**THE REGULATION OF HEDGE FUND MANAGERS IN SOUTH AFRICA-
AN IMPACT ASSESSMENT**

by

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MINOR DISSERTATION

Submitted in partial fulfilment of the requirements for the degree

MAGISTER COMMERCII

In

BUSINESS MANAGEMENT

In the

FACULTY OF MANAGEMENT

At the

UNIVERSITY OF JOHANNESBURG

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MAY 2011

EXECUTIVE SUMMARY

2008 and 2009 have been characterised by a credit crunch, slowing of economic growth, high unemployment, and the period has been dubbed as one of the harshest financial eras to hit the global financial markets.

The crunch undermined the existing financial regulations, including the Basil requirements and other prudential structures, and necessitated a re-evaluation and revamp of the entire financial sector regulations. This has also called for the consolidation of the market regulations which would close gaps created by the fragmentation of the current legislation.

The G20 recommendations together with the IOSCO have cast a new regulatory regime that takes into account all aspects as have been unveiled by the recent global financial crisis.

It has been concluded in a study undertaken in Europe in April 2009, that regulation focussed at hedge fund manager level is more effective than the legislation focussed at funds level. The study viewed hedge funds as just legal entities for the pooling of funds, and they (funds) have no economic life of their own. On the other hand, hedge fund managers are responsible for all key decisions in relation to the management of the funds.

The South African's fund-manager-level-focused-FAIS Act 37 of 2002 was implemented late in 2007 and managers had to abide by it by February 2008.

The National Treasury of South Africa, as well as the Financial Services Board is currently working on a legislation that will seek to regulate hedge funds in addition to the current hedge fund manager regulation. The discussions are ongoing.

The results of the survey indicate that the South African hedge fund managers view the cost associated with compliance to be far greater than the benefits of regulations. Nevertheless, they view regulation as crucial. The behaviour of the fund managers seem not to have changed after regulation, however, according to Smith (2008:1), it is possible that hedge fund managers could have factored in their expectations of regulation long before the FAIS Act became law.

DECLARATION OF ORIGINAL WORK

I, **NKULULEKO MQOKIYANA**, declare that this dissertation is my own unaided work. Any assistance that I have received has been duly acknowledged in the dissertation. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce at the University of Johannesburg. It has not been submitted before for any degree or examination at this or any other university.

…………………………………………… …………………

Nkululeko Mqokiyana Date (DD. MM. Year)

ACKNOWLEDGEMENTS

I wish to express my sincere gratitude to the following individual who contributed directly or indirectly to the study.

- My family including my late parents- Nontembeko and Tulekile Mqokiyana and my siblings - Vuyisa, Nkosinathi, Zanethemba, Mzamo, Akhona, Ezile and Athini.
- I would like to thank Mr Jonathan Dixon, from South Africa's Financial Services Board, for his invaluable input and advice.
- I would also to thank Mrs Elisabeth Marnitz for editing and proofreading the document.
- Finally, I would like to particularly thank Ms Seugnet Bronkhorst (my study supervisor), for her dedication and wisdom, without whom this document would never have seen the light of day.

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CHAPTER 1

1.1 INTRODUCTION

The global hedge fund industry has grown significantly over the years, and was estimated at about 8 000 funds valued at about $1 trillion in 2005, and in 2008 the size grew to about $ 2.5 trillion (Cumming & Dai, 2008:1).

According to Malkiel and Saha (2005:3), these financial products, which became an increasingly popular asset class during the1990s and early 2000s, play an important role in the global securities markets. The leverage that they employ actually makes their exposure much larger than their net asset value, making them economical in capital use with high gross returns. This huge hedge fund growth can mainly be ascribed to the comparatively lack of regulations that govern the industry (Dai, 2009:2). Fiford (2004:1) also concurs with Dai's (2009) remarks and adds that South African hedge funds also flourished in the same period due to the same lack of hedge fund regulation or permitted structures to pool and utilise hedge funds as well as a very low key presence of hedge fund investment medium.

Cumming and Dai (2008:1) go on to suggest that the loose regulatory environment allowed the industry to create super-sized and opaque structures with interwoven relationships with prudential entities. The environment, according to Cumming and Dai (2008:1) has therefore created a platform for unscrupulous managers to defraud the system. The Madoff Ponzi scheme is a typical example. Other financial failures or scandals that can be associated with this lack of regulation include the following cases, according to Berman (2005:2):

1. The 1992 fall of the British pound which is believed to have been caused by hedge funds, including Mr George Soros' Quantum Fund. In this regard, Soros and others played the British pound against the Japanese yen, and that led to a significant depreciation of the pound.
2. The 1997 fall of the Russian rouble, which made many investors, including South African corporations, to lose in their Russian bond investments.
3. The 1998 collapse of the LTCM (Long Term Capital Management LP) and the subsequent intervention by the US authorities to rescue the company.

4. The technology bubble of the year 2000 (Y2K), which led to the dissolution of the two well- known American based funds, the George Soros' Quantum Fund and Julianne Robertson's Tiger Fund. The closure of these two funds, according to Berman (2005:2), increased the public perception that hedge funds investment vehicles are highly risky products.

The most recent events include the following:

1. The 2006 collapse of the Amaranth Fund, which is said to be the second biggest hedge fund blow-up after the 1998 LTCM scandal. This fund was strictly invested in on gas, and had little or no diversification (Stoyeck, 2007:1).
2. The current financial crisis, which was triggered by the 2008 reprising of the housing market in the United States of America. Although there is a general-held view that the crisis was not caused by the hedge funds, there is a strong perception that hedge funds played a major role in it (Brown, 2009:1).

Following the events listed above, more in particular the 2008/2009 global financial crisis, the G20 countries met in London in 2008 to craft solutions to the problems. Recommendations were drafted and member states, including South Africa, were advised to put up regulatory frameworks, which included the setting up of regulatory regime for the private pooled funds, which include the hedge funds and private equity. (G20, 2009:1). The G20 committee intervened to seek solution in the financial markets crisis, because the crisis was systemic and was causing havoc to the global markets.

According to Chan, Getmansky, Haas and Lo (2005:1), "hedge fund industry has a symbiotic relationship with the banking sector, providing an attractive outlet for the bank capital, investment management services for banking clients, and fees for brokerage services, credit and other banking functions. Accordingly, the risk exposure of the hedge funds industry may have material impact on the banking sector, resulting in new sources of systemic risks" (Chan, 2005, 1).

In line with the G20 recommendation above, the International Organization for the Securities Commission (IOSCO) formed a Task Team. According to the June 2009 IOSCO report (2009:3), the Task Team was formed and mandated to assess the activities of the hedge funds, and as part of its deliverables, published the six principles that IOSCO members should follow in instituting their respective regulatory frameworks.

The principles included that the managers for private pooled funds, which include hedge funds, be subjected to compulsory registration, among others (June 2009 IOSCO Report, 2009:3).

At the time the recommendation was made, major hedge fund investing communities, including South Africa, already had this principle (i.e. mandatory hedge fund registration) in practice. South Africa introduced its framework for the regulation of the hedge fund managers late in 2007, and entities had to comply with it by February 2008 (FAIS Act 37: 2002: 1). South Africa, and other jurisdictions that pioneered the regulation of hedge fund managers, will have to witness and determine if the framework in place is a panacea to the problems that were underpinned in the recent financial markets crisis.

1.2 BRIEF HISTORY OF HEDGE FUNDS

According to McWhinney (2005:1), the history of hedge funds dates back to the late 1940s and it began when Alfred Winslow Jones launched the first hedge fund in 1949. Alfred Jones was inspired by the financial articles that he wrote for the Fortune magazine to start his own hedge fund. He raised $100 000, contributing $40 000 of his own. He then implemented his strategy of minimising risk. He held long position of some stock, and also sold short some position to minimise risk. He also used some leverage to enhance returns. The performance of the funds he managed was exciting, and as a hedge fund manager he earned a 20% incentive fee (McWhinney, 2005:1)

As can be observed in the subsequent discussion, Alfred Jones' modus operandi of hedge fund construction flows through to the today's description of hedge funds.

1.3 THE DESCRIPTION OF HEDGE FUNDS

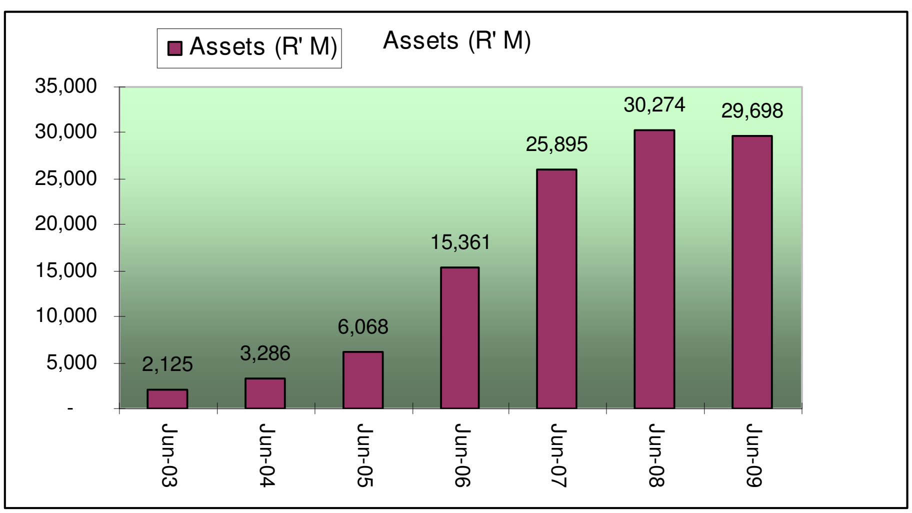
Since hedge funds are not regulated in South Africa, there is no consistent and generally accepted definition. However, according to Berman (2005:2), a hedge fund is a private investment vehicle where the manager has a significant personal stake and also enjoys a high level of flexibility to employ a broad spectrum of strategies involving use of short selling and / or leverage to enhance returns and better manage risk.

IOSCO[1], in its Consultation Report (2009:5) released in April 2009, also acknowledged that there is no generally used definition, and added that a fund that displays a combination of some of the following characteristics will be called a hedge fund:

- Borrowing and leveraging restrictions, which are typically included in the collective investment schemes related regulations, are not applied, and many (but not all) hedge funds use leverage
- Significant performance fees (often in the form of percentage of profits) are paid to the fund manager in addition to an annual management fee
- Investors are typically permitted to redeem their investments periodically e.g. quarterly, half yearly or annually
- Often significant "own" funds are invested by the manager
- Derivatives are used, often for speculative purposes, and there is an ability to short sell securities
- More diverse risks or complex underlying products are involved.

1.4 THE SIZE OF THE SOUTH AFRICAN HEDGE FUND INDUSTRY

FIGURE 1. ASSETS UNDER MANAGEMENT



Data source: Novare Investments- South African Hedge Fund Survey (October 2009, p4)

[1] IOSCO (International Organization for Securities Commission) is the global association for the financial markets regulators. South Africa is a member of this organization.

According to Novare (2009:4), the South African hedge funds have been growing steadily over the years and currently stand at R29.7 billion in assets under management. As per Figure 1 above, the assets under management dropped from just over R30 billion in June 2008 to about R29.7 billion in June 2009.

These funds, according to Novare (2009:6), represent 150 different mandated funds and are managed by 77 management companies. In addition, according to this report, these management companies manage other funds which in total add up to 220, including mirror funds[2].

According to Morris(2009:13), 2008 was a strenuous year in the financial markets, and the drop in the value of assets as reflected in Figure 1, above, represents the gravity of such disaster in that year. Morris (2009:13) also adds that the South African financial markets environment did not suffer the same shockwaves that were felt around the world, more in particular in the United States. Morris (2009:13) attributes this phenomenon, partly, to the limited proliferation of the asset backed securities in South Africa, and also to the high level of self restraint[3] in the South African investing community. Timbadia (2009:3) adds another dimension to the discussion and says that the prudent South African Exchange Control measures have shielded the South African financial markets from the global conundrum. The author continues to suggest that the South African funds were not exposed to the US toxic assets and had relatively low number of foreign investors, which would have triggered an avalanche of panic withdrawals (Timbadia, 2009:3).

1.5 HEDGE FUND STRATEGIES IN SOUTH AFRICA

According to Nailana and Gopi (2004:3) hedge funds are classified according to the strategies and styles they employ. Nailana and Gopi (2004:3) go on to mention and describe the different styles mostly popular in the South African market as follows:

Equity Market Neutral: This style takes long and short positions in equity securities, while maintaining a neutral position to market systematic risk as defined by the

[2] A mirror fund is a type of mutual fund, typically run by a life insurance company, which enables an investor to access another company's mutual fund through his or her life insurance policies. These funds usually involve higher fees or charges. For example, you might be able to invest in a Mutual and Federal fund (Pty) Ltd through your life insurance policy with Old Mutual Plc.

[3] Self restraint will cover the self-regulation aspect and more in particular the use of 3rd party administrators as well as the prime brokers.

Beta[4]. Managers neutralise exposures to directional market risk by combining long and short positions in broadly equal amounts. About **18%** of the South African hedge fund money is invested on equity neutral strategy.

Equity Long Short: This strategy is similar to the equity market neutral style, except for its tendency to take timing bets, i.e. active bets related to systematic risk. Managers aim to reduce exposures to directional market risks. In this instance, the portfolio may vary from net long to net short, depending on market conditions. According to Novare (2009:10), this is the most popular strategy in South Africa and over **40%** of the R29.7 billion hedge fund assets under management are invested on this strategy.

Fixed Interest Hedge: This strategy takes long and short positions in fixed interest market (such as bonds and interest rate swaps). Managers neutralise exposure to interest rate risk. This strategy constitutes about **13%** of the hedge fund assets under management (Novare, 2009, 10).

Multi Strategy: This strategy is used when a manager wants to diversify through using different strategies to reduce risk. This strategy accounts for **11%** of the South African hedge fund assets (Novare, 2009, 10).

1.6 SOUTH AFRICAN HEDGE FUND INVESTORS

According to Novare's report (2009:11), the South African hedge funds are dominated by funds of funds which invest about 60% of the total hedge fund assets. This translates to about R18 billion of the R29.7 billon hedge funds. High Net Worth individuals, who include family trusts, invest about 9% (about R3 billion of hedge funds). These individual components (i.e. life funds, HNW or pension funds) invest directly on hedge funds and also through a fund of hedge fund structure.

1.7 THE DISTRIBUTION OF HEDGE FUNDS

Many countries have similar hedge fund distribution channels, except in jurisdictions where there are strict regulations or prohibitions of hedge fund products. In most instances, distribution channels that are used include private placements, wrappers[5], investments managers, fund distribution companies, banks, and other regulated or non- regulated institutional investors (Cumming & Dai, 2008:3).

[4] Beta is the sensitivity of the fund with respect to the market. For instance, if the market moves 10% in a single day and the fund moves by 8%, the fund is said to be less sensitive than the market.

[5] A wrapper can be described as an insurance issued structured product that encapsulates a hedge fund component. The insurance policy could be a life product or any other insurance product.

The drive to bring hedge funds to retail outlets will, without a doubt, dictate the mix of distribution channels that hedge funds will use in future. According to Phillips and Artabane (2008:7), the European Union is contemplating to have a separate regime for private placement of funds to be marketed under the pan- European set of rules. Phillips and Artabane (2008:7) postulate that currently, the UCITS[6] III legislation only allows the development of short extension funds, e.g. 130/30 funds, which replicates similar structures in the United States of America.

The following Table shows different jurisdictions, and the distribution channels used.

TABLE 1: **Channels of distribution of hedge funds by country**

Country	Distribution Channels					
	Banks	Fund distribution companies	Via wrappers	Private placements	Investment managers	Other Financial institutions
Austria	√	√	√	√	√	√
South Africa	√		√	√	√	
Cayman Islands	√			√	√	
United Kingdom (UK)	√			√	√	
United States				√		
Italy				√		

Source: Phillips and Artabane (2009:63-68). Operational Risk: An alternative challenge

As per the above Table, South Africa uses four different platforms to sell its hedge funds and these include wrappers (insurance products), banks and others. UK and the Cayman Islands also use the same platforms as South Africa, except via hedge fund wrappers[7].

According to Bell (2005:1), the Internal Revenue Services (UK Tax Authority) passed a regulation that discouraged the wealth advisors from wrapping clients' stakes in hedge funds or other forms of alternative investments. The UK tax

[6] UCITS refers to the set of European Union Directives which aim to allow collective investment schemes to operate freely throughout EU on the basis of a single license.

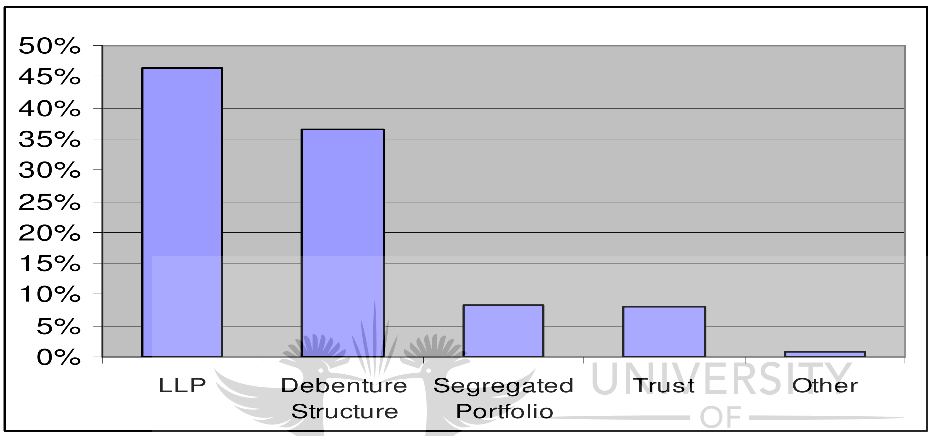
[7] A hedge fund insurance wrapper is an insurance product where insurance companies wrap hedge fund inside life insurance or annuity segregated accounts.

authority pronounced that it would treat a hedge fund wrapped in life insurance policy or annuity contract as a single investment holding, rather than looking through the hedge fund to count the number of holding and measure the percentages inside the wrapper (Bell, 2005:1).

1.8 HEDGE FUND LEGAL STRUCTURES

The following are the legal structures that the South African hedge fund managers use to pool funds.

FIGURE: 2. SA Hedge Fund Structures.

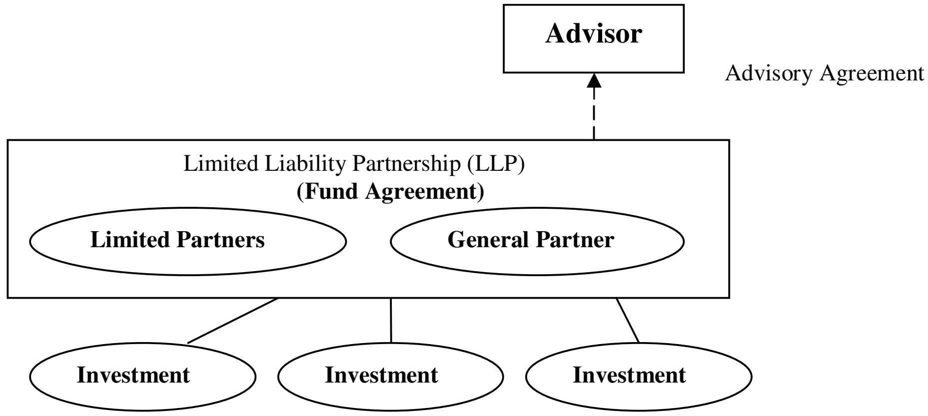


Source: ASISA (2010:16). Regulation 28 Derivative Workshop, 16 April 2010.

According to the above Figure, the most popular legal structure that the private pooled fund managers use is the Limited Liability Partnership (LLP), and this is followed very closely by Debenture Structures and then Segregated Portfolio.

According to the South African Private Equity and Venture Capital Association (SAVCA) (2010:6), the Limited Liability Partnership has the following structure:

FIGURE: 2.1. Limited Liability Partnership



Source: SAVCA (2010:6). 16 April 2010. Submission to National Treasury: An Industry response to Regulation 28.

The structure in the above Figure is one of many that are used to qualify the fund for a tax transparent status in South Africa, as indicated in the tax treatment of hedge funds below.

1.9. TAXATION OF HEDGE FUNDS

TABLE 2: Taxation of hedge fund and hedge fund managers

Country	Taxation	
	Hedge funds	**Hedge fund managers**
Austria	Fund is tax transparent	Subject to corporate income tax at 25% rate
South Africa	Fund is tax transparent	Subject to Corporate income tax at 28% rate
Caymans Islands	0% tax	0% tax
United Kingdom	Funds organised as OEICs/AUTS are taxed on income at 20%, with capital gains exempt from tax	Corporate managers taxed at 30%. Fund managers organised as LLP are tax transparent
United States	Hedge funds marketed to US investors are structured through a parallel or master- feeder structure. Under this structure, a separate fund in the form of an offshore fund is set up for US tax exempt investors, and another one is also set up for US tax purposes	
Italy	12.5% or 0% for foreign qualified investors	27.5% corporate tax and 3.9% regional tax on productive activities

Source: Phillips and Artabane (2009:75-77). Operational Risk: an Alternative challenge

According to the survey carried out by Phillips and Artabane (2009:75), most jurisdictions adopted the flow- through principle, wherein hedge funds are assigned a tax transparency status, and the tax flows through to the partners or beneficiaries. South Africa also has tax transparent hedge funds and the hedge fund managers are taxed at the corporate rate of 28% (as per the Table above). Interestingly, as the Taxation of Hedge Funds' Table above shows, the Caymans Islands have a zero tax for both hedge funds and hedge fund managers. These countries are sometimes called "Tax Haven Countries".

1.10 PROBLEM STATEMENT

The regulation for hedge fund managers in South Africa was introduced in 2007 to be complied with in February 2008. This study attempts to determine whether the regulations had an impact in the hedge fund industry of South Africa.

1.11 RESEARCH OBJECTIVES

According to Zikmund (2003:99), the research objective is the researcher's version of the business problem. Its purpose is to express in measurable terms, the definition of what the researcher should accomplish.

The objective of this study is to access the impact of the regulation of hedge fund managers is South Africa. This will be a causal research.

1.11.1 Hypothesis

A hypothesis, according to Zikmund (2003:44), is an unproven proposition or suppositions that tentatively explain certain facts or phenomena, a proposition that is empirically testable. The hypotheses will include the following:

- The regulation has helped bring fair play in the market, including transparency, increased disclosures and has also helped heighten the protection of market participants;
- The regulation has also helped the consumers understand the risk they are taking;
- The regulation is helping to bring confidence into the hedge fund market and increase activities, contributing to increased liquidity in the general South African financial markets.

1.11.2 Proposition

Zikmund (2003:43) defines propositions as statements concerned with the relationships between concepts. A proposition explains the logical linkage among certain concepts by assessing universal connection between concepts. A proposition further states that every concept about an event or thing either has a certain property, or stands in a certain relationship to other concepts about the event or thing. The statement could constitute the following:

The FAIS Act regulation is not making any significant impact on the functioning of the hedge fund markets and the market in general.

1.12 LITERATURE REVIEW

Volckel and Usher (1995:435) are of the opinion that the literature review should interpret and analyse what has been published in the area of interest.

According to the study conducted to investigate the impact of the new legislation in Europe and other parts of the world, the response was mixed (Rajan & Brown, 2005:16).

The findings of the study were reported, and they are as follows:

- The regulation adds greater transparency to some hedge fund activities and raises the comfort levels for the new generation of clients.
- In Europe, the regulation is seen as instrumental in bringing in both institutional and retail investors.
- In Asia Pacific and offshore centres, it is seen as raising the comfort levels of the fund of hedge funds' managers, and also serves as method of improving due diligence.
- Regulation is seen as the minor way of driving out those hedge funds managers who lack the necessary basic fiduciary and compliance structures that are essential for success.
- Finally, the regulation will create more work for administrators in the area of reporting and compliance, thereby enhancing some of the existing service lines.

The G20 summit that took place in London in 2008, made recommendation to its signatories, on how the private equity funds, especially hedge funds, should be regulated. The recommendation (number 10) that emerged from Work Group 1 stated that:

"Private pools of capital, including hedge funds, can be a source of risk owing to their combined size in the market, their use of leverage and maturity mismatches and their connectedness with other parts of the financial system. They or their managers should therefore be required to register with the financial authority and disclose appropriate information to access the risks the pose" (G20, 2009:10).

When the G20 made their recommendations in 2009, South Africa already had, and had implemented its framework that regulates hedge fund managers- at least the micro aspect of hedge fund manager regulation.

According to Novare (2009:12), the South African hedge fund managers are regulated through FAIS (Financial Advisory and Intermediary Services) registration requirement. (A provision that is located in Section 7 & Section 8 of the Financial Advisory and Intermediary Services Act 37 of 2002). A special condition, Type 2A[8], was introduced late in 2007, and the hedge fund managers had to comply with the requirements by February 2008 (Novare, 2009:12).

South African financial regulatory authorities are currently working on a document that will see to it that the hedge funds products are regulated, and the consultation process with the industry has already begun. According to Pengelly (2010:1), the Financial Services Board has indicated that they intend tabling the paper with firm recommendations on the regulations of the hedge fund products during 2010.

In April 2009, the European Commission issued a press release containing their (EU) proposed directive on Alternative Investment Fund Managers, and this was part of the European Union's response to the global financial crises as envisaged in the G20 road map. This was a means of bringing the privately pooled funds into the regulatory net and also to give the regulatory authorities power to intervene in the sector, (should a problem arise), to bring back stability to the sector (Brown, 2009:1).

According to Brown (2009:1), the United Kingdom (UK) requested that an Impact Assessment be conducted before the EU rules governing London's hedge funds and private equity were to be agreed to. The UK's concerns, according to Brown (2009:1), are that the proposed (privately pooled funds) rules could be restrictive and threaten the good standing of London as international financial hub, and this is after it was reported that some companies are threatening to leave London if the EU Directive on the regulations of the hedge fund managers is not revised. London has about 80% of the European hedge funds and 60% of EU Private Equity funds (Brown, 2009:1).

[8] Type 2A is a special condition created under FAIS Act, for discretionary Financial Services Providers.

The Impact Assessment was then conducted in April 2009, and some of its findings confirmed that the regulation targeted at the level of the fund managers, is much more meaningful than targeting regulation at the level of the funds. (Commission of the European Communities Report (CECR), 2009:1). According to this report, hedge funds are just legal entities for the pooling of the funds and have no economic life of their own, and on the other hand, hedge fund managers are responsible for all key decisions in relation to the management of the fund.

The near collapse of Long Term Capital Management (LTCM) in 1998 triggered principal policy issues on how excessive leverage can be restrained. This is because excessive leverage can increase the likelihood of a general breakdown of financial markets. The Working Group that analysed the reasons that led to the near collapse of LTCM, made several recommendations aimed at restraining leverage to the House of Representative in America and those included the following:

- To design a financial markets environment that will encourage transparency, enhance private sector risk management practices,
- To develop more risk – sensitive approaches to capital adequacy,
- To support financial contract netting in the event of bankruptcy, and encourage offshore financial centres to comply with international standards (Working Group on Financial Markets, 1999:2).

The US is currently seeking to close the loopholes for small funds. In the US, privately pooled funds advisors, responsible for assets under management less than US $ 100 million, are not required to register with SEC (Securities Exchange Commission) and the harsh disclosure requirements are not applicable to those funds. However, that will soon change since the regulators are seeking to reduce the compliance limit for the private pooled funds to US $ 30 million instead (Sorkin, 2010: 1).

The Greek prime minister called on the world economic and financial powers to introduce stricter regulations to hedge funds and currency traders. The minister believes that these players have aggravated his country's financial woes, and he also believes that failure to rein in their activities could trigger a new global financial crisis (SETimes, 2010:1).

The US and EU have agreed that in developing their respective hedge funds regulatory regimes, they would avoid discriminatory and over protectionist rules that will favour one country over another. This was after the US had criticised the EU hedge fund rules, which US believed were hostile to the foreign funds (The Wall Street Journal, 2010:1).

The Securities and Exchange Board of India (SEBI) has banned the investments through participatory notes by unregulated entities, and this move is said to be directed at the hedge funds, limiting their access to broader market (Oranika, 2010:3).

Oranika (2010:3) goes on to say that some analysts/ academics are of the view that the hedge funds are designed to operate with maximum flexibility, and in addition, the regulations are "somewhat incompatible with the fundamental role and character of hedge funds". Oranika (2010:3) further adds that increased regulations are not good for the hedge fund market. The writer believes that such a move would destroy, or at least reduce the natural setting under which hedge funds operate. Oranika also postulates that it is because the market is able to regulate itself and has done a great job, thus far.

Perryman (2010:1) believes that the introduction of the UCITS structure will distort hedge fund strategies, and their liquidity premiums will diminish and result in performances to fall. According to the survey Perryman (2010:21) conducted, hedge funds believe that the AIFM[9] directive, with its UCITS packaging requirements, has brought about uncertainties in the market regarding the distribution of funds. In addition, the survey also suggests that incentives should be incorporated into the AIMF structure that will encourage people to invest in illiquid assets, and such incentives could be designed as regulated closed funds with a fixed horizon.

1.13 BENEFITS OF THE STUDY

It is very important to test the hedge fund regulation framework and see if we can confirm that the regulation is living up to expectations of bringing needed protection for the investors, and also of helping to shape up the behaviour of hedge fund managers to level the playing field for all players.

[9] AIFM directive is the European set of rules to regulate alternative investment fund managers.

The regulation of the industry should be seen as a milestone to the pension funds and other forms of traditional investments that are under pressure to produce good returns, but could not freely invest on hedge funds because of the lack of proper regulations.

This paper will be able to help answer the following questions:

- Are we going to experience the migration of institutional investors into the hedge funds?
- Is the investment landscape in South Africa going to change all together, following regulation?

1.14 RESEARCH DESIGN AND METHODOLOGY

According to Zikmund (2003:65), a research design is the master plan specifying the methods and procedures for collecting and analysing the needed information to obtain evidence to answer the research questions, and should include the sources of information, the research method to be used, the sampling methodology and a schedule or timeframe, as well as the budget for the research to be undertaken.

In addition, Malhotra(1996:86) describes a research design as the framework or blue-print for conducting the marketing research project which specifies the details of the procedures necessary for obtaining the information needed to structure or solve the marketing research problem.

1.14.1 Research Approach

The study will follow a qualitative approach, as it is believed that such method will be suitable to the study. The purpose of the study is to access the effectiveness of the recently proposed regulation of hedge fund managers in South Africa. As indicated in the following discussion, the data gathering technique that will be used is the questionnaire method. A full description of the results, as they come through, will be given. The chosen method is believed to be feasible and reflects on the objectives of the study.

1.14.2 Methodology for data gathering

Zikmund (2003:62) refers to secondary data as data that had previously been collected and assembled for some project other than the one at hand. The first step is to do a literature study in order to determine whether any secondary data exists on the regulation impact on hedge funds.

The questionnaire method will be used as a data gathering technique. The technique is preferable to other data gathering techniques because it is efficient and cost effective. The hedge fund managers usually have busy schedules, and as a result, it is not easy to sit them down for questioning. In addition, some hedge fund managers operate from offices outside Gauteng Province. These reasons make interviews, both in person and telephonic, cost ineffective, and most probably, not efficient. In addition to this view, Barbie (2007:270) has observed that personal interviews are potentially risky for both the researcher and the target audience. Barbie goes on to say that some researchers could be sued for large sums if something goes wrong. With regard to the telephone interview, Barbie (2007:270) adds that some respondents have become apprehensive to participating in the telephone interviews, because of bogus sale people who disguise as researchers.

A questionnaire will be sent to hedge fund managers through an e-mail link that will facilitate the filling of the form on-line. The researcher expects the number of participants to increase, because the technique (e-mail link) involves no paperwork and it will take about 5 minutes of their time.

As indicated in the following discussion, the aim is to determine if there are any changes following the recently created micro prudential regulatory framework for hedge fund managers. The data collected will be compared to each other (in the form of content analysis), in order to determine if any trends exists.

A detailed report will then be generated detailing the findings of the study.

1.14.3 Sampling procedure and sample size

According to Barbie (2007:111), population for a study refers to the group of people or things about whom one wants to draw a conclusion. Barbie goes on to say that it is almost impossible to study an entire population, and hence a sample has to be selected (Barbie, 2007:111).

The South African hedge fund industry is relatively small comprising about 77 (known) hedge fund management companies. These management companies employ some 117 hedge fund managers (according to the Financial Services Board Schedule received in August 2010). The questionnaires will be sent to all 77 hedge fund management companies. There will be no need for sampling the population, since the population is small.

1.14.4 Data collection

According to Malhotra (1996:22), data collection involves a field force of staff that operates either in the field, as in the case of personal interviewing, from an office by telephone interviewing, or through mail.

In this survey, the questionnaire method will be use in the collection of the data and this is due to the effectiveness and cost efficiency attributable to this method. The telephone interview method will be very expensive and will, most probably, not be conducive to the project as a result of the budgetary constraints. The mail method, will take too long to provide feedback, and will also discourage people from participating.

Software experts will design a facility that will house the questionnaire, implying that the respondents will fill the questionnaire online and also submit it online, without having to print it. As the hedge fund managers submit their responses, the Table on the researcher's side will be updated and a summary of the data will be presented.

1.14.5 Data analysis

Barbie (2007:112) describes data analysis as the situation where data has been collected for the purpose of drawing conclusions that reflects the interest, ideas, and theories that initiated the inquiry.

As indicated in the preceding discussion, the aim is to determine if there are any changes following the recently created regulatory framework for hedge fund managers. The data collected will be compared to each other (in the form of frequency count and content analysis), in order to determine if any trends exist.

1.14.6 Measuring instrument

The method that will be applied in appraising and evaluating the research, will be in the form of a structured questionnaire method that will be conducted with seventy seven hedge fund management companies to determine the level of impact of the regulation, on the hedge fund managers in South Africa.

The link containing the questionnaire will be e-mailed to the respondents, and the responses will then be compared to each other in order to determine if any trends exist between the participants in the industry. A statistical inference will be made in the end on the impact of the FAIS Act regulation on the hedge fund industry of South Africa.

1.15 ETHICAL CONSIDERATIONS IN THE RESEARCH

The data collected will not be used for any other use other than for the intended research purpose. In addition, the researcher will treat all the information collected as confidential and sensitive.

1.16 LIMITATIONS OF THE STUDY

The South African Hedge Fund industry is not well researched, and as such, it is not possible to get adequate material from the South African archives. Moreover, South Africa is a young and growing market with some hedge fund managers not yet registered with the Financial Services Board. This will not undermine the validity of this research as the data available is sufficient for the chosen topic.

1.17 PROJECT BUDGET AND SCHEDULE

Malhotra (1996:105) suggests that budgeting and scheduling help to ensure that the marketing research project is completed within the available resources: financial, time, and human. By specifying both the time parameters within which each task should be completed and the cost of each task, the research project can be effectively managed.

The costs related to this project will be small, and this is because of the proposed paperless and online questionnaire method. It is expected that the project will not cost more than R2 000, 00 (Two thousand rand). This will probably cover internet usage for research purposes, and some administration costs. Moreover, it is not envisaged that additional costs would be incurred relating to travelling, as this will be online and at the convenience of the researcher's home.

1.18 CONCLUSION

The study seeks to investigate if the FAIS Act (no 37 of 2002) that was passed in 2007 is having any impact on the hedge fund industry in South Africa. The FAIS Act regulates financial service providers, which include hedge fund managers in South Africa. The Type 2A section looks specifically into the regulation of hedge fund managers. It is very important to test the hedge fund regulation framework and see if it can be confirmed that the regulation is living up to expectations of bringing needed protection for the investors, and also of helping to shape up the behaviour of hedge fund managers to level the playing field for all players.

The literature has demonstrated how the hedge funds in South Africa have grown in the period between 2002 and 2009, attributed mainly to the lack of hedge fund targeted regulation in the country. On the other hand, it has also demonstrated how the lack of targeted regulations has created an environment where it was effortless for hedge fund managers to create opaque and complicated structures that were also intertwined with prudential entities like banks. The Madoff Ponzi scandal was also highlighted as a product of the lack of stricter regulation.

In this report, a reference was made to the articles that made claims that hedge funds did not cause the recent global financial crisis, but contributed to worsen it. The South African hedge fund investment landscape, including how hedge funds are being taxed, the type of investors in these investment vehicles, and their legal structures have also been discussed briefly in the document.

Also it was illustrated how the G20 countries paved the way for the reform of the regulatory regime, following the 2008/2009 financial crisis, and also how those G20 recommendations filtered through into the IOSCO principles for its member states. South Africa is a member of IOSCO.

It has also been illustrated how the data will be collected and analysed.

The next chapter will focus on the literature review. This chapter will encapsulate the analysis of the work that has been published on hedge funds by various authors. The sift-through issues and short discussion on issues that related to the topic at hand will follow.

After the literature review, discussion in detail on the scope of the questionnaire and how it relates to the research objects will follow.

Subsequent to that interpretation of the results of the survey will follow, after which the recommendations will conclude the study.

CHAPTER 2

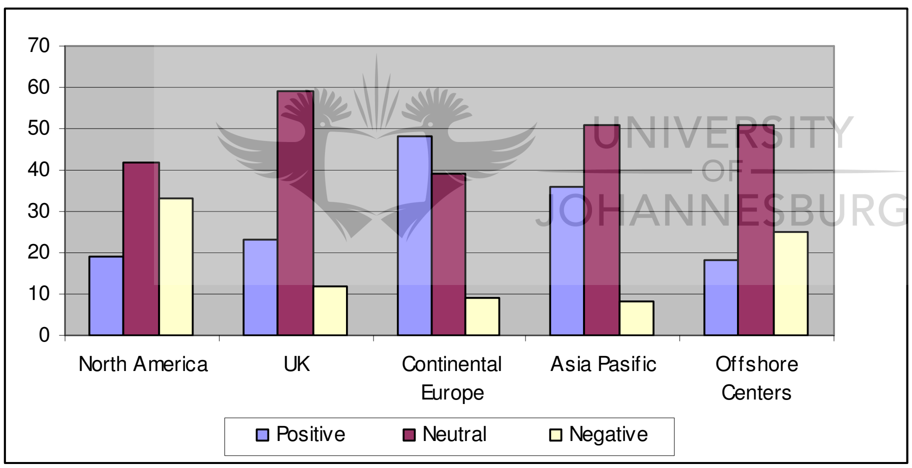
2.1 LITERATURE REVIEW

Volckel and Usher (1995:435) are of the opinion that a literature review should interpret and analyse what has been published in the area of interest. For instance, in the study conducted by Rajan and Brown (2005:16), which sought the impact of the hedge fund legislation in Europe and other parts of the world, the response was mixed.

Some of the respondents believed that the impact of the regulation would be negative, while others believed the impact would be positive. North Americans were less optimistic about the impact, whereas central Europe was more optimistic about the regulation.

(**See the figure below**)

FIGURE 3: Hedge Funds: a catalyst reshaping global investments



Source: Rajan and Brown (2005: 16). Create and KPMG International 2005. Hedge Funds: a catalyst reshaping global investments.

Rajan and Brown (2005:16), as indicated in the figure presented, had the following findings:

- The regulation adds greater transparency to some hedge fund activities and raises the comfort levels for the new generation of clients.
- In Europe the regulation is seen as instrumental in bringing in both institutional and retail investors.

- In Asia Pacific and offshore centres, it is seen as raising the comfort levels of hedge funds of fund managers, and also as method of improving due diligence.
- Regulation is seen as the minor way of driving out those hedge funds managers who lack the necessary basic fiduciary and compliance structures that are essential for success.
- Finally, the regulation will create more work for administrators in the area of reporting and compliance, thereby enhancing some of the existing service lines.

Following the 2008/9 financial crises, the G20 countries met in London in 2008, and recommendation were made to its signatories, on how the private equity funds, especially hedge funds, should be regulated. Recommendation 10 from Workgroup 1 stated that:

"Private pools of capital, including hedge funds, can be a source of risk owing to their combined size in the market, their use of leverage and maturity mismatches and their connectedness with other parts of the financial system. They or their managers should therefore be required to register with the financial authority and disclose appropriate information to access the risks the pose" G20 (2009:10).

Following the G20 recommendations on the regulation of hedge funds, the IOSCO published 6 principles that would lay a foundation for the reformed hedge fund regulatory regime for its member states (IOSCO, 2009:8). The six principles are: "

- Hedge funds and/ or hedge fund managers/ advisors should be subject to mandatory registration.
- Hedge fund managers/ advisors who are required to register, should also be subject to appropriate ongoing regulatory requirements relating to:
  - (i) Organisational and operational standards
  - (ii) Conflicts of interests and other conducts of business rules
  - (iii) Disclosure to investors
  - (iv) Prudential regulation
- Prime Brokers and banks which provide funding to hedge funds should be subject to mandatory registration/ regulation and supervision. They should have in place appropriate risk management systems and controls to monitor their counterparty credit risk exposures to hedge funds.

- Hedge fund managers/ advisors and prime brokers should provide information for systemic risk purposes (including the identification and mitigation of systemic risk) to the relevant regulator.
- Regulators should encourage and take account of the development, implementation and convergence of industry good practice, where appropriate.
- Regulators should have the authority to cooperate and share information, where appropriate, with each other, in order to facilitate efficient and effective oversight of globally active managers/ advisors and/ or funds, and to help identify systemic risks, market integrity and other risks arising from the activities or exposures of hedge funds with a view to mitigating such risks across borders. "

When the G20 made their recommendations in 2008, South Africa already had and had implemented its framework that regulates hedge fund managers. According to Novare (2009:12), the South African hedge fund managers are regulated through the FAIS (Financial Advisory and Intermediary Services) registration requirement. (A provision that is located in Section 7 & Section 8 of the Financial Advisory and Intermediary Services Act 37 of 2002). A special condition, Type 2A[10], was introduced late in 2007 and the hedge fund managers had to comply with the requirements by February 2008 (Novare, 2009:12).

This special condition, Type 2A, according to Goosen (2009:1), was further strengthened in December 2008 with the additional Fit and Proper requirements, as well as the revised code of conduct, specifically, for hedge funds. Goosen (2009:1) further states that these fit and proper requirements as well as the revised code of conducts for the discretionary Financial Service Providers (FSP) inevitably replace the previous structure introduced in 2007. This new framework stipulates that a manager applying to be hedge fund manager should have qualifications and skills of managing a hedge fund and his/her conduct and criminal record should also be of good standing (Goosen, 2009:1).

The Fit and Proper aspect of the FAIS Act Type 2A requires that the key individual and the representative of the hedge fund management company should have a clean criminal and credit record. "Over and above that, the person should have at least 3 years experience gained in the rendering of financial services in respect of hedge fund products and strategies. Moreover, the person should have at least one year

[10] Type 2A is a special condition created under FAIS Act, for discretionary Financial Services Providers.

experience in the management and oversight of services similar to or corresponding with the financial services rendered by the provider, and must actually have provided the financial services in relation to hedge funds on the date of approval" (Goosen, 2010:2).

This piece of legislation, according to Goosen (2009:3), means that the hedge fund managers will have to sign new discretionary mandates with hedge funds, which will reflect on the new framework with regard to the inclusion of disclosing the hedge fund risk, the disclosure of the specific investment objectives, guidelines and trading philosophy, and the hedge fund strategies used by the hedge fund manager.

The Financial Services Board annually issues a fee schedule that the financial services providers should comply with each year. As per the 28th March 2010, the schedule for 2010/11 was issued and it stated that:
"The financial services providers authorised in terms of Section 8 of the Financial Advisory and Intermediary Services (FAIS) Act, 2002, as category II, IIA, or III as defined in the Determination of Fit and Proper Requirements for Financial Services Providers, 2008, must on or before 31 October of each year pay a levy which is subject to a maximum of R 1 110 000, and which is calculated as follows:

(i) a base amount of R5 138
(ii) A x R400
(iii) B x 0.00001395546
Where –

A= the total number of key individuals of the financial services provider approved by the Registrar, plus the total number of representatives appointed by the financial services provider, less key individuals who are also appointed as representatives, as at 31 August of the levy year;

B= the total value of investments managed on behalf of clients in terms of the authorisation as a financial services provider on 30 June of the levy year, provided that investments under management held in foreign currency must be included as the exchange rate published in the press at that date" (Financial Services Board Notice No 75 of 2010 gazetted on 28 May 2010, 2010:13).

South African financial regulatory authorities are currently working on a document that will seek to product-regulate hedge funds and the consultation process with the industry has already begun. According to Pengelly (2010:1), the Financial Services Board has indicated that they intend tabling the paper with firm recommendations on the regulations of the hedge fund products during 2010. At the moment, there are currently no authorisation requirements as such, and according to Hopkins (2010:2), the restrictions on the types of investments or the type and number of investors will be contained in the trust deed or prospectus distributed to shareholders.

In April 2009, the European Commission issued a press release containing their (EU) proposed directive on Alternative Investment Fund Managers, and this was part of the European Union's response to the global financial crises as envisaged in the G20 road map. This was a means of bringing the privately pooled funds into the regulatory net, and also to give the regulatory authorities powers to intervene in the sector, should a problem arise, to bring back stability to the sector (Brown, 2009:1).

According to Brown (2009:1), the press release of the European Union Commission's proposed directive will do the following:

- "Adopt an all encompassing approach so as to ensure that no significant AIFM escapes effective regulation and oversight, while recognising the legislative differences in existing business models and providing exemptions for smaller managers for whom the requirements would be disproportionate. For instance, this directive will only apply to managers managing portfolios with assets more that €100 million.
- Regulate all major sources of risks in the alternative investment value chain by ensuring that AIFM are authorised and subject to ongoing regulation, and that key service providers, including depositories and administrators, are subject to robust regulatory standards.
- Enhance the transparency of AIFM and the funds they manage towards supervisors, investors and other key stakeholders.
- Ensure that all regulated entities are subject to appropriate governance standards and have robust systems in place for the management of risks, liquidity and conflicts of interest.
- Permit AIFM to market funds to professional investors throughout the EU, subject to compliance with demanding regulatory standards.

- Grant access to the European market to third country funds after a transitional period of three years. This is to give enough time to EU to check if the necessary guarantees are in place in the countries where the funds are domiciled."

According to Brown (2009:1), the United Kingdom (UK) requested that an Impact Assessment be conducted before the EU rules governing London's hedge funds and private equity are agreed to. The UK's concerns, according to Brown (2009:1), are that the proposed (privately pooled funds) rules could be restrictive and threaten the good standing of London as international financial hub. This came to the fore after it was reported that some companies were threatening to leave London if the EU Directive on the regulation of the hedge fund managers was not revised. London has about 80% of the European hedge funds and 60% of EU Private Equity funds (Brown, 2009:1).

The Impact Assessment was then conducted in April 2009, and some of its findings confirmed that the regulation targeted at the level of the fund managers is much more meaningful than targeting regulation at the level of the funds (Commission of the European Communities Report (CECR), 2009:1). According to this report, hedge funds are just legal entities for the pooling of the funds and have no economic life of their own, and on the other hand, hedge fund managers are responsible for all key decisions in relation to the management of the fund.

The near collapse of Long Term Capital Management (LTCM) in 1998 triggered principal policy issues on how excessive leverage can be restrained. This is because excessive leverage can increase the likelihood of a general breakdown of financial markets. The Working Group that analysed the reasons that led to the near collapse of LTCM, made several recommendations aimed at restraining leverage to the House of Representative in America, and those included the following: to design a financial markets environment that will encourage transparency, enhance private sector risk management practices, develop more risk – sensitive approaches to capital adequacy, support financial contract netting in the event of bankruptcy, and encourage offshore financial centres to comply with international standards (Working Group on Financial Markets, 1999:2).

In September 2006 Amaranth Advisors LLC collapsed. The fund announced that they had lost as much investors' money as LTCM did back in 1998. However, the market did not react to that news as it was believed that the market could easily absorb the fallout from this fund (Mufson, 2006:1).

It could be deduced from the preceding statement, that the American market may have already absorbed the recommendations as put forward in the Report to the House of Representatives after the near collapse of the LTCM. The transparency, indicated in the Amaranth case, meant that most investors knew that the (Amaranth) fund was highly geared and not diversified, and hence the market was able to shrug off the news of its demise (Mufson, 2006:1).

The US is currently seeking to close the loopholes for small funds. Privately pooled funds advisors responsible for assets under management less than US $ 100 million are not required to register with SEC (Securities Exchange Commission) and the harsh disclosure requirements are not applicable to those funds. However, that will soon change since the regulators are seeking to reduce the compliance limit for the private funds to US $ 30 million instead (Sorkin, 2010:1).

The Greek prime minister called on the world economic and financial powers to bring upon stricter regulations to hedge funds and currency traders. The minister believes that these players have aggravated his country's financial woes, and he also believes that failure to rein in their activities could trigger a new global financial crisis (SETimes, 2010:1).

The US and EU have agreed that by developing their respective hedge funds regulatory regimes, they will avoid discriminatory and over protectionist rules that will favour one country over another. This was after the US has criticised the EU hedge fund rules, which US belied were hostile to the foreign funds (The Wall Street Journal, 2010:1).

The Securities and Exchange Board of India (SEBI) has banned the investments through participatory notes by unregulated entities, and this move is said to be directed to the hedge funds- thus limiting their access to broader markets (Oranika, 2010:3). Oranika (2010:3) goes on to say that some analysts/ academics are of the view that the hedge funds are designed to operate with maximum flexibility and, in addition, the regulations are "somewhat incompatible with the fundamental role and character of hedge funds". Oranika (2010:3) further adds that increased regulations are not good for the hedge fund market. The writer believes that such a move would destroy or at least reduce the natural setting under which hedge funds operate. Oranika is of the opinion that the reason for that is that the market is able to regulate itself, and has done a great job, thus far (Oranika, 2010:3).

Perryman (2010:1) believes that the introduction of the UCITS structure will distort hedge fund strategies, and their liquidity premiums will diminish resulting in the fall of performances. According to the survey Perryman (2010:21) conducted, hedge funds believe that AIFM directive, with its UCITS packaging requirements, has brought about uncertainties in the market regarding the distribution of funds. In addition, the survey also suggests that incentives should be incorporated into the AIMF structure that will encourage people to invest in illiquid assets and such incentives could be designed as regulated closed funds with a fixed horizon.

As is has been highlighted in the preceding discussion, hedge funds are a separate asset class from the well-known traditional asset classes. Berman (2005:2) elaborates on the key differences between these two asset classes, in the Table which follows.

TABLE 3: The Global Property Hedge Fund Newsletter

	HEDGE FUNDS	MUTUAL FUNDS
Return strategy	Seek absolute returns	Seek relative returns
Typical investment instrument used	Active trading, used of derivatives, short selling, and other sophisticated investment techniques	Many employ, buy and hold investing or index tracking. Limited regulated use of derivatives
Performance driver	Manager skill (uncorrelated to the market)	Many use the major market / index behaviour (generally correlated to the market).
Management fees	Fixed annual investment fee (1% - 2%) plus a [performance/ incentive fee (5%- 25%)	Fixed annual management fee (0.2% - 1%)
Liquidity	Periodic (monthly quarterly or annually)	Generally daily
Initial Lock-up	Varies	Generally none
Transparency	Performance information may be provided by manager or prime broker	Performance information is supplied by third-party custodian
Regulation	Not regulated	Regulated
Investor type	High net-worth individuals or institutions	Any investor

Source: Berman, M (2005:2). The Global Property Hedge Fund Newsletter

As has been enunciated in the Table above, these products (hedge funds) are different in form and, as it will be demonstrated in the following Table, also have different risk characteristics to that of traditional assets classes.

According to the Commission for the European Communities (2009:2), hedge funds can pose a number of potential risks on the economy, and those risks are mentioned in the Table to follow.

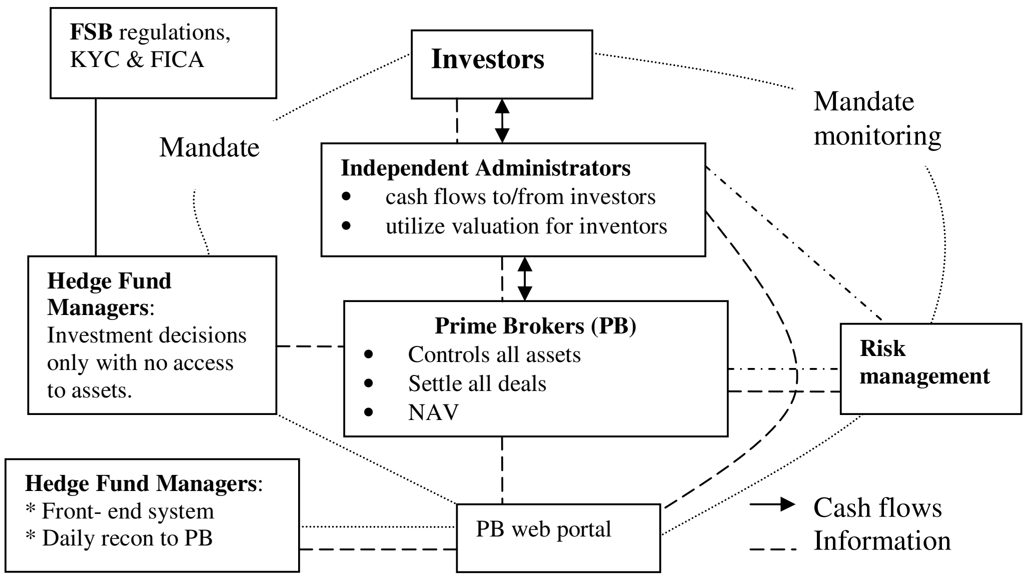
TABLE 4: Risks associated with hedge funds

Type of Risk	Explanation
Macro- Prudential (systemic) risks, relating in particular to the use of leverage	Direct exposure of systematically important banks (as the providers of leverage) to the AIFM sector. Pro-cyclical impact of herding behaviour, risk concentration in particular market segments and 'forced' deleveraging which are transmitted to the counterparties through asset prices and market liquidity
Micro – Prudential risks	Possible weaknesses in internal risk management systems with regard to liquidity risks, market risk, counterparty risks (credit and settlement risks, especially in the case of short selling) and operational risks
Investor Protection	Gaps in investor disclosure on investment policy, risk management, and internal processes as barrier to effective due diligence. Conflicts of interests and failures in fund governance, in particular with respect to remuneration, valuation and administration
Market Efficiency and Integrity	Impact of the dynamic trading and short selling techniques on market functioning. Potential for market abuse in connection with certain techniques, for example short selling
Impact on market for corporate control	Lack of transparency when building stakes in listed companies (e.g. through use of stock borrowing, contracts for differences), or concerted action in 'activist' strategies
Acquisition of control of companies by Fund Managers	Potential for misalignment of incentives in management portfolio companies, in particular in relation to use of debt financing. Lack of transparency and public scrutiny of companies subject to buy- outs

Source: Commission of the European Communities. 30 April 2009. Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives, 2004/39/EC and 2009/EC

The South African hedge fund industry has a number of stakeholders, as it will be observed in the following Figure. The risks that have been elaborated on in the Table provided earlier, speak to the individual stakeholders as demonstrated in the following Figure.

FIGURE 4. SA Hedge Fund Industry- Key Participants



Source: RMB presentation to the National Treasury. 16 April 2010. Use of Financial Derivatives: Investing in Hedge Funds. A Banking Perspective

According to the RMB presentation (2010:16), there are 6 main stakeholders in a trade that involves a hedge fund. They are as follows:

- ***Investors.*** This is a group whose funds create flow into the hedge funds environment. In South Africa, this group is made up of Fund of Funds, which takes 60% of the market, Pension funds 9%, and High Net Worth 8% (RMB presentation, 2010:16).
- ***Risk Managers:*** This group is mandated by the investors to monitor the hedge fund manager activities, including whether they comply with the type of risk they are mandated by investors to take. This group, according to a RMB presentation (2010:16), includes companies like Riscura and MAP.
- **Independent Administrators:** These are the companies or institutions that administer funds on behalf of the investors. These institutions work very closely with the prime brokers, and they keep the records for all funds and are said to be gatekeepers for the investors' funds. Investment Data Services (IDS) Group and Maitland Group are the two main players in South Africa (RMB presentation, 2010:16).
- **Prime brokers:** Prime brokers are mainly banks and comprise a very important piece of the hedge fund trading environment. They (PB) take full control of the

assets of the hedge fund, making sure that the hedge fund manager has no physical access to the funds and is only responsible for investment performance. (RMB presentation, 2010:16). These institutions provide leverage and support to the hedge fund manager. Prime brokers need to KYC[11] their clients and work with National Intelligence Association, and this is to make sure that the hedge fund business does not become a gateway to money laundering business (RMB presentation, 2010:16).

- **Hedge fund managers:** These are institutions that make investment decisions on behalf of the investors. They have the power of attorney (POA) and the mandate details of all that they can and cannot do with the investor's funds. These institutions need be registered with the Financial Services Board as category II A financial services providers, as per Section 7 of the Financial Advisory and Intermediary Services (FAIS) Act 37 of 2002 (RMB presentation, 2010:16).
- **Financial Services Board (FSB) regulation:** This is a South African regulatory / supervisory authority for the non-bank financial institutions (RMB presentation, 2010:16).

According to Goosen (2010:1), "it is considered best practice for hedge fund FSP's to outsource the administration and valuation of their hedge fund portfolios to a third party administrator, and to utilise the services of a nominee custodian for the receipt and holding of clients' funds and assets." To boost their profile hedge fund will also outsource audit and compliance function to a reputable company (Goosen, 2010:1).

2.1.1 THE RATIONALE FOR INVESTING IN HEDGE FUNDS

The Morden Portfolio Theory, according to Peile and Van der Merwe (2004:27), suggests that the overall efficiency of a portfolio of assets is determined by three factors: individual asset returns, the volatilities of these returns, and the correlation between the returns of these asses. Peile and Van der Merwe (2004:27) also mention that the great contribution made by Morden Portfolio Theory to the challenge of efficient portfolio construction, was to show how a diversified portfolio made up of assets with low correlations with each other could potentially have a lower risk than any of the assets that make up the portfolio. This is referred to as a diversification effect.

[11] KYC- Know Your Client. The term refers to a situation where the financial institutions or intermediaries do a due diligence on a prospective client so that they understand how their client makes money. This prevents rouge investors from using the system to launder dirty money.

The lower the overall risk of the portfolio, the greater in the diversification benefit and the opposite also holds (Peile & Van der Merwe, 2004:27).

From the narration above it can be deduced that investors would go for investment vehicles that offer good returns for minimum risk, which would be represented by greater diversification benefit arising from a well-constructed portfolio.

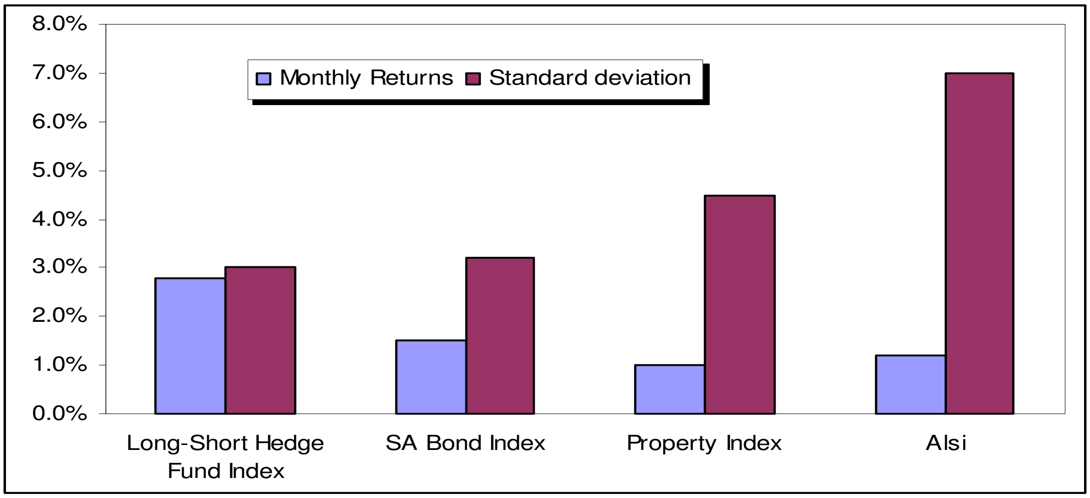
Harris (2006:17) adds to the above by suggesting that the hedge funds offer exactly what investors want, as they control risk, preserve capital and also offer real returns. Harris (2006:17) goes on to say that the performance of hedge funds has little correlation with the performance of the equity markets, and that makes them good vehicles for protecting equity profits if the market turns down.

Harris (2006:17) supports his claims by citing a report by Nedgroup Investments, which runs a hedge fund index on the industry in South Africa. He mentions that hedge funds, since inception in 2001, have returned 23.9% annualised, the SA equities returned 22.9% annualised, and the BESA all-bond index delivered an annualised return of 15.1%.

This notion is also backed by Nailana and Gopi (2004:16) in the following graph where they also display the hedge fund index (Long-Short benchmark) offering a risk – return combination which is more attractive than that of traditional assets represented by the ALBI (all-bond index), Property index and ALSI (SA All share Index).

This graph displays that the hedge funds delivered a 2.9% return with a risk (standard deviation) of about 3%, compared to the All Share Index that returned just above 1% with a risk of 7%.

Figure 5. Efficient Frontiers from Equity, Bond, Property and Long-Short Hedge Fund Benchmark (August 1998- August 2004)



Source: Nailana and Gopi (2004: 16). Efficient Frontiers from Equity, Bond, Property and Long-Short Hedge Fund Benchmark (August 1998- August 2004)

The risk-return combination offered by hedge funds, as it can be witnessed in Figure 5, is a real value-for-money investment compared to other asset classes (traditional portfolios).

The FAIS Act[12] requires that the managers communicate the hedge fund performance values periodically, and also educate their clients on how these funds do with reference to the benchmark chosen.

Table 5: Frequency of NAV or performance reporting to clients as percentages of assets.

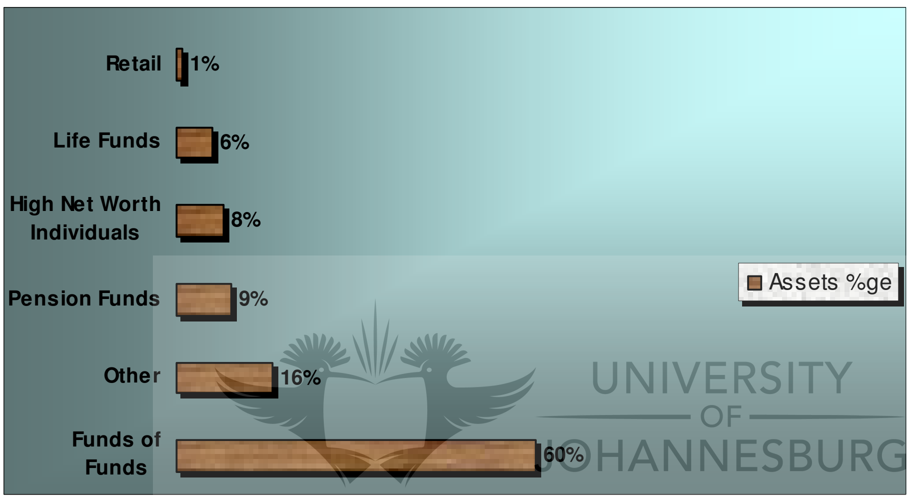
	Daily	Weekly	Bi-weekly	Monthly	Quarterly	Other
Jun-06	43%	12%	0%	43%	3%	0%
Jun-07	24%	7%	3.3%	62%	3%	0%
Jun-08	33%	7%	0%	58%	0%	2.3%
Jun-09	45%	8%	0%	44%	2%	1.2%

Source: Novare Investments. 2009. South African Hedge Survey. June 2009 (Published October 2009).

12 Section 8 on the FAIS Act 37 of 2002 stipulates on the qualities of the hedge fund manager together with his/her fiduciary duties to clients. This should be read in conjunction with the fit and proper requirements which give impetus to the Type 2A category of the FAIS Act. Hedge fund managers are discretionary and therefore fall under the Type 2A category of the FAIS Act.

According to Table 5[13] above, in 2009, 45% (2008:35%) of managers reported funds' NAV daily, 8%(2008:7%) reported weekly, 44% (2008:58%) reported monthly. In addition, we observe a substantial increase in daily reporting between 2008 and 2009. This change is probably driven by clients wanting to know the status of their portfolios during this crisis period. Nonetheless, this improved daily communication between fund managers and the investors is in line with the spirit of FAIS Act (37 of 2002). The South African investor profile is dominated by Funds of Funds – which invest about 60% of the R29 billion, and the least invested cluster is the retail investors. (See following Figure).

FIGURE 6: South African Investor Profile



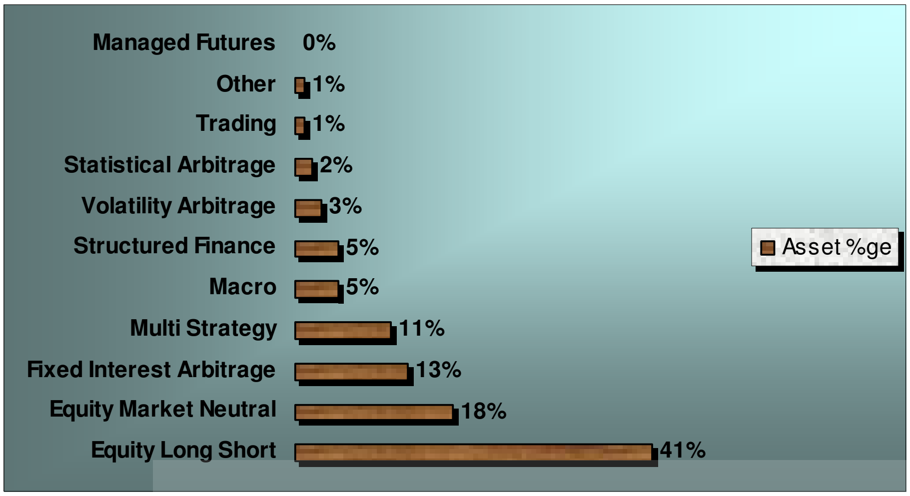
Data source: Novare Investments- South African Hedge Fund Survey. October, 2009. p11.

According to Thornton-Dibb (2009:5), the 2008 crisis meant some restructuring in the hedge fund space- which will include some consolidation and migration of funds from poorly performed funds during the crisis. Clients will redraft their mandates in line with their reduced risk appetites (Thornton-Dibb, 2009:5). The hedge fund investing is still skewed in favour of high net worth and institutional investors; this could be ascribed to, according to Goosen (2010:2), the fact that hedge funds in South Africa are not allowed to solicit[14] for investments into their hedge funds portfolio.

[13] Table 5 indicates the frequency of NAV or performance reporting by fund managers, as represented by assets under management. For instance some managers report daily, weekly or monthly.
[14] According to Goosen (2010:2), solicitation refers to any marketing in any form or inviting members of the public by any means to invest in specific funds.

As can be observed in the Figure that follows, as at June 2009, most hedge funds (about 60% assets size) employed strategies with binary[15] characteristics- including Equity long-short and Equity market neutral strategies.

FIGURE 7. South Africa Hedge Fund Strategies (by Asset Size)



Data source: Novare Investments- South African Hedge Fund Survey. October 2009. p10.

Mathieson and Eichengreen (1999:4) state that governments are carefully considering the rules and/ or policies that will control the activities of hedge funds. These authors are unclear on whether hedge funds do more harm than good in precipitating the fall of assets prices, and than they do well by helping break the free fall that can afflict oversold markets (Mathieson & Eichengreen, 1999:4).

Agnew (2010: 1) has observed that hedge fund managers in the United Kingdom are petrified of the UK Financial Services Authority's (FSA) hard-nosed stance on delinquent hedge fund managers. According to the report, the FSA has fined the British GLG Hedge Fund Management company and its star trader, Philippe Jabre, GBP 750 000 each, and this was believed to be the biggest success of the regulator to clean up the British hedge fund industry to date (Agnew, 2010:1).

[15] A Binary Strategy refers to a strategy that has two transactions going in different directions. E.g. an Equity long-short. This means a long position plus a short position in equities plus a little biasness either on the short or long side.

Cumming (2008:26) believes that there is an ambiguous relationship between hedge fund regulation and the structure and performance for the fund. Cumming is also of the opinion that the stricter regulations deters unscrupulous hedge fund managers from creating opaque and complicated structures, and contributes towards improving hedge funds in general (Cumming, 2008:26).

Cumming on one hand concurs with Perryman (2010:1) on the notion that the hedge regulation could curtain the activities within the fund. Cumming (2008:26) believes that "the hedge fund regulation could hamper fund performances where hedge fund managers and their investors lose freedom to contract and organise their resources in the way that they deem to be more efficient, and thereby exacerbate agency problems" (Cumming, 2008:26).

Smith (2008: 4) believes that the notion that expectations do shape market behaviour is a core feature of organisational and economic sociology. The markets start moving towards what they expect would be norm, before the regulation starts filtering in.
Smith further postulates that this notion has been used in explaining empirical instances of organisational conformity and market isomorphism that runs counter to competition based theories of organisational behaviour" (Smith, 2008:4).

2.2 CONCLUSION

In this literature review, a number of publications that were recently issued with regard to the hedge funds, both locally and abroad, were highlighted, and where possible comparisons have been made between jurisdictions.

Also, issues were highlighted around the G20 recommendations on the regulation of privately pooled funds that include hedge funds. The IOSCO principles that were drafted following the G20 recommendations were laid out in this chapter. These principles, as has been cited in this chapter, form a basis of the regulatory framework of jurisdictions that are member states to the IOSCO. South Africa is also a member.

In addition, the literature in this study has displayed mixed views and perceptions around hedge fund regulations. In this study an endeavour was made to entertain both groups to give a balanced view in the end. For instance, some strong views were expressed that hedge fund regulation is crucial, as well as that it is more important to target regulation at the level of hedge fund managers, than targeting hedge fund products. As has been indicated above, the advocates of this form of regulation, which is targeted at hedge fund manager level, believe it is more relevant and confronts the problems associated with hedge funds. On the other hand, there is a group whose views are contrary to the above and who believe that hedge funds, by mere design, are not meant to be regulated. This group believes that the market did well in the past under self-regulation, and no financial crises can be said to have been caused or linked to their industry. This group believes the hedge fund market should be left to regulate itself.

In South Africa, hedge manager regulations (FAIS Act, 37 of 2002) were introduced late in 2007 and an additional layer, Fit and Proper requirements, was added late in 2008. This study aims to demonstrate if this regulation (FAIS Act) had an impact on the South African hedge fund industry.

In Chapter 3, the research methodology that will be followed in this study will be discussed. In Chapter 4, the results of the survey will be presented and interpreted. Chapter 5 will contain a summary of the study and recommendations which will conclude the study.

CHAPTER 3
RESEARCH METHODOLOGY

3.1 INTRODUCTION

In Chapter 2, a number of literatures that have been published with regard to hedge funds, and more in particular issues relating to hedge funds regulations, have been discussed.

Chapter 3 will delve on the research methodology of this study. As part of this chapter, three research paradigms will be laid out, and the researcher will then identify the research paradigm that will be used in this study. The discussion will briefly follow on the methodology, as well as the sample and the sampling method that will be used.

3.2 RESEARCH PARADIGMS

Buckingham and Saunders (2004:293) define a research paradigm as "a distinctive approach in science which has its own theories and methods (which may be incompatible with those of other approaches), and its own criteria of scientific adequacy and rigour."

According to Newman (2003:69), there are five research paradigms that are used by academics to carry out educational research- they are positivist paradigms, interpretive social science, critical social science, the feminist paradigm, as well as the postmodern research. These paradigms, individually and collectively, embody a carefully created path through which a systematic observation of the world, combined with careful logical thinking, could provide a new and valuable type of knowledge about human relations (Newman, 2003:69).

Buckingham and Saunders (2004:24) add to this revelation that humans see things is certain ways and put them into categories. Buckingham and Saunders (2004:24) continue to suggest that "in the process of observing things, [people] simultaneously make sense of them by fitting [their] experiences into a pre-existing conceptual framework." This would suggest that people will observe and interpret similar situations differently, reflecting on their stereotypes and backgrounds.

Buckingham and Saunders (2004:24) postulate that people are not free to use any framework to interpret the world; meaning that researchers can only use the pre-existing frameworks such as those mentioned above, namely positivist, interpretive, critical theory or feminist paradigm. It should be noted that there are other paradigms that that are not mentioned in this study- those include mixed method, pragmatic and transformative-emancipatory paradigms and so forth.

Tashakkori and Tendlie (2003:4) add another dimension to this discussion and suggest that researchers in the social and behavioural sciences are in three categories: (a) Quantitatively oriented researchers working with the post positivist tradition and primarily interested in numerical analyses, (b) Qualitatively oriented researchers working with constructivist tradition and primary interested in the analysis of narrative data, and (c) The mixed methodology researchers working within other paradigms and interested in both qualitative and quantitative data.

3.2.1 Positivist paradigm

Tashakkori and Tendlie (2003:713) define positivism as the empiricist approach, or simply as the view "that social research should adopt a scientific method that consists of the vigorous testing of hypotheses by means of data that take the form of quantitative measurements". This paradigm, according to Tashakkori and Tendlie (2003:713), is sometimes referred to as logical positivism, logical empiricism or post positivism.

Newman (2003:71) concurs with Tashakkori and Tendlie, and describes the positivist paradigm as the social science research process that involves the use of precise quantitative data and that often uses experiments, surveys and statistics. Newman (2003:70) further suggests that this is a widely used approach, and researchers often do not hear about other alternative methods. Newman (2003:71) also states that "positivism sees social science as an organised method combining deductive logic with precise empirical observations of individual behaviour in order to disclose and confirm a set of probabilistic causal laws that can be used to predict the general pattern of human behaviour". As with Tashakkori and Tendlie (2003:713), Newman (2003:70) also suggests that positivism has lost it appeal to an extent that many scholars do not like to be referred to as a positivist- so they, as result, go by names of logical positivists, logical empiricists, or post positivists.

3.2.2 Interpretive social theory

Somekh and Lewin (2005: 346) describe the concept of interpretivism “as the term given to research in the hermeneutic tradition which seeks to uncover meaning and understand the deeper implication revealed in data about people”. Newman (2003:75) states that interpretive social science originated in the 19th century, from Max Weber and Wilhelm Dilthey, a German sociologist and a German philosopher, respectively. Newman (2003:76) concurs with Somekh and Lewin (2005:346), and further suggests that the interpretive paradigm has the following sub-paradigms: Hermeneutics[16], Constructionism, Ethnomethodology, Cognitive, Idealist, Phenomenological, Subjectivist, and Qualitative Sociology.

Newman (2003:76) suggests that the interpretive approach is often referred to as a qualitative approach, and the writer adds that this approach is a loyal opposition to the positivist approach. The differences between positivist and interpretive approaches, are laid out in Table 6 that follows.

Symon and Cassell (1998:7) add that the interpretive paradigm is qualitative in its nature. In addition, this approach, according to Symon and Cassell (1998:7), has been subjected to heightened criticisms because it did not justify the way the data is interpreted. This mould of criticism, according to Symon and Cassell (1998:7), has led to a group of qualitative researchers coming up with a framework that could be used to test the validity of the qualitative research results. The framework has four pillars and these authenticity pillars are:

- Resonance (the extent to which the research process reflects the underlying paradigm)
- Rhetoric (the extent of the presenting argument)
- Empowerment (the extent to which the findings enable the readers to take action)
- Applicability (the extent to which readers can apply the findings to their own context).

3.2.3 Critical Social Science

Newman (2003:81) states that critical social science represents, mostly, the criticisms that the interpretive approach levelled against the positivist approach, but critical social science is a distinct paradigm that goes beyond what interpretive approach stands for.

[16] Hermeneutics is an ancient term in humanities that refers to uncovering hidden meaning.

This approach, according to Newman (2003:81), is said to have been popularised by Karl Marx and Sigmund Freud in the 19th century, and it criticises the positivist approach for being undemocratic and unreasonable in its approach when analysing human behaviour. Critical social science provides an alternative methodology to the other processes mentioned above, and its purpose is to suggest means to change the world. In other words, the researchers use this approach to give voice to the poor and the marginalised members of the community (Newman, 2003:81). This information is tabulated in Table 6.

3.2.4 Feminist and postmodern research

These two approaches are still in their developmental stages and both extend from the interpretative and critical theory mentioned above. The feminist approach is used mostly by female researchers and its purpose is to liberate them. In other words, the feminist approach gives an alternative to the male perspective that is currently dictating terms to how the social science research should be carried out.

Newman (2003:16) gives a brief summary among some of the research approaches mentioned above, in Table 6.

Table 6: A summary of differences among various approaches to research

	Positivism	Interpretive social science	Critical social science	Feminist	Postmodern
Reasons for research	To discover natural laws so people can predict and control events	To understand and describe meaningful social action	To smash myths and empower people to change society radically	To smash myths and empower people to advance values of nurturing others and equality	To express the subjective self, to be playful and to entertain and stimulate others
Nature of social reality	Stable pre-existing patterns or order that can be discovered	Fluid definitions of situation created by human interaction	Conflict filled and governed by hidden underlying structures	Conflict-filled, structured power relations that keep many people oppressed	Chaotic and fluid without any real patterns or master plans
Nature of human beings	Self interested and rational individuals who are shaped by external forces	Social beings who create meaning and who constantly make sense of their worlds	Creative, adaptive people with unrealised potential, trapped by illusion and exploitation	Creative, gendered beings with unrealised potential who are often trapped by unseen forces	Creative, dynamic beings with unrealised potential
Role of common sense	Clearly distinct from and less valid than science	Powerful everyday theories used by ordinal people	False beliefs that hide power and objective conditions	False beliefs that hide power and objective conditions	The essence of social reality that is superior to scientific or bureaucratic forms of reasoning
Theory looks like	A logical deductive system of interconnected definitions, axioms and laws	A description of how a group's meaning system is generated and sustained	A critique that reveals true conditions and helps people see way to a better world	A critique that reveals true conditions and helps people see the way to a better world	A performance or work of artistic expression that can amuse, shock or stimulate others
An explanation that is true	Is logically connected to laws and based on facts	Resonates or feels right to those who are being studied	Supplies people with tools needed to change the world	Supplies ideas/ tools to help liberate people from oppressive relations	No one explanation is more true, are all true for those who accept them
Good evidence	Is based on precise observations that others can repeat	Is embedded in the context of fluid social interactions	Is informed by a theory that unveils illusions	Is informed by theory that unveils illusions	Has aesthetic properties and resonates with peoples' inner feelings/emotions
Place for values	Science is value free, and values have no place except when choosing a topic	Values are an integral part of social life: no group's values are wrong, only different	All science must begin with a value position; some positions are right; some are wrong	Values are essential to research and feminist ones are clearly preferred	Values are integral to research; but all value positions are equal

Source: Newman, E (2003:16). Social Research Methods: Quantitative and Quantitative Approaches

3.3 RESEARCH APPROACH

Based on the preceding discussion, the following points in the form of a Table, can be deduced:

Table 7: Research approaches

Research paradigm	Form	Nature of human beings
Positivist	Quantitative, connected to laws, use figures to explain human behaviour	Rational and self interested shaped by external forces
Interpretive	Qualitative, search for meaning, narrative, explains things	Social beings who create meaning and who constantly make sense of their worlds
Critical theory	Creative, critical, supplies tools needed to change the world	Creative, adaptive people with unrealised potential, trapped by illusion and exploitation
Feminist	Gender sensitive. Supplies tools needed to liberate people from oppressive forces. Empathy, intuition, women's liberation	Creative, gendered beings with unrealised potential who are often trapped by unseen forces

The purpose of this study is to examine if the introduction of the hedge fund manager regulation in South Africa had any impact on the way the hedge fund business is carried out in South Africa. This will be narrative in form, and the researcher intends following interpretive paradigm. As per Table 7, the interpretive paradigm is qualitative in form, meaning that through this approach, the search for meanings and also trying to make sense of the world can be achieved. It is believed that the chosen method is feasible and reflects on the objectives of the study.

Symon and Cassell (1998:3) argue that the ongoing social science research debate between the qualitative and the quantitative approaches is inadvertently about a small but an impactful sphere- which is epistemology[17] and ontology[18]. Symon and Cassell (1998:4) further posit that a true qualitative research method draws from a "subjectivist ontology and possibly from an interpretivist epistemology".

[17] Epistemology describes a situation whereby humans describe and accept knowledge as warranted.
[18] Ontology refers to the nature of reality that is to be studied and what can be known about it.

Symon and Cassell (1998:3) further suggest that the most important thing should be selecting a right technique, bearing in mind its weaknesses and strengths, as opposed to other methods.

Henwood (as quoted by Symon and Cassell, 1998:3) states that "…researchers who adopt a more… interpretative stance have a clear affinity for a qualitative research plus a strong conviction that a choice of a method is liberated and informed by the position one takes within the epistemological debate".

Tashakkori and Tendlie (2003:676), advocate the use of mixed methodology because the approach provides an opportunity for presenting divergent views. These two authors cite the example of a study, conducted by Trend in 1978 on an American housing subsidy programme. The study entailed both the collection of qualitative data, as well as the collection of quantitative data. Data gathering was conducted separately. According to this study, the structures of the two processes were as follows:

- The quantitative data was gathered through surveys on agency activities, expenses, demographic characteristics of clients and housing quality. The intention of this data gathering technique was to gauge the success of the programme.
- The qualitative data, on the other hand, was gathered through a case study of various sites as submitted by the anthropologists using field observations, interviews and documents. In this regard, the intention was to get an understanding of how the programme has been implemented (Tashakkori & Tendlie, 2003:676).

Tashakkori and Tendlie (2003:676) conclude that an opportunity to present divergent views was obtained in this case study. This means that the findings through the qualitative approach could conflict with the findings of the quantitative approach -giving rise to the divergence that these writers believe what is good for the research.

3.4 REASERCH DESIGN

Malhotra(1996:86) describes a research design as the framework or blueprint for conducting the marketing research project, and it specifies the details of the procedures necessary for obtaining the information needed to structure or solve the marketing research problem.

There are a number of research designs that can be used, depending on the type of research, research topic, and the reasons for the research. Symon and Cassell (2005:99-100) identify the following key questions that a researcher can use to choose an appropriate design:

- What are you interested in finding out?
- Who is your target audience?
- How often should the respondents complete the questionnaire and over what period?
- What questions should you ask and what is the best medium?
- What is the distribution medium?
- What happens after the respondents have participated?
- How do you collect your responses?

The different designs can be briefly explained as follows:

3.4.1 Cross-sectional design

Somekh and Lewin (2005:216) describe the cross-sectional design as the design that is often used is surveys, which also involves the collection of quantitative data at any one point in time. The data can be collected through questionnaires, interviews, and other methods. The data collected is used to look for trends or relationships in a group of people with the same attributes (Somekh & Lewin, 2005:216).

Cross-sectional design takes a one-snap shot in the social world and can be exploratory, descriptive or explanatory- but it is mostly in line with the descriptive research process. Newman (2003) goes on to suggest that this process is preferred, because it is simple to implement and less costly (Newman, 2003:31).

This design will be used as a guiding instrument for the chosen topic. Structured questionnaires will be developed to collect data from South African hedge fund managers in order to observe if there has been a change in South African hedge fund manager behaviour following the introduction of the FAIS registration requirement in South Africa. This design would be suitable for this topic because of its simplicity and cost efficiency.

3.4.2 Longitudinal design

The longitudinal design is seen as an extension of the cross-sectional design. The only deference being that this design is mostly applicable when there is a more established causality and also where the survey can be repeated over a number of years (Somekh & Lewin, 2005:217).

Newman (2003:31) sees the longitudinal approach as more powerful, but also very complex and costly. Examples of this process include time series analysis, panel study and cohort analysis.

3.4.3 Case study process

This design can be used either with the cross-sectional process or longitudinal process. In other words, the researcher aims to dig deeper, to examine the features on many people or units, on any one period or across time periods (Newman, 2003:33).

3.4.4 Experimental design

Newman (2003:35) explains this process as using both logic and principles found in natural science research, and this process can take place either in a laboratory or in real life. This process is used to address a specific question. An example would be researchers in a laboratory experimenting with different combinations of medicines to find a cure for a certain disease. Another example would be an organisation testing a system change in a small scale environment before they roll it out on full scale.

3.4.5 Comparative research design

Buckingham and Saunders (2004:17), explains the process as follows: "We have only one way to demonstrate that a given phenomenon is the cause of another, viz., to compare the cases in which they are simultaneously present or absent, to see if the variations they present in these different combinations of circumstances indicate that one depends on another… The method employed is that of indirect experiment, or the comparative method." The process normally involves experiments (Buckingham & Saunders, 2004:18). Newman (2003:39) examines the impact of one or more variables on two or more different circumstances.

3.5 METHODOLOGY FOR DATA GATHERING

Zikmund (2003:62) refers to secondary data as data that had previously been collected and assembled for some project other than the one at hand. It has already been laid out in Chapter 2 what literature has already been published with regard to the hedge funds and regulation. The second step is to conduct an empirical study to get more data about the chosen topic.

3.5.1 Sampling procedure and sample size

According to Barbie (2007:111), the population for a study refers to the group of people or things about whom one wants to draw a conclusion. Barbie goes on to say that it is almost impossible to study the whole population, and hence a sample has to be selected (Barbie, 2007:111).

Somekh and Lewin (2005: 217) advise that a researcher should make sure that the sample is representative (in terms of characteristics and all other attributes) in order to make it possible to generalise about the whole population. The authors also advise that a researcher should explain the sampling method used so that the readers can make determinations about sampling biases reflected in the research (Somekh & Lewin, 2005:217).

According to Somekh and Lewin (2005:217), there are two types of sampling, namely:

- **Probability sampling**

This method gives each member of the population an equal or known chance of being selected to participate in the survey. This method gives a pedestal to generalise about the whole population.

- **Non-probability sampling**

Non-probability sampling is different from the probability sampling in that there are circumstances that disallow probability sampling. The issues include consent needed from certain important participants, their availability, and confidential issues within their organisations. These issues make the sampling non-probabilistic.

It was decided not to sample the population, for this study, because the hedge fund industry in South Africa is small and relatively new. South Africa has about 77 known hedge fund management companies with an estimated117 hedge fund managers (according to the Financial Services Board Schedule received in August 2010). The questionnaires will be sent to all 77 hedge management companies.

3.5.2 Data collection

According to Malhotra (1996:22), data collection involves a field force of staff that operates either in the field, as in the case of personal interviewing, from an office by telephone interviewing, or through mail.

In this survey, the questionnaire method will be used to collect data and this is because of the effectiveness and cost efficiency attributable to this method. The telephone interview method will be very expensive and will, most probably, deter the project as a result of the budgetary constraints. The mail method, on the other hand, will take too long to give feedback and will also discourage people from participating.

A structured questionnaire will be sent to all registered South African hedge fund management companies through an email-link which will facilitate the completion of the form online. The researcher expects the number of participants to increase because the technique (email- link) involves no paperwork, and will take about five minutes of their time. This is also an environmentally friendly method since it does not promote excessive paper use.

As the managers submit their responses, the Table on the researcher's side will be updated, as the data comes through and a summary data will be presented. A detailed report will then be generated detailing the findings of the study. This report will be containing the data that the researcher will analyse.

3.6 CONCLUSION

Chapter 3 described the methodology that was used to carry out the research process. Also, as part of the research methodology, the sampling methods that were used were briefly outlined.

In summary, the interpretive paradigm, as a guiding force in the research has been used. Secondly, a cross-sectional design was used because of its simplicity and cost efficiency. A structured questionnaire has been sent to all registered hedge fund companies in South Africa. As discussed in this chapter, it was decided that there will not be any sampling of the South African hedge fund management companies, for this study because the population is small with an estimated seventy seven hedge fund management companies.

Chapter 4 will be dedicated to the presentation and the interpretation of the research results.

CHAPTER 4
PRESENTATION AND INTERPRETATION OF THE RESULTS

The survey was conducted between 13 August 2010 and 19 August 2010, and 35 respondents participated out of seventy seven (77) management companies that received invitations. It is believed that the thirty five hedge fund companies that responded are adequate to generalise about the whole South African hedge fund industry.

The questionnaire has five different themes, which are (1) Regulation, (2) Character of Regulation, (3) Credibility of Regulation, (4) Investor Protection, and (5) the Hedge Fund Manager Behaviour. Under each theme a set of questions was asked and those questions reflected on the theme under which they had been listed. The respondents had to choose the most suitable answer from a list of 5 choices. Those choices varied from 'strongly agree' to 'strongly disagree'.

These results have been interpreted as line questions and in the end, concluded under themes where they were listed. The purpose was to establish if the results confirm if the FAIS Act (no 37 of 2002) had any impact on the hedge fund industry of South Africa. Also, to establish if the results confirm the research objectives. The research objectives, as contained in our hypothesis statements, are:

(i) The regulation has brought credibility in the market, and business activities and liquidity has improved.

(ii) The protection of market participants has improved following regulation.

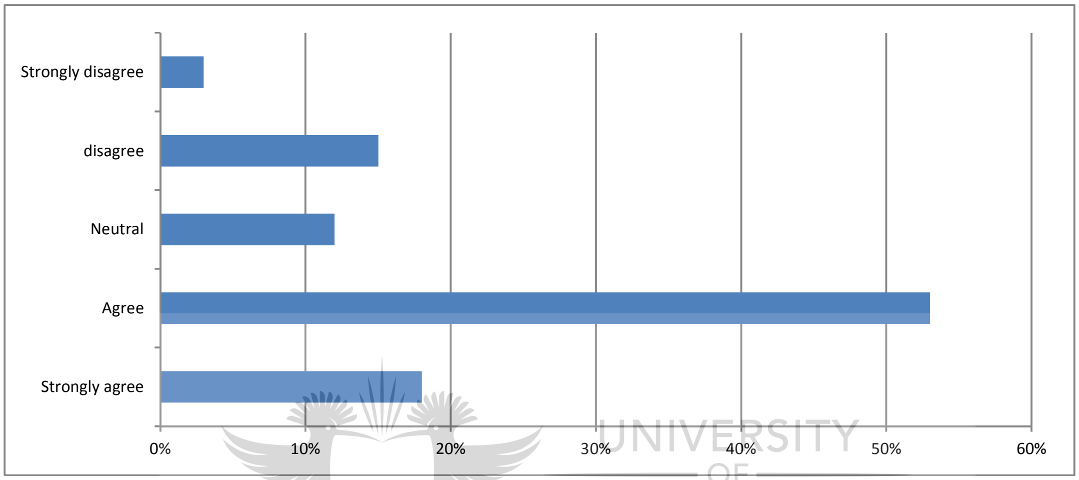
(iii) Other features, including transparency, and disclosures of important information to the customers, have also improved.

<u>THEME 1</u>: <u>The Hedge Fund Regulation</u>

Question 1

The regulation of hedge fund managers in South Africa is a necessity.

(i) 2% of the respondents **strongly disagreed**;
(ii) 15% of the respondents **disagreed;**
(iii) 12% of the respondents were **neutral;**
(iv) 53%of the respondents **agreed;** and
(v) 18% of the respondents **strongly agreed**;

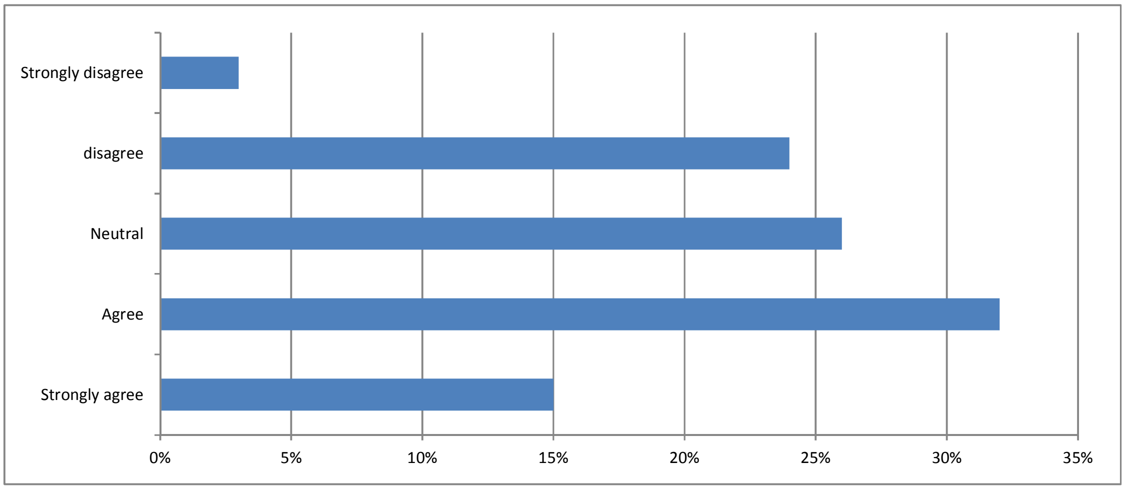


The 35 hedge fund managers who participated in our survey responded as follows: 18% strongly agreed that regulating hedge fund managers in South Africa is a necessity with 53% of the respondents just agreeing that regulation is a necessity. In other words 71% of the respondents agreed or strongly agreed that hedge fund regulation is a necessity.

Question 2

It is more important to regulate hedge managers than hedge fund products.

(i) 3% of the respondents **strongly disagreed;**
(ii) 24% of the respondents **disagreed**;
(iii) 26% of the respondents were **neutral**;
(iv) 32% of the respondents **agreed**; and
(v) 15% of the respondents **strongly agreed.**

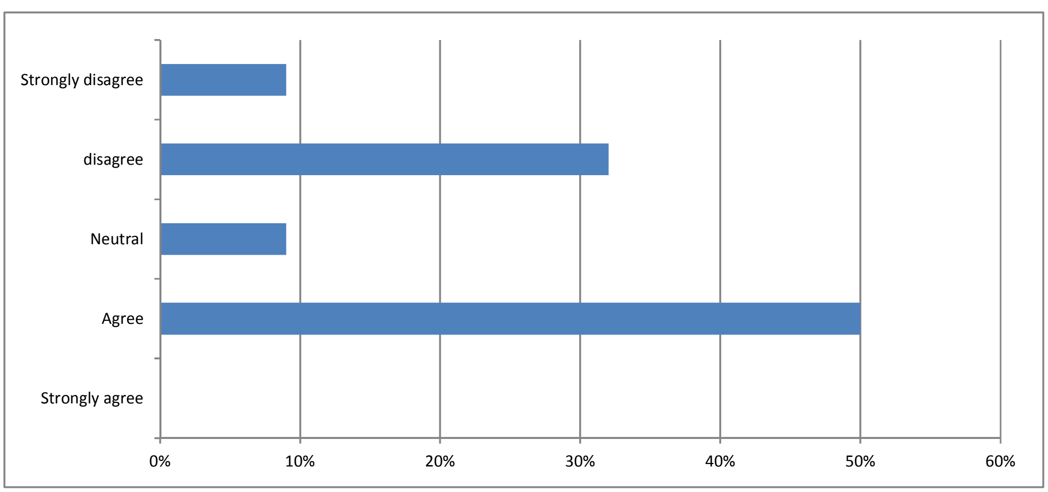


The researcher received mixed views on the issue of whether it was more important to regulate hedge fund managers than hedge fund products. 32% agreed to that notion, with an additional 15% strongly agreeing. 26% was neutral and 24% disagreed. 3% strongly disagreed. In other words 47% (15% + 32%) , which is a forced majority, agreed or strongly agreed that regulation targeted at hedge fund managers is more effective than regulation targeted at the hedge fund product level.

Question 3

Both hedge fund managers and hedge fund products should be regulated.

(i) 9% of the respondents **strongly disagreed;**
(ii) 32% of the respondents **disagreed**;
(iii) 9% of the respondents were **neutral;**
(iv) 50% of the respondents **agreed;** and
(v) 0% of the respondents **strongly agreed**.



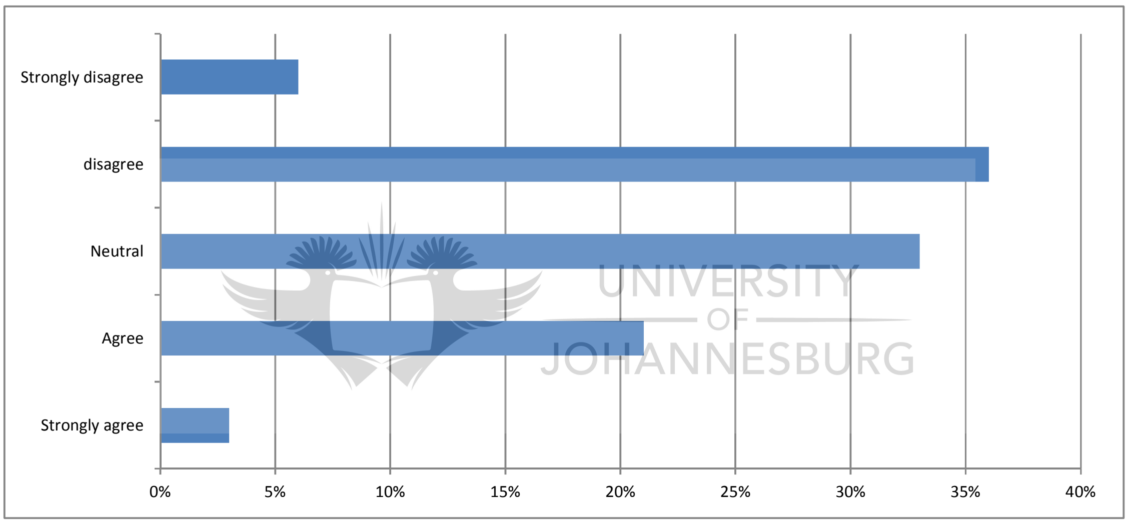
In this question, the majority of the respondents (50%) agreed that both hedge fund managers and hedge fund products should be regulated. The other 9% were neutral.

32% disagreed with that notion and an additional 9% strongly dissagreed with regulating both hedge fund products and hedge fund managers. It is therefore safer to say that the majority of the respondends are comfortable with regulation both at hedge fund product level, as well as at hedge fund manager level.

Question 4

The South African funds should be left to regulate themselves.

(i) 6% of the respondents **strongly disagreed;**
(ii) 37% of the respondents **disagreed;**
(iii) 33% of the respondents were **neutral;**
(iv) 21% of the respondents **agreed**; and
(v) 3% of the respondents **strongly agreed**.



Is this case, 37% of the respondents disagreed with the suggestion that the market should be left to regulate itself, with an additional 6% strongly dissagreeing. 33% of the respondents were not sure. Therefore, the majoty of the respondents want to be regulated.

Under theme 1 (Regulation), it can safely be concluded that hedge fund managers in South Africa prefer to be regulated rather than to be left to regulate themselves. In addition, they believe that regulation is a nessessity. This opinion is in line with the findings in the survey that was carried out by Rajan and Brown (2005:15), qouted in the literiture review in Chapter 2, wherein the majority of the respondents expected positive outcomes for the hedge funds from regulations. However, some authors have a different view. For instance, Oranika (2010:3) is of the view that hedge funds are not designed to be regulated and in addition, the industry has done well in the past through self-regulation.

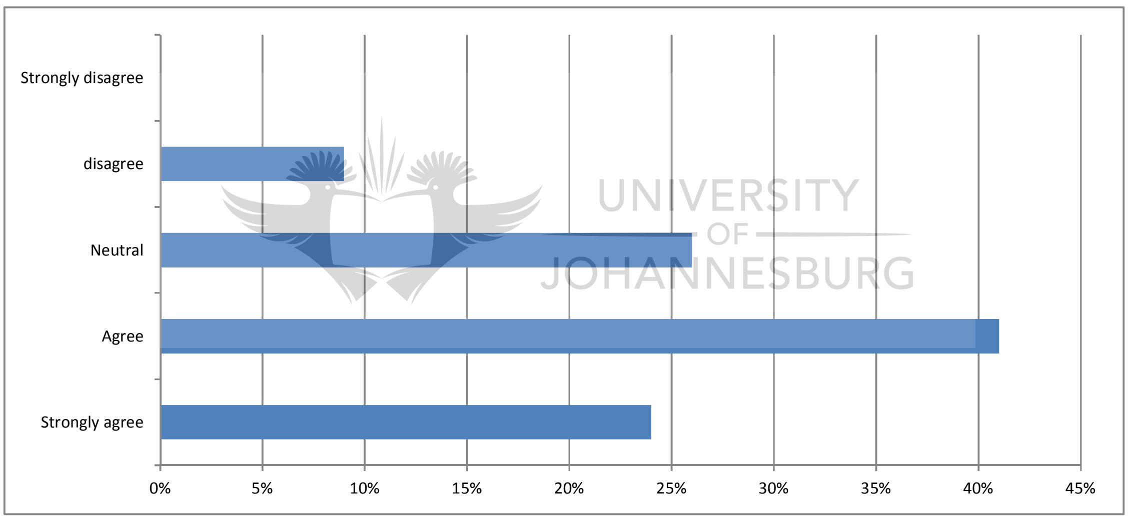
Theme 2 : Character of Regulation

Under this theme, 4 (four) questions reflecting on the character of the FAIS regulation were asked.

Question 5

The hedge funds compliance costs are very high.

(i) 0% of the respondents **strongly disagreed;**
(ii) 9% of the respondents **disagreed;**
(iii) 26% of the respondents were **neutral;**
(iv) 41% of the respondents **agreed**; and
(v) 24% of the respondents **strongly agreed**.

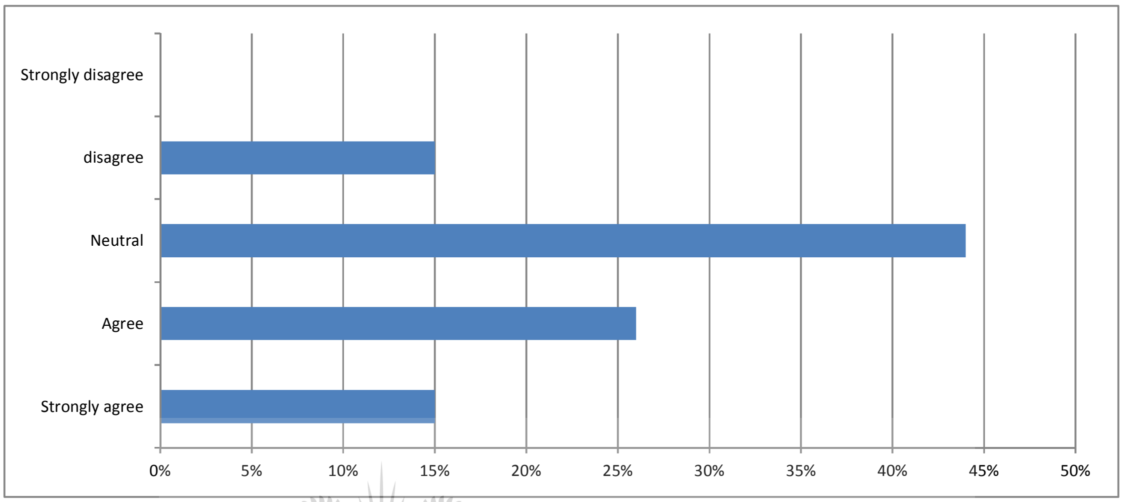


In this question, the respondents were asked if they thought the compliance costs for hedge funds were high. 24% of the respondents strongly agreed, with a further 41% agreeing that hedge funds compliance costs are very high. Only 9% disagreed with that notion. In other words, the majority of the respondents in the industry believe that the compliance costs for hedge funds are very high.

Question 6

The licence fees are very high.

(i) 0% of the respondents **strongly disagreed;**
(ii) 15% of the respondents **disagreed;**
(iii) 44% of the respondents were **neutral;**
(iv) 26% of the respondents **agreed;** and
(v) 15% of the respondents **strongly agreed.**

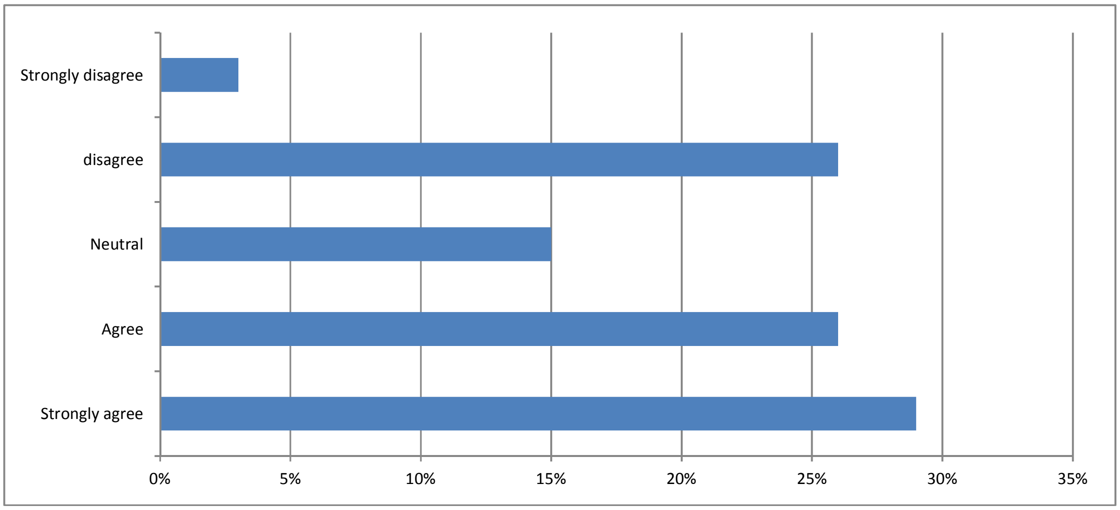


In this question, the majority (44%) of the respondents did not take sides (they were neutral). 15% strongly agreed, with an additional 26% just agreeing with the view that licence fees were high. It can be concluded that the industry is not sure whether the costs are indeed high or reasonable.

Question 7

The FAIS regulation is unfair for small hedge fund managers.

(i) 3% of the respondents **strongly disagreed;**
(ii) 26% of the respondents **disagreed**;
(iii) 15% of the respondents were **neutral;**
(iv) 27% of the respondents **agreed;** and
(v) 29% of the respondents **strongly agreed**.

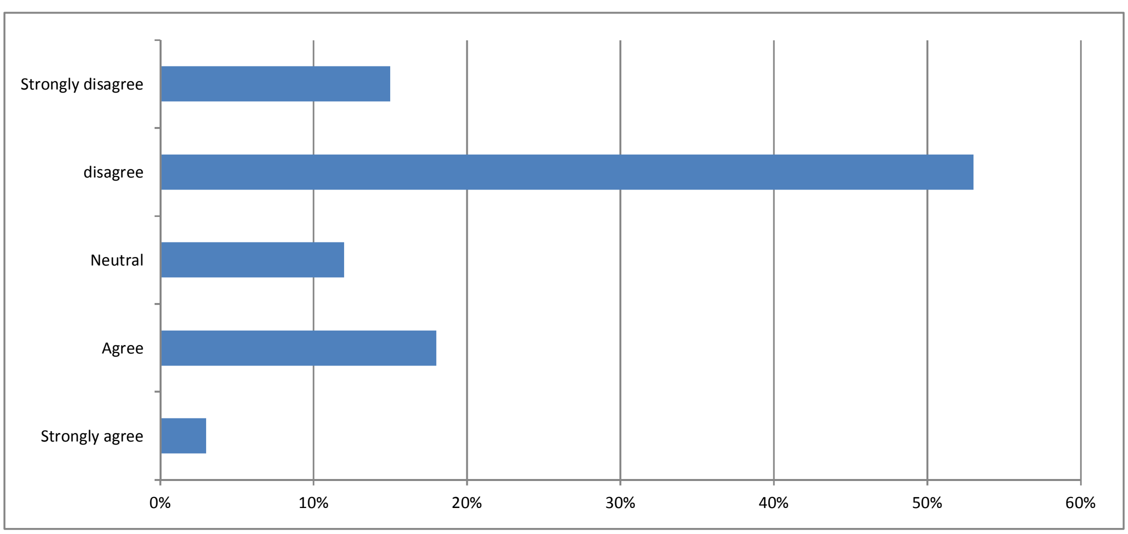


It can be concluded, in this case, that the majority of the hedge fund managers believe that the FAIS regulation is unfair for small hedge fund managers. 27% of the respondents agreed that the act is not fair for small hedge fund managers, with an additional 29% strongly agreeing with the impression. 26% disagreed and the further 15% were neutral.

Question 8

The small hedge fund managers should not be required to comply with the FAIS Act.

(i) 15% of the respondents **strongly disagreed;**
(ii) 53% of the respondents **disagreed;**
(iii) 12% of the respondents were **neutral;**
(iv) 18% of the respondents **agreed**; and
(v) 2% of the respondents **strongly agreed**.

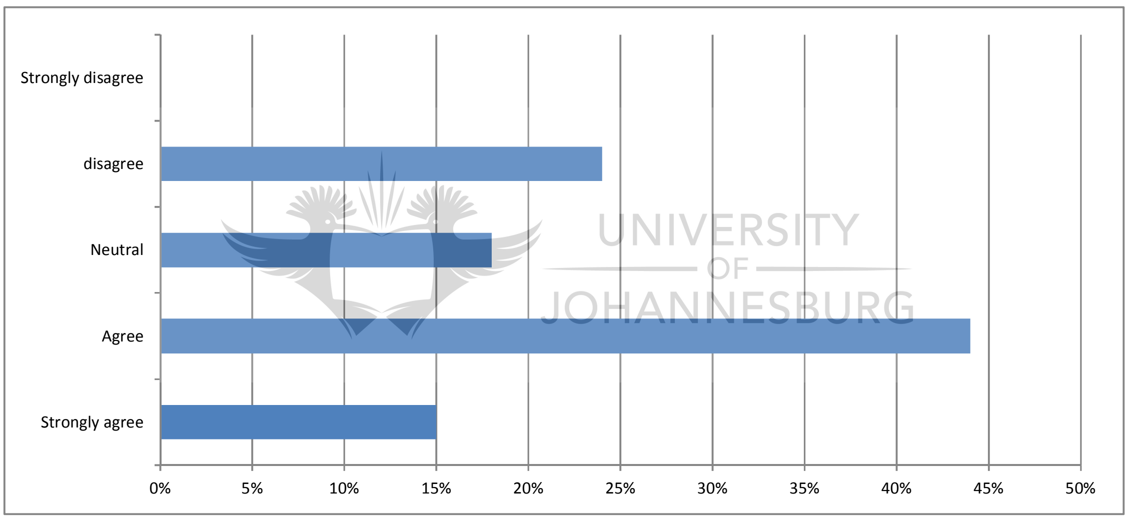


In this case, the majority of the hedge fund managers (53%) are against the idea that the small hedge fund managers should not be required to comply with FAIS Act, with an additional 15% strongly disagreeing. It can therefore be concluded that although the industry believes that the FAIS Act is unfair for small hedge fund managers, they also believe that the regulation is important for all to implement and comply with, regardless of the manager size.

Question 9

The set of qualifications and experience required by FAIS, means more costs for hedge funds.

(i) 0% of the respondents **strongly disagreed;**
(ii) 24% of the respondents **disagreed**;
(iii) 17% of the respondents were **neutral;**
(iv) 44% of the respondents **agreed**; and
(v) 15% of the respondents **strongly agreed.**



In this case, 44% of the hedge fund managers who participated in the survey, believe that the stricter FAIS requirements, with regard to the work experience and set of qualification required, add to the costs of compliance. It seems from the results of the study that the majority of respondents from the industry believe that the work experience and the set of qualifications required add to the costs of hedge funds.

Under Theme 2 (Character of regulation), it has been observed that although the hedge fund industry believes that the compliance costs associated with the FAIS Act are very high, nonetheless, respondents also believe that the FAIS Act is a just regulation that every manager should uphold, regardless of their size. This opinion is partly supported in the survey that was carried out by Rajan and Brown (2005:16), wherein the respondends also believed that the regulation would add to administration burden, including compliance costs. It should also be stated that in the same survey (Rajan & Brown, 2005:16), it was also mentioned that the regulation is meant to drive out rogue hedge fund managers.

The findings of this survey are also in line with the study that was carried out in Europe in April 2009 by the Commission of the European Communities (2009:1), where it was confimed that the regulation targeted at the level of hedge fund managers is more effective that the regulation that is targeted at the hedge fund product level.

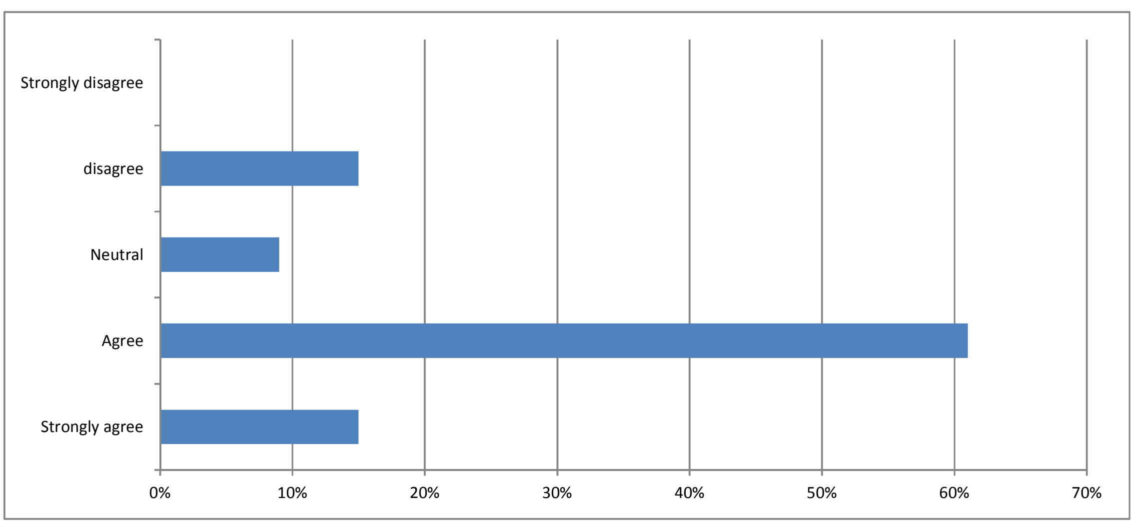
Theme 3. The Credibility of the Regulation

Under this theme, four questions that relate to the credibility of the hedge fund industry following regulation, were asked. The respondents respondend as follows:

Question 10

The introduction of hedge fund manager regulation has improved the creditbility of hedge funds in South Africa.

(i) 0% of the respondents **strongly disagreed;**
(ii) 15% of the respondents **disagreed**;
(iii) 9% of the respondents were **neutral;**
(iv) 61% of the respondents **agreed**; and
(v) 15% of the respondents **strongly agreed.**

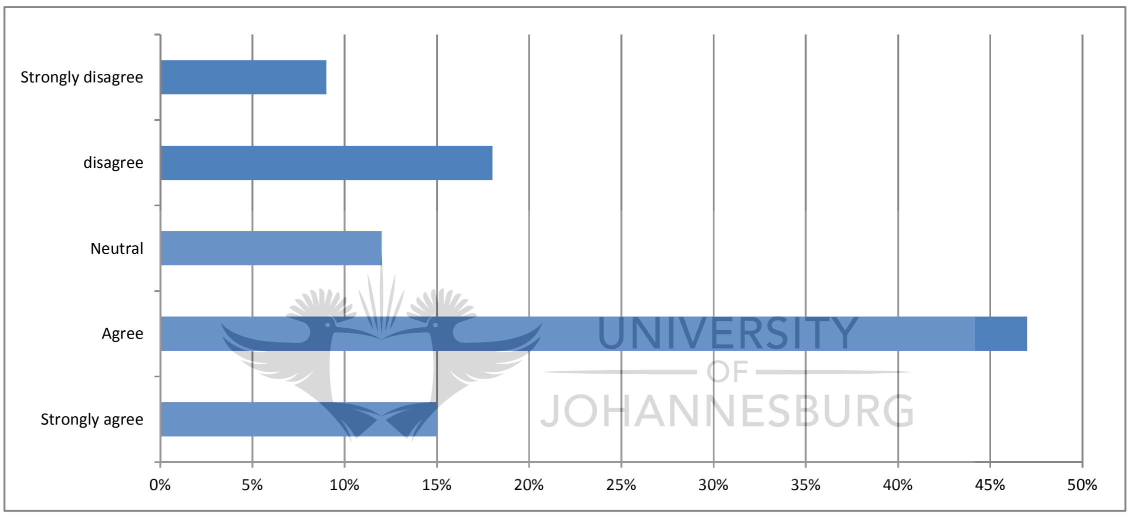


In this case, 61% of the hedge fund managers believe that the introduction of the hedge fund manager regulation has improved the credibility of hedge funds in South Africa. There is also a small group of hedge fund managers who believe that the introduction of the hedge fund manager regulation has not impacted on the credibility of the industry in South Africa.

Question 11

The qualifications and experience required for FAIS Act registration is an important contribution to the credibility of hedge funds in South Africa.

(i) 9% of the respondents **strongly disagreed;**
(ii) 18% of the respondents **disagreed**;
(iii) 12% of the respondents were **neutral;**
(iv) 48% of the respondents **agreed**; and
(v) 15% of the respondents **strongly agreed.**

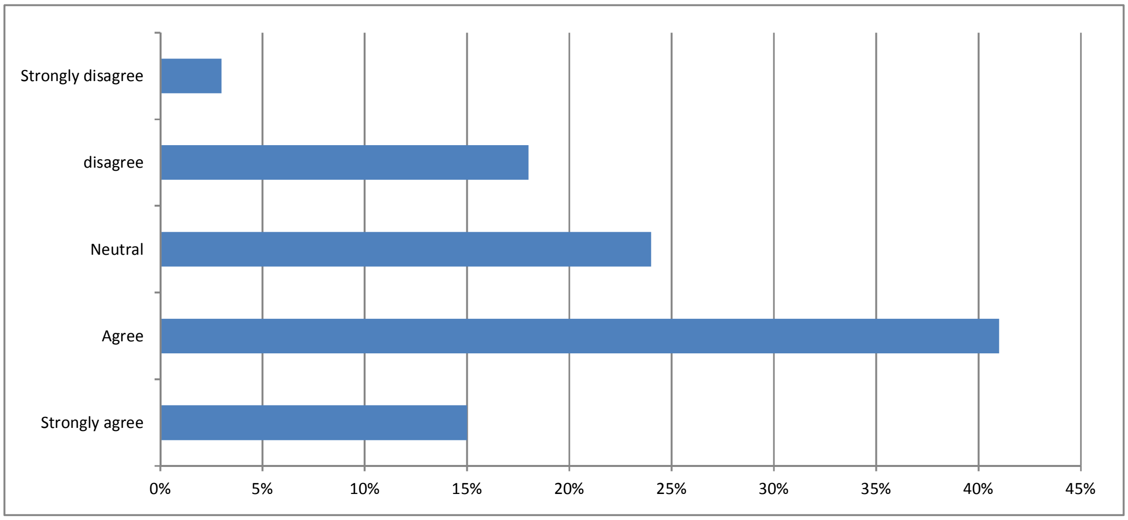


In this case, the majority (48%) of the hedge fund managers believe that the set of qualifications and the experience required contribute to the credibility of the South Africa's hedge fund industry. A small group of managers had a contrary view.

Question 12

The hedge fund manager regulation has improved the reputation of hedge funds in South Africa.

(i) 2% of the respondents **strongly disagreed;**
(ii) 18% of the respondents **disagreed**;
(iii) 24% of the respondents were **neutral;**
(iv) 41% of the respondents **agreed**; and
(v) 15% of the respondents **strongly agreed.**

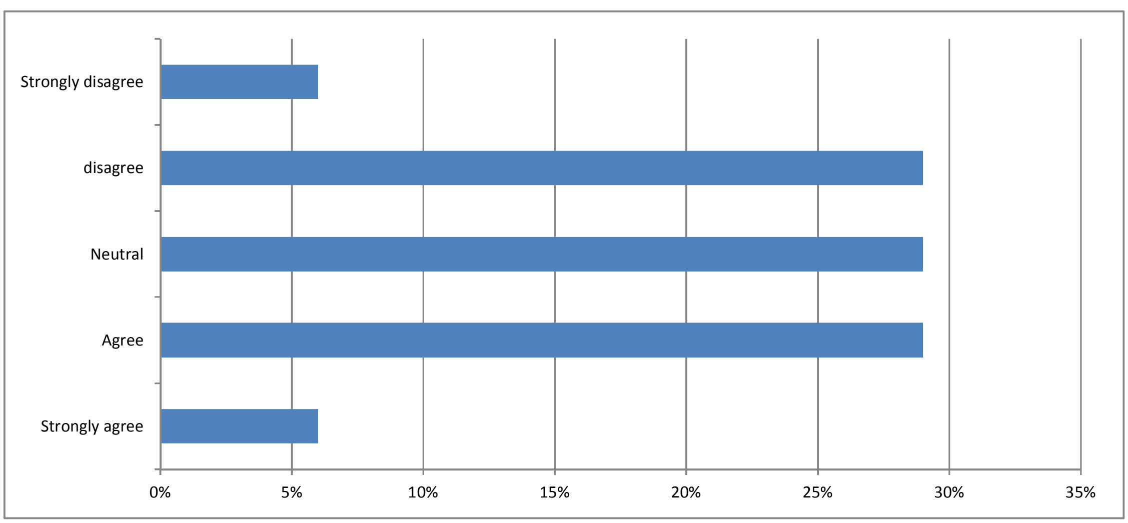


The majority (41%) of the hedge fund managers believe that the regulation of the hedge fund managers has improved the reputation of the hedge funds in South Africa. A small group of managers did not believe that the reputation of hedge funds has improved following regulation.

Question 13

The introduction of hedge fund manager regulation has enhanced the hedge fund business activities

(i) 7% of the respondents **strongly disagreed;**
(ii) 29% of the respondents **disagreed**;
(iii) 29% of the respondents were **neutral;**
(iv) 29% of the respondents **agreed**; and
(v) 6% of the respondents **strongly agreed.**



In this case, no conclusion can be made as the views of the managers were mixed. A large group of managers (29%) agreed that the regulation contributed to the enhancement of hedge fund activities. The other 29% believed that it was not true that the regulation improved hedge fund activities.

Under theme 3, (Credibility of regulation), it can be concluded that the hedge fund managers in South Africa believe that the regulation of hedge fund managers has improved the credibility and the reputation of the South African hedge fund industry. This view reflects on one of the researcher's objectives that regulation will bring credibility to the hedge fund industry in South Africa. This statement is also supported by the results in the survey that was carried out by Rajan and Brown (2005:16), where it was reported that the regulation of hedge funds brings credibility to the market.

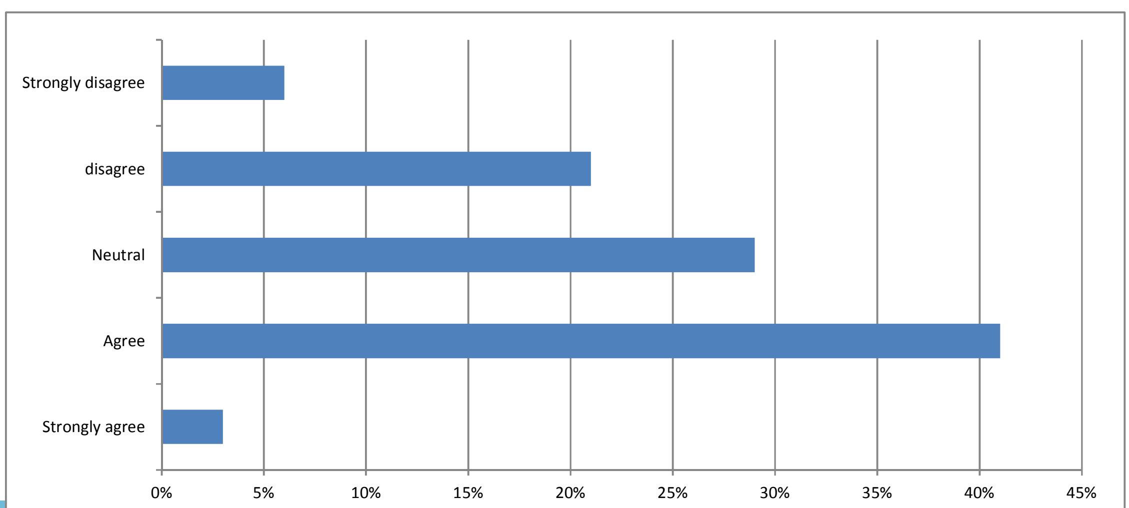
Theme 4: Investor Protection

Under this theme, four questions were asked that reflect on the investor protection aspect of the FIAS Act.

Question 14

The hedge fund investors need protection through regulation.

(i) 6% of the respondents **strongly disagreed;**
(ii) 21% of the respondents **disagreed**;
(iii) 29% of the respondents were **neutral;**
(iv) 41% of the respondents **agreed**; and
(v) 3% of the respondents **strongly agreed**.

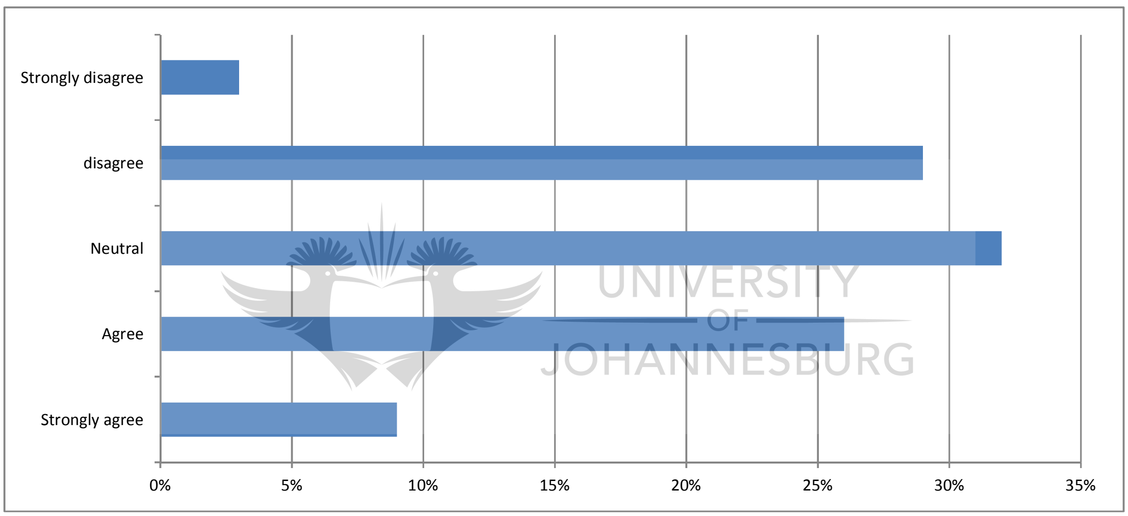


In this case, the majority (41%) of the hedge fund managers believe that hedge fund investors need protection through regulation. 21% disagreed, while 29% were not sure. The results here confirm the objectives of this research that regulation will go a long way in protecting the market participants, especially the investors.

Question 15

The South African hedge fund investors are sophisticated and do not need protection.

(i) 3% of the respondents **strongly disagreed;**
(ii) 29% of the respondents **disagreed;**
(iii) 26% of the respondents **agreed**;
(iv) 33% of the respondents were **neutral; and**
(v) 9% of the respondents **strongly agreed**.

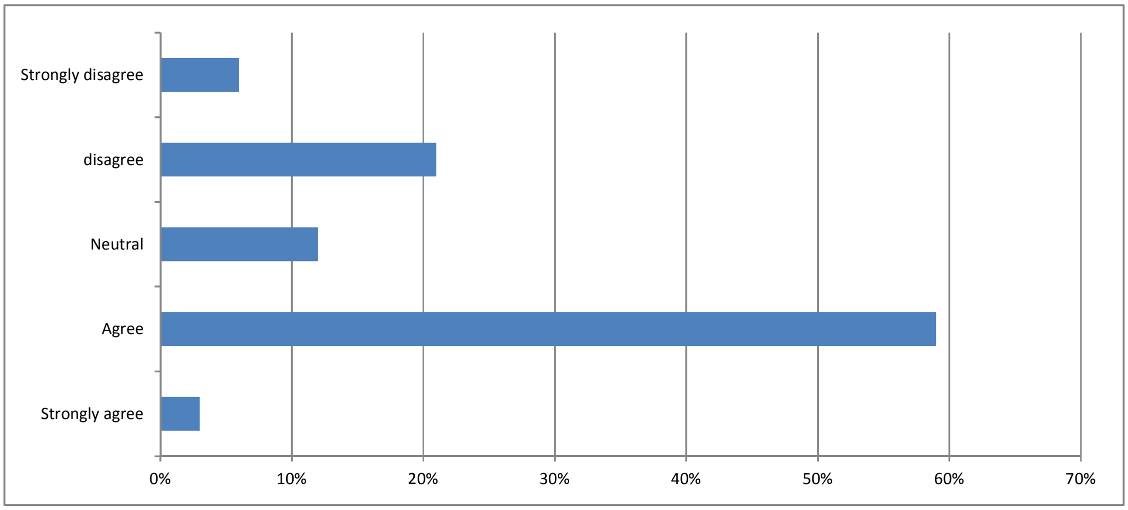


In this section, 29% of the respondents disagreed that hedge fund investors are sophisticated and do not need protection, with an additional 3% strongly disagreeing. On the other hand, 33% of the respondents were neutral. On the contrary, a 26% agreed that hedge funds investors are sophisticated and do not need protection, with an additional 9% strongly agreeing that hedge funds investors do not need protection. The respondents are spread across on this one, however from the previous question, the majority of the respondents agreed that hedge fund investors do need protection through regulation. It can, therefore, be concluded that the industry is divided on whether the South African hedge fund investors are sophisticated or not.

Question 16

The qualifications and the experience required by the FAIS Act add to the protection of investors.

(i) 6% of the respondents **strongly disagreed;**
(ii) 21% of the respondents **disagreed**;
(iii) 12% of the respondents were **neutral;**
(iv) 59% of the respondents **agreed**; and
(v) 2% of the respondents **strongly agreed.**

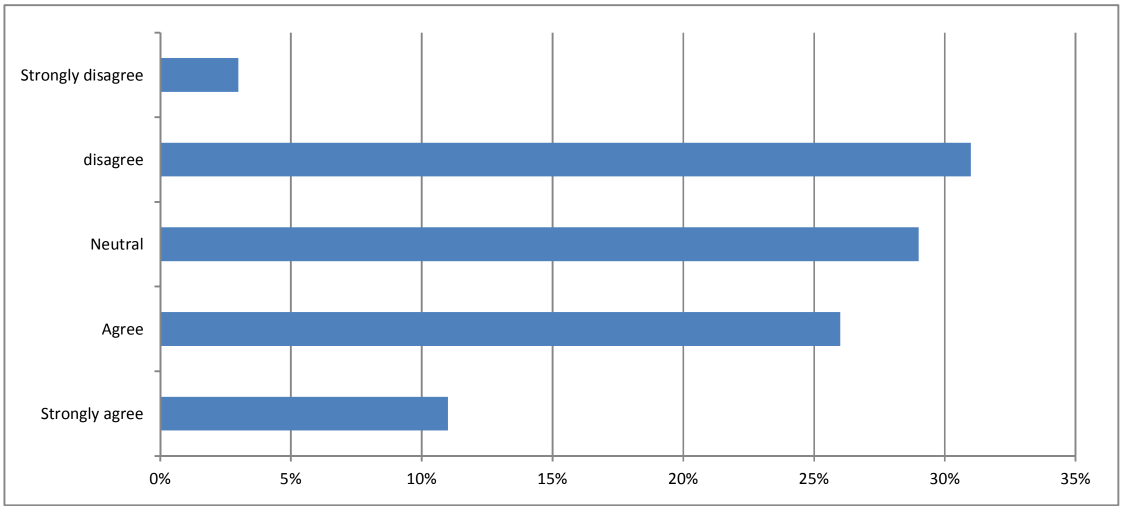


In this case, the majority of the participants (59%) agreed that the qualifications and the experience required by FAIS Act add to the protection of investors. A small group of hedge fund managers (21%) disagreed with this view. It can be concluded that the South African hedge fund industry representatives believe that relavant qulafications, coupled with sufficient experience, do help in protecting the hedge fund investors.

Question 17

The costs associated with compliance are greater than the benefits of investor protection.

(i) 3% of the respondents **strongly disagreed;**
(ii) 31% of the respondents **disagreed;**
(iii) 29% of the respondents were **neutral;**
(iv) 26% of the respondents **agreed**; and
(v) 11% of the respondents **strongly agreed**.



In this case, the majority of the respondents (31%) do not believe that the compliance costs are greater than the benefits of investor protection. 29% of the industry respondents are neutral on this view. On the contrary, 11% of the respondents strongly believe that the costs of compliance are greater than the benefits of investor protection, with an additional 26% just agreeing that the compliance costs are greater than protection benefits for investors. It can thus be concluded that the market is divided on this issues, however, 31% disagreed that the costs of compliance outweigh the benefits of invetor protection.

Under theme 4 (Investor protection), it can be concluded that the industry believes that regulation is a great achievement for a hedge fund investor protection drive. However, the respondents also believe that the costs of compliance do not exceed the benefits of invetor protection. The industry also believes that the FAIS Act qualification and experience required are a welcome addition to the investor protection arrangement. Lastly, the industry remains undivided on whether the South African hedge fund investors are sophisticated not. The conclusion, under theme 4, confirms the objective of this research with regard to the investor protection aspect of the FAIS Act regulation.

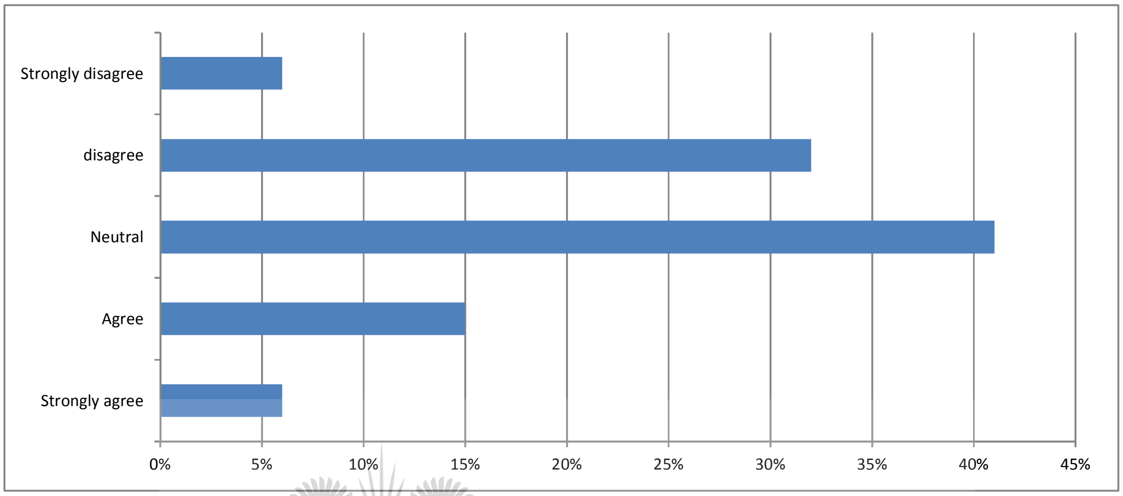
Theme 5: The hedge fund manager behaviour

In this theme, five questions were asked that reflect on the fund manager behaviour following the hedge fund manager regulation.

Question 18

The hedge fund managers are more conservative following FAIS regulation

(i) 6% of the respondents **strongly disagreed;**
(ii) 32% of the respondents **disagreed**;
(iii) 41% of the respondents were **neutral;**
(iv) 15% of the respondents **agreed**; and
(v) 6% of the respondents **strongly agreed.**

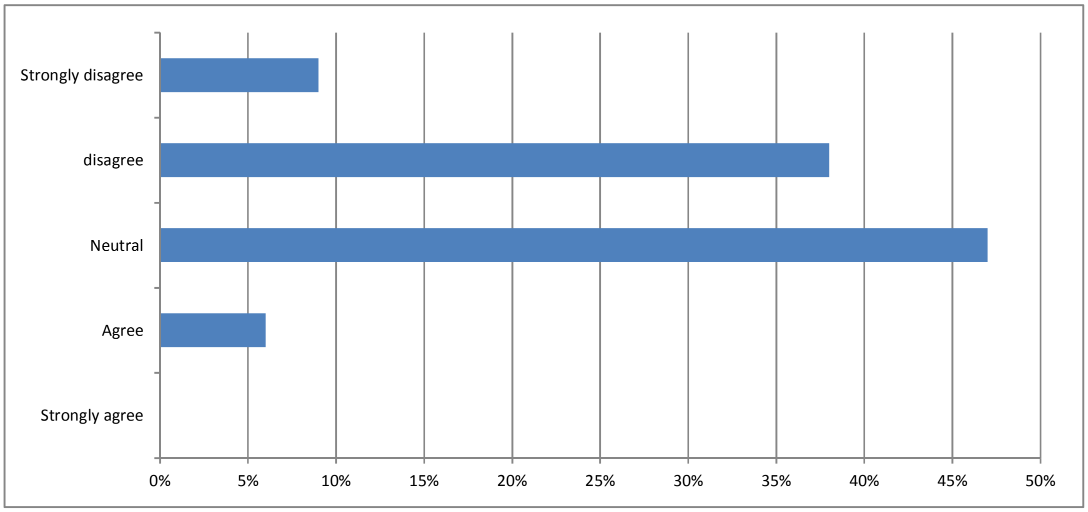


In this case, 41% of the managers are not sure if the introduction of the FAIS Act has made them conservative or not. 31% dissagrees with the notion that the regulation has made them conservative, with an additional 6% strongly disagreeing. It can therefore be concluded that, in this regard, the FAIS Act regulation did not have an impact on limiting the attitudes of the hedge fund managers towards risk. This therefore should be read in conjunction with the view expressed by Timbadia (2009:3) that South African hedge funds are not exposed to highly risky assets. As such, the risk levels of the South African hedge funds should be low.

Question 19

The hedge fund manager creativity has improved following regulation.

(i) 9% of the respondents **strongly disagreed;**
(ii) 38% of the respondents **disagreed;**
(iii) 47% of the respondents were **neutral;**
(iv) 6% of the respondents **agreed**; and
(v) 0% of the respondents **strongly agreed.**

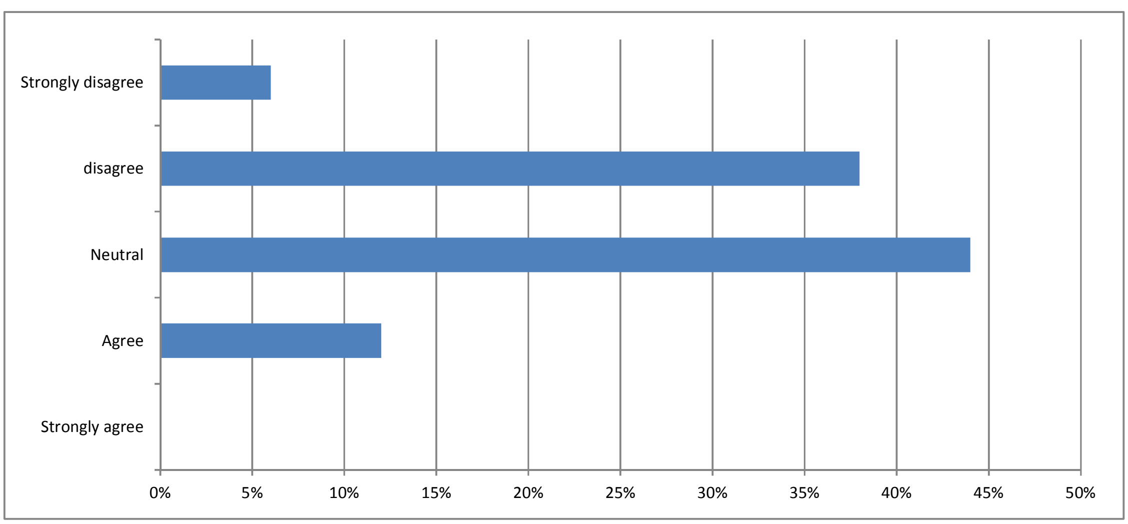


In this regard, 38% of the hedge fund managers do not believe that the introduction of the regulation has improved their creativeness. 47% of the managers are neutral. This links to the response in question 18, wherein the managers expressed that the introduction of the regulation did not impact on their behaviour.

Question 20

The hedge fund managers have changed the way they do business following the FAIS Act regulation

(i) 6% of the respondents **strongly disagreed;**
(ii) 38% of the respondents **disagreed**;
(iii) 44% of the respondents were **neutral;**
(iv) 12% of the respondents **agreed**; and
(v) 0% of the respondents **strongly agreed.**

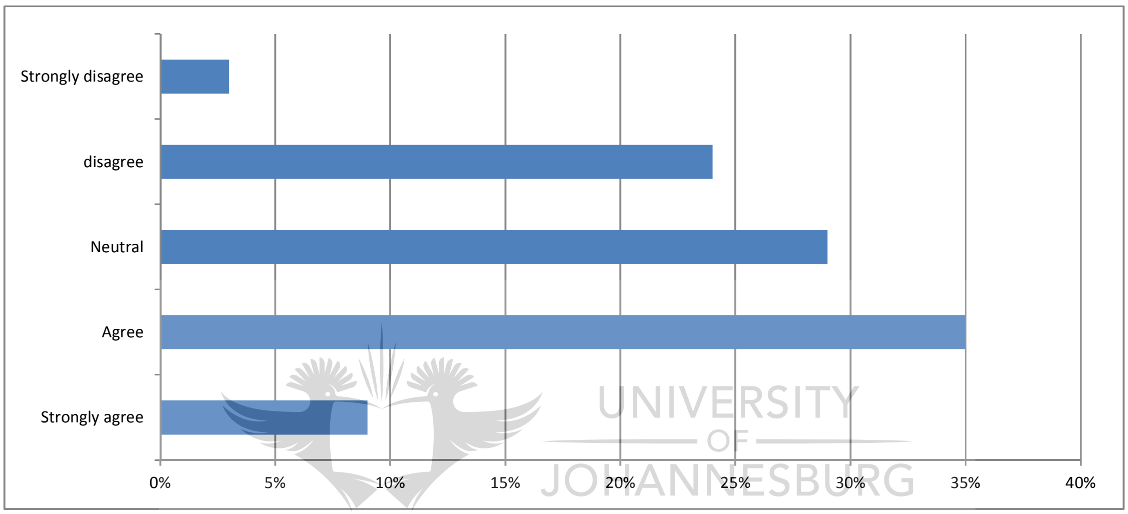


Also in this question, the managers are consistant is airing the view that the introduction of the regulation did not change the way they do business. Same as in question 19, the majority of the managers are neutral, with 38% disagreeing with the view that the regulation has changed the way they do business.

Question 21

The regulaton limits the hedge fund manager innovation

(i) 3% of the respondents **strongly disagreed;**
(ii) 24% of the respondents **disagreed;**
(iii) 29% of the respondents were **neutral;**
(iv) 35% of the respondents **agreed**; and
(v) 9% of the respondents **strongly agreed.**

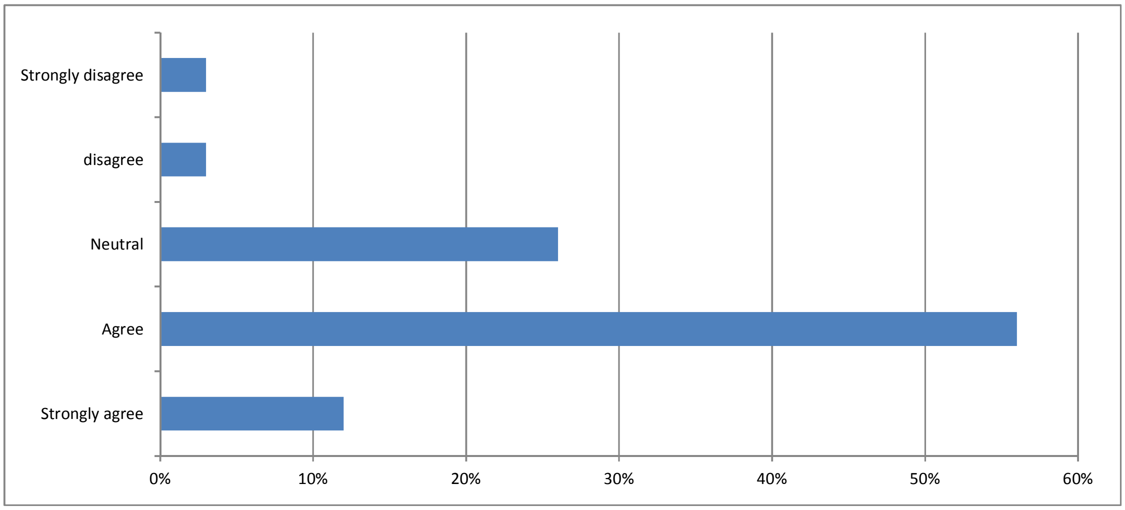


In this case, the majority of the hedge fund managers (35%) agree with the view that regulation limits innovation. 29% of them are neutral in this regard. 24% of the respondents disagree with this view. This opinion is in line with the belief, as expressed by Mathieson and Eichengreen (1999:2) that regulation does influence the hedge fund manager behaviour. Cumming (2008:1) concurs with the view that regulations compromise managers and investors' freedom to explore, however, it is also believed that regulation is important to eradicate opaque structures in the industry and improve fund performances.

Question 22

The hedge fund managers are more transparent and keep their investors informed about investments.

(i) 3% of the respondents **strongly disagreed;**
(ii) 3% of the respondents **disagreed**;
(iii) 26% of the respondents were **neutral;**
(iv) 56% of the respondents **agreed**; and
(v) 12% of the respondents **strongly agreed.**



In this case, the majority of the hedge fund managers (56%) have agreed that they have become more transparent and keep their investors informed following regulations, with an additional 12% strongly agreeing with this view.

Under theme 5 (hedge fund manager behaviour), it can be concluded that the managers do not believe that the introduction of the FAIS Act has influenced their behaviour significantly in any way. This could indicate that the FAIS regulation brought a framework that had already been in agreement with the way the managers conducted their hedge fund business. The South African funds are not exposed to the toxic (risky) assets available outside the boarders of South Africa. The author believes that the reason for nil or minimal exposure to toxic assets could be partly attributed to the strong South African financial system coupled with its potent exchange controls (Timbadia, 2009:3).

CONCLUSION

As mentioned in the preceeding chapters, South Africa has about 77 hedge fund management companies, and as such, the reseacher did not see a need to sample the population. The questionaire was therefore sent to all 77 companies. Out of that 77 , thirty five (35) managers responded. This accounts for about 48% of the industry. The researcher therefore believes that a conclusion can be drawn about the industry, based on the 48% that responded. Twenty two questions were asked under five different themes. The answers, under those themes, can be summarised as follows:

Under theme 1 (Regulation), it was discovered that the South African hedge fund managers want to be regulated both at hedge fund manager level and at hedge fund product level. It was noted that there are some members in the hedge fund industry, outside South Africa, who do not want the industry to be regulated.

Under Theme 2 (Character of regulation), it was found that the South African hedge fund industry wants every hedge fund manager to comply with the FAIS Act regulation regardless of their size. The South African hedge fund industry did, however, highlight that the compliance costs are very high. This could mean that investors are not benefiting in terms of lowered costs as a result of regulation which this acts purports to do.

Under theme 3 (Credibility of regulation), the idustry believes that the regulation has improved the credibility of the hedge fund industry in South africa.

Under theme 4 (Investor protection), it was found that the industry believes in general that the regulation will bring the required protection for the South African hedge fund investors.

Under theme 5 (hedge fund manager behaviour), no change in hedge fund manager behaviour was observed following regulation. This could mean that the industry factored in their expectations of the industry long before the act became law. As stated in the literature review, Smith (2008:4) believes that an industry starts factoring in its expectation of regulation long before it becomes effective. This came as no surprise because the South African regulators are transparent. So it is easy for the industry to second guess the regulator and stay ahead of the game.

CHAPTER 5
CONCLUSIONS AND RECOMMENDATIONS

5.1 INTRODUCTION

Chapter 4 was set aside for the presentation and the interpretation of the results. Chapter 5 will conclude and summarise the key lessons learnt from the study, and put forward recommendations with regard to further studies that could be embarked on in the future. The chapter will also highlight some of the limitations of this study.

5.2 SUMMARY

5.2.1 A brief summary of the problem

The purpose of the study was to investigate the impact of the Financial Advisory and Intermediary Services Act (FAIS Act 37 of 2002) regulation on the hedge funds industry in South Africa. The FAIS Act was promulgated late in 2007, and Financial Services Providers- including hedge funds managers- had to comply with it by February 2008. A type IIA category was created under the FAIS Act, and its purpose was to accommodate discretionary-mandated fund managers. Hedge funds managers fall into that category. Furthermore, in December 2008, additional requirements under Fit and Proper framework were added to this category to reinforce the regulation of discretionary fund managers.

In a nutshell, this study investigated whether the FAIS regulation, with respect to the hedge fund managers of South Africa, has had any impact on the way the hedge fund managers operate- i.e. their operational behaviour, investor protection aspects and transparency. The results of the study are summarised next.

5.2.2 A brief summary on the methodology

The research methodology that was used and the findings were discussed in Chapter 3 and Chapter 4, respectively. It was also mentioned in the preceding discussions, that this study would followed an interpretive paradigm with a questionnaire in a cross-sectional environment. The sample and the sampling method were also discussed under Chapter 3.

5.2.3 A brief summary of the major findings

The summary of the major findings is formulated in relation to the research questions of this study.

5.2.3.1 Theme 1: Hedge fund regulation

The South African hedge fund industry welcomes the regulation of hedge fund managers. In addition, these hedge fund managers believe that it would bring an added advantage if hedge fund products were regulated as well. Currently, South Africa only regulates hedge fund managers, however, in the near future an additional layer of regulations, targeted at hedge funds' product level will be introduced.

5.2.3.2 Theme 2: The character of the FAIS Act regulation

The South African hedge fund managers believe that every hedge fund manager should be required to comply with the regulation, regardless of their size. This is in contrast to the American belief that small hedge fund managers are not sytemic, and therefore should not be subjected to the same stringent regulation as big hedge fund managers. However, respondents made it clear that they are unhappy with the level of compliance costs- which they believe are extremely high.

5.2.3.3 Theme 3: Credibility of hedge fund manager regulation

The hedge fund industry believes that the regulation has brought credibility to the hedge funds. It stands to reason that an investment scheme, without regulation is as credible as the next pyramid scheme and makes it difficult for the managers to attract investors. For instance, protected funds, like pension funds, will ultimately find their way to hedge funds as a result of this regulation, as it has been witnessed in the recently gazzeted pension fund Regulation 28[19].

5.2.3.4 Theme 4: Investor protection

The hedge fund industry believes that the regulation is a welcome intiative to improving the protection of the interests of the investors. This adds to the credibility issue mentioned above, and makes it relatively easier to attact investors if investors believe that their investments are protected through regulation.

[19] Regulation 28 is a South African legislation that guides the pension funds on how the pension fund money should be invested. It gives specific rules on the type of product, and the exposure the pension fund should have.

5.2.3.5 Theme 5: Hedge fund manager behaviour

No changes were observed in hedge fund manager behaviour as a result of the regulation. The South African financial market regulators are transparent, which could mean that the industry could have factored in their expectations of regulation long before February 2008 when the FAIS Act became effective. Any industry would always prefer to be one step ahead of regulators, a factor that improves their credibility. A transparent regulator makes it easy for the industry to second guess its next move, and takes away the burden of having to quickly restructure the investment portfolio in order to align with eminent regulation.

5.3 LIMITATIONS OF THE STUDY

There are some limitations to the study with respect to the availability of research material in South Africa. As indicated in the preceding discussions, the industry is relatively new and largely unregulated, therefore not much information is available. However, it is believed that the available data is sufficient for this topic.

5.4 RECOMMENDATIONS

As indicated in this study, the South African hedge fund industry is not well researched and as such a lot still needs to be done to gather and analyse data.

This study only focused on the general impact of the FAIS Act regulation on the South African hedge fund industry. A number of trends were observed, including that hedge fund managers believe that the regulation of hedge fund managers was more optimal than regulating hedge fund products. There is an awareness that the National Treasury and the Financial Services Board are currently working on a piece of legislation that will regulate hedge funds products, in addition to the current regulation that focuses on hedge fund managers only. In this study, the representatives of the hedge fund industry indicated that it is not effective to regulate at hedge fund product level. With this in mind, it would be interesting to see how the hedge funds industry' behaviour changes after the proposed product regulation becomes law.

In addition, it was also observed that hedge fund managers believed that regulation reduces hedge fund activities or hedge fund manager innovation. A study to confirm or dispute this claim would yield interesting results. This study could also take into account other shortcomings of the regulation including the appropriateness of the level of compliance costs for the hedge funds.

5.5 CONCLUSION

It has been observed in this study that the regulation of the hedge fund industry in South Africa is a welcome initiative. The study also demonstrated that the industry recognises the importance of regulation both in terms of investor protection, and also contributing to improve the credibility and reputation of the young South African hedge fund industry. The main shortfall of the regulation, as per the industry response, is the high compliance costs.

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QUESTIONAIRE FOR HEDGE FUND MANAGERS

1. The regulation of hedge fund managers in South Africa is a necessity.

○ Strongly Agree
○ Agree
○ Neutral
○ Disagree
○ Strongly Disagree

2.
It is more important to regulate hedge fund managers than hedge fund products.

○ Strongly Agree
○ Agree
○ Neutral
○ Disagree
○ Strongly Disagree

3.
Both hedge fund managers and hedge fund products should be regulated.

○ Strongly Agree
○ Agree
○ Neutral
○ Disagree
○ Strongly Disagree

4.
The South African hedge funds should be left to regulate themselves.

☐ Strongly Agree
☐ Agree
☐ Neutral
☐ Disagree
☐ Strongly Disagree

5.
The hedge Funds compliance costs are very high.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree

6.
The Licence fees are very high.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree

7.
The FAIS regulation is unfair for small managers.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree

8.
The small hedge fund managers should not be required to comply with the FAIS Act.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree

9.
The set of qualifications and experiance required, by FAIS, means more costs for hedge funds

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree

10.
The introduction of hedge fund manager regulation has improved the credibility of hedge funds in South Africa.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree

11.
The qualifications and experience required for FAIS registration is an improtant contribution to the credibility of hedge funds in South Africa.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree

12.
The hedge fund manager regulation has improved the reputation of the hedge funds in South Africa.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree

13.
The introduction of hedge fund manager regulation has enhanced the hedge fund business activities.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree

14. The hedge fund investors need protection through regulation.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree

15.
The South African hedge fund investors are sophisticated and do not need protection.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree

16.
The qualifications and experience required by FAIS Act add to the protection of investors.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree

17.
The costs associated with compliance are greater than the benefits of investor protection.

○ Strongly Agree
○ Agree
○ Neutral
○ Disagree
○ Strongly Disagree

18.
The hedge fund managers are more conservative following FAIS regulation.

○ Strongly Agree
○ Agree
○ Neutral
○ Disagree
○ Strongly Disagree

19.
The hedge fund manager creativity has improved following regulation.

○ Strongly Agree
○ Agree
○ Neutral
○ Disagree
○ Strongly Disagree

20.
The hedge fund managers have changed the way they do business following FAIS regulation.

○ Strongly Agree
○ Agree
○ Neutral
○ Disagree
○ Strongly Disagree

21.
The regulation limits the hedge fund manager innovation.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree

22.
Hedge fund managers are more transparent and keep their investors informed of investments.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly Disagree