



**ASIC**

Australian Securities & Investments Commission

## REGULATION IMPACT STATEMENT

# Hedge funds: Improving disclosure

September 2012

### **About this Regulation Impact Statement**

This Regulation Impact Statement (RIS) addresses ASIC's proposals for improving disclosure by hedge funds to retail investors.

## What this Regulation Impact Statement is about

- 1 This Regulation Impact Statement (RIS) addresses ASIC's proposals for improving disclosure by hedge funds to retail investors.
- 2 In developing our final position, we have considered the regulatory and financial impact of our proposals. We are aiming to strike an appropriate balance between:
  - maintaining, facilitating and improving the performance of the financial system and entities in it;
  - promoting confident and informed participation by investors and consumers in the financial system; and
  - administering the law effectively and with minimal procedural requirements.
- 3 This RIS sets out our assessment of the regulatory and financial impacts of our proposed policy and our achievement of this balance. It deals with:
  - the likely compliance costs;
  - the likely effect on competition; and
  - other impacts, costs and benefits.

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## A Introduction

### Background

#### What is a hedge fund

- 4      There is no universal definition of a hedge fund; various definitions have been adopted in different jurisdictions. However, there are some characteristics that distinguish hedge funds from other managed investment schemes, such as the use of leverage, derivatives and short selling to seek returns with low correlations to equity and bond markets. These characteristics and other features of hedge funds mean that investors in these funds can be exposed to more complex risks than investors in funds pursuing more ‘vanilla’ investment strategies.
  
- 5      Hedge funds in Australia are defined in Class Order [CO 12/749] *Relief from the shorter PDS regime* as a registered managed investment scheme that:
  - (a) is promoted by the responsible entity using the expression and as being a ‘hedge fund’; or
  - (b) exhibits two or more of the following characteristics:
    - (i) use of investment strategies intended to generate returns with low correlation to equity and bond indices and/or complex investment structures;
    - (ii) use of leverage to increase returns;
    - (iii) use of derivatives for speculative purposes;
    - (iv) use of short selling; or
    - (v) performance fees (in contrast to fees based on funds under management (FUM)).
  
- 6      Funds of hedge funds gain indirect exposure to a range of investments in financial products by investing in other vehicles (called ‘underlying funds’) that use hedge fund strategies.
  
- 7      Funds of hedge funds are defined in [CO 12/749] as registered managed investment schemes:
  - (a) where at least 35% of the fund’s assets are invested by the responsible entity in one or more hedge funds; or
  - (b) that promotes itself as a fund of hedge funds.

## Size of the hedge fund market

- 8        The number of hedge funds in Australia has remained relatively stable over the last two years, with 14 new hedge funds being established in 2011. Total FUM for the hedge fund industry was approximately \$47.7 billion, up from \$46.5 billion in December 2010.
- 9        Our analysis of hedge fund data shows that as at 31 December 2011 there were at least 677 hedge funds and funds of hedge funds available for investment in Australia. There has been a steady decline in the number of new funds being established since 2005.
- 10       The Australian hedge fund industry is dominated by a small number of very large firms. There were seven funds with FUM above \$1 billion at 31 December 2011 that accounted for an aggregate share of 35.6% of the market. However, this was down significantly from 2010, when the 13 funds with over \$1 billion FUM accounted for over 53% of the market. The average size of a hedge fund operating in Australia in 2011 was \$174 million. This is very different from the median size of \$45 million, which reflects the large number of smaller funds (92 funds reported FUM equal to or less than \$20 million).
- 11       The FUM for single hedge funds and funds of hedge funds represent only a very small slice of the total assets in the managed funds industry, accounting for 2% and 0.6% respectively.
- 12       Australian hedge funds have benefitted significantly from the growth of the superannuation industry in the last 20 years. A 2007 survey of pension funds by Russell Investments<sup>1</sup> found that 56% of respondents used hedge funds in their investment portfolio, while the share of total assets allocated to hedge funds was 4.1% on average.

## Profile of typical hedge fund retail investors

- 13       We understand that in excess of 48,000 investors invest in hedge funds in Australia, although the exact figure is difficult to determine precisely due to differing uses of terminology.
- 14       A report published by the Australian Trade Commission<sup>2</sup> found that 64% of investors in hedge funds and funds of hedge funds are Australian retail and high net worth investors (including self-managed superannuation funds). The remaining investor base comprises Australian institutional investors (25%) and offshore institutional investors (11%).

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<sup>1</sup> Russell Research, *The 2007–2008 Russell survey on alternative investing: A survey of organizations in North America, Europe, Australia, and Japan*, Russell Investments, 2008.

<sup>2</sup> Australian Trade Commission, *Alternative investments in Australia*, September 2010, [www.austrade.gov.au/Invest/Investor-Updates/100330-Australian-Alternative-Investments-Report-published/default.aspx](http://www.austrade.gov.au/Invest/Investor-Updates/100330-Australian-Alternative-Investments-Report-published/default.aspx).

- 15 While investors who have received financial advice are currently more likely to have a hedge fund investment than direct investors, the direct investment channel may become more important in the future, with a higher level of latent demand. Current hedge fund investors are more likely to use a financial adviser (58%), while those investors who are considering, but not currently invested in, a hedge fund are more likely to invest without advice (57%).
- 16 Hedge fund investors are aged around 51 on average, typically with very high incomes and high levels of investable assets. Among current investors, the average investment size is between \$50,000 and \$70,000, depending on the fund type, with an expected hold time of four to six years.
- 17 Prospective investors who do not currently invest in hedge funds but are considering it are more diverse, with a large proportion of younger, lower or middle income investors. For example, 29% of prospective hedge fund investors are aged under 35 with an income between \$50,000 and \$125,000 per annum.

### **Regulation of hedge funds**

- 18 The offer of interests in hedge funds is regulated under the Corporations Act.<sup>3</sup> An interest in a hedge fund is a financial product, so the obligations for the offer of financial products in Pt 7.9 apply to the offer of interests in hedge funds, including the requirement to prepare a Product Disclosure Statement (PDS) for the offer of interests in the scheme, ongoing disclosure obligations and requirements on advertising and publicity for the offer of interests.
- 19 In addition, Ch 5C imposes various requirements on hedge funds, including (where applicable) the requirement to be registered as a managed investment scheme, to be operated by a responsible entity that holds an Australian financial services (AFS) licence, and to have a scheme constitution and compliance plan.

### **PDS disclosure**

- 20 The Corporations Act requires disclosure in the form of a PDS for an offer of interests in a hedge fund to retail investors. The PDS must:
- (a) be worded and presented in a clear, concise and effective manner (s1013C(3));
  - (b) make specific disclosures (s1013D), including among other things about the significant risks associated with holding the product; and

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<sup>3</sup> All sections (s), chapters (Chs) and parts (Pts) referred to in this RIS are from the Corporations Act unless otherwise stated.

- (c) include all other information that might reasonably be expected to have a material influence on the decision of a reasonable person (when investing as a retail client) about whether or not to invest in the product (s1013E).

21 The general PDS content requirement in s1013E is designed to:

- (a) promote efficiency in the capital markets;
- (b) promote disclosure of relevant information;
- (c) reduce the likelihood of omitting important information;
- (d) focus responsible entities on the information needs of investors; and
- (e) be sufficiently flexible to accommodate changes in investors' information needs.

22 There is currently no sector-specific guidance that provides advice on which aspects of hedge funds should be included in a PDS to satisfy the general PDS content requirement under s1013E.

#### **Ongoing disclosure**

23 A hedge fund operator also has obligations to provide ongoing disclosures to investors under the Corporations Act, including:

- (a) disclosure of material changes and significant events (s675 and 1017B);
- (b) notification of any material change to a matter that would be required to be specified in a PDS (s1017B); and
- (c) periodic statements to members who acquired their interests as retail clients (s1017D).

#### **Recent developments in the hedge funds sector**

24 Through our surveillance of the managed funds industry, we have noted many schemes that exhibit 'hedge fund' characteristics (such as complex investment structures and the use of derivatives, leverage and short selling), but are not marketed or promoted as hedge funds.

25 Our concerns should also be read in light of recent large-scale financial collapses involving hedge funds, particularly that of Trio Capital, in which approximately \$176 million in superannuation funds was lost or went missing from two managed investment schemes: the Astarra Strategic Fund and the ARP Growth Fund.<sup>4</sup>

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<sup>4</sup> Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, [www.aph.gov.au/Parliamentary\\_Business/Committees/Senate\\_Committees?url=corporations\\_ctte/trio/report/index.htm](http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/trio/report/index.htm), p. 15.

- 26 The collapse of Trio Capital demonstrated the way in which hedge funds and funds of hedge funds can be overly complex, unclear and lacking in transparency, particularly for retail investors.
- 27 The financial structure and operation of Trio Capital involved a variety of holding and subsidiary companies both in Australia and overseas, as well as significant investment in overseas hedge funds. The Astarra Strategic Fund was set up under Trio Capital as responsible entity, and had an overarching investment strategy that involved investing money in overseas hedge funds.
- 28 According to PPB Advisory, liquidator of Trio Capital, the most significant losses to Trio investors related to investments in overseas hedge funds. \$123 million was invested by the Astarra Strategic Fund via deferred purchase agreements in a variety of overseas hedge funds.<sup>5</sup>
- 29 PPB Advisory's findings on the collapse of Trio found that a lack of transparency to investors about what comprised the underlying investments was one cause behind the substantial losses incurred.<sup>6</sup>
- 30 It should be noted that other factors regarding the operation of the fund (such as expensive fee structures, conflicts of interest, lack of due diligence, lack of insurance and undisclosed payments to financial advisers) were also responsible for the collapse of Trio. Better disclosure of the underlying investments may have encouraged Trio to undertake better due diligence before investing the fund's assets. Better disclosure of fee structures and payments to financial advisers may have prompted investors to examine the product more closely before investing.

### International regulation of hedge funds

- 31 A number of overseas jurisdictions have introduced stronger regulation of hedge funds. These regulations have included investment restrictions and disclosure requirements.
- 32 The International Organization of Securities Commissions (IOSCO) recommended that the regulatory system should provide for proper disclosure to investors on the risks incurred, details of redemption conditions and information about the fund's strategy and performance.<sup>7</sup> The funds contained in the portfolio should also be disclosed, allowing investors to obtain all necessary information irrespective of the location of the fund.

<sup>5</sup> PPB Advisory, *Submission to the Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into the Collapse of Trio Capital* (Submission 26), 19 August 2011, [www.apf.gov.au/Parliamentary\\_Business/Committees/Senate\\_Committees?url=corporations\\_ctte/trio/submissions.htm](http://www.apf.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/trio/submissions.htm).

<sup>6</sup> PPB Advisory, *Submission to the Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into the Collapse of Trio Capital* (Submission 26), 19 August 2011, [www.apf.gov.au/Parliamentary\\_Business/Committees/Senate\\_Committees?url=corporations\\_ctte/trio/submissions.htm](http://www.apf.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/trio/submissions.htm), p. 3.

<sup>7</sup> Technical Committee of IOSCO, *Hedge funds oversight* (IOSCOPD293), IOSCO, June 2009, paragraphs 34, 45 and 49.



- 33 Due to how recently hedge fund regulatory regimes have been adopted overseas, there are not yet any relevant studies on their effectiveness.

## Assessing the problem

- 34 We are concerned that inadequate disclosure has contributed to investors not having access to full information about the risks associated with purchasing a hedge fund product. This means that investors may have little comprehension of the major risks associated with the product in which they are investing.

### Retail investors understanding of hedge funds

- 35 Hedge funds come with risks greater than those associated with the majority of financial products offered to investors. We are concerned that a lack of adequate disclosure is resulting in investors being exposed to a heightened risk when investing in these kinds of products. Investors are unclear about the nature of the products and whether the products are appropriate to meet their own investment needs, objectives and risk profile.
- 36 Hedge funds and their managers may invest in many types of securities across diverse markets and in non-mainstream asset classes, may use a wider variety of complex investment techniques than traditional funds, and may borrow money to leverage the funds' investments. Each hedge fund is different, so the PDS is a key mechanism for making sure that the investor understands the investments and strategies the investment manager will be using.
- 37 Inadequate disclosure occurs when the information required to be disclosed under the Corporations Act:
- (a) is not included in the PDS; or
  - (b) is included in the PDS, but it is not clear, concise and effective. Rather, the information is presented in such a dense and complex way that investors are unable to understand the true nature of the investment. This problem can be exacerbated if advertising and other sales practices do not highlight risks and thus give a misleading impression of the product.
- 38 We are concerned about the general quality of PDSs for hedge funds. While we believe that hedge funds generally include the information required by the Corporations Act, the principles-based nature of the disclosure requirements mean that many hedge fund PDSs are long and complicated documents. There is currently no guidance for industry on how to present information about a hedge fund in a clear, concise and effective manner. Retail investors rely on the information in the PDS when choosing where to

make an investment. It is therefore important that information in the PDS is informative, of high quality and readily understood by retail investors investing in hedge funds.

- 39 The following table illustrates the key features and areas of risk associated with hedge funds. To meet the existing obligations under s1013E—to disclose any information that might reasonably be expected to have a material influence on the decision of a reasonable person (when investing as a retail client) about whether or not to invest in the product—responsible entities must disclose information about these features and risks. This will allow investors to gain a full understanding of the product and the risks associated with it.

**Table 1: Key features and risks associated with hedge funds**

Key feature/risk	Explanation
<b>Investment strategy</b>	<p>Hedge funds generally have complex investment strategies. A clear and concise explanation of the fund's investment strategy is a key requirement to enable an investor to make an informed decision about whether to invest in the fund.</p> <p>There is a risk that the fund will not provide clear information about the details of the investment strategy for the fund—the type of strategy, how it works in practice and how risks are managed.</p>
<b>Investment manager</b>	<p>The experience and qualifications of the key investment decision makers, and the time that they devote to executing the investment strategy, is critical information for investors, given:</p> <ul style="list-style-type: none"> <li>• the higher level of fees paid to investment managers of many hedge funds;</li> <li>• the complexities of the strategies involved; and</li> <li>• the prospect held out of exceeding equity and/or bond industry benchmarks.</li> </ul> <p>There is a risk that investors may not be given sufficient information about the people responsible for managing the fund's investments, as well as the arrangement between the responsible entity and any investment manager.</p>
<b>Fund structure</b>	<p>There is a risk that investors may not be given appropriate information to allow them to understand the investment structures involved, the relationships between entities in the structure, fees and other costs payable to the responsible entity and investment managers, jurisdictions and details of due diligence performed on underlying funds.</p>
<b>Valuation, location and custody of assets</b>	<p>There is a risk that investors may not be provided with information about the types of assets held by the fund, where assets are located, how they are valued and custodial arrangements.</p>
<b>Liquidity</b>	<p>Hedge funds often invest in illiquid assets. There is a risk that investors may not be made aware of the fund's ability to realise its assets in a timely manner and the risks of illiquid classes of assets.</p>
<b>Leverage</b>	<p>Information about the use and extent of leverage is critical because it amplifies both positive returns and losses. There is a risk that investors may not be given information about the anticipated level of leverage of the fund.</p>

Key feature/risk	Explanation
<b>Derivatives</b>	There is a risk that investors may not be provided with information about the type and purpose of derivatives used by the fund and the associated risks.
<b>Short selling</b>	There is a risk that investors may not be provided with information about short selling strategies employed by the fund and the associated risks and costs.
<b>Withdrawals</b>	There is a risk that investors may not be made aware of the circumstances in which a fund allows withdrawals

## Characterisation of the problem

- 40 The current problem with hedge fund disclosure can be characterised in a number of ways.
- 41 First, as one of market failure through asymmetric availability of information. Investors do not have access to sufficiently clear information about a hedge fund because the current product disclosure information available to them does not describe the risks of the product clearly enough.
- 42 Second, as one of legislative failure. The PDS content requirement (described in paragraph 20) is principles based and applies to all financial products, without specifically addressing the risks and characteristics of hedge funds. We believe that responsible entities are attempting to comply with the law, but the law is not sufficiently clear on how to produce a good PDS for this product.
- 43 Third, we do not see that industry itself is capable of addressing some of the inherent problems in hedge fund disclosure through self-regulation.
- 44 Self regulation requires significant compliance and cooperation from industry. The primary problem that we see is that investment funds are often reluctant to define themselves as ‘hedge funds’. If the industry is left to regulate itself, this definitional problem is likely to result in compliance issues. Hedge funds that do not wish to be seen as such will situate themselves as outside any self-regulatory policies and guidelines. Our proposed policy will mean that funds that are ‘hedge funds’ are correctly defined as such, resulting in fairer, clearer and more transparent regulation.
- 45 While self-regulation is an important part of the wider regulatory process, there are inherent issues in the practice, including negative perceptions of self-regulated industries in the wider community. Recognising the objective of achieving public confidence in the industry, it is unlikely that allowing hedge funds to self-regulate would provide a satisfactory solution.
- 46 Because we consider that the problem is partly one of legislative failure (namely the principles-based nature of the PDS content requirements, together with a lack of guidance for industry on how to present information

about a hedge fund in a clear, concise and effective manner), and not necessarily the lack of compliance among responsible entities, we do not consider that targeting individual responsible entities is an efficient solution to the problem. Rather, a holistic solution to improve disclosure is required.

- 47 While the regulatory framework in the Corporations Act is intended to provide adequate disclosure for the offer of interests in hedge funds, there appears to be a need for clarification of the requirements of the Corporations Act to improve disclosure in PDSs to enable investors to better assess the risks of hedge funds. If investors are better informed about the risks involved in the investments they are about to make, they are better equipped to make an investment decision that suits their needs.

## Objectives of government action

- 48 We aim to improve the quality of disclosure available to retail investors about hedge funds. We acknowledge that, even if an investor has full information, some investors might lack the necessary financial literacy to be able to take advantage of that information to choose a product that is suitable for them. However, it will allow some investors to become more aware of the level of risk they are assuming.
- 49 Our proposal is not directly aimed at preventing situations like the collapse of Trio: see paragraphs 25–30. However, we expect that better disclosure will prompt some investors to avoid particular types of high-risk investments on the basis that they are not appropriate for that investor.
- 50 We also aim to encourage hedge fund managers to promptly address any deficiencies in the fund in areas such as fee structures, conflicts of interest, due diligence, insurance, and disclosure of payments to financial advisers.
- 51 Our proposals relate to hedge funds in the retail sector. We have directed our focus in this way because it is the retail sector that is most vulnerable to the impacts of misinformation and poor disclosure. We believe that our disclosure principles will improve consumer and investor confidence in the hedge fund industry and in financial products more generally.
- 52 We aim to strike an appropriate balance between:
- (a) disclosure that assists investors to make better-informed decisions about investing in hedge funds;
  - (b) not unduly interfering with the market and the flexibility of the market in raising funds; and
  - (c) promoting efficiency in the capital markets.

- 53           The need to strike an appropriate balance between protecting investors' interests and allowing markets to operate freely is part of ASIC's mandate under the *Australian Securities and Investments Commission Act 2001*.

## B Options and impact analysis

### Options

- 54 ASIC considers the following as possible options to meet the objectives:
- (a) Option 1: Current disclosure requirements continue to apply (status quo).
  - (b) Option 2: ASIC provides guidance on disclosure in PDSs, including benchmarks and disclosure principles that apply (as appropriate).

#### Option 1

- 55 Option 1 is to maintain the status quo for disclosure obligations of hedge funds in Pt 7.9 of the Corporations Act.

- 56 We would continue our normal surveillance of hedge funds' disclosure and take action on a case-by-case basis where hedge funds breach their obligations under the Corporations Act. Option 1 would see no change in ASIC policy in this area, and no provision of additional guidance to hedge fund managers about what exactly must be disclosed under the Corporations Act.

#### Option 2

- 57 Under this option, we would publish a regulatory guide to clarify our expectations about what is required to be included in a PDS to comply with the Corporations Act.

- 58 The means of achieving this would be through the benchmark and disclosure principle models of disclosure, which would include setting out the information that we believe is legally required to be disclosed and that might reasonably be expected to have a material influence in a reasonable retail investor's decision whether to acquire the product. Responsible entities of hedge funds would be required to address these benchmarks on an 'if not, why not' basis, as well as disclose against standard categories of information.

#### The benchmarks and principles model of disclosure

- 59 This model of disclosure provides concrete standards by which retail investors can assess financial products for which there are typically few such external benchmarks.

- 60 The benchmark model of disclosure:
- (a) identifies, for a particular financial product, the key risk areas potential investors should be made aware of before making a decision to invest;
  - (b) outlines benchmarks on how a responsible entity can address these risks in establishing its business model and compliance procedures; and
  - (c) sets out our expectation that a responsible entity will state in the PDS and other disclosures whether its hedge fund meets the benchmarks and if not, why not.
- 61 Disclosing on an ‘if not, why not’ basis means, for each benchmark, stating that a responsible entity either:
- (a) meets the benchmark; or
  - (b) does not meet the benchmark, and explaining why not.
- 62 For a responsible entity to explain ‘why not’, they will be required to explain how the responsible entity deals with the issues underlying the benchmark in an alternative way.
- 63 If a responsible entity cannot meet all aspects of a benchmark, it should state that it does not meet the benchmark and clearly explain which aspects it meets and, for those it does not meet, explain why not and how it deals with the associated risks in another way.
- 64 The disclosure principle model of disclosure:
- (a) identifies, for a particular financial product, the key risk areas potential investors should be made aware of before making a decision to invest;
  - (b) encourages a responsible entity to disclose those key risks and the details underlying the key risks, where appropriate; and
  - (c) sets out our expectations that a responsible entity will state in the PDS and other disclosures that its investment scheme applies the disclosure principles.
- 65 The disclosure principle model of disclosure provides concrete standards by which retail investors are provided with key information to assess financial products for which there are typically few readily comparable products.

### **Proposed disclosure benchmarks and principles**

- 66 We propose to clarify that the benchmarks and disclosure principles listed in our proposed regulatory guide reflect the key areas of risk for retail investors in hedge funds. Our view is that the information identified in the benchmarks and disclosure principles is information that is legally required to be disclosed. No responsible entity is under the obligation to adopt the benchmark in operating its business—however, we consider the responsible

entity is under the obligation to disclose whether or not the benchmark is met.

**Table 2: Proposed benchmarks**

Benchmark	Description
<b>1 Valuation of assets</b>	This benchmark addresses whether valuations of the hedge fund's non-exchange traded assets are provided by an independent administrator or an independent valuation service provider.
<b>2 Periodic reporting</b>	This benchmark addresses whether the responsible entity of the hedge fund will provide periodic disclosure of certain key information on an annual and monthly basis.

**Table 3: Proposed disclosure principles**

Disclosure principle	Explanation
<b>1 Investment strategy</b>	This disclosure principle is intended to ensure that investors are made aware of the details of the investment strategy for the fund, including the type of strategy, how it works in practice and how risks are managed.
<b>2 Investment manager</b>	This disclosure principle is intended to ensure that investors have the necessary information about the people responsible for managing the fund's investments, such as their qualifications and relevant commercial experience, and the proportion of their time devoted to the hedge fund.
<b>3 Fund structure</b>	This disclosure principle is intended to ensure that the responsible entity of the hedge fund explains the investment structures involved, the relationships between entities in the structures, fees and any other costs payable to the responsible entity and investment manager, the jurisdiction involved (if these involve parties offshore), the due diligence performed on underlying funds, and the related party relationships within the structure.
<b>4 Valuation, location and custody of assets</b>	This disclosure principle is intended to ensure that the responsible entity of the hedge fund discloses the types of assets held, where they are located, how they are valued and the custodial arrangements.
<b>5 Liquidity</b>	This disclosure principle is intended to ensure that investors are made aware of the fund's ability to realise its assets in a timely manner and the risks of illiquid classes of assets.
<b>6 Leverage</b>	This disclosure principal is intended to ensure that investors are made aware of the maximum anticipated level of leverage of the fund (including leverage embedded in the assets of the fund)
<b>7 Derivatives</b>	This disclosure principle is intended to ensure that investors are made aware of the purpose and types of derivatives used by the responsible entity or investment manager, and the associated risks.
<b>8 Short selling</b>	This disclosure principle is intended to ensure that that investors are made aware of how short selling may be used as part of the investment strategy, and of the associated risks and costs of short selling.



Disclosure principle	Explanation
<b>9 Withdrawals</b>	This disclosure principle is intended to ensure that investors are made aware of the circumstances in which the responsible entity of the hedge fund allows withdrawals and how this might change.

### Existing stop order power

- 67 As we consider that the information covered by the proposed benchmarks and principles is already required by the Corporations Act to be included in a PDS, ASIC's existing powers to issue a stop order where we consider that a PDS is defective will continue to apply. A stop order has the effect of requiring the product issuer to withdraw the defective PDS from the public.

### Option design

- 68 In developing Option 2, we consulted industry and consumer stakeholders. The major issues we considered in developing the final proposal were:
- (a) the definition of hedge fund; and
  - (b) application of the benchmarks and principles to funds of hedge funds.

### Definition of hedge fund

- 69 A key issue in designing Option 2 was defining the term 'hedge fund'. In our Consultation Paper 174 *Hedge funds: Improving disclosure—Further consultation* (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, CP 174.
- 70 Subsequent to CP 174, [CO 12/749] 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.

- 71 Our proposed definition of hedge fund 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 a more objective definition as this gives greater certainty about which disclosure regime applies to a fund.
- 72 Submissions on CP 174 proposed alternative approaches to defining the term ‘hedge fund’.
- 73 Some sectors of industry were concerned that the more objective definition of hedge fund is too broad and would result in ‘false positives’—that is, it classes as a hedge fund some funds that the investment community at large does not consider to be hedge funds. 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.
- 74 We acknowledge that the definition originally proposed in CP 174 would allow more flexibility for industry when classifying 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.
- 75 Some sectors of industry 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.
- 76 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 believe that adopting a more general approach to complex products would apply too widely across the industry, and the disclosure expectations for this wider group of funds may be different from those for hedge funds. We also note that our proposed regulation of hedge funds is consistent with international standards: see paragraphs 31–32.

- 77 Some sectors of industry proposed that the responsible entity of the scheme, acting reasonably and taking into account the relevant criteria, 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.
- 78 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.

*Application of the benchmarks and principles to funds of hedge funds*

- 79 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 defined as a scheme which has invested 25% or more of its assets in an underlying hedge fund or similar product. Following consultation with industry, we propose adopting a 35% threshold. This will align with the definition of 'fund of hedge funds' under [CO 12/749].
- 80 Some industry submissions in response to CP 174 expressed concern that the proposed benchmarks and disclosure principles may be difficult to apply to funds of hedge funds. We have addressed this concern by clarifying, 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.

## Impact analysis

### **Option 1: Current disclosure requirements continue to apply (status quo)**

#### **Impact on industry**

- 81 There would be no impact on industry as there is no change to the status quo. However, a lack of clear guidance for hedge fund managers about how we expect them to comply with the disclosure provisions in the Corporations Act may ultimately cause industry and consumers to lose confidence in the hedge fund market. Additionally, where disclosure fails to clearly separate

hedge funds from less risky managed funds, this may lead to loss of investor confidence across the sector.

### **Impact on consumers**

- 82 We believe that there will be a long-term cost on consumers because this option would not adequately address the problem identified in Section A.
- 83 Hedge funds are becoming increasingly complex as hedge fund managers seek new investment opportunities. There is a risk that the information asymmetry between consumers and hedge funds will widen so that investors may not be aware of the level of risk they are assuming. This may ultimately mean that the problem of investors having little information about the risks associated with the funds or products they invest in will not only continue, but may also increase. It may also mean that hedge fund managers will have little incentive to improve the current practices (discussed at paragraph 30) that have led to decreases in investor confidence, such as expensive fee structures, conflicts of interest, lack of due diligence, lack of insurance and undisclosed payments to financial advisers.

### **Impact on government**

- 84 We would continue our normal surveillance of hedge funds' disclosure and take action on a case-by-case basis where hedge funds breach their obligations under the Corporations Act. While we believe that hedge funds generally include the information required by the Corporations Act, the principles-based nature of the disclosure requirements mean that many hedge fund PDSs are long and complicated documents that are not easily understood by investors. Because we consider that the problem is concerned with the principles-based nature of the PDS content requirements, together with a lack of guidance for industry on how to present information about a hedge fund in a clear, concise and effective manner, and not necessarily the lack of compliance by responsible entities, we do not consider that targeting individual responsible entities is an efficient solution to the problem.
- 85 We are concerned that failing to implement guidance in relation to hedge fund disclosure will maintain and exacerbate existing problems in hedge fund disclosure.
- 86 Loss of investor confidence may lead to more complaints being made to ASIC by consumers, although the exact number of additional complaints cannot be estimated as we do not currently disaggregate complaints statistics between hedge funds and other types of managed investment schemes.

## Option 2: 'If not, why not' benchmarks and disclosure principles

### Impact on industry

- 87 Our improved disclosure regime would effectively address the objective of improving the quality of disclosure available to retail investors about hedge funds.
- 88 As has been described at paragraph 9, there are at least 677 hedge funds and funds of hedge funds available for investment in Australia. At least 143 of these offer units to retail investors (note that a further 212 funds do not report on whether they offer to retail or wholesale; it is likely that most of these will offer to retail investors, although the proportion of their investors who are retail is unknown).<sup>8</sup>
- 89 Responsible entities are already subject to the disclosure regime in the Corporations Act. Our proposal is not a 'new' requirement; rather, it is a clarification of what we expect a hedge fund to include in order to comply with the existing law.
- 90 Furthermore, our 'if not, why not' regime means that responsible entities are not necessarily required to conform with each benchmark, so long as they explain why not. We do recognise the potential for an increase in costs if responsible entities see the need to change their business model to accommodate the improved disclosure regime.
- 91 As part of our consultation process, we sought feedback on the quantifiable impact of our disclosure regime. Generally, respondents did not provide detailed information on the exact compliance and administrative costs that they anticipated.
- 92 In Regulatory Guide 232 *Agribusiness managed investment schemes: Improving disclosure for retail investors* (RG 232), industry bodies estimated the initial and ongoing compliance costs to address the benchmarks and disclosure principles to be:
- (a) \$170,000 for initial compliance costs; and
  - (b) \$90,000 for annual ongoing compliance costs.
- 93 We consider that the substantially similar nature of the benchmarks and disclosure principles, and the similar nature of the entities, means that this estimate is a reasonably reliable cost estimate of this option.
- 94 Based on our estimate at paragraph 88 of between 143 and 355 hedge funds offering units to retail investors, the aggregate compliance costs across the

<sup>8</sup> These figures are based on voluntary reports by hedge funds to research houses. There is no legal requirement for hedge funds to report.

industry will be \$24.3 million–\$60.4 million for initial compliance costs and \$12.9 million–\$32.0 million for annual ongoing compliance costs.

- 95 We appreciate that precise costs arising from our principles will vary from entity to entity. It will depend on the size of the entity, the complexity of their products and the extent to which the proposed disclosure information is already known to the entity.
- 96 Funds of hedge funds are likely to incur more of a cost compliance burden than hedge funds themselves. While hedge funds will already have access to much of the data required, funds of hedge funds may need to adopt processes to ensure that they are able to acquire that information from the hedge funds in which they invest.
- 97 Increased disclosure will invite increased scrutiny from consumers, other responsible entities and ASIC. Specific guidance will mean that individual instances of non-compliance can be identified more quickly, and encourage hedge fund managers to address deficiencies in the operation of their fund. This will in turn lead to higher investor confidence, and is likely to benefit the hedge fund industry as a whole. Demand for hedge funds is likely to improve as investors approach previously complex and confusing funds with fresh confidence.
- 98 We envisage that any increased compliance costs will be absorbed by hedge funds and will not be passed on to consumers. Fees charged by hedge funds to investors tend to be higher than for other types of managed investment schemes. The ability of hedge funds to increase fees is likely to be constrained by other partial substitutes (i.e. other types of managed investment schemes).
- 99 We note that industry has objected to the proposal on the basis that some of the proposed disclosure requirements (such as details of investment strategy) are proprietary. We believe that transparency about the activities of the fund is essential to investors making an informed decision about whether to invest. As noted at paragraph 29, a lack of transparency about what comprised the underlying investments was one cause behind the substantial losses incurred by investors in the collapse of Trio. We acknowledge that, to the extent that our proposal will require hedge fund managers to disclose at a higher level of transparency than they are comfortable with, this may cause some hedge funds to exit the retail market and only offer to wholesale investors.

#### **Impact on consumers**

- 100 As noted at paragraph 13, we understand that in excess of 48,000 investors invest in hedge funds in Australia. Better disclosure by hedge funds is therefore likely to have a significant benefit for Australian retail investors.

- 101 Retail investors will benefit from improved transparency in hedge funds disclosure documents. More transparent disclosure about these complex products will facilitate effective and informed decision making, helping consumers to choose appropriate products that most suit their needs.
- 102 As noted at paragraph 25, the collapse of Trio Capital involved the loss of approximately \$176 million. This proposal will not directly prevent hedge funds from experiencing financial distress or failure, nor will it prevent fraud from occurring. However, it will address the twin objectives of the proposal set out at paragraphs 48–50 by:
- (a) providing investors with additional information to help them understand the key risks associated with investing in that particular fund and allow them to compare funds and products. This will allow them to make a more informed decision when deciding whether or not to invest, and also compare among different hedge funds; and
  - (b) requiring greater transparency to push hedge funds to institute better governance practices and allow fraud to be discovered at an earlier stage.
- 103 Our disclosure principles are not designed to discourage investors from taking investment risks. Rather, our policy will help consumers understand the inherent risks in these kinds of investments. This policy will have a positive impact on consumers as they will be able to make a more informed decision about whether the potential return on their investment warrants the level of risk involved.
- 104 As discussed at paragraph 98, we expect that hedge funds will not pass on increased compliance costs to consumers. However, it is likely that, by bringing greater transparency about a fund's investment strategy, some funds may engage in less risky investment activities, with consequently lower potential returns for investors.

#### **Impact on government**

- 105 We do not anticipate that our improved hedge fund disclosure regime will result in a significant impact on ASIC or government more generally.
- 106 ASIC responsibilities flowing from our policy may lead to the incurring of nominal costs. Those responsibilities could include:
- (a) reviewing more substantial disclosure documents; and
  - (b) determining whether a particular responsible entity is to be classified as a 'hedge fund'.
- 107 We will prepare and deliver educational material for consumers and responsible entities, but this is part of our business as usual and is not an additional cost resulting from the proposal.

- 108 We also consider that ASIC would benefit from the proposals through fewer complaints resulting from investors better understanding these products, meaning that our resources can be focused on other areas. The exact size of the reduction in complaints about hedge funds cannot be estimated as we do not currently disaggregate complaints statistics between hedge funds and other types of managed investment scheme.
- 109 We also expect that improvements in the level and consistency of disclosure should result in us being able to focus fewer resources on this sector in the medium to long term.



## C Consultation

### Initial consultation: CP 147

- 110 In February 2011, we issued Consultation Paper 147 *Hedge funds: Improving disclosure for retail investors* (CP 147) setting out our proposals for improving disclosure by hedge funds. We invited submissions on our proposed disclosure principles and benchmarks. Additionally, CP 147 provided a background to our proposals, as well as the existing legal framework relating to disclosure to investors.
- 111 In response to CP 147, we received seven submissions from a variety of sources including individuals, relevant industry bodies and investment companies.
- 112 The submissions were generally supportive of our proposals, but raised some issues, as discussed in paragraphs 113–114.
- 113 The primary comments and concerns received from respondents on the proposed disclosure principles and benchmarks as outlined in CP 147 related to:
- (a) whether the definition of a ‘hedge fund’ was too broad. Many respondents were concerned that funds displaying only one of the proposed ‘characteristics of hedge funds’ may be erroneously classified as ‘hedge funds’; and
  - (b) the proposed characteristics of hedge funds themselves (complex investment strategy, use of leverage to increase investment returns, use of derivatives, practices short selling and exposure to diverse risk and complex underlying products). Some submissions saw gearing and capital protection as characteristics more relevant to the question of whether a fund should properly be characterised as a ‘hedge fund’.
- 114 Other issues raised by some of the submissions included:
- (a) the extent to which ‘funds of hedge funds’ and underlying funds should fall under the disclosure regime;
  - (b) who would be given the task of deciding whether a fund should be rightly defined as a ‘hedge fund’. Some submissions suggested that ASIC was the most appropriate body, whereas others saw this task as a self-assessment process that ought to be undertaken by the responsible entity itself, with ASIC playing a consultative role;
  - (c) the application of ASIC’s disclosure regime. Some submissions noted that, due to the inherent complexity of a number of financial products, our proposals should apply consistently across all investment products that meet the definition, not just to managed investment schemes;

- (d) hedge funds' interaction with the shorter PDS regime. Submissions were generally in agreement that all complex funds, including hedge funds, should be excluded from the shorter PDS regime; and
- (e) whether disclosure principles and benchmarks should apply to funds of hedge funds the same way that they apply to hedge funds.

## Further consultation: CP 174

- 115 Following the comments received in relation to CP 147, we released CP 174 in February 2012 accompanied by a draft regulatory guide.
- 116 We also made a number of minor changes to the benchmarks and disclosure principles proposed in CP 147.
- 117 We received eight submissions on CP 174; some from respondents who were different from those who provided comments on CP 147.
- 118 The primary concerns raised by respondents related to:
- (a) our proposed definition of a hedge fund. Respondents repeated their concerns that the proposed definition was too broad, and also proposed the inclusion of further features to the definition of 'hedge fund'. One respondent suggested dropping the term 'hedge fund' and regulating by risk. Another was concerned that benchmarks and principles should apply to all complex products, not just 'hedge funds'. Many respondents also commented that to achieve regulatory certainty, the onus should lie with the responsible entity acting reasonably. We propose to address this by adopting an objective definition of hedge fund closely following the approach taken in [CO 12/749];
  - (b) the application of our proposed principles and benchmarks to funds of hedge funds. Respondents provided various comments on the suitability of a 25% threshold, also canvassing the extent to which disclosure should be necessary for underlying funds. We propose to increase the threshold to 35%;
  - (c) independent custodial arrangements. Some respondents expressed concern about 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. We propose to remove this requirement; and
  - (d) fee disclosure. Some respondents commented that it was unnecessary to require 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. We propose to amend this benchmark to now require disclosure of the fund's net investment return on an after fees, costs and taxes basis.

## D Conclusion and recommended option

- 119 We consider Option 2 will better address the twin objectives of the proposed regulation by:
- (a) providing investors with additional information to help them understand the key risks associated with investing in that particular fund and allow them to compare funds and products; and
  - (b) requiring greater transparency to push hedge funds to institute better governance practices and allow fraud to be discovered at an earlier stage.
- 120 This policy can be seen as a clarification of the existing legal requirement to include all information that might reasonably be expected to have a material influence on the decision of a reasonable person (when investing as a retail client) about whether or not to invest in a product. While we believe that hedge funds generally comply with their existing disclosure obligations under the Corporations Act, the principles-based nature of the disclosure requirements mean that many hedge fund PDSs are long and complicated documents. We consider that implementing Option 2 may result in a better culture of disclosure among hedge funds by providing better guidance for industry on how to present information about a hedge fund in a clear, concise and effective manner. This may lead to an overall improvement in the quality of disclosure.
- 121 Our proposed disclosure principles and benchmarks are likely to benefit consumers. Improved disclosure will result in a more transparent product. This will mean that retail investors will have access to better information and may be more confident when considering whether or not to invest, although we note that these benefits are incremental, unquantified and uncertain. We acknowledge that, even if an investor has full information, some investors might lack the necessary financial literacy to be able to take advantage of that information to choose a product that is suitable for them. However, it will allow some investors to become more aware of the level of risk they are assuming.
- 122 By improving transparency about the fund, Option 2 may encourage hedge fund managers to promptly address any deficiencies in the fund in areas such as fee structures, conflicts of interest, due diligence, insurance, and disclosure of payments to financial advisers.
- 123 We anticipate that industry will face aggregate compliance costs of around \$24.3 million–\$60.4 million for initial compliance costs, and \$12.9 million–\$32.0 million for annual ongoing compliance costs. We note that precise costs will vary from entity to entity, depending on the size of the entity, the

complexity of their products and the extent to which the proposed disclosure information is already known to the entity.

124      Given the uncertain nature of the costs and benefits of this proposal, it is not possible to definitively state the net benefit.

## E Implementation and review

- 125 We would implement our proposals by issuing a regulatory guide. Following the release of our regulatory guide, we expect that responsible entities will implement improved disclosure with regards to their products.
- 126 We expect responsible entities to begin complying with our regulatory guide by 22 June 2013 (this transition period coincides with the expiry of the interim relief under [CO 12/749]). This includes existing products, which will need to update their disclosure documents to include disclosure against the benchmarks and provide information as stipulated in our disclosure principles.
- 127 We may conduct a review of a selection of disclosure documents against the ‘if not, why not’ benchmarks as these documents become publicly available, in addition to our ongoing monitoring duties in the industry. Our reviews will ensure that the benchmark and disclosure principle information has been duly disclosed to investors, and indicate whether or not the improved disclosure was well received by investors.
- 128 Over the transition period, we will:
- (a) work with responsible entities to ensure that the benchmarks and disclosure principles are understood;
  - (b) discuss concerns we have about a responsible entity’s disclosure with them and, where necessary, request additional disclosure;
  - (c) discuss whether particular entities are correctly to be classified as ‘hedge funds’ for those entities that are unsure;
  - (d) conduct surveillance activities, as needed, to ensure compliance and to reinforce the benchmarks and disclosure principles; and
  - (e) consult with industry and consumers to assess the effectiveness of our benchmarks and disclosure principles.
- 129 ASIC will also use its stop order powers if we consider that a responsible entity’s disclosure documents do not comply with the newly implemented regime. We will continue to monitor the relevant documents on a risk-based approach.