

# **Impact of Tighter Regulations on Performance of Hedge Funds in South Africa: A case study of Selected Industry Stakeholders**

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## Abbreviations and Acronyms

ASISA	The Association for Savings and Investment South Africa
AUM	Assets under management
CAT IIa	Category Two
CHFS	Centre for Hedge Fund Supervision
CISCA	Collective Investment Schemes Control Act, No 45 of 2002
FAIS	Financial Advisory and Intermediary Services Act
FSA	Financial Services Authority
FSB	Financial Services Board
G20	Group of Twenty
HF	Hedge Fund
IMF	International Monetary Fund
PWG	President's Working Group on Financial Markets
QIHF	Qualified Investor Hedge Fund
RIHF	Retail Investor Hedge Fund
SEC	Security and Exchange Commission
UK	United Kingdom
USA	United States of America

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## **Declaration**

I, **Makhahlele Richard Manzini**, declare that the research work reported in this Research Report is my own, except where otherwise indicated and acknowledged. It is submitted for the degree of Masters of Management in Finance and Investments the University of Witwatersrand Business School (WBS), Johannesburg. This Research Report has not, either in whole or in part been submitted for a degree and or diploma to any other university and or publication.

Signature: \_\_\_\_\_

Date: **27<sup>th</sup> February 2019**

## **ABSTRACT**

### Introduction and Background

Historically, hedge funds in South Africa as noted by Betsalel (2006) have been largely an unregulated investment vehicle that accumulated billions of rands in assets under management. In 2015 South Africa became the first country to introduce comprehensive regulation for hedge fund products. The new regulations provide for two categories of hedge funds, namely Qualified Investor Hedge Funds and Retail Investor Hedge Funds. This required the hedge fund industry to prioritise the conversion of hedge fund products to structures that conform to the provisions of the Collective Investment Schemes Control Act (CISCA).

### Aim and Objectives

This study examines Hedge Fund stakeholders' views on the effects that the transition to regulated environment has on the Hedge Fund Industry, first understand the effect of regulations on hedge funds post-promulgation of the new regulations in 2015, and second, to identify the challenges posed by these regulations.

### Methods

To investigate the research aim, the research employed a cross-sectional two-fold mixed-methods approach which was a mixed methodological approach including qualitative and quantitative components. The qualitative component of this study involved in-depth key-informant interviews while the quantitative component utilised a semi-structured, electronically distributed self-administered questionnaire. The quantitative component was included in order to further investigate the qualitative themes obtained from the qualitative component.

### Results

The results indicate that the SA financial services is comprehensively regulated. Since promulgation of the CISCA Act, HFs have been adhering to governance and all regulations that pertain to them. In terms of transitioning, by end of 2017, more

than 65% of HF assets had moved to Qualified Investor Hedge Funds and 24% to Retail Investor Hedge Funds. The majority of respondents agreed that the Hedge Fund Industry is important to the South African Financial Services Market because among others, the industry has an important social role and provides value to the broader economy, beyond facilitating market efficiency.

## Conclusion

Regulated hedge funds tend to reduce the chances of things going wrong for hedge fund investors and thus enhance the reputation of hedge funds and dispel some of investors' doubts. There is the general feeling that enhanced disclosure and risk control measures supports better protection but could mean higher admin costs. The enhanced disclosure ensures that investors know what they are getting into and present an opportunity to hold fund manager accountable through appropriate legal provision. Overall, regulation supports the better management of systemic risk that can have ramifications for the financial system.

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Ke mmone Jesu

Ke ya mo tseba Jesu

Yena o dira tše dibotse fela

A testimony of my life, needs nothing much to expand on; than to simply state that I know now, that His grace for my life is sufficient; and I continue to observe the wonders of my Life, and remain forever thankful. I have witnessed you, Lord. And you only do great things. To Makhahlela and Shalati Manzini (my parents), to Lunghile and Gezani (my siblings); God saw fit to bless me with such an incredible family.

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Angatsandzeki Yehovah

Ku kuhlulela mirhingweni ya wena

Anga tsandzeki yehovah wa hina.

There is so much peace in God. And this, I know. As for this academic work; I hope you thoroughly consume the little that has been added to academic literature, as it serves to explore an industry long associated with being indiscernible to financial market participants.

# CHAPTER 1: INTRODUCTION

## 1.1 Background

After the 2008 Global Financial crisis, South Africa, through its participation in multilateral institutions such as the International Monetary Fund (IMF), the Group of Twenty (G20), the Financial Stability Board, the Basel Committee on Bank Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors, committed itself to implementing higher global financial standards to make the financial sector safer and better (National Treasury, 2013). This meant enhanced regulation and oversight of private pools of capital, which included hedge funds. South Africa, then embarked on a consultative process with the South African hedge fund industry to create suitable regulation to monitor systemic risk and also enhance investor protection (Novare, 2017).

Hedge funds in South Africa operate as collective investments. According to the Novare Investments South African Hedge Fund Survey Report (2013) the first pooled hedge funds first appeared in South Africa in 1995. Based on this report, the total assets under management (AUM) was R1.4 billion in 2002 and have continued to grow consistently over the years peaking at R68.6 billion in 2016 and a reduction of R6 billion to R62.6 billion in 2017 (Novare, 2013; Novare, 2017; ASISA 2018). Before 2012, South African hedge funds were loosely regulated under the Financial Advisory and Intermediary Services Act (FAIS) since October 2007 under a separate license category, Category IIA – Hedge Fund for Financial Services Providers (CAT IIA for FSPs) discretionary asset managers (unit trust asset managers)(Financial Services Board Act, 1990).

However, in 2012, the National Treasury and Financial Services Board (FSB) proposed a framework for the regulation of hedge funds in South Africa. The regulations came into effect on 1<sup>st</sup> April 2015, when the minister of finance in terms of section 63 of the Collective Investment Schemes Control Act, No 45 of 2002 (CISCA), declared the business of hedge funds as a Collective Investment Scheme. This made South Africa one of the few countries to put in place comprehensive regulation for hedge fund products. (ASISA, 2018)

One of the main purposes of the regulation of hedge funds by National Treasury is the monitoring and measuring of systemic risk while enhancing product requirements to protect investor interests (National Treasury, 2009). It also enhances transparency and helps monitor the development of financial market.

According to the Government Notice dated 25<sup>th</sup> February 2015 from the National Treasury (National Treasury Notice 38503, p 3), for purposes of the Cisca (Act of 2002) a hedge fund is defined as “*an arrangement in pursuance of which members of the public are invited or permitted to invest money or other assets, which uses any strategy or takes any position which could result in the arrangement incurring losses greater than its aggregate market value at any point in time and which strategies or positions include but are not limited to- (a) leverage; or (b) net short positions*”.

The new regulations provide for two categories of hedge funds. These are Qualified Investor Hedge Funds (limited to institutions and high net worth individuals) and Retail Investors Hedge Funds (open to ordinary investors). The FSB Board Notice 52 of 2015 (Government Gazette, 2015), defines a Qualified investor as “*Any person who invests a minimum investment amount of R1 million per hedge fund and who- (a) has demonstrable knowledge and experience in financial and business matters which would enable the investor to assess the merits and risks of a hedge fund; or (b) has appointed a Financial Services Provider (FSP) who has demonstrable knowledge and experience to advise the investor regarding the merits and risks of a hedge fund investment.*” The same notice defines a Retail investor fund as “*a hedge fund in which any investor may invest because it meets the requirements set out by the FSB.*”

In 2016, Novare reported that 67.8% of fund managers elected to be categorised as Qualified Investor Hedge Funds, while 32.1 percent elected to be categorised as Retail Investor Hedge Funds, and 0.1 percent were undecided on the scheme they wanted to employ (Novare, 2016). The overall aim of the introduction of regulation was to provide better protection to investors, assist in monitoring and managing systemic risk to financial services industry, enhance transparency and monitor the development of financial market.

## 1.2 Problem Statement and Motivation for the Study

Apart from the international multilateral institutions'/platforms' commitments of implementing higher global financial standards to make the financial sector safer and better through participation, the lack of regulation was considered a hindrance by SA hedge fund managers. It was foreseen that regulation would bring with it credibility to the industry and serve to increase investments into this sector. Betsalel, (2006) posited investors by in large stayed away from the unregulated SA market as among others, there were no clear procedural guidelines in place to ensure that their funds would be adequately managed and that they would possibly have no recourse in case of their investments being mismanaged. The 1<sup>st</sup> April 2015 implementation of regulation through the Cisca was therefore a welcome development.

Historically, hedge funds in South Africa have been largely an unregulated investment vehicle that accumulated billions of Rand in assets in its formative years (SAVCA, 2016). They operated loosely as part of the regulation of Hedge Fund managers requiring only a CAT IIa certification. It has been just over three (3) years since implementation and transition to a regulated environment started. This necessitates the need for an exploratory analysis of its effects from the perspective of industry stakeholders. More specifically, there is a need, on the one hand, to conduct an early exploratory inquiry into whether regulation has brought credibility and increased investor confidence evidenced through a flow of new or additional assets into the SA industry. On the other hand, it is also imperative to explore whether regulation has presented additional costs and challenges to the industry. The challenges among others could be such as over-regulation as well as inability to cater for different types of investors. The latter is particularly important because the regulatory needs, such as those for investors in the retail sector, are very different from the sophisticated investor (Hedge Funds World Africa, 2005).

Additionally, due to hedge funds being of a global nature, exploring the impact of these regulations locally and internationally would be explored. A case in point are the statistics released by the Association for Savings and Investment South Africa (ASISA, 2018), that the South African hedge fund industry ended 2017 with assets under management of R62.4 billion. This was a decline of R5 billion from the R67.4 billion managed at the end of 2016. This was the hedge fund industry's first decline in assets under

management since 2011 when assets stood at only R31.4 billion. Of particular interest would be to explore a possible association of the transition to a regulated environment with this development.

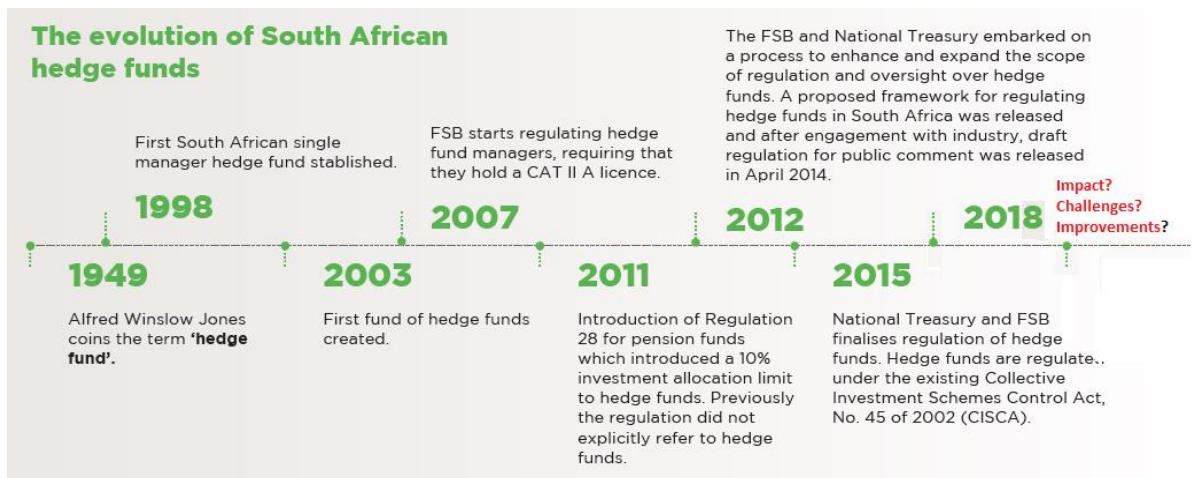
Studying the effects of the transition to a regulated environment is absolutely necessary making this study crucial. This is in order to inform the early identification of both positive and negative outcomes of the change unique to South Africa as well as to inform risk management and mitigation strategies as well as government policy. This is especially important as SA is documented as one of the few countries to comprehensively regulate the industry and research in this arena remains in its infancy. Moreover, as will be described in later chapters, regulation of the Hedge Fund industry in a larger economy, namely the United States of America, was implemented in 2004 and later struck down by the US Court of Appeals for the District Columbia two years later, in a landmark case of *Goldstein and others v. Securities Exchange Commission (2006)*, citing important components of the Hedge Fund regulation as "arbitrary". This is a very important lesson for South Africa in that some of its regulatory requirements, if tested before a court of law may be found wanting. Another example that will also come in more detail in Chapter two is Germany's attempt to promulgate a regulated local hedge fund market. This is very similar to South Africa's situation today. A review and comparative analysis of experiences and best practices, as will be conducted in the literature review makes this exploratory study imperative.

### **1.3 Conceptual Framework**

A conceptual framework presents a model of existing research or knowledge around a particular area of research focus. It informs research design supporting the assessment and refinement of research goals targeting realistic and relevant research questions. It also helps in the selection of the most appropriate methods and to identify potential validity threats to the conceptual framework. (Maxwell, 2008; Miles *et al*, 1994),

The conceptual framework of this research study proposed herein is presented in Figure 1. It illustrates the comparative analysis, before and after regulation, in terms of impact, challenges and new policies that could be introduced to improve the

Industry. It presents the historical evolution of South African Hedge Funds and why it is important that a preliminary analysis be conducted.



**Figure 1 : Conceptual Framework. Adapted from Novare Hedge Fund Survey, 2017.**

## 1.4 Aim and Objectives

### 1.4.1 Aim

The aim of this study was to consider Hedge Fund stakeholders' views on the effects that the transition to regulated environment has on the Hedge Fund Industry.

### 1.4.2 Objectives

In order to achieve the aforementioned aim, the specific objectives of this research were:

1. To study the effect of regulations on hedge funds after their promulgation in 2015
2. To identify the challenges posed and/or encountered as a result of these regulations in the South African context between 2015 and 2018.

## **1.5 Benefits and Relevance of The Study**

### **1.5.1 General Societal**

This research contributes to previous research in an attempt to generate the building blocks and understanding on the future of hedge funds industry globally in general, and in South Africa in particular. Specifically it will make a contribution to the public's understanding of the impact and challenges of the recent regulation of the Hedge Fund industry in South Africa.

### **1.5.2 Public Policy**

The study may also contribute to influencing government policy measures with regards to Hedge Fund regulation and it will assist in informing how these policies can best be shaped.

### **1.5.3 Scientific Contribution**

A review of the literature suggests that academic communities along with professional bodies and industry stakeholders have provided some indication of the resultant impact of regulation. However, this arena still remains fairly impervious and questionable. Thus, the intended study will strive to shed additional light and help to bridge the gap in the existing literature with respect to the impact of the recently promulgated regulations by obtaining the opinions of industry leaders and thereafter testing these opinions through a is topic. The study will examine the sources from published academic papers, conduct interviews with hedge fund specialists using a qualitative semi structured interview and perhaps include a survey method via questionnaires in order to generate data for analysis.

## **1.6 Delimitations Of The Study**

### **1.6.1 Study Geographic Coverage**

The scope of this study will be limited to Gauteng province of South Africa. The province is the economic powerhouse of the country and it is expected that it will adequately represent the Hedge Fund industry of South Africa.

### **1.6.2 Sector to be covered**

This study will concentrate on select Hedge Fund Stakeholders and a convenient/purposive selection approach/process will be undertaken. This process will be further elaborated in the methodological section in Chapter three.

### **1.7 Outline of the Final Report**

This dissertation is arranged as follows: Chapter 1 introduces the purpose of the study, its rationale, objectives and envisaged benefits. Chapter 2 presents the literature review which provides for an in-depth understanding of previously documented literature on impact of regulation of the Hedge Fund Industry. Chapter 3 provides a detailed discussion and overview on the research design and methodology employed in this study. Chapter 4 outlines the findings and results obtained from the research undertaken and lastly, Chapter 5 gives a discussion and conclusion as well as further research which could be undertaken in order to further develop the findings of this work.

### **1.8 Chapter One Summary**

As illustrated thus far, the study of hedge funds and regulations is still an ongoing area of research. In general, there has not been extensive research with regards to regulations in the hedge fund industry. The nature of this study was to explore the established and the upcoming regulations and their impact. It should be noted that there still exists a great deal of uncertainty in this arena. This study highlights the upcoming trends in the hedge fund industry and sheds further light on the overall performance of this industry. It builds on the understanding that can be used for future frameworks to investigate current knowledge and develop or formulate new strategies.

## **CHAPTER 2: LITERATURE REVIEW**

### **2.1 Introduction**

Generally, this chapter presents a review of the literature on Hedge Funds and their regulation. More specifically, it starts with a theoretical framework of regulations and then the theory impacting the promulgation of Hedge Fund regulations. It then traces the historical evolution of Hedge Funds as an investment vehicle in section 2.2. The rest of this chapter is structured as follows: Section 2.3 attempts to define Hedge Funds while 2.4 introduces regulation as a general concept. Section 2.5 presents the Scope of regulation and section 2.6 proceeds with the need for regulation of hedge funds. In the statement of the problem of Chapter 1, it has been presented that South Africa is one of the few countries that have regulated Hedge Funds. Section 2.7 therefore goes on to describe the other countries, apart from South Africa and their experience with regulation. This chapter then concludes with section 2.8 which is a summary conclusion of the review of the literature.

### **2.2 Theoretical Framework**

#### **2.2.1 Definition of Regulations**

Economic and legal researchers have both agreed on the difficult to define the term “*regulation*”. They have attempted to systematically define it in order to enable further analysis. For purposes of this research, “*regulation*” will be defined per the suggestion of Hertog (1999) that “*It is the employment of legal instruments for the implementation of social-economic policy objectives*” (Hertog, 1999). A characteristic of legal instruments is that individuals or organizations can be compelled by government to comply with prescribed behaviours under penalty of sanctions. For example, corporations can be compelled to observe price control, supply certain goods, stay out of certain markets, apply particular techniques in the production or pay the legal minimum wage. Sanctions may include fines, publicizing violations, imprisonment, orders to make specific arrangements, an injunction against withholding certain actions, or closing down the business.

It is important to note that there is a distinction between social and economic regulation. Social regulation comprises regulation in the area's such as environment, labour conditions and equal opportunities, consumer protection and labour. Instruments applied here may include regulation dealing with the discharge of environmentally harmful substances, safety regulations in factories and workplaces, the obligation to include information on the packaging of goods or on labels, the prohibition of the supply of certain goods or services unless in the possession of a permit and banning discrimination on race, skin colour, religion, sex, or nationality in the recruitment of personnel (OECD, 1997).

Economic regulation on the other hand has been described to consist of two forms namely structural regulation and conduct regulation (Kay and Vickers, 1990). Structural regulation' is used for regulating market structure. The latter may be restrictions on entry and exit and rules against individuals supplying professional services in the absence of recognized qualifications. Meanwhile, conduct regulation is used for regulating behaviour in the market. This is such as price control, rules against advertising and minimum quality standards among others. Economic regulation is mainly exercised on natural monopolies and market structures with limited or excessive competition. From a broad perspective therefore, economic regulation encompasses all forms of state intervention in the economy (Dal Bó, 2006). Among others, two main theories of economic regulation have been proposed. The first one is the "Capture" theory and the second is the "public interest" theory of regulation.

### **2.2.2 The public interest theory**

The public interest theory was the standard economic thinking on regulation from the late 19<sup>th</sup> century until the late 1960s. This theory is based on two basic assumptions. Firstly, it is that markets are extremely fragile and are likely to work inefficiently if allowed to operate autonomously. Secondly, that government regulation can correct these shortcomings, i.e., it can compensate for social welfare losses associated with market failures (McCraw, 1975).

On the basis of these assumptions, the main public interventions in the economy can be seen as the government's response to the need to rectify the inefficiencies resulting from the free functioning of markets (Posner, 1974). These are such as protection of

trade unions, regulation of utilities and natural monopolies, subsidies to agriculture, minimum wages, price and quantity control. Public intervention requires, the identification of market anomalies and the definition of a corrective policy of those failures (Pigou, 1932).

Government may also seek to tackle problems such as monopolies and oligopolies or externalities. Generally, economic regulation, viewed from this perspective, promotes productive efficiency and an adequate allocation of resources, and protects consumers from market power abuse by monopoly sectors. (Laffont, 2005).

### **2.2.3 Regulatory capture theories**

Unfortunately, the existence of regulation does not in itself ensure that the objectives it pursues are met, because regulators are permeable to private interests. Regulatory capture may occur by the firms that are subject to regulation. This theory became known in the 1970s due to the work of George Stigler and economist from University of Chicago, who first defined the term (Stigler, 1971) It is an economic theory that says regulatory agencies may come to be dominated by the industries or interests they are charged with regulating. The result is that the agency, which is charged with acting in the public's interest, instead acts in ways that benefit the industry it is supposed to be regulating.( Etzioni, 2009).

In a more theoretical approach, regulatory capture occurs when groups of individuals or firms that, having an interest in the outcome of regulatory policy decisions, direct their efforts and affect their resources in seeking to achieve the desired outcomes of those policies. In this context, a more precise concept of regulatory capture, is connected to the success in influencing (capturing) legislators or regulatory agencies, so that policies and legislation preferred by regulated firms are implemented.

### **2.2.4 Public interest theory impacting the promulgation of Hedge Fund regulations**

As described above, public interest theory holds that regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market practices. According to public interest theory, Arrow (1970) put forward that the disadvantages created by unbalanced market operations, imperfect competition and

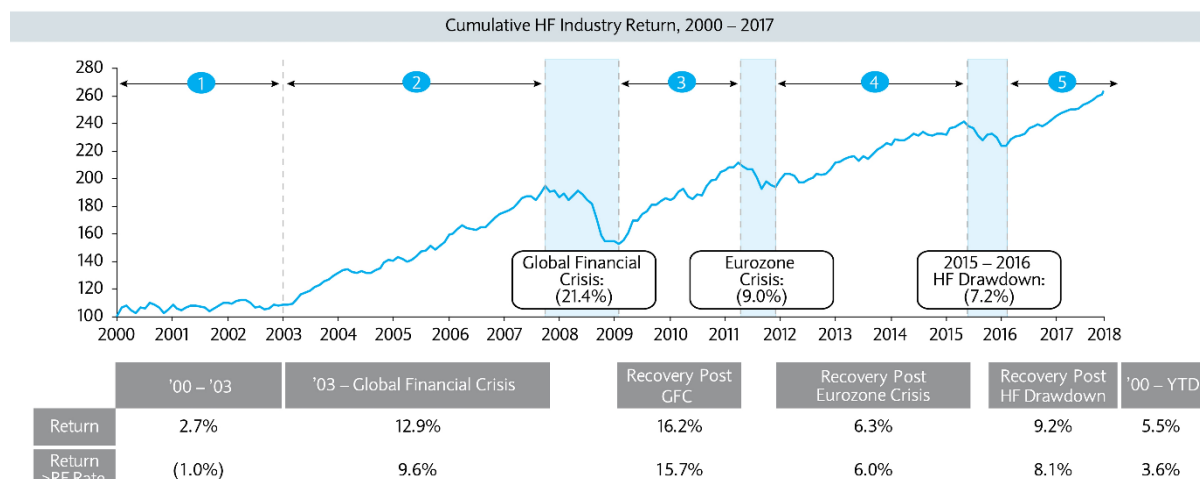
undesirable market outcomes could be overcome by government regulations. Lanerolle (2011) said that it is the public interest theories that have brought about new theories on financial regulations, and therefore the promulgations of Hedge Fund regulations is underpinned and explained by the public interest theories. Public interest theory, regulation can explain the need to prevent and or correct undesirable market results as was witnessed by the 2008 financial crisis. The regulation of the financial sector is essentially presupposed to promote economic and social development benefiting all stakeholders and that regulatory failure means that regulation fails to achieve such goals and promotes more costs than benefits on a micro and/or macro level. New theory on financial regulations illustrates the necessity for a staged approach to liberalisation, which first assesses the capacity to conduct effective prudential supervision, before attempts are made to remove protective measures (Currie, 2006). In South Africa, the recent introduction of the Twin Peaks model, the proposed consolidation of financial services acts under one umbrella legislative act is positioned to provide for a seamless environment for the financial services sector (Treasury, 2013).

### **2.3 History of Hedge Funds**

By definition, “hedge” refers to an investment strategy utilized by Alfred Winslow Jones back in 1949. Mr Jones hedged a long stock position by selling short other stocks to protect against market risk. His HF was kept outside of public scrutiny until 1966, when his success (85% better returns than his nearest rival for five years) was broken to the public, another symptomatic issue with the secrecy and information basis that surrounds the industry. To further observe the growth of the industry, post the publication, over 200 new hedge funds had been launched. However, subsequent to this rapid growth over these two years, many funds suffered significant losses during 1969 and 1973. This led to a significant loss of interest in hedge funds until around 1986 when an article in Institutional Investor documented the superior performance of Julian Roberston’s Tiger Hedge Fund, providing an annual return of 43% during the first six years of its existence.(Institutional Investor magazine, 1986) Another innovation attributed to Winslow according to (Gabelli 2000), which exists to date, is the contracting partnership structure that governs Hedge Funds operationally, being the general partnership into a limited liability partnership in order to remain privately

held as to note attract Security and Exchange Commission (SEC) rules and regulations.

The hedge fund industry has grown exponentially in popularity and has grown into a USD\$ 3 trillion industry globally (Barclays Bank, 2018; Figure 2). This growth, as well as periodic slumps over the years, has caused regulators to take note.



**Figure 2 : Global hedge fund industry outlook (Barclays bank, 2018)**

## 2.4 Definition of Hedge Funds

In arriving at an apt definition, Antia (2005) finds that the word ‘hedge’ in the name, does not necessarily use hedging to protect themselves and that a lot of hedge funds do not hedge in the strict sense of the term (Antia, 2005). As a matter of fact, there is no universally accepted definition of hedge funds. However, they have been broadly described by several authors. In a Financial Mail (2012) cover story, Cranston described them as “*private investment vehicles where the manager has a significant personal stake in the fund and enjoys high level of flexibility to employ a broad spectrum of strategies involving use of derivatives, short selling and leverage in order to enhance returns and better manage risk*”.

Cameron (2004) also emphasises that as there is no generally accepted classification standard for hedge funds, and therefore it is difficult to compare their respective performance. Another definition proposed by Caslin (2004) of a hedge fund is an investment characterised by some or all of the following features:

1. hedge fund investment vehicles may not be open to the general public;

2. the minimum investment may be very high by the standards of mutual funds;
3. there may be a general lack of transparency regarding the investment strategy;
4. long and short positions can be taken as part of the investment strategy;
5. positions may be leveraged;
6. there may be capacity constraints on the amount of money that can be managed within a hedge fund investment strategy;
7. the level of regulatory supervision of the investment vehicle may be low relative to long-only funds;
8. fees are structured at two levels, namely, an annual management fee and a performance fee; and
9. there may be a minimum investment time horizon or a rolling minimum notice period before investors can withdraw their money.

As illustrated in the survey of the literature relating to hedge funds above, there is no single universally accepted definition. Most of the literature presents broad definitions that aim to encompass critical elements of the concept. However, notwithstanding their broadness, the prescribed for definitions above attempt to encapsulate the various strategies and options accessible to hedge funds. These are arbitrage, event-driven strategies that apply shorting – short and or long positions.

## **2.5 Regulation**

Schauer (1992) posited that “*Our life plans are so often impeded by rules, large and small, that the very idea of a life plan independent of rules is scarcely imaginable.*” (Schauer 1992: 1) Like many other concepts, political or otherwise, regulation is difficult to define because it means different things to different people. The term can be used in many contexts that have many a times required clarification. Several authors have argued that the notion of regulation is itself highly contested. (Black 2002; Parker and Braithwaite 2003; Baldwin et al. 1998) They have gone on to argue that for some, regulation represents the heavy hand of authoritarian governments that constrains human liberties while others have described it as a part of the superstructure that serves the interests of dominant societal classes. It has also been described as a public good as a tool to controls profiteers. (Black, 2002)

Other conceptions have defined regulation with reference to state-made laws, while other analysts and scholars of globalization tend to point to the proliferation of regulatory institutions beyond the state (Laffont 1994). These are in the form of relationships such as civil-to-civil, civil-to-government, civil-to-business, business-to-business, and most importantly, for purposes of this research, business-to-government. For yet other, regulation is the amalgamation of all types of laws – primary, secondary, and tertiary and that for economists it is usually a strategic tool used by private and special interests. (Jarrell 1978; Priest 1993)

## **2.6 Scope of Regulation**

Apart from its definition, the scope of the regulation has also been evaluated. Acknolo (2006) suggested, in his paper on The Scope of Economic Sector Regulation, includes the following: the functional and operational activities, associated ownership, the pricing, its geographical focus and market entry. These factors tend to be used together to create a regulatory matrix. Goodspeed *et al.* (1991) stated that “*the general philosophy of the financial markets implies a tacit admission that both the regulatory authorities and the regulated parties have an interest in the institution and maintenance of an efficient and effective system of regulation*”.

They list three regulatory objectives of particular relevance:-

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

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

## **2.7 The Need to Regulate Hedge Funds**

Traditionally, hedge funds have been structured to deliberately side-step legislative structures, requirements for disclosure and other compliance requirements imposed on institutions and as such have operated within the cracks of the law (Sappideen,

2016). The aftermath of the 2008 Global Financial Crisis intensified that debate on the regulation of hedge funds. However, even before the financial crisis, authors such as to Der Hovanesian (2005) argued that a constructive aspect of an unregulated market such as hedge funds is that they are able to execute transactions efficiently and with less bureaucratic red tape that other institutions such as regulated financial institutions require. Additionally, Betsalel (2006) points out that cumbersome regulation can disadvantage and stifle this type of investing activities. Seco (2005) attributes the success of hedge funds to being their ability virtually transact on any opportunity with an investment thesis to derive substantial gains at a reduced risk or inefficiencies. After the crisis, those arguing against, arguing that unregulated hedge fund activity generates efficiency in the marketplace including securities markets by '*mitigating price downturns, bearing risks that others will not, making securities more liquid, and ferreting out inefficiencies*' (Shadab, 2007).

On the other hand, those arguing for regulation and those fearful of financial markets argued for a stratified regulatory intervention aimed at several different levels namely, the fund, the managers, the investors and intermediaries such as brokers. (Sappideen, 2016). On until recent times, hedge funds were the exclusive domain of the super wealthy (The Economist 2006). Prior to the 2008 crisis, McDowall (2006) opines to the need for increased regulations in order to make hedge funds mainstream investment vehicles. This was primarily because hedge funds were becoming accessible to the ordinary investors. Hedge funds had then created a direct link between unregulated and regulated markets raising potential policy problems especially when excessive speculation in unregulated markets impacted regulated markets (Hanlon, 2002). With the growth in Hedge Funds, the availability and accessibility of these products tended to impact traditional investment vehicles more and more.

Albeit unregulated, the hedge fund industry grew, the investor mix broadened and it impacted on regulated markets and the Global Financial crisis of 2008 occurred. This drew the attention of multilateral institutions (IMF, the Group of Twenty (G20), the Financial Stability Board, the Basel Committee on Bank Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors) and commitments were made to implement higher global financial standards to make the financial sector safer and better (National Treasury, 2013). In 2015, South Africa implemented the regulation of the Hedge Fund industry.

## 2.8 Other Currently Regulated Markets

Before, during and after the Global Financial Crisis, a number of countries around the globe conceptualised, drafted and transitioned to a regulated Hedge fund market. As described earlier, as transactions grew larger and buyout private equity and hedge fund sizes grew, some form regulation began to appear overseas as noted by Flaherty, 2006. Countries like the United States of America commenced the registration of hedge Funds as well as transitioning on February 1<sup>st</sup> 2006 (Flaherty (2006)). A summary review of important hedge fund markets globally are presented in the next section.

### 2.8.1. Hedge Fund Regulation in the United States of America

In the United States of America (USA), hedge funds, traditionally, were unregulated. This was because they usually qualified for an exemption under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisors Act of 1940. In 2004, the United States Securities and Exchange Commission (SEC), which is the regulatory body, passed the Hedge Fund Rule under the Investment Advisers Act to close the exemption. This rule effectively subjected an overwhelming majority of hedge funds to SEC registration and regulation. However, two years later, in the case of *Goldstein v. Securities Exchange Commission (2006)*, the US Court of Appeals for the District Columbia, struck down the Hedge Fund Rule citing it as "*arbitrary*". The SEC did not appeal this decision (SEC, 2006). Consequently, the current state of hedge fund regulation reverted to its prior state which exempted hedge funds from SEC registration and regulation. A year later however, a President's Working Group on Financial Markets (PWG) released a report setting out principles and guidelines designed to provide regulators with guidance in their oversight of hedge funds (PWG Report, 2007). This report concluded that "*Public policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk.*"

Soon after the PWG's release, the SEC published three new rules, namely, the Private Pooled Investment Vehicle Release; the Prohibition of Fraud by Advisers Release and the Revisions of the Limited Offering Release. This seems to suggest that the SEC has not abandoned its *pre-Goldstein* rules-based approach in regulating hedge funds.

In the mean time however, Betsalel (2006) notes that the hedge fund industry remains largely unregulated in the United States of America.

### **2.8.2. Hedge Fund Regulation in the United Kingdom**

In the United Kingdom (UK), the body responsible for the regulation of financial markets is called the Financial Services Authority (FSA). Its approach in its oversight of hedge funds, the FSA focuses on risks associated with market stability, investor protection barriers, and valuation standards (Schmidt, 2007).

According to Schmidt (2007), the FSA identifies threats to the stability of financial markets, and then allocates resources to monitoring such threats depending on their severity. It established the Centre for Hedge Fund Supervision (CHFS), which is responsible for supervising 20 of the country's largest hedge funds that can potentially have significant market impact or pose a great risk to financial markets.

The FSA in 2002, published a discussion paper (DP 16) which stated it would not prohibit the marketing of hedge fund products and services to the public as long as they abide by certain regulations (Tiffith, 2007). Among others, these were that only "*authorized persons*" who abide by the "*collective scheme requirements*" may conduct general solicitations. One of these requirements was that funds have to be authorized by the FSA and that they should report particular elements about their investment strategies. However, most funds ended up not registered for fear of their novel strategies and intellectual property falling into the public domain.

In 2005, with the growth in UK hedge funds under management as well as the increase in fraud, and the increased role of hedge funds in providing market liquidity, the FSA reviewed its hedge funds regulatory framework. It released two DPs concerning the risks and potential problems caused by hedge funds (Schmidt, 2007). The first one focused on the risks consumers are exposed to as a result of the growing "*retailization*" of hedge funds whilst the second one focused on risks and concerns related to hedge funds and how they should be addressed (FSA, 2005).

The two papers identified numerous potential key risks. Firstly, it was the concern about potential serious market disruption and erosion of consumer confidence, not only in hedge funds but also in their creditors and stakeholders, Secondly, the possibility of liquidity disruption which could adversely impact the markets. Thirdly that

there were inadequate methodologies for risk evaluation and imprudent management. Fourthly, the FSA stated that there were deficiencies in asset valuation methodologies and there was inadequate information systems that would have had significant potential for ill-informed investment decisions (FAS, 2005). After release of the DPs, the FSA then followed a consultative process with market players around the risks so identified as well as mitigation measures.

Thereafter, in 2006, the FSA provided feedback which concluded that the FSA would not institute any new regulations on hedge fund advisers unless there is a market failure requiring regulatory remedies (FSA, 2006). The feedback identified the difficulty or impossibility of adequate asset valuations in hedge funds' investments in illiquid financial instruments, including those where fund managers had conflicts of interest or have an incentive to manipulate asset valuations. It also found that the industry made use of "*side-letters which result in some, often large, investors receiving more information and preferential redemption terms compared with other investors in the same share class and who may not be aware of the existence of these side letters and therefore denied the same terms*" (FSA, 2006). The latter was found to constitute a breach of business integrity. The FSA stated that they will continue to study this situation.

### **2.8.3. Hedge Fund Regulation in Germany**

According to Schmidt (2007), Germany's regulatory approach is characterized by substantial regulatory measures that are "*diametrically opposite to the United States' approach*". He further states that while the SEC's approach is indirect regulation with a prohibition on general solicitation of investors, Germany allows public solicitation but it nevertheless heavily regulates the management of hedge funds. Therefore, while it appears that Germany's regulatory efforts seem to have had some success, its share of the global hedge fund market is relatively small therefore making the cost of regulation much lower than in other countries, such as the USA and the UK, which have relatively large shares globally.

#### **2.8.4. Hedge Fund Regulation in Japan**

Wells (2005) has described the Japanese Hedge fund as regulated by the Financial Services Agency (FSA) and “*apart from being haphazard, is not the friendliest*”. Wells further notes that establishing a local presence is both a burdensome undertaking and grossly expensive to maintain. Stakeholders that provide investment advice are required by Japan’s Investment Advisory Business Law to be registered with the FSA, Betsalel (2006). Therefore, these foreign-based advisors as registered by the FSA, by legislative requirements, are only able to advise other Japanese investment trust firms and registered advisors. An additional encumbrance identified is that foreign firms are required to register with the Discretionary Investment Advisory (DIA) which then introduces tax implications.

#### **2.9 Literature Review Conclusion**

A review of the USA, UK, Germany and Japan above indicates the diversity of approaches towards the issue of Hedge Funds regulation as well as the challenges faced by authorities resulting in continued minimal or no regulation as well as legal challenges. Gaber *et al* (2004) in commenting on the low or lack of regulation in the industry stated “*The challenge in some countries is the ease of moving the funds to greener pastures. If hedge funds are forced to come under regulation in the future, it is likely they would relocate offshore, thereby threatening an exodus of billions of dollars out of the USA and into foreign banks in tax havens*”. (Gaber *et al*, 2004) Accordingly, Beales (2006), quotes the Federal Reserve Bank of New York stating the need for “regulators needing to work more closely as the world’s financial systems become more integrated”.

## **CHAPTER 3: METHODOLOGY**

### **3.1 Introduction**

This chapter describes the procedures and methodologies that were undertaken in conducting this study whose aim was to consider Hedge Fund stakeholders' views on the effects that the transition to regulated environment has on the Hedge Fund Industry. Specifically, this chapter includes information about the research strategy, population, sample size, data collection technique, questionnaire design and development, face validity of the questionnaire, pre-test the questionnaire, pilot study, final content of the questionnaire, and analytical methods of data.

### **3.2 Research Design, Plan and Strategy**

A research design is the overall strategy that integrates the different components of a study coherently and logically to effectively respond to a research problem or aim(s). It is the protocol for the collection, measurement, and analysis of data (Dul *et al.*, 2008). To investigate the research aim, the research employed a two-fold mixed-methods approach which was a mixed methodological approach including qualitative and quantitative components.

#### **3.2.1 Qualitative Approach**

A qualitative exploratory research approach was utilised to explore the above research objectives.. One of the advantages gained from this method was that it offers itself to new areas with deficiencies in established research findings (Welman and Kruger, 2005; Manerikar and Manerikar, 2014). Exploratory Research is useful as it ensures more rigorous, more conclusive future studies and it provides greater understanding of a concept or crystallizes a problem. It is an initial research conducted to clarify and define the nature of a problem.

For purposes of the qualitative component of this study, a qualitative in-depth key-informant interview approach offers the ideal flexibility as 'variables' being the responses remain in an uncontrolled environment. It is precisely for this freedom and for the natural flow of events and discussions, with would emanate from the

perspective of select industry stakeholders, that we wish to capture. This approach is well documented in the literature (Henning, 2004). In the context of this research and against the background that stakeholders' points of view have not been identified post-regulatory implementation, it is exactly these liberties that can allow new fully formed views and information to be further explored within the interviews, which, in turn, may lead to new understandings being gained. These insights would be used to inform forthcoming interviews in order to evaluate their validity and develop further views on them. Kumar (2005), affirms the suitability of this methodology in that it allows for a flexible and open minded approach which is unstructured; with the main objective being to ascertain and further describe a variation in a phenomenon, and or event.

### **3.2.2 Quantitative Approach**

The second component of the research was a quantitative study utilising a semi-structured, electronically distributed self-administered questionnaire. The quantitative component was included in order to further investigate the qualitative themes obtained from the qualitative component discussed in sub-section 3.2.1.

## **3.3 Research Data**

### **3.3.1 Study Population**

#### **3.3.1.1 Qualitative Component**

The population of relevance for the qualitative component were the stakeholders in the hedge fund industry. Firstly therefore, it targeted Fund Managers. These are market participants in the industry, such as fund managers, institutional investors, fund traders and other financial institutions. Secondly, it sought to interview Investment Advisors who are stakeholders defined as any person or group that makes investment recommendations or conducts securities analysis in return for a fee, whether through direct management of client assets or via written publications. (CISCA Act, FSB Act) This cadre of stakeholders included include institutional investors, pension fund managers and portfolio investors. The third group the study targeted are staff at

Regulatory and/or related bodies such as Financial Services Board (FSB), the Alternative Investment Management Association (AIMA), National Treasury and Association for Savings and Investment *South Africa* (ASISA). Finally, it will also aim to include Industry Watchdogs such as analysts and/or journalists.

### **3.3.1.2 Quantitative Component**

The target study population for this component of the study were stakeholders in the Financial Markets, especially those in Investment Management and specifically, those in Hedge Funds.. Electronic mail (e-mail) contacts were obtained from online sources.

## **3.4 Sampling**

### **3.4.1 Qualitative Component**

This study used a non-probability, quota sampling method to collect data for the research. When a number of elements in a population are either unknown or not easily identifiable, or where the selection of participants is based on other considerations, one can employ non-probability approach which is useful in pilot and exploratory studies (Kumar, 2005; Welman, 2005). The study aimed to conduct in-depth interviews with a minimum of eight (8) participants in a quota sampling approach as illustrated in Table 1.

**Table 1 : Proposed pattern of in-depth interviews**

<b>Cadre</b>	<b>Number</b>
Fund Managers	2
Investment Advisors	2
Regulators	2
Industry Watchdogs	2

### **3.4.2 Quantitative Component**

Convenience sampling approach was selected for the conduct of the structured, electronically distributed, self-administered survey tool. Convenience sampling is yet another type of non-probability sampling in which respondents are sampled simply because they are convenient sources of data for the researcher (Lavrakas, 2008). In other words, they are selected because of their convenient accessibility and proximity to the researcher (Dillman *et al.*, 2014). Contact details of stakeholders involved in investment management were obtained using professional networking site [www.linkedin.com](http://www.linkedin.com). The survey method was used to collect and generate a set of responses with respect to the issues regarding regulations.

## **3.5 Data Collection**

### **3.5.1 Qualitative Component**

The primary data collection was performed using in-depth interviews. The latter are a more intimate form of data collection which enable the researcher to further explore the participants perspective on relevant topics as well as allow for deviation from the planned format. The questions in the interview guide only acted as a guide and the interview was allowed to flow unsurprisingly with follow ups on any lead up questions. This allowed for the breadth and sequence of topics to flow naturally from respondents' answers to questions opening each topic. This was central to ensuring that the self-regulatory nature of the hedge fund industry, as it existed pre-2015, could be thoroughly assessed as well as enable new insights into the experiences with the transition to regulation of the industry. Each interview was recorded in digital format and transcribed for analysis.

### **3.5.2 Quantitative Component**

The primary data collection tool was a semi-structured, electronically distributed self-administered questionnaire. The process for the design of the data collection tool is discussed in subsequent sections.

### **3.6 Interview Guide, Questionnaire Design and Development**

Identification of items for the study and preparation of the interview guide as well as the questionnaire was a crucial step for the success of the research. An in-depth interview guide was developed. Four fundamental stages were undertaken for constructing the data-collection tools namely:

1. Literature review to identify preliminary theses for discussion based on the study objectives
2. Formulation of the qualitative interview guide
3. Analysis of relevant qualitative themes from interviews
4. Formulation of quantitative data collection tool content

#### **3.6.1 Interview Guides and Questionnaire face validity**

Face validity is important to see whether an interview guide appears to be valid or not. A “common-sense” assessment, reported in literature, was used whereby the researcher distributed the first draft to two industry experts for assessment of the validity of the tool (Salkind, 2010). This resulted in some minor but important modifications to the tool. This approach was used for both the qualitative and quantitative tools.

#### **3.6.2 Interview Guides and Questionnaire Pre-testing**

Pre-testing an interview guide as well as the questionnaire was performed to ensure that the right questions were asked as well to ensure good quality data is collected. It was an important and necessary step to ensure that the study did not have any logic problems, or if the questions are too hard to be understood, if the wording of the questions is ambiguous, or if it has any response bias. Pre-testing was conducted with 2 industry experts who were not part of the main study. This approach was used for both the qualitative and quantitative tools respectively.

### **3.7 Pilot study**

After successfully pretesting the tools, a trial run on the tool was conducted. They were both piloted with an industry expert that was also not part of the main study. The data

collected were then extracted, coded and a data analytical plan developed for the main study.

### **3.8 Conducting of the interviews**

#### **3.8.1 Qualitative Interviews**

The researcher visited the study participants to conduct the interviews. The interviews followed any leads, allowing for the breadth and sequence of topics to flow naturally from respondents' answers to questions opening each topic. Each interview was recorded and transcribed for analysis.

#### **3.8.2 Quantitative Interviews**

The questionnaires were administered to the respondents through online platform Qualtrics. The quantitative component involving structured questionnaire was included to further investigate themes emanating from the qualitative interviews. A link was generated through Qualtrics© and sent to 120 potential participants/respondents via email.

### **3.9 Data Analysis**

#### **3.9.1 Qualitative Data**

Data analysis was conducted using grounded theory content analysis as reported in the literature. This involved coding, dividing text into small units and the grouping of codes into themes (Creswell, 2011; Guest, 2012). As reported in the literature, the themes then became the categories for analysis (Fereday, 2006). Thematic analysis was consequently performed through the process of coding in six phases to create established, meaningful patterns (Braun, 2006). These phases are Familiarization with data; Generating initial codes; Searching for themes among codes; reviewing themes; defining and naming themes, and conducting the analysis and producing the final report.

### **3.9.2 Quantitative Data**

The data were analysed using Qualtrics. Reliance was placed on the survey to gauge investment managers perceptions about the promulgation of new regulations for hedge Funds and their impact on the sector. A series of Likert-type questions were also included. Appropriate descriptive statistics were used to provide an analysis on the findings.

### **3.10 Research Limitations**

Firstly, the stakeholders were interviewed based on their confirmed availability and not on randomly selected. Secondly, all of the interviews were conducted physically, and therefore appreciation is given to the fact that a certain personal bias may be attributed by the manner in which the interview is conducted. The interaction quality based on a number as factors, being language barriers, articulation of thoughts and ideas; may also have had an impact. Thirdly, there may have be some bias when analysing the data. Additionally, as personal interviews tend to be lengthily, the information given could deteriorate as the interview progresses. On the other hand, due to personal time constraints of both interviewer and interviewee, certain aspects of the interviews may have been rushed through.

### **3.11 Ethical Considerations**

There was the potential of obtaining confidential information from the research process herein proposed. Consequently, relevant approval was obtained from the University of Witwatersrand Research Ethics Committee. Additionally, all interviews were conducted in a confidential manner, and written informed consent obtained from the key informants. All research undertaken here was within ethical principles and guidelines. The recordings of the interviews were saved on a secure drive to which only the researcher had access, which is also security protected. Transcripts of the interviews were also securely handled.

### **3.12 Summary**

This chapter discussed the methodology that was utilised in this research. It included information about the research plan/strategy, population, sampling, data collection technique, questionnaire design and development, face validity of the questionnaire, pre-test the questionnaire, pilot study, final content of the questionnaire, and analytical methods of data.

# CHAPTER 4: RESULTS

## 4.1 Qualitative Component - Key Informant In-depth Interviews

The previous chapter presented the methodological framework used for this research study. This chapter presents the results from the study.

### 4.1.1 Interview Respondents Statistics

As described in the methodological section, eight (8) experienced industry stakeholders were identified and interviewed. Only 8 were interviewed on account of convenience and time and resource availability. Their profiles are presented in Table 2.

**Table 2 : Interview Respondents and Statistics**

	<b>Role in Industry</b>	<b>Brief Background and Experience</b>
1	Fund Manager 1	10 years in the hedge fund industry. A principal in their current company. The latter manages approximately R35billion. The organization is classified as a hedge fund and their clients are mainly High Net Worth Individuals
2	Fund Manager 2	5 years' experience and came in at about the time the new legislation was promulgated. Employing organization manages over R50 billion in family office money, majority for foreign nationals.
3	Associate 1	5 years-experience working for a multi-strategy hedge fund, that primarily invests in the South African stock exchange.
4	Associate 2	A senior vice president of an organization that covers Fintech as well as a mix of other unlisted stocks. Generally, the organization is a hybrid being in both hedge fund and private equity.
5	Regulatory Representative 1	10 plus years' experience working as a compliance officer for a hedge fund and PE firm.
6	Regulatory Representative 2	10 plus years' experience working for one of the regulatory bodies, that oversees most FSP's and their regulatory compliance.
7	Industry Watchdog 1	10 plus years' experience as a Senior data analyst for Private Equity and Hedge Fund Industry in SA .
8	Industry Watchdog 2	10 plus years' experience in Private Equity and then later in Hedge Funds

## 4.2 Interview Respondents

Objective one was to study the impact of regulations on hedge funds so far. This question reflected on qualitative factors and dynamics before and after regulation of hedge funds in the South African economy. The major discussion points and/or questions that emerged during the research process were captured in 18 key thematic areas reported in subsequent sub-sections below.

#### **4.2.1 Observations of the hedge fund industry in South Africa and Observations on reasons that have led to its growth as reported by SAVCA in recent years.**

Generally, all the respondents acknowledged that the hedge fund industry in South Africa has exhibited positive growth during the period after regulation. Fund Manager 1 said that the growth was likely as a result of several reasons. Firstly, it was the ability for investors to diversify their portfolio and therefore allocate a bit of risk capita into this space. He went on to say that SA now has a robust financial regulatory framework that in his opinion is better than the British and United States of American frameworks were he has previously worked before settling in SA. This framework is a plus for SA but one of his concerns is it is rather too protective in nature and reduces innovation in certain parts of the country's capital markets.

The second reason for the growth Fund Manager 1 said can be attributed to very credible individuals coming into the market and driving the much-needed change and providing returns to clients above the SWIX. However he reported that most of the money sitting in this industry is international money, attracted by the nature of its regulations. These observations are consistent with those reports by Reuters (2013) where at least ten new hedge funds were launched in Switzerland in 2013 compared to none in 2012, in a boost to the country's \$24 billion industry. Fund managers had feared tighter legislation passed in 2013 would damage the hedge fund sector in Switzerland, but the new rules in fact attracted institutions previously unable to invest in such funds by giving them more protection. <sup>i</sup>

Fund Manager 2 said the SA industry is ripe for growth as there were a lot of individuals becoming millionaires that need to have their money managed. He reported seeing increasing numbers of people willing to commit R10 –R15 million into funds. He however expressed fear that SA was too small an economy for the many players coming into the market and that the JSE would not be able to accommodate all of them. He feared that if all were forced to be accommodated, it may leads to a lot of mispricing and therefore create arbitrage opportunities only for the smarter players who *“understand how to play this game”*. Additionally he was of the view that while SAVCA and RISCURA do a great job at giving insights into the industry, they did not really capture the AUM growth properly saying *“According to my team's recent estimate; a further R100 billion is playing in our market.”*

Associate 1 said he has seen and learned from his peers that Hedge Funds are an avenue that most people would like to enter and understand and that it was an arena that was *“amazingly competitive and selective and therefore as much as finance professionals have taken an interest in it”*. He noted that where he works, they continue to see a rise in AUM based on newly advised rich people who they refer to as *“new-money-high-net-worth individuals”* that are becoming aware of diversification strategies offered by Hedge Funds. He also observed that there was a lot of money sitting in SA, chasing a few credible managers and that other asset classes are quite stretched in that there are a lot of players.

Associate 2 opined that the pension funds and institutions are growing and have a small market place in SA and therefore need to go globally and look into other asset classes such as hedge funds and private equity have historically been neglected. He was of the view that the increase in allocation from regulation 28 and the CISCA laws will serve to allow for funds to flow to the SA market. He was confident that SA hedge fund businesses *“understand risk and more so understand how to price it better than other asset classes, regardless of the sector exposure of the fund.”*

Regulatory representative 1 stated that from his perspective in compliance, after promulgation of the new regulations, there was a major move to have hedge funds report like all other mutual funds in terms of the FSP and the Nominee Fund on the times regulated by FCSA. This was not as clear cut before and is an indication of growth in the industry.

Regulatory representative 2 said the hedge fund industry is highly misunderstood by regulators and stakeholders, and in most instances institutions in SA. However, with time it is becoming understood and it is becoming demystified as SA seeks to unpack the industry. There is a shift towards transparency to firms and fund managers seeking investors and the general public to understanding what it is that they do and their investment thesis and philosophy. He added that this could have been driven by the compliance and submission requirements of the investment thesis and risk policies as well as willingness by the industry to comply and adhere to the FSP regulations. He said he had noticed that *“hedge funds are not different to any other investment*

*business in that they work and invest under the same guidelines and also need to manage their risk, just like all the other fund managers that exist”.*

Industry Watchdog 1 observed that there has been an increasing transparency in the way hedge funds, put across and forward their governance processes and that they truly seek to have investors understand their investment thesis. He said they go to extra lengths to explain to their clients the investment decisions and the rationale at the time; even though they have the discretion. He reported that the industry has seen growth in the last couple of years and also the attention and awareness given to it saying. I hold a view that it is this kind of analysis, that we believe hedge funds in SA have a role to play and have strengthened the depth of financial markets. We have over the years found that this growth has led to the growth in collective scheme setup for hedge funds, where people can buy units and sell them, as they would for unit trusts. It is an advancement and hedge funds setup like this seem to be coming up and some awaiting registration.

He added that he had seen other funds, institutional and family offices trying to understand and conducting due diligence on some of these fund managers, and more often than not, calling the services of accountants, legal practitioners and other services to better understand which money manager would be best placed to service their investment needs as part of their portfolio. A few years, back this would have not happened. There was no interest in allocating money towards hedge funds, these assets held at the time were from foreign capital and family offices and rich bankers whom were managing their own funds and had understood the market. We are seeing now, people whom do not have a true technical understanding of the industry; but seeing the numbers and the returns and trying to enhance their portfolio's.

The hedge fund industry, just like the PE industry for the earlier years was only understood by the savvy and this was by and large the mystery created around the funds and the structures. However, it is quite an easy model to understand than a banking model. So it is has always bewildered me why it was such that this industry, only “belonged” to a few savvy financially literate people whom over the years had adopted such.

Alas, I think the opening up of the industry has been a big drive in South Africa. I opine this is partly because of the lack of capital growth in commitments in this space and the limited amount of investor base that sought to create the environment for them wanting to grow the industry through organic growth; crystalized by hedge fund specific legislation.

Further to this, there has been a level of effort by policy makers, industry stakeholders to come together (being SARB, Treasury, SARS, FSCA and all other regulatory bodies) seeking to better understand the industry and its value add; and more importantly; I think they do appreciate the role of hedge funds in the industry more so within the financial markets (in the listed space); in helping to provide for the ever elusive efficient market hypothesis.

#### **4.2.2 Opinion on whether the Industry was now better regulated than before**

The respondents provided slightly different opinions and/or observations with regards to regulation post-promulgation. Some of the respondents were of the opinion that the industry was now much better regulated and was transparent with established robust financial systems in relation to hedge funds. However, this group also cautioned that the new regulations seemed slightly protectionist in nature with reduced room to manoeuvre. On the other hand, others maintained that , nothing much has changed and that they remain as regulated as previously. They were of the view that Cisca only sought out to have the hedge fund industry registered with the regulator so as to provide oversight and that this oversight then levels the playing field in that it allows one to know who their competitors are and who the fund managers are.

Fund Manager 1 reported that he is happy that the industry has been regulated, because that is how it should be adding that *“this has been one of the overriding principles that continues to make it an exciting place to work because right from the onset, we are geared to take risks with capital which would not necessarily be taken”*.

Fund manager 2 said *“Yes, there are now enough checks and balances; sufficiently so in the system to allow for the hedge fund industry to thrive. Ideally this industry also should serve to attract upstanding finance professionals whom have an acute*

*understanding of knowing that they manage other people's money".* He added that although there was some kind of oversight previously, he did not think it was sufficient enough before the new CISCA laws were promulgated. The situation now is such that there is awareness around what fund managers can be entrusted with and the investor knows from the onset that they are giving the fund manager full discretionary rights. Additionally that they are aware that their risk matrix matches the risk being advanced for by the mandate they are signing.

Associate 1 however was of the view that with CISCA, nothing much has changed and that they remain as regulated as previously. He said "*CISCA only sought out to have the hedge fund industry registered with the regulator so as to provide oversight" and that this oversight then levels the playing field in that it allows one to know who their competitors are and who the fund managers were.*" In his view, the other minor changes were essentially CISCA's requirement to have a separation between the fund manager and the nominee vehicle that owns the assets as well as to put further regulations on how the fund manager must be capitalized in order to make sure that they are liquid.

Associate 2 said "*Perhaps it being well regulated, but the regulator has simply placed more emphasis on compliance in the basic tenants such as registration, appropriately trained personnel that continuously develop themselves and also on the compliance with all the reporting and management of conflict of interest and personal trading accounts*".

Regulatory representative 1 said the industry is "*absolutely being well regulated because we have continuously sought to develop a robust financial system that would be able to sustain the economy and help it build towards a better life for everyone*". He thought this has fitted well with the new regulations but indicated that SA has been slightly protectionist in nature which has led to a few countries facing difficulty in manoeuvring around some of the legislative pieces. He was however confident that the policy makers and government have continued to assist us in navigating the murky financial history SA comes from because Treasury and SARB continue to play a critical role.

He added that the government is in no way trying to limit and/or restrict the trade and business; but to simply seek that trade in HFs be legal and be done in a legal manner and therefore all other governance decisions are within the prescripts of the fund managers. He stated that as compliance officers, they continuously progress and hold stakeholder engagements to assess the impact of these policies and seek to understand, whether the specific piece of legislation has influenced behavior positively as was intended. He said, “for the most part and that is the benefit of having a robust financial services regulatory bodies and state organs that want to assist”.

Regulatory representative number 2 said SA has a lot of structural issues and there is over reliance on government and policy to drive the change and implement things. He argued that SA is a relatively young country and economy that is still at developmental by a lot of measures and it is necessary to regulate as tightly as possible. He however noted that as it matures, it is worth putting certain relaxations to continuously aid economic growth.

Respondent number 7 who works for an industry watchdog said that there has always been some level of oversight only perhaps not enough. Industry watchdog respondent number two also agreed that the industry fell under discretionary fund managers for a while and has always had some underpinning legislation that guided its compliance. She added that the recent developments are just “*a specific and intentional inclusion now to write a legislative framework for it alone, however, the financial system, overarching is regulated.*”

#### **4.2.3 Awareness of the regulatory requirements Centered around the hedge Fund industry, and what differentiated it from other mutual funds**

Generally, all the respondents said they were already aware of the regulatory requirements around HFs and how they are different from other mutual funds. Fund Manager number 1 said “*yes, funny enough besides the nuances of how we can invest and making it clear that there is pure investment risk for the investor; which the manager takes no liability to. It has the same processes and these processes have always allowed us to make sure we do not engage and or take money of illicit areas*”. In agreeing with him, Fund manager number 2 said while HFs may be seen as obscure

and misunderstood, they are no different from other asset classes that have their own unique reporting requirements.

Associate respondent 1 said he knew all about the regulatory requirements of HFs and emphasized that it is important that the FSCA appreciates that they can be a risky investment asset class for investors and therefore requires the submission of mandates and investment thesis and also requires higher capital adequacy ratios. This last point is telling of a sense that policy makers and regulators are aware of the premised risk that exists and want consumers to be aware and more importantly, they want to understand the extent of the risk being taken by the fund managers.

The second regulatory representative said he was aware of the new regulations and that the difference really came in, from the form of disclosure requirements to the public and that besides this, that an investor can choose which investments. Generally he was of the view that the regulators intended to strengthen their view of the hedge fund industry. Both industry watchdogs were also in agreement with this with watchdog respondent number 1 saying *“I think what perhaps differentiated them; is the protection of consumers other mutual funds always offered and the layer of regulations that served to underpin those operations and the compliance requirements. I think what is happening is that FSCA and other stakeholders want to have uniform standards across the FSP and different product lines. And it is worth mentioning that this approach, has since garnered a lot of interest from pension fund trustees, as we saw when this kind of approach was given to private equity fund manager FSP’s many years ago”*.

#### **4.2.4 If SAs financial services sector is well regulated, what leads you to this assessment or observation**

All the respondents except Associate respondent two and Regulatory respondent 1 agreed that the SA financial services is well regulated. Fund manager number 1 said *““Going back to what I previously said earlier. It is a regulatory environment that is founded on the right principles and has the guidelines that assist in making our capital markets attractive to a lot of people outside South Africa. However, I caution against it becoming too protectionist in nature and therefore restrictive for transacting.”*

The second fund manager respondent was however very concerned that the regulations were probably quite stringent. He added that *“looking back to what*

*happened in 2008, we were protected and insulated primarily due to the regulations at the time. Perhaps we didn't aid in economic growth due to those restrictions, but further we didn't bust as well."* He added that what leads him to this observation was that SA survived the 2008 credit crisis and that overall, the system is robust, the markets are robust and the monetary policy equally so provides for economic support at times when needed.

Agreeing to the position given by the other respondents, regulatory respondent number 2 said *"Yes, we are. In fact, we continuously monitor the negative and positive impact these regulations have had though tricky to do so. We have seen a lot of good coming out of them than bad. From guided investment decisions that are not as risk loving, which meant the financial crisis didn't impact us much. The capital flight restrictions and other mechanisms that are supportive of growth have impacted well. Our credit lending institutions, the regulation of banks is tight and SARB continuously to play an important role, towards with treasury function"*.

Both industry watchdogs then added that the new regulations are *"one of our pride and joy and we should celebrate them as a country, we are amongst the best, on a more integrated system. And that is the beauty of our financial system; it is integrated in accounting for flows; but disconnected in making sure we do not have that much systemic risk to each other"*.

Additionally, the second watchdog respondent went on to say *"yes, without a doubt, we have a more robust system that though relies on multiply parties to function in order to work"*. He added that there is a seamless talking of pieces of legislation that talk to one another, which you can easily see that stakeholders came together to truly understand how to build the best financial services system that could be able to function to bolster the economy. He said one can assess this three-fold as follows:

- Firstly, looking at the number of amendments that occur in SA bills, that are trying to keep abreast with financial innovation. The SARB and treasury now wanting to understand blockchain and further wanting to figure out how best to implement it and understand it.

- Secondly, the consumers act, which has flown through to the credit act, insurance act, FAIS act and all other acts that simply call for continued consistent applications of the specific codes as prescribed to the benefit of the public.
- Thirdly, the mere fact that SA has less transgressions in many of the financial services processes, and the Ombudsman can serve as these watch dogs for consumers; means *“we do pride ourselves in making sure our regulatory environment is progressive and fair, according to the prescripts of the constitution and failing that; there are bodies which are effective in assisting one to make sure they can be better served. I think this is one of our pride”*.

#### **4.2.5 Opinion on the need to regulate Hedge Fund industry**

None of the respondents disputed the need to regulate the industry. However, they were generally of the view that for the moment, we are regulated enough and the FSCA has a view on the types of risk being taken and advisors are explicit to clients and sign on to the very same things that all other collective investment scheme financial service providers sign on to. Investors understand the risk and their legal stand point and those that invest in hedge funds, have a level of sophistication. Regulatory respondent number 1 added that *“from my perspective, I think the industry should appreciate the compliance aspect of it. And right now, they do it as a by the way thing and its not to necessarily appreciate the importance of it and the confidence it gives to our markets.”*

#### **4.2.6 Opinion on whether the hedge fund industry was actually always regulated**

The respondents all reported that all financial services provider in South Africa is regulated to a degree. It is in interpreting whether those regulations are perfectly suited to the fundamental aims of the industry. I hold a view that hedge funds by their very nature thrive due to a minimal regulatory environment in terms of how they operate and their transparency requirements; which allows for money to be properly allocated.

Regulatory respondent 2 however said *“even though HFs appeared to not be really regulated, I think we monitored them from afar but not as closely as their counterparts such as the banks. We needed to understand their impact. However, this was quite difficult considering how they are rather private in their affairs and reporting”*. He added that after promulgation, the FAIS would possibly start doing good work in this regard

as the nominee companies and the fund managers respectively now must submit their AFS's.

#### **4.2.7 Awareness of Intention of CISCA and what is has legislated**

All the respondents were aware of the introduction of CISCA and believe it will drive awareness to the industry and give the big institutional players comfort to drive their funds and allocate to HFs. While there is an allocation requirement by Reg2 8, the pension funds and/or big collective scheme do not allocate funds to the hedge fund industry; primarily because it is still not seen has a transparent asset class in how they arrive to their investment decisions and guidelines. However, the HFs are making sure that the market place understands that this environment didn't have properly structured investment juristic person. And it seeks to formalize the setup structures, so it is easier to regulate and monitor for the regulator. In this regard, regulator respondent number two said *"Yes, it is a start to monitor compliance within the industry and I think it's a step in the right direction and hopefully we get a better understanding of the environment within the next few years, which could allow policy makers to better aid the industry. You see there a positive to policies and legislations, that I think in most cases truly seek to benefit the industry and empower it."*

#### **4.2.8 View on the Aims of CISCA in the hedge fund industry**

The respondents generally all understood that CISCA seeks to formalize certain operating vehicles that the South African Legislative Framework understands. Being a Manager, and appoint competent people with the necessary skills to safe guard assets. It further makes sure that people understand the risks inherent in the businesses. One respondent in fact said *"In point form. I would say:*

- *Make sure the regulator can track the activities by formalizing the setup structures*
- *Make investors comfortable that the people adhere to the FSB fit and proper requirements*
- *Make treasury be able to understand the flows and money being managed*
- *Put a certain level of layers that make it possible to audit these firms, and their investment decisions and processes*

- *And that the regulator now knows the kind of mandate you are contracted your investors to.”*

Another respondent said the aims of CISCAs were firstly to understand the industry and that it may have previously been frustrating for policy makers and regulators to not be able to measure the impact of the industry, simply based on its secrecy and how it operates. He then said secondly, CISCAs aim to “*count as to how many managers they are out there. I guess it wants to have everyone registered. - My view is that they hope to understand the industry much better and not be in the end of the line and just be like consumers whom have no true understanding.*”

#### **4.2.9 View on Whether CISCAs has achieved its Objectives in the Industry**

All eight respondents said that CISCAs have achieved what they set out to do. They were however concerned that some investors who preferred anonymity may leave the country for others where there are no requirements for disclosures.

Fund manager respondent number 1 said *he thinks while it did cause a lot of confusion in the industry, the rules were principled based and not to threaten the fundamental operating philosophies of the industry.* He said “*I think that is still intact and people are entrenched in understanding the operating model. What CISCAs did was to strengthen that for the investors to understand and have reliance that it is being adhered to*”.

Fund manager respondent number 2 said “*I think so. It has had all managers whom want to remain legal registering. Now we have an idea as to how many players there are and where they are located. Secondly, it has created a database of monitoring the activities of these companies and I think for your study to be enhanced 10 years from now, you might want to look into how these have evolved*”. However he further added that there are areas where it has not assisted the industry in that all the players now know each other. He said “*this industry has investors whom have always preferred their money to be held in trust by someone not known to everyone and invested on their behalf and not part of a collective scheme, in my view making these declarations where we all start getting a sense of whose managing whose money has seen ultra-rich investors who want privacy exiting the country for other havens where their money need not be disclosed under these investment decisions.*”

Respondent number 3 said CISCA was aimed at understanding the hedge fund community by the regulators and policy makers. He is however of the view that it probably *“put a dent into how people understand us, and now more so as a riskier proposition especially due to the put forward statement that we are quite risky as an investment class”*. Associate number two said CISCA got all the managers to want to adhere with the status.

Regulatory respondent number 2 said *“yes, it has started to see a lot of fund managers, wanting to comply and I think it has fundamentally shifted the mindset of the industry as a whole in that there is an interest in their activities by the policy makers, but not as a deterrent; but because I think they are slowly appreciating their impact in the financial markets and their place in asset allocation for the South African asset managers, as they money expands”*.

Both industry watchdog respondents said CISCA has led to an increased sense of governance being put ahead by an industry that is rather hidden and has a lot of myths created around it. It has also led to myths being set aside for the market and clarity being achieved. There were myths around there not being regulations the fee structure not being understood. They also reported that CISCA regulated what was already in existence essentially and it was for this reason that a lot of hedge funds were able to immediately register accordingly.

#### **4.2.10 Observable factors that about how new regulations have affected the industry**

Respondent fund manager number 1 agreed that there were obvious observable factors that had affected the industry. He reported that *“for us it has been the amount of explanations we have had to give investors on how it serves to safe guard their assets to a degree and give credence to the investment philosophies as this is supposed to be submitted. We have had to reprint our advertising material. We have also found that we are doing a lot more road shows to convince people to allocate funds into the industry”*. He added that there is a perception that the legislative piece will make it difficult for HFs to operate and they are choosing to go abroad to other markets. He observed that while SAVCA have recently reported a fall in AUM, in his business, fortunately we has not been a decrease in AUM.

Fund manager 2 said there were observable factors such as firstly, the large number of HFs that immediately sought to comply which included over 150 hedge fund managers was indicative of the intention to make sure the market is robustly represented. Secondly, there was AUM growth in the collective schemes where a lot of wealthy individuals were putting in bite size chunks of their money with different asset managers and creating a fund of funds strategy. Thirdly, he said he had seen institutional investors start allocating a bit of their allocation under Regulation 28 to the hedge funds. This he attributed to the credence given to those that comply with FSCA and this is telling of the advancements in this area. He observed that regulation has brought the HF industry into the forefront where it is pitched alongside private equity and other traditional collective schemes, being unit trusts.

Regulatory respondent number one said “*a key observation has been on compliance*”. He said there are a lot of inquiries by firms and associated bodies to understand how they need to comply. His compliance colleagues who are independent have been getting work to assist these funds and also there has been an increase of training firms that are specially focusing on offering FAIS AND FICA and well as Key individual and Representative training for the hedge fund industry. Regulatory respondent number 2 noted that there have been a lot on inquires being about legal opinions from law firms trying to understand and guide fund managers on what it means for their operations. He reported the key observations through:

- Willingness of industry parties to continue in the game
- New entrants (shows that it didn't really deter the industry)
- Steady growth in the AUM (shows an interest by investors and qualified investors in trying to put money into the industry)
- The awareness and surveys conducted by Novare and SAVCA, dispelling the myths that exist around the industry has done well to bring it to the forefront on investing. I've noticed that more and more people are talking about the industry and trying to understand it
- The retail side of it has opened up doors to the average investor.

He further said “*we do have savvy investors whom are simply just not liquid and don't have the R1million that was usually the required amount and now you can get products*

*which offer R50k, R40K lump sums and / or monthly debit orders at a minimum of R1k; and these I have seen. It should allow for more entrants and demand for the product. It's a good space for the industry as a whole".*

#### **4.2.11 Opinion on Whether Regulation has brought confidence to the industry, locally and internationally**

Locally, all the respondents agreed that the CISCA has brought confidence. However, there were concerns about the international perspective. Respondent number one said locally, it has allowed for bigger institutions, being pension funds and collective schemes, to consider the hedge fund as an avenue to allow for their asset allocation. However, he said *"internationally, I do not think so. It is rather problematic to have them have a universe where fund managers can allocate this risk capital and they have a perception that this place is not well equipped to provide them the return they want. And this is problematic to the market; because reliance comes from dollar funds and this limits us. And we have spent time running around trying to understand this bit and how to have investors abroad see us as an avenue."*

Fund manager 2 also agreed stating *"Locally, yes, absolutely. The simplest way to put it, is that an investor asks if you are registered with the FCSA and if you are they are willing to speak to you. There is more inward enquiries from institutions on their fund of funds strategy allocation. This is a positive. Wealthy individuals are not necessarily holding cash anymore in fixed secured products; but allocating a bit of it to hedge funds. Reporting by SAVCA paints a confidence increase as well"*. However, when asked about whether CISCA had brought confidence internationally, he was also of the opinion that it is "still murky". He added that SA was quite small in terms of the market size and the strength of the rand wasn't very helpful. He found that there were hedge funds that had concerns about the SA currency and stock market whilst others registered in the country only for compliance with legislation.

Associate 1 was of the opinion that the international arena was still too advanced for SA and there was a lot more capital allocators with less restrictions to money flows internationally. Associate 2 was of the view that internationally, capital had given a pause to allocating more for SA, until they truly understand the implications of the new regulations and consequently, offshore money has been on a decrease. He was

however of the opinion that local money was on the increase. Regulatory respondent number 1 stated that generally, in terms of assuring other stakeholders of the reportable increase in compliance, he was of the view that the regulators were gaining confidence in the sector and also understanding it more with its nuances.

The responses from the industry watchdog participants was also positive locally. Watchdog respondent 1 reported that surveys, growth and interest in the market by all industry stakeholders are positively aligned to try and understand how and what is the cause of these influences in the industry. Furthermore, the hedge fund industry itself is opening up to wanting to be known and understood by the market. They are becoming vocal proponents of change and governance in the stock markets. We have seen value capital partners, at times playing these roles and they are classified, well at least the former as hedge funds as per their registration with the FSCA. Internationally, he as of the opinion that *“they believe South Africa remains an open market. The inflows and interest I think is fundamentally just based on the yield; which is currently not as apparent in the country.”*

#### **4.2.12 Opinion on Whether Legislation Will serve to advance the industry**

All the respondents were of the opinion that the legislation would serve to advance the industry but that this would not happen overnight and would take time. Additionally they all agreed that what it can achieve locally was different to internationally. Fund manager number 2 said he had seen the legislation already give credence to the industry. It had allowed for other capital market players to pay attention to SAs movements and also how it executes on certain transactions more especially how structured solutions and investment decisions on the bond market. He added that *“We chase yields and more so I think we have the ability to even make sure these yields are sustainable. We aren’t simply taking bets anymore that are protected by fancy instruments. We are intentionally making investment decisions that would be made even by a typical fund manager. We just know when to truly enter and exist.”*

Regulatory respondent number 1 said it was good to see all FSP’s being aligned so similar reporting frameworks which allows for critical oversight. Regulator number 2 added that the piece of legislation was well received, which truly means it was understood for truly what it means and what it intends to actually do and achieve.

#### **4.2.13 Has Promulgated Legislation Enhanced competition**

All the respondents agreed that the transparency brought on by the legislation has increased the competition in the SA market. Fund manager number 1 captured the sentiments of all the participants in saying *“The transparency and in us knowing whose a registered Hedge Fund and also SAVCA helping with the data. We have found that there is an increased number of entrants into the market. This has come with a lot of competitive for the already limited funds that get allocated to the industry. I am of a view that it will slowly lead to a saturation. There is over 200 registered hedge funds, or something to that effect. So it is quite a few of us; whom are running family offices and or managing a large part of people’s life earnings which offer a variety of things. A better team, brand of individuals and a track record of outperforming your benchmarks”*.

#### **4.2.14 Has Promulgated Legislation Led to More innovative initiatives that have translated to returns**

The respondents were all mainly of the opinion that the legislation will settle down and enhance innovation which will in turn translate into returns. Fund manager number 2 said *“ I think the legislation put in the building blocks to assess how we are structurally able to operate and that others understand our structural organogram. It has not impacted in how we do it. And due to transparency, and increased competition and awareness. We believe this will drive innovation and bring forward creative investment decisions that will deliver on great risk adjusted returns for our investors”*. Adding to this, Associate respondent number 2 said it has most probably led to HFs now having to be slightly more innovative in that there is a level of transparency. *”We now know who the players are, and therefore can look out for them in the market”*. He also said it is often not hard to understand the investment thesis of certain funds after a while and therefore one can understand the value add they were giving to clients. He concluded by saying, regardless, the mandate of HFs was to outperform the benchmark and more so make sure it can be maintained.

Regulatory respondent number 2 added to this conversation by saying innovation in the financial industry is interesting from a regulators perspective as *“we are cautious not to even try to stifle it in anyway. All we try to balance is that it be legally right and further also that it is within the ambit of all the observable laws.”*

Industry watchdog respondent number 1 in agreeing to this said a good measure tends to be the performance as well as the commitments given to the funds which is indicated by AUM growth and this has seen a sustained positive tick and upwards over the years even post CISCA. He added that *“For the most part, I can say that the legislation didn’t stifle any innovation that was within the industry and I think it better serves to have us understand now how these firms continue to understand risk and price it accordingly in their investment decisions.”*

Industry watchdog respondent number 2 said if competition has enhanced, it should follow that the new entrants would bring with them some form of innovation. He added that *“To be honest, I think we will see a lot of this coming from the retail market side of the business. These guys will offer competitive fees and artificial intelligence capabilities as well as other cross functional investment products that link to other offerings and you see it with multi-managers such as Novare”.*

#### **4.2.15 Has Promulgated Legislation Brought about an influx of educated people to open up more hedge fund businesses and offering alternatives**

Generally all the respondents said that it had brought in an influx of educated people and has also motivated those that were already in the industry. Fund manager number 1 said it has brought a few smart guys into the industry. He said this industry needs hard workers and people who know and deeply understand investments and finance from a fundamental basis and with well-reasoned investment ideas or else it will not work out in the long run. He reported having seen different people come and go and find this space rather aggressive and extremely competitive. One of the reasons is because within SA they have a restricted mandate.

Fund manager number said *“It has allowed for people such as myself to know that you can be deemed to be credible now and there is a measure of how this is measured against your peers and against legislative paper”.* Associate number 1 said he had seen an influx of Chartered Financial Accountants, Chartered Accountant and colleagues with Masters of Business Administration. He was sure that it is an industry that was always going to attract top talent especially because it places one at the forefront of corporate finance innovation and how to understand value and more so how best to derive it in order to see the mispricing. He added that *“Our models are*

*exciting and this is what keeps me going, it is an ever changing dynamic. For example, the topical Steinoff. We had a model that had such permutations, but no one bothered to take it up. It needs a little extra then just brains to push for your thoughts in this industry. Because nearly everyone agrees on and works off the same formulae with more or less the same facts”.*

Both industry Watchdog respondents said that most of the individuals heading up these funds are highly educated ranging from MBA’s, CFA’s and Phd level individuals. He said this serves to motivate the younger crowd and SA has seen an increased number of CFA registrations in SA. He added that *“It is such a great thing to know that the industry is filled with incredibly smart individuals. What is however critical is to understand their integrity and I think the FSCA tries to do a bit in this regard.”*

Industry watchdog respondent number two added that *“This has always been the space for the top elite MBA’s, CFA’s and CA’s and surprisingly and of late engineers and mathematicians are making changes into this field and I guess finance is mathematics at the end of it and the logic and rationale to it should appeal to such advanced thinkers; so it is of no doubt in my mind that it will continue to draw them in. Further to this, I think it will successfully bring about a change in the Fintech space. I think the added on advantage by hedge funds, is that they position themselves as people who understand risk and people whom do so, can only do so, if they can swallow nearly all the information available in the market and provide for some predictive analysis to it”.*

Recruiting the right staff is a vital characteristic for any hedge fund and some managers admit to putting job candidates through up to 10 stages of interviews. Once on board, the challenge then lies in retaining the right people as low employee turnover speaks about the stability of the manager’s operations. While employee turnover can play a key role in investor confidence, its impact will depend on the seniority or specific expertise held by a given individual, and in some cases a degree of turnover can be seen as helpful in maintaining the high performance of an investment team (Accountancy in SA, 2017).<sup>ii</sup>

#### **4.2.16 Has Promulgation Brought Awareness to consumers within South Africa and or globally**

All the respondents reported that since the promulgation, there has been increased awareness amongst consumers in SA as well as globally. This awareness includes the benefits of the Cisca legislation. Fund manager respondent 1 yes it has brought awareness around issues of working within the framework that the FSB and National Treasury has put together. He added that *“It is legislation which shielded us from taking risks that would have added to the 2008 crisis. My view, is that it continues to drive accountability in these investments that we make. Though the discretion is there and we can take risks; its good to know that you have to explain the rationale as to why a certain level of risk was taken and perhaps best it was taken to accommodate these elements that have led to withholding and not sharing even the investment mandate and therefore managers going bust”*.

However, Associate respondent number 1 had a different opinion said it had not really increased awareness among all consumers. His response was *“Not really, the common South African, still has no idea what it is we do. If we classify consumers as the typical clients of hedge funds, I can safely say these category of people or companies have always had an acute understanding of what we do.”*

However, Regulatory respondent number 2 answered in the negative stating *“I would say no. The average south African has no idea about this sector and when I say average; I mean majority of South Africa’s. About 99% of south africa’s would not have any exposure to just the listed environment; if it wasn’t for their pension funds, uif and or some form of contribution they make. That should tell you”*.

Both industry watchdog respondents were cautious and said although there were indications that consumers were becoming increasingly aware, it is not as much as they would have hoped. Watchdog respondent number 2 said *“But I think the fact that now it is open to everyone means they can considerably consider it as an investment avenue. However, South African investors especially in the Retail side are only aware of the big players, being old mutual, Sanlam; those guys and it is hard to convince and average citizen that you can get better returns from a firm they have never heard off.”*

#### **4.2.17 Demand by consumers of Hedge funds as an alternative in their investment objectives post- promulgation of the law**

Generally, the respondents reported that there is an increasing number of enquiries, however these seem not to have translated into any sizeable market shift. Fund manager number 1 expressed concern that to a point, the CISCA has regressed in a sense as the legislative pieces put emphasis on the risk and the potential to lose ones capital and more, which in most instances is not true considering the level of sophistication the South African funds have and also the operating environment and size of the market.

Fund manager two added to the conversation by saying *“in the collective schemes offering, we have seen an influx. So yes we have seen an increase and essentially this is no different to a unit trust and the quantum needed is just higher and therefore you sign the adherence letters and that you understand the risk you undertake and with these mandates in place. They are still seeing a lot of wealth and newly wealthy individuals doing just that”*. However, Associate respondent number 2 said she was not particularly sure. She stated *“What I can say I have observed is that there is a growing need to understand how industry by professionals and more particularly the trustees of pension funds. That can only be a positive in my books. But I can only provide you with better numbers on growth and such if you so desire from our research desk.”*

While both regulatory representatives had no comment referring it to industry players, industry watchdog respondent 1 said they have observed from surveys a renewed need to understand the market and to consult on their benefits and what it means for their portfolio. His experience is that most institutional investors and/or the single investors tend to look for a fit in investment and management thinking as their top priority. Industry watchdog 1 then said *“So we have had due diligence requests, where we needed to truly understand the key personnel of the funds and their philosophies”*.

On the other hand, industry watchdog respondent 2 said she did not think there was an increased demand by consumers of Hedge funds as an alternative in their investment objectives since the promulgation of the law. Her reason was that it is because of the saving culture in SA. She said *“SA has a saving culture and not*

*necessarily that of an investing culture yielding returns. Most consumers in SA are alright with getting their capital back and its why in SA, banks make tons of money due by in large to the not so sophisticated market of consumers. And I mean even in higher LSM's (doctors, even CA's whom save with banks and not even an investment house and or unit trust of some sort); considering the market now; I guess there is an argument for it; but you get what I'm trying to say. The culture here is of preserving money and not taking risk capital and making it work and that is something that continues to be an issue."*

### 4.3 Survey

The results provide some perspective on the findings of this work. This section will provide a detailed explanation of the resulting information collected from the survey through the data collection instrument and method used in this study.

#### 4.3.1 Demographic profile of Respondents

##### 4.3.1.1 Gender

The questionnaire was distributed to 120 potential participants. 103 (86% response rate) participants responded giving a response rate of 64% (66) were male while 35.9% (37) were female. (Table 3)

**Table 3 : Gender of participants**

#	Answer	%	Count
1	Male	64.08%	66
2	Female	35.92%	37
	Total	100%	103

##### 4.3.1.2 Age Profile

The age of the respondents was divided into 4 categories. Bracket age group 18 – 30 constituted 22.3% (23), 31 – 40 constituted 62.14% (64), 41 – 50 constituted 8.74% (9) and 50+ constituted 6.8% (7) . The majority of the participants were in the age group between 31 to 40 years of age. Studies suggest that the most productive age in a human beings life cycle peaks in the 30s (Grund, 2005; Hægeland and Klette 1999). This corroborates the finding of the qualitative component of the study in that this industry is attracting young talent at the peak of their productivity (Table 4).

**Table 4 : Age Profile of Respondents**

#	Answer	%	Count
1	18-30	22.33%	23
2	31-40	62.14%	64
3	41-50	8.74%	9
4	50+	6.80%	7
	Total	100%	103

**4.3.1.3 Professional Profile of Respondents**

The profile of the respondents have various interests in the hedge fund industry and range from professionals in the Hedge fund industry (65.05%,n= 67), regulators (10.68%, n=11) and investors (10.68%, n=11). There were also observers with a keen interest to understand the Hedge Fund Industry (3.88%, n=4) and reporter, researchers (9.71%, 10). Although the study aimed to get respondents being all professionals in the industry, at least all respondents were knowledgeable in the area. (Table 5) What was interesting was that close to 24% of the respondents were something other than professionals in the industry or regulator is an indication that the industry is beginning to attract interest. These findings support the vision of the SA treasury policy on a safer financial sector to serve South Africa better with regards to encouraging citizens participation with confidence in financial markets through regulatory changes (National Treasury, 2011). Additionally, investment in hedge funds is becoming more attractive investment avenue for sophisticated investors, high net worth individuals (HNI) or families and big institutions (Baser et al, 2012)..

**Table 5 : Professional Profile**

#	Answer	%	Count
1	As a Professional in the Hedge Fund Industry	65.05%	67
2	As a Regulator in the Hedge Fund Industry	10.68%	11
3	As an Investor in the Hedge Fund Industry	10.68%	11
4	As an observer with a keen interest to understand the Hedge Fund Industry	3.88%	4

5	As a Reporter, Researcher & or Industry Expert in the Hedge Fund Industry	9.71%	10
	Total	100%	103

<b>Table 6 : Likert Responses to Survey</b>				
#	Question	Agree	Neutral	Disagree
1	Regulations can play a meaningful role in the Hedge Fund Industry	99%	1%	0%
<p>The majority (99%) responded that regulations play a major role in HF industry. These findings are consistent with the literature in that greater regulation can attract investment away from other, more regulated and conservative sectors. Studies have indicated the need to increase the regulatory requirements for the hedge fund industry so that pension fund and retail investors apportion more of their asset allocation to this sector (McDowall, 2006).</p>				
2	Hedge Funds have had some form of regulations in South Africa as from the very beginning	43%	0%	57%
<p>While the majority (57%) were in disagreement that there was some form of regulation before 2015, SA hedge funds were loosely regulated under the Financial Advisory and Intermediary Services Act (FAIS) since October 2007 under a separate license category, Category IIA – Hedge Fund for Financial Services Providers (CAT IIA for FSPs) discretionary asset managers (unit trust asset managers)(Financial Services Board Act, 1990).</p>				
3	The Regulations before Cisca were sufficient for the Hedge Fund Industry	27%	1%	72%
<p>72 % of the respondents said regulations before Cisca Act were insufficient. While some kind of regulation as described above existed, it was not sufficient to provide an adequate safety net for investors and/or recourse to the law in case of a breach. In general, many investors possibly stayed away from the unregulated SA market as there were no procedures in place to ensure that their funds would be properly managed and that they would possibly have no recourse in case of their investments being mismanaged. The 1<sup>st</sup> April 2015 implementation of regulation through the Cisca was therefore a welcome development.</p>				
4	Regulations can serve to drive innovation and financial inclusion in the Hedge Fund Industry	90%	4%	6%
<p>That 90% of the respondents agree that regulation can drive innovation is in agreement with opinions in the literature. Wintermeyer a contributor to the Forbes Daily (2018) stated that regulatory innovation can drive better financial services for consumers. This is applicable in the context of HFs. However, researchers say that the regulations should in themselves also be aimed at increasing competition and openness in the financial services industry and should encourage industry players to utilise technology and to collaborate with new players to innovate and improve offerings (Capgemini, 2018)</p>				

5	CISCA took a measured approach to undertaking the process of regulating the Hedge Fund Industry without comprising on its value proposition to investors	88%	2%	10%
26	CISCA is balanced in trying to bring regulations in the Hedge Fund Industry, without putting restrictive rules to the operational environment of these Hedge Funds	92%	0%	8%
80% of the respondents were in agreement that CISCA took a measured approach in its approach to regulation. However, the outcome of this measured approach has been the direct regulation of the industry. The literature seems to suggest that direct regulation continues to be a subject of debate in places such as Europe whose HF industries are more mature and much larger than in SA. In this regard, Dardanelli (2011) wrote that direct regulation does not seem to be in line with the thoughts of most scholars and market operators.				
6	Regulations tend to be protectionist in nature, and in doing so might drive down the demand for Hedge Funds as an asset class	93%	0%	7%
93% of the respondents felt that the regulations were protectionist in nature. A number of studies have argued that the “enemies” of regulatory protectionism are transparency and vigilance (Watson, 2013). Consequently, it is recommended that SA policy makers should be sceptical of protectionism.				
7	Hedge Funds have over the years delivered on innovative investing models which continues to assist economic growth	89%	1%	10%
23	Going forward, the Regulations will serve provide more innovation and growth in the Hedge Fund Industry	87%	4%	9%
89% of the respondents said that HFs deliver innovative investment models which assist economic growth. The firm Ernst and Young agree with this proposition stating “A majority of hedge fund managers are innovating to improve their operational efficiency in response to market disruptions and to avoid falling behind the industry”. According to the findings of their 11th annual survey, hedge fund managers are actively seeking innovative ways to improve operational efficiency and grow their asset base, as pressure on margins shows no signs of abating. Of the results from the 11 <sup>th</sup> Annual Survey, Michael Serota, an Ernst and Young Global Hedge Fund Services Leader, says “ <i>The pace at which the hedge fund industry is being disrupted continues to accelerate, as advances in technology bring new threats, but also opportunity. The evolving landscape forces managers to not only be reactive but also proactive in identifying novel solutions that allow them to deliver alpha and remain competitive. Managers of all sizes are embracing innovation to stand out in a crowded hedge fund universe and to achieve a common strategic objective: growth.</i> ”				
8	The Hedge Fund Industry is secretive and mysterious to the public of South Africa	58%	3%	39%

The majority of the respondents (58%) responded affirmatively to the question around the secrecy and mystery surrounding HF investments. Goldstein (2007) said that it is logical to argue that hedge funds and their privatized nature dove into a realm that is predominately secretive, one that the SEC ought to take measures such as registration of the HF stakeholders in order to gauge the prevalence of problematic practices that they may engage in.

9	Hedge Funds are risky investments	50%	3%	48%
10	Hedge Funds deliver on returns to clients, Regulations would not affect them if they continue to do their job	6%	0%	94%

Only 50% of the respondents said HF are risky investment vehicles and only 6 percent were of the view that they delivered on returns to clients. It is not uncommon to find warnings against the dangers of hedge funds, describing them as complex, high-risk investments that expose the investor to almost infinite downside risks in the pursuit of optimistic returns.

Since the CISCA 2015, HFs have been regulated by the same legislation that governs local unit trusts. According to an Ashburn Investments (2018) report, this further increased the protection of investors that might not have the industry knowledge to fully consider investment risks involved. However, they have a higher level of flexibility in the choice of strategy which encourages the creation of funds that are a very beneficial addition to an investor's overall portfolio. Unfortunately, there have been some hedge funds with atypical risk appetites that used the flexibility to expose investors to very risky investments resulting in large capital losses, and a smearing of hedge funds' reputation with the ensuing bad press. It must be emphasised that these limited examples did not occur within the South African regulated environment. According to Ashburn Investment reports therefore, the true nature of hedge funds is typically quite the opposite.

11	Hedge Funds tend to charge incredibly high fees	28%	3%	69%
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The majority of the respondents (69%) said the fees were not incredibly high. This result could be because the majority of them were Hedge Fund managers and this is their revenue. However, the literature also supports this position. HF fees vary widely with fixed base management fees being as low as 0.5 per cent or as high as 5 per cent. However, a common HF fee structure consists of a fixed base management fee (e.g. 1%) and an incentive fee (e.g. 20 per cent) which is applied to the performance net of the base management fee. Given the frequency with which HFs generate returns, the incentive fee can generate a sizeable payment back to the HF manager raising suggestions that they are excessive. According to Brown (2011) price is only relevant in the absence of value as HF managers who deliver high levels of alpha with clearly superior consistency probably deserve a sizeable reward and such managers fully justify their high performance-based fees ([Ammann et al 2010](#); [Jagannathan et al 2010](#)).

12	Hedge Funds also create and produce big swings in performance	28%	5%	67%
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While the majority responded in the negative when asked about HFs producing big swings in performance, some literature tends to agree with this. In a press release regarding their quarterly performance, Prequin, an international HF company, reported wide swings in Q1 2018 (Prequin, 2018). Herein they reported that HFs posted strong returns in Q4 2017, with performance of 3.02%. However, the opening quarter of 2018 saw wide swings in monthly performance, and year-to-date gains stood at a paltry 0.35% at the end of the first quarter. Having seen widespread gains in January, almost all top-level strategies saw losses in February and March, including CTA funds which returned -5.49% and -0.86% respectively. However, they then reported that the volatility experienced in HF performance was also experienced in other markets as well. Swings and volatility may not necessarily be “created and produced” and/or indeed experienced by HFs alone.

13	The regulatory environment for Hedge Funds has been in need of amendments	96%	1%	3%
96% of the respondents agreed to the need to amend the regulatory environment. This is mirrored by the steps taken to regulate the industry by the treasury.				
14	The Financial Services Regulatory framework in SA is amongst the best in the world and is well regarded	98%	1%	1%
The majority (98%) of the respondents agreed with the notion that the SA framework is the best in the world. While this is debatable, SA remains one of the few regulated industries globally.				
15	Regulating the Hedge Fund Industry has brought about credibility and much needed awareness to an asset class that has been previously ignored	89%	1%	10%
While 89% said that regulation had brought about credibility, 10% responded in the negative. The literature however agrees with the majority and as described above, Betsalel (2006) in this regard posited investors previously stayed away from the unregulated SA market as there were no clear procedural guidelines in place to ensure that funds would be adequately managed and that they would possibly have no recourse in case of their investments being mismanaged.				
16	The regulatory environment of Hedge Funds should be measured, else it will stifle the growth of the industry	97%	2%	1%
24	The Regulations might restrict the Fund Managers from taking on as much risk as they previously did	94%	0%	6%
25	Hedge Fund, Fund Managers were weary of the Regulations due, by in large of the limitations it would pose to their discretionary mandate and hamper the innovation around their investment strategies	93%	1%	6%
97 % of the respondents agreed that the regulatory environment ought to be measured. Whilst there may be a lot of value to this proposition, the SA industry continues to grow so whether regulation will stifle growth or not in SA, it remains to be seen.				
17	Hedge Funds have been adhering to governance and all regulations that pertain to them from the onset	36%	4%	60%

The majority (60%) of the respondents did agree with HFs not adhering to all regulations. While there currently exists a paucity of literature around this position, it is recommended that the regulators perhaps pay attention to this view of the respondents.				
18	Hedge Funds make use of exotic assets and investment strategies that aren't well known	33%	5%	62%
The majority (62 %) of the respondents agreed with the fact that HFs used exotic assets and investment strategies. However, with the new regulations which require registration, this perhaps will be demystified.				
19	Hedge Funds have been adhering to international standards of investing on behalf of their investors and continue to provide meaningful reporting to their investors	50%	3%	48%
While only 50% of the respondents agreed to adherence to international standards and best practices, 48% said they were. However, as the promulgation of the new regulations is only 3 years old, further studies around this issue are awaited.				
20	Hedge Funds have failed to attract further investments after the promulgation of the Cisca act	17%	2%	82%
82% of the respondents disagreed that HFs are failing to attract investment. The AUM in SA continue to grow among HFs which in itself is sufficient proof of growth.				
21	The growth in Hedge Funds before the enactment of the Cisca Act were principled based on the investment structure, credibility and regulatory environment of the whole Financial Services	82%	3%	16%
The majority of the respondents agreed that before the Cisca Act, growth was principled based on the structure of the whole Financial Services industry.				
22	The Hedge Fund Industry is important to the South African Financial Services Market	98%	1%	1%
Almost all the respondents (98%) agreed that the HF is important to the SA financial markets. Holler (2012) presents a theoretical and empirical analysis of how HFs play an important role in financial markets affecting important aspects of financial intermediation such as asset allocation decisions and corporate governance. His analysis offers strong support that hedge funds enable investors to improve asset allocation decisions. Consequently, hedge funds are an interesting alternative asset class for institutional investors.				

### 4.3.2 Measuring the impact of CISCA on the Hedge Fund Industry

The majority of the respondents to the survey (67.96%) said the best way to measure the impact of the CISCA Act was to monitor compliance and the filing of reports by the Financial Services and Conduct Authority (FSCA)(Table 7), while 15% said it would be best measured by Growth in AUM of the Industry as a whole, as reported by either SAVCA, Novare and or RisCura due to commitments given to respective funds. There exists a paucity of literature that attempts to measure the impact of the 2015 regulations in the SA hedge fund industry. What the literature does suggest however is that regulations developed are according to the circumstances of the situation and demand of the market to avoid losses and setbacks to investors (Chadha, 2016).

**Table 7 : Measure the impact of the CISCA Act**

#	Answer	%	Count
1	Growth in AUM of the Industry as a whole, as reported by either SAVCA, Novare and or RisCura due to commitments given to respective funds	15.53%	16
2	Compliance and filing reports by the Financial Services and Conduct Authority (FSCA)	67.96%	70
3	Increased competition, meaning that the legislative pieces have not created barriers to entry or other perceived barriers to entry	5.83%	6
4	Any restrictive and or burdensome comments put forward by industry stakeholders (e.g. administrative burden, time lags and associated registration processes that aren't clear)	10.68%	11
	Total	100%	103

According to literature, measuring hedge fund performance differs significantly from the analysis used in other investments because of their risk/return characteristics and unique strategies (Smith, 2017). While one can use Growth in AUM of the industry, compliance and filing reports by the Financial Services and Conduct Authority (FSCA), increased competition and monitoring restrictive and or burdensome comments put forward by industry stakeholders to measure impact, there exist a number of metrics that can provide evidence and add insight into the performance of HFs. This list of

metrics can be endless and every analyst tends to gravitate toward a group of select favorites that provide enough information. A hedge fund can be evaluated based on absolute returns, the Sharpe Ratio which measures the amount of return adjusted for each level of risk taken. Other metrics include Benchmarks which analyze relative returns versus a benchmark. A quartile chart is yet another analysis that is a bit more sophisticated which carefully evaluates funds including in the peer analysis of funds with the most comparable strategies (Smith, 2017)..

### 4.3.3 Advancements Hedge Fund companies can make in South Africa

51% of the survey respondents favoured awareness campaigns and seminars on the value add of investing in HFs for the general public 51.46% while 43% said transparent disclosures to the general public of returns over duration, such as those done by fund fact sheets of unit trusts for public consumption and scrutiny (Table 8). These findings are important because studies have shown that many investors are not aware of the advantage that they can get by investing in hedge funds nor are they aware of the basic functioning of hedge funds. They have shown that investors still prefer to invest in government securities and fixed deposits of nationalize banks were they can have complete safety of their funds though they get less returns (Baser et al., 2012).

**Table 8 : Advancements of Hedge Fund Companies**

#	Answer	%	Count
1	Marketing of their products in the general public space	3.88%	4
2	Awareness campaigns and seminars on the value add of investing in Hedge Funds for the general public	51.46%	53
3	Transparent disclosures to the general public of returns over duration, such as those done by fund fact sheets of unit trusts for public consumption and scrutiny	43.69%	45
4	Current portfolio holdings and percentage waiting on the portfolio	0.97%	1
5	Assets under management confirmation as reported by SAVCA to be confirmed, and not be by approximation	0.00%	0
	Total	100%	103

#### **4.4 Summary of Chapter**

This chapter has presented the results of the study. The following chapter will be a discussion of the findings.

## CHAPTER 5: DISCUSSION OF RESULTS

While all the participants in the interviews said they were aware of the regulatory requirements around HFs and how they are different from other mutual funds and that there is a large amount of information on hedge funds and their regulation, there are no studies that show the extent of understanding of the actual regulatory requirements of stakeholders other than those involved in the industry.

All the interview participants agreed that the SA financial services is well regulated. By 2016, 89% of HF assets were transitioned to regulated structures. By the end of 2017, more than 65% of HF assets had moved to Qualified Investor Hedge Funds and 24% to Retail Investor Hedge Funds. In April 2015 South Africa became the first country to put in place comprehensive regulation for hedge fund products. The new regulations provide for two categories of hedge funds, namely Qualified Investor Hedge Funds and Retail Investor Hedge Funds. Presently, The local hedge fund industry consists of 14 hedge fund management companies that have 277 portfolios: 116 are Retail Investor Hedge Funds and 161 are Qualified Investor Hedge Funds. According to Visagie, the 10 largest hedge fund managers in South Africa manage 73% of the hedge fund industry's total assets under management. The bulk of HF assets are invested in sizeable portfolios managed by well-established hedge fund asset managers with a consistent track record of success (ASISA, 2017)

Ninety-eight percent of the respondents to the survey said the Hedge Fund Industry is important to the South African Financial Services Market. There could be a number of reasons why almost all of the respondents gave this position. Among others, the industry has an important social role and provides value to the broader economy, beyond facilitating market efficiency. For example, the industry provides a lot of jobs, both directly (for managers) and indirectly (for advisers and service providers like lawyers and accountants) and generates significant tax revenues. According to Andrew Baker of the Alternative Investment Management Association (AIMA, 2010), because it is increasingly institutional investors like pension funds who make up the majority of assets managed, the industry has an important social role as the guardian of people's pensions, of university endowments and charitable investments. Hedge funds do a good job protecting and growing those socially valuable investments

because the investment strategies it employs, such as short-selling and allow it to “hedge” and help prevent losses when markets fall. That’s why the industry delivers such solid returns for its investors. Baker added that *“It’s better for everyone if risk is dispersed among lots of small, diverse players, rather than concentrated among a few big guys who all do similar things.”* The diversity capability of HFs helps reduce systemic risk and thus prevents financial instability. Andrew Baker is chief executive of the Alternative Investment Management Association.

Half of the participants (50%) reported that Hedge Funds are risky investments. The risk involved in HFs is a well-documented phenomenon. However, it is exactly this risk that attracts many investors who believe higher risk leads to higher return. The same three characteristics that allow hedge funds to promise greater rewards also makes them very risky. First, hedge funds managers are paid a percentage of their funds' returns. This study found that 28% of the respondents said HFs charge incredibly high fees. In case of losses however, the managers are not paid which makes them very risk tolerant. This makes the funds appear very risky for the investor, who can potentially lose their full investment. However, the Risk Africa magazine (2016) observed that hedge funds tended to invest in the same asset classes as traditional unit trust funds. In the same article, Hugo (2016), notes the difference being the inherent advantage of being able to access and apply to a wide range of investment tools and thereby generate other sources of return offering more ways of protecting assets and delivering positive returns irrespective of market direction. Additionally, HFs tend to have low correlations to the traditional portfolio of stocks and bonds, therefore, allocating an exposure to hedge funds can be a good diversifier. HFs therefore aim to achieve positive returns at a reduced level of risk. Characteristics making hedge funds unique includes the use of derivatives, short selling, leveraging etc. to be able to extract positive performance in both upward or downward trending financial markets.

Twenty-eight percent of the respondents said HFs create and produce big swings in performance. While this may be so, no matter what strategy or asset class, the markets directional movement trends and subsequent volatility affect investments. According to the SEC Investor Bulletin (2013) HF managers take calculated risks just like all other managers of asset classes. However, with HFs, the extent of the draw-down in negative markets is less and therefore, the recovery is quicker (Hugo, 2016). With the

application of varied investment tools and strategies to profit from either rising and or failing markets, a key differentiator and advantage as opposed to the traditional notion of buying low and selling high.

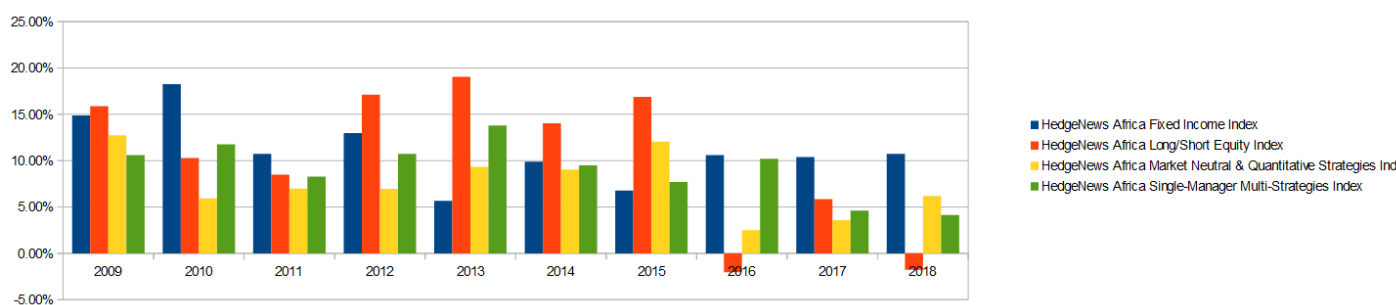
Thirty-three percent of the respondents said that HFs make use of exotic assets and investment strategies that are not well known. According to Alexander Forbes Investments Hedge Fund Risks and Disclosures, they may include leverage, short-selling and short term investments. In addition, hedge funds often invest in unlisted instruments, low-grade debt, foreign currency and other exotic instruments. All of these expose investors to additional risk. However, Reuters (2012) has previously reported investors fed up with losses from their mainstream hedge fund holdings are eyeing some exotic and/or niche alternatives where profits are less to do with general market trends and more a manager's skill. Reuters (For instance in 2012, the pension fund of Barclays Bank UK considered investments in sub-Saharan Africa's fast-growing economies, and in hedge funds which play the reinsurance industry. Another example is having money in funds shorting stocks of Chinese companies caught up in scandals, and in funds involved in lending securities to borrowers for a fee.

Since promulgation of the CISCA Act, HFs have been adhering to governance and all regulations that pertain to them from the onset and this was confirmed only by 36% of the respondents. This low response with regards to governance is a source of concern. This could be a key problem that could potentially be as a result of the lack of understanding of the range of complex legal and governance issues that are challenging the industry.

Fifty-eight percent of the respondents said that the Hedge Fund industry has been secretive and mysterious to the public of South Africa and 96% said it had been in need of amendments. In this regard, Goldstein (2007) posited that with the changing times and economy regulators should seek out measures of regulation for HFs especially because their services have become available to those investors who simply can't afford to lose their investments and may in fact do so without having sufficient knowledge to understand what their investments entail. Therefore, it is logical to argue that hedge funds and their privatized nature dove into a realm that is no longer predominately secretive, one that has reached retail investors. This was in line with the findings of this study that regulating the industry has brought about credibility and

much needed awareness to an asset class that has been previously ignored. In fact, 88% of the respondents said that CISCA took a measured approach to undertaking the process of regulating the Hedge Fund Industry without comprising on its value proposition to investors and without putting restrictive rules to the operational environment. Ninety-nine percent of the respondents said that after promulgation, regulations have played a meaningful role and again, the majority supported the fact that regulations were very much needed to prevent losses to the investor by suggesting an increase in transparency and managing risk. While, the minority don't agree with the idea of regulations in the hedge fund industry 89 % said after regulations, HFs have delivered on innovative investing models which continue to assist economic growth and that they can serve to drive innovation and financial inclusion in the industry. However, 97% cautioned that the regulatory environment should be monitored closely and measured, else it will stifle the growth of the industry.

93% of the respondents said the regulations tend to be protectionist in nature, and in doing so might drive down the demand for Hedge Funds as an asset class. It may be inferred that on account of regulation, alpha return may reduce due to a reduction in the fund manager's propensity to take on risk and may also lead to higher costs, which will be passed on to investors, leading to lower returns by limit investment opportunities and increase costs of execution. However, firstly, officials and regulators posit that it is in the best interest for the industry to have regulations introduced to keep track of the transactions by introducing hedge fund registration system, illegal frauds, and profit making by the hedge fund managers. Potentially, regulations will only bring out the best in the system. For example, the regulated Hedge Fund Markets in Canada and Latin America did not face any troubles during the 2008 crisis, Mallaby (2008). However, according to a report by Novare (2018), while HFs had the best opportunity to grow their market and gain wider acceptance and have grown over the years in terms of AUM, managers ran into a sustained patch of underperformance and low equity return. Equity long-short portfolios had performed extremely well between 2008 and 2015, delivering on average around 11.5% a year. However, they suffered weak returns in 2016, 2017 and 2018 (Figure 3)



**Figure 3 : Trends in Long-short portfolios SA : Source Novare**

According to Novare as reported on Money Web (2018), the equity long-short funds have failed to meaningfully differentiate themselves from general equity unit trusts. Consequently, there were significant outflows as some investors reportedly pulled their money out of hedge funds, especially that they were not getting any extra value for the fees they were being charged. However, this didn't stop the SA hedge fund industry from growing in terms of AUM which are now reported to be in the region of R68.5bn (SAVCA 2017). This is in agreement with the response from only 83% of the respondents who said HFs are still attracting investments after the promulgation of the CISCA act as well as from all the respondents to the interviews said they were seeing significant growth. In fact one of the respondents said a recent calculation by the organisation he works for placed AUM at around R100bn. Nevertheless, the low returns may have a negative impact on the reputation of the new regulations. It may potentially produce negative perceptions on the background that regulation is expected to bring more credibility to the industry and increase investment into this sector and literature reports that many investors stayed away from the unregulated SA market as among others, there were no procedures in place to ensure that their funds would be properly managed and that they would possibly have no recourse in case of their investments being mismanaged (Betsalel, 2006).

In principle, Du Preez (2016), notes that regulated hedge funds should reduce the chances of things going wrong for investors and thus improve the reputation of these funds under management and do away with some investor doubts. However, regulations cannot protect investors from poor returns. Du Preez, further opines that It will make only a limited contribution to reducing risk for investors. Some unit trusts have reported significant losses from time to time, despite being regulated. There are

specific examples are such as those of a unit trust fund with a high exposure to derivatives that incurred large losses is the MetCI Third Circle Target Return Fund, a South African multi-asset flexible fund, which lost almost 60 percent of its value over the quarter to the end of December 2015 (Cairns, 2016)

## 5.1 Challenges

Based on the Novare (2017) report described above, the HF industry poor performance coincided with fairly poor performance, broadly across the different asset classes. Secondly, the industry is still small, but it has the potential to be a key role player in the South African savings industry. This is where the new regulation is of particular importance as it provides a much-needed structure for making hedge funds marketable to new investors. Thirdly, the implementation of new the regulation has led to it being a demanding time for industry participants where some players have been observed consolidating their hedge fund product offering (Novare, 2017). The debate as to how the industry can raise assets continues as new challenges have made it harder to attract inflows. Another challenge is while investment performance is clearly essential for the success of a hedge fund and growth in assets under management, the rapidly evolving demands of a sophisticated investor population are making it increasingly difficult for performance to shelter any shortcomings in other areas, particularly over the long term. Finally, there are challenges around public consumer awareness of the industry. The industry should increase their awareness campaigns and seminars on the value add of investing in HFs for the general public and enhance their transparent disclosures to the general public of returns over duration, such as those done by fund fact sheets of unit trusts for public consumption and scrutiny.

Most of the participants said HFs *disperse the risk among lots of small, diverse players, rather than concentrated among a few big guys who all do similar things*. The diversity capability of HFs helps reduce systemic risk and thus prevents financial instability. While some agreed that while this risk involved in HFs is a well-documented phenomenon it is exactly this risk that attracts many investors who believe higher risk leads to higher return. The same three characteristics that allow hedge funds to promise greater rewards also makes them very risky. However, they have the

advantage of more investment tools at their disposal which they may take advantage of during rising and/or falling markets and profit from and it provides capital protection.

### *Protectionism versus Growth*

However, there were concerns that the regulations tend to be protectionist in nature, and in doing so might drive down the demand for Hedge Funds as an asset class. It may be inferred that on account of regulation, alpha return may reduce due to a reduction in the fund manager's propensity to take on risk and may also lead to higher costs, which will be passed on to investors, leading to lower returns by limit investment opportunities and increase costs of execution. In fact, the study found that while equity long-short portfolios had performed extremely well between 2008 and 2015, delivering on average around 11.5% a year, they suffered weak returns in 2016, 2017 and 2018. Nevertheless, the respondents reported seeing growth during the period and this is evidenced by the continued rise in assets under management. In fact one respondent argued that SAVCA had under calculated as estimations by his firm were that AUM was over 100 Bn demonstrating significant growth albeit with all the challenges. Nevertheless, it was found that the low returns may have a negative impact on the reputation of the new regulations.

### *Investor protection*

In principle however, the findings were that regulated hedge funds should reduce the chances of things going badly wrong for hedge fund investors and thus improve the reputation of hedge funds and dispel some of investors' doubts. Most of the respondents however acknowledged that regulations cannot protect investors from poor returns and only make a limited contribution to reducing risk for investors.

### *Challenges Faced by the Industry*

Regulation of the HF industry coincided with poor performance. Secondly, the industry is still small, but it has the potential to be a key role player in the South African savings industry. This is where the new regulation is of particular importance as it provides a much-needed structure for making hedge funds marketable to new investors. Thirdly,

the implementation of new the regulation has led to it being a demanding time for industry participants where some players have been observed consolidating their hedge fund product offering. Fourthly, while investment performance is clearly essential for the success of a hedge fund and growth in assets under management, the rapidly evolving demands of a sophisticated investor population are making it increasingly difficult for performance to shelter any shortcomings in other areas, particularly over the long term. Finally, there are challenges around public consumer awareness of the industry.

## **CHAPTER 6: CONCLUSION**

Studying the effects of the transition to a regulated environment is absolutely necessary making this study crucial. This is in order to inform the early identification of both positive and negative outcomes of the change unique to South Africa as well as to inform risk management and mitigation strategies as well as government policy. This is especially important as SA is documented as one of the few countries to regulate the industry and research in this arena remains in its infancy. This study has considered Hedge Fund stakeholders' views on the effects that the transition to regulated environment has on the industry. Their view is that regulation was imperative and that although it has had some undesired effects, it brings confidence to the industry and has resulted in growth of AUM.

In spite of the typically unfavourable publicity that hedge funds garner, HFs play a constructive role in the overall economy and financial markets as detailed above. Their presence and influence span many different aspects of the securities markets, investment products, residential mortgage purchases and modifications, corporate finance including bankruptcy and reorganisation and sovereign credit. Hedge funds create risk return trade-offs unavailable otherwise. They enhance liquidity in the bond market and stock market. They have a presence in reinsurance market and commercial lending. Hedge funds are the new liquidity providers, lenders, market moving analysts, corporate raiders and strategists, lead re-organizers in a bankruptcy process and paradoxically the profits guided yet kind-hearted residential mortgage loan modifiers.

### **6.1 Policy implications for Investors**

Regulated products in the HF industry provide confidence to investors. Investment in Collective Investment Schemes as protected by the Cisca Act are transparent and a convenient way to save for the long term. The two types of products namely Qualified Investor Hedge Funds and Retail Investor Hedge Funds cater for different risk appetites. Additionally, within this protected environment, losses are only up to the invested capital and not beyond. The enhanced disclosure ensures that investors know what they are getting into and present an opportunity to hold fund manager

accountable through appropriate legal provision. Overall, going forward, the SA treasury should ensure that promulgated regulation supports the better management of systemic risk that can lead to financial crises that may affect an entire society.

## **6.2 Policy Implications of Regulations on Funds**

This is the first time regulations are being promulgated at fund level. There is the general feeling that enhanced disclosure and risk control measures will mean better protection but could mean higher admin costs. However, the benefits of disclosure could outweigh higher admin costs but HFs could be required to change structures depending on business for example to focus on QIHF means having an independent administrator or trustee or to focus on RIHF which means converting fully to the current Trust structure with trustee and management company.

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