SOUTHERNCROSS CAPITAL
NAVIGATING UNCERTAINTY

REGULATORY LANDSCAPE OF HEDGE FUNDS

"Navigating Uncertainty" is a dynamic finance series designed to demystify the complexities of hedge funds. We provide clarity on intricate concepts, ensuring accessibility to readers of all backgrounds.

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WHAT IS THE REGULATORY LANDSCAPE FOR HEDGE FUNDS AND THEIR MANAGERS?

Let's start with hedge fund managers. Although hedge funds themselves only became formally regulated in 2015/2016, hedge fund managers have long been financial service providers. They have consistently been regulated - first by the Financial Services Board (FSB) and now by the Financial Sector Conduct Authority (FSCA).

In fact, hedge fund managers have functioned as accountable institutions even before the regulatory framework specifically addressed hedge funds.

This pre-regulation period still saw oversight of the managers through existing financial service structures, underscoring their enduring responsibility within the financial system.

HOW DOES ONE BECOME LICENSED AS A HEDGE FUND MANAGER WITH THE FSCA?

Obtaining a "2A" license to manage hedge funds through the FSCA is notably more rigorous than most other Financial Services Provider (FSP) licenses. The requirements, particularly in terms of experience and capital, are significantly higher compared to those for traditional fund managers or financial advisors.

WHEN DID HEDGE FUNDS BECOME REGULATED AND CLASSIFIED AS COLLECTIVE INVESTMENT SCHEMES?

In 2015, hedge funds transitioned from an obscure, unregulated space into the unit trust environment. This shift occurred when the Minister of Finance amended the Collective Investment Schemes Act, officially classifying hedge funds—previously structured similarly to private equity—as collective investment schemes. The new regulatory framework introduced two categories of hedge funds:

- Qualified Investor Hedge Funds, targeting institutional investors who were already involved in such funds.
- Retail Investor Hedge Funds, designed for individual investors, structured similarly to traditional unit trusts.

WHAT WILL THE PROPOSED AMENDMENT TO CISCA MEAN FOR HEDGE FUNDS?

The proposed amendments to the Collective Investment Schemes Control Act (CISCA) would allow balanced Fund of Funds to allocate up to 10% of their overall holdings to hedge funds.

Under the current regulatory framework, Fund of Funds are technically prohibited from investing in hedge funds due to outdated conflicts between various pieces of legislation.

However, draft legislation is currently with National Treasury, aiming to amend CISCA to align with Regulation 28, which already permits Fund of Funds to invest in hedge funds. This change would resolve the regulatory inconsistencies and expand investment opportunities for balanced Fund of Funds.

DOES MY FINANCIAL ADVISOR NEED A SPECIALIST LICENSE TO INVEST IN HEDGE FUNDS?

Yes, hedge funds are classified as a specialist investment, and your financial advisor must have a specific category on their license to advise on or invest in hedge funds. Quality advisors should already have this specialist category or, at a minimum, be in the process of obtaining the necessary supervision to add it. This ensures they can offer you access to hedge fund investments and navigate the complexities of this asset class on your behalf.

WHAT TYPES OF HEDGE FUNDS HAVE BEEN AVAILABLE SINCE THE 2015 REGULATION?

When hedge funds became regulated in 2015, two distinct legal structures were established to cater to different types of investors:

- Qualified Investor Hedge Funds (QIHFs): These are designed for institutions and high-net-worth individuals, typically characterized by higher risk, greater concentration, and less transparency, similar to traditional hedge funds.
- Retail Investor Hedge Funds (RIHFs): These funds are structured for individual investors, offering a more transparent, liquid, and regulated product, akin to traditional unit trusts.

WHAT ARE THE MINIMUM INVESTMENT THRESHOLDS FOR RETAIL INVESTOR HEDGE FUNDS VS. QUALIFIED INVESTOR HEDGE FUNDS?

- Qualified Investor Hedge Funds (QIHFs): These funds require a minimum investment of R1 million and demand that investors demonstrate a certain level of investment competence. QIHFs can take on significant concentration risk and invest in a broader range of less liquid securities.
- Retail Investor Hedge Funds (RIHFs): With a much lower entry point, RIHFs have a minimum investment of around R1,000, often with the option for monthly debit orders. They are more tightly regulated, especially regarding liquidity and investment concentration, ensuring they are more accessible and secure for individual investors.

RIHFs are the only hedge funds available on investment platforms, offering daily pricing and liquidity, similar to traditional unit trusts. QIHFs, on the other hand, typically have a three-month notice period for both subscriptions and redemptions, making them far less liquid and potentially less tax-efficient.

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