



ASIC

Australian Securities & Investments Commission

REPORT 301

Response to submissions on CP 174 Hedge funds: Improving disclosure— Further consultation

September 2012

About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 174 *Hedge funds: Improving disclosure—Further consultation* (CP 174) and details our responses in relation to those issues.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see Regulatory Guide 240 *Hedge funds: Improving disclosure* (RG 240).

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A Overview/Consultation process

- 1 This project commenced in 2010 and was prompted by our experience that, in some cases, inadequate disclosure has contributed to investors not understanding the risks when purchasing a hedge fund product.
- 2 We have released two consultation papers on hedge fund disclosure:
 - (a) Consultation Paper 147 *Hedge funds: Improving disclosure for retail investors* (CP 147) was released in early 2011; and
 - (b) Consultation Paper 174 *Hedge funds: Improving disclosure—Further consultation* (CP 174), which attached a draft regulatory guide, was released on 23 February 2012.

Initial consultation: CP 147

- 3 In February 2011 we released CP 147, which consulted on introducing benchmarks and disclosure principles for hedge fund disclosure documents, setting out the specific features and risks of hedge funds that we think should be addressed in a Product Disclosure Statement (PDS) for these products.
- 4 As stated in CP 147, our proposed disclosure guidance was not designed to stop or discourage investors from taking investment risks, but to help them and their advisers understand the risks involved in any particular investment or type of investment. This enables them to make a more informed decision about whether the potential reward (the return on their investment) warrants the level of risk involved.
- 5 Given the risks for investors associated with investing in hedge funds, and that many investors and their advisers rely on disclosure material to inform their decisions to invest, we think it is necessary to ensure that disclosure gives investors the information they need to make an informed investment decision. In some cases, this may include a decision not to invest in these products.
- 6 We received seven submissions in response to CP 147. The submissions were generally supportive of our proposals, but raised some issues.

Note: A summary of the issues raised by submissions on CP 147 and our response is set out in Section A of CP 174.
- 7 Based on responses to CP 147, we refined our proposals and sought further feedback from stakeholders on our proposed disclosure guidance through CP 174.

Further consultation: CP 174

- 8 We received eight submissions in relation to CP 174. We also undertook further targeted consultation with the two main industry bodies, the Alternative Investment Management Association and the Financial Services Council.
- 9 This report highlights the key issues that arose out of the submissions received on CP 174 and the draft regulatory guide attached to CP 174, and our responses to those issues. Feedback received on CP 174 was used to finalise our policy, which is published in Regulatory Guide 240 *Hedge funds: Improving disclosure* (RG 240). Where relevant, this report explains where we have modified key aspects of the policy proposed in CP 174 in producing our final guidance.
- 10 Generally, respondents were supportive of the need for guidance in relation to disclosure by hedge funds. However, a number of respondents had concerns about some aspects of the proposed guidance. We have revised our guidance to take account of many of these concerns. These matters are addressed in Section B of this report.
- 11 For a list of the non-confidential respondents to CP 147 and CP 174, see the appendix. Copies of these submissions are on our website at www.asic.gov.au/cp under CP 147 and CP 174.

B Response to submissions on CP 174

Key points

This section outlines the key issues covered in submissions received on CP 174, and our responses to those issues.

It covers:

- the definition of ‘hedge fund’;
- application of the benchmarks and disclosure principles to funds of hedge funds and disclosure relating to significant underlying funds;
- independent custodial arrangements;
- sub-custodial arrangements where a hedge fund invests outside Australia; and
- fee disclosure.

Definition of ‘hedge fund’

- 12 A key issue in developing RG 240 was defining the term ‘hedge fund’. In CP 174, we proposed a ‘generally regarded as’ test. That is, a hedge fund would be defined as ‘a registered managed investment scheme that is, or has been promoted as, or is generally regarded as, a hedge fund or a fund of hedge funds’. In determining whether a particular registered managed investment scheme is a hedge fund, a list of factors may be relevant, such as complex investment strategy, use of leverage, derivatives or short selling, or exposure to diverse risks and complex underlying investments: see proposal B1 in CP 174.
- 13 Subsequent to CP 174, Class Order [CO 12/749] *Relief from the Shorter PDS regime* excluded hedge funds from the shorter PDS regime. This class order used a definition of hedge fund similar to that proposed in CP 174. However, in order to provide the certainty necessary for a class order, the definition was refined significantly to provide more objective criteria. That is, a hedge fund is defined as a registered managed investment scheme that is:
- (a) promoted by the responsible entity as a ‘hedge fund’; or
 - (b) exhibits two or more of the characteristics of a hedge fund:
 - (i) complexity of investment strategy or structure;
 - (ii) use of leverage;
 - (iii) use of derivatives;

- (iv) use of short selling; or
- (v) right to charge a performance fee.

- 14 The definition of hedge fund we have adopted in RG 240 is based on the definition in [CO 12/749]. Adopting the same definition in the proposed regulatory guide and class order means that we expect all funds that are excluded from the shorter PDS regime under the class order to disclose against the benchmarks and apply the disclosure principles in the regulatory guide. We have preferred an objective definition as this gives greater certainty about which disclosure regime applies to a fund.
- 15 Some respondents were concerned that the objective definition of hedge fund is too broad and results in ‘false positives’—that is, it classes some funds as a hedge fund that the investment community at large does not consider to be a hedge fund. This has a commercial impact on funds, as hedge funds may be placed in the ‘alternatives’ asset class by research houses and platforms. This can drive asset allocation decisions, where lower allocations are generally applied to alternatives in some portfolios.

ASIC response

We acknowledge that a more subjective definition (such as that originally proposed in CP 174) would allow more flexibility for industry as to how to classify these schemes. However, the lack of objective criteria may still cause uncertainty about whether a particular fund is covered by the shorter PDS regime or the hedge fund disclosure regime. To the extent that the more objective definition means that a particular scheme is a ‘false positive’, this can be dealt with through appropriate individual relief on application by the responsible entity of a scheme.

- 16 Some respondents proposed setting disclosure benchmarks and principles to cover all complex products that exhibit the relevant characteristics, rather than just hedge funds. We note that this proposal was supported by the alternative investments sector of the industry, but was not supported by the wider managed funds industry.

ASIC response

We have not adopted this proposal. We have developed our proposal in the context of the response to the Trio inquiry, as well as overseas regulatory developments relating to hedge funds. We consider that adopting a more general approach to complex products would apply too widely across the industry at this time, and the disclosure expectations for this wider group of funds may be different from those for hedge funds. We also note that our regulation of hedge funds is consistent with international standards.

- 17 Some respondents proposed that the responsible entity of the scheme, acting reasonably and taking into account the relevant criteria, should be solely responsible for determining whether its scheme is a hedge fund or not. By allowing the responsible entity to determine for themselves whether their scheme is a hedge fund, industry argues this option would provide the greatest degree of regulatory certainty. This is because an issuer would be able to make its own determination about whether it is a hedge fund (i.e. a process of self-assessment) before it issues a PDS.

ASIC response

We do not support this proposal. This approach focuses on the issuer's perspective of the fund, rather than the market's perspective. Issuers may be driven in how they classify their fund by the label of 'hedge fund', regardless of the fund's investment strategy.

Hedge fund criteria

- 18 Along with submissions on the overall approach to defining a hedge fund, many respondents also raised concerns about the specific criteria used to classify a particular fund as a 'hedge fund'. These respondents commented that, if we adopted the objective criteria under [CO 12/749], we should consider some amendments and clarifications:
- (a) clarifying uncertainty about the extent to which a fund might have a 'low correlation' with the relevant indices;
 - (b) including a materiality threshold on some criteria, such as the use of short selling; and
 - (c) removing performance fees as a criterion, as they are charged by many types of funds, not just those that should be considered to be 'hedge funds'.

ASIC response

We do not consider there is likely to be widespread industry confusion about the meaning of 'low correlation'. Inserting a specific level of correlation would not necessarily assist in clarifying the concept.

Our view is that the inclusion of materiality thresholds will add significant uncertainty and is not consistent with prevailing international practice.

We note that performance fees are almost universal among hedge funds, although they are also used in some other funds where managers have some level of discretion in their trading. Our approach is consistent with overseas approaches, as performance fees are used as an indicative criterion for identifying a fund as a hedge fund by the US Commodity Futures Trading Commission and US Securities and Exchange Commission, the

Managed Funds Association (based in the United States), the US President's Working Group on Financial Markets, the Hedge Funds Standards Board (based in the United Kingdom) and the International Organization of Securities Commissions.

Funds of hedge funds and significant underlying funds

- 19 In CP 174 we proposed to apply the same requirements to funds of hedge funds as to hedge funds. We originally proposed that a fund of hedge funds be a scheme that has invested 25% or more of its assets in an underlying hedge fund or similar product.
- 20 Some respondents commented on the application of ASIC's proposed principles and benchmarks to funds of hedge funds. Respondents provided various comments about the suitability of a 25% threshold.

ASIC response

We have taken on board concerns raised by some respondents that the 25% threshold for determining disclosure requirements to a fund of hedge funds is too low. We have increased the threshold from 25% to 35%. This will align with the definition of 'fund of hedge funds' under [CO 12/749].

A 'fund of hedge funds' is defined under [CO 12/749] as a managed investment scheme where at least 35% of a fund's assets is invested by the responsible entity in one or more hedge funds (including a scheme or body in or outside this jurisdiction that would be a hedge fund if it were a registered managed investment scheme).

- 21 Some industry submissions in response to CP 174 expressed concern that the proposed benchmarks and disclosure principles may be difficult for funds of hedge funds to address in relation to the underlying investments of the fund.

ASIC response

We have refined the requirements for 'look-through' disclosure so that, where a hedge fund has invested in one or more significant underlying funds (being an underlying fund that accounts for 35% or more of the fund of hedge fund's assets), the benchmarks and disclosure principles in RG 240 should be taken to apply to each such significant underlying fund on a look-through basis.

We have also clarified, for each benchmark and principle, how it applies to funds of hedge funds. In particular, we have specified which elements of the relevant benchmark or disclosure principle should be disclosed in relation to the fund of hedge funds itself and which should be disclosed in relation to any significant underlying funds.

Independent custodial arrangements

- 22 The draft regulatory guide released with CP 174 included a benchmark requiring that valuations of the hedge fund's assets that are not exchange traded be provided by independent third-party administrators, as well as all custodians involved in the fund structure (including custodians of any underlying funds) be unrelated to the responsible entity or investment manager of the hedge fund.
- 23 Respondents commented that this requirement goes beyond the existing legal requirement, and should not be required of hedge funds as it is not required of other types of managed investment schemes.

ASIC response

We have changed this benchmark to remove the requirement that all custodians involved in the fund structure (including custodians of any underlying funds) be unrelated to the responsible entity or investment manager of the hedge fund.

The Corporations Act was specifically drafted to allow a custodian to be related to the responsible entity. Further, placing a high level of emphasis on the custodian's role through this benchmark may be in tension with efforts to minimise the gap between what custodians are required to do, and what some retail clients might think they would do. However, ASIC is currently reviewing aspects of the regulatory framework of custodians (see Report 291 *Custodial and depository services in Australia* (REP 291)).

We have retained Disclosure Principle 4, which requires disclosure of the custodial arrangements, including details of the roles provided by custodians. Where assets are not held by a third-party custodian, the responsible entity should disclose the types and proportion of those assets relative to the fund's net asset value.

Sub-custodial arrangements where a hedge fund invests outside Australia

- 24 In Disclosure Principle 4 in CP 174, we proposed that the responsible entity should disclose the custodial arrangements, including details of the roles provided by custodians.
- 25 Respondents argued that hedge funds commonly engage prime brokers and custodians. It would be difficult for hedge funds to specifically identify the location and jurisdiction of fund assets in custody due to practices in prime broker arrangements such as industry stock lending and collateralised norms, particularly where assets are held overseas. The respondents argued that it

would be more useful for a PDS to include disclosure around risks of holding assets offshore.

ASIC response

We consider that a fund should be aware of the location and value of its assets, regardless of where they are invested. This includes sub-custodial arrangements, both in Australia and overseas. We propose to retain this requirement in Disclosure Principle 4.

Fee disclosure

- 26 The draft regulatory guide released with CP 174 included a benchmark requiring the responsible entity to disclose the monthly pre-tax return on the fund's assets on both a before and after fees and costs basis.
- 27 Respondents commented that there are practical difficulties in calculating the returns before fees and costs because unit prices are calculated on an after fees and costs basis. This would mean that responsible entities would need to estimate what the unit prices were before fees and costs were deducted in order to work out the returns.

ASIC response

We have amended this benchmark to now require disclosure of the fund's net investment return on an after fees, costs and taxes basis.

This change more closely aligns with overseas approaches, as well as being consistent with the Financial Services Council Standards, which many issuers of hedge funds follow.

Appendix: List of non-confidential respondents

CP 147

- Alternative Investment Management Association
 - AMP Capital Investors Limited
 - Greg Hogan
 - K2 Asset Management
 - McCullough Robertson
 - Stockbrokers Association of Australia
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CP 174

- Johnson Winter & Slattery
 - Financial Services Council
 - Hedge Funds Standards Board
 - St Davids Rd Advisory
 - McCullough Robertson
 - Australian Custodial Services Association
 - K2 Asset Management
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