularly for the regulators that were interviewed, as they have to project a certain image and their responses would therefore lean towards maintaining the *status quo* of a regulator.

CHAPTER 5: RESULTS

5.1 Introduction

The previous chapter explained the methodology used to test the research questions, which were formulated in Chapter 3. This chapter presents the findings of the study.

5.1.1 Description of choice of respondents

The rationale used to choose respondents was based on a number of factors. One of these was to obtain as wide a source of opinions as possible from a spectrum of participants in the industry. Another factor that was taken into consideration was the availability of respondents, as well as confidentiality issues, as many of the respondents are in the same industry and interact on a regular basis. It was therefore decided to approach respondents from funds of funds, single hedge fund management companies, the regulator, the industry association, compliance officers, risk managers and an independent expert. Due to fund manager/client confidentiality issues, investors were not included in the list of prospective respondents, however it must be noted that fund managers also invest in their own hedge funds and they were therefore able to give opinions based on their own investment experience.

The types of interview questions did not lend themselves to responses from investors, as they required detailed information on a specific piece of proposed legislation. In total, 17 respondents were interviewed. All the respondents were contacted directly via email or through a representative of the hedge fund management company. The email that was sent to potential respondents or to company representatives specified the topic and the objectives of the research and requested referrals to individuals who had intimate knowledge of the topic. Those respondents who were nominated by a representative of their company were chosen for their expertise and knowledge, based on the information that was contained in the email about the objectives of this research paper. Those respondents who were from companies other than hedge fund management companies were also chosen based on referrals by company representatives, direct contact, or by invitation from respondents that had already been contacted. Three respondents were referrals made by one of the respondents that had already been interviewed.

5.1.2 Classification of respondents

As previously mentioned, the respondents interviewed included single hedge fund managers, fund of funds managers, the regulator, industry association, compliance officers, risk managers and an independent expert. According to Morgan Stanley (2012), single hedge funds are privately managed investment funds that utilise complex investment strategies in pursuit of a yield for investors. Barclay Hedge (2012) defined fund of funds as investment vehicles with actively managed portfolios, consisting of shares in a single or multiple hedge funds.

Hedge fund management companies were chosen based on their classification according to the current regulations in place, which require all Hedge Fund management companies to be registered as category IIA financial services providers. The Hedge fund management companies where respondents manage funds were established between the early 1990s and early 2000s. The industry body, the Association for Savings and Investment in South Africa (ASISA), compliance practice, risk management platform and regulator were all established between 1991 and 2010. The majority of the Hedge Fund management companies are headquartered in the Western Cape Province, specifically in the Cape Town area. Many of the individual respondents have been in the asset management business for between five and 25 years, bringing together combined industry experience of over 150 years of knowledge, which was imparted during the interview process.

The independent expert and the industry association respondent have also been in the asset management space for over 15 years each, bringing in a different perspective of opinions as they are not directly involved in fund management. Brief profiles of the individual respondents are provided in an appendix and for confidentiality purposes each respondent is coded with a letter of the alphabet. The list of respondents will be profiled in no particular order, however in the discussion of results a distinction will be made with regards to the category that respondents fall within.

5.1.3 Description of data collection and analysis

Once the respondents were identified, interviews were scheduled with each respondent via email. Upon agreeing a time, respondents' diaries were scheduled and respondents were required to accept the meeting request. Most respondents were scheduled for 30 minutes but later in the interview process the time was extended to 45 minutes in order to allow those respondents who were willing to volunteer more information to do so. The preferred method of conducting the interviews was face-to-face interviews for those respondents who were domiciled in the Gauteng province, but due to some respondents' busy schedules and time pressures, some were interviewed telephonically. The challenge with telephonic interviews is that the lack of personal contact does not allow for the interviewer to probe for lengthier responses due to time constraints and the inability to read the respondent's body language. However some of the telephonic interviews ran over the allocated time, as respondents were willing to keep the conversation going. Those respondents who were domiciled in the Western Cape were interviewed telephonically and all were contacted on fixed telephone lines versus mobile telephones for better sound quality. Respondents who were interviewed telephonically were interviewed in their offices and those who were interviewed face-to-face were interviewed in boardrooms at their respective workplaces.

A mobile recording device was used to capture the interviews and handwritten notes were also made during the interviews. Immediately after the interview was completed a backup copy of the recording was made and saved in two separate locations. The interviews were sent to a professional transcriber who transcribed the responses to the interview questions. The transcripts were then collated and printed out in order to scrutinise the different themes. One of the challenges that was experienced with the transcriptions was that more than one transcriber was utilised due to the inability of transcribers to meet the deadline. Transcribers used voice detection software and some transcripts had to be corrected, as the software would pick up the word UCITS and capture it as usage. Another challenge was that the transcribers were not familiar with the technical terms used in the hedge fund industry and many of the transcripts were corrected to reflect the correct terminology.

Each respondent's answer for each of the seven interview questions was combined into a single document and analysed using Atlas TI qualitative data software. The transcripts are presented in the appendices, however each respondent's will be presented as per the original transcript. Although most respondents answered all seven questions, some respondents provided more insights in one question, the answers of which were applicable to other questions. These answers were kept in the section where they were originally captured for data integrity purposes.

The most common themes that emerged from each question are presented in a frequency table or depicted graphically (the number of responses may not necessarily tally to the number of respondents as some respondents gave two answers and some did not answer certain questions). In conducting the analysis it was found that some respondents gave lengthy answers, some of which were related to other questions. The interview schedule was aimed at soliciting detailed responses as opposed to single word responses. As a result the theme most relevant to the question at hand was captured for the purpose of data analysis.

5.2 Discussion of results

5.2.1 Question 1

How will the proposed Hedge Fund regulation impact on the Hedge Fund industry?

Table 1: Frequency table on the impact of regulation

Response	Frequency recorded
Good	4
Positive	4
Grow	5
Negative	4
Bad	2

Thirteen of the respondents used positive words in their responses to the question about the impact of regulation on the industry. The words were more related to how they perceived regulation as opposed to the impact. Some of the opinions expressed in response to this question were that the proposed regulation would positively impact the industry because it would give the industry more credibility, as the Hedge Fund industry was not well understood by the "man on the street". The proposed product regulation would also make investors more comfortable, knowing that there is regulatory oversight on their investments. The proposed regulation was viewed as an opportunity to allow more people access to alternative investments via the restricted and retail version of funds being proposed. The observation was made that the proposed regulation would potentially increase the investor base, as more people would be able to access Hedge Fund products. Additionally, Hedge Funds would be able to market themselves to a wider investor base, whereas previously they were not able to market themselves to potential investors. To support the above-mentioned perceptions, some of the comments that were made are detailed below.

Respondent B mentioned that there was a positive angle to the increased regulation because the regulation would give credibility to the industry and potentially open up an entire new investor base for hedge funds.

Respondent E mentioned that the proposed regulation should be embraced by the hedge fund industry because it would shed some light of integrity on an industry, which is perceived to lack integrity.

The respondents who answered on the actual impact of regulation on the Hedge Fund industry had the following to say. Respondent L mentioned that the proposed regulation would have a more negative impact on the industry especially if it comes in the form of a UCITS product. According to the European Commission (2012) UCITS (Undertakings for Collective Investment in Transferable Securities) are investment funds that have been established in accordance with the UCITS Directive (adopted in 1985). Once registered in one EU country, a UCITS fund can be freely marketed across the EU.

Respondent L mentioned that UCITS type products were unsuitable for South African Hedge Funds due to the restrictive nature of UCITS investment limits. Respondent L also added that the way the limits were set up could result in the circumvention of the rules, which in turn would defeat the purpose of the proposed regulation.

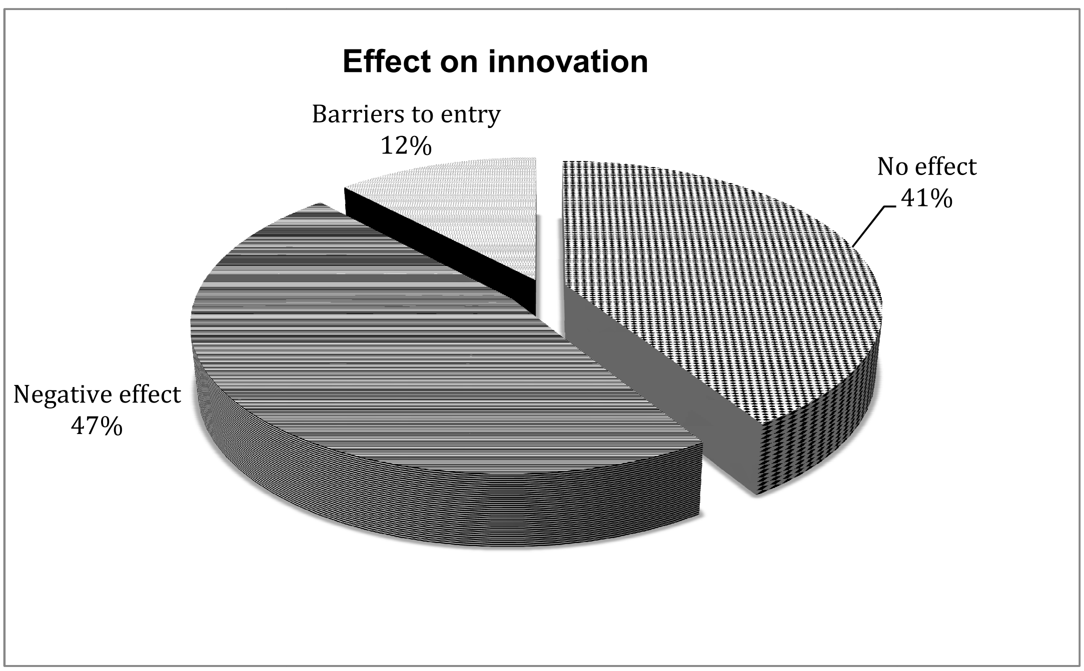
Respondent Q said that the proposed regulation would impact the industry negatively because regulation would increase the cost of alternative assets and more specifically the cost of managing hedge fund assets. Respondent Q also mentioned that regulation could possibly increase the systemic risk that regulators are trying avoid, because it would force hedge fund managers to trade in a more consistent way thereby increasing systemic risk.

The question about innovation followed but a number of respondents also mentioned it as part of their response to this question, however any opinions on innovation will be addressed in the next section. The reason that most respondents mentioned innovation in this question was because they were not aware that there would be a subsequent question on the impact of regulation on innovation. Innovation is viewed as an integral part of hedge fund management; hence the theme would have come up in this section. Although some respondents answered the question here, it was subsequently asked and if they wanted to add any further comments to their original response it was documented under the respective section in the discussion of results.

5.2.2 Question 2

How will the proposed regulation affect innovation in the Hedge Fund industry?

FIGURE 3: EFFECT ON INNOVATION



The responses for this question were not overwhelming in any particular direction. Less than half the respondents felt that the regulations would not affect innovation, while more than half, were of the opinion that regulation would have a negative effect and would create barriers to entry. The negative effect and barriers to entry responses have been combined because the barriers to entry that would be created by the new regulations would in essence stifle innovation in the smaller hedge funds or even in those investment managers who had the potential to generate new ideas, as they would not be able to enter the industry due to the onerous requirements.

The observations related to the negative effect of regulation on innovation included observations such as that the most innovation emerged from the smaller to medium sized hedge funds and that the proposed regulation would place an additional burden on the smaller hedge funds, which would ultimately either consolidate with the larger funds or go out of business. The biggest concern was around the regulation of mandates for Hedge Funds. If the mandates were to be regulated then the end result would be the demise of innovation, as this would not give Hedge Fund managers room to manoeuvre. It was also observed that regulation would diminish the entrepreneurial flair of Hedge Fund managers.

Respondent I mentioned that it would become difficult to innovate, as the proposed regulation would be restrictive with regards to what the hedge fund managers could do in the search of yields for their investors.

No effect

One of the overriding reasons for the response in this section was because the proposed regulations were not yet clear on the exact details of product regulation and as such, those respondents who said there would be little or no impact on regulation were basing their response on the premise that the regulation would not interfere with how they employ their investment strategies.

Respondent H said that regulation had no effect on innovation as yet because the proposed regulations were not regulating the mandates of the hedge fund managers, because if regulations were to prescribe the mandates to be used by fund managers that would destroy innovation.

Respondent A echoed respondent H’s sentiment by saying that the regulator was aiming to create a safe environment, which would encourage development in the industry by affording hedge fund managers an opportunity to explain products better to the consumer and by ensuring that investors are equipped to make the right investment decisions. Respondent A explained that the regulation was really aimed at protecting the consumer and not at stifling innovation.

Respondent N said that innovation would continue irrespective of regulation because the alternative investment industry was made up of individuals who were highly skilled and entrepreneurial and who want to set up their own investment businesses. As a result, these individuals would continue to innovate.

Negative effect

Those respondents who said that there would be a negative effect on innovation cited various reasons for their responses. One of the most cited reasons for this response was that regulation would create herd behaviour in how hedge fund managers ultimately manage money and that hedge fund managers would effectively lose their entrepreneurial and innovative abilities. Compliance with the regulation would hinder hedge fund managers from carrying out their mandate because they would continuously have to be aware of not breaching the limits prescribed by the regulations.

Respondent P said that for those hedge fund managers that would be operating a retail fund the regulations would be constrictive and would most likely have a negative effect on innovation.

Respondent E said that one of the greatest selling points or appeal of hedge funds was its unregulated and unconstrained nature which allowed investment managers to think out of the box and come up with new ideas, therefore respondent E viewed the proposed regulation as an innovation killer.

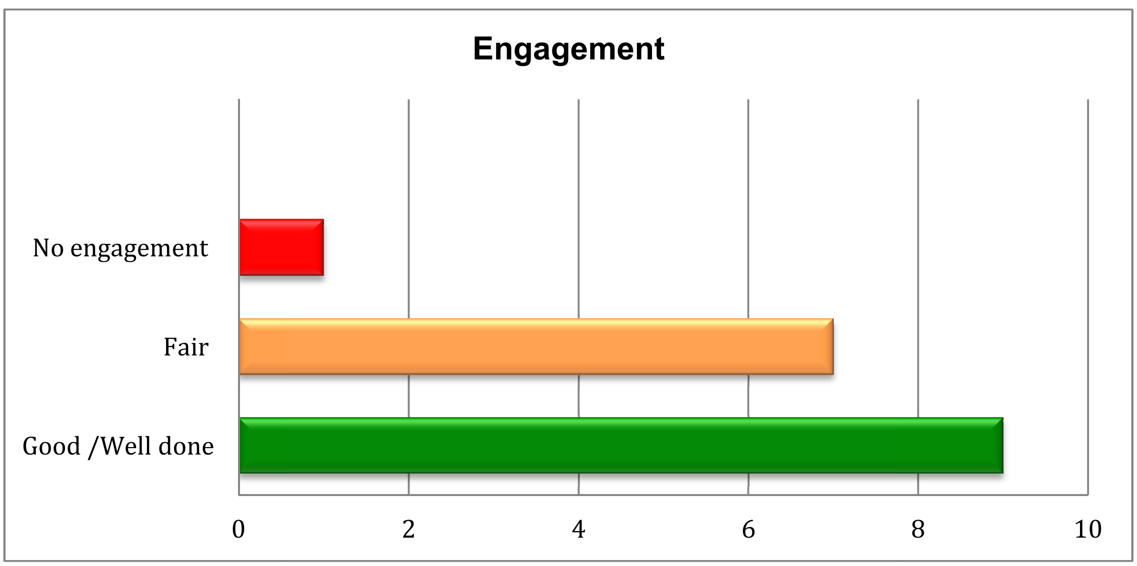
Barriers to entry

Although two respondents explicitly cited barriers to entry as an effect on innovation, it is a theme, which emerged in three of the responses from the previous question. Five respondents mentioned this as an issue particularly because of the onerous start-up requirements for Hedge Funds. The cost factor barrier to entry emerged as an issue because the drafting of Hedge Fund partnership documents involve the use of attorneys and costs of compliance were also cited as a major barrier to entry. The capital adequacy requirements as prescribed by the regulator were also seen to be onerous and would contribute to the shrinking of the industry. When combined, these factors would effectively diminish the number of Hedge Fund start-ups and result in the closure or merging of the smaller Hedge Funds with the larger Hedge Funds that have a compliance platform in place already.

5.2.3 Question 3

How well does the Regulator engage the Hedge Fund industry before legislation is introduced? State the reason for your response.

FIGURE 4: ENGAGEMENT OF REGULATOR



Respondents indicated that engagement with the regulator had been good during the current process of proposed regulation, whereas previously the engagement process was non-existent or lacking due to a number of factors, which will be substantiated by the responses. Only one respondent was of the opinion that engagement by the regulator was not sufficient, partly because the communication about compliance issues and proposed changes in the industry were directed to that particular fund manager’s compliance officer.

Good interaction

The nine respondents who found the interaction from the regulator to be good said it was due to the formalised structure that was created in the form of the industry body - the Association for Savings and Investment in South Africa. There was also consensus on the fact that regulation could only be effective if the regulator engaged industry thoroughly. Two respondents mentioned that although interaction had been good they were concerned that the industry body only listened to the “big players” in the industry. Some of the comments that were made in support of the above mentioned perceptions were from Respondent B, who said that there had been general interaction through ASISA and that on several occasions ASISA representatives had taken some of the issues discussed in the sub-committees back to the regulator. Respondent B also mentioned that the interaction with the regulator had improved particularly in the last two years.

Respondent N also found the engagement process to be good because the FSB had been very open to suggestions from the industry. Respondent N mentioned that the initial part of the engagement had been very positive and that the hope was that the entire process would go well.

Fair

The seven respondents who said the process was either fair or had improved mentioned that inclusivity had improved. In answering this question, three respondents related their response to their previous experience where there was a lack of clear communication and the industry felt that legislation was being passed without proper consultation.

Some of the observations made to support this view were from Respondent O, who said that the process was probably not too bad and that it was fairly inclusive and that the industry had not been excluded from the deliberations. Respondent O went on to say that the regulatory framework that was released for public comment was not too different from what was discussed during the deliberations.

Respondent G said that the proposed regulation was being promulgated in the best interests of the industry and investors, as well as that it was being done in a fair manner. Respondent G went on to say that the regulator was trying to understand the industry and what the industry wants in terms of regulation so that there would be a meeting point where all parties are satisfied.

5.2.4 Question 4

How well does the Regulator enforce and monitor the current regulations?

Table 2: Enforcement and monitoring

Response	Frequency
Active monitoring/ frequent visits	**16**
Strong on process	**6**
Skills shortage / limited resources	**5**
Feedback	**3**

Sixteen of the respondents echoed similar sentiments with regards to the monitoring and enforcement of the current requirements that are in place for supervising Hedge Fund managers. Five respondents mentioned that the Regulator was strong on process and many of the respondents had experienced on-site visits, which form part of the Regulator's monitoring process.

Respondent A said that the Financial Services Board was diligent in conducting their inspections but they could only do so much and could not possibly pick up all the transgressions. Respondent A also mentioned that no amount of regulation could prevent fraud, because if people wanted to steal, the regulator had no way of stopping them.

Judging from the overall responses, respondents could not fault the Financial Services Board's process for granting a licence and the process was praised as being thorough and effective, but sometimes lengthy due to the numerous licensing requirements. Respondents were of the opinion that it was necessary to carry out due diligence in order to ensure that the management companies that are granted licenses have the required levels of expertise to handle client funds.

Active monitoring

The respondents from Fund of Funds received more regular visits compared to single Hedge Fund managers, as they had to comply with more requirements than single Hedge Fund managers. Respondent F said that the Financial Services Board had visited the fund a few weeks prior to the interview and that the representative from the regulator had inspected everything from client files, licenses, legal structures and assets held in trust, to the risk management that is provided to clients. Respondent F was of the opinion that the process was very firm and was a good indicator of the regulator's commitment to ensuring investor protection.

Strong on process

Six respondents said that onsite visits were conducted regularly and most had received a visit from the Regulator within the last two years. In terms of the benefit of the onsite visits, there were isolated remarks that the inspections were not adding any value or helping the funds in doing business better. The visits were seen as part of a tick-box approach and inspection driven stance that the Financial Services Board had taken. Although respondents mentioned that the Regulator had a tick box approach, they mentioned that it was better than what happened in other countries in terms of monitoring managers.

Respondent C said: “They do make an effort, they do spend time at the fund and they do come around quite often. And that's certainly not always the case overseas, I mean overseas it's often the case of you know, until you stuff up they leave you alone, it's not the case here, they do have a process.”{sic}

A crucial point that was mentioned by respondent J was that a regulator could not rely on everyone doing a good job and that often times regulation was not aimed at punishing those who comply, but was aimed at regulating the outliers who do not do the right thing.

Skills shortage and feedback

Eight respondents were of the opinion that there was a skills shortage and a lack of resources at the Financial Services Board. The respondents were of the opinion that the Financial Services Board was unable to keep up with the industry because it could not source skills from the industry. The lack of resources was also said to affect continuity with regards to analysts who are allocated to monitor the Hedge Fund managers.

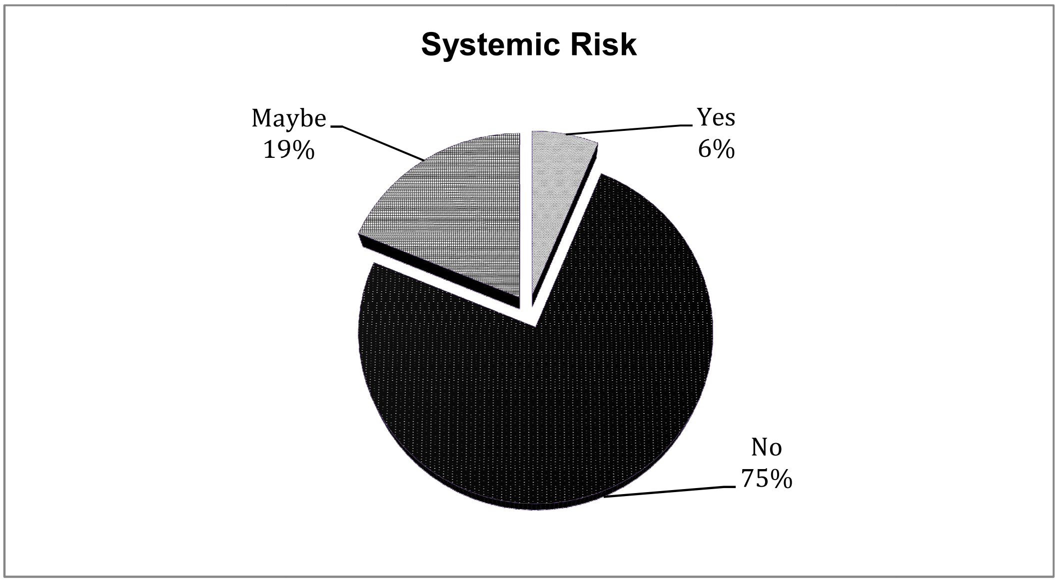
Respondent K said, “I think previously we had problems because there was a lack of continuity with the analysts but lately we have seen an improvement in that problem. It used to take up a lot of time to have a new analyst because you had to show them what the fund does and how it’s structured from scratch.”{sic}

Linked to the skills shortage was the issue of feedback from the Financial Services Board. Four respondents mentioned that feedback from the Financial Services Board took a long time and that after onsite visits they would wait more than three months for feedback or a report regarding the findings. Respondents also said that although they were mentioning these issues, they understood the root of the problems and would be willing to assist the regulator in understanding their businesses better.

5.2.5 Question 5

Do Hedge funds have the potential, now or at a later stage, to pose systemic risk to the South African financial system? State reasons for your response.

FIGURE 5: SYSTEMIC RISK



12 of the respondents unequivocally responded that Hedge Funds do not pose a systemic risk to the financial system. The most common reasons for their responses have been tabulated in Table 3 below. Three respondents said that maybe Hedge Funds could pose systemic risk in the future, but there would have to be a number of catastrophic events that take place at the same time for Hedge Funds to have that kind of impact. Respondents mentioned that even if all the banks had exposure to hedge funds, the industry could not cause any risk to the banking sector, which has three trillion Rands worth of assets. Three respondents echoed the sentiment that even if hedge fund assets doubled to R64 billion, they still would not be a cause of systemic risk.

Respondent I alluded to this by saying, “Even if the industry doubles from these levels and even if you say that on the doubled assets side that we’ve got 200% growth in the industry, it’s still very small in the bigger scheme of things. So my view is that systemic risk is highly unlikely in the South African hedge fund industry. {sic}

Respondent M supported this sentiment by stating that there was no chance of systemic risk arising in the industry at this stage because the industry was so small, and even if the industry would grow or double, the impact of systemic risk arising from that growth would be negligible.

Respondent D further affirmed that Hedge Funds did not pose systemic risk to the financial system by saying that South African investors were generally very conservative in the investment strategies they employ and that the international view that hedge funds pose systemic risk was not applicable in the South African context.

Table 3: Justifications for systemic risk responses

Reasons	Frequency
Manifest in other areas	3
Low leverage	5
Banking regulation	6
Counterparty risk	2

Three of the respondents mentioned systemic risk was more likely to manifest from the banking sector because of the size of the sector. However, the strong regulatory framework and supervision currently imposed on the banks were seen as sufficient to prevent systemic risk. Five respondents mentioned low leverage in the Hedge Fund industry as another factor that reduces the chance of Hedge Funds posing systemic risk to the financial system.

Respondent J said that the size of the hedge fund industry was about R 30 billion and the majority of hedge funds had very low leverage compared to hedge funds in other countries. The low leverage employed by hedge funds therefore reduced the potential for systemic risk.

A thought-provoking observation that was mentioned by a respondent related to counterparty risk. Respondent Q mentioned that the rules that were being proposed were not well understood by the regulator itself, and one example was that of the re-hypothecation of assets. Respondent Q went on to say that in other jurisdictions re-hypothecation of assets was permissible, and what this meant was that prime brokers could take investors' assets and lend them out as if they were their own, and that South African regulations up to now did not permit this but the proposed regulations would allow this practice.

According to Elias (2011), re-hypothecation occurs when a bank or broker re-uses collateral posted by clients, such as hedge funds, to back the broker's own trades and borrowings. In their study, Singh and Aitken (2010) found that as of the end of 2007, about $1 trillion of the market value of securities of the global hedge fund industry were re-hypothecated. This practice is prevalent in financial markets across the globe.

5.2.6 Question 6

What, if any, unintended consequences will flow out of the regulations?

Table 4: Unintended consequences of regulation

Response	Frequency
Unregulated space	4
Consolidation/ shrinking of industry	5
Conflicting laws	3
Mediocre returns for investors	4
Self-regulation	4

Unregulated space

Four of the respondents were concerned that product regulation would cause smaller Hedge fund management companies to go out of business and as a result end up operating in the unregulated space or in the "shadow financial system."

Respondent E said that one example of unintended consequences of regulation would be that some Hedge fund managers who feel that the regulations are too onerous to comply with may choose to start investing funds exclusively for private investors, friends and family. Respondent E said this would possibly shut the doors to some skills that are currently out in the market.

Respondent D disagreed with this perception by saying that it would not be possible to dodge the regulations, particularly because the definition of Collective Investment Schemes excluded hedge funds because fund managers also had their own funds invested in the hedge fund which they manage. Respondent D also mentioned that the regulator was looking at ensuring that all investment funds are regulated.

Consolidation

Respondent I said that balance sheet requirements for new potential managers required a large amount of capital, and as a result potential hedge fund management company start-ups would have difficulty entering the industry. The impact of regulation was likened to a recent piece of legislation (Regulation 28), which impacted the Hedge Fund industry negatively.

Respondent L mentioned that the inability of hedge fund managers to comply with the onerous regulations could result in outflows in the industry and that these outflows would ultimately shrink the industry.

Conflicting laws

There are a number of regulations, which govern financial markets, and often more than one of these laws will affect the industry at some point. Some of the observations made about the conflicting laws in the financial industry were that hedge funds had to comply with a number of financial services laws, and compliance with these laws often resulted in duplication of duties (Respondent K).

Respondent M supported this sentiment by saying "So I think where we could have unintended consequences is where you don't align all the different regulations across the various different areas that affect the investment management industry. If you don't align the G20 requirements with Regulation 28, with the hedge fund regulation, with the derivatives regulation, with the withholding tax regulation, with the securities lending regulation, I think that is when you could have unintended consequences." {sic}

Mediocre returns for investors

Those respondents who cited mediocre returns as an unintended consequence of regulation elaborated by saying that the Hedge Fund industry had been self-regulating for a number of years and that the proposed regulations would diminish the returns that had made the industry attractive to investors.

Respondent B mentioned that **"**I think where we have to think very carefully about the impact of regulation on the industry is if for example we go down the route of UCITS style regulation where there are very strict and onerous limits on gearing, what you end up with is what I often refer to as a hedge fund-like. So you get a hedge fund portfolio, it doesn't have the ability to properly protect and preserve capital in down markets because of regulatory restrictions. Investors flock towards hedge funds because they look at the past performance, and they look at the fact that it's now a regulated industry, and they move in there, but what they're buying is actually not what produced the returns in the past. {sic}

5.2.7 Question 7

Are there any additional comments that you would like to add, which can enhance the discussion on Hedge Fund regulation in South Africa?

This final question was asked in order to give respondents an opportunity to provide more insights on issues that may not have been addressed in the interview schedule. Additional comments that were mentioned by the respondents are included below.

Some of the responses in this section referred to recent bad press relating to hedge funds, representation of the smaller hedge funds on the industry body, transparency issues and definitions in the proposed regulations.

Respondent C said that the Herman Pretorius fallout was a terrible thing for the hedge fund industry because the investment vehicle that was used by Pretorius was not a hedge fund but more like a Ponzi scheme. Respondent C also said that the media needed to be more careful about their reporting because the manner in which the story was reported gave the impression that the scheme was considered to be a hedge fund.

According to Moneyweb (2012), Herman Pretorius was an investment manager who shot himself in July 2012. After his death it was confirmed that Pretorius had been running a Ponzi scheme called the Relative Value Arbitrage Fund (RVAF). Pretorius was not registered with the FSB and was not a registered category IIA financial services provider.

Respondent N said, “The last point I want to make is about the large players in the Collective Investment Schemes side, they have strong presence in ASISA whereas the small hedge fund manager which to my mind is the backbone of the industry their views are not always brought forward.”{sic}

Respondent O said, “The role of the third party providers must also be addressed. There needs to more transparency in the process going forward and it would be useful that an obligation is placed on a third party administrator or a risk manager to do daily or weekly monitoring of a portfolio and to report on specific agreed upon mandate parameters, whether it’s your gearing, your exposure, gross - net exposures or short positions. Industry can decide on parameters. But the idea that daily reports are made available to investors and to compliance officers is important.”{sic}

Respondent P mentioned a concern about the definition of a qualified investor: “I have two problems with that; are two things which concern me with the definition of a qualified investor. I believe that any current investor in the fund should be grandfathered; if they are not then we might have to kick out a couple of individual investors who don’t meet that restrictive criteria and the other thing, we seem to have adopted the UCITS rules, the Europe route. I think the US route might be better, I mean if you look at the definitions there, some are not relevant. That definition needs to be modified, there needs to be some exclusion clause for some employees and family members who want to invest in the funds. I think the definition needs to be wider to include high-net worth individuals."{sic}

5.3 Summary

The objective of this study was to determine the impact of regulation on the Hedge fund industry and to determine how compliance with the proposed product regulation will impact the functioning of the industry. The results of the study that are outlined in this chapter reveal that that further regulation is not perceived as having a negative effect on the industry. There were, however, mixed views, with some respondents providing both negative and positive responses to this question.

The results indicate that regulation will not stifle innovation but will make it more difficult for new entrants to come into the market. The general sentiment was that innovation would be able to thrive even under the proposed regulations because it was in the nature of hedge funds to continue to seek new ways to obtain desired returns.

Positive views were expressed on the engagement between the regulator and the industry, however some concerns were raised as to the ability of the industry body to represent the views of the smaller players. However there was a view that the regulator should be looking into eradicating the rogue traders in the industry instead of placing more onerous regulation on an industry, which has been self-regulating for most of its existence.

One of the reasons that there have been recommendations from international regulatory bodies to regulate Hedge Funds has been due to systemic risk. The likelihood of systemic risk arising from Hedge Funds was ruled out due to the low leverage that the industry employs, but more so because counterparty risk related to banks was limited.

Regulation always brings with it unintended consequences, and two potential consequences that would have an impact on the industry were mediocre returns that would be experienced due to product regulation. The conflicts in the laws that govern the financial industry are a major unintended consequence, as regulation often focuses on regulating an industry, which could already fall into the ambit of other legislation. Chapter 6 will focus on the implications of these results on the industry and will link them to the theory, which was explored in Chapter 2.

CHAPTER 6: DISCUSSION OF RESULTS

6. Introduction

The previous chapter presented the results of the survey questions, which were designed to answer the research questions presented in Chapter 3. This chapter will discuss the implications of the results and will link back to Chapter 1, where the real world problem was initially discussed. These insights will then be evaluated against the literature, which was reviewed in Chapter 2.

6.1 Research question 1

Will the proposed regulation encourage or impede growth in the Hedge Fund industry?

The two interview questions that were used to draw answers from participants in order to answer this research question related to the impact or regulation on the Hedge Fund industry, as well as the effect of regulation on innovation. The responses in Table 1 demonstrate that regulation was viewed as a positive development for the industry, while Figure 3 showed that regulation would stifle innovation. The implications of some of the observations made by respondents will be addressed in the sub-sections below.

6.1.1 Growth and market inefficiency in the industry

The positive responses in Table 1 support the theory that regulation encourages growth.

Growth would be encouraged by factors such as:

- Giving more credibility to the industry;
- Expansion in the investor base;
- Increase the amount of assets in the industry; and
- Improvement in the economic welfare of investors.

Joskow and Noll (1981) said that the public-interest theory of regulation assumes that government intervention corrects market inefficiencies to maximise social welfare. This finding was supported in studies by Feldstein (1972a; 1972b) and Schmalensee (1979), but was challenged in papers by Stigler (1971), Peltzman (1976; 1989) and Becker (1983), who argued that regulation is sometimes used to advance private interests in order to extract rents at the expense of other groups, thereby reducing social welfare.

The results do not support Joskow and Noll's notion that government intervention corrects markets inefficiency. To date, there have been few Hedge fund failures in South Africa and therefore the rationale to regulate the industry to correct market inefficiencies as theory proposes does not hold true. It can therefore be concluded that the proposed regulation of the Hedge fund industry is not aimed at addressing market inefficiencies, but rather at ensuring that the industry can remain efficient and to encourage further growth in the industry.

6.1.2 Inappropriate regulation

One of the implications of the proposed regulation in the Hedge Fund industry was that of the regulator importing legislation from developed markets and applying it to the South African market without adapting it to local circumstances. Regulatory regimes for Hedge funds are still works-in-progress in a number of countries, so South Africa should not try to be a pioneer in regulating Hedge Funds, but should rather adopt a wait and see approach before deciding what will work for the domestic industry.

6.1.3 Cost implications

The results reveal that regulation of Hedge funds will increase the costs of the asset class from the perspective of added compliance costs. Regulation will increase the compliance burden on the smaller Hedge fund management companies as these management companies do not have the capacity of larger management companies.

The cost of regulation has long been a point of contention and in the 2005 SBP report, the costs of complying with regulations were found to be equal to 6.5% of GDP. In their paper, Kay and Vickers (1988) said that the direct costs of regulation must be viewed in relation to the value added within the financial sector, and that regulation can be pursued provided that it does not reduce competitiveness. In this case applying a generic model of regulation and not taking into consideration how it will affect different parts of the industry goes against the theory.

It can therefore be concluded that the increased cost of compliance has no value add for the financial sector and will eventually be passed on to the consumer, thereby eroding the returns which accrue to them.

6.1.4 Barriers to entry

The results in figure 3 show that the proposed regulation will increase barriers to entry into the hedge fund industry. The most significant obstacles to entering the hedge fund industry include:

- Cost of establishing an operating structure;
- The minimum capital requirement required for a licence;
- The cost of a compliance platform; and
- The amount of time that it takes to get a licence.

Djankov (2009) reviewed the literature on barriers to entry and found that burdensome entry regulations inhibit innovation and thus reduce future productivity. It can be concluded that increased entry requirements have a negative impact on the industry and the financial system as a whole, because they decrease consumer choices by virtue of there being less players in the industry.

6.1.5 Innovation

The responses in Figure 3 support the theory that regulation will stifle innovation in the hedge fund industry. The entrepreneurial nature of Hedge Funds is captured in literature by Stulz (2007), Wiethuechter (2010) and Yeoh (2007), who stated that Hedge Funds take advantage of arbitrage opportunities in order to make returns. Kaiser (2008) also supported this stance, and Blinder (2010) stated in his paper that although regulation is necessary it should not stifle valuable innovation - especially because the secrecy of hedging strategies is a key component of the hedge funds' business models.

It can be concluded that regulation in the hedge fund industry will effectively diminish the entrepreneurial flare of Hedge fund managers and stifle innovation.

6.1.6 Summary of research question 1

This research question was aimed at finding out whether regulation will encourage or impede growth in the Hedge Fund industry. The findings indicate that although regulation is viewed in a positive light in that it will encourage growth, upon in-depth analysis of the commentary provided in the responses, it is evident that regulation will have a negative impact on the industry through increased costs of compliance, it will shrink the industry, it will lower returns for investors, and will stifle innovation. There results for this question are inconclusive if looked at together.

6.2 Research question 2

Are the objectives of regulation being achieved by the regulation and how is the quality of regulation?

Falkena, Bamber, Llewellyn and Store (2001) found that one of the ways to measure if the objectives of financial regulation are being achieved is to assess if the principles of regulation are being applied when formulating regulatory policies. The questions that were asked attempted to determine whether the objectives of financial regulation would be achieved by the proposed regulation, and were related to the regulator's consultation with industry before legislation is introduced and their ability to enforce and monitor the current regulations. A model constructed by Parker (2002) was used to determine if the three pillars proposed by the model were adhered to during the current process of proposed regulation.

FIGURE 6: PARKER'S MODEL OF A WELL FUNCTIONING REGULATORY SYSTEM

6.2.1 Accountability

The results in Figure 4 indicate that the consultation process has been fair to very good compared to previous interactions, which were ineffective because of multiple methods of communication with the regulator. Parker (2002) found that three pillars made up a well-functioning regulatory system - accountability, transparency and consistency. Regulators must be accountable for the consequences of their actions and must ensure that proper consultation occurs.

The responses indicate that the regulator is achieving this objective, however there are still minor issues. It can be concluded that the regulator has shown accountability to the hedge fund industry and therefore fulfills the accountability pillar of Parker's model.

6.2.2 Transparency

The responses in Figure 4 demonstrate that the process followed for introducing the proposed legislation was transparent. The regulator went to industry with proposals and the industry body raised concerns with the regulator after consultations with its members. The regulator subsequently published the proposed regulation discussion paper, which stakeholders will be able to comment on.

Although the process seems to be transparent, two issues were raised with regards to the length of time that the regulator gives the industry for comment, as well as the inappropriateness of the proposed regulatory model for the South African context. Parker's (2002) second pillar, transparency, means that regulatory decisions must be reached in a way that is disclosed to all interested stakeholders. It can therefore be concluded that the regulator has partially fulfilled the conditions of the second pillar of Parker's model.

6.2.3 Consistency

The responses in Table 2 showed that there was little consistency in regulation in the financial services industry. One of the reasons for the inconsistencies was related to the lack of alignment between financial services legislation. It was said that often when regulation is passed, the laws are conflicting and become onerous even for the regulated entities to keep up with. The third pillar of Parker's (2002) model requires that the regulator's decisions are consistent when proposing or implementing legislation. It can be concluded from the results that the regulator is unable to meet the requirements for the third pillar - consistency.

6.2.4 Summary of research question 2

This research question aimed at determining if the regulator was achieving the objectives of regulation. In a paper by Parker (2002), the quality of regulation was linked directly to the three pillars presented in Figure 6. The findings in Figure 4 demonstrate that the regulator engaged the industry, while the results in Table 2 demonstrate that there is thorough enforcement and monitoring. Although it would appear that the regulator was rated well in these aspects, there was one aspect, which was lacking; therefore the pillar of transparency and consistency were partially fulfilled.

6.3 Research question 3:

How will compliance with the new legislation impact the functioning of Hedge funds?

The interview questions that were asked in order to address this research question were whether hedge funds posed systemic risk to the South African financial system and what the unintended consequences would be for the hedge fund industry.

6.3.1 Self-regulation

The subject of self-regulation was mentioned by a number of respondents (table 4). The sentiment was that the industry had been doing a good job self-regulating for many years without any major problems; therefore regulation would create a number of problems, which would otherwise not exist. Respondents were of the opinion that the industry was not getting enough credit for having self-regulated since its inception and for maintaining the high standards that it had managed to maintain.

Jalilian, Kirkpatrick and Parker (2006) argued that regulation is usually as a result of the existence of significant market failure, which is supported by Arrow (1970; 1985) and Shubik (1970) in den Hertog (2010). Ogus (1995) proposed that the public interest justification for self-regulation is based on three conditions: that the activity is affected by a market failure; that private law instruments are insufficient to correct the failure; and that self-regulation is a better method of solving the problem than conventional public regulation.

The general sentiment is that the Hedge fund industry could continue self-regulating, as it has been effective in doing so thus far. The proposed regulation in its current format will have far-reaching and costly implications. It seems that there will be more of a negative impact on the industry, especially with regards to hedge fund returns.

6.3.2 Consolidation

Table 4 shows that respondents were of the opinion that the proposed regulation would have a negative impact in the functioning of Hedge funds, especially the smaller funds. Consolidation of the industry also has the potential to cause systemic risk as the industry will only have a few big players left. Systemic risk is addressed in another section in this chapter. The regulatory requirements that are being placed on Hedge Funds in other countries have had a negative impact, and based on the responses it appears that regulation in South Africa will effectively decrease the size of the industry and drain valuable skills from the financial sector.

6.3.3 Shadow financial system

Gorton, Metrick, Shleifer and Tarullo (2010) defined shadow banking as a financial system that operates in an unregulated space. The responses in Table 4 supports the premise that sometimes when the regulatory burden becomes too much, players in the financial system may seek opportunities which become available in a less regulated space.

Although four respondents mentioned this as a concern, globally the issue of shadow banking has become a major source of controversy for regulators. There is however no consensus on whether these regulatory loopholes exist for the Hedge Fund industry. Based on the results, it can be concluded that the probability of hedge funds moving into a less regulated space is unlikely.

6.3.4 Systemic risk

Figure 5 shows the responses related to systemic risk. The argument of systemic risk being posed by Hedge Funds was invalidated because Hedge funds do not pose systemic risk in the South African context, however by virtue of regulating the industry there was potential to increase systemic risk as the regulations would force Hedge Funds to trade in a similar manner, cause consolidation in the market and decrease the returns for investors. The respondents who said that there was a likelihood of systemic risk manifesting from Hedge Funds mentioned that there would have to be a number of catastrophic events taking place at the same time, which correlates to the theory posed by Chan et al. (2007). An alternative perspective that emerged was that regulation could create systemic risk because it would result in the consolidation of the industry.

Systemic risk can manifest in a number of ways, but Bianchi and Drew (2010) articulated that many hedge funds fail but their failure does not impact on systemic risk. However consolidation can lead to a similar set of circumstances that were exhibited by banks during the global financial crisis, where some banks became too-big-to-fail. Effectively, the regulation, part of which is intended to mitigate systemic risk, might ultimately lead to systemic risk.

The term systemic risk is defined in literature by the IMF (2009), FSB (2010), Chan, Getmansky, Haas and Lo (2007), and Brown, Hwang, In and Kim (2011) as a series of correlated defaults among financial institutions caused by a major event that occurs in the financial system. There is no evidence from the responses to support the concept that the Hedge funds pose systemic risk, but that could be related to the fact that the industry, when compared to the other parts of the financial sector, is significantly smaller and therefore does not pose a threat to the financial system as a whole. The impetus driving the regulation of Hedge funds internationally is therefore misdirected in the South African context, as there is no compelling reason to apply the same reasoning to the South African Hedge Fund industry.

6.3.5 Summary of research question 3

This research question was aimed at determining the unintended consequences that could arise as a result of regulation in the hedge fund industry and the systemic risk implications of hedge funds on the South African financial system. The findings from the interviews indicate that respondents were of the opinion that Hedge funds did not pose systemic risk to the South African financial system due to a number of factors, however the consolidation of the industry due to regulation may create systemic risk. A proposed regulatory engagement model to address the pertinent issues that have been identified in the results is presented in the six-step model in Figure 7.

Step 1 – Global regulatory authorities make recommendations for regulation to local regulator. These recommendations are usually in the form of prescribed standards or principles.

Step 2 – Local regulator informs industry association and industry about recommendations.

Step 3 - Local regulator engages industry regarding proposals. Industry association engages all stakeholders (efforts must be made to include views of the smaller hedge fund management companies).

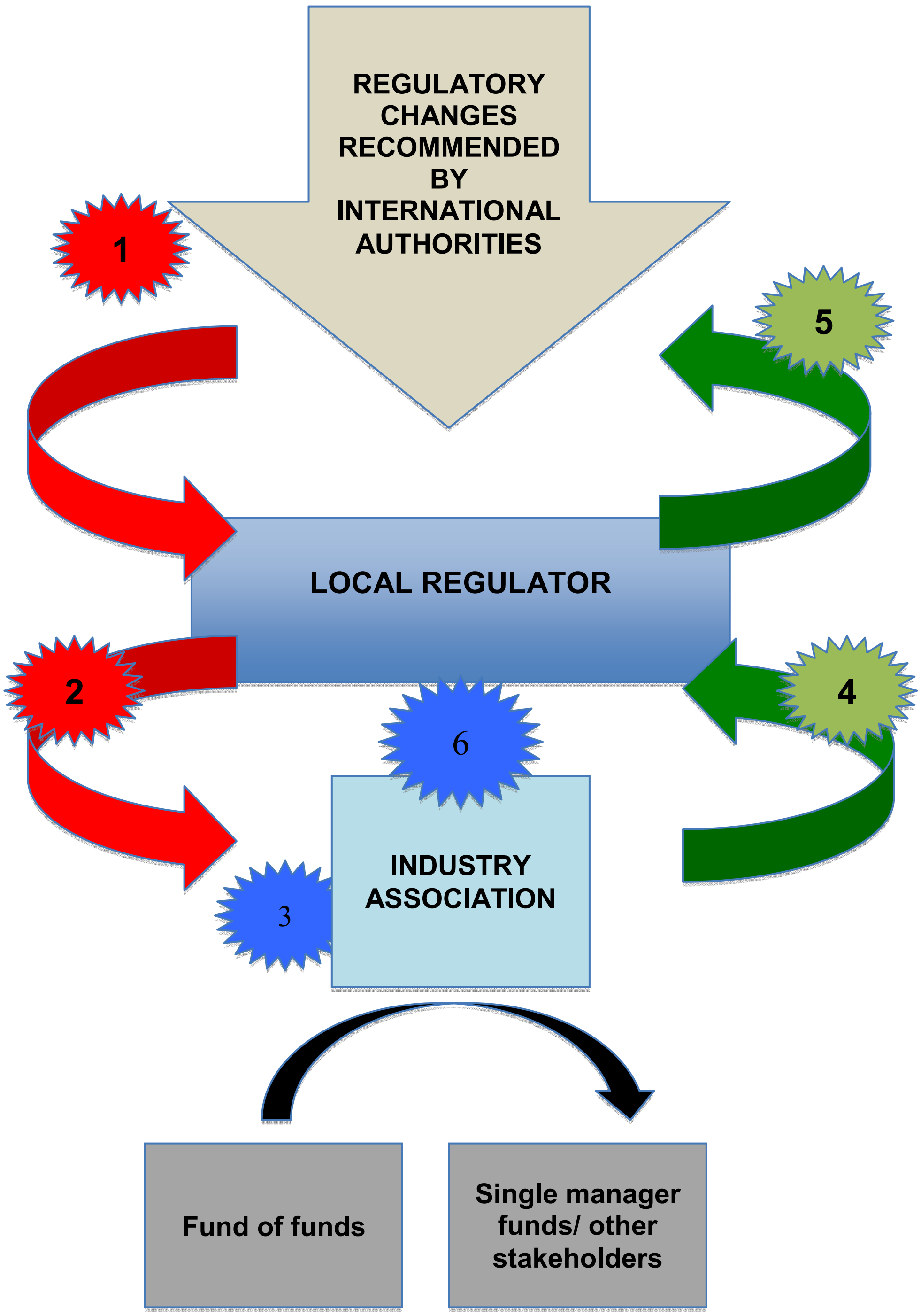
Step 4 – Industry association compiles views of all involved stakeholders and put them forward to the regulator. Regulator engages industry further or interrogates the proposals for appropriateness and relevance to local conditions.

Step 5 - Local regulator reverts to global regulatory authorities with regards to challenges that are presented by industry and requests discretion on certain parts of the proposed regulation if any is required.

Step 6 – Local regulator continues to be involved in dialogue with industry association to arrive at viable form of regulatory proposal that will not be detrimental to the industry.

6. 4 Proposed regulatory engagement model

FIGURE 7: IDEAL REGULATORY INTERACTION MODEL



CHAPTER 7: CONCLUSION

7.1 Introduction

The previous chapter discussed the implications of the results, which were presented in Chapter 5. This chapter will discuss what the objectives of the study were and the main findings of the research will be presented, followed by recommendations for some of the stakeholders who participated in this study. Finally, this chapter will address the limitations of the research and make recommendations for future research.

7.2 Research objectives

The purpose of this study was to explore the impact of regulation on the Hedge Fund industry in South Africa by looking at factors such as possible impact on growth in the sector, cost implications, effect on innovation and systemic risk.

7.3 Main findings

The main findings of the research are summarised below:

⇒ More than three-quarters of the respondents interviewed said that regulation was a good development for the hedge fund industry, however there were some respondents who gave both positives and negatives in responding to this particular question. Some of the disadvantages that were mentioned included:

- The proposed regulatory regime was not suitable for the South African hedge fund industry;
- The regulator was importing regulation that was not well understood;
- Regulation would increase the cost of the asset class;
- Regulation would cause the industry to shrink as smaller hedge fund managers' battle with the onerous regulatory requirements. and
- Creating a regulatory environment where hedge funds will almost trade in similar manner will create systemic risk.

⇒ More than half of the respondents were of the opinion that regulation in the hedge fund industry would stifle innovation for the following reasons:

- The proposed regulation will diminish the entrepreneurial flair of hedge funds;
- Regulation would create barriers to entry, especially for budding hedge fund entrepreneurs; and
- It would drain the country of financial resources, which could enter the hedge fund industry.

⇒ Almost all the respondents said that the engagement process that the regulator followed had become more inclusive.

⇒ Many of the respondents said that the regulator was making a good effort in the enforcement and monitoring of the regulatory requirements that were currently in place, however some areas of concern that were mentioned included:

- The regulator has a skills shortage and this results in a lack of continuity with on-site teams;
- The regulator needs to engage industry a lot more as the industry was prepared to assist them in gaining a more in-depth understanding the business of hedge funds; and
- The feedback loop from the regulator regarding on-site visits was very sluggish.

⇒ Hedge funds do not pose systemic risk to the financial system.

⇒ Regulation would have the following unintended consequences:

- Consolidation of smaller hedge fund management companies;

- Lower revenues for the regulatory agency due to fewer players in the industry; and
- Mediocre returns for investors due do generic trading strategies.

7.4 Recommendations for stakeholders

7.4.1 Regulator

The stakeholders interviewed raised a number of issues related to the process that is followed when new regulation is introduced. The following recommendations capture some of the key issues, which emerged from the interviews:

⇒ The regulator should conduct a thorough analysis of all the financial services legislation, which has an impact on a particular industry prior to proposing further legislative measures. This approach could also be useful when the regulator conducts an economic impact analysis on an industry before introducing legislation.

⇒ The regulator should assess the current self-regulatory arrangements that have been in place in the hedge fund industry and try to incorporate those checks and balances into proposed regulation, versus proposing onerous regulation, which could ultimately stifle the industry.

⇒ The regulator needs to form solid relationships with hedge fund managers - especially those who have indicated a willingness to help the regulatory team gain a better understanding of the industry. This can be done through workshops and possibly short-term secondments, which will allow analysts to observe some of the high level functions that take place in the daily business of the hedge fund industry.

⇒ The regulator needs to be wary of over-importing legislation from other jurisdictions.

7.4.2 Hedge Funds

Some of the respondents were critical at times of the regulator, especially with regards to the examinations which need to be written by hedge fund managers in order to comply with “fit and proper requirements”.

⇒ It is recommended that fund managers should give feedback to the regulator through the industry regarding issues related to the examinations. Feedback should be constructive and should mention exactly what the concerns about examinations are. This constructive dialogue could possibly lead to the compilation of exams that are more relevant to the industry.

⇒ It is recommended that hedge fund managers keep abreast of the developments which take place in the industry so that they are able to give valuable feedback to the industry association. Smaller hedge fund management companies which do not have the capacity or time to keep up with the developments should request that their compliance officers inform them of any changes taking place in the industry and how these will affect them.

7.4.3 Industry association

Respondents lauded the industry association, ASISA, for being an effective communication conduit between the regulator and the Hedge fund management companies, however there were some concerns regarding the representation of the smaller hedge fund management companies. A sentiment was expressed that only the views of major players in the industry were taken into consideration.

⇒ It is recommended that the industry association take steps to ensure that feedback from all stakeholders is taken into consideration and find a way to express the concerns of the smaller players in the industry. The process should not be one-sided and will rely on the association and the smaller hedge fund management companies being actively involved.

7.5 Limitations of the research

This study used qualitative methods to determine the impact of regulation on the Hedge Fund industry. The following research limitations were identified:

⇒ Telephonic interviews took place with 13 of the 17 respondents. The lack of personal interaction could have resulted in less information being volunteered because a time limit was set prior to the start of the interview.

⇒ The respondents interviewed were mostly from hedge fund of funds management companies, and as a result there was not an even balance of opinions from single hedge fund management company respondents because a few declined to partake in the interview process due to resource and time constraints.

⇒ The views expressed by respondents were mostly their own personal views and did not represent those of the organisations they represented.

7.6 Recommendations for future research

This research was exploratory in nature and can be used as a base for future research.

⇒ Future research could be undertaken using quantitative methods to measure the quantitative impact of regulation on growth in the hedge fund industry.

⇒ Future research could be undertaken using quantitative methods to measure the impact of regulation on compliance costs for single hedge fund managers using a case study method.

⇒ The research focused only on proposed legislation in the Hedge fund industry. Regulation is being proposed or currently in the process of being implemented in a number of financial industries such the insurance and banking industry. Future research could explore the impact of regulation on both these industries, using qualitative or quantitative methods.

⇒ Future research could be undertaken to determine whether the process being followed to propose and enforce financial services legislation is suitable for the South African environment.

7.7 Conclusion

The impact of the global financial crisis is being felt by the financial services sector across the globe. The recommendations that have come from international regulatory agencies have in turn forced the hand of domestic regulators, leaving them with little option but to comply. Regulation in the financial services industry has an impact on the entire economy because financial services are a major contributing factor to the South African economy. It is therefore imperative that regulation is proposed and enforced in a way that does not hurt the financial industry and stifle innovation. Domestic regulators need to engage their international counterparts more rigorously and challenge some of the reforms that are being put forward, as the impact of regulation on emerging economy financial markets would not be the same as in more developed economies' financial markets.

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APPENDIX A: INTERVIEW SCHEDULE

GORDON INSTITUTE OF BUSINESS SCIENCE
University of Pretoria

INTERVIEW QUESTIONNAIRE

Dear Participant,

MBA – Master of Business Administration – Participant Briefing and Interview Questionnaire

I am conducting a research on the impact of regulation on Hedge Funds. The key objectives of the study are to;

- Determine whether regulation in the South African Hedge Fund industry has encouraged or impeded growth in the industry.
- Determine how compliance to the proposed further regulation of Hedge Funds will impact the functioning of the industry.
- Identify possible unintended consequences that will flow out of the regulations.

To that end you will be asked several questions through ***telephonic or face-to-face interviews***. This will help us better understand the impact of regulation in the Hedge Fund industry. Our interview should take no more than 30 minutes of your time.

Your participation is voluntary and can be withdrawn at anytime without penalty. The data you provide will only be used for the dissertation, and will not be disclosed to any third party, except as part of the dissertation findings, or as part of the supervisory or assessment processes of the University of Pretoria Gordon Institute of Business Science (GIBS). If you have any concerns, please contact me or my supervisor. Our details are provided below.

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DEMOGRAPHIC INFORMATION

SECTOR:	FUND MANAGER	INDUSTRY ANALYST	REGULATOR
	COMPLIANCE	INDUSTRY ASSOCN	RISK MANAGER

RESEARCH QUESTION 1:

HOW WILL THE PROPOSED HEDGE FUND REGULATION IMPACT ON THE HEDGE FUND INDUSTRY?

RESEARCH QUESTION 2:

HOW WILL THE PROPOSED REGULATION AFFECT INNOVATION IN THE HEDGE FUND INDUSTRY?

RESEARCH QUESTION 3:

HOW WELL DOES THE REGULATOR ENGAGE THE HEDGE FUND INDUSTRY BEFORE LEGISLATION IS INTRODUCED AND STATE REASONS FOR YOUR RESPONSE?

RESEARCH QUESTION 4:

HOW WELL DOES THE REGULATOR ENFORCE AND MONITOR THE CURRENT REGULATIONS?

RESEARCH QUESTION 5:

DO HEDGE FUNDS HAVE THE POTENTIAL, NOW OR AT A LATER STAGE TO POSE SYSTEMIC RISK TO THE SOUTH AFRICAN FINANCIAL SYSTEM? STATE REASONS FOR YOUR RESPONSE?

RESEARCH QUESTION 6:

WHAT, IF ANY, CONSEQUENCES WILL FLOW OUT OF THE REGULATIONS, WHICH WERE NOT INTENDED BY THE REGULATION?

RESEARCH QUESTION 7:

ARE THERE ANY ADDITIONAL COMMENTS THAT YOU WOULD LIKE TO ADD, WHICH CAN ENHANCE THE DISCUSSION ON HEDGE FUND REGULATION IN SOUTH AFRICA?

APPENDIX B: RESPONDENT CODE LIST

A - INDUSTRY ASSOCIATION
B - SINGLE MANAGER HEDGE FUND
C- FUND OF FUNDS
D- REGULATOR
E- FUND OF FUNDS
F- FUND OF FUNDS
G- FUND OF FUNDS
H- SINGLE MANAGER HEDGE FUND
I- SINGLE MANAGER HEDGE FUND
J- FUND OF FUNDS
K- FUND OF FUNDS
L- FUND OF FUNDS
M- INDEPENDENT EXPERT
N- FUND OF FUNDS
O- COMPLIANCE OFFICER
P- SINGLE MANAGER HEDGE FUND
Q- RISK MANAGER

APPENDIX C: PROFILES OF INDUSTRY PLAYERS & RESPONDENTS

NAUTILUS MANAGEMENT ACCOUNT PLATFORM

Nautilus Management Account Platform, is the only managed account platform in the world owned by a stock exchange. It was launched under the FirstRand Stable and as of July 1 2011 it falls under the Johannesburg Stock Exchange (JSE). Nautilus Management Account Platform is a facilitator for all stakeholders in the industry and aims to improve the quality and integrity of the hedge fund sector and finally to positively affect the perception of the hedge fund asset class for regulators.

The interviewee

Alexia Kobusch (CA) SA). Alexia spent 6 years working in Market Risk Management for the likes of Credit Suisse and ING in London she returned to South Africa. Alexia worked for Afgri for a year before joining RMB as the Risk Manager for the Equities & Commodities Division. Alexia joined the Managed Account Platform (MAP) at its inception in November 2007 to initially manage the risk of the underlying hedge funds and now heads up the business

NOVARE

Novare® was founded in October 2000 as an independent investment advisory business in South Africa. In 2006 we began expanding into Africa where we've built an extensive network and gained invaluable experience and insight into investing on the African continent. Having been in the business for over a decade, Novare® has ± 300 years of collective experience in the investment industry. Novare® currently has over R38.18 billion under management/ advice.

The interviewee

Carla de Waal B.Com (Actuarial Science) joined Novare in 2002 after completing her B.Com (Actuarial Science) degree at the University of Pretoria. She has been part of the Mayibentsha Fund of Funds Team since inception in April 2003, and is also a member of the team responsible for manager research, portfolio management and alternative investment risk management within the Novare Group. Carla compiles the annual Novare Investments South African Hedge Fund Survey and regularly writes educational articles for the Press. She has passed Level III of the CFA Program. Carla has eight years experience in the industry.

BLUE INK INVESTMENTS

Blue Ink Investments was established in 1993 as a private wealth asset management company. During the late 1990's volatility in equity markets increased to levels unacceptable for most clients, who sought consistent, positive, low volatility returns. Accordingly, Blue Ink modified its modus operandi to become a specialist alternative asset manager. Blue Ink continues to research and secure innovative investment solutions, with 2 principal targets in mind:

- Protection and preservation of clients' capital
- Production of consistent, risk-adjusted, positive returns

Blue Ink Investments' key institutional shareholders are Sanlam Investments and Ubuntu-Botho Investment Holdings (UBIH).

<u>The interviewees</u>

Selwyn Pillay has a BSc Actuarial Science degree and a post graduate degree in Management Studies. He was appointed as Portfolio Manager at Blue Ink Investments in November 2011. Prior to joining Blue Ink Investments, Pillay served as a Portfolio Manager and prior as the Head of Quantitative Research at Sanlam Multi Manager International. Before joining the Sanlam group in 2004.

Tatenda Chapinduka BBusSc Actuarial Science) is Research Analyst at Blue Ink Investments in Quantitative Finance. He joined Blue Investments in March 2010. His tasks include□development of new products, □financial markets analysis and operational/ legal functions, which involves reviewing legal and operational structures for hedge funds.

Grant Hogan is a Research Analyst at Blue Ink Investments. His tasks include reporting on Hedge Fund performance and he is a also regular contributor to the Blue Ink investments newsletter.

EDGE CAPITAL

Edge Investments and its asset management subsidiary Edge Capital were founded in 1999 in Cape Town as a private investment firm for high-net-worth individuals and family offices. Today, Edge Capital ("Edge") has become South Africa's leading provider of alternative strategy investment products to institutional investors. Edge Capital is a member of ASISA (Association for Savings & Investment SA)

<u>The interviewee</u>

Pieter Viljoen (B.Sc. (Comp. Sc); CFA) began his career in actuarial valuation at Momentum, later specialising in derivative, fundamental and quantitative research. After that, he was Chief Investment Officer of Coris Capital and Senior Portfolio Manager and Head of Research at the Iscor Pension Fund. 2006: He joined Sanlam Multi Manager International as Senior Portfolio Manager and member of the Executive Committee. Pieter currently oversees the investment process at Edge, focusing on the institutional market s the Chief Investment Officer.

PEREGRINE HOLDINGS

Founded in 1996, Peregrine is a leading financial services group providing management solutions in respect of wealth and alternative assets. Headquartered in Johannesburg with operations across South Africa as well as in the UK and Channel Islands, the company employs over 550 people worldwide. Peregrine is listed on the Johannesburg Stock Exchange under Financial Services Sector and at March 2012 had a market capitalisation of R2.4 billion.

The interviewees

Andre Tonkin is a qualified actuary with the Faculty of Actuaries and has four years of investment-related experience gained at Fifth Quadrant as well as Old Mutual. He also holds the FRM (Financial Risk Manager) and CAIA (Chartered Alternative Investment Analyst) qualifications. Andre's focus is on the South African and international institutional market. Andre previously worked at Old Mutual Corporate where he was the market actuary responsible for creating customised investment solutions for the institutional market.

Tania Waller (BAcc, Accounting and Finance) is the Chief Operating Officer at the Peregrine Fund Platform. Tania was previously Financial Director Peregrine Fund Platform.

Debra Zietsman is in Hedge fund compliance at the Peregrine Fund Platform.

HEDGE FUND ACADEMY

The Hedge Fund Academy is an advisory and training organisation that aims to demystify hedge funds' operations, unpack their vital role in the economy, and discuss current and proposed regulation. By educating industry and investors about hedge funds, the Hedge Fund Academy can help foster sound, effective investment policies that ensure that hedge funds remain a positive force in the South African financial system.

The interviewee

Marilyn Ramplin is an experienced capital markets professional with core expertise around regulated European onshore structures such as UCITS, QIF and SIF. This is combined with strong advisory, trading, derivatives, prime brokerage and risk management skills. Growing demand for information from regulators and the public as well as industry professionals led Marilyn to found UCITS for Hedge Funds and The UCITS University. These are devoted to showcasing the challenges and opportunities of UCITS Hedge Funds, and educating fund managers, investors and service providers.

Marilyn was formerly Executive Director at the Prime Brokerage business of JPMorgan, where she was the investment bank's primary UCITS expert, planning and launching the UCITS for Hedge Funds strategy and offering. She provided strategic advice to the bank's clients on the structuring and set-up of complex hedge fund strategies within the UCITS environment. Before her role in Prime Brokerage, Marilyn acted as Executive Director of JPMorgan's Equity Derivatives and OTC Derivatives Collateral Management businesses. She was instrumental in building and bringing to market JPMorgan's multi award-winning OTC derivatives collateral management business. She developed its strategic vision and delivery and advised clients such as the Bank of International Settlements on their credit counterparty risk management framework. A regular speaker on the conference and training circuit, Marilyn is often voted as the top speaker in her area of expertise.

STEYN CAPITAL

Steyn Capital Management is a value-orientated investment management firm investing principally in publicly traded African equity securities. We seek to maximize partner capital by buying securities with trading values materially lower than their intrinsic values, and by selling short securities with trading values materially higher than their intrinsic values. Our aim is to achieve high absolute rates of return over the long term while minimizing the risk of capital loss.

<u>The interviewee</u>

André Steyn is the CEO and Portfolio Manager of SCM, which he founded in 2008. From 2004 to 2008, André was the CEO of Temujin Fund Management UK, the UK arm of a billion dollar New York based hedge fund. At Temujin, André was responsible for all non-US investments comprising a long/short portfolio of approximately USD2 billion. He founded the UK office and built it into a team of five professionals. From 2002 to 2004, André was an investment associate at Ziff Brothers Investments, a multi-billion dollar hedge fund. At Ziff Brothers, he performed fundamental research for the purpose of recommending new investments for the firm's capital, and generated significant alpha by shorting companies with poor earnings quality. André began his career at Andersen in 1998, completing his Chartered Accountant articles in Cape Town before transferring to the New York Mergers & Acquisitions practice where he advised companies and private equity funds on acquisitions. André is a Chartered Accountant and a Chartered Financial Analyst, and is a member of the New York Society of Security Analysts.

FAIRTREE CAPITAL

Firmly rooted as one of the largest African hedge fund managers, Fairtree Capital has been delivering consistent, high-quality returns to investors since January 2003. As experts in South Africa, African and emerging markets, we have developed a diverse product portfolio, which encompasses a variety of equity, fixed income and commodity mandates, with over R2bn combined assets under management.

The interviewee

Bradley Anthony (B.A (Economic History), CAIA) has a strong background in fund management and in alternative fund of fund management. Bradley started his career at Nedcor in 1993 and has held positions as head of domestic treasury; head of fixed income and as structured products fund manager at the Nedcor Banking Group, BOE Asset Management Group, RMB and Momentum Capital Management, respectively. In 2007 Bradley joined the Momentum Alternative Investments Group where he was appointed as the chief investment officer of FRAIM. In 2011 Bradley joined Fairtree where he is responsible for distribution of all Fairtree funds and for fund management of the Multi-Strategy products.

SYGNIA

Sygnia is a South African financial services company specialising in multi-management and fund of funds management. Sygnia provides a range of investment services and technology solutions to corporate and individual clients in South Africa, the United Kingdom and the United States.

The interviewee

Simon Peile (BBusSc(Actuarial), FFA, FASSA, CFP) is one of the founding members of Sygnia and a pioneer in introducing the concept of life-stage investing into South Africa. Trained as an actuary, he gained a wealth of experience in retirement fund and investment consulting (including quantitative analysis and asset manager research) by consulting to a wide range of major corporate clients in South Africa, the United Kingdom and Australia. Simon was a member of the Actuarial Society Retirement Matters Committee for many years, focusing on investment strategies for retirement funds. He was also the Head of Retirement Fund Consulting at South Africa's largest firm of Consultants and Actuaries prior to leaving to start Sygnia, where he developed the firm's methodology for advising institutional clients on their investment strategies. He is currently the Joint Head: Investments at Sygnia.

INDEPENDENT COMPLIANCE SERVICES

ICS is a Financial Services Board registered compliance practice, which acts as an outsourced compliance officer to Financial Services Providers, and provides consulting services on compliance related issues

The interviewee

Enrique Goosen (BA LLB CFP: Admitted Attorney and Compliance Officer) is the Managing Director of ICS and has 17 years experience in the financial services industry, having worked as legal advisor at Metropolitan Life and financial planner at SANLAM and ABSA Private Bank. Enrique has completed the attorneys admission requirements, is a member of the Compliance Institute of South Africa and a Certified Financial planner with the Financial planning Institute of South Africa.

ASISA

ASISA was formed in 2008 by members of the Association of Collective Investments (ACI), the Investment Management Association of South Africa (IMASA), the Linked Investment Service Providers Association (LISPA) and the Life Offices' Association

(LOA). These associations have disbanded and their staff, assets and activities have been transferred to ASISA. As the custodian of the bulk of South Africa's savings and investments, ASISA and its members must ensure, in the interest of the country and its citizens, that the South African savings and investment industry remains relevant and sustainable into the future.

The interviewee

Stephen Smith is a Senior Policy Advisor Coordinator for the Economics & Savings Policy Board Committee; projects include regulatory reform, retirement reform, hedge funds and restructuring of SA capital markets.

ACUMEN CAPITAL

Acumen Capital was established in 2001 by Stuart Conway and Mark O'Brien. The initial purpose of the company was to act as a structured intermediary between market participants in South African interest rate products. Greg Kamstra joined the company in March 2007, to focus on the management of 3rd party capital, resulting in the launching of the AcuityOne hedge fund in September 2009.

The interviewee

Greg Kamstra (Director of Acumen Fund Managers, BSc. Hons) has 22 years experience in the investment industry. He previously set up and managed an interest rate hedge fund at Peregrine, was head of fixed income at Citibank NA for 2yrs and was head of Merrill Lynch Capital Markets SA for 3yrs.

FINANCIAL SERVICES BOARD

The Financial Services Board (FSB) is a unique independent institution established in 1990 to oversee the South African non-banking financial services industry. The FSB's mission is to promote sound and efficient financial institutions and services together with mechanisms for investor protection in the markets they supervise. The FSB's task is to promote and maintain a sound financial investment environment in South Africa.

The FSB is responsible for ensuring that regulated entities comply with legislation and capital adequacy requirements for financial soundness, thereby protecting the investing community. We regulate and supervise pension funds, friendly societies, long-term and short-term insurance, capital markets, collective investment schemes, and financial advisors and intermediary services.

The interviewee

Tholoana Makhu (BA and an LLB) is an admitted attorney who joined the Financial Services Board on July 2011. She is a Senior Legal Advisor in the Collective Investment Schemes Department of the Financial Services Board and previously worked in the Insurance Registration Department. Prior to joining the Financial Services Board she was a Director at Routledge Modise Moss Morris. Tholoana's main expertise is in communications law, entertainment law, corporate compliance and black economic empowerment.