

FSCA COMMUNICATION 20 OF 2021 (RF)

Update on draft Conduct Standard [-] of 2020 (RF) – Conditions for Investment in Hedge Funds

1. Purpose

The purpose of this communication is to inform the retirement fund industry of the status of the draft Conduct Standard [-] of 2020 (RF) – Conditions for Investment in Hedge Funds and confirm the way forward regarding the draft Conduct Standard.

2. Background

- 2.1 In November 2015 the former Financial Services Board, being the predecessor to the Financial Sector Conduct Authority (“the Authority”), published a draft Notice – Draft Conditions for Investment in Hedge Funds (“the Notice”) for public consultation. A revised draft of the Notice, informed by public comments received, was published for further consultation in February 2017.
- 2.2 At the end of March 2018, the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) (“FSR Act”) came into effect, which accorded the Authority the powers to make conduct standards and prescribed the consultation process to be followed in making regulatory instruments (including conduct standards). Accordingly, the second draft of the Notice was converted into the draft Conduct Standard – Conditions for Investment in Hedge Funds (“draft Conduct Standard”) and was published on 9 October 2020 for public comment.
- 2.3 Four industry stakeholders submitted comments on the draft Conduct Standard, and these were considered in detail by the Authority. Early in 2021 the Authority also had targeted engagements with some of the commentators to understand the concerns raised. Commentators questioned whether the proposed conditions are necessary, considering:
 - a) existing requirements in Regulation 28 made in terms of section 36 of the Pension Funds Act, 1956 (Act No. 24 of 1956) (“Regulation 28”); and
 - b) draft amendments to Regulation 28, including an amendment to the definition of “hedge fund” (published by the National Treasury on 12 February 2021).
- 2.4 The Authority therefore deemed it necessary to reassess the need and appropriateness of the draft Conduct Standard. The conclusions flowing from this assessment are discussed below.

3. Conclusions following the reassessment of the draft Conduct Standard

- 3.1 The Authority is of the view that given the impending change in the definition of “hedge funds” in the Regulation 28, the proposed condition 2(a) in the conduct standard may no longer be necessary as the ‘new’ definition will be linked to a “hedge fund” regulated under the Collective Investment Schemes Act, 2002 (Act No. 45 of 2002) (“CISCA”) and be administered by a

registered manager in accordance with section 42 of Cisca. This means that, by definition, retirement funds will only be able to invest in Cisca regulated hedge funds and will only be able to use registered managers for members' investments.

- 3.2 With regard to the proposed condition 2(b), it is the view of the Authority that it will be sufficient to only rely on Regulation 28(3), which prohibits investment in an asset where the potential loss exceeds the value of the investment. Specifically, Regulation 28 provides that a fund must not invest or contractually commit to invest in a hedge fund where the fund may suffer a loss in excess of its investment or contractual commitment in the asset. As Regulation 28(3) prohibits investment in an asset where the potential loss exceeds the value of the investment, placing a requirement on the hedge fund manager to be contractually bound to disclose an investment in embedded derivatives in a hedge fund exceeding 100% of such derivative is superfluous (as the fund may not invest in such a type of investment in the first place, i.e. if there is a risk of losing in excess of the initial investment value). Regulation 28(3)(d) also has an added protection measure that requires a hedge fund to hold liability exposure in a limited liability structure.
- 3.3 In respect of the proposed condition 2(c), the Authority is in agreement with commentators' views that section 7D(1)(e) of the Pension Funds Act, 1956, places an obligation on boards of retirement funds to "obtain expert advice on matters where board members may lack sufficient expertise". As such, it is not necessary to retain this condition in a Conduct Standard. Section 7D(1) is worded in a wide and principles-based manner and can therefore be applied in the context of hedge funds investments. If it is found through ongoing supervision that there is lack of adherence to this principle, the Authority will communicate this to the industry, for example by way of a Guidance Notice issued under Section 141 of the FSR Act.
- 3.4 The conclusion, based on the above assessment, is that there is no longer a critical need to proceed with imposing the conditions through a Conduct Standard.

4. **Withdrawal of the draft Conduct Standard**

Given the above, the Authority confirms that it will not proceed with the making of draft Conduct Standard [-] of 2020 (RF) – Conditions for Investment in Hedge Funds.

5. **Enquiries**

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