PRACTICAL LAW
MULTI-JURISDICTIONAL GUIDE 2012
INVESTMENT FUNDS

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1. What is the structure of the retail funds market? What have been the main trends over the last year?

Open-ended retail funds
The open-ended retail funds market in South Africa consists of:

- Collective investment schemes (CISs).
- Property loan stock companies (PLSs).

The Financial Services Board Annual Report 2011 records the following market developments:

- CISs in securities. The funds attracted net annual inflows of ZAR107 billion (as at 1 November 2011, US$1 was about ZAR7.8). The bulk of the inflows came in the fourth quarter of 2010, when the funds attracted a record-breaking ZAR36 billion.

- Foreign CISs in securities. Net inflows for the period up to the end of March 2011 reached ZAR16 billion. The overall value of assets under management increased from ZAR107 billion in March 2010 to ZAR122 billion in March 2011.

- CISs in property. The market capitalisation of funds increased to ZAR29 billion at 31 March 2011 compared to ZAR28 billion at March 2010. The number of participatory interests in the industry increased to ZAR4.6 billion from ZAR4.5 billion in 2010.

- CISs in participation bonds. The aggregate amount owing to 21,680 participants as at 31 March 2011 was ZAR3.7 billion (compared to ZAR3.5 billion in March 2010). There are five schemes and 1,417 registered participation bonds.

For definitions of these types of funds, see Question 2, Open-ended retail funds.

PLSs obtain their income from a property portfolio. According to a newsletter dated 18 November 2011 published by the Property Loan Stock Association (the representative umbrella body of the property loan stock sector in South Africa), from October 2001 to 2011 the South African listed property sector’s market capitalisation increased considerably from ZAR12.8 billion to ZAR144.1 billion.

Closed-ended retail funds
Closed-ended retail funds are CISs with a limited number of securities in issue. They are normally created as open-ended retail funds and then change into closed-ended retail funds. This normally happens when the fund has raised the required capital and there are typically no more shares available from the fund for subscription (for example, in the case of a CIS in property). It is also important to note that there can be various other reasons why an open ended fund may become closed. In practice, both open-ended retail funds and closed-ended retail funds are subject to the same regulation.

2. What are the key statutes, regulations and rules that govern retail funds? Which regulatory bodies regulate retail funds?

Open-ended retail funds
Regulatory framework. The key statutory provisions are:

- The Collective Investment Schemes Control Act 2002 (CISCA), which regulates CISs.
- The Companies Act 2008 (Companies Act), which regulates PLSs.

Regulatory bodies. CISs are also subject to the regulatory supervision of the Financial Services Board (FSB). The Registrar of CISs (Registrar) must authorise the managers of CISs (see Question 6, Open-ended retail funds).

PLSs are also subject to the supervision of the Companies and Intellectual Property Commission (CIP Commission). Listed PLSs are also subject to the Johannesburg Stock Exchange (JSE) regulations.

CISCA defines and regulates the following types of CISs:

- CIS in securities. This refers to a scheme the portfolio of which consists principally of securities.
- Foreign CIS in securities. This refers to a scheme the portfolio of which consists of securities, which is authorised or approved in a foreign jurisdiction.
- CIS in property. This includes a scheme the portfolio of which consists of property shares, immovable property and assets as determined by the Registrar to be included in the portfolio.
- CIS in participation bonds. This refers to a scheme of which the portfolio consists principally of assets in the form of participation bonds, and in pursuance of which members of the public are invited or permitted to acquire a participatory interest in all the participation bonds included in the scheme.
- Declared CIS. This refers to a scheme declared a CIS by the Registrar.

Closed-ended retail funds
Regulatory framework. See above, Open-ended retail funds.

Regulatory bodies. See above, Open-ended retail funds.
3. Do retail funds themselves have to be authorised or licensed?

Open-ended retail funds
The authorisation rules depend on whether the fund is local or foreign:

- **Local funds.** CISs do not need to be licensed or authorised. PLSs must be incorporated under the Companies Act and listed on the JSE (if they are listed). PLSs do not require any further regulatory approval.

- **Foreign funds.** There are no specific requirements for foreign funds to be authorised or licensed. However, the country where the foreign CIS is based must have a regulatory environment of at least the same standing as that of South Africa. Where a representative office has been established in South Africa, it must have, and maintain, a paid-up share capital and reserves of at least ZAR2 million. This must be invested in assets that can be liquidated within seven days. The Registrar can exempt a representative office from compliance with these capital requirements.

Specific requirements are placed on the managers of local and foreign CIS funds (see Question 6, Open-ended retail funds).

Closed-ended retail funds
See above, Open-ended retail funds.

Marketing

4. Who can market retail funds?

Open-ended retail funds
An authorised CIS manager can market CISs in South Africa. Similarly, an authorised manager of a foreign CIS can solicit investment in South Africa.

Authorised financial services providers (FSPs), who are approved under the Financial Advisory and Intermediary Services Act 2002 (FAIS), can also market retail funds in South Africa. FAIS regulates the provision of financial services which take the form of advice and/or intermediary services. Both advice and intermediary services must relate to a financial product that is regulated under the FAIS.

Where a PLS, whether local or offshore, appoints a manager who provides marketing and advisory services, that manager must be an authorised FSP.

Closed-ended retail funds
See above, Open-ended retail funds.

5. To whom can retail funds be marketed?

Open-ended retail funds
Open-ended and closed-ended schemes can be marketed to members of the public in South Africa (including individuals and institutional investors). Foreign CISs, which have been approved in South Africa, can be marketed to members of the public in South Africa (see Question 3, Open-ended retail funds).

Closed-ended retail funds
See above, Open-ended retail funds.

Managers and operators

6. What are the key requirements that apply to managers or operators of retail funds?

Open-ended retail funds
There are no specific requirements for foreign CISs. The general duties and key requirements apply to managers of CISs. The general duties are:

- The manager must avoid any conflict between the manager’s interests and the interests of an investor.
- The manager must disclose the interests of its directors and management to investors.
- The manager must maintain adequate financial resources to both:
  - meet its commitments;
  - manage the risks to which the CIS is exposed.

The key requirements that apply to managers of CISs depend on whether the CIS is a local fund or a foreign fund:

- **Local funds.** The Registrar must authorise managers of CISs. Certain organisational and capital requirements must be met before the Registrar will grant authorisation:
  - the manager must be a company incorporated or registered under the Companies Act;
  - specific capital requirements apply to the manager of a CIS in property and the manager of a CIS in participation bonds;
  - the manager must administer the CIS:
    - honestly, fairly, and with skill, care and diligence;
    - in the interests of investors and the CIS’s industry.
  - the manager must appoint either a trustee or custodian for the CIS;
  - the manager must appoint an auditor to audit the entire business of the CIS.

- **Foreign funds.** Managers of foreign CISs must apply for the Registrar’s approval before they can solicit investment from members of the public in South Africa. The following conditions must be met before approval can be granted:
  - the manager must either:
    - enter into a representative agreement with a locally approved CIS manager; or
    - maintain a representative office in South Africa.
  - the country where the foreign CIS is based must have a regulatory environment at least of the same standing as that of South Africa;
  - where a representative office is established in South Africa, it must have, and maintain, a paid-up share capital and reserves of at least ZAR2 million. This must be invested in assets that can be liquidated within seven days (the Registrar can exempt a representative office from compliance with these capital requirements);
The application for approval must be accompanied by the following:

- the name of the foreign country where the scheme was originally authorised to conduct business, together with a letter from the relevant supervisory body of that jurisdiction. This letter must confirm that the manager is fit and proper to operate the scheme, is actively operating the scheme in that country, and is permitted to promote the scheme in South Africa;
- if the manager has entered into a representative agreement, a copy of that agreement;
- if the manager has established a representative office in South Africa, the details of that representative office;
- copies of any materials that will be used to promote the scheme (for example, founding statement, promoters’ agreement, prospectus or application form), along with the scheme’s most recent audited annual financial statements;
- a list detailing the similarities and differences between the scheme as compared with a local, South African CIS that is registered under CISCA;
- a completed standard form questionnaire concerning the scheme;
- the auditor’s confirmation that the scheme complies with the paid-up share capital and reserve requirements (where a representative office has been established in South Africa).

A foreign manager can be approved to manage a local fund in South Africa, although that manager must meet the same requirements as a local manager. In practice, there is no separate arrangement for a foreign manager to be approved to manage a local fund, and it is more usual for a foreign manager to seek approval only to market a foreign scheme in South Africa.

Closed-ended retail funds
See above, Open-ended retail funds.

Assets portfolio

7. Who holds the portfolio of assets? What regulations are in place for its protection?

Open-ended retail funds

The assets of a portfolio for CISs must be registered in the name of either a trustee or a custodian. The assets can be registered in the name of a trustee’s or custodian’s nominee company, provided that written approval to do so is obtained from the Registrar.

CISCA imposes the following rules:

- The assets of the portfolio, together with any money or other assets received from an investor, are considered “trust property” for the purposes of the Financial Institutions (Protection of Funds) Act 2001 (FI Act). A manager and either its authorised agent, trustee or custodian, must deal with trust money and assets in accordance with the trust deed, the requirements of CISCA and the best interests of investors.
- The assets of a portfolio must be separated so that they are protected in the event of a claim against a manager, trustee or custodian.
- The manager must open and maintain a separate operational trust account controlled by the trustee or custodian for all the portfolios administered under its CIS.
- The manager must also open and maintain a separate operational trust account for all the portfolios administered under the CIS, which must be controlled by the trustee or custodian.

The FI Act imposes certain fiduciary responsibilities on any person who holds, keeps in safe custody, controls, administers or alienates any of the funds of a CIS. The FI Act also provides that trust property held by a financial institution must be kept separate from the assets belonging to that institution.

For PLSs, a PLS company holds the portfolio. The portfolio is protected by regulations contained in the Companies Act and, if listed, the JSE regulations (see Question 2, Open-ended retail funds).

Closed-ended retail funds
See above, Open-ended retail funds.

Legal fund vehicles

8. What are the main legal vehicles used to set up a retail fund and what are the key advantages and disadvantages of using these structures?

Open-ended retail funds

Legal vehicles. The main legal vehicles used to create a CIS are the:

- Trust.
- Open-ended investment company.

Advantages. The key advantage of a trust is that it is a well-established structure. The FSB has also issued templates that can be used during the approval process.

The open-ended investment company structure is not commonly used. Its principal advantage is the flexibility that it offers.

Participants’ interests in the CIS are called “participatory interests”.

The only legal vehicle that can create a PLS is a company which is incorporated under the Companies Act. Participants’ interests in the PLS are called a “linked unit”.

Disadvantages. The disadvantage of using the above structures is that they operate within a regulatory environment that can be perceived to be too restrictive. In addition, some of the structures aren’t necessarily internationally competitive (for example, a CIS in property or a PLS is not the same as a real investment trust structure that is well-known and recognised internationally).

Closed-ended retail funds

Legal vehicles. See above, Open-ended retail funds.

Advantages. See above, Open-ended retail funds.

Disadvantages. See above, Open-ended retail funds.
9. **What are the investment and borrowing restrictions on retail funds?**

**Open-ended retail funds**
The investment and borrowing restrictions vary according to the category of CIS:

- **CIS in securities.** The investment and borrowing restrictions are contained in General Notice 1503 of 2005 (GN1503), which includes the prohibition of the use of certain over-the-counter (OTC) instruments and leverage short-selling. In addition, only limited exposure to derivative instruments is allowed.

- **CIS in property.** This portfolio can only consist of property shares, immovable property and the units of a foreign CIS in property.

- **CIS in participation bonds.** This portfolio can only consist principally of assets in the form of participation bonds.

- **Foreign CIS in securities.** The Registrar can refuse to approve a foreign CIS in securities in the following circumstances:
  - where the scheme invests in markets not similar to those qualifying for investment by a local CIS in securities;
  - where less than 90% of the interest bearing instruments included in a fund have a credit rating of "investment grade" by Moody's Investors Service Limited, Standard and Poor's or Fitch Ratings Limited;
  - where the borrowing of money goes beyond 10% of the value of a fund (and that borrowing is not restricted only to the redemption of a participatory interest);
  - where unlisted OTC instruments are allowed to be included in a fund;
  - where gearing by a fund is permitted;
  - where investments are offered for sale which cannot, under the terms of CISCA, be offered for sale by a local manager of a CIS;
  - where the risk profile of the investments a scheme proposes to offer for sale in South Africa is significantly higher (than a local CIS) in the Registrar’s opinion.

The company’s constitutive documents determine the investment and borrowing restrictions of the PLS.

**Closed-ended retail funds**
See above, Open-ended retail funds.

10. **Can the manager or operator place any restrictions on the issue and redemption of interests in retail funds?**

**Open-ended retail funds**
The constitutive documents of a CIS can give the manager the power to restrict the issue of participatory interests in a scheme (CISCA).

The manager of a CIS in securities can (with the consent of the trustee or custodian) suspend the repurchase of participatory interests if it offers, as an aggregate amount, more than 5% of the market value of that portfolio. The portfolio’s most recent valuation determines the market value of the portfolio.

The redemption of interests is restricted for CISs in participation bonds, which have a minimum investment period of five years. After five years, an investor must give three months’ notice before redeeming all or part of its investment in the scheme. The constitutive documents of a PLS can provide restrictions on the issue and redemption of the linked units of a fund.

**Closed-ended retail funds**
Closed-ended retail funds cannot issue new shares. Shares are not redeemed for cash or assets until the fund liquidates.

11. **Are there any restrictions on the rights of participants in retail funds to transfer or assign their interests to third parties?**

**Open-ended retail funds**
The constitutive documents of the fund set out the rights and restrictions of participants to transfer or assign their interests.

**Closed-ended retail funds**
Participatory interests in closed-ended retail funds can be obtained on the secondary market.

**Reporting requirements**

12. **What are the general periodic reporting requirements for retail funds?**

**Open-ended retail funds**
Investors. The manager of a CIS must transmit to every investor, for each financial year, at least the following information:

- A report by the chairman or managing director disclosing every material fact or circumstance that occurred during the year that affected the financial affairs of the portfolio or its manager. In particular, details of any deviation from the investment policy or the scheme’s objective (as outlined in its deed) must be disclosed.

- An abridged income statement and balance sheet of the portfolio.

- Details of any qualification made in the auditor’s report concerning the portfolio’s, and the manager’s, financial statements.

- Details of all the distributions made by the portfolio, including the amounts and the dates they were made.

- The portfolio’s performance figures for the current and previous years, based on repurchase price to repurchase price and compared (where relevant) to a market index.

- Details of:
  - all charges levied by the manager;
  - any charge levied on the repurchase of participatory interests; and
  - any change to those charges or the method by which they are calculated.
The composition of the assets of the portfolio, classified by appropriate category or industry sector.

A statement that copies of the scheme’s, and the manager’s, audited annual financial statements are available, free of charge, at an investor’s request.

This information can be transmitted to investors electronically, or in hard copy, and must be sent within three months after the end of each financial year. For PLSs, the requirements to report to investors are contained in the fund’s constitutive documents.

Regulators. The manager of a CIS must:

- Send the Registrar a copy of the manager’s audited financial statements (including those of every portfolio that the manager administers) within 90 days after the close of the financial year.
- Lodge any further information or explanations requested by the Registrar concerning the scheme’s financial, and other, statements on or before the date requested by the Registrar.
- Lodge copies, as determined by the Registrar, of all advertisements, brochures, pamphlets, circulars and announcements (published or proposed for publication by the manager, or its authorised agents), unless the Registrar has exempted the manager from this obligation.
- Send the CIP Commission a copy of every return, or notice, which the manager is obliged to provide.

There are requirements for PLSs to report to the CIP Commission together with the JSE if they are listed. PLSs (as companies) are required to file annual returns with the CIP Commission.

Closed-ended retail funds

Investors. Provided the fund remains registered, it is subject to the same requirements as open-ended schemes (see above, Open-ended retail funds: Investors).

Regulators. Provided the fund remains registered, it is subject to the same requirements as open-ended schemes (see above, Open-ended retail funds: Regulators).

Tax treatment

13. What is the tax treatment for retail funds?

Open-ended retail funds

Funds. The tax treatment for funds is determined by the type of fund:

- CIS in securities. Before 1 January 2010 CISs in securities were treated as companies for the purposes of the Income Tax Act (ITA). From 1 January 2010 a CIS in securities is treated, for tax purposes, in the same manner as a trust and is subject to tax at a rate of 40%. The amounts received by this CIS are taxed at investor level, provided that they are distributed to the investors within 12 months of their receipt by the CIS (ITA). CISs in securities are exempt from capital gains tax, but must provide the South African Revenue Service (SARS) with an annual return containing certain information (including the names of the participatory holders and any disposals of interests). Holders of participatory interests are subject to capital gains tax on the disposal of their participatory interests.

- CIS in participation bonds. CISs in participation bonds are treated in the same manner as trusts for tax purposes. They are subject to tax at a rate of 40%. The amounts received by the CIS are taxed at investor level, provided that they are distributed to the investors within 12 months of their receipt by the CIS (ITA). Amounts that are not distributed to investors within the 12-month period are taxed at the CIS’s level. Tax paid by the CIS can be higher than the tax paid by the investor. This will depend on the tax rate applicable to the investor and the tax deductions available to the investor. CISs in participation bonds are exempt from capital gains tax, but holders of participatory interests are subject to capital gains tax on the disposal of their participatory interests.

- Declared CIS. A declared CIS is also treated in the same manner as a trust for tax purposes. Declared CISs are also exempt from capital gains tax, but holders of participatory interests in declared CISs are subject to capital gains tax on the disposal of their participatory interests.

- CIS in property. These are treated, for tax purposes, in the same manner as a trust in respect of any income that has not been distributed to the holders. Effectively, income which is not distributed to holders within a 12-month period is taxed at a rate of 40%. This CIS must account for capital gains realised, or capital losses incurred, during a tax year. It must also provide SARS with an annual return containing certain information (including the names of the participatory holders and any disposals of interests).

- PLS. These are companies and are taxed at a rate of 28%. Interest expenditure that a PLS incurs on the debenture component of a linked unit is tax deductible, provided that it is incurred in the production of the income of the PLS. Because PLSs pay out their profits (in the form of interest) to linked unit holders, they are often left with very little, or no, taxable income. Dividends declared by a PLS are subject to a secondary tax on companies at a rate of 10%. A PLS disposing of fixed property which it holds is subject to capital gains tax.

- Foreign CIS. Foreign CISs are treated as companies for tax purposes. The definition of a company in the ITA specifically includes a portfolio comprised in any investment scheme carried on outside South Africa that is comparable to a portfolio of a collective investment scheme in participation bonds or a portfolio of a collective investment scheme in securities where members of the public are invited or permitted to contribute to and hold participatory interests in that portfolio through shares, units or any other form of participatory interest. Although a foreign CIS is treated as a company for tax purposes, amounts paid to redeem participatory interests do not constitute dividends for tax purposes. Redemptions of participatory interests can trigger a capital gain or loss for the investor unless the participatory interests are held as trading stock.

Resident investors. Investors in a CIS in securities, a CIS in participation bonds and a declared CIS are taxed on any income received by, or accruing to, the CIS provided that it is distributed within a 12-month period. Any income which is exempt from income tax (or tax exempt dividend income) distributed by the CIS remains exempt from income tax once it has been received by an investor. Dividends received from a fixed property company are not exempt from tax once received by an investor, unless they are paid out of capital profits or are paid to a non-resident person who does not carry on business in South Africa. Holders of linked
units in a PLS are taxed on the interest income that they receive (or are entitled to receive) from the PLS.

**Non-resident investors.** Non-resident investors can be taxed in South Africa on the income received from a CIS or a PLS, unless the provisions of a double taxation agreement (DTA) between South Africa and the non-resident’s country of residence provides otherwise. As a general principle, South Africa taxes non-residents on income received or accrued to them from a South African source. To determine whether a non-resident is subject to tax in South Africa, regard must be had to the specific DTA applicable, and the type of income.

**Closed-ended retail funds**

Funds. See above, *Open-ended retail funds.*

**Resident investors.** See above, *Open-ended retail funds.*

**Non-resident investors.** See above, *Open-ended retail funds.*

**Reform**

14. What proposals (if any) are there for the reform of retail fund regulation?

The following regulatory developments are noteworthy:

- Substantial progress has been made in revising GN1503, which concerns the classes of assets that can be included in the portfolio of a CIS in securities. Anticipated changes include a 10% decrease in the threshold for unlisted investments, which do not have to be listed within a year of creation. This will bring South African law in line with the limit for unlisted equities under EU law (in particular, Directive 2001/107/EC amending Directive 85/611/EEC on undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses (UCITS Management Directive) and Directive 2001/108/EC amending Directive 85/611/EEC on undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS (UCITS Product Directive)). No over-the-counter (OTC) derivatives will be permitted other than those currently allowed. It is still envisaged that the review process will be completed in 2011.

- Following the financial crisis, local and international developments have occurred, including changes to principles, policies, laws and regulatory practices as well as an intensified focus on increased regulation of investment schemes. Consequently, the CIS Department of the FSB will undertake a major review of CISCA and bring it in line with international standards of good practice. This state of regulation will be finalised by 2012.

- A proposed amendment to the ITA will consider amounts that are not distributed within a 12-month period and which are derived from dividends received by or accrued to a CIS to be the income of the CIS. Consequently, all dividends will be treated as ordinary revenue if retained by the CIS beyond a 12-month period. Effectively, they will be taxed as ordinary income, and not as dividends. From 1 April 2012, a 10% withholding tax will apply to dividends, which is lower than the 40% tax rate that applies to ordinary revenue.

**HEDGE FUNDS**

15. What is the structure of the hedge funds market? What have been the main trends over the last year?

Industry analysts note that there are just over 100 registered hedge fund companies with assets worth ZAR32.1 billion under management in 2011.

South Africa does not have a formally regulated hedge fund structure, but the activities of hedge fund managers are regulated.

**Regulatory framework and bodies**

16. What are the key statutes and regulations that govern hedge funds in your jurisdiction? Which regulatory bodies regulate hedge funds?

**Regulatory framework**

There is no specific legislative regulation of hedge funds. However, the Financial Advisory and Intermediary Services Act 2002 (FAIS) regulates the activities of hedge fund managers. Hedge fund managers must be approved as category IIA FSPs. A category IIA FSP is a financial service provider who provides intermediary services of a discretionary nature in relation to a particular hedge fund. A hedge fund manager must also apply to the FSB for a category II licence, which applies to discretionary financial services providers. The FSB issues the licence under the FAIS.

The Code of Conduct for Discretionary FSPs (Code of Conduct) issued under FAIS refers specifically to the regulation of hedge fund managers. The FSB also has supervisory powers over hedge fund managers.

**Regulatory bodies**

See above, *Regulatory framework.*

17. How are hedge funds regulated (if at all) to ensure compliance with general international standards of good practice?

**Risk**

Under the Code of Conduct, the mandate between an investor and a hedge fund manager must contain a statement explaining the risks associated with investing in hedge funds. This statement is required in addition to the general risk disclosures that are required in mandates between FSPs and their clients.

**Valuation and pricing**

The rules and regulations governing valuation and pricing are contained in the constitutive documents of the fund.

**Systems and controls**

These are also contained in the constitutive documents of the fund.

**Insider dealing and market abuse**

The provisions of the Securities Services Act 2004 concerning insider dealing and market abuse apply to hedge fund managers.

**Transparency**

Hedge fund managers must provide clients with written reports on request. At a minimum, a written report must be supplied at least once every three months.
Money laundering

Hedge fund managers are subject to the Financial Intelligence Centre Act 2001 (FICA), which regulates the identification of the proceeds of unlawful activities, and includes measures to combat money laundering activities.

Short selling

Under the Code of Conduct, clients must expressly confirm that they approve the use by the hedge fund manager of net short positions.

Marketing

18. Who can market hedge funds?

Both local and foreign hedge fund FSPs are prohibited from soliciting investments for their hedge fund portfolios. However, publishing industry surveys does not constitute “solicitation” for these purposes, and so is permitted under the regulations.

19. To whom can hedge funds be marketed?

Hedge funds can be marketed to both institutional and sophisticated individual investors. There are no differences between local and foreign hedge funds in this regard.

Investment restrictions

20. Are there any restrictions on local investors investing in a hedge fund?

Local investors in hedge funds can either be high net-worth individuals or institutional investors or both. In this regard, there are no restrictions on high net-worth individuals’ investment in hedge funds.

“Institutional investor” is not generally defined. However, for exchange control purposes, there are certain restrictions placed on the following types of institutional investor as regards investing in hedge funds:

- **Retirement funds.** These can only invest up to 5% per fund of hedge funds, and 2.5% of their total assets in hedge funds.
- **CISs.** These cannot invest in a hedge fund.
- **Investment managers.** These can only invest in hedge funds to the extent allowed in the mandate from clients.
- **Insurers.** These cannot invest in hedge funds unless the hedge fund is housed in a limited liability structure, which:
  - limits any potential loss by the insurer to the amount of capital invested by the insurer in that hedge fund; and
  - protects all other policyholders from any contagion risk should the hedge fund incur losses greater than the total capital invested in the fund.

Assets portfolio

21. Who holds the portfolio of assets? What regulations are in place for its protection?

The mandate between the investor and the hedge fund manager must identify in whose name the financial products will be registered (Code of Conduct). Hedge funds must also maintain appropriate insurance to protect investors against any fraudulent and/or negligent activity.

Requirements

22. What are the key disclosure or filing requirements (if any) that must be completed by the hedge fund?

Investors must be made aware of the risks of investing in a hedge fund. The hedge fund manager must also provide investors with written reports on request. At a minimum, a written report must be supplied at least once every three months. The report must contain all information, which is reasonably necessary to enable the client to:

- Produce a set of financial statements.
- Determine the composition of the financial products comprising their investment and the change(s) over the reporting period.
- Determine the market value of the financial products comprising the investment and the changes over the reporting period.

There are no specific filing requirements for hedge funds.

23. What are the key requirements that apply to managers or operators of hedge funds?

The key requirements for hedge fund managers are that they must:

- Be approved as by the FSB as category II and IIA hedge fund FSPs.
- Meet the experience and qualification requirements necessary for those within the hedge fund industry.
- Meet the “fit and proper” requirements for FSPs.

There are no differences between local hedge funds and foreign hedge funds in this regard.

Legal fund vehicles and structures

24. What are the main legal vehicles used to set up a hedge fund and what are the key advantages and disadvantages of using these structures?

Open-ended retail funds

Legal vehicles. The majority of hedge funds use the following legal vehicles:

- **Public and private companies.** A public company is a company whose memorandum of incorporation (MOI) does not prohibit offering shares to the public. A private company is a company whose MOI must prohibit it from offering any of its shares to the public and must restrict the transferability of its shares. Participants are issued with shares when they make an investment.
- **Trusts.** Investors hold units following investment.
Limited liability partnerships (the *en commandite* partnership). An *en commandite* partnership is a limited partnership, under which the partner *en commandite* limits its liability to its co-partners for the losses of the partnership up to an agreed amount, on the condition it receives a fixed share of the profits. This type of partnership allows for a maximum of 20 partners. Partners hold an interest following an investment.

**Advantages.** The advantage of a public company is that it offers a limited liability structure and its shares can be issued to the public. Also, a public company can have an unlimited number of shareholders.

The key advantage of a trust is that it is a well-established structure and is commonly used. Also, the founders of the trust can determine the terms of the trust in its constitutive documents in line with the objects of the trust.

The *en commandite* partnership offers investors limited liability. Also, it is easy to establish because it is not a regulated structure.

**Disadvantages.** The regulatory compliance burden arising under the Companies Act can add to the cost of using a public company as a fund structure.

A trust structure offers flexibility. However, institutional investors, like South African retirement funds, can be reluctant to make investments into a trust structure because there is a transfer of ownership of the assets invested. There is the option of establishing a *bewind* trust, which does not result in the transfer of ownership, but gives the trustees administrative powers over the assets. However, the FSB has not been happy for pension funds to invest in a *bewind* trust structure.

The disadvantage of the *en commandite* partnerships is that its membership is limited to 20 partners.

**Closed-ended retail funds**

**Legal vehicles.** The same legal vehicles are used as for open-ended retail funds (see above, Open-ended retail funds: Legal vehicles).

**Advantages.** Private companies can have:

- A limited liability structure.
- The ability to restrict the transfer of shares.
- An unlimited number of shareholders.

The advantages of the trust and *en commandite* partnership are the same as those described above under open-ended retail funds (see above, Open-ended retail funds: Advantages).

**Disadvantages.** The disadvantage of a private company is that, under the Companies Act, it cannot issue debt instruments to the public without first complying with the provisions of the Companies Act, which governs the public offering of securities (which require a prospectus that complies with the requirements of the Companies Act).

The disadvantages of a trust and *en commandite* partnership are the same as open-ended retail funds (see above, Open-ended retail funds: Disadvantages).

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25. What are the advantages and disadvantages of using onshore and offshore structures?

**Onshore**

**Advantages.** The advantage of using onshore structures includes that fact that the regulatory framework for these is settled.

**Disadvantages.** The disadvantage is that local structures are not always internationally recognised, and their regulation can be considered too restrictive.

**Offshore**

**Advantages.** The advantage of using an offshore structure is that it can be more flexible and better recognised internationally than local structures.

**Disadvantages.** The challenge of using offshore structures is that this structure may require regulatory approval (for example, a foreign company may have to be registered with the CIP Commission as an external company). In addition, there can be exchange control implications when using an offshore structure (for example, when bringing money into, and out of, South Africa). However, the approval of the South African Reserve Bank can be obtained.

**Tax treatment**

26. What is the tax treatment for hedge funds?

**Funds**

This depends on whether the hedge fund is structured as a trust or a partnership:

- **Trust.** Any income that the fund receives is exempt from tax, provided that income is distributed to the beneficiaries during the tax year in which it is received. The fund is only subject to tax on any income it retains.

- **Partnership.** The partnership is not a “person” for tax purposes. The partners, in their individual capacities, are subject to tax on the income received by, or accruing to, the partnership according to their profit-sharing ratio.

**Resident investors**

This depends on whether the hedge fund is structured as a trust or a partnership:

- **Trust.** The investors are taxed on the income distributed to them by the fund. Any fund income which is tax exempt retains that tax exempt status upon distribution, provided it is distributed to the beneficiaries within the same tax year. Any tax deductions, or allowances, permitted by the fund can also be made by the beneficiaries where income is distributed (and can still be made by the fund where the amount is not distributed).
**Partnership.** Where a hedge fund is structured as a partnership, any income received by, or accrued to, the partnership is considered to pass to the partners on the same date (and in their profit-sharing ratio). The partners can deduct any permitted expenses and allowances. The ITA regulates the tax treatment of limited partners, provided that each limited partner is carrying on the trade or business of the partnership (whether or not it is a limited partnership). A limited partner is defined in the ITA as any member of a partnership en commandite, an anonymous partnership or any similar partnership where a member’s liability towards creditors is limited to their contributions.

Partners must make a joint return to SARS, and each partner is separately and individually liable to SARS for their portion of the taxes due.

**Non-resident investors**

Non-resident investors can be taxed in South Africa on income received which is sourced from South Africa, unless the provisions of a specific DTA provide otherwise.

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**Restrictions**

27. Can participants redeem their interest? Are there any restrictions on the right of participants to transfer their interests to third parties?

**Redemption of interest**

The fund’s constitutive documents can contain restrictions on the right of participants to redeem their interest, and the right of participants to transfer their interest to third parties.

**Transfer to third parties**

See above, *Redemption of interest.*

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**Reform**

28. What (if any) proposals are there for the reform of hedge fund regulation?

The Alternative Investment Management Association, the Association for Savings and Investment South Africa, the FSB and the National Treasury are currently looking at ways in which hedge fund regulation can be implemented within South Africa. These proposals are currently confidential. We are not aware of any litigation or enforcement action relating to hedge funds in South Africa.
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