

AIMA Australia's Guidelines to Risk Disclosure for Australian Hedge Funds

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Alternative Investment
Management Association

Australia Chapter

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Disclosure Guidelines for Australian Hedge Funds AUGUST 2007

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DISCLAIMER

Whilst AIMA Australia has used all reasonable efforts to produce these disclosure Guidelines, the Guidelines do not purport to be complete or necessarily consistent with applicable law or regulatory policy in every particular.

Accordingly, none of AIMA, AIMA Australian Chapter, or any of the members of any committee of AIMA Australian Chapter, or any officers employees or agents of AIMA or AIMA Australia Chapter (collectively "AIMA and its associates") makes any representation or warranty, express or implied, as to the adequacy, completeness or correctness of the Guidelines. AIMA and its associates accept no responsibility jointly or individually for any loss howsoever arising from any use of the Guidelines or otherwise arising in connection with this document.

AIMA strongly recommends you obtain your own legal advice in relation to any disclosure document.

These Guidelines have been produced by the AIMA Australian Chapter. Although AIMA Australian Chapter has informed the Australian Securities and Investments Commission (ASIC) of the existence and contents of the Guidelines and will continue to liaise with ASIC on regulatory issues involving the Australian hedge funds industry, ASIC has had no role in the drafting of the Guidelines and ASIC gives no approval of and bears no responsibility for these Guidelines.

Introduction

Hedge Funds in Australia are required to conform to the same regulatory obligations as other managed funds, however, the nature of hedge fund structures and trading strategies suggests additional disclosure is required compared with more traditional managed funds. AIMA Australia believes that the hedge fund industry will benefit from adopting good disclosure and promotion practices in the marketing of hedge fund products. To this end it has prepared guidelines on disclosure, which are set out in this document.

AIMA Australia believes it will be worthwhile to allow general industry discussion and feedback on these guidelines, based on applied practice. AIMA Australia plans to raise their profile once this period of review has occurred and make the document widely available.

These Guidelines do not address the statutory content requirements of a Product Disclosure Statement (PDS) or other documents required to be given to a retail client, under Chapter 7 of the Corporations Act. However, issuers should have regard to these Guidelines to the extent that a PDS is required to include all information a prospective investor would reasonably require in order to make a decision on whether or not to invest in the fund.

While these Guidelines are voluntary, AIMA Australia strongly encourages members to take them into account in their disclosure material.



AIMA Australia Regulatory Committee

AIMA wishes to acknowledge the substantial contribution, in terms of time and consideration, made to the production of the Guidelines by the members of the AIMA Australia Regulatory Committee for 2006-7.

The members of the Regulatory Committee are:

- John Currie, Henry Davis York, Chairman
- Philip Barlin, Colonial First State Investments Limited
- Steven Beare, GMO Australia Limited
- Nathan Cahill, Minter Ellison
- Peter Dobson, Basis Capital Pty Limited
- Kim Ivey, Vertex Capital Management Limited
- Martin Jamieson, Phillips Fox
- John Moutsopoulos, Clayton Utz
- Rick Steele, TechInvest Pty Limited

Legal and Regulatory Imperatives

Obligation to make disclosure

The broad objective of providing a disclosure document is to provide investors with sufficient information to make an informed decision in relation to the acquisition of an interest in the fund.

The type of disclosure, and the degree to which the disclosure document is regulated by the Corporations Act 2001, will depend largely upon the classification of target investors. There are a number of tests used to determine whether a client is wholesale or retail. For example, generally a client is wholesale if they have certified net assets of at least A\$2.5 million or certified gross income for the last 2 years of at least A\$250,000, the price of the relevant product is at least A\$500,000, or the client is a "professional investor" as defined in the Corporations Act.



Product Disclosure Statement

When an offer is made concerning the issue of a financial product, or a financial product is issued to a retail client, the Corporations Act requires the issuer of the financial product to provide a PDS relating to that product.

A PDS is an offer document that sets out information on a product relevant to an investor's decision to acquire the product, including the features of the product, fees that apply, the benefits and risks of investing in the product, commissions that may affect returns, and information about complaints handling and cooling-off rights, amongst other things.

IMPORTANT NOTE: These Guidelines do not address the statutory content requirements with respect to a PDS. For example, there are detailed prescriptive content requirements relating to the disclosure of fees in a PDS. If you are preparing a PDS, AIMA strongly recommends that you obtain your own legal advice to ensure your PDS complies with these requirements.

Information Memorandum

Many hedge fund managers will structure the offer of securities so that a PDS or other formal disclosure document under the Corporations Act is not required. In these cases, issuers of interests in hedge funds usually provide a document, known as an Information Memorandum. Whilst technically an Information Memorandum is not required under the Corporations Act to satisfy the statutory content requirements for a formal disclosure document (because the offer of units in the fund is a non-retail offer), it is still prudent to approach the preparation of an Information Memorandum with a high degree of diligence to ensure it contains nothing inaccurate, misleading or deceptive and (equally importantly) that it does not omit anything rendering the document inaccurate, misleading or deceptive.

In particular, it is important to ensure all significant issues and risks are disclosed in the Information Memorandum. It is also essential that the substance of the Information Memorandum is complete, accurate and up to date throughout the period of the offer.

This is because:

- the issuer of the Information Memorandum and persons involved in the issue may be liable for criminal and civil penalties if the information contained in the Information Memorandum is misleading or deceptive. This could occur, for example, if the Information Memorandum did not contain all material information, but rather only some of the material information. That is to say, an omission can render a document misleading or deceptive; and
- full disclosure of risks may help in protecting an issuer from any claim by investors that they had not been aware of, or had not assumed, a particular risk.

Accordingly, it is important that an Information Memorandum contains all the information that a reasonable investor would usually require to make an investment in the fund.



Disclosure

The purpose of these Guidelines is to outline the type of information that would assist a prospective investor to make a decision as to whether to invest in a hedge fund or not. Therefore the Guidelines set out the information which would generally be contained in an Information Memorandum for a hedge fund. The Guidelines do not set out the statutory content requirements with respect to a PDS.

In the discussion that follows, an Information Memorandum or PDS will be described as a disclosure document. Such disclosure documents for hedge funds should generally disclose the following information.

1. **Disclaimers**

Appropriate disclaimers should be inserted, usually in the inside front cover of the disclosure document. These disclaimers usually include statements:

- that the disclosure document does not constitute a recommendation by the issuer or any person named in the document to invest in the relevant fund;
- if the disclosure document is an Information Memorandum, that it is not a PDS and therefore may not contain the same level of disclosure as required for a PDS;
- as to the types of clients the offer is open to (e.g. Australian wholesale clients);
- that the information in the disclosure document is current as at date of the document (unless otherwise stated);
- that an investment in the fund is subject to investment risks including possible delay in repayment and loss of income and principal amount invested; and
- that the issuer does not guarantee the performance of the fund or the repayment of capital or income invested.

2. **Key features of the fund**

Often the disclosure document will contain an overview of the fund at the front of the document. This overview will set out key information about the fund such as the fund's investment objective, name of the fund manager, minimum investment amounts, and frequency of unit pricing, fees, and key risks. This overview may include cross-references to the sections which include the detailed information.

3. **Details about the fund manager and other intermediaries**

This should include details of the key personnel of the fund manager and an overview of their respective roles and experience. You may wish to include information about current funds under management.

If the fund manager is not the trustee of the fund, details should be given as to the agreement pursuant to which the fund manager has been appointed and also details as to the scope of the services to be performed by the fund manager.

It may also be advisable to include some details as to other key intermediaries such as prime broker, custodian and administrator, where applicable.

4. **Investment approach, strategy and style of the fund**

The investment objectives of the fund and the investment strategy of the fund should be detailed in the disclosure document.

The scope of intended activity of the hedge fund should be expressed using the strategy descriptions found in the main hedge fund industry databases. This will allow investors to gauge the expected patterns of returns and risks, and where the fund manager has a performance track record, to assess that record using a relevant benchmark. If the conduct of the expected activity is to be materially different to the expectation a reasonable person might assume from the strategy name, the distinction should be highlighted.

For example, the CSFB/Tremont strategy categories shown below may form a reasonable starting point for the labelling of the fund's activities. The use of descriptors common to a generally available industry database facilitates investor consideration.

- Convertible Arbitrage;
- Dedicated Short Bias;
- Emerging Markets;
- Equity Market Neutral;
- Event Driven;
- Distressed Investing;
- Risk Arbitrage;
- Fixed Income Arbitrage;
- Global Macro;
- Long/Short Equity;
- Managed Futures;
- Multi-Strategy.

An issuer of a PDS cannot assume that a retail investor has any knowledge of or familiarity with the different investment strategies and accordingly a more detailed explanation of the strategies may be helpful.

Further issues that may be discussed in a disclosure document for a hedge fund include:

Leverage

The intention to leverage the investors' capital, whether through financial gearing, or amplified market exposure through derivatives, should be disclosed. The disclosure should indicate the conditions under which the leverage is expected, typical leverage to be applied and the maximum degree of leverage proposed. Where financial leverage is proposed, the generic source of that leverage (eg banks, prime brokers or derivatives) and whether the manager has committed credit facilities available, should also be disclosed.

Where appropriate, the discussion of leverage should distinguish between gross and net leverage. Gross leverage shows long and short positions as being additive from a market risk perspective, while net leverage shows long and short positions as being offsetting.

The risks associated with leverage and how they will be managed should be clearly described.

Short-Selling

Short-selling securities exposes a fund to limited gains, but if left unhedged, potentially unlimited downside. Where the manager is involved in short-selling on behalf of the fund, it should be clearly indicated how short-selling will be effected, the risks associated with short-selling and how these risks will be managed.

Liquidity

Hedge fund liquidity can differ in several respects from the experience of investors in traditional managed funds. For example, investment securities purchased may form part of larger transactions. These securities may require more time to be converted to liquid assets than individual securities. Some funds may hold non-listed securities. This means that:

- the redemption terms should be clearly and prominently disclosed;
- the liquidity of the investment assets and the terms of redemption of the fund should be clearly distinguished; and
- particular disclosure should be made if the expected liquidation time of the investment portfolio exceeds the normal redemption period available to investors.

It is also preferable to explain the reasons behind the terms of redemption. Hedge fund redemption terms are designed to ensure fairness between redeeming and continuing unitholders. Investors are more likely to understand the generally longer terms of hedge fund redemption if they understand the reasons for the difference.



Market exposure

The level and limits of expected market exposure should be disclosed including the conditions that will drive the level of the exposure undertaken. Market exposure should be described in terms of exposure to the relevant asset class, geography, financial markets, and if pertinent, the industry sector.

The base currency of the fund should be disclosed and also any consequent currency exposures or hedging activity.

Past performance

The disclosure of a fund's past performance requires particular attention and is one of the areas receiving close attention from ASIC. ASIC is concerned to ensure that the past performance information is not misleading or deceptive. Before including past performance information in a disclosure document, you should consider the ASIC Guide on the Use of Past Performance in Promotional Material.

It is important that a warning be included to the effect that past performance is not a guarantee of future performance.

Past performance information should:

- not be for an inappropriately short term period (generally considered to be less than 12 months);
- be up to date (being the most recent data available at the last practical opportunity to update the information before it is published) ;
- be for standardised periods (ASIC prefers a per annum return over the previous five years or the single figure for the per annum return for the whole period the investment has been available); and
- be available on-line to reflect performance achieved after the publication date of the disclosure document.

Great care should be taken using past performance information that is not the actual past performance information for the fund, for example information relating to a predecessor fund.

Non-actual past performance of a predecessor fund may be acceptable where:

- it was possible to invest in the predecessor fund;
- the performance of the predecessor fund was subject to audit or is capable of verification;
- the predecessor fund and current fund have the identical strategy and a continuity of management personnel; or
- it is clearly disclosed that you are using non-actual performance information.

The prior performance series should be adjusted for the effects of any difference in fees, taxation or currency base, or where such adjustment is not practical (or the adjustment itself is misleading), clear disclosure of the differences should be made.

Generally, the use of simulated or back-tested performance or performance based on managers (in fund of funds) should be avoided.

5. Risks of investing

Generally the risks statement should include a general statement that the hedge fund is subject to investment risk including possible delays in repayment and loss of income and principal amount invested and the fund manager does not guarantee the performance of the fund or the repayment of capital or income invested in the fund.

Information about any significant risks associated with investing in the hedge fund should be provided. This does not mean that a fund manager needs to disclose every possible risk of investing, but should outline the key risks of investing in the particular hedge fund.

ASIC considers that disclosure of the risks should be given as much prominence as the disclosure of the benefits of a fund.

The policies applicable to defining and controlling risk should also be disclosed in terms that will allow the investor to gauge the expected diversification of risk that will exist among the investments of the hedge fund.

A fund manager will need to disclose the specific risks associated with a particular investment strategy. Some of the more common risks associated with particular strategies are detailed below:

- **Arbitrage:** Interest rate risk; sector, country and currency exposure.
- **Event-driven:** The prospect that event will fail or not occur in the expected time frame. The existence of opportunities will depend on the level of deal activity in the market place.
- **Equity based:** Long or short biases will expose the investor to equity market movements.
- **Global macro:** High volatility will depend on the level of gearing and the degree of concentration of positions within the fund.
- **Emerging markets:** Difficulty in obtaining information about a company, poor accounting, unsophisticated local investors, political and economic turmoil, inefficient markets and illiquid securities.
- **Managed futures:** Market risk, counterparty risk.

Other risks that may need to be disclosed include:

- the risk that returns may be adversely affected by market conditions including market volatility, interest rates, economic variables, political events, war, natural events and changes in law which may occur globally or at a country, industry or asset class specific level;
- the risk that changes in tax laws or their interpretation could adversely affect the tax treatment of the fund, its investments and its investors;
- liquidity risks, including the risk of illiquidity of securities or underlying investments;
- correlation risks i.e. unexpected and adverse correlations between markets/sectors;
- market event risks;
- risks in relying on the manager, investment advisor and underlying managers;
- transparency risk;
- potential conflicts of interest;
- key person risk;
- risks associated with the use of derivatives;
- the risk of fraud; and
- risks associated with the use of leverage.

6. Fees and other costs

A description of fees and other costs, including where appropriate indirect costs ratios should be included. This should include how and when fees and other costs are incurred and paid.

Fees requiring disclosure may include:

- establishment fees;
- contribution fees;
- withdrawal fees;
- termination fees;
- management costs (the fees and costs for managing the investment, including a detailed description and explanation of any performance fees);



- high watermarks and hurdles; and re-sets of these;
- fees of third party service providers such as custodians and administrators; and
- financing and leverage costs.

There are detailed content requirements in Chapter 7 of the Corporations Act, the Corporations Regulation, and ASIC guidelines relating to the disclosure of fees in a PDS.

7. **Information about investing in the fund**

There will be a number of administrative and procedural type issues that investors of the hedge fund will need to be aware of. Accordingly, appropriate disclosure of these issues should be made. Examples of typical issues an investor will need to be aware of include:

- details of the minimum initial investment and additional investment;
- how a potential investor may invest in the fund (i.e. details of any bank account where a potential investor can transfer the application amount);
- how additional investments in the fund may be made;
- how an investor may withdraw their investment including how the redemption price is calculated, lock-up periods that may apply and the treatment of redemptions (including suspension of redemptions) in the case of an extraordinary event; and
- whether units in the fund may be transferred, and if so, the method by which the transfer may occur.

8. **Valuation, unit pricing and distributions**

Valuation

The valuation section should describe in detail the valuation policies for valuing the investments of the hedge fund (and if applicable, the underlying investments), and identify who performs the calculations.

It should state whether or not the net asset value (NAV) is actual or estimated and whether it is verified by an independent third party.

Unit Pricing

The disclosure document should provide detailed disclosure of how unit prices are calculated. Unit prices determine how many units are received pursuant to any application or redeemed under any withdrawal.

The frequency of unit pricing should also be disclosed (e.g. daily, monthly, etc) and the model used by the hedge fund or its administrator to calculate unit prices should be



adequately explained. In particular, the section should clearly state whether a fund's underlying assets are valued in public markets, subject to frequent price discovery or whether the assets are priced according to third party valuation models that are subject to assumption changes.

The method of calculating the performance fee, if applicable, and its unit price accrual methodology should be clearly disclosed, eg series or equalisation method used.

For further information on unit price valuation and methodology, members should refer to AIMA's Guide to Sound Practices of Hedge Fund Valuation (released March 2007). An Executive Summary can be found on the AIMA Australia website - www.aima-australia.org.

Distributions

The hedge fund's distribution policy should also be explained. This explanation should provide details of the composition and frequency of the fund's distributions. In addition, disclosure should be made as to whether or not distributions may be reinvested into additional units.

9. **Reporting**

There should be some indication as to how the fund manager intends to report to investors and the intended frequency of such reporting.

10. **Taxation**

A brief overview of the tax status of the fund and its consequences for investors should be disclosed. This would normally include consideration of capital gains tax (CGT). The section of the disclosure document dealing with taxation may include the following:

- any assumptions relied upon for the purposes of the taxation summary;
- details of the characterisation of the hedge fund for taxation purposes (e.g. the fund may be a "fixed trust" which is "widely held" for the purposes of the Income Tax Assessment Act 1936 (Cth) and the Income Tax Assessment Act 1997);
- details of the tax treatment of the hedge fund's net income;
- details of the tax treatment of distributions of the hedge fund; and
- the impact of Foreign Investment Fund (FIF) legislation, and withholding taxes.

Investors should be encouraged to obtain their own advice on taxation issues.

11. Further information about the hedge fund

Constitution

The disclosure document should provide a brief summary of the material clauses in the fund's constitution. Examples include:

- details of the rights of unitholders;
- the rights and obligations of the trustee/responsible entity or other Governing Body of the hedge fund;
- details of any limitation of liability of unitholders;
- details of any borrowing powers afforded by the constitution; and
- an explanation of the investor's right to privacy and how the manager of the hedge fund will comply with relevant privacy provisions.

In addition to providing a summary of the constitution, details of other relevant third parties may need to be provided. For example, key service providers for the unitholder registry, prime broking, trade clearance, portfolio accounting, custody, audit and any other material contracts should be disclosed. Consideration should be given to describing the contracted responsibilities.

Conflicts management

There is a general obligation in the Corporations Act on holders of Australian Financial Services Licences to have adequate arrangements for the management of conflicts of interest that may arise wholly or partially in relation to the provision of financial services as part of an issuer's financial services business.

The disclosure document should adequately disclose what arrangements the issuer has in place to control and manage conflicts of interest. Having adequate arrangements in place to manage conflicts of interest will include ensuring that there is adequate disclosure of conflicts to investors, who can then consider their impact before making investment decisions.

Adequate disclosure means providing enough detail in a clear, concise and effective form to allow investors to make an informed decision about how the conflict may affect their investment. This is particularly relevant for hedge funds which are generally more complex than traditional managed funds.

An example of a potential conflict of interest relevant to hedge funds is performance fees. The conflict may arise because the hedge fund manager will position investments with a view to achieving the greatest possible return (resulting in greater performance fees for the fund) within a specified performance fee measurement period. The conflict may arise due to the inconsistency between the hedge fund manager's personal interest in seeking to maximise performance fees, and the manager's obligation to investors to seek to minimise the risk of capital loss as well as to maximise the return on their investment.

Alternative Dispute Resolution

Where appropriate, the existence of avenues for the resolution of dispute without recourse to litigation (alternative dispute resolution) should be outlined briefly in the disclosure document.

Application form

Generally, an application form is provided with the disclosure document. The form usually requires the applicant to complete contact details, tax file number information and elect distribution options and methods of payment.

In the case of an Information Memorandum, the application form will generally include declarations from the investor that they are a wholesale client, they have read the Information Memorandum and agree to be bound by the terms of the offer set out in the Information Memorandum and the constitution for the fund, and they have received the offer in Australia. Statements required by the Privacy Act 1988 will also need to be included.

AIMA Australia Recommendations as to Disclosure

There will be some advantage if hedge funds adopt a common order and terminology of presentation. To foster this, AIMA Australia encourages members to present this disclosure information in the order set out in these Guidelines, although we recognise this may not be practical or convenient in every case. Members are also encouraged to use these headings where possible either as headings or as keyword identifiers in their text.

Promotion content

AIMA Australia's general principle is that promotional content should encourage realistic investor expectations as to the sources and character of the expected performance of the fund. Promotional presentations should be such as to ensure that a reasonable person will be able to access and comprehend the salient features of the offering. Promotional material should also be balanced and give equal prominence to the disclosure of key risks as is given to key benefits of the fund.

Feedback

The Regulatory Committee of AIMA Australia welcomes feedback on these Guidelines.

Comments may be sent to: Mr John Currie, Chairman
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Appendix 1

The Alternative Investment Management Association (AIMA)

About AIMA Australia

AIMA Australia, established in 2001, is one of AIMA's largest and most active chapters. Chapter members are derived from all areas of the local alternative investment community with the vast majority being hedge fund managers. In 2007, members of the Australian Chapter manage over 80% of the hedge fund assets invested by Australian investors.

Members of the Chapter support individual working committees that focus on Regulation, Education, and Membership & Marketing support.

The Chapter maintains an active dialogue with Australian regulators and other government agencies on issues related to the hedge fund industry.

The Chapter organises informational forums for industry participants in most capital cities, as well as commissioning studies and reports on the local hedge fund industry.

In addition to regular networking events, the Chapter also confers with conference organisers to ensure worthy topics and knowledgeable speakers are included in conference agendas.

For more information on the AIMA Australia Chapter, please visit our website: www.aima-australia.org.

About AIMA

As the only truly representative global hedge fund association, AIMA, the **Alternative Investment Management Association**, has over 1,200 corporate members worldwide, based in 47 countries.

Members include leading hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting services and fund administrators. They all benefit from AIMA's active influence in policy development, its leadership in industry initiatives, including education and sound practice manuals and its excellent reputation with regulators, worldwide.

AIMA is a dynamic organisation that reflects its membership's interests and provides them with a vibrant global network.



Its objectives are:

- ≈ To provide an interactive and professional forum for our membership and act as a catalyst for the industry's future development;
- ≈ To be the pre-eminent voice of the industry to the wider financial community, institutional investors, the media, regulators, governments and other policy makers;
- ≈ To offer a centralised source of information on the industry's activities and influence, and to secure its place in the investment management community.



AIMA is committed to developing industry skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) - the industry's first and only specialised educational standard for alternative investment specialists.

One of AIMA's objectives is to encourage sound practices within the alternative investment community. These items form a canon of work that has been adopted by investors and practitioners globally, and welcomed by policy makers and regulators.

Each has been structured to offer both practitioners and investors with meaningful and practical guidelines. Other recent Sound Practice Guidelines include:

[Guide to Sound Practices for European Hedge Fund Managers \(May 2007\)](#)

Guide to Sound Practices for Hedge Fund Valuation (March 2007)
[Executive Summary free to download](#)

Offshore Alternative Fund Directors' Guide (2005)

[Guide to Sound Practices for Asian Hedge Fund Managers \(Dec 2004\)](#)

[Guide to Sound Practices for Hedge Fund Administrators \(Sep 2004\)](#)

For further information, please visit AIMA's website www.aima.org



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